

Presentation to Security Analysts of San Francisco
Omni Hotel, San Francisco
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The Economic Outlook for the Nation and the Region: A Monetary Policymaker's View

- I. Good afternoon.
 - A. As you know, the Fed's monetary policymaking committee met last week.
 - B. At the time, we announced that we were maintaining our current accommodative stance as well as the bias toward the potential for weak growth in the economy.
 - C. Today I'd like to spell out my own views on the national economy,
 - 1. and I'll also share my thoughts on conditions here in California and the Bay Area.
- II. In terms of the national economy,
 - A. my basic view is that we're now in the midst of an expansion that's both modest and 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 1.3 percent.
 - B. 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 we expected that effect to taper off, as firms got their inventories closer and closer to desired levels.

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 in data for the third quarter,

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

3. Also, it's likely that the economy's growth rate will continue to bounce around in the last half of the year.

a Most economists expect the third quarter data on real GDP to come in at more than double the rate in the second quarter,

b and then to advance more slowly in the fourth quarter.

III. What do we need, then, 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, businesses are being cautious—and I’ll return to this point later—but investment has been 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 actually saw sizable increases.

c And the data suggest that business spending on equipment generally showed further improvement in the third quarter.

C. Now to the consumer.

1. In the first half of this year, the data suggest that consumer spending grew at a rate I’d have to call respectable.

a And the data for July and August were solid.

2. 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 look like they're moving in the right direction.

IV. But there's no question that caution is the byword in the business world. And it's not hard to understand why.

A. One thing that businesses—and consumers—naturally are worried about is the slide in the equity markets.

1. The loss of wealth is affecting consumer spending to some extent,

a and it's also making it more costly for firms to finance their operations and their plans for expansion.

(1) As a result, firms are more reluctant to invest.

b These effects together can lead to weaker demand throughout the economy and ultimately slow down growth.

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

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

b But the news about corporate governance and accounting practices has intensified those concerns dramatically.

3. There's one final point I'd like to make about the equity markets.

a Some people misconstrue why the Fed pays attention to these markets.

b Developments in equity markets *are* important in making monetary policy because they can have an effect on economic activity.

c I do *not* believe that monetary policy should try to affect valuations themselves.

B. Another development that's making people and firms cautious is the situation in the Middle East and the possibility of war with Iraq.

1. This adds to the sense of uncertainty going forward.
 2. And a related concern is the recent hike in oil prices.
 - a At the beginning of the year, it was under \$20 a barrel.
 - b Today, it's more than \$30 a barrel.
- C. Finally, there's the situation on the waterfront here on the West Coast.
1. If this gets resolved immediately, then I think the impact on the national economy will be pretty minimal.
 2. But if shipments in and out of ports here are interrupted much longer, the drag on the economy would be more significant.
- V. Now let me mention some important factors that are working to boost economic activity.
- 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 policy stance is accommodative.

1. Given what we know now about economic conditions, an accommodative stance is appropriate.
- a There's still a lot 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) Rising core inflation does *not* appear to be a problem,
 - (a) as there's still quite a bit of excess capacity left in the economy.

- B. So, I believe monetary policy is positioned to promote the economy's expansion,
 - 1. while maintaining the favorable rates of core inflation we've seen recently.

VII. Now let me turn briefly to the state and 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. The Southern California economy has fared pretty well since the national slowdown began,
 - 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.
 - b Moreover, it will soon receive an additional boost from several large Pentagon contracts.
 - (1) which have raised hopes for expansion in the region's aerospace sector for the first time since 1988.
- C. By contrast, the Bay Area —with its concentration in information technology— took a major hit during the recession,
 - 1. and it's still struggling to recover.
 - 2. Since the slowdown began, 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.
 - 4. There has been some good news this year,
 - a notably solid consumer spending and a surge in home sales.

5. But a durable recovery in the tech sector has not yet materialized,
 - a and conditions in the labor market and commercial real estate markets remain weak.

- D. Moreover, the severe deterioration in the state government fiscal picture poses a challenge for every region of California.
 1. California's situation is among the worst in the nation.
 2. The accumulated deficit—about thirty percent of the current fiscal year budget—reflects a unique combination of circumstances.
 - a Specifically, the normal cyclical slowdown in income tax revenues was exacerbated by California's unusually high exposure to stock market movements.
 3. The resulting decline in state spending will reduce economic growth going forward.

- E. Finally, if the work disruptions at West Coast ports continue,
 1. They'll create a noticeable drag on the state economy,
 - a because the jobs most directly affected are concentrated in the West Coast port cities.

- F. Despite these negatives, I'm confident of the Bay Area's underlying ability to bounce back.
 1. Its flexible, dynamic economy responded to past crises by developing new products that established new waves of innovation and growth.
 2. And it's likely to do so again, once the national recovery is firmly in place.

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