

Chamber of Commerce  
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**1992: PROSPECTS FOR RECOVERY**

- I. It's a pleasure to be here in Seattle.
  - A. Today I'll be talking about the outlook for the new year, and I'll be summing up some of the changes between 1991 and 1992.
  - B. While I'm on the topic of change, I'd like you to know that there are some important changes to our Board of Directors that involve people from this community.
    - 1. In January, Judy Runstad, who had been the chair of the Seattle Branch Board, will join the Head Office Board in San Francisco.
    - 2. George Russell, of Tacoma, will ascend to the chair of the Seattle Branch Board,
    - 3. and Emilie Adams, president of the Seattle Better Business Bureau, will fill Judy's term.
    - 4. We're very, very pleased to add these distinguished leaders in the community to our Boards,
      - a. and we're looking forward to their participation and contribution to the monetary policy process.
- II. As I said, now that we're approaching the end of the year, it's a good time to sum up what's happened in the past twelve months, and peer ahead into the next twelve.
  - A. Of course, the big economic story of 1991 is the recession.
  - B. And the big question for many people is whether we'll have a recovery in 1992.
- III. Let me start by taking a regional look at this recession.
  - A. Research at our Bank has shown that this recession has been unusual in terms of its regional impact.

1. Job losses have been more concentrated geographically, and they've been especially severe in the Northeast.
  2. Three states -- Massachusetts, New York, and New Jersey -- account for over 40 percent of the nation's employment decline.
- B. At the San Francisco Fed, our focus is on the nine western states that comprise the Twelfth Federal Reserve District.
1. While a number of District states have done reasonably well, California's performance has been uncharacteristically weak, and because of its size, it has pulled down the totals for the West.
    - a. Of course, with its large and diverse economy, it would be amazing if California were **not** affected by a national recession.
  2. What's unusual this time around is that California also has had to cope with some specific problems, such as:
    - a. defense cutbacks,
    - b. a commercial real estate glut,
    - c. blows to the agricultural sector (drought, freeze, and the white fly invasion),
    - d. and, last, but not least, cutbacks in spending by state and local governments.
- C. Here in Washington, overall conditions continue to compare favorably to the national average.
1. But that's cold comfort when you consider that the state registered its first job losses in March, and that since June the number of jobs has been only fairly stable.
  2. There are at least three reasons why Washington isn't growing as rapidly as it did a year or two ago.
    - a. The national recession, of course, is one reason.
    - b. And, like California, there have been defense cutbacks, though they're not quite so painful for Washington.

- (1) Defense accounts for a smaller share of aerospace revenues here than in some other areas.
    - (2) And the commercial side of aerospace continues to be in good shape.
  - c. Third, the production of logs and lumber is constrained, both because of
    - (1) environmental issues,
    - (2) and the slowdown in home-building nationally.
- 3. These factors aren't enough, though, to change Washington's fundamentally bright longer-term outlook.
  - a. The state would share in a resurgent national economy.
  - b. And the strong migration and international trade patterns of a couple of years ago will become important forces in a recovery for Washington as well.

IV. Turning back to the national picture, it looked like the recession was coming to a halt this summer.

- A. Output increased at less than a 2 percent pace in the third quarter, just ended.
- B. But both the timing and the source of the growth have raised some doubts about whether it will continue.
  - 1. Most of the growth actually occurred through about August, and since then, the economy has moved basically "sideways."
  - 2. In addition, the growth was due to changes in inventories.
- C. What's needed to sustain an expansion is growth in underlying demand for goods and services, not just changes in inventories.
  - 1. In the third quarter, final demand for goods and services was weak, declining at nearly a 1 percent (annual) rate.
  - 2. So far in the current quarter, the data haven't been any more encouraging.

- a. For example, consumer spending, by far the largest component of overall demand, fell in October.
  - D. But there is a fundamental factor working to stimulate underlying demand.
    - a. Since July of 1990, the federal funds rate has dropped by more than 3 and a half percentage points, due in part to a series of easing moves by the Federal Reserve.
    - b. The latest was last month when the discount rate was lowered by ½ point to 4½ percent.
  - E. On this basis, then, I think we stand a good chance of seeing an expansion next year.
- V. What kind of expansion will it be? For several reasons, I'd say that it will probably be moderate.
  - A. First, federal and state budget deficits are leading to cutbacks in government spending and, in many cases, to higher taxes.
    - 1. More balanced budgets may be good for the economy in the long run, but they also present some short-run adjustment problems.
  - B. Second, we have a huge commercial real estate "overhang."
    - 1. It may take years before high vacancy rates are worked down far enough to stimulate spending in this sector.
- VI. Finally, developments in the financial sector are a major source of concern.
  - A. We've seen unusual weakness in lending on an economy-wide basis.
    - 1. This isn't just because of the crisis in the S&L industry.
      - a. In fact, home mortgage lending--the "bread and butter" of savings and loans--is not unusual when you compare it to other recessions.
      - b. Commercial and mortgage banks are picking up the slack.
  - B. The problem seems to be with business lending, which has been unusually weak at commercial banks.

1. Part of the weakness is due to the recession itself.
  2. But part is also due to shocks to the banking system.
    - a. For example, stiffer regulation has constrained lending as banks try to build their capital to meet new requirements.
    - b. And sectoral problems have played a role--that is, problems in industries, such as commercial real estate, where banks normally lend.
  3. These developments raise banks' fundamental cost of channeling funds between lenders and borrowers.
- C. Some of the effects of these costs on the economy will be short-lived, while others will be longer-lasting.
1. As the market shifts to lower-cost channels of financing, these effects will diminish.
  2. But, to the extent that banks have a special function that other markets and institutions can't perform, we can expect some long-lasting reduction in the flow of credit.
    - a. A good deal of this probably is appropriate in view of the need to avoid excessive risk-taking by banks.
- D. In any event, there's reason to suspect that these reduced credit flows could be weakening the economy.
1. As I mentioned earlier, monetary policy has tried to cushion these effects during the transition by lowering interest rates.
- E. So far, the picture I've painted isn't especially bright. As I said, the recovery from the recession is not going to be a "fast break" to high growth, but instead it will be a period of moderate growth.
- VII. There is some clearly good news, though, on the inflation front. Inflation appears to be on a downward trend.
- A. First of all, oil prices are well below their peak during the Gulf war, while the dollar has increased on balance this year. Both of these factors will hold prices down for a time.

- B. More important, we are beginning to see meaningful reductions in underlying inflation, which are key to long-term control of inflation.
  - 1. During the recession, labor and product markets have slackened, and this has restrained growth in labor compensation and product prices so far.
  - 2. Moreover, with the economy expected to pick up only gradually next year, this downward pressure on underlying inflation most likely will continue for some time to come.
- C. Overall, then, I wouldn't be surprised to see consumer inflation come in at 3½ percent or lower this year and next.
  - 1. This would mark significant progress from the 4½ to 5½ percent core rate of consumer inflation in recent years.

VIII. As we deliberate about monetary policy, the progress against inflation plays a pivotal role.

- A. Because inflation is on a downward trend, we have greater latitude to react to weakness in the economy.
- B. Of course, the Fed's main longer-term goal is to control, and ultimately eliminate, inflation.
  - 1. Such a policy is crucial in achieving a maximum economic growth trend in the long run.
- C. However, maintaining reasonable economic growth in the face of short-run business cycle swings also is an important concern of the Fed.
  - 1. As I hope our policies over the past year and a half have demonstrated, we are working hard to help the economy move into a recovery phase.
    - a. I believe our efforts ultimately will pay off.

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