For release on delivery
2:15 p.m. EDT
June 5, 2006

Panel Discussion:

Comments on the Outlook for the U.S. Economy and Monetary Policy

Remarks

by

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at the

International Monetary Conference

Washington, D.C.

June 5, 2006

I am pleased to be here this afternoon to participate in the International Monetary Conference. In my remarks, I will provide a brief update of the economic outlook for the United States and discuss the implications of that outlook for monetary policy.

It is reasonably clear that the U.S. economy is entering a period of transition. For the past three years or so, economic growth in the United States has been robust, reflecting both the ongoing re-employment of underutilized resources as well as the expansion of the economy's underlying productive potential, as determined by factors such as productivity trends and the growth of the labor force. Although we cannot ascertain the precise rates of resource utilization that the economy can sustain, we can have little doubt that, after three years of above-trend growth, slack has been substantially reduced. As a consequence, a sustainable, non-inflationary expansion is likely to involve some moderation in the growth of economic activity to a rate more consistent with the expansion of the nation's underlying productive capacity. It bears emphasizing that productivity growth seems likely to remain strong, supported by the diffusion of new technologies, capital investment, and the creative energies of businesses and workers. Thus, productive capacity should continue to expand over the next few years at a rate consistent with solid growth of real output.

Real gross domestic product grew rapidly in the first quarter of this year, but the anticipated moderation of economic growth seems now to be under way. Consumer spending, which makes up more than two-thirds of total spending, has decelerated noticeably in recent months. One source of this deceleration is higher energy prices, which have had an adverse impact on real household incomes and weighed on consumer attitudes. As had been expected, recent readings also indicate that the housing market is cooling, partly in response to increases in mortgage rates. To be sure, the data on home sales and construction have been somewhat erratic from month to month, reflecting weather conditions, statistical noise, and other factors. However, overall, housing activity has softened relative to the high levels of last summer, and the rate of house-price appreciation appears to have lessened. A slowing of the real estate market will likely have the effect of restraining other forms of household spending as well, as homeowners no longer experience increases in the equity value of their homes at the rapid pace seen in recent years.

Gains in payroll employment in recent months have been smaller than their average of the past couple of years, and initial claims for unemployment insurance have edged up. These developments are consistent with the softening in the pace of overall economic activity that seems to be under way. That said, going forward, relatively low unemployment and rising disposable incomes may counter to some extent the factors tending to restrain household spending.

Although spending by the household sector is showing signs of moderation, other sectors of the economy retain considerable momentum. According to the available data, business investment appears to have risen briskly, on net, so far this year. In particular, investment in nonresidential structures, which had been weak since 2001, seems to have picked up appreciably, raising the possibility that increased nonresidential construction may absorb some of the resources released by the slowing housing sector. Spending on equipment and software is also on a strong upward trend, and backlogs of orders for capital goods are still rising. Business investment is being supported by high rates of profitability and capacity utilization. Credit conditions for businesses are favorable: Although market participants appear to have become more attuned to risks in recent weeks, corporate bond spreads remain low, and banks are well capitalized and willing to lend.

Globally, output growth appears poised to exceed 4 percent for the fourth consecutive year--a strong performance that will support the U.S. economy by continuing to stimulate our exports of goods and services. The buoyant global economy does present some challenges, however. In particular, the increased world demand for crude oil and other primary commodities, together with the limited ability of suppliers to expand capacity in the short run, has led to substantial increases in the global prices of those goods. Those price increases are a partial offset to the forces supporting global growth and are also a source of inflationary pressure.

Longstanding concerns about global imbalances remain with us as well. Along with greater national saving in the United States, increased domestic demand in countries with current account surpluses and a greater flexibility of exchange rates more broadly would help to reduce those imbalances over time. Should U.S. economic growth moderate as expected, sustaining the global expansion will require a greater reliance by our trading partners on their own domestic spending as a source of growth.

Consumer price inflation has been elevated so far this year, due in large part to increases in energy prices. Core inflation readings--that is, measures excluding the prices of food and energy--have also been higher in recent months. While monthly inflation data are volatile, core inflation measured over the past three to six months has reached a level that, if sustained, would be at or above the upper end of the range that many economists, including myself, would consider consistent with price stability and the promotion of maximum long-run growth. For example, at annual rates, core inflation as measured by the consumer price index excluding food and energy prices was 3.2 percent over the past three months and 2.8 percent over the past six months. For core inflation based on the price index for personal consumption expenditures, the corresponding three-month and six-month figures are 3.0 percent and 2.3 percent. These are unwelcome developments.

Although the rate of pass-through from the higher prices of energy and other commodities to core consumer price inflation appears to have remained relatively low, the cumulative increases in energy and commodity prices have been large enough that they could account for some of the recent pickup in core inflation. Despite recent increases in spot oil prices, futures markets imply that oil prices are not expected to continue rising. The realization of that outcome would reduce one source of upward pressure on inflation. However, the volatility of these and other commodity prices is such that possible future increases in these prices remain a risk to the inflation outlook. Subdued growth in most broad measures of nominal labor compensation and the ongoing expansion of labor productivity have held down the rise in unit labor costs, the largest component of business costs. Anecdotal reports suggest, however, that the labor market is tight in some industries and occupations and that employers are having difficulty attracting certain types of skilled workers. Finally, some survey-based measures of longer-term inflation expectations have edged up, on net, in recent months, as has the compensation for inflation and inflation risk implied by yields on nominal and inflation-indexed government debt. As yet, these expectations measures have remained within the ranges in which they have fluctuated in recent years, but these developments bear watching.

With the economy now evidently in a period of transition, monetary policy must be conducted with great care and with close attention to the evolution of the economic outlook as implied by incoming information. Given recent developments, the medium-term outlook for inflation will receive particular scrutiny. There is a strong consensus among the members of the Federal Open Market Committee that maintaining low and stable inflation is essential for achieving both parts of the dual mandate assigned to the Federal Reserve by the Congress. In particular, the evidence of recent decades, both from the United States and other countries, supports the conclusion that an environment of price stability promotes maximum sustainable growth in employment and output and a more stable real economy. Therefore, the Committee will be vigilant to ensure that the recent pattern of elevated monthly core inflation readings is not sustained.

Toward this end, and taking full account of the lags with which monetary policy affects the economy, the Committee will seek a trajectory for the economy that aligns economic activity with underlying productive capacity. Achieving this balance will foster sustainable growth and help to forestall one potential source of inflation pressure. In addition, the Committee must continue to resist any tendency for increases in energy and commodity prices to become permanently embedded in core inflation. The best way to prevent increases in energy and commodity prices from leading to persistently higher rates of inflation is by anchoring the public's long-term inflation expectations. Achieving this requires, first, a strong commitment of policymakers to maintaining price stability, which my colleagues and I share, and, second, a consistent pattern of policy responses to emerging developments as needed to accomplish that objective.

Our economy has reaped ample rewards in recent years from the achievement and maintenance of price stability. Although challenges confront us, as they always do, I am confident that we will be able to preserve those hard-won benefits while promoting sustainable economic growth.