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U.S. Economic Outlook

At its August meeting, the FOMC announced no change in the federal funds rate target, for the first time in 17 meetings. The front page headline of the Chicago Tribune was “Fed Stops Here.” The Financial Times of London, however, had a different perspective. It argued that a careful reading of the statement accompanying the decision indicated just a pause in the rate cycle. To me these two stories illustrate the uncertainties of making monetary policy in today’s complex economy.

In addressing the current situation, three questions present themselves—regarding growth, inflation, and monetary policy. In terms of economic growth, the U.S. economy is decelerating from what have been relatively high growth rates over the last three and a half years. The first key question is: how will this deceleration in activity settle out? That is, will the current moderation in growth provide some counterweight against potential resource strains—or how likely is it that the moderation builds into a more significant slowing in economic activity?

On the pricing front, core inflation has increased and now stands above the 1 to 2 percent range, which several policymakers—including myself—have identified as a comfort zone for inflation, or a zone consistent with price stability. So, the second key question is: when will inflation return to the comfort zone?

In terms of monetary policy, the third key question is: how should policy react to these developments going forward? That is, against the backdrop of our policy goals, how should we assess the cross-currents and weigh the uncertainties about growth and inflation?

In my remarks today, I’d like to give you my perspective on these three questions.

Growth outlook

To start, it is useful to remember the Federal Reserve's policy mandate. In accordance with the Federal Reserve Act, the primary goals of monetary policy are to achieve maximum employment and price stability. For a variety of reasons, each of these goals requires some interpretation. One might take price stability to literally mean a flat level of prices, or zero inflation. But, as I'll discuss later, an inflation rate of zero isn't the best operational goal, so instead policymakers interpret price stability to be a low and stable rate of inflation. Similarly, maximum employment might be taken to literally mean that every person of working age has a job. But, at any given moment in time, many men and women voluntarily choose not to work and some are not employed because they are changing jobs. So instead, we focus on achieving maximum sustainable growth, which in turn creates the job opportunities that lead to the highest sustainable levels of employment.

To set a benchmark for maximum sustainable growth, we often use a concept called potential output growth, or potential GDP growth. (GDP, or gross domestic product, is our broadest measure of economic output.) 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, in part because of the dramatic change we have seen in it during the past decade. Productivity growth had averaged less than 1½ percent per year between the early 1970s and mid-1990s, but since then it has averaged over 2½ percent per year.

The sector with the most dramatic acceleration in productivity is manufacturing. Manufacturing productivity growth averaged 2.5 percent per year from the 1950s to the 1970s. But things changed beginning in the 1970s, as significant technological advancements spread through the manufacturing sector. For example, many manufacturers began investing in computer numerical code machine tools. These cut curves as easily as straight lines and build complex 3-D structures efficiently, thus reducing the number of machining steps that required human action. Other advances in technology, improvements in logistics, and better management of the workplace also created efficiency gains. Manufacturing productivity growth took off, averaging 2.9 percent per year in the 1980s, 3.8 percent in the 1990s, and then 5.0 percent during the past 5 years.

These productivity gains are good for the country overall. But we should recognize that they aren't good for everyone. The human costs of this process can be significant, as individual workers are forced to change jobs or move into new industries. Many of these costs have been felt most acutely here in the Midwest.

I do not want to minimize the impact of the job losses associated with changes in the economy, no matter what their source. We should strive to ease the transition for the impacted workers and their families, whether it is through financial assistance, retraining programs, or other efforts.

But dynamic changes in the economy are important if we are to continue to increase overall incomes and our standard of living. Commentators often point to our manufacturing job losses as a sign that we are losing our edge in manufacturing. In fact, the job losses are an unfortunate consequence of the strength of productivity in the manufacturing sector. Even as the number of manufacturing jobs declines, factories in the United States are producing record volumes of machinery, computers, motor vehicles, plastics, and other manufactured goods—and in general they are producing them at lower costs—all due to strong productivity growth.

Indeed, the underlying trends in productivity for manufacturing and other sectors of the economy remain quite solid today, and should continue to support a healthy growth rate of potential output.

The other factor that affects potential output—the size of the available labor force—receives less attention. But, as our demographics change, it deserves more scrutiny. The growth in the labor force is slowing, reducing the potential growth rate of GDP. It also affects our benchmarks for one of the most closely watched economic statistics: payroll employment.

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. Over the next decade, it's projected to slow a bit further. These developments reflect the demographics of the baby boom and echo boom generations and patterns of immigration.

The labor force participation rate, which measures the proportion of the population aged 16 and older that is working or actively looking for work, is also declining. The participation rate had been rising for many years, but it likely reached a peak in the late 1990s, and should continue to trend down over the next several years. Several factors are at work, but most importantly, labor force participation will be pushed down as the baby boomers wind down their careers, therefore increasing the share of the population that is retired. In addition, the long-running increase in women's participation has leveled off, and the long-running decline in men's participation continues.

So the trends in both the growth of the population and labor force participation point to slower growth in the labor force. This has important implications for our benchmarks for the monthly employment statistics. Earlier in the decade, most economists estimated that job growth of about 150,000 per month was consistent with an economy expanding near potential. However, research at the Chicago Fed and elsewhere suggests that, given the slower growth in the labor force, monthly increases of roughly 100,000 are most likely consistent with potential.¹ This transition has not yet been fully appreciated by market observers. In each of the past three months, financial markets have expected job growth of about 160,000 on average. When actual job growth averaged just above 100,000, many analysts interpreted this as a sign that the economy is growing slower than its potential. In contrast, we at the Chicago Fed see these numbers as actually consistent with an economy moving ahead at about its potential.

That said, these changes in labor force growth also imply that, in the absence of changes in productivity trends, our estimates of potential GDP growth should be revised down 2 or 3 tenths of a percentage point to near 3 percent.

Against this 3 percent figure, it is clear that the actual GDP growth rate of 3½ percent that we experienced during the past few years is not sustainable. While it is natural for growth to be above trend for a time after a recession, the last recession ended almost five years ago. Consequently, a deceleration to average growth rates is only natural. If the economy continued to expand above potential, imbalances would develop that would lead to rising inflation and, possibly, the premature end of the expansion.

On top of the natural deceleration in output, higher energy prices, the slowing in housing markets, and other factors should push near-term growth a bit below potential for a short period. However, I don't see evidence of a more worrisome downshift in activity. Importantly, the job market is solid: The unemployment rate is below 5 percent and, as I just noted, job creation has been consistent with potential output growth. And

financing conditions appear reasonably accommodative. So businesses and consumers are likely to continue spending at a reasonably healthy rate.

Of course, there are some risks. One relates to housing. The orderly declines that we've been expecting could become more significant. Housing had been an area of strength for an extended period during this business cycle. The large increases in home values added an indirect boost to household spending growth by increasing homeowners' wealth.

Some analysts say that housing is overvalued and that prices are going to decline nationwide. To be sure, we currently are seeing a good deal of softening in housing markets, and home prices are increasing at a slower rate. Looking ahead, most forecasts for GDP growth factor in slow home price appreciation and marked declines in residential investment. But it seems unlikely that prices will actually decline for the nation overall. Housing markets are local in nature. Home prices have risen only modestly in Chicago, Bloomington, 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. And even if prices did decline nationally, history suggests that the impact on 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 moved well above \$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.

To date, the rapid increases in energy costs haven't led to much of a slowing in U.S. economic growth. 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 the energy equivalent of 2½ barrels of oil to produce one thousand dollars of real GDP; today, it takes the equivalent of 1½ barrels. 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 economic activity going forward.

Inflation outlook

The outlook for inflation also poses a number of concerns for policymakers. As I mentioned earlier, the Federal Reserve Act charges the FOMC with maintaining price stability, which is generally regarded as low and stable inflation.

Many policymakers think about price stability as inflation staying within a certain comfort zone. For core PCE inflation—that is, for the Personal Consumption Expenditures index excluding food and energy prices—I set my comfort zone 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 rate of about 1½ percent strikes a good balance between avoiding the costs of inflation with the value of having a cushion 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 1½ percent. So specifying a zone gives us a rough indication of where we should try to keep inflation, at least most of the time.

For the past 27 months, the 12-month change in core PCE has been running at or above 2 percent, and is now 2.4 percent. One reason for core inflation being elevated has been the sharp run up in energy prices. 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. For example, airfares have increased because fuel costs have gone up. And the prices of other goods, such as sofas, have increased because they include foam cushions that are made with petrochemicals. In fact, the magnitude of the energy and commodity price increases has been large enough to account for a goodly portion of the increase in core inflation.

Looking ahead, it's likely that core inflation will come down somewhat, but risks remain. The expected deceleration in economic growth will help avoid the inflation pressures from tightening resource constraints. Moreover, the oil futures market expects that oil prices will stabilize. Should this occur, once businesses adjust their own prices to cover the higher energy costs, overall inflation should return to its earlier rate.

But there is a risk that core inflation could run above 2 percent for some time. We could yet see further cost shocks, and we no longer have excess capacity to help offset their effects on inflation. We also might not have seen the end of the effects of the highly accommodative policy that was in place during 2003 and 2004. As a result, economic growth could continue to average above potential for some time, putting further pressure on resources. And perhaps most importantly, inflation expectations could rise. Indeed, in recent weeks some financial market observers have questioned what a 1 to 2 percent inflation comfort zone means when core inflation has been above 2 percent for so long.

Higher inflation expectations make it more difficult to keep inflation contained. If firms and workers expect inflation to be high, they will want to keep up with the perceived general increase in prices and costs. They will set higher prices and wages or build in plans for automatic increases. In this way, higher inflation expectations can boost actual inflation and become self-fulfilling. That is, they can lead to a persistently higher inflation rate, instead of simply a temporary increase. To date, inflation expectations appear to be contained. Nonetheless, we have to be vigilant in monitoring these expectations; if they did increase, it would be incumbent on the Federal Reserve to adjust policy in a way that would affirm our commitment to price stability.

Policy implications

Of course, the FOMC must consider both its goals of price stability and maximum sustainable growth in assessing risks to the outlook. We need to judge the likelihood of certain events occurring and understand the costs to the economy if they do. At the August meeting, the FOMC held the funds rate target at 5¼ percent, but it noted that “the extent and timing of any additional firming that may be needed to address these risks will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.” By pausing at this time, the Committee will have more time to evaluate a variety of important developments. This was a constructive choice for a number of reasons.

First, the amount of liquidity in financial markets. It continues to be difficult to judge just how restrictive or accommodative financial conditions are today. Despite the increase in the federal funds target from 1 percent to 5¼ percent, long-term interest rates remain low and financial liquidity appears to be deep. With more

time, we'll be better able to determine the impact of past rate increases on financial conditions.

Second, housing. While we factor a housing slowdown into our outlook, there is some evidence—such as higher rates of cancellation in homebuilding contracts—that the slowdown could be more extensive. Although it is only 5 percent of GDP, an unexpectedly sharp decline in residential investment could have significant implications for a number of other economic sectors. With more time, we can better assess the extent of the slowdown and possible spillover effects.

Third, the resilience of growth. In the second quarter, GDP growth slowed to 2½ percent, due to weaker household spending and business investment. I believe a good portion of this moderation was probably due to transitory and one-off events, such as the timing of shipments in transportation and communications equipment. But, more time will provide greater information about whether there is more fundamental weakening in the economy. Alternatively, growth could recover even more than expected.

And finally, energy prices. Recent increases in core inflation have occurred at a time when energy and other commodity prices have been elevated. We expect these prices to at least level off. Accordingly, the passthrough effects on inflation from these cost increases should wane somewhat. More time and data will help us quantify the contribution of these effects.

Of course, as I noted earlier, we are very concerned about inflation expectations. To date, they have been contained, even as core inflation has remained above 2 percent. This stability of expectations, so far, allowed us to wait and gain information on the other developments in the economy.

Taking all of these factors into account, my assessment is that the risk of inflation remaining too high is greater than the risk of growth being too low. Thus some additional firming of policy may yet be necessary to bring inflation back into the comfort zone within a reasonable period of time. That decision will depend on how the incoming data affect the outlook. And we must remember that the typical lags are long between monetary policy actions and changes in inflation. So we need to balance the benefits of gaining new information against the costs of waiting too long. If inflation stays stubbornly high while we wait to see the effects of earlier policy actions, inflation expectations could increase—and that would be very costly.

Conclusion

In conclusion, while the near-term policy path is uncertain, the FOMC's resolve to achieve price stability and sustainable growth remains certain. 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 had to act aggressively to lower inflation and inflation expectations.

Looking ahead, I am optimistic about the fundamentals of the US economy. 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. The methodology for forecasting labor force participation developed in Aaronson and Sullivan (2001) suggests that, currently, the participation rate is trending downward about 0.2 percentage point per year. Alternatively, Tossi (2005) forecasts a drop of about 0.1 percentage point per year over the next ten years, while Aaronson, et al (2006) predict a drop of about 0.3 percentage point per year. Given that the working-age population is growing at a rate of about 1.2% per year, the median of these estimates implies a labor force growth rate of about 0.9% per year. On a base of around 135 million, this suggests monthly increases of approximately 100,000 for nonfarm payroll employment. (135 million * 1.009 / 12 = 101,000.)

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