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The Economic Outlook for the Nation and the Region: A Monetary Policymaker's View

I. Good afternoon. It's a pleasure to meet with you.

A. As many of you know, the Fed's monetary policymaking committee met last week in Washington, D.C.

1. At these meetings, we discuss both

a What's going on in the Federal Reserve Districts around the country

b as well as our views on the outlook for the national economy.

B. Last week, we decided to hold the federal funds rate steady at 1-3/4 percent.

C. Today I'd like to give you my views on why I think that's an appropriate stance for policy at this point.

1. And I'll also share my thoughts on conditions here in the Bay Area.

II. I'll start with the national economy.

A. My basic view is that we're now in the midst of a modest expansion.

1. Of course, the recession hasn't been *officially* declared over.

2. But the data we have so far suggest that it is.

3. My own guess is that the end-date probably will be December or January.

B. At this point, though, the path of the expansion does appear to be volatile.

1. For example, in the first quarter, real GDP growth surged to an impressive rate of 5 percent,

2. and then in the second quarter, it dropped to just 1.1 percent.

C. There are many ways to interpret these quarterly numbers. And my own interpretation is that it makes some sense to look at them *together*—as a high balanced by a low.

1. For example, if we look at the first half of the year *as a whole,* those two growth rates average to a pretty good clip of about three percent.

2. And if we dig down into the data a bit, we can see that a slowing after such a surge isn't so surprising.

a For example, much of the exceptional strength in the first quarter came from a dramatic reduction in the pace of inventory liquidation.

(1) But that's a development that we'd expect to taper off as firms get their inventories closer and closer to desired levels.

(2) And, in fact, that's just what happened in the second quarter,

(3) which contributed to slower GDP growth.

b Here's another example of a factor that probably won't last long.

(1) In the second quarter, there was a big surge in imports,

(a) which pulled down GDP growth.

(2) We're unlikely to see a repeat of that this quarter,

(3) so that's a reason to expect more positive growth in the near term.

III. Looking beyond these transitory developments, what do we need to see for follow through—that is, what are the elements that will keep the expansion going?

A. Basically, there are two of them:

1. One is a strengthening in business spending on equipment and software,

2. and the other is 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. Last year, consumers' spending patterns were quite different from businesses'.

a Instead of pulling back sharply, consumers kept on buying, though at a somewhat slower pace.

2. In the first half of this year, the data suggest that consumer spending has been growing at a rate I'd have to call respectable.

3. I think it's also worth pointing out that two of the strongest sectors of consumer spending were autos and housing.

a Of course, that strength is largely because of low interest rates.

b But it also suggests something positive going forward.

(1) Borrowing to buy cars and SUVs and condos and houses

involves a serious commitment to making payments into the future.

(2) And since consumers are willing to make those long-term commitments, it suggests that they have a certain confidence in their ability to meet them.

(3) That also suggests that consumers have some confidence in the economy's resilience.

D. So far, I've focused on some important indicators that we can already see moving in the right direction.

IV. Now let me turn to some fundamental factors that will drive the economic outlook.

A. I'll start with a negative factor.

1. In our recent statement, we noted weakness in financial markets and stated that the risks for the economy are weighted mainly toward economic weakness.

a An important element in this risk is the slide in equity markets.

B. Before I get into this element, let me make one point.

1. Some people misconstrue why the Fed pays attention to these markets. So I want to clarify that issue.

2. Developments in equity 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.

C. 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.

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.

D. 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. But counterbalancing this downside factor are several important factors that are boosting growth now and 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—

a. —the lowest rate in more than 40 years.

2. And this year, we've *held* the rate at that level.

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

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

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

3. 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 I think that's quite appropriate.

   a Inflation does *not* appear to be an imminent problem,

   b as there's still quite a bit of excess capacity left in the economy.

2. Furthermore, there's still uncertainty about the strength and durability of the expansion.

B. So, our current policy stance will promote the economy's expansion

1. without sacrificing the gains we've made against inflation.

2. That's the best way we can contribute to prosperity for our country.

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

A. Not everybody in California will agree that we're in a modest recovery—

1. —that depends on where you live and what industry you're in.

B. For example, the Bay Area as a whole—with its concentration in technology—took a major hit during the recession,

1. and it's still struggling to recover.

2. In 2001, employment dropped at a much faster pace here than it did in the rest of the nation,

   a and the unemployment rate more than doubled.

3. Commercial real estate has been hit especially hard,

   a with the huge increase in vacant space causing lease rates to drop by half or more in some areas.

      (1) Of course, the impact was spread unevenly, with tech-heavy areas like San Jose hit much harder than Alameda County.

      (2) But on the whole, no part of the Bay Area was spared.

C. By contrast, the Southern California economy fared pretty well in 2001,

1. with most areas seeing slight growth rather than declines.

    a The main reason is the region's economic diversity, which helped insulate it from the effects of the downturn in tech spending.

D. Despite the struggles of our tech-dependent region, I'm confident of its ability to rebound.

1. This year,

    a the labor market has largely stabilized,

    b consumer spending has been solid,

    c and demand for housing surged.

2. Of course, a more robust and durable recovery in the Bay Area depends on a further pickup in the tech sector,

    a which won't happen until business and investor confidence improves nationwide.

3. Nevertheless, given the Bay Area's continued advantage in the development and sale of technology products,

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

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