Robert T. Parry, President, Federal Reserve Bank of San Francisco
Cedar City, Utah
For Delivery August 6, 1992 -- FOR RELEASE: 12:00 noon, MST

A POLICYMAKER'S PERSPECTIVE ON THE U.S. ECONOMY

I. Thank you. It's a pleasure to be here in this beautiful city.

   A. I want to talk to you today about

      1. the economic outlook for the nation and the region,

      2. and then focus on the role of monetary policy.

II. As you know, the recent news on the national economy has been somewhat disappointing. So let me start by putting the current situation into some historical perspective.

   A. The last three years have been one of the longest periods of slow growth in this country's postwar history—

      1. one in which the unemployment rate rose from 5¼ to 7¾ percent.

   B. The slowdown began in the spring of 1989, and continued for a little over a year.

   C. Then the recession hit in July 1990, with the onset of the Gulf crisis and temporarily higher oil prices, and it lasted through the Spring of last year.

   D. At that point, the economy pulled out of the recession, but only enough to resume the very sluggish growth that prevailed before.

III. The prolonged weak national performance *has* cast the shadow of slower growth over Utah, mainly in manufacturing.

   A. But overall, Utah is doing well compared to the rest of the country.

   B. And two sectors in particular—construction and financial industries —are standouts.

   C. Since the recession, construction employment *declined* 11 percent nationally, but in Utah it *grew* almost 20 percent—a stellar performance by any standard,

Robert T. Parry
Cedar City, Utah
For Delivery August 6, 1992

A POLICYMAKER'S PERSPECTIVE ON THE U.S. ECONOMY

I. Thank you. It's a pleasure to be here in this beautiful city.

   A. I want to talk to you today about

      1. the economic outlook for the nation and the region,

      2. and then focus on the role of monetary policy.

II. As you know, the recent news on the national economy has been somewhat disappointing. So let me start by putting the current situation into some historical perspective.

   A. The last three years have been one of the longest periods of slow growth in this country's postwar history—

      1. one in which the unemployment rate rose from 5¼ to 7¾ percent.

   B. The slowdown began in the spring of 1989, and continued for a little over a year.

   C. Then the recession hit in July 1990, with the onset of the Gulf crisis and temporarily higher oil prices, and it lasted through the Spring of last year.

   D. At that point, the economy pulled out of the recession, but only enough to resume the very sluggish growth that prevailed before.

III. The prolonged weak national performance *has* cast the shadow of slower growth over Utah, mainly in manufacturing.

   A. But overall, Utah is doing well compared to the rest of the country.

   B. And two sectors in particular—construction and financial industries —are standouts.

   C. Since the recession, construction employment *declined* 11 percent nationally, but in Utah it *grew* almost 20 percent—a stellar performance by any standard,

1. Of course, Utah deserves a bit of good news in the construction sector these days, after suffering through some tough years during the mid-80s.

D. Likewise, while employment in the financial industries declined nationally, it grew in Utah,

1. largely because of the strength in construction and real estate, as well as in the overall economy.

2. In keeping with the strong state economy, Utah's banks report problem loan ratios that are only about half the national average.

IV. Now let me focus again just on the national picture.

A. In order to vitalize the economy during this period of slow growth or no growth, the Fed has eased monetary policy substantially.

1. The federal funds rate and other short-term rates are now about a third of what they were in early 1989.

2. The discount rate now stands at 3 percent, its lowest level in nearly three decades.

B. This easing works to stimulate spending on goods and services, and therefore economic activity.

1. Lower short-term rates boost spending on housing, business equipment, and consumer durables, like 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,

b. and causes buyers here at home to shift from imported to U.S.-produced goods.

C. This interest-rate environment should set the stage for a sustained, though moderate, expansion.

1. I say "moderate" because there are several potential drags on the recovery; in particular, there are:

a. cutbacks in government spending, especially for defense,

b. a commercial real estate "overhang" that will limit new construction,

c. and slow growth abroad, which will restrict the size of markets for our exports in the near term.

D. It looked as if we were on our way toward this sustained, moderate expansion in the first quarter of 1992.

1. The results for the quarter were pretty good, and spending seemed to be increasing in line with our expectations.

E. In the second quarter, though, the economy struggled again.

1. The unemployment rate stood at 7¾ percent in June, the highest rate in over eight years.

2. Last week, we learned that real GDP grew at just under a 1½ percent rate in the spring quarter.

V. Now, I'm sure you're asking yourself, what's the problem? When is the recovery going to kick in? When is the easing on interest rates going to result in some substantial growth?

A. To answer these questions, let me begin with a reminder:

1. we have to remember that monetary policy actions affect spending with a lag—generally, from six months to a year, and sometimes longer.

2. In fact, the length of the lag is hard to predict.

a. And, in this cycle, the lag may have been especially long.

b. If this were an average recovery, then the earlier easing of policy would have produced faster growth more than a year ago.

VI. But, obviously, this *isn't* an average recovery. And the Fed's job in helping the economy move back to sustainable growth has been complicated by a number of factors.

A. For example, one of the main signals the Fed relies on for gauging the effects of monetary policy on the economy is the money supply, known as M2. Unfortunately, its behavior lately has been distorted.

    1. M2 consists of funds issued mainly by depository institutions.

        a. But, in recent years, depository institutions have played less of a role in channeling credit through the economy.

        b. This process was accelerated in the 1990s by the thrift crisis,

        c. and by the phenomenal growth more recently in stock and bond mutual funds.

    2. In this environment, we haven't been able to depend on M2 as an indicator of the thrust of policy as we once could.

B. Second, the behavior of long-term interest rates—that is, the rates on mortgages and corporate bonds, for example—has put the Fed in a bit of a bind in recent years.

    1. Although very recently, long-term rates have been falling,

        a. they remain well above levels we would have expected, given the sharp drop in short-term rates.

    2. Part of the explanation for this behavior may be that people expect inflation to be relatively high in the future.

        a. For example, a survey of financial decisionmakers shows that they continue to expect inflation rates of about **4 percent** over the next ten years, only a little lower than the figure given when the slowdown began.

        b. And a survey of consumers shows that they expect inflation to average **nearly 5 percent** over the next ten years.

    3. When there are persistent fears of inflation, an easing of short-term interest rates sometimes leads to higher inflation expectations, which translates into *higher* long-term interest rates.

        a. This response of long-term rates would be counterproductive to efforts to boost economic activity.

4. Concerns about rising inflation expectations have limited the Fed's range of action in recent times.

VII. Now, let me give you my own outlook for inflation.

A. As I've said, the economy has grown slowly or actually declined for three years now.

B. During this period, labor and product markets slackened, and this restrained growth in labor compensation and product prices.

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

1. So far this year, consumer inflation has risen at around a 3 percent rate, and I expect to see it average out to about the same rate for this year as a whole and in 1993.

2. In other words, compared to the 4½ percent core rate of consumer inflation in 1991, 3 percent definitely represents progress.

VIII. This downward trend in core inflation is in keeping with the Federal Reserve's main long-term goal of moving gradually toward price stability—a crucial element to achieving maximum economic growth in the long run.

A. So, frankly, I've been surprised and even disappointed that the public seems to expect high inflation in the near future, although recent developments in credit markets are encouraging on that score.

B. And I can only speculate on why inflation expectations haven't come down more quickly.

1. One factor may be the huge federal budget deficits that have persisted over the past decade and show no signs of abating.

a. Some people may fear that they ultimately will result in higher inflation.

2. Or perhaps the Fed's message of its intention to gradually eliminate inflation just isn't getting through very clearly.

a. Typically, the Fed has signaled its anti-inflation stance by gradually lowering the M2 targets.

b. But, as I mentioned before, M2 has been sending confused signals lately.

c. So the Fed may have to work harder to state more clearly its intention of gradually eliminating inflation.

IX. The public's belief in our commitment to eliminating inflation plays a crucial role in policy formulation.

A. To the extent that the public's inflation expectations move on a downward trend, we will have a little more latitude to react to weakness in the economy, when necessary.

B. As I believe our policies over the past three years have demonstrated,

a. while we're doing what we can to help sustain the recovery,

b. we're also being careful to preserve and advance hard-won gains against inflation.

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

wc 1421