The Economic Outlook: Prospects for 2007
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Introduction
Thank you for that kind introduction, Mark, and for the invitation to speak with so many leaders from the Philadelphia business community.

As a newcomer to the area I want to say what a pleasure it is to be in Philadelphia. It is an extraordinary and vibrant city, and my wife and I are looking forward to meeting new friends and exploring our new environs.

I will focus my remarks this morning on the outlook for the U.S. economy in 2007. But be forewarned. Economists don’t have a great reputation as forecasters—indeed we have a hard enough time explaining the past and that doesn’t bode well for our ability to predict the future. For that reason, I will try to focus on the broader themes that seem to be shaping our economy and some of the implications these themes may have for the year ahead.

Economic Outlook

As the economic data on year-end 2006 filter in, we are beginning to recognize that the economy turned in a very respectable performance last year. I think this is a pleasant surprise, particularly to those prophets of gloom and doom that seemed in such great abundance last fall.
Current estimates are that real GDP grew by 3.4 percent in 2006, about the average rate of growth over the past 10 years. The economy also added 2.2 million jobs to nonfarm payrolls in 2006, ratcheting the unemployment rate down to 4.5 percent as of December. With the strong labor market came strong gains in labor compensation. Average hourly earnings increased 4.1 percent in 2006. Unfortunately, inflation came in higher than I would have liked. The PCE — that’s personal consumption expenditures – price index increased by 2.3 percent. Stripping out its food and energy components, core PCE increased by 2.2 percent. And both CPI and core CPI increased by 2.6 percent.

I will return to the inflation outlook before I conclude, but for now let me just emphasize one of my themes for today: the incredible resiliency of the U.S. economy. Consider its performance not just last year, but throughout this expansion. We saw oil prices rise from $40 a barrel to $75 a barrel, and then fall back to less than $60. We experienced devastating hurricanes that wreaked havoc in the Gulf Coast states, and we faced geopolitical risks that contributed to economic uncertainty. We watched the domestic automobile industry struggle to remain competitive, and we saw a boom and bust in the housing market. Through all of this, our economy has continued to expand and produce new jobs and new opportunities.

Now, as we hear so often, past performance is no guarantee of future success. As was the case in 2006, don’t be surprised if 2007 has its own surprises in store for us. But my best guess is that the economy will continue to perform well in 2007. I expect real GDP to grow by about 3 percent, which I estimate to be its underlying trend rate. That kind of growth should hold the unemployment rate to just below 5 percent. The outlook for inflation is more uncertain. Inflation stopped accelerating in the last few months, but whether it will continue to recede in the coming year is not yet clear. Additional monetary policy action may be needed to keep us moving along the path to price stability.

Underlying the solid growth I foresee for 2007 are three themes that we saw emerging as 2006 drew to a close: hopeful signs of an improvement in the housing market; robust
growth in consumer spending; and small but encouraging progress in our foreign trade balance.

Let’s first consider the housing market. While overall growth was good in 2006, its pattern was uneven as the economy weathered a substantial downturn in the housing market. The good news is that the housing market is beginning to show signs of stabilizing. As home sales pick up, the pace of home construction should begin to move back toward more normal levels later this year. Having said that, I realize we are still in the early stages of that process and it is still a source of considerable uncertainty in the outlook. So I’ll talk more about the housing situation in a minute.

A second theme, and the real story in 2006, was the continued strength in overall consumer spending. Consumer spending accounts for over two-thirds of GDP, so the economy does not grow very much if consumers are not willing to open their wallets. Supported by a strong job market and rising incomes, consumers increased their spending by a healthy 3.7 percent in 2006. The January employment report indicates that solid employment gains continued into the new year. I expect the combination of more jobs and higher wages will help keep consumer spending growing at a moderate pace in 2007.

By the way, the labor market numbers are consistent with the stories I hear from business leaders around the District, including many of the people in this room. They tell me it is becoming increasingly difficult to find and retain employees. Also, each month our Bank surveys a large sample of manufacturing firms in our District and releases the results in our well-known Business Outlook Survey. Recently, we asked survey participants to list the biggest problems facing their firms. Topping the list was finding enough qualified workers, with 37 percent of respondents labeling this a “major problem.”

The third theme I mentioned was improvement in our trade balance. It is noteworthy that we saw a significant reduction in the trade deficit in the fourth quarter of 2006. Exports grew at a very robust 8.4 percent pace, while imports expanded by just 1.2 percent during the second half of the year. This shift in the direction of net exports has been driven
primarily by two factors. First is the strong economic growth of our trading partners. Europe and Japan have been experiencing stronger than expected growth, and other nations such as China have been growing very rapidly. This growth in the world economy boosts demand for our exports. Second, the recent declines in the value of the dollar have made our exports cheaper on the world market and at the same time made imports more expensive here in the U.S. While there is no guarantee these trends will carry over into 2007, the signs are encouraging.

The Housing Market

As I said a moment ago, the recovery path of the housing market is a major source of uncertainty in forecasters’ outlook for the 2007 economy. It is a source of uncertainty for me as well. But I think both the economic fundamentals and the data we have seen thus far point to gradual improvement in the housing sector over the course of 2007.

Home construction accounts for only about 5 percent of economic activity, on average. But it is a relatively volatile sector, and swings there can have a significant impact on the pace of overall growth. For example, residential investment declined at a 19 percent annual rate in the fourth quarter, and that drained 1.2 percent from overall growth in the economy. Moreover, aside from its direct impact on economic activity, swings in the housing market can have spillover effects on other markets that amplify its impact. So the movements in the housing market are important.

At the same time, I think it is important to recognize that the underlying demand for homes continues to grow. As people’s incomes rise, they tend to become homeowners rather than renters, and then they tend to upgrade their residence by buying larger homes. For instance, between 1995 and 2005, the fraction of homes that are owner occupied rose from about 65 percent to 69 percent, and the average size of a new home built increased by 20 percent. So, as incomes continue to rise, we should expect to see continued strong demand for housing.
Over the past several years, the pace of new home construction got out ahead of this underlying growth in demand. Consequently, unsold inventories of homes have accumulated, and the pace of residential construction has slumped. It will take some time for the excess inventory to be absorbed, but eventually it will be and the pace of construction will realign itself with the growth in demand.

Indeed, recent data suggest that this process may be beginning. New home sales have risen in the last two months, as have housing starts. Here in the Third District I am starting to hear comments from some bankers and other business people that the market may have “bottomed out” in their communities.

And what of spillover effects? Is the weakness in housing spreading to other sectors of the economy? While this was, and still is, a possibility, there is no evidence it has thus far, and I think there are good reasons to think it will not.

In principle, there are two sorts of spillovers that might occur. The first would be the ripple effects of the decline in home building on employment and on the businesses that supply goods and services to the building industry. This effect has partially been mitigated by strong growth in nonresidential construction.

On the employment front, the number of construction jobs actually increased by about 100 thousand from January 2006 to January 2007. Residential construction jobs have remained flat, so the increase is attributable to other construction-related jobs. Given the strong growth in aggregate employment over the past year, the employment impact of the housing downturn seems to have been minimal.

As for the businesses that have close ties with the home building industry, undoubtedly some have been hurt, but many have seen the weakness on the residential construction side at least partially offset by stronger activity on the commercial construction side. A number of businesspeople have told me the slowdown in home building has freed up construction workers and materials to make commercial projects more feasible. Indeed,
the data show that while residential investment declined almost 13 percent in 2006, that
decline was partially offset by nearly 12 percent growth in nonresidential investment.

I must add that this phenomenon points out an important source of our economy’s
resiliency, namely, its innate flexibility. When market prices are free to adjust, resources
shift to their highest valued use, allowing the economy to continue to grow.

The second source of potential spillover from a weak housing market works through its
impact on home prices. For many households, their home is their biggest single asset.
So a big change in home prices – up or down – could mean a big change in their net
worth. And a big change in their net worth could mean a big change in their willingness
to spend. This is the classic “wealth effect”: the wealthier you feel, the more of your
current income you feel free to spend.

Certainly, recent changes in the rate of home price appreciation suggest the potential for a
big effect. Every quarter, the Office of Federal Housing Enterprise Oversight (OFHEO)
publishes an index of home prices. It shows that during the housing boom years of 2004
and 2005, the price of the average house rose 10.7 and 13.3 percent, respectively. This
was the first double-digit increases since the inflationary days of the late 1970s.
However, the most recent data show that through the first three quarters of 2006, the rate
of price appreciation for the average house declined steadily, to just 3.5 percent.

The wealth effect suggests that the run-up in home prices during the boom was a source
of strength for consumer spending. You would then expect the recent slowdown in home
price appreciation to weaken consumer spending. Yet factors other than home prices are
also influencing household wealth, including a strong stock market and rising long-term
income prospects associated with productivity growth. These factors have tended to
strengthen household net worth and supported continued strength in consumer spending.
Regional Housing

By the way, we all know that national numbers are averages, and so they often mask important differences in regional economic conditions. Certainly this is true for housing numbers. For, as they say, all real estate markets are local markets.

Consider that according to the OFHEO, home prices in the U.S. have risen by an average of 9 percent per year over the past five years. In Pennsylvania, home price appreciation essentially matched the national average, but in Delaware, homes appreciated by over 11 percent per year, in New Jersey the rate of appreciation was over 12 percent, and in Maryland it was nearly 15 percent.

States in the South and West – Florida, Arizona, Nevada, and California – also saw home prices increases in the 15 percent range.

Of course, home prices rose even more rapidly in some local markets. Parts of Florida around Miami, Naples, Fort Lauderdale, and Orlando experienced home price increases averaging nearly 20 percent per year. Parts of California around Los Angeles, Fresno, and Bakersfield had a similar experience. For comparison, home prices down in Ocean City, N.J., rose by about 16 percent per year over the last five years.

My point is a simple one: regional markets had different experiences when the housing market heated up. Now they will have different experiences as the market cools. And the areas where the run-up in home prices was most dramatic will most likely feel the adjustment process the most acutely.

At your places is our Bank’s fourth-quarter Business Review. If you have further interest in this topic, you might take a look at the article by Tim Schiller entitled “Housing: Boom or Bubble?”
Inflation and Monetary Policy

Let me close with a few thoughts about the outlook for inflation and the proper stance of monetary policy. As I mentioned at the outset, I considered inflation to be uncomfortably high in 2006, and inflation remains a primary concern of mine for 2007. While we got some encouraging inflation numbers toward the end of last year, I am not convinced that underlying inflation is on a downward trend. We may simply be seeing the temporary effect of recent declines in the price of oil, which seems just as likely to rise as to fall in the future.

On the other hand, let me add that I do not see the recent strength in labor compensation as necessarily inflationary. We often hear the assertion that rapid growth in wages is an important source of inflationary pressures. I do not subscribe to this view. As an empirical matter, wage growth is not a very useful predictor of future inflation. If anything, it seems to work the other way: inflation is a useful predictor of future wage growth.

Perhaps more important in the current environment, wages tend to rise with labor productivity. Productivity growth in the U.S. has shifted up over the past decade or so, and as long as that continues, we should expect to see a pattern of persistently higher wage increases. The important point is that increases in wages matched by productivity gains are not indicative of any inflationary pressure.

In short, while I think it is possible that the recent moderation of inflation will continue, and I certainly hope that’s the case, I believe it is too soon to declare victory. After all, core inflation has been above 2 percent for the better part of three years, and many forecasters do not expect inflation to decline much over the next year or two.

This brings me to the outlook for monetary policy. It is a truism in economics that the primary source of persistent inflation is monetary policy, and clearly monetary policy was accommodative for the period from 2001 through 2005. It is an open question
whether our current monetary policy is sufficiently restrictive to return the economy to price stability over a reasonable horizon.

My own assessment is that with growth prospects of the economy improving, there is some risk that we may not see a return to price stability unless monetary conditions are further tightened. When economic growth is strong, there is a tendency for market interest rates to move higher in order to match aggregate savings with aggregate investment. If the Fed does not allow short-term interest rates to rise with the market, it sets the stage for even higher inflation.

A month or two ago I believed it was possible that the somewhat slower economy combined with a constant federal funds rate might be sufficient to ensure a decline in core inflation and a return to price stability. But as the economy strengthens, that scenario becomes less likely, and the risk that core inflation will not moderate increases. Consequently, in this environment, we must remain particularly vigilant in evaluating the incoming data and its implications for the inflation outlook.

Thank you.