

THE NATIONAL ECONOMY AND MONETARY POLICY IN 2007

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Kansas City, Missouri
January 19, 2007

It is a pleasure to be with you today to discuss the outlook for the U.S. economy in 2007 and the implications for monetary policy in the period ahead. The turn of the year is traditionally a time to look back at the events of the past year and to look forward to the prospects for the new year. In the distant past, soothsayers peered into a crystal ball to deliver their prognostications. Nowadays, economists use computers. But, despite the increased sophistication of the forecasting instrument, the economic outlook is inherently uncertain, and there are always risks that the economy may perform differently than expected.

With that caution, then, what does our high-tech crystal ball tell us about 2007? Overall, the economy should continue to improve with stronger growth and lower inflation. However, there are at least two major risks that could cloud the scene. The first of these is the housing market, where a substantial adjustment in housing activity and home price appreciation is underway. Although there are some signs that housing may be bottoming out, weaker residential investment and related spillover effects on consumer spending remain a downside risk to the near-term outlook for economic growth.

The second risk is that tight labor markets or a resurgence in energy prices could exacerbate inflationary pressures. Last year's solid employment growth brought the unemployment rate down to a very low level, and labor cost pressures could build if labor markets tighten further. There is also the ever-present risk that recent energy price declines could be reversed, leading to a less favorable outlook for inflation in the coming year.

Let me spend the next few minutes providing more detail to this general outlook, and then I'll close with comments on its implications for monetary policy.

A quick look back

To provide some perspective on the outlook, it may be helpful first to look back at some of the key economic developments in 2006. Last year, real GDP grew near its trend rate of about 3 percent, but the growth rate slowed notably over the course of the year. Growth in the second half of 2006 likely averaged around 2 percent to 2.5 percent at an annual rate, about half the average rate of the first half of the year.

Much of the softening in growth last year can be attributed to weaker housing market activity and lower automotive production. Some analysts feel these sectors were unsustainably strong earlier in the expansion, and now they may be adjusting back toward more sustainable levels. In addition, past increases in interest rates have slowed housing activity, and higher energy prices earlier in the year hurt auto sales. Housing and autos also affect a broad network of industrial suppliers, causing a slowdown in several manufacturing and materials industries. But, there is little evidence so far that the softness in housing and autos has spilled over to other parts of the economy, especially consumer spending.

Employment grew fast enough last year to keep labor market conditions relatively tight. The civilian unemployment rate drifted down by 0.5 percentage point over the year to 4.5 percent in December. Although this unemployment rate is below most estimates of the full-employment rate, recent reports on labor costs are mixed, with some hinting at increased labor cost pressures while others remain fairly steady.

Partly because of higher energy prices in the first part of 2006, consumer price inflation was higher last year than I would find acceptable over the long term. The core CPI, which excludes food and energy prices, rose 2.6 percent over the past 12 months. Core inflation was even higher than that in the spring and summer of 2006, but moderated somewhat at year's end as growth slowed and energy prices declined.

A look ahead at 2007

Looking into 2007, we are likely to see some important shifts in the trajectories for growth and inflation. Although real GDP growth slowed over the last year, I expect to see a recovery in growth in 2007 back toward trend. And, I expect to see core consumer price inflation gradually recede from last year's unacceptably high rate.

In my view, real GDP growth is likely to rise gradually from 2 percent to 2.5 percent annually in the second half of last year to around 2.5 percent to 3 percent in 2007. The gradual recovery in growth will reflect several factors. First, the drag on growth from the housing market should diminish by mid-year as housing markets stabilize. Second, the spillover effects from housing on consumer spending should continue to be relatively small and be offset by such other factors as solid employment and labor income growth. And third, the more favorable energy price developments in the second half of 2006 have raised households' discretionary income and boosted their willingness to spend.

Financial conditions also remain favorable for growth. The more restrictive stance of monetary policy over the recent past has helped contain long-term inflation expectations and helped hold long-term interest rates relatively low. Moreover, these

actions have set a favorable background for the stock market, which posted strong gains last year.

Favorable financial conditions and strong profit growth should encourage further solid gains in business investment, which are likely to offset some of the continuing weakness in housing. In addition, international trade should be less of a drag on economic growth this year, and perhaps even a contributor to growth. The temporary slowing of growth is helping hold down imports, and past depreciation of the dollar has made our products more competitive in world markets.

Solid foreign economic growth will also encourage stronger gains in U.S. exports this year. Although world growth may moderate somewhat from last year's pace, the consensus outlook is that world growth will remain more than 3 percent. Moreover, growth will likely remain strong in many emerging markets. For example, growth in China is projected to be almost 10 percent, and Indian growth could be near 8 percent. Last year's decline in energy prices has supported foreign demand, helping balance world growth by making it less dependent on U.S. imports.

With our real GDP only gradually rising toward trend this year, labor market pressures should moderate somewhat in the first half of the year. Although I do not expect large changes in the unemployment rate, we could see the unemployment rate move back toward 5 percent over the course of the year.

As to the inflation outlook, most forecasters expect some moderation of the inflation rate in 2007. Past monetary policy actions combined with moderate economic growth and stable energy price pressures should contribute to a reduction in both the overall and core inflation rates.

Recent inflation readings seem largely consistent with this expectation. In particular, core CPI inflation has slowed noticeably in the last few months. For example, the three-month average inflation rate for core CPI fell from a high of 3.8 percent last May to 1.4 percent in December. The 12-month average has shown less improvement, falling from a high of 2.9 percent in September to 2.6 percent in December. I share the view that core consumer price inflation is likely to moderate from last year's high level, and I think that we will continue to see stable long-term inflation expectations.

Risks to the outlook for growth and inflation

As always, there are many uncertainties in the outlook, so let me turn, now, to a discussion of some of the major risks to economic growth and inflation.

The housing market

The housing risk is foremost in the minds of many homeowners and home builders right now. Some observers have warned for some time that the housing market was overheated. Over the past several years, there was a rapid increase in home prices fueled partly by low mortgage rates. The increase in household wealth from home price appreciation also helped sustain strong consumption growth in the current expansion.

Clearly, we have now seen a substantial cooling in housing market activity in most parts of the country. Single-family housing starts have dropped about 25 percent from a year ago, and both new- and existing-home sales have declined sharply.

Moreover, the slowdown in home sales and the increased inventory of unsold homes have dramatically reduced the rate of home price appreciation. The Office of Federal Housing Enterprise Oversight's national home price index rose at a 3.5 percent annual rate in the third quarter of 2006, which is down substantially from a 12 percent

rate in the last quarter of 2005. And, some areas of the country, where house prices were most elevated, have experienced substantial price declines.

The slowing in the housing market has direct and indirect effects on the economy. Less home construction means fewer jobs for construction workers and fewer building materials purchased. Moreover, the reduced appreciation in home values 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. In recent years, many homeowners have used their home equity to finance strong consumption growth through mortgage refinancing or home equity loans.

The risk of a sharper-than-predicted slowdown in residential investment and falling home prices 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, there are also some good reasons to think that the adjustment in the housing market may be more moderate going forward. We are already seeing some signs that the housing market may be near the bottom. Housing starts and home sales have increased somewhat from their lows in 2006, and home builders' attitudes and mortgage applications to purchase a home are no longer plummeting. Underlying this more positive tone are fairly low mortgage rates and strong labor market conditions, although some of the improvement may also reflect mild weather at the end of last year.

Moreover, continued income and employment growth and high levels of stock market wealth will help to cushion any adverse effects of the weaker housing market on consumer spending. I do not mean to say that we could not see further weakness in

housing activity and prices, but the evidence at this point suggests that the housing market adjustment is unlikely to derail the broader economic expansion.

Labor markets and energy prices

There are also factors which pose upside risks to the inflation outlook. Strong labor market conditions could result in cost pressures that are passed on to consumer prices. In addition, disruptions to energy supplies could result in renewed strength in energy prices.

Despite the slowdown in overall economic activity in 2006, employment growth remained solid. Payroll employment growth averaged about 150,000 jobs per month in 2006, and the unemployment rate declined over the course of the year. Growth in service and government jobs offset weakness in manufacturing and construction.

In reviewing these data, I would note that one reason labor markets have remained relatively tight is that the labor force has not been growing as fast as in the past. Demographic factors, such as the aging of the baby-boom generation and the smaller size of the following generations, are part of the explanation. Also, the labor force participation rate of women has stabilized after trending upward for many years

Recent research conducted at our Bank suggests the trend growth rate for employment over the next 10 years may be around 120,000 jobs per month. Thus, it should not be too surprising that last year's employment growth has kept labor market conditions fairly tight.

The tight labor market conditions have put some pressure on labor costs. For example, growth of unit labor costs has drifted upward over the last couple of years. This increase partly reflects stronger gains in compensation per hour. Compensation growth

was particularly strong in the first quarter of last year when some employees received exceptionally large bonuses. Faster growth of unit labor costs also reflected weaker productivity gains in 2006 as real GDP growth fell below trend.

Should these recent trends in compensation and productivity continue, there is a risk that businesses may be under pressure to raise prices. Although a risk, there are forces in play that may restrain increased labor cost pressures from contributing to a rise in inflation in 2007. Some companies, for example, may absorb increased cost pressures through reduced profit margins rather than raise prices and risk losing valued customers. In addition, productivity growth should rebound in 2007 because of strong business investment and the continued adoption of new technologies. And, there is no evidence yet, at least, that labor market tightness is fostering an inflationary psychology.

A second immediate risk to the inflation outlook is that we could see a resurgence of energy prices in 2007. The decline in energy prices during the second half of 2006 and so far this year is a welcome development as it helps to lower short-term inflation pressures while providing support to consumer spending.

However, many analysts view the recent energy price declines as resulting from a more favorable short-run supply situation rather than longer run fundamentals. In particular, these analysts attribute the recent weakness in energy prices to a combination of higher-than-normal inventories coupled with a more benign fall hurricane season, unusually warm weather earlier in the winter, and the absence of major geopolitical disruptions in supply. Thus, there is a risk that price pressures could reemerge if the supply situation worsens in an environment of steadily increasing world energy demand.

Monetary policy in 2007

Let me close with some discussion on the outlook for 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 Federal Open Market Committee's decisions in the period ahead.

In my opinion, there has been a discrepancy lately between the views of FOMC members, as summarized in the Committee's public statements, and the views of many financial market participants. Although there is a wide range of views in the market, some participants have jumped to the conclusion that monetary policy will be eased in the near future. Surveys of financial market economists show that many expect an easing in monetary policy sometime this year. In addition, the yield curve and financial futures prices incorporate some expected easing of monetary policy later this year.

In contrast, the FOMC has continued to express its concern about the upside inflation risks. After its last meeting on Dec. 12, the FOMC stated that "some inflation risks remain," and that the "extent and timing of any additional firming" would depend on how incoming data affected the outlook for growth and inflation.

In my view, the easing of monetary policy that market participants expect would be appropriate only if inflation clearly subsided from recent elevated levels, and if the incoming data implied the inflation outlook would remain favorable in the future. And, of course, it would depend too on the growth path of the economy itself. In my judgment, it is premature to conclude that current conditions define a clear path for policy. Although recent inflation reports have been encouraging, the inflation rate over the last 12 months remains higher than I would find acceptable for the long term. And, as

I suggested earlier, upside inflation risks still exist from possible labor market pressures or higher energy prices.

As economic data accumulate over the next few months, I suspect some of the current uncertainty will dissipate, and we will have a clearer view of the monetary policy path going forward.