

1992-93: PROSPECTS FOR SUSTAINABLE GROWTH

- 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. In the economy,
 - a. the good news is that I think we're seeing the beginning of a sustained expansion.
 - b. The "not so good" news is that the rate of the expansion will be on the anemic side compared to our usual performance following a recession.
 2. On inflation,
 - a. the good news is that it seems to be on a downward path.
 - b. But we still have a long way to go in achieving our goal of price stability.
- II. Let me start with a quick look at conditions here in California.
 - A. As you know, the news lately has been pretty grim,
 1. including the civil disorders a few weeks ago,
 2. and a series of natural disasters.
 - B. The economic picture isn't much better.
 1. California is in its longest and deepest recession since World War II, and the first since 1969-70 in which it's done worse than the nation.
 - C. And the situation is toughest in Southern California.

1. Of the 550,000 jobs lost statewide since employment peaked in May 1990, 330,000 were in Los Angeles County alone.
- III. I'm sure you'd all agree that things are looking bleak at the moment. But I think that if we take a little longer view, conditions aren't as bad as some of the gloomier reports suggest.
- A. Although the fall-off in construction activity has been sharp,
 1. it's actually no worse than it was during the early 1980s.
 - B. Defense cuts have hurt, but I think it's a mistake to overemphasize their role in California's economy.
 1. This round of defense cuts brings to mind the 1970 recession and the defense cutbacks related to winding down the Vietnam war.
 - a. Those cutbacks continued until 1975,
 - b. yet California began its recovery in 1971.
 2. So even with continued deterioration in defense spending, California managed to stage a robust recovery.
 - a. And California is *far less* dependent on defense now than it was then.
 - C. Most importantly, as the national economy gets onto a solid growth path, California's economy should pick up steam as well.
 1. Research at the San Francisco Fed suggests that about three-quarters of fluctuations in California's economy are associated with changes in the national economy.
 2. But because the state is suffering from an unusually large number of problems at the same time, California's recovery will occur later than the nation's, and will be more restrained than we're used to.
- IV. 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.
- C. 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, the Fed can't do anything about this factor.

- V. The lion's share of the slowdown, though, represents a cyclical decline in the economy relative to its lower trend, and this *is* of concern to the Fed.
 - A. That's why we've worked to stimulate 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,
 - 1. and the discount rate now stands at 3½ percent, its lowest level since 1964.
 - C. Although long-term rates moved back up a bit, they're still below their levels last summer.
- VI. Now, some people argue that these rate cuts aren't very effective anymore.
 - 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, came in near the lower end of its annual target range in 1990 and 1991,
 - a. and has remained there so far this year.
 - B. But this in part reflects the fact that M2 deposits are issued mainly by depository institutions, whose role in the economy has been shrinking for years.
 - 1. This process was accelerated in the 1980s by the thrift crisis,
 - 2. and by the phenomenal growth more recently in stock and bond mutual funds.
 - a. These funds, which grew by almost 50 percent last year alone, have attracted some assets that otherwise would have been held as M2 deposits.
 - 3. 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.
- D. In fact, the first quarter results were very promising.
 - 1. Purchases of domestically produced goods and services 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.

VII. Why do I expect the pace of expansion to 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 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," which may take years to work down.
- C. Finally, 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 relatively **small** positive effect on our economy this year, compared with the sizeable boost it gave in 1991.
- D. Overall I do 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.

- VIII. Now let me focus on a 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. So far this year, consumer inflation has risen at a 3¼ percent rate, and I expect to see it average out to around 3 percent for this year as a whole and in 1993.
- IX. 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 a little more 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 sustain the recovery,
 - b. we're also being careful to augment hard-won gains against inflation.
 2. I believe our efforts in both areas ultimately will pay off.

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