San Francisco Bay Area Chapter of the Appraisal Institute
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Current Issues for U.S. Monetary Policy

I. Good afternoon. It's a pleasure to address the San Francisco Bay Area Chapter of the Appraisal Institute.

   A. As you all know, the Fed recently announced a one-quarter point cut in the federal funds rate.

      1. I'd like to take this opportunity to give you my perspective on that move.

      2. But first, let me give you a quick overview of conditions here in California and the Bay Area.

II. Overall, the state's performance has been pretty good.

   A. The unemployment rate has fallen slightly this year,

      1. largely because the Los Angeles are economy continues to pick up steam.

   B. In fact, it's now growing *faster* than the Bay Area!

      1. The main problem here is that the financial turmoil in East Asia is contributing to dramatically slower growth in one of our most important industries—high-tech manufacturing.

      2. This industry goes through cycles anyway,

         a. and the East Asia slowdown is playing a key role in the current industry downswing.

   C. As a result, the Bay Area economy has cooled quite a bit—

         a. —with job growth falling from over 4 percent in 1997 to about 1½ percent so far this year.

D. The housing market, of course, reflects what's going on in the economy more generally.

1. Over the last year or two, we've seen a tremendous boom.

a. This year, the median sales price for single-family homes in the Bay Area is up nearly 15 percent,

b. and other indicators of market conditions—such as the rate of sales and time to sale—show strong demand.

2. But as the are economy has slipped below its previously torrid growth path,

a. the pace of housing sales and price increases has slowed in recent months.

E. On the whole, although substantial economic strength still is evident in the state and the Bay Area, the outlook includes the possibility of additional moderation,

1. especially given recent developments in the national economy.

III. So now let me turn to conditions in the nation and the Fed's decision last week to cut the federal funds rate.

A. We were chiefly concerned with two goals:

1. First, to sustain the long expansion we've enjoyed,

2. and second, to maintain the low inflation we've achieved.

B. For several years now, we've had the best of both worlds.

1. Inflation performance has not only been good, it's actually been trending down.

a. In fact, the August CPI showed only a 1-3/4 percent increase over the prior twelve months.

b. This is due not only to the strong dollar and low world commodity prices,

c. but also to more fundamental factors, such as

(1) ample industrial capacity

(2) and faster productivity growth over the last couple of years.

2. And this good inflation performance has gone hand in hand with very fast growth.

a. We've had strength in virtually all sectors and regions of the economy

b. and an unemployment rate that has hovered near levels we hadn't seen for 25 years!

C. Not so long ago, I would have said that our biggest concern was the possibility that growth was *too* robust—

1. —that is, we couldn't sustain that pace in the long run without leading to inflationary pressures,

a. and that would have threatened the continuation of the expansion.

D. But today, it's clear that the key concern about the health of the U.S. economy has shifted to the increased degree of financial and economic risk—

1. —not only abroad,

2. but also here in the U.S.

IV. Let me begin by taking a look at the risks from abroad.

A. I'll start with East Asia, where the problems have been going on long enough to give us some basis for assessing their impact on the U.S. economy.

1. Falling currencies and stock markets as well as weak economic activity in many Asian countries have led to a sizable increase in our trade deficit with that part of the world.

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 had been expected.

a. A good part of the reason appears to be that the banking crises in a number 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 that trade problems with East Asia have had noticeable—but fairly modest—effects on our economy—

a. —mainly because our trade with Asia represents only a small part of U.S. output.

5. But we can't be sure 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. When we turn to the recent turbulence in other financial markets, such as Russia and Latin America, the uncertainties about their impacts on the U.S. are even greater.

1. But we do know that the riskiness in these countries has led investors to withdraw from them.

2. In Latin America in particular, this has led to soaring interest rates and declining currencies, as well as falling stock markets.

3. These developments cannot help but have a significant negative impact on economic growth in the region, which in turn will increase our trade deficit.

V. Now here in the U.S. we've had a taste of retrenchment on the part of investors as well.

A. Given all of the economic and financial risk in the world, investors are looking for ways to reduce their exposure to it.

1. One way they're doing it is by moving their money to U.S. Treasury securities, which are regarded as a "safe haven."

a. And, indeed, we've certainly seen interest rates on those instruments drop sharply.

2. They're also reducing their risk exposure by moving out of U.S. stock markets, which have fallen more than 10 percent since the high point in July.

3. In addition, many lenders are apparently reducing risk by withdrawing from the market.

   a. That's raising the risk premium for virtually all borrowers, and actually raising interest rates for riskier borrowers.

B. Both the stock market declines and the higher risk premiums could put a sizable damper on consumer spending and business spending.

C. So, when we combine these factors with weaker economic growth among many of our trading partners,

1. they add up to increased risk in the outlook for the U.S. economy.

2. In fact, the most likely outcome is a noticeable slowdown in real GDP growth.

VI. But before we get *too* gloomy about this situation, I think it's important to put our economic position in some perspective.

A. First, while I don't want to downplay the importance of international economic and financial problems, we should keep in mind that our international trade exposure isn't all that great.

1. In fact, we export only about 11 percent of our output each year.

B. Second, it's important to remember that, *historically*, spending in this country has not been very responsive to losses of stock market wealth.

1. While we can't be sure what will happen this time around, typical estimates suggest that each dollar of decline in stock market wealth leads to only about a three-cent reduction in real GDP in the U.S.

C. Third, these problems are coming at a time when spending inside the U.S. has been strong, so that our economy has some room to absorb a shock from abroad.

VII. With all of these issues in mind, the Fed decided to reduce interest rates.

A. This reduction should help to cushion the U.S. economy from

1. the effects of weakness among many of our trading partners

2. and the less accommodative financial conditions here at home.

B. In the current environment, a lower federal funds rate is now consistent with furthering our goals of keeping inflation low and sustaining economic growth in the U.S.

C. I'd like to close by emphasizing that although international developments are an important part of our assessment of prospects for the U.S. economy, they're not *themselves* the reason for our recent policy action.

   1. While we certainly are concerned about the deepening financial and economic problems elsewhere in the world,

   2. we believe the best way for Federal Reserve policy to contribute to the health of the world's economy is to maintain the health of U.S. economy.

   3. And that's just what we were trying to do when we cut the funds rate last week.

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