

Rotary Club
Los Angeles
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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. economic prospects for the region and the nation,
 - B. and then I'll focus on monetary policy.
- III. As you know, the national economy's performance hasn't been anything to cheer about.
 - A. The last three years have been one of the longest periods of slow growth in this country's postwar history.
 - B. And though we're technically out of the recession, the recovery is sluggish.
 1. According to data for the spring quarter—the most current complete data available—real GDP grew at only a 1½ percent rate.
 2. Moreover, partial data for the third quarter suggest a continuation of the sluggish pace.
- IV. Here in California, sluggish growth would actually be an improvement over 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 Road,
 - c. and the spending cuts that came out of it are severe.
 - B. The situation is toughest in Southern California.

1. Los Angeles County alone has lost 371,000 jobs since its employment peaked in March of 1990.
 - a. That's an 8.6 percent drop,
 - b. and it accounts for almost three-fifths 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 Los Angeles County has dropped 27 percent since March of 1990—a loss of 39,000 jobs.

- E. The news in construction and real estate is especially dismal.
 1. L.A. County has lost 28 percent of its construction jobs—that's more than 45,000 lost jobs in construction alone.
 2. 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.
 3. And residential construction has taken a big hit as well.
 - a. The number of housing permits issued in LA County last year was less than a quarter of the 1986 peak.
 - b. And so far this year, we're doing even worse.

4. Still, while there are certainly some homeowners who have had large declines in home values, most parts of the L.A. area have seen relatively modest drops—on the order of 5 to 10 percent.
- F. The problems in both real estate and defense are going to be with us for at least a few more 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, 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 interest rates boost spending on business equipment and consumer durables, like autos, furniture, and appliances.
 2. We've also seen the effects of dramatically lower rates on the housing market.
 - a. 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 in single-family units.
 - b. Although housing activity slowed a few months ago, we got good news on housing starts for August, and I expect to see fairly strong figures in the year ahead.
 3. Finally, lower U.S. interest rates tend to lower the foreign exchange value of the dollar.
 - a. This boosts our economy for two reasons:
 - (1) it leads buyers here at home to shift from imported to U.S.-produced goods,
 - (2) and it stimulates foreign demand for our products.

- VI. But lately, the turmoil in the foreign exchange markets has moved the dollar around a lot. So naturally, we want to know what effect this turmoil has on our economy. Does it magnify the effects of our lower interest rates, or does it nullify them?
- A. As you know, in recent years, several European countries have pegged their currencies to the German Mark.
 - 1. In effect, this means that they coordinate their monetary policies.
 - B. Over the last year or so, Germany has been concerned about the inflationary effects of the costs of reunification,
 - 1. so they've followed a tight monetary policy with high interest rates.
 - C. But a tight monetary policy was a hard pill to swallow for a number of other European countries that have been facing slow growth or outright recession during this period.
 - 1. For example, the U.K. has been in recession since the middle of 1990, with unemployment at almost 10 percent as of August.
 - D. So, in September, as conditions worsened, the U.K. decided to let the pound float, and Italy and Spain devalued their currencies.
 - 1. In other words they've let their interest rates and currencies fall.
 - E. What's the effect of these developments on our economy?
 - 1. Easier monetary policy in those countries should help to cushion their economic declines.
 - a. However, the policy actions taken so far don't seem to be big enough to offset fully the weakening trends in their economies.
 - b. This is *not* good news for U.S. exports.
 - 2. In addition, declines in the currencies of these countries mean that our exports are more expensive, which should further weaken their demand for our products.
 - F. Overall, then, developments in Europe may have offset part of the positive effect of lower U.S. interest rates.
- VII. This is one reason that the present low-interest-rate environment in the U.S. is likely to produce only a modest expansion.
- A. There are other reasons as well.

1. We've been importing foreign goods, especially computers, at a rapid pace in recent years, and we expect this trend to continue.
 - a. This cuts into demand for domestically produced goods and services.
2. Then there's fiscal policy.
 - a. In view of large federal budget deficits and the end of the cold war, the government has cut back 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, lower interest rates tend to stimulate spending on commercial real estate.
 - b. In fact, this is one of the 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.

VIII. Now, let me give you my outlook for inflation.

- A. During the past three years of recession and slow growth, labor and product markets slackened, and this restrained growth in labor compensation and product prices.
- B. 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 inflation.
 1. So far this year, core consumer inflation -- which excludes the volatile food and energy component from the consumer price index -- has risen at around a 3½ percent rate, and I expect to see it decline to about 2½ percent for this year as a whole and in 1993.
 2. Compared to the 4½ percent core rate of consumer inflation in 1991, 2½ percent definitely would represent progress.

IX. This downward trend in 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. Our progress on this front in recent years is important because it gives us greater latitude to respond to weakness in the economy if it's necessary.

- B. Given our recent persistent sluggish economic performance and our expectations of only a modest expansion, we can't rule out the possibility that further action will be needed.
- C. But I want to emphasize that while we're doing what we can to help sustain economic recovery,
 - 1. we're also being 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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