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Bakersfield , California
For delivery September 10, 1992 RELEASE UPON RECEIPT

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

I. Thank you. I'm delighted to be here today.

II. Today I'll be going over

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

2. and then I'll focus on the role of monetary policy.

III. As you know, the national economy's performance recently is nothing to cheer about.

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 Gulf crisis and temporarily higher oil prices shoved us into recession in July 1990.

D. In the late spring of last year, the economy pulled out of the recession, but only enough to resume the very sluggish growth that prevailed before.

1. And the sluggishness continues.

a. According to data for the spring quarter—the most current complete data available—real GDP grew at only a 1½ percent rate.

IV. Of course, here in California,

A. we've had our own problems to contend with.

1. There's the violence and destruction that hit South Central L.A.

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

B. The economic news has been bad, too.

1. California has lost about 600,000 jobs since employment peaked in May of 1990.

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

C. This performance is pretty unusual for California. If you look back at our history, you know that we're used to weathering recessions somewhat better than the nation.

1. In a national recession, California's economy typically just "hesitates."

2. Only once before, in 1970, did California do worse than the U.S.

D. It seems to me that part of the explanation is that a number of negative forces have hit the state more or less at once.

1. For example, commercial real estate is seriously overbuilt in many parts of the state—and especially in southern California.

   a. As a result, about a quarter of the construction jobs that existed two years ago are gone today.

2. And the defense sector has been hit hard by cutbacks.

   a. Real defense spending in California has fallen more than 13 percent since its 1988 peak.

   b. And aerospace employment has fallen 24 percent since the beginning of 1990—a loss of 60,000 jobs.

3. Finally, these problems are reflected in the turmoil surrounding the state budget.

a. Last year it took some last-minute maneuvering to close a $14 billion shortfall.

b. This year, the budget process had more twists and turns than Highway 178 through Kern County to Lake Isabella.

c. And the spending cuts that are coming out of it are severe.

E. Here in Bakersfield, you're feeling the pain, too.

1. For example, the area's unemployment rate is high, both in absolute terms and compared with its pre-recession level.

a. And the construction, mining, and manufacturing industries have suffered significant employment losses.

2. Still, compared to the rest of the state, this area's losses don't look so bad.

a. For example, during the nine months of decline in Bakersfield, employment fell 1.8 percent.

b. In contrast, California employment has been on the decline for over two years, and has fallen almost 5 percent.

F. Overall, then, the recession has been both milder and briefer in Kern County than in most other regions.

V. Now let me focus again on the national picture.

A. In order to revitalize the economy during this period of slow growth or outright recession, 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. First of all, 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. The dollar recently has fallen rather sharply, mainly in response to high interest rates in Germany compared to those here in the U.S.

    d. This decline extends a pattern of depreciation that began a year ago.

        (1) The 15 percent depreciation since then will be an important impetus to growth in this country over the next year.

2. Lower interest rates also boost spending on business equipment and consumer durables, like autos, furniture, and appliances

3. And, of course, we've also seen the effects of lower rates in the housing market.

    a. Mortgage interest rates have declined steadily since early 1989,

        (1) and recently reached their lowest level in almost two decades.

    b. As a result, (real) residential investment has grown at an average rate of more than 12 percent for nearly a year and a half, with most of the increases occurring in single-family units.

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

C. I say "moderate" because there are several potential drags on the recovery.

1. First, there's slow growth abroad.

   a. This will restrict the size of markets for our exports in the near term.

2. Second, there are the cutbacks in government spending, especially for defense.

3. Finally, I don't need to tell you that there's trouble in the commercial real estate market.

   a. Normally, we could expect lower interest rates to stimulate spending on commercial real estate.

   b. In fact, this is one of the important channels monetary policmakers traditionally rely on to pull the economy out of a recession.

   c. But, because of the overbuilt market and the resulting high vacancy rates we have now, it's unlikely that this channel will work the way it has in the past.

VI. Now, let me give you my 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, since the pick-up in the economy will probably be gradual over the next year or so, we're likely to see continued downward pressure on core, or underlying, inflation.

   1. Of course, we may see <u>measured</u> inflation rise a bit, but that will be because of the declining dollar.

   2. We're more concerned about core inflation.

a. So far this year, core consumer inflation has risen at around a 3½ percent rate, and I expect to see it decline to about 3 percent for this year as a whole and in 1993.

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

VII. 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 have continued to expect high inflation in the future.

1. For example, a survey of financial decisionmakers shows that they continue to expect inflation rates of about **4 percent** over the next ten years.

a. This is only a little lower than what they expected three years ago when the slowdown began.

2. And a survey of consumers is even more disappointing.

a. It shows that consumers expect inflation to average **5 percent** over the next ten years.

B. 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.

a. So we may have to work harder to state our resolve more clearly.

VIII. Let me take a moment to explain why the public's belief in our commitment to eliminating inflation has played a role in policy formulation.

A. The behavior of long-term interest rates—for example, the rates on corporate and government bonds—has put the Fed in a bit of a bind in recent years.

1. Although long-term rates have been falling in recent months, they remain above levels we would have expected, given the sharp drop in short-term rates.

a. In part, this may reflect the persistent fears of inflation I've already discussed.

2. In this environment, an easing of short-term interest rates sometimes leads to higher inflation expectations.

3. And higher inflation expectations translate into *higher* long-term interest rates, which are counterproductive to efforts to boost economic activity.

B. So, to the extent that the public's inflation expectations move on a downward trend, the Fed will have more latitude to react to weakness in the economy when necessary.

C. As I believe our policies over the last three years have demonstrated,

1. while we've done a great deal to help sustain the recovery,

2. we've also been careful to preserve and advance hard-won gains against inflation.

D. I think our efforts in both areas ultimately will pay off.

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