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to Business Leaders
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The Crises in East Asia and Their Impacts on the U.S. and Western Economies

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

- A. The problems in East Asia have been with us since mid-1997—
    1. —well over a year now.
    2. And the consequences for the people of those countries have been severe.
- B. Tom is going to cover the situation in Asia itself.
    1. So my focus will be on how this turmoil has affected the economy here in the West, as well as in the nation.
- C. Of course, East Asia hasn't been the only trouble spot to affect the U.S. economy.
    1. We've also seen turmoil in other foreign markets—
        - a. —Latin America and Russia, for example.
- D. Clearly, the Federal Reserve is concerned about the impacts on our financial markets and on our economic strength.
    1. As I'm sure you know, just last week, we made the third in a series of quarter-point reductions in the federal funds rate.
- E. I plan to go into these issues in some depth today.
    1. I'll start with a look at the U.S.,
    2. and then move on to conditions here in the West.

II. When we look back at the beginnings of the problems in East Asia and their impact on the U.S. economy,

A. I think it's safe to say that, if they *had* to happen, they couldn't have come at a better time for us.

B. Economic growth had been rapid for several years.

1. There was strength in virtually all sectors and regions of the economy.

2. And the unemployment rate had been declining.

C. The news that really warmed the hearts of central bankers was about inflation.

1. Even with all this growth and low unemployment, inflation was very well-behaved.

2. In fact, inflation actually was trending down.

D. So in July of last year, when Thailand's currency crisis set off a “domino effect” in East Asia, we were in a pretty good position to absorb some of the shocks.

III. But there clearly *have* been effects, and they fall into two categories—

A. —trade effects and financial effects.

B. The trade effects reflect the weakness in the economies of our trading partners—

1. —that leads to less production in the U.S. economy.

C. In terms of the financial effects, the increased risk in world financial markets spilled over to U.S. stock and bond markets as well as credit markets.

IV. Let me look at the trade effects first.

A. The U.S. has experienced a sizable increase in our trade deficit with East Asia.

1. According to the latest data for 1998, U.S. exports to East Asia fell substantially compared to last year.

2. This isn't surprising, of course.

a. The plunge in the value of their currencies, the near-collapse of their stock markets, and the jump in their interest rates have left these countries with severely weakened economic activity—

(1) —in fact, almost all are in recession,

(2) and in some cases, it's severe.

b. So they've hardly been in a position to be buying a lot of U.S.-produced goods and services!

B. But there has been an interesting development on the import side.

1. You might expect that the drop in their currencies relative to the dollar would have led to a flood of cheap imports from these countries into the U.S.

2. But that hasn't materialized.

3. It appears that a good part of the reason they're not sending us their products reflects problems in their banking sectors.

a. These banking problems have made it hard for businesses there to find the financing they need to send goods to the U.S.

C. How does the worsening trade deficit fit into the overall picture of the U.S. economy's health?

1. Well, it *is* contributing to some slowing of the economy,

a. but most estimates suggest that the contribution is fairly modest.

2. The reason for this is, I think, sometimes overlooked, so let me take a moment to emphasize it.

a. We need to remember that our international trade exposure isn't really all that great.

b. In fact, we export only about 11 percent of our output each year to the rest of the world, and only about 3-1/2 percent to East Asia.

3. So, given our somewhat limited exposure,

        a. these estimates aren't surprising.

V. Now let me turn to the story in the financial sector.

  A. The main financial spillovers on our economy date from the financial crisis in Russia in August.

    1. As you may remember, Russia couldn't to meet its foreign debt obligations, even though it had help from the IMF.

    2. And that seemed to make investors around the world much more sensitive to risk—

        a. —indeed, there was a general withdrawal from risk worldwide.

    3. One consequence of this sensitivity to risk was felt in Latin America.

        a. A number of countries there saw their interest rates soar, their currencies fall, and their stock markets plummet.

        b. These developments threatened to be a drag on their economies,

        c. And that's a concern to the U.S.

            (1) Since we have substantial trade with Latin America,

            (2) weakness in those economies could increase our trade deficit.

  B. The consequences of the skittish investors worldwide was felt in U.S. markets as well.

    1. There was a greater demand for U.S. Treasury securities, which are regarded as a “safe haven.”

        a. And that made interest rates on those instruments drop sharply.

    2. Some investors also reduced their risk exposure by pulling back from U.S. stock markets,

        a. which fell sharply below their high points in July.

3. In addition, many lenders apparently reduced their risk by withdrawing from the market.

   a. That raised the risk premium for virtually all borrowers in the private sector,

   b. and it actually raised interest rates for riskier borrowers.

C. By the time the Fed first cut interest rates in late September, all of these developments—both in the trade area and the financial area—made it apparent that there was increased risk in the U.S. outlook.

   1. On top of weaker economic growth among many of our trading partners,

   2. stock market declines and higher risk premiums threatened to put a damper on consumer and business spending.

VI. Since then, as I said, the Fed decided to cut interest rates two more times—once in mid-October and again last week. So today, the funds rate stands at 4-3/4 percent.

A. These actions were designed to help sustain the U.S. economic expansion in the face of

   1. weakness among many of our trading partners

   2. and less accommodative financial conditions here at home.

B. Over the last couple of months, we *have* seen things settle down a bit.

   1. In East Asia, the picture is getting a little more optimistic, as financial conditions have improved.

      a. Most equity markets and exchange rates have moved up, while interest rates have come down.

      b. Although these important variables aren't close to their pre-crisis levels yet, at least they've been moving in a positive direction.

      c. And perhaps the best news for East Asia has been a sense that Japan is making some progress on addressing its problems.

         (1) Now, I know Tom will have a lot to say about that.

(2) But I want to emphasize that Japan's situation is a critical piece of the solution to getting the rest of East Asia back on its feet.

2. As for the problems in Latin America,

   a. the U.S., the IMF, and other international agencies have worked out a program to help Brazil deal with its economic problems,

   b. and that's eased concern about that region in general.

C. These international developments, combined with the cuts in the funds rate, have had a positive effect on world and U.S. financial markets since mid-October.

1. Our stock markets have actually regained most of their losses dating from last July.

2. Furthermore, it looks as if investors' tolerance for risk has moved back toward more normal levels—though it's not what it was *before* the Russian crisis.

   a. Risk spreads have narrowed a bit,

   b. and U.S. Treasury rates have risen as safe-haven demands have ebbed.

D. What's the outlook then for the overall economy?

1. One thing we’ve accomplished with the recent rate cuts is to bring a better balance between the upside and downside risks to the economy.

   a. Of course, the downside risks are the international problems and the fragility in financial markets.

   b. The upside risk is that the economy may grow faster than we expect—as, indeed, it has for about three years.

      (1) And if the pace of growth becomes unsustainably fast, then we could face accelerating inflation.

2. So I'd say the most likely outcome is that we’ll see continued expansion, though probably not at the rapid rates we’ve seen in recent years.

3. Furthermore, the outlook for inflation appears good.

   a. For example, the October CPI showed only a 1-1/2 percent increase over the prior twelve months.

   b. This is due not only to

      (1) the strong dollar

      (2) 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.

E. So, all in all, though we've been in some pretty choppy waters in the last year, I think we're still on course for continued growth.

VII. Now let me turn to conditions here in the West.

A. Overall, the western economy has been pretty healthy this year, although signs of slowing are clearly evident.

B. The slowing is attributable largely to the effects of the financial turmoil in East Asia.

1. States like California, Washington, and Oregon have substantial trade flows with that region—

   a. —and the data so far indicate a sharp drop this year in their merchandise exports to that part of the world.

2. As a result, manufacturing job growth has slowed substantially,

   a. especially for products that form the bulk of our East Asian export base.

      (1) These include wood and metal products and most types of machinery, such as high-tech items like computers and electronics.

(2) Exporters of farm products and processed food also have taken a hit due to conditions in East Asia.

C. These effects vary somewhat across states and regions in our District.

1. On my home turf, the San Francisco Bay Area, the economy has cooled quite a bit—

a. —in no small part because of the slowdown in Silicon Valley's semiconductor manufacturing sector.

(1) Weak East Asian demand has exacerbated a more general slowdown in demand that occurs periodically in this industry.

2. The Los Angeles area, in contrast, has maintained a strong pace of growth so far this year.

a. Although some L.A. sectors have been hit by East Asia's problems,

(1) strength in service sectors—such as transportation, financial services, and retail and wholesale trade—is outweighing the negative effects.

3. Arizona also has maintained rapid growth this year,

a. with a pickup in construction activity largely offsetting the slowdown in their manufacturing sector.

4. Conditions are even better here in Nevada, which has only limited exposure to the problems in East Asia and in the high-tech manufacturing sector.

a. Employment growth in the state has picked up noticeably this year,

b. and it's been spurred in recent months by renewed vigor in the Las Vegas hotel and gaming sector.

(1) This sector actually lost jobs early in the year.

(2) But stronger gaming revenues in the second quarter,

(3) combined with new casino construction and a recent “splashy” opening, are keeping the Las Vegas economy bustling for now.

c. The state does face some challenges.

(1) The mining industry has been hit by low gold prices, causing weak economic conditions in some rural counties.

(2) And Las Vegas must find ways to fill the large number of new hotel rooms under construction or planned.

D. More broadly, although our regional economy remains vigorous for now,

1. the outlook is tempered somewhat by the potential for some slowing in the national economy.

VIII. In concluding my portion of this presentation, let me just turn again to the Fed's recent actions.

A. I think it's important to emphasize 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 actions.

1. While we certainly are concerned about the 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 recently cut the funds rate.