

*Community Leaders Breakfast
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A Look at the Regional and National Economies

- I. Good morning.
 - A. Today I'm going to take a look at the regional and national economies.
 - B. I'm especially glad to be doing it in San Jose—
 - 1. —since a good portion of what I have to say today is closely tied to the achievements of the people and businesses here in Silicon Valley.
- II. Let me start with the state and local economies.
 - A. Job growth in California continues to expand at an impressive rate.
 - 1. Indeed, it's outpacing the average for the rest of the nation.
 - 2. Over the past year, California's economy generated more than 450,000 new jobs,
 - 3. keeping labor markets tight,
 - 4. and housing and commercial real estate in short supply.
 - B. A key driver in the state's performance was the 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.
 - 3. The jobs and investment returns created by high-tech companies have generated tremendous gains in income and wealth,
 - a powering robust consumer spending
 - b and helping to maintain strong economic conditions in our area—

c —despite ongoing weakness in manufacturing.

C. This scenario played out even more intensely here in the Bay Area.

1. The sustained strength of the high-tech expansion is reflected in local labor and real estate markets, which are especially tight right now.

a The unemployment rate in the Bay Area remains below three percent.

b Prices on existing homes sold rose nearly 23 percent between June of this year and June of last year.

c And commercial real estate is in short supply.

(1) As of the first quarter of this year, vacancy rates on office space were hovering around 1 percent in San Francisco and the Silicon Valley,

(2) and lease rates were up more than 25 percent compared to their values in the preceding quarter.

2. A key question going forward is whether resource constraints will begin to hinder growth in our area.

a It's still too early to tell, of course.

b But recent events—such as interest rate increases and turbulence in the market for high-tech stocks—may have helped ease pressures in both the labor and housing markets.

(1) For example, recent layoffs in the dot-com sector helped meet hiring demands at other high-tech enterprises.

(2) And increased mortgage rates as well as declines in stock market wealth appear to have brought the temperature of the Bay Area's sizzling housing market down a few degrees.

III. Now let me turn to the national picture.

A. As you know, the U.S. economy's performance has been outstanding.

1. This expansion has lasted longer than any other in U.S. history,

a and it has been remarkably strong.

2. The unemployment rate continues to hover near its lowest level in thirty years.
 3. And, if we take out the temporary effects of higher oil prices, inflation has remained pretty tame.
 4. Finally, the changes in U.S. productivity have been truly remarkable.
 - a After averaging about 1-1/2 percent from the 1970s to about the mid-1990s,
 - b productivity has accelerated sharply.
 - c Over the past four quarters, it hit a phenomenal five percent!
- B. These developments have raised challenges for the Fed in conducting monetary policy,
1. because there's more than one possible explanation for what's been driving this remarkable economy.
- IV. One pretty obvious explanation has a lot to do with what's been going on here in this valley—namely, a surge in the *supply* of goods and services due to rapid technological change.
- A. According to economic theory, as well as simple common sense, the acceleration in productivity I just mentioned could be boosting output and—at the same time—holding down inflation.
 - B. And aside from this *indirect* evidence, we have a lot more *direct* observations to support a so-called technology shock explanation.
 1. First, firms have been investing heavily in information processing equipment and software.
 - a This would be very unlikely to happen unless these items were boosting productivity.
 2. Second, we can all think of many examples of technological developments that have improved the way business is done.
 - C. While a technology shock seems to be playing a significant role in recent events, it's probably not the only important force we have to think about—

1. —it's also possible that the booming economy has been driven by a strong *demand* shock.
 2. In other words, people and businesses have been willing and able to get out there and buy a lot of goods and services—
 - a —in part because of the incredible gains in the stock market over the last few years that have added so much to overall financial wealth.
 3. Normally, when demand is a major player in the economy, the buying surge runs the risk of igniting inflation.
 - a But some important developments in addition to the technology shock held prices in check.
 - b First, the prices of imported goods were kept down by a strong dollar and weakness in some of our trading partners abroad.
 - c In addition, from late 1997 through early 1999, oil prices were falling.
 4. From a policy point of view, if demand *were* the main driving force, then inflation would be looming large on the horizon, and something would need to be done about it—
 - a —especially since both import and oil prices are no longer falling.
 - b Moreover, labor and product markets are tight after so many years of rapid expansion in the economy.
- D. The uncertainty in monetary policy arises because we don't know whether a technology shock is dominating or a demand shock.
- E. But there is something that we *do* know with more certainty.
1. And that is—no matter which force is dominant, monetary policy had to tighten sooner or later.
 2. Of course, if we're dealing mainly with excess demand, the reason for tightening is obvious.
 3. But even if we were dealing mainly with a supply shock, the Fed *still* would have had to tighten—eventually.

- V. The reasons for tightening in response to a supply shock aren't that obvious. So let me sketch them out briefly.
- A. First, at the beginning, a supply shock typically entails accelerating productivity.
1. That leads to declining inflation for a time,
 - a 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.
 2. Eventually, though, the shock wears off,
 - a as productivity growth levels off
 - b and wage increases catch up.
 3. So a supply shock is a “golden opportunity”—
 - a —initially, it gives us lower inflation without a slowdown in growth or a rise in unemployment.
 - b And it may give us a permanently faster rate of productivity growth.
 - (1) That would be great, because then living standards would rise faster.
 4. The key point is this—to *lock in* the benefits and keep inflation at the new lower level, monetary policy had to tighten.
 - a After all, in the end, inflation is determined by monetary policy, not by productivity growth.
- B. The second reason for tightening has to do with what economists call “equilibrium real interest rates.”
1. These are the rates that bring supply and demand in the economy into balance,
 - a so that output equals its potential level.
 2. When productivity growth settles at a higher level, that also raises the level of those “equilibrium” real interest rates.

3. Here's how it works.
 - 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.
4. If the Fed tried to hold real rates at their old levels, we'd be contributing to an inflationary monetary policy.

C. The third reason has to do with the behavior of consumers and businesses.

1. A supply shock implies that incomes will continue to be higher in the future.
 - a If consumers and businesses look ahead thinking they're going to have higher incomes, they may increase their spending *before* the additional capacity comes on line.
2. Add to this the possibility that a supply shock also may give a boost to stock prices by raising expectations about future corporate profits.
 - a This possibility might produce basically the same effect—
 - (1) —that is, people and firms may feel wealthier today and go out spending before the economy's capacity to produce has expanded.
 - b In the U.S., consumer spending has advanced at a phenomenal pace—in part due to wealth effects—
 - c —and as a consequence the personal saving rate is at a record low.

VI. So, to sum up, we know that monetary policy had to tighten to contain inflationary pressures, regardless of whether the economy was being dominated by demand effects or supply effects.

A. The Fed began tightening even before we saw any upward trend in inflation because, in general, it's risky just to sit back and wait.

1. The reason is that monetary policy actions don't take hold immediately, and during that time, inflation can go from a simmer to a boil.

- B. At the same time, we needed to proceed with some caution because of the uncertainties I mentioned.
1. It's not clear whether the economy has been dominated by strong demand or by a supply shock.
 - a And even if we're now enjoying a supply shock, we can't be sure
 - (1) how long it will last
 - (2) or how big it is.
 - b So it has been hard to tell
 - (1) *when* to tighten
 - (2) *and* by how much.
 2. Our response to this uncertainty was to tighten policy—but to do so cautiously, paying attention both to pressures for higher future inflation as well as to the news of moderate inflation.
 - a Overall real GDP growth remained strong in the spring quarter.
 - (1) However, part of this was due to temporary factors,
 - (2) and, importantly, there was a dramatic slowdown in spending by consumers.
 - b While this slowing is encouraging,
 - (1) it's still too soon to tell if it's just a pause
 - (2) or if growth will settle in at a more sustainable rate.
- C. One thing I *am* certain of is that we're not about to let this golden opportunity slip through our fingers. The Fed will continue to aim policy at
1. keeping this remarkable expansion on track
 2. while consolidating our gains against inflation.

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