THE ECONOMIC CLUB OF SHEBOYGAN

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U.S. Economic Outlook

Looking at the economy today, you sure can say: "Oh what a difference a year makes." A year ago, economic growth was sluggish; today, it is much stronger. A year ago, payrolls were shrinking; today, they are expanding. A year ago, we were worried that inflation might fall too low; today, inflation has increased from its lows of late last year.

All of these improvements suggest that the highly accommodative monetary policy that was appropriate last year may not be appropriate going forward. Tonight, I'd like to talk more specifically about some of the differences between conditions a year ago and those today, and discuss what these changes imply for monetary policy.

Economic conditions a year ago

A year ago, the recession had been over for nearly a year and a half, but the recovery had yet to gain any significant momentum. Geopolitical events and the lingering fallout from corporate scandals continued to weigh on business confidence, and in turn led firms to put off hiring new workers and to delay spending on capital equipment.

Many businesses were optimistic that the economy was ready to accelerate, but they were waiting for definitive signs of stronger demand before acting. Our contacts told us: "We can meet current demand through higher productivity, so we are going to put off hiring new workers for a while longer." And, "Some of our equipment may be outdated, but we want to be sure that sales will hold up before we invest in replacements." As a result, payroll employment was still falling and the manufacturing sector had yet to show any signs of life.

Few regions felt the lackluster manufacturing performance more than we did here in the Midwest. A disproportionate amount of the nation's manufacturing activity—especially in motor vehicles and other durable

goods—is based here, and the region tends to be more sensitive to changes in these sectors. Our manufacturing decline started earlier and was sharper than the rest of the nation's, as was our decline in overall payroll employment. And while light vehicle sales were strong for much of the recovery, a good deal of the strength was in foreign nameplates and light trucks, fewer of which are built in the Midwest than cars.

But, other sectors of the regional economy continued to grow modestly, as was the case nationally. Overall, the national economy was expanding in the first half of last year—real Gross Domestic Product grew at a 2½ percent annual rate—but it was not growing fast enough to reduce the elevated unemployment rate and excess capacity that had developed during the recession.

In turn, this slack exerted a downward influence on inflation and even raised the risk that inflation could fall too low. To be sure, this was an unusual situation for the Federal Reserve and put our goal of price stability in a new light. We were faced with the possibility that inflation might turn negative, thus limiting the ability of conventional monetary policy tools to further stimulate demand if needed. While the risk of such an outcome was small, the negative consequences associated with this scenario could be significant.

At this time last year, the FOMC was getting ready for our regular mid-year meeting where, in addition to voting on monetary policy, we prepare our biannual economic forecast to report to Congress. That forecast called for real GDP growth in 2003 to be only in the range of 2½ to 2¾ percent. Such growth would not have been strong enough to reduce excess capacity or slack in labor markets. Furthermore, because of the lack of business confidence, there was a good deal of uncertainty surrounding the forecast. In order to add extra insurance for strong growth, the FOMC decided to lower the Fed Funds rate target to the current level of 1 percent—pushing the rate to its lowest level since the 1950s. A policy that was already accommodative in late 2001 and 2002 became even more so.

Economic conditions today

Since last June, conditions have improved markedly. Accommodative monetary policy was just one in a confluence of factors that helped the economy. Low interest rates allowed businesses to strengthen their balance sheets and allowed consumers to refinance some of their debt. Strong productivity gains fueled growth in profits and real incomes. And stimulative fiscal policy boosted business and consumer spending.

During the second half of last year, real GDP grew at annualized rate of more than 6 percent—the fastest rate in nearly 20 years. The economy's strength became more wide-spread as businesses ramped up their capital spending and hiring. The manufacturing sector rebounded, with production increasing 6½ percent over the past year. Payroll employment increased by 1.4 million jobs from its low point last summer. And real disposable income, which held up well throughout the recession and early quarters of the recovery, accelerated during the past year.

Although conditions are much better than a year ago, activity here in the Midwest lagged the progress in the rest nation. Employment has only started to pick up recently. However in Wisconsin, the job market actually perked up earlier than in the rest of the country, and employment growth here has been more vigorous.

In general, the national economy is moving in the right direction. Many indications of this are evident in the Fed's latest Beige Book, which is a report that was released yesterday and summarizes anecdotal information from business contacts around the country. In most regions, contacts reported that employment was increas-

ing, retail sales were generally positive, residential real estate activity was still robust, and manufacturing activity was growing stronger. And almost all of our industrial contacts in the Chicago Fed district reported that new orders for heavy equipment were "up substantially" —which I take as a sign that manufacturing activity has momentum behind it.

In the Fed's Monetary Policy Report to Congress in February, the central tendency forecast was for real GDP to rise 4½ to 5 percent this year. Given the data we've seen since then, I believe this forecast is still a good one.

With the economy back on solid ground, the inflation picture has also changed. Businesses are making greater use of previously idle resources, and the risk of an unwelcome decline in inflation has subsided. Most recently, we have begun to see some signs of upward pressure on prices; and I'm not just talking about the signs that read "Unleaded gas: $2 per gallon" —or higher. Prices for a wide range of goods and services have been increasing more sharply in recent months. This includes prices for shoes, women's clothes, movies, magazines, potted plants, pet services, etc. But, we've also seen offsetting price declines or slower price increases for other goods and services, including computers, software, furniture, and telephone service. On average, core consumer price inflation (which excludes the volatile food and energy components) has picked up in recent months. Some of this increase represents the passthrough of higher costs for energy and other commodities as well as higher import prices; some likely reflects the speed at which resource usage is increasing. We are carefully monitoring the persistence of these developments. Still, over the past 12 months, the core CPI has risen 1.7 percent—that remains a relatively low inflation rate by historical standards.

Nonetheless, the shift in the economy over the past year has clear implications for monetary policy. The Fed's current, highly accommodative monetary policy stance cannot be maintained forever. If rates were to remain accommodative for too long, the economy would begin to overheat. When rates are low, households increase their demand for goods, services, and housing; and businesses increase their demand for investment goods. Eventually, demand would begin to outpace the economy's potential to produce those goods and services, put pressure on labor and capital resources, and lead to upward pressures on prices. In this case, the original need for accommodative policy would no longer remain. The Federal Reserve must be vigilant to make sure that such pressures do not jeopardize our goal of price stability; at some point, monetary policy will have to move toward a neutral stance.

What is a neutral monetary policy?

Now, when I mention "neutral monetary policy" to an audience, I often get the question: "Mr. Moskow, what does it mean for monetary policy to be neutral? What Fed Funds target rate is consistent with a neutral stance?" Unfortunately, I can't give an easy answer to that question. In practice, the neutral rate is rather difficult to determine-it can and does change over time. However, I can discuss the theory behind the neutral interest rate and the factors that determine it.

In the abstract, the neutral federal funds rate is the rate that supports output moving along its path of long-run potential growth. That is, a neutral interest rate is associated with an economy that has made all its adjustments, closed all its imbalances, and is on its potential growth path. Interest rates below neutral provide extra liquidity, stimulate spending, and eventually push the economy above potential growth; rates above neutral restrain demand and can hold the economy below potential growth. The level of the neutral interest rate is determined by three factors: the time preference of households, the productivity growth trend, and the expected inflation rate.

The first factor, the time preference of households, refers to consumers' natural preference to buy goods and services today, rather than waiting until some time in the future. Given this preference, households require a positive return on their savings as compensation for postponing their consumption. While academic economists often emphasize the role of the time-preference of households in determining interest rates, it is fairly constant over time and does not constitute an important source of variation in the neutral interest rate.

For our purposes, a more important factor is the underlying trend of productivity growth. Faster productivity growth increases the returns on investment. In turn, higher returns on investment lead businesses to increase their demand for funds, which then puts upward pressure on interest rates—believe it or not, this is one instance where business people like you can cheer higher rates.

Productivity can be an important source of change in the neutral interest rate. As we've seen in the past decade, productivity trends do change over time. The rate of growth in labor productivity jumped from an average of 1.5 percent between 1973 and 1994 to an average of 2.7 percent between 1995 and 2003. Some of this increase in productivity growth may be temporary, but the consensus view is that a large part of it will persist for some time. This is because a good deal of the increase is a consequence of the improvements in information technology. Over time, firms discover more and more ways to use IT—not just in production, but in logistics, administration, sales, and other areas. By improving how efficiently business is conducted, information technology leads to persistently faster productivity growth. As a result, the neutral interest rate, net of inflation expectations, is likely higher than it was between the mid 1970s and mid 1990s.

The final factor that determines the neutral interest rate is inflation expectations. Whenever households delay spending, they want to ensure that the return on their savings is not eroded by price increases. The neutral interest rate must include compensation for what households expect inflation to be.

Where do these expectations come from? Most economists would agree that, in the long run, inflation is purely a monetary phenomenon. Business cycle fluctuations in demand will only have long-run effects on inflation if the Fed allows them to. The long-run rate of inflation ultimately is determined by how much liquidity is provided to the economy when it is trending along its potential growth path. Since the Federal Reserve's monetary policy decisions determine how much liquidity is provided to the economy, our resolve and credibility in maintaining price stability is a key factor in shaping long-run inflation expectations.

Over the last 25 years, the Federal Reserve has demonstrated its strong commitment to fighting inflation. Even with the recent up-tick in inflation, consumers' long-term inflation expectations continue to be much lower than they were 25 years ago—a sign of their continued confidence in the Fed. As a consequence, the neutral Fed Funds rate could be lower than it was in the past.

Inflation forecasting: not as easy as it looks

Nonetheless, short-run inflation expectations have increased in recent months. And long-run expectations undoubtedly would rise if we were to see a period of persistently higher inflation rates.

So one challenge the Fed now faces is judging to what extent the higher inflation we've seen this year reflects a general increase in inflationary pressures and to what extent it reflects a transitory or temporary fluctuation. In other words, we have to forecast inflation.

This is a difficult task. Inflation is the outcome of complicated interactions among the structure of the economy, inflationary expectations, monetary policy, and unforeseen events. Forecasting inflation well requires a combination of economic theory, statistical analyses, and judgement. Accordingly, monetary policymakers look at a wide variety of economic data and models in their search for general patterns of consistency that signal incipient inflationary pressures.

One way to find and quantify these patterns is to use statistical techniques. At the Chicago Fed, we have been publishing our Chicago Fed National Activity Index, or CFNAI, since March 2001. The index is a statistical summary measure of 85 economic indicators that provides useful predictive information about turning points in inflation. Still, we wouldn't advocate exclusively using the CFNAI to forecast inflation; it's just one tool in the box.

Incorporating many different models and a variety of data in forecasting inflation can pay off. Researchers at the University of California and Princeton University have found that the Federal Reserve Board staff's inflation forecasts have performed better than those of professional forecasters over the last 20 years. This is obviously good news to us, but you may also find it reassuring.

Inflation outlook

Today, our forecasts at the Chicago Fed tell us that inflation should remain low. While inflation has picked up in recent months, futures markets and other indicators suggest that some of the factors underlying the increase—namely energy and other commodity prices—may have peaked. If so, then their boost to inflation should turn out to be temporary. And at the macro level, we have yet to see the kinds of pressure on labor and capital resources that usually foreshadow a worrisome increase in inflation. Thanks to strong sustained productivity growth, unit labor costs—that is, compensation per unit of output produced in the economy—have been falling on average for the past two years. Outright declines are unlikely to continue as labor markets tighten—in fact, unit labor costs edged up the past couple of quarters—but strong productivity trends should help keep overall cost pressures in check.

Furthermore, in the aggregate, the current markup of prices over unit labor costs is relatively high. While this markup varies over time, it usually does not stray from its historical trend for more than a few years at a stretch. So, going forward, the markup should fall back toward its long-run average—it always has in the past. This decline will tend to dampen the passthrough of increases in unit labor costs to price inflation.

As I mentioned earlier, the improvement in economic conditions implies the Fed must move toward a more neutral policy stance. With inflation low and expected to remain low, we can likely do so at a measured pace. However, we cannot become complacent and expect that inflation will remain at low levels without appropriate action. Ultimately, economic developments will determine the course of monetary policy. Our record of success in forecasting inflation offers us some comfort that we will be able to adjust policy proactively to achieve our goals. But, should unexpected events prove our forecasts wrong, we are ready to make whatever further policy adjustments are necessary.

Conclusion

In closing, I'd just like to note that in the late 1990s, when the Fed was tightening policy, many analysts used the phrase "soft landing" to describe the process of the economy cooling off from its red-hot pace to a sustainable growth path. Today, rather than heading toward a soft landing, the economy is approaching its cruising altitude. For some time, highly accommodative monetary policy has supported the economy's climb toward its sustainable growth path. Our eventual move toward a neutral policy will be aimed at stabilizing activity along this path.

And this growth path looks good—the fundamentals of our economy are strong. With our market-based principles, our entrepreneurial culture, and our continuing technological advances, our economy has the foundation to enjoy solid growth and price stability in the years ahead.