

OUTLOOK FOR EQUITY INVESTMENTS 2006
THE UNIVERSITY OF CHICAGO GRADUATE SCHOOL OF BUSINESS
ALUMNI FINANCE ROUNDTABLE

Chicago, Illinois
January 12, 2006



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 the early stage of the recovery, which was sluggish. With inflationary pressures muted, the Federal Open Market Committee adopted a highly accommodative monetary policy stance in order to support that growth.

But now, the slack has been mostly eliminated. The unemployment rate has fallen to 4.9 percent; at the Chicago Fed, we think that this rate is roughly consistent with an economy operating at potential. In addition, the capacity utilization rate in manufacturing has nearly reached its historical average. This indicates that there may be some slack remaining in manufacturing, but probably not much. Finally, core inflation has changed only modestly 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 having strengthened, the FOMC began to remove its policy accommodation in June 2004, raising the target for the federal funds rate 31/4 percentage points since then. As we move through 2006 and consider the appropriate stance for monetary policy, the FOMC will have to answer some critical questions: Will economic growth settle in at a rate near its potential? Will there be persistent pressures on core inflation? And how should policy respond to changes in economic prospects?

I'll address each of those questions in my speech today, as well as two of the long-term issues—national savings and education—that will determine our economic fortunes in the coming years.

Outlook for economic growth

So, let's start with the prospects for economic activity over the next several quarters. I'd say that outlook is good: Sound underlying economic fundamentals appear to be supporting self-sustaining economic growth. On the consumer side, employment has increased, rising home prices and rising equity prices 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, real GDP growth is expected to average about $3\frac{1}{4}$ percent over the next two years—close to recent estimates for potential. And Blue Chip projects the unemployment rate will stay a bit below 5 percent through the end of next year.

The unemployment rate deserves a bit of elaboration. 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 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 return to its prerecession level? At the Chicago Fed, we've spent a good deal of time analyzing the long-term demographic trends, and our best judgment is that we will not see a big rebound in participation. This suggests that the current low levels of labor force participation are not indicative of a slack labor market.

First, roughly half of the decline in labor force participation since 2000 has been caused by a sharp decline in the percentage of teenagers in the labor force. Given their short work hours and low wages, a decline in participation by teenagers has a smaller effect on the aggregate labor market than a decline in participation by prime-age workers. Moreover, much of the recent drop in teen participation may only be an acceleration of what has been a 25-year trend. That trend is for higher school enrollment and lower labor force participation by young people, a development that likely reflects the increased premium on education in the economy. Therefore, we don't expect to see teenagers flood back into the labor force.

Trends in adult labor force participation are also important. While we have seen large secular increases in women's labor force participation for several decades, this was mostly due to differences in behavior between women born before and after 1960. More recent cohorts of women have not been much more likely to work outside the home than their mothers. So the increase in women's labor force participation appears to have largely run its course. Men's labor force participation, in contrast, has been declining since the 1950s, and 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.

Given the fundamentals, I think the Blue Chip forecast is reasonable. But there certainly are some 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. Indeed, even if there were large price declines in some cities, there probably would be little spillover to a more general drop in prices nationwide.

Furthermore, it's far from certain what will happen to home prices. Some of the increase in the price-to-rental ratio presumably 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.

That said, I am starting to hear more 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, such gradual changes would allow time for any appropriate recalibration of policy—if in fact, one is needed.

Another risk to the outlook relates to energy prices. Crude oil prices have more than doubled since 2002. At the consumer level, not only are gasoline prices much higher than they were two or three years ago, but natural gas and home heating oil prices have also risen significantly. According to the Department of Energy, the average U.S. household spent \$786 to heat its home last winter; this winter, the DOE estimates that if temperatures are normal, homeowners will spend an additional \$200.

Given the large amount we spend on imported energy, oil and gas price increases represent an even larger transfer of income from U.S. consumers to foreign producers. The price increases act like higher taxes, negatively affecting economic growth. So why haven't we seen a slowdown in U.S. economic growth over the past couple of years? 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 move back up again noticeably, we could see some more troublesome effects on growth.

Outlook for inflation

In addition to being a 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 readings on the core price index for personal consumer expenditures, the Fed’s preferred measure of inflation, have been favorable, and as of November, the year-over-year increase in the index was 1.8 percent. Still, for most of this past year, core PCE inflation has been running close to 2 percent, which is at the upper end of the range that I feel is consistent with price stability.

Even though core inflation does not include energy prices directly, businesses may pass through higher 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 oil prices are still high, they are down from their hurricane-related spike, and futures markets are not expecting a rebound.

There are other concerns, however. First, given the limited resource slack currently in the economy, possible increases in resource utilization have the potential to increase inflationary pressures. Second, if—for whatever reason—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 businesses 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

Nonetheless, it will take appropriate monetary policy to keep inflation and inflation expectations contained. For me, this likely entails some further policy action. Whatever actions are taken, however, will depend on economic conditions.

When the funds rate was very low, it was clear that the FOMC would need to remove the excess monetary policy accommodation at some point. The rate was far below any reasonable estimate of neutrality.

Conceptually, it’s easiest to think about the neutral—or equilibrium—rate as being the rate consistent with an economy growing steadily along its potential growth path over a long period of time. One can make rough estimates of the neutral real rate by using historical averages of the real federal funds rates from comparable periods. To get a neutral nominal rate, you then add in a forecast of inflation. One can produce a range of estimates for the neutral nominal rate depending on the historical periods you choose and your inflation forecast. By such measures, we’re currently in the bottom end of this range.

Of course, this is a rough estimation. And we have to recognize that many factors can cause differences between the longer-run concept of neutral policy and what may be neutral policy over the short or medium term. For example, all else equal, stronger trends in productivity would raise the equilibrium real rate; in contrast, increased willingness of foreigners to invest their savings in the U.S. would lower the rate.

But there is another very important point to emphasize. Even if the funds rate were at neutral, further changes in policy might be appropriate. My view is that inflation will likely remain contained. Energy prices have come off their highs, and solid underlying trends in productivity should keep overall production costs in check. But, as I mentioned earlier, there are risks to the inflation outlook—namely, the potential for energy cost pass through, pressures from increases in resource utilization, or rising inflationary expectations. And with inflation near the upper end of my comfort zone, an unexpected increase in inflation would be a serious concern, while a decline in inflation would be beneficial. My views about policy will depend importantly on how various cost factors play out and affect the outlook for inflation. In addition, if inflation or inflation expectations were to rise persistently, then policy clearly would have to be tightened further. Of course, other events could transpire that result in prospects for inflation and growth that would be consistent with a less firm policy stance.

What I've just described is the conditionality of monetary policy. As we've said many times, the FOMC will react to changes in economic prospects. Future policy will not be a mechanical reaction to the next number on inflation or employment. Indeed, given the reduction in the degree of monetary accommodation over the past 18 months, the policy firming that is likely to be appropriate over the near term is less certain now than it was earlier in the interest rate cycle. This increases the importance of economic conditionality in the policy decision.

Long-term outlook risks

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 physical and human capital at sufficiently high rates.

In the case of physical investment in plant and equipment, the long-term 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 the current federal budget deficit means 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 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 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, 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 current 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. If, as expected, health care costs continue to outpace inflation, Medicare and Medicaid outlays will account for a rapidly expanding share of the national budget. 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 will affect our future economic growth is our ability to improve the quality of our workforce. This requires us to do a better job educating our school age population and providing further opportunities for training and retraining of those already in the workforce. Education has historically been a strength of the United States, but some current trends are worrisome.

While measures of primary school achievement have improved over the last thirty years, secondary school achievement levels have not. Test scores (from the National Assessment of Educational Progress) in reading and math for 9- and 13-year-olds are significantly higher now than in the early 1970s, but those for 17-year-olds show no improvement. Even for the younger students, however, recent developments are not encouraging: reading scores for 9- and 13-year-olds have been stagnant or declining over the last three years.

Furthermore, high school dropout rates have declined little since the early 1980s. And even with recent increases in enrollments, the graduation rate from traditional 4-year high schools¹ is down nearly 5 percentage points from the late 1960s. It is only when GED holders are included that today's overall graduation rates match those of earlier years. And research shows that when it comes to labor market success, GEDs are not the equivalent of a high school degree. Thus, it seems that many teenagers are not receiving the education they need to be successful in a competitive workplace.

There also are some troubling developments regarding college education. The percentage of 25- to 29-year-olds who have completed a bachelor's degree or higher increased nearly 18 percentage points between 1960 and 2000. However, this percentage has changed little since then. 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 developments raise the concern that our pool of highly educated individuals in the workforce may not be sufficient in the future. This is especially important since the impending retirement of the baby boomers over the coming years will deplete the workforce of many of its most experienced workers.

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. It's encouraging that we have started to discuss Social Security reform at the national level, though I am disappointed that the conversation seems to have stalled. I also am glad to see concerted efforts at education reforms, such as Renaissance 2010, a program currently underway in Chicago that aims to create 100 excellent new schools with more independent and entrepreneurial leadership. But we can't just talk about possible reforms or implement a few pilot programs—we must keep attacking these issues in a meaningful way.

Conclusion

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. 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.

1. Number of diplomas awarded divided by the population of 17-year-olds.