California Municipal Treasurers' Association
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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 on Monday.

1. This is the third increase in the past three months.

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 here in the Golden State.

A. Frankly, there hasn't been much "golden" about the economy for three and a half years.

1. And you in local government have had a hard time balancing your budgets

a. with the declines in taxable sales, falling property tax assessments, and shrinking state revenues.

B. But we may be seeing a little glint of gold shining through at last.

1. First, some indicators have stopped dropping.

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

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

a. The number of existing homes sold has been trending up for several months now.

b. And there's even some anecdotal evidence that home values are stabilizing.

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(1) That should halt the erosion of the property tax base that we've seen in the past couple of years.

3. Third, in recent months we've finally started to see some improvement in the employment picture.

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

C. 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 defense contract 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.

III. Now let me turn to the national outlook.

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

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. It's important to remember that although this is contractionary now, it will be good for growth in the long run.

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

(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 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.

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,

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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.

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, March, and again this week.

1. This, of course, also has raised short-term *real* rates--that is, adjusted for inflation--which affect spending in the economy.

a. Now, calculating exactly what the real rate is, or what it should be, is subject to a lot of debate.

b. But it does appear that real short-term rates probably are still in a range that will continue to provide some stimulus to the economy.

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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.

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 raise rates are appropriate.

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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.

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