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ECONOMIC PROSPECTS FOR CALIFORNIA AND THE NATION IN 1993

- I. Tonight I'm going to discuss the outlook for both the nation and California,
 - A. and their stories are different enough that we could almost call this "The Tale of Two Economies."
 - 1. In the nation, we're seeing more and more signs that we're moving into a phase of sustained economic expansion.
 - 2. Here in California, though, the economy presents a much different picture.

- II. So let me start with a look at developments in our region.
 - A. To put it bluntly, California is in a long and deep recession.
 - B. And this is unusual for us.
 - 1. If you look back at our history, you see that we're used to weathering recessions somewhat better than the nation.
 - 2. When the national economy slumps, California's economy typically just "hesitates."
 - 3. Only once before, in 1970, did California do worse than the U.S.
 - a. But now we're faced with an unemployment rate of 9.4 percent, more than two percentage points higher than the national rate.
 - C. The current economic scene in California is unusual for another reason, as well.
 - 1. Usually, as the nation heads into recovery, California picks up steam at the same time.

2. But not in this cycle.
 - a. According to the NBER, the U.S. economy has been in recovery—a sluggish recovery, but a recovery nonetheless—since March 1991.
 - b. In California, though, we now have 160,000 *fewer* jobs than we did just one year ago.

- D. Now, from a lot of the news coverage, you might think that just a few industries are accounting for a lot of the employment losses.
 1. For example, commercial real estate is seriously overbuilt in many parts of the state -- especially in southern California.
 - a. The resulting declines in property values have created problems for developers and for lenders.
 2. And the defense sector has been hit hard by cutbacks.
 - a. Real defense spending in California has fallen by around 17 percent since its 1988 peak.
 - b. And defense contractors continue to lay off workers.
 3. But these aren't the only industries facing hard times.
 - a. Manufacturing activity is weak across a broad range of non-defense industries as well.
 - b. And retail trade also has suffered.

- E. It's also tempting to put the focus on southern California, where, clearly, the problems have been most severe.
 1. That's partly because defense is more important to the southern California economy,
 2. and the commercial real estate problems are worse in that part of the state.

- F. But the rest of the state is hardly immune.
1. Here in the Sacramento area, employment has fallen slightly during the past year.
 2. That doesn't look bad compared with Southern California's 1.3 percent decline;
 3. but it does look bad when you compare it with national employment, which grew by 1 percent during the year.
- G. When can we expect to see the state's economy turn around?
1. Well, we have gotten some encouraging news in the last few employment reports,
 - a. which showed flat or growing employment during the first three months of 1993.
 - b. Still, it's too soon to tell whether these figures represent the beginning of a positive trend.
 2. But there will be tough times ahead.
 - a. Downward adjustments in defense will continue, especially in light of the proposed base closures in the state.
 - b. And problems in commercial real estate are likely to last at least a couple of years.
 3. In consequence, the state government is going to face some tough choices in the budget process, which seem certain to intensify California's short-term troubles.
 - a. This could pinch Sacramento, if a tighter budget involves freezing state workers' salaries or reducing their numbers.
 4. So it's likely that, even if we are near the bottom of the cycle, we'll see little in the way of growth during the next couple of years.

- a. To a large extent, whether we see any growth at all over the short term will depend on the pace of improvement in the national economy.

III. Now let me turn to the national economy.

A. The good news for the nation is that a sustained expansion seems to have been established.

B. After nearly three years of recession and sluggish growth, a pattern of moderate expansion took hold in the first half of 1992, when real GDP grew at a 2¼ percent rate.

1. Then, in the second half of the year, economic growth accelerated further.

a. In fact, the economy expanded in the fourth quarter alone at a strong 4.7 percent rate!

b. Although data available so far in 1993 suggest that the economy has slowed from its brisk pace late last year, there are reasons to believe that the expansion is firmly in place.

C. In my view, monetary policy can take some of the credit for this.

1. Since economic growth turned sluggish about four years ago, the Fed has eased monetary policy substantially.

a. These actions have brought down the federal funds rate and other short-term rates to about a third of what they were in early 1989,

b. and have helped to bring down long-term interest rates as well.

IV. As I look ahead to the remainder of 1993,

A. I expect interest-sensitive sectors of the economy to lead the continuing expansion.

1. These sectors -- business investment in equipment and consumer

spending on housing and other durable goods -- expanded rapidly last year, and are likely to do so again in 1993.

- B. But there are a number of reasons to believe that developments in other parts of the economy will hold the expansion to only a moderate pace.
 - 1. I look for growth to be in the neighborhood of 3 percent, rather than the 4 to 5 percent that would be normal early in a business cycle expansion.
 - 2. As a result, the unemployment rate will decline only gradually.
- C. What are some of the factors?
 - 1. First, a number of our most important industrialized trading partners are going through slowdowns themselves,
 - a. and this will tend to hold back the volume of U.S. products we can sell abroad.
 - b. The recent easing of monetary policies in Japan and much of Europe will help, but I still don't expect to see robust growth abroad.
 - 2. Second, we've been importing foreign goods, especially computers, at a rapid pace in recent years, and I expect this trend to continue.
 - a. This cuts into demand for domestic products.
 - 3. Then, there's trouble in the commercial real estate market in a number of places.
 - a. The vacancy rate nationally is high, at about 20 percent.
 - b. And it will probably take years to work off this much overhang.
 - 4. Finally, the large budget deficit and the end of the cold war have led the federal government to cut back, especially for defense.

- a. And state and local governments, too, have been constrained in the face of their own deficits.
- b. Of course, the outlook may change once we know how negotiations on Clinton's budget proposal work out.

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

A. Over the period of recession and slow growth, labor and product markets slackened, and this restrained growth in labor compensation and product prices.

- 1. Since the economy probably will grow only moderately this year, these pressures for disinflation are likely to continue.
- 2. Another factor contributing to the disinflationary trend is the large increase in worker productivity in 1992
 - a. —the largest of any year in the last two decades.
 - b. If this continues, firms will have a better chance of meeting increased demand without having to increase prices.

B. Despite these favorable fundamentals, we did get some worrisome inflation numbers in January and February.

- 1. Core consumer inflation—which excludes the volatile food and energy component from the consumer price index—rose at a 6 percent annual rate in both months.
- 2. Although it dropped in March to only a little over 1 percent,
- 3. this still left the average inflation rate for the first quarter as a whole at a relatively high 4¼ percent.

C. It's too soon to tell if recent data represent a trend or an aberration.

- 1. But for now, I expect to see core inflation decline somewhat this year and next from the 3½ percent rate registered in 1992.
- 2. However, future inflation figures will warrant careful attention to

see if they reverse the strong increases early this year, or if inflation is turning out to be more of a problem than now seems likely.

VI. What does this mean for monetary policy?

- A. The main way in which the Federal Reserve can contribute to long-run economic growth is by providing an environment of low inflation.
 - 1. So the downward trend in inflation that seems to be in place would be in keeping with that long-term goal.
 - 2. However, we cannot rule out the possibility that the first quarter inflation figures are a danger signal,
 - a. especially now that the expansion seems to have been established.
 - 3. Therefore, the situation should be watched carefully.
- B. I want to emphasize that while we'll pursue policies consistent with the continuation of the economic expansion,
 - 1. we also must be careful to preserve and advance hard-won gains against inflation.
- C. I think our efforts in both areas will pay off.

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