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A Monetary Policymaker's Perspective on the Economy

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

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

   B. And I'll also say a few words about economic conditions here in Hawaii.

II. I'll start by putting recent events in the national economy in perspective.

   A. From mid-1995 to mid-2000, the U.S. economy had a phenomenal run.

      1. Annual growth averaged a very high 4-1/2 percent rate during those years, and the inflation rate actually edged down.

      2. A key contributor to that performance was the surge in technological advances.

         a It helped boost productivity growth to an average rate of almost three percent a year during this period.

         b This upward shift in productivity growth means the economy's *potential* growth rate is higher.

         c That is, the economy has been able to expand at a faster rate for a number of years

            i. without generating inflationary pressures.

   B. Since the middle of last year, of course, the economy has slowed quite a bit—

      1. —averaging a growth rate of only about one and a half percent.

      2. Furthermore, some sectors actually are in recession—most notably, manufacturing.

3. And within manufacturing, high-tech has really been shrinking.

a I'll be returning to this point, because it's a very significant development in both the national and the local economic stories.

III. To understand where we go from here, it's useful to look at what contributed to the slowdown.

A. By the middle of 1999, real GDP growth was faster than could be sustained—even *with* optimistic estimates of productivity growth.

1. This, combined with financial market developments, indicated that inflation could become a concern.

2. So the Fed raised the funds rate gradually from mid-1999 through mid-2000 to rein in demand.

B. On top of that, some other factors also slowed demand in terms of business investment—and, as I mentioned, this was especially true for investment in high-tech equipment and software.

1. First, unexpected increases in the prices of oil, natural gas, and electricity cut into firms' budgets.

2. Second, the drop in stock prices raised firms' cost of capital.

a Part of this stock price slide may be related to a re-evaluation of the long-run profitability of many high-tech firms.

i. But, 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.

b It's just that—even with this surge—markets may have gotten carried away.

3. The third factor slowing business demand is what I'll call "the overhang problem."

a For years, there was extraordinarily strong growth in business investment in high-tech—averaging more than twenty percent a year from 1996 to 2000.

b After all that investment, many firms seem to have large stocks of capital equipment *already*.

i. So they're not in the market to buy more.

c This suggests that there may be an "overhang" of business equipment and software that spells weakness in business spending going forward.

C. Finally, let me say a word about the consumer side of the demand slowdown.

1. Typically, the three items I mentioned that have been slowing business demand—the energy surprise, the drop in stock prices, and the "overhang"—also tend to slow consumer demand.

2. But, so far, at least, while consumer spending has slowed some, it has held up remarkably well.

IV. Looking forward, I'd say the U.S. economy still has a lot going for it, and that we're likely to see an acceleration in growth by the end of the year.

A. As you know, the Fed has responded to economic weakness by cutting short-term interest rates five times since January.

1. Those cuts have brought the federal funds rate down from 6-1/2 percent in January to 4 percent today.

2. This easing will help stimulate the economy.

B. In addition, the recently passed tax cuts will probably add some strength to the economy before the year's end—

1. —and they may provide more of a boost in 2002.

C. Finally, as I mentioned before, the continuing advances in technology suggest that the economy's *potential* for growth is a good deal higher than before the late 1990s.

1. So—even though we're in a cyclical slowdown—in economists' terms, we're probably "cycling around a higher potential growth rate."

D. No doubt, the road ahead may be rocky, since there *are* some downside risks.

1. For example, if the stock market or consumer confidence slide a good deal more, households could cut back further on spending.

2. Another risk is the global nature of the slowdown.

   a When the U.S. economy slows, it tends to have a dampening effect on many other economies,

      i. and that feeds back to us through a smaller demand for our exports.

   b Moreover, some of the slowing in Asia and Europe appears to be related to economic issues specific to those countries.

      i. As I'll mention later, slowing in Asia, of course, will have an impact here in Hawaii.

E. On the national level, while these risks are important to keep in mind, it's also important to recognize that the 250-basis-point reduction in the funds rate overall represents a significant easing of policy.

1. This easing affects the economy with fairly long lags, so it may be some time before the stimulus works its way through the economy fully—

   a —perhaps through the end of this year and into next year.

2. As this stimulus unfolds, the Fed will need to keep its eye on its longer-term goal of price stability.

V. Now let me turn to the economy closer to home.

A. As I've indicated, slower growth in the U.S. economy as well as ongoing weakness in Japan pose some risks to Hawaii's economy.

B. The vulnerabilities I mentioned for the nation—the adjustments in the technology sector and the slowing in Asia—are even more significant for the state.

1. Declines in the U.S. technology sector are likely to spill over and cool growth in Hawaii's developing high-tech industries.

2. And ongoing weakness in Japan's economy will continue to restrain Eastbound visitor traffic and spending in the state.

3. Furthermore, the downturn in the stock market and the corresponding slowing in consumer spending may cut further into visitor traffic from the mainland—

a —which has shown weakness in recent months.

C. And then there's the California effect.

1. Like many states in the West, Hawaii feels the ups and downs of the California economy.

2. Although California has *not* slowed as much as the U.S. so far,

a it *is* vulnerable to greater slowing in the future,

b as adjustments in the technology sector and the energy crisis play out.

D. These risks I've mentioned already appear to be damping growth in Hawaii.

1. From January through April, employment growth averaged about half a percent at an annual rate—

a —well below the pace of growth in 1999 and 2000.

2. As a result,

a unemployment has jumped up this year,

b and consumer spending and state revenue growth have slowed.

VI. While such news is never good, Hawaii's economy currently is in a better position to weather these difficulties than at any time during the last ten years.

A. For most of the 1990s, Hawaii didn't share in the rapid expansion we saw on the mainland.

1. In fact, from 1991 to 1998, Hawaii's economy contracted by about 1 and ½ percent,

2. for a net reduction of 8,700 jobs in eight years.

B. Much of the reason for Hawaii's weakness during the 1990s had to do with factors beyond the state's borders—

1. —slow growth in Japan and the Asian financial crisis come to mind.

C. While the state's economy is still quite vulnerable to these external factors, Hawaii *has* worked to diversify its economy.

1. One area of development has been high-tech.

a During the 1990s, while many other sectors of the Hawaiian economy were contracting,

i. private sector employment in high-tech was growing, increasing twenty six percent between 1994 and 2000.

b These high-tech jobs were created in industries such as telecommunications, biotech, information processing, and research and development.

c And they produced many of the benefits we've come to expect from the technology sector, including

i. high wages and salaries,

ii. rapid wealth creation,

iii. and strong demand for educated workers and commercial real estate.

2. Most importantly, the development of a technology sector gives Hawaii an additional mechanism for economic expansion,

a and helps lessen your dependence on traditional sectors.

D. At the end of the 1990s, with the high-tech sector gaining a foothold, some of the negatives that had been holding the state's economy back started to reverse themselves.

1. The effects of the Asian crises began to wane,

2. And mainland visitor traffic returned to strong—even record-setting—levels.

E. With these positive developments, Hawaii's economy started to pick up.

1. In 1999 and 2000, payroll employment averaged more than two and a half percent growth rates,

    a producing more than 28,000 net new jobs,

    b and more than recovering from the malaise of the previous eight years.

F. As a result, the Hawaiian economy is now in a very different position from the early 1990s, when the last downturn began.

1. So, even though Hawaii is by no means immune from the risks I've mentioned,

    a and may face some rough times ahead,

2. the state's economy at least will be on a stronger footing.

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