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Business Partnership Breakfast  
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### **Economic Trends in California and the Nation**

Good morning. It's a pleasure to be here.

Today I want to talk about the economy on two different levels.

First I'll look at the local picture

and I'll focus fairly closely on what's going on in California.

Then I want to broaden the focus to discuss an issue that's gained national prominence.

That issue is the so-called "potential" growth rate of the national economy—

—that is, the rate the economy can sustain in the long run.

It's the subject of broad public debate.

And the reason it matters so much is that our potential growth is a key determinant in our standard of living

and an important benchmark for monetary policy.

Let me begin with California.

Typically the state's economy is in synch with the nation's.

But lately that hasn't been true.

While economic activity in the nation moderated in 1995,

in California it accelerated—

—to a pace that probably was well above the national average.

One reason for this kind of performance is that California already had made significant adjustments during its deep and long recession of the early 1990s.

By 1995, this prolonged period left more slack in California than in most other parts of the country.

Another reason is California's prominence in fast-growing sectors—like high tech, business services, and entertainment.

For example, here in the Sacramento Metro area, the number of jobs in the computer and office equipment sector more than doubled,

accounting for one-fourth of the net gains in overall employment in 1995.

The electronics industry and other sectors in California also have been able to capitalize on the state's proximity to the booming Asia-Pacific region.

Last year, U.S. exports were very strong to Japan and the Newly Industrialized Countries in Asia, like Hong Kong, Korea, Singapore, and Taiwan.

That's good news for California.

A relatively larger share of its exports goes to these Asian countries,

and its exports also grew faster than overall U.S. exports to these countries.

Now, I should note that California certainly hasn't *completely* adjusted from the negative shocks of the recession.

The state's unemployment rate is still well above the U.S. rate.

And so is the rate here in the Sacramento area—in fact, it's still well above pre-recession levels.

Furthermore, more cutbacks in defense jobs lie ahead, which will dampen employment growth.

Some local governments—in Orange County and Los Angeles, for example—still face fiscal problems.

And the devalued peso and weak Mexican economy are offsetting some of the state's strong export growth.

But the bottom line looks promising.

California has just about regained the jobs that were lost during the recession, and it's ready to move from recovery to expansion.

Now let me broaden the focus and turn to the issue of the country's "potential" economic growth.

Basically, it's the growth rate that the economy can sustain in the long run without generating inflationary pressures.

And it's measured as the long-run trend of economic growth—

—that is, abstracting from the ups and downs of the business cycle.

It depends on two things:

the number of people available to work—

—that is, the *size* of the labor force,

and how much output those people can produce an hour—

—the *productivity* of the labor force.

Potential growth—or, potential GDP—is a matter of real importance, since it reflects the potential for growth of jobs and income in the economy.

It also matters for the conduct of monetary policy.

The Fed looks at potential GDP as a benchmark.

Although we don't have a target for real GDP growth, we know that if it consistently exceeds its potential, higher inflation eventually and inevitably will result.

Until recently, a conventional estimate of potential GDP growth was close to 2½ percent a year.

There's been a lot of debate about this, mainly because some analysts argue that the estimate is way too low.

And the debate is likely to intensify, since revised GDP data constructed by the Commerce Department suggest that potential growth is close to 2 percent,

and that it actually slowed from 2¾ percent in the 1980s to 2 percent in the 1990s.

Let me explore this issue by looking at the likely explanation for a slowdown in the 1990s.

It appears that the slowdown has to do mainly with the first point—the size of the labor force.

For one thing, the working age population is growing more slowly.

Its annual growth rate has gone from 1¼ percent in the 1980s to about 1 percent in this decade.

But there's an even more significant change—and it has to do with the role of women in the workforce.

While the pattern of men's participation has been pretty much the same for the last 35 years,

the pattern of women's participation has changed dramatically.

From 1960 to 1990, women's participation rate rose from under 40 percent to just under 60 percent.

But since then, it's stayed right about there.

This is due to a leveling off in a couple of things:

the number of women *entering* the workforce

and the number of *hours* women are working.

For example, in 1960, they averaged fewer than 40 weeks a year and then gradually increased it to about 48 weeks—

—close to the number of weeks that's been typical for men for

quite some time.

We can't say for sure what will happen to women's participation in the future,

but we can say that the proportion of women working and the number of weeks they're working recently has reached a plateau.

Now—what about productivity?

Well, according to the new Commerce Department data,

the trend growth rate hasn't changed in over 20 years—

—it's still about 1 percent a year,

with no sign of a pickup in the 1990s.

As I said, a lot of analysts would argue with that.

They'd claim that productivity growth is *underestimated*.

More than that, they'd also say actual productivity growth has been *rising faster* in the 1990s.

Their reasoning is that current measures aren't accounting for the improvements computers have made.

They focus on the fact that much of the growth in computer use has been in the service sector, where it's hard to measure exactly *what* the output *is*.

For example, how do you measure the output of a lawyer—or an economist?

And if it's hard to measure the output itself, it's even harder to measure the improvement in quantity or quality made by a faster, more powerful computer.

In addition, we can all think of instances in which computers have revolutionized the way we do things.

Unfortunately, there's no consensus on whether computers have led to a major productivity surge.

For example, some economists have done elaborate studies *looking* for evidence of a pickup in productivity growth due to computers.

But they haven't found it.

Instead, they found that although computer investment is large, most of it goes to replacing obsolete machines.

In fact, computers make up only about 2 percent of the U.S. capital stock.

So, what we're left with is a lot of uncertainty about productivity.

And that means there's also uncertainty about potential GDP.

Now, what does this uncertainty about potential GDP mean for policy?

It basically raises the following question: If potential GDP growth is being underestimated, does that mean that monetary policy's likely to be unduly restrictive?

The answer's "no." Let me explain why:

As I mentioned earlier, the Fed uses potential GDP as a kind of benchmark for judging whether actual GDP growth is "fast" or "slow".

In other words, it's the *gap* between actual and potential GDP that enters into monetary policy.

But since potential GDP is simply estimated from the GDP data itself, it's usually not crucial if those data are biased toward underestimation.

Both rates are likely to be biased to about the same degree,

so the gap isn't likely to be seriously affected by measurement problems.

Moreover, although potential GDP is a very important benchmark for the Fed, it's certainly not the only thing we look at.

So if it turned out we weren't reading potential GDP correctly, we'd get signals about that from other indicators.

For example, if actual GDP had been below potential GDP in recent years, we'd have seen increases in unemployment rates and unused industrial capacity, as the demand for workers and capital fell short of potential gains.

At some point, this would have translated into downward pressure on inflation.

But, in fact, we haven't seen this happen:

Instead, inflation has remained relatively constant

—at 2½ to 3 percent—

and the unemployment rate has fallen to around its natural rate.

Let me conclude by saying that the Fed certainly would be just as happy as anybody to see faster growth in potential GDP.

But it's important to remember that the Fed can't *create* it.

If we were to try—by consistently pushing GDP growth beyond its potential—the inevitable result would be higher inflation.

What we *can* create is an environment of low, stable inflation.

It's that environment that allows our market economy to function as

efficiently as possible and that leads to investment in capital and labor in the long run.

Ultimately, that's the kind of environment we need to promote productivity and improve the living standards of all Americans.

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