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Spotlight on the Economy—A Monetary Policymaker’s Perspective

- I. Good morning.
 - A. Today I’ll be giving you my views on the economy and what they imply for monetary policy.
- II. Let me start with 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. Economic conditions in the Twelfth District remain strong, despite recent moderation in the pace of expansion.
 2. Job growth in the District continues to expand at an impressive rate, well outpacing the average for the rest of the nation.
 - a Indeed, over the past year, the District’s economy generated about seven hundred thousand new jobs,
 - b keeping labor markets tight,
 - c personal income growth strong,
 - d and housing and commercial real estate markets healthy.
 3. Moreover, District export growth has begun to rebound,
 4. and District semiconductor manufacturers have started to add jobs, following two years of job cuts.
 - 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.
 3. And it was financed by
 - a record-breaking venture capital investment
 - b and surging proceeds from Initial Public Offerings.
 4. The intensity of the high-tech expansion has affected commercial real estate markets in both Northern and Southern California,
 - a driving office vacancies down and lease rates up.
 5. 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 in the state.
- C. Looking forward, signs of moderation are apparent.
1. Recent layoffs among dot-coms appear to have slowed employment growth in business services,
 2. and slower home sales as well as the moderation of office rent appreciation have slowed growth in construction employment.
- D. But overall, prospects for the District and California look good.
1. Indications are that those laid off from dot-coms are having little trouble finding jobs,
 2. and the layoffs in the dot-com sector helped meet hiring demands at other high-tech enterprises.
 3. Moreover, the recent pickup in exports and semiconductor manufacturing should work to offset some of the slowdown in consumer spending and housing that has fueled the state's expansion for the past year.
- III. Now let me turn to the national picture. Here, too, our economic performance has been outstanding.

- A. This expansion has lasted longer than any other in U.S. history,
 - 1. and it has been remarkably 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. These developments have raised challenges for the Fed in conducting monetary policy, because there's more than one possible explanation for what's been driving this remarkable economy.
- A. One pretty obvious explanation is 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 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. 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 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 also 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 it's not clear whether the economy has been dominated by strong demand or by a technology shock.

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.

- b So it's been hard to tell
 - (1) when to tighten
 - (2) and by how much.

2. Our response to this uncertainty was to raise interest rates—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 appears to have slowed moderately in the third quarter.
 - (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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