Inaugural Economic Outlook Conference
Central Washington University
Ellensburg, Washington
For delivery October 26, 1999, at approximately 11:00 am Pacific Daylight Time
(2:00 pm Eastern)
by Robert T. Parry, President, Federal Reserve Bank of San Francisco

A Look at the Regional and National Economies

I. Good morning. It's a pleasure to be here with you in Ellensburg.

- A. As President of the San Francisco Fed, I'm concerned about both the economy here in the west and the national economy.
    - 1. So today, I want to say a few words about the economic outlook for both areas.
- B. When I turn to the national economy, I hope to explain a little about the current stance of monetary policy.
    - 1. As you may know, at the last meeting of the Federal Open Market Committee, we decided to hold short-term interest rates steady.
    - 2. At the same time, we indicated a tilt toward possible firming going forward.
- C. Naturally, many issues come up at these meetings, and we consider a broad array of factors in coming to our decision.
    - 1. Today, I'd like to give you my own perspective on some of these issues and factors,
    - 2. with a view to explaining why this decision makes sense.

II. Let me begin with a look at the economic situation in your state and area.

- A. The Washington State economy has continued to perform well this year,
    - 1. even though Boeing has had production and employment cutbacks.
    - 2. There are several factors underlying Boeing’s adjustment,
        - a. including competition from the Airbus consortium in Europe.

b. But another key factor has been the economic slowdown in East Asia.

c. Although recent news regarding East Asian aircraft purchase plans has been more upbeat,

i. Boeing's role as a primary source of economic growth for the state clearly is diminishing.

B. Fortunately, the Seattle-area economy has benefited from other sources of growth,

1. most notably the substantial success of the software sector.

2. This sector mostly has been expanding at a double-digit pace in recent years

a. and it's an increasingly important determinant of the state's economic fortunes.

b. The jobs and investment returns created in this sector have generated tremendous gains in income and wealth,

i. which have helped maintain robust economic conditions in the Seattle area.

III. In the rest of the state, conditions are more varied.

A. Here in Ellensburg and Kittitas County, Seattle's prosperity has spilled over to some degree.

a. For example, although I know the county has experienced high unemployment in the past,

b. in recent months, the unemployment rate has been close to the state average.

B. However, much of Central Washington has faced weak conditions in the agricultural sector.

1. Farmers nationwide are struggling to keep profits up in the face of the lowest commodity prices in many years.

2. And Washington has been especially hard hit, with gross sales of farm commodities declining by about 5 percent in 1998.

a. This is due in large part to Washington farmers' heavy dependence on exports, which have been very weak since the East Asian crisis began.

C. Overall, then, the main source of restraint for the state economy has been East Asia.

1. So, going forward, the prognosis looks pretty good,

a. as that part of the world recovers and the U.S. economy continues to expand.

IV. Now let me turn to the national picture.

A. For more than three years, the U.S. economy has delivered a remarkable performance:

1. Real GDP has grown at a phenomenal pace—

a. —averaging three and three-quarters percent a year.

b. The unemployment rate has hovered around its lowest levels in decades.

2. And inflation also has remained remarkably low, no matter how you measure it—

a. —between one and a quarter and two and a half percent.

B. This is, of course, a wonderful combination—and one that's pretty rare, to tell the truth.

1. Typically, when there's a sustained period of fast growth and tight labor markets, we begin to see signs of rising inflation.

V. So what has been keeping inflation in check in the U.S. economy for the last few years? Well, there are several candidates.

A. One important candidate is last year's global financial turmoil, which significantly weakened foreign demand.

1. The weakened demand led to a stronger dollar—and therefore lower import prices—

2. as well as falling commodity prices worldwide

3. and a drop in capacity utilization rates in U.S. manufacturing.

B. In addition,

1. energy prices were falling during 1997 and 1998,

2. and so were the costs of health care, as the industry restructured itself.

C. At this point, though, these factors are beginning to reverse themselves somewhat.

D. And, with the pickup in demand from abroad combined with continuing strong *domestic* demand, we face the risk of building inflationary pressures.

1. Furthermore, with the unemployment rate hovering around 4-1/4 to 4-1/2 percent for the past year and a half,

a. labor markets appear to be tight.

VI. But there *is* a factor that might mitigate some of the inflationary pressures—and that factor would be a continuation of the fast productivity growth we've enjoyed.

A. Over the last two years, growth in productivity in the non-farm sector averaged about two and a half times the pace of the long-run trend of the last decade or so.

B. What's the source of the rapid productivity growth? Well, it’s certainly natural to link it to the technological boom we’ve seen in recent years.

1. There are plenty of examples of new technologies that have led to labor-saving devices.

2. But even beyond that, new technologies are changing the *way* some firms do business.

3. In fact, I can give you an example I saw firsthand.

a. I visited a lumber mill in Oregon not long ago.

b. They showed me how they used lasers to define the geometry of a log,

c. and they then cut it based on the latest price information for different cuts.

d. If there's a shortage of two-by-fours, for example, then prices on them rise, and the mill cuts more of them and fewer of other sizes.

4. Improvements like this in production flexibility and real-time information flows can make a difference for U.S. firms.

5. They can help

a. eliminate bottlenecks,

b. streamline production,

c. and fine-tune specifications

d. so firms can better match—and even anticipate—customers' needs.

6. And all this could translate into faster productivity growth for the economy.

C. But even though there are indicators—and anecdotes galore—suggesting that productivity has surged because of new technologies, there also are serious uncertainties.

1. One of the fundamental uncertainties is that we can't tell

a. whether the surge in productivity is a *cause* of the fast output growth

b. or whether it's a *result* of it.

c. It may be a result because, historically, productivity growth has followed a pro-cyclical pattern.

d. In other words, the fast productivity we've had may be due largely to the strong business cycle upswing we've been in.

e. In that case, continued strong GDP growth and tight labor markets eventually would create pressures for inflation to increase.

2. Another fundamental uncertainty is that we don't know whether the fast productivity growth will continue into the future.

a. And if the productivity growth rate slows,

b. inflation could pick up in the face of rapidly expanding demand.

VII. These uncertainties about recent productivity growth appear to be the major issues in the outlook for the U.S. economy and also for the conduct of monetary policy.

A. For policy, these uncertainties complicate the question of where the Fed should be along the spectrum of pre-emptive action or more cautious action.

B. Ideally, the Fed would tend more toward the pre-emptive end of the spectrum, because of the long lags between policy actions and their effects on the economy.

1. For example, if policymakers wait until inflation actually begins to pick up steam, they face a problem that was all too familiar in the 1970s and early 1980s.

a. In order to quell inflation,

i. interest rate increases have to be bigger,

ii. which means the output losses are bigger,

iii. and the employment losses are bigger.

2. So, if policymakers react early and quickly, they can alter inflation expectations and cut off the rise in inflation before it gets started.

C. But when there’s a high degree of uncertainty about the underlying structure of the economy,

1. it could be best for policy to tend more toward the cautious part of the spectrum.

D. In the current situation, there's a great deal of uncertainty about

1. whether future inflation will be more affected by tight labor markets

2. or whether it will be more affected by faster productivity growth.

E. As a result of these uncertainties, the Fed has taken a fairly cautious approach in reacting to indications of higher future inflation—especially since actual inflation has been so well-behaved.

1. Our recent decision *not* to raise rates but to have a bias toward firming in policy going forward is consistent with the cautious approach.

2. So far, this strategy seems to have worked well.

a. Inflation has remained subdued,

b. while the expansion has not only continued for eight years—

c. —it has even *strengthened*.

3. As we go forward in these uncertain times, I can assure you that we're quite certain about our ultimate goal—

   a. —and that is to provide a low-inflation, stable environment in which the U.S. economy can prosper.

# # #