Modesto Rotary
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Prospects for the U.S. Economy in the New Year

I. Today, I'd like to give you my views on prospects for the U.S. economy over the next year or so.

A. In view of recent economic news, it's easy to be pessimistic about the future.

1. Developments in the Middle East have caused oil prices to fluctuate wildly and have unsettled financial markets.

2. Inflation surged initially, and now the economy is contracting.

B. However, the news isn't all bad. In fact, there's a reasonable chance that the current economic weakness will be short-lived, and that by the end of this year we'll look back to see some gains against inflation.

C. In my remarks today, I'll touch on some major uncertainties that will help determine whether an optimistic or pessimistic scenario develops, and on how this uncertainty affects monetary policy.

II. To put today's developments in perspective, it's useful to recall our recent economic performance.

A. From 1982 to '89, economic growth was vigorous -- averaging 3½ percent a year.

B. Over the same period, the unemployment rate was cut in half -- from nearly 11 percent in '82 to under 5½ percent through the first half of last year.

C. However, 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.

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 happened. Since then, the economy has grown at a sluggish 1½ percent annual rate, on average.

F. Last quarter, the sluggish growth we saw earlier turned into an outright contraction. And with each passing day, the chance that this downturn will qualify as a recession seems to rise.

   1. Weakness has shown up in nearly every sector of the economy, including consumer spending, business investment, and housing, and employment.

   2. Unemployment for December was up two-tenths of a point to 6.1 percent.

III. The national weakness is apparent in California as well, although some areas, including here in the Central Valley, remain strong.

A. California's unemployment rate rose to 7.1 percent in November, well above the 6.1 percent national average.

B. Employment growth, too, has weakened in the state.

   1. The latest figures show 1990 employment growth at a rate of 1.0 percent, compared to a better than 4 percent rate in much of 1989.

C. Still, employment growth has consistently stayed about a half point above the national average, and the performance of the economy in Modesto and the Central Valley explains a good portion of this relative strength.

   1. Employment growth in the Modesto area was above 4 percent last year.

      a. While the state's manufacturing employment dropped 2.2 percent, Modesto reported a 7.3 percent increase.

      b. Most service industries in the area had employment growth at roughly double the state-wide average.

      c. And construction employment rose in Modesto, while falling in the state as a whole.

   2. On the agricultural front, as always, performance depends on the weather.

a. If there's sufficient water, the outlook for crops is strong.

D. So, while a national recession is likely to bring recession to California, the decline is not likely to be as severe.

IV. Given these concerns, it's not surprising that a number of possible causes of the downturn have been proposed. I'll say a few words about some major candidates.

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. But caution is a normal and healthy response during a downturn, when the economic environment is riskier.

2. At the same time, it's important to note that the financial industry is facing some special strains, such as turmoil in the S&L industry as well as more stringent capital requirements.

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 12th District.

4. However, since many borrowers have other sources of credit, tighter credit standards by banks most likely are having only a modest effect on overall economic activity.

B. The situation in the Middle East and its impact on oil prices undoubtedly is contributing to current economic problems, although I doubt it is a full explanation.

1. The price of West Texas crude jumped from under $17 a barrel in June to over $40 at times. Recently, it's been in the range of $25 to $30.

2. There's no telling how long Iraqi and Kuwaiti oil supplies will be off the world market, but increased production by Saudi Arabia and others is making up for the shortfall.

3. If there **is** a war, then we could be in for a round of higher oil prices, which could seriously stunt economic growth in the U.S. and abroad, and raise inflation for a time.

4. However, based upon analysis of the much larger oil shocks in the 1970s, the oil price hikes we've seen to date are **not** big enough to explain the degree of weakness currently evident in the economy.

C. The final factor I'd like to mention is sagging consumer confidence.

1. Two major surveys show very large declines in consumer confidence in recent months. In fact, the Conference Board's index registered the largest drop in its 22-year history in October; and the level has not changed appreciably for either November or December.

2. Consumers certainly have a number of good reasons to be pessimistic -- in addition to the oil shock and the political uncertainties in the Middle East, well-publicized problems in the thrift industry and doubts about prospects for reducing the budget deficit are serious enough to create low levels of confidence.

3. Such attitudes may go a long way toward accounting for the unusual weakness we've seen recently in consumer spending -- particularly on "big ticket" items, such as autos and housing.

V. As I mentioned at the outset, there are bright spots in today's generally gloomy environment. In fact, there are good reasons to expect an upswing in the pace of economic activity by mid-year.

A. The sharp drop in the dollar since mid-89 should give a substantial boost to our economy.

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

2. Growth in most of our major trading partners has been more rapid than here, giving an added impetus to demand for our products abroad.

B. Second, inventories now are at relatively low levels, especially in the manufacturing sector.

1. This is good news. If inventories were high, then we'd expect significant further production cut-backs, a typical scenario that has intensified most other downturns.

C. Last, Fed policy has become more accommodative.

1. Since July, short-term rates have dropped one and a quarter percentage points.

2. This decline in rates should begin to boost the monetary aggregates and add strength to economic activity in the next few months.

D. Thus, weighing the pluses and minuses, my best guess is that we'll see a modest rebound in the latter half of this year.

1. But, given the situation in the Middle East, as well as the consumer confidence problem, we must be prepared for a wide range of developments.

VI. Let me turn now to inflation.

A. As I mentioned at the outset, there are signs that bode well for inflation later this year and beyond.

1. For example, some market indicators of inflation have begun to look positive.

a. Commodity prices are down from their peak in the middle of last year.

b. Long-term interest rates have fallen substantially in recent months, perhaps suggesting an easing of inflation expectations, as well as softness in the economy.

2. More importantly, the inflationary effects of the oil shock are beginning to dissipate.

a. The annual inflation rate, which had jumped to 9 percent between August and October, dropped back to 3-1/2 percent in November.

b. Assuming war does not break out, the worst effects of the oil shock appear to be behind us.

3. Finally, there are indications that underlying inflation has peaked, and may even be on a

slightly downward trend.

a. The latest figures show some attenuation in the growth of wages, salaries, and benefits.

b. This may reflect the recent slackening that has developed in labor markets, as the unemployment rate has risen by about ¾ percent.

c. Although the lower dollar is raising the cost of our imports and temporarily pushing up prices, improvements in underlying inflation should be felt by year-end.

VII. Many are suggesting that the current downturn in activity calls for a significant easing of monetary policy, especially since there seems to be more room for optimism on the inflation front.

A. Maintaining sustainable economic growth is one of the Fed's most important concerns.

1. The Fed's series of moves since July to lower interest rates should help to prevent a prolonged downturn.

B. At the same time, we've got to be careful in responding to today's weak economic numbers.

1. It is important to recognize that monetary policy affects the economy with a considerable lag.

2. The point is that today's actions to offset current weakness in the economy will be felt mainly after mid-year, when strong exports and the dissipation of the oil shock could lead to relatively rapid growth.

3. We don't want to over-react to the current downturn, and thereby lose or even reverse hard-won gains on underlying inflation.

4. We also want to be flexible enough to change the course of policy should the economy turn out to expand more rapidly than expected.

VIII. Thus we're faced with the difficult task of delicately balancing competing goals.

A. Unfortunately there are no guarantees in this process, especially in view of the major uncertainties clouding the outlook for this year.

B. However, even in the context of serious concerns about economic contraction, monetary policy must not lose sight of its ultimate longer-term goal: only by bringing inflation under control will we be able to promote sustainable growth in the U.S. economy in the years ahead.

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