1992-93: Prospects For Sustainable Growth

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I. It's a pleasure to be here today.

A. I want to focus my remarks on the outlook for the economy and monetary policy for this year and next.

B. Frankly, I have some good news and some "not so good" news.

1. One very good piece of news is that inflation seems to be on a downward path.

2. Another piece of good news is that I think we're seeing the beginning of a sustained expansion.

3. The "not so good" news is about the rate of the expansion:

a. I expect it will be on the anemic side compared to our usual performance following a recession.

II. Let me start by taking a look here in our own backyard.

A. A few statistics tell a pretty bleak story.

1. Since employment peaked in May 1990, California has lost almost half a million jobs, a decline of 4¼ percent.

2. And the state's unemployment rate has risen to 8.5 percent, more than a percentage point higher than the national rate.

B. The construction and real estate sectors have been especially hard hit.

1. A quarter of the construction jobs that existed two years ago are gone today.

2. The real estate services sector also has suffered, losing around 4¼ percent of its jobs.

3. Taken together, the real estate and construction sectors account for close to 30 percent of the jobs lost in California during the current downturn.

C. Lower interest rates appear to have breathed some life into the residential side of the business.

1. The number of home sales (seasonally adjusted) statewide has been on an upward trend in recent months despite a drop in March.

   a. It's now about 5 percent above its year-earlier level.

2. And home values appear to be holding steady.

   a. Despite reports of plummeting values of higher-end homes in coastal areas,

      (1) the statewide median price has stayed within the $195-200,000 range for most of the last three years.

3. Finally, the pieces are starting to fall in place for some improvement in residential construction activity as well.

   a. The number of housing permits issued stopped deteriorating in 1991, after a precipitous decline in 1990.

   b. And the consensus forecast is that the number of housing permits will be almost 20 percent higher in 1992 than it was in 1991, with an additional 35 percent pickup expected in 1993.

D. But California's commercial real estate sector suffers from serious overbuilding, and it will take some time before activity picks up.

1. Some of the worst stories come out of southern California.

   a. Just last year, about 9 million square feet of new office space came on line in the Los Angeles area.

   b. As a result, the office vacancy rate rose to 22 percent, from 19 percent in 1990.

   c. And projects already under way assure that the problem will get worse before it gets better.

2. Conditions aren't quite so bad here in the northern part of the state.

   a. San Francisco's office vacancy rate is under 15 percent, one of the lowest in the state.

   b. And, since construction activity slowed earlier here than it did in Southern California, not much new space is coming on line.

   c. Still, it will probably be a few years before building activity in the Bay Area picks up in any substantial way.

III. Now let me turn to the national outlook.

A. I have what may be surprising news for you.

1. It's very likely that the end of the recession will be officially dated as the second quarter of 1991.

   a. That means, we've been in recovery for about a year!

2. But, as one pundit put it, "if the economy *has* turned a corner, it sure hasn't left any skidmarks."

B. To put this situation into perspective, let me look backward for a moment.

1. The recession basically amounted to two quarters of contraction—a relatively mild contraction at that.

   a. In fact, by historical standards, this was the mildest recession of the post-war era.

2. But one reason it hasn't *felt* mild is that the recession was embedded in the longest slow-growth period of the post-war era.

   a. The slowdown in the economy began in the spring of 1989, and continued for the next year and a half.

   b. With the onset of the Gulf War and temporarily higher oil prices, the recession began in July 1990 and persisted through the Spring of last year.

c. Since then, the economy has resumed the very sluggish upward trend that prevailed before the recession.

(1) With growth at only about a 1½ percent pace, we fell far short of the 6 percent pace that's typical of the first year of expansions.

C. So, the full picture is that we've had three full years of slow growth, during which we had a relatively "short and shallow" recession.

1. The unusual length of this slowdown may help explain why consumer and business confidence has been so low.

D. In research at our Bank, we've analyzed some of the sources of this slow economic growth,

1. and found that, in part, it's simply a natural response to demographics.

a. The growth of the labor force is slowing as the baby-boom bulge in the working-age population dissipates.

2. Obviously, there's nothing the Federal Reserve can do about this factor.

IV. The lion's share of the slowdown, though, represents a cyclical decline in the economy relative to its lower trend, and this *is* of great concern to the Fed.

A. This is why we have worked to stimulate underlying demand, and therefore economic activity, by easing monetary policy since mid-1989.

B. The federal funds rate and other short-term rates are now less than half what they were in July 1990, and the discount rate now stands at 3½ percent, its lowest level since 1964.

1. Although long-term rates have moved back up a bit recently, they're still below their levels last summer.

V. Now some people argue that these rates cuts haven't worked.

A. For evidence, they point to slow growth in the monetary aggregates, and argue that policy hasn't really eased that much.

1. It's true that M2, the Fed's main monetary aggregate has come in near the lower end of its annual target range in each of the last two years.

B. But it's important to note that

1. the decline in M2 relative to GDP in part reflects the shrinking role of depository institutions in the economy.

2. M2 deposits are issued mainly by depository institutions.

3. And as we all know, their role in total credit extension in the economy has been shrinking for years.

a. This process was accelerated in the 1980s by the thrift crisis.

4. In this environment, it's more difficult to interpret what slow M2 growth means for future economic activity.

C. My own view is that despite slow M2 growth, lower interest rates have begun to stimulate demand in the economy and will continue to do so this year and next.

1. Lower borrowing costs boost demand in sectors like housing, business equipment, and consumer durables, which includes, for example, autos, furniture and appliances.

2. And, lower U.S. interest rates tend to lower the foreign exchange value of the dollar.

a. This stimulates demand for our exports, and causes buyers here at home to shift from imported to U.S.-produced goods.

D. In fact, this week's report on first quarter results is very promising.

1. Final demand for domestic product hit almost a 5 percent rate of growth producing a sharp inventory runoff.

2. This sets the stage for increased production and a sustainable expansion in the months ahead as businesses work to rebuild their inventories.

VI. However, the pace of expansion is likely to be moderate when compared to the typical expansion, for several reasons.

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 are good for the economy in the long run, but in the meantime they also present some 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.

C. Finally, even with a lower dollar, demand from our major trading partners—such as Germany, Japan, and Canada—is dampened by their own economic slowdowns.

1. There *is* a mitigating factor on the foreign demand front, though.

a. A number of our important less developed trading partners, especially Mexico, can look forward to rapid growth this year, which will provide some support for our products.

2. So foreign trade is likely to have only a **small** positive effect on our economy this year, compared with the sizeable boost it provided in 1991.

D. Overall I <u>do</u> expect lower interest rates to provide a strong stimulus for recovery this year and next, but in view of the contractionary factors I've mentioned, recovery is likely to proceed at only a modest pace.

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.

C. The gradual pick-up in the economy this year and next is likely to continue to exert downward pressure on core inflation.

1. We saw some evidence of this in the first quarter report on labor compensation which rose at a moderate 3.6 percent rate.

2. Although there was a blip up in consumer inflation in the first quarter, I expect to see it average out to around 3 percent this year and next.

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. As I believe our policies have demonstrated, however,

   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.

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

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