FRBSF ECONOMIC LETTER

Number 2003-07, March 14, 2003

Economic Prospects for the U.S. and California: A Monetary Policymaker's View

This Economic Letter *is adapted from remarks by Robert T. Parry, President and CEO of the Federal Reserve Bank of San Francisco, delivered to the Stanford Institute for Economic Policy Research Associates on the campus of Stanford University on March 4, 2003.*

As the year begins, both the nation and the state face challenging economic conditions. In these remarks, I will focus on several of the fundamentals underlying those conditions as well as on the risks—both on the downside and the upside—going forward, and I'll try to draw out some of the implications for monetary policy. I'll conclude with my views on the California and Bay Area economies.

The national picture in brief

Revised numbers came out for the fourth quarter's real GDP growth on Friday, February 28. They were revised up from a weak 3/4 percent rate to a somewhat more respectable 1 1/2 percent. This brought growth for last year as a whole to just under 3 percent. This isn't such a bad number—in fact, it's only a bit below many estimates of the growth rate our economy can sustain in the long run. But to a lot of people, it felt pretty bad. Growth was quite uneven from quarter to quarter and ended the year on a down note. Moreover, employment was stagnant—in popular terms, this has been another "jobless recovery." And, with business investment leading the recent recession, the manufacturing sector has taken a hard hit. The bright spot has been consumer spending, especially on motor vehicles and housing.

Looking ahead to the rest of 2003, the most likely outcome—and one that a lot of forecasters share—appears to be that we'll have another year of moderate growth, probably a bit faster than last year. This outlook is by no means tipping in the direction of a "double-dip" recession. At the same time, growth isn't expected to be strong enough to make a significant dent in the excess capacity we currently face in labor and product markets, and core inflation is likely to trend modestly lower.

Positive fundamentals

What goes into this forecast? First, there are some positive fundamentals. One is the stimulus in the pipeline both from fiscal policy and from monetary policy. On the fiscal side, Congress passed stimulus packages in 2001 and 2002, and, of course, further proposals for fiscal stimulus packages are being debated right now. In terms of monetary policy stimulus, the Fed cut short-term interest rates from 6 1/2 percent to 1 3/4 percent in 2001. And we cut again last November by half a percentage point, bringing the federal funds rate to its lowest level in more than 40 years.

Another important fundamental is the economy's strong productivity performance. The surge in productivity that began with the economic boom in the mid-1990s has managed to continue, even through the recession and the modest recovery. This suggests that the process of technological innovation that drives productivity in the long run is still alive and well. And that bodes well for the future, because faster productivity growth creates business opportunities that stimulate economic growth. With these kinds of stimulus in place, I think we have good conditions for continued growth in consumer spending and a pickup in business investment this year.

Risks to the national outlook and issues for monetary policy

At the same time, there are some significant risks to consider, both on the downside and on the upside. First, the pickup in growth seems to depend on an acceleration in business fixed investment occurring before consumer spending falters. As I said, the consumer side of spending has been the main bright note in the past few years. But how long can consumers go on buying so many cars and houses? Furthermore, as I mentioned, the employment situation is not likely to improve substantially this year. So, if this remains a "jobless recovery," it can weigh on consumer confidence and lead people to pull back on spending. Frankly, the longer growth has to depend on the auto and housing sectors, the riskier the situation becomes.

Next, we come to geopolitical risks, which have created huge uncertainties that appear to be putting a damper on business investment. War with Iraq, of course, tops the list. Will it actually happen? Will the United States win a swift and decisive victory, or will it be a long, dragged out affair? What will the aftermath be? Without answers to these questions, firms are operating with their caution lights on, making them reluctant to expand employment and to invest in new equipment and software.

Related to the Iraq situation, of course, is the oil situation. And that has been exacerbated by developments in Venezuela. Finally, tensions with North Korea and the continued threat of terrorist attacks at home add to the sense of instability and uncertainty.

While the downside risks are easy to spot, it's important to remember that there are related upside possibilities. If current tensions are holding back investment, a lifting of uncertainties could stimulate a big increase in spending, as it did immediately after the resolution of the 1991 Gulf War. In addition, the fairly modest pickup in the growth rate of business investment I mentioned is typical of most forecasts, in that it represents a kind of average of a wide range of possible outcomes. In fact, once investment starts to pick up, it usually does so with a lot of vigor. So, we certainly can't rule out the possibility that investment will end up surprising us on the strong side this year.

What does all of this mean for monetary policy? The Fed's current stance is accommodative, and that seems appropriate, given the uncertainty about the strength and durability of the expansion. If it were called for, we still have room to give a boost to the economy, even in the face of some upside risks, because core inflation is low and trending downward. In fact, inflation itself could become a reason for an expansionary stance of policy, if this trend were to continue. So, I believe monetary policy is positioned to react appropriately to surprises—positive or negative—that may well come our way.

The California and Bay Area economies

Now let me turn to the state and Bay Area picture. As you may know, employment data for California recently were rebenchmarked up to March 2002. This helps us see the downturn somewhat better, and it actually looks a bit worse than we thought, both for California and for the Bay Area. The downward revisions were led by the information technology (IT) sector, where job cuts were even larger than originally recorded. This helps explain why the Bay Area has struggled more than the rest of the state throughout the downturn.

Of course, what we really want to know is where we are now and where we're headed. For that information, we rely heavily on the Fed's direct contacts with the business community, and what we're hearing from them is pretty interesting. For example, our contacts say there's a little more hiring activity than we can see in the data. So, just as the data missed the extent of the downturn, they also may be missing the early stages of recovery in the state.

Our contacts also shed some light on why job growth hasn't been faster. They say that they're generally concerned with reducing costs and emphasizing productivity gains to improve margins. In fact, one retail consultant noted that she now spends more time helping firms increase output per worker than she does helping them boost market share.

In terms of indicators about the future, our contacts say that capacity utilization rates have improved in the beleaguered IT sector—especially for cutting-edge technologies, such as bigger wafers and smaller transistors. In fact, in some cases, capacity is being expanded. They also say that the federal government's investments in defense and homeland security are starting to pay off for California firms involved in information security and aerospace.

So, taking together the official data and a good dose of grassroots input, here's the picture we seem to get: while there's no doubt that the state's economy—and the Bay Area's—are still sluggish, there are some signs of positive momentum.

The California budget

This brings me to the state budget situation, which certainly will be one of California's primary challenges this year. The state's budget crisis has two faces, and neither one is pretty. On the revenue face, the deficit reflects the national slowdown. California relies very heavily on income taxes for state revenues, and the cyclical slowdown in income tax revenues was exacerbated by California's unusually high exposure to stock market movements. On the spending face, California got caught in the same bind a lot of individual investors did—and a lot of other states, for that matter. They budgeted expenditures as if the stock market rally of the late 1990s would last forever. As a result, California now faces the daunting challenge of adjusting to the cyclical downturn *and* working through more long-lasting changes in revenue flows.

Just how big is the necessary adjustment? The numbers we've been hearing are pretty large, and they vary depending on the source. But it's important to keep in mind that the estimated budget shortfalls represent the gap between *desired* spending and projected revenues, not an outright deficit. Therefore, the reported shortfalls probably overstate the spending cuts and tax increases required to balance the budget, which in turn implies a more limited economic impact.

Of course, this is not intended to minimize the severity of California's fiscal crisis. The recent downgrades in California's bond rating suggest that the rating agencies now put the current fiscal crisis in about the same category as the one the state faced during the prolonged recession of the early 1990s. Moreover, the pain of tax and spending adjustments will be felt throughout the state for at least the next several years.

Let me conclude with a word on what this means for the national economy. Some have been concerned that the budget crises in California and other states could put a serious drag on national economic growth. But it would be more accurate to say that the national slowdown has put a drag on state budgets. So it's an improving economy—both in the state *and* in the nation—that's going to help solve the states' budget problems.

Robert T. Parry
President and Chief Executive Officer

ECONOMIC RESEARCH

FEDERAL RESERVE BANK

OF SAN FRANCISCO

P.O. Box 7702
San Francisco, CA 94120
Address Service Requested

PRESORTED
STANDARD MAIL
U.S. POSTAGE
PAID
PERMIT NO. 752
San Francisco, Calif.

Printed on recycled paper
with soybean inks

Index to Recent Issues of *FRBSF Economic Letter*

DATE	NUMBER	TITLE	AUTHOR
9/06	02-26	The Role of Fiscal Policy	Walsh
9/20	02-27	Why Do Americans Still Write Checks?	Gowrisankaran
9/27	02-28	Japan Passes Again on Fundamental Financial Reform	Cargill
10/4	02-29	Can the Phillips Curve Help Forecast Inflation?	Lansing
10/11	02-30	Setting the Interest Rate	Marquis
10/18	02-31	Learning from Argentina's Crisis	Moreno
10/25	02-32	Stock Market Volatility	Krainer
11/8	02-33	Productivity in the Twelfth District	Wilson
11/15	02-34	Riding the IT Wave: Surging Productivity Growth in the West	Daly
11/22	02-35	Recent Trends in Unemployment Duration	Valletta
12/13	02-36	The Promise and Limits of Market Discipline in Banking	Kwan
12/20	02-37	Bank Security Prices and Market Discipline	Kwan
12/27	02-38	Financial Issues in the Pacific Basin Region: Conference Summary	Glick
1/24	03-01	Using Equity Market Information to Monitor Banking Institutions	Krainer/Lopez
1/31	03-02	Increased Stability in Twelfth District Employment Growth	Laderman
2/14	03-03	How Financial Firms Manage Risk	Lopez
2/21	03-04	Where to Find the Productivity Gains from Innovation?	Wilson
2/28	03-05	Extended Unemployment in California	Valletta
3/7	03-06	House Price Bubbles	Krainer