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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 developments suggest that the highly accommodative monetary policy that was appropriate last year is not appropriate going forward. This morning, 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

About this time last year, the recession had been over for more than 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 And, "Some of our equipment may be outdated, but we want to be sure that sales will hold up before we invest in replacements."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.

But, other sectors of the economy continued to grow modestly. Overall, the national economy was expanding in the first half of last year—real gross domestic product increased 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 adverse consequences associated with this scenario could be significant.

These were the conditions and risks that prevailed last year when the FOMC was getting ready for our regular mid-year meeting. At this meeting, in addition to voting on monetary policy, we discuss the forecasts that go into our biannual Monetary Policy Report to Congress. The central tendency of those forecasts 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 against weak growth and unwelcome disinflation, the FOMC decided to lower the fed funds rate target to 1 percent—pushing the rate to its lowest level since the 1950s. A policy that was already quite accommodative in late 2001 and 2002 became even more so.

Economic conditions today

Since then, 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 debt. Strong productivity gains fueled growth in profits and real incomes. And stimulative fiscal policy boosted both business and consumer spending.

The economy's strength became more wide-spread as businesses ramped up their capital spending and hiring. The manufacturing sector rebounded, with production increasing 6 percent over the past year. Nonfarm payroll employment is now up 1½ 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, has accelerated during the past year.

During the second half of last year, real GDP expanded at the fastest rate in nearly 20 years. Some recent monthly data have been a bit on the soft side, but on average economic growth in the first half of this year was quite solid. In general, the national economy continues to move in the right direction—the expansion appears self-sustaining. Rising payrolls should support income growth and with it, consumer spending. And business spending, supported by flush cash positions, should continue to move forward. So our outlook is good: In the Fed's recent Monetary Policy Report to Congress, which was released earlier this week, the central tendency forecast was for real GDP growth in 2004 to run between 4½ and 4¾ percent.

With the economy back on solid ground and expected to remain there, 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. More recently, we have seen 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 clothes, 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 so far this year. 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 1.9 percent—that remains a relatively low inflation rate by historical standards.

Nonetheless, the shift in the economy clearly means that the monetary policy that was appropriate a year ago, is no longer appropriate today. And as a result, the Fed has begun to remove its policy accommodation. On June 30, the FOMC raised its target for the federal funds rate to 1¼ percent. To be sure, monetary policy remains accommodative and this 25 basis point increase is only one step moving policy toward a neutral stance. With inflation currently expected to remain relatively low, policy accommodation likely can be removed at a measured pace. However, the Federal Reserve will be vigilant to make sure that inflationary pressures do not jeopardize our goal of price stability. If the economy begins to overheat, the Fed will move more aggressively toward a neutral policy 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, this factor 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 when business people can cheer higher rates—they are a sign of a healthy, productive economy.

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 rate. 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 uptick 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 infla-

tion well requires a combination of economic theory, statistical analyses, and judgment. 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. The most recent CFNAI numbers—released just yesterday—suggest that general inflationary pressures remain muted. 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 at Berkeley 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 tell us that inflation should remain low. While core CPI inflation has picked up, the most recent monthly readings have been more moderate than earlier in the year. Prices of energy and other commodities are still high, but futures markets suggest that they have peaked. If so, then their boost to inflation should turn out to be temporary. Most importantly, 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.

In our Monetary Policy Report to Congress, the central tendency inflation forecast was for core PCE prices to increase 1¾ to 2 percent, up from the 1 percent inflation rate last year, but still relatively low.

With inflation low and expected to remain low, we can likely move toward a more neutral policy stance 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.