Monetary Policy and the Economic Outlook

Introduction
Please note that the opinions I express here tonight are mine alone. I do not presume to speak for any of my colleagues in the Federal Reserve System.

I want to explain some of the factors that I believe have shaped current policy decisions and some of the economic signposts I am watching for on the horizon. I will begin with some perspectives on the goals and direction of monetary policy. Then I will describe how we as a nation are transitioning to a slower pace of economic growth. Finally, I will talk about some of the risks that I see to our economic outlook.

The Goals and Direction of Monetary Policy
Let me begin, then, with some background on monetary policymaking. We routinely hear and read in the financial media about decisions that the Federal Open Market Committee, or FOMC, makes, but I find that few people know very much about the FOMC and how it operates. This Committee is the policymaking body of the Federal Reserve - the group that sets the direction for short-term interest rates. The FOMC consists of the seven members of the Board of Governors, plus the 12 Reserve Bank presidents. We meet eight times a year in Washington.

The FOMC's objectives are to maintain price stability - meaning a low and stable rate of inflation over the long term - and to promote maximum sustainable economic growth.

We use the federal funds rate - that is, the interest rate at which banks lend money to other banks overnight - as our main policy tool. By adjusting the target for this rate, we are trying to make sure that the financial system accommodates the economy's needs for money and credit. It is a delicate balance. Adding too much money and credit might cause the demand for goods to increase faster than their supply, which will eventually generate inflation. Adding too little money and credit can slow demand relative to supply and ultimately depress prices.

In judging where to set the target for the federal funds rate, we evaluate many aspects of the economic environment. Of course, current conditions in the economy play an important role. But beyond how the economy is performing now, we must also look forward, because where we set the funds rate today affects the performance of the economy and inflation in the future.

In fact, setting the federal funds rate target is a little like throwing a
forward pass in a football game. Any good quarterback knows that you cannot just throw the ball to where the receiver is when you see him. You have to throw the ball to where you think he will be by the time the ball gets downfield. So it is with setting the federal funds rate. It is not just where the economy is positioned today that matters, but also where we think it is headed. That’s a little free advice for Ben Roethlisberger.

Enough about football - I am more knowledgeable about monetary policy. Let’s consider the FOMC’s recent policy moves for a moment. In June of 2004, the FOMC raised the federal funds rate for the first time in almost four years. At that time, we did not know by how much we would need to raise the funds rate - that would depend on how the economy evolved. But we knew it had to go considerably higher to avoid the risk of inflation taking hold. So, in a series of 17 quarter-point adjustments over a two-year period, the FOMC has brought the federal funds rate from a low of 1 percent to 5-1/4 percent, where it stands today.

At our last three meetings, we decided to leave the federal funds rate target unchanged. Holding the rate steady is giving us time to assess the full impact of our 17 rate increases and to see how economic conditions unfold over the near term.

Transitioning to a Slower Pace of Economic Growth

So how do I see economic conditions unfolding? In a nutshell, I see the economy growing at a slower pace than it did over the past few years, but as I will explain, I don’t think we should be overly concerned about this somewhat slower pace of growth.

When I think about changes in economic activity, I tend to separate them into two categories: those that reflect short-term changes in supply or demand, and those that reflect longer-term supply or demand factors. The economy’s performance at any particular time reflects a combination of these short-term and longer-term developments.

Identifying the longer-term factors - and assessing how they may be changing - can give us a baseline for estimating longer-term economic growth. Two of the most important forces in our economy that affect longer-term growth are the number of people working and how productive they are. In simple terms, these two factors alone determine how much an economy can produce. When the workforce grows, so too does our economic output. Likewise, when we are more productive, we can generate more goods and services.

Take the second half of the 1990s. Innovations in information technology generated gains in productivity that were a full percentage point greater than they had been over the previous two decades. At the same time, labor force participation - the share of the working-age population who choose to be in the labor force - was at an all-time high. The result was the “roaring ’90s,” when the economy grew much faster than its average rate during the post-World War II period.

Although we can expect productivity growth to remain strong throughout this decade, growth in our workforce has started to slow a bit. Our population is aging, and the baby boom generation is increasingly heading into retirement. I know that this development is a concern here in Allegheny County, whose population has the second-highest average age of any large county nationwide.

The point is that we cannot take the economic boom that we saw at the end of the 1990s as an appropriate guide for what to expect in
the years to come. As our population ages, we should expect a somewhat slower baseline rate of economic growth going forward. If the labor force grows more slowly, output should grow more slowly as well. This would not mean that the economy is performing poorly, but that there are structural limitations to how rapidly it can expand.

So what about the short-term fluctuations in economic activity I mentioned? How should we think about these in the context of the economic outlook? These are changes in economic activity that temporarily push the economy off its baseline growth path. They can appear in the form of booms or busts.

The housing sector is a perfect example. The United States enjoyed a housing boom over the past few years, with more than 7 million new homes built since 2000. This resulted in the highest homeownership rates in history. During the past year, however, home building has fallen off sharply, with a particularly steep decline in the third quarter. The supply of unsold homes on the market has risen to levels we have not seen in more than 10 years.

The housing boom lifted economic growth above its baseline in the early part of the decade, but the housing slump we are experiencing now is pushing economic growth below that baseline over the near term. For this reason, and as a result of the longer-term factors I outlined earlier, I expect the economy to grow at a more moderate pace over the next few years than we saw in the past couple of years.

Two Risks to the Outlook: Housing and Inflation

Still, there are risks to this scenario. The first risk is that the weakness in housing will spill over to other sectors of the economy. The second risk is that inflation will remain too high.

Housing

Let me speak to the housing risk first. Most of the data suggest that investment in new housing will remain weak at least through 2007. Surveys tend to confirm this outlook. Both consumers and builders report much less confidence in the housing markets than they did a year ago.

Nevertheless, we need to remember that the current decline in home building follows a dramatic increase in recent years. In other words, the downturn is coming off a very high base. Still, I recognize the possibility that this situation could get worse before it gets better. If further declines in the housing sector are abrupt, and if home prices fall sharply, we could see spillover effects in other parts of the economy. One obvious area that could be affected is consumer spending.

Why could consumer spending be affected? During the late 1990s and early 2000s, homeowners often tapped into the appreciating value of their houses by refinancing and taking out home equity lines of credit. Some homeowners also may have felt wealthier, saving less and spending more than usual. If home prices continue to fall, as they have begun to do recently, we may see this reflected in weaker consumer spending. This concern might be a little less pronounced for those of us in western Pennsylvania and Ohio, where, in general, our home values have appreciated by only about half as much as the national average.

Fortunately, despite the housing risks I have described, other sectors of the economy still look pretty good. For the most part, consumers are still buying things. Businesses are still investing in new plants and
office buildings. And foreign economic activity also remains strong, which provides an additional source of demand for our goods and services. Certainly the tone in labor markets has been very positive lately. Continued hiring suggests a high level of business confidence about economic growth next year.

Think of it this way. We seem to have two economies at work - the housing economy, which is experiencing a very large adjustment, and the "everything else" economy, which is performing fairly well.

**Inflation**

The second risk to the economic outlook is the notable increase in inflation we have seen over the past few years.

Unlike the housing contraction, the current elevated inflation rate does not pose an immediate threat to economic growth. However, if the inflation rate fails to move lower, people might believe that inflation has permanently shifted higher, and then adjust their behavior accordingly. If that happened, the whole inflation environment could change for the worse - distorting investment, reducing productivity growth, and affecting economic growth in the long-run.

How did inflation become a risk? How did inflation move from about 1 percent in 2003 to roughly 3 percent this year? In large part, the answer can be traced to the rapid increase in energy prices we have experienced. Oil prices are more than three times what they were in early 2002, rising from roughly $20 a barrel then to nearly $70 a barrel in recent months.

Oil prices have recently moderated somewhat, bringing down the "headline" rate of inflation - what is commonly referred to as the Consumer Price Index. However, core consumer price inflation - which excludes energy and food items - remains at a higher level than I would like. The reason for this is that the production of almost everything we use requires energy. The continuing price increases outside the energy sector are partly a reflection of prior increases in energy and commodity prices being passed through to the prices of other goods and services. We still don't know how these increases will work their way through the system.

But there is some good news. Consumer and business expectations about inflation have remained fairly stable, despite the run-up in inflation over the past couple of years. We have many measures of inflation expectations to look at, but they all generally suggest that long-term inflation expectations are holding steady. This suggests that financial markets believe that the Federal Reserve's monetary policy will bring the trend in inflation back down.

**Conclusion**

To sum things up, I expect the economy to weather the recent challenges in the housing market. Of course, we are not entirely out of the woods with respect to the housing risk, but I do not expect conditions in the housing market to spill over into the broader economy in a meaningful way. I fully expect the economy to continue to grow at a moderate, but sustainable, pace.

The inflation outlook is a slightly different story. I do not believe that inflation will accelerate further. In fact, I expect some slowing in the rate of inflation as recent energy price changes and the effects of monetary policy actions work through the economy.
But some risk remains that inflation will not recede into a range consistent with the FOMC's price stability objective. In that event, it is possible that some additional monetary policy restraint would be required.

I hope that my remarks here tonight have helped to shed some light on the monetary policy issues you have been reading and hearing about. Thank you for this opportunity to share my thoughts with you.