

Community Leaders Luncheon
Salt Lake City
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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"?
 - B. In a nutshell, here are my answers:
 1. We'll see a sustained--but moderate--expansion begin in the second quarter;
 2. and monetary policy will have an effect in stimulating the economy—in fact, it already is having an effect;
- 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. Like the nation, the District has seen wide variation in economic performance.
 - 2. The worst conditions are in California, which is suffering from a significant recession.
 - a. This performance is pretty unusual, since California typically weathers recessions somewhat better than the nation.
 - b. This time around, though, cutbacks in defense spending and overbuilding in commercial real estate have led to significant job losses in manufacturing and construction.
 - 3. The media have certainly had a field day--with several stories reporting the demise of the California economy.
 - 4. California certainly has some long-term structural problems,
 - a. including an inadequate infrastructure, stringent regulations, and a government budget imbalance.
 - 5. But these problems are likely to slow growth--rather than prevent it.
 - 6. When the national recovery starts, I expect the California economy to recover as well.

- D. The bright spots in our District are Idaho and Utah.
 - 1. Both have registered economic growth that's among the strongest in the nation.
 - 2. While California and the nation as a whole suffered job losses, these states added jobs,

- a. with employment growth rates consistently ranking in the top five states nationally.
3. Utah especially has recorded impressive gains in jobs, in personal income, in population, and in building permits.
- E. Why the superior performance?
1. Utah certainly isn't immune to national economic trends.
 2. Manufacturing jobs have fallen, with layoffs occurring in computer and defense related industries.
 3. But Utah's manufacturing sector has shown strength in civilian sectors, such as manufacturing airbags for cars.
 4. And weakness in manufacturing has been more than offset by growth in residential construction, trade, and business services, such as WordPerfect and Novell.
 - a. [Optional: And, of course, there's the tourist and recreation industry--I'd like to add that I personally am a contributor to the strength there!]
- F. This strong performance reflects the attractiveness of Utah as a place to live, and as a place to do business, drawing both people and firms from other states.
1. Utah boasts affordable housing, a pro-business regulatory environment, and a state budget that's in the black.
 2. The economic outlook for Utah is good, in part because the state has, in a sense, already paid its dues.
 - a. In the early to mid-1980s, Utah went through some tough times, largely due to weak energy prices.
 - b. Since then, the state has worked through some of the problems, such as an overbuilt commercial real estate market that now plagues other areas of the country.

3. And while the Utah economy is not as closely linked to the national economy as California is, a national recovery will serve to boost demand for Utah manufactured products.

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.
 - b. After excluding food and energy, the core rate of consumer price inflation rose 4½ percent in 1991.
 - (1) Although this rate is far from acceptable, it compares favorably with the 5 percent increase in 1990.
3. 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.

- C. Although I expect to see actual consumer inflation again come in at around 3 percent this year,
1. I do think we can look forward to improvement in the core rate of consumer inflation.

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

- A. Of course, the Fed's main longer-term goal is to control, and ultimately eliminate, inflation.
1. Such a policy is crucial to achieving a maximum economic growth rate in the long run.
- B. Because inflation is on a downward trend, we have greater latitude to react to weakness in the economy.
1. I must admit, though, that I find it curious to see long-term bond rates jump at any sign of an economic turnaround—as if market participants feared that the economy would suddenly overheat.
 2. As I believe our policies have demonstrated,
 - a. while we're working hard to help the economy move into a

recovery phase,

b. we're also being careful to preserve hard-won gains against inflation.

3. I believe our efforts in both areas ultimately will pay off.

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