Robert T. Parry, President
Federal Reserve Bank of San Francisco

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

I. Good afternoon.

A. It's a real pleasure for me to have a chance to address the Council on Economic Education and its sponsors and friends.

B. As both an economist and an official of the Federal Reserve, I'm aware that people have a lot of questions not only about

1. *what* the Fed does,

2. and *how* the Fed does it,

3. but most importantly, about *why* the Fed does it.

C. So I applaud the Council's efforts at taking some of the mystery out of economics in general--and the Fed in particular.

D. This is especially pertinent now, because the Fed has been in the news quite a bit lately.

1. We raised the federal funds rate slightly in February, March, and April, and then by 50 basis points in May, for a total increase of 1¼ percentage points.

2. Not surprisingly, there's been a wide range of reaction to these moves.

a. In California, for example--where unemployment is back up over 9½ percent--some commentators are none too happy.

b. And I expect that here in Hawaii--where the economic recovery has yet to take hold--a lot of people also are wondering about the wisdom of our recent moves.

E. Today, I'd like to give you my views on the recent Fed actions.

1. I'll focus on the attention we give to regional concerns,

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2. as well as on the rationales for the short-term interest rate hikes.

II. Let me start with a brief look backward.

A. Coming out of the recession, the national economy was pretty sluggish compared with previous expansions.

B. The Fed did its part to keep the recovery going by lowering short-term interest rates.

1. We moved cautiously because we were concerned that lowering rates too fast could be inflationary, but we did bring rates down *substantially*.

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

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

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

III. But the effect of the monetary stimulus hasn't been uniform across the country, because states like Hawaii and California have had to deal with some special problems.

A. Here in Hawaii, the visitor count declined in 1991, 1992, and 1993, and the result is that the state lost around 2 percent of its jobs.

B. In fact, Hawaii ranks 50th out of all the states in terms of job growth for the latest 12-month period.

1. Let me focus on three of the main reasons for this decline in the tourism industry.

a. First is the modest recovery on the mainland--compounded by the ongoing recession in California.

b. Second is the weak economy in Japan.

c. Third, Hurricane Iniki destroyed a good portion of the visitor industry infrastructure in Kauai,

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(1) and the decline in the number of visitors to Kauai accounted for three-fourths of the total decline in the number of visitors to Hawaii.

2. In the first quarter of 1994, you *have* had some improvement in the visitor count,

    a. but that hasn't translated yet into significant job gains.

C. So, with the state's economy still lagging behind the nation's, it's natural to think that Hawaii could use more stimulus.

D. The problem is that monetary policy can't deliver that stimulus just to the states that need it.

1. The reason is that monetary policy operates through *national* credit markets, so the Fed can't make credit less expensive in any *particular* region of the country.

2. Now some people might say that the Fed should keep short-term interest rates low until the recession is over in *all* the states.

    a. Well, that's simply not a feasible strategy.

    b. That would just lead to overheating in most *other* regions, which would produce higher national inflation.

E. I want to emphasize that the Fed *does* pay close attention to what's happening in individual states.

1. These "grass roots" assessments are an important element in shaping policy.

2. And we use them to help fit together a picture of how the *whole* economy is doing.

IV. Now let me look at the overall national performance, which has been pretty good for some time now.

A. 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.

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2. And, based upon the partial information available so far, it appears that growth is continuing to average about 3 percent in the first half of this year.

B. This kind of moderately robust pace was ideal at that stage of the cycle--that is, as we emerged from a recession and tried to employ excess capacity.

C. 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.

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

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

2. --within range of levels that most economists think represent "full" utilization.

V. Looking forward to the rest of 1994 and 1995,

A. I expect to see some moderate deceleration in the pace of economic activity--to around its 2½ percent sustainable rate of growth.

B. The three main factors affecting the economy will be fiscal policy, the world economy, and monetary policy.

1. First, fiscal policy:

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

(1) And there's more deficit-trimming to come.

b. I want to emphasize that even though this exerts a contractionary force on the economy for now, in the long run it will be *good* for economic growth.

(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.

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2. Second is the world economy.

   a. For some time now, the only bright spot has been the boom in U.S. exports to developing countries in Asia and Latin America.

   b. Many of our industrialized trading partners, however--such as Canada, France, Japan, and Germany--have had sluggish growth or worse.

      (1) But the overall performance in these countries is starting to show signs of improvement,

      (2) and we expect noticeably stronger growth next year.

VI. Turning to monetary policy, as I mentioned, the Fed raised short-term interest rates slightly in February, March, and April, and then by 50 basis points in May.

A. These actions were taken in pursuit of the Fed's goal to provide the economy with a stable, low-inflation environment.

1. This is the main way that the Fed can contribute to a healthy, efficiently functioning economy.

   a. High inflation often is associated with more uncertainty about *future* inflation, and this makes our market economy less efficient.

      (1) It hinders capital formation by increasing long-term real interest rates,

      (2) and it makes it harder for businesses to plan for the future.

   b. High inflation also drives people to spend a lot of time, energy, and money looking for inflation hedges.

   c. Finally, as we learned in the early 1980s, if inflation gets out of control, it can cost many jobs to stop it.

B. But the process of keeping inflation under control has its pitfalls.

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

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2. This kind of time lag means that we can't wait until the problems show up in the data, because then we're likely to be too late.

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

C. 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. In fact, recent inflation news has been favorable.

D. But some important warning signs of future inflation have appeared.

1. First, 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.

2. Second, 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.

b. Historically, once the economy has moved beyond its potential levels of production and employment, the result has been higher inflation, with no long-run improvement in the unemployment rate.

E. As a consequence, I think the steps we've taken to raise rates are appropriate because they guard against getting into this kind of "no-win" situation by fostering stable, sustainable economic growth with low inflation.

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