CARTHAGE BUSINESS AND PROFESSIONAL COALITION
CARTHAGE COLLEGE

Kenosha, Wisconsin
December 1, 2006

U.S. Economic Outlook

Today, 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. This potential growth rate of the economy depends primarily on how fast productivity grows and how fast the labor force grows.

As you know, productivity measures how much output can be produced by an hour of work, and it 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 sector with the most dramatic acceleration in productivity is manufacturing. Beginning in the 1970s, manufacturers increasingly used technology to improve efficiencies in all aspects of their businesses. Many manufacturers began investing in computer numerical code machine tools, which cut curves as easily as straight lines and build complex 3-D structures efficiently. Some have set up computer networks with their suppliers, to facilitate automatic ordering. And one snack maker even used a supercomputer to study the aerodynamics of its potato chips after it found that too many were flying off the assembly line. With these

advances in technology and better management of the workplace in general, 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 over the past 5 years.

These productivity gains are good for the country overall. But we should recognize that sometimes productivity gains require difficult changes for firms and workers. The human costs can be significant, as individual workers are forced to switch jobs or move into new industries. Many of these costs have been felt 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, 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. I went to the International Manufacturing Technology Show this summer and was impressed by the amount of new technology and tools in development. I was probably most impressed by one device that was similar to an ink jet printer, only it uses metal dust to “print” three-dimensional parts. These innovations and others should continue to support gains in productivity and, by extension, a healthy growth rate of the economy’s 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. Growth in the population over 16 has slowed over the past 10 years and is projected to slow a bit further over the coming decade. The labor force participation rate—the share of the working-age population that is working or actively looking for a job—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 has averaged 138,000 over the past six months. By the old standard, 138,000 would have been slightly subpar. But given current trends in the labor force, such growth is quite 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 2.2 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 the data for October were 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 7.7 percent year-to-date, and in the third quarter it shaved 1.2 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 declines 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. Over the past decade, the size of a typical new home increased nearly 20 percent, and many homeowners invested in home improvements and renovations. Today, many middle-class homes have bigger kitchens and more bathrooms, and it's not uncommon to see some with state-of-the-art media rooms.

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. 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 here as it did elsewhere. And home price appreciation was more subdued here. The biggest home price gains in the U.S. were in cities such as Miami, Phoenix, and Las Vegas. In southeast Wisconsin, 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. Light vehicle sales have slowed somewhat from the pace of the past two years. Furthermore, 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.

Nonetheless, all of the news in the auto industry isn't negative. The so-called transplants—the Toyotas, Hondas, and other foreign-brand vehicles assembled in the U.S.—continue to sell well. Indiana and several southern states have had some success attracting transplants, bringing with them additional jobs supplying auto parts to the assembly plants. Most recently, Honda announced that it is going to open an assembly plant in Greensburg, Indiana, that will employ 2000 workers when it comes on line in 2008.

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 October 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, core inflation likely 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.

Of course, there are risks to the inflation outlook. We could see further cost shocks, or we could be wrong about reduced pressures from resource constraints. Long periods of high resource utilization are often associated with rising costs and prices. 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. Today, the unemployment rate has fallen to 4.4 percent and labor markets have tightened. Compensation per hour, which includes benefits as well as wages and salaries, appears to have accelerated somewhat above the 4 percent range seen in 2004 and 2005. With productivity growth reverting from exceptionally strong growth rates, unit labor costs are also accelerating. Some of this increase in costs has been absorbed by businesses in the form of lower profit margins, and there may still be room for margins to absorb some further pay increases. But the risk remains that labor cost pressures will show through to inflation.

The recent price data have been consistent with some easing in inflation. But that is only one month. The key is whether that trend can be sustained and how quickly inflation will move back to the range that is commensurate with price stability. 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. As reflected in the minutes of the October meeting, all Federal Open Market Committee members agreed that inflation risks remained the dominant concern. 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 FOMC 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.)

Aaronson, Daniel and Daniel Sullivan (2001), "Growth in Worker Quality," *Federal Reserve Bank of Chicago Economic Perspectives*, 4th Quarter, pp. 53-74.
http://www.chicagofed.org/publications/economicperspectives/2001/4qepart5.pdf

Tossi, Mitra (2005), "Labor Force Projections to 2014: Retiring Boomers," *Monthly Labor Review*, November, pp. 25-44.
http://www.bls.gov/opub/mlr/2005/11/art3full.pdf

Aaronson, Stephanie, Bruce Fallick, Andrew Figura, Jonathon Pringle, and William Wascher (2006), "The Recent Decline in Labor Force Participation and its Implications for Potential Labor Supply," March, prepared for the Spring 2006 meeting of the Brookings Panel on Economic Activity.
http://www.brookings.edu/es/commentary/journals/bpea_macro/200603bpea_aaronson.pdf