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PROSPECTS FOR THE U.S. AND ALASKA ECONOMIES

I. Good morning. Today I'm going to give you my views on the economic outlook for the nation and Alaska.

A. As I'm sure you know, monetary policy—past, present, and future—plays an important role in the outlook over the next year or so.

1. Although I can't talk about *future* monetary policy;

2. I want to talk about where policy is today and how we got there.

B. During 1994 and early 1995, the Fed tightened policy in order to slow the economy—

1. —we thought this was necessary in order to keep inflationary pressures from building.

C. We now have solid evidence that the economy has slowed substantially from the unsustainably rapid pace over the prior three years.

1. In fact, the current quarter may be quite weak.

D. I'd like to give you my interpretation of these developments

1. and discuss what they mean for the economic outlook.

II. Let me start with a little background—I want to cover a few principles from Economics 101 that set the environment in which we conduct policy.

A. First of all, low and stable inflation is important,

1. and achieving that goal is the main way that monetary policy can promote the maximum *sustainable* advance in the country's economic output and the people's standard of living.

B. Second, 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.

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;

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 very recent history.

A. As I've indicated, the economy grew rapidly in '92, '93, and '94—

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

2. This rapid growth was great when the economy had plenty of excess capacity coming out of the 1990-91 recession.

B. But the rapid pace lasted so long that the economy began to operate beyond its long-run capacity to produce goods and services.

C. The unemployment rate fell from a peak of about 7½ percent to as low as 5½ percent,

1. which appeared to be somewhat below the natural rate.

D. Signs of strain showed up in things like manufacturing capacity utilization rates.[1]

E. And the overall picture suggested that we overshot capacity.

F. As a result, inflation would have been on the rise—

1. —unless the economy had slowed down.

IV. In fact, recent data do indicate that the pace of economic activity is cooling.

A. The first quarter numbers show that growth slowed substantially—from a 5 percent pace in the fourth quarter of 1994 to 2¾ percent.

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

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

B. So far data on the second quarter aren't complete, of course;

1. the information we *do* have suggests that the slowdown has intensified.

C. But, in part because of the continuing strength in business investment and exports, I'd expect moderate growth to resume later this year.

1. I think it's worth emphasizing that the Fed won't be focusing so much on any individual quarter's performance as much as it will focus on the longer-run *average* rate of growth.

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

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

(1) may include some individual quarters that are weak—as this one is likely to be—

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[1] The manufacturing capacity utilization rate fell to 83.5 percent in April compared with 85.2 percent in December 1994 and January 1995; the equilibrium rate generally is estimated at 81-82 percent.

(2) and others that are strong.

V. What does a national slowdown mean for Alaska?

A. The answer is a little tricky, since movements in economic activity here aren't necessarily "in synch" with national performance;

1. for example, in last year's fourth quarter,

a. job growth *contracted* here,

b. while the national economy *expanded* quite smartly.

B. Of course, the connection between the state's and the nation's economy is loose mainly because natural resources play such an important role in Alaska's economy.[2]

1. For example, although the industry base here has expanded some over the years,

a. Alaska remains less diversified than many other states,

b. so it's more apt to move independently of the national economy.

2. In fact, the importance of natural resources may even move the state's economy in the *opposite* direction from the country's.

a. For example, higher oil prices are good news for Alaska,

b. but often bad news for many of the other states.

3. Finally, the prices of oil and other natural resources are determined by world supply and demand conditions,

a. not just by conditions in the U.S.

C. So although the national slowdown will have some effect, factors affecting the supply and demand for Alaska's resources may be more important.

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[2] Regression analysis shows that the growth rate of real GSP for Alaska is negatively correlated with the growth rate of U.S. GAP. One explanation would be that changes in the prices of natural resources, like oil, have positive effects on regions that are net producers and negative effects on those that are net consumers of the resource.

1. For example, on the negative side, sagging employment in the oil sector, along with declines in oil-related tax revenue, have held down growth in the state.

D. But there are some pluses that should allow Alaska to realize moderate growth over the near term.

1. One is the recovery of oil prices over the past year or so.

2. Looking a little further ahead, steps to open additional areas for oil exploration and to lift the ban on North Slope oil exports also should add to economic growth.

3. Mining will get a boost from the planned construction of the Fort Knox gold mine and exploration of the Ryan Load and True North mines. [3]

4. Also, the tourism industry here is growing rapidly, as it capitalizes on another of Alaska's outstanding natural resources--its beauty.

a. And it should do even better this year, since it's the start of the Centennial of the Klondike Gold Rush.[4]

b. If the pundits are right, Alaska will have almost 2 visitors for every resident in 1995.[5]

VI. Let me conclude with a quick overview of the economic outlook.

A. The Fed's actions to slow the national economy to a sustainable pace appear to have taken hold.

1. Although economic performance in 1995 may vary from quarter to quarter,

a. we should see continued—but slower—*average* growth for the year,

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[3] These mines are northeast of Fairbanks.

[4] The kickoff to the Centennial takes place in Skagway this summer.

[5] Alaska population in 1993 was about 600,000. In 1994 Alaska had 1.1 million visitors. Separate data show 1.62 million travelers to Alaskan parks last year. One must assume that some people visited more than one park and that some Alaskans visited the parks.

b. and that should help contain inflationary pressures.

2. Furthermore, the general feeling is that the Alaska economy can continue to grow despite the national slowdown.

B. As the rest of 1995 unfolds, we'll be monitoring developments closely.

1. During a tricky period like this, 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.

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