The U.S. Economy in 1989: An Uncertain Outlook

By J. A. Cacy and Richard Roberts

After completing a sixth year of uninterrupted expansion, the U.S. economy enters 1989 in remarkably good condition. The nation's output of goods and services is expanding at a moderate pace, employment is showing strong growth, and unemployment appears to have stabilized at a relatively low level. Inflation, moreover, remains within a moderate range, even though it is high by historical standards.

Generally good economic performance is likely to continue throughout 1989, although a number of factors could cause the economy's performance to deteriorate. An important, potentially threatening factor is that the economy is operating at increasingly high capacity levels, raising the possibility that strong inflationary pressures could develop in the period ahead. Unless checked, these pressures could lead to sharply rising interest rates, falling equity prices, and economic recession. With the economy expected to continue growing in 1989, monetary policy will likely focus on preventing rising inflationary pressures from emerging.

After reviewing developments in 1988, this article discusses the economic outlook for 1989 and the uncertainties facing the economy in the coming year.

Strong economy in 1988

The economy performed much better than expected in 1988, especially during the first half of the year, as the anticipated negative fallout from the October 1987 stock market collapse did not materialize. Economic output grew moderately in 1988, employment expanded rapidly, and the unemployment rate declined. Inflation picked up somewhat during the year compared with 1987.

The strong 1988 economy, despite the stock market shock, was due in part to rising export demand, which helped maintain growth in domestic production and income. Also, timely postcollapse monetary and fiscal policy actions

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TABLE 1
Real gross national product and components
(percent change at seasonally adjusted annual rates)

	1987	1988		
	Q4	Q1	Q2	Q3
GNP	6.1	3.4	3.0	2.5
Final sales	0.4	3.6	6.3	2.0
Gross domestic demand	5.4	1.6	1.3	2.5
Personal consumption expenditures	−2.1	4.5	3.0	3.9
Nonresidential fixed investment	1.7	7.6	15.0	4.0
Residential fixed investment	1.3	−6.5	0.2	4.3
Government purchases	5.0	−7.9	3.9	−5.2
Exports	17.7	25.7	9.1	14.5
Imports	9.9	6.9	−3.7	13.1
Addenda				
Inventory investment*	67.1	66.0	35.3	39.5
Net exports*	−126.0	−109.0	−92.6	−93.9

*Level, billions of 1982 dollars
Source: Commerce Department, Bureau of Economic Analysis

helped repair the damage to consumer and business confidence administered by the plunge in stock prices.

Monetary policy maintained an accommodative stance in early 1988, but concern about inflation resulted in some policy tightening as the year progressed.

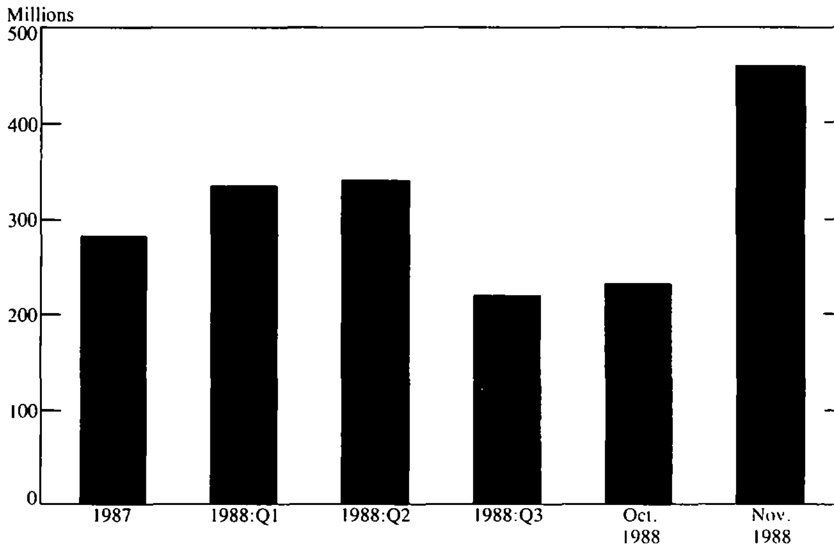
Potential stock market effects

A sudden, sharp drop in stock prices can theoretically affect economic activity in a number of ways. Falling stock prices might precipitate a widespread financial crisis, which in turn would adversely impact the economy. In the absence of a financial crisis, a stock market collapse could directly affect the economy by causing a decline in consumer and business spending. The effect on consumer spending could result from a decline in household wealth, or a drop in consumer confidence about future economic conditions. The effect on business spending could result from an increase in the cost of raising equity capital as well as from a decline in business confidence.

These theoretical linkages between stock prices and the economy are supported by historical experience. While the historical connection between stock prices and the economy is not as close as many contend, past experience shows that stock market declines are frequently followed by economic weakness.

It is not surprising, then, that the stock market collapse generated widespread expectations that economic weakness would develop in late 1987 and early 1988. These expectations appeared highly warranted given the unprecedented magni-

CHART 1
Average monthly change in employment



Source: Labor Department, Bureau of Labor Statistics

tude of the drop in stock prices.

First-half economic strength

Contrary to expectations of economic weakness, real gross national product (GNP) increased at a healthy annual rate of 3.2 percent during the first half of 1988 (Table 1). In addition to strong net exports, economic growth was bolstered by robust consumer spending and sharply rising outlays for capital equipment by the nation's business sector.

The first half's strong economic growth rate was accompanied by large employment gains and a decline in unemployment. Monthly increases in nonfarm payroll employment averaged 343 million during the first two quarters of 1988, up from 286 million in 1987 (Chart 1). These large employment gains were more than enough to absorb ongoing increases in the nation's labor force. As a result, the unemployment rate declined from 5.8 percent in December 1987 to 5.3 percent in June 1988.

Economic strength was also accompanied by signs of rising inflationary pressures, as most price indexes increased more rapidly than in 1987. The Consumer Price Index (CPI) less food and energy, a good measure of underlying inflationary pressures, rose at an annual rate of 4.9 percent in the first two quarters of the year, compared with 4.2 percent in 1987 (Table 2). Labor costs also increased more rapidly in the first half of 1988, with the employment cost index increasing at an annual rate of 4.2 percent during the period, up from 3.3 percent in 1987.

Growth continues after midyear

The economy continued to expand after midyear, although the pace of real GNP growth

TABLE 2
Measures of inflation
(percent change from prior period at seasonally adjusted annual rates)

	Consumer price index		Producer price index			GNP	
Period	All items	All items less food and energy	All items	All items less food and energy	Employment cost index*	Fixed weight index	Implicit price deflator
1987	4.4	4.2	2.4	2.2	3.3	4.0	3.1
1988							
Q1	4.2	5.4	2.7	4.6	3.9	3.5	1.7
Q2	4.5	4.3	3.8	2.4	4.5	5.0	5.5
Q3	4.8	4.0	6.5	6.7	4.5	5.3	4.7
Sept.	4.1	4.9	4.5	7.4	—	—	—
Oct.	5.1	5.9	0.0	−1.0	—	—	—
Nov.	3.0	3.9	3.3	3.1	—	—	—

*Percent change from year earlier in the wages, salaries, and benefits of private industry employees, not seasonally adjusted

Source: Labor Department, Bureau of Labor Statistics and Commerce Department, Bureau of Economic Analysis

slowed to 2.5 percent in the third quarter, compared with 3.2 percent in the first half (Table 1). Net exports declined slightly in the third quarter, as export growth slowed from the rapid first-half pace and import growth picked up. Also, business fixed investment grew less rapidly than earlier in the year. Much of the slower GNP growth in the third quarter was due to a decline in agricultural production caused by widespread drought conditions during the summer months. The drought effect held down economic growth even more in the fourth quarter.

Employment growth continued strong after midyear, although less so than earlier, and unemployment stabilized. Monthly increases in nonfarm payroll employment averaged 276 million during the July-November period, down from 343 million in the first half (Chart 1). The unemployment rate was 5.4 percent in November, about the same as in June.

Inflationary pressures remained fairly strong after mid-1988. While the CPI less food and energy increased somewhat less rapidly than in the first half, other price indexes grew more rapidly (Table 2).

Economy bolstered by net exports

An important factor countering the effects of the stock market collapse and bolstering economic growth in 1988 was the strength of the economy's foreign sector. During the first three quarters of the year, real net exports increased a total of $32 billion. As a result, the international sector accounted for about 37 percent of the total growth in real GNP during the three-quarter period. The rise in net exports reflected a combination of surging exports, which increased at an annual rate of

16 percent during the period, and subdued growth in imports, which rose at a rate of only about 5 percent.

The strength in net exports was due importantly to the lagged effects of past declines in the value of the U.S. dollar, which made U.S. exports more competitive in world markets, while reducing the competitive position of goods imported into the country. Also, U.S. export growth was aided by continued expansion in most foreign economies.

The U.S. dollar's foreign exchange value trended upward during much of 1988, but declined in October and November (Chart 2). The somewhat surprising strength in the dollar was due in part to increases in U.S. interest rates and to the strong rise in net exports, which bolstered international confidence that the large U.S. trade imbalance was being redressed. The dollar weakness in the fall of 1988 reflects in part renewed concern about the long-run outlook for the trade deficit.

Policy actions strengthen confidence

Another factor contributing to economic strength in 1988 was the Federal Reserve's monetary policy. The System's timely actions in the wake of plunging stock prices helped avert widespread financial instability and bolstered consumer and business confidence. Timely fiscal policy actions in the fall of 1987 also helped shore up confidence in the economy.

The most urgent danger immediately following the stock market collapse was that a widespread financial crisis would develop. The Federal Reserve responded to this danger by announcing on October 20, 1987 its readiness "to serve as a source of liquidity to support the economic and financial system."[1] Also, in telephone conferences held daily in the last two weeks of October, the Federal Open Market Committee (FOMC) agreed on the need to meet promptly any unusual liquidity requirements of the economic and financial system. In the process of meeting these liquidity requirements, the Federal Reserve used open market operations to reduce the degree of pressure on bank reserve positions shortly after October 19 and again late in the month.[2]

As a result of these actions, nonborrowed reserves held by the banking system rose sharply in late October and short-term interest rates declined. Long-term interest rates also dropped following the stock market collapse, as funds withdrawn from the stock market were placed in the bond market.

While monetary policy actions helped steady financial markets in the immediate postcollapse period, widespread concern remained that the economy could be entering a period of weakness, a concern that was shared by the Federal Reserve and supported by ongoing developments.[3] Consequently, from early November through late January, the FOMC sought to maintain the reduced degree of pressure on reserve positions that was sought in late October.[4] In late January

[1] See press release, Board of Governors of the Federal Reserve System, October 20, 1987.

[2] Record of Policy Actions of the Federal Open Market Committee, meeting held on November 3, 1987, *Federal Reserve Bulletin*, Board of Governors of the Federal Reserve System, February 1988, pp. 113-14.

[3] Record of Policy Actions of the Federal Open Market Committee, meeting held on November 3, 1987, *Federal Reserve Bulletin*, Board of Governors of the Federal Reserve System, February 1988, p. 115.

[4] Record of Policy Actions of the Federal Open Market Committee, meeting held on November 3, 1987, *Federal Reserve Bulletin*, Board of Governors of the Federal Reserve System, February 1988, p. 119; and Record of Policy Actions of the Federal Open Market Committee, meeting held on February 9-10, 1988, *Federal Reserve Bulletin*, Board of Governors of the Federal Reserve System, May 1988, p. 319.

and early February, moreover, some further easing was sought in the degree of reserve-position pressure.[5]

Short-term interest rates remained at the immediate postcollapse levels in late 1987 and early 1988 (Chart 3). Long-term interest rates also remained below precollapse levels in the latter part of 1987 and declined further in early 1988 (Chart 4).

The continued accommodative monetary policy, along with the lower interest rates, apparently bolstered consumer and business confidence in the economy. Confidence was likely buoyed as well by some rebound in stock prices and reduced stock price volatility, and by the continued growth in employment and income. An important fiscal policy development occurred in late 1987 that also helped bolster confidence in the economy. The Administration and the Congress agreed to take action reducing the budget deficit for fiscal years 1988 and 1989.

Inflation concerns emerge in spring and summer

By the spring and early summer of 1988, evidence mounted that the economy was remaining strong and the prospect of economic weakness was diminishing. At the same time, greater concern emerged that inflationary pressures were increasing. At the March FOMC meeting, members generally agreed that recently available information pointed to a stronger expansion in business activity than earlier anticipated. Also, most members agreed that the risks of more inflation stemming from capacity pressures had increased, and the economy might be near the point where faster growth in business activity would induce greater inflation. In addition, some concern was expressed about the inflationary potential of recent rapid growth in the broader monetary aggregates.[6]

Given the improved economic outlook, and, in view of the increased concern about inflation, the FOMC decided at its March meeting to increase slightly the degree of pressure on bank reserve positions.[7] Due to continued concern about inflation, reserve-position pressure was increased further in late May, in late June, and in early July.[8] Then, on August 9, the Federal Reserve Board approved an increase in the discount rate from 6 to 6½ percent. In announcing this action, the Board of Governors said, "The decision reflects the intent of the Federal Reserve to reduce inflationary pressures. The action also was taken in light of the growing spread of market interest rates over the discount rate."[9]

After midyear, FOMC members continued to express concern about the possibility of rising inflation. In view of the tightening steps taken

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5 Record of Policy Actions of the Federal Open Market Committee, meeting held on February 9-10, 1988, *Federal Reserve Bulletin*, Board of Governors of the Federal Reserve System, May 1988, p. 320.

6 Record of Policy Actions of the Federal Open Market Committee, meeting held on March 29, 1988, *Federal Reserve Bulletin*, Board of Governors of the Federal Reserve System, July 1988, pp. 470-72.

7 Record of Policy Actions of the Federal Open Market Committee, meeting held on March 29, 1988, *Federal Reserve Bulletin*, Board of Governors of the Federal Reserve System, July 1988, p. 473.

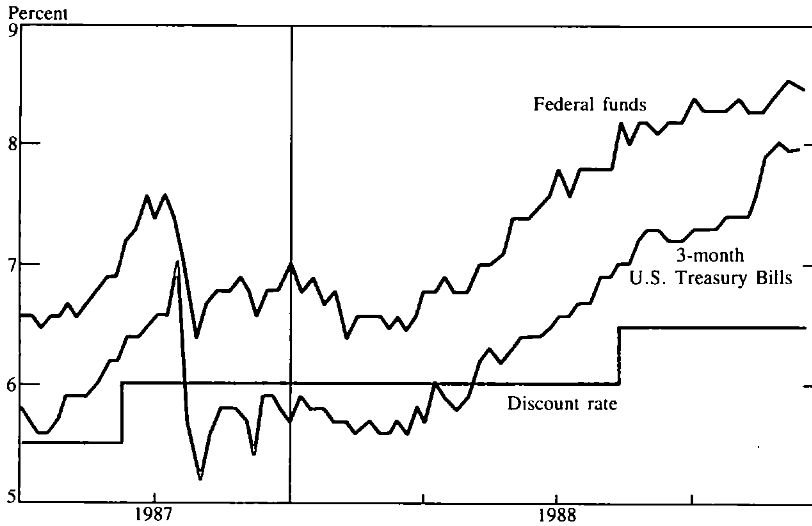
8 Record of Policy Actions of the Federal Open Market Committee, meeting held on June 29-30, 1988, *Federal Reserve Bulletin*, Board of Governors of the Federal Reserve System, October 1988, p. 655; and Record of Policy Actions of the Federal Open Market Committee, meeting held on August 16, 1988, *Federal Reserve Bulletin*, Board of Governors of the Federal Reserve System, November 1988, p. 755.

9 See press release, Board of Governors of the Federal Reserve System, August 9, 1988.

CHART 2
Exchange value of the U.S. dollar, 1987-88

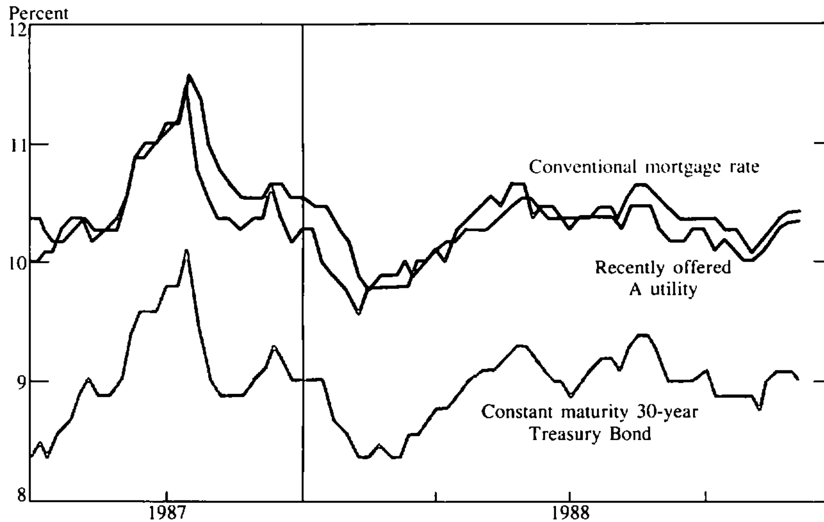
NOTE: Weighted average of the exchange value of the dollar against currencies of other G-10 countries plus Switzerland
Source: Board of Governors of the Federal Reserve System

CHART 3
Selected short-term interest rates, 1987-88



Source: Board of Governors of the Federal Reserve System

CHART 4
Selected long-term interest rates, 1987-88



Source: Board of Governors of the Federal Reserve System

earlier, however, and, with the economic growth rate apparently slowing somewhat, the FOMC sought to maintain an unchanged degree of reserve-position pressure during the late summer-fall period.[10]

Short-term interest rates, after easing slightly in early 1988, trended upward throughout most of the year (Chart 3). Long-term interest rates increased in the spring, but subsequently trended downward, due perhaps in part to a lowering of inflation expectations in light of the display of Federal Reserve resolve to contain inflation. Long-term interest rates rose again in the fall, due to concerns about the dollar and the U.S. budget deficit (Chart 4).

The economy in 1989

Generally good economic performance is likely to continue throughout 1989. Several factors, however, could adversely affect the economy's performance during the year. In addition to the possibility of rising inflation, threats to good economic performance are posed by continued large budget and trade deficits, and by the high and growing debt levels carried by the nation's households and businesses. The overhang of international debt and the poor condition of many of the nation's financial institutions could also cause macroeconomic problems.

[10] Record of Policy Actions of the Federal Open Market Committee, meeting held on August 16, 1988, *Federal Reserve Bulletin*, Board of Governors of the Federal Reserve System, November 1988, pp. 756-57, 759; and Record of Policy Actions of the Federal Open Market Committee, meeting held on September 20, 1988, pp. 5, 7, 12.

Economic growth to continue

Moderate economic growth is likely to continue in 1989. Real GNP growth will be strengthened by a recovery of farm output to normal levels compared with 1988's drought-reduced output. Excluding this factor, the nonfarm economy is likely to grow within a range of 2 to 3 percent. Rising net exports are again expected to provide some strength, as the 1986-88 downward trend in the dollar continues to spur export growth and contain import expansion. Business fixed investment also will help bolster the economy, as businesses invest to alleviate capacity constraints. Residential investment, however, will add little to economic growth in 1989. Heavy debt burdens and only modest growth in incomes, moreover, will result in slow growth in consumer spending.

Moderate economic growth in 1989 will be accompanied by continued growth in employment. Unlike 1988, however, employment growth may be less than labor force growth, so the unemployment rate may increase slightly.

The outlook is for relatively stable inflation in 1989. Increases in industrial capacity and labor-force growth likely will allow moderate economic growth to proceed without greatly spurring underlying inflationary pressures. Overall inflation will be affected by the behavior of oil prices, which will depend importantly on whether the Organization of Petroleum Exporting Countries (OPEC) is able to enforce constraints on oil production. Due to the ongoing impact of the 1988 drought, food price increases are expected to boost inflation in 1989.

Inflation could accelerate in 1989

An important troublesome factor in the economic outlook is the possibility of unexpectedly strong inflationary pressures. The economy appears to be operating at or near full capacity, in both labor and product markets. As a result, demand and supply forces are delicately balanced, so that a shock to the economy could strengthen inflationary pressures. For example, a sharp rise in the economic growth rate could quickly create excess demand in product and labor markets, and place sharp upward pressure on labor costs and prices.

In judging the extent that the economy may be operating near full capacity, economists often focus on the behavior of the capacity utilization rate in industry. Rising capacity use rates indicate increasing pressure on the economy's resource base. Higher utilization brings less efficient, higher cost capacity into production and is often accompanied by tighter labor markets that put further upward pressure on wages.

Capacity utilization rates in industry have increased considerably over the past year. Utilization rates have increased in all three major industrial categories—manufacturing, mining, and utilities. For industry as a whole, the increases pushed the utilization rate in November 1988 to 84.2 percent, more than two percentage points higher than a year earlier (Table 3).

Comparison of current capacity utilization rates with average rates over the last 20 years shows that the important manufacturing sector is experiencing the greatest capacity pressures. The utilization rate for manufacturing of 84.5 percent in November 1988 was 3.9 percentage points above its 1967-87 average (Table 3). The capacity utilization pressures in manufacturing have arisen due to strong export demand for manufacturing output as well as to firm domestic demand.

Not only is the manufacturing capacity utilization rate noticeably above the 20-year average, it appears to be near a level that in the past has been associated with rising inflation. Sustained acceleration of inflation typically has occurred when the manufacturing utilization rate has risen past a threshold level. While the threshold level is generally consistent with stable inflation, rates of utilization above the threshold are associated

TABLE 3
Capacity utilization rates for major industrial sectors
(percent of capacity, seasonally adjusted)

	Nov. 1988	Dec. 1987	Nov. 1987	1967-87 Average
Total industry	84.2	82.4	82.1	81.5
Manufacturing	84.5	82.6	82.2	80.6
Durable	83.1	80.1	79.9	78.7
Nondurable	86.5	86.4	85.6	83.5
Mining	82.2	81.5	81.5	86.7
Utilities	81.0	80.0	81.2	86.9

Source: Board of Governors of the Federal Reserve System

with increasing inflation. Econometric studies suggest that the threshold rate of capacity utilization for manufacturing is within a range of 78.5 to 83.5 percent.[11]

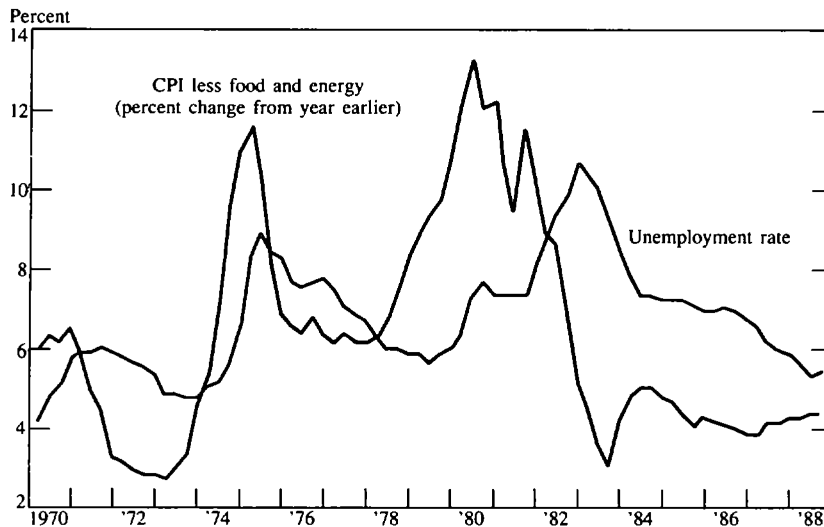
The recent rise of the rate of capacity utilization in manufacturing to a level slightly above the upper end of the estimated threshold range justifies concern about the possibility of rising inflation. The extent that capacity constraints contribute to greater inflation in the period ahead depends on the strength of demand for manufactured goods and on the growth of capacity. Rapid growth of domestic demand for manufactured goods in 1989, combined with rapid growth in exports, would place further pressure on industrial capacity and threaten higher inflation. But the expected, more moderate domestic demand growth will likely allow manufacturers to expand their export volumes without raising the utilization rate much further. Moreover, growth in business fixed investment has been strong recently and is expected to continue moderately strong in 1989. New investment will increase capacity over time and alleviate inflationary pressures emanating from capacity constraints.

Another measure often used in judging the extent that the economy is operating at full capacity is the unemployment rate. A declining unemployment rate indicates that the supply of labor is growing more slowly than labor demand, which tends to place increasing upward pressure on wages and the economy's overall inflation rate.

Historical experience supports the notion of a linkage between the rate of inflation and the rate of unemployment. As shown by Chart 5, declines in unemployment tend to be followed, after a time lag, by increases in inflation, while increases in unemployment tend to be followed by declines

[11] See Rose McElhattan, "Estimating a Stable-Inflation Capacity-Utilization Rate," *Economic Review*, Federal Reserve Bank of San Francisco, Fall 1978, pp. 20-30; and Rose McElhattan, "Inflation, Supply Shocks and the Stable-Inflation Rate of Capacity Utilization," *Economic Review*, Federal Reserve Bank of San Francisco, Winter 1985, pp. 45-63. For a further discussion of capacity utilization rates, see C. Alan Garner, *Financial Letter*, Federal Reserve Bank of Kansas City, June 1988.

CHART 5
Consumer Price Index (less food and energy) and unemployment rate, 1970–88



Source: Labor Department, Bureau of Labor Statistics

in inflation. A straightforward interpretation of Chart 5 implies that a rise in the inflation rate can be expected in 1989 because unemployment declined over the past year. Moreover, if unemployment continues to decline, inflation will accelerate further. But, if unemployment remains stable, inflation will stabilize following the 1989 upward movement.

Most economists agree that the linkage between inflation and unemployment is more complicated than indicated by a straightforward interpretation of Chart 5. In analyzing the true relation between inflation and unemployment, economists use the concept of the full employment rate of unemployment, also referred to as the natural rate of unemployment. According to this approach, as with the threshold capacity utilization rate, there is a particular natural rate of unemployment that is consistent with stable inflation. When the actual unemployment rate falls below this natural level, the rate of inflation tends to accelerate.

The implications of this theory for inflation in the period ahead depend on the value of the natural unemployment rate. For example, if the natural rate of unemployment were 6 percent, which is above the actual unemployment rate of 5.4 percent in late 1988, the theory implies that inflation would accelerate in 1989. Moreover, inflation would continue to accelerate until the unemployment rate increased to 6 percent. On the other hand, if the natural unemployment rate were around the current level of 5.4 percent, inflation would not accelerate unless unemployment declined further.

Economists have made numerous attempts to measure the natural rate of unemployment. It has been variously estimated to lie between 5 and 7 percent, although a wider range is possible. Most

economists would probably agree that the natural rate is likely not below 5 percent.[12]

As with the manufacturing capacity utilization rate, therefore, the current unemployment rate appears to be near a point that indicates an economy operating very close to full capacity. Thus, the danger of inflation accelerating is relatively high, particularly if unexpectedly vigorous economic growth pushes the capacity utilization rate sharply higher and the unemployment rate sharply lower.

The dollar and the trade deficit in 1989

Another concern about the outlook for 1989 is the future course of the nation's international trade deficit and the foreign exchange value of the U.S. dollar. Lack of progress in reducing the trade deficit could lead to dollar weakness and adversely impact the U.S. economy.

Considerable progress has been made in the past year in reducing the trade deficit. In nominal terms, the merchandise trade deficit averaged $11.3 million per month during the first ten months of 1988, down from $14.3 million during the comparable period in 1987. The improvement has been due mainly to strong export growth spurred by a lower dollar and economic growth abroad. Somewhat slower import growth has also contributed to the decline in the trade deficit.

A further improvement in the trade deficit is likely in 1989. It is unclear, though, whether continued growth in net exports and improvement in the trade deficit will require further declines in the dollar. In any event, most economists agree that long-run progress in reducing the trade deficit hinges importantly on progress in reducing the U.S. budget deficit. A lower budget deficit would reduce domestic demand, thereby freeing resources for exports and reducing the need for imports.

For this reason, any perceived lack of progress toward reducing the budget deficit could cause investors to lose confidence in the nation's ability to redress the trade imbalance. Loss of confidence could lead to sharp downward pressure on the dollar and higher U.S. interest rates, as foreigners withdraw their funds from dollar-denominated assets. The rise in interest rates, along with inflationary pressures emanating from the declining dollar, could then weaken the U.S. economy.

TABLE 4

U.S. budget deficit, national debt, and interest on debt as percent of gross national product, selected periods

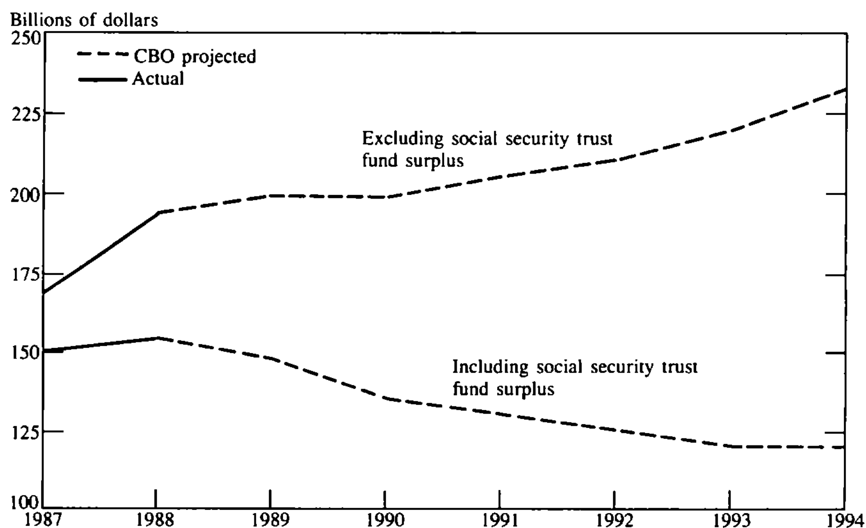
	Percent of GNP		
Period	Deficit	Debt*	Interest on debt
1980	2.8	26.8	2.0
1987	3.3	43.0	3.1
1988	3.2	42.6	3.2
1989 projection	2.9	42.7	3.2
1994 projection	1.7	40.1	2.9

*Debt held by the public

Source: For the years 1980, 1987, and 1988, "Historical Tables—Budget of the United States Government, Fiscal Year 1989," Office of Management and Budget; for the projected years 1989 and 1994, "The Economic and Budget Outlook: An Update," Congressional Budget Office, August 1988

[12] See Stuart E. Weiner, "The Natural Rate of Unemployment: Concepts and Issues," *Economic Review*, Federal Reserve Bank of Kansas City, January 1986, p. 23.

CHART 6
Federal budget deficits, 1987-94



Source: Congressional Budget Office

The need to reduce the budget deficit

The budget deficit is a third area of concern about the economic outlook. In addition to generating doubts about the future of the trade deficit and creating dollar weakness, failure to make credible progress in reducing the budget deficit could fuel inflationary expectations, placing further upward pressure on interest rates. Continued large budget deficits also constrain the use of stimulative fiscal policy in the event of recession, reducing the flexibility of the federal government's economic stabilization efforts. Over the longer run, continued large budget deficits hinder economic growth by reducing the flow of savings available for private investment and add to the debt-servicing burden of future generations.

As shown in Chart 6, the budget deficit increased in fiscal year 1988 to $155 billion, up from $150 billion in 1987. As a percent of GNP, the deficit was 3.2 percent in 1988, about the same as in 1987 (Table 4). According to estimates made by the Congressional Budget Office (CBO), if no further efforts are made to reduce the deficit, it will decline to $148 billion in fiscal year 1989 and decline further to $121 billion by 1994 (Chart 6). The budget deficit excluding the social security trust fund was significantly higher in 1988 than the deficit including the fund and is estimated to increase rather than decline over the CBO projection period. These CBO deficit estimates assume continued moderate economic growth and some decline in interest rates.[13] Assumptions of

[13] The Congressional Budget Office projections assume an average real GNP growth rate of 2.4 percent during the 1989-94 period. Also, the projections assume that the three-month U.S. Treasury bill rate declines from an average of 7.1 percent in 1989 to 5.9 percent in 1994. See "The Economic and Budget Outlook: An Update," Congressional Budget Office, August 1988.

rising interest rates or of a recession would result in higher deficit projections.

The 1988 deficit boosted the national debt to $2.0 trillion at the end of the year, placing the debt at 43 percent of GNP, slightly less than in the previous year, but sharply higher than the 27 percent of 1980 (Table 4). Due to this sharp rise in national debt, interest on the debt has skyrocketed in recent years, amounting to $155 billion, or 3.2 percent of GNP in 1988, up from 2.0 percent in 1980. According to the CBO projections, if no further efforts are made to reduce the deficit, the interest-on-the-debt/GNP ratio will remain near the relatively high current level during the projection period, even as the deficit declines.

Private debt burdens

The heavy debt burdens carried by the private sector provide an additional source of concern for the economy in 1989. Private debt has increased sharply in the 1980s, both absolutely and relative to GNP. By 1987, the private-debt/GNP ratio had reached a record high level of 122 percent, up from 101 percent in 1980 (Table 5). The rise in debt emanated from both households and businesses. While the private-debt/GNP ratio declined slightly in the first half of 1988, it remains near a record level.

For a significant portion of households and businesses, the unusually heavy debt burdens could become unmanageable during a period of rising interest rates or a recession period of declining revenues and incomes. This in turn could prolong and deepen any period of economic weakness that develops. Another possibility is that, during a period of uncertainty about the economy that develops for any reason, a significant number of households and businesses could simultaneously attempt to reduce their debt burdens, thereby precipitating economic weakness that would exacerbate their debt-reducing task.

TABLE 5
Private debt outstanding, as percent of gross national product, selected periods

	Percent of GNP		
Period	Households	Businesses	Total private
1980	50.9	50.1	101.0
1987	59.6	62.1	121.7
1987 Q3	59.4	62.0	121.4
Q4	59.6	62.4	122.0
1988 Q1	60.1	63.1	123.2
Q2	59.4	62.1	121.5

Source: Board of Governors of the Federal Reserve System

Monetary policy in the new year

Given the threat of rising inflation, the Federal Reserve in 1989 will likely continue to focus on dampening emerging inflationary pressures, while continuing to provide sufficient money and credit expansion to support moderate economic growth. Over the longer run, the Federal Reserve seeks reasonable price stability, implying an inflation rate below that experienced in recent years.

In accordance with the long-run goal of price stability, and with the need to contain near-term inflationary pressures, the FOMC set tentative growth rate ranges for the monetary and credit aggregates for 1989 that were lower than the 1988 ranges. M2's range was reduced to 3 to 7 percent, one percentage point lower than 1988's range. The ranges for M3 and domestic nonfinancial debt were reduced one-half percentage point to 3½ to 7½ and 6½ to 10½, respectively (Table 6). The Federal Reserve was able to achieve its monetary growth objectives in 1988,

TABLE 6
FOMC growth rate ranges
(percent change at seasonally adjusted annual rates)

Period	M1	M2	M3	Domestic non-financial debt
1988 actual*	4.0	5.4	6.4	8.8
1988 FOMC growth ranges	—	4–8	4–8	7–11
1989 tentative ranges	—	3–7	3.5–7.5	6.5–10.5

*Fourth-quarter 1987 through November 1988
Source: Board of Governors of the Federal Reserve System

as the actual growth rates of all three aggregates were well within their specified ranges.

In implementing policy in 1989, the Federal Reserve will continue to be guided by a number of factors, including the evolving outlook for inflation, the strength of business conditions, developments with regard to the dollar, and the behavior of the monetary and credit aggregates. Unexpected strength in business conditions, signs of greater inflationary pressures, and pronounced or sustained dollar weakness are developments that may call for greater pressure on bank reserve positions and increases in the discount rate. An easing in the pressure on reserve positions and a downward adjustment in the discount rate may occur in the event of weaker-than-expected economic growth, accompanied by an improved outlook for inflation and stability of the dollar.

Summary

The generally good performance exhibited by the U.S. economy in recent years is likely to continue throughout 1989. Continued moderate economic growth, rising employment, and little marked change in unemployment and inflation appear to be the most likely prospects for the 1989 economic scene.

A number of factors, however, could cause the economy's performance to deteriorate. A perceived failure to make progress in reducing the U.S. budget deficit could fuel inflationary expectations and cause a loss of confidence in the nation's ability to redress its large trade imbalance. These developments could result in a further decline in the U.S. dollar, higher interest rates, and, perhaps, a recession. Alternatively, an unexpected spurt in the pace of economic growth, given the extant capacity constraints, could fuel inflationary pressures, boost interest rates, and lead to economic weakness. Problems created by rising interest rates and recession would likely be exacerbated by the large debt burdens currently carried by households and businesses, the overhang of international debt, the poor condition of many of the nation's financial institutions, and fiscal policy's reduced recession-fighting flexibility brought on by the large budget deficit.

Given the threat of rising inflation caused by capacity constraints, the Federal Reserve will likely continue in 1989 to focus on dampening any inflationary pressures that emerge, while continuing to provide sufficient money and credit

expansion to support moderate economic growth.

As inflationary pressures are contained in 1989, continued moderate economic growth and generally good economic performance will provide the opportunity to make progress in reducing the U.S. trade and budget deficits and to deal with other national economic problems. Utilization of this opportunity would reduce the threat of near-term economic instability while contributing to a healthy economy in the long run.