Presentation to Chapman University Annual Economic Forum
Hyatt Regency, Huntington Beach, CA
By Robert T. Parry, President and CEO of the Federal Reserve Bank of San Francisco
For delivery May 29, 2003, 12:50 PM Pacific Daylight Time

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

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I. Good afternoon. I'm very pleased to be here with you today.

  A. What I plan to do is focus on economic conditions, both in the nation and here in Southern California.

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

II. I'll start with the local picture.

  A. Economic activity has held up better in Southern California than it has in the rest of the nation during the past few years—especially in areas outside of Los Angeles County.

    1. After years of out-migration in the early to mid-1990s, Southern California has seen its population expand substantially in recent years,

      a. and this has produced solid growth in demand for population-dependent services, such as health care and retail trade.

    2. Of course, the housing market here has been very strong—

      a. —with sales prices and new home construction surging over the past year.

  B. But the local economy has *not* been immune

    1. from the effects of the weak national economy,

    2. nor, of course, from the economic effects created by tensions over the Iraq war and by the SARS epidemic.

  C. To help us get a handle on the immediate impact of significant economic events like these, we rely quite a bit on our contacts in the business community.

    1. One point they make is that—unlike the 1991 Gulf War—the latest military action

did not lead to a sharp drop in consumer spending.

2. But it *did* curtail travel and tourism activity in the western states,

    a. and the effect was exacerbated by the SARS epidemic in East Asia.

3. We *have* seen some bounce-back in domestic travel in the last month, as war-related fears have eased.

    a. But the SARS outbreak is still having a sharp negative effect on East Asian visits to Los Angeles and certain other West Coast markets.

4. Moreover, given Southern California's reliance on East Asia as a trading partner,

    a. continuing fears about the spread of SARS have potentially important implications for the area's trade flows as well.

D. Fortunately, such effects are likely to be limited to the short term, as the epidemic appears to be coming under control at this point.

III. One problem that will last beyond the short term is the state's budget situation.

A. Like a lot of other states, California budgeted its spending in recent years as though the good times of the late 1990s would last forever.

1. So when the economic slowdown led to a drop in revenues,

    a. a big gap opened up between planned spending and actual revenues.

B. How much must be done to close that gap?

1. The answer depends in large part on what you assume about spending.

2. For example, the Governor's estimated shortfall represents the gap between the administration's *desired* spending and projected revenues.

    a. But if you look at the gap in terms of a more limited alternative, such as holding state spending *constant*, the budget gap is much smaller.

    b. From that perspective, the reported shortfalls overstate the spending cuts and tax increases needed to balance the budget.

3. Now, this is not meant to minimize the severity of California's fiscal crisis—which is large by any measure.

a. Moreover, since the Governor and the legislature haven't been able to agree to a comprehensive package of spending cuts and tax increases,

(1) the Governor's May budget proposal includes some compromises, such as substantial deficit financing and spending deferrals.

(2) Most of the borrowed funds will be used to get through the current fiscal year.

(a) This leaves a shortfall to be dealt with *next* year,

(b) and the size of it will depend on the strength of the economic expansion.

C. This brings me to a few concluding words about what this means for the national economy.

1. Some have been concerned that the budget crises in California and other states could put a serious drag on national economic growth.

2. But it would be more accurate to say that the economic slowdown has put a drag on state budgets.

3. So it's an improving economy—both in the state *and* in the nation—that's going to be key to resolving the states' budget problems.

IV. Now let me turn to the national picture.

A. At this point, it appears that the economy is still mired in the soft patch we hit last fall.

1. Real growth averaged a little over a 1-1/2 percent rate in the last quarter of 2002 and the first quarter of 2003.

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

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

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

B. Looking ahead to the rest of 2003, the most likely outcome—and the one that a lot of forecasters share—appears to be that the slow first half will give way to a modest pickup in the second half.

1. This forecast raises a challenging issue for monetary policy.

a. It suggests that growth probably won't be strong enough to make a significant dent in the excess capacity we currently face in labor and product markets.

(1) And that means that core inflation—which already is low—is likely to trend down even lower.

b. Let me put some numbers on this scenario.

(1) The measure of consumer inflation that the Fed relies on quite a lot came in at just one and three-quarters percent last year.

(a) That measure is the price index for personal consumption expenditures, excluding food and energy.

(2) Now, this measure is by no means perfect.

(a) In fact, there's fairly broad agreement that it probably *overstates* inflation by about half a percentage point.

(3) So, given that bias, it's possible that so-called "true" core inflation could go below one percent this year—even with a pickup in growth in the second half.

c. As I said, this presents a challenging issue for policy, and I plan to return to it.

V. But first, let me say a few words 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, the ink is still drying on the latest tax cut package.

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.

VI. What's especially tricky at this point, though, is the range of issues that could surprise us and make the economy grow significantly slower—or faster—than this forecast suggests.

A. Let me look at the issues that could slow things down first.

B. One is that the forecast depends on fairly robust consumer spending.

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

   a. —especially when it comes to large interest-sensitive items, like autos.

      (1) However, we *have* seen personal consumption actually slow a bit recently.

   b. At the same time, housing also has responded strongly to low interest rates.

   c. But, so long as this *remains* a jobless recovery, it can weigh on consumer confidence and lead people to pull back on spending.

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

C. Another issue is the lack of vigor in business investment.

1. Of course, it's possible that a big part of the reason businesses have been cautious is all the uncertainty associated with the war in Iraq.

   a. At this point, it's still a little early to tell, because most of the data we have come from the period before the war ended.

2. But there's another possibility. The caution may have 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. weak corporate profitability,

d. and concerns about corporate governance.

VII. Now that I've talked about some of the downsides, here are a few 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 represents a kind of average of a wide range of possible outcomes.

1. 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 later this year,

(1) especially given the continued strength in productivity.

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

A. The Fed's current stance is accommodative.

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

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

a. —even though it's possible the economy could pick up vigorously later in the year.

3. Put another way, in the current low-inflation environment, downside surprises to growth—and, as a result, to inflation—would be more of a concern than upside surprises.

4. Why? Because, as I said, we're still likely to have a considerable amount of excess capacity by the end of the year—even *with* the generally anticipated pickup in growth in the second half.

a. And that means the already low inflation rate is likely to trend lower.

B. Now, you're used to hearing central bankers like me cheer when we think the risk of inflation is low.

1. I guess that's why we're sometimes called "inflation hawks."

   a. And that made sense when inflation was viewed as clearly too high.

2. But the "inflation hawk" stance has been a means to achieve the Fed's goal of 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 price stability will remain our goal, whether the threat to the economy is *in*flation *or de*flation.

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