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The U.S. Economic Outlook: A Monetary Policymaker's Perspective

I. Good afternoon. Today my topic is the national outlook for the economy and inflation and their implications for monetary policy.

  A. As you know, the Fed nudged up short-term interest rates in February and again in March.

    1. I'm wholeheartedly in favor of these moves, because they'll reduce the risk of a problem with inflation "down the road."

  B. Today, I'd like to explain why.

II. But before I get into these issues, let me say a few words about the economy in California. I'll start with four positives.

  A. First, some indicators that dropped sharply earlier in the recession have stabilized.

    1. For example, state tax revenues have been relatively stable for the last year or two.

  B. Second, residential real estate activity has picked up nicely during the past six months or so.

    1. It looks like the number of housing permits bottomed out last summer, after a decline that was much larger and longer-lasting than most of us had expected.

    2. And the number of existing homes sold has been trending up for several months now.

  C. Third, in the past couple of months we've finally started to see some growth in employment.

  D. Finally, the recent strengthening in the national economy bodes well for improved sales by producers here.

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E. So, for a change, not *all* the California news is negative. But I do think we'll probably continue to "bump along the bottom" for a while before we see sustained growth.

1. For one thing, it's too early to tell whether the employment growth we've seen so far represents the beginning of an upward trend.

2. And the recent increases in long-term interest rates could dampen the housing recovery.

3. Moreover, we still face a number of problems that will constrain our economy for the next few years.

a. Defense cutbacks are nowhere near complete, in terms of either contract defense activity or the closure of military bases.

b. And the state government's "red ink" to date means that the fiscal situation will be tight for a few years, even *after* the state's economy improves.

F. Finally, while many are arguing that the rebuilding effort after January's earthquake will pull Southern California out of the doldrums, I'd expect much of that stimulus to be offset by *losses* from the quake: lost business, reduced spending capacity, and the like.

III. Now let me turn to the national outlook.

A. I'll begin with a brief look backward—on the theory that "what's past is prologue."

B. This expansion so far has been blunted by two major contractionary forces.

1. First is fiscal policy.

a. The federal government apparently has gotten serious about trimming the deficit, and we've seen cutbacks at all levels of government.

b. Now, I should point out that although this is contractionary now, it will be good for growth in the long run.

(1) Cutting the deficit will mean that the government will absorb less private saving,

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(2) and that would make more available for private capital formation, which is a key to long-term growth.

2. The second contractionary force is the slow growth among many of our major trading partners.

   a. Last year the other G-7 countries—Canada, France, Germany, Italy, Japan, and the UK—saw output grow on average by only about 1¾ percent.

C. In the face of these contractionary forces, the Fed lowered short-term interest rates substantially.

1. Though the drop was substantial, we moved cautiously because we were concerned that moving too fast could be inflationary.

2. By the end of last year, short-term rates were about a third of what they were in early 1989.

   a. In fact, real short-term rates—that is, adjusted for inflation—were around zero levels throughout the year.

3. These low short-term rates stimulated rapid growth in the interest-sensitive sectors of the economy—consumer durables, housing, and business investment.

4. The net result of these offsetting forces is that we've had eleven consecutive quarters of growth.

D. Now, it's important to emphasize that for the last two years, the rate of growth has been faster than the economy can sustain in the long run.

1. Current estimates of sustainable growth are about 2½ percent.

2. But

   a. in 1992 growth averaged nearly 4 percent,

   b. in 1993 it averaged just above 3 percent,

   c. and in the fourth quarter, the economy really surged, achieving a growth rate of 7 percent.

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3. As a result, a good deal of the excess capacity that built up in the 1990 recession has evaporated:

    a. Both the unemployment rate and the rate of unused industrial capacity have fallen rather sharply over the past year and a half—

    b. —near to levels that most economists think represent "full" utilization.

4. At the same time, inflation last year edged down only very slightly,

    a. and in the case of core consumer inflation averaged about 3 percent.

IV. For the rest of 1994, fiscal policy, the world economy, and monetary policy will continue to play important roles.

A. Fiscal policy, of course, will remain contractionary, as the deficit-trimming continues.

B. In terms of the world economy, the picture is starting to get a *little* brighter.

1. Exports to developing countries in Asia and Latin America have been booming, and this situation certainly won't be hurt by NAFTA.

2. And we do expect the overall performance of our industrialized trading partners to improve modestly this year.

C. Turning to monetary policy, as you know, the Fed raised short-term interest rates slightly in February and March.

1. This has had some effect on long-term rates, but it's probably not the only reason why long-term rates rose so much in recent months—far more than short-term rates did.

    a. One important factor may be the signs of continuing strength in the economy.

        (1) These may contribute to expectations that cyclical pressures on credit demands and inflation will be strong in the future.

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b. Another factor may be the recent declines in the dollar and increases in *foreign* interest rates.

2. Regardless of the cause of the rise in long-term rates, they're still well below the levels that prevailed in recent years.

3. Furthermore, short-term *real* rates—that is, adjusted for inflation—remain only slightly above zero.

4. Therefore, interest rates should continue to provide stimulus to interest-sensitive sectors.

D. So, putting all these factors together,

1. the most likely outlook is that the economy *won't* keep up the very fast pace we saw at the end of 1993.

2. But it probably *will* continue to grow somewhat above its long-run potential growth rate.

3. I wouldn't be surprised to see the growth rate come in at around 3 percent this year,

a. with some further declines in the unemployment rate and in unused industrial capacity.

V. Now let me turn to the outlook for inflation.

A. The Fed's goal—like that of many other central banks—is to get inflation down—to near zero.

B. And there are good reasons for this goal.

1. For one thing, low inflation often is associated with less uncertainty about *future* inflation, and this promotes growth in the long run in a couple of ways:

a. it fosters lower long-term real interest rates,

b. and it simplifies the planning and contracting by business that's so essential to capital formation.

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2. Low inflation also reduces the distortionary effects of most tax systems, so people don't waste time, energy, and money trying to hedge against inflation.

3. Finally, as we learned in the early 1980s, once inflation creeps up, it can get out of control, and it can cost many jobs to stop it.

C. But the process of reducing inflation has its pitfalls.

1. For one thing, it takes a long time for a policy action to produce inflation results—probably from 1½ to 2 years.

2. This kind of time lag means that if we wait for problems to show up in the data *before* we act, then we're likely to be too late.

3. Instead, we have to *anticipate* problems, and pay attention to the warning signs.

D. The current situation is a good example. We have *not* seen an increase recently in the important inflation statistics, like the consumer price index.

1. Still, I *am* concerned about inflation *in the future*, primarily because of two warning signs. I've already mentioned them, but they're worth emphasizing.

2. First, slack in labor and product markets has all but evaporated.

a. This means that we have little or no leeway to give extra stimulus to the economy without sowing the seeds of inflation in the future.

3. Second, short-term real interest rates were near zero for over a year.

a. The last time short-term real rates stayed at low levels for a long period of time was in the 1970s, just before the run-up in inflation in the late 70s and early 80s.

b. Although the current situation isn't nearly as dire as that one was, we don't want to risk even a small part of that kind of problem again.

E. Because of these warning signs, I think the steps we've taken to nudge up rates are appropriate.

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1. Whether or not additional action is required is difficult to say at this point.

2. That will depend, in part, upon an ongoing assessment of current and prospective developments in the economy.

F. We *have* made progress in achieving our long-term goal of providing the U.S. economy with a low-inflation environment.

1. But we still have a way to go.

2. It's important that we continue to strive for it, since it's the main contribution that monetary policy can make to maximizing standards of living in our economy.

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