

MONETARY POLICY AND THE ECONOMIC OUTLOOK

Thomas M. Hoenig  
President and Chief Executive Officer  
Federal Reserve Bank of Kansas City

New Mexico Economic Forums  
Albuquerque, New Mexico  
October 3, 2006

It is a pleasure to be in Albuquerque tonight and to have this opportunity to share my views on the economic outlook and monetary policy. Although our economy has performed well over the last few years, some observers are uneasy about the current situation. Economic growth is slowing from the brisk pace earlier in the year, and inflation has been higher than desired as past increases in energy and other materials prices raised production costs and strained consumer budgets.

Much of the recent concern has been driven by two issues. One of these is the risk of a larger than anticipated decline in the housing market. Although economists have been predicting a slowing in the housing market for some time, definitive signs of this slowing only appeared in the last few months. The extent of this slowing and its impact on future consumer spending is naturally a concern because the family home is the primary asset for many households.

The other issue is uncertainty about the direction of energy prices. Over the past three years, sharp increases in petroleum prices have pressured household budgets and raised the inflation rate. But, recently, we have seen gasoline prices declining and petroleum inventories building, creating uncertainty about future energy price movements.

In tonight's remarks, I would first like to provide a brief assessment of current economic conditions and the outlook through 2007. Then I will spend some time discussing the issues related to the housing and energy markets and how these might influence the outlook. Finally, I will speak briefly about some of the challenges facing monetary policy in the period ahead. I would emphasize that these views are my own

and do not represent the official position of the Federal Reserve System or the Federal Open Market Committee.

### Current Economic Conditions

Let me begin by taking a closer look at recent economic performance. Real GDP grew at a brisk pace in the first half of this year. Although growth slowed from the first quarter to the second, real output expanded at a 4 percent rate over the first half of 2006, well above the economy's long-run sustainable rate. Part of this surge in economic activity was, however, a rebound from economic weakness in the second half of 2005 related to the Gulf hurricanes, higher energy costs, and reduced auto sales incentives.

Most forecasters believe that growth slowed further in the third quarter because of another decline in residential investment and more moderate business investment in structures and inventories. Housing starts and sales declined over the last few months, the inventory of unsold homes on the market is rising, and home price appreciation is decelerating. However, consumer spending appears to be growing moderately despite the pressure on household budgets from past energy price gains.

Although the labor market remains healthy, the pace of hiring slowed in the spring. Nonfarm payroll employment grew at an average pace of 176,000 jobs per month in the first quarter of this year, but only by about 119,000 jobs per month over the next five months. While hiring has slowed, the unemployment rate was quite low in August at 4.7 percent of the labor force. This unemployment rate is below the level that many economists believe is consistent with full employment and stable prices.

The inflation rate has been a major concern so far in 2006. Past sharp increases in energy prices caused broad inflation measures to rise over the last few years. Reflecting

high resource utilization and some pass-through of higher energy prices, core inflation measures, which exclude volatile food and energy prices, also worsened earlier this year. For example, the core CPI inflation rate rose from about 2.2 percent in 2005 to 2.8 percent over the year ending in August. This is a pace of inflation that I would not find acceptable over the longer term. However, it is encouraging that core CPI inflation moderated somewhat in July and August, and core producer price inflation eased as well.

### The Economic Outlook

Although policymakers carefully monitor current conditions, our focus is on what the indicators imply for the economic outlook. Monetary policy must be forward-looking because policy actions affect growth and inflation with long lags. With that in mind, let me turn to the outlook for real economic growth and inflation.

Reflecting past increases in energy prices and interest rates, many forecasters now anticipate somewhat below-trend real GDP growth over the second half of this year and for most of 2007. Many economists believe the potential growth rate for the U.S. economy is around 3 to 3 ¼ percent.

I share the view that real growth is likely to be slightly below the potential growth rate, averaging around 2 to 2 ½ percent at an annual rate over the second half of this year and around 2 ½ to 3 percent in 2007. But I would stress that the economy *is* likely to keep expanding, and that growth that is a little below trend in the near term may help to keep the economy from overheating and thus sustain growth over the longer term.

An important factor in this outlook has been the gradual tightening of monetary policy. Since June 2004, the Federal Reserve has raised its federal funds rate target from 1 percent to the current level of 5 ¼ percent. Over this period, the stance of monetary

policy has moved from being extremely accommodative to a setting that I would describe as somewhat restrictive. Other interest rates have also increased over this period, although the rise in long-term rates has been fairly moderate.

Much of the slowing in economic growth will likely come from housing and consumer spending. To some degree, higher interest rates have produced this slowing because housing and consumer durables spending are interest-sensitive sectors. In addition, past increases in oil prices hurt consumer confidence and left many households with less income to spend on discretionary items. Moreover, sharp gains in home prices have reduced the affordability of new homes for first-time buyers.

Offsetting some of the weakness in consumer spending and housing will probably be healthy business investment and solid export growth. With regard to business investment, equipment spending was weaker than expected in the second quarter, but nonresidential construction posted large gains, partly due to increased spending on energy production. Orders for capital equipment continue to trend upward, and operating rates are above-average in the manufacturing sector. Moreover, strong growth in corporate profits should help to sustain business investment spending.

In addition, export growth will likely be a positive for economic growth through 2007. Although the latest monthly trade deficit was disappointing, much of the deterioration was due to high oil imports. Going forward, solid growth by our major trading partners should increase the demand for U.S. goods and services. The International Monetary Fund, for example, just raised its forecast for world economic growth in 2006 and 2007. At the same time, the expected slower growth in domestic household spending should moderate import growth. As a result, I expect international

trade to be less of a drag on growth over the next year or so, and possibly even a modest contributor to growth.

With real GDP growth slowing below the trend rate, labor market pressures are likely to ease somewhat. Although I do not expect large changes in the unemployment rate, we could see the unemployment rate drift upward by late next year to 5 percent, or perhaps slightly higher.

As to the inflation outlook, most forecasters expect some moderation in the inflation rate over the next year or so. Slower economic growth and reduced energy price pressures are expected to gradually reduce both the overall and core inflation rates. I share the view that core consumer price inflation is likely to moderate from the elevated pace in the first half of this year, and I am pleased that long-term inflation expectations were reasonably well contained during the past run-ups in oil prices.

#### A Closer Look at Housing and Energy

As always, there are many uncertainties about the economic outlook. I want to highlight two issues in particular because these issues are foremost in the minds of many economists as well as American households. These are, first, the risk of a sharper than expected decline in residential investment and, second, uncertainty about the future direction of energy prices.

With respect to housing, some observers have warned for a long time that the housing market was becoming overheated. Over the past several years, there has been a rapid increase in the value of U.S. housing fueled by low mortgage rates. This has increased household wealth and contributed to strong growth in household consumption during the current economic expansion. If housing prices have risen above levels

dictated by economic fundamentals, there is a chance that housing prices could fall, hurting consumption as well as residential investment.

My own view is that the housing market is cooling, but this adjustment seems to be happening in an orderly way. Of course, orderly does not necessarily mean painless, but there appears to be enough strength in other sectors to keep real GDP growing. Policymakers, however, must remain aware of the risk that the housing market might soften more than is built into current economic forecasts.

Evidence of a cooling housing market is abundant. Single-family housing starts fell more than 20 percent over the last year. Existing home sales and new home sales have also declined this year, and the number of unsold homes on the market has risen. Home price appreciation as measured by the OFHEO index has slowed sharply from over a 13 percent annual rate last year to less than a 5 percent annual rate in the second quarter.

The slowing housing market has both direct and indirect economic effects. Less home construction means fewer jobs for construction workers and fewer building materials purchased, and a lower rate of home sales decreases brokerage commissions. But the reduced appreciation of homes also may have important indirect effects by lowering the growth rate of household wealth and the ability of households to easily tap into past wealth gains. Many homeowners have used their home equity to finance strong consumption growth through mortgage refinancing or home equity loans.

There is a risk of a sharper than predicted slowdown in residential investment and falling home prices, which cannot be dismissed entirely. Policymakers will need to

monitor the situation carefully, both in terms of the state of the housing market and its broader economic effects.

But at the national level, we have not seen prolonged declines in nominal home prices when the housing market slowed in the past. Moreover, continued income and employment growth and high levels of stock market wealth will help to sustain consumer spending. As a result, I believe the housing market adjustment is unlikely to derail the economic expansion.

Let me turn to a second issue that is very much on people's minds right now—the future direction of energy prices. The outlook for energy prices appears to have shifted somewhat.

We have been through a difficult period in which energy prices soared because of strong world demand and unexpected disruptions to energy supplies. As a result, we have become accustomed to nothing but bad news on the energy front, and risk premiums were built into energy prices to reflect possible supply disruptions. But the forces affecting the energy market appear to have become more balanced.

Oil and natural gas prices are extremely volatile by nature. Small changes in the quantity of oil supplied may require large price changes to balance the market because demand is relatively insensitive to price changes in the short run. Shocks to the energy market can come suddenly—as we saw with the hurricanes last year—and there is little excess production capacity in the world right now with which to meet unexpected developments. Thus, the risk of a sharp upward movement in oil prices has not disappeared.

But although markets have focused on rising energy prices for several years, we now must seriously consider the possibility of further decreases in energy prices.

Supplies of petroleum products and natural gas are building, and we have seen some large declines in the prices of gasoline prices, crude oil, and natural gas. For example, the price of a gallon of regular gasoline is more than 20 percent below levels in July. Natural gas prices have also plummeted because inventories are at record highs for this time of the year. These recent declines in energy prices may help to moderate future inflationary pressures and free up some discretionary income for many households and perhaps also cushion the effects of weaker housing.

#### Challenges for Monetary Policy

Finally let me turn to the challenges facing monetary policy in the period ahead. In doing so, I am not in a position to speculate about the future course of policy. Instead, I hope to convey some of my thinking about the factors that will shape the FOMC's decisions in the period ahead.

We must always remember that monetary policy decisions are not based on individual data releases. Rather, policy decisions depend on the implications for the economic outlook of the accumulation of data over time. Monetary policy must be forward-looking because policy influences inflation with long lags. Generally speaking, a change in the federal funds rate may take an estimated 12 to 18 months to affect inflation measures.

The existence of lags in monetary policy has two important implications. First, the Federal Reserve should only respond to high current inflation to the extent that it is expected to be highly persistent. If inflation pressures are seen to be temporary and

policy is currently restrictive, maintaining the current policy stance may be consistent with a reduction in inflation over time. Second, given the existence of policy lags, the actions that the Federal Reserve took over the past year in raising the federal funds rate have not yet had their full effects on the economy or inflation.

As I have stated previously, I believe a reasonable case can be made that the current stance of monetary policy is likely to be consistent with a reduction in inflation pressures over the next few quarters as energy prices moderate and economic growth slows. If housing were to weaken more than in the consensus outlook or if energy prices dropped further, the case for maintaining the current policy stance might be reinforced.

But at the same time, I recognize that further policy tightening could be warranted if the expected slowing in inflation does not materialize or if long-term inflation expectations should rise suddenly. As economic data accumulate over the next few months, I suspect some of the current economic uncertainty will dissipate, and we will have a clearer view of the monetary policy path going forward.

#### Concluding Comments

In summary, although some observers are uneasy about the current economic situation, my reading of the incoming data and economic forecasts is that the economy is making the transition to a somewhat slower growth path. At the same time, inflationary pressures may moderate if growth does slow to a below-trend pace and upward pressures on energy prices abate.

Two important issues that bear close watching are the risk of a sharper than predicted slowing in the housing market and uncertainty about the future direction of

energy prices. The forces affecting the energy market have become more balanced, however, with both price increases and decreases being possible.

The current somewhat restrictive stance of monetary policy may be sufficient to reduce core inflation over the next few quarters. But the course of monetary policy is not entirely certain and will depend on how the economy evolves in the coming months. In this regard, I can assure you that the Federal Reserve will continue to maintain its commitment to price stability and economic growth.