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A Look at the Regional and National Economies

I. Good morning. 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 near its lowest level 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 during the past year.

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 point, 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 here in California and the Bay Area.

A. The California economy entered the new year with considerable momentum and continues to expand at an impressive pace, with growth outpacing the average for the rest of the nation.

1. Over the past year, California’s economy has generated an average of thirty-six thousand new jobs a month,

2. producing significantly tighter labor markets,

3. while substantially boosting personal incomes, housing values, and wealth.

B. A key source of this performance was the state's high-tech sector.

1. Job growth was especially strong in businesses like biotech, communications, and software and Internet services.

2. And it was financed by

a) record-breaking venture capital investment

b) and surging proceeds from Initial Public Offerings.

C. This scenario has played out most intensely here in the Bay Area.

1. The jobs and investment returns created by local high-tech companies during the year generated tremendous gains in income and wealth,

a) which powered robust consumer spending,

b) and helped maintain strong economic conditions in our area—

c) —all this despite weak export demand and job losses in durable manufacturing.

D. Looking forward, there *are* some factors that could restrain growth in this area.

1. With the unemployment rate at just 2.4 percent, labor markets are tight.

2. And the rising cost of real estate is phenomenal!

a) In the first four months of this year, Bay Area median home prices were up 27 percent relative to a year earlier.

b) And the market for office space is even hotter,

(1) with vacancy rates at all-time lows

(2) and lease rates rising at a dizzying pace, especially in San Francisco and Silicon Valley.

3. Beyond these factors, uncertainty about market valuation—especially for high-tech stocks—could damp the gains in income and wealth that have driven consumer demand and financed business expansion.

E. But overall, the Bay Area's prospects look excellent.

1. Job creation remains solid overall,

a) With high-value sectors—such as software and Internet applications—continuing to create substantial wealth.

2. And exports of many Bay Area products have increased noticeably as the East Asian economies have recovered somewhat.

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 per year.

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 spent at a phenomenal pace in the first quarter.

a) On the business side, real fixed investment rose by more than 25 percent.

b) On the consumer side, real expenditures jumped by more than seven and a half percent!

c) And though consumer and other spending appears to have cooled slightly in the past couple of months,

(1) it's too soon to tell if that slowing will be sustained.

C. In the meantime, one consequence of the fast pace of growth since 1996 is that labor markets in the U.S. have now become very tight.

1. With the unemployment rate at around four percent,

a) it's no wonder we hear stories about how hard it is for some firms to find people to fill jobs.

2. Labor markets as tight as this eventually can lead to faster increases in labor costs—and therefore to higher price inflation than we've seen so far.

a) When we look to the data for evidence on this, we're getting somewhat mixed signals.

(1) We saw a noticeable jump in the first-quarter employment cost index, a broad measure of labor compensation that includes wages, salaries and benefits.

(2) But a narrower measure that includes only wages barely increased at all in May.

b) Despite these mixed signals, the tightness of today's labor markets definitely bears watching.

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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