

Speech to Mission Professional and Business People's Luncheon  
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ECONOMIC PROSPECTS AND POLICY ISSUES AT THE TURNING POINT

I. Today I'd like to give you my version of the outlook for the economy.

A. Basically, I'm optimistic: it appears that the bottom of the business cycle is behind us.

1. I expect moderate economic growth in this half of the year, with inflation moving on a downward trend over the longer term.

B. But I also have some concerns.

1. Business cycle turning points can be tricky.

2. We're likely to see conflicting signals about the direction the economy is taking.

3. This uncertainty raises special problems in determining the appropriate monetary policy. I'll have more to say about that later.

II. Let me begin by putting this recession into perspective.

A. First, the recession hit the country after eight years of robust growth (3½ percent annual rate, on average).

B. Second, compared to other recessions, this one has been mild and probably shorter than average.

1. In the seven other post-war recessions, real GNP declined more than 2 percent and the downturns lasted just under a year, on average.

2. 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.

3. Of course, "mild" is a relative term.

a. By using it I don't mean to discount the pain and dislocation it has caused.

b. This recession has hit employment harder than

GNP.<sup>1</sup>

C. California, of course, has not been immune--

1. especially the Hispanic community, which makes up over a fourth of the state's population.

a. Between the second quarter of '90 and the second quarter of '91, the unemployment rate for Hispanics rose 3½ percentage points compared to 2½ percentage points for the population statewide.

2. Here in the San Francisco area, there is no breakdown available by ethnic groups. But I can give you a feel for overall business conditions.

a. The latest figures show that the unemployment rate locally has been a good deal lower than the nation's.

(1) In June, it stood at 5.1 percent.

b. The bright spot--for this area as well as for the state and the nation--is the service sector.

c. And though we have lost manufacturing and construction jobs locally during the past year, our losses are considerably smaller than those in the state and the nation.

III. Now let me turn back to the national picture.

A. 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.

B. In my view, the most important underlying factor was the war in Kuwait.

1. It led to a sizable oil price shock--oil prices more than doubled in a matter of months.

2. Added to a number of other factors--trouble in the

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<sup>1</sup>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.

financial and real estate industries, climbing unemployment rates, and the federal budget deficit--it shook consumer and business confidence.

3. The effects weren't felt just in the U.S., either.
  - a. Uncertainty about the war and the oil shock also hit the economies of our major trading partners, which reduced their demand for our exports.
- C. But the causes of the recession are largely behind us now.
  1. The war is over.
  2. Oil prices have settled down to their pre-invasion levels.
- D. We expect to see signs of improvement both in confidence and in the economic health of our trading partners.
  1. 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.
  2. And renewed strength in the economies of our major trading partners should boost our exports.
- E. Other factors, too, should pave the way for recovery.
  1. First, throughout this recession, inventories have been kept relatively low.
    - a. So, as sales pick up, firms will need to increase production to rebuild stocks.
  2. Second, since July of last year, short-term interest rates have dropped about 2½ percentage points, due in part to a series of easing moves by the Federal Reserve.
    - a. Lower interest rates should add strength to economic activity, especially in housing and consumer durables.
- F. Although the data so far aren't conclusive, it's likely that the business cycle has entered an expansion phase.

IV. Now let me explain why I think this recovery may be moderate compared to other recoveries.

- A. 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.
- B. But I expect the first year of this recovery to be less robust--probably around 3 percent.
- C. What holds us back?
  - 1. The dollar is an important "wild card" in the forecast.
    - a. When it was declining last year, we were counting on it to help improve our trade balance, and therefore stimulate growth.
    - b. But, the dollar unexpectedly began to rise early this year. Since February, it's up by about 12 percent.
    - c. So, instead of being a major factor pulling us out of the recession, as we thought only six months ago, the dollar may be a drag on the recovery.
  - 2. Second, federal and state budget deficits are leading to cutbacks in government spending.
    - a. Although such cuts may be good for the economy in the long run, they may present some short-run adjustment problems.
  - 3. Substantial over-building in commercial real estate also will be a drag on the economy.
    - a. High vacancy rates must be worked down before spending in this sector can be expected to pick up.
  - 4. 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.
    - a. But it's too soon to tell how much the reduction in bank lending is affecting the strength of the expansion.
- D. 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.

1. For example, forecasts of a weak expansion were common in 1982 at the trough of the last recession.
  - a. Yet real GNP rose by a strong  $6\frac{1}{2}$  percent over the first year of the ensuing expansion.
2. So, we can't rule out the possibility that this will be stronger than expected.

V. Now let me move on to inflation.

- A. We have seen noticeable improvement in this area in recent months, and I'll focus on three factors that help explain it.
  1. First of all, the turnaround in oil prices has been pulling our inflation indexes down.
    - a. Since oil prices peaked last October, the producer price index actually has declined somewhat, and the consumer price index has risen at only a  $2\frac{3}{4}$  percent annual rate.
  2. Second, the run-up in the dollar also should help hold inflation down, mainly next year, as price increases for imported goods are restrained.
  3. And finally, there's reason to believe that underlying inflation has peaked, and may be on a downward trend.
    - a. Labor and product markets have slackened, as reflected in the  $1\frac{1}{2}$  percentage point rise in the unemployment rate since early 1990.
    - b. This should restrain growth in labor compensation over the next year or two.
- B. Overall, I wouldn't be surprised to see consumer inflation of a bit over  $3\frac{1}{2}$  percent this year, and closer to 3 percent in 1992.
  1. This would mark significant progress from the 4 to  $4\frac{1}{2}$  percent underlying rate of inflation that has prevailed in recent years.
  2. 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.

VI. 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?

- A. Certainly, maintaining sustainable economic growth is one of the Fed's most important concerns.
- B. Turning points in the business cycle are especially risky times for monetary policy.
  - 1. For one thing, they're a time when signals often are quite mixed.
  - 2. For another thing, they're a time when it's natural to be overly pessimistic about the robustness of the ensuing recovery.
  - 3. This may explain why there have been too many times when policy has eased well after the trough has passed.
  - 4. These instances typically were followed by unsustainable growth and eventually painful struggles with inflation.
- C. 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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