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

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

A. Today I'll be going over

1. how I think the economy will shape up in both the region and the nation over the next year,

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

II. Let me begin with California, which certainly has had more than its share of troubles.

A. California currently is in its deepest and longest recession since World War II.

1. The state has lost nearly 717,000 jobs since employment peaked in May of 1990.

2. And as of this November, we were still losing jobs, and the unemployment rate went into double digits.

3. The severity of economic problems is reflected in the depth of our fiscal problems.

a. Even with the painful cuts already made in the state, it looks like we're headed for another shortfall in revenue this year.

B. This performance is unusual for California.

1. We're used to weathering recessions somewhat better than the nation.

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

b. In fact, only once before, in 1970, did California do worse than the U.S.

C. Part of the explanation for what's happening in California this time is that, on top of the national recession, the state has been hit relatively hard by a number

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of negative forces at the same time.

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 2-1/2 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 27 percent since the beginning of 1990—a loss of 68,000 jobs.

D. Agriculture also has had several trying years in California.

1. But the biggest problems haven't come from the slow national economy.

2. Rather, the agriculture sector has suffered at the hands of Mother Nature:

    a. with a freeze that destroyed much of the citrus crop,

    b. whitefly infestations,

    c. and the continuing drought.

3. These setbacks have taken their toll on the farm community.

    a. Net farm income in 1991 was down 20 percent from the level of a year earlier.

    b. And through August, cash receipts were down 2.3 percent from a year earlier.

    c. Moreover, reduced production has decreased employment in food processing by 7 percent in the last year, with most of the losses in fruit and vegetable processing.

E. Over the longer term, though, the picture looks brighter for California agriculture.

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1. California is a leader in the development of specialty crops and high value-added food products.

2. Export demand for many California crops will continue to rise as a number of Pacific Rim countries enjoy economic prosperity and continue to relax trade barriers.

   a. We're hopeful that the GATT negotiations will finally bear fruit next year,

      (1) and we expect that California producers will share in expanded trade with Europe and the Pacific Rim.

   b. NAFTA, as well, offers real opportunities for rising trade with Mexico,

      (1) as their demand for U.S. food products rises with their growing incomes.

F. Generally, agriculture should help boost the sluggish California economy by creating more jobs in food and trade-related industries.

   1. But the overall outlook for the state depends largely on the pace of the nation's expansion.

III. So now let me turn to the national economy.

A. For a number of years, it's been hard to find signs of robust growth.

   1. Real GDP grew at only a 1½ percent pace from the first quarter of 1989 until mid-1990;

   2. then the economy fell into a relatively short and mild recession following the onset of the Gulf War.

      a. The decline lasted three quarters,

      b. and it looks like the economy reached a business cycle trough in the spring of 1991.

B. But the recovery has been far from robust.

   1. Real GDP has increased by a total of only 3 percent so far in this recovery;

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2. In other postwar recoveries, at this stage real GDP was typically up 6½ percent.

C. Now, we may be able to take some comfort from the latest statistics for the third quarter.

1. The growth rate of almost 4 percent in real GDP brings growth for the first three quarters of this year to an average of 2¾ percent.

a. This is a substantial improvement over last year's virtual standstill.

2. And the unemployment statistics seem to have improved,

a. falling from a high of 7.8 percent in June to 7.2 percent in November.

3. But the rate is still well above most estimates of full employment.

IV. In order to revitalize the economy, the Fed has eased monetary policy substantially.

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

1. 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 close to 11 percent for over a year and half, with most of the increases in single-family units.

b. Although housing activity slowed in the late spring and summer, it has picked up in the last few months, and I expect to see

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fairly strong figures in the year ahead.

V. Still, there are a number of reasons why this low-interest-rate environment in the U.S. is likely to produce only a modest expansion, probably in the neighborhood of 3 percent next year.

A. First, even though lower interest rates tend to lower the value of the dollar, and therefore make U.S. goods cheaper abroad, we're not seeing much action in exports.

1. The problem is that a number of our most important trading partners are going through slowdowns themselves, so they're not buying as many U.S. products.

B. Second, we've been importing foreign goods, especially computers, at a rapid pace in recent years, and we expect this trend to continue.

1. This cuts into demand for domestically produced goods and services.

C. Then, there's trouble in the commercial real estate market in many places, not just California.

1. The vacancy rate nationally is high, at about 20%.

2. Normally, lower interest rates tend to stimulate spending on commercial real estate.

a. In fact, this is one of the channels monetary policy traditionally relies on to pull the economy out of a recession.

3. But, with this much "overhang" in the commercial real estate market, it's unlikely that this channel will work the way it has in the past.

D. Finally, there's fiscal policy.

1. In view of large federal budget deficits and the end of the cold war, the government has cut back spending, especially for defense.

2. However, once Clinton's in the White House, we may see more expansive fiscal policy.

a. For example, there's been talk of an investment tax credit.

b. At this point it's too soon to tell what kind of fiscal program

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will be proposed by the new administration.

VI. 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. And I think we'll probably see continued downward pressure on inflation for a couple of reasons.

1. First, the economy is likely to pick up only gradually, so this will keep inflationary pressures from building up.

2. Second, we've seen strong increases in worker productivity over the last four quarters,

a. which means that firms will have a better chance of meeting increased demand without having to increase prices.

C. 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 3¼ percent rate,

1. and I expect to see it decline to about 3 percent for this year as a whole and 2½ percent in 1993.

2. Compared to the 4½ percent core rate of consumer inflation in 1991, 2½ percent next year definitely would represent progress.

VII. 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 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

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against inflation.

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

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