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Global Financial Crises and the U.S. Economy: A Monetary Policymaker's Perspective

I. Good morning.

A. For almost two years now, we've seen currency crises flare up in various parts of the world—

1. —first in East Asia,

2. then in Russia,

3. and most recently in Brazil.

B. In their wake have come

1. hard times for those economies,

2. and hard questions—about

a. why these crises erupted,

b. whether they'll spread,

c. and how best to plan for recovery.

C. But as a U.S. monetary policymaker, the question that most concerns me is: "How do these crises affect the U.S. economy?"

1. Even though international developments are important in the Federal Reserve's assessments of the U.S. economy's prospects,

a. they're not *themselves* the reason we take policy actions.

b. Our *prime* concern is the U.S. economy.

2. In fact, the best way for U.S. monetary policy to contribute to the health of the world's economy is to maintain the health of our nation's economy.

II. Of course, as President of the San Francisco Fed, I'm also concerned with how these international developments have affected this District. So let me spend a few moments on California economy.

A. California exports nearly twice as much of its merchandise output to East Asia as the nation does.

B. As a result, East Asia's problems have hit the state's manufacturers hard, especially the high-tech producers.

1. You've seen it here in San Diego among producers of electrical equipment and industrial machinery, such as computers.

2. And the San Jose area has *really* felt it—

a. —jobs grew by 1 percent in 1998,

b. compared to over 5 percent on average in 1996 and 1997,

c. and recent sluggishness has continued into the early part of 1999.

C. Despite the slump in the manufacturing sector, California's economy continued its powerful expansion last year.

1. Employment grew by 3.3 percent in both 1997 and 1998.

2. Last year, this pace exceeded the national growth rate by a full percentage point,

a. and it represents the creation of 450 thousand new jobs in the state.

D. Here in San Diego, employment growth slowed somewhat in 1998 but remained strong.

1. That has caused the unemployment rate to fall a bit farther here, and it's now hovering around 3½%.

2. And while your trade ties to East Asia have been a source of weakness,

a. trade ties to Mexico have probably been a source of strength.

b. California's exports to Mexico are now nearly as large as they are to Japan,

c. and they continued to grow in 1998.

III. Now let me turn to the impact of the global financial crises on the U.S. economy. I'll begin by sketching in the international picture and some of the effects we've seen in the past year or so.

A. Outside the U.S., 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 most other parts of Asia.

B. The troubles abroad—especially the turmoil in East Asia—had two impacts on our economy last year.

1. One impact was on trade.

a. But trade effects actually slowed the economy less than expected for a couple of reasons.

(1) First, our nation's overall trade exposure isn't all that great,
(a) so even though exports to East Asia fell off substantially, the effect on our economy in the aggregate wasn't too serious.

(2) Second, we didn't get the flood of cheaper imports we expected 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. The second impact from the turmoil abroad was on our financial sector.

a. A lot of investors and lenders got pretty anxious about their risk exposure—

(1) —not just in the troubled countries,

(2) but in the U.S. as well.

b. Some investors withdrew from U.S. stock markets,

(1) and that sent equity values into a nosedive last August and September.

c. In addition, many lenders reduced their risk by withdrawing from private debt markets.

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

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

3. By fall, these trade and financial developments made it clear there was increased risk in the U.S. outlook,

a. and that's when the Fed responded with a series of interest rate cuts.

C. That stimulus—combined with some positive developments abroad—has led to things settling down.

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

a. Korea's economy actually moved out of recession in the last half of the year.

b. Perhaps the most important news has been a sense that Japan is making at least some progress on addressing its problems.

2. Here in the U.S.,

a. our stock markets have regained their losses and beat their July averages.

b. 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. we still face uncertainties about the international situation.

1. International financial markets remain fragile.

2. And though Asia seems to be improving, that region isn't out of the woods yet.

a. For example, many forecasters expect 1999 to be another year of economic contraction in Japan.

3. Furthermore, Brazil has been in a major recession since the middle of 1998,

a. and it's likely the recession will continue in 1999.

B. But the *domestic* side of the outlook presents quite a contrast.

1. The U.S. economy has turned in a phenomenally strong performance recently. In fact,

a. it has outstripped most forecasters' expectations for growth for the past three years,

b. it has delivered inflation *below* expectations,

c. and it has produced the lowest unemployment rate in 29 years!

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

a. 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. Understanding why productivity growth has strengthened is at the heart of many of our discussions on monetary policy.

1. One possibility is that 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 another possibility is that something more fundamental and sustained is going on.

V. While it's too soon to say for sure whether the productivity surge is temporary or permanent,

A. two pieces of evidence *do* seem to point to a fundamental shift in productivity—

    1. —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.

C. One piece of evidence is the phenomenal pace of consumer spending—5-1/4 percent last year!

    1. Research suggests that this reflects expectations because many consumers take the long view when they make spending decisions.

        a. In other words, how much they spend today depends on how much income they expect to have in the future.

    2. What makes these expectations believable is that they're based on individual consumers' personal knowledge—

        a. —knowledge about the specific industries they're in

        b. and about their own potential incomes.

    3. So the strong pace of consumer spending may reflect people's expectations that good times are ahead for their firms and for their incomes,

        a. perhaps because of enhanced productivity.

D. 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. Along with a robust economy, we've had low inflation in recent years.

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

B. Faster growth in productivity has contributed to this excellent inflation performance.

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

D. Of course, some temporary factors also have been at work.

1. Weak international demand—especially from Asia—has

    a. reduced capacity utilization rates in U.S. manufacturing,

    b. and put downward pressure on oil and other commodity prices.

E. These temporary and longer-lasting factors have been strong enough to hold inflation at low levels despite apparently tight labor markets.

F. Of course, the price of oil *has* risen recently in response to OPEC's efforts to limit supply.

1. But it's still well below the levels of a couple of years ago.

2. It remains to be seen how large and how long-lasting this effect will turn out to be.

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.

B. Overall we're expecting to see a modest slowdown—

1. —with growth in the range of 2 and a half to 3 percent—

2. and with continued low inflation.

3. Partial data for the first quarter seem to be consistent with this.

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

    a. —especially if the world economic situation continues to improve.

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