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Inside the Federal Reserve: A District Bank President's Perspective

I. Introductory remarks (no prepared text)

II. Federal Reserve purposes and functions (no prepared text)

III. Federal Reserve response to September 11, 2001 (no prepared text)

IV. Since that time, of course, the economy has shown remarkable resilience.

A. At this point, the evidence is pretty convincing that the recession—the first in ten years—is over.

B. One positive indicator is business investment in inventories.

1. This measure plunged during the recession—

a —but that actually suggests good news going forward.

2. Firms will have to replenish those inventories,

a and that sets the stage for more production in the future.

C. Another is consumer spending.

1. It has continued to hold up through much of the downturn,

2. and it looks as if it grew at a respectable rate in the first quarter as well.

a To get a feeling for the durability of the consumer's role, just consider what's happened in the auto industry.

(1) A lot of forecasters thought there'd be a huge drop in auto sales after last year's surge, when people jumped on extraordinary financing incentives.

(2) But, instead, auto sales have held up well in recent months.

b And we've seen pretty remarkable strength in the housing sector as well.

D. There's even a flicker of good news about business investment in equipment and software.

1. This type of spending basically "overshot" during the boom times—especially when it came to investing in high-tech.

a For five solid years up through 2000, firms invested in high-tech at phenomenal rates.

b And when they pulled back, beginning in 2001, they did so sharply.

2. But we may be seeing early signs of a turnaround here.

a Although this category of business spending was falling at the end of last year,

(1) it did so at a much slower rate.

b Furthermore, business investment in a subcategory of high-tech—computers and related equipment—showed a large increase in the last part of 2001,

(1) —the first since the fourth quarter of 2000.

c And that demand is driving increased production in high-tech manufacturing.

(1) During the first quarter of this year, production rose more than five percent.

E. Another very positive sign for the future is our productivity performance.

1. Last year it registered a 2 percent growth rate.

2. That's impressive.

a For one thing, during a recession, productivity growth usually turns *negative.*

b For another, this growth rate is about double the trend rate that prevailed from the 1970s to the mid-1990s.

c On top of that, it looks like the first quarter will turn in a *very* strong performance.

3. So it most likely means that the process of technological innovation that spurred the economy in the latter half of the 1990s is alive and well.

F. Finally, the economy should get a significant boost from all the stimulus that's in the pipeline from both fiscal and monetary policy.

1. Congress

a passed two packages last year that are providing substantial stimulus this year.

b And this year, they passed a package that includes

(1) extended unemployment benefits

(2) and a big tax break on equipment and software spending made between September last year and September 2004.

2. On the monetary policy side,

a the Fed cut interest rates eleven times last year

(1) for a total reduction of four and three-quarters percentage points.

b That brings the federal funds rate to 1-3/4 percent,

(1) the lowest rate in over 40 years.

V. Of course, there are risks out there.

A. One has to do with consumers.

1. In most recoveries, there's a big bounce in demand as consumers get back into the spending mode—especially for big-ticket items.

2. But, as I said, during the recession, consumers didn't really slow their spending that much,

a so growth isn't likely to get that big a push from consumer spending.

B. Another possibly tempering factor involves the value of equities, especially in light of questions about the reliability of corporate accounting.

C. Finally, there's the oil situation.

1. So far, the surge in oil prices hasn't had a big effect on the economy.

2. But the turmoil in the Middle East and Venezuela create a lot of uncertainty on that front.

VI. Let me wrap up this discussion of the national economy with some of my views on how these developments play out for monetary policy.

A. After our last FOMC meeting, our announcement referred to a shift in the risks the economy faces.

1. Instead of being weighted toward economic weakness,

a there's now a balance between our goals of price stability and sustainable economic growth.

2. At the same time, we decided to hold the federal funds rate steady, at 1-3/4 percent.

B. Of course, that's a very stimulative policy.

C. Let me explain what I mean by "stimulative."

1. The "real interest rate" —that is, the rate adjusted for inflation—

a —is below the "equilibrium real interest rate" —that is, the rate where overall supply and demand in the economy are in balance.

2. To put some rough numbers on those concepts—

a —with the core consumer inflation rate somewhere between 1 and 2-1/2 percent,

(1) the real interest rate today is near zero.

b And most economists figure that the current real equilibrium rate is between 2 and 3-1/2 percent.

3. Rough as these numbers are, they show that the real interest rate is well below the real equilibrium rate.

4. So at some point, the funds rate will have to move up,

   a or we'll ignite inflationary pressures.

D. But, for now, I think we can be deliberative as we approach the issue of when policy has to change and how aggressive it has to be.

1. For one thing,

   a There's still quite a bit of excess capacity left in the economy,

   b and core inflation doesn't appear to be an imminent problem.

2. For another, there's still some remaining uncertainty about the strength and durability of the recovery.

E. What's certain is that

1. the Fed will do what it takes to preserve the gains we've made against inflation,

2. because that's the best way we can contribute to economic growth and prosperity for our country.

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