

*Community Leaders/CEO Luncheon
Salt Lake City, Little America Hotel
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by Robert T. Parry, President, Federal Reserve Bank of San Francisco*

A Look at the Regional and National Economies

- I. Good afternoon. It's a pleasure to be here.
 - A. As you know, the national economy's performance has been outstanding.
 1. This expansion has lasted longer than any other in U.S. history.
 2. And in the last four years especially, it has shown remarkable strength, averaging 4-1/2 percent growth per year.
 3. Furthermore, the unemployment rate continues to hover at the lowest levels in thirty years,
 4. and although inflation flared up a bit recently, it has remained pretty tame overall.
 - B. With all this good news,
 1. it's natural to ask why the Fed has been raising interest rates since last summer.
 - a. May was the sixth time we raised the short-term rate since last summer.
 - b. And at that time, we moved in a half percentage point step, rather than a quarter percentage point step, as we had done before.
 2. Today I want to give you my views on why the Fed has been raising interest rates, and try to explain why we see risks of potential inflation in the economy.
- II. But before I get into the national picture, let me take a moment to discuss conditions closer to home for you.
 - A. To put it simply, they remain excellent, despite recent moderation in the state's rate of expansion.

1. That expansion reached a peak in the early and mid-1990s, when Utah was one of the fastest-growing states,
 - a. with employment gains averaging in excess of 5 percent per year.
- B. Since then, the pace of growth hasn't been quite as sizzling.
 1. One thing that took some sizzle out of the economy was the Asia crisis,
 - a. which hurt Utah's manufacturing sector.
 2. Another likely factor was the slowdown—or reversal—of immigration from California,
 - a. as that state's economy began to boom.
 3. As a result, the pace of employment growth in Utah fell from nearly 5 percent in 1996 to 2.6 percent in 1999.
 4. In addition, Utah's construction and real estate boom has shown signs of winding down a bit.
 - a. Here in Salt Lake City, the rate of home price appreciation has slowed,
 - b. and vacancy rates on commercial property have risen.
 - c. And statewide, declines in residential and nonresidential construction plans were evident in the first quarter of this year.
- C. But overall, the Utah economy is doing very well, and prospects for the future remain excellent.
 1. The pace of employment growth has remained close to the national average recently,
 - a. and Utah's already low unemployment rate has fallen even further this year, to a remarkably low 2.7 percent in April.
 2. The state has received national recognition as a desirable place to live and do business—
 - a. —for example, *Inc. Magazine* rated Salt Lake City-Provo as the second best metropolitan area for launching and growing a new business,

- b. and *Places Rated Almanac* ranked the Salt Lake-Ogden metro area as the best place to live in North America!
 - c. And, of course, Salt Lake will be the site of the 2002 Olympics.
3. Looking forward, Utah's highly educated population and solid base of information-technology firms will keep the state very competitive in our rapidly changing national economy.

III. So now let me turn to the national picture.

- A. As I've already hinted, technology is playing a key role in the national economy.
- B. Indeed, one of the key reasons the economy has been able to grow so vigorously with relatively low inflation for the last few years is the remarkable surge in productivity that's related to the advances in technology.
 - 1. Not so long ago, most estimates suggested that the U.S. economy probably couldn't sustain productivity growth faster than 1-1/2 percent.
 - a. That had been the average from the 1970s to about the mid-1990s.
 - 2. But the numbers we've seen over the last few years have led us to revise our estimates substantially.
 - a. In 1997, productivity grew at a little under two percent, which seemed blazingly fast at the time.
 - b. Then, in 1998, it came in even higher—at just over three percent.
 - c. And last year it accelerated *again*—to three and three quarters percent!
 - d. The first quarter numbers came in at a still respectable 2-1/2 percent.
- C. These increases in productivity have wonderful effects on the economy.
 - 1. One effect is that a *faster* growth rate for productivity means that living standards rise faster.
 - 2. Another effect is that when productivity *accelerates*, it tends to hold down inflation.

- a. This is true mainly because increases in labor compensation tend to lag behind increases in productivity growth.
- b. So, for a while, more goods are being produced at the old, lower wages.

D. But I want to emphasize that there's an important distinction between *fast* productivity growth and *accelerating* productivity growth.

- 1. As I said, faster productivity growth raises our standards of living more quickly.
 - a. And that's great.
- 2. And we get an initial *inflation* benefit when productivity *accelerates*.
 - a. But thereafter, if productivity growth levels off at the faster rate,
 - b. monetary policy must respond to keep inflation at the new lower level.

E. The near term question is: Can productivity keep accelerating fast enough to push inflation down further?

- 1. Yes, that's possible.
- 2. But it's not something we can count on.

F. So, even though it's clear that technological advances are expanding the supply side of the economy,

- 1. we still have to watch for conditions that raise inflationary risks.
- 2. And there are several of them.
- 3. These are the risks that have led the Fed to follow a course of gradually raising short-term interest rates.

IV. Let me outline them for you briefly.

A. One potential area of inflation risk involves the relationship between faster productivity growth and the levels of "equilibrium" real interest rates—

- 1. —that is, the rates that bring supply and demand in the economy into balance,

- a. so that output equals its potential level.
- 2. Here's what happens—higher trend productivity growth actually raises the level of equilibrium real interest rates in the long run.
- 3. How does this work?
 - a. Faster productivity growth increases the profitability of various investment projects that firms might undertake.
 - b. This means, they'll bid more aggressively for financing.
 - c. And that will raise equilibrium real interest rates.
 - d. So, if the Fed tried to hold real rates at their old levels, we'd be contributing to an inflationary monetary policy.
- B. Another area of risk is the growth in demand.
 - 1. We've seen a real pickup in demand from abroad—
 - a. —real GDP growth in the rest of the world rose to around 4-1/2 percent last year, from less than one percent in 1998.
 - b. And it's projected to be almost as strong this year.
 - 2. Here in the U.S., businesses and consumers have been spending at a phenomenal pace.
 - a. And this spending actually accelerated in the first quarter.
 - (1) On the business side, real fixed investment rose by more than 25 percent.
 - (2) On the consumer side, real expenditures jumped by more than seven and a half percent!
 - 3. Consumer spending especially appears to have been fueled by the very large increases in equity values in recent years.
 - a. Now, that doesn't mean that the Fed has set its sights on some kind of goal for the stock market.
 - b. We're not so concerned about *why* consumer demand is so strong.

- c. What we *are* concerned about is that demand—for whatever reason—may be outstripping supply.
- C. This brings me to another inflationary risk.
 - 1. One consequence of the fast pace of growth since 1996 is that labor markets in the U.S. have now become very tight.
 - 2. With the unemployment rate at just under four percent,
 - a. it's no wonder we hear stories about how hard it is for some firms to find people to fill jobs.
 - 3. Labor markets as tight as this eventually can lead to faster increases in labor costs—
 - a. —and therefore to higher price inflation than we've seen so far.
 - b. In fact, we saw a noticeable jump in the first-quarter employment cost index, a broad measure of labor compensation that includes wages, salaries and benefits.
- D. The final risk I want to mention is the recent run-up in energy prices.
 - 1. At the end of 1998, OPEC cut back on its production,
 - a. and that drove oil prices to the highest levels we've seen since the Gulf War.
 - b. But the good news is that OPEC *did* agree recently to increase production somewhat.
 - 2. Overall, then, we expect only a modest effect,
 - a. because oil prices haven't risen above their highs in March.
- V. Now, with all these inflationary threats, what's a reasonable course for the Fed to follow?
 - A. Well, it's risky just to sit back and wait for an upward trend in inflation to show up before we do something,
 - 1. because monetary policy affects inflation with a long lag,
 - B. Though it's too soon to say that we've got such a trend,

1. the numbers *do* show a pickup in core inflation so far this year compared to 1999.
 2. So the most recent evidence now makes it pretty clear that we've reached a stage where inflation is no longer *falling*.
- C. At the same time, we need to proceed with some caution, because there's a fair bit of uncertainty about the economy's behavior right now.
1. Most forecasts—including my own—have predicted a *sustained* rise in core inflation for a couple of years.
 2. but we haven't seen it yet.
 3. And that makes me less confident about the old relationships between the growth of the economy and the level of the unemployment rate and the effect on inflation.
- D. Given these considerations, I think the cautious approach of gradually increasing short-term interest rates over the past nine months was appropriate.
1. Though we did take a bigger step at our last meeting, I still think it's in keeping with the gradual approach.
 2. Going forward, we'll continue to aim policy at
 - a. keeping this remarkable expansion on track
 - b. without risking our ultimate goal of price stability.

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