THE NATIONAL ECONOMY AND MONETARY POLICY IN THE NEW YEAR

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I’m pleased to be back at the Central Exchange to speak with you about the outlook for 2006 and implications for monetary policy. With the start of the New Year, it’s a particularly opportune time to reflect on the past year and to anticipate the opportunities and challenges that the current year might bring. Some of you might recall that I spoke here a year ago, providing my perspective on the U.S. economy for 2005. Fortunately, last year, my crystal ball proved reliable, and the year unfolded largely as I expected.

Today, I would like to review the performance of the economy in 2005 and take a look at some of the fundamental forces that will be shaping the outlook in 2006. I also would like to give you my perspective on monetary policy over the period ahead. I hope—but can’t guarantee—that my crystal ball will prove as reliable this year as it did last year.

Looking back at 2005

Let me begin by taking a look back at the year just ended. While we don’t yet have GDP data for the fourth quarter, it appears the economy experienced solid growth throughout the year. In the first three quarters of the year, the economy grew at an annual rate of 3.7 percent. This strong growth—which is above most estimates of the economy’s long-run growth potential—largely closed the output gap and returned the economy close to full resource utilization. For example, the unemployment rate fell from 5.4 percent in December of 2004 to 4.9 percent in December of last year, and capacity utilization in manufacturing edged up. This growth rate was also close to the forecast of 3½ to 4 percent that I gave here last year.

All major components of domestic demand contributed to this performance. Consumer and business spending remained robust, 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 deficits. But, depending on what happened in the fourth quarter, even that sector likely has been less of a drag on growth than in previous years.

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 relatively low and stable. On a year-over-year basis, the overall CPI rose by 3½ percent in November of last year. But, the CPI excluding food and energy prices rose a more modest 2.1 percent. This outcome was consistent with what I expected last year at this time. Although last year I mentioned a number of factors that made me cautious about the outlook for inflation, my expectation was that core inflation would remain stable.

Now, before I get carried away with my forecasting ability, let me acknowledge that last year I obviously was not anticipating the disruption to economic activity caused by hurricanes Katrina and Rita or the spike in energy prices they precipitated. Indeed, the long-run outlook for oil and gas prices has changed dramatically since this time last year. Had the hurricanes *not* struck, I suspect economic growth might have come in even stronger than I was anticipating last year, and, certainly, overall inflation would have come in lower.

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 our eight meetings last year, for most of the year, the rate remained below the level most analysts would describe as neutral. A neutral funds rate is one that neither over-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 2¼ percent in nominal terms and zero percent after adjusting for inflation. Today, it is 4¼ percent in nominal terms and just over 2 percent after inflation. 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. Although monetary policy has become less accommodative, it will continue to support economic activity. 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, though clearly far less so than in the past several years. My sense is that most forecasters expect growth of around 3½ percent (Q4/Q4) for 2006, which is just slightly above most estimates of trend GDP growth. My own view is that we will see growth in the 3¼ to 3½ percent range, which encompasses the consensus estimate.

As in 2005, consumer spending is expected to be a primary contributor to growth in 2006. In recent months, consumer confidence measures have sharply rebounded from the hurricane-related decline last fall. More importantly, consumer expectations of the future are positive. One possible drag on consumption lies in the persistence of high energy prices, especially for natural gas. High utility prices for heating are expected to constrain spending somewhat during the winter months. This drag should diminish by spring as heating demands decline and production in the Gulf region is more fully restored. Overall, I expect to see consumption growth of around 3 percent for 2006.

Despite the upheavals in several sectors of the economy, such as the 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 have led to marked improvement in firms' balance sheets. In the first three quarters of 2005, corporate profits were nearly 15 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 around 8 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 slow the growth of the trade deficit. An expanding world economy is expected by many economists to generate increasing demand for U.S. exports. Such growth, however, is also likely to further increase global demand for natural resources. This implies that prices for commodities such as oil 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 between 1.5 and 2 million in 2006.

Turning to inflation, I expect the core inflation rate to remain low. Thus far, the impact of higher energy prices on the core measure of CPI inflation has been moderate. However, the longer energy prices remain at elevated levels, the greater the probability that these higher costs will be passed on from producers to consumers. For 2006, I 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.

<u>Risks to the outlook</u>

With the general performance of the economy outlined, let me next discuss what I see as the major risks for the U.S economic outlook. Over the past year, the economy again has displayed its resilience to economic shocks. In first half of 2005, we experienced a sharp run-up in energy prices. In the second half, we faced the devastating impacts of hurricanes Katrina and Rita, which led to an additional increase in energy prices. Throughout these events, the economy has continued its robust growth, and related inflation pressures appear to have been temporary. Despite the excellent performance of the economy in the wake of these events, it is important that we continue to be on the lookout for potential problems ahead.

The primary near-term concern pertains to the upside risks for the economy and inflation. If global demand continues to accelerate, total resource demands could increase as well. As mentioned earlier, the increase in energy prices may lead to higher core inflation if higher energy costs are passed on by businesses to consumers. In addition, if the U.S. economy continues expanding at a rate faster than underlying trend growth, the pool of available workers will shrink. Such expansion eventually should 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 only 2 percent. But looking forward, measures of wage pressures and total resource demands will require careful monitoring as the economy continues to grow.

A second, longer-term concern relates to the current low savings rate in the United States. For seven of the past eight months, the personal savings rate has been negative. So while businesses have been improving their balance sheets as a result of strong earnings growth, consumer debt has been increasing as consumers have spent in excess of their incomes. 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. To finance this trade deficit, foreigners have acquired large holdings of U.S. securities. At some point, the domestic savings rate must 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 the low probability that a rapid transition could lead to a downturn in the economy through a sharp falloff in consumption.

A third concern relates to a possible imbalance in asset prices. Over the past several years, there has 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. If housing prices have risen above levels dictated by economic fundamentals, there is a chance that prices could fall. With the current low savings rate and high debt level of consumers, such a drop in household wealth would have negative implications for the economy. While I do not think there is much risk of a significant housing price decline on a nationwide basis, we could see a decline in prices in certain markets.

These three factors present both upside and downside risks to the economy. As the economy nears the point of full utilization of resources, it will become more challenging to set a course for monetary policy that appropriately balances 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 4¼ percent today. As a result of these actions, the funds rate now has returned to a more normal level and is within at least the lower range of what most analysts associate with neutrality. Whether the funds rate is now precisely at the point within the neutral range where it needs to be is a question I cannot answer with any degree of certainty. This depends on possible increases in resource utilization as well as elevated energy prices, and whether other factors add to inflation pressures.

More generally, when the funds rate is within the neutral range, as I believe it is now, changes in the funds rate target become more dependent on incoming economic data and on anecdotal information on economic activity and inflation. If such evidence were to suggest that core inflation was increasing above the level associated with price stability, it might be necessary to move the funds rate target higher within the range of neutrality. Or, depending on the extent of upward price pressure, it might be necessary to move the funds rate above the neutral range to offset the tendency for inflation to rise. One indicator that would be of particular concern to me would be any upward movement in long-run inflation expectations. It is essential for long-run inflation expectations to remain well anchored if price stability is to be maintained.

In contrast, if incoming evidence suggested the expansion were faltering, it might be necessary to adjust the funds rate downward. As I suggested earlier, the burden of high energy prices or a desire by consumers to curtail their spending could lead to a slower-growth scenario. Depending on the outlook for inflation in such a scenario, it might be appropriate to move the funds rate lower within the neutral range or, potentially, below neutral to help stimulate spending and production.

On balance, while the current setting of monetary policy may be close to where it will ultimately need to be, we won't know this until new data are reported. The point is that we still must monitor closely incoming information as we seek to calibrate our policy in the months ahead.

Conclusion

Let me conclude by saying that I expect we will continue to enjoy solid economic growth with low inflation throughout 2006. Output will likely grow at or slightly above the economy's long-run growth potential. With the possibility of increased resource utilization and the pass-though of higher energy prices to core inflation, there is a risk that inflationary pressures could build. In this environment, we will need to monitor carefully incoming data and take necessary actions to keep the risks to the attainment of both sustainable economic growth and price stability roughly in balance.