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The Asia Crises and the U.S. Economy:
A Monetary Policymaker's Perspective

I. Good afternoon.

  A. It has been almost two years now since currency crises flared up in East Asia.

    1. And during this time, we've also seen currency crises hit Russia and, more recently, Brazil.

  B. In the wake of these crises have come

    1. hard times for those economies,

    2. *and* hard questions:

      a. Why did these crises erupt?

      b. Will they spread further?

      c. How can we best 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 the local economy.

A. So let me begin with a few comments on California, which, as you know, is one of the states most affected by the East Asian slowdown.

B. Compared to the rest of the nation, California exports nearly twice as much of its merchandise output to East Asia—

  1. —and in 1998 the state's exports to East Asia fell by about one-fifth.

  2. Since most of these exports are high-tech equipment, the Bay Area, which specializes in these products, felt the largest impact.

    a. Durable goods producers in this area lost 12,000 jobs since the peak from last April,

      (1) and the effects spilled over to other sectors as well.

C. The impact on total job growth has been most severe in the San Jose area—

    a. —jobs grew by 1 percent in 1998,

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

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

D. Growth in other Bay Area cities, such as San Francisco and Oakland, also slowed in 1998,

  1. but by far less than it did in San Jose.

E. In fact, on net, Bay Area employment growth has remained pretty healthy—

  1. —as of March this year, Bay Area employment was 2.4 percent above its level from a year earlier.

  2. Moreover, the Bay Area unemployment rate has remained stable and extremely low during the East Asian crisis,

    a. hovering just below 3½ percent in recent months.

  3. And with area home prices appreciating at a double-digit pace over the past year,

a. you’d have a heck of a time convincing local home buyers that there’s been any economic slowdown at all!

F. So, as East Asia recovers, the Bay Area's prospects remain favorable in 1999.

III. Now let me turn to the impact of the financial crises in East Asia and elsewhere on the U.S. economy.

A. Last year, world real GDP—outside the U.S.—grew just half a percent. 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—affected economic activity in the U.S. mainly through two channels last year—trade and the financial sector.

1. But, fortunately, a number of factors served to cushion us from the worst effects.

2. For example, trade effects slowed the economy less than expected for a couple of reasons.

a. First, our nation’s overall trade exposure isn’t all that great,

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

b. Second, we didn’t get the flood of cheaper imports we expected from countries that devalued their currencies.

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

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

3. And in the financial sector, we were cushioned in part by a "flight to safety."

    a. With other economies facing so many problems, international capital moved to the U.S. as a “safe haven.”

    b. That drove down some of our medium and long-term interest rates,

        (1) including those on home mortgages and highly rated corporate debt.

    c. And those interest rate declines stimulated economic activity here.

4. All the same, there *were* some serious negative effects in the financial sector.

    a. The "flight to safety" meant that a lot of investors and lenders were reducing 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 riskier 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.

5. By fall, the fragility of the financial sector, the continuing problems in East Asia, and the worsening problems in Russia and Brazil all 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 are now well above 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.

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

1. The U.S. economy's performance has been nothing short of phenomenal, with

a. very fast growth,

b. low inflation,

c. and 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 won't last very long, because it's just 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.

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

   1. some evidence *does* seem to point to a fundamental shift in productivity—

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

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

A. For example, the March CPI showed only a 1-3/4 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 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.

VI. 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 of around 3 percent—

2. and with continued low inflation.

C. 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—

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