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U.S. Economic Outlook and the Role of Inflation Inertia

The latest economic headlines have generally been positive. Real GDP grew at a brisk pace in the first quarter of this year. The pace of job growth has moved up and down, but on balance has been solid in recent months; and the unemployment rate has fallen to its lowest point in more than four years. However, core inflation has been running somewhat higher in recent months, a development that requires close monitoring.

Today, I will talk about these and other developments, and what they mean for the outlook for economic growth, inflation, and monetary policy in the U.S.

Outlook for economic growth

Let's start by reviewing recent developments. Real GDP growth bounced back to 5.3 percent in the first quarter after a surprisingly weak reading for the last three months of 2005. Notably, spending by consumers and businesses increased at a much higher rate in the first quarter than it did in the fourth.

GDP growth is expected to slow this quarter; but this step down is natural given last quarter's outsized gain. Looking beyond these quarterly fluctuations, the outlook is good: Sound underlying economic fundamentals appear to be supporting self-sustaining economic growth. According to the Blue Chip consensus, real GDP is expected to increase about 3½ percent this year, due in part to the strong first quarter, and increase 3 percent in 2007. I think this forecast is reasonable.

Importantly, this forecast puts the economy close to many economists' estimates for potential growth—that is, it is close to the rate at which the economy can expand while fully employing labor and other resources and at the same time keep inflation stable. The potential growth rate of the economy depends primarily on two factors: how fast productivity grows and how fast the labor force grows.

Productivity, which measures how much output can be produced by an hour's worth of work, receives most of the attention, and it's easy to see why. Productivity growth had averaged less than 1½ percent per year between the mid-1970s and mid-1990s, but then it jumped to over 2½ percent per year.¹ And the underlying trends in productivity remain quite solid today. This has caused the potential growth rate of GDP to increase, and it has resulted in a more rapid improvement in our standard of living. That 1 percentage point acceleration may seem small, but it cuts the time to double our productivity from about 50 years to 30; which in turn means that incomes grow much more rapidly.

The size of the available labor force, however, has been growing more slowly over the last few years. This is a drag on the potential growth rate of GDP. There are two components to labor force growth: growth in the working-age population, and changes in how many people in that group participate in the labor force. Growth in the working-age population has slowed to 1.2 percent per year over the last 10 years, compared to a peak of nearly 2 percent in the mid-1970s. And it's projected to fall a bit further over the next decade.

The labor force participation rate, which measures the proportion of the population aged 16 and older that is working or actively looking for work, had been rising for many years. But, it likely reached a peak in the late 1990s, and should trend down over the next several years. Several factors are at work. First, there seems to have been acceleration in the decline in teenagers' participation. Teenagers are going to school more and working less. Second, the long-running increase in adult women's participation appears to have largely run its course. Younger women are not participating in the labor force much more than their mothers did when they were young. That's a big change from a generation earlier. Third, the rate for adult men has been declining for many years and there is no reason to expect this trend to change. Finally, and most importantly, labor force participation will be pushed down as the baby boomers wind down their careers, because it means the share of the population that is retired will increase.

It's worth noting that the trends in labor force participation are quite different for the Hispanic population. The working-age Hispanic population is growing around 3 percent per year, much more rapidly than the overall population. Also, the Hispanic population is younger on average, and as a result, Hispanics tend to have somewhat higher labor force participation rates. For these reasons, Hispanics have accounted for about 40 percent of our recent labor force growth, even though they make up less than 14 percent of the population. Moreover, some estimates suggest that they could account for almost 60 percent of labor force growth in the next few years. With the decline in the overall participation rate, the growing number of Hispanic workers is adding needed vibrancy to the U.S. economy.

With overall population growth continuing to slow and labor force participation not expected to rise, we probably need to adjust our benchmarks for what level of employment growth is consistent with economic growth near potential and a steady unemployment rate. It used to be that increases in payroll employment that averaged 150,000 per month were consistent with flat unemployment. Now that number may be closer to 100,000. These developments also imply that, in the absence of changes in productivity growth, our estimates of potential GDP growth should be revised down 2 or 3 tenths of a percentage point to a range of 3 to 3¼ percent.

Although the near-term outlook for the economy is mostly favorable, as always there 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.

Some analysts have suggested that housing has become overvalued and that prices are going to decline nationwide. To be sure, we are seeing some softening in housing markets, and home prices are increasing at a slower rate. But it seems unlikely that prices will actually decline nationwide. Housing markets are local in nature. Home prices have risen only modestly in Chicago and most Midwestern cities; the largest increases have occurred in cities such as Miami, Phoenix, and Las Vegas. Even if there were large price declines in some cities, there probably would be little spillover to a more general drop in prices nationwide.

Most forecasts for GDP growth factor in some moderation in home price appreciation and residential investment. But if prices did decline nationwide, history suggests that the impact on overall consumer spending would be modest and gradual.

Another risk to the outlook relates to energy. Crude oil prices have more than doubled since 2002. Gas prices have topped \$3 per gallon in many areas. And home heating and cooling costs are also elevated. Given the large amount we spend on imported energy, increases in oil and gas prices represent a sizable transfer of income from U.S. consumers to foreign producers, which can negatively affect economic growth.

Yet despite the recent increases in energy costs, we haven't seen much of a slowdown in U.S. economic growth over the past couple of years. Some of the negative effect of rising oil prices has been offset by solid productivity growth and accommodative monetary policy. Plus, the U.S. economy is less dependent on oil today. In 1980, it took more than 15,000 BTUs of energy to produce one real dollar of GDP; today, it takes less than 9,000 BTUs. In addition, in the early 1980s, 11 cents of every dollar of consumer spending went to energy-related expenses; in 2005, it was only 8.5 cents. And, the increase in crude prices, after adjusting for inflation, is smaller than during the energy shock in the 1970s. The level remains below the peak reached in 1980 of \$86 per barrel in 2005 dollars.

Nevertheless, the cumulative effect of higher energy prices may yet have a more significant impact on consumer spending going forward. This will require careful monitoring because of the potential impact on the growth of the economy.

Outlook for inflation

In addition to being a risk to growth, rising energy prices are also a risk to the outlook for inflation. When economists try to assess the underlying trends in inflation, we like to look at so-called "core" measures, which strip out volatile food and energy prices. The readings on the core price index for personal consumption expenditures, the Fed's preferred measure of inflation, have stayed low, relative to my early years on the FOMC in the mid-1990s. Nonetheless, for most of the 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 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." And the price of other goods—even those that don't include any petrochemical materials—may rise because the cost of shipping them has increased.

However, higher energy prices do not necessarily imply a persistent rise in inflation. Suppose energy costs stabilize, as the oil futures market predicts. Once businesses adjust their own prices to cover the higher costs, prices would not have to rise faster than increases in the cost of other inputs, and overall inflation would return to its earlier rate. Thus, the energy price increases we have seen to date should result in a one-time increase in prices and a temporary rise in the core inflation rate, not a sustained higher rate of core inflation. Indeed, this pattern can be seen in the slightly lower range for most core inflation forecasts in 2007 compared to 2006.

There are other concerns, however. First, with the unemployment rate currently at 4.6 percent and capacity utilization somewhat above its long-run average, it is important to ask how much slack remains in the economy. Many estimates place the natural rate of unemployment around 5 percent. While there is a great deal of uncertainty surrounding these estimates, an unemployment rate of 4.6 percent likely indicates a vibrant labor market in which more firms may begin to bid up wages to attract and retain workers.

Long periods of high resource utilization are often associated with rising costs and prices. For example, as recently as 2000, the unemployment rate fell below 4 percent and “Help Wanted” signs were everywhere. Businesses offered attractive wages to many workers, and these costs were passed along in the form of higher core consumer price inflation. We are not at that point yet. Increases in compensation have been relatively moderate, and strong trends in productivity have held back the rise in overall unit labor costs. Furthermore, manufacturers often tell me they have a great deal of flexibility to produce without generating cost pressures.

Inflation inertia

Still, given that the economy is operating close to potential, we need to be careful to monitor for the emergence of any economy-wide strains on resource utilization. Such strains would have the potential to increase inflationary pressures, which can have long-lasting consequences. Inflation in the US tends to exhibit inertia. That is, it has a pronounced tendency to stay near whatever level it has been in the recent past. So, when economic developments occur that would eventually cause inflation to change, the actual price adjustments tend to be slow to emerge. However, once in place, the effects are very persistent.

This inflation inertia results from the complexity of firms’ price-setting decisions. These decisions often require a lot of time and effort to implement. As a result, many prices are not changed on a frequent basis. For example, most restaurants don’t want to print a new menu each day, so their prices change less frequently. Automakers enter into annual contracts for the purchases of many inputs, including steel and glass. And some services—such as apartment rents, college tuition, or cell phone service—are sold with longer-term contracts, so their prices change even less often. There are exceptions, of course. Prices of gasoline and some other commodities are adjusted on nearly a daily basis.

However, even some prices that appear to adjust frequently are relatively rigid on a longer-term basis. For example, some firms run sales every few weeks, perhaps when inventories creep up, but the decisions about their base level of prices are made only a few times each year. According to research, the prices for typical consumer goods and services—such as auto maintenance, dry cleaning, and cosmetics—are in effect for about 8 months on average.

Of course, firms will want to raise their prices when their unit costs increase. But, there can be a significant amount of time between when cost pressures begin to build and when the firm actually raises prices. For instance, wages are often adjusted only once per year, so it can take quite some time for tightening labor mar-

kets to be reflected in higher wages and other employment costs. And even when costs do rise, firms often adjust their prices gradually. This is because in the short run, competitive pressures can keep them from more rapidly increasing prices.

Because they are slow to adjust their prices, firms need to anticipate the economic conditions that will prevail over the time until it next adjusts its pricing policy. This makes inflation expectations crucial. If firms expect inflation to be high, they will want to keep up with the general increase in prices. As a result, they will set their own prices higher or build in plans for automatic increases. The higher inflation expectations can become self-fulfilling.

Firms likely form these crucial expectations of inflation largely by taking note of recent actual inflation rates. Because the data bounce around so much from month to month, inflation must be averaged over a period of at least a year or two. The dependence of future inflation on inflation expectations, and the dependence of inflation expectations on several years of inflation rates, contributes to the inertia we see in inflation data.

Since I came to the Fed in 1994, I've talked to many firms about their planning processes, and I have seen important changes in how inflation expectations affect business' price-setting behavior. Initially, most firms would say that they expected their costs to rise by a few percentage points over the coming year and they would plan to increase prices by a similar amount. Given their plans, that's usually what happened. By the late 1990s, however, things had changed dramatically—most firms would say that they thought they would be unable to raise their prices over the coming year. But they still expected to earn greater profits anyway—by boosting productivity and demanding price concessions from their suppliers. That's when I felt we were making real progress on achieving price stability. Firms had come to expect overall inflation to be low and were acting accordingly.

Policy discussion

Inflation inertia has important implications for monetary policy. It might naively be considered a good thing. If the economy started to overheat, inertia means that we would initially see only a small run-up in inflation. But inflation inertia is a double-edged sword. If underlying inflation were to rise significantly above levels associated with price stability, it would have a strong tendency to stay at high levels absent a commensurate policy response. In order to avoid such a scenario, monetary policy needs to remain vigilant for signs of incipient inflation and adjust its stance accordingly.

The 12-month change in core PCE has been running close to 2 percent for the past several months. Personally, my comfort zone for core inflation is between 1 and 2 percent—that's the range of inflation rates I consider to be consistent with price stability. But that doesn't mean that I view the 1 to 2 percent range as a "zone of indifference." I think it's better to be in the middle of the range. In fact, some research suggests that an inflation figure of about 1.5 percent strikes a good balance between avoiding the negative effects of inflation with the value of being able to push short-term real rates into negative territory in periods when the economy is weak.

Given the shocks that are constantly hitting the economy, it's unrealistic to think we can always stay near 1.5 percent. So specifying a zone gives us a rough indication of where we can expect to keep inflation, at least most of the time.

But when we are running near the top or bottom of the range, there's a greater chance that a shock will push us outside of our comfort zone than if we're in the middle of the range. The Blue Chip forecasts indicate that inflation will likely remain contained, and this is my view as well. Importantly, 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, and rising inflationary expectations. With inflation at 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. So I think monetary policy should be calibrated to bring us back to the middle of the range over time.

Moreover, setting policy in a way that tends to move inflation toward the center of the comfort zone is useful for anchoring the public's expectations of inflation. If inflation runs near the top of the comfort zone for long enough, people may begin to question whether that zone accurately reflects our policy. For instance, if inflation were to stay at 2 percent for a couple of years, the public might conclude that 2 percent is not the upper limit of our notion of an acceptable range, but rather the middle of what we think is appropriate. Such tendencies can lead to creeping inflation.

When formulating my views on policy, I factor in all of these considerations regarding cost pass through, inflation expectations, inflation inertia, and where inflation is relative to my comfort zone. And, my views about the appropriate policy action depend critically on how various developments affect the outlook for inflation and growth. In other words, monetary policy is conditional. The FOMC will react to changes in economic prospects. Future policy is not predetermined, nor will it be a mechanical reaction to the next number on inflation or employment. Currently, the exact path for policy is much less certain than it was when rates clearly were well below any rates consistent with long-run sustainable growth and price stability. This increases the importance of economic conditionality in our decisions about the timing and magnitude of policy changes.

Conclusion

But, don't mistake uncertainty about the near-term policy path for any weakening in our resolve to achieve price stability and sustainable growth. The credibility of the Federal Reserve is an important factor in the economy's long-term health, and it is an asset that we do not treat lightly. In the 1970s, we saw how rising inflation and eroding Fed credibility can disrupt the economy, and in the early 1980s, we saw the painful effects on American workers and businesses when the Fed has to act to lower inflation expectations. Together with our nation's core economic values—our belief in free markets and competition, our use of technology and innovation, and our openness to trade—the current environment of price stability, and the Fed's credibility to defend it, give the economy the ability to weather short-term challenges and provide a solid foundation to expand overtime.

1. This is productivity for the entire economy, not just nonfarm businesses.