1992-93: Prospect for Sustainable Growth

given by

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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 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 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.

      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 by taking a look at conditions in this area.

   A. California has received more than its share of bad news lately.

      1. We're still reeling from the violence in L.A.

      2. And we've also suffered from an unusual spate of natural disasters: drought, earthquakes, fires, floods, and pestilence.

      3. The economic news has been bad as well.

         a. California has lost more than half a million jobs since employment peaked in May of 1990.

      4. The unexpectedly weak state economy has created monumental fiscal problems at both the state and local level.

   B. The Fresno area has felt the impact of economic weakness, both nationally and statewide.

1. For example, employment in Fresno County fell about 2 1/2 percent between its August 1990 peak and last April.

    a. Still, the decline here is not as bad as the 4 1/4 percent employment loss seen statewide.

2. And the unemployment rate, which tends to be high in this area even in good times, hit 14.9 percent in April.

C. Despite its problems, I think that the area's economic prospects are actually quite bright.

1. Population in this area continues to grow at a brisk pace.

    a. Fresno remains a popular destination for people from other parts of the state, seeking more affordable housing and a better quality of life.

    b. Indeed, Fresno County's population grew by an astounding 4.2 percent during 1991.

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 whole 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, 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 money, 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.

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 growth of money means for future economic activity.

C. My own view is that despite slow money 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 slightly over 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 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.

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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