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L.A. Commercial Realty Association
Westwood Marquis Hotel
For delivery September 11, 1992 -- 8:30 a.m. PDT

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

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

B. 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. Here in California, sluggishness would actually look good compared to our current situation.

A. For the first time since 1970, California is doing *worse* than the nation.

1. And our state budget woes reflect it.

    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 Topanga Canyon,

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

B. The situation is toughest in Southern California.

1. Los Angeles County alone has lost 358,000 jobs since its employment peaked in March of 1990.

    a. That's an 8.4 percent drop,

    b. and it accounts for almost two-thirds of the state's job losses.

C. Of course, this area has had a number of severe problems—

1. —strife in south central L.A., earthquakes, and the drought, just to name a few of the most dramatic.

D. But I think we can explain much of the area's weakness in terms of the national recession, defense cutbacks, and problems in the construction and real estate sectors.

1. For example, real defense spending in California has fallen more than 13 percent since its 1988 peak.

2. And aerospace employment in southern California has dropped 32 percent since the beginning of 1990—a loss of 51,000 jobs.

E. The news in construction and real estate is especially dismal.

1. Many parts of southern California, especially downtown L.A., are experiencing a glut in commercial real estate.

a. The seeds of this glut were planted well before the recession.

b. In March of 1990, downtown LA's office vacancy rate was well below the national average.

c. But so much construction was under way that more than 3½ million square feet of new space came on line during 1991, pushing the vacancy rate up to its current level of about 20 percent.

2. The result is that L.A. County has lost 27 percent of its construction jobs—that's more than 43,000 lost jobs in construction alone.

3. And the value of nonresidential construction awards has plummeted:

a. In 1988 it was $5.1 billion,

b. in 1991 it was $2.8 billion,

c. and if the the second half of 1992 plays out like the first half, the value will fall to $2.1 billion this year.

F. The problems in both real estate and defense are going to be with us for at least the next couple of years, and they'll continue to drag down the area's economy.

1. That's why I think that it will take a significant improvement in the national economy before we'll see L.A.'s situation improve.

V. So now let me turn to 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 policymakers 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 measured 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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