Presentation to the Portland Rotary
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The U.S. and Regional Economic Outlook

I. Good afternoon.

A. It's always a pleasure to meet with the Portland Rotary Club.

B. Today I want to give you my views on economic conditions both here in Oregon and in the nation.

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

II. Let me start with the local scene.

A. As you well know, in economic terms, both Portland and the state of Oregon have seen better days.

1. Since the beginning of the downturn a couple of years ago, Oregon has suffered the most severe job losses in percentage terms of any state in the Twelfth District.

2. And in October, it shared the unpleasant distinction of having the highest unemployment rate in the nation with Michigan.

B. Like other states, Oregon has seen its manufacturing sector take a beating during the recession and slow expansion.

1. For example, employment at Oregon Steel is less than half what it was just a year ago.

C. On top of that, Oregon was especially exposed during the downturn because high-tech manufacturing has been so important to the state's economy.

1. As the bubble in the information technology sector collapsed, those jobs evaporated—

a. —now about one out of four of them in the Portland area is gone.

2. Of course, coming from the Bay Area, I'm very familiar with this scenario of high-tech job losses.

a. And, frankly, I'm afraid many of those jobs aren't likely to return to either Oregon or the Bay Area any time soon.

b. A fairly recent example is in Salem,

(1) where two wafer plants will be closed next year.

D. These hard times for the economy have led to a large shortfall in Oregon's state budget—a situation that's also been all too familiar in California and many other states.

1. To deal with the shortfall, Oregon's state legislature passed several tax increases.

E. Are better days on the horizon? I'd say, yes, there certainly are some encouraging signs and some reasons for optimism.

1. Employment in the state appears to have stopped falling.

a. In fact, manufacturing employment has increased for three straight months.

2. More fundamentally, I'm hopeful about the prospects for Oregon's economy for four reasons.

a. First, you have a highly skilled work force.

b. Second, you have good access to growing markets, especially in Asia.

c. Third, with its great natural beauty—and very good wine—Oregon is a terrific place to live,

(1) and that will always be an attraction for entrepreneurs and businesses to locate here.

d. My final reason has to do with the national economy, where the picture is finally starting to brighten.

(1) As the nation moves into a sustained robust recovery, it certainly will bode well for economic activity in Oregon.

III. So now let me turn to conditions in the nation.

A. It looks as if—after a couple of years of sluggish performance—the economy may have finally found its legs.

B. 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.

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

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

b. and a series of tax packages.

2. Another is the stimulus from monetary policy.

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

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

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

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

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

b. and it has continued—

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

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

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

IV. The most recent data clearly have been positive.

A. Real GDP grew by 3.3 percent in the second quarter and by a sizzling 8.2 percent in the third quarter.

1. This increase reflected broad-based strength in the economy.

2. It was especially encouraging to see the performance of business investment in equipment and software, where much of the sluggishness over the past couple of years had been concentrated.

    a. This sector showed very rapid gains.

    b. Moreover, within the sector, the information processing equipment component was quite strong.

B. This improvement in business investment has helped the beleaguered manufacturing sector, which has finally begun to grow in recent months.

C. And, along with the rapid productivity growth, profit reports have been excellent for the most part.

D. Finally, consumers still appear to have their wallets open.

1. Although auto sales have moderated in recent months,

    a. this is probably a payback for the extraordinary strength in the third quarter,

    b. which means it's likely to be temporary.

2. Outside of autos, consumer spending has been robust, especially in housing.

E. So the most likely outcome appears to be

1. robust economic growth for the next year or so.

V. Now, we've thought for some time that the main downside risk to a robust economy was the consumer.

A. Consumers helped prop up the economy to a substantial degree during the last two and a half years of sluggish growth.

1. Therefore, at least part of the risk was that, by this point, consumers might have "run out of steam."

2. And this was intensified by the employment situation.

a. The loss of jobs and the uncertainty about employment could cause consumers to become more cautious

b. and hold off on making some purchases.

B. 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.

1. If this continues, it should provide support to the expansion.

VI. Now, what about the outlook for inflation?

A. As I mentioned, labor markets have a lot of slack—

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

B. And product markets have slack, too—

1. —that is, there's excess capacity out there.

C. So it's going to take more than a few quarters of robust growth to work off that slack.

1. And until it *is* worked off, there might be some downward pressure on inflation.

2. In other words, the inflation rate, which is already down to one and a quarter percent, may slip even lower—

a. despite rapid economic growth.

VII. Let me wrap this up with a few words on the implications for monetary policy.

A. As you may know, the primary goal of the Federal Reserve is price stability—

1. —that is, an environment where people and firms can make financial decisions without worrying about where prices are headed.

B. Typically, we're aiming at price stability by working to bring the inflation rate *down.*

C. But conditions today aren't typical.

1. In fact, this is the first expansion in over forty years that *began* with a very

low inflation rate.

2. So the response of monetary policy isn't necessarily going to be typical, either.

D. What's typical when an expansion starts to take hold?

1. Most of the time, the main concern is an upside surprise—

a. —that is, the possibility that the economy will come roaring back, possibly pushing the inflation rate even higher.

2. Since it takes considerable time for policy to have an impact on prices,

a. the Fed has often found it necessary to get an early start on holding the pace of expansion within sustainable limits by tightening policy.

3. But in today's low-inflation environment, upside surprises aren't as much of a concern.

E. 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.

1. 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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