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245 THE ECONOMIC SITUATION AND THE OUTLOOK

Wayne D. Angell
Member, Board of Governors of the [Federal Reserve System]

I am pleased to have the opportunity to talk with you today about the current economic situation and the outlook. I know it is often the practice on occasions like this for speakers to lay out in some detail their forecasts of economic prospects for the coming year. However, my approach today is going to be a little different. I want to step back from the current situation and take a broad view of how the economy has evolved over the past several years and provide--again, in broad terms--my assessment of the main forces that will be influencing the future course of the economy.

As you may know, the economic expansion in the United States turned six years of age this month, and, in many respects, those six years have witnessed an unusually successful economic performance. Real GNP--the total output of goods and services--has increased nearly 27 percent since the expansion began in late 1982. In the labor market, employment has risen 16 million, and the unemployment rate has declined to the lowest level in a decade and a half.

However, the most impressive gain of the past few years--and one that I wish to discuss in some detail--is the turnabout in inflation. Inflation had accelerated through the 1960s and 1970s and moved into the double-digit range by the end of the last decade. I believe that acceleration reflected a monetary accommodation of both the price shocks that arose in the petroleum and agricultural markets and the growth-oriented objectives that gave short shrift to the goal of price stability.

In the end, of course, we were to have neither price stability nor strong growth. As price increases accelerated, the inflation took on a dynamic of its own. Businesses increasingly attempted to meet profit rate objectives by increasing prices. Workers responded by demanding big wage increases to stay ahead of inflation, and businesses in turn had to raise prices once again to cover the hike in wage costs. Asset values, including the price of farm land, doubled and even tripled during the decade of the 1970s reflecting the present value of expected future commodity prices. Businesses and consumers began to alter their real spending and investment plans in anticipation of rising prices. And, this acceleration of inflation expectations reduced the demand for money and raised velocity, so that the observed growth rate of the money stock, in effect, understated the extent of monetary ease--policy simply was not as tight as policymakers thought it was at the time. An observation of auction markets

for both commodities and foreign currencies should have pinpointed the pervasiveness of monetary ease during this period.

Eventually, the inflation resulted in an impairment of the allocative function of the price system, as it proved increasingly difficult to distinguish changes in relative prices from pure inflation. Nominal measures of economic performance, such as corporate profits, suffered a similar malfunction. Inflation, in effect, clouded the very signals upon which our free market economy depends if it is to operate efficiently.

As the social and economic costs of inflation mounted, the goal of price stability came to occupy a more central place in the public's thinking, and economic policies shifted accordingly. At first, policy was attracted to the misguided view that wage-price guidelines would contain inflation. But, eventually, the anti-inflation effort took the form of a restrictive monetary policy turnaround in October 1979. In the ensuing three years, the nation went through two painful recessions as the inflationary tendencies that had taken hold over two decades began to be squeezed out of the economy. By 1982 the rate of consumer price inflation had been brought down to under 4 percent, less than a third of what it had been only two years before. The speed with which inflation decelerated in that period undoubtedly shifted outward the demand for money, and monetary policy thereby became more restrictive than suggested by the growth of the monetary aggregates.

Since the recovery began in late 1982, the goal of price stability has continued to occupy a central place in economic policy-making, both in the United States and in other industrial countries; and--at least thus far--the results have been generally favorable. Inflation rates in the United States remained stable in around the 3 to 4 percent range through the first three years of the expansion and then dipped further in 1986 when world oil prices caught up with an earlier and more general collapse of commodity prices.

Deflation in key parts of the goods-producing sector came close to causing a recession in 1986; second-quarter GNP was negative that year, and the average rate of growth over the second and third quarters was close to zero. Monetary reflation succeeded in avoiding a recession, but propelled a rebound in commodity prices, including oil, and contributed to an exchange rate adjustment.

This monetary stimulus contributed to both a reversal of commodity price trends including a partial rebound in the price of oil, and an exchange rate adjustment which increased import prices. Consequently, the CPI measure of inflation picked up to a 4.4 percent rate in 1987. Although the exchange value of the dollar is little changed from its year-ago level, and oil prices have weakened once again this year, inflation overall has been maintained at about its 1987 pace. This plateau in inflation in 1988 reflected the effects of the drought, together with higher prices for some imports, and a slight updrift in the rate of increase in wages. Unit labor costs have picked up in the nonfarm business sector, despite a continuation of remarkably good performance in the manufacturing sector.

Mindful of the experience of the 1970s, the Federal Reserve began a shift toward gradual restraint in 1987 and 1988 in order to ensure that the runoff in commodity prices that accompanied the decline in the exchange value of the dollar would not lead to a more deeply rooted pick-up in inflation. Growth in the money supply has been restrained, with the M2 measure of money restricted

to an annual rate of 4.8 percent over the two years ended in October of this year. This is the slowest growth of M2 over a two-year period since 1961, and compares to a 9-1/2 percent rate of growth over the first four years of the expansion.

On the whole, I would view the shift to slower money growth rates these past two years as a measured response to limit the step-up in the price level to a one-time occurrence. This action, if maintained, should forestall embedding inflation into the wage structure and should enable us to continue the disinflation process to achieve our goal of price level stability.

In assessing whether these policies will be successful in extinguishing inflation, I am encouraged by some important changes that have occurred in the United States and world economies since the 1970s. These changes, in my view, are likely to work in the direction of reinforcing anti-inflation policies. First, many other industrial countries also were deeply scarred by the inflation of the 1970s, and these countries, like the United States, are giving greater weight to the goal of price stability than was previously the case. Thus, if these policies remain intact, a worldwide surge of inflation would seem less likely than in the 1970s.

Second, the world has become a far more competitive place than it was a decade ago. Our trade sectors now face competition not only from Japan and the European Community but also from the newly industrialized economies of the Pacific Rim. And, if third-world countries, as well as China and the Soviet Union continue to move toward more market-oriented economies, then those countries probably also will gradually become more important competitors in the world marketplace.

Third, the deregulation of markets in the United States, accompanied by a reduction in the real minimum wage, has dramatically improved the competitive position of the United States in a more competitive world economy.

All told, these changes in the world and U.S. economies have important implications for the processes of wage and price determination. Profit rates in U.S. manufacturing are increasingly dependent on the success in cutting costs, due to an inability to pass price increases forward. In this environment, any forward-looking labor union or business that is exposed to export or import competition has to recognize that pushing hard for wage or price increases may be a disastrously counterproductive action if such increases result in a loss of markets and a loss of jobs.

I feel that this shift toward a more flexible wage and price structure presents an unusual opportunity to continue to restrain monetary growth to a level consistent with price stability, without engendering an increase in unemployment. I hope that we can seize that opportunity. Indeed, I believe that a reasonable goal over the medium term would be to reduce inflation by about 1/2 to 1 percentage point per year, and I believe that this can be done while unemployment remains in the 5 to 6 percent range.

Let me now turn from inflation to a discussion of some other issues that bear upon the outlook. As I noted at the start of my talk, the expansion now is six years old. All forecasters are asking: How long can it continue?

To provide some basis for comparison, the current expansion is more than two years longer than the average expansion of the postwar period. It also is the third longest expansion of this century, and the two that were longer owed their longevity partly to wartime demands during World War II period and during the Vietnam period, respectively.

However, merely because the expansion has become relatively long does not mean that it is "old" in a biological sense or that it necessarily will end soon. Indeed, this expansion is quite different in that the unprecedented rise in exchange value of the dollar in the first two years of expansion served to keep some industries, including agriculture, in a depressed condition while other sectors were growing vigorously. The combination of slower money growth served to provide a soft landing for the downward adjustment of U.S. exchange rates and resulted in a less than robust expansion in some sectors. But now that the exchange value of the dollar is in the approximate range that prevailed in 1980, a new rapid recovery is underway in manufacturing, particularly the capital goods sector. This expansion is not going to wither away by itself; rather, the expansion will end only if economic imbalances of one sort or another cause it to be cut short.

The two imbalances that are attracting attention currently--as they have almost since the start of the expansion--are, of course, the trade deficit and the federal budget deficit. In the remainder of my talk this morning, I would like to lay out my own views of the risks that these imbalances pose for the economic outlook. As you will see, I view the trade and budget deficit problems as being important but by no means insurmountable obstacles; and I therefore am relatively optimistic about the prospects for the economy.

The trade imbalance, it seems to me, posed its most serious threat to the economy back in 1986. At that time, exports were still lagging from the dollar appreciation that also was contributing to a surge in imports.

Since 1986, however, the trade situation has begun to turn around, in a fairly dramatic way. The foreign exchange value of the dollar, after peaking in 1985, has fallen substantially over most of the subsequent period; and U.S. industry, with the benefit of continued restraint on wages and costs, has regained much of the competitiveness that had been lost during the period of dollar appreciation. As the effects of this depreciation took hold, U.S. exports began to strengthen, and by 1987 a major export boom was underway. Real exports of goods and services rose 18-1/2 percent over the four quarters of last year. This year has brought further strong gains. In September, for example, merchandise exports, in nominal terms, were up nearly 30 percent from a year earlier.

With this rise in exports, the prospects in many of our tradeable goods sectors have taken a strong turn for the better. Agricultural exports have risen markedly, both in volume and in value. Industrial production began strengthening in late 1986 and has surged more recently, rising nearly 6 percent over the four quarters of 1987 and at close to a 5 percent rate so far this year. Growth of GNP, which had slowed below 2 percent in 1986, has averaged 4 percent over the 1987-88 period.

In the period ahead, I think that we shall see further substantial growth in real exports of goods and services and a slower rate of growth of real imports than in the early years of the expansion. Overall, the external sector

should be making a significant positive contribution to the growth of real GNP, maintaining the pattern of the last two years. The tradeable goods sectors should benefit significantly from this trend, and over time, the trade balance should continue to narrow from the still substantial deficit position of today.

The federal budget deficit is the other imbalance that remains an issue of much concern. In approaching this issue, I think it is first important to try to identify more precisely the nature of the threat that the budget deficit poses, as well as some areas in which the potential effects of budget deficits have been misconstrued by many analysts.

For example, I believe that the deficit is inflationary only if the Federal Reserve tries to monetize it; and I want to assure you that we at the Federal Reserve have no intention of following such a course. This does not mean, however, that the deficit is unimportant. To the contrary, there are two significant consequences. First, the U.S. budget deficit serves to lessen the economic power of the congressional and executive branches of our government. As interest on the debt rises as a percent of federal tax receipts, these interest payments crowd out discretionary spending options. This does not mean that the U.S. economy suffers a restraint, only that the government sector is restrained.

Second, the deficit does have an effect on interest rates: it causes the level of rates to be higher than would otherwise be the case and thereby causes a capital inflow or squeezes out private investment. However, in thinking about how the deficit might affect the future course of interest rates, it is important to take account of market expectations. I would argue, for example, that the current structure of interest rates already incorporates the market's expectations of how the budget deficit is going to evolve over time. Budgetary developments would therefore cause rates to change only if those developments were to alter expectations in an important way. A failure to move the deficit down as fast as the markets are expecting would likely result in higher rates, but a faster-than-expected reduction of the deficit would more than likely lead to lower rates than would otherwise be the case.

It will not be possible for Congress and the new administration to eliminate the deficit in one swift stroke. No one expects that. What the financial markets do need to see is some convincing evidence that the government still is on a course that will take it, over time, back toward budgetary balance. My own hunch is that signs of progress along the lines laid out in the Gramm-Rudman-Hollings legislation would be viewed in the markets as an acceptably rapid pace of deficit reduction. To the extent that the progress is faster than the markets might be anticipating, I believe that we would see interest rates lower than would otherwise be the case, with accompanying benefits for capital spending and other interest-sensitive sectors. The key question for our future is the decision to stay with Gramm-Rudman-Hollings, to continue plausible efforts to bring the 1990 budget deficit down to the \$100 billion requirement and, failing to reach a compromise, to leave the sequester law intact.

In summary, I personally do not believe that the imbalances that we see currently will necessarily derail the expansion. Rather, I see the period ahead as an opportunity for a combination of monetary discipline and continued progress in reducing the federal budget deficit. Together they can provide the necessary underpinnings for a continued healthy economic performance with strong

export growth. Monetary discipline will continue to be required to ensure that inflation is squeezed out of our economy. And, in the context of moderately restrictive fiscal policy, restrained money growth will still provide ample resources for a continued improvement in net exports, and continue the impetus to keep the expansion on track.

Granted, the course ahead may not work out smoothly at every point in time. But, if policymakers will continue to monitor auction market signals, the rough spots should be surmountable and a year from now, when another Agricultural Outlook Conference convenes, I rather expect that we shall be looking back at a year in which some further progress has been made in reducing the current imbalances, that we shall be looking back at the successful conclusion of a seventh year of economic expansion, and that we shall see inflation somewhat below its pace of the past two years.