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A POLICYMAKER'S PERSPECTIVE AT THE TURNING POINT

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

   A. 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.

   B. 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.

   C. 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.

      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 <u>has</u> been hit harder than GNP.

III. And some regions have been hit much harder than others.

A. Job losses have been particularly severe in the Northeast,

1. and most Midatlantic and Southeastern states also have fared poorly relative to the national average.

2. Most Midwest states, in contrast, actually have seen a little bit of job <u>growth</u> since July 1990.

B. At the San Francisco Fed, we pay particular attention to the nine western states that comprise the Twelfth Federal Reserve District.

1. While our region as a whole is currently performing better than the national economy, there are also sharp variations from state to state.

a. Utah and Idaho, for example, continue to show very healthy growth.

(1) In fact, they rank right after Nebraska as the second and third fastest growing states since the economy peaked in July 1990.

C. California, however, has been the weakest of the western states in this recession.

1. This performance has come as quite a shock to us residents of the "Golden State," since we're used to having one of the strongest economies around.

2. 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 may have been much greater.

D. The San Diego area has suffered along with the State.

1. The recession has come down hard on some industries like construction and aerospace, that have been relatively important to San Diego's economy.

a. This led to weak performances in the area's retail sales and in some of its financial and insurance sectors.

2. Continued growth in service industries--particularly health services--has been a much-needed positive note throughout the recession.

a. Still, the rate of growth in service employment has fallen substantially--from a robust 7 percent in 1989 to around 2 percent during the past year.

IV. 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 we don't have complete data yet, it appears that the economy expanded at a more robust pace in the third quarter just ended.

V. 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 <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, though industrial production has slowed somewhat since late summer.

1. It increased at a 6½ 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.

VI. 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. Although we don't have an inventory "overhang," we do have a commercial real estate "overhang."

1. High vacancy rates must be worked down before

the unemployment rate since early 1990.

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

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

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.

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