The Economic Outlook

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I am pleased to be here today to discuss the economic outlook for the nation. There are always issues of one sort or another, and today is no different. Still, although I'll discuss these issues, it is worth reminding ourselves just how sound the U.S. economy is. In short, life is good for most Americans and the nation has done a fine job in seizing opportunities. The fact that we have issues to discuss is a consequence of how ambitious we are. We know that our nation always has further opportunities to exploit, improvements to make and problems to solve. My point is simply that in discussing problems we not lose sight of what we have and why we have it.

With regard to longer-run issues, perhaps their key unifying feature is that they arise from the changing demographic situation in the United States and the rest of the world. Demands on government from our aging population, centered on, but not confined to, Social Security and Medicare are at the top of the agenda. Although not the whole story, these spending pressures have much to do with the federal budget deficit and prospects for future deficits. It would be easy to expand the list of longer-run issues, but doing so would make impossible a discussion of the topic for today—the U.S. economic outlook over the next few years.

The major issues in the economic outlook, much in the news in recent weeks, concern prospects for inflation and the possibility of a slowdown in economic growth. I'll take up the growth situation first, and then turn to inflation.

Before proceeding, I want to emphasize that the views I express here are mine and do not necessarily reflect official positions of the Federal Reserve System. I especially appreciate assistance provided by Kevin Kliesen, associate economist in the Research Division of the St. Louis Fed. However, I retain full responsibility for errors.

EMPLOYMENT AND OUTPUT

Over the past few weeks, government statistical agencies and private-sector organizations have released several key economic reports. Recent data pound home an important lesson. High-frequency data, such as monthly reports, tend to be variable and subject to revision. Before last Friday's employment report, the financial press was full of articles on the prospects for a soft patch in the economy. The large increase in employment in April reported on Friday, and upward revisions of employment data for February and March, dispelled much of the soft-patch talk. While I talk about recent data, however, keep in mind that, as one of my economist friends put it, because of data revisions economic history is never quite what she used to be.

To emphasize how important it is to examine statistical reports closely, note that even revisions must be examined closely. Consider the April employment report. Seasonally adjusted employment for March was revised up by 93,000, a significant number of jobs. But the seasonally unadjusted count was revised up by only 50,000 jobs—still significant but many fewer than 93,000. Thus, revision of seasonal factors accounted for 43,000 of the total revision of 93,000 in the seasonally adjusted job count. Revisions of seasonal factors are not fundamental, but merely change

how employment gains are distributed across the months of the year.

The lesson, by the way, is not that the data are misleading but instead that they must be interpreted with due regard to the statistical processes behind their construction. Current estimates published by the statistical agencies represent the best estimates our first-class professional statisticians can supply. Agency publications provide ample information on the statistical properties of these estimates, and we ignore those properties at our peril.

From a forecasting perspective, perhaps the most important of the recent data releases was indeed the employment report for April. Based on this report—a total seasonally-adjusted jobs gain of 274,000—it appears that economic conditions improved dramatically in April. In addition, growth of aggregate hours was the strongest in more than eight years, while average hourly earnings advanced at almost a 4 percent rate. Together, these numbers imply considerable growth in personal income in April.

Other important reports released recently include first-quarter estimates of real GDP, employment costs and productivity, or output per hour of labor input. At the beginning of every month the Institute for Supply Management (ISM) releases its reports for manufacturing and non-manufacturing, and so we now have those reports for April. The ISM manufacturing report is a particularly valuable indicator of economic activity in the manufacturing sector.

As measured by the ISM's diffusion index, the pace of manufacturing activity slowed a little more than expected in April, as both the index of new orders and order backlogs dipped and firms reportedly pared their inventory stocks. Of note, the ISM report ran a bit counter to the tone of the latest Beige Book report, which noted "largely positive" readings from most Districts, and to a few other surveys of the manufacturing sector released in April. Nonetheless, the Fed's monthly industrial production report for March suggest that growth of manufacturing output has retreated modestly, albeit from rather high rates of growth. These readings on manufacturing are consistent with the April jobs report, which showed that manufacturing jobs actually declined by 6,000 despite the strong overall jobs growth of 274,000.

On the non-manufacturing side, the ISM's April business activity index also edged down modestly from March's level, but was slightly stronger than expected. Moreover, the report indicates continued strong growth in the services sector of the economy, which is much larger than the goods producing sectors.

The flood of news continued with this morning's report on international trade in March, which I've not yet had a chance to digest. Tomorrow we'll learn how sales at the nation's retailers fared in April. The retail sales report is followed with great interest, but I always issue a word of special warning on this report. The report that will get all the attention is the Advance Report on Retail Sales, which tends to be volatile and is often revised substantially. Analysts should pay almost as much attention to the revisions of prior advance reports as they do to the initial estimate. That said, indications are retail sales posted a sizable gain in April—even when last month's impressive auto sales are excluded.

As many analysts have commented, some of the latest data are suggestive of an economic soft patch. I do not disagree with this interpretation, but emphasize that there is so much noise in monthly data that it is unwise to dramatically alter economic forecasts for this year and next. The latest Blue Chip forecast for 2005 is 3.4 percent real growth, measured in terms of the entire year compared to 2004, and also 3.3 percent growth for 2006 compared to 2005. Admittedly, these are modestly below last month's Blue Chip forecasts, which were for 3.7 and 3.4 percent for 2005 and 2006, respectively. These forecasts probably reflect the weaker-than-expected first-quarter GDP report, but I would not be at all surprised if they were marked up in response to the strong April jobs report. In any event, the forecasts are below last year's 4.4 percent growth, as should be expected as the economy absorbs its margin of underutilized labor and capital resources.

Now I'll turn to recent GDP data. The broadest measure of economic conditions is the nation's gross domestic product. A couple of weeks ago, the Bureau of Economic Analysis (BEA) pegged first-quarter real GDP growth at 3.1 percent, which was about three-quarters of a percentage point below both the April Blue Chip Consensus forecast and the economy's growth registered in the fourth quarter of 2004. This first-quarter report was the BEA's "advance" estimate, which is based on incomplete data. Among other items, the BEA lacks solid estimates of exports, imports, and business inventories for the last month of the quarter when the advance estimate is released. The BEA projects the missing data using past data and some judgment.

As the missing source data trickle in, and the existing source data get revised, the BEA will revise its estimate of first-quarter real GDP; it will publish the first revision, which it calls the "preliminary" estimate on Thursday, May 26. I have no reason to believe that the revision will be either up or down.

The advance GDP report for the first quarter had several key features. First, growth of consumer expenditures remained fairly strong, though its contribution to real GDP growth lagged a bit from the previous quarter. For the most part, weaker growth of consumer outlays reflected a sizable decline in purchases of light trucks. In fact, outlays for new light trucks—a significant component of which are SUVs—declined at a double-digit rate for the second consecutive quarter. This segment of the auto market has obviously been adversely affected by higher gasoline prices. However, domestic auto and light trucks sales improved dramatically in April, and combined were up a little more than 7 percent from two months earlier; sales of foreign-produced light vehicles were up a bit more, about 7.5 percent.

Dissecting the components of the report, the largest single reason for slower GDP growth in the first quarter was a slowdown in business expenditures on equipment and software. Business investment in structures also slowed. After growing at about a 13 percent rate over the final three quarters of 2004, real business fixed investment only increased at about a 5 percent rate in the first quarter. Given that many forecasters continue to expect relatively strong growth in business capital for the remainder of 2005, and even into 2006, it may be the case that some of the rapid growth of business investment in 2004 reflected the efforts of firms to take advantage of the business investment tax incentives that expired on the last day of 2004. If so, then the first-quarter investment lull may have merely reflected the fact that some firms decided to move forward into 2004 some of the capital expenditures that otherwise would have occurred in early 2005.

Partially offsetting the capital-spending slowdown in the first quarter was a modest increase in the growth of housing construction. For some time now, the resiliency of the U.S. housing industry has surprised many in the forecasting community. Indeed, March construction spending rose by more than expected. Although housing is susceptible to long-term demographic trends such as a declining number of new household family formations, for purposes of discussing the short-term outlook movements in mortgage interest rates and real household incomes matter more for this segment of the economy. Accordingly, as long as mortgage rates remain relatively low and growth of real after-tax income remains relatively strong, then housing should do fine. Should either of these factors take a turn for the worse, it would be natural to expect a different outcome.

Finally, I should note that the growth of U.S. exports to foreign residents rebounded rather strongly in the first quarter, but that the pace of spending by U.S. residents on foreign-produced goods and services rose by even more. Because the U.S. economy remains considerably stronger than many of our trading partners, and the growth differential will likely persist for the rest of this year and into next year, foreign demand for U.S.-produced goods and services will probably continue to lag U.S. demand for foreign products. As long as the United States remains a good place for foreigners to invest their excess saving, one should not expect a significant realignment between the growth of U.S. exports and imports.

On balance, there seems to be a firmer tone to the very latest data, in contrast to the soft texture that characterized some of the previous readings. Now I'll discuss recent developments on the inflation front.

RECENT INFLATION DEVELOPMENTS

Perpetuating one of last year's most significant developments, consumers and businesses continue to face higher-than-expected prices of crude oil and refined products this year. To put some numbers into this discussion, I'll concentrate on prices for West Texas Intermediate, the benchmark grade of U.S. crude oil. At the end of 2004, the futures contract for delivery in December 2005 closed at a little under $42 per barrel, and the spot price at about $43.50 per barrel. By early April, futures prices had risen to a little less than $59 per barrel while the spot price had risen to more than $57 a barrel. Since then, spot prices have fallen back to around $50 per barrel, but futures prices have only dropped to around $53 per barrel. Although still high, it is useful to remember that current prices would need to rise to around $77 per barrel to reach their record inflation-adjusted highs that were seen in early 1980.

Traditionally, large oil price increases have principally reflected reductions, either actual or expected, in supply as a consequence of oil embargoes and wars. However, a key feature of the current episode is the prominence of demand-side factors associated with an increased call on world supplies by fast-growing economies like China and India. Significant growth in the United States has also boosted world energy demand.

Looking ahead, it is likely that demand-side pressures will continue to be important. The International Monetary Fund's latest *World Economic Outlook* projects that world oil demand will increase by about 68 percent between 2004 and 2030. However, China's projected demand is expected to increase by more than 192 percent, and its share of world consumption is projected to nearly double to 13.5 percent. To meet this increased worldwide demand, the IMF projects that non-OPEC supply will increase by about 40 percent; to make up the difference, the IMF projects that OPEC production will have to rise by about 112 percent.[1] Already, OPEC is estimated to be producing at about 95 percent capacity. What this means, in short, is that new fields or alternative sources of energy will need to be found and developed, or enhanced conservation measures will be required.

In a market-based economy like ours, the pricing mechanism eventually allocates resources to their most productive uses. Hence, higher oil prices will stimulate both increased production and active energy conservation measures, both of which will tend to limit further price increases and perhaps reduce prices over time. This process is not something that usually occurs rapidly. Longer-dated futures prices, such as the contract for delivery of West Texas Intermediate in December 2009, have risen from about $27.75 per barrel in early March 2004 to just under $48 per barrel currently. That fact suggests that many market participants believe that higher oil prices will be with us for some time.

High prices, however, should not be confused with rising prices. Although there may be some continuing pass-through of higher energy prices into prices for other goods, energy itself should not be a source of long-continuing inflation pressure.

Should we be concerned about the economic effects of higher energy prices? Over the near-term, as last year showed, the increase in real oil prices, which exceeded 25 percent, helped to produce higher inflation rates and modestly weaker growth than would otherwise have occurred. If this year's unexpected increase in oil prices persists, then it would be reasonable to expect a drag on the growth of real incomes, and thus output,

[1] International Monetary Fund *World Economic Outlook,* April 2005, Table 4.5. Supply projections are mid-point estimates between upper- and lower-bound projections for non-OPEC supply and Call on OPEC.

and higher inflation relative to what was originally expected.

The National Association for Business Economics recently asked its panel of industry economists to estimate the effect on their estimates for real GDP growth and CPI inflation for 2005 if West Texas Intermediate ends the year at $56 per barrel, which is where the December 2005 futures price was in early April. Most of the panelists reported that the most likely outcome would be for real GDP growth to be reduced by between 0.2 and 0.6 percentage points, and for CPI inflation to rise by between 0.2 and 0.6 percentage points. These estimates give the sense that energy prices are significant for the U.S. economy, but not so significant as to change the outlook in any fundamental way.

If the effects of energy prices today seem relatively small, it is useful to understand that the magnitude of today's increases would have probably produced much larger effects if we were using technologies and economic production processes from the 1970s. Technological improvements, which have made our economy much more energy efficient, and improvements in our regulatory structure, which have allowed the price mechanism to work more freely, mean that today's economy can endure periods of sharply higher energy prices with less damage than in earlier periods. U.S. energy demand per dollar of real GDP has declined by about 21 percent since 1990, and by about 38 percent since 1980. Thus, while higher oil prices do have adverse effects, we should not underestimate the capacity of the U.S. economy to adjust to those higher prices. Our economy's solid performance during the period of rising oil prices over the past four years is a testament to its resilience.

In few areas is this resiliency more evident than in the nation's labor productivity growth, which has averaged a shade over 3 percent per year since 1996. In the first quarter of this year, output per hour in the nonfarm business sector rose at a 2.6 percent annual rate after rising at about a 1.75 percent annual rate over the second half of 2004. For quite some time, the FOMC has regularly commented on the "ongoing support to economic activity" from "robust underlying growth in productivity." Should this support begin to erode—and there appears to be little evidence that it has—one of the consequences would be an elevated risk of higher inflation.

Labor costs depend on wages and productivity. Labor costs have been increasing only modestly, because productivity increases have been almost as large as wage increases. If productivity growth falters, labor costs will increase more rapidly and, at some point, firms will attempt to recoup some of these costs in the form of higher product prices. Although unit labor costs edged modestly higher over the second half of 2004, growing at a 3 percent rate, their rate of gain in the first quarter of 2005 slowed to about a 2¼ rate. Even though costs have drifted modestly higher over the past year relative to a few years earlier, as best we can judge forecasters do not envision a sustained upturn that would grab the Fed's attention. If anything, as the modest first-quarter gains in the employment cost index showed, the threat level is not terribly high, though it is obviously important for the FOMC to follow these developments closely.

THINKING ABOUT THE OUTLOOK

In thinking about the outlook over the next couple of years, policymakers will be paying especially close attention to three unfolding developments. First, inflation pressures may continue to intensify, particularly for prices of non-energy and non-food items. The FOMC will have to sort out whether the data indicate that more rapid price increases are a temporary blip on an otherwise steady long-term outlook or an indication of a more fundamental inflation problem. Second, the FOMC will be following incoming data closely to determine whether the recent moderation in economic growth is likely to persist into the summer and beyond. Finally, at what point will we perceive that FOMC policy actions have been sufficient to maintain long-run price stability?

As I see it, there is little reason to modify the output and inflation projections that the FOMC presented to Congress in February. The central tendency of the Board of Governors and Reserve Bank presidents was that real GDP would increase by between 3¾ and 4 percent this year, and that core PCE inflation was most likely to come in at 1½ to 1¾ percent. As the April employment report vividly showed, the data can sometimes turn on a dime. When we put all the recent data together, we get a mixed picture that does not require a fundamental change to the outlook. Nevertheless, we should not forget the usual forecast errors. Given the unpredictable things that can happen, a point forecast of 3¾ percent real growth over the four quarters of 2005 should really be expressed as a growth rate of 3¾ plus or minus 1¼ percent.[2]

The Federal Reserve's strategy for encouraging maximum sustainable economic growth depends on maintaining price stability. Forecasters were surprised by the pickup in inflation last year: The consumer price index (CPI), the best known measure of consumer prices, rose by 3½ percent over the twelve months of 2004, which was about 1½ percentage points higher than forecasters had expected. Much of this forecast error was due to unexpectedly higher energy prices. Still, when we strip out food and energy prices, we find that "core inflation" rose to about 2¼ percent on a CPI basis.

The Fed's preferred measure of prices is the price index used to deflate personal consumption expenditures (PCE) in the national income and product accounts, less food and energy prices. One area of concern is that core PCE prices have risen rather rapidly thus far in 2005; they are up at almost a 3 percent annual rate for the three months ending in March, compared to the 1½ percent gain seen for all of 2004. As yet, though, nominal interest rates have not moved in a manner that would suggest the market is beginning to price-in a larger inflation premium. If anything, yields on 10-year Treasury securities suggest just the opposite because they are not only little changed since the first of the year but also still below last June's level when the FOMC began its policy of bringing the federal funds target rate toward an equilibrium level. To me, that suggests that the market is confident of the FOMC's resolve to keep inflation well-controlled. This view is generally confirmed by the financial market's view of long-term inflation expectations over a period of 5 to 10 years as registered in the yield spread between conventional and inflation-protected Treasury securities.

The FOMC has emphasized that it is prepared, if necessary, to move more aggressively to protect the relatively low rate of core inflation that now exists. Nevertheless, the FOMC's best judgment at this time is that the target federal funds rate can continue to rise at a measured pace and that this policy will maintain economic growth without rising inflation.

I've emphasized on any number of occasions my view that today's expected policy path ought to be considered tentative. The expected path is based on the FOMC's best judgment from data currently in hand. If there are surprises in newly arriving data that require a major revision to the outlook, with regard to either GDP growth or inflation, then the FOMC will revise its expected policy path.

The only important surprise I've seen in the past year is that there has not been a major surprise in the economic data, except for energy prices. This stability in the economy is reflected in the stability of economic forecasts. In January 2004, the Blue Chip consensus forecast for 2005 was for real GDP to grow at a 3.7 percent rate. Month by month since January 2004 the Blue Chip consensus for 2005 growth has been remarkably constant, ranging between a low of 3.4 percent this month and a high of 3.8 in several months, most recently July 2004. Indeed, the consensus was 3.7 percent last month.

The Blue Chip consensus inflation forecast for 2005, as measured by the total CPI, has

[2] Gavin, William T. and Mandal, Rachel J. "Evaluating FOMC Forecasts." *International Journal of Forecasting*, October-December, 2003, *19*, pp. 655-67.

changed more, from 2.1 percent in January 2004 to 2.8 percent this month. Much of that increase reflects energy price increases that were not foreseen. Over the past 12 months, the total CPI has risen by 0.8 percentage points faster than the core CPI.

Looking ahead, I'm optimistic about the inflation situation. Wage inflation remains modest. Productivity growth remains good. The pricing environment remains quite competitive, which means that firms cannot readily expand profit margins. Should any of these factors change adversely—wages rise more rapidly, productivity rise more slowly, and/or profit margins expand—then inflation risks will rise. Although I believe that inflation risks are tilted to the upside, I do not believe that the probabilities are high enough to justify concern at this time. My optimism also reflects the fact that money growth—the fuel for long-run inflation—remains quite low and has in fact declined over the past 6 months.

At some point we'll almost certainly see some surprises in the data. What should not be uncertain, however, is the Fed's iron-clad commitment to maintaining price stability. Maintaining fundamental price stability is central to maximizing sustainable economic growth and the economy's ability to adjust successfully to inevitable shocks. That has been the Fed's message for many years, and its guide to its own policy actions. When a strategy has succeeded so well, why change it?