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U.S. Economic Outlook*

A brief description of what's happening in the U.S. economy is never easy. That's one reason you'll always hear economists giving you that old "on the one hand, on the other hand" line. It's not just that we—like accountants—are cautious by nature, it's also that the U.S. economy is very complicated. So on the one hand, the outlook for the next couple of years is pretty good: the economy seems to be growing at or near potential, and the output gap, which I'll explain in a moment, is likely small. On the other hand, the U.S. economy also faces challenges which, if not addressed soon, pose significant risks to the prospects for growth over the longer run.

When gauging the performance of the economy, it's useful to have some kind of a benchmark. Many economists, myself included, like to use the concept of potential output, which is the amount of goods and services that the economy can produce on a sustained basis, when available technology, labor, and capital resources are put to their best use.

Over time, the level of potential output expands, and the level of actual output fluctuates above and below its potential. The difference between the levels of actual and potential output is what economists call the output gap. The economy can operate above its potential for a period of time by utilizing its labor and capital resources at unsustainably high rates. But this will increase inflationary pressures. Conversely, when economic output is below potential, the presence of underutilized resources reduces inflationary pressures. Of course, it's best when actual output equals potential. Then, resources are neither left unnecessarily idle nor put under such pressure that inflation worsens.

Unfortunately, determining how the economy is doing relative to its potential is not easy. Economists and accountants at the Commerce Department estimate GDP each quarter, which gives us a handle on the economy's actual output. But they don't tell us its potential output. Instead, we have to infer potential by

looking at a wide range of economic indicators. To do that we employ sophisticated statistical models as well as a good deal of judgment.

One part of this analysis is trying to determine how fast, on average, the economy's potential tends to grow. So-called trend or potential output growth depends crucially on the growth in labor productivity, which is how much output can be produced by an hour's worth of work. For an accountant, that might be measured by how many hours it takes to process a tax return. Obviously, technology has reduced that amount of time significantly in recent years—just think about all of the products on display here.

For the overall economy, productivity growth averaged a disappointing 1.2 percent per year between 1970 and 1995. Since then, however, productivity growth has picked up, in large part due to advances in high tech, and the 2.7 percent productivity growth rate in the first half of this year is right in line with its post-1995 trend. Combining trend productivity growth with other factors, many analysts come up with estimates of potential output growth in the range of 3 to 3½ percent per year.

Over the last two years GDP growth has been 4.1 percent, somewhat faster than the estimates I just mentioned for potential. Of course, this was no cause for concern, because the 2001 recession had pushed the economy below its level of potential. This meant that the economy needed to grow faster than potential for a time in order to eliminate the excessive slack that had built up. Indeed, over the past two years, we saw the unemployment rate decline by 1.2 percentage points and capacity utilization increase by 4.5 percentage points.

More recently, economic growth appears to be close to a sustainable pace. At the Chicago Fed we use the Chicago Fed National Activity Index, or CFNAI, to summarize 85 monthly measures of economic activity—data such as industrial production, employment, and retail sales. Currently the CFNAI indicates that the economy is growing just slightly faster than its trend rate of growth.

It's worth emphasizing that this growth we are now seeing appears to be self-sustaining. On the consumer side, employment gains have increased incomes, rising equity and home prices have boosted wealth, and currently households are not experiencing difficulty servicing their debt. Together, these factors point to solid growth in household spending. For businesses, expanding sales, flush cash positions, low capital costs, and the need to replace and upgrade aging equipment and software imply that capital spending will continue to increase. Also, although Europe and Japan are experiencing weak growth, our other trading partners are growing sufficiently so that demand for U.S. exports should keep rising. All of these factors add up to a solid base for demand. This demand supports continued growth in employment, income, and profit, which in turn supports further increases in demand.

I've been talking a lot about growth, but as I mentioned earlier, we also need to know where the economy is relative to the level of potential output. Has the relatively robust growth of the last two years been enough to return the economy to potential, or is there still a good deal of slack? This is difficult to judge, but on balance, I'd say that we've come quite close to eliminating what had been a significant output gap. The unemployment rate now stands at 5 percent. While unemployment was lower in the late 1990s, at the Chicago Fed we think that given current economic circumstances, 5 percent is about as low as the unemployment rate can go on a sustained basis. In addition, today's capacity utilization rate of 77.6 percent in manufacturing is only slightly below its historical average. This indicates that there may be some slack remaining in manufacturing, but not much. Finally, despite the rise in energy prices, inflation has remained relatively well contained, also suggesting some degree of slack.

So together, the unemployment, capacity utilization, and inflation data point to an economy currently operating just a little below its potential. But we need to be humble about our ability to make such fine judgments. We face an enormous amount of uncertainty in trying to estimate the level of potential. It could easily be somewhat higher or lower than we think.

What about going forward? Will the economy remain near potential? Well, twice a year the Governors of the Federal Reserve Board and the Presidents of the Federal Reserve Banks submit economic projections. These forecasts are summarized in the Fed's Monetary Policy Report to the Congress, which was released at the time of Chairman Greenspan's congressional testimony last month. The Report's projections have GDP growing by 3½ percent in 2005 and between 3¼ and 3½ percent in 2006—numbers within the range of estimates for potential. Meanwhile, the unemployment rate is projected to remain around 5 percent for both 2005 and 2006.

I mentioned earlier that the current unemployment rate of 5 percent is one piece of evidence suggesting that the economy is operating near potential. However, some analysts question whether that rate accurately reflects the "true" degree of labor market slack. Their concern is that an unusual number of those who want to work may have become so discouraged about their prospects of finding a job that they have given up looking for work. These discouraged workers are not counted among the unemployed when surveyed, even though they may return to the labor force when conditions improve. This is because, in our employment statistics, a person must be actively looking for work to be classified as unemployed.

Indeed, the labor force participation rate, which is the fraction of the population either working or actively looking for work, is well below where it was prior to the 2001 recession. In contrast, 4 years after the 1990-91 recession, the labor force participation rate had returned to its prerecession level.

So the question is, do we think the participation rate will likely return to its prerecession level? At the Chicago Fed, we've spent a good deal of time analyzing the long-term trends, and our best judgment is that we will not see a big rebound in participation.

First, much of the unusual behavior of labor force participation during this cycle has been caused by a sharp decline in the percentage of teenagers in the labor force. Teenagers tend to work fewer hours than adults, so their exit from the labor force has a smaller effect on production than when adults leave the labor force. Furthermore, the recent declines in teenage participation were accompanied by increases in school enrollments—a trend that's been going on since the 1970s. Given the continued need for an educated workforce, the value of staying in school is likely to remain high. This means that we don't expect to see teenagers flood back into the labor force, so they are not likely a large source of slack labor.

Trends in adult labor force participation are also important. While we have seen large secular increases in women's labor force participation for decades, this trend is unlikely to continue. Men's labor force participation, in contrast, has been declining since the 1950s. While this decline also may not continue, we do not see any reason to expect a strong reversal.

Finally, and perhaps most importantly, the aging of the baby boomers is putting downward pressure on labor force participation, because it increases the share of the population that is retired.

Putting all these pieces together, I do not expect a large increase in labor force participation. Accordingly, the current unemployment rate is probably close to the level associated with a healthy economy and little labor market slack.

Now I'd like to turn to the outlook for inflation. Clearly, we're all aware that prices at the gas pump have been increasing rapidly. Although gas and grocery store prices may be the most common indicators of inflation that we see, they are often very volatile. For this reason, economists like to look at so-called "core" measures, which strip out volatile food and energy prices.

In July the Fed Governors and Reserve Bank Presidents forecast that the core price index for personal consumption expenditures, or PCE, would increase between 1¾ and 2 percent for both 2005 and 2006. However, since those forecasts were made, the annual revisions to the national income and product accounts were released in late July. Before the data revisions, core PCE inflation was estimated to be 1.6 percent during 2004; the revised figure is a much higher 2.2 percent. On the bright side, the core PCE inflation rate has been coming down this year, and the latest reading is 1.9 percent over the past 12 months. In my view, the new data mean that inflation this year and next is likely to come in at the high end of the original 1¾ to 2 percent forecast range.

But, it will take appropriate monetary policy to keep inflation well contained. For me, appropriate policy means that we continue to reduce accommodation and return to a neutral federal funds rate, which is a rate consistent with the economy producing and growing at potential over the long run. This should keep inflation in check. I should also note that other indicators support the view that inflation will remain well-contained. Notably, financial market data and surveys suggest that the private sector's long-run inflation expectations remain stable.

While the current outlook is good, there certainly are risks. Unforeseen shocks are always a possibility, of course, but since they are unforeseen they're hard to talk about. There are, however, a few identifiable risks to the near term outlook that we can see now: risks of increasing energy prices, higher core inflation, and the potential for a decline in housing prices.

Since 2002, oil prices have more than doubled, driven by increases in world demand combined with smaller increases in supply capacity. Furthermore, futures markets see crude oil prices remaining high for some time—although not continuing to increase. This is a big change from one year ago when futures prices were well below spot prices.

Rising oil prices may reduce economic growth. The increased amount we spend on imported oil represents a transfer of income from U.S. energy consumers to foreign producers of oil. To date, we think the higher prices have had some effect on growth in the U.S., but it's been relatively modest. Why hasn't the effect been more noticeable? First, solid productivity growth and accommodative monetary policy have offset some of the negative effect of rising oil prices on growth. Second, in real terms, the increase in crude prices is smaller than during the 1970s, and the level remains well below the peak reached in 1980 of $86 per barrel in 2005 dollars. And third, the U.S. economy is less dependent on oil today. Twenty-five years ago, it took more than 15,000 BTUs of energy to produce one real dollar of GDP; in 2003, it took just under 9,500 BTUs. Of course, if prices continue to rise, we could see some more troublesome effects on growth.

In addition to the potential negative effect on growth, rising oil prices, like other unfavorable cost shocks, can also feed through and raise core inflation. So there is also a risk on the inflation front, and the risk is higher now than it was a year ago. Because the economy is running nearer to potential, unfavorable cost developments are more likely to pass through to core inflation. And core inflation is now at the upper end of the range that I feel is consistent with price stability.

If we indeed start to see a string of higher inflation numbers, people may begin to expect permanently higher inflation. Such expectations could become self-fulfilling if they become built into the behavior of households and businesses. And this would have adverse effects on longer term economic performance. If this occurred, the Fed would need to respond accordingly in order to restore price stability.

A third risk to the short-run outlook that analysts have been talking a lot about is a drop in housing prices. Housing has been an area of strength in the economy throughout this business cycle. But there is concern that housing is overvalued and that prices may decline, adversely affecting residential construction and household spending on other goods and services.

The price-to-rental ratio for housing can be used to evaluate whether housing is overvalued in the same way that the dividend ratio can be used to evaluate whether a stock is overvalued. Nationally, the house price-to-rental ratio has been rising sharply since the mid-1990s and currently is at its highest level ever. However, the largest increases have occurred in cities on the East and West Coasts; the price-to-rental ratio has risen much less in Chicago and most other Midwestern cities. These differences highlight the local nature of housing markets. So, unlike many financial markets, there is much less of a tendency for a house price decline in a particular region spilling over to a more general drop in prices at the national level.

If house prices fell, the change in wealth and related spending adjustments likely would be slow. This would give policymakers time to formulate appropriate policy responses and for those actions to affect economic activity.

Furthermore, it's far from clear what's going to happen to house prices. Indeed, some of the increase in the price-to-rental ratio likely reflects real changes in the value of housing. Low mortgage rates have increased the demand for houses. Additionally, financial innovations in mortgage markets, which improve the liquidity of housing investments, and lower capital gains taxes have likely increased the value of residential investment relative to other types of investment.

The risks I've talked about so far primarily relate to the near-term economic outlook. But in the long term, we face a different set of challenges. In order to support productivity growth and maintain a solid trend in economic growth, we need to continue to invest in plant and equipment and human capital at sufficiently high rates.

In the case of physical investment in plant and equipment, the challenge will be financing. Spending on physical capital must be financed by our national savings—which includes saving by households, businesses, and the government—and capital inflows from abroad. Saving by households is quite low, a fact that gets a lot of attention in the media. And, of course, current federal budget deficits mean that government saving is negative. Even when the higher rate of corporate saving is included, overall national saving has fallen in recent years.

Fortunately, the rest of the world has so far viewed the United States as a good place to invest. They have supplied us with enough capital to allow our investment to exceed our own national saving. But this also reflects the fact that our current account deficit—mainly, the difference between our imports and exports—has been rising and is now more than 6 percent of GDP.

Unfortunately, for a number of reasons, such deficits are not sustainable indefinitely. Eventually, our current account deficit must fall and capital inflows will slow. This means that if we are to maintain our cur-

rent rates of capital investment, national saving will have to rise to make up for this adjustment. This will be happening at the same time that the aging of our population will put increasing pressure on our Social Security and Medicare spending. Without changes in spending or taxes or both, this increased demand for social insurance will further increase government deficits and decrease net national saving.

Finally, another factor that can affect our future economic growth is our ability to maintain an educated workforce—a main element of what economists like to call investment in human capital. Historically, this has been a strength of the United States, but some current trends are worrisome. While measures of primary school achievement have improved over time, secondary school achievement levels have not. Test scores (from the National Assessment of Educational Progress) in reading and mathematics for 9- and 13-year-olds are significantly higher now than in the early 1970s, but those for 17-year-olds show no improvement. In addition, over the past 25 years, high school dropout rates have declined little. Furthermore, among 25- to 29-year-olds with the equivalent of a high school degree, there has been an overall increase in the share who have an alternative credential such as a GED rather than a high school diploma. All of these facts point out that too many teenagers are not getting the education they need while in high school in order to be successful in a more competitive workplace.

Among more highly educated individuals, the trends may also be troublesome. The percentage of 25- to 29-year-olds who have completed a bachelor's degree or higher has increased nearly 18 percentage points since 1960. However, this percentage has stagnated since 2000. And foreign students—many of whom stay in the U.S. and enhance our workforce—are having a greater difficulty getting visas to study in our graduate schools. Together, these trends indicate a danger that our pool of highly educated individuals in the workforce will not be sufficient in the future.

Given that the economy currently looks healthy, now is a good time to attack some of our longer-term challenges. How we generate increases in national savings and improve education are important issues for our nation. I think it's encouraging that Social Security reform is being discussed at the national level and that we're seeing education reforms, such as those currently being made in Chicago. But we can't just talk about possible reforms or implement a few pilot programs—we must keep addressing these issues in a meaningful way.

Though the answers aren't easy, I think these are solvable problems. For certain, it's going to take some tough decisions, strong leadership at the national, state, and local level, as well as active participation by all of us. But America is resourceful, and so I'm optimistic. The near-term economic outlook is for solid growth and low inflation. Although there certainly will be some obstacles as we address our longer-term challenges, we can lay the foundation now to reach our future potential.