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A POLICYMAKER'S PERSPECTIVE AT THE TURNING POINT

I. Thank you. It's a pleasure to be here today, and I'm honored to be the inaugural speaker in your Distinguished Lecturer Series.

   A. Today my topic will be the economic outlook for the nation and the region.

   B. To put it briefly, I think that we're going through a turning point in the business cycle.

      1. We're moving from the recession into an expansion

      2. --an expansion that's likely to be moderate.

   C. I want to stress that turning points can be tricky to navigate--for policymakers and businesses as well:

      1. Some signals are up and some are down, which makes for uncertainty.

      2. And, after months of bad news, it's tempting to focus on the down signals and ignore the positive ones.

   D. So today I want to spend some time explaining

      1. why I think the recession is over,

      2. why the recovery is likely to be moderate,

      3. and, finally, what this means for monetary policy.

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

   A. 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.

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

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

   b. This time around employment has been hit harder than GNP.

B. Here in California, our poor performance has come as a bit of a shock, since we're used to outperforming the nation by a substantial margin.

1. Statewide, the employment situation deteriorated along with the rest of the nation, and remains weak.

   a. Official data suggest that California has lost over 100,000 jobs since employment peaked in July of last year.

   b. But recently published information based on disappointing tax receipts, suggests that actual job losses have been much greater.

2. Southern California, and Orange County in particular, have been among the hardest hit regions in the State.

   a. In fact, Orange County's job losses for the period were higher than the nation's, amounting to almost 1½ percent.

3. What happened?

   a. For one thing, the recession came down hard on some industries like construction, aerospace, and durable manufacturing, that have been relatively important to Orange County's economy.

   b. This led to weak performances in the County's retail sales and many of its service sectors.

4. I realize I've painted a fairly bleak picture of the region.

   a. It may seem a little alarming when added to all we've heard lately about manufacturers leaving the L.A. basin because of the high cost of labor and housing, tighter air quality regulations, and the like.

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b. But based on available data, manufacturers fared no worse in Orange County than they did nationally during this recession.

c. And, with continued growth in the area's population, the region's longer-term outlook continues to be quite promising.

III. Turning back to the national picture, let me explain why I think that the recession is over and that we're on the path to recovery.

A. First, the causes of the recession--the war and the rise in oil prices--are largely behind us now.

B. And other important factors pave the way for recovery.

1. Since July of last year, short-term interest rates have dropped by 2½ to 3 percentage points, due in part to a series of easing moves by the Federal Reserve.

a. The latest was last month when the discount rate was lowered by ½ point to 5 percent.

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

2. And fortunately, we don't have an inventory "overhang" to worry about.

a. Since inventories have been kept low, firms will need to increase production to rebuild stocks as sales pick up.

C. We may be getting a glimpse of the some of these effects.

1. Economic activity was roughly unchanged in the second quarter, an improvement over the decline registered in the prior six months.

2. Although this isn't conclusive evidence, it appears that the economy expanded at a more robust pace in the third quarter just ended.

IV. So why doesn't if <u>feel</u> like the recession's over and that we've moved into an expansion?

A. First, it's important to keep in mind that the transition from recession to expansion occurs at the

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<u>bottom</u> of the business cycle, when <u>levels</u> of economic activity are very low.

B. Second, the pickup so far has been concentrated mainly in the industrial sector, rather than in the broad services sector.

1. Industrial production has accelerated sharply, growing at a 7½ percent annual rate since March, compared to a 10½ percent rate of decline over the previous six months.

C. Finally, the recovery from this recession is not likely to be a "fast break" to high growth as in many other recoveries.

1. In the first year of most post-war recoveries, the economy has averaged 5¾ percent growth, almost twice its long-term trend growth rate.

2. In the first year of this recovery I expect the economy to grow much more slowly--probably around 3 percent.

V. Now let me explain why this recovery is likely to be moderate.

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

1. These cuts may be good for the economy in the long run, but they also may present some short-run adjustment problems.

B. Substantial over-building in commercial real estate also will be a drag on the economy.

1. High vacancy rates must be worked down before spending in this sector can be expected to pick up.

C. 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.

1. 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.

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

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

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

VI. Now let me move on to inflation.

A. We've 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 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 2½ percent annual rate.

2. Second, the run-up in the dollar since February 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 affect inflation rates temporarily.

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 haven't seen significant improvement in the data yet.

C. Overall, however, I wouldn't be surprised to see consumer inflation of around 3 percent both this year and next.

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

2. But as I've tried to emphasize, I'd feel much better if this reflected improvement in underlying inflation, rather than mainly a temporary response to oil prices and the dollar.

VII. What's the appropriate direction for monetary policy in a setting where gains against inflation--at least to date--have been mainly temporary, and where the economic recovery may be fairly modest?

A. For monetary policymakers, transition periods from recession to recovery are especially risky times.

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

2. And they're also a time when it's natural to be overly pessimistic about the strength of the recovery.

a. For example, forecasts of a weak expansion were common in 1982 at the trough of the last, much more severe recession.

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

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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