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Economic Prospects and Policy Problems at the Turning Point

I. Today I'd like to give you my views on the economic outlook.

A. Basically, I'm optimistic.

B. My "capsule" forecast is that we've just about hit the bottom of the business cycle. Modest growth should resume in the second half of this year, and that's good news.

C. But I also want to raise a cautionary flag.

1. Though I'm usually pretty fearless about making a forecast, turning points can be tricky.

a. These are times when we're particularly likely to see conflicting signals about the direction of the economy.

2. Because of this uncertainty, deciding on the appropriate monetary policy requires especially careful consideration.

So today I'll explain my forecast by discussing

1. how we got into this recession,
2. what the factors are that signal a modest recovery,
3. and my concerns about monetary policy at this important stage of the cycle.

II. Let me begin with a brief look at the recent course of the economy.

A. After eight years of robust growth (3½ percent annual rate, on average), in July 1990 the economy officially was in a recession.

1. In fact, the national economy began to slow down somewhat earlier--in 1989.

2. The slowdown continued into the third quarter of 1990. And in the next two quarters, it turned into an outright contraction.

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B. California has not been immune to this weakness.

1. Employment in the state has fallen three-quarters of a percent since July.

2. And the unemployment rate for April was 7.4 percent, nearly a point above the national rate.

3. But there are bright spots in California, and Santa Rosa is one of them.

a. Most of the state's fastest-growing regions are on the periphery of the largest urban areas.

b. These communities offer access to large markets at a relatively low cost.

c. In fact, Santa Rosa is one of the state's--and indeed the nation's--fastest growing regions at present.

III. Now let me turn back to the national picture. How did we get into this recession? Three factors--the credit crunch, the oil price shock, and plummeting consumer confidence--have received a lot of attention, and I'll say a few words about each.

A. First, the credit crunch. There has been concern that slow growth in bank loans contributed to the downturn, and may stall the pace of recovery. But I'm not convinced that this was a major factor.

1. There's no question that depository institutions, especially S&Ls, have been in turmoil.

2. Even sound institutions have made fewer loans. But this is probably more a symptom of the downturn than a cause of it:

a. First, the demand for loans is typically lower during these times.

b. Second, banks have been more cautious, especially in commercial and real estate lending, and caution is a normal and healthy response to a riskier environment.

3. What's important to note is that other credit markets have been growing. . . enough at least to

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provide some offset against the slowdown in bank loans.

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. Therefore, though reduced bank lending is having a sectoral effect, I'm doubtful that it has been a major drag on the recovery, overall.

B. Second, soaring oil prices following the invasion of Kuwait contributed to the decline. But I doubt the oil price shock provides a full explanation.

1. Prices began to settle down fairly quickly.

2. In any event, they now are around their pre-invasion levels and should not interfere with an economic turnaround.

C. Last I'd like to mention consumer and business confidence.

1. We had some indication of a decline in consumer sentiment as early as the beginning of 1990.

2. After the invasion of Kuwait, both major surveys showed consumer confidence plummeting.

3. It's no wonder. The list of political and economic uncertainties at the time was long enough to put quite a chill on plans to buy big-ticket consumer items and business investment; I'll name just a few:

a. the war and the oil supply;

b. the trouble in the financial and real estate industries;

c. the climbing unemployment rate;

d. and, the federal budget deficit.

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4. These uncertainties may go a long way toward accounting for the weakness we've seen since last fall in consumer spending and business investment.

5. Survey results right after the war reflected the general euphoria of a quick victory.

   a. But since then, confidence has backed off a bit, and remains below '89 levels.

   b. We expect that it will improve only gradually over the next year or so.

IV. Beyond these factors, two others are helping to keep the recession from being very deep. And they should help smooth the way to recovery.

A. First, business inventories have been kept to relatively low levels.

1. Even in the face of last quarter's decline in overall demand, nonfarm inventories dropped by $27 billion.

   a. While recently we've seen increases in inventory-to-sales ratios, they are still low in manufacturing, especially in the auto industry.

   b. This is good news, since it means that firms will need to increase production to rebuild stocks. This could provide a "spark" for recovery.

B. Second, Fed policy responded to the signs of the downturn promptly and decisively.

1. Since July, short-term rates have dropped more than 2¼ percentage points, in part in response to a series of easing moves by the Federal Reserve.

   a. And since mid-December, we reduced the discount rate by one and a half percentage points, with the latest cut coming April 30th.

   b. Lower interest rates should add strength to economic activity, especially in housing and consumer durables.

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c. We estimate that the decline in interest rates will add nearly 2 percent to real GNP growth in the second half of this year, and around 1 percent in 1992.

V. I must admit, though, that the data so far have not given us clear signs of a recovery.

A. What we have seen is a possible "bottoming out" of the economy, so that the level of economic output is likely to be flat in the current quarter.

B. Business cycle turning points are always times when uncertainties about the outlook intensify. This turning point is no exception. I want to highlight a few uncertainties that seem especially important.

1. The recovery depends on an improvement in consumer and business confidence, and on a pickup in spending for inventories.

a. Although the surveys indicate some improvement from war-time lows, confidence is notoriously fickle and difficult to forecast.

b. And, though the inventory numbers look promising, the fact is that inventory management has changed.

(1) With advances in computer technology and business know-how, firms are managing inventories more efficiently.

(2) The result is that we're dealing with a new inventory cycle, which will also be difficult to predict.

2. Finally, the dollar raises concerns as well.

a. Through the end of last year, the dollar was on a downward trend. We expected this depreciation to lead to an improvement in the nation's trade balance this year and next, and therefore to stimulate economic growth.

b. However, the dollar unexpectedly began to rise early this year. Since February, it is up by a hefty 11 percent.

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(1) The result? Instead of being a major source of growth for our economy, as we thought three months ago, the dollar may become a drag on the recovery.

(2) Given the difficulty in forecasting the dollar, and its powerful effects on the economy, this factor is an important "wild card" in the outlook.

VI. Now let me move on to inflation.

A. We have seen noticeable improvement in this area in recent months.

1. First of all, the turnaround in oil prices has been pulling our inflation indexes down.

a. Since the peak in oil prices last October, the producer price index has declined at an average annual rate of nearly 2 percent, and the consumer price index has risen at only a 2½ percent rate.

B. The run-up in the dollar also should help hold inflation down, mainly next year, as price increases for imported goods are restrained.

C. And there are reasons to believe that underlying inflation has peaked, and may be on a downward trend.

a. Labor markets have slackened, as the unemployment rate has risen by nearly 1½ percentage points since early 1990.

b. This should restrain growth in labor compensation over the next year or two.

D. Overall, I would not be surprised to see consumer inflation of around 3½ percent this year, and closer to 3 percent in 1992.

1. This would represent significant progress from the 4 to 4½ percent underlying rate of inflation that has prevailed in recent years.

VII. With inflation trending down and the economy not yet "out of the woods," what is the appropriate direction for monetary policy?

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A. It's tempting to think that the Fed should give the benefit of the doubt toward a policy of easing--to make absolutely sure that the recession is over soon.

   1. Certainly, maintaining sustainable economic growth <u>is</u> one of the Fed's most important concerns.

B. But turning points in the business cycle are especially risky times for monetary policy.

   1. For one thing, they're marked by mixed signals, as some indicators move up and some move down.

   2. For another thing, they're never clearly identified until after they're over.

   3. This may explain why there have been too many times when policy has eased well after the trough has passed. These instances typically were followed by unsustainable growth and eventually painful struggles with inflation.

C. In the present environment, we don't want to over-react to the downturn, and thereby lose or even reverse the hard-won gains on underlying inflation.

D. Given the lags in monetary policy, the series of actions the Fed has already taken should strongly affect the economy in the second half of this year and in 1992.

E. Thus, although we must be careful to facilitate the recovery, we cannot lose sight of our longer-term goal, which is to control, and ultimately eliminate, inflation.

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