A Perspective on the Economic Slowdown

I. News on the economic front hasn’t been too good lately:
   A. The threat of war in the Middle East has caused oil prices to rise and gyrate;
   B. Congress and the Administration can’t agree on meaningful deficit relief;
   C. and even though the economy is slowing down, inflation remains a thorny problem.
   D. For all these reasons, the stock market dropped sharply, while long-term interest rates jumped up, and the dollar has slipped.
   E. What I plan to do today is give you a perspective on recent developments.
      1. I particularly want to take some time to discuss the consequences of the hike in oil prices.
      2. 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 under 6% currently.
      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 reduce the strain on our economy’s resources and to get inflation under control, the pace of activity needed to slow down.

E. And starting in early 1989, that’s exactly what it did.

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.

F. Given numbers like these, several recent developments have taken on a more ominous cast.

1. I’m referring to the alleged "credit crunch," developments in the Middle East, and the federal budget situation.

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. To me, "credit crunch" refers to a situation in which money is not available to broad groups of borrowers at any reasonable price. That’s not the case today.

3. It’s true that lenders -- and borrowers -- have become much more cautious.

4. But caution is a normal and healthy response to a business environment that has become more uncertain.

5. Prudent lending practices help to make our economy more stable.

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 jumped from under $17 a barrel in June to over $40 at times.

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’ pledges to increase production should make up most of the shortfall.
a. As a result, the oil price has fallen recently, to $\_
 today.

b. Assuming no war that knocks out capacity in the Gulf
 area, we had expected the oil price to decline to within
 a range of $25 to $30 per barrel.

4. But if tensions escalate, and especially if there’s war, we
 could be in for a long bout of very high oil prices.

5. In a sense, the high price of oil since early August has split
 the difference between these two scenarios: it has tended to
 move up and down as fears of war have risen and declined.

6. A prolonged period of high oil prices:
   a. Would stunt economic growth in the U.S. and around the
      world.
   b. Inflation also would be higher for a time.

7. Fed can’t prevent higher oil prices ultimately from reducing
   economic output.
   a. A rise in the price of an important raw material like
      oil reduces the capability of our economy to produce.
      (1) For example, plant and equipment that were built
          to use cheap oil become less efficient and maybe
          even obsolete when oil prices rise.
      (2) No amount of monetary stimulus can change the
          fact that economy must adjust to these changes.
   b. I hope this is one of the lessons we learned from the
      oil price shocks of the 1970s.
   c. Research at the San Francisco Fed suggests that the way
      monetary policy responded to the two oil crises in the
      ’70s was inappropriate.
      (1) In each case, policy was too stimulative at
          first. This postponed the inevitable decline in
          output associated with the oil price shocks.
      (2) But it also revved up inflation.
      (3) 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.
d. 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.

I. The third development I want to mention is the budget stalemate.

1. The current uncertainty about fiscal policy is weighing heavily on our economy.

2. As Chairman Greenspan has pointed out, meaningful deficit reduction is an important prerequisite for lower long-term interest rates and stronger business investment.

3. In this regard, two considerations are key.

   a. First, to be meaningful, the five year deficit reduction plan must be big. $500 billion over the next five years is a good start.

   b. Second, the plan should provide a balance between tax increases and spending cuts.

(Additional comment based upon recent developments.)

III. Now, let me turn 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 percent.

B. And in the final three months of this year, output may actually decline.

1. Weakness is likely to be centered in consumer spending, housing investment, and inventories -- the latter as businesses attempt to keep inventories in line with weaker sales.

2. Higher-priced oil since early August also is going to be a big negative for a while.

   a. If the price remains high, it will make our current plant and equipment less productive, for one thing.

   b. And it has cut into households' budgets and forced cutbacks on other expenditures like services.
C. In this regard, I might note that California and the West are less oil-dependent than other parts of the country. So the effects of the Middle East crisis won’t be quite as painful here as they might be elsewhere.

1. In fact, the West generally has fared rather well in spite of the slowdown in the rest of the nation’s economy.
   a. This is due to the diversity of our region’s economy, as well as the strong population growth we’ve seen.

2. But even here in California, things have begun to slow.
   a. September’s employment numbers raise a caution signal, in fact.
   b. Shifts in defense spending and slower real estate and construction activity are both partly responsible.

3. At the same time, I think the California and western economies are fundamentally sound. They should continue to do well -- as long as the national economy doesn’t head 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.

1. The rather sharp drop in the dollar since last Fall should provide a boost to the economy.
   a. A lower dollar makes our exports more attractive, and thus
   b. should help to improve our trade balance.
   c. However, the possibility of slowdowns abroad, particularly in oil-dependent countries, makes the extent of improvement uncertain.

2. Another positive factor could be the price of oil. Oil supplies from Saudi Arabia and several other nations have begun to ease shortages. Therefore, assuming war is avoided in the Middle East, the price of oil should stabilize at lower levels. This would provide a boost to our economy.

E. In sum, I’d say that the best odds are that the nation’s economy will experience a modest pickup after year-end weakness. But movements in the price of oil and the dollar will have an important bearing on how things unfold.
IV. On the inflation front, the news remains less than encouraging.

A. Consumer prices rose at a 6 1/2% annual rate during the first nine months of this year. (6.6% -- 5.7% excluding food and energy.)

B. The upward trend in wages, salaries, and benefits also has not been encouraging. (Civilian ECI rose 5.4% over last 12 months.)

C. Finally, the lower dollar and threat of high priced oil do not bode well for inflation over the next year or two.

D. 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.

E. Nonetheless, 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.

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.

3. Indeed, in the current environment, 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.

4. And if we lose sight of our ultimate goal, -- to eliminate inflation -- we’ll end up with a kind of rudderless monetary policy that tends to generate higher and higher inflation.

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. In any event, 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 and prosperity in the U.S. economy in the years ahead.