

MONETARY POLICY AND THE ECONOMIC OUTLOOK

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I appreciate the opportunity to speak with you today about my views on monetary policy and the economic outlook. In the past month, much of our attention has been focused on hurricanes – first Hurricane Katrina and now Hurricane Rita. With regard to Katrina, we have seen both the vast human suffering caused by this storm and the tremendous disruption to the regional economy. In the coming days, we will learn more about the destruction caused by Hurricane Rita. Fortunately, it appears that the evacuation efforts in preparation for Rita have dramatically limited the loss of life resulting from this catastrophic storm.

The combined impact of these storms on the national economy is difficult to gauge. The United States has not faced such a large displacement of people and businesses in recent times, so we have very little experience to draw upon in terms of estimating the precise impact on the regional and national economy. In coming months, data will be closely monitored to assess how quickly the affected regions are rebuilding and how the hurricanes' impact is being felt around the country.

Despite the uncertainties that exist, I believe that these unfortunate events do not pose a persistent threat to national economic activity. My overall assessment is that the national economy, while not without challenges, is in reasonably good shape and that conditions should allow for solid growth in the future. In this context, I believe that the Federal Reserve should continue to focus on having a neutral monetary policy which reflects its commitment to price stability.

In my remarks today, I would like to begin with a brief overview of the recent performance of the U.S. economy. Then, I will discuss the outlook for the remainder of

2005 and 2006 and address some of the risks to the economy. I will conclude by providing my assessment of the appropriate course for U.S. monetary policy, given the likely economic impact of Hurricanes Katrina and Rita and the other risks to the economy. In this regard, I would note that I am expressing my own views and not those of the Federal Reserve System.

Recent Performance of the U.S. Economy

The U.S. economy has experienced solid growth in the past two and a half years, following a slow initial recovery from the 2001 recession. In 2003 and 2004, real GDP growth averaged just under 4 percent, and growth in the first half of this year was 3.5 percent. This strong growth, which was above most estimates of potential growth, has led to a gradual reduction in the output gap. This reduction can be seen through the decline of the unemployment rate, which has fallen from a peak of 6.3 percent in 2001 to 4.9 percent today.

Throughout much of this period, fiscal and monetary policy have provided stimulus to the economy. Federal tax cuts led to more disposable income for households and increased consumer spending. Increased spending for defense and homeland security contributed to higher demand for goods and services. And finally, monetary policy was eased considerably to aid the economic recovery and limit the economic effects of September 11th.

Despite these two sources of stimulus, the current economic recovery took longer to gain momentum than past recoveries. In part, this delayed recovery was due to cautious behavior on the part of businesses. Spending on business fixed investment, which had grown rapidly in the late 1990s, declined in real terms during the first two

years of the recovery. And as economic growth returned, firms found that they could meet the increased demand for goods and services without hiring additional workers. This resulted in strong gains to productivity, which is an important source of long-term growth for the economy, but it meant that employment gains were weaker than in prior recoveries.

As solid employment growth returned last year, the Federal Reserve began the process of gradually removing policy accommodation. Monetary policy has been shifted toward a more neutral position as the federal funds target rate has been slowly raised from 1 percent to its current level of 3.75 percent.

Outlook before Hurricanes Katrina and Rita

What about the outlook for the rest of this year and 2006? Given the uncertainties for the economy raised by the destructive impact of Hurricanes Katrina and Rita, let me start by discussing the outlook prior to these hurricanes. Before Katrina, most private sector forecasts indicated that growth in the second half of 2005 would be above 3.5 percent, slowing only slightly in 2006. This represents slower growth than in the preceding years, in part a result of less stimulus from fiscal and monetary policy. But still, solid employment gains were projected to continue, and business investment was expected to remain strong.

Even before Katrina, one of the leading concerns for the economic outlook this year has been the impact of higher energy prices. The price of oil had increased by over 50 percent this year while the natural gas price had increased by nearly 60 percent. Here in Wyoming, natural gas and oil price increases are good news for many businesses, but unfortunately, that is not the case in the rest of the country.

The impact of energy prices is negative for both U.S. economic growth and inflation. Higher energy prices cause consumers to spend a greater share of their income on gasoline and natural gas. As a result, less income is available for other purchases, potentially leading to a decrease in overall demand for goods and services. And since oil prices have increased worldwide, foreign demand for U.S. exports is likely to suffer as well.

Higher energy prices have also contributed to inflation pressures. The overall CPI inflation rate over the past 12 months was 3.6 percent, up from 2.7 percent a year ago. Thus far, the impact of higher energy prices on the core measure of CPI inflation, which excludes food and energy, has been moderate. This narrower measure of inflation was 2.2 percent over the past year, up from 1.7 percent a year ago.

Economic Effects of Hurricanes Katrina and Rita

How have the recent hurricanes affected this outlook? In estimating the damage caused by a natural disaster, economists tend to make predictions based on the impact of similar events in the past. In the case of Katrina, there is no clear precedent that applies, given the scale of the destruction. The immediate impact will stem from the loss of life and the destruction of businesses and homes. The disruption in economic activity will lead to a slowdown in growth. Most forecasters have lowered their growth estimates for the second half of 2005 by about one half of a percentage point. In addition, there will likely be a significant decrease in employment as a result of the displaced workers and businesses. In the case of Hurricane Rita, it is too early to offer a full assessment, but it appears that the damage, while significant, will not be on the scale of Katrina.

In the affected regions, the disruption of economic activity primarily will be

temporary. As the focus of efforts turns from clean-up to rebuilding, it is likely that growth in 2006 will strengthen. The federal government has already committed \$60 billion to the Katrina recovery efforts, and some estimates project that total federal expenditures will exceed \$200 billion over the next year. This is in addition to rebuilding based on insurance payments – predicted to be in the range of \$40 billion to \$60 billion. Given the magnitude of the destruction, it is likely that the rebuilding effort will take several years to complete, providing a long-lasting added stimulus to growth in the economy. It is unclear at this point what type of rebuilding efforts will be needed in the Rita-affected region.

Concerns for the Outlook

Let me next discuss what I see as the major concern for the U.S. economic outlook. For the past two and a half years, the economy has grown at an above-trend rate, inflation pressures have been reasonably well contained, and monetary policy accommodation has been gradually removed over the past year as economic slack has dissipated. Growth going forward is expected to remain sound despite some near-term slowdown caused by the impact of the hurricanes. The primary concern for the outlook is that higher costs may lead to greater inflation pressures.

As mentioned earlier, let me first address rising energy costs for oil and natural gas. The impact of an increase in the price level is a temporary boost to inflation. So far this year, we have seen only modest passthrough of energy price increases into core inflation this year. The price of oil surged even higher following Katrina's arrival, but subsequently fell to pre-Katrina levels. In response to Hurricane Rita, the oil price has increased again, but only modestly. The more important effect from the hurricanes is that

the oil price is much less likely to decrease over the next six months due to the disruptions in oil production in the Gulf Coast region. If the oil price remains high in coming months or increases further, then there is an increased concern for higher core inflation.

The hurricanes appear to be having a larger effect on natural gas market. Since the beginning of 2005, we have seen a large increase in the price for natural gas. As a result of the two hurricanes, the price has risen even further. A higher natural gas price will lead to higher heating costs for consumers this winter and may also lead to higher electricity rates in regions that rely heavily on natural-gas-fired electricity plants. For businesses, the costs of energy and transportation will likely increase, and firms will likely pass some of the higher costs on to customers in the form of higher prices.

In addition to energy prices, a second possible inflation concern is that labor costs may increase for firms as the pool of available workers continues to shrink. Thus far in the current economic expansion, firms have benefited from strong increases in productivity that have allowed them to offer higher wages to workers without affecting their profitability. But as the labor market has tightened and as productivity growth has slowed, further efforts to expand may result in faster wage growth. In the past year, unit labor costs have increased over 4 percent, the fastest increase since 2000. Over the past three years, unit labor costs have increased at a historically slow pace, so the current increase is not an immediate source of alarm, but wage pressures will require careful monitoring going forward.

A third inflation concern relates to prices of raw materials. The massive rebuilding effort from Hurricanes Katrina and Rita will lead to a strong increase in

demand for construction materials. While it is likely that the impact on raw materials prices will only be temporary in nature, the sheer scale of the reconstruction could lead to higher demand for several years. Already, prices of lumber, cement, and roofing materials have increased sharply. For cement, most states had already been experiencing a shortage before Katrina hit, and price increases are likely in coming months.

Thus far in the current economic recovery, inflation pressures have remained mostly contained. By themselves, none of the sources of concern just mentioned is likely to lead to a strong inflationary response in the near term. The concern is that in an environment in which monetary policy has been accommodative, the joint effect of several inflationary pressures could erode price stability. The FOMC will need to be alert and diligent as it works to maintain future price stability.

Perspectives on Monetary Policy

I would like to spend my remaining time offering my thoughts on the appropriate response of monetary policy to large-scale disasters, such as the impact of Hurricanes Katrina and Rita. But first let me take a moment to tell you a little about the other ways that the Federal Reserve has responded to these crises. Hurricane Katrina had a direct impact on the Federal Reserve in New Orleans, where a branch office of the Federal Reserve Bank of Atlanta is located. Like all other businesses in the city, this branch was closed as result of the storm. One of the important roles of this branch is to provide cash and check processing services to the area. As a result of its closure, nearby branches in Birmingham, Memphis, Houston, and Jacksonville have quickly stepped up to provide the services needed to keep the financial system operating smoothly. The Federal Reserve System has also joined with other government financial agencies to help

facilitate the recovery of the banking system in the affected areas and to ensure that the financial needs of consumers and businesses in the region are being met. With regard to Rita, the Federal Reserve Bank of Dallas established a comprehensive contingency plan to ensure that cash and check processing services are provided with as little disruption as possible.

Regarding monetary policy, the obvious question is what is the appropriate response to this type of event? Can monetary policy assist with the recovery from a large-scale disaster? Or are other government responses better suited for aiding in recovery?

There are three key distinctions to be made in determining whether monetary policy can provide a useful response to a large-scale event. First, it must be determined whether the impact will be regional or national in nature. Monetary policy's effects are national in scale. It is unable to direct assistance to a single region without having an effect on the rest of the country. In the case of the hurricanes, the largest impact is likely to be of a regional nature: the need to rebuild businesses, homes, and infrastructure along the affected Gulf Coast regions. If monetary policy was redirected to provide more accommodation to the rebuilding efforts, such policy could lead to excessive stimulus in the rest of the country. The overall result would likely be an economic boom and rising inflation.

The national implications for the hurricanes come through the impact on energy prices and the shipping industry. Both of these impacts can be viewed as negative supply shocks, which monetary policy cannot easily address. A negative supply shock leads to higher prices and decreased demand for goods and services. As we have learned from the

experience of the 1970s, a more accommodative monetary policy that attempts to offset decreased demand during a negative supply shock leads to higher inflation that can be very costly to remove in the future.

The second distinction is the time frame in which assistance is needed. In most circumstances, monetary policy can only provide assistance with a long lag. Most economists estimate that the time lag between a monetary policy action and its impact on the economy is six to nine months. In the case of the hurricanes, the negative effects are most likely to be felt over the next six months. If monetary policy were to increase the level of accommodation, the benefits would not likely be felt until next year. By that time, the rebuilding effort would be well underway, and there might be a danger that monetary policy stimulus could combine with the sizeable fiscal stimulus to overheat the economy and lead to higher inflation.

The third distinction is the condition of the overall economy relative to the affected region. If the economy is in a recession or early in a recovery phase, the arrival of a regional disaster could be sufficient to worsen conditions or at least prolong the period of slow growth. In such circumstances, monetary policy is likely to already be accommodative, so some additional accommodation may be warranted based on the economy's fragile state. In the current situation, the national economy has been growing strongly for two and a half years, and monetary policy has been gradually removing accommodation. Given the positive momentum of the economy, it is much less likely that a regional shock will have an overall negative impact. And should additional policy accommodation be added, there is a much greater chance that the economy will overheat and result in strong inflationary pressures.

But this discussion is not meant to imply that monetary policy should never respond to regional disasters. In the wake of the September 11th attacks four years ago, the FOMC lowered the federal funds target rate by 50 basis points just six days after the event. In that situation, the distinctions I mentioned earlier all pointed toward the need for a policy response.

First, while the September 11th attack affected a much smaller geographic area than Hurricanes Katrina and Rita, the potential for a national impact was greater. The attack disrupted services in the financial area of New York that serves as the hub of financial markets for the United States. It disrupted payments across the country. In addition, as a foreign attack on U.S. soil, this event had a significant psychological impact on all Americans. It was unclear how Americans would respond to the events and how such responses would affect the economy.

Second, as lender of last resort, the Federal Reserve was the best organization to provide assistance to the financial system. While monetary policy affects most of the economy with a significant lag, changes in the federal funds target rate can have an immediate effect on financial markets. By greatly increasing the amount of reserves available to financial markets, the Federal Reserve was able to provide liquidity and near-term stability in a time of crisis.

And third, at the time of the attacks, the economy was very slowly emerging from recession. In the year leading up to the event, monetary policy had been increasingly accommodative. Given the fragile state of the economy, the downside risks to the economy were viewed as much greater than the upside risks, so additional accommodation was viewed as the appropriate response.

Considering all possible policy responses, most economists would argue that fiscal policy is more suited to assist with disasters such as a hurricane. With a regional crisis, the federal government can direct resources to the areas affected. In addition, the government response can be accomplished much more quickly than that of monetary policy. For example, within two weeks of Katrina's arrival, the federal government allocated \$60 billion to aid in the recovery of the region. And finally, the ability of the government to direct aid toward a specific region reduces the extent of excessive stimulus to the rest of the country.

Concluding Comments

To conclude, let me provide a brief summary of my view of the U.S. economic outlook and monetary policy. The overall outlook for the economy for the remainder of this year and 2006 is good. Considerable time will be required for the recovery from Hurricanes Katrina and Rita, but I currently expect that the storms' impact on economic growth will be limited. In the next six months, I expect growth will be somewhat slower due to the disruption of business activity. In 2006, the rebuilding efforts in the affected Gulf regions could add overall stimulus to growth. I believe that the greatest concern for the outlook is the potential for inflationary pressures to emerge. Currently, these pressures appear to be modest, but they will need to be carefully monitored going forward.