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

I. Good morning. 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 on Monday.
  - 1. This is the third increase in the past three months.
- B. Today, I'd like to explain why.

II. I'll begin with a brief look backward.

- A. This expansion so far has been blunted by two major contractionary forces.
  - 1. First, the federal government apparently has gotten serious about trimming the deficit.
    - a. And that has led to a *contractionary* fiscal policy with cutbacks at all levels of government.
    - b. Cutting the deficit will be good for long-run growth,
      - (1) because the government would absorb less private saving,
      - (2) so more would be available for private capital formation, which is a key to long-term growth.
  - 2. Second, many of our major trading partners have--for various reasons--been battling down inflationary pressures, and this has been associated with slow growth or recession in those countries.
    - a. In fact, last year, the other G-7 countries--Canada, France, Germany, Italy, the UK, and Japan--
      - (1) saw output grow, on average, by less than 1 percent.

b. In Japan, after years of strong expansion and phenomenal growth in asset values, in 1989 the central bank put on the brakes to head off inflation.

(1) The result was a collapse in money growth, which led to a big dive in asset values and sent the economy into recession.

c. In Germany, the high costs of reunification begun in 1990 created inflationary pressures,

(1) and the central bank has been insistent about keeping inflation under control.

(2) The result is that in 1993, the German economy fell into a recession, and took much of the rest of Europe with it.

3. This weakness abroad has limited foreign demand for our products, and acted as another contractionary force in the short run--

a. --though, in the long run, it lays the groundwork for healthier economic growth.

B. 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 lowering rates 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.

C. 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.

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.

III. 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, and again yesterday.

1. This still leaves short-term *real* rates--that is, adjusted for inflation--low enough to provide some stimulus to the economy.

2. Long-term rates have risen, too--in fact, more than short-term rates did.

    a. An important factor behind the big increase in long-term rates is the continuing strength in the economy.

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

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

D. So, overall,

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.

IV. 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.

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 raise rates are appropriate.

1. Whether or not we'll need to take additional action -will depend on 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.