
The U.S. Economy: A Look Ahead

By Thomas M. Hoenig

As we begin a new year, it is appropriate to reflect upon the highlights of the past year and to look forward to future developments and opportunities. In that spirit, I want to offer my perspective on the current state of the U.S. economy and provide some thoughts on the longer term economic outlook.

In the near term, I am confident that in 1995 we are likely to see a continuation of the recent strong performance posted by the U.S. economy. I am also very optimistic about the long-term prospects for the U.S. economy. Our success in achieving economic progress over a longer time horizon, however, will depend greatly on our ability to take policy actions that promote sustainable economic growth and ensure that we reach our full economic potential.

AN ASSESSMENT OF THE CURRENT STATE OF THE ECONOMY

As we close the books on 1994, we can look back with considerable satisfaction on the performance of the U.S. economy. Over the past year, real economic growth increased nearly 4 percent; and this strong growth led to very impressive employment

gains. The economy created over 3 million new jobs in 1994, including over a quarter million new manufacturing jobs. These job gains, in turn, led to a significant drop in the unemployment rate to the lowest level in four years.

The strength in the U.S. economy last year was broad-based among both consumers and businesses. On the consumer side, a notable development was the strong spending on durable goods, particularly automobiles. Business investment spending was also exceptionally strong throughout the year, as businesses restocked inventories to keep pace with higher sales and made major purchases of new plant and equipment. A third source of strength was a significant increase in U.S. exports. Through the first three quarters of 1994, U.S. export growth was running at twice the pace of the preceding two years.

A final highlight of 1994 was the performance of inflation. Despite some indications of tightening labor markets and increased materials prices, inflation remained under control. For example, the consumer price index (CPI) in November was up only 2.7 percent over a year ago.

THE OUTLOOK FOR 1995

Turning to the outlook for 1995, an important issue is whether the recently strong U.S. economic performance is likely to continue this year. Most

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analysts—and I would include myself among them—see continued solid growth, but at a more moderate and sustainable pace.

The principal reason for expecting a reduced pace of U.S. economic activity in 1995 is the effect of last year's interest rate increases on housing and other interest-sensitive sectors of the economy. With mortgage rates up considerably over the past 12 months, we are beginning to see a slackening in residential construction activity. As this activity slows, we are also likely to see reduced consumer spending on furnishings and other items related to housing purchases.

Nonetheless, the overall outlook for 1995 remains very positive. And, I would like to highlight three factors that are likely to contribute to continued solid growth this year.

The first positive factor is the absence, at least to this point, of an unwanted buildup in business inventories. Inventory-to-sales ratios remain at historically low levels, which suggests there will be no substantial inventory overhang heading into the new year.

A second positive factor for the U.S. economy in 1995 is the likelihood of continued strength in U.S. exports. As I indicated earlier, exports contributed importantly to the stronger-than-expected performance of the U.S. economy during 1994. Much of our export growth in recent years has been in sales to Mexico and Asia. In contrast, sales to some of our major trading partners in Europe and Japan have slowed as these countries experienced recessions. Now, however, these countries appear to be expanding more rapidly, and that should give an additional boost to our exports and provide an offset to some domestic factors that might otherwise slow our economy in the near term.

The third positive factor for the U.S. economy in 1995 is the renewed strength in U.S. bank lending.

During the early stages of the current expansion, credit flows were very weak. Consumers and businesses reduced their credit needs to lower their debt burdens and repair their balance sheets. At the same time, banks were reluctant to extend new credit. Indeed, bank business loans declined for three consecutive years—in 1991, 1992, and 1993; a period that was referred to, not so affectionately, as “the credit crunch.”

Recently, bank loan demand has increased considerably. And, banks have shown an increased willingness to lend, as evidenced by an easing of terms and standards on new loans. As a result, business lending at banks rebounded sharply in 1994. Consumers have also shown a greater willingness to borrow, and bank consumer lending has expanded as well. I believe these improved credit flows provide additional support to the view that there will be considerable underlying strength in the economy in the period ahead.

KEYS TO LONG-TERM GROWTH

With this favorable near-term economic outlook, we now have an opportunity to focus our attention on some important long-run issues. Over a longer time horizon, the ability of the U.S. economy to continue to provide new jobs and raise living standards will depend on our ability to promote sustainable economic growth. Today, I would like to highlight four keys to our economy's long-run performance.

The first key is a continuing commitment to open international markets for goods and services. In a world economy that is increasingly interdependent, international trade is a vitally important factor stimulating growth. While trade liberalization may have certain short-run costs, as some industries must adapt to increased competition, these costs are outweighed in the long run by the benefits of growing export markets and lower prices for consumers.

As the world's largest economy and single largest exporter, it is important that the United States take the lead in reducing trade barriers worldwide. The recent passage by Congress of the Global Agreement on Tariffs and Trade, or GATT agreement, was an important milestone on the road to lower trade barriers and greater world economic growth. Coupled with last year's approval of the North American Free Trade Agreement, or NAFTA, the U.S. economy will certainly derive long-run benefits from an expansion in world markets that stimulates exports and new job creation.

A second key to long-run growth is the provision of a positive climate for investment and savings. Our long-run economic potential depends critically upon our ability to provide incentives for businesses to make productive investment decisions and for households and businesses to generate the savings necessary to finance these investments. In recent years, our economy has fallen behind other industrialized countries in generating savings and investment. For example, our personal savings rate, which runs between 4 and 5 percent of income, is less than half that of Japan and Germany, and private investment spending has lagged as well.

Part of the investment shortfall can be attributed to the large federal government budget deficits in the United States that have absorbed financial resources from the private sector. While we have made some progress in reducing the budget deficit in the past year, the long-term outlook for deficit reduction is not encouraging. For example, there is increasing concern about the projected huge growth in government spending on entitlement programs, such as pensions, social security, and Medicare. Projected out to the year 2030, it is estimated that entitlement spending alone will consume all tax revenue collected by the federal government, leaving no funds to pay for other programs or even to pay interest on the national debt. Controlling these expenditures will be extremely difficult and presents some very difficult choices, including reduc-

ing promised benefits, raising taxes, and perhaps privatizing these programs as is being done in other countries facing a similar dilemma.

As you may know, there are a number of proposals currently circulating in Washington designed to change tax laws to stimulate investment and savings. These include capital gains tax reform, changes in the tax treatment of long-term fixed investment, and switching from an income tax to a consumption or value-added tax to encourage savings. Without commenting on the relative merits of these proposals, I would stress that for any proposed tax changes to have a positive impact on investment and savings incentives they must be fiscally responsible. If such actions result in further increases in the size of the deficit, the long-run effects on savings and investment will be negative, and long-term potential growth will be harmed. Therefore, it is vitally important to continue to emphasize a reduction in government spending as a key ingredient to reducing the budget deficit.

A third key to long-run performance is maintaining a strong and vibrant financial system. Our future growth prospects will be enhanced by a stable financial system that helps channel savings and investment funds to their most productive uses. In this regard, one of the most important developments in the past few years is the return to health of our commercial banking industry. Improved profitability and higher capitalization have allowed banks to put problem loans behind them and have positioned them to meet the credit needs of an expanding economy.

Looking ahead, there are two important changes in the financial environment that may affect financial stability. One change is the growing interdependence of world financial markets, which increases the likelihood that economic or financial problems in one country may spread to other countries. The second change is the growing use of new types of financial instruments such as derivatives.

Recently, we have seen several instances where financial institutions, corporations, and municipalities have experienced large losses from these instruments. Maintaining financial stability in this changing environment will require greater understanding of the risks involved by regulators both here and abroad, and a greater degree of international cooperation among regulators.

The fourth and final key to future prosperity is the one that is central to the mission of the Federal Reserve: price stability. An environment of stable prices contributes to higher potential economic growth by promoting productive investment and savings decisions. From our experience in the 1970s and 1980s, we have seen how quickly an increase in inflationary expectations can be built into market interest rates and distort investment and savings decisions. Moreover, because inflationary expectations are so difficult and painful to eradicate once they become entrenched in the economy, it is vitally important that monetary policy respond quickly to signs of inflationary pressures.

While the near-term outlook for inflation appears favorable, it is important that we do not become complacent. For example, we are seeing increases in the prices of some raw materials and industrial goods and some tightening in labor markets. Thus far, these pressures have been contained and have not been passed along to the prices of final goods because of significant productivity gains. However, measures such as the unemployment rate and the manufacturing capacity utilization rate suggest the economy is now operating past the point of full capacity, which increases the prospects of a pickup in inflation in the months ahead.

It is important to remember that inflation is ulti-

mately a monetary phenomenon. That is, a sustained increase in inflation cannot occur without monetary accommodation. Accordingly, the Federal Reserve's actions to tighten monetary policy this past year look beyond the immediate time period. They are designed to prevent future inflation and, thereby, help ensure that the economy will operate at its long-run potential in the period ahead.

I would note that the response of financial markets recently to our tightening actions has been quite favorable. Long-term bond yields have declined somewhat, as market participants have endorsed the Federal Reserve's vigilant stance against inflation. In addition, the continued strength of consumer spending, business investment spending, and employment growth indicates that both households and businesses share this optimism about the future.

CONCLUSION

In conclusion, I want to emphasize my optimistic assessment about our economy's future. The strong performance of the U.S. economy in 1994 is likely to continue in 1995, but at a more moderate and sustainable pace. The long-run outlook for the economy is also very positive. As I have indicated, however, achieving our economy's full potential in the coming years should not be taken for granted. Rather, it will depend on how successful we are in promoting open international markets, encouraging savings and investment, and maintaining a healthy financial system.

And, as history and recent developments most assuredly tell us, achieving sustainable economic growth in the future will depend crucially on our ability to foster and maintain price stability over time.