

Presentation to the Australian Business Economists
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U.S. Economic Outlook

Good afternoon. I'm very honored that the Australian Business Economists invited me to speak at this conference. Frankly, I wish I were there with you in Sydney, instead of here in San Francisco doing this via teleconferencing. I just hope you have as good a view of Sydney Harbor as I have of the San Francisco Bay from my office.

My aim today is to discuss economic conditions in the U.S. economy and to draw out some of the implications I see for the Fed's conduct of monetary policy.

I must admit, the recent reports on the economy make this a more upbeat talk than I might have given earlier this year. At that time, the word that best described the U.S. economy was "sluggish."

Real GDP was growing at a slow rate, and employment was stagnant, at best. In fact, we were having *another* "jobless recovery," much like the one in the early 1990s. Although consumers were still spending--especially on homes and autos--businesses investment was weak. And that made things especially hard in the manufacturing sector.

Of course, there were plenty of reasons for business investment to lack vigor. There were the uncertainties raised by the war in Iraq, for one thing.

But there also were underlying economic concerns. One was the “overhang” from the 1990s investment boom. Another was the bursting of the stock price bubble. Last, but by no means least, were concerns about corporate governance.

The good news is that the latest reports indicate that the economy may have finally found its legs. I must admit, we’ve been *expecting* to see faster growth for quite a while, because of some very positive fundamentals at work in the economy.

One is the stimulus in the pipeline from fiscal policy. This includes the pickup in defense spending to support the action in Iraq and a series of tax packages.

Another is the stimulus from monetary policy. The Fed cut short-term interest rates from six and a half percent to one and three-quarters percent in 2001. And we brought the rate down to one percent with additional cuts in November 2002 and last June. So short-term rates are now at their lowest levels in more than forty years.

A third important fundamental is the economy’s phenomenal productivity performance. It began with the economic boom in the mid-1990s and it has continued--even through the 2001 recession and the modest expansion. Since the end of 1995, the average rate of increase has been

a rapid three and a quarter percent. And over the past three years, the rate has been an extraordinary four and a quarter percent.

Of course, this pace is undoubtedly not sustainable in the longer run. But many economists *are* estimating long-run productivity growth rates in the neighborhood of two and a half percent. And that's a good deal better than the one and a half percent rate we were used to for the twenty-five years from 1970 to 1995!

Estimates like these suggest that the process of technological innovation that drives productivity in the long run is still alive and well. And that bodes well for long-run increases in living standards in the U.S.

Rapid productivity growth also bodes well for a continuation of the current upswing in economic activity, because faster productivity growth creates business opportunities that stimulate spending.

As I indicated, recent data are showing signs of a pickup. Real GDP soared at a rate of more than seven percent in the third quarter. This increase reflected broad-based strength in the economy.

It was especially encouraging to see the performance of business investment in equipment and software, where much of the sluggishness in the economy over the past couple of

years had been concentrated. This sector showed very rapid gains. Moreover, within the sector, the information processing equipment component was quite strong.

This improvement in business investment has helped the beleaguered manufacturing sector, which has begun to grow in recent months. Along with the rapid productivity growth, profit reports have been excellent overall.

Now, we've thought for some time that the main downside risk to a robust economy was the consumer. As I mentioned, consumers helped prop up the economy to a substantial degree during the last two and a half years of sluggish growth.

So, at least part of the risk was that, by this point, consumers might have "run out of steam." And this was intensified by the employment situation. The loss of jobs and the uncertainty about employment could cause consumers to become more cautious and hold off on making some purchases.

Fortunately, we've begun to see some signs of life in the labor market recently, as payroll employment has risen moderately for three straight months. If this continues, it should provide support to the expansion.

So, overall the most likely outcome for the U.S. economy appears to be robust growth in the current quarter and in 2004.

Of course, when the U.S. economy's growth is strong, that's good news for the world economy--and certainly for Australia and your other major trading partners, Japan and the euro area.

In fact, in Japan there are signs of a dawning recovery. GDP showed solid growth in both the second and third quarters. And forecasts for the rest of the year have been shaded upward into the one to two percent range. In addition, deflation seems to be lessening.

But I think it's still premature to claim that "Japan is back." This wouldn't be the first "false dawn" in the country's long and troubled period of stagnation and decline.

Moreover, Japan still faces some significant longer-term challenges, such as large government budget deficits and the need to maintain the pace of structural reforms of its corporate and banking sectors.

In the euro area, there also are signs of a gradual recovery. But the European economies will probably grow by only about half a percent this year on average. As a result, their labor markets may remain weak, as unemployment hovers around eight or nine percent.

So, given the prognosis of robust growth in the U.S., what about the outlook for inflation?

Well, after a couple of years of sluggish performance the economy has built up slack in labor and product markets--the unemployment rate has been at or above six percent for the last seven months, and there's also excess capacity in product markets.

So it's going to take more than a few quarters of robust growth to work off that slack. And until it IS worked off, there might be some downward pressure on inflation.

Another factor to consider is the very strong productivity growth we've seen recently. As you know, a surge in productivity growth can lower inflation temporarily by lowering growth in unit labor costs. So, for both of these reasons, core inflation--which already is down to 1-1/4%--may slip even lower, despite rapid GDP growth.

Now, let me close with a few observations about the implications for monetary policy.

As you know, our primary goal is price stability--in other words, an environment where people and firms can make financial decisions without worrying about where prices are headed. Typically, we're aiming at price stability by working to bring the inflation rate *down*.

But conditions today aren't typical. In fact, this is the first expansion in over forty years that *began* with a very low inflation rate. So the response of monetary policy isn't necessarily going to be typical, either.

What's typical when an expansion starts to take hold? Most of the time, the main concern is an upside surprise--that is, the possibility that the economy will come roaring back, possibly pushing the inflation rate even higher, or at least preventing a desired decline.

Since it takes considerable time for policy to have an impact on prices, the Fed has often found it necessary to get an early start on holding the pace of expansion within sustainable limits. And it does this by making sure that the funds rate rises relative to the inflation rate. But in the current low-inflation environment, upside surprises aren't as much of a concern.

The Fed's current stance is in the accommodative range, reflecting in part the high level of excess capacity and the low level of inflation. Given that, I believe there's still room for some pretty strong growth before the risk of inflationary pressures would become a primary concern.

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