

THE NATIONAL ECONOMY AND MONETARY POLICY

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It's a pleasure to be with you again at our Economic Forums series to discuss the national economy and monetary policy. In the two years since I last spoke at our Kansas City Economic Forum, the U.S. economy has grown at a robust pace, and, as a result, labor and capital resources are now at or near the point of full utilization. While inflation has risen as a result of increased energy prices, outside the energy sector, inflation has remained well contained. Over the same period, monetary policy has moved from a highly accommodative stance to one that today is more neutral. Remarkably, this performance of the economy has occurred despite a number of shocks to the economy, including hurricanes and considerable energy price volatility. The U.S. economy continues to demonstrate its resiliency and underlying macroeconomic strength.

This evening, I plan to review recent economic performance, provide my assessment of the near-term economic outlook and discuss the implications of the outlook for monetary policy. In particular, I will start by looking back at the performance of the U.S. economy in 2005 and then take a look at some of the fundamental forces that will be shaping the outlook in 2006. Next, I'll discuss some of the risks to the outlook—both on the upside and the downside. I'll conclude with a brief discussion of how monetary policy has contributed to the favorable performance of the economy over the last year or so and discuss factors that will influence the course of monetary policy over the next several months.

Looking back at 2005

Let me begin by taking a look back at the year just ended. Real gross domestic product (GDP) growth was weaker than expected in the fourth quarter of last year,

growing at an annual rate of just 1.7 percent. It is important to note, though, that the slower growth was probably due to transitory factors. Auto sales weakened early in the fourth quarter because of reduced sales incentives. Defense spending fell sharply, which is unlikely to continue in the months ahead. And, because of the hurricanes, net exports worsened. In particular, exports were temporarily depressed by the shutdown of some Gulf ports, and imports of crude oil and chemicals surged temporarily to replace lost production.

Despite the weaker-than-expected numbers for the fourth quarter, the economy grew at a solid pace of 3.2 percent in 2005 as a whole. Moreover, growth was strong enough to further reduce the unemployment rate and raise industrial capacity use. For example, the unemployment rate fell from 5.4 percent in December 2004 to 4.9 percent in December 2005, and it has continued to fall this year to 4.8 percent in February. In addition, capacity utilization in manufacturing has edged up to around its long-run average rate.

All major components of domestic demand contributed to this performance. Consumer and business spending grew solidly, and residential investment spending actually accelerated a bit relative to the previous year. The only major sector not contributing significantly to overall growth was the foreign trade sector, where we continued to see large and growing deficits.

On the inflation front, the news was also reasonably good. Although there was a significant impact of higher energy prices on overall inflation, the core inflation rate remained low and stable. Over the year ended in December, the overall consumer price index (CPI) rose by 3.4 percent. But the CPI excluding food and energy prices rose a

more modest 2.2 percent. Looking at the more recent data for the 12-month period through February 2006, overall CPI rose 3.6 percent, but core CPI inflation actually declined a bit to 2.1 percent. Thus, while we have seen sharp increases in energy prices contribute to higher headline inflation, we have not seen these price pressures passed through to a higher core inflation rate.

One of the factors that contributed to the solid economic performance last year was the accommodative stance of monetary policy. Although the Federal Open Market Committee (FOMC) raised the target for the federal funds rate by 25 basis points at each of its eight meetings last year, and at both meetings so far this year, for most of 2005, the rate remained below the level most analysts would describe as neutral. A neutral funds rate is one that neither stimulates nor restrains overall economic activity. Although no one knows exactly what level of the funds rate is consistent with neutrality, we clearly did not approach the neutral range until late in 2005. Recall that at the beginning of the year, the funds rate was just 2 ¼ percent in nominal terms—and zero percent after adjusting for inflation. Today, it is 4 ¾ percent nominal and around 2 ½ percent real. So, throughout most—if not all—of 2005, monetary policy remained accommodative.

Looking ahead at 2006

Looking ahead, I expect the favorable performance of the economy to continue. Most private forecasters expect the momentum from the solid growth in 2005 to continue into 2006. While 2005 ended on a weak note, that weakness was due to special factors that will not likely be repeated in 2006. In addition, the limited data we have so far for the first quarter of 2006 suggest a rebound is likely in the first quarter. Consumer spending was strong in January, and construction activity actually picked up speed due to

the unusually warm weather, backing down only recently. Labor market indicators suggest continued growth in employment and a low level of unemployment.

Although monetary policy is less accommodative, it will continue to support economic activity in the near term. Because of the lags with which monetary policy affects the economy, monetary policy accommodation over the past year will continue to act as an economic stimulant in the near term, though clearly not as much of one as in the past several years. Over the second half of this year, our moves to remove monetary accommodation should help ensure the economy settles into a growth rate that is consistent with the economy's long-run growth potential.

My view is similar to the consensus of private sector forecasters. I would expect growth of around 3 ½ percent (Q4/Q4) for 2006, which is just slightly above most estimates of trend GDP growth. That said, growth in the first quarter may come in well above 3 ½ percent, as the economy rebounds from the sluggish fourth quarter. But over the course of the year, I would expect to see GDP decelerate to around its trend growth rate.

As in 2005, consumer spending is expected to be a primary contributor to growth in 2006. In recent months, consumer confidence has rebounded sharply from its hurricane-related plunge last fall. More importantly, consumer expectations of the future are positive. Concerns about high heating costs this winter have been mitigated to some extent by unseasonable warm weather, which has kept fuel supplies ample and costs more or less in check. And these concerns should diminish further this spring as heating demands decline and production in the Gulf region is more fully restored.

Despite the upheavals in several sectors of the economy, such as the domestic auto industry, business investment is also expected to contribute to growth in 2006. Strong growth of corporate earnings combined with low borrowing costs over the past two years has led to marked improvement in firms' balance sheets. In the fourth quarter of last year, corporate profits were 21 percent higher than the year-earlier period. Looking ahead, while there may be some slowing from recent performance, most private sector forecasters expect profit growth of 8 percent to 9 percent in 2006. Together, improved balance sheets and strong profit growth will provide fundamental support for investment spending.

In the international sector, continued strong growth in the rest of the world will reduce the drag on U.S. GDP growth coming from net exports. Such growth, however, is also likely to increase further global demand for natural resources. This implies that prices for some commodities, such as oil and cement, may remain at elevated levels for an extended period.

The solid growth forecast for the economy also should translate into steady growth in employment. The increases will be somewhat less than employment gains seen in the past two years due to two factors. First, as growth slows and converges toward the economy's trend growth rate, fewer additional workers will be needed. And second, strong productivity growth over the past few years is expected to continue, suggesting that the existing workforce will be able to produce a sizeable portion of the projected increase in output. Based on these factors, I would expect that employment will grow by

between 1.5 million and 2 million jobs in 2006. That translates into an increase of 125,000 to 167,000 jobs per month.

Turning to inflation, I expect the core inflation rate to remain at about its current level. Thus far, the impact of higher energy prices on the core measure of CPI inflation has been moderate. However, I recognize that the longer energy prices remain at elevated levels, the greater the possibility that these higher costs will be passed on from producers to consumers. Still, for 2006, I generally expect these energy price pressures to result in a modest increase of core inflation in the first half of the year before diminishing in the second half.

Risks to the outlook

Let me turn now to some of the risks to this very favorable outlook. Despite the remarkable resilience of the U.S. economy to a variety of economic shocks over the past several years, it's important that we continue to remain aware of potential problems. Right now, in my view, the risks to the favorable outlook for inflation and growth are reasonably well-balanced. While there might be a small upside risk to the inflation outlook, that risk is balanced by a small downside risk to economic growth.

The upside risk for inflation stems from two sources. First, the increase in energy prices has led to increased costs for transporting and producing many goods and services. If these higher costs of production are passed through to consumer prices, we could see a greater-than-expected increase in core inflation. Second, if the economy expands at a rate faster than underlying trend growth, the pool of available workers will shrink. Such expansion could eventually result in higher labor costs. Thus far, we have yet to see rapid growth in wages. Over the past year, unit labor costs have increased by about only1

percent, but they accelerated by 3.3 percent in the fourth quarter. Looking forward, measures of wage pressures and total resource demands will require careful monitoring as the economy continues to grow.

The risk of slower-than-expected output growth also stems from several sources. Over the past several years, as you know, there's been a rapid increase in the value of housing in the United States fueled by low mortgage interest rates. This has increased household wealth and contributed to strong growth in household consumption during the current economic expansion. But, if housing prices have risen above levels dictated by economic fundamentals, there's a chance prices could fall. With the current high debt level of consumers, such a drop in household wealth could cause them to sharply curtail their spending, leading to slower growth in the economy. While I don't think there is much risk of a housing price collapse on a nationwide basis, we could see a decline in prices in certain markets.

Another risk to output growth is the current low savings rate in the United States. For the last three quarters of 2005, the personal savings rate was negative. That means that personal consumption spending exceeded disposable income. So while businesses have been improving their balance sheets as a result of strong earnings growth, consumer debt has been increasing. The picture for government savings is not any better due to the current large federal budget deficit. Combined, strong consumer and government demand have caused imports to exceed exports, resulting over time in the large U.S. trade deficit, now approaching 7 percent of nominal GDP. To finance this trade deficit, foreigners have acquired large holdings of U.S. securities.

At some point, the domestic savings rate will need to increase to reduce this trade imbalance. Many economists expect that the transition to a higher savings rate will occur smoothly, but with an imbalance of this magnitude, there is a chance that a rapid transition could lead to a downturn in the economy through a sharp falloff in consumption.

To summarize, the risks to the favorable outlook—while present, as always—currently appear to be balanced. A small risk of higher inflation is roughly balanced by a small risk of slower output growth. With the economy now at or near the point of full utilization of resources, it will become more challenging to set a course for monetary policy that continues to properly balance these risks.

Implications for monetary policy

That brings me to the final part of my presentation: the role of monetary policy in fostering sustainable economic growth with price stability. Over the course of the last year and a half, the FOMC gradually has raised its target for the federal funds rate from an unusually low level of 1 percent in 2004 to 4 $\frac{3}{4}$ percent today. As a result of these actions, the funds rate now has returned to a more normal level and is within the range most analysts would associate with neutrality. In fact, the funds rate now may be at the upper end of the range I would associate with neutrality. While this strikes me as where we most likely should be, balancing inflation and output risks, we cannot know this for certain. Only as new data and anecdotal information on the economy arrive will we know how monetary policy will need to respond.

When the funds rate was at the unusually low level of 1 percent two years ago, it was relatively easy to signal a direction for future changes in monetary policy. As the

economy gained momentum in 2004, it was clear that the funds rate needed to increase gradually back to a more normal or neutral range. However, as the funds rate has entered the neutral range and risen to the upper end of that range as estimated by most analysts, it has become more difficult to know in advance what the next move is likely to be or when the next move should occur.

Currently, as I have described, the economy is operating at or near full resource utilization, output is projected to grow at roughly the economy's growth potential over the course of the year, and core inflation is projected to remain relatively low and stable. In addition, the risks to the outlook are balanced, and the funds rate has returned to a more normal level.

Given lags in the effects of monetary policy on the economy, however, we cannot be sure how our past policy actions will impact the economy down the road. We therefore will need to carefully examine incoming data for signs of inflationary pressure or economic weakness and be prepared to take appropriate action. Because economic data often give ambiguous signals, we must go cautiously, watching the new information to confirm where we are in the current economic and policy cycle and that we not tighten policy too much, thus, needlessly slowing the economy below potential. That said, balance requires that long-run inflation expectations remain well anchored if price stability is to be maintained.

Conclusion

Let me conclude by saying that I expect we will continue to enjoy solid economic growth with low inflation throughout 2006. Output likely will grow at or slightly above the economy's long-run growth potential. With the possibility of increased resource

utilization and the pass-through of higher energy prices to core inflation, there is a risk that inflationary pressures could build. At the same time, there are also risks—though perhaps small—that a decline in housing prices or a disorderly adjustment to our trade imbalance could cause a pullback in consumer spending. In this environment, we will need to carefully monitor incoming data and take necessary actions to keep the risks to the attainment of both sustainable economic growth and price stability roughly in balance.