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Economic Prospects for the New Year

I. Good morning. It's a pleasure to be here with you to talk about economic prospects for the new year.

- A. As you know, the U.S. economy is starting 1999 with tremendous momentum.
    1. The performance in the last quarter of 1998 was truly remarkable—
        - a. —real GDP growth came in at over 6 percent,
        - b. the CPI rose at a rate less than 2 percent,
        - c. and unemployment was below 4 and a half percent!
    2. It's even more remarkable that 1998 was the third year in a row in which the economy's strength, combined with low inflation, far outstripped expectations.
- B. What's going on?
    1. Well, it's too soon to know for sure, but evidence seems to be building that we're in a sustained productivity surge—
        - a. —one that could well be related to the growth and spread of high technology.
        - b. And a sustained productivity surge would be a great thing—it would mean
            - (1) faster economic expansion,
            - (2) lower unemployment,
            - (3) growing real wages,

(4) *and* low inflation.

C. At the same time, though, the global economic environment is far from rosy.

1. If the economic performance of our trading partners deteriorates further, our own economy faces risks—

a. —not only in terms of our trade performance,

b. but also in terms of the stability of international financial markets.

D. In my remarks today, I'll examine these issues in some detail.

II. But first, let me touch briefly on economic conditions closer to home.

A. California's economic expansion slowed somewhat last year from the fast pace of 1997.

1. And the Bay Area—especially around San Jose—saw noticeable slowing, largely because the troubles in East Asia reduced demand for high-tech equipment.

B. But the state's performance in 1998 was still pretty impressive,

1. with 350,000 new jobs created last year.

2. That adds up to somewhat faster job creation than the national average.

C. In contrast to the Bay Area, the Los Angeles area economy has maintained the momentum of the powerful expansion established in 1997.

1. Growth in the counties surrounding Los Angeles has been especially rapid, including Riverside/San Bernardino.

a. The job count at firms in these two counties rose by 5.2 percent in 1998, twice the pace of the state as a whole.

b. Your area appears to be realizing its potential as an industrial center. Job growth has been rapid

(1) in the manufacturing sector,

(2) in the business services sector,

(3) and in sectors that support industrial expansion, such as transportation services.

c. So it’s no surprise that the construction trade is booming locally.

(1) Although I know the panel will talk about real estate in more detail, I’ll preview their discussion by pointing out that employment at area construction firms grew by 30 percent, or about 14,000 jobs during the past two years.

(2) And data on construction permits indicate that 1998 was a very strong year for both residential and nonresidential building plans in this area.

III. Now let me turn to the national economic scene. I'll start by sketching in the international picture and its implications for our own economy.

A. In the rest of the world, real GDP grew just half a percent last year. That reflects

1. moderate growth in Europe and Canada,

2. a sluggish performance in Latin America,

3. and outright recessions in Japan and some other parts of Asia.

B. Certainly, the troubles abroad had an impact on our economy last year, especially the turmoil in East Asia.

1. One of the main blows was to our trade deficit.

a. But for a couple of reasons the slowing effect was only modest.

(1) First, our nation’s trade exposure isn’t all that great,

(a) so even though exports to East Asia fell off substantially, the effect on our economy wasn’t too serious.

(2) Second, we didn’t get the flood of cheaper imports we expected to see from countries that devalued their currencies.

(a) It appears that a good part of the reason is related to problems in their banking sectors.

(b) In other words, it's been hard for Asian businesses to find the financing they need to send goods to the U.S.

2. Another blow from the turmoil abroad hit our financial sector.

   a. A lot of investors grew anxious about their risk exposure, not just in the troubled countries, but in the U.S. as well.

   b. Some investors withdrew from U.S. stock markets, as we saw when equity values took a dive last August and September.

   c. And many lenders reduced their risk by withdrawing from private debt markets as well.

      (1) This raised the risk premium for virtually all borrowers in the private sector,

      (2) and actually raised interest rates for riskier borrowers.

3. By the time the Fed first cut interest rates in late September, these trade and financial developments made it clear there was increased risk in the U.S. outlook.

   a. Since then, of course, the Fed cut interest rates two more times, so today the funds rate stands at 4-3/4 percent.

C. This stimulus—combined with some positive developments abroad—has led to things settling down a bit since the summer.

1. For example, in East Asia, the picture is somewhat more optimistic.

   a. Most equity markets and exchange rates have moved up a bit, while interest rates have fallen below levels at the height of the crisis.

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

2. Here in the U.S., our stock markets actually regained their losses and beat their July averages.

3. Furthermore, it looks as if investors' tolerance for risk has moved back toward more normal levels, although risk spreads remain elevated.

IV. When we turn to the outlook for 1999,

A. uncertainties about the international situation continue to loom.

1. International financial markets remain fragile,

2. and the problems of many troubled economies are by no means solved.

a. While Asia seems to be improving, that region isn't out of the woods yet.

b. Furthermore, things have deteriorated in Brazil,

(1) and this threatens other parts of Latin America, including the two major economies of Argentina and Mexico.

c. Many analysts forecast a recession in Latin America in 1999,

(1) and if it *does* occur, it would have negative effects on our trade balance,

(2) and also pose a threat to global financial markets.

V. Now let me turn to the positive side of the outlook.

A. As I said at the beginning of my remarks, the U.S. economy's recent performance has been *remarkable.* In fact,

1. it has outstripped most forecasters’ expectations for growth for the past three years,

2. it has delivered inflation *below* expectations,

3. and it has produced the lowest unemployment rate in 25 years!

B. In keeping with this remarkable performance, productivity also has been growing at a faster pace.

1. Over the last three years, growth in productivity in the non-farm sector averaged about double the pace of the long-run trend of the last decade or so.

C. The key question is

1. whether this productivity surge is just temporary, and due to the strong business cycle upswing we're in—

    a. —in that case, continued strong growth and low unemployment would create pressures for inflation to increase.

2. But it's also possible that something more fundamental and sustained is going on.

3. While it's too soon to say for sure whether the productivity surge is temporary or permanent, two pieces of evidence *do* seem to point to a fundamental shift in productivity—

    a. —most likely related to the development and use of computers, software, and other technological advances.

    b. And both pieces of evidence have to do with expectations about the future.

D. One piece of evidence is the phenomenal pace of consumer spending.

1. In 1998, it rose 5-1/4 percent, and it contributed substantially to the 4-1/4 percent rise in overall GDP.

2. Research suggests that, for many consumers, the decision about how much to spend today is influenced by how much income they expect to have in the future.

3. So the strong pace of consumer spending may reflect their expectations that their incomes will be higher in the future.

4. And consumers would base these expectations on what they know about their own individual industries and their own potential incomes.

    a. If they see good times ahead for their firms and for their incomes, perhaps because of enhanced productivity, they'll be willing to increase their spending now.

E. The second piece of evidence is the stock market, which also is based on expectations.

1. That is, part of the stock market boom could reflect expectations of rapid growth in the economy and profits,

a. which in turn could be linked to continued rapid productivity growth.

2. Of course, the stock market and consumer spending also interact, since increases in stock market wealth have led directly to higher consumer spending.

VI. Faster productivity growth also is contributing to the excellent inflation performance of recent years.

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

B. And investment in technology also may help explain why we have ample industrial capacity today.

C. Of course, some temporary factors—such as lower prices for oil and other commodities—also have held inflation down.

D. These factors have been strong enough to hold inflation at low levels despite apparently tight labor markets.

VII. What do these factors suggest for 1999?

A. Answering this question requires doing a complex balancing act.

1. We have to balance

a. issues of whether the productivity surge is temporary or more lasting

b. against the risks from abroad.

2. Overall, we expect a modest slowdown from the very rapid rates of last year—in the range of 2 and a half to 3 percent—with continued low inflation.

B. But, frankly, after three years of underestimating the U.S. economy's ability to grow, it wouldn't surprise me to see it exceed expectations for a fourth year—

1. —especially if the world economic situation holds steady or improves.

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