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U.S. Economic Outlook

Thank you all very much for inviting me to speak tonight. As you may know, I gave a speech here in 1997, just over 10 years ago. When I spoke here before, I was in my third year at the helm of the Federal Reserve Bank of Chicago. Looking back to when I started in 1994, the U.S. economy was well into two very important transitions that have made the policymaking environment easier.

The first was the shift from a high- or moderate-inflation economy to one with relatively low and stable inflation. Core PCE inflation, which measures the percent change in the price index for Personal Consumption Expenditures, excluding food and energy, had fallen from staggering double-digit rates in the late 1970s and early 1980s to 2½ percent in 1994. While challenges remained in the pursuit of price stability, the inflation issues the Federal Open Market Committee (FOMC) has faced since then have been much less severe than those confronted by the Paul Volcker-led Fed in 1979.

The second transition was the evolution to a low-volatility economy. Since the mid-1980s, fluctuations in real economic activity have been significantly smaller than they had been over the previous 30 years. Economists have called this transformation “The Great Moderation.” So the FOMC has faced smaller cyclical fluctuations in growth than it had in the past.

Nonetheless, during my tenure at the Fed, the FOMC has had to react to a number of important and difficult challenges: the Asian financial crisis, the Russian debt default, major movements in asset prices, the acceleration in productivity, Y2K, 9/11, and the risk of deflation. All of these issues generated policy questions that did not fit neatly into any familiar textbook framework. They exemplify how, when making tough decisions in unusual circumstances, it’s important to follow sound policy-making principles:

- Look at a wide range of data and information, instead of one or two summary indicators;
- Use cogent economic theory to shape analysis;
- And respect the risks of undesirable outcomes for growth or inflation, even in environments that appear benign.

As you'll see in my talk tonight, these principles are no less important in today's policy environment. I'll be discussing the outlook for economic growth and inflation over the next couple of years. As I do, I'll highlight some of the important policy challenges that we face today, such as judging how the adjustments in residential real estate and lending markets will affect economic growth, and whether inflation expectations will evolve in a manner consistent with price stability.

Recent developments

Before turning to the outlook, it's useful to review the recent performance of the economy. After a period of relatively rapid growth following the 2001 recession, the economy has been expanding at a more moderate rate for the past few quarters. Real gross domestic product, or real GDP—our broadest measure of economic output—increased at an annual rate of about 2¼ percent over the last three quarters of 2006. And while we don't yet have the official data for the first quarter of this year, growth again appears to have been near, or even somewhat below, that pace. To put these numbers in perspective, economists use a concept called potential output growth—that's the rate of growth the economy can sustain over time, without generating inflationary pressures, given its labor and capital resources. At the Chicago Fed, our current estimate of potential GDP growth is just a bit under 3 percent. So by this standard, the last four quarters have been a period in which economic growth was somewhat below potential.

However, even though overall growth has been below our estimate of potential, labor markets have continued to tighten. Employment increased by nearly 2 million over the last year. That compares to an employment growth pace of about 1.2 million per year that likely can be maintained over the long run. This 1.2 million pace is slower than what we thought the long-run sustainable growth rate of employment was in the early part of the decade. The change in our view reflects research done at the Chicago Fed and elsewhere in the Federal Reserve System, which suggests that the fraction of the population choosing to participate in the labor market is now trending down. Several factors underlie this development. One is that many members of the large baby boom generation have recently begun to wind down their working careers. And at the other end of the age spectrum, fewer teenagers are choosing to work, perhaps because the importance of getting additional education has increased.

As a result of the stronger-than-trend employment growth, the unemployment rate fell from 5 percent in late 2005 to under 4½ percent today. Such tightening resource pressures, as well as high energy and commodity prices, likely contributed to faster increases in prices. As a result, inflation is running too high. Over the last 12 months, the core PCE price index, the Fed's preferred measure of inflation, rose 2.4 percent, up from the 2.0 percent rate of the prior 12-month period. 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.

Outlook for growth and inflation

That's the past. What about the future? For the balance of 2007, economic growth likely will average modestly below potential. But I expect that growth will be picking up gradually over the coming quarters and return to near potential by 2008. The additional period of below-potential growth this year 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 small. We expect to end 2008 with an unemployment rate only somewhat higher than it is now. Core inflation should gradually come down, moving closer to the levels I view as being consistent with price stability.

Growth outlook

Let me now talk about some of the factors underlying this outlook. One important factor is the housing market. After several years of rapid increases, new home construction and sales fell sharply in 2006, and inventories of unsold homes swelled. Residential investment declined at an annual rate of 16.5 percent over the last three quarters of 2006, and it appears to have continued to fall at a substantial rate in the first quarter. These declines have reduced GDP growth by roughly a percentage point. That's more than enough to account for the entire shortfall in growth relative to its potential.

More recently, some home builders have reported tentative signs of stabilization in demand, and some data—for example, applications for mortgages and sales of existing homes—are consistent with this assessment. Furthermore, conventional mortgage rates remain low by historical standards, lending support to housing demand. However, other data are weaker, such as the inventory of unsold new homes, which has increased further this year. Unless sales rebound dramatically (and unexpectedly), construction will be depressed for some time in order to reduce inventories to more desirable levels.

The recent developments concerning variable-rate subprime mortgages may tend to prolong the declines in housing markets. Foreclosures from failed loans could add to stocks of unsold homes, and potential buyers with spotty credit histories now face higher financing rates, which may price some out of the market. So far, however, the difficulties appear to be confined to a relatively small segment of the market.

Taking a step back, though, it's important to keep in mind that the home ownership rate in the U.S. has increased from 66 to 69 percent over the past decade. This has been a positive development for our nation. Instruments such as subprime mortgages, interest-only loans, and hybrid ARMs have opened up financing to borrowers who previously could not obtain financing at all or could not borrow as much as they would like. But it's clear that some new home owners did not have sufficient income or understanding of the risks involved in the use of such products. Furthermore, some lenders did not provide adequate transparency regarding the full cost of these loans. Still, even though some problems exist, we should not lose sight of the fact that increased availability of credit to historically underserved groups is, on balance, a good thing.

The Fed is, of course, tracking carefully the developments in the subprime mortgage market in accordance with our goal of fostering financial stability. The Fed, along with the other federal banking agencies, has recently proposed guidance to subprime mortgage lenders. This guidance recommends sound risk management practices—especially, careful evaluation of the borrower's 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.

We are also interested in helping borrowers make good decisions about mortgages and other financial products. The Federal Reserve is actively involved in financial literacy for consumers. On April 30, the Chicago Fed will kick off our 6th-annual Money Smart Week, during which we partner with almost 200 banks, community groups, and local governments to put on over 300 financial education activities in the Chicago area. We have events this year being held in 10 different languages, ranging from Arabic to Russian, and almost 40 of them will be in Spanish. Some of the events include workshops on avoiding identity theft, navigating the health care maze, and protecting your important financial records.

We also conduct research into how consumers make financial decisions and the factors that influence those decisions. For example, a Chicago Fed economist, Sumit Agarwal, and his coauthors have investigated whether consumers make systematic mistakes when making credit decisions and whether those mistakes vary by age.[1] They looked at 10 different product categories, such as credit cards, auto loans, and mortgages. This research was discussed in a recent front-page Wall Street Journal article.[2] They find that the ability to make good financial decisions peaks at middle age. Both younger and older borrowers are more prone to make financial mistakes. Why this happens requires further research. One possibility is the difference in experience with sophisticated financial products across age groups. Another possibility is that, on average, young people have better cognitive ability, but lack the wisdom of age. If you were wondering when we reach our peak financial savvy, their answer is approximately 53 years, 4 months, and 24 days old. (I would have said "precisely," but they're still working on the hours and minutes.) The important point is that this research provides us with important insights into how consumers select mortgage products, in addition to a multitude of other financial decisions.

But let's move back to the outlook for home building. After considering the various developments, including the problems in the subprime mortgage market, I expect that residential construction will stabilize as we move through 2007. However, it could be next year before we see any noticeable increases in home building.

For some time, there has been concern that the slowdown in housing could spill over to other sectors of the economy, most importantly to consumer spending. Despite these worries, consumer spending has held up well; it has grown 3.2 percent over the last year, which is a healthy pace by historical standards. And going forward, the recent strong gains in employment and income should continue to support healthy gains in consumption. However, slower house price appreciation and the past increases in interest rates should boost savings rates and lower consumption relative to income. Balancing all of these forces, I think consumption will grow in line with its longer-run trend over most of the forecast period.

One area where we have seen some spillovers from the weakness in housing has been capital spending. Many firms that supply the building industry have scaled back expansion plans. We have seen similar declines in capital spending associated with the auto sector, where the Big 3 U.S. nameplate producers have faced significant difficulties. Partly as a result, investment spending declined in the fourth quarter of last year, and orders for new capital goods have dropped further this year. However, while developments associated with housing and autos have played a significant role, the recent drop in orders for capital goods has not been limited to those sectors; the weakness has been more general.

Some slowing in the overall pace of investment was to be anticipated given the downshift we have seen in GDP growth. But it has been somewhat greater than one would expect on the basis of the usual relationships. It's possible that this reflects an increase in business caution, perhaps from wariness over recent housing market developments and how they will affect the overall economy. However, there are few other signs of a major retrenchment in business sentiment. The solid pace of hiring suggests a certain

degree of confidence, and surveys of business sentiment have been generally steady in recent months. In addition, the fundamentals remain supportive of investment. Notably, many firms have ample cash balances to spend on capital goods, and for those that are borrowing, financing terms are generally quite favorable. So we expect the recent softness to be relatively short lived. Still, we are monitoring developments in investment closely.

The final piece of the growth picture is international trade. Although the U.S. continues to run a large trade deficit, that deficit has narrowed relative to early last year, helping to boost real GDP growth. Many of our trading partners continue to experience solid economic growth. I have traveled to both India and China recently, and I was amazed to see firsthand the progress and the vigorous expansion in those economies. Overall, the strong growth in the world economy is helping 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.

Although there are risks, the outlook for the next several quarters that I've just described is relatively favorable. And I'm optimistic about the longer run prospects for the U.S. economy as well. I expect us to continue to experience sustained and substantial improvements in our standard of living. That's because economic theory tells us that the underlying determinant of our standard of living is productivity, and I believe that the overall trend in U.S. productivity growth is still solid. Technology continues to advance—new and exciting innovations occur every day. Many innovations directly boost productivity by providing cheaper ways to produce better goods and services. Some innovations also have additional effects on productivity as workers become more skilled in using them and managers find new ways of applying the new technologies to their businesses.

This productivity growth generates spending in a number of ways. New technologies provide strong incentives for firms to invest. Moreover, higher productivity eventually shows through to increases in workers' wages, salaries, and benefits, which in turn supports consumer demand.

The strong pace of productivity growth that we have seen since the second half of the 1990s has greatly boosted our living standards. Over the last year, however, productivity growth has slowed. If this were the start of a longer-term trend, it would have important implications for the outlook for both growth and inflation. So this development deserves careful monitoring. But our take is that most of the recent slowing is likely a relatively transitory cyclical development. Firms may be finding that some of the very rapid productivity increases they experienced in the earlier years of this decade were simply unsustainable. Output may have been increased at the expense of activities such as maintenance that can be put off for only so long. In addition, given the current difficulty in recruiting qualified workers, firms may be reluctant to significantly slow their pace of hiring, even in the face of somewhat softer demand. Such "labor hoarding" is often a feature of mature expansions. We expect these developments to run their course over the next few quarters. This should set the stage for further solid gains in productivity, as technology advances further, workers become more skilled in using technology, and managers find new ways to apply technology to their businesses.

Inflation outlook

Turning to inflation, as I noted earlier, we think inflation pressures seem likely to moderate over time. Indeed, late last year we had a string of more positive readings on core inflation. However, so far this year inflation has been somewhat elevated, highlighting the risk that inflation could stay stubbornly high.

First, the economy appears to be operating in the neighborhood of its potential level of output. The unemployment rate is low, and growth in compensation per hour has moved up some over the past year. Furthermore, as I just discussed, productivity growth has slowed. The higher compensation and lower productivity numbers translate into an acceleration in unit labor costs. These costs increased nearly 3½ percent in 2006, up from a 1½ percent rise in 2005. Looking ahead, tight labor markets could result in larger increases in compensation. If these exceed productivity gains, then they will 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. But the situation requires careful monitoring.

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. But that is not something we can take for granted. Ultimately, expectations of inflation depend on the public's perception of the Fed's willingness to carry out monetary policy in a manner that will ensure price stability. 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.

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 falling too low. 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.

Conclusion

Looking ahead, I am optimistic about the fundamentals of the U.S. economy. We believe in free markets and competition, the use of technology and innovation, and openness to trade. These core principles provide a solid foundation for our economy to weather short-term challenges and expand over time. And the Federal Reserve's commitment to price stability means that we will be achieving this in an environment of low and stable inflation.

1. Sumit Agarwal, John C. Driscoll, Xavier Gabaix, and David I. Laibson, "The Age of Reason: Financial Decisions Over the Lifecycle" (March 15, 2007), MIT Department of Economics Working Paper No. 07-11. Available at http://ssrn.com/abstract=973790.

2. David Wessel, "Why Middle Age May Be Healthy for Your Wallet," *Wall Street Journal,* Page A1 (March 22, 2007).