Southern California RMA Chapters
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A Perspective on the California and U.S. Economies

I. Good evening. It's a pleasure to be here.

A. Recently, the U.S. economy and monetary policy have changed course.

1. Economic activity slowed substantially this year, after three years of rapid growth.

2. And in early July, the Fed cut its key policy tool_the federal funds rate_by one-quarter percentage point,

a. reversing the pattern of interest rate increases it had undertaken in 1994 and early 1995.

B. This evening, I'd like to give you my perspective on these developments and their consequences for both California and the nation.

1. I believe these developments are interrelated_

2. _indeed, I see them as part of a consistent monetary policy regime designed to aim at price stability.

II. Let me start with a look at California and what the national slowdown in the first half of this year has meant for the state's economy.

A. If the state were following its usual pattern, our growth rate would have slowed by about the same amount as the nation's.

1. That would have been especially bad news, given the moderate economic expansion underway here in Southern California and the rest of the state.

B. But in this business cycle, California has been "out of sync" with the national economy,

1. and that's affecting the dynamics of our recovery.

C. California has had to absorb severe shocks to sectors like defense, aerospace, and construction.

1. As a result, the state went into a deep downturn that lasted more than three times as long as the national recession.

D. The impact has been especially harsh here in Southern California.

1. During the recession, job losses in this area equaled over 95 percent of the net decline in the state's payroll jobs,

a. even though this area accounted for only about 60 percent of the jobs going into the recession.

E. This region and other parts of the state still are adjusting to the negatives that plagued the state during the recession,

1. including cutbacks in aerospace and defense,

2. not to mention the state and local fiscal problems,

3. and developments affecting trade with Mexico.

F. These factors have held back the pace of recovery.

1. According to the payroll employment numbers, California ranked 40th among the states in the percent increase in payroll jobs over the past year.

2. And while California's unemployment rate is about 1 percentage point lower than a year ago,

a. it hasn't changed much on balance so far this year

b. and it's still well above the national rate.

G. But there also are definitely some positive features for California.

1. For example, sectors such as high tech, business-related services, entertainment, and tourism, are experiencing impressive gains.

2. We've even seen decent gains in construction employment.

H. The net effect has been some strengthening in the state's economy, despite a moderation in U.S. growth this year.

1. For example, based on performance to date, total payroll employment growth for California has been stronger this year than last.

I. This pattern is expected to continue_

1. _in keeping with the consensus forecast for California, which is for a moderate_but stronger_recovery in 1995.

III. Now let me turn to the national economic picture. First I'll give you a little background on the Fed's thinking about the economy over the last year and a half, and then I'll give you my views on the outlook.

A. The Fed became concerned about rising inflationary pressures last year.

1. In 1992, 1993, and 1994, the economy grew rapidly,

a. averaging between 3 and 4 percent growth rates_

b. _well above the 2 to 3 percent long-run potential rate.

2. This long stretch of rapid growth ultimately pushed goods and labor markets to operate beyond their long-run capacities.

a. For example, signs of strain showed up in manufacturing capacity utilization rates.

b. And the unemployment rate fell to just under 5½ percent,

(1) which appeared to be somewhat below the rate that can be sustained without rising inflation.

3. So, based on these indicators, the overall picture suggested that we had overshot capacity.

B. As a result, inflation would have been on the rise in the future_

1. _unless the economy had slowed down.

2. That's why we raised short-term interest rates from February 1994 to February 1995.

C. Since the beginning of this year, the pace of economic activity has cooled, and the timing of the slowdown has followed the normal lags between a policy action and economic activity.

1. The first quarter numbers showed substantially slower growth_

a. _from a 5 percent pace at the end of 1994 to 2® percent.

2. In the second quarter, the numbers showed an even greater slowdown_

a. _to a meager ½ percent.

D. As a result of this slowing in the economy, inflationary pressures receded a bit.

1. In fact, they receded enough that we felt a modest reduction in short-term interest rates was warranted.

2. That's what led to our ¼ percentage point cut in the funds rate in July.

IV. Looking ahead, I'm optimistic that we'll have a fairly quick return to the kind of moderate, sustainable growth that the economy needs.

A. For one thing, the second quarter GDP figures weren't as weak as they appeared on the surface.

1. Most of the weakness occurred in inventory investment, as firms made progress in working off excess stocks.

2. But it now appears that inventories are in better balance with sales,

a. so a good deal of this depressing factor appears to be behind us.

3. In addition, the demand of households and firms for goods and services held up quite well in the second quarter,

a. growing at a modest and sustainable 2 percent rate.

B. It looks as if demand probably will continue to hold up, although there are some pluses and minuses.

1. On the minus side,

a. government spending will continue to contract moderately.

b. While there's good reason to believe that less government spending and lower federal budget deficits will be good for the economy in the long run,

c. in the short run, this contraction dampens demand.

2. But on the plus side,

a. prospects for growth among most of our major trading partners appear reasonably good, so that foreign purchases of our exports should bolster growth in this country.

b. In addition, I expect to see continuing strength in business investment.

(1) For example, spending on computers is likely to continue the remarkable upward trend it has followed for the last several years.

c. Finally, various financial factors_such as the strength in the stock market and recent declines in long-term interest rates_should help boost the economy.

(1) In fact, I expect the lower long-term rates to contribute to a reasonably good performance next year for the housing sector.

V. Now, so far,

A. I've described

1. the Fed's concerns,

2. its course of action,

3. and the effects on the economy.

B. What I'd like to do in closing is to tie this together;

1. I'd like to show you how these actions and outcomes are consistent with a set of goals and procedures the Fed has adhered to for quite some time now.

C. The goal, of course, is to deliver stable prices.

1. There's a good reason we focus on price stability:

a. it's the main way monetary policy can promote the maximum sustainable advance in the country's economic output and the people's standard of living.

2. This isn't just a theoretical matter.

3. For one thing, we're not the only central bank with that focus.

a. In the 1980s, a number of countries_both developed and developing_shifted their emphasis to reducing inflation.

(1) Let me just rattle off a short list:

(2) There's Australia, Canada, New Zealand, Sweden, the United Kingdom, France, and Argentina.

b. Of course, Germany and Japan have had this emphasis for a lot longer.

D. For another, here in the U.S., we learned about the need for price stability from hard experience:

1. In the 1970s, when inflation rose to double digits,

a. we had economic and financial instability,

b. and ultimately a big, double-dip recession in the early 1980s.

E. Since that episode some 15 years ago, the Fed has basically been following the same policy regime:

1. While being responsive to cyclical ups downs in the economy, we're also seeking to lower inflation gradually.

2. And the emphasis is on gradual change,

a. because we want monetary policy to have the smallest possible adverse effect on economic activity during the transition.

F. Both the interest rate increases from 1994 to early this year_as well as the recent cut in rates_were in keeping with this policy regime.

1. As I said, we raised rates when it became apparent

a. that the economy had overshot capacity

b. and that inflation would be on the rise unless the economy slowed.

2. Well, it did slow, and therefore inflationary pressures receded enough to warrant a modest reduction in rates.

G. Now, pursuing this policy isn't a straightforward, mechanical proposition.

1. It calls for frequent reassessments and readjustments, as economic conditions develop.

2. But there is a constant in this policy regime that you can count on.

3. And that's the policy goal_

a. _providing the maximum sustainable economic growth through fostering price stability.

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