Presentation to the Tucson Chapter of the Association of Investment Management and Research
Skyline Country Club, Tucson, AZ
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For delivery April 22, 2003, 12:40 PM Pacific Standard Time

Prospects for the National and Local Economies: A Monetary Policymaker's View

I. Good afternoon.

   A. I'm going to focus on economic conditions, both in the nation and here in the west, with a few words on Arizona and Tucson.

      1. And I'll try to draw out some of the implications I see for monetary policy.

II. I'll start with the nation.

   A. Last year, the economy grew at a rate of just under 3 percent.

   B. This isn't such a bad number—in fact, it's only a bit below many estimates of the growth rate our economy can sustain in the long run.

      1. But to a lot of people, it felt pretty bad.

         a. Growth was quite uneven from quarter to quarter,

            (1) and in the final quarter it ended on a down note, coming in at a modest 1-1/2 percent.

         b. Moreover, employment was stagnant—in popular terms, this has been *another* "jobless recovery."

         c. And, with business investment leading the recent recession, the manufacturing sector took a hard hit.

         d. The bright spot was consumer spending, especially on motor vehicles and housing.

   C. We won't have data on GDP growth for the first quarter until this Friday, so we can't say for sure what the number for the growth rate will be.

      1. But based on the indicators we do have, it looks to me as if the first quarter wasn't all that different from the last quarter of 2002—

a. —we saw continuing job losses,

b. little strength in business investment,

c. and most of the momentum coming from consumer spending.

D. Looking ahead to the rest of 2003, the most likely outcome—and one that a lot of forecasters share—appears to be a slow first half, with more robust growth in the second half.

1. This outlook is not tipping in the direction of a "double-dip" recession.

2. At the same time, growth isn't expected to be strong enough to make a significant dent in the excess capacity we currently face in labor and product markets—

a. —and, core inflation is likely to trend modestly lower.

b. This is an issue for monetary policy, and I'll return to it later.

III. But first, let me talk about what goes into this forecast.

A. To begin with, there are some positive fundamentals.

1. One is the stimulus in the pipeline both from fiscal policy and from monetary policy.

a. On the fiscal side,

(1) there's some extra stimulus from the pickup in defense spending to support the action in Iraq.

(2) In addition, Congress passed stimulus packages in 2001 and 2002,

(a) and, of course, further proposals for fiscal packages are being debated right now.

b. In terms of monetary policy, the Fed cut short-term interest rates from 6-1/2 percent to 1-3/4 percent in 2001.

(1) And we cut again last November by half a percentage point,

(a) bringing the rate to its lowest level in more than 40 years.

2. Another important fundamental is the economy's strong productivity performance.

a. The surge in productivity that began with the economic boom in the mid-1990s has managed to continue—

(1) —even through the 2001 recession and the modest recovery since then.

b. This suggests that the process of technological innovation that drives productivity in the long run is still alive and well.

c. And that bodes well for the future, because faster productivity growth creates business opportunities that stimulate economic growth.

IV. What's especially tricky about any forecast at this point is the range of issues on *both* the downside and the upside that could have a big effect.

A. Let me look at the downside first.

B. One is that the pickup in growth seems to depend on an acceleration in business fixed investment occurring before consumer spending falters.

1. As I said, the consumer side of spending has been the main bright note in the past few years.

a. But the question is, how long can consumers go on buying so many cars and houses?

b. Furthermore, if this *remains* a jobless recovery, it can weigh on consumer confidence and lead people to pull back on spending.

c. Frankly, the longer growth has to depend on the auto and housing sectors, the riskier the situation becomes.

C. So—what about the lack of vigor in business investment?

1. One possibility is that the huge uncertainties associated with the war in Iraq have inhibited it to some extent.

a. So far, at least, many of the scenarios that would have been most damaging to the economy didn't materialize.

(1) The conflict has not spread to other countries in the Middle East.

(2) The oil wells in Iraq were not destroyed.

(3) And the U.S. and other coalition countries have not suffered retaliatory terrorist attacks.

b. At the same time, the military action and the fall of Saddam Hussein's regime have not produced signals that

(a) business investment is about to surge

(b) or that economic growth is about to take off.

c. At this point, it's still a little early to tell how important the Iraq effect is—

(1) —we're just days from the end of the heavy action,

(2) and most of the data we have come from the period before the war started.

2. Of course, the other possibility that could explain the lack of vigor in business investment has more to do with underlying economic concerns—such as

a. the overhang from the late 1990s investment boom,

b. the bursting of the stock bubble,

c. corporate profitability,

d. and concerns about corporate governance.

V. Now that I've enumerated some downsides, here are the related upside possibilities.

A. If war tensions *have* been holding back investment, a lifting of uncertainties *could* stimulate a big increase in spending.

B. In addition, the fairly modest pickup in the growth rate of business investment I mentioned is typical of most forecasts,

1. in that it represents a kind of average of a wide range of possible outcomes.

2. In fact, once investment starts to pick up, it often does so with a lot of vigor.

a. So, we certainly can't rule out the possibility that investment will end up surprising us on the strong side this year.

VI. What does all of this mean for monetary policy?

A. The Fed's current stance is accommodative.

1. And that seems appropriate, given the uncertainty about the strength and durability of

the expansion.

2. Furthermore, if it seemed warranted, we still would have room to give a boost to the economy

    a. —even in the face of some upside risks.

3. Why? Because, as I said, most forecasts show that we'll still have excess capacity by the end of the year, even *with* a pickup in growth in the second half—

    a. —which means the already low inflation rate is likely to trend even lower.

B. Now, you're used to hearing central bankers like me give a cheer when we think inflation is trending lower.

1. But if today's downward trend in inflation were threatening to turn into *deflation*, this also would be a serious a problem.

2. My point is that for many years now, the Fed's goal has been *price stability*—

    a. that is, an environment in which people and businesses can make financial decisions without worrying about where prices are headed.

3. And I want to assure you that it will remain our goal, whether the threat to the economy is *in*flation *or de*flation.

4. I think one can argue that the Fed's efforts to achieve this goal have made a positive difference to the economy over the last twenty years.

VII. Now let me turn to the local scene.

A. Arizona's economy has been held back by the same factors as the national economy.

B. With its extensive tech sector—including industry leaders like Intel and Motorola, along with a host of smaller companies—

1. the state felt the pain of the nationwide slowdown in business spending on computers and related products.

2. This has been only partially offset by increased federal contracts for military and security products,

        (1) some of which are being handled by Raytheon's operations here in the Tucson area.

3. Despite the struggles of the state's tech sector, Arizona has fared relatively well during the national slowdown,

   a. with recently revised employment figures showing that a modest number of new jobs were created here in 2002.

VIII. As with the national economy, the main question remains: "When will a more robust recovery kick in?"

A. To help answer that question, we rely heavily on our contacts in the business community throughout the District.

   1. And their early reports suggest that the war in Iraq has not had a substantially negative impact on overall economic activity.

      a. Unlike the 1991 Gulf War, this conflict has not produced a sharp drop in consumer spending.

      b. And while businesses remain reluctant to hire or invest in new equipment,

         (1) many claim that the reason is uncertainty about the economic environment rather than direct effects of the war.

      c. The one sector that *has* seen a sharp negative effect is travel and tourism.

         (1) However, the main impact has been a steep drop in East Asian visitors to Hawaii and selected West Coast markets,

            (a) and that's probably as much because of SARS as because of the Iraq conflict.

B. When you add it up, our information is consistent with national and regional economies that are poised to rebound,

   1. once the cloud of uncertainty is lifted.

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