

Cash Management Conference
Beverly Hills, CA
for delivery May 4, 1993

ECONOMIC PROSPECTS FOR CALIFORNIA AND THE NATION IN 1993

- I. This afternoon 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 continuing signs of moderate expansion—
 - a. —not a boom, by any means, but a sustainable pace of economic growth.
 - 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 has been 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."
 - a. Only once before, in 1970, did California do worse than the U.S.
 - 3. But now we're faced with an unemployment rate of 9.4 percent, nearly two and a half percentage points higher than the national rate.
 - C. There's something else unusual about the current economic scene in California.
 - 1. In most business cycles, 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 -- and it's especially a problem here in southern California.
 - a. The resulting declines in property values have created some hard times 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. There's no question that southern California has had the most severe problems.
 - 1. It goes without saying that the devastation in L.A. from last year's riots took a toll on the whole area.
 - 2. But beyond this, the area has suffered because defense is more important to the southern California economy,
 - 3. and because the commercial real estate problems are worse in this part of the state.

4. So, altogether, over the last year, the number of jobs here fell by about $1\frac{1}{4}$ percent.
- F. But the rest of the state is hardly immune.
1. For example, in the Bay Area, the number of jobs fell 1 percent over the same period.
- 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. They showed that the number of jobs was holding steady or growing during the first three months of 1993.
 - b. Still, it's much too soon to tell whether these figures represent the beginning of a positive trend.
 2. But, as we all know, 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 more years.
 3. In consequence, the state government is going to face some hard choices in the budget process, which seem certain to intensify California's short-term troubles.
 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. So now let me turn to the national economy.

- A. 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 $2\frac{1}{4}$ 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!
 2. Data released last week show that the economy slowed in the first quarter of this year.
 - a. However, part of the slower growth is weather-related, and it appears that the expansion is still well in hand.
- B. In my view, monetary policy can take some of the credit for this expansion.
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 they've 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 a moderate pace.
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 much of Europe and of monetary and fiscal policies in Japan will help, but I still

expect to see weak growth abroad this year.

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, not just here in southern California..
 - a. The vacancy rate nationally is high, at almost 19 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.
 - (1) The Administration's failure on the temporary spending program will have only a very small negative effect on economic growth this year and next.

C. So, all in all,

1. I look for growth to be in the neighborhood of 3 percent, rather than the 4 to 5 percent that would be normal at this stage of a business cycle expansion.
2. As a result, the unemployment rate will decline only gradually.

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 $4\frac{1}{4}$ percent.
 4. Furthermore, employment costs also rose at a faster pace in the first quarter.
- 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 $3\frac{1}{2}$ 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 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 can't 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.

wc 1510