

Community Leaders
Tacoma
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THE ECONOMY OF THE U.S. AND THE PACIFIC NORTHWEST

- I. Good afternoon.
- A. As you know, since the beginning of the year, the Fed has raised short-term interest rates four times--for a total increase of 1 ¼ percentage points.
1. Not surprisingly, some of the reaction to these moves has been pretty negative.
- a. Two of the strongest reactions have focused on the timing.
- b. The first complaint is, "Why is the Fed raising rates when states like California and Hawaii are still in the doldrums?"
- c. The second is, "Why raise short-term rates now when there's little sign of inflation heating up?"
- B. In my remarks today, I'll try to address these questions and explain the rationales for the short-term interest rate hikes.
- II. Let me start with a little background.
- A. After the recession, the national economy didn't boom as it so often has. Instead, the recovery was pretty sluggish.
1. The Fed did its part to keep things going by lowering short-term interest rates *substantially*.
- a. By the end of last year, short-term rates were about a third of what they were in early 1989.
- b. In fact, *real* short-term rates--that is, adjusted for inflation--were around zero levels throughout the year.
- B. These low short-term rates stimulated rapid growth in the interest-sensitive sectors of the economy--consumer durables, housing, and business investment.

1. And they led to average growth rates of anywhere from 3 to 3¾ percent for '92, '93, and the first half of '94.
- C. This growth has brought us to the point where a good deal of the excess capacity that built up during the 1990 recession has evaporated:
1. Both the unemployment rate and the rate of unused industrial capacity have fallen rather sharply over the past year and a half--
 2. --within range of levels that most economists think represent "full" utilization.
- D. These circumstances suggest that continuing to stimulate the economy with such low short-term rates would lead to higher inflation.
- E. Now, as I said at the beginning, not everyone agrees that it was the right *time* to reduce the monetary stimulus.
- III. So let me address the first question: Shouldn't the Fed *keep* stimulating the economy until the weaker regions gain more strength? Doesn't the Fed care about regional performance?
- A. Part of the answer is that the Fed places *great* importance on understanding economic conditions in the various regions of the country.
1. In this Federal Reserve District--the largest both in terms of geography and population--we have five offices--
 - a. --our headquarters in San Francisco, and four branches, including one just up the road in Seattle--
 - b. each with its own set of directors.
 2. We rely on the directors to give us a good *regional* perspective on economic conditions, which is often quite different from what we hear from Wall Street or Washington, D.C.
 3. For example, back in the fall of 1987, a lot of people thought the stock market crash would reverberate throughout the country, and signal a major downturn.
 4. But our directors told us it simply wasn't having that big an effect on their business or geographic areas.

- a. And they were right.
 - b. The economy didn't come to a screeching halt.
- B. In addition to providing assessments of the region's performance, the Directors also vote on the discount rate recommendation, which is then forwarded to the Board of Governors in Washington.
- C. Finally, the Research staff at each Bank uses the Directors' input--as well as survey responses from local people and regional data--to prepare a report on regional conditions for the meetings of the FOMC, the Fed's monetary policymaking body.
 - 1. Here in the Twelfth District, these reports cover a lot of territory--literally and figuratively--and a wide variety of economic performance.
 - a. Right now, we have the nation's three fastest growing states--Utah, Nevada, and Idaho---as well as its two poorest performers--Hawaii and California.
 - 2. Washington isn't at either extreme, but it *is* lagging the nation.
 - a. During the past year, payroll employment in Washington grew at less than a 2 percent rate, almost a full percentage point behind the nation's growth rate.
 - 3. Much of the weakness in the state's economy is right here in the Puget Sound area, and it's largely due to Boeing.
 - a. Manufacturing employment in this area is down more than 5 percent from a year ago,
 - b. and the pace of job growth in other sectors ranges from negative to modestly positive.
 - 4. But it looks like the worst is nearly over.
 - a. With the Boeing layoffs nearly complete, the pace of growth should pick up here in the Puget Sound area.
 - b. And that bodes well for the state of Washington, since the rest of the state is doing very well.

- (1) In fact, on a statewide basis, manufacturing employment would have *grown* during the past year if the aircraft sector hadn't lost any jobs.¹
 - (2) And most measures of statewide construction activity show very strong growth during the past year.²
- D. This kind of regional information plays an important role in determining the course of monetary policy.
- 1. In fact, it's the subject of a good portion of each FOMC meeting.
 - 2. And we use it to fit together a picture of how the whole economy is doing.
- IV. And that's where the Fed's emphasis *has* to be--on the nation as a whole. The Fed *can't* conduct monetary policy based mainly on helping out a particular state or region.
- A. The reason is simple: monetary policy works through *national* credit markets.
- 1. And, in the U.S., credit markets are very efficient,
 - a. processing transactions from coast to coast in no more than a split second.
 - 2. Therefore, monetary policy affects the economy *as a whole*.
 - 3. That's why it's sometimes called a "blunt" instrument.
- B. Above and beyond the practical difficulties, there's also a real danger in focusing too much on any one region of the economy that's having a hard time.
- 1. Often enough, *some* state or region is going through a recession of its own while the national economy is humming along.

¹ This does not include any "multiplier" effects.

²

Construction employment	6/93 to 6/94	+7.5%
Housing permits (3-mo. moving average)	5/93 to 5/94	+9.5%
Nonres construction awards (3-mo. average)	5/93 to 5/94	+23.4%

- a. It's simple arithmetic. If the nation is growing at, say, 3 percent, then some states are growing faster, and some are growing slower.
 - 2. If the Fed stimulated whenever *any* state had economic hard times, we'd be stimulating almost *all* the time.
 - 3. And the upshot of that would be a very pro-inflationary environment,
 - a. and ultimately a deteriorating economy as well.
- V. Now let me turn to the second reason some people think the Fed should have maintained a stimulative policy: Inflation just doesn't seem to be a problem now.
- A. The trouble with this view is that monetary policy is not only "blunt," as I've already mentioned, but it's also subject to "delayed reactions":
 - 1. It takes a long time for a policy action to produce results against inflation--probably from 1½ to 2 years.
 - 2. This kind of time lag means that we can't wait until the problems show up in the data--
 - a. --by then we're likely to be too late.
 - 3. Instead, we have to *anticipate* problems, and pay attention to the warning signs.
 - B. The current situation is a good example. It's true that we haven't seen an acceleration recently in the important inflation statistics, like the consumer price index.
 - 1. In fact, recent inflation news has been favorable.
 - C. But for a couple of reasons, some action was warranted to prevent an increase in future inflation.
 - 1. First, short-term real interest rates were near zero from late 1992 through 1993.
 - a. The last time these rates stayed at low levels for a long period was in the 1970s, just before the run-up in inflation in the late 70s and early 80s.

- b. Although the recent situation wasn't nearly as dire as that one was, we didn't want to risk even a small part of that kind of problem again.
2. Second, there's much less slack in labor and product markets.
- a. In fact, we can't be certain that *any* slack remains
 - (1) because these things are notoriously hard to measure.
 - b. This raises the chance that extra stimulus to the economy would sow the seeds of inflation in the future.
 - c. Historically, once the economy has moved beyond its potential levels of production and employment, the result has been higher inflation, with no long-run improvement in the unemployment rate.
- D. As a consequence, I think the steps we've taken to raise rates are appropriate:
- 1. They guard against getting into this "no-win" situation by fostering stable, sustainable economic growth with low inflation.
 - 2. Such forward-looking monetary policy helps avoid the "go-stop" economic environment of the 1970s, and it's much more likely to produce a lasting economic expansion.

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