

**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? Especially Southern California? Has the "Golden State" permanently lost its luster?
  - B. In a nutshell, here are my answers:
    - 1. A sustained--but moderate--expansion seems to be starting now;
    - 2. monetary policy is having an effect in stimulating the economy;
    - 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, before that, 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.
  
- 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 weeks ago, a 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 the reason we're doing worse than the nation during this downturn has more to do with some very compelling shorter-term problems.
  - 1. First, the agricultural sector had to deal with the drought, the freeze, and the white fly invasion.
  - 2. Second, the defense cutbacks weakened the economy even before the recession came along.
    - a. National defense spending actually peaked in 1987, so by the beginning of 1990, the cutbacks were starting to hurt.
    - b. And those cuts have been especially painful for Southern California, because the area's economy depends more heavily on defense than most other regions do.
      - (1) The volume of defense contracts per capita in Los Angeles and Orange Counties ranks them among the most defense-dependent regions in the country.
  - 3. And finally, many parts of southern California—especially downtown L.A.—have been facing a glut in commercial real estate.
    - a. The seeds of the glut were planted well before the recession.
      - (1) In March of 1990, downtown L.A.'s office vacancy rate was well below the national average.
      - (2) But so much construction was under way that more than 3½ million square feet of new space came on line during 1991, pushing the vacancy rate up to its

current level of around 20 percent.

4. The weakness in the defense and real estate 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 last three quarters of the year, the contraction in output turned into a modest expansion,
  1. averaging around a 1 ¼ percent.
- B. So far this year, growth is still pretty slow, but we're starting to see more positive signs than negative signs.
  1. Employment rose in February, and the numbers on retail sales have been up for two months in a row.
- C. I think this bodes well for seeing the beginning of a sustained recovery.
- D. Another important factor to consider is lower interest rates, which are working to stimulate underlying demand, and therefore economic activity.
  1. 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 stimulate the economy through three channels.
- B. First, lower borrowing costs 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 usually lower the foreign exchange value of the dollar.
  - 1. A lower dollar tends to stimulate demand for our exports,
  - 2. 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—are combining 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 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 definitely are good for the economy in the long run, but they can 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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