The Economic Outlook and Monetary Policy

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Good afternoon. It is a pleasure to be back in Rochester and to see so many familiar faces. I have spoken at this event for the last 27 years, but today is a bit different. In the past, I have always been the outsider looking in on economic policymaking. Now, having become president of the Federal Reserve Bank of Philadelphia in August, I sit in a different chair, not as an outsider looking in but as a policymaker on the inside looking out.

This is a tremendous opportunity for me and I am enjoying it. As a long-time academic, I am used to learning new things, and I am certainly doing so now. But it is also important to recognize that the principles of economics are not changed because of where I sit. I see my responsibility as attempting to apply those principles as best I can in an effort to promote sound monetary policy.

I am fortunate, I think, to begin my tenure at the Fed at an interesting and challenging time for forecasters and policymakers alike. After 17 straight 25-basis-point increases in the federal funds rate, the Federal Open Market Committee, or FOMC, decided to keep rates unchanged on August 8, which happened to be my first FOMC meeting. Since then, the FOMC has met two more times and has continued to maintain the funds rate at 5¼ percent.

Today I would like to talk about the state of the economy and what I think it implies for monetary policy. Overall, I think the economy, despite recent slowing, is still in pretty good shape and that the fundamentals are present for a return to growth near trend in 2007.

Economic Conditions

The period between the end of 2003 and June of this year showed a remarkably robust and resilient economy. Real GDP grew at an average rate of about 3½ percent—a rate that is probably slightly above trend. Almost 5 million new payroll jobs were added to the economy, and the unemployment rate fell from just under 6 percent to about 4½ percent.

This performance is even more remarkable when you realize that during this same period the price of oil rose almost 250 percent—from about $30 to nearly $75 a barrel. We saw major hurricanes inflict substantial damage to several Southeast states; we witnessed ongoing geopolitical risks that elevated domestic and global economic uncertainty; and we experienced a rise in short-term interest rates from historical lows to more normal levels.

But despite this remarkable performance, inflation accelerated over this period, which is worrisome, especially from the standpoint of a monetary policymaker. Headline consumer price inflation rose from an annual rate of less than 2 percent in the last half of 2003 to over 6 percent during the first half of 2006. Even core CPI inflation (which excludes food and energy) rose from an annual rate of about 1 percent during the last half of 2003 to 3.6 percent during the first half of 2006.

While the economy performed well through June of this year, recent signs of weakness have caused some concern among a number of observers. The preliminary data on third-quarter real GDP suggest the economy grew at 1.6 percent. This follows growth of 5.6 percent and 2.6 percent in the first two quarters of the year. While this still reflects a respectable rate of growth of about 3.3 percent for the year so far, the recent sluggishness has created considerable uncertainty about the future.

Much of this slowdown is attributable to the slowdown in the housing market over the last several months. However, given the record-breaking pace of the housing market over the past two years, this slowdown is not unexpected nor, in my view, unwelcome. In the third quarter, residential investment declined at an annual rate of 17.4 percent, taking a little more than one percentage point off third-quarter growth.

I will have a little more to say about residential real estate in a few minutes, but first let's turn to some of the other sectors of the economy. Outside of housing, other sectors of the economy are performing fairly well.

On the demand side of the economy, real consumer spending rose 3.1 percent in the third quarter. More encouraging for the outlook is that real household incomes continue to expand at a healthy pace. Strong growth in incomes, in combination with rising stock prices, reduces the likelihood that consumer spending will weaken appreciably in response to the slowdown in the housing market.

Business investment spending remains strong. Reflecting continued strong corporate profits, business fixed investment expanded at an annual rate of 8.6 percent in the third quarter. This not only reflects strong investment in equipment but also in commercial structures. Indeed, the problems in the real estate market are largely confined to residential real estate, while the commercial market remains healthy.

With respect to manufacturing, growth has been a little sluggish in the last couple of months. This largely reflects weakness in autos and, to a lesser extent, those businesses that depend on residential construction. Outside of these sectors, manufacturing appears to be holding up well.

The labor market remains a bright spot for the economy as well. While employment is typically a lagging indicator, there has been little evidence during the last several months of a weakening in the demand for labor. The unemployment rate fell to a five-year low, reaching 4.4 percent in October. So far, there has been no evidence that job growth is slacking off in the last half of this year. Since June, the country has created about 148,000 jobs per month, about the same number per month as during the first six months of this year, when we saw new jobs averaging 146,000 per month.

The robust job market is reinforced by the data on wages. September and October saw substantial increases in real average hourly earnings. Evidence of this wage trend has been reinforced in my conversations with many business leaders who indicate that hiring qualified people remains one of their primary challenges. Moreover, this tightness in the labor market exists for both skilled and unskilled workers.

These factors suggest to me that despite some near-term sluggishness attributable to the weakness in the housing sector, the fundamentals of the economy remain sound. Economic growth in the second half of this year will not achieve the 4-plus percent growth we witnessed in the first six months—which, by the way, was not really sustainable. Nevertheless, I believe that growth will gradually pick up and return to trend in 2007.

Of course you might ask, what is trend growth? Well, over the years I have told this group that the easiest way to think about trend growth is to look at the growth in the labor force and the growth in productivity—add them together and you can come up with a rough estimate of the sustainable trend growth in real GDP. Up until July, most economists would have said that the rate was somewhere close to 3.5 percent, assuming labor force growth of about 1 percent and productivity growth of almost 2.5 percent. However, in July, the government issued a benchmark revision to its estimates of GDP for the last three years. The fallout from that revision was that wages and employment grew somewhat faster than was previously estimated and productivity growth was slightly lower than we thought. As a result, the commonsense estimate of trend growth has now been lowered slightly. My own view is that trend growth is closer to 3 percent than 3.5 percent. Some even claim that trend growth is as low as 2.8 percent. I don't think it is useful to quibble over two-tenths of a percentage point, since our ability to measure productivity is so fraught with problems. Nevertheless, almost everyone agrees that estimates of trend growth are now lower. Thus, when I say that growth should return to trend in 2007, I am expecting that growth will be near 3 percent. Note that this means that it should not surprise or concern us to see growth slowing from its pace of the last few years.

In fact, over the next decade or so we might expect to see trend growth decline further as the growth rate of the labor force slows. Although we frequently note the role of productivity in determining trend growth, the contribution of labor force growth is often overlooked. As the baby-boomers retire, demographic analysis suggests that the growth in the overall labor force will slow. Moreover, we are no longer getting the boost in the labor force from a growing number of women entering the work force, and we also have somewhat lower fertility rates. For all these reasons, labor force growth will slow in the coming years unless it is offset by increased immigration. Barring a boom in immigrants, even if productivity remains strong, the trend growth rate of the economy is likely to moderate.

Of course, this slowing of trend growth also implies a slowing in the rate of job creation needed to maintain low unemployment. For example, not too long ago many observers estimated that the economy had to create something like 150-175 thousand jobs a month just to employ new entrants into the labor force. Numbers below that were often greeted with dismay and concern about the state of the economy. With slower growth in the labor force, this number will decline, and the market will have to adjust its expectations accordingly as to what a “good” monthly number is for job growth.

Risks to the Outlook

Of course, no forecast is without risks. As I mentioned, the decline in residential investment took about one percentage point off third-quarter GDP growth. The question on many people’s mind is: Will the decline in housing contribute to a more broad-based decline in economic activity? So far, the decline in the housing sector has had very limited consequences for other sectors, and I think the spillover effects of the housing downturn will be modest for several reasons.

First, the housing boom we experienced over the past few years was clearly unprecedented, and I think most people saw it as unsustainable. This suggests that the slowdown in home price appreciation was not entirely unanticipated. Consider that, according to the house price index compiled by the OFHEO (in case you didn't know, that is the Office of Federal Housing Enterprise Oversight), the average house price rose at a 13.3 percent rate in 2005, after a 10.7 percent increase in 2004. To find double-digit appreciation in that index you have to go back to 1979. And let us not forget that in 1979 we also had double-digit inflation. So, the real return earned in the housing market over the past two years has been far out of line with any recent experience. In fact, if you compute a simple real rate of return by taking year-over-year changes in house price data and subtract the percentage change in the consumer price index, you find that from 2000 through 2005, real house price appreciation was 6.6 percent per year. From 1990 to 2000, real house price appreciation was just over ½ percent per year.

Some observers argue that the rapid appreciation in house prices must have significantly boosted consumption in recent years because of the accompanying increase in households' wealth attributed to the rise in the value of their homes. Now that home prices are moderating, the concern is that consumers will pull back significantly as the increase in household wealth from homeownership stabilizes or moderates, thus slowing the economy.

However, if the consumer did not believe this increase in wealth was permanent, then there is no reason to believe that consumers radically adjusted their spending upward in response to the housing boom. If so, the reverse will also be true – meaning there is no reason to think consumers will radically adjust their consumption downward as the housing boom ends. And, remember, for the most part homeowners who are not planning on moving, and who purchased their house to live in, tend to ignore temporary market fluctuations anyway.

A second reason that I think the spillover impact of the slowdown in housing will be modest is that the modest declines in house prices are largely being offset by a strong stock market and strong income growth. Thus, household balance sheets are still healthy.

Finally, despite the increase in the fed funds rate, mortgage rates remain at relatively low levels and are lower than they were in 1999 or early 2000 by about 2 percentage points. What's more, as mortgage rates have begun to move up from their historical lows, the percentage of people moving to long-term fixed rate loans has been rising.

Inflation Outlook

While I am fairly optimistic that the fundamentals remain sound for continued economic expansion, I am not as sanguine about the prospects for inflation.

As I mentioned at the outset, CPI inflation has been on the rise since 2003. The same has been true for the price index for personal consumption expenditures, or the PCE price index. On a year-over-year basis, core PCE inflation (which, again, excludes food and energy) has risen from about 1½ percent in mid 2003 to about 2½ percent in 2006. Indeed, it has been above 2 percent for almost three years. And if current forecasts are accurate, it will remain above 2 percent through at least 2007. Inflation above 2 percent is higher than the level consistent with most people's view of price stability, including my own.

Now, it is true that in the last couple of months inflation readings have looked more encouraging. But we should not read too much into these figures. The run-up in headline inflation was partly the result of rapidly rising oil prices. Recently, oil prices have come off their peaks and seem to have, at least temporarily, stabilized around $60 per barrel. The inflation numbers we are seeing now reflect that reversal in the oil price trend, and if oil prices remain about where they are now, we will likely see benign headline inflation numbers for some months to come.

But my sense is that the increase in inflation that we have seen over the past several years is not simply the result of rising oil prices. If the inflation was primarily energy related, we would expect goods and services most dependent on energy to show a greater response to oil price shocks, while goods and services that have a more modest energy component should be less affected. However, in the last three months the cost of medical care rose at an annual rate of 4.2 percent, personal care products and services at a 5.8 percent rate, and education at a 6.6 percent rate. Thus, the energy pass-through hypothesis does not appear to be the whole story.

Ultimately, broad-based inflation on a sustained basis is a monetary phenomenon. So, we cannot rule out the possibility that the Fed's stimulative monetary policy during the last five years may have contributed to the rise in core inflation. If this is so, then core inflation will not decelerate to acceptable levels until monetary policy has firmed enough to take out the cumulative effects of the accommodation.

Now, over the past two years, the FOMC has moved the federal funds rate up considerably from its historically low levels, so it is possible that inflation could return to acceptable levels without further policy actions. On the other hand, the fed funds rate adjusted for inflation remains relatively low. Thus, to my mind, there remains some risk that policy is not yet firm enough to ensure a return to price stability over a reasonable time horizon.

The risk of allowing inflation to remain too high for too long is that it will become embedded in market expectations. Once that occurs, the Fed will lose credibility, and it will be costly to regain it. That was one of the important lessons of the inflation episode of the 1970s. Once the higher rates of inflation were built into nominal interest rates and price setting, the Fed had to reassert its commitment to get and keep inflation low. The price the economy had to pay was high in terms of lost output and high unemployment. We simply do not want to pay that price again. Thus, it is critical that the Fed continue to re-assert its commitment to price stability and to take the actions necessary to back up that commitment.

Conclusion

So, to sum up, I think the U.S. economy is on course for sustained expansion. Sectoral adjustments notwithstanding, the overall economy is likely to return to trend growth in 2007. With that said, I also believe there is a significant possibility that inflation rates will remain above those consistent with price stability for some time and that this prolonged period of relatively high inflation runs the risk of undermining public confidence in our commitment to price stability. As a Fed policymaker, I am concerned about that possibility.

One of the primary goals of the Federal Reserve is price stability. Indeed, it is part of our mandate from Congress. It is also important to stress that the Federal Reserve is the only institution charged with achieving price stability and it is the only institution capable of delivering it.

All of this suggests to me that while the Fed must keep a careful eye on the pace of economic activity and be prepared to adjust its policy in either direction, at present, the predominant risks – and the attendant economic costs – are on the inflation side. So we need to remain vigilant and recognize that maintaining the current stance of policy, or even firming further, may be in the best interests of the economy's long-run performance.

The views expressed today are my own and not necessarily those of the Federal Reserve System or the FOMC.