Presentation to a Community Leaders Lunch
Salt Lake City, Marriott City Center Hotel
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The Economic Outlook for the Nation and the Region: A Monetary Policymakers View

I. Good afternoon. I'd like to focus on developments in the national economy and what they imply for monetary policy.

A. I'll also share my thoughts on conditions in the District and here in Salt Lake City.

II. In terms of 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 last December or January.

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

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 see that it's not so surprising that the

economy slowed after such a surge.

a For example, in the first quarter, much of the exceptional strength 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 And the data for July suggest that business spending on equipment generally got off to a good start in the current quarter.

C. Now to the consumer.

1. Early last year, even as the economy was turning down, consumer spending held up reasonably well.

a And even after the devastating attacks on September 11, consumer spending was remarkably strong.

b Just think back to a year ago today—September 12, 2001.

c Who would have expected so much resilience from the American consumer?

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.

a And the data for July were strong.

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 the last FOMC 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.

V. Counterbalancing this downside factor are some important factors that are boosting growth now and are very likely to boost growth in the future.

A. One, of course, is the nation's fiscal policy.

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

2. And this past 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.

C. 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. The Fed's monetary policy stance is quite accommodative.

1. Given what we know now about economic conditions, an accommodative stance seems appropriate to me.

   a There's still a fair bit of uncertainty about the strength and durability of the expansion, so the economy needs that boost.

   b Furthermore, we do have room to provide that boost.

      (1) Inflation does *not* appear to be an imminent problem,

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

B. So, I believe our current policy stance can promote the economy's expansion

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

VII. Now let me turn to the local picture here in Utah and Salt Lake City.

A. The story I told about business investment in information technology—or "IT"—looms a bit larger here than it does for most other states.

1. Utah is more dependent on tech industries than the typical state, ranking twelfth in the nation in terms of the high-tech share of total employment.

2. And because wages in tech industries are higher than wages in other industries, tech job losses have significant ripple effects on the rest of the economy.

3. So when the tech slowdown hit last year, Utah's economy turned around sharply.

B. This year, a surge in tourist activity due to the Winter Olympics offset the decline in the first quarter,

1. but it wasn't enough to overcome the effects of the national recession.

C. This recession hit Utah hard—especially compared to the last recession in the early 1990s.

1. The state went through that one largely unscathed.

2. But this time,

a labor market conditions have deteriorated noticeably,

b and, among other impacts, home foreclosures are rising.

3. As a result of the slowdown, the state government faces a substantial deficit.

a The shortfall equals nearly 5% of this year's budget,

(1) and the necessary adjustments will be a drag on growth going forward.

b This may seem bad, but compared to the budget situation in some other states, like California, it's pretty mild!

D. Moreover, the underlying strengths of Utah's economy remain intact.

1. The state boasts a high quality of life,

a and its favorable demographics

(1) —a young, well-educated population—

b will combine with its healthy industry base to support continued growth.

E. Overall, despite the current challenges, Utah's economy is poised for solid growth as soon as the national recovery is firmly in place.

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