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**Recession and Recovery:
Prospects and Policy Issues in 1991**

- I. Today I'd like to discuss the economic outlook for 1991. The key elements, of course, are the recession and the recovery.
 - 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 it's particularly complicated because of the strains and uncertainties that were created by the Gulf war.
 - D. 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 me begin by putting our current economic situation in perspective.
 - A. From 1982 to '89, economic growth was vigorous -- averaging $3\frac{1}{2}$ 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. The 12th District has been feeling the decline, too, though on the whole our region's economy is performing somewhat better than the nation's.
 - A. And the latest figures suggest that while the California economy remains fragile, with a February unemployment rate of 7.4 percent, the worst of the downturn may be over.
 - B. After peaking in July 1990, employment in California contracted at a 2.1 percent annual rate through the

last half of the year.

1. By December, some 112,000 jobs were lost.
 2. The hardest hit sectors have been manufacturing and construction.
 - a. Cutbacks in high tech defense and aerospace orders have hurt manufacturing, as has weak nationwide demand for manufactured goods.
 - b. Both residential and nonresidential construction have been weak since before the Gulf crisis.
 - (1) Home sales activity also has been off significantly, with prices that are flat or even declining in some markets.
- C. There are some signs, however, that the worst of the downturn is over in California.
1. Since December, California employment has grown at a 3.8 percent annual rate.
 - a. Most of the increase occurred in January, which saw growth in all sectors.
 - b. February figures were flat.
 - (1) But, with the end of the Gulf war, we can expect further improvements as demand for California high tech defense equipment increases and California companies contribute to rebuilding Kuwait.
 - (2) Construction markets also should improve, given lower interest rates and renewed consumer confidence.
- IV. With the recession 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 has been concern that slow growth in bank loans and the monetary aggregate M2 has contributed 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.
 - 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. Throughout the crisis, alternatives to Kuwaiti and Iraqi oil were ample.
 2. 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.
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 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-backs, a typical scenario that has intensified most other downturns.
 - C. Third, 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 rate 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. Last, the fairly quick resolution of the Gulf conflict is likely to boost real GNP growth in the U.S. through improved consumer and business confidence and continued lower oil prices.
- E. Thus, weighing the pluses and minuses, my best guess is that we'll see a modest rebound in the latter half of this year.

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.
 2. More importantly, the inflationary effects of the oil shock have begun 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. Since the war was fairly short, the worst effects of the oil shock are probably 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 one and a quarter 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 is the appropriate direction for monetary policy?

- A. Maintaining sustainable economic growth is one of the Fed's most important concerns, and we have responded 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 1½ 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 .
 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.

Thank you for your attention. I'll be happy to answer a few questions.