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Seattle Rotary Club
for delivery December 5, 1990
1:00 p.m. PST; 4:00 p.m. EST

A Perspective on the Economic Slowdown

I. News on the economic front hasn't been too good lately:

A. Problems in the Middle East have caused oil prices to fluctuate wildly.

B. Even though the economy appears to be contracting, inflation remains a thorny problem.

C. And, the stock market and the dollar are well below their pre-August levels.

D. Today, I plan to give you a perspective on recent developments, including comments on the consequences of the hike in oil prices, and the broad implications for monetary policy.

II. Turning first to the national economy, it's useful to begin by looking back a few years to get a better perspective.

A. We've enjoyed a remarkable peacetime expansion. From 1982 to '89, economic growth has been vigorous -- averaging 3½% a year.

B. Such rapid growth pushed the economy to the limits of its capacity -- and maybe beyond, contributing to the increases in inflation we've seen since 1986.

C. To reduce the strain on our economy's resources and to get inflation under control, the pace of activity needed to slow down.

D. And, starting in early 1989, that's exactly what happened. Since then, the economy has grown at a 1½% annual rate, on average, in contrast to the 3½% growth rate in 1988 (Q4-Q4) and the 5% rate in '87.

III. Given these numbers, developments in the Middle East, as well as the so-called credit crunch, take on a more ominous cast. I'll say a few words about each.

A. First, the credit crunch. To me, "credit crunch" refers to a situation in which money is not available to broad groups of borrowers at any reasonable price. It's not clear that this is the case today.

1. It's true that lenders -- and borrowers -- have become more cautious.

2. But caution is a normal and healthy response to an

environment that has become riskier.

a. More prudent lending standards should be applauded because they enhance the stability of our economy.

3. Research at the San Francisco Fed does suggest that bank lending nationwide has been somewhat lower than would normally be observed at this stage of the business cycle, although this development has not been evident in the Twelfth District.

4. However, given that many borrowers have sources of credit other than banks, it remains to be seen how much of an effect reduced bank lending will have on overall economic activity.

B. A more thorny problem is the situation in the Middle East and its impact on oil prices.

1. The price of West Texas crude has jumped from under $17 a barrel in June to over $40 at times. Now, it's $29.85.

2. There's no telling how long Iraqi and Kuwaiti oil supplies will be off the world market.

3. But Saudi Arabia's and other countries' increased production is making up for the shortfall.

a. Assuming no war that knocks out capacity in the Gulf area, the oil price probably will settle at around $25 per barrel.

4. If there is a war, however, we could be in for a long bout of even higher oil prices, which would further stunt economic growth in the U.S. and around the world, and raise inflation for a time.

5. A rise in the price of an important raw material like oil reduces the capability of our economy to produce.

6. No amount of monetary stimulus can alter the fact that the economy must adjust to higher priced oil and its effects on production costs.

7. I hope we learned this lesson from the oil price shocks of the 1970s.

a. In each case, policy was too stimulative at first. This postponed the inevitable decline in output associated with the oil price shocks.

b. But it also revved up inflation.

c. Policy then had to shift gears and try to bring inflation under control. This tightening, coupled with the economy's need to adjust to higher oil prices, helped to bring on recessions.

8. In the current situation, then, the main contribution the Fed **can** make is to follow a steady course, taking care not to worsen the problems caused by the oil shock.

IV. Let me turn now to the economic outlook for the months ahead.

A. For 1990 as a whole, growth probably will come in at a very sluggish pace of around one-half percent.

B. In the current quarter, output appears to be declining, and with each passing day, the chance of two consecutive quarterly declines seems to increase.

1. Weakness is showing up in nearly every sector of the economy, including consumer spending, business investment, and housing.

a. Real estate problems, in particular, have been in the news a lot lately. We have seen substantial declines in housing starts and sales on a national basis, as well as falling home prices in many areas.

2. Higher-priced oil is going to be a big negative for a while, making our current plant and equipment less productive, and cutting into households' budgets.

C. In this regard, I might note that the economy of the Twelfth Federal Reserve District -- including nine western states -- is less oil-dependent than other parts of the country.

1. The West generally has fared relatively well so far in the face of the slowdown in the rest of the nation's economy.

a. This is due largely to the strong population growth we've seen.

b. Nevertheless, as the national economy has slowed, most western states have seen growth slow down from the robust rates seen a year or so ago.

2. Although Washington's growth also has slowed in recent months, the state is significantly stronger than the nation as a whole.

a. To be sure, employment at Boeing is no longer expanding. And manufacturing employment is down nearly 1-1/2 percent from a year ago.

b. Moreover, some signs of the national real estate decline have begun to appear in Washington, following the frenetic pace seen earlier.

(1) Residential permits are down from a year ago, as is resale activity.

(2) But real estate conditions remain stronger here than in many other parts of the nation. Despite slowing appreciation in home prices, the median price of a home in the Seattle area still is well above its year earlier level.

c. The overall employment situation in the state also looks reasonably good: employment grew by nearly 3-3/4 percent over the past year, nearly 2-1/2 times the national rate.

3. Despite the current areas of weakness, I think the Washington and western economies are fundamentally sound. They should continue to outperform the nation, though that may be cold comfort if the national economy heads into a period of prolonged decline.

D. Fortunately, for next year and beyond, there's reason to expect a modest upswing in the pace of overall activity after a weak first quarter.

1. The sharp drop in the dollar since last Fall should provide a boost to the economy next year.

a. A lower dollar makes our exports more attractive, and thus should help to improve our trade balance.

b. Moreover, growth in most of our major trading partners has been more rapid than here, giving an added boost to our exports --

(1) even though the possibility of slowdowns abroad -- in response to the oil shock, and tight monetary policies in Japan and Germany -- makes the extent of improvement uncertain.

2. Ironically, another positive factor could be the price of oil. As I have mentioned, assuming war is avoided in the Middle East, the price of oil may stabilize at lower levels. This would boost our economy.

V. On the inflation front, the news has not been encouraging.

A. Consumer prices rose at more than a 6½% annual rate during the first ten months of this year. Even excluding food and energy, consumer inflation was 5½%.

B. The lower dollar does not bode well for inflation over the next year or two.

C. The trend in wages, salaries, and benefits also has not been encouraging. These costs rose by 5% over the 12 months ending in September.

1. Although this figure is down slightly from the previous quarter, it still represents unacceptably strong underlying pressure on inflation.

VI. Before I discuss my own perspective on what all of these developments mean for monetary policy, I want to emphasize that the Fed's monetary-policy decisions are based upon a consensus of many views.

A. The main-decision making body -- the Federal Open Market Committee, or FOMC -- is made up of the seven Federal Reserve Board Governors as well as five Reserve Bank Presidents who serve on a rotating basis.

1. One of the strengths of the FOMC is that it incorporates broad geographical representation.

B. We base our decisions on a wide array of information and analysis. The Governors and Presidents have their own research staffs. We look at a large amount of data, and in addition, obtain information on economic conditions from individuals in each District.

1. Prior to each FOMC meeting, Directors and other community leaders are surveyed, and this information is summarized in the Fed's "Beige Book". This grass-roots information is an important part of the input we use in our decisions.

VII. Currently, we need all the information we can get to sort out the divergent trends in the economy.

A. Despite continuing high inflation, many are suggesting that the current pace of activity calls for a significant easing of monetary policy, especially since the rise in oil prices could slow things further.

B. The risk of a downturn is one of the Fed's most important concerns.

C. At the same time, we've got to be careful not to over-react to today's weak economic numbers.

D. With the oil shock and the lower dollar adding fuel to inflation, a significant move towards ease by the Fed might well cause long-term interest rates to rise, especially from today's levels.

VIII. Thus we're faced with a rather daunting task. We must guard against recession, but not lose the fight against inflation.

A. Unfortunately there are no guarantees in this process.

B. However, monetary policy needs to keep its primary focus on the longer term. Only by bringing inflation under control will we be able to promote maximum economic growth in the U.S. economy in the years ahead.