Board of Governors of the Federal Reserve System

Speech

Governor Mark W. Olson

Update on the U.S. economy

At the University of Arkansas at Little Rock, Little Rock, Arkansas

April 13, 2006

Recent trends in the U.S. economy have been, on the whole, quite favorable. Real gross domestic product (GDP) increased 3-1/4 percent during 2005, on the heels of two years during which it rose at an annual rate of almost 4 percent. By the end of last year, businesses had added another 2 million jobs to their payrolls, and the unemployment rate had dropped to its lowest level in five years. Although top-line consumer price inflation was boosted by the run-up in energy prices, core consumer price inflation remained relatively steady, at about 2 percent for the year.

One of the significant challenges for a policymaker is to be able to discern the underlying trends in real activity and inflation in the midst of the inevitable noise and shocks that come along. The recent period has presented a number of those types of unanticipated events: Most notably, the devastating hurricanes that hit the Gulf Coast last fall destroyed residential and business capital and tragically uprooted the lives of many people. The resulting disruptions to economic activity, particularly in the energy and petrochemical sectors, held down the rise in real GDP in the fourth quarter. The restarting and rebuilding that began late last year should be providing a boost to activity this year, but the size of that effect and the extent to which it will be distributed in coming quarters remain uncertain. Another special factor at work early this year was the atypically warm weather that very likely advanced homebuilding and perhaps other spending that might otherwise have stretched into the spring. As a result, most forecasters believe that the incoming information has been adding up to a sizable, but quite likely temporary, acceleration in real GDP in the first quarter after the small increase in the final quarter of 2005.

Another, more persistent economic challenge in recent years has been the climb in world oil prices. As a result, last year marked a third consecutive year of rapidly rising--and sometimes volatile--domestic energy costs. To be sure, higher energy prices cut into households' purchasing power and the profits of non-energy firms. While recognizing the difficulty of identifying the reactions of consumers and businesses to higher energy prices, Chairman Bernanke has recently noted that the surge in energy prices since late 2003 probably reduced the growth of real GDP between 1/2 percent and 1 percent per year. One important change in the economic landscape that has limited the current effect of an energy shock compared with the effects in our earlier experience is that energy costs today are not nearly as important as they were during the 1970s, when the energy intensity of U.S. production was significantly higher.

After taking into consideration the unusual factors that have been influencing the pattern of economic activity of late, most forecasters are projecting that, after a sizable increase in the first quarter, production and spending will return to a moderate and sustainable pace over the remainder of the year. Several fundamental factors support that view. First, although longer-term yields have begun to move up recently, they remain low by historical standards, and financial conditions remain favorable. Second, business balance sheets are strong, and corporate earnings have been robust. Third, household credit quality has shown few signs of stress. Finally, households' real income has been receiving a boost from the recent strong gains in employment, and the ongoing increases in house prices and gains in the stock market have kept the ratio of wealth to income at a high level.

All told, prospects for ongoing gains in consumer spending and business investment appear good, and the recent indicators are positive. This morning's report on retail sales, together with the information on motor vehicle sales released last week, points to a solid rise in real consumer spending in March and a very strong reading for the first quarter as a whole. The outlook for moderate increases in personal consumption expenditures in the near term is consistent with the latest readings on consumer sentiment. In addition, the continued low level of new claims for unemployment insurance bodes well for further net gains in employment and, thus, income. A survey of businesses' capital spending plans conducted by the National Association of Business Economists at the end of last year pointed to another solid year of spending on plant and equipment. And, through February, backlogs of orders for nondefense capital goods were still moving up.

Another important factor in the outlook for the United States is the likelihood of a continued solid expansion in economic activity abroad. Notably, the Japanese economy has strengthened, and economic activity in emerging Asian economies has continued to rise at a brisk pace, while the outlook in Canada calls for sustained moderate growth.

Domestic economic activity should also continue to receive a boost in coming quarters from reconstruction in the Gulf region. In part, the reconstruction represents some temporary federal fiscal stimulus from the hurricane relief that the Congress has provided. However, despite the additional support to construction from hurricane-related repair and rebuilding, residential construction overall appears likely to cool a bit this year. The most recent indicators suggest that demand and home-price inflation have begun to moderate.

With respect to inflation, although forecasting energy prices is risky, I should note that the futures market suggests that crude oil prices will move up a bit further in coming months before flattening out at $70 per barrel. If so, the drag on real income and spending from rising energy costs should diminish over time, as should the risk of additional energy cost pressure on underlying, or "core," inflation.

The general contour of economic activity that most forecasters are expecting, in which they see little change in resource utilization over the year, should be consistent with relatively stable core inflation. As I noted earlier, the unemployment rate is now at a five-year low of 4-3/4 percent. More important, it and other indicators of resource utilization--such as the industrial capacity utilization rate--are now at levels at which, in the past, little or no economic slack remained. At this point, we have seen few signs of upward pressure on labor compensation or core inflation. Although we have experienced run-ups in prices of commodities, such as building supplies, that are more sensitive to changes in supply and demand conditions and in prices of energy-intensive commodities and services, the pass-through to core inflation appears to have been limited. Important in that regard is the fact that longer-run inflation expectations have been well anchored, as is apparent in the stability of the five-to-ten-year inflation expectations of households in the Michigan SRC survey and in the reading implicit in Treasury-inflation-protected securities.

The observations I've just shared illustrate the evolving economic forces that the Federal Open Market Committee (FOMC) will consider as it makes monetary policy decisions over the remainder of the year. The FOMC has raised the target federal funds rate 25 basis points at each of the past fifteen meetings over roughly two years. During much of that time, we described our actions as "removing accommodation" at a "measured pace." At our March meeting, we indicated that some additional tightening may be necessary to keep the risks to the attainment of both sustainable economic growth and price stability roughly in balance. Thus, the future path for the target federal funds rate will depend importantly on how incoming information on economic activity and inflation affect our assessment of these risks.

▲ Return to top