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U.S. Economic Outlook

This morning, I'll talk about the outlook for the economy and how it affects monetary policy. In particular, I'd like to focus on a key element to the outlook: housing markets.

Growth outlook

To start, it is useful to remember the Federal Reserve's two objectives for monetary policy: maximum sustainable economic growth and price stability. When assessing sustainable growth, we often use a benchmark 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 how fast productivity grows and how fast the labor force grows.

Productivity, which measures how much output can be produced by an hour of work, receives most of the attention. It is the fundamental determinant of our standard of living. During the past decade, we have seen a dramatic pick-up in productivity growth. It 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 size of the available labor force receives less attention, but as our demographics change, it deserves more scrutiny. Two factors determine the growth in the labor force: growth in the population over 16—the working-age population—and the labor force participation rate, which is the share of the working-age population that is working or actively looking for a job.

Currently, both of these factors point to slower labor force gains. Growth in the working-age population has slowed over the past 10 years and is projected to slow a bit further over the coming decade. The participation rate is also declining and expected to continue to trend down, as more baby boomers retire.

These developments have 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 many market observers. Job growth was 92,000 last month, and it has averaged 138,000 during the past six months. By the old standard, such a performance would have been slightly subpar. But given current trends in the labor force, such growth is actually fairly solid. Indeed, labor market conditions have been strong enough that the unemployment rate has declined to just under 4½ percent, further evidence of tight labor markets.

The 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 somewhat to around 3 percent.

Against this 3 percent benchmark, it is clear that the actual GDP growth rate of 3½ percent that we experienced during the past few years is not sustainable today. A deceleration to average or even below average growth rates—as we have seen recently—is only natural.

Real GDP increased at a 1.6 percent rate in the third quarter. Similarly, the National Activity Index, which is a barometer of economic growth published by the Chicago Fed, has moved down in recent months and is now consistent with an economy expanding at below-average growth rates. Part of the slowdown reflects the natural moderation in growth.

A significant part, though, was due to developments in the housing sector. Residential investment has fallen 7½ percent year-to-date, and in the third quarter it shaved 1.1 percentage points off of GDP growth. Additionally, home prices have been rising more slowly and by some measures have even declined. These developments raise important questions for the economy as a whole: Will there be further declines in housing markets? And will the current and any further declines in housing lead to more general economic weakness?

Here, it's important to remember the positive longer-run fundamentals underpinning housing demand. Since the mid-1990s, the housing capital stock—which reflects the number of homes in the U.S. as well as their size and quality—has been growing about 3 percent per year on average.

This demand for housing has been supported by the step-up in productivity growth, which improved the long-run income prospects for Americans. Furthermore, financial innovations lowered borrowing costs and greatly increased access to credit. As a result, the homeownership rate in the U.S. has increased from 64 percent in the mid-1990s to 69 percent in 2005, with improvements across nearly all demographic and income groups. And many people have put their money into bigger and better homes. Between 1995 and 2005, the size of a typical new home increased nearly 20 percent, and many homeowners invested in home improvements and renovations.

Nonetheless, with underlying housing demand growing 3 percent per year, the large gains in residential investment—which averaged 8½ percent per year between 2001 and 2005—clearly could not continue indefinitely. Moreover, housing demand may slow to less than 3 percent, as demographics point to slower growth in household formation. As a result, we at the Chicago Fed expect some further weakness in residential construction.

By themselves, the declines in residential investment could contribute to some volatile numbers for overall GDP growth, as we saw in the third quarter. But their direct impact on the economy is limited by the relative size of residential investment. Home construction is on average only about 5 percent of GDP—that's about the same as people spend on recreation items such as books, golf clubs, and tickets to theater and opera.

In order to generate more general economic weakness, the housing slowdown would have to spill over into other sectors of the economy. One avenue for this to occur is through home prices. We all know that home prices have soared during the past five years. The factors that caused fundamental increases in the demand for housing should be reflected to some degree in higher home prices. But there is still a risk that prices have also been boosted by factors unrelated to demand fundamentals. If that is the case, prices in some regions could unwind and reduce residential construction. And the negative wealth effects from softening house prices could reduce consumption more than anticipated.

Currently, we do not see the slowing in housing markets spilling over into a more prolonged period of weakness in the U.S. economy overall. On balance, the 95 percent of the economy outside of housing remains on good footing. Employment has been increasing near its long-run sustainable pace. Productivity trends remain solid. Recent declines in oil prices should give household budgets a boost. Economic growth in other countries should increase demand for our exports. And current financial conditions are not very restrictive by historical norms.

My baseline forecast is that GDP growth will pick up from the weak third quarter and average somewhat below its potential growth rate over the next year or so. Of course, that's an average—I do expect to see some volatility in the numbers.

Here in the Midwest, the outlook is more nuanced. While a significant risk to the national outlook is the fallout from the housing slowdown, that risk seems smaller here. Home construction did not quite boom in the region as it did elsewhere, and home price appreciation was more subdued here. In the Chicago metropolitan area, the run-up in home prices was slightly below the national average during the past five years. Other parts of the Midwest—particularly Michigan and Indiana—did not have any run-up at all. These movements suggest that home prices in the region have been little influenced by factors unrelated to demand fundamentals.

Instead, the biggest risk to the regional economy relates to the struggles of the auto industry. Customer tastes have been shifting from large pick-ups and SUVs to more fuel-efficient vehicles. In response, the Big 3 automakers have been cutting light truck production to get their inventories in line with sales. Many of those cuts have been felt acutely here in the Midwest, restraining local economic activity. And ongoing restructuring efforts by the Big 3 will likely continue to contribute to relatively sluggish growth in the region.

The Chicago metro area will feel some of the declines in the auto industry. But Chicago is the business services hub for all of the Midwest. And fortunately, not all Midwest businesses are struggling, and many others continue to record strong sales. Such growth, along with continued U.S. economic expansion, is lifting Chicagoland employment.

Inflation outlook

For Fed policymakers, the national growth outlook is only one piece of the puzzle. The other is inflation. Many policymakers assess inflation with a comfort zone—that is, a range for inflation that they feel is consistent with their view of price stability.

By my standards, inflation has been too high. I prefer to see it between 1 and 2 percent. But the 12-month change in the price index for personal consumption expenditures excluding food and energy, also known as core PCE, has been running at or above 2 percent for 30 months, and in September it was 2.4 percent. In part, core inflation has been elevated because businesses have raised their prices in response to earlier increases in energy costs. High levels of resource utilization also have added more generally to inflationary pressures.

Looking ahead, it's likely that core inflation will come down somewhat over time. The recent declines in oil prices clearly are a positive factor. And the expected deceleration in economic growth will help avoid sustained pressures from resource constraints. Still, there is a risk that core inflation could run above 2 percent for some time. We could be wrong about reduced pressures from resource constraints, or we could see further cost shocks. And perhaps most importantly, if actual inflation continues at high levels, it could cause inflation expectations to run too high. If firms and workers expect inflation to be high, they will want to compensate by raising prices and wages or building in plans for automatic increases. In this way, high inflation expectations can lead to persistently high actual inflation.

Policy implications

Taking all of the factors on growth and inflation into account, my current 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 to a range consistent with price stability in a reasonable period of time. But that decision will depend on how the incoming data affect the outlook.

In each of our past three meetings, the Federal Open Market Committee has held the funds rate target at 5¼ percent. The Committee's decision to pause gives us more time to gather information on a number of important developments and assess their implications for the outlook for growth and inflation. And we were able to pause because inflation expectations have been 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 to affirm our commitment to price stability.

Conclusion

In conclusion, I am optimistic about the fundamentals of the U.S. economy. In the near term, we face some challenges from slowing residential investment and elevated inflation rates. But we have the ability to weather these challenges. Together with the Federal Reserve's commitment to its policy goals of sustainable growth and price stability, our nation's core economic values provide a solid foundation for the economy to expand over time.

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, Toosi (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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