

*National Association for Business Economics
Los Angeles Chapter
Hotel InterContinental, Los Angeles, California
For delivery January 24, 2000, at approximately 12:30 pm Pacific Standard Time
(3:30 pm Eastern) or upon delivery
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The U.S. and Regional Economies in the New Year

- I. Good afternoon. It's a pleasure to be here with you today.
 - A. Well, it's hard to think of a better way to start the new year—and the new millennium.
 1. Y2K turned out to be pretty tame—at least in the financial industry.
 2. And the economy has just kept on rolling. We're continuing to see
 - a) rapid economic growth,
 - b) low unemployment,
 - c) *and* low inflation.
 - B. With conditions like these, you might think that the Fed would just sit back and rest on its laurels.
 1. But instead, it's the Fed's job to *look ahead* as much as possible.
 - a) The reason is that when the Fed tightens or loosens monetary policy, the effect isn't instantaneous—
 - b) —instead, it can take anywhere from six months to two years for monetary policy actions to affect the economy and inflation.
 - C. And when we *do* look ahead, the inflation outlook is even *less* clear than usual.
 1. To put it simply, two especially important factors are influencing inflation—
 - a) —tight labor markets
 - b) and faster productivity growth.

2. And there's a lot of uncertainty about how these two factors will play out.

a) Will tight labor markets lead to higher inflationary pressures?

b) Or will accelerating *productivity* growth dampen inflationary pressures?

D. In my remarks today, I'd like to look at this issue in a bit more detail, and then discuss its implications for the nation's monetary policy.

II. But before I get into the national picture, let me take a moment to discuss conditions here in California and the Los Angeles Area.

A. The California economy was impressive in 1999, with growth outpacing the average for the rest of the nation.

1. It generated over 400,000 new jobs last year,

2. bringing the state unemployment rate to its lowest level in 30 years,

3. while boosting personal incomes, housing values, and wealth.

B. A key source of this performance was the state's high-tech sector.

1. Job growth was especially strong in businesses like biotech, communications, and software and Internet services development.

2. And it was financed by

a) record-breaking venture capital investment

b) and surging proceeds from Initial Public Offerings.

C. Now, usually when you say "high-tech," you think of Silicon Valley, but the Los Angeles area saw a lot of this activity, too.

1. This region attracted a significant amount of venture capital in 1999,

a) which financed a growing network of dot-com businesses,

(1) largely in the multimedia entertainment sector.

b) L.A. is a natural place for this to happen, given its prominence in

(1) developing,

(2) marketing,

(3) and distributing entertainment products.

2. These companies created jobs not only in the high-tech sector, but also in the service firms that support their growth—

a) —accounting firms,

b) P.R. firms,

c) and law firms, for example.

3. The combination of strong job growth *and* strong investment returns generated sizable gains in income and wealth during the year,

a) which powered robust consumer spending,

b) and helped maintain strong economic conditions in your area—

c) —all this despite weak export demand and job losses in durable and non-durable manufacturing.

D. Looking forward, there are several reasons to think the L.A. area will continue to do well.

1. Job creation remains solid overall,

a) with high-value sectors—such as e-commerce and entertainment- based Internet applications—creating substantial wealth.

2. The area's unemployment rate has fallen to just 4.8 percent.

3. East Asia's recovery has begun to boost port activity and tourism here.

4. And, local real estate markets remain strong,

- a) with construction employment growing rapidly,
- b) area home sales and prices increasing,
- c) and commercial vacancy rates falling.

III. Now let me return to the national picture.

A. To begin with, we're on the brink of the longest expansion ever—

1. —this month, we tied the record set in the 1960s of 106 months!

B. And for more than three years, the economy has been truly remarkable:

1. Real GDP has grown at a phenomenal pace—

- a) —averaging about 4-1/4 percent a year.
- b) The unemployment rate has hovered around its lowest levels in decades.
- c) And core inflation also has remained remarkably low, no matter how you measure it—

(1) —between one and a quarter and two and a half percent.

C. This is, of course, a wonderful combination—and one that's pretty rare, to tell the truth.

1. Often, when there's a sustained period of fast growth and tight labor markets, we begin to see signs of rising inflation.

IV. So what's been keeping inflation in check in the U.S. economy for the last few years? Well, there are several candidates.

A. One important candidate is the global financial turmoil that began in 1997.

1. Weakened foreign demand led to a stronger dollar—and therefore lower import prices—

- a) as well as falling commodity prices worldwide

b) and a drop in capacity utilization rates in U.S. manufacturing.

B. In addition,

1. energy prices fell during 1997 and 1998,
2. and so did the costs of health care, as the industry restructured itself.

C. At this point, though, these factors have reversed themselves.

1. Foreign demand is beginning to strengthen,
 - a) as many of the economies that were in trouble a couple of years ago are getting back on track.
2. And we're seeing a rise in
 - a) oil and other commodity prices,
 - b) as well as U.S. capacity utilization,
 - c) and health care costs.

D. More fundamentally, with continued strong *domestic* demand, labor markets in the U.S. appear to be quite tight.

1. The unemployment rate has fallen to just over 4 percent, the lowest figure since early 1970!
2. Certainly, we've all read stories about how hard it is for some businesses to find people to fill jobs.
3. If history is any guide, this can be expected to show up in faster increases in labor costs than we've seen so far.

V. Whether such increases end up in prices of goods and services over the next few years depends importantly on what happens to productivity.

A. Fortunately, we have a slightly better handle on the productivity data, now that the Commerce Department has made some important revisions to them.

1. The revised data confirm a productivity surge in the last four years or so.
 - a) The old numbers reckoned productivity growth at 2-1/4 percent,
 - b) While the new numbers actually bump the four-year average up another half percent to 2-3/4 percent.
 - c) This compares favorably with a recalculated measure of about 1-1/2 percent during the prior ten years or so.

- B. What's the source of the surge in productivity growth? Well, it's certainly natural to link it to the technological boom we've seen in recent years.
 1. There are plenty of examples of new technologies that have led to labor-saving devices.
 2. But even beyond that, new technologies are changing the *way* some firms do business.
 - a) By improving production flexibility and real-time information flows, new technologies can help
 - (1) eliminate bottlenecks,
 - (2) streamline production,
 - (3) and fine-tune specifications
 - b) so firms can better match—and even anticipate—customers' needs.
 3. All this appears to be translating into faster productivity growth for the economy.

- C. What does a faster productivity growth rate mean for monetary policy?

1. For one thing, it means the economy can grow faster than we thought without adding to inflationary pressures going forward.
 - a) Just a few years ago, most economists would have said that anything much over two percent would be unsustainable.
 - b) It now appears that growth could be sustained at a much higher rate.
2. But the story about any direct link from productivity to inflation is more complicated.
 - a) First, it's important to remember that inflation is a *monetary* phenomenon and, therefore, is determined by monetary policy over the longer term.
 - b) So, in the long run, there's *no* relation between faster productivity growth and inflation.
 - (1) Instead, faster growth in the trend of productivity eventually will be absorbed by faster growth in labor compensation.
 - c) At best, an increase in the productivity growth rate can hold down inflation *for a time*,
 - (1) since the pace of labor compensation may lag behind.

D. The data suggest that this may be what's been happening in recent years.

1. But even if the faster productivity growth is a cause of the low inflation and strong output growth we've experienced, we *still* face some uncertainty about the future.
 - a) With tight labor markets, upward pressure on labor costs should develop eventually, and

b) there's uncertainty about whether the acceleration in productivity

(1) will be strong enough

(2) and last long enough

(3) to keep inflationary pressures down.

VI. These uncertainties about the effect of productivity growth on inflation are a major issue for the conduct of monetary policy.

A. Given the favorable inflation results so far, the Fed has taken a fairly cautious approach in reacting to indications that inflation may rise in the future.

1. For example, we began to tighten policy gradually only last summer.

B. As we go forward, we'll be carefully evaluating whether the current strength in the economic and financial environment is going to permit inflation to remain at acceptable levels.

1. After all the progress we've made in the area of inflation in recent years, it would be a tragedy to allow those gains to be lost.

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