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to

The Seattle Economists' Club

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<u>1992-93: PROSPECTS FOR SUSTAINABLE GROWTH</u>

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

   A. I want to focus my remarks on the outlook for real economic growth and inflation in the U.S. this year and next, and on monetary policy.

   B. I'll also briefly comment on economic conditions in the western states that comprise the 12th Federal Reserve District.

II. Let me start by taking a look at the western region.

   A. Western states have registered some of the best--and some of the worst--economic performances during the recession.

      1. Idaho and Utah rank first and second among states in job growth since July 1990.

      2. In contrast, California is in its longest and deepest recession since World War II, and the first since 1970 in which it has done worse than the nation.

         a. The state has lost over half a million jobs since employment peaked in May of 1990 -- a 4.1 percent decline.

         b. Eighty percent of those losses were in the Los Angeles area--making that 5-county region one of the worst hit in the country.

   B. Washington's economic performance lies between these two extremes.

      1. Although the total number of jobs has edged up 1.6 percent since July 1990, the state has lost manufacturing jobs due to cutbacks in aerospace and defense-related industries.

      2. Reflecting these cutbacks, Washington's unemployment rate has risen 2½ percentage points to just under 7 percent, compared to about 7½ percent for the District.

III. To put the national outlook into perspective, let me look backward for a moment.

   A. As you know, the recession lasted for only two quarters, and by historical standards, was the mildest of the post-war era.

1. One reason it didn't *feel* 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.

B. In research at our Bank, we've analyzed some of the sources of this three-year period of slow 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.

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 concern to the Fed.

A. That's why we've 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,

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.

V. 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, and are in roughly the same position 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.

   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, the first quarter results were very promising.

   1. Final sales of domestically produced goods and services hit a little more than a 4½ 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. 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."

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 relatively **small** positive effect on our economy this year, compared with the sizeable boost it gave 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 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.

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 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 preserve and advance hard-won gains against inflation.

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

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