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A POLICYMAKER'S PERSPECTIVE AT THE TURNING POINT

I. Thank you very much. It's a pleasure to be here.

A. I want to talk to you today about the outlook for the regional and national economies.

B. To set the stage a bit, let me tell you about a cartoon a friend of mine from Chicago sent me.

1. In the cartoon, a woman is watching a television report that says, "According to economists at Chicago's biggest banks, the recession probably ended in April or May." And the woman thinks to herself, "I miss everything."

C. Well, I grant you, a lot of people across the country probably feel the same way. And, like the economists in Chicago, and elsewhere, for that matter, I'm going to suggest that the recession is over.

D. So why doesn't it feel like it's over?

1. Part of the answer is that we're at the turning point in the business cycle. Turning points can be tricky times for the economy--as well as for economists and policymakers.

2. Another part of the answer is that the recovery from this recession is not likely to be a "fast break" to high growth. Instead it's likely to proceed at only a moderate pace.

II. To explain this outlook, let me begin by putting the 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.

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 barely 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 <u>has</u> hit employment harder than GNP.

C. Here in Idaho, though, economic performance has been strong.

1. Between July 1990 and July 1991, employment in the state grew about 4 percent--a stellar performance, compared with a 1¼ percent decline nationally.

    a. This makes Idaho the third fastest-growing state in the country during this period.

2. Idaho's construction sector is a real standout compared with the woeful national performance.

    a. During the year ending July '91, construction employment grew here by more than 7 percent, which is strong by any measure.

    b. And it's particularly impressive compared with a 9 percent <u>decline</u> in the nation.

3. Even in the service sector, where the nation <u>did</u> show some growth, Idaho outperformed it by a wide margin.

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 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 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, pave the way for recovery.

   1. First, throughout this recession, inventories have been kept 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. We may be getting a glimpse of the effects of these factors in the current data.

   1. The latest GNP statistics show that economic activity was roughly unchanged in the second quarter, an improvement over the decline

registered in the prior six months.

2. Although the data so far aren't conclusive, it appears that the economy is expanding at a more robust pace in the current quarter.

G. Overall, 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 others.

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. First, federal and state budget deficits are leading to cutbacks in government spending.

a. Cuts in government spending may be good for the economy in the long run, but they may present some short-run adjustment problems.

2. 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.

3. Developments in the financial sector also are a source of concern. Banks, thrifts, insurance companies, and other institutions are extending less credit than we would normally see at this stage of the business cycle.

a. Naturally, weak bank and thrift credit helps explain why the Fed's main monetary aggregate, M2, now stands at the lower boundary of its 1991 target range.

b. Part of the shortfall in credit extensions from financial institutions has been made up by direct lending by households and corporations.

c. Part of it represents a sensible response to the excesses of the past.

d. In any case, it's too soon to tell how much the reduction in total credit is affecting the strength of the expansion.

D. Now that I've warned you that the recovery may be weaker than normal, I should also 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, much more severe recession.

a. Yet real GNP rose by a strong 6½ percent over the first year of that expansion.

2. The dollar could be a wild card for the economy this time around. It has a strong effect on economic performance, and is one of the most difficult variables to forecast.

a. The dollar unexpectedly began to rise early this year. Unless it is reversed, the 15 percent appreciation since February will restrain future economic growth.

b. However, some of the fundamental factors that determine the dollar in the long run do suggest that it may decline over time.

3. This is one reason that this expansion could turn out to be stronger than expected.

V. Now let me move on to inflation.

A. We have seen some improvement in this area in recent months, although a good deal of this may be temporary.

1. First of all, the turnaround in oil prices has been pulling our price indexes <u>down</u>.

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 2½ percent annual rate.

2. Second, the run-up in the dollar, if it is not reversed, also should help hold prices down, mainly next year, as price increases for imported goods are restrained.

3. However, new levels of oil prices and the dollar can only **temporarily** affect inflation rates.

B. Factors affecting underlying inflation are far more important for the long term.

1. In this area, the situation is uncertain.

a. Labor and product markets have slackened, as reflected in the 1½ percentage point rise in the unemployment rate since early 1990.

b. This should restrain growth in labor compensation before long.

2. But although this provides a reason to believe that underlying inflation may start on a downward trend, we have not yet seen significant improvement in the data.

C. 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.

1. This would mark significant progress from the 4 to 4½ percent inflation that has prevailed in recent years.

2. But as I have emphasized, I would feel much better if this reflected improvement in underlying inflation, rather than mainly a temporary response to oil prices and the dollar.

VI. What's the appropriate direction for monetary policy in the present setting where gains against inflation may be mainly temporary, and where the economic recovery may be fairly modest?

A. As I said at the beginning, these transition periods from recession to recovery are especially risky times for monetary policy.

1. For one thing, they're a time when signals often are quite mixed.

2. But I think it's important to recognize that they're also 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.

B. Maintaining sustainable economic growth is one of the Fed's most important concerns. At the same time, we should recognize that inflation remains a stubborn problem.

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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