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### U.S. Economic Outlook

As you may know, the Federal Reserve has two primary goals for monetary policy. One is to foster financial conditions that help the overall economy expand at its maximum sustainable pace. This is no easy task. The economy rarely grows at a steady pace, and it is made up of many diverse parts, which rarely evolve in the same way at the same time. Today, for example, the perspective of an exporter is quite different from the perspective of a home builder or mortgage broker and different still from the perspective of a retailer. The Fed is ill-equipped to and should not try to even out the differences among sectors. But by looking carefully at developments in the various sectors of the economy, we can identify risks to achieving overall sustainable growth.

Our second primary goal is to maintain price stability, or low and stable inflation. We also try to identify risks to this goal. Some are relatively easy to spot, such as cost pressures from a tight labor market, or shocks to energy and commodity prices. Others are more difficult to see, such as changes in consumer and business expectations about inflation.

So today, I'd like to give you my thoughts on recent developments in each of the sectors of the economy, and I'll discuss how they affect my outlook for growth and inflation in 2007 and 2008.

#### The macroeconomy

In order to see where the economy is heading, it's important to look back on where it's been. In 2006, the economy weathered some periods of uneven growth and a sharp decline in housing activity. However, the housing slowdown did not spill over to weaker growth in other sectors of the economy. Real gross domestic product, or real GDP—our broadest measure of economic output—increased 3.1

percent last year. Many economists estimate that the economy's potential growth rate—that is, the rate of growth it can sustain over time given its labor and capital resources—is close to 3 percent. So, on average, the economy expanded near its potential in 2006. However, growth was stronger early in the year and below potential in the second half. Meanwhile, throughout the year firms were hiring workers at an impressive pace, and labor markets continued to tighten; the unemployment rate fell to 4½ percent in the fourth quarter, down from 5 percent at the end of the previous year.

Such tightening resource pressures, as well as high energy and commodity prices, likely contributed to faster increases in prices. As a result, inflation ran too high. The Fed's preferred measure of inflation is the price index for personal consumption expenditures excluding food and energy, also known as core PCE. In 2006, core PCE increased 2.3 percent, up a bit from 2.1 percent in 2005. By contrast, I prefer inflation to be between 1 and 2 percent—that's the range that I consider to be most compatible with the Fed's goal of price stability. The monthly inflation numbers did come in lower toward the end of the year, and I was pleased to see the improvement. However, core PCE moved up in January. Clearly, it is much too early to say that inflation is no longer a concern.

Looking to the outlook for the next couple of years, the Federal Reserve published our biannual Monetary Policy Report to the Congress in mid-February. In it, the participants on the Federal Open Market Committee gave forecasts for GDP, unemployment, and inflation. The central tendency of the growth forecast is for real GDP to increase between 2½ and 3 percent in 2007 and for it to increase between 2¾ and 3 percent in 2008.

A good deal has happened since these forecasts were prepared. Financial markets have been volatile, which imparts more uncertainty to the outlook. The data we have received on economic activity have been mixed, but on balance have come in on the soft side. Many of our business contacts also have pointed to slower growth early in the year. However, they also gave a number of indications that economic activity has been firming in recent weeks. And I still think that the underlying economic fundamentals are conducive to a pickup in growth as we move through 2007 and 2008. So I am not prepared to significantly change my projections at this time.

## Housing

Among the individual sectors of the economy, the most significant area of concern has been housing markets. Last year, home sales fell sharply and fewer new homes were built. Residential investment fell 12.6 percent, reducing GDP growth by ¾ of a percentage point. A key question for the outlook is: What will be the full extent of the housing slowdown?

To gain some insights into where housing activity may settle out, it's important to think about the factors that led to the housing boom during the first half of this decade. Part of the boom was the result of strong productivity growth, which led to solid income gains that many people spent on bigger and better homes. Additionally, financial innovations helped keep the cost of financing low and improved many people's access to credit—in fact, the housing boom coincided with large improvements in homeownership for people in all income and ethnic groups. A boom in construction was needed to build the new homes that people were demanding. But once these homes were built, construction needed to settle back to more sustainable levels. So some slowdown in construction was to be expected; but the degree and timing of the slowdown were—and still are—uncertain.

The most recent data on housing have been mixed, but suggest that downside risks remain. Housing starts showed signs of stabilizing when they ticked up toward the end of last year, but they then declined sharply in January. These numbers can be highly volatile—especially during the winter months—so we should be careful not to read too much into the decline. Indeed, permits for home building—which tend to be less susceptible to weather changes—fell by a much smaller amount than starts. Nonetheless, inventories of unsold homes remain much higher than they were a year ago, and it will take some time for the excess inventory of homes to be sold. Home builders we talk to report some tentative signs of markets stabilizing, but the progress is uneven. For example, one national home builder recently told us that it has yet to see any stabilization in some Midwest markets, including Chicago.

That said, the longer-term fundamentals remain positive. The same factors that supported the housing boom—strong productivity trends, improved access to credit, and low mortgage rates relative to historical norms—are still in place. These factors likely put a floor under how far housing will decline. So I think home building will stabilize as we move through the year, but I don't expect to see any noticeable increases, either.

There also are financial risks associated with the declines in housing markets. Notably, defaults on subprime mortgages could have a larger-than-expected effect on households and lenders. True, these instruments are riskier than traditional mortgages. Still, to the extent that both borrowers and lenders fully understand the risks involved and markets have priced this risk properly, these instruments can represent a net gain to society by opening up financing to borrowers who previously could not obtain it. Here there is a role for public policy. The Fed, along with the other federal banking agencies, has recently proposed guidance to lenders on subprime mortgages. This guidance recommends sound risk management practices, especially careful evaluation of borrowers' ability to repay loans. It also advises banks to provide consumers with clear and balanced information about the benefits and risks of various types of loans. In addition, the Fed has long been involved in promoting financial literacy efforts for borrowers.

## Consumption

Beyond the issue of housing activity itself, there has been concern that the slowdown in housing could spill over into other sectors of the economy, most importantly to consumer spending.

Consumers adjust their spending patterns based on many factors, including their current income, their expected earnings, and their overall wealth. For most American households, the value of their home accounts for between ½ and ⅔ of their total assets. As home prices soared from 2001 to 2005—rising an average of 9 percent per year—the resulting increase in wealth contributed to strong consumer spending. But home price appreciation slowed sharply last year—the gain in home values was about half as fast—leading many to worry that a pullback in consumer spending would soon follow.

Despite these worries, consumer spending has been well maintained; it grew 3.6 percent in 2006, which is a robust pace by historical standards. Spending in January was solid as well. Any drag from slower increases in housing wealth appears to have been more than offset by positive fundamentals underlying consumer demand. Job creation has been continuing at an impressive pace, generating healthy increases in income. The recent decline in energy prices has also been a positive factor.

Whereas household budgets were strained by the run-up to $3-per-gallon gas prices, the retreat in gas prices has improved purchasing power.

Moreover, the long-run expected earnings of households—that is, their permanent income—looks good. This reflects trends in productivity. Increases in worker productivity, or output per hour of work, eventually show through to increases in wages, salaries, and benefits. Productivity growth has averaged 2½ percent over the past ten years. Solid 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.

Looking to 2007, consumer spending should continue to be supported by vibrant labor markets, lower energy prices, and solid productivity trends. However, slower house price appreciation and the past increases in interest rates should boost savings and lower consumption relative to income. Balancing all of these forces, I think we will see solid growth in consumption in line with longer-run trends.

## Business investment

Let's now turn to the business sector. Business capital expenditures rose a healthy 6.2 percent in 2006. This covers spending on equipment, software, and commercial and industrial construction that is used to expand productive capacity or retool existing operations.

We should see continued growth in investment in 2007. The cyclical fundamentals driving investment are somewhat mixed, although on balance positive. On the upside, corporate profits have been strong, and even with the recent increase in risk premia, financing conditions remain quite favorable. But business investment usually lags the economic cycle somewhat, and the softer economic growth recently is likely to restrain investment.

Indeed, some of the recent indicators of investment have been weak. Orders for nondefense capital goods excluding aircraft fell 6.3 percent in January, the third decline in four months. But not all of the news has been bad: the Manufacturing Purchasing Managers Index moved up in February, and most business executives I talk to remain confident in the economy and are not expecting any fundamental pullback in spending.

Moreover, the longer-term fundamentals for investment continue to be strong. Advances in technology are an important driver of spending for equipment and software. Computer makers are always developing new and faster PCs and servers to replace older machines. And technology is embedded in other kinds of equipment that isn't considered high tech. For example, modern machine tools contain a great deal of hardware and software that allow them to precisely cut and mill complex structures. Ongoing improvements in technology should help maintain healthy demand for high-tech equipment and for some kinds of industrial machinery. Of course, spending on equipment is always uneven across sectors. For example, demand for small machines used in residential construction is likely to moderate in line with the trends in the housing market.

The outlook for business investment in structures is relatively favorable. Growth in construction spending by businesses was particularly strong in 2006. The gains were widespread in such diverse categories as health care facilities, office buildings, retail space, and power generators. And high levels of energy prices spurred ongoing strong growth in mining and drilling activities. But the recent declines in energy prices make it less likely that we will see further large increases in such expenditures going forward. So some slower growth in structures investment may be expected in 2007.

The last major category of business spending is inventory investment. As we moved through 2006, a few industries found themselves overstocked with materials or products. Many of those manufacturers, such as the domestic automakers and steel producers, are based here in the Midwest. Their subsequent efforts to lower inventories contributed some to the weakness in manufacturing production that we saw in the second half of the year.

But looking at the economy as a whole, I don't see evidence of widespread inventory overhangs that would lead to significant production cuts. At the same time, inventories are not so lean that I'd expect a burst of stock building that would boost aggregate activity. So while we could see some quarterly volatility, on balance I expect inventory investment to be a relatively neutral factor for growth in 2007.

## International trade

The final piece of the growth picture is international trade. Although the U.S. continues to run a trade deficit, net exports did increase last year, which added about ½ of a percentage point to real GDP growth. Many of our trading partners experienced solid economic expansion last year. This helped fuel demand for U.S. products, including many produced by companies headquartered in the Midwest. For example, Caterpillar's sales growth in the fourth quarter was led by foreign demand, and Boeing has a deep backlog of orders from foreign carriers. I was in India recently, and I was amazed to see firsthand the progress and the vigorous expansion in the Indian economy.

Too often commentators bemoan the rise in India, China, and other countries as coming at the expense of the U.S. Certainly, difficult displacements can take place because of international trade, and we should do our best to provide assistance to those affected. But trade is mutually beneficial overall. As countries like India grow, they buy more from us. Indeed, our exports to India have more than doubled in the past three years. Looking ahead, most forecasters expect continued solid growth in the world economy in 2007, which should help sustain growth in our exports. Of course, we'll keep an eye out to see if the recent developments in international capital markets change the outlook for growth of our major trading partners.

## Inflation

The outlook for activity in the U.S. that I have just described is one in which the economy gains momentum and, on average, expands at a rate slightly below its long-run potential in 2007 and at a pace near potential in 2008. The brief period of below-potential growth would be consistent with slight increases in the unemployment rate and other measures of resource slack. But the magnitude of the increases would likely be modest. Indeed, the central tendency of the FOMC forecasts for both 2007 and 2008 is for an unemployment rate of 4½ to 4¾ percent, which would represent little change from its current value.

These levels of unemployment are relatively low by historical standards, and they raise at least some concern about whether labor market conditions are tighter than can be sustained in the long run. Long periods of low unemployment have often been associated with rising costs and prices. When "Help Wanted" signs are everywhere and businesses have trouble filling their job openings, they try to attract and retain workers by offering higher wages that can exceed growth in productivity. These costs must be passed on to someone: either businesses bear the cost through lower profits or consumers pay the cost through higher prices. Many economists estimate that the natural rate of unemployment, or the unemployment rate that can be sustained in the long run, is around 5 percent. While there is a great deal of uncertainty surrounding these estimates, unemployment in the range envisioned in the FOMC's outlook likely indicates a vibrant labor market in which an increasing number of firms may begin to bid up wages in excess of productivity.

I don't think we are at that point yet. True, we've heard more than a few stories of shortages of high-skilled workers, and some measures of compensation growth have picked up. However, firms often tell me that new technologies and organizational changes have given them a great deal of flexibility to manage production in ways that mitigate cost pressures. Still, we need to be careful to watch for the emergence of the kind of economy-wide strains on resource utilization that can increase inflationary pressures. Such increases in inflationary pressures would be of concern because, as I noted earlier, I view inflation as already being too high.

In January, the 12-month change in core PCE was 2.3 percent. The FOMC's central tendency forecast is for inflation to run between 2 and 2¼ percent in 2007 and between 1¾ and 2 percent for 2008. If inflation were to come in at the middle or bottom of such ranges, that would represent reasonable progress toward price stability.

One development helping to ease inflationary pressures is the fall in energy prices that has occurred since the middle of 2006. The previous run-up in the price of oil was likely one of the main culprits responsible for boosting core inflation. Even though measures of core inflation do not reflect changes in energy prices directly, businesses often pass through higher energy costs to the prices of products that are included in the core. Increases in fuel costs boosted airfares. Higher shipping costs increased the consumer price of many manufactured goods. And higher prices for plastics and other petrochemicals raised the cost of manufacturing many products. Now, with energy prices having fallen, a reasonable expectation is that consumer prices should not need to increase as rapidly and core inflation should fall.

While the progress on inflation envisioned by the FOMC is a likely scenario, there is a risk that inflation will stay stubbornly high. First, the economy appears to be operating in the neighborhood of its potential level of output. Unemployment is below many estimates of its natural rate, and other measures of resource pressures, such as capacity utilization, also suggest that little slack remains. Faster growth in compensation per hour, together with slower growth in productivity, has resulted in an acceleration in unit labor costs in 2006. In this environment, tight labor markets could generate additional cost pressures. That said, profit margins are relatively high, so some further increases in labor costs could be absorbed by businesses in the form of lower margins.

Second, inflation has run above 2 percent for the past three years. With inflation at such high levels for so long, we have to recognize the risk that inflation expectations could become stuck in a range that would not be conducive to price stability. If firms and workers expect inflation to be high, they will want to keep up with the general increase in prices and costs. As a result, they will set higher prices and wages or build in plans for automatic increases. In this way, higher inflation expectations can 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, the longer inflation runs above levels consistent with effective price stability, the greater the danger that expectations of future inflation will settle in above those levels as well.

## Policy implications

In setting policy, the Federal Reserve needs to be mindful of the risks to the outlook for both growth and inflation. In my judgment, there are some risks to the outlook for growth that remain a concern. There are some uncertainties around the outlook for business spending. Housing likely will still be a negative for growth during the first half of this year, though the degree and timing of its influence are uncertain. However, at this time the risks of housing spilling over to cause substantial weakness in other sectors of the economy do not appear to be unduly large.

On the inflation front, readings on core inflation have, on balance, been a bit better, and the fall in energy prices should provide some additional help going forward. But as I have noted, I expect the economy to continue to operate at a high level relative to its potential, which could eventually lead to the emergence of increased inflationary pressures. In addition, if actual inflation does not show clear enough signs of returning to the center of the range I associate with price stability, there is a danger that expectations of inflation could run too high, which would likely be a self-fulfilling prophesy.

Taking all of these factors into account, my assessment is that the risk of inflation remaining too high during the forecast period is greater than the risk of growth falling too low. Thus, some additional firming of policy may yet be necessary to address this inflation risk. Of course, whether policy will need to be adjusted and the degree of any adjustment will depend on the data we see in the months to come and how that data influences our forecast of the economy.