Presentation to the Business Week CEO Leadership Forum
U.C. Berkeley Haas School of Business
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For delivery Thursday, October 16, 2003, 8:20 AM Pacific, 11:20 AM Eastern

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Economic Outlook: National Trends, Regional Implications

I. Good morning.

A. The organizers of this event asked me to focus a bit on Silicon Valley, and I'm glad they did.

1. Around the world, Silicon Valley is synonymous with high tech.

a. Some would say it "wears the crown" among the country's high-tech centers.

2. The innovative technologies that were born there have fundamentally changed

a. the way we work,

b. the way we play,

c. the way we communicate,

d. and the way we learn.

3. As a monetary policymaker, I'm especially interested in the fact that these innovations propelled a surge in the U.S. economy's productivity growth—

a. —a surge that began in the mid-1990s,

b. and that has continued despite a recession and a less than stellar expansion.

B. So, in my remarks today,

1. I'll give you my perspective on developments in Silicon Valley

2. and then I'll turn to conditions in the national economy and their

implications for monetary policy.

II. If Silicon Valley does wear the crown among high-tech centers in the nation,

A. there's no question that the downturn in the information technology sector knocked it askew.

1. Since the employment peak in late 2000,

a. the Bay Area has lost nearly one in three jobs in the IT industry,

b. a good deal more than most other IT centers in the country.

c. This, of course, contributed to the nearly one in ten jobs lost throughout the Bay Area economy.

2. And according to the latest data, employment in the IT sector is still contracting—

a. —though not as rapidly as before—

b. with firms continuing rounds of layoffs.

3. Likewise, the industry has made cutbacks in almost every area:

a. computer manufacturing,

b. semiconductor manufacturing,

c. software publishing,

d. and web hosting and data centers.

B. That was the bad news. Now let me focus on some good news.

1. One bright sign is the national pickup in IT investment.

a. This is likely to continue to improve,

b. in part because of partial expensing tax incentives.

2. With this pickup has come an improvement in IT firms' revenues.

3. Finally, venture capital may be stabilizing or even showing some improvement—

a. —and, Silicon Valley is continuing to get a hefty proportion of their funds.

C. So, what's the future for that high-tech crown on Silicon Valley's head?

1. Well, let's not forget that the Bay Area also is a large biotech center—the second largest in the nation.

2. And, more fundamentally, the ingredients for a thriving high-tech industry are still in place—

a. our universities,

b. our research labs,

c. and our skilled workforce.

3. However, in these times of tight budgets,

a. we must be vigilant and continue investing in our universities and labs,

b. to make sure that the Bay Area provides the rich environment that attracts innovative entrepreneurs and keeps more established IT companies.

4. If we can manage that, I believe that the Bay Area will hold on to that crown for some time,

a. though it may take a while for the employment picture to brighten.

III. Now let me turn to the national picture.

A. As I said, until very recently we had been living through a less than stellar expansion.

B. The bright spot has been consumer spending, especially when it comes to autos and housing.

C. But employment has been stagnant or worse—

1. —in popular terms, this has been *another* "jobless recovery."

D. What has been missing is solid, sustained growth in business investment.

1. Weakness in business investment led us into the recession,

2. and it's going to take strength in business investment to keep the expansion on track.

IV. I must admit, we've been *expecting* to see a solid pickup in growth for quite a while, because of some very positive fundamentals at work in the economy.

A. One is the stimulus in the pipeline from fiscal policy. This includes

1. the pickup in defense spending to support the action in Iraq

2. and a series of tax packages.

B. Another is the stimulus from monetary policy.

1. The Fed cut short-term interest rates from six and a half percent to one and three-quarters percent in 2001.

2. And we brought the rate down to 1 percent with additional cuts in November 2002 and last June.

3. So short-term rates are now at their lowest levels in more than forty years.

C. A third important fundamental is the economy's phenomenal productivity performance.

1. It began with the economic boom in the mid-1990s

2. and it has continued—

a. —even through the 2001 recession and the modest expansion.

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

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

V. Indeed, recent data are showing signs of a pickup.

A. Business investment in equipment and software—and especially the information processing equipment component—has showed healthy overall gains,

B. and profit reports have been excellent.

C. The beleaguered manufacturing sector has begun to grow modestly,

D. and the numbers for autos and other retail sales in recent months have been strong,

1. indicating that consumers are still spending.

E. So the most likely outcome appears to be

1. reasonably strong economic growth for the second half of this year

2. and then a further pickup in 2004.

VI. Now, there *are* downside risks. After all, these positive signals haven't been sustained long enough to be conclusive.

A. One of the main risks is that consumers might pull back, and there are a couple of reasons why they might.

B. One is the rise in longer-term interest rates—including mortgage rates—since June.

1. They've already taken the wind out of the refinancing boom, which put so much money in people's pockets.

2. And later on, they could slow growth in new-home construction.

C. Furthermore, so long as this *remains* a jobless recovery,

1. consumers may become more cautious

2. and hold off on making some purchases.

VII. Now, what about the outlook for inflation?

A. Because of the economy's sluggish performance,

1. we've built up a lot of slack in labor and product markets over the past 2-1/2 years—

a. —the unemployment rate has been at or above six percent for the last six months,

b. and there's a lot of excess capacity in product markets.

2. So it's going to take more than a few quarters of reasonably strong growth to work off that slack.

a. In fact—it's going to take more than a few quarters of *quite* strong growth to work it off,

b. in part because of the large gains in productivity.

3. And that means that core inflation—which already is under 1-1/2%—may slip even lower.

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

A. That makes sense when inflation is clearly too high, because it gets us closer to the Fed's main goal, which is price stability.

1. And price stability, of course, just means an environment where people and firms can make financial decisions without worrying about where prices are headed.

B. But, as I said, the inflation rate today is very low.

1. So in this environment,

a. there's less concern about surprises that could push the inflation rate up

b. and more concern about surprises that could push the inflation rate lower, possibly even leading to deflation.

IX. Now, I'd like to conclude with a few words about *why* this could be a concern.

A. Frankly, the word "deflation" has not only generated a lot of discussion recently, but it has also generated some apprehension.

B. That's understandable, given Japan's experience over the last decade or so

1. with deflation

2. *and* a weak economy.

C. But it's important to note that the effect deflation has on the economy depends on what caused prices to fall in the first place.

1. Suppose prices fall mainly because of a decline in the *demand* for goods and services.

    a. That might happen for a number of reasons, such as a drop in consumer or business confidence.

    b. Of course, such a drop in demand would *weaken* the economy.

2. But, if prices fall mainly because of an increase in *supply*—say, due to a surge in productivity—the situation is very different.

    a. In that case,

        (1) it's likely that business opportunities will spring up,

        (2) which *strengthens* the economy.

3. Clearly, it's the falling demand case—with its potential for a weak economy—that people worry about.

D. Of course, the U.S. isn't in a deflationary episode at the moment, and I don't expect there to be one.

1. But when thinking about the risk of deflation, which case is more likely?

2. Over the past couple of years, there appears to have been *both* a fall in demand *and* a surge in supply.

    a. As I mentioned earlier, business demand has been weak, though we're now seeing a pickup.

        (1) And it has not only led to a fall in inflation

        (2) but it also has depressed economic activity.

    b. And we've *also* seen a surge in supply, largely because of the strong productivity performance I mentioned.

        (1) This suggests that the economy's capacity to produce is growing rapidly.

3. So, to the extent that we *do* risk moving toward deflation—and I think that risk is small—we most likely would face the less worrisome case.

X. Still, the FOMC has made it clear that further declines in inflation would not be desirable. Why?

A. First, there's what economists call the "zero bound" problem.

1. Put simply, deflation leads to low interest rates.

2. And once the funds rate gets to zero, the Fed can't push it any lower if it needs to stimulate the economy.

3. Instead, the Fed would have to stimulate the economy through nontraditional policy instruments.

4. Such a situation would be manageable.

a. But it would be preferable to be able to stick with our tried and true methods.

B. The second reason is a little more straightforward.

1. Any *unexpected* change in inflation—up or down—can hurt the economy's performance,

a. because it adds to uncertainty in the economic environment.

2. That's why our goal is price stability.

C. And I want to assure you—

1. —price stability will *remain* our goal,

a. whether the threat to the economy is *in*flation

b. or *de*flation.

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