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A Look at the Regional and National Economies

- I. Good morning. It's a pleasure to be here.
 - A. As you know, the national economy's performance has been outstanding.
 - 1. This expansion has lasted longer than any other in U.S. history.
 - 2. And in the last four years especially, it has shown remarkable strength, with growth over four percent in each of those years.
 - a. In fact, growth in the last quarter of 1999 hit a phenomenal seven and a quarter percent,
 - (1) bringing the rate for the year to a bit over four and a half percent.
 - 3. Furthermore, unemployment continues to hover at the lowest levels in thirty years,
 - 4. and inflation has remained pretty tame.
 - B. This sounds about as good as it can get.
 - 1. So it's natural to ask why the Fed has been raising interest rates since last summer—
 - a. —last month was the fifth time we raised the short-term rate a quarter point.
 - 2. Today I want to give you my views on this question, and try to explain why we see risks of potential inflation in the economy.
- II. But before I get into the national picture, let me take a moment to discuss conditions here in the west.
 - A. The San Francisco Fed is headquarters for the Twelfth Federal Reserve District, which comprises the nine westernmost states.
 - 1. Over the past year, the District economy has generated over seven hundred thousand new jobs.

- a. That has brought the District unemployment rate to its lowest level since the Bureau Labor Statistics began maintaining state records in 1978.
- B. The economy in California has been especially strong.
 - 1. And a key source of the state's strength has been its high-tech sector.
 - 2. Job growth has been especially strong in businesses like biotech, communications, and software and Internet services development.
 - a. And it was financed by
 - (1) record-breaking venture capital investment
 - (2) and surging proceeds from Initial Public Offerings.
 - 3. The intensity of the high-tech expansion has affected many commercial real estate markets in the state.
 - a. Vacancies are down, and lease rates are up.
 - 4. Moreover, the jobs and investment returns created by high-tech companies generated tremendous gains in personal income and wealth.
 - a. This has powered robust consumer spending,
 - b. fueled rapid appreciation in home prices,
 - c. and helped maintain strong economic conditions—
 - d. —all this despite lagging export demand and job losses in durable manufacturing.
- C. One thing we at the Fed watch for in times like these—when labor markets are tight—is greater wage inflation.
 - 1. But we're not seeing signs of it in the data.
 - a. In fact, recent data indicate that wage growth in California slowed in 1999 compared to 1998.
 - 2. A number of factors may explain this surprising pattern of falling unemployment and slower wage growth. Let me focus on two of the most important.
 - a. First, employers are increasingly compensating employees

with things other than salaries—

- (1) —for example, stock options
- (2) and hiring bonuses.
- (3) Neither of these is, for the most part, included in the wage statistics.

b. Second, slower employment growth in the high-tech manufacturing sector also has slowed wage growth in that sector.

- (1) This factor may play less of a role in the future, however.
- (2) With export demand from East Asia beginning to increase, high-tech manufacturing has started to recover.

III. Now to the national economy.

A. One of the key reasons the economy has been able to grow so vigorously without igniting inflation for the last few years is the remarkable surge in productivity that's related to the advances in technology.

1. Not so long ago, most estimates suggested that the U.S. economy probably wouldn't sustain productivity growth faster than 1-1/2 percent.
 - a. That had been the average from the 1970s to about the mid-1990s.
2. But the numbers we've seen over the last few years have led us to revise our estimates substantially.
 - a. In 1997, productivity grew at a little over two percent, which seemed blazingly fast at the time.
 - b. Then, in 1998, it came in even higher—at just over three percent.
 - c. And last year it accelerated *again*—to three and a half percent!

B. These increases in productivity have wonderful effects on the economy.

1. One effect is that a *faster* growth rate for productivity means that living standards rise faster.

2. Another effect is that when productivity *accelerates*, it tends to hold down inflation.
 - a. This is true mainly because increases in labor compensation tend to lag behind increases in productivity growth.
 - b. So, for a while, more goods are being produced at the old, lower wages.
- C. But I want to emphasize that there's an important distinction between *fast* productivity growth and *accelerating* productivity growth.
1. As I said, faster productivity growth raises our standards of living more quickly.
 - a. And that's great.
 2. And we get an initial *inflation* benefit when productivity *accelerates*.
 - a. But thereafter, if productivity growth levels off at the faster rate,
 - b. monetary policy must respond to keep inflation at the new lower level.
- D. In the near term, can productivity keep accelerating fast enough to push inflation down further?
1. Yes, that's possible.
 2. But it's not something we can count on.
- E. So, even though it's clear that technological advances are expanding the supply side of the economy,
1. we still have to be watchful for conditions that raise inflationary risks.
 2. And there are several of them.
 3. These are the risks that have led the Fed to follow a course of gradually raising short-term interest rates.
- IV. Let me outline them for you briefly.
- A. One potential area of inflation risk involves the relationship between faster productivity growth and the levels of "equilibrium" real interest rates—

1. —that is, the rates that equilibrate supply and demand in the economy for goods and services
 - a. so that output equals its potential level.
 2. Here's what happens—higher trend productivity growth actually raises the level of equilibrium real interest rates in the long run.
 3. How does this work?
 - a. Faster productivity growth increases the profitability of various investment projects that firms might undertake.
 - b. This means, they'll bid more aggressively for financing.
 - c. And that will raise equilibrium real interest rates.
 - d. So, if the Fed tried to hold those rates at their old long-run levels, we'd be contributing to an inflationary monetary policy.
- B. Another area of risk is the growth in demand.
1. We've seen a real pickup in demand from abroad—
 - a. —real GDP growth in the rest of the world rose to around 4-1/4 percent last year, from less than one percent in 1998.
 - b. And it's projected to be almost as strong this year.
 2. Here in the U.S., consumers and businesses have been spending at a phenomenal pace.
 - a. Consumer spending especially appears to have been fueled by the very large increases in equity values in recent years.
 3. Now, that doesn't mean that the Fed has set its sights on some kind of goal for the stock market.
 - a. We're not so concerned about *why* consumer demand is so strong.
 - b. What we *are* concerned about is that demand—for whatever reason—may be outstripping supply.
- C. This brings me to another inflationary risk.
1. One consequence of that fast pace of growth since 1996 is that labor markets in the U.S. have now become very tight.

2. With the unemployment rate at just over four percent,
 - a. it's no wonder we hear stories about how hard it is for some firms to find people to fill jobs.
 3. Labor markets as tight as this eventually can lead to faster increases in labor costs—
 - a. —and therefore to higher price inflation than we've seen so far.
- D. The final risk I want to mention is one that's made front-page news lately.
1. And that's the run-up in energy prices.
 2. Since the end of 1998, OPEC has cut back on its production,
 - a. and that has driven oil prices to the highest levels we've seen since the Gulf War.
 3. So far, these increases haven't affected the general price level outside the energy sector.
 - a. And the good news is that OPEC *did* agree recently to increase production somewhat.
 4. Overall, then, we expect only a modest effect, because oil prices appear to be stabilizing, and they may even be falling.
 - a. But we certainly won't see anything like what happened during the 1970s embargoes.
- V. Now, with all these inflationary threats, what's a reasonable course for the Fed to follow?
- A. Well, it's risky just to sit back and wait for inflation to show up before we do something,
 1. because monetary policy affects inflation with a long lag,
 - B. To my mind, one point arguing for monetary restraint is that we seem to have reached a stage where inflation is no longer falling.
 1. We certainly don't want to let it rise again.
 2. And we *also* certainly don't want to abandon our goal of achieving price stability.
 - C. At the same time, we need to proceed with caution, because there's a fair

bit of uncertainty about the economy's behavior right now.

1. Most forecasts—including my own—have predicted a rise in core inflation for a couple of years,
2. but we haven't seen it yet.
3. And that makes me less confident about the old relationships between the growth of the economy and the level of the unemployment rate and the effect on inflation.

D. Given these considerations, I think the cautious approach of gradually increasing short-term interest rates over the past nine months has been appropriate.

1. This process has been aimed at
 - a. keeping this remarkable expansion on track
 - b. without risking our ultimate goal of price stability.

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