

*Community Leaders Breakfast
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By Robert T. Parry, President, FRBSF*

Current Issues for U.S. Monetary Policy

- I. Good morning. It's a pleasure to be here in Sacramento.
 - A. Today I'd like to focus on three issues that are currently in the forefront of monetary policymaking in the U.S.
 - 1. The first issue is the extraordinary performance of the economy in the last few years.
 - 2. The second issue involves the impact on the U.S. of international developments.
 - 3. And, finally, the third issue is the recent evidence of slowing in the economy.
 - B. These three issues are, of course, closely related to one another,
 - 1. but I think it's useful to treat them one at a time.
- II. First, let me review the goods news on the extraordinary performance of our economy.
 - A. Even though growth slowed last quarter, the U.S. economy has averaged a fast pace of growth for the last few years, with strength in virtually all sectors and regions.
 - 1. One result is that for the first time in years, Congress is debating what to do about a budget surplus instead of a deficit!
 - 2. And, the unemployment rate has hovered near low levels we hadn't seen for 25 years.
 - B. Normally, a prolonged period of fast growth and very low unemployment leads to rising inflation. But, as I said, we've had good news on that front too.
 - 1. Inflation has been trending down,

2. and the July CPI showed only a 1-3/4 percent increase over the prior twelve months.

III. There are several reasons for inflation's tame behavior.

A. First, even though labor markets have been tight, *goods* markets appear to have some slack.

1. This is because manufacturing industries have expanded capacity through sizable business investment.

B. Second, we've had faster productivity growth over the last couple of years, and that has held down business costs.

1. This *may* be the payoff we've been waiting for from the rapid spread of computer and other technologies in the 1990s.

C. Finally, two temporary factors have played a role—

1. —the drop in oil import prices over the past year.
2. and the strengthening dollar over the past couple of years

D. Despite these reasons, we still face a risk that the good news on inflation could come to an end so long as labor markets remain tight.

1. Of course, this risk would be reduced if the growth of aggregate demand slowed to a more sustainable rate.

IV. This brings me to international developments, which give rise to a different set of risks—specifically, could the turmoil in world financial markets undercut the expansion in the U.S. economy?

A. Let me begin with East Asia, where the problems have been going on long enough to give us some basis for assessing the effects on our economy.

1. The sizable increase in our trade deficit shows that East Asia's problems are clearly having an effect on the U.S. economy.
2. According to the latest data for 1998, U.S. exports to East Asia fell substantially compared to last year.

3. On the import side, however, we haven't seen the flood of low-priced products from these troubled countries that many people expected.
 - a. A good part of the reason appears to be that the banking crises in many of these countries have made it hard for businesses to find the financing they need to send goods to the U.S.
 4. So far, most estimates still suggest fairly modest effects of East Asia's problems on our economy,
 - a. mainly because our trade with Asia represents only a small part of U.S. output.
 5. But we can't say with any certainty how soon the problems in East Asia will be resolved.
 - a. That will depend importantly on Japan:
 - b. The effectiveness of its policies in strengthening the economy and straightening out its financial system will be crucial to the recovery in the rest of Asia.
- B. Indeed, there's even more uncertainty with the recent turbulence in financial markets in Russia, Latin America, and some other countries.
1. These developments certainly present our economy with additional risks, which must be taken seriously.
- C. At the same time, I think it's also important to put our economic position in some perspective. So let me describe a number of factors that are cushioning the U.S. economy from some of the effects of the turbulence abroad.
1. First, we should keep in mind that our international trade exposure isn't all that great.
 - a. For example, we export only about 11 percent of our output each year.
 2. Second, the U.S. and many other countries are benefiting from lower commodity prices,
 - a. which are due in part to the fall-off in Asia's demand for commodities.

3. Third, with other economies facing so many problems, international capital is moving to the U.S. as a “safe haven,”
 - a. and our medium and long-term interest rates have fallen,
 - b. which stimulates activity here.
4. Finally, these international problems are coming at a time when spending inside the U.S. is strong, so that our economy has some room to absorb a shock from abroad.

V. This brings me to the final issue—the recent slowing in our own economy.

A. Real GDP growth in the second quarter came in at a modest 1.6 percent—the lowest rate in three years.

1. Clearly, Asia’s problems are part of the explanation.
2. Another part is the strike at General Motors—
 - a. —but that’s settled now.
3. A third part is the significant slowdown in inventory building.
 - a. This is unlikely to restrain GDP growth for long.
 - (1) It came after an extraordinary increase in the prior period,
 - (2) and businesses should be able to pare inventories to desired levels within a quarter or two.

B. But the slowing isn’t the only important story for the second quarter.

1. Perhaps more important than the temporary effects of the GM strike and the inventory correction is the behavior of U.S. consumers and businesses—
 - a. —they continued to spend at a rapid pace.

C. However, recent financial developments in the U.S. and around the world raise uncertainties about whether this strength in domestic spending will continue.

1. Falling U.S. and foreign stock markets, as well as possible effects of problems abroad on U.S. corporate profits, could restrain consumer and business spending in this country.
- D. So while we have the strong “plus” of quite robust domestic demand for consumer goods, housing and business investment,
1. we’ll have to see how big a “minus” unfolds from world events.
- VI. Now let me turn to the California economy, which also has slowed this year.
- A. Our state has substantial trade flows with East Asia, and the data so far indicate a sharp drop this year in our exports to that part of the world.
1. As a result, job growth has slowed most noticeably in the manufacturing sector,
 2. and especially for products that form the bulk of our East Asian export base.
 - a. These include wood and metal products and most types of machinery, such as high-tech items like computers and electronics.
 - b. Exporters of farm products and processed food also have taken a hit due to conditions in East Asia.
- B. These effects are most evident by region.
1. The Bay Area economy has cooled quite a bit this year.
 - a. The high-tech slowdown in Silicon Valley accounts for a significant part of the slowing.
 - (1) Weak East Asian demand has exacerbated a more general slowdown in demand that occurs periodically in this industry.
 2. Among broad regions, the Central Valley has slowed the most.
 - a. Farmers and food processors have seen yields on most fruit crops come in at levels below 1997,

- b. and they've also suffered from weak exports and low prices for products, such as grain.
 - c. Although Sacramento is not as dependent on agriculture and food processing, here too growth has fallen off substantially.
 - 3. In contrast, growth in Los Angeles has picked up further this year,
 - a. with service sectors such as transportation, financial services, and retail and wholesale trade benefiting from renewed consumer and business optimism.
 - 4. Moreover, despite more moderate growth elsewhere in the state, unemployment rates generally have stayed stable,
 - a. and construction activity and real estate sales are vigorous.
- C. Economic prospects in California remain very favorable, although the outlook is tempered somewhat by the potential for continued slowing in the national economy.

VII. Let me conclude with the observation that there are a number of important signals about our economy that bear watching, and they have conflicting implications.

- A. On the strong side,
 - 1. labor markets remain tight, and while we saw a slowdown in economic growth in the second quarter, a good deal of this was due to temporary factors that already are behind us.
 - 2. In addition, the economy has been surprising most forecasters on the strong side for several years.
- B. On the weak side,
 - 1. the Asian situation has had a negative effect on our economy, and the situation in that part of the world has deteriorated further in recent months.
 - 2. In addition, problems in other parts of the world are of concern, and it's too soon to tell how much we might be affected by them.

3. Finally, declines in equity values in the U.S., and to some extent in foreign markets, are likely to slow domestic consumer and business spending to some extent.
- C. We at the Fed will be paying close attention as these conflicting developments unfold with the aim of keeping the economy on the expansion track while maintaining low inflation.