San Francisco NABE Outlook Conference
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U.S. Economic Outlook

I. Good afternoon. On behalf of the San Francisco Fed, I'm very pleased to welcome the local chapter of NABE to our Bank for its annual outlook conference.

A. I'm especially glad to have the opportunity to talk to you today about the outlook for the economy for 2001.

1. Since the other speakers on the agenda will deal in depth with conditions in California−

2. –and especially with infrastructure issues–

3. –I'll keep my remarks focused on the national picture.

B. This is quite a time to be a monetary policymaker, as you might guess.

1. After several years of truly astounding economic performance,

a We're facing a slowdown that–frankly–has been surprisingly sharp.

2. In fact, I wonder how many of your predictions a year ago included growth of less than 2 percent in the second half of 2000!

C. Today I'd like to give you my own views on the economy, and I'll take it in three steps.

1. I'll start with a review of economic developments over the past year and a half or so.

2. Then I'll give you my account of Fed policy during this period.

3. And, finally, I'll try to give you a context for looking forward over the next year or so.

II. It's hard to find a word to sum up the U.S. economy's performance during this expansion. Remarkable? Astounding? Phenomenal? Well, it has been all that–and more.

A. For one thing, it has been record-setting, in terms of length.

1. It started in 1991, and in 2000 it beat the record as the longest expansion in U.S. history.

2. Furthermore, the past five years produced an especially noteworthy performance,

a with average real GDP growth of just over 4 percent.

b This period was driven by a large technology shock, which spurred productivity growth to an astounding average of just under 3 percent.

(1) It now appears that potential output is expanding much more rapidly than the 2 percent rate of the 70s and 80s.

c With productivity expanding so rapidly, we were able to have rapid growth of output *and* moderate inflation.

B. Even so, by mid-1999, the Fed began raising interest rates. At that time, it appeared that the risks were tilting toward inflationary pressures–pressures that might eventually threaten the expansion.

1. Consumer demand and business demand were growing at a furious pace,

a and labor markets appeared to be tight.

2. At least some of this strong demand may have been related to the technology shock.

a With the *prospects* of income looking so good, and equity values so high, consumers may have felt comfortable spending instead of saving–

(1) –indeed, the official personal saving rate fell sharply and actually went into the negative range.

b This situation can lead to inflation because people may spend before the added capacity comes on line.

3. In addition, a positive supply shock raises real equilibrium interest rates.

a So, assuming that inflation prospects hadn't changed, nominal rates *also* had to rise.

(1) That is, if we hadn't raised the nominal funds rate, we would have, in effect, been *easing* policy.

b This, of course, would have been counter-productive given our concerns about inflationary pressures.

4. With these considerations in mind, the Fed raised the funds rate gradually from mid-1999 though mid-2000.

a The aim was to bring about a gradual slowdown in growth,

b so that inflation could be contained and the expansion prolonged.

C. The dampening effects of the Fed's actions were felt directly in some parts of the financial markets.

1. Short- and long-term interest rates rose, especially to riskier borrowers.

2. And the terms of bank lending became tighter.

D. In addition, other parts of the financial markets also tightened, perhaps in part due to the Fed rate increases and in part due to other developments.

1. For example, the fall in stock prices may have been related to people's beliefs that equities had risen to an unsustainably high level anyway.

2. And the stronger dollar may have been related to problems of confidence in the euro.

E. Beyond these financial market issues, the economy also was hit by an unexpected spike in energy prices.

1. The price of oil rose sharply–especially in 1999–as OPEC reduced supplies.

2. And I don't need to tell anybody here about the dramatic run-ups in the prices of natural gas and electricity.

3. These energy "surprises" reduced the purchasing power of households and businesses and led to a fall in demand.

F. The final factor I'll mention that put a drag on demand is one that's typical of most business cycles.

1. After years of spending liberally on big-ticket items, consumers had accumulated a large stock of autos and consumer durables.

2. The same point can be made for businesses.

a Investment has been strong for so long that many firms had taken care of a good deal of their needs for capital equipment.

3. So demand was bound to slow down at some point.

G. Beginning in the second half of 2000, all of these developments worked to slow the pace of economic activity.

1. The 1-3/4 percent average growth rate in the economy in the second half of 2000 looks a lot like the modest slowdown that could gradually eliminate inflation risks.

2. But in November–and especially December–signs began to emerge that suggested the risks were tilting toward a more severe slowdown–and even the possibility of a recession.

a Consumer and business confidence plummeted.

(1) And this was reflected in a sharp fall in the consumption of autos and durables.

b In addition, activity in the industrial sector weakened dramatically.

3. As for the current quarter, the jury is still out.

a We've gotten mixed signals about activity in January.

(1) Things looked better in terms of employment, as well as auto and overall retail sales,

(2) but consumer confidence and the National Association of Purchasing Management survey were worse.

III. As you know, the Fed responded to this situation with two 50-basis point cuts in the funds rate in January.

A. Some thought this was an unusually quick, strong response; some even thought it meant that the Fed saw a recession just around the corner.

B. I have a different interpretation—for a couple of reasons.

1. First, I don't agree with those who claim that the Fed tends to move in slow, halting steps.

a On the contrary, it's not unusual for the Fed to react quickly and decisively.

b In fact I can give you a couple of examples of swift Fed action.

(1) There was the preemptive strike against inflation in 1994.

(2) And there was the quick response to the Asian currency crisis in 1998.

2. Second, it *was* a bigger rate cut than we've often made, but that size doesn't necessarily require that there be a recession at hand.

a The focus here is on losses in output relative to the long-run potential of the economy,

(1) which has been boosted so much by rapid productivity growth in recent years.

b With potential GDP now expanding at a higher rate,

(1) the implication for inflation and the growth of employment may be the same for low positive rates as it used to be for periods of small declines in output.

C. In summary, over the past year and a half the Fed has been doing its usual balancing act.

1. If the expansion had continued at its earlier rapid pace, inflationary pressures eventually would have emerged, and we would have faced the old "boom-bust" syndrome.

a That is, the Fed would have had to tighten fairly severely,

b and, as we know from history, that often rings down the curtain on most expansions.

c So, our gradual tightening in 1999-2000 was an attempt to *preserve* the expansion by slowing things down moderately.

2. Of course, whenever the economy slows, it unavoidably becomes vulnerable to a more severe downturn than expected.

a Unexpected developments, like the recent energy shock, can play a big role.

b At this point, it's simply too soon to say how sharp the slowdown will be and how long it will last.

IV. Looking forward, the underlying situation for the U.S. economy still has a lot going for it.

A. It's important to keep in mind that productivity growth held up remarkably well in the second half of 2000.

1. That implies that the supply side of the economy is still expanding rapidly.

2. Despite the slowdown in demand, productivity growth averaged 2.6 percent in these two quarters, which is faster than the 2 percent figure we used to think of as the long-run trend!

a Continuing advances in technology and the associated new business opportunities should help boost the economy.

B. The Fed's easing also should help the economy bounce back.

1. Fortunately, the financial markets have shown confidence in the Fed responses, and this has aided our effort to limit weakness in the economy.

a Interest rate risk spreads are way down since we started easing, suggesting that the market now put lower odds on a recession than it did in November and December.

C. No doubt, the road *immediately* ahead may be rocky, given the uncertainties in the economy.

1. As we said in our last FOMC announcement, the risks do seem to be tilting toward weakness.

D. But looking toward the rest of the year, I'd have to agree with my Fed colleagues.

1. The most likely outcome is a gradual rebound in the economy–

a −with real GDP growth averaging two to two-and-a-half percent for the four quarters of 2001.

2. This is below potential, and well below the blazing growth rates we've seen in recent years, of course.

3. But it *does* suggest continued expansion for the U.S. economy.

4. And you can be sure that the Fed will be paying close attention to *keep* this expansion on track.

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