Presentation to the San Diego Rotary
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A Monetary Policymaker's Perspective on the Economy

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

A. I'd like to give you my views on the national economy.

B. And I'll also say a few words about economic conditions in California and the San Diego region.

II. I'll start by putting recent events in the national economy in perspective.

A. From mid-1995 to mid-2000, the U.S. economy had a phenomenal run.

1. Annual growth averaged a very high 4-1/2 percent rate during those years, and the inflation rate actually edged down.

2. A key contributor was the surge in technological advances.

a It helped boost productivity growth to an average rate of almost three percent a year during this period.

b This upward shift in productivity growth means the economy's *potential* growth rate is higher.

c That is, the economy has been able to expand at a faster rate for a number of years

i. without generating inflationary pressures.

B. Since the middle of last year, of course, the economy has slowed quite a bit—

1. —averaging a growth rate of only about one and a half percent.

2. Furthermore, some sectors actually are in recession—most notably, manufacturing.

3. And within manufacturing, high tech has really been shrinking.

   a I'll be returning to this point, because it's a very significant development in both the national and the local economic stories.

III. To understand where we go from here, it's useful to look at what contributed to the slowdown.

A. By the middle of 1999, real GDP growth was faster than could be sustained—even *with* optimistic estimates of productivity growth.

1. This, combined with financial market developments, indicated that inflation could become a concern.

2. So the Fed raised the funds rate gradually from mid-1999 though mid-2000 to rein in demand.

B. On top of that, some other factors also slowed demand in terms of business investment—and, as I mentioned, this had a significant effect on investment in high-tech equipment and software.

1. First, unexpected increases in the prices of oil, natural gas, and electricity cut into firms' budgets.

2. Second, the drop in stock prices raised firms' cost of capital.

   a Part of this stock price slide may be related to a re-evaluation of the long-run profitability of many high-tech firms.

      i. 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.

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

3. The third factor slowing business demand is what I'll call "the overhang problem."

   a For years, there was extraordinarily strong growth in business investment in high-tech—averaging more than twenty percent a year from 1996 to 2000.

   b After all that investment, many firms seem to have large stocks of capital equipment *already*.

i. So they're not in the market to buy more.

c This suggests that there may be an "overhang" of business equipment and software that spells weakness in business spending going forward.

C. Finally, let me say a word about the consumer side of the demand slowdown.

1. Typically, the three items I mentioned that have been slowing business demand—the energy surprise, the drop in stock prices, and the "overhang"—also tend to slow consumer demand.

2. But, so far, at least, while consumer spending has slowed some, it has held up remarkably well.

IV. Looking forward, I'd say the U.S. economy still has a lot going for it, and that we're likely to see an acceleration in growth by the end of the year.

A. As you know, the Fed has responded to economic weakness by cutting short-term interest rates five times since January.

1. Those cuts have brought the federal funds rate down from 6-1/2 percent in January to 4 percent today.

2. This easing will help stimulate the economy.

B. In addition, the recently passed tax cuts will probably add some strength to the economy before the year's end—

1. —and they may provide more of a boost in 2002.

C. Finally, as I mentioned before, the continuing advances in technology suggest that the economy's *potential* for growth is a good deal higher than before.

1. So—even though we're in a cyclical slowdown—in economists' terms, we're probably "cycling around a higher potential growth rate."

D. No doubt, the road ahead may be rocky, since there *are* some downside risks.

1. For example, if the stock market or consumer confidence slide a good deal more, households could cut back further on spending.

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

a When the U.S. economy slows, it tends to have a dampening effect on many other economies,

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

b Moreover, some of the slowing in Asia and Europe appears to be related to economic issues specific to those countries.

E. While these risks are important to keep in mind, it's also important to recognize that the 250-basis-point reduction in the funds rate overall represents a significant easing of policy.

1. This easing affects the economy with fairly long lags, so it may be some time before the effects are fully felt—

a —perhaps through the end of this year and into next year.

2. As this stimulus unfolds, the Fed will need to keep its eye on its longer-term goal of price stability.

V. Now let me turn to the economy closer to home.

A. The California story is very similar to the U.S. story with a couple of important differences.

1. First, the slowdown in California has been less pronounced than in the rest of the U.S.

2. Second, our economy is more vulnerable to greater slowing in the future as adjustments in the technology sector and the energy crisis play out.

B. Given the prominence of technology firms in California, we can expect to be hit harder than the rest of the U.S.

1. Indeed, we've already seen the slowing in the technology sector spill over to other sectors of the economy.

a For example, vacancies are up and lease rates are falling in some commercial office markets.

b And growth in personal income has slowed from its frenzied pace of the last several years while stock values have declined.

C. On the energy front, it's hard to predict precisely how the crisis will affect the state's economy, but here's a rough guess.

1. The electricity rate hikes this year, combined with the higher cost of natural gas, will equal about 1-1/4 percent of output in the state.

    a This will wipe out our advantage as a low energy consuming state.

2. The summer blackouts are a wildcard, but based on projected supplies and usage of electricity, the disruptions from outages easily could be frequent enough to affect economic growth.

D. Despite these vulnerabilities, the California economy remains structurally sound.

1. And we're coming off a very strong run.

    a California's job growth last year was almost four percent.

2. Compared to that, even average growth feels and looks like bad times.

E. Turning to the local picture, San Diego, of course, faces the same vulnerabilities.

1. Over the past several years, San Diego has become one of the nation's leading centers for developing and producing biotechnology, pharmaceuticals, and wireless communications equipment.

    a Indeed, many of America's premier players in these high-tech markets—

        i. —Gen-Probe, Agouron Pharmaceuticals, and Qualcomm for example—

    b —have facilities in the area.

    c And other established technology businesses in fields such as computer manufacturing and software development are headquartered in your area—

        i. —Gateway Computers and Science Applications International (SAIC) come to mind.

    d This is not to mention a host of smaller start-ups, including a number of niche biotech companies.

    e While being a technology center has brought rewards to this area,

i. as we've seen, it also can bring risks.

2. The other area of vulnerability, of course, is the electricity crisis.

a San Diego Gas and Electric has not had the same financial difficulties as Southern California Edison or Pacific Gas and Electric.

b Still, rate hikes for consumers and businesses are almost a certainty.

i. As you know from last summer, increased prices for electricity can have a substantial impact on consumer budgets and business profits.

c And if there are significant power outages this summer, they may, as I mentioned earlier, be substantial enough to temper economic growth.

F. Balancing these risks is some pretty good news.

1. This area ended 2000 with considerable momentum, and things look good so far this year.

2. Over the past twelve months, job growth averaged about 3 percent,

a with nearly every major sector of the economy adding jobs.

3. Residential and commercial real estate markets remain strong,

a producing continued expansion in construction payrolls.

G. Going forward, then, the San Diego area economy appears to be relatively sound.

1. And, with its highly educated population

a and vibrant research community, anchored by UC San Diego,

b it has an excellent base that can help keep it competitive in our rapidly changing national economy.

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