THE ECONOMIC OUTLOOK AND LONG-RUN GROWTH

Comments by
THOMAS M. HOENIG
President, Federal Reserve Bank of Kansas City

to

Capital Formation Conference
Kansas City, Missouri

June 5, 1996

INTRODUCTION

I am pleased to have this opportunity to share with you some of my thoughts on the current and prospective state of the U.S. economy. My subject, of course, blends well with the focus of your conference on capital formation, because strong growth in capital formation is a necessary and vital ingredient for a healthy economy. At the outset I want to say that I am very optimistic about the U.S. economy. Economic growth is expanding at a solid pace, unemployment is relatively low, and inflation is moderate. Moreover, we are now beginning to look at ways, as you are doing at this conference, on how to enhance economic growth. So today, I also want to take a few minutes to discuss our country's potential economic growth rate.

THE NATIONAL ECONOMIC OUTLOOK

Let me begin by looking at current U.S. economic conditions. In the first quarter of this year, real GDP was reported to have increased at a 2.3 percent annual rate. Despite unusually severe weather in January, a GM layoff, and continued restraint on federal government spending, real final sales increased at a very healthy 3.7 percent annual rate. Sources of strength in the first quarter included spending by consumers, particularly on durable goods, and spending by businesses, particularly on computer equipment. Partly offsetting the strength from these sectors was a decline in net exports and business inventories.

The Near-Term Outlook for Economic Growth

Looking ahead, I expect real GDP growth to remain solid over the remainder of this year and on into next year. In the near term, we will very likely see growth at an even faster pace than in the first quarter, perhaps around 3 percent in the current quarter. This outlook reflects the likelihood of a continued bounce back of the economy from earlier bad weather and the GM strike. In addition, given a continuation of solid growth in final demand, businesses will likely raise the pace of their inventory investment in the second quarter. Consistent with this view are most of the limited monthly data that we have for April and May. For example, consumer confidence is high, and housing and auto sales are solid. And, although indicators of manufacturing activity have been mixed recently, they are nevertheless consistent with rising activity, at least outside the volatile transportation equipment industry.

In the second half of this year, I expect economic growth to taper off a bit toward a 2 percent annual rate. Higher long-term interest rates will act to dampen activity somewhat in certain interest rate sensitive sectors of the economy, such as consumer spending and business-fixed investment. But from my perspective, this is a good outlook for the U.S. economy because economic growth remains solid and moves toward its long-run potential.

The risks to this outlook appear to be roughly balanced. On the downside, rising debt burdens could dampen spending by consumers, and sluggish growth abroad could reduce demand for our exports. On the upside, businesses might invest in new plant and equipment and build inventories at a pace greater than we currently expect.

The Near-Term Outlook for Inflation

Turning to inflation, the news also has been largely positive. Last year, inflation as measured by the consumer price index increased 2.7 percent, the third consecutive year that CPI inflation was below 3 percent. The core CPI, which excludes the volatile food and energy items, increased just 3 percent. Such overall price behavior was impressive from a business cycle perspective. In the past, an economic expansion of the current length would typically have been associated with more inflation by now. That inflation has not increased more rapidly this time is importantly linked, I believe, to the preemptive tightening moves taken by the Federal Reserve in 1994 and early 1995.

While recent developments have been generally positive, I would quickly add that we cannot become complacent about the inflation outlook. So far this year, core CPI inflation is still at 3 percent, and the overall CPI has risen to 4.1 percent due principally to sharply higher food and energy prices. While these increases in food and energy prices are expected to be temporary, we need to be alert that such "price shocks" do not enter into inflation expectations.

We also need to be mindful about the current level of economic activity relative to the economy's full productive potential. For example, the unemployment rate is currently 5.4 percent, below most estimates of full employment. In the past, inflation has tended to rise when labor markets have become as tight as they appear to be today. Recent increases in various wage measures, though mixed, tend to support this view. Moreover, in my travels throughout this region of the country, I have been given numerous, albeit anecdotal, reports of labor shortages.

As for my outlook, I expect inflation to remain moderate this year, provided the economy does not grow much beyond its potential. For the year as a whole, it is likely that economic growth will be somewhat above its potential of about 2 percent, with core CPI inflation slightly above 3 percent. But, should the economy grow substantially faster than its potential, we could see a more significant increase in inflation this year and especially next year.

THE U.S. ECONOMY'S LONG-RUN GROWTH POTENTIAL

Within this context of a currently strong U.S. economy, let me turn briefly to the topic of our country's potential economic growth rate, which has gained considerable attention lately. At issue in recent discussions is how fast the economy can grow without causing inflation to worsen.

Conventional estimates indicate that potential economic growth, as measured by GDP, is about 2 to 2 1/4 percent per year. Continued growth above this range, it is believed, with the economy at or near full capacity, would cause inflation to rise. However, a number of persons have recently challenged this view, suggesting that potential growth might be substantially higher than 2 to 2 1/4 percent. If so, the economy would be able to grow markedly faster than commonly thought without fueling inflationary pressures. Clearly, this is an important issue, with implications for monetary policy. The higher the economy's potential growth rate, the more the Federal Reserve could follow an accommodative monetary policy stance without fearing an increase in inflation.

Potential GDP Growth in the 1990s

My view is that the conventional estimates of economic growth are fundamentally correct. In arriving at this assessment, it is useful to recognize that potential growth of GDP is roughly the sum of two components: labor force growth, which is the number of workers in the labor force, and productivity growth, which is the output efficiency of the labor force. Over recent years, potential economic growth, and hence growth in its components, has varied dramatically. In the 1960s and early 1970s, potential growth exceeded 4 percent a year, with labor force growth about 2 percent and productivity growth above 2 percent. In the 1980s, however, the economy's potential growth dropped to about 2 ½ percent annually. During that time, labor force growth was near 1 ½ percent and productivity growth slowed to about 1 percent.

In the 1990s, the outlook is for continued slow growth in these two components of potential economic growth. For example, Department of Labor estimates that labor force growth will be only 1 percent over the ten-year period from 1994 to 2005, due mainly to smaller gains in the labor force participation rates of women. Productivity growth is estimated by most economists as likely to remain at 1 percent over the near term. Thus, overall potential economic growth is likely to be close to 2 percent in the 1990s, down from the 2 1/2 percent rate in the 1980s and the 4 percent rate in the 1960s.

Faster productivity growth, of course, could result in a more rapid potential economic growth rate. Unfortunately, in my view, such a development is unlikely. This point is controversial, however, and is the source of much the debate over potential economic growth. Proponents of the higher potential growth view argue that productivity growth has increased and will continue to do so. As a result, they believe the conventional estimates of potential growth are simply too low.

But the fact remains there is virtually no hard evidence at the present time of any increase in long-term productivity growth. Research done at the Federal Reserve Bank of Kansas City, the Board of Governors, the President's Council of Economic Advisors, and elsewhere has so far failed to detect any significant increase in productivity growth in the 1990s. Last year is a case in point. The Commerce Department has reported that productivity grew only 0.7 percent in 1995, on a fourth quarter over fourth quarter basis.

Nonetheless, there is a belief that recent technological advances and corporate downsizings should be enhancing productivity growth. For whatever reason, though, such as the possibility of a lengthy time lag between technological advances and productivity increases, the existing data offer little support for this view.

For monetary policy purposes, fortunately, the Federal Reserve does not require a precise estimate of potential economic growth. As

Chairman Alan Greenspan indicated in recent Congressional testimony, "persistent deviations of actual growth from that of capacity potential will soon send signals that a policy adjustment is needed." Under present circumstances, with the U.S. economy operating at or near full capacity, an increase or decrease of actual GDP growth relative to potential would soon provide evidence of a need for monetary policy actions.

For example, over the last two years, if the economy had been growing slower than potential, we would have seen factory capacity use rates steadily decline and the unemployment rate steadily rise. Instead, we saw the opposite happen, suggesting the economy has not been growing slower than its potential. Looking ahead, we continually monitor a variety of real and financial market indicators that can signal the need to adjust monetary policy. If these indicators signal that GDP is expected to grow slower than potential, the Federal Reserve can certainly ease monetary policy to accommodate faster long-run growth.

Policies for Boosting Potential GDP Growth

Let me quickly emphasize that I do not believe we as a nation should be satisfied with potential economic growth of 2 to 2 1/4 percent. We should strive to do better. In order to increase potential growth we need to look at its two major components. Labor force growth, of course, reflects long-run demographic forces and, as such, largely falls outside the scope of public policy. But productivity growth, I believe, can be enhanced.

One key to improving productivity growth, and hence potential economic growth, is to provide a positive climate for savings and investment. The economy's growth potential depends critically on our ability to provide incentives to make productive investment decisions, and for households and businesses to generate savings necessary to finance these investments. Unfortunately, in the matter of generating savings to finance investment, our economy has fallen behind where it was in the 1960s and behind a number of other industrialized countries as well.

A major reason our economy has slipped in terms of generating savings and investment is the large federal government budget deficits of recent years. These deficits have absorbed financial resources from the private sector, increased the cost of capital, and thereby inhibited productive investment and enhancements to the country's growth potential. It is vitally important, therefore, that we continue to reduce and ultimately eliminate these deficits.

Another key to improving productivity and long-run economic growth is to ensure that the U.S. work force is well-educated and well-trained. New technologies are of limited use if workers do not have the skills to take advantage of these technologies. Frankly, I am concerned that worker skills are increasingly falling short of job requirements.

Finally, and within the context of enhancing economic growth, I believe the Federal Reserve can best do its part by assuring an economic environment of stable prices. Such an environment reduces uncertainties and distortions in the economy, promotes lower market interest rates, and encourages productive investment and long-run economic growth.

CONCLUSION

In conclusion, I want to emphasize my optimistic assessment about our economy's future. In the near term, I expect to see healthy economic growth and moderate inflation. Real GDP is expected to grow somewhat faster than 2 percent in the first half of 1996 and near 2 percent in the second half of the year. Over the longer term, economic growth of roughly 2 percent should maintain full resource utilization and contain inflationary pressures.

We at the Federal Reserve would certainly welcome faster economic growth, provided it is sustainable over time in an environment of price stability, and hopefully achieved by means of increased savings, capital formation, and productivity growth. Such a development would not only improve our country's standard of living but would provide the opportunity to address some of our country's other economic challenges in the period ahead.