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U.S. and Regional Economic Outlook

I. Good afternoon.

A. Today I'd like to give you my views on the national economy

B. and explain a bit about the Fed's recent policy moves.

II. But before I begin, let me take a moment to look at the economy closer to home.

A. Here in California, economic conditions remain solid, even though the pace of expansion has slowed quite a bit in recent months.

B. The slowing is especially noticeable in the technology sector.

1. We're all familiar with the shakeout of the dot-coms.

2. But, beyond that, manufacturers of high-tech products are going through a process of adjustment,

a with many curbing investment plans

b and reducing payrolls.

3. Given the prominence of technology firms in California, we can expect to be hit harder than the rest of the U.S. as businesses work through these adjustments.

C. Slowing in the technology sector has begun to spill over to other sectors of the economy.

1. For example, vacancies are up and lease rates are falling in some commercial office markets.

2. And consumer spending has slowed from its frenzied pace of the last several years.

a One factor damping consumer spending is the fall in stock values.

3. Looking forward, given the concentration of high-tech firms and the withering value of the options held by their employees,

a we expect the hit to household wealth associated with the stock market to be greater in California than in the rest of the U.S.

D. Energy is another distinct negative for California.

1. California has seen the largest increases in natural gas prices in the nation.

2. On top of that, the recent increase in electricity rates for much of the state will average out over a year to almost 1% of median household income for the state.

3. An even bigger problem for the state may be blackouts.

4. Although higher retail electricity rates will help reduce demand, we still face the threat of forced outages this summer.

a The impact from such outages can add up.

(1) This January, for example, the outages—which mainly hit customers with interruptible contracts—amounted to about 1 percent of electricity usage for the month.

(2) Outages on that scale during the summer months would have a measurable impact on the state's economy.

E. Despite these negatives, the California economy remains structurally sound.

1. And we're coming off a very strong run.

a California's job growth last year was almost four percent.

2. Compared to that, even average growth may seem like bad times.

F. Turning to the local picture, Sacramento ended 2000 with incredible momentum, and things look good so far this year.

1. Over the past twelve months, job growth has averaged about 42 percent,

a with nearly every sector of the economy adding jobs.

2. Residential and commercial real estate markets remain strong,

    a producing double-digit expansion in construction payrolls.

3. Even state government employment in Sacramento is expanding.

G. That being said, this area is not completely immune from the risks I alluded to for the state.

1. For example, the Sacramento area can expect to face some of the adjustment going on in the high-tech sectors.

    a Over the past several years, Sacramento has become one of the nation’s centers for computer and semiconductor manufacturing.

        (1) Indeed, many of America’s best-known players in these high-tech markets—

        (2) —Apple, Intel, and NEC for example—have facilities in the area.

    b Beyond computers and chips, established technology businesses in fields such as software development and database management are located in your area —

        (1) —DST Innovis and Oracle come to mind.

    c And recently, a host of smaller startups, including a number of dot-coms, have decided that Sacramento is a *better* place to do business than San Jose or San Francisco.

2. With regard to electricity, I have to say that, at this point, I’d rather be getting my power from SMUD than from PG&E

    a Nevertheless, power outages are a reality that many of us likely will face this summer.

H. As for the future, Sacramento has several of the key ingredients that can help keep it competitive in our rapidly changing national economy—

1. —a highly educated population,

2. a vibrant research community, anchored by UC Davis,

3. and a solid base of electronics manufacturers and information-technology firms.

I. And since Sacramento's not all that far from Silicon Valley,

1. It's well-positioned to take advantage of the ongoing technology revolution filtering through all aspects of our economy and society.

III. Now let me turn to the national picture.

A. Given all the negative news about the economy recently, I may need to remind you that—

1. —the data so far seem to indicate that the U.S. economy is still expanding, if only very slowly.

B. Frankly, economic conditions probably feel especially bad because we're coming off a long period of truly phenomenal growth.

1. From 1996 through 2000, real GDP growth averaged a very rapid 4-1/4 percent rate.

2. And for most of that time, inflation remained pretty tame.

3. Why? Because the growth was being driven by a large surge in technological change that has spurred productivity growth to an astounding average of just under 3 percent.

C. Still, inflation worries did start to emerge in the middle of 1999.

1. At that time, consumer demand and business demand were growing at a furious pace,

2. and labor markets appeared to be tight.

3. So the Fed raised the funds rate gradually from mid-1999 though mid-2000.

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

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

D. Once the dampening effects of the Fed's actions started to take hold, though, a couple of other developments kicked in and slowed the economy even more.

1. One development was the fall in stock prices.

a While part of this may be related to the Fed's tightening,

b part of it also may be related to people's beliefs that stock prices had risen to unsustainably high levels.

(1) With a slower-growing economy, earnings reports have been coming in negative.

(2) In addition, investment plans have also been deferred,

(a) especially in the high-tech area.

2. Another development was the unexpected spike in energy prices.

a The price of oil rose sharply—especially in 1999—as OPEC reduced supplies.

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

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

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

1. The manufacturing sector especially has seen a drop in activity—

a February was the fifth straight month of decline in manufacturing production,

b and as a result this sector now has substantial excess capacity.

2. On the positive side, however,

a consumer spending

b   and construction activity and employment growth have held up reasonably well.

3.   So, at this point the data suggest a period of slow growth, not an outright recession.

a   But, of course, there *are* some downside risks.

b   For example, further sizable declines in the stock market or consumer confidence could make matters worse than now seems likely.

IV.   As you know, the Fed has responded to the slowing with three 50-basis point cuts in the funds rate this year—two in January and one in March.

A.   The reactions have been interesting.

1.   The cuts in January surprised some people because they seemed to be very large—

a   —some even thought the cuts meant that the Fed expected a recession.

2.   And the most recent cut surprised—and disappointed—some people because it seemed too small.

a   And the stock market showed its dissatisfaction by dropping dramatically.

B.   I'd like to take a moment here to try to clarify how stock market developments fit into monetary policy.

1.   The main thing to remember is that the Fed does not have—nor should it have—goals for equity values.

a   Instead, the Fed's goals are long-run stability in the prices of goods and services and sustainable economic growth.

2.   The stock market plays a role in this because changes in equity values can have important effects on consumer and business spending.

3.   And when any important economic factor—like the stock market, or foreign exchange rates, or consumer confidence—appears to cause inflation or economic activity to deviate from the Fed's basic goals,

a the Fed will respond.

4. So it's not the stock market itself that drives policy.

a Rather, it's how the stock market might affect future economic developments.

V. Looking forward, I'd say 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. Despite the slowdown in demand, productivity growth averaged two and a half percent in those two quarters,

a That's much faster than the figure of a little over one percent that we used to think of as the long-run trend!

2. And it implies that the supply side of the economy is still expanding rapidly.

3. Continuing advances in technology and the associated new business opportunities should give a boost to the economy.

B. And the Fed's easing also should help.

C. To me, this all suggests that, if everything goes right, we'll continue to see the economy expand—

1. —not at the blazing rates we've seen in recent years—

2. —but still at a respectable positive rate by sometime in the latter half of this year.

D. No doubt, the road now and *immediately* ahead may be rocky, given the uncertainties in the economy and financial markets.

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

2. So that's all the more reason to assure you that the Fed will be especially alert in monitoring economic developments.

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