Presentation to the Los Angeles Chapter, National Association of Business Economists
Omni Hotel, Los Angeles
By Robert T. Parry, President and CEO of the Federal Reserve Bank of San Francisco
For delivery June 2, 2003, 12:30 PM Pacific Daylight Time

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

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

   A. What I plan to do is focus on economic conditions in the nation and then draw out some of the implications I see for monetary policy.

II. But I'd like to start with a few brief comments on the California state 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, in all the Governor's estimates of the gap, the focus is on the difference 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 new budget proposal released last month tries to close the gap with 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.

(3) And that, of course, depends on the course of the national economy, as well.

III. So 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 under one and a half percent over 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 quite possible that so-called "true"core inflation could be 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.

IV. 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.

V. 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. Low mortgage interest rates have kept the housing market strong,

b. and consumers have kept spending on large interest-sensitive items, like autos.

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

c. 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 housing and auto 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.

VI. 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.

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

A. The Fed's current stance is accommodative, reflecting the uncertainty about the strength and durability of the expansion.

1. 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.

2. 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.

3. 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. That means the already low inflation rate is likely to trend lower.

b. And, with a lower inflation rate, it wouldn't take a very big standard error of the forecast to come up with a small, but still worrisome, possibility of deflation going forward.

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

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.

# # #