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The Economic Outlook for 1989

The following is a modified text of the speech given by Robert T. Parry, President and Chief Executive Officer of the Federal Reserve Bank of San Francisco, before a General Meeting of the Town Hall of California, in Los Angeles on December 6, 1988. In this speech, President Parry discusses the recent performance of the U.S. economy and his views regarding the economic outlook and monetary policy in the coming year.

A remarkable expansion

The past six years have seen a strong expansion in the U.S. economy—the longest peacetime expansion in U.S. history. More than 18½ million jobs have been created since the business cycle trough in 1982. The unemployment rate has fallen to a fourteen-year low of under 5½ percent. At the same time, consumer price inflation has been brought down from a peak of nearly 15 percent in 1980 to 4 percent over the past twelve months.

In 1987, real output grew by 5 percent, a remarkably robust performance for an economy in its fifth year of expansion. The economy slowed modestly to a 3¼ percent rate of growth in the first half of this year. This still is surprisingly strong, considering the October 1987 stock-market crash and the drought in 1988.

Improvement in our foreign trade balance has been an engine for growth in the past year and a half. Spending by businesses on equipment, and consumer spending on services and durable goods also have kept things moving along.

Since midyear, the economy has continued to grow at a robust pace, growing at a 2.6 percent annual rate in the third quarter. That's down slightly from the first half, mainly due to the temporary effects of the drought on agricultural production. The effects of this decline in the agricultural sector will be felt through the fourth quarter. However, we're seeing signs of considerable strength in the nonfarm sectors. If we abstract from the effects of the drought, third-quarter growth registered a 3¼ percent annual rate, and recent monthly numbers on unemployment, retail sales, and industrial production were strong. Thus, overall, the slowdown in the economy compared with the first half of the year probably is more apparent than real.

From my perspective as a central banker, a slowing trend actually would be desirable. In the Summer of 1987, the Federal Reserve was becoming increasingly concerned that the economy was in danger of "overheating." The unemployment rate was dropping and capacity utilization was rising—both into ranges that signalled the economy was approaching its maximum capability to produce goods and services. Long-term interest rates were rising, reflecting the market's concern about future inflation. So, the Fed raised the discount rate in September 1987 from 5½ percent to six percent to make clear our intention to cool things off a bit.

The stock-market crash in October required a detour in the course of monetary policy. As fears of recession rose, the Fed provided the liquidity needed by the financial and economic system. By March of this year, however, the threat of recession largely had passed, and the Fed returned to its anti-inflation course.

Since then, we have raised the discount rate another ½ percent to 6½ percent. Market interest rates have risen about 1½ percentage points since Spring, partly as a result of the discount rate hike and a series of other tightening moves. Overall, financial markets have responded favorably to our efforts: long-term interest rates have not risen as fast as short-term rates, reflecting lower expectations of inflation.

Key concerns

But the economy still is growing at a pace that cannot be sustained in the long run without higher inflation. The pattern of growth, particularly in the third quarter, also is of concern. Consumer spending remained strong while business spending on plant and equipment tapered off sharply. Likewise, our trade balance (adjusted

for price changes) worsened for the first time since the end of 1986. And although federal government spending has declined markedly over the course of this year, the federal budget deficit remains massive.

These developments illustrate the persistent and dangerous structural imbalances in our economy that have arisen in the current expansion. By "structural imbalances," I mean the federal-budget and trade deficits, and the low personal saving rate. The combination of strong spending in the private sector and unprecedented deficits in the federal government's budget have outstripped our nation's saving and productive capacity. As a result, we have had to rely on imports of foreign goods and foreign funds to make up the shortfall. As a nation, we are spending beyond our means.

Foreign financing has enabled us to do this. But in the process, we are mortgaging our future income, and the income of our children, to pay for this spending spree. Of course, as every homeowner in California knows, a big mortgage is not so onerous when we expect our incomes and wealth to rise. But I worry when I look at how we're spending the money. The combination of continued strength in consumption, large budget deficits, and only moderate business investment in plant and equipment is troublesome: we're simply not investing enough in productive capacity to boost our future income and cover the rising foreign debt service.

Another problem with these imbalances is that they have made U.S. economic developments highly sensitive to changes in the foreign-exchange value of the dollar. After falling sharply from early 1985 through 1987, the dollar has risen on balance in 1988. In September, it was 10 percent higher on a trade-weighted basis than at the end of 1987. Since then, the dollar has fallen, but its level still is 2 percent higher now than at the end of last year. The dollar's higher level throughout much of the year has had, and could continue to have, a dampening effect on the growth of net exports and the economy generally. Of course, slower growth in our export sector actually is beneficial in one respect: it is helping to keep inflation under control and reducing upward pressure on interest rates. But the higher dollar also is slowing the needed adjustment in our trade deficit and increasing our foreign debts.

Conversely, a weaker dollar would help out on the foreign trade front, but also would have a downside: a lower dollar would increase inflationary and interest-rate pressures. In effect, the dollar has become a "catch-22" for the U.S. economy. If it falls, it creates inflation, and if it rises, it delays the needed adjustment in our foreign deficit.

Some have embraced trade barriers as a way to reduce the trade deficit. But this approach would be disastrous. Trade protectionism invites retaliation, thereby threatening the world-wide economic expansion and raising prices in the U.S. without helping our overall trade situation.

However, there is one way out of the "catch-22" of the dollar: reduce the federal budget deficit. Reducing the budget deficit would lower the demand for foreign funds as well as the demands on the economy's resources. This would allow the dollar, the trade deficit, and interest rates to subside simultaneously. It also would set the stage for more balanced and sustainable economic growth over the long run, and thus enhance the chances of extending the expansion well into the next decade.

Prospects for reducing the deficit are very difficult to assess. The projections of the Administration and the Congressional Budget Office present very different pictures. The Administration expects that Gramm-Rudman-Hollings spending cuts will reduce the deficit by about $25 billion per year over the next five years and bring the budget close to balance in 1993. The CBO sees improvement of only $7 billion per year. These differences rest mainly on alternative assumptions about economic developments over the next five years, and my outlook is closer to that of the CBO.

But more important than differences in economic assumptions are the *actions* the new Administration will take to reduce the deficit. Unfortunately, the gargantuan potential liability of the Federal Savings and Loan Insurance Corporation won't help matters. Estimates of the cost of dealing with all the insolvent S&Ls run as high as $100 billion! But despite the problems, it is imperative that strong actions be taken—and soon—to set the deficit on a decidedly downward course.

Price stability
There is very little the Federal Reserve can do to correct the imbalances I have described. Until concrete progress is made in lowering the budget deficit, we are stuck with structural imbalances that foster underlying inflationary pressures. Although overall inflation has not accelerated this year compared to 1987, there have been disquieting signs of a pick-up in wages, salaries, and benefits. The most comprehensive measure of labor compensation rose by 4½ percent over the twelve months ending last September, versus less than 3½ percent over the prior twelve months. Although part of this increase was due to special factors, it does suggest that underlying wage pressures are rising. And the longer the economy continues to grow at rates that strain capacity, the more these wage pressures will mount.

Now, I don't want to give the impression that inflation is about to return to double-digit levels. The combination of a higher dollar and lower oil prices so far this year provides some temporary relief. But we can't depend on these factors, which are beyond our control, to solve our inflation problem. For example, developments at the recent OPEC meeting raise the specter of higher oil prices, and threaten to put upward pressure on inflation in the future.

We should not shy away from corrective medicine while the inflation problem is still manageable. Even so, it takes time for this medicine to work. The choices we make today will have a larger impact on inflation in 1990 than in the coming year.

But some may wonder, "what's wrong with a little inflation in the future if reining it in means we have to accept slower economic growth now?" The problem is, a little inflation has a disturbing tendency to turn into a lot of inflation. Inflation stunts economic growth and exacerbates business cycle swings. And the experience of the early 1980s showed that once inflation gets embedded in expectations, it's difficult to root out. It took two back-to-back recessions, soaring interest rates, and postwar-record unemployment to tame inflation the last time around.

For this reason, we need to make steady progress towards price stability. Now that we're operating in the range of full employment, the economy can't afford to grow faster than the rate of growth in our long-run capability to produce goods and services. This means the economy should expand next year (and over the next several years) at less than a 2½ percent pace.

Looking ahead
Fortunately, the monetary tightening so far and the behavior of the dollar this year should restrain economic growth somewhat in 1989. Whether these factors *alone* will be sufficient to hold economic growth to a sustainable rate of under 2½ percent next year remains to be seen. I expect to see prices (as measured by the fixed-weight GNP price index) rise at about the same rate next year as this year; that is, in the 4 to 4½ percent range. Inflation at this pace next year is worrisome because luck has had a lot to do with keeping a lid on prices recently. Movements in the dollar and the price of oil this year as well as expected favorable developments in agriculture next year should contribute to slightly lower inflation next year. However, underlying inflationary pressures, which are of primary concern to monetary policy, most likely will continue to accelerate.

Thus, the key issue in 1989 will be whether growth is balanced and conducive to the longer-run health of the economy. Unfortunately, the prospects for more balanced growth in 1989 are not as bright as I'd like. Improvements in the trade balance and investment spending seem likely to slow. Moreover, I expect the personal saving rate to remain around its present low level through the end of next year. Finally, the federal budget deficit will remain massive, by even the most optimistic projections.

As I have stressed, the Fed's number one job is to promote price stability. We can't solve these structural imbalances in the economy, but we can and will resist the inflationary pressures they create.

Robert T. Parry
President and Chief Executive Officer

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