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 three times 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 local economy.

A. Here in the Tucson area, you’re enjoying very healthy economic growth.

1. In fact, it would be the envy of people in many other parts of the country—especially those about 500 miles West of here.

B. If you look at the employment numbers, they’re strong almost across the board.

1. The glaring exception is the weak mining sector.

C. But what really stands out is the incredible strength in manufacturing and construction activity.

1. The number of manufacturing jobs has grown more than 7 percent in the past year.

   a. That’s pretty remarkable when you consider that nationally the number of manufacturing jobs rose less than 1 percent.

   b. An important contributor to this robust growth in manufacturing, of course, is the new Hughes facility.

2. The data on construction jobs are even more startling: The number of construction jobs is up 25 percent from a year ago.
a. And, as I'm sure you're all aware, housing markets in this area are very hot right now -- almost as hot as the temperature will be outside in a few months!

b. Prices and sales activity are looking very good -- at least for those who already own property here.

III. Now let me turn to the national outlook.

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

B. This expansion so far has had to contend with two major contractionary forces.

1. The 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.

   (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 1 3/4 percent.

C. In the earlier stages of the recovery, the Fed countered these contractionary forces by lowering 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.

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

1. In fact, in 1992 growth averaged nearly 4 percent, and in 1993 it averaged just above 3 percent.

E. This kind of fast growth is just what you’d want when we’re coming out of a recession and trying to employ excess capacity.

1. But we can’t keep up that pace of growth over the long term—at least not if our sustainable growth rate is about 2½ percent, as most economists think.

2. As a result of the fast growth, 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.

IV. As for 1994,

A. the first quarter registered a growth rate of 2.6 percent—within the range of the potential rate.

1. But I think that figure probably understates the economy’s *current* strength.

2. The first quarter data included a couple factors that were quite weak, but they’ll most likely bounce back this year.

B. For the rest of 1994, fiscal policy, the world economy, and monetary policy will continue to play important roles.
C. Fiscal policy, of course, will remain contractionary, as the deficit-trimming continues.

D. 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.

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

F. So, for this year as a whole,
   1. the economy probably will grow somewhat above its long-run potential growth rate.
   2. 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.

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. It takes a long time for a policy action to produce results against inflation—probably from 1½ to 2 years.

2. This kind of time lag means that if we don’t act until the problems show up in the data, 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. But a couple of warning signs have cropped up. 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.

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.