Economic Prospects for 1986

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The economic forecast for 1986 is expected to show a much more modest growth than that of 1984 and 1985, mostly due to increases in imports, causing a reduction in domestic production.

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A Speech to the Annual Correspondents Conference of
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November 14, 1985
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A cynic once said that economic forecasting is neither an art nor a
science -- it is a hazard. The present time is a good example of what he
meant. Most forecasters are now lowering their predictions of real economic
growth for 1985 and 1986. This shift comes soon after a period in which
economists were raising their projections of growth for the American economy.
Not too surprisingly, all this has not exactly inspired public confidence in
the ability of economists to make reliable forecasts. The harsh reality is
that economists are not good at estimating the economy's performance for very
short time periods, such as the next month or quarter. However, the record
for forecasts of year-to-year changes is much better.

For example, each month a group of 50 professional economic forecasters
provides a consensus estimate for the year ahead. The result is called Blue
Chip Economic Indicators. The forecast made by the panel in October of each
year is especially important, because that month is the typical starting point
for the annual company planning cycle.

Over the past eight years, the Blue Chip panel's October estimates of
real growth for the next year have turned out to be within 1.2 percentage
points of the actual figure. The record on inflation is about the same, with
the Blue Chip panel averaging within 1.1 percentage points. That record will not qualify for the Guinness Book of World Records, but it suggests why government and business executives continue to rely on economic forecasts.

When we step back from the details of econometric models, we can spot some basic trends. Virtually all forecasters are now singing a variation of the same song: 1985 and 1986 are not going to be nearly as good as 1984. But the economy will continue to grow, by between 2 and 3 percent. That compares to almost 7 percent last year.

The basic reason for the slowdown is that domestic production is much weaker than domestic consumption. The difference, of course, is due to the rising tide of imports. For a while, consumer credit can finance the gap between income earned and money spent. But most people's spending ultimately reflects their income. Thus, the more modest pace of domestic production and income generation is slowing down the purchases of American consumers.

As usual, there is a range of viewpoints among professional forecasters. The optimists see the GNP accelerating in 1986, as the economy gets its second wind. The pessimists expect the next recession to start some time in the coming 12 months. Personally, I am in the middle of the road.

I do not now see the seeds of the next recession. They may be there, but their sprouts are not yet visible to the naked eye. The usual factors that precede a recession are not present. Consumer sentiment, judged by the standard surveys, remains high. Significant excess capacity exists in American industry; in fact business investment continues at a high level. Inventories are balanced with sales. Interest rates are not rising; rather it is the money supply that is rising at a rapid clip. There is not much oomph in the economy, but there is nothing seriously pushing it down.
By 1986, however, the recovery will be four years old; that is rather mature when we consider past business cycles. It is not, however, an adequate reason for projecting the end of the expansion in the economy. It is an occasion for sounding a note of caution. The recovery is at the stage where it is susceptible to all sorts of negative influences that could lead to a downturn, but I do not now see the onset of recession.

**HIGHLIGHTS OF ECONOMIC FORECAST**

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<th>1985</th>
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<tr>
<td>Real GNP</td>
<td>+2.4%</td>
<td>+3.0%</td>
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<tr>
<td>Inflation</td>
<td>+3.7%</td>
<td>+4.2%</td>
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<td>Unemployment</td>
<td>7.2%</td>
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**Inflationary Expectations**

With the inflation rate hovering between 3 and 4 percent, it seems that the alarmists who have been forecasting an early return to escalating if not double digit inflation were wrong. Surely, the specific forecasts for high and rising inflation rates in 1984 and 1985 were off the board.

Nevertheless, I harbor a growing suspicion that the main error of some monetarists and other inflation alarmists was in timing. They forgot how long it took to build up the inflationary pressures of the late 1970s. On the other hand, perhaps too many of us have quickly forgotten how painful it was, as measured by high unemployment rates, to bring inflation down to current levels.

What concerns the monetarists is the extremely rapid rate of growth in the various monetary aggregates. M1 -- the most widely watched monetary indicator -- has been rising at a 13 percent annual rate since early this
year. More specialized measures have also been expanding at a rapid rate. For example, the monetary base (a key ingredient in future money supply movements) has been expanding at a 9 percent rate since early in the year. More sanguine observers point to technical shifts, such as changes in the composition of deposits, to explain away the apparently excessive expansion of the money supply.

I believe that the monetarists are crying wolf again. What concerns me, however, is the way the fable ends. Eventually, the little boy was right. And some straws in the wind are worrisome.

What cannot be readily explained away is the rise in measured inflationary expectations. According to one recent survey, financial decision-makers anticipate that the inflation rate over the coming five years will be about 5 1/2 percent a year. That is 170 basis points higher than the current inflation rate.

According to some observers, today's economic policy environment is reminiscent of 1967, 1972, and 1977. These were the periods prior to the outbursts of rapid inflation in the fairly recent past. History does not have to repeat itself, but the current attitude toward inflation may be too sanguine.

The International Outlook

Let us take a few minutes to examine the foreign trade situation. The fact is that the United States is running a triple digit trade deficit. Meanwhile, Congress is searching for villains.

Let's face it. If Congress restricts imports, that raises the danger of retaliation against our exports. We do not have to guess about the consequences or remember as far back as the Smoot Hawley tariff of the 1930s.
Recent experience with China provides a good example. When we imposed quotas on their textile exports to us, they promptly reduced their agricultural and chemical imports from us. The U.S. textile industry got the benefits, while our farmers and our chemical companies and their employees bore the costs.

A significant decline in the exchange rate of the dollar would be a far better solution to our international trade problems than any of the protectionist approaches. The 40 percent rise in the dollar since 1980 means a 40 percent price increase for U.S. firms competing against foreign goods. But that, in turn, gets us to our own budget deficit, which is at the heart of the superstrong dollar. And that has strictly a made-in-America label.

The Fiscal 1986 Budget

Looking at the Washington scene, the annual budget debate has become a sad spectacle. We all know what has to be done. It is not a question of bringing an outlandish $200 billion deficit down to merely an outrageous $180 billion or a bloated $150 billion annual level. It is a matter of restoring our country's finances to a semblance of balance.

To those who say that economic growth will cure our fiscal problems, I respond that the next recession -- which we can neither pinpoint nor rule out -- will push the budget deficit to a new peak. History argues for at least one more recession in the 1980s. It will only take an average downturn to accelerate government spending and slow down revenue sufficiently to produce a deficit of $250 billion a year or more.

Washington's favorite parlor game is still spin-the-budget. But it now has a new name, the Gramm-Rudman-Hollings amendment to the bill to raise the debt limit to $2 trillion. That amendment requires Congress and the President to
reduce the deficit progressively until it is eliminated in fiscal 1991. This provision has been subjected to all sorts of criticism, some quite valid. But the fact remains that the Gramm approach is now the only legislative game in town to eliminate the deficit. The amendment reflects widespread exasperation with the status quo. It surely is a challenge to the Congress and the White House to do a better job of bringing spending into line with revenues.

At first blush, the Gramm-Rudman-Hollings bill seems to be an abdication of the Congressional budget function to the President. After all, if they don't cut enough, he has to do it. But, on reflection, the potential is more serious than that. The bill would let Congress do the popular thing -- enact generous appropriations -- while giving the President the onerous task of cutting spending or proposing tax increases.

In any event, we must remember that the meter is running. Interest payments are mounting steadily. Delay means choosing in the future between even larger spending cuts and more unpopular tax increases. The best way to reduce the deficit -- and to lay the foundation for responsible tax reform in the years ahead -- is to carry through that necessary pruning of federal spending programs. The key to reducing federal spending is simple but not easy. It is the ability to say no.

**Tax Reform**

Meanwhile, for most of 1985 politicians in both parties have been busy diverting attention from the difficult question of cutting the deficit by focusing on tax reform. It is discouraging to hear the representatives of both political parties on this subject. If you listen to Democratic spokesmen, you quickly learn that they are embracing tax reform in the hope that, in the voters' eyes, such action will return the party to the nation's mainstream.
But the Republicans are not any better on that score. They tell us that the beauty of their current tax reform plan is that it will help to attract blue collar families to the Republican party. The problems facing our nation deserve more serious responses than such exercises in cheap (or perhaps expensive) politics.

When we push aside the labels attached to any of the proposed "reforms" of the federal tax structure -- be they Rostenkowski's approach, Kemp-Kasten, Bradley-Gephardt, the November Treasury proposal, or the current White House recommendations -- we find that they are all variations of the same theme: reduce federal income taxes paid by American families and individuals and offset the revenue loss by raising taxes on business.

Most of those "loophole" closers boil down to increasing taxes on business, mainly by reducing incentives to investment. What this means is that the proposed tax reform will not really be economically neutral. By discouraging investment the proposed tax changes would depress the economy, preventing the achievement of revenue neutrality. It also means a higher budget deficit.

It is ironic that policymakers in Washington are seriously considering such tax changes just as the growth rate is slowing down. Moreover, many of the industries hard hit by imports would be precisely those faced with the largest tax increases. Why worry about the problems of meeting foreign competition? Businesses don't vote.

My sense of irony is further aroused by the fact that the investment incentives adopted in 1981, which were then hailed as tax reform, are now proposed for diminution also as part of tax reform. That sounds like the invention of a political perpetual motion machine.
When you think about the key economic challenges facing the U.S. in the 1980s -- foreign competition, farm and foreign debts, and huge budget deficits -- the tax reform now being discussed should be dismissed as irrelevant.

**Summary**

I will recap briefly. We are basically a strong and wealthy country that is not managing its economic affairs too well. We are consuming more than we are producing. We are spending more than we are earning. We are borrowing more than we are saving. As a result, the economic future is, in a phrase, so-so. I see no recession in sight, but economic growth is resuming at a very slow pace. Unemployment is leveling off at a high level. On the bright side, inflation is staying low for the time being. This is not a period that will go down in the economic history books, but it is not nearly as bad as the doom and gloom talk we continue to hear.