American Council for Gift Annuities
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PROSPECTS FOR THE U.S. ECONOMY

I. Good morning. It's a pleasure to be here today and to welcome you to our beautiful city.

A. I think it's quite appropriate that the American Council for Gift Annuities has chosen to meet here in San Francisco.

1. It's a city where bridges matter a lot,

a. both as beautiful landmarks,

b. and as critical links with the rest of the Bay Area.

B. And I think it's fair to say that your work with planned charitable giving is something like a bridge as well—

1. —not only linking the donors and the receivers in the present time,

2. —but also linking the present and the future through investments.

C. Now, one of the great virtues of a good bridge is, of course, stability.

1. Given the choice,

a. I'd say most people would rather take a safe, scenic stroll across the mighty Golden Gate Bridge

b. than make a hair-raising dash across a bridge made of vines and slats.

D. Stability is also one of the virtues of a well-functioning economy—and that will be one of my key themes today.

1. Again, given the choice,

a. most people would do better with the economy growing at a steady, sustainable pace

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b. rather than trying to navigate through the cyclic swings of the booms and busts that were common in the past.

2. Providing that stability is one of the main concerns of the Federal Reserve's monetary policy.

a. In fact, it's what motivated the Fed's actions to double the federal funds rate between February 1994 and February 1995.

3. So, in my remarks today, I want to explain

a. some of the reasons for the Fed's moves to tighten monetary policy,

b. and then discuss how we expect developments to play out in the economy in 1995 and beyond.

II. Let me start with a few key principles.

A. First of all, keeping inflation at low and stable rates is important:

1. It's the primary way that monetary policy can contribute to achieving the maximum *sustainable* advance in the country's economic output and the people's standard of living.

2. The point is that high inflation imposes significant costs on the economy.

a. For example, high inflation often is associated with high uncertainty about *future* inflation.

b. And more uncertainty hinders the long-run growth potential of the economy

(1) by fostering higher long-term real interest rates

(2) and by complicating the planning and contracting by business that are essential to capital formation.

c. High inflation also hinders economic growth

(1) by heightening the distortionary effects of most tax systems,

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(2) and by driving people to wasteful inflation-hedging activities.

B. My second key principle is that monetary policy doesn't produce results *instantaneously*.

1. In fact, it can be a little like trying to steer a fifty-thousand ton tanker:

a. You move the wheel, but the ship doesn't start to make the turn for a couple of miles!

2. In monetary policymaking, this is known as the problem of "long"—and I might add—"variable lags."

3. It can take anywhere from a year and a half to three years for a monetary policy action to produce results on inflation.

4. This kind of time lag means that it's dangerous to wait until the problem shows up in the inflation data—by then we'd be too late.

5. Instead, we have to *anticipate* problems,

a. by looking for signs that inflationary pressures are on the rise.

C. This brings me to my third point: the pressures for *higher* inflation intensify the longer the economy operates beyond its *long-run* capacity to produce goods and services.

1. Two of the basic guidelines to judge whether the economy is, or will be, exceeding its long-run capacity are measures of

a. its potential growth rate

b. and the so-called "natural rate of unemployment."

D. I'd like to take a few minutes to develop these two ideas,

1. because they're at the heart of much of the Fed's deliberation,

a. and yet they can't be pinned down to decimal point accuracy.

2. I'll start with a definition of the potential growth rate: It's the growth rate an economy is capable of sustaining in the long run.

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a. For the U.S., it appears to be in the range of 2 to 3 percent per year.

b. The potential growth rate is determined by a lot of factors,

(1) including population growth

(2) and improvements in technology and productivity,

(a) such as inventions and a more skilled workforce.

c. Obviously, monetary policy has little impact on these factors, so it can't determine the potential growth rate;

(1) although most economists believe that low, stable inflation—which monetary policy *can* produce—does tend to enhance the potential growth rate in the long run.

3. The second key factor underlying the inflationary risks in the economy is the so-called "natural rate of unemployment."

a. This is the rate the economy can sustain in the long run, and it's determined by current technology, labor market size and composition, and so forth, in today's economy.

(1) Currently, most economists put it in the range of 5¾ percent to 6¾ percent.

E. An important point to take away from what I've said so far is that the Fed doesn't decide

1. what the natural rate of unemployment is,

2. or what the potential growth rate of the economy is,

3. or what the lags in monetary policy are.

4. Even though we don't control them, we must take them into account in designing policies.

III. Now, let me put this together and apply it to the current situation.

A. As I've indicated, the economy has grown rapidly for the past three years—

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1. —well above the long-run potential rate.

   a. This rapid growth was great when the economy had plenty of excess capacity coming out of the 1990 recession.

B. But the rapid pace has lasted so long that the economy's now operating beyond its long-run capacity to produce goods and services.

C. The unemployment rate has fallen from a peak of about 7½ percent to 5½ percent,

   1. which appears to be below the natural rate.

D. Signs of strain are showing up in things like manufacturing capacity utilization rates.

   1. Thus manufacturing firms are operating at just under 85 percent of capacity,

   2. which exceeds rates that can be sustained without higher inflation.

E. So the overall picture suggests that excess capacity has been pretty much used up.

   1. In fact, it appears that we've overshot capacity in both labor and product markets, so that there's excess demand for resources in today's economy.

IV. And that's why the Fed moved to tighten monetary policy.

A. Unless the economy cooled down a bit, inflation would be on the rise in the future.

B. We couldn't wait to act until we actually observed a problem in the inflation numbers.

   1. In fact, in 1994, inflation looked pretty well-behaved.

   2. For example, the consumer price index rose by a moderate 2¾ percent last year.

C. But, as I said earlier, since the effects of monetary policy occur with a lag, waiting to act until the problem shows up in the data means that our attempts to fix it will always be too late.

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1. Once inflation is allowed to build up a "head of steam,"

   a. bringing it back under control may result in a recession—

   b. —that's the hard lesson we learned in the late 1970s and early 1980s.

V. Does it appear that the economy has slowed down—started to take a "breather," as it were, so that inflationary pressures will subside?

A. Developments so far this year suggest that the answer is yes.

B. First, the most recent data show that, after the very rapid 5 percent pace of growth in last year's fourth quarter, this year's first quarter has come in at 2¾ percent—a substantially slower rate.

   1. The deceleration in spending was especially evident in housing and consumer durables.

C. Since both of these sectors are sensitive to interest rates, this is exactly where a slowdown induced by tighter monetary policy would be expected to show up.

D. Moreover, these first quarter developments are consistent with analysis at the San Francisco Bank,

   1. which suggests that the tighter monetary policy put in place last year will have its main restraining effects throughout 1995.

VI. Thus things seem to be unfolding just as we had hoped--so far we are seeing a modest slowdown in growth to bring inflation under control without setting off a boom and bust cycle.

A. But let me emphasize a couple of important points.

B. Since we appear to have overshot capacity, we'll need moderate growth for more than just a quarter or two to avoid higher inflation.

C. In addition, it's the longer-run average rate of growth that the Fed will be focusing on, not any one quarter's performance.

   1. Real GDP growth tends to be volatile from quarter to quarter.

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2. So a sustained period in which economic growth *averages* a moderate rate

   a. may include some individual quarters that are weak,

   b. and others that are quite strong.

VII. I'd like to conclude with a quick overview of the economic outlook.

A. Overall, the Fed's actions to slow national economic growth to a sustainable pace seem to be taking hold.

   1. 1995 should continue to show slower growth, as we've seen in the first quarter,

   2. and that should help contain inflationary pressures.

B. These generally desirable trends don't mean, of course, that now the Fed can just sit back and relax.

   1. The appropriate policy requires frequent re-assessment and re-adjustment.

C. However, the steps we've taken so far are consistent with our primary goal to foster stable, sustainable growth with low inflation.

D. Finally, if we are to follow a course of gradually declining inflation in 1996 and beyond, we will need to maintain a firm grip on the policy lever.

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