U.C. San Diego Economic Roundtable
For delivery April 7, 1995, 7:30 AM PDT

PROSPECTS FOR THE CALIFORNIA AND U.S. ECONOMIES

I. Good morning. Today I'm going to give you my views on the 1995 economic outlook for the nation and California.

A. As I was thinking about my remarks, I came across an interesting cartoon.

B. It accompanied a story about the economy, inflation, and the Fed.

1. In the cartoon, people in party hats were throwing streamers and having a great time.

2. But in the background, there lurked a shadowy monster.

3. About the only person who noticed the monster was a sort of non-nondescript, worried-looking figure in a business suit.

C. I think you can guess at the interpretation.

1. The party-goers represent people enjoying the very quick pace of economic growth we've had for the last several years.

a. After all, economic activity expanded by a robust 3¼ percent in 1993,

b. and it registered an even stronger 4 percent in 1994.

2. The monster lurking in the background, of course, is the threat of inflationary pressures.

3. And that worried person is a somewhat unflattering portrait of your typical central banker.

D. A cartoon like this raises some interesting issues.

1. One of the first ones that comes to a lot of people's minds is whether there really *is* something out there—

a. —namely, inflation—

p:\parry\ucsd4-4-95.pi

2. —or whether it's just the play of shadows.

E. As a representative of that worried figure, let me tell you what's on my mind as we chart the course of U.S. monetary policy for 1995 and beyond.

II. I'll start with a few key principles.

A. First of all, keeping inflation at low and stable rates is important:

1. It's the primary way that monetary policy can contribute to achieving the maximum *sustainable* advance in the country's economic output and the people's standard of living.

B. Second, monetary policy doesn't produce results *instantaneously*.

1. In fact, it can be a little like trying to steer a fifty-thousand ton tanker:

a. You move the wheel, but the ship doesn't start to make the turn for a couple of miles!

2. In monetary policymaking, this is known as the problem of "long"—and I might add—"variable lags."

3. It can take anywhere from a year and a half to three years for a monetary policy action to produce results on inflation.

4. This kind of time lag means that it's dangerous to wait until the problem shows up in the inflation data—by then we'd be too late.

5. Instead, we have to *anticipate* problems,

a. by looking for signs that inflationary pressures are on the rise.

C. This brings me to my third point: the pressures for *higher* inflation intensify the longer the economy operates beyond its *long-run* capacity to produce goods and services.

1. Two of the basic guidelines to judge whether the economy is, or will be, exceeding its long-run capacity are measures of

a. its potential growth rate

b. and the so-called "natural rate of unemployment."

p:\parry\ucsd4-4-95.pi

D. I'd like to take a few minutes to develop these two ideas,

1. because they're at the heart of much of the Fed's deliberation,

   a. and yet they can't be pinned down to decimal point accuracy.

2. I'll start with a definition of the potential growth rate: It's the growth rate an economy is capable of sustaining in the long run.

   a. For the U.S., it appears to be in the range of 2 to 3 percent per year.

   b. The potential growth rate is determined by a lot of factors,

      (1) such as population growth

      (2) and improvements in technology,

         (a) such as inventions and greater education,

         (b) which enhance productivity.

   c. Obviously, monetary policy has little impact on these factors, so it can't determine the potential growth rate;

      (1) although most economists believe that low, stable inflation—which monetary policy *can* produce—does tend to enhance the potential growth rate in the long run.

3. The second key factor underlying the inflationary risks in the economy is the so-called "natural rate of unemployment."

   a. This is the rate the economy can sustain in the long run, and it's determined by current technology, labor market size and composition, and so forth, in today's economy.

      (1) Currently, most economists put it in the range of 5¾ percent to 6¾ percent.

E. An important point to take away from what I've said so far is that the Fed doesn't decide

1. what the natural rate of unemployment is,

p:\parry\ucsd4-4-95.pi

2. or what the potential growth rate of the economy is,

3. or what the lags in monetary policy are.

4. Even though we don't control them, we must take them into account in designing policies.

III. Now, let me put this together and apply it to the current situation.

A. As I've indicated, the economy has grown rapidly for the past three years—

1. —well above the long-run potential rate.

a. This rapid growth was great when the economy had plenty of excess capacity coming out of the 1990 recession.

B. But the rapid pace has lasted so long that the economy's now operating beyond its long-run capacity to produce goods and services.

C. The unemployment rate has fallen from a peak of about 7½ percent to just under 5½ percent,

1. which appears to be below the natural rate.

D. Signs of strain are showing up in things like manufacturing capacity utilization rates.

E. So the overall picture suggests that excess capacity has been pretty much used up.

1. In fact, it appears that we've overshot capacity, so that there's excess demand for resources in today's economy.

F. As a result, inflation most likely will be on the rise in the future—

1. —unless the economy slows down a bit.

IV. What are the prospects that the economy *will* slow down—take a "breather," as it were?

A. The early signs in the first quarter are reasonably good.

p:\parry\ucsd4-4-95.pi

1. The economic data available so far point to a possibility of the kind of moderate growth that we need.

B. Looking ahead, analysis at the San Francisco Bank suggests that the tighter monetary policy put in place last year should have its main restraining effects in 1995,

1. as interest-sensitive sectors—such as housing and consumer durables—slow.

C. But let me emphasize a couple of important points.

1. Since we appear to have overshot capacity, we'll need moderate growth for more than just a quarter or two to avoid higher inflation.

2. In addition, it's the longer-run average rate of growth that the Fed will be focusing on, not any one quarter's performance.

a. Real GDP growth tends to be volatile from quarter to quarter.

b. So a sustained period in which economic growth *averages* a moderate rate

(1) may include some individual quarters that are weak,

(2) and others that are quite strong.

V. Now, with the national economy slowing, people have been concerned about what's going to happen to California.

A. Looking at the average historical pattern suggests that California's growth rate would probably moderate by about the same amount as the nation's.

B. But California's current business cycle has been very unusual.

1. The state has been "out of sync" with the national economy,

2. and that's affecting the dynamics of the state's recovery.

C. California's economy got out of sync when it had to absorb severe shocks to sectors like defense, aerospace, and construction.

p:\parry\ucsd4-4-95.pi

1. As a result, the state went into a deep downturn that lasted more than three times as long as the national recession.

2. Southern California, the center of the troubled aerospace industry, took the hardest hit,

   a. accounting for 90 percent of the over 500,000 jobs lost in the state.

D. And the recovery has not only been slow to get started, but it's also been slow in building momentum.

1. According to the payroll employment numbers, the state has been in recovery since April 1993.

2. And while California's unemployment rate dropped about 1¾ percentage points last year

3. it's still well above the national rate.

E. In San Diego, it looks like the recovery has lagged the rest of the state,

1. as the unemployment rate here is still a good deal above its pre-recession figure.

2. So it's not surprising that things don't feel like they're back to normal.

F. As we look ahead, California faces a number of challenges, including

1. further cutbacks in defense and aerospace jobs,

2. problems with state and local budgets,

3. and the developments affecting trade with Mexico.

   a. Of course, these developments are especially an issue here in San Diego,

      (1) where trans-border shopping is estimated to account for 10 percent of retail sales,

      (2) and a much higher share in certain areas like Chula Vista.

p:\parry\ucsd4-4-95.pi

G. But there are definitely some positive features.

1. For example, dynamic sectors—like business services, entertainment, and tourism, among others—are experiencing impressive employment gains

2. We even could see some further improvement in residential construction in the state.

3. Furthermore, the relatively high unemployment rate means that the state's economy can expand without facing widespread bottlenecks in labor and product markets.

H. These positive features have the potential to mitigate the impact of a slower national economy;

1. and they help explain why the consensus forecast is for California to maintain a moderate pace of recovery in 1995, with perhaps even some pickup in employment growth.

VI. Let me conclude with a quick overview of the economic outlook.

A. Overall, the Fed's actions to slow the national economy to a sustainable pace may be taking hold.

1. 1995 should show continued, but slower growth,

2. and that should help contain inflationary pressures.

3. Furthermore, the general feeling is that the California economy can continue to grow despite the national slowdown.

B. These generally desirable trends don't mean, of course, that now the Fed can just sit back and relax.

1. The appropriate policy requires frequent re-assessment and re-adjustment.

C. However, the steps we've taken so far are consistent with our primary goal to foster stable, sustainable growth with low inflation.

wc 1583

p:\parry\ucsd4-4-95.pi