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A Perspective on the Economic Slowdown

- I. News on the economic front hasn't exactly been encouraging.
 - A. For example,
 - 1. output growth has slowed significantly;
 - 2. the stock market has dropped sharply;
 - 3. interest rates have risen;
 - 4. oil prices have soared in response to developments in the Middle East;
 - 5. and inflation remains a thorny problem.
 - B. What I'd like to do today is give you my perspective on recent developments in the national economy and our region. I'll conclude with comments on 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.
 - 1. Since the end of 1982, when this expansion began, 22 million jobs have been created.
 - 2. And the unemployment rate has dropped from close to 10% (in 1982) to around 5½%.
 - 3. The growth in output has been nothing short of vigorous, averaging 3½% a year for the last 7½ years.
 - B. Such rapid growth pushed the economy to the limits of its capacity -- and maybe beyond.
 - C. As a result, we've had a problem with rising inflation since 1986.
 - D. To get inflation under control, what was needed was a slowdown in the pace of activity so that it didn't strain our economy's capacity to produce goods and services.
 - 1. Beginning in 1988 and continuing through early 1989, monetary policy aimed at producing such a gradual moderation in economic activity.
 - E. And starting in early 1989, that's exactly what we got.
 - 1. Since then, the economy has grown at a 1½% annual rate, on average.
 - 2. This is in sharp contrast to the economy's 3½% growth rate in 1988 (Q4-Q4) and the 5% growth rate in '87.
 - 3. The slowdown is broadly-based: It has shown up in slower growth in spending on consumer goods, housing, and business investment in plant and equipment.
 - 4. It's also broadly-based geographically.
 - a. In all but five states, employment has grown more slowly in the last fifteen months than it did in the preceding fifteen months.
 - F. Given numbers like these, several recent developments have taken on a more ominous cast.
 - 1. I'm referring to the "credit crunch," the situation in the Middle East, and the serious downturns that certain parts of the country are experiencing.
 - 2. I'll say a few words about each of these concerns.
 - G. First, the so-called credit crunch.

1. "So-called" because I don't think there is one.
 2. It's true that lenders have become more cautious, but that doesn't imply that they've stopped lending.
 3. Caution is a normal and healthy response to a business environment that has become more uncertain.
 4. It's also a response to the need for tighter credit standards in the wake of the high-flying lending that got the thrift industry in trouble.
 - a. In the long-run, more prudent lending practices will make our economy more stable.
 5. The Fed recognizes, however, that the transition to more prudent standards has the potential to temporarily slow the economy.
 6. To account for this possibility, monetary policy was eased slightly in July.
- H. 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 \$30 a few weeks ago. More recently it has fallen back somewhat to around \$26 per barrel.
 2. There's no telling how long oil supplies will be disrupted.
 3. Saudi Arabia's and other countries' pledge to increase production will reduce price pressures.
 4. But if that's not enough, we could be in for a sustained period of higher oil prices which would stunt economic growth in the U.S. and around the world. Inflation also would be higher for a time.
 5. Unfortunately there's really nothing the Fed can do to prevent higher oil prices ultimately from reducing economic output.
 - a. Of course, we must be careful not to exacerbate the problems caused by the oil shock.
 - b. But there's no getting around the fact that we just don't have the ability to prevent higher oil prices from diminishing the economy's underlying growth potential.
- I. Finally, a number of commentators have been concerned that recessions in some states would spread to the economy as a whole.
1. As I said a while ago, most states are experiencing slower growth.
 2. We also know that a number of states are experiencing outright declines in employment
 - a. and that they're concentrated in New England.
 3. However, it seems unlikely that regional problems will be the catalyst for a national downturn.
 4. Regional disparities in growth are not at all unusual, even during boom times.
 - a. When the economy slows as it has, it's normal for differences in economic performances across regions to widen.
 - b. What's interesting is that these differences are actually smaller than usual, based on the experience of the past 20 years.
- III. On the positive side, the West has fared well while the national economy has slowed.
- A. In fact, it's fared better than most other regions throughout the 1980s.
1. Population growth has been a key factor in much of this region.

- a. In California, Arizona, and Nevada, population grew much more rapidly than the national average for the entire decade of the 1980s.
 - b. More recently, rapid population growth in Oregon and Washington has stimulated economic growth as well.
2. Key industries in the West also have enjoyed sustained growth.
- a. The western economy saw strong manufacturing activity through most of the current expansion, with the aerospace industry providing a particularly large boost.
 - (1) These developments had the greatest effect in Washington and Southern California.
 - b. Another important factor has been the West's location on the edge of the Pacific. This has allowed it to take advantage of the increased trade flows with Pacific Rim countries.
 - (1) Sales of our exports have benefitted.
 - (2) Increased trade also has led to growth in the transportation and finance industries that service both imports and exports.
3. Clearly the West has enjoyed some important advantages. But I don't want to paint an unrealistically rosy picture.
- a. Several of the West's resource industries -- including agriculture -- fell on hard times during the mid-1980s.
 - b. The region's economic diversity cushioned the impact of these problems.
 - c. Nevertheless, problems in resource markets did cause stagnation or decline in resource-dependent parts of the West like Alaska, Oregon, Idaho, and Utah.
 - d. And it wasn't until fairly recently that conditions began to improve in these states.
- B. How well each of the states in this region is performing right now depends on a variety of factors.
1. First, cutbacks in defense-related employment have been a key factor in slowing growth in the San Francisco and Los Angeles areas and, to a lesser extent, in Washington.
- a. Other parts of the West, in contrast, have not been affected much at all.
 - b. Of course, developments in the Middle East are raising the possibility that additional defense-spending cuts would be shelved. This would eliminate a potential source of drag on the California and Washington economies.
2. Conditions in resource markets also are influencing the relative performance of western states.
- a. For example, improved conditions in lumber-related industries and in mining were the catalyst for robust growth in states like Oregon and Utah that had been weak in the mid-'80s.
 - (1) At present, however, restrictions on logging and the slower pace of home-building activity will diminish lumber's role in stimulating the Northwest's economy.
 - b. Likewise, more stable conditions in oil markets over the last several years helped turn Alaska's economy around.
 - (1) The current run-up in oil prices, moreover, should provide a further boost to the state's revenues.
 - (2) Oil-producing areas of California also may enjoy some gains.

- (3) However, for other western states (and most of California, for that matter), the recent rise in oil prices will be a negative factor.
 - (4) I want to point out, though, that on the whole, the West is less oil-dependent than other parts of the country. So, higher energy prices shouldn't be as painful here as might be the case elsewhere.
 - 3. A third factor that is influencing the performance of western states is changes in the pattern of real estate and construction activity within the region.
 - a. The coastal areas in California and Washington that have enjoyed boom conditions for some time are now cooling off.
 - (1) This probably marks a return to more "normal" conditions.
 - (2) It also may reflect a trend favoring development of the smaller metropolitan areas in central California, Arizona, Nevada, and Oregon.
 - (3) Compared with the larger, coastal metropolitan areas like San Francisco, Los Angeles, and Seattle, the smaller metropolitan areas are attractive because of cheaper land and less congestion, air pollution, and crime.
 - b. At any rate, the western states that had weak real estate markets in the mid-80s, now are enjoying robust growth.
 - c. Overall, western states should do well compared with other regions during the next year or so.
 - 1. But performance does depend on what happens to the national economy.
- IV. So, let me turn to the national outlook and the implications for monetary policy.
- A. Overall, we expect output to grow over the remainder of this year at around the same sluggish pace as it did over the past 15 months.
 - 1. The best odds are that the economy will continue to "chug" ahead. However, especially considering the situation in the Middle East, no one can rule out the possibility that sometime during the second half the nation's output won't grow at all or might even decline.
 - B. Fortunately, the conditions are already in place for somewhat faster growth next year.
 - 1. The rather sharp drop in the dollar since last Fall should provide a substantial boost to the economy by improving our trade balance.
 - 2. In addition, business investment in plant and equipment has declined on balance over the past nine months, and we expect activity in this area to pick up next year as businesses gradually rebuild plant and equipment to more normal levels.
 - C. On the inflation front, the news remains less than encouraging.
 - 1. I said at the outset that we needed slower growth to make a dent in inflation.
 - 2. So far, inflation hasn't yielded much.
 - a. CPI rose at close to 6% annual rate during the first seven months of this year.
 - b. And before problems arose in the Middle East, we had expected it to rise at about a 4½% rate through end of 1991.
 - c. The upward trend in wages, salaries, and benefits also has not been encouraging. (Civilian ECI rose 5.4% over last 12 months.)
 - d. Finally, the lower dollar and rising price of oil do not bode well for inflation over the next year or two.

3. Thus, the economy must grow at only a moderate pace for some time before we are likely to see significant, lasting progress on the inflation front.
- D. Nonetheless, many are suggesting that the current pace of activity calls for an easing of monetary policy, especially since the rise in oil prices could slow things further.
1. I want to emphasize that the risk of a downturn certainly is one of the Fed's most important concerns in charting the course for monetary policy.
 2. At the same time, however, we've got to be careful not to over-react to today's weak economic numbers.
 - a. As I said earlier, an oil price shock reduces our economy's productive capacity.
 - b. And there isn't anything the Fed can do to make these painful adjustments go away.
 3. If we lose sight of our ultimate goal, we'll end up with a kind of rudderless monetary policy that tends to generate higher and higher inflation.
 4. This would be counterproductive because high inflation tends to inhibit economic growth over the long haul.
- V. 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. But by keeping on course towards our ultimate destination, and taking into account the cross currents along the way, we have the best chance of promoting maximum economic growth and prosperity in the U.S. economy in the years ahead.