

Presentation to a Portland Community Leaders Lunch
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After the Recession: A Monetary Policymaker Looks Ahead

- I. Good afternoon. It's a pleasure to meet with you.
 - A. Today I'd like to discuss the national economy and its implications for monetary policy.
 - B. I'll also say a few words about economic conditions here in Portland.
- II. Let me start with the national picture.
 - A. As some of you may know, the Commerce Department recently announced a revision to some of the most important data we use to track the economy.
 - 1. I want to try to take these into account in giving you my views today.
 - B. One change that got a lot of comment was the revision showing that real GDP growth was negative during the first three quarters of last year.
 - 1. This suggests that the recession was somewhat deeper and more sustained than many originally thought.
 - 2. But the decline in output was still mild by historical standards.
 - C. In addition to revisions, the Commerce Department also released its initial estimate of growth for this year's second quarter.
 - 1. Growth dropped from five percent in the first quarter to a little over one percent.
 - 2. While the second quarter number came in somewhat lower than we expected, there appear to be some transitory factors that account for that.
 - a One is that the growth of imports was very large last quarter—

- (1) —and that subtracts from GDP growth.
- b Looking ahead, it's quite unlikely that we'll see such a large number for imports for this quarter,
 - c so that's at least one reason to expect more positive growth in the near term.
- D. While these new numbers contain some new twists, they don't change my basic view that we're in the midst of a modest expansion.
 - 1. Of course, the recession hasn't been *officially* declared over,
 - a but the data certainly suggest that it's over.
 - b My own guess is that the end-date will probably be December or January.
 - c And though the path of expansion does appear to be volatile,
 - (1) I believe it's still intact.
- E. A key factor driving the recovery has been a turnaround in business spending on inventories.
 - 1. Last year, firms liquidated their inventories at a very rapid pace.
 - 2. But this year,
 - a the pace of inventory liquidations slowed dramatically in the first quarter,
 - b and in the second quarter firms actually started *accumulating* inventories.
 - 3. I call this turnaround a key factor because it accounted for nearly two-thirds of the growth in GDP in the first half of this year.
 - 4. Although I expect it to play out a while longer,
 - a its contribution to growth will taper off, as inventories approach desired

levels.

III. So, what do we need for follow through—that is, to keep the expansion going?

A. Basically, we need two things:

1. a strengthening in business spending on equipment and software,
2. and a continuation of growth in consumer spending.
3. Let me take these one at a time.

B. First, business spending on equipment and software.

1. The dramatic fall-off in this kind of investment was a prime mover in driving economic growth into negative territory last year.
 - a Why did it happen? In large part, because businesses had “overinvested” during the boom years—especially in the area of high-tech.
 - b So when firms pulled back, beginning in 2001, they did so sharply.
2. At this point, things appear to be moving in the right direction.
 - a In the second quarter, business investment in equipment and software turned positive for the first time in almost two years.
 - b And the story on business investment in *information processing equipment* and software is even more encouraging.
 - (1) After over a year of declines, we’re actually seeing sizable increases again.

C. Now to the consumer.

1. Their spending patterns last year were quite different from businesses.
 - a Instead of pulling back sharply, consumers kept on buying, though at a somewhat slower pace.
2. Since then, the data suggest that consumer spending has been growing at a rate

I'd have to call respectable.

3. Moreover, we've seen remarkable strength in the housing sector,
 - a in part, of course, because mortgage rates are pretty low.

D. So, in these important respects, the indicators are moving in the right direction.

IV. These pretty good signals bring me to the other signals we've seen in the equity markets.

A. But first let me make one point.

1. Some people misconstrue why the Fed pays attention to the equity markets. So I want to clarify that issue.
2. Developments in these markets are important in making monetary policy because they can have an effect on economic activity.
3. I do *not* believe that monetary policy should try to affect valuations.

B. So, how does a slide in the stock market affect economy activity?

1. For one thing, it can have what's called a "wealth effect" on consumers.
 - a In other words, when consumers realize that their overall wealth is lower than before,
 - b they may retrench—stop buying and start saving more.
2. An equity market slide also can make firms reluctant to invest.
 - a With lower stock valuations, it's more costly for firms to finance their operations and their plans for expansion.
3. These effects together can lead to weaker demand throughout the economy and ultimately slow down growth.

C. Of course, there are some good reasons why we *shouldn't* be so surprised that equity markets have fallen.

1. For some time, people have been concerned about whether corporate profits could live up to market expectations.

2. Now, the news about corporate governance and accounting practices has intensified those concerns dramatically,
 - a because investors aren't sure that they can believe the profit reports in the first place.
- V. Even with these concerns, it's important to remember that there are several factors that are boosting growth and that are very likely to boost growth in the future.
- A. One, of course, is fiscal policy.
1. Congress passed two packages last year that are providing substantial stimulus this year.
 2. And this March, they passed a package that includes
 - a extended unemployment benefits
 - b and a big tax break on equipment and software spending made between September last year and September 2004.
- B. Then there's monetary policy.
1. Last year, we steadily cut the funds rate from 6-1/2 percent to 1-3/4 percent.
 2. And this year, we've *held* the rate at 1-3/4%—
 - a —the lowest rate in 40 years.
 - b This is quite stimulative, and I'll return to this point later.
- C. Another factor that could boost growth is the drop in the dollar so far this year.
1. Let me just remind you that while the Fed does not have any goals for the dollar, it does need to consider the effects of changes in the dollar on the economy and inflation.
 2. In the near term, a lower dollar will tend to raise both foreign *and* domestic demand for U.S. goods,
 - a by making them less expensive abroad

b and by making foreign goods more expensive at home.

D. Finally, I'll mention our productivity performance.

1. This is an important issue for the economic recovery because

a faster productivity growth rates create business opportunities that stimulate economic growth.

b Of course, in the long run, faster productivity growth rates mean that our standard of living rises faster.

2. Now, we don't have revised data on productivity yet.

a And many expect to see the numbers revised downward a bit,

(1) given the other data revisions I've already mentioned.

3. But I think it's important to view our productivity performance from a longer perspective.

a Beginning in the mid-1990s, we saw truly astounding rates of productivity growth.

b And even as the economy slowed in mid-2000 and then went into recession, the numbers were surprisingly good.

4. To me, this suggests two things:

a First, the process of technological innovation that drives productivity in the long run has probably been at work in the economy since the latter half of the 1990s.

b Second—and this is good news for the future—this process appears to be alive and well.

VI. What does all this mean for monetary policy?

A. As I mentioned, the Fed's monetary policy stance is quite stimulative right now.

1. And at some point, of course, interest rates will have to move up toward

historical levels, or we could risk igniting inflation.

- B. But that doesn't look like an immediate concern.
 - 1. Core inflation does *not* appear to be an imminent problem,
 - a as there's still quite a bit of excess capacity left in the economy.
 - 2. In addition, there's still some uncertainty about the strength and durability of the expansion.
- C. What *is* certain is that
 - 1. the Fed will do what it can to promote the economy's expansion
 - 2. without sacrificing the gains we've made against inflation.
 - 3. That's the best way we can contribute to prosperity for our country.

VII. 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. Oregon ranks sixth among all states in the IT share of total employment, and seventh in the IT share of wages.
 - 2. So when sales of IT products plummeted last year, the economy here took a big hit.
 - a High-tech manufacturers and service providers cut employment sharply.
 - (1) These job losses had especially serious consequences for the rest of the economy as well,
 - (2) since, on average, Oregon's high-tech salaries are about twice as high as its overall salaries.
 - 3. In fact, Oregon was one of the nation's slowest performers in 2001.
 - a Overall employment fell several percentage points,

- b and Oregon has been trading places with Washington for the unenviable position of the state with
 - (1) the highest unemployment rate
 - (2) and the slowest growth in income per capita.
- c The fallout has been felt throughout the private sector,
- d and also by the state government,
 - (1) which faces a large revenue shortfall in the middle of its biennial budget cycle.

B. This recession has been deeper and longer for Oregon than the early 90s recession.

- 1. In that sense, your state's high-tech success in the 1990s has been a mixed blessing:
 - a It propelled strong growth during the expansion
 - b but left you more exposed to the downturn.

C. Fortunately, the downturn is showing signs of ending.

- 1. Job growth returned in the second quarter of this year, bringing the unemployment rate down,
- 2. and the firming of demand for high-tech equipment that I noted earlier should encourage business investment in coming months.
- 3. Moreover, in a sign of underlying strength, housing demand in Oregon has been very robust this year.
- 4. And despite the weak economy,
 - a Oregon remains an attractive place to live, with its population growth ranked tenth among the states last year.
- 5. So although the state economy is not out of the woods yet,

- a the high quality of life will help Oregon return to a solid growth path once the national expansion is firmly in place.

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