Economic Forum
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The Economic Outlook for the West, California, and the Nation

I. Good afternoon. It's always a pleasure to be a part of the University's Economic Forum.

A. Today, I'd like to start by looking at economic conditions in the West, with some emphasis on California.

B. Then I'll turn my attention to the national picture, and especially to the recent move by the Federal Reserve to cut interest. rates.

II. In the last year, the western economy outperformed the nation as a whole, though there have been signs of slowing.

A. The slowdown certainly isn't surprising, given national monetary and fiscal policies in 1994 and early 1995.

B. But some states have faced unique problems.

1. For example, Nevada was growing so fast that the rate it was simply unsustainable—some slowing was inevitable.

2. Then there's Idaho.

a. Weakness in the forest products industries there downshifted the pace of economic growth from "overdrive" to about "second gear."

3. In Washington, the Boeing strike moved the state's economy from a moderate pace of growth to a sluggish pace.

4. And in Hawaii, weakness in real estate and tourism has essentially kept the state's economy in recession.

C. Still, as I said, overall growth has been stronger in the West than in the nation.

1. And this region still boasts some of the country's fastest growing states:

a. Nevada and Utah are Numbers One and Two,

b. and Oregon and Arizona rank Numbers Five and Six.

D. But the big trend-breaker in the West last year was California.

1. If the Golden State had followed its *usual* pattern, its growth rate would have moderated along with the nation's.

    a. And that would have been bad news, since the state's *own* expansion was only moderate.

2. But California *didn't* follow the usual pattern.

    a. Instead, the growth in economic activity increased to a pace that's probably now above the national average.

3. One reason for this kind of performance is that California already had made significant adjustments during its deep and long recession—

    a. —there just was less fat and more slack in California.

4. Perhaps more importantly, California is now well-positioned both

    a. because of its prominence in fast-growing sectors like

        (1) high tech,

        (2) business services,

        (3) and entertainment,

    b. and because of its access to the booming Asia-Pacific region.

5. Both factors have helped push the recovery in California,

    a. and they've helped the state just about regain the jobs that were lost during the recession.

E. Now, I should note that California certainly hasn't *completely* adjusted from the negative shocks of the recession.

1. The unemployment rate is still well above the U.S. rate.

2. More cutbacks in defense jobs lie ahead—although the aerospace sector seems to be leveling out.

3. Some local governments—in Orange County and Los Angeles, for example—still face fiscal problems.

4. And the devalued peso and weak Mexican economy are offsetting some of the state's strong export growth.

F. But the general picture looking forward indicates that the stage is set for California to move from recovery to expansion.

1. That's why they were cheering when we cut short-term interest rates by a quarter percentage point in December.

2. Recession-weary Californians welcomed the cut, and might have hoped for even *more* monetary stimulus to keep the expansion going.

G. But, as you may know, the key to the Fed's action in December was not so much to provide stimulus to economic activity as to respond to inflation developments.

1. And that's what I'd like to turn to now.

III. Let me begin by quoting from Chairman Greenspan:

A. "Since ... July, inflation has been somewhat more favorable than anticipated, and this result, along with an associated moderation in inflation expectations, warrants a modest easing in monetary conditions."

1. Now, I know that sometimes people have complained that the Chairman's quotes aren't so easy to understand.

a. In fact, Herb Caen, a well-known columnist for the San Francisco *Chronicle,* said that the next edition of *Bartlett's Familiar Quotations* is going to contain the following quote from him:

b. "If I seem unusually clear to you, you must have misunderstood what I said."

B. But the statement he made about the inflation outlook is both clear and free of misunderstandings—and there are a couple of good reasons for that.

1. One reason is the recent performance of the CPI.

a. Since May of 1995, there's been a string of low numbers for the CPI—so that inflation has risen at just over a 1½ percent rate.

b. That's much better than the 3½ percent rate we had in the first part of the year,

c. and it also beats the average rate for 1994, which was 2½ percent.

2. Another reason is the recent lowering of expectations about inflation.

   a. For example, the latest Philadelphia Fed Survey of Professional Forecasters indicated a significant drop—

   b. —inflation expectations ten-years-ahead fell from 3½ percent at the end of 1994 to 3 percent at the end of 1995.

   c. A half percentage point drop over a year is significant because, typically, expectations move down at a "glacial" pace.

C. Now, because of these favorable developments on the inflation front, some people were hoping for a bigger move by the Fed.

D. But, frankly, we just didn't feel it was warranted.

1. In fact, I think there's room for uncertainty about potential pitfalls the Fed could face in pursuing its goal of price stability.

2. So, I'd like to go over a few of the concerns that are on my mind as we look ahead to possible inflation developments in the years ahead.

IV. Let me start by looking at capacity issues.

A. Now, it's not so easy to be precise about this at the moment, as you know.

1. We're *all* lacking data since the government was literally and figuratively "snowed under"—both by Mother Nature and by the budget stalemate.

B. But based on what we *do* know so far, the economy *appears* to have operated at around its full capacity to produce last year,

1. As a result, it makes sense to have some doubts about whether there's much downward pressure on inflation now.

C. First, capacity utilization in manufacturing stands at just over 82 percent—

1. —somewhat above common estimates of full utilization.

2. Taken literally, this measure suggests that there may be some excess demand in goods markets right now.

D. Second, the unemployment rate is now at 5.6 percent, which is probably somewhat below the so-called natural rate of unemployment—the lowest rate the economy can sustain without rising inflation.

1. Until very recently, mainstream estimates of the natural rate were around 6 percent, which would suggest that the economy has overshot capacity.

E. I realize that there's been some talk about the natural rate falling *below* this estimate—in part because of changes in the structure of the labor market.

1. An example of this that's often cited is the growing role of temporary workers, who have less strong ties to the labor market.

2. But,

a. even if the structure *is* changing,

b. and even if the natural rate *has* fallen a bit,

c. the current 5.6 percent unemployment rate *still* seems to suggest that there's not much excess capacity in the labor market that would be moderating inflation.

V. The next issue I'd like to touch on is the recent slowdown in the growth of labor compensation costs.

A. Some people have gotten pretty excited about this and think it's a sign that inflation is on the way downward.

B. After all,

1. the employment cost index has risen at a 2½ percent rate so far this year,

a. compared to 3 percent in 1994.

C. But I'm not completely convinced that we can take this as a sign of slowing inflation.

1. For one thing, all of the decline in labor cost inflation has been due to moderating benefits costs.

a. A good part of the reason for this, of course, is that firms are holding down medical costs by switching to managed care and other medical cost-containing programs.

b. We've certainly done it at the Fed, and I'm sure many of your companies have as well.

2. This switch may very well have permanently lowered the *level* of benefit costs.

3. But it *can't* permanently reduce the *rate of change* in benefit costs.

a. After all, eventually this route to cost savings will come to an end.

4. Moreover, even if benefit cost inflation *does* stay down a while longer, *total* compensation may not.

a. Workers and firms care about *total* compensation, including wages, salaries and benefits.

b. As a result, persistently low benefits costs may eventually show up in higher wages.

5. So, at some point, we may see a reversal in the recent downward trend in labor cost inflation.

VI. Now, I started out by saying that, while the inflation picture has improved, it's important not to exaggerate what that improvement means.

A. As I've tried to argue, it doesn't mean that the battle on inflation has been won.

1. On the contrary: the Fed's goal is to move gradually towards price stability.

2. And we're not there yet.

B. In my remarks today, I've mentioned a few of the areas of uncertainty we face as we make progress toward our goal—

1. —such as whether there's any excess capacity in the economy,

2. and how much longer benefit costs will continue to moderate.

C. To make our way through these uncharted waters, we'll need to maintain our vigilance and be prepared to respond as new information illuminates the way ahead.

D. But one thing that remains constant *and* certain is the *reason* for our goal of price stability—

1. —that is, through a policy of delivering low and stable inflation, the Fed makes its best contribution toward maximum sustainable growth for our nation's economy.

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