Presentation to a Community Leaders' Luncheon
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Three Questions about the Economic Slowdown

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

A. Today I'd like to talk about the economy—

1. —both here in the West

2. and in the nation.

II. Since the middle of last year, the national economy, has shifted into a lower gear.

A. Growth rates have gone from boiling hot to barely simmering.

1. In fact, though we're not technically in a recession, it certainly feels like one, with last quarter's growth rate a mere two-tenths of a percent.

2. And some sectors actually *are* in recession—

a —notably, manufacturing, and especially high-tech manufacturing.

III. The high-tech slowdown has had especially big impacts here in the West, where this sector is so important.

A. In California, nearly 11,000 high-tech manufacturing jobs have been lost this year, equaling about 3-1/2% of the total.

1. Moreover, in the San Francisco Bay Area, where the dot-com implosion has been most severe,

a the disappearance of large numbers of computer service companies and jobs has produced noticeable softening in local real estate markets.

2. Similar impacts are evident in other high-tech centers, such as Phoenix and Portland,

a and job losses have spread to other cyclically sensitive sectors in the District, such as construction.

B. Utah has not been immune to these trends,

1. with about 1600 manufacturing jobs and 5000 construction jobs lost in the state so far this year.

2. As a result, total employment in the state is essentially unchanged,

a and unemployment has risen somewhat.

3. Here in Salt Lake, the slowdown is especially evident in commercial real estate markets,

a where vacancy rates on office space and industrial property are up substantially in the second quarter.

b And conditions aren't helped, of course, by the latest news from Gateway.

i I understand they plan to shut down the local plant and lay off all 660 employees by the end of October.

4. But some other indicators *are* more positive in Utah and Salt Lake.

a Personal income statewide grew at a good clip in the first three months of this year.

b The demand for housing has remained solid,

i with the level of sales and prices continuing to grow at a moderate pace through June.

c And labor markets remain quite tight for now.

i For example, the seasonally-adjusted unemployment rate is still below 4% in Salt Lake City,

(a) which suggests that workers who lose jobs are likely to find new ones in short order.

C. So despite the high-tech slowdown, underlying strength is evident in our region.

1. And depending on developments in the national and world economies, the District is poised to resume a strong growth path.

IV. So now let me turn to conditions in the national economy and monetary policy.

A. Here I'll organize my comments around three questions.

1. What caused the slowdown?

2. Are we likely to slip into a recession?

3. What kinds of risks are in the road ahead?

B. Let me take these questions one at a time.

V. First, why did the economy slow at all?

A. Part of the answer has to do with the imbalances that prompted the Fed to tighten monetary policy beginning in mid-1999.

1. By that time,

a the economy had been growing at phenomenal rates for several years.

b In fact, from mid-1995 to mid-2000, annual growth averaged a very high 4-1/4 percent.

c The unemployment rate fell to a thirty-year low of just under four percent.

d And the inflation rate actually edged *down*.

2. This is a rare set of circumstances.

a And most likely it's due to a surge in technological advances—

b —information technologies, biotechnology, communication technology, and the like.

c These advances helped boost productivity growth to more than double what it had been for the previous 20 years or so.

d And that faster productivity growth rate means that the economy has been able to expand at a faster rate for several years—

i —without igniting inflationary pressures.

3. But by mid-1999—even *with* optimistic assumptions about trend productivity growth—

a —it looked as if the economy was growing faster than its sustainable rate.

b Furthermore, labor and product markets appeared to be tight.

c And, in the financial markets, real corporate interest rates were rising significantly—

i —which suggested some difficulty in continuing to fund all the demand for investment.

d So we were seeing signs that inflation could become a concern after all.

4. As a result, the Fed tried to slow demand down a bit by raising short-term interest rates gradually from mid-1999 through mid-2000.

a This was felt directly in credit markets,

b so that businesses and consumers faced higher borrowing costs.

B. On top of this, though, some other factors worked to raise firms' cost of capital even more and to put a strain on their budgets.

1. One factor was the slide in the stock market.

a Part of it also may be related to a re-evaluation of the long-run profitability of many high-tech firms.

b Now, don't get me wrong. I still think we're not near the end of the surge in technological innovation that has propelled the economy since the mid-1990s.

c It's just that—even with this surge—markets may have gotten carried away.

2. Another factor was the unexpected increases in the prices of oil, natural gas, and electricity.

a For example, the price of oil nearly tripled between early 1999 and late 2000.

3. A third factor is the exchange value of the dollar.

a It's been quite strong,

b and that has reduced domestic production by lowering our exports and raising our imports.

4. Finally, businesses faced what I'll call "the overhang problem."

a For years, many firms had made big investments in information processing equipment and software—averaging twenty percent a year from 1996 to 2000.

b After all that investment, they had accumulated large amounts of capital equipment already.

c And they're just not in the market to buy more now.

C. With all these factors together,

1. It's not surprising that firms have pulled in their horns,

2. and cut back on investment, hiring, and production.

VI. Now, to the second question—are we likely to slip into a recession?

A. Obviously, there's no way to know for sure. But my best estimate at this point is that there will be

1. a modest pickup in activity by the end of this year,

2. with more acceptable growth rates in 2002.

B. A number of factors point in this direction. First, the Fed has cut short-term interest rates seven times since January.

1. The federal funds rate now stands at 3-1/2 percent, compared to 6-1/2 percent back then.

2. And though some have expressed concern about monetary policy's effectiveness this time, we *are* seeing signs of easing in credit markets.

a Short and intermediate rates—the rates we associate with car loans and home equity loans, for example—are down substantially.

i And some interest-sensitive sectors, like housing and consumer durables are holding up pretty well.

b In addition, with lower rates on variable-rate mortgages, many homeowners now have more money in their pockets to spend on other things.

C. The second source of stimulus is the tax rebates. They can be expected to add strength to the economy before the year's end—

1. —and to continue to boost growth in 2002.

D. Third, energy prices have turned around this year.

1. For example,

a the price of imported oil has fallen by about 20 percent since last November.

b And the price of natural gas has fallen dramatically.

2. That's given firms and households more purchasing power.

E. Fourth, the "overhang problem" is one that will correct itself with time.

1. At some point, the stocks of these assets will get to low enough levels that firms will need to start spending on them again.

VII. Now, what are the risks on the road ahead?

A. One is that consumers might pull in *their* horns more than they have.

1. The fact is, despite the drop in stock prices and the general economic slowdown, consumer spending has held up reasonably well.

a Indeed, it's the main reason the economy has *not* slipped into recession.

2. What might undermine consumer spending?

3. Two candidates would be

a a slide in the stock market

b or a slide in consumer confidence.

B. Another risk is the global nature of the slowdown.

1. Part of the slowing in the world economy is due to our own slowing—

a —and that feeds back to us through a smaller demand for our exports.

2. But part of it also is due to home-grown problems

a in countries like Japan and Argentina, for example,

b and, to a lesser extent, in Europe.

VIII. Now let me wrap this up by concluding on a more positive note.

A. After our most recent meeting of the Federal Open Market Committee, we did say that the risks at the moment appear to be mainly on the downside.

B. However, this economy still has a lot going for it.

1. The ongoing advances in technology have boosted our trend productivity growth rate.

2. And that's a real strength. It means that longer-term our economy has a greater potential

a to grow,

b to create new jobs and businesses,

c and to produce improvements in our standard of living.

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