FEDERAL RESERVE BANK OF SAN FRANCISCO

OFFICE OF THE PRESIDENT

ECONOMIC PROSPECTS AND POLICY ISSUES AT THE TURNING POINT

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Today I'd like to talk to you about the economic outlook. Basically, I'm optimistic: it appears that the bottom of the business cycle is behind us. I expect moderate economic growth in this half of the year, with inflation moving on a downward trend over the longer term.

But I also have some concerns. 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.

Putting the Recession in Perspective

Let me begin by putting this recession into perspective. First, the recession hit the country after eight years of robust growth (3½ percent annual rate, on average). Second, compared to other recessions, this one has been mild. In the seven other post-war recessions, real GNP declined more than 2 percent and the downturns lasted just under a year, on average. In this recession, real GNP declined a little over 1 percent, and at this point the fall-off appears to have lasted only two or three quarters, depending on the exact timing of the trough. Of course, "mild" is a relative term. By using it I don't mean to discount the pain and dislocation it has caused. This recession

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has hit employment harder than GNP.[1]

California, of course, has not been immune. The unemployment rate in the state has been higher than the nation's since last September. But it did improve somewhat in July--to 7.6 percent. Unemployment also remains high in Fresno County. Most of the local unemployment is in the important agricultural sector, where last December's devastating freeze led to large job losses. Outside of agriculture, though, employment in Fresno over the past year through June increased a very solid 4.9 percent. This compares to non-agricultural job losses of 0.5 percent for the state for the same period.

The Path to Recovery

Now let me turn back to the national picture. Getting out of the recession hinges in part on whether there are changes in the factors that got us into it in the first place. I believe there are.

In my view, the most important underlying factor was the war in Kuwait. It led to a sizable oil price shock--oil prices more than doubled in a matter of months. Added to a number of other factors--trouble in the financial and real estate industries, climbing unemployment rates, and the federal budget deficit--it shook consumer and business confidence.

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[1] Nonfarm payroll employment declined 1.5 percent from its peak in June 1990 to its trough in April 1991. Real GNP declined 1.1 percent from its peak in the third quarter of 1990 to its trough in the first quarter of 1991.

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The effects weren't felt just in the U.S., either. Uncertainty about the war and the oil shock also hit the economies of our major trading partners, which reduced their demand for our exports.

But the causes of the recession are largely behind us now. The war is over. Oil prices have settled down to their pre-invasion levels. We expect to see signs of improvement both in confidence and in the economic health of our trading partners. Indexes of consumer confidence soared after the war and then backed off a bit. Confidence should continue to improve gradually over the next year or so. And renewed strength in the economies of our major trading partners should boost our exports.

Other factors, too, pave the way for recovery. First, throughout this recession, inventories have been kept relatively low. So, as sales pick up, firms will need to increase production to rebuild stocks. Second, since July of last year, short-term interest rates have dropped more than 2 percentage points, due in part to a series of easing moves by the Federal Reserve. Lower interest rates should add strength to economic activity, especially in housing and consumer durables.

We may be getting a glimpse of the effects of these factors in the current data. The latest GNP statistics suggest that the economy expanded by a small amount in the second quarter, an improvement over the decline registered in the prior six months. Although the data so far aren't conclusive, it's likely that the business cycle has entered an expansion phase.

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A Moderate Recovery?

Now let me explain why I think this recovery may be moderate compared to other recoveries. Typically, the first year of post-war recoveries has averaged 5-3/4 percent growth, almost twice the rate of the long-term trend growth of the economy. But I expect the first year of this recovery to be less robust--probably around 3 percent.

What holds us back? The dollar is an important "wild card" in the forecast. When it was declining last year, we were counting on it to help improve our trade balance, and therefore stimulate growth. But, the dollar unexpectedly began to rise early this year. Since February, it's up by about 15 percent. So, instead of being a major factor pulling us out of the recession, as we thought only a six months ago, the dollar may be a drag on the recovery.

Second, federal and state budget deficits are leading to cutbacks in government spending. Although such cuts may be good for the economy in the long run, they may present some short-run adjustment problems. Substantial over-building in commercial real estate also will be a drag on the economy. High vacancy rates must be worked down before spending in this sector can be expected to pick up.

In the financial sector, institutions, such as banks, thrifts, and insurance companies, are extending less credit than we would normally see at this stage of the business cycle. Part

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of this shortfall has been made up by other sources of credit, especially direct lending by households and corporations. Part of it represents a sensible reponse to the excesses of the past. But it's too soon to tell how much the reduction in total credit is affecting the strength of the expansion.

Having given you a laundry list of reasons why the recovery may be weaker than normal, I should warn you that forecasts often are too pessimistic at this stage of the business cycle. For example, forecasts of a weak expansion were common in 1982 at the trough of the last recession. Yet real GNP rose by a strong 6½ percent over the first year of the ensuing expansion. So, we can't rule out the possibility that this will be stronger than expected.

The Outlook for 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 2¾ percent annual 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's reason to believe that underlying inflation has peaked, and may be on a downward trend. Labor and

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product markets have slackened, as reflected in the 1½ percentage points rise in the unemployment rate since early 1990. This should restrain growth in labor compensation over the next year or two. Overall, I wouldn't be surprised to see consumer inflation of a bit over 3½ percent this year, and closer to 3 percent in 1992. This would mark significant progress from the 4 to 4½ percent underlying rate of inflation that has prevailed in recent years. But before we get carried away in our optimism, let me caution you that to date the core rate of inflation, which excludes food and oil prices, has been a bit disappointing.

Where Does Policy Go From Here?

With inflation trending downward, what's the appropriate direction for monetary policy in a setting where the economy isn't clearly "out of the woods" and where the recovery may be fairly modest? Certainly, maintaining sustainable economic growth **is** one of the Fed's most important concerns.

In recent months, slow growth in M2 has raised concerns in this regard. In June and July, M2 moved from the midpoint of its annual range close to the lower boundary. But though M2 does have a stable relationship to total spending in the economy in the long run, its relationship to economic activity in the short run is highly variable. This makes it tricky to interpret implications about future economic developments from short-run movements in M2.

Turning points in the business cycle are especially risky

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times for monetary policy. For one thing, they're a time when signals often are quite mixed. For another thing, they're a time when it's natural to be overly pessimistic about the robustness of the ensuing recovery.

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

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