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Recession, Recovery, and War: Prospects and Policy Issues in 1991

I. As the title of my speech suggests, the key elements of any economic outlook for 1991 are the recession, the recovery, and the war.

   A. Although the NBER has not officially made the call, it is pretty clear that we are in a recession.

   B. How did we get into it? How long will it last? What kind of recovery can we anticipate?

   C. The answers to these kinds of questions are never easy to come by, and adding the uncertainties of war makes it all the more difficult.

   D. In my remarks today, I'll touch on these and other major uncertainties that will help determine the path to recovery, and on how those uncertainties affect monetary policy.

II. Let's begin by putting our current economic situation in perspective.

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

   B. But after the beginning of 1989 the economy slowed substantially.

   C. Last quarter, the sluggish growth turned into an outright contraction, hitting nearly every sector of the economy.

   D. By now, as I said, it is pretty clear that this decline will last long enough to qualify as a recession.

III. California, too, is feeling its share of the decline-- including Southern California, which has been such an economic powerhouse over the past decade. Let's review some basic facts.

   A. Southern California has been an engine of economic growth with national impact.

      1. In the 1980s, on net, one out of every 11 new jobs in the nation was created in the greater LA area

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and in San Diego.

2. Population growth also was strong, at 25 percent.

B. Because the nation consumes much of Southern California's output, however, the area is not immune to national slowdowns in demand.

C. While the Southern California economy continued to expand long after regions like New England and New York had slipped into recession, it now feels the effects of the national slowdown.

1. Job growth here, which was at a 2 percent annual rate as recently as August, dropped to a 0.7 percent year-over-year rate in December.***

a. Manufacturing has lost 3.2 percent of its jobs, and construction employment has fallen 7 percent.

b. Other hard-hit sectors include the high-tech computer industry and defense-related areas.

D. But the story a lot of us are focusing on is real estate.

1. Sales activity is off by over 20 percent in most areas, with Los Angeles suffering a 23 percent decline and San Diego a 39 percent drop from a year earlier.

2. The number of residential building permits is off 37 percent, led by a 48 percent decline in single-family permits.

IV. With the downturn being felt in many areas, it's not surprising that a number of possible causes have been proposed. I'll say a few words about some major candidates.

A. First, the credit crunch. There is concern that slow growth in bank loans and the monetary aggregate M2 is contributing to the current downturn, and that it portends continued weakness in the economy.

1. To me, "credit crunch" refers to a situation where money is not available to broad groups of creditworthy borrowers at any reasonable price.

2. It's not clear that this is a major factor in today's economy.

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a. It's true that the depository institutions, especially S&Ls, have been in turmoil.

b. Even sound institutions have grown more cautious.

(1) But that's a normal and healthy response to a riskier economic environment.

c. 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, though not in the Twelfth District.

3. At the same time, though, other credit markets have been growing.

a. Households have channeled larger amounts of money directly to the credit markets through increased holdings of government and private securities.

b. And nonbank intermediaries, like insurance companies and mutual funds, have supplied more credit.

4. Thus it remains to be seen how much of an effect reduced bank lending is having on overall economic activity.

B. Second, higher oil prices contributed to the economic decline last year, although I doubt they are a full explanation.

1. There's no telling how long Iraqi and Kuwaiti oil supplies will be off the world market, but alternative sources of oil appear to be ample at the present time.

2. If the war drags on, we could be in for a bout of higher oil prices, which could stunt growth in the U.S. and abroad, and raise inflation for a time.

3. 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 recession.

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

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1. Two major surveys show very large declines in confidence since the invasion of Kuwait last year.

2. The list of political and economic uncertainties affecting confidence is long enough to put quite a chill on plans for big purchases or investment; I'll just name a few:

   a. the war and the oil supply;

   b. the almost daily news of trouble--or just change--in the financial industry;

   c. the climbing unemployment rate;

   d. and, the budget deficit.

3. Preoccupation with these uncertainties may go a long way toward accounting for the unusual weakness we've seen in consumer spending and business investment.

V. But, there are some rays of hope in today's generally gloomy economic environment.

A. The steep 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.

   a. In contrast to most other sectors of the U.S. economy, exports rose at a robust 8 percent annual rate last quarter.

   b. However, that demand could be dampened if the oil shock and tight monetary policy in some countries slow growth abroad.

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

1. Even in the face of last quarter's weak overall demand, nonfarm inventories dropped by $20 billion.

2. This is good news. If inventories were high, then we'd expect significant further production cut-

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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 about 2 percentage points, in part in response to a series of easing moves by the Federal Reserve. Most recently, we reduced our discount rates 1/2 percent on February first, the second 1/2 percentage point since mid-December.

2. Lower interest 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 war in the Middle East, we must be prepared for a wide range of developments.

2. A quick resolution of the conflict probably would boost real GNP growth in the U.S. through improved consumer and business confidence and lower oil prices.

3. The effects of a prolonged conflict on U.S. economic activity are more difficult to gauge.

a. High oil prices and consumer and business uncertainty could reduce real GNP.

VI. Let me turn now to inflation.

A. 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, and growth in the monetary aggregates has been slow.

b. Long-term interest rates now are substantially lower than in September, perhaps suggesting an easing of inflation expectations, as well as weakness in the economy.

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

   a. The annual consumer inflation rate, which had jumped to 9 percent between August and October, dropped back to around 4 percent between November and January.

   b. Of course, if the war goes on for long, we may see higher oil prices and inflation. But assuming the war is fairly short, the worst effects of the oil shock may be behind us.

3. Finally, there are signs that underlying inflation has peaked, and may even be on a slightly downward trend.

   a. The latest figures show some slowing 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 nearly 1 percent since early 1990.

   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. Given these possibilities, probabilities, and uncertainties, what are the appropriate directions for monetary policy?

A. Maintaining sustainable economic growth is one of the Fed's most important concerns, and we have responded to to the wide-spread signs of weakness in the economy.

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

   2. We estimate that the decline in interest rates since then is likely to add about 1 to 1¼ percent to real GNP growth this year.

B. At the same time, we've got to be careful not to re-ignite inflation.

   1. Monetary policy affects the economy with a considerable lag. Today's actions to offset current weakness will be felt mainly after mid-year, when the economy already may be picking up .

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

C. Thus the present environment requires that the Fed do a delicate balancing act: guarding against the risk of a prolonged downturn, while maintaining a longer-term perspective, so that we do not lose sight of our ultimate goal of eliminating inflation.

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