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The U.S. Economic Outlook: A Monetary Policymaker's Perspective

Thanks for that very kind introduction, Dean Mittelstaedt. It's a pleasure to participate in your forecast luncheon, and I'm delighted to be able to set the stage for the other speakers by giving you my views on the outlook for the nation's economy and the implications for monetary policy.

As Dean Mittelstaedt said, I began my tenure at the San Francisco Fed in June. Just a couple of weeks later, I attended my first meeting of the Federal Open Market Committee as a Reserve Bank President. At that June meeting, the Committee decided to raise the federal funds rate by 25 basis points, the first increase in over three years. Since then, there have been three more meetings, and at each one, the Committee raised the funds rate by 25 basis points, bringing it now to two percent. With core consumer inflation running at one and a half to two percent, the real—or inflation-adjusted—rate has moved from negative territory, where it had been for more than three years, to a level of zero or a bit higher. The Committee's November 10th press release states that, even at the current, higher level of the funds rate, monetary policy remains accommodative. One indication of the continuing monetary stimulus is that the real federal funds rate remains well below its long-run average of around two and a half percent, depending

* The opinions expressed in this speech are those of the author and do not necessarily reflect the views of the Federal Reserve Bank of San Francisco or of the Board of Governors of the Federal Reserve System.

on which inflation measure you use. The statement notes that this stimulus, combined with robust productivity growth, should provide ongoing support to economic activity.

One reason for the Committee's decision to raise the federal funds rate is to undo, or "take back," the policy of "exceptional easing" that the Committee put in place between 2001 and 2003. During that period, the economy was struggling to overcome the headwinds from the bursting of the stock market bubble, heightened geopolitical risk and a wave of corporate governance scandals. With substantial and growing labor market slack, there was even a concern about the risk of deflation. Though deflation was never very likely to be realized, it still made sense to address the risk by erring on the side of ease--taking out an "insurance policy" against the possibility. As Japan knows all too well, deflation can lead to serious economic problems.

Another rationale for the increase in the federal funds rate is that we have been seeing more positive signs in the economy and now can have greater confidence that the economy is on course for self-sustaining growth going forward. A broad range of economic data suggests that real GDP is now growing modestly above trend, which, by most estimates, is around three and a quarter to three and a half percent. Recently, we've seen good news on manufacturing output and consumer spending.

Finally, and very importantly, the data on the labor market turned out to be stunningly good in October—the economy gained 337,000 jobs that month. After such a long—and, I might add, surprisingly long—period when employment growth seemed to be stuck in the doldrums, this news is very heartening. Growth in wage and salary income is critical to consumer spending. More rapid employment growth thus improves the prospects for consumer spending, raising the odds that the remaining slack in the labor market will decline gradually over time.

These results for the economy certainly look pretty good. But I think there *are* some important issues to consider about the economy's performance so far that may have implications for the outlook—and for monetary policy—going forward. In particular, it's important to recognize that, in order to get this performance, monetary policy has had to be extremely accommodative and for a very long time. Indeed, the economy has been getting a push not only from substantial monetary stimulus, but also from substantial *fiscal* stimulus, including several tax cut packages and increased spending on defense and homeland security.

So today, I'd like to spend a few moments exploring *why* this might be happening—that is, exploring what factors might be putting a drag on demand in the U.S., necessitating a lot of stimulus just to achieve trendlike growth. I'm going to focus on five factors altogether. Three appear to be having an impact now and may continue to do so next year; they are: higher oil prices, “restraint” in investment spending, and a large and growing trade gap. The remaining two have not had an impact yet, but they have the potential to exert a drag on the economy going forward; they are: the low personal saving rate and the waning impetus from fiscal policy.

I'll start with the oil price shock. The price of oil nearly doubled—from around thirty dollars a barrel last summer to fifty-five dollars—though most recently it has fallen back to between forty-five and fifty dollars. Higher oil prices act like a tax on households to depress spending on other goods and services at least to some extent. Let me hasten to say that this effect is nowhere near as dire as it was when oil price shocks hit the U.S. economy thirty years ago. For one thing, even at fifty dollars a barrel, in real terms, oil prices are only about half what they were in the 1970s. For another, the U.S. economy is much less dependent on oil today than it was thirty years ago.

Nonetheless, higher oil prices *do* appear to be damping spending. Insofar as the higher prices are transitory, we'd expect consumers and firms not to change their spending patterns much, instead defending their living standards for the duration by consuming fewer oil products and by dipping into savings. But the concern is that oil prices may *not* be transitory—they may stay high, or go even higher. If that were to happen, we could expect consumers and firms to seal up their wallets somewhat tighter.

It's extremely difficult to predict what will happen to oil prices, of course. But some recent evidence from the futures markets can give us at least a sense of the probabilities. That evidence suggests that the market sees a large portion of the recent oil shock as long-lasting. Futures prices are not predicting as sharp a falloff in prices as they usually would.

Higher oil prices also have an impact on inflation—at least for a time. The real issue here is whether that uptick in inflation gets incorporated into inflation expectations. We learned during the 1970s that once that happens, wages and prices get built around those expectations, and inflation can start spiraling upward. Is this likely to happen now? Fortunately, it does not seem very likely. Again, we can turn to the markets for a sense of what inflation expectations look like. Recently there has been a noticeable increase in the average compensation for inflation over the next five years implicit in the spread between the yield on Treasury bonds and on Treasury inflation-indexed securities. Part of this undoubtedly reflects higher oil prices. But there has been almost *no* change in the compensation for inflation from five to ten years into the future. The stability of compensation for this period presumably reflects the market's view that the Fed will remain vigilant in its long-run commitment to controlling inflation. Of course, actions ultimately speak louder than expectations, and the Fed will have to continue to

demonstrate that it is willing to do what is necessary to ensure price stability in the U.S. economy.

A second drag on the U.S. economy relates to business investment. It may seem surprising to pinpoint capital spending as a drag since growth in this type of spending *has* been strong. However, it is probably less strong than one would expect, given the very favorable “fundamentals”—the low real interest rates that we’ve seen in recent years, solidly growing demand, and very high corporate profits and cash flow; indeed, for the first time in decades, business cash flow has actually exceeded total capital investment. This may suggest a continuation of the caution that has marked business decisionmaking in the wake of the terrorist threats and the issues surrounding corporate governance.

Another element that could put the brakes on business investment is a slowdown in the high-tech sector. The data aren’t conclusive on this point, but they are suggestive: In the third quarter, real investment in high-tech fell to nine and a half percent—about half what it was over the prior four quarters—high-tech manufacturing production slowed noticeably since midyear, and stock prices for some major high-tech firms slid; insofar as stock prices are good predictors, this suggests a more subdued outlook. So, taken together, these data suggest that we should be cautious about assuming that the heady days of massive IT investment are likely to return any time soon. The peak of strength in IT investment occurred at the end of 2000 when it was boosted by several special factors. One was the capital spending binge by telecom service providers. A second was the build-up to Y2K. A third was the very rapid pace of diffusion of personal computers and networks, a pace which may prove difficult to maintain much longer. Moreover, over the last year, we’ve seen that quality-adjusted computer prices haven’t been falling as fast, and that may signal some slowing of technological innovation in this sector.

Finally, there is some industry opinion that the pace of software development is beginning to drop off.

A third drag on the economy relates to the trade gap. It has risen from near balance in the mid-1990s to a deficit of around \$600 billion now, and it subtracted around a full percentage point from real GDP growth in the first half of this year. Narrowing the trade gap depends—in part—on the strength of domestic demand among our trading partners, because that affects demand for our exports. However, most of our major trading partners have had only sluggish growth in domestic demand recently, although their overall real GDP growth has been relatively healthy. One economy with strong domestic demand has been China; but, even there, concerns about overheating have led to efforts to restrain its economy. So long as these conditions prevail among our trading partners, they will not provide much impetus for growth in our own economy. Finally, non-oil import prices have risen by just under three percent over the past year, hardly enough to stem the trend of rising imports into this country.

Let me turn to two factors that are not now, but have the potential to be, drags on the economy going forward. First is the very low personal saving rate, which has fallen over the past decade from about seven percent to under half a percent in the third quarter of this year. Part of the reason that consumers are saving so little out of disposable income is that interest rates are low. In addition, their wealth has been on the rise; in the latter half of the 1990s, rising stock prices had a lot to do with the increase in wealth, but more recently, the main impetus has been house price appreciation. With interest rates rising now and housing prices unlikely to continue advancing at their recent robust pace, consumers may want to get their finances in order and curtail their spending in order to bring the saving rate up to more normal levels.

Fiscal policy is another factor that will come into play next year. The effects of the tax cuts and spending increases have been significantly positive for economic growth last year and this year. Next year, however, if current plans remain in place, the impetus from fiscal policy will wane. Most estimates suggest that fiscal policy could turn to being roughly neutral by 2005. This means that the main impetus to growth will have to come from private sector spending.

Let me next turn to the outlook for inflation. Over the last twelve months, inflation in the core CPI—that is, in the index excluding volatile food and energy prices—has come in at a moderate 2 percent. However, in the past couple of months, the readings have been a bit higher, most likely reflecting some pass-through of higher oil prices into core prices as well as increases in both commodity and import prices. This uptick in core CPI inflation bears close watching, but it's not a big concern at this point for a few reasons. First, inflation figures can be a bit volatile from month to month, so two months of data aren't enough to establish a trend. Second, another measure of core inflation—based on the personal consumption expenditures index—has been more modest. Third, as I mentioned earlier, supply-side effects should raise inflation only temporarily unless they become embedded in inflation expectations. And longer-run inflationary expectations seem to be well-anchored because the Fed's strong commitment to maintaining price stability is well understood. Furthermore, slack still remains in the labor market and that slack is working to moderate the pace of wage and salary increases, putting continued downward pressure on inflation. So despite the uncertainties raised by oil prices, inflation—especially core consumer inflation—seems to be relatively well-contained at present.

I'd like to end my remarks today with some thoughts about the challenges monetary policymakers are confronting now. We know that the current policy stance is accommodative, and that, as the expansion firms up, that degree of accommodation will have to diminish. But, by

how much and at what pace? This will depend importantly on what actually happens to employment, output and inflation going forward.

If the various drags on aggregate demand I've been discussing show signs of lessening, it may be appropriate to remove accommodation more rapidly. If they continue to weigh on the economy, or worsen, there will be more opportunities for the Committee to pause. The challenge, then, for monetary policymakers is to be on high watch as developments unfold, to evaluate them with an open mind, and to adjust the course of policy to achieve our dual mandate—promoting price stability and maximum sustainable employment.

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