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California and the Nation: A Monetary Policymaker's Perspective

- I. Good afternoon. I'm very pleased to be part of the Milken Institute's "State of the State Conference."
 - A. I plan to give you a somewhat different perspective from most of those you're hearing today.
 - 1. As a monetary policymaker, I try to keep a very close watch on economic conditions in the nine western states in my District.
 - a. And for obvious reasons, developments in California get—and deserve—a lot of my attention.
 - 2. But, because monetary policy works through national credit markets, the Fed's focus is not so much on individual states or regions within states.
 - 3. Rather, my colleagues and I at the Fed use regional analyses to fit together a picture of the national economy's performance.
 - B. With that background in mind,
 - 1. I'd like to start with a brief overview of conditions here in California.
 - 2. Then I'll move on to discuss national economic developments and their implications for monetary policy.
- II. As you know, California's recent economic performance has been impressive, with growth well above that of the rest of the nation.
 - A. A key driver has been the state's high-tech sector.
 - 1. Indeed, California is the nation's leading state for high-tech development and production in a number of ways.

- a. First—employment:
 - (1) High-tech firms in California employ nearly a million workers,
 - (2) about 17 percent of the U.S. high-tech workforce.
 - b. Second—venture capital:
 - (1) California’s high-tech firms attract about half of all venture capital distributed to high-tech businesses in the U.S.,
 - (2) nearly 21 billion dollars in the first half of this year.
 - c. Third—exports:
 - (1) Firms in California account for about one-third of all U.S. exports of high-tech manufactured goods,
 - (2) not to mention the untold number of high-tech services we export.
- B. During the past several years the high-tech sector has expanded at double-digit rates and generated tremendous gains in income and wealth. These gains have
- 1. powered robust consumer spending,
 - 2. fueled demand for housing, office space, and a variety of business and consumer services,
 - 3. boosted state and local revenues,
 - 4. and helped maintain strong economic conditions in our area,
 - a. despite the Asian financial crisis and associated weakness in manufacturing and exports.
- C. But the boom hasn’t resonated through every region of the state.
- 1. For example, in some areas, especially in the Central Valley,
 - a. unemployment rates remain high,
 - b. and poverty and low income remain a concern.
- D. Moreover, the high-tech boom has brought us a few new challenges.

1. For example, not everyone in California has enough education to take full advantage of the new high-wage jobs being created by the high-tech sector.
 - a. This imbalance between the people's skills and our fastest growing employers' needs highlights the importance of education and training as part of our investment.
 2. The rapid economic growth also has tested the boundaries of our infrastructure.
 - a. As you've heard, with job growth outpacing the supply of new homes,
 - (1) house prices are soaring
 - (2) and many have to live far away from their jobs.
 - b. So
 - (1) commute times are longer
 - (2) and our roadways and public transit systems are reaching capacity.
- E. The good news is that, with the state budget in excellent shape, state and local officials have the resources to begin to address some of these challenges.
- III. When we turn from the California economy to the national economy, we see a lot of similarities.
- A. This expansion has been remarkably long and strong.
 - B. The unemployment rate is at its lowest level in thirty years.
 - C. And, if we take out the temporary effects of higher oil prices, inflation has remained pretty tame.
 - D. Finally, the changes in U.S. productivity have been truly remarkable.
 1. After averaging about 1-1/2 percent per year from the 1970s to about the mid-1990s,
 2. productivity has accelerated sharply.

3. Over the past four quarters, it hit a phenomenal 5-1/4 percent!
- IV. Clearly, part of the explanation for this extraordinary performance is related to the high-tech developments that are driving California's economy.
- A. Specifically, it's likely that technological advances have been pumping up productivity.
1. This, in turn, has expanded the overall supply of goods and services.
 2. As I'll explain later, accelerating productivity also tends to lower inflation for a time,
 - a though it takes action by the Fed to lock in those gains.
 3. This "technology shock" explanation makes sense.
 - a After all, since the mid-1990s, firms across the country have been investing heavily in information processing equipment and software.
 - (1) And they'd only be likely to do that if these items were enhancing productivity.
 - b Moreover, we can all think of examples where technological developments have improved the way business is done.
- B. But a technology shock probably is 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 since the mid-1990s 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.
 - (1) And this also poses a risk of rising inflation.
- V. While the reasons for raising interest rates in response to a demand shock are obvious, it may be less obvious that the Fed still would have had to do so even if we were dealing mainly with a technology shock.
- A. Since this is one of the main points I'd like to make today, I'll go through the reasons one by one.
 - B. The first reason 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—
 - b —in other words, the level that would keep inflation from either rising or falling.
 - 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.
 - a So, just to maintain our policy stance, we had to raise rates.
- C. The second reason actually argues for tightening the stance of policy. And it has to do with the way a technology shock may boost consumer and business demand.
1. A technology shock implies that incomes will continue to be higher in the future.
 - a If consumers and businesses feel pretty confident about that,
 - b they may increase their spending before the technological improvements actually succeed in expanding capacity.
 2. In addition, a technology shock may send stock prices higher 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.
- D. The third reason also argues for policy to be tighter, but in this case it has to do with what happens when the technology shock wears off.
1. As productivity accelerates in response to a technology shock, inflation tends to fall at first.
 2. The reason is that increases in labor compensation tend to lag behind increases in productivity growth.
 - a So, for a while, more goods are being produced at the old, lower wages.
 3. Eventually, though, the shock wears off,
 - a as the rate of productivity growth stops increasing

- b and wages accelerate to catch up.
- 4. So a technology 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 gives us
 - (1) a higher level of productivity
 - (2) and possibly a permanently faster rate of productivity growth.
 - (3) That would be great, because then living standards would be higher.
- 5. But the key point is this—monetary policy would have to take responsibility for locking in the benefits and keeping inflation at the new lower level.
 - a After all, in the end, inflation is determined by monetary policy, not by productivity growth.

VI. So, to sum up,

- A. we know that interest rates had to rise to contain inflationary pressures,
 - 1. regardless of whether the economy was being dominated
 - a by too much demand
 - b or by a technology shock.
- B. At the same time, we needed to proceed with some caution because,
 - 1. even if we’re now enjoying a technology shock,
 - a we can’t be sure
 - (1) how long it will last
 - (2) or how big it is.
 - 2. So it’s hard to tell

- a when to tighten
 - b and by how much.
- C. With this cautious approach, we're paying attention both to pressures for higher future inflation as well as to the news of moderate inflation.
 - 1. So far, overall real GDP growth appears to have slowed moderately in the third quarter.
 - a It's still too soon to tell if it's just a pause
 - b or if growth will settle in at a more sustainable rate.
- D. 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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