Connecticut Business and Industry Association's Economic Summit and Outlook

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Another January has rolled around — to me, anyway, they seem to come faster every year. The holidays are over, and the reality of a new year has set in. Thus, it's a good time to stop and reflect on where we've been and what the economy might have in store for us. In that spirit, I'll begin with a short review of the past year and say a little bit about the local situation here in Connecticut. Then I'll talk about my national forecast. As always, the views I express will be my own and not necessarily those of my colleagues on the Federal Open Market Committee.

To preview: the economy has come through the last year pretty well, successfully making a difficult transition from above trend growth rates early in the year to a slower pace, with solid job growth and low unemployment. Inflation has been and remains a challenge, though recent data provide a bit of assurance that price pressures may be beginning to ebb. Our best guess at the Boston Fed is that 2007 will bring continued moderate growth, with GDP at or a bit below potential, unemployment likely remaining below 5 percent, and core inflation gradually declining. Has our economy once again reflected the amazing resilience that enabled us to meet the challenges of Y2K; the tech boom and bust; 9/11; the Iraqi war; a variety of geopolitical tensions; more than one energy shock, and now a cooling housing market? Are we on a trajectory to that sought after but hard to obtain "soft landing?" So far, so good, though there are risks to both economic growth and price stability, and I will talk about them.

But first let's start by looking back to a year ago. At this time last year, the economy was growing robustly. After strong years in '03 and '04, real GDP rose at better than 3 percent in 2005, and was on course to expand at an even stronger 5.6 percent in the first quarter of '06. On January 9, the stock market closed above 11,000 for the first time since June 7, 2001, and longer term debt yields were equally, if somewhat surprisingly, accommodative. Unemployment hit 4.7 percent in January, and remained below 5 percent for the rest of the year. The economy was cooking along nicely, although perhaps the heat was turned up a bit too high.

And not all signs were positive. For one thing, oil price increases were poised to affect both growth and prices. After rising through most of 2005, spot prices of West Texas Intermediate crude oil began 2006 at about $60 a barrel, and continued to climb, exceeding $75 by mid-year before dropping back to about $60-$65, where they remained at year's end. The summer travel season saw the impact of both higher prices and seasonal demand, and anecdotes abounded about the toll high gasoline prices were taking on retailers, hotels, and recreational businesses as consumers' pocketbooks were pinched. Concerns were raised about both the potential for weakening demand, and the upward impact on prices -- virtually a central banker's nightmare.

On the inflation side, core CPI, that is consumer prices net of food and energy costs, ran at an annual rate of just over 2 percent in the first quarter. Then core CPI accelerated to almost 2.5 percent in the second quarter, and to 2.8 percent in the third. The headline numbers, those including food and energy, rose even more dramatically, with headline CPI topping out at an annual pace of 5 percent in the second quarter.

As you know, while the costs of food and energy are important to all of us, such costs can spike temporarily due to shortages, such as those that occurred with the devastating hurricanes in the fall of 2005. What concerns policymakers is if these cost spikes feed through to the broader economy -- to prices of non-oil goods and services -- as a result of

lengthy supply problems or burgeoning demand or some combination of the two. Thus, the strength in both U.S. and global demand in '05 and '06, combined with rising energy costs, heightened Federal Reserve concerns about inflation. And the rise in core price measures in early '06 did nothing to assuage those concerns. The Fed continued raising the key policy interest rate -- the overnight Federal Funds Rate -- at each of its first four meetings in 2006, a process which had begun two years earlier. By late June, the rate stood at 5.25 percent, in my view very much in keeping with the risks facing the economy.

This slow but steady rise in short-term interest rates, and a related gradual erosion in housing affordability, intensified a slowing in the housing market that had begun in 2005. Truth be told, however, just as "trees don't grow to the sky," U.S. housing markets had to cool off after a good five or more years of rapid escalation, as price growth outstripped income growth, and demographically driven demand eased off. By early '06, a number of housing market indicators were deteriorating though starts remained positive. By the second half of the year, however, starts dropped off as did sales of both new and existing homes, and certain areas saw some actual home price declines. So far, however, such decreases have not been large or widespread geographically. In fact, according to the best national measures from OFHEO, prices have only decelerated, not declined. But any protracted weakness in housing can make consumers nervous—houses are, after all, a major source of most household wealth, and given the proliferation of new financing methods, have become a source of liquidity as well. Reports on housing activity have consistently come in a little worse than expected, though very recent data on home buying attitudes, new home sales, mortgage applications and slowly declining inventories of unsold homes suggest some bottoming out may be at hand. As of now, our best estimate is that the housing slowdown will shave a percentage point or so off GDP in the second half of 2006.

Outside of housing, however, much of the rest of the economy seemed to fare pretty well. Rising corporate profits and healthy margins continued to reflect strong corporate balance sheets and productivity growth. Non-residential construction surged as industries looked to add to capacity, after some years of slow capital spending. In fact, at least until quite recently when measures of business spending weakened, non-residential construction served to offset a portion of the impact of the housing investment slowdown. And businesses continued to hire as well, with monthly job increases more than meeting the level necessary to absorb new entrants to the labor force, taking into account that demographic factors probably have reduced that level from what it was in the late '90s. More jobs meant rising incomes. Lower oil prices by year end also increased the purchasing power of disposable income. And with the impetus of a strong stock market, real personal consumption grew at a solid 2.7 percent in the third quarter, and likely exceeded that growth rate in the fourth.

Spending on autos was off a bit, and certainly the large domestic manufacturers -- the traditional Big Three -- have faced more than a few challenges. But Bank staff believe this took only a small toll on the economy, with the so-called "transplanted" firms -- the foreign auto firms producing cars in U.S. factories -- picking up market share. Inventories of manufactured goods, particularly goods related to housing and autos, rose and measures of manufacturing strength dipped in the fourth quarter as supply was trimmed in the face of cooling demand. Many suggested, however, that business purchases of high-tech goods were off, in part, as a result of the delay of the new Microsoft operating system. On the plus side, the cumulative effects of several years of dollar depreciation and relatively strong economic growth among our trading partners resulted in better net trade data, and some stabilization in measures of the country's indebtedness to the rest of the world.

Thus, as the year ended, the economy seemed to have completed that difficult down-shift in tempo, often referred to as a soft landing. On the inflation front, pressures seemed to ease a bit as November headline CPI grew at an annual pace just under 2 percent and core CPI was flat for the month. But for the 12-month period as a whole, core remained close to its third-quarter high, suggesting inflation may be slow to taper off.

Turning to Connecticut, the state has seen slow but steady growth for over two years. This is reflected in the unemployment rate which is essentially the same as the national average and well below the state's early 2003 high of almost 6 percent. However, job growth has been slow during this period. Payroll employment in November was up only 0.6 percent compared to a year earlier, while national growth was more than double that. Manufacturing and construction employment was flat or declining, but, like the nation, services employment grew nicely -- particularly education and health services and financial activities.

The significance of financial activities is sometimes overlooked. Finance and insurance account for about 8 percent of employment in Connecticut, but 17 percent of labor compensation – double the share of that sector nationally and more than any other sector of the Connecticut economy. Thus, while other sectors in the state employ more people, none contributes as much to the earnings of the state. And overall, earnings and related incomes in Connecticut remain strong with the state retaining its spot as the state with the highest per capita income. Of course, a high cost of living goes along with this high income level, a concern that is shared by other New England states, most notably your neighbor Massachusetts.

As in the nation, Connecticut is currently experiencing a sharp decline in housing activity. The number of new housing permits in November was more than 40 percent below the level of a year ago. Sales of existing homes were also off sharply. Home prices seem to be holding up relatively well, however. According to the OFHEO index, prices in the third quarter were still 6 percent above the year before, although most of this gain took place in late 2005 and early 2006. There has been a pickup in foreclosures as there has been elsewhere in the region. But the state's foreclosure rate is less than that for New England states overall, and below that for the nation as a whole.

Finally, let me mention an aspect of the state's longer term health that has received considerable attention -- recent demographic trends including net-out migration and an aging population. These concerns are shared to varying degrees by all the New England states, most particularly Massachusetts.

These concerns are clearly understandable. The state's population grew only 3 percent from 2000 to 2005 compared to growth of 5 percent nationally. But we should put this into perspective. Such growth was a relative improvement over the 1990s, when the state grew only 3.6 percent over the entire decade, while the nation grew almost 4 times faster. Despite Connecticut’s recent weak employment growth, net out-migration over the past five years was half the level during the period 1995 to 2000 and immigration from abroad has been robust. And while it is true that Connecticut’s population is older than the nation's, it is not older by New England standards. Maine and Vermont rank at the top in terms of median age, while Connecticut is a relatively young #8.

I do not mean to trivialize concerns here as state leaders try to tackle the real challenges the state faces, but at least for the current cycle Connecticut seems likely to continue to benefit from the health of the national economy. Connecticut's economic performance over the past year has been quite solid; the state's businesses seem to be providing jobs for those who want work, and attracting an inflow of mature, educated workers and immigrants; incomes are high and rising, and the state stars in the important area of financial services. Nothing is without risks, of course, and there are longer-term issues both in this state and others in New England, but '06 seems to have left Connecticut well positioned for the new year.

So what do I think is in store for the nation in '07? I expect growth to continue at a moderate pace, in the neighborhood of 2 percent in the last quarter of 2006. This should reflect sustained consumer spending and business investment offset in part by fallout from the housing market and the manufacturing inventory swing that is underway largely in the housing and motor vehicle sectors. Then, I expect growth to accelerate modestly as 2007 progresses, with the housing and inventory situations gradually ebbing. With a growth path at or slightly below potential, unemployment is likely to remain below 5 percent while core inflation should continue to ease.

Of course, risks abound, both to growth and inflation. What are the chances the economy in '07 will be weaker than I have forecast? The most likely culprit would be a longer and deeper contraction in housing markets than now expected -- one that hits not only residential construction but also consumption spending harder than forecast and, through consumers, reduces business profits and spending. This could happen if home prices fall significantly nationwide, affecting not just investment in residences but also how wealthy consumers feel. A significant change here could cause consumers to spend less and save more than now expected, a good thing over the longer run given this country's savings/investment gap, but difficult over the short term -- especially given the forecast of moderate growth overall.

And some have argued that new forms of mortgage financing may have exacerbated both increased spending out of rising home equity on the upside, and contraction on the downside as falling prices eliminate a major source of household liquidity. This is hard to see empirically, but some communities, where mortgage foreclosures have risen as these new forms of financing reprice, are clearly seeing the negative aspects of the broad access to credit these new

instruments provided.

And there are other signs beyond housing that may be flashing yellow on growth vulnerability. Certainly, many have focused on what long-term Treasury yields of 50 basis points below the overnight federal funds rate might be telling us about the probability of a downturn. There are several possible alternative explanations for this phenomenon, but it does raise one's antennae. Very recent indicators of business spending such as the inventory buildup have been less-than-sparkling. Consumer sentiment data has been more positive of late, but Gallup polls suggest the share of those who see economic conditions as good or excellent is lower than one might expect, and exit polls after the election also suggest that concerns about the economy, while not necessarily driving the election results, played a key role.

Some consumer pessimism could stem from a sense that many workers and their families may have that they are not sharing much in recent economic growth. In the nonfarm business sector, inflation adjusted compensation growth fell short of productivity by 2 percentage points or more for several years until 2006. This slow wage growth occurred even as business profits were at historically high levels, causing worry that workers are not getting their fair share of the pie. Indeed, median household income fell in real terms in every year from 1999 to 2004, and even though it rose slightly in 2005 -- the latest year for which we have data -- it was still only at about 1998 levels. All of this begs the question -- could some combination of housing downturn and pressures on consumers produce a much slower rate of growth than now expected?

While possible, in my view this is not likely for a number of reasons. First, a nationwide drop in house prices fairly measured would be unprecedented, at least for any extended period of time. Indeed, as I noted before, there are signs that the real estate market may be bottoming out and prices firming, though residential investment growth is likely to be negative for some time. Second, employment trends remain solid, and equity markets upbeat, counteracting the impact on consumer wealth and spending from flattening or even falling home prices in some areas.

Third, the rest of the world is expected to grow at a pace that equals or surpasses the U.S. Domestic demand abroad combined with a lower dollar should continue to improve the balance of net exports. And finally, U.S. businesses continue to experience solid profits, and business spending, though affected by the inventory issues mentioned earlier, seems likely to rebound in the spring especially in high-tech. Thus, while the consumer could be harder hit than we now expect, I believe the best bet is still that the same resilience that has marked the last decade or so will continue as the economy picks up some speed in '07 and a bit more in '08.

So that brings up the other risk facing us -- will inflation ease off as expected, or will upward price pressures remain? Could all the positive aspects of our economy -- growing employment, supportive financial conditions, strong corporate profitability and solid worldwide economic growth -- begin to stress labor and product markets, putting pressure on already elevated rates of inflation? A couple of cautionary notes. As I noted earlier, wage growth trailed productivity for most of the last several years. This pattern changed in '06, and unit labor costs rose. This is good news for workers, and given the record-setting corporate profit margins of the past year, rising wage costs ought to be manageable, particularly in the context of continued solid, if a bit slower, productivity growth. But one should not ignore the balance of supply and demand in labor markets with unemployment as low as it is. The decline in oil prices we saw last year was certainly welcome, and helped to bring inflation down from its mid-year peak. But absent further declines, lower energy costs won't bring about much of an additional decrease in inflation this year.

Price stability, so vital to stable economic growth, is a key goal for the Federal Reserve. With unemployment low, and other measures of economic capacity suggesting resources are being fully used, it is not surprising that the Federal Open Market Committee has stressed the risks to inflation in its recent statement and minutes. After all, if inflation were to escalate, bringing it back under control would require policy changes that restrict short term growth even further. Contained inflation expectations on the part of markets and the public are crucial to the price situation going forward. In that regard, it is encouraging to note that despite dramatic swings in headline inflation, and a steady rise in core data, inflation expectations, as best they can be measured by market and survey data, seem to suggest markets and the public believe inflation will be well-contained. Managing the risks around that seems to me to be the key issue facing the central bank at this juncture.

In sum, the past year has seen the U.S. economy make a difficult transition from higher to slower rates of growth, while

maintaining a solid employment trend, good corporate profit growth, and optimistic equity markets. Similarly, the rest of the world has grown as well, even against a backdrop of significant geopolitical uncertainty. I expect U.S. economic growth to accelerate slightly this year, unemployment to remain low, and price pressures to ease a bit. There are risks to this outcome to be sure, but I believe that with the continued resilience of the consumer, and policymaking that is focused on managing inflation, my sense of cautious optimism will turn out to have been justified.

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