

1992: PROSPECTS FOR RECOVERY

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Now that we have started the new year, it is a good time to sum up what has happened in the past twelve months, and peer ahead into the next twelve. Of course, the big economic story of 1991 was the recession. And the big question for many people is whether we will have a recovery in 1992.

The Regional Recession

Let me start with a regional look at this recession. At the San Francisco Fed, our focus is on the nine western states that comprise the Twelfth Federal Reserve District. A number of District states have done reasonably well during the last year. But California has been hurt more than usual in this recession.

One reason is that defense cutbacks already had weakened the state's economy when the recession came along. California defense contractors have not been hit any harder than defense contractors elsewhere. But the concentration of defense work in California--especially Southern California--has magnified the effects of those cuts on our economy.

Another reason is the commercial real estate glut that was developing in some parts of the state just as the economy weakened. This knocked the pins out from under the construction industry, and reduced property values in some areas, which has just added to the general economic weakness.

A third sector that has had unusual problems is agriculture. In the past couple of years, it has been hit by a triple whammy:

the drought, the freeze, and the white fly invasion.

But some people have been saying that California--the Golden State--is beginning to show some tarnish. They think that California will end up struggling through the nineties the way Texas and New England struggled through the eighties. Their reasoning is that the state faces serious long-term, structural problems, such as an inadequate infrastructure, especially the transportation system, and stringent air quality controls--particularly in the southern part of the state--that restrict the activities of businesses and individuals. And finally, our state and local governments seem to find it increasingly difficult to fund the services people expect within the existing tax structure.

While these are serious issues, my own view is that what we are seeing now is essentially a business cycle--although a more severe business cycle than we are used to in California. Why? Just look at the timing. California employment did not start to fall until the national recession began in July of 1990. This is after the declines in employment in the defense industry, which began at the start of 1990.

Moreover, the concerns about the structural problems--the infrastructure, air quality restrictions, and state and local budget crunches--have been with us for quite some time. So the chronology suggests that it was primarily the national recession that brought us down, not the litany of California-specific factors.

If I am right, then the recovery in the national economy should pull California out of its own recession. This means, we will see California growing again, although the rate of growth will be constrained by the structural factors I mentioned.

The National Outlook

Turning to the national picture, it looked like the recession was coming to a halt this summer. In the second and third quarters, the contraction in output turned to a modest expansion, at a $1\frac{1}{2}$ to 2 percent pace. The problem is: Much of that growth--especially in the third quarter--was driven by changes in inventories, not by growth in domestic demand for goods and services.

The data we have so far on the fourth quarter have not been very encouraging about demand. The November level of real consumer spending, by far the largest component of overall demand, was barely above its average of the third quarter. The real durable goods component, which includes autos, furniture, and appliances, for example, was actually down.

As a result of weak demand, the economy appears to have slowed again in the fourth quarter. Although employment grew a little in December, this did not come close to offsetting the large decline in November. And industrial production fell for the third straight month in December.

But there is a fundamental factor working to stimulate underlying demand. Since July of 1990, the federal funds rate has dropped by more than 4 percentage points--1½ percentage points since August alone--due in part to a series of easing moves by the Federal Reserve. And other short-term interest rates have dropped by almost as much. The discount rate now stands at 3½ percent, its lowest level since 1964, although long-term rates have fallen by only about a third to a half as much as short-term rates.

Does Monetary Policy Still Work?

Some people, though, shrug their shoulders at the interest rate cuts and say, "So what? The Fed has been cutting rates for months. Where's the recovery?" Let me try to answer that.

Lower interest rates will stimulate the economy through several channels. First, the interest-sensitive sectors--housing, consumer durables, and business equipment--all will begin to respond to lower borrowing costs when confidence turns around. Residential construction already appears to have picked up recently.

Second, lower U.S. interest rates create a lower foreign exchange value of the dollar. While turmoil in the Middle East, Eastern Europe, and the Soviet Republics caused the dollar to rise for an extended period, it has fallen sharply since last summer. The lower dollar will stimulate demand for our exports, and cause buyers here at home to shift from imported to U.S.-

produced goods.

Finally, lower interest rates raise the net wealth position of the private sector (by raising the present value of capital and land). We see confirmation of the wealth effect because easier monetary policy generally boosts the stock market. Efforts to measure the wealth effect indicate that it is important, but its impact on spending is quantitatively smaller than the effects of lower borrowing costs or lower exchange rates. Lower interest rates also raise the values of long-term (fixed-rate) assets and debts such as CDs, mortgages, and bonds-- and lower the cash flows of short-term assets and debts. However, while the distributional effects of these changes across borrowers can be very large, the net wealth effects tend to be small since there are individuals on each side of debt instruments.

The three channels -- lower borrowing costs, a lower dollar, and higher net wealth -- will combine to stimulate U.S. demand this year. Our model of the economy indicates that--on average-- for every 1 percentage point decline in the real short-term interest rate, real output growth is boosted roughly $\frac{3}{4}$ percentage point in the first year following the decline, and almost $\frac{1}{2}$ percentage point in the second year. However, this output response can vary considerably, depending on other factors, and for several reasons, the strength of this year's expansion is open to question.

A Moderate Expansion

My own view is that the expansion will probably begin by about the second quarter, and it is likely to be moderate. First, federal and state budget deficits are leading to cutbacks in government spending and, in many cases, to higher taxes. More balanced budgets may be good for the economy in the long run, but they also present some short-run adjustment problems. Second, we have a huge commercial real estate "overhang." It may take years before high vacancy rates are worked down far enough to stimulate spending in this sector.

Moreover, the unusual weakness in credit flows in the economy could be a drag on the recovery, though it is hard to say exactly how big a problem this might be or how long it might persist. Weak credit flows cannot be pinned simply on the crisis in the S&L industry. In fact, home mortgage lending--the "bread and butter" of savings and loans--is not unusual when you compare it to other recessions. Commercial and mortgage banks are picking up the slack.

Instead, the problem seems to be with business lending, which has been unusually weak at commercial banks. Part of the weakness is due to the recession itself. But part is also due to shocks to the banking system. For example, stiffer regulation has constrained lending as banks try to build their capital to meet new requirements. And sectoral problems have played a role--that is, problems in industries, such as commercial real estate, where banks normally lend. These developments raise banks' fundamental cost of channeling funds between lenders and

borrowers, which could lead to a prolonged reduction in the flow of credit.

I realize I have painted a somewhat fuzzy picture. I do expect lower interest rates to provide a strong stimulus for recovery this year. But the three factors I have mentioned-- federal and state fiscal restraints, the commercial real-estate overhang, and reduced credit flows--suggest to me that the recovery will be modest.

Good News on the Inflation Front

Now let me focus on a very clear bright spot in the picture--the downward trend in inflation. We are beginning to see meaningful reductions in underlying inflation, which are key to long-term control of inflation.

During 1991, labor and product markets slackened, and this restrained growth in labor compensation and product prices. For example, labor costs, including benefits, for the total private and state and local government sectors rose $4\frac{1}{4}$ percent over the 12 months ending in September, a full percentage point below the rise over the prior 12-month period. During 1991, consumer prices increased only 3 percent. Of course, this included the effects of the dramatic fall in oil prices. But, even excluding food and energy, the CPI rose only $4\frac{1}{2}$ percent over the 12 months ending in December, compared with $5\frac{1}{4}$ percent over the prior 12-month period. With the economy expected to pick up only gradually this year, downward pressure on underlying inflation

most likely will continue for some time to come.

Overall, then, I would not be surprised to see consumer inflation stay at around 3 percent this year. This would mark significant progress from the $4\frac{1}{2}$ to $5\frac{1}{2}$ percent core rate of consumer inflation only two years ago.

The Role of Monetary Policy

As we deliberate about monetary policy, the progress against inflation plays a pivotal role. Of course, the Fed's main longer-term goal is to control, and ultimately eliminate, inflation. Such a policy is crucial to achieving a maximum economic growth trend in the long run.

Because inflation is on a downward trend, we have greater latitude to react to weakness in the economy. 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. I believe our efforts ultimately will pay off.