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After the Recession: A Monetary Policymaker Looks Ahead

I. Good afternoon.

A. It's always a pleasure to speak before the Rotary, especially here in my home city of San Francisco.

B. Today I'll give you some of my views about economic conditions in the local area,

1. but I'll start with a look at the national economy.

II. As some of you know, last week I was at a meeting of the Federal Open Market Committee, where the Fed sets the nation's monetary policy.

A. We decided to hold the federal funds rate steady, at 1-3/4 percent.

1. As our press release explained, we felt that the risks for the foreseeable future continued to be balanced between our goals

a of price stability

b and sustainable economic growth.

B. Let me explain what I was thinking as we reached that decision.

III. First, I think we've gotten a good bit of positive economic news recently.

A. The economy grew very rapidly in the first three months of this year.

1. And that makes it pretty clear that last year's recession—the first in ten years—is over.

B. A key factor has been business spending on inventories.

1. This measure plunged during the recession—

   a —but that worked to set the stage for growth this year.

2. In fact, this category of spending actually accounted for more than half of the growth in the first quarter,

   a and it probably will continue to boost growth for a while longer,

   b as firms increase production to replenish their inventories.

3. Eventually, though, the size of this contribution will drop off.

C. So, to keep the expansion going, we'll need to see strength in business investment in equipment and software.

1. And here we've gotten at least a flicker of good news.

2. This type of investment basically "overshot" during the boom times—especially when it came to 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.

3. What's that flicker of good news?

   a In the first quarter this category of business spending did continue to fall—

      (1) —but it did so only barely.

   b Moreover, business investment in information processing equipment and software showed a respectable increase.

D. Turning to the consumer side,

1. spending grew at a respectable rate in the first quarter.

2. This was a little surprising, considering how well it had held up during the recession.

a For example, consumer spending on automobiles is still pretty strong,

(1) even after the big surge in auto sales at the end of last year.

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

E. Looking ahead, a very positive sign is our productivity performance.

1. It grew

a at a very strong rate in the last quarter of 2001,

b and at a rather astounding rate in the first quarter of this year.

F. Of course, some of that performance is due to temporary factors related to September 11.

1. Since that day,

a a lot of firms have trimmed their workforces or been cautious about expanding jobs—

(1) —because they thought the economy might be weak.

2. Now that the economy has turned out to be so much stronger,

a firms have increased production

(1) by getting people to work overtime

(2) or just by getting them to work harder.

b And this obviously can't go on for long.

G. But the sheer strength of the productivity numbers suggests that more enduring forces *also* are at work.

1. For one thing, productivity growth was positive during the recession—which is pretty unusual.

a In a typical recession, productivity growth turns *negative.*

2. For another, there's reason to think that all that investment in high-tech and technological change I mentioned before is probably *still* boosting productivity.

a After all, it often takes some time for workers and firms to realize *all* the potential of new technologies,

b so it also takes some time for the full effects to show up in the productivity data.

3. Finally, those strong numbers support the view that the process of technological innovation that drives productivity in the long run is still alive and well.

H. The last positive I'll mention is 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 March, 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 a very low 1-3/4 percent.

IV. Now let me turn to the risks.

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 uncertainties about corporate profits and the value of equities.

    1. Both factors are important in determining how much firms invest in capital going forward.

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.

V. 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. As I said, we decided to leave the federal funds rate at 1-3/4 percent.

    1. That's the lowest rate in 40 years,

    2. and it's quite stimulative.

B. So, once the expansion really takes hold,

    1. the funds rate will have to move up,

    2. or we'll ignite inflationary pressures.

C. But, for now, I think we can be deliberative in approaching the issue of when policy has to change and how aggressive it has to be.

    1. For one thing, core inflation doesn't appear to be an imminent problem, because

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

b and because accelerating productivity growth will dampen inflationary pressures for a time.

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

D. 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.

VI. Now let me turn briefly to the local scene.

A. Here, the story I told about business investment in information technology—or "IT"—looms especially large.

1. In the Bay Area, the share of employment and wages in IT industries is about three to four times higher than in the rest of the nation.

2. And last year, product demand, employment, and financing in this region's IT sector dropped sharply.

a Employment fell at a double-digit pace in electronics, computer equipment, and computer services.

b And compared to 2000, the amount of venture capital invested and the number of IPOs in the Bay Area fell by about 75 percent.

3. The effects spilled over throughout the local economy.

a In 2001, employment dropped at a much faster pace in the Bay Area than it did in the rest of California or the nation.

b And the unemployment rate more than doubled.

4. Commercial real estate has been hit especially hard.

a The huge increase in vacant space, combined with substantial additional space scheduled to come on line this year, suggests that lease rates are not likely to firm up anytime soon.

B. Despite the depths of the slowdown in 2001, the Bay Area economy has shown signs of improvement in early 2002.

1. Labor market conditions have largely stabilized.

2. Retailers have been hiring, suggesting that consumer spending has picked up.

3. And the real estate market heated up very quickly in recent months, as buyers leaped in to take advantage of low interest rates.

a This suggests that income and wealth remain high.

C. Looking ahead, given the Bay Area's continued advantage in the development and sale of technology products,

1. this area is poised to return to a rapid growth path once the national recovery is firmly in place.

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