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U.S. Economic Outlook

When I look at the economy today, I find that many of the issues I was focused on toward the end of 2006 still apply, and my overall outlook is little changed. Continued weakness in the housing sector is holding back economic growth. But the economy outside of housing is on good footing, and I expect the pace of expansion in overall economic activity will move back up to trend. Solid job growth should support consumer spending; ample liquidity and profitable opportunities should sustain business investment; and strong growth outside the US should boost demand for our exports. My predominant concern remains the risks to the inflation outlook. We've seen some welcome easing in inflation in the past couple of months, and I'm hopeful this development will continue. But there is still the risk that resource pressures or other factors, such as elevated inflation expectations, could prevent actual inflation from falling in a timely fashion.

So today, I'd like to discuss in greater detail why I have these views on the economy.

Growth outlook

Let's start with the outlook for overall economic growth. Real GDP—our broadest measure of economic output—increased at a 2.6 percent annual rate in the second quarter of the year and 2.0 percent in the third. We'll get the fourth quarter numbers at end of January—the latest private sector forecasts have GDP increasing at a 2.3 percent rate last quarter. These numbers compare with an average annual growth rate over the prior three years of 3.8 percent. So growth over the past nine months has been a good deal slower than over the previous few years.

The robust growth in those years in part was making up for ground lost due to the recession of 2001 and the sluggish start to the recovery. That catch-up process has run its course, and some of the slowdown in 2006 is part of the natural process of the economy shifting from a high-growth, recovery mode to one that puts growth on a more sustainable path for the longer run.

Looking ahead, my baseline forecast is that GDP growth will pick up and over the next year or so will average a bit below its potential growth rate—where potential refers to the rate of growth the economy can maintain in the long run without generating increasing inflation pressure. Of course, that's an average—I do expect to see some volatility in the numbers.

A number of factors should support growth. The first is the continued solid underlying trend in overall productivity, or output per hour of work. Productivity growth picked up from a 1¼ percent rate over the period between 1973 and 1995 to average about a 2½ percent rate over the past ten years. Productivity gains should continue, as technology advances further, workers become more skilled in using technology, and managers find new ways to apply technology to their businesses. This will support continued growth in real income and profits. Next, the labor market is healthy. And lower prices for energy-related products have boosted the real purchasing power of households and businesses. Current financial conditions also are not particularly restrictive by historical norms; corporate balance sheets are in good shape, and there is ample liquidity in financial markets to support borrowing. Finally, the recent slowdown in GDP growth does not appear to have shaken business confidence, and the majority of the business people that I talk to remain optimistic about the outlook for the economy.

Indeed, many sectors of the economy have been experiencing solid growth. Consumer expenditures—which represent about ⅔ of the spending in the economy—have held up quite well, increasing at an average annual rate of 3.6 percent through November. Though we are expecting more moderate growth ahead, business fixed investment rose at an average rate of 9.3 percent over the first three quarters of 2006, the strongest stretch of growth since before the 2001 recession. And our exports have increased 9 percent over that time, and further solid growth in countries outside the U.S. should continue to boost demand for our products.

Residential investment

But the economy rarely expands evenly in all sectors at the same time. Other factors have restrained U.S. economic activity and caused growth to run below potential in recent quarters. The most notable is weakness in the housing sector.

Housing starts had risen to a very high annual rate of 2.1 million units in the last quarter of 2005 but have since declined sharply, falling to a 1.5 million unit pace by the fall of last year. The level of residential investment—which includes both new construction and improvements—fell 7.7 percent over the second and third quarters of last year. In the third quarter alone home construction 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 about the economy's growth prospects. But while I expect to see some further declines in residential construction, I do not think that the developments in housing markets will lead to more general economic weakness. One reason is that a number of positive longer-run fundamentals underpin housing demand and thus put a floor on how far residential construction will decline.

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 is a very healthy growth rate by historical standards, particularly given demographics. Over the same time, the homeownership rate in the U.S. has increased from 64 percent to 69 percent in 2005. And homeownership rates are up across nearly all demographic groups and income categories.

An important factor supporting housing demand and homeownership is the increase in the underlying trend in productivity growth that occurred in the U.S. economy in the mid-1990s. This improved the long-run income prospects for Americans. 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. Many middle-class homes now have bigger kitchens and more bathrooms, and it's not uncommon to see some with state-of-the-art media rooms.

Another factor supporting housing is that financial innovations have lowered borrowing costs and greatly increased access to credit. These innovations started in the 1980s and their momentum continued to build through the 1990s. Along with changes in the tax code that favored housing relative to other investments, they have increased the attractiveness of housing as an investment.

One financial innovation is securitization. Most single-family mortgage originations now are bundled together and sold as mortgage-backed securities, diversifying risk by pooling a large number of loans and investors. This lowers the risk premia built into mortgage rates.

Other innovations, such as credit scoring, have increased the efficiency of mortgage origination. Automation also makes the process much less costly. In addition, homebuyers can now easily shop the internet for a wide range of competing mortgage brokers for the lowest interest rates and other terms. These changes have contributed to a drop in initial fees and charges on mortgages from about 2½ percent in the mid-1980s to under ½ percent in recent years.

Further changes broadened the selection of loan types available to homeowners. Subprime mortgages, interest-only loans, and hybrid ARMs have opened up financing to borrowers who previously could not obtain it at all or could not borrow as much as they would like. True, these instruments are riskier than traditional mortgages. Still, to the extent that both borrowers and lenders understand the risks involved and markets have priced this risk properly, these instruments represent a net gain to society. Here there is a role for public policy. On the part of the Fed, we are supervising lenders with regard to the disclosure of terms and costs to borrowers and with regard to the risks of carrying such nonstandard loans on their books. We are also promoting financial literacy efforts for borrowers. At the Chicago Fed, we established Money Smart Week in Chicago, in partnership with local businesses, community groups, and government; and we're expanding the program to other parts of our District, including events in Iowa this year, from April 16 to 21.

Finally, the financial environment underlying today's mortgage market is quite different from previous decades. Contrast today's environment with the 1960s and 1970s, when there were regulatory ceilings on interest rates, or with the early 1990s, when "financial headwinds" were restricting the supply of credit. These factors prevented some people from obtaining mortgages regardless of the interest rates they were willing to pay.

The pickup in productivity and financial innovations represent permanent improvements that support housing demand. Still, it is clear that the large gains in residential investment we experienced in the first half of this decade could not continue indefinitely. In order to satisfy the increased demand for housing, residential investment increased an average of 8½ percent per year between 2001 and 2005. This surge was needed to build the new and bigger homes that people were demanding—that is, to boost the growth rate of the overall housing stock to 3 percent. But now that it has, residential investment growth can adjust back down to rates more in line with the trends in underlying housing demand. Moreover, underlying housing demand may slow to less than 3 percent, as demographic trends point to slower growth in household formation.

In addition, there is the issue of the large increases in house prices that we have seen over the past five years. In some cities in California, Florida, and Arizona, house price increases seem to have defied gravity. Here in the Midwest, price appreciation was more modest. The factors that caused fundamental increases in the demand for housing should be reflected to some degree in higher home prices. But prices in some locations likely have also been boosted by factors unrelated to longer-run fundamentals.

So all told, we at the Chicago Fed expect some further weakness in residential construction. But I do not expect a large spillover of the weakness to other sectors of the economy. Importantly, there has been concern that the unwinding of prices in some regions could result in negative wealth effects that would reduce consumption significantly. But we have not seen that—consumer spending has held up quite well.

Sustainable job growth

One reason that consumer spending has continued to grow at such a healthy rate is that labor markets remain vibrant, generating solid gains in real personal income. Over the past six months, employment has increased by an average of 160,000 per month. During the 1990s and early 2000s, we used to think that the monthly job growth that was sufficient to employ the net number of entrants into the labor force was about 150,000. So by this standard, the recent performance of labor markets has been slightly above average. But recent changes in demographics and cultural trends imply that this benchmark has likely moved down—we at the Chicago Fed think it's now closer to 100,000.

There are two reasons for this. First, growth in the working-age population has slowed. The working-age population grew rapidly in the 1960s and '70s, averaging 2 percent per year, as the baby boomers finished school and entered the labor force. But starting in the early 1980s, working-age population growth slowed to a little more than 1 percent per year. And it's projected to slow a bit further over the next decade, given the small size of the generation entering the workforce relative to the size of the retiring baby-boom group.

Second, the percentage of the population in the labor force—the labor force participation rate—has begun to decline. From the early 1960s until around 2000, the labor force participation rate increased steadily. More women chose to work outside the home, offsetting a slow decline in the fraction of men in the labor force. But now the increase in female labor force participation seems to have run its course, and more and more boomers are past the age at which people are most likely to participate in the workforce.

Together, the changes in population growth and labor force participation imply that about 100,000 new jobs per month are needed to employ new entrants to the labor force. So against this standard, the 160,000 per month job growth over the past six months is quite strong.

Natural rate of unemployment

Labor markets are also important for our views about inflation. In our dynamic economy, workers constantly move from one employer to another in response to changes in demand and technological innovations. Some of these job changes are voluntary, some are involuntary. Other workers lack the skills demanded by employers in their locales. Unfortunately, because it takes some time for workers to find new jobs, a certain level of unemployment is unavoidable. Economists refer to this level of unemployment as the "natural rate of unemployment." Expansionary monetary policy cannot keep unemployment below this level on a sustained basis. Trying to do so only generates increasing inflationary pressures.

When I joined the Chicago Fed in the mid-1990s, conventional thinking was that the natural rate of unemployment was around 6 percent. But since then, the unemployment rate has averaged 5 percent and inflation actually fell, averaging just 1.8 percent (as measured by the core PCE price index). So it is likely that the natural unemployment rate is lower than it was in the early 1990s.

One reason the natural rate may have fallen is that job search and the process of matching workers with jobs has become more efficient. In the 1990s, the wide use of fax machines and then email reduced the time needed to submit a resume or application to mere minutes. Numerous web sites now allow people to more quickly search and apply for jobs. Similarly, businesses can automatically search large databases of resumes and quickly screen applicants for desired qualifications. Who knows where this is heading? For instance, I read the other day that Google has its job applicants fill out an elaborate online survey, which asks all sorts of odd questions, such as whether you have a neat or messy work space, or even whether you have ever set a record in anything. They then use a complicated algorithm to sort through the answers to determine how well the job applicant would fit into its unique culture.

The very rapid growth of new employment practices, which some call just-in-time hiring, also likely played a role in lowering the natural rate of unemployment. Thanks to a number of developments, but particularly the rise of temporary help services firms, companies now have greater flexibility to adjust their work forces on short notice. Demographic changes are also in play. As the baby boomers acquired more working experience, their ability to find jobs improved. Experienced workers have more employable skills, know more about what jobs match their skills, and have a broader network to help them conduct a job search. The natural rate of unemployment for the entire economy should be lower because these experienced and relatively employable workers comprise a larger portion of the workforce. Other changes in the workforce, such as higher average education levels, may also have brought the natural rate down.

It is difficult to quantify the total impact of these demographic changes and the improvements in hiring and job search efficiency. In a recent survey of economists, most estimate that the natural rate of unemployment is between 4½ and 5½ percent—suggesting that it is a full percentage point lower than in the mid-1990s. In December, the unemployment rate was 4½ percent, at the bottom of this range. This suggests that we need to be vigilant for the possibility of increases in inflationary pressures.

Inflation outlook

On the inflation front, core inflation—as measured by the 12-month change in the price index for personal consumption expenditures excluding food and energy—increased from 1.3 percent in the summer of 2003 to a recent high of 2.4 percent in October. 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.

By my standards, inflation has been too high. I prefer to see it between 1 and 2 percent. The most recent news on inflation has been good, with the 12-month change in core PCE coming down from 2.4 percent in October to 2.2 percent in November. Looking ahead, core inflation likely will ease somewhat further. The deceleration in economic growth reduces somewhat the risk of sustained pressures from resource constraints. And the recent period of lower oil prices clearly is a positive factor.

Although the recent news has been favorable, risks to the inflation outlook remain. Additional cost shocks at this time would be unwelcome, 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. And today, as I mentioned, the unemployment rate is at the low end of the estimates for the natural rate. Growth in compensation per hour over the past year was not much higher than it was in 2004 and 2005. This measure includes benefits as well as wages and salaries. But unit labor costs have accelerated because of changes in productivity. Although the underlying trend is still solid, productivity growth over the past several quarters has moderated from exceptionally strong rates. And down the road, tight labor markets could generate some larger gains in compensation. However, profit margins are relatively high, so some further increases in labor costs could be absorbed by businesses in the form of lower margins.

Another risk to the inflation outlook would be if the recent positive news on inflation turns out to be transitory. Disappointing numbers on actual inflation rates 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.

So the summary on inflation is that the recent price data have been consistent with some easing in core inflation. The key going forward is whether that trend can be sustained and how quickly inflation will move back to the range that is commensurate with price stability. And we need to continue to be vigilant in monitoring the risks to the inflation outlook.

Conclusion

In conclusion, I am optimistic about the fundamentals of the U.S. economy. Our nation believes in free markets and competition, is open to trade, and welcomes new technology. These core economic values promote and encourage innovations that create jobs, boost productivity, and raise our standard of living. We have all seen how innovations in technology work this way. But so do innovations in intangibles, such as those which enable us to more efficiently allocate, organize, and manage our productive resources. Not only does the U.S. economy do a good job developing computers, we do a good job in developing these intangible assets.

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.