San Francisco Rotary Club
Marines Memorial Club
For delivery December 5, 2000 at approx. 12:55 PM PST
By Robert T. Parry, President, Federal Reserve Bank of San Francisco

---

Keeping the Economy on Track

I. Good afternoon.

A. Today I want to give you my views on the national economy, and I'll close with some observations on economic conditions here in California and the Bay Area.

II. The U.S. economy has performed magnificently well—for quite some time.

1. This expansion has been the longest in our history.

2. It has been remarkably strong, especially in the last few years.

3. It has produced the lowest unemployment rate in thirty years.

4. And, if we take out the temporary effects of higher oil prices, inflation has remained pretty tame.

III. At this point, most economists believe that one important source of this performance is a so-called "technology shock."

A. In other words, technological advances have been pumping up productivity.

1. And productivity has indeed been phenomenal.

a. Over the past four quarters, the growth rate of productivity hit an amazing rate of just under 5 percent!

b. This is about two and a half times the rate that prevailed during the 70s, 80s, and early 90s!

B. Faster productivity growth expands the overall *supply* of goods and services.

1. And that means the economy's sustainable growth rate can be higher without generating ever-increasing rates of inflation.

2. Furthermore, an acceleration of productivity from two percent to three percent and beyond tends to hold inflation down.

C. Attributing the productivity surge to a "technology shock" makes sense for a couple of reasons.

1. First, since the mid-1990s, firms have been investing heavily in information processing equipment and software.

a. And they wouldn't do that unless these items were enhancing productivity and therefore profits.

2. Second, we can all think of examples where technological developments have improved and even revolutionized the way firms do business.

IV. But a rapid expansion of the supply side of the economy probably is *not* the only important force we've been dealing with—

A. —it's also possible that the booming economy has been driven by strong *demand*.

1. In other words, people and businesses have been willing and able to get out there and buy a lot of goods and services.

2. A good part of this rapid growth in demand may stem from the technology shock itself.

a. For example, enhancements to productivity have made a substantial contribution to the incredible gains in the stock market since the mid-1990s that have added so much to overall financial wealth.

b. In turn, the surge in wealth has stimulated consumer spending.

B. Normally, this kind of buying surge runs the risk of igniting inflation.

1. But for a while, at least, some important developments in addition to accelerating productivity held prices in check.

a. For example, the prices of imported goods were kept down by a strong dollar, as the strong U.S. economy attracted foreign investment.

b. And from late 1997 through early 1999, oil prices were falling.

C. Since then,

1. oil prices have been on the rise.

2. Furthermore, years of rapid economic expansion have led to a tight labor market.

a. In fact, many businesses are reporting great difficulty in finding qualified workers.

D. To sum up, then, the Fed has faced a combination of good news about the present and reasons for concern about the future.

1. The good news has been about the technology shock and faster productivity growth, which ultimately translate into faster sustainable growth for the economy.

2. The concern has been about rising inflation risks, even though actual inflation has remained moderate.

E. Deciding how to set policy to keep the expansion on track while guarding against inflation involved dealing with a lot of uncertainty.

1. For example, we couldn't know how long the technology shock would last, nor even exactly how big it was.

2. In addition, though we knew we were dealing with a higher sustainable growth rate—

a. —we didn't know exactly what that rate was.

F. As a result, we took a cautious approach and raised short-term interest rates gradually.

1. From September of 1999 to May of this year the federal funds rate—our main policy tool—moved from 5-1/4 percent to 6-1/2 percent.

V. Since May, the Fed has basically been sitting tight. There are several reasons for this.

A. First, we know that monetary policy actions affect the economy with a lag.

1. So the last round of rate increases is probably still affecting the economy.

B. Second, we know that many things *besides* increases in the funds rate could tend to slow the economy. And we've wanted to watch how those factors play out.

1. For example, the overall stock market is about where it was a year ago, after increasing rapidly for several years —

a. —so that could put a dent in consumers' spending plans, which would contribute to some slowing.

2. Another factor is the dollar, which has been quite strong.

a. That, too, could contribute to slowing, since it makes U.S. exports more costly for consumers and businesses abroad, and makes imports less costly for U.S. buyers.

3. Finally, conditions in financial markets have tightened.

a. Borrowing costs for all but highly rated companies have risen sharply in recent months.

b. And business borrowers also have been facing more stringent conditions on bank loans.

VI. With these slowing factors and the Fed's short-term interest rate increases, it appears that the economy has moved into a more sustainable growth range.

A. First, we saw a significant slowing in real GDP growth in the third quarter to a moderate 2-1/2 percent rate, following a 6 percent increase over the prior four quarters.

1. A good deal of this slowdown occurred in interest-sensitive sectors of the economy like housing and business investment.

2. In addition, recent information on the early part of the fourth quarter suggests that the growth is continuing at a moderate pace.

B. Second, employment growth has been more moderate for several months now.

C. Third, the inflation numbers also look reasonably good, in general.

1. Core inflation—that is, excluding food and energy—rose about 1-3/4 to 2-1/2 percent over the past twelve months, depending on the measure used.

a. And though real wages have gone up about two percent over the past year,

(1) that's still well below the increase in productivity,

(2) so labor costs have remained moderate.

D. All in all, then, it looks as if the economy is on track for

1. continued, but moderated, growth,

2. with reasonably favorable inflation performance.

E. Of course, it's still too soon to know *for sure* if we've really got the inflation risks under control.

1. However, the evidence is getting more and more convincing that the economy is on track toward our goal of sustainable growth and low inflation.

VII. I'd like to conclude with a few remarks about state and local economies.

A. Economic conditions in California remain strong, despite recent moderation in some sectors.

1. The rate of job growth has expanded about twice as fast here as it has in the rest of the nation.

a. Indeed, over the past year, the state's economy generated more than 445,000 new jobs.

b. That has led to tight labor markets,

c. strong personal income growth,

d. and a squeeze in housing and commercial real estate markets.

B. A primary driver in the state's performance has been the information-technology sector.

1. Job growth has been 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. Moreover, the jobs and investment returns created by high-tech companies during the year generated tremendous gains in income and wealth,

a. powering robust consumer spending

b. and a hot real estate market.

C. Nowhere in California has this scenario played out as intensely as 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 2½ percent.

b. Prices on existing homes sold rose nearly 22 percent between September of this year and September of last year.

2. And commercial real estate is in short supply.

a. As of the third quarter of this year, commercial vacancy rates in San Francisco and the Silicon Valley were hovering around 2 percent.

D. Looking forward, hints of moderation have appeared in some parts of California.

1. Recent layoffs among dot-coms appear to have slowed employment growth in business services,

2. and slower home sales as well as a moderation of office rent appreciation have slowed growth in construction employment.

E. But overall, prospects for the Bay Area and California look good.

1. Indications are that people who were laid off from dot-coms are having little trouble finding jobs.

a. In fact, the layoffs in the dot-com sector have helped meet hiring demands at other high-tech enterprises.

2. In addition,

a. state export growth has begun to rebound,

b. and the manufacturing side of the high-tech sector has started to *add* jobs, after two years of job cuts.

3. Finally, early reports show that many retailers in the Bay Area started this important shopping season off with a bang—

a —well ahead of expectations

b *and* well ahead of the performance in some other regions of the country.

c So the holidays should be pretty happy for most of us.

# # #