

*Bay Area Council 1999 Outlook Conference
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The 1999 Economic Outlook

- I. It's a pleasure to be here today to talk about prospects for the national and regional economies.
 - A. And it's a special pleasure to share the dais with Abby Cohen.
 - 1. Abby, of course, is well-known for her bullish views on the stock market.
 - 2. In contrast, Fed officials like me are sometimes known for being prophets of gloom and doom.
 - B. And I must admit, for quite a while now, many of my economist colleagues—
 - 1. —both inside and outside the Fed—
 - 2. have been underestimating the performance of the U.S. economy.
 - C. A good example is the way the East Asian financial crises have affected our economy.
 - 1. Back in mid-1997, when the turmoil first began, we expected noticeable effects and some slowing in the economy.
 - 2. But, in fact, U.S. economic growth has shown substantial strength—
 - a. —despite the fact that the situation in East Asia became even more serious than we expected,
 - b. and despite the crises that developed in other places, such as Russia and some Latin American countries.
 - 3. We're in our eighth year of expansion,
 - a. and if this year shapes up as I think it will, then by January 2000, we'll have matched the longest expansion on record.

- b. All this with remarkably well-behaved inflation!
 - D. In my comments today, I want to give you some sense of *why* the economic picture is pretty bright at this point.
 - 1. Of course, I must be true to my Fed position and also tell you that there are risks in this forecast—
 - a. —risks that things could turn out worse than I'm predicting,
 - b. as well as risks that they could turn out better!
- II. Let me begin with a look at how the U.S. economy is doing in the face of economic troubles in so many areas abroad.
 - A. One of the main blows to our economy has been felt in our trade deficit—
 - 1. —especially with East Asia, where our exports have fallen off substantially.
 - 2. But, as I said, the effect on our economy has been only modest slowing.
 - a. One reason is that our exports to that region aren't that significant.
 - b. In addition, we haven't seen the flood of cheap imports we expected from those countries.
 - (1) It appears that a good part of the reason is related to problems in their banking sectors.
 - (2) In other words, it's hard for Asian businesses to find the financing they need to send goods to the U.S.
 - B. Another blow was to our financial sector, where investors became more skittish following the Russian default and wanted to reduce their risk exposure.
 - 1. Some investors withdrew from U.S. stock markets,
 - 2. And many lenders reduced their risk by withdrawing from debt markets.
 - a. This raised the risk premium for virtually all borrowers in the private sector,
 - b. and actually raised interest rates for riskier borrowers.

- C. By the time the Fed first cut interest rates in late September, these trade and financial developments made it clear there was increased downside risk in the U.S. outlook.
 - 1. Since then, of course, the Fed cut interest rates two more times, so today the funds rate stands at 4-3/4 percent.

- III. One thing we accomplished with the recent rate cuts was to bring a better balance between the upside and downside uncertainties for the economy.
 - A. Of course, the downside uncertainties involve the international problems and lingering unease in financial markets.
 - 1. East Asia's problems are certainly not yet resolved, though there are some optimistic signs.
 - a. For example, most of their equity markets and exchange rates are up a bit,
 - b. and their interest rates are below the levels they reached at the height of the crisis.
 - c. Perhaps the most important issue in East Asia is Japan.
 - (1) The effectiveness of its policies in strengthening the economy and straightening out its financial system will be crucial to the recovery in the rest of Asia.
 - 2. As for Latin America, the latest news about the currency devaluation and central bank shakeup in Brazil certainly adds to the uncertainty about global financial markets and their effect on the U.S.
 - B. On the upside, there are a number of things to consider.
 - 1. First, U.S. stock markets have actually regained their losses and surpassed their July averages.
 - 2. Second, it looks as if investors' tolerance for risk has moved back toward more normal levels,
 - a. although risk spreads are still pretty wide.

3. Third, the economy has outstripped most forecasters' expectations for growth for the past three years,
 - a. perhaps because of the rapid technological change we seem to be experiencing.
 - b. This pattern of pleasant surprises could continue—
 - (1) —a point well-illustrated by the unexpected surge in payroll employment for December.
4. Finally, the outlook for inflation appears good.
 - a. For example, the December CPI showed only a 1-1/2 percent increase over the prior twelve months.
 - b. This is due to
 - (1) the strong dollar
 - (2) and low world commodity prices,
 - c. as well as to more fundamental factors, such as
 - (1) ample industrial capacity
 - (2) and faster productivity growth over the last few years.
5. To sum up, then, there's an unusually high degree of uncertainty surrounding the outlook—both on the downside and the upside.

C. With that in mind, the most likely outcome for 1999 seems to be

1. continued low inflation
2. and continued expansion,
 - a. though probably not at the rapid rates we've seen in recent years.

IV. Now let me turn to the Bay Area and California.

A. The impact of East Asia's problems on the nation's manufacturers has certainly been felt in the state,

1. and especially here among the computer and semiconductor producers in Silicon Valley.
- B. And this isn't surprising, given California's extensive East Asian exports.
1. Since many of these exports are computer and semiconductor products,
 - a. Silicon Valley especially is highly exposed to the crisis.
- C. During the first nine months of 1998, the value of California's merchandise exports sold in East Asia fell about twenty percent compared to the same period in 1997.
1. As a result, a substantial number of California high-tech manufacturing jobs have been lost this year,
 2. and job growth has plummeted here in the San Jose area, where many of the state's computer and semiconductor industry jobs are located.
 - a. Growth in total employment in San Jose has slowed from over five percent to one percent on a yearly basis,
 - b. and the unemployment rate has risen from its low point of 2.7 percent in December 1997 to about three and a half percent in recent months.
- V. Still, I'd say the prospects for the Bay Area economy are favorable.
- A. For one thing, it's important to remember that the slowdown is relative to the very fast growth rates we've enjoyed in the last few years—
1. —which were almost certainly unsustainable.
- B. For another, Silicon Valley has weathered downturns before.
- C. Finally, the most recent growth signs are quite positive.
1. After a very weak second quarter,
 2. employment growth in the Bay Area as a whole picked up again in recent months.
- D. Overall, then, the Bay Area economy is poised for solid growth in 1999—

1. —assuming, of course, that the national expansion remains on track.

VI. In concluding my portion of this presentation, let me just turn again to the Fed's recent actions.

A. I think it's important to emphasize that although international developments are an important part of our assessment of prospects for the U.S. economy, they're not *themselves* the reason for our recent policy actions.

1. While we certainly are concerned about the financial and economic problems elsewhere in the world,
2. we believe the best way for Federal Reserve policy to contribute to the health of the *world's* economy is to maintain the health of *U.S.* economy.
3. And that's just what we were trying to do with the recent cuts in the funds rate.

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