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Economic Outlook

Remarks by

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I am pleased to be with you tonight to discuss my views on current economic conditions and the economic outlook. These have been challenging times for economic forecasters and policymakers. Since the summer of 2005, the economy has absorbed a wide variety of shocks--major hurricanes, ongoing geopolitical tensions, and substantial increases in energy prices--and has adapted to a rise in short-term interest rates to more normal levels. Yet real gross domestic product (GDP) increased a respectable 3-1/2 percent from the second quarter of 2005 to the second quarter of 2006, and the unemployment rate fell to 4-3/4 percent. At the same time, however, headline consumer price inflation has been quite high, and an upward movement in core inflation has raised concerns about the persistence in price pressures, a very worrisome development from the point of view of a monetary policy maker.

The economic outlook for the next few years will be importantly shaped by ongoing responses to these developments. Reflecting those responses, economic activity has slowed noticeably over the course of the year, and inflation, though down from its level earlier this year, remains uncomfortably elevated. However, I expect that the continuing adjustment will be relatively benign overall: The economy will grow at a moderate pace for a while, somewhat below the rate of increase of its potential, and then growth will begin to strengthen. In addition, as the cost pressures from the run-up in energy and materials prices begin to play out, or perhaps even partly reverse, and as pressures on resources ease slightly, I think we will likely see much lower headline inflation and a gradual diminution of core consumer price inflation.

I know that to some this story of a soft landing seems too good to be true--the triumph of hope over experience. One question is whether it is even feasible. Can inflation pressures decrease with only a modest shortfall of economic growth from potential? And is it possible that a modest decline in resource utilization will not cumulate into something more serious, as it has tended to do in the past--at least without a major adjustment of policy? My view is that this economy is capable of generating the type of favorable outcome that I have just sketched, but, as in any period of transition, policymakers must be aware of heightened risks on all sides of the forecast. I must emphasize that these views are my own and not necessarily those of my colleagues on the Federal Open Market Committee (FOMC).[1]

Economic Activity

Based on the data we now have, the growth of real GDP in the third quarter appears to have remained as subdued as it was in the second quarter and may well have slowed further. As we enter the fourth quarter, little in the way of hard economic data or anecdotal information suggests any sharp shift in the pace of economic activity. If that is so, the economy could be in the process of registering several consecutive quarters of growth below its potential rate, the first time it has done so since early 2003.

After three years of growth above potential, some slowing was inevitable and desirable. Trees do not grow to the sky, and neither do the stocks of houses and durable goods held by households and businesses. In addition, the run-up in energy prices sapped consumers' purchasing power and cut into firms' profit margins. These hits to real incomes have restrained the growth of household and business spending. The effects of the high relative price of energy that we have experienced for much of the past year do appear to be reducing the demand for energy-intensive products. In particular, the major domestic automakers are cutting production to eliminate unwanted stocks of gas-

[1] Charles Struckmeyer, of the Board's staff, contributed to these remarks.

guzzlers, and these cuts are exerting a further drag on the growth of real GDP in the second half of this year.

Spending is also being restrained by the removal of monetary policy accommodation over the past two years. Without these policy actions, the developing pressures of demand on potential supply would have added to inflationary pressures. As anticipated, higher interest rates have been felt most clearly in the market for residential real estate. The adjustment in these markets has proven to have been more rapid and deeper than many economists had predicted, and we have yet to see signs that indicate just how the process will work itself out. Given the importance of housing markets in the evolution of the economy, I will spend a bit more time discussing the performance of this sector over the past five years and the factors that are likely to shape the adjustment process that is now under way.

From a trough of fewer than 1.5 million units at an annual rate during the recession of 2000, starts of new single-family and multifamily homes rose to a post-World War II high of 2.2 million units last year. Sales of new and existing homes followed the same broad pattern, and the boom in residential real estate markets was a powerful force driving the post-2000 economic expansion. Monetary policy played an important role in these developments: Responding to the weakness in other sectors of the economy, the FOMC held short-term interest rates at unusually low levels over much of this period. With inflation expectations well contained, with investment weak relative to saving in other countries, and with investors requiring much less extra compensation for holding longer-term obligations, long-term mortgage rates also dropped to historically low levels. Housing affordability increased substantially, and the homeownership rate hit new highs. In addition, a speculative element may have emerged in this market as investors projected rapid price increases into the future.

And those price increases were considerable. Between the beginning of 2001 and the end of 2005, the constant-quality price index for new homes rose 30 percent and the purchase-only price index of existing homes published by the Office of Federal Housing Enterprise Oversight (OFHEO) increased 50 percent. These increases boosted the net worth of the household sector, which further fueled the growth of consumer spending directly through the traditional "wealth effect" and possibly through the increased availability of relatively inexpensive credit secured by the capital gains on homes. By the end of last year, however, the high price of houses and rising interest rates had begun to take a meaningful toll on demand for homes.

Determining the exact timing of the recent peak in the housing market is difficult given the effects of last year's hurricanes, the volatility in the data, and timing differences in the evolutions of home sales and housing starts. That said, the fourth quarter of last year seems to provide a reasonable reference point: Since that time, housing starts have fallen about 20 percent, and home sales are down 10 percent. Home-price appreciation has also slowed dramatically since late last year, and some local markets have experienced outright price declines. Homebuilders report that cancellations have increased sharply, especially for second homes. Realtors note that existing houses are staying on the market longer, and sellers must increasingly make concessions to buyers.

How much longer will the correction in housing last, and how much deeper will it go? I do not have a definitive answer but would venture four observations. First, the reported declines in new home prices in a number of areas should help to facilitate the rebalancing of supply and demand in those markets--though it may accentuate the adverse spillover of the housing market correction to other sectors. Deeper price cuts would allow builders to clear out their inventories of unsold homes sooner, helping to stabilize the pace of residential construction activity faster, but the near-term hit to household wealth presumably would also be greater. Second, calculations about the sustainable level of housing starts based on demographic factors, such as population growth and household formations, suggest that starts may be closer to their trough than to their peak. Although such calculations are, in general, not particularly useful for near-term forecasting, they do suggest that any overbuilding in 2004 and 2005 was small enough to be worked off over coming quarters at close to the current level of housing starts. Third, the Federal Reserve has returned short-term interest rates only to more-normal levels and long-term rates are unusually low relative to those short-term rates. This situation stands in sharp contrast to some past downturns in the housing market that followed actions by the Federal Reserve to tighten credit conditions significantly. And fourth, continuing growth in real incomes should underpin the demand for housing and, as home prices stop rising, help to erode affordability constraints.

To date there is little evidence that this correction in the housing market has had any significant adverse spillover effects on other parts of the economy. The production of construction supplies has decelerated, but in general, resources freed up in the residential market appear to have been largely absorbed in nonresidential building or elsewhere. Indeed, after languishing for many years, the market for nonresidential structures seemed to revive around the time that the residential market was starting to show signs of slowing. This shifting of resources can likely continue for a while longer given the declines seen in office and commercial vacancy rates and the higher rates of capacity utilization in manufacturing.

Still, adverse spillovers will occur, and, as I indicated, their extent depends in part on the changing mix of prices and quantities as the housing market adjusts. In the past, outright declines in the nominal prices of houses have been relatively rare and localized. If something like this pattern prevails again, the decline in real housing wealth relative to incomes will be modest, and household saving rates should trend gradually higher. Such a rise in personal saving would not be an adverse outcome for an economy that generates relatively little saving domestically.

One reason I expect the economic expansion to continue despite the retrenchment in housing markets is the recent declines in energy prices. Oil prices have fallen around $15 a barrel from their recent highs this summer, and because of abundant supplies and cooperative weather, the spot price of natural gas is down significantly as well. If sustained, these lower prices are likely to boost consumers' purchasing power and help to offset to some extent the adverse spillover effects from weakness in the housing market.

In addition, financial conditions remain quite supportive of borrowing and spending. Market interest rates are not high in nominal or real terms; credit spreads are narrow and equity prices continue to rise, conditions that keep the cost of business finance down and suggest investor confidence in the future course of the economy.

As the inventory overhangs in residential housing and automobiles are worked off, economic growth should pick up again to a rate closer to the growth rate of its potential. One potential pitfall in this argument is that, in the past, a noticeable and sustained shortfall of growth from its potential and an accompanying decrease in resource utilization have often cumulated into a full-fledged recession. Several features of the current financial situation, however, support my contention that "this time will be different." These recessions have often been triggered by a highly restrictive stance of policy and a generalized tightening of credit conditions through high long-term rates, wide risk spreads, and a pull-back of bank lending. Obviously, these conditions are not present today. Although one cannot rule out the possibility that a withdrawal from risk-taking could impinge on credit supplies and intensify downward pressure on activity, the preconditions for such a response do not seem to be in place. Business balance sheets are in very good shape and financial institutions are quite well capitalized.

To be sure, the risks to these expectations of a limited shortfall of growth from potential seem to me to be weighted toward a weaker outcome. The housing market is not yet clearing, prices are still elevated relative to rents, the overhang could be larger than I perceive, and the attendant readjustment could be more abrupt and destabilizing--and could possibly even overshoot on the downside. And spillovers from the housing market could extend well beyond wealth effects if households had been relying on easy access to rising housing equity to finance a substantial portion of their consumption spending. Consumer confidence could erode as job growth and income gains slow, thereby sparking a steeper rise in saving. But, given current information, including on consumer confidence and spending, I judge my more benign scenario the more likely outcome.

Inflation

Would such an outcome for economic activity be consistent with an abatement of inflation pressures? As you know from our announcements, minutes, and public utterances, the members of the FOMC are very concerned about the rise in core consumer price inflation over the past year. From a pace of 2 percent in the twelve months ending in August 2005, the rate of core personal consumption expenditures (PCE) inflation has risen to 2-1/2 percent.

One of the key issues in the analysis of core inflation is the role of the pass-through of energy cost increases into the prices of other goods and services. The pass-through turns out to be harder to find either econometrically or in the price data themselves than any savvy consumer might think. Turning first to the data, a detailed breakdown of the consumer price index shows that the prices of the most energy-intensive services, such as air travel or refuse collection, have picked up considerably, a result likely attributable, at least in part, to the run-up in fuel prices over the past few years. But these items represent a relatively small part of the core index; the small acceleration in many other nonshelter portions of the index, while consistent with a small pass-through of energy costs, could also be attributable to non-energy factors.

When we try to model energy pass-through econometrically, the results indicate that a break occurred in pricing patterns in the early 1980s: Pass-through is clearly evident before 1980 but it is difficult to find thereafter. I suspect this pattern has something to do with the monetary policy reaction to those shocks and its effect on inflation expectations. In the 1970s, monetary policy not only accommodated the initial shocks but also allowed second-round effects to become embedded in more persistent increases in inflation. Since the early 1980s, the pass-though to core prices has been limited or non-existent, at least in part because households and firms have expected the Federal Reserve to counter any lasting inflationary impulse that they might produce. This result reinforces the need today to keep inflation expectations well anchored. In addition, movements in relative oil prices were more persistent before 1980 and less persistent after--until recently. After 1980, households and firms probably expected deviations of energy prices from long-run averages to be largely reversed and saw less reason to try to adjust wages and prices in response to what they viewed as transitory changes in energy costs.

In the final analysis, I think we probably saw some pass-through of higher energy costs into core inflation once price and wage setters came to believe that the rise in energy prices would not soon be reversed. But the magnitude of the effect has been small--perhaps on the order of a cumulative 1/2 percentage point or less since the end of 2003. If crude oil prices hold at close to current levels over the next few years, the resulting absence or even partial reversal of these energy cost shocks should, all else equal, put some modest downward pressure on core inflation.

Consumer energy prices have already flattened out according to the August data, and we will probably see a big decline in September's report. This decrease will not erase the increases of the past few years, but I believe that it will contribute to a lessening of consumers' fears that continued energy-price increases will lead to a ratcheting up of inflation in the long run. Indeed, the most recent readings on inflation expectations from the University of Michigan Survey Research Center showed a noticeable decline in September, especially in the inflation rate expected twelve months ahead. In financial markets, the spread of nominal over indexed yields has also retreated substantially at the near end of the yield curve. To a monetary policy maker focused on the evolution of inflation expectations, these developments are indeed steps (albeit small) in the right direction.

Another major force driving up core consumer price inflation over the past year has been shelter costs, especially tenants' rent and owners' equivalent rent. Together, these two components account for a substantial part of the core price indexes--38 percent for the consumer price index (CPI) and 17 percent of PCE prices--and as a result, small shifts in price trends in these areas can have a noticeable effect on core inflation. For example, after running at about a 2-1/2 percent pace for several years, increases in owners' equivalent rent stepped up to an annual rate of 5 percent in the six months ending in August. As you know, these prices are imputed from the rental housing market, and quite possibly this acceleration resulted from a shift in demand toward rental housing as higher interest rates and home prices, along with reduced expectations of capital gains, made the owner-occupied market increasingly less attractive. In response to greater demand, the supply of rental housing should increase over time, in part by drawing from the overhang of owner-occupied units; hence, I do not expect rents to be a major influence on core inflation a year or two from now, the horizon that is the focus of monetary policymaking. Clearly, however, the band of uncertainty about such a forecast is rather wide.

Not only should the contribution of energy and shelter costs to underlying inflation be diminishing over coming quarters, but the generalized pressure of demand on supply should also decrease if, as I am anticipating, economic growth falls short of potential for a time. I would not expect modest changes in the output gap to exert more than a marginal influence on inflation. But the anticipated slower pace of growth will result in an environment in which firms will be less able to pass on increases in costs.

One potential source of higher costs comes from the labor market. I would not be surprised to see a gradual rise in labor costs as workers capture a greater share of the productivity gains of recent years. However, compensation per hour, a measure derived from unemployment insurance tax records, indicates that labor costs accelerated sharply, to a pace of 7-3/4 percent from the second quarter of 2005 to the second quarter of 2006. In contrast, readings from the employer cost index (ECI), which is derived from a probability sample of firms, shows labor costs decelerating. Some of the divergence appears to be the result of an increased volume of stock option exercises in early 2006--an occurrence captured by the compensation per hour measure but not by the ECI--and these option exercises should not represent costs that firms actually internalize when calculating their marginal cost of production. Thus, in my own thinking, I have tended to discount, though not dismiss, the latest readings on labor costs. However, I acknowledge that rising labor costs are an upside risk to my inflation outlook, especially if they occur under product-market conditions in which firms can readily pass costs through.

In sum, I think that the odds favor a gradual reduction in core inflation over the next year or so, but the risks around this outlook do not seem symmetric to me: Important upside risks to the outlook for inflation warrant continued vigilance on the part of the central bank. I say that not only because of the questions about underlying labor costs and about the future direction of energy and shelter prices but also because our understanding of the inflation process is limited, and I cannot rule out the possibility that the upward movement earlier this year reflected a more persistent impulse that I cannot now identify. Although I believe I have offered plausible explanations for the acceleration of inflation this spring and summer and reasonable rationales for expecting inflation to moderate, I would feel much more confident about where we are heading if I had a more accurate bearing on the direction from whence we have come. In addition, in my view, if inflation failed to abate it could impose considerable costs on economic performance over time, a concern that brings me to the topic of monetary policy.

Monetary Policy

Even if my relatively favorable forecast comes true, the level of short-term interest rates that will produce this forecast remains uncertain. Obviously, as my FOMC voting record indicates, I believe that, for now, the current level of short-term rates has the best chance of fostering this outcome. Looking ahead, policy adjustments will depend on the implications of incoming data for the projected paths of economic activity and inflation. I must admit I am surprised at how little market participants seem to share my sense that the uncertainties around these paths and their implications for the stance of policy are fairly sizable at this point, judging by the very low level of implied volatilities in the interest rate markets.

As I have outlined tonight, I think that the risks to my outlook for economic activity may be skewed a bit to the downside, while those to my forecast of gradually declining inflation are tilted to the upside. In my view, in the current circumstances, the upside risks to inflation are of greater concern. Although to date inflation expectations have remained contained, failure to check and then reverse the greater inflation pressures of earlier this year would risk embedding those higher inflation rates in the decisions of households and businesses, an outcome that would be costly to reverse and would impinge on the economy's long-term performance.