

Hacienda Owners Association,
Pleasanton, CA
For delivery on March 4, 1992
8:00 a.m. PST

1992: PROSPECTS FOR RECOVERY

- I. It's a pleasure to speak to you today about the economic outlook.
- A. From the questions I get, there are at least three issues typically on people's minds:
1. First, when are we going to start seeing sustained, strong growth in the economy?
 2. Second, are the Fed's actions to lower interest rates really doing anything?
 - a. Or are we just "pushing on a string"?
 3. And, finally, what about California? And what about the Bay Area? Has the "Golden State" lost its luster?
- B. In a nutshell, here are my answers:
1. We'll see a sustained--but moderate--expansion begin in the second quarter;
 2. monetary policy will have an effect in stimulating the economy—in fact, it already is having an effect;
 3. and, "yes," California has its problems,
 - a. but, "no," it's not likely to go through the kind of freefall we've seen in the economies of New England and Texas.
- II. Let me start by taking a regional look at this recession.
- A. Some regions certainly have been hit much harder than others.
- B. If you tuned in to the New Hampshire primaries, you know that job

losses there and throughout New England have been severe.

1. The situation isn't much better along most of the Atlantic Coastline.
 - a. New York, New Jersey, Pennsylvania, and Maryland have suffered.
 - b. Even some of the Southern states, like Virginia, Georgia, and Florida, have been taking some nasty blows.

- C. At the San Francisco Fed, we pay special attention to the nine western states that comprise the Twelfth Federal Reserve District.
 1. Most of the District states are doing relatively well.
 - a. And Idaho and Utah even have fairly robust employment gains to report.
 2. But here in California, we're in a significant recession, with the worst problems in the southern part of the state.
 - a. We can see the problems not only in the numbers, but also in the comments and forecasts of our contacts.
 - (1) Our sources in Utah and Idaho typically have been most optimistic, and those from Southern California the most downbeat.

- D. This performance is pretty unusual for California. If you look back at our history, you know that we're used to weathering recessions somewhat better than the nation.
 1. While the national economy actually contracts in a recession, California's economy typically just "hesitates."
 2. Only once before, in 1970, did California do worse than the U.S.

- E. The media reaction to the situation here has been dramatic--maybe even melodramatic.
 1. A few days ago, the front page headline of the Wall Street Journal

said, "California, the Place Long in the Sun, Now Is Clouded by Doubts."

2. There's no question that the state has some serious long-term structural problems, such as
 - a. an inadequate infrastructure—especially our roads and bridges;
 - b. stringent regulations—especially in the southern part of the state—that restrict business activity;
 - c. and budget crunches at the state and local level.
- F. But I think our current problems have more to do with the national recession, and there are clear reasons why it has hit us so hard.
1. First, the defense cutbacks had weakened the economy just before the recession.
 - a. And they've been especially painful for southern California because so much defense work is concentrated there.
 2. Second, the agricultural sector has had to deal with the drought, the freeze, and the white fly invasion.
 3. And finally, some parts of the state faced a glut in commercial real estate, just as the economy weakened.
- G. Here in the Bay Area, we've felt the pinch, though not as much as Los Angeles. Why the relative strength?
1. In part, we've had less overbuilding in commercial real estate,
 2. and we're also less dependent on defense spending.
 3. These two sectors have compounded the recession in southern California,
 - a. and they'll hamper its recovery during the next couple of years.

- III. Turning to the national picture, it looked like we were at a turning point last summer.
- A. In the second and third quarters, the contraction in output turned into a modest expansion,
1. at around a 1½ percent pace.
- B. Since then, though, the economy basically has moved sideways, with some positive and some negative signs.
1. On the positive side,
 - a. retail sales turned in a fairly strong performance in January.
 2. But on the negative side,
 - a. recent declines in employment have wiped out the advances made last spring and summer,
 - b. and industrial production declined or stayed the same for four straight months.
- C. Nonetheless, I look to the second quarter for the beginning of a sustained recovery.
- D. Why? One important reason is that a fundamental factor is working to stimulate underlying demand, and therefore economic activity. That factor is lower interest rates.
1. The federal funds rate and other short-term rates are now about half what they were in July 1990,
 - a. due in part to a series of easing moves by the Federal Reserve.
 2. The discount rate now stands at 3½ percent, its lowest level since 1964.
 3. Although long-term rates moved back up in recent weeks, they're

still below their levels last summer.

- IV. Now some people just 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.
- A. Lower interest rates will stimulate the economy through three channels.
 - B. First, lower borrowing costs will stimulate demand in sectors like new housing, business equipment, and consumer durables, which includes, for example, autos, furniture and appliances.
 - 1. We're already seeing a pickup in the residential construction sector.
 - C. Second, lower U.S. interest rates probably will lower the foreign exchange value of the dollar.
 - 1. While turmoil in the Middle East, Eastern Europe, and the former Soviet Republics caused the dollar to rise for a while, it has fallen since last summer.
 - 2. The lower dollar will stimulate demand for our exports,
 - 3. and cause buyers here at home to shift from imported to U.S.-produced goods.
 - D. The third channel has somewhat less of an effect than the other two. It involves raising the net wealth position of the private sector (by raising the present value of capital and land).
 - 1. On the equity side, we see confirmation of the wealth effect because easier monetary policy generally boosts the stock market.
 - 2. On the debt side, the effects are mainly distributional.
 - a. Lower interest rates raise the values of long-term (fixed-rate) assets and debts, such as mortgages and bonds,
 - b. and lower the cash flows of short-term assets and debts.

- c. But this doesn't have much of a net wealth effect, since there are individuals on each side of debt instruments.

- E. The three channels -- lower borrowing costs, a lower dollar, and higher net wealth -- will combine to stimulate U.S. demand this year and next.
 - 1. Our model of the economy indicates that--on average--every 1 percentage point decline in real short-term interest rates boosts real output growth
 - a. roughly $\frac{3}{4}$ percentage point in the first year after the cut in rates
 - b. and almost $\frac{1}{2}$ percentage point in the second year.
 - c. Just to give you a feeling for the magnitudes here, half a percentage point increase in GDP means an additional \$25 billion in goods and services.

- F. But, as we know, this hasn't been an average recession,
 - 1. and for several reasons, the strength of this year's expansion is open to question.

- V. My own view is that, once the recovery starts, the growth for the rest of the year will 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 won't be getting the same boost we got in 1991 from foreign trade.
 - 1. Now many of our major trading partners also are dealing with economic slowdowns, which will reduce their demand for our products.
 - 2. However, this negative impact will be offset by the lower dollar.

3. So foreign trade is likely to have only a neutral effect on our economy this year.
- C. Third, 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.
 - D. Finally, the shakeout in banks and S&Ls has led to unusual weakness in credit flows in the economy.
 1. This weakness could be a drag on the recovery, though it's hard to say exactly how big a problem this might be or how long it might persist.
- VI. I realize I've painted a somewhat fuzzy picture.
1. I do expect lower interest rates to provide a strong stimulus for recovery this year.
 2. But the factors I've mentioned suggest to me that the recovery will be modest.
- VII. Now let me focus on a very clear bright spot in the picture--the downward trend in inflation.
- A. We're beginning to see meaningful reductions in underlying, or core, inflation, which are key to long-term control of inflation.
 - B. During 1991, labor and product markets slackened, and this restrained growth in labor compensation and product prices.
 1. For example, last year the rise in total labor costs, including benefits, was half a percentage point below the rise in 1990.
 2. Furthermore in 1991, consumer prices increased a much improved 3 percent.
 - a. Of course, one of the things that drove the inflation rate down was the dramatic fall in oil prices.

