ECONOMIC PROSPECTS AND POLICY ISSUES

AT THE TURNING POINT

by

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Today I'd like to talk to you about the economic outlook. Basically, I'm optimistic. My best guess is that we've hit the bottom of the business cycle. I expect to see moderate growth resume in the second half of this year, with inflation moving on a downward trend over the longer term. That's the good news.

But I also have some concerns. Though I'm usually pretty fearless about making a forecast, business cycle turning points can be tricky. We're likely to see conflicting signals about the direction the economy is taking. This uncertainty raises special problems in determining the appropriate monetary policy. I'll have more to say about that later.

Recent Developments in the Nation and the Pacific Northwest

Let me begin my comments with a brief look at the recent course of the national and Pacific Northwest economies. After eight years of robust growth in this country (3½ percent annual rate, on average), the economy officially entered a recession in July of last year. In fact, the economy began to slow down somewhat earlier--in 1989. The slowdown continued into the third quarter of 1990. And in the next two quarters, it turned into an outright contraction.

Of course, some regions have been hit worse than others.
And some, like the Northwest, have performed relatively well. During the past year, employment grew by almost 2 percent in Alaska, and by almost 3 percent in Washington. These growth rates look good in comparison with the job losses seen nationally.

In Alaska, the important energy sector has continued to show robust growth. And construction employment in the state grew during most of the last two years, following a dismal period in the middle of the 1980s. In addition, a good fish harvest, and the food processing activity that goes with it, have kept manufacturing employment above its year-earlier level. Still, Alaska’s growth rate has slowed considerably during the past year, and the slower growth is affecting a broad range of sectors. For example, employment in the state’s large service sector grew only 2.8 percent in the past twelve months, compared to almost 10 percent in the previous twelve-month period. The large state and local government sector also saw employment growth slow, to less than 1 percent in the last twelve months, compared to over 3 percent for the year earlier.

Other areas of the Northwest have felt the effects of the national weakness as well. In Washington, for example, slower demand and reduced defense spending have contributed to cutbacks in manufacturing employment. But the manufacturing job losses continue to be modest compared with those in other parts of the country -- Washington lost 1.8 percent of its manufacturing jobs during the last year, compared with 4½ percent nationwide. And,
while total job growth has slowed substantially from the 6 percent pace seen a year or two ago, employment is still a healthy 2½ percent above its year-ago level. In fact, employment in the service sector is a robust 6 percent above the level of a year ago.

Factors Behind the National Recession

Now let me turn back to the national picture. The key question on everyone’s mind is, when will the recession be over? The first step in finding an answer is understanding how we got into the recession in the first place.

One important factor that was apparent to everyone was the oil price shock following the Iraqi invasion of Kuwait--oil prices nearly doubled in a matter of months. But fortunately, prices began to settle down fairly quickly, and now are around their pre-invasion levels. Thus this factor should not interfere with an economic turnaround.

Consumer and business confidence also played an important role. We had some indication of a decline in consumer sentiment as early as the beginning of 1990. After the invasion of Kuwait, the surveys showed consumer confidence plummeting. It’s no wonder, given the political and economic uncertainties at the time. I’ll name just a few: the war and the oil supply; the trouble in the financial and real estate industries; the climbing unemployment rate; and, the federal budget deficit. These uncertainties may go a long way toward accounting for the
weakness we've seen since last fall in consumer spending and business investment.

Right after the war consumer confidence survey results rebounded, reflecting the general euphoria of a quick victory. But since then, confidence has backed off a bit, and remains below 1989 levels. We expect that it will improve only gradually over the next year or so.

There also has been concern that a "credit crunch"--reflected in slow growth in bank loans--made a major contribution to the downturn, and may stall the pace of recovery. But I'm not convinced of this. Declining bank loans may be more a symptom of the downturn than a cause of it. In addition, other credit markets have been growing, enough at least to provide some offset against the slowdown in bank loans. Therefore, though banks' share of overall credit market activity has shrunk, I'm doubtful that this is a major obstacle to recovery in the national economy.

Other Forces for Recovery

In addition to relatively low oil prices and a likely improvement in confidence, two other indicators bode well for the economy in the latter half of this year and in 1992--business inventories and interest rates.

First, it's a good sign that inventories have been kept to relatively low levels. Even in the face of last quarter's decline in overall demand, nonfarm inventories dropped by $27
billion. While recently we've seen increases in inventory-to-sales ratios, they are still low in manufacturing, especially in the auto industry. This is good news, since it means that as soon as sales start to pick up firms will need to increase production to rebuild stocks.

Second, since July short-term interest rates have dropped more than 2 percentage points, due in part to a series of easing moves by the Federal Reserve. And since mid-December, we have reduced the discount rate by 1½ percentage points, with the latest cut coming April 30th. Lower interest rates should add strength to economic activity, especially in housing and consumer durables. 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.

We may be getting a glimpse of the effects of these factors in the data. Economic statistics available over the past month have raised the chance that the recession ended this quarter. Most significantly, employment at nonfarm businesses rose in May for the first time in ten months. Overall, my best guess is that the level of economic output should be flat in the current quarter instead of declining, as it has over the previous two quarters. Economic growth should resume, although at a moderate rate, in the second half of this year. In fact, I wouldn't be surprised if the economy came back even stronger than expected. Forecasts of recovery are often too pessimistic at this stage of the business cycle.
Uncertainties

I must admit, though, that so far we don’t have enough data to say for sure that the recovery has already begun. Troughs in the business cycle 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.

As I indicated, the recovery depends on an improvement in consumer and business confidence, and on a pickup in spending for inventories. But confidence is notoriously fickle and difficult to forecast. And, the inventory numbers, though promising, could be misleading. The fact is that inventory management has changed. With advances in computer technology and business know-how, firms are managing inventories more efficiently. The result is that we could be dealing with a new inventory cycle, which will also be difficult to predict.

Finally, the dollar raises concerns. 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. However, the dollar unexpectedly began to rise early this year. Since February, it is up by over 15 percent.

The result? Instead of being a major source of growth for our economy, as we thought only a few months ago, the dollar may become a drag on the recovery. Given the difficulty in forecasting the dollar, and its powerful effects on the economy, this factor is an important "wild card" in the outlook.
Inflation

Now let me move on to inflation. We have seen noticeable improvement in this area in recent months, and I’ll focus on three factors that help explain it. First of all, the turnaround in oil prices has been pulling our inflation indexes down. Since oil prices peaked last October, the producer price index actually has declined somewhat, and the consumer price index has risen at only a 2½ percent rate.

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

And finally, there are reasons to believe that underlying inflation has peaked, and may be on a downward trend. Labor markets have slackened, as the unemployment rate has risen by 1½ percentage points since early 1990. This should restrain growth in labor compensation over the next year or two.

Overall, I would not be surprised to see consumer inflation of 3½ to 4 percent this year, and closer to 3 percent in 1992. This would represent significant progress from the 4 to 4½ percent underlying rate of inflation that has prevailed in recent years.

Monetary Policy

With inflation trending downward and some uncertainty about whether the economy is now "out of the woods," what is the appropriate direction for monetary policy? It’s tempting to
think that the Fed should give the benefit of the doubt toward a policy of making absolutely sure that the recession is over soon. Certainly, maintaining sustainable economic growth is one of the Fed’s most important concerns.

But turning points in the business cycle are especially risky times for monetary policy. For one thing, they’re a time when signals often are quite mixed. For another thing, they’re never clearly identified until after they’re over. 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.

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

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.