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U.S. and Regional Economic Outlook

I. Good morning. It's a pleasure to be here.

- 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 market 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

         (a) because the interruptible contracts are essentially drawn down.

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.

III. When we turn to the national picture, there are, of course, a lot of similarities with California.

A. The U.S. economy also has had a phenomenal run,

1. and technological advances have played a very important role.

2. They've helped boost productivity growth to an average annual rate of almost three percent a year from 1995 to 2000.

a As a result of this upward shift in productivity growth, the *potential* for the economy to grow has risen also.

b In other words, with higher productivity growth, the economy can grow at a faster sustained rate without generating inflationary pressures.

3. In addition to raising the economy's *potential* growth rate, the technology surge also drove the economy's *actual* growth to exceptionally fast rates.

B. So compared to *that* performance, the slowdown since the middle of last year *feels* pretty bad—even though the economy appears to be growing at a small positive rate.

1. For example, growing at a slower, but still positive, rate today

a is likely to push up unemployment rates about as much as small contractions have done in past business cycles.

2. In addition, manufacturing is being hit hard by the slowdown,

a as output in that sector actually is contracting.

IV. To understand where we go from here, we need to look briefly at where we've been. So let me take a moment to look at what contributed to the slowdown.

A. In the middle of 1999—after four years of phenomenal growth—inflation risks started to become a concern.

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

2. and labor markets appeared to be very tight.

3. So the Fed raised the funds rate in several steps from mid-1999 though mid-2000.

    a The aim was to bring demand down gradually so that

        (1) inflation wouldn't take off

        (2) and the economic expansion could continue.

B. 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 bank lending terms became tighter.

C. On top of that, some other developments kicked in and slowed demand even more. I'll focus on three of the most important—energy, the stock market, and what I'll call "taking a breather."

1. First, 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.

2. Second is the drop in stock prices.

    a Part of this may be related to the Fed's tightening.

    b But part of it also may be related to a re-evaluation of the long-run profitability of many high-tech firms.

        (1) Now, don't get me wrong. I still think we're not near the end of the surge in technological innovation that has propelled the economy since the mid-1990s.

        (2) It's just that—even with this boom—markets may have gotten carried away.

c With stock market levels a good deal lower now, spending by both consumers *and* businesses has been squeezed.

(1) Although growth in consumer spending is still positive, it has slowed as people have felt a negative “wealth effect.”

(2) And for businesses, the higher cost of capital has led them to cut back on investment—especially in the high-tech area.

3. The third factor affecting demand is that consumers and businesses may be “taking a breather” at this point.

a For example, the growth in consumer spending has been very strong for years.

(1) So consumers already *have* large quantities of cars, refrigerators, and other durables.

(2) This may spell a slowdown in spending for a while.

b Likewise, business investment—especially in the high-tech area—has been extraordinarily strong for some time.

(1) So, many firms seem to have large stocks of capital equipment already.

(2) This suggests that there may be an “overhang” of business equipment and software that could spell weakness in business spending for a time.

4. I think it’s interesting to point out that “new economy,” high-tech activity plays a dual role in this story.

a As I just suggested, it’s *intensifying* the slowdown.

b But it also may actually help the economy to adjust more quickly.

(1) In the past, it usually took quite a while for producers to cut back on their output in response to a slowdown in demand.

(a) That often meant a significant buildup of unwanted inventories.

(b) And the way firms dealt with that was to scale back sharply, often producing a recession.

(2) But today—with new technologies improving the quality and the timeliness of information—firms seem to be able to manage their inventories much better.

(3) And that may tend to mitigate the extent of the slowdown.

V. As you know, the Fed has responded to this situation with four 50-basis point cuts in the funds rate this year—two in January, one in March, and one last week.

A. Now, I know the first thing that gets reported after a Fed move is how the stock markets reacted.

B. So 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, as I mentioned.

3. And when *any* important economic factor appears to cause inflation or economic activity to deviate from the Fed's basic goals, it will have to be taken into account in our policy deliberations—

a —whether that factor is foreign exchange rates, oil prices, *or* the stock market.

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

a Rather, it's how the stock market—within the context of other economic and financial developments—might affect the economy in the future.

VI. Looking forward, I'd say the underlying situation for the U.S. economy still has a lot going for it.

A. For one thing, the Fed's easing will help.

B. For another, it's important to note that productivity growth held up remarkably well in the second half of 2000—despite the slowdown in demand.

   1. That implies that the economy's *potential* for growth is a good deal higher than before.

   2. So, even though we're in a cyclical slowdown—in economists' terms, we're probably "cycling around a higher trend."

C. At this point, the data suggest we're in a period of very slow growth, not an outright recession.

   1. And we'll get some important information on that tomorrow when the advance data on first quarter GDP are released.

D. By the latter half of this year, it seems likely that we'll see somewhat faster growth—

   1. —not up to our full potential, perhaps—

   2. —but at a more respectable rate.

E. No doubt, the road now and *immediately* ahead may be rocky, given the fact that there *are* some downside risks.

   1. For example, further sizable declines in the stock market or consumer or business confidence could further dampen demand.

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

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

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