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U.S. Economic Outlook

Over the last two years real Gross Domestic Product has been growing an average of 3.7 percent each year. This is somewhat faster than potential, or the rate of GDP growth that can be sustained without creating inflation pressures. At first, the rapid pace was a natural response to the prior period of weakness. The economy needed to grow faster than potential in order to eliminate the slack labor and capital resources that had built up during the recession in 2001 and early stages of the recovery, which were sluggish. As such, the Federal Open Market Committee adopted a highly accommodative monetary policy stance in order to support that growth while inflationary pressures were muted.

But now, much of the slack has been eliminated. The unemployment rate has fallen to 5 percent; at the Chicago Fed, we think that such a level is roughly consistent with an economy operating at potential. In addition, the capacity utilization rate in manufacturing is only slightly below its historical average. This indicates that there may be some slack remaining in manufacturing, but probably not much. Finally, core inflation has changed little in recent months. Currently we're not seeing the kinds of disinflationary forces that would be associated with a substantial degree of resource slack like we did a couple years ago.

With economic growth remaining strong, the FOMC began to remove its policy accommodation in the middle of last year, raising the target for the federal funds rate 3 percentage points since then. As we move into 2006 and try to determine whether we have removed enough accommodation, the FOMC will have to answer two critical questions: One, will the economy continue growing near its potential? And, two, will there be persistent pressures on core inflation?

Outlook for Economic Growth

In recent months, economic growth has slowed a bit due to the effects of Hurricanes Katrina and Rita. Clearly, the storms were devastating in terms of lost lives and property destruction, and they created large losses for the local economies. For the national economy, however, it appears that the negative effects of the hurricanes are modest. Furthermore, rebuilding efforts will boost economic activity.

Abstracting from the effects of the storms, current economic growth appears to be self-sustaining because the underlying economic fundamentals continue to be sound. On the consumer side, employment gains have increased incomes, equity and home price gains have boosted wealth, and households have had little difficulty servicing debt. Looking ahead, higher home heating bills and the potential for some slower home price appreciation could moderate consumer spending some. On balance, though, its growth likely will remain solid. 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. All of these factors add up to a solid base for demand. This demand supports continued growth in employment, income, and profits, which in turn supports further increases in demand.

According to the Blue Chip consensus, GDP is expected to grow by 3.5 percent in 2005 and by 3.3 percent in 2006—numbers on the high side of recent estimates for potential. And the unemployment rate is projected to remain around 5 percent through the end of next year.

While this forecast is good, there certainly are risks. One relates to home prices. Housing has been an area of strength throughout this business cycle, and we've seen strong increases in home prices. These higher valuations have increased homeowners' wealth, helping to facilitate more robust spending growth.

Now, many analysts warn that housing is overvalued. One way we can judge this is by looking at the price-to-rental ratio for housing; this is similar to using the price-dividend ratio to evaluate stocks. Nationally, the price-to-rental ratio has been rising sharply since the mid-1990s and currently is at its highest level ever. However, the price-to-rental ratio has risen only modestly in Chicago and most Midwestern cities; the largest increases have occurred in cities such as Miami, San Francisco, and Las Vegas. These differences highlight the local nature of housing markets. There is little tendency for housing price declines in a particular region to spill over to a more general drop in prices at the national level.

However, I am starting to hear more anecdotes about softening in housing markets, and seeing more reports that home prices are increasing at a slower rate. If housing does prove to be overvalued and home prices fall, residential construction would be adversely affected. But history suggests that the impact on overall consumer spending would be more modest. Moreover, the changes in wealth and any related spending adjustments likely would be gradual. Depending on the configuration of other economic factors, it seems likely that these gradual aggregate changes would allow time for any appropriate recalibration of policy—if in fact, one is needed.

But, it's far from certain what will happen to home prices. Some of the increase in the price-to-rental ratio likely reflects real changes that have made housing more valuable relative to other investments. Financial innovations have improved the liquidity of housing investments, and the tax code has tilted even more favorably towards housing.

Another risk to the outlook relates to energy prices. Oil prices have more than doubled since 2002, and natural gas and home heating oil prices are significantly higher. According to the Department of Energy, the average U.S. household spent \$786 to heat its home last winter; this year, the DOE estimates that if temperatures are normal, homeowners will spend \$1044. That's an increase of nearly $\frac{1}{3}$ (32.9%).

Given the large amount we spend on imported energy, oil and gas price increases represent a transfer of income from U.S. consumers to foreign producers. The price increases act like higher taxes, negatively affecting economic growth. Higher energy prices have had some effect on growth in the U.S., but to date, it's been relatively modest. Why hasn't the effect been bigger? First, solid productivity growth and accommodative monetary policy have offset some of the negative effect of rising oil prices. Second, the increase in crude prices, after adjusting for inflation, 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.

Outlook For Inflation

In addition to the risk to growth, rising energy prices are a risk to the outlook for inflation. When economists think about inflation, we like to look at so-called "core" measures, which strip out volatile food and energy prices. The latest reading of the core price index for personal consumer expenditures, the Fed's preferred measure of inflation, shows an increase of 2 percent over the last 12 months. This is at the upper end of the range that I feel is consistent with price stability.

One question about inflation is whether businesses will pass through the recent increases in energy costs to the prices of their products, thus raising core inflation. Higher oil prices find their way into many products, some that you might not think of. To give one example, I've heard from a furniture manufacturer who says that increases in petrochemical prices have raised the cost of polyfoam used in sofas and chairs. He said, "This is the first time in 30 years that the stuffing costs more than the fabric."

Still, unless energy costs continue to rise, such pass-through would just result in a one-time increase in prices and a temporary spike in the core inflation rate, not a sustained higher rate of core inflation. Once businesses adjust their prices to cover the higher costs, prices should not have to rise further, and inflation should return to its earlier rate. Furthermore, although energy prices are still high, they have been falling recently, and futures markets expect energy prices to continue falling modestly next year.

There is another worry however. If we indeed start to see a string of higher inflation numbers, then people may begin to expect permanently higher inflation. Such expectations could become self-fulfilling if business and households factor them into their spending and investing decisions. We could then have a sustained, higher rate of inflation. And this would have adverse effects on longer term economic performance. Fortunately, current financial market data and consumer surveys suggest that long-run inflation expectations remain contained.

Policy Discussion and Conclusion

Nonetheless, it will take appropriate monetary policy to keep inflation and inflation expectations well contained. For me, at this time such policy likely entails further removal of policy accommodation. And if inflation expectations did become unhinged, this might require a stronger response. Looking ahead, we will carefully monitor developments, recognizing that future economic prospects will dictate the course of policy that would be consistent with our goals of maximum sustainable growth and price stability.