Luncheon Address to Commercial Real Estate Women (CREW)
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A Look at the Local and National Economies

I. Good afternoon. It's a pleasure to be here to talk to you about the economic outlook.

   A. I'd like to start by looking at the local economy briefly.

   B. Then I'll spend some time on the Fed's latest monetary policy announcement.

      1. As you know, in June the FOMC

         a. raised short-term interest rates a quarter point

         b. and at the same time indicated a "neutral" stance going forward.

      2. I'd like to take this opportunity to explain my own thinking about this move.

II. But, as I said, first the local economy.

   A. The Bay Area is the nation's leading region for high-tech development and production, and we've recorded a remarkable economic performance in recent years.

   B. From 1995 to 1997, employment grew nearly 4 percent per year—

      1. —that amounts to 335,000 new jobs!

   C. This expansion was powered by nearly double-digit job growth rates in high-tech sectors,

      1. such as computer and semiconductor manufacturing and software design,

      2. and growth was strong in all major private industry sectors.

   D. But the challenge posed by the East Asian situation in late 1997 and 1998 was especially severe in our area.

1. Exporting sectors have been critical to the success of the state and Bay Area economies,

    a. and East Asia is our most important export destination.

    b. Our merchandise exports are largely high-tech equipment, along with related durable manufactured products.

E. In 1998, these exports fell substantially.

1. As a result, the Bay Area has lost 14,000 durable manufacturing jobs since the peak from April 1998,

    a. with Silicon Valley bearing the brunt of the losses.

F. Despite the manufacturing slowdown, the Bay Area's prospects are very good.

1. Job creation remains solid overall,

    a. with high-value sectors—such as software—continuing to create substantial wealth.

2. And the area unemployment rate, which was largely stable in 1998, has actually fallen a bit this year—

    a. —from 3½ percent at the end of 1998 to about 3 percent now.

G. Not surprisingly, activity in local real estate markets has mirrored these broader developments.

1. The value of private nonresidential building permits in the Bay Area doubled between 1995 and 1998,

    a. from $2.4 billion to about $4.8 billion.

2. Most of the growth occurred in 1996 and 1997, however—

    a. —and plans are down for the first half of 1999 compared to the same period last year.

3. I should note, however, that the decline this year is due mostly to office and industrial buildings in Silicon Valley.

    a. And with the economic resurgence in East Asia, that situation may reverse itself.

4. Finally, although the number of new home permits also has declined a bit in the Bay Area this year,

    a. the latest price figures indicate double-digit rates of appreciation,

    b. so you'd have a heck of a time convincing local home buyers that the Bay Area economy has slowed at all!

III. Now let me turn to the national picture and to our last monetary policy action.

A. I'll start with a little background:

1. For more than three years, the U.S. economy has delivered a remarkable performance:

    a. Real GDP has grown at a phenomenal pace—

        i. —averaging just under four percent a year.

    b. The unemployment rate has hovered around its lowest levels in decades.

    c. And inflation has also remained remarkably low, no matter how you measure it—

        i. —between one and a half and two and a half percent.

    d. We've been concerned for some time about whether such sustained fast growth, tight labor markets, and low inflation can co-exist much longer.

2. In fact, we expected to see some slowing last year,

    a. because the financial crises in East Asia and Latin America had led to a swelling U.S. trade deficit.

3. And last fall, the picture really *did* darken, as the crises spread to U.S. financial markets.

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

        i. and many lenders withdrew from riskier private debt markets.

    b. At that time, East Asian countries still were in recession,

        i. and the problems in Russia and Brazil were worsening.

4. These troubling developments raised the possibility that we might face a *dramatic* slowdown.

    a. So the Fed responded with a series of interest rate cuts—

        i. —totaling three-quarters of a percentage point.

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

1. On the international front,

    a. Korea's economy actually moved out of recession in the last half of 1998.

    b. Japan has been making progress on addressing its problems.

    c. And the Brazilian economy is improving.

2. Here in the U.S., concerns about risk abated.

    a. Our stock market is up.

    b. And lenders' tolerance for risk has moved back toward more normal levels.

IV. Throughout this period, the Fed has been keeping a close watch on demand—both here in the U.S. and abroad—because it is key to the outlook for inflation.

A. Demand was strong enough in the U.S. to make real GDP grow at a very rapid pace, even though the global financial crises put a drag on our economy—

1. —in fact, it averaged a robust 4.3 percent in 1998 and in the first quarter of this year.

2. And though the pace of growth slowed noticeably last quarter—

a. —to 2.3 percent—

b. —it was *not* because of weaker domestic demand.

3. Rather, a good part of the slowing was due to a decline in inventory investment,

a. which may have only a temporary effect.

B. Of course, foreign demand was weak last year—due to the global financial crises—and it helped keep U.S. inflation in check.

1. Commodity prices fell worldwide,

2. and capacity utilization rates in U.S. manufacturing dropped somewhat.

C. But, with improved prospects for recovery abroad, we can't expect this to help as much on the inflation front going forward.

1. The capacity utilization rate in manufacturing has leveled off this year, after falling throughout 1998,

a. and commodity prices are rising.

2. In addition, oil prices are rising due to reduced supply from OPEC.

D. In other words, when we combine strong domestic demand with a pickup in demand from recovering economies abroad, the risk of inflationary pressures begins to build.

1. The capacity of the U.S. economy to produce enough to satisfy that demand could become strained.

2. Furthermore, with the unemployment rate hovering around 4-1/4 to 4-1/2 percent for the past year and a half,

a. labor markets are tight.

V. One factor that *could* keep inflation in check is a continuation of the fast productivity growth we've enjoyed.

A. Over the last two years, growth in productivity in the non-farm sector averaged about two and a half times the pace of the long-run trend of the last decade or so.

1. With sustained strength in productivity growth, the economy can enjoy

a. faster growth,

b. lower unemployment,

c. growing real wages,

d. *and* low inflation.

B. But there are uncertainties about this fast productivity growth.

1. We don't know for sure whether it's temporary or more permanent.

2. For example, it's possible that the productivity pickup won't last very long, because it might just be due to the strong business cycle upswing we've been in.

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

3. On the other side, some evidence *does* seem to point to the possibility of a fundamental shift in productivity.

a. For example,

i. strong U.S. consumption spending may indicate that the public is confident the economy will continue to expand.

ii. And so may some of the strength of the stock market.

b. If, indeed, there is such a fundamental shift in productivity, it's most likely related to the development and use of computers, software, and other high-tech advances.

C. But it's important to note that even if the faster productivity growth *is* permanent, we still have to be cautious.

1. Productivity growth may not be fast enough to keep inflationary pressures down in the face of rapidly expanding demand.

VI. These, then, are the main issues the Fed will be concerned with in the coming months.

A. There are risks for future U.S. inflation, given the improved prospects abroad, continued rapid growth in domestic demand, and tight labor markets.

B. And though more rapid productivity growth tends to mitigate these risks,

1. we can't be certain if it will be sustained,

2. or if it will be enough.

3. So far, at least, the inflation news has been favorable.

a. It’s true that some indicators of labor costs *did* jump up recently.

b. But, it's too soon to tell if this amounts to

i. just a wiggle in the data that will disappear soon

ii. or the beginning of a new trend.

C. We'll be monitoring these issues carefully as events unfold,

1. and we'll be especially alert to developments that indicate the emergence of increased inflation or inflationary risks for the future.

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