

# Challenging Times for the U.S. Economy

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Thank you. I am pleased to be in Durango today to talk with you about current economic conditions and the prospects for the national economy and monetary policy in the period ahead. As you know, the U.S. economy is in the midst of a very difficult period. Economic growth has slowed considerably, employment has declined and the unemployment rate has risen. Despite these developments, there remain some positive signs in the economy and, with current fiscal and monetary policy actions, we may yet avoid a recession. At the same time, however, higher oil, food, and commodity prices have boosted inflation, undermining the economy and causing hardship for many households and businesses.

In this environment, monetary policy must walk a fine line: supporting growth, while ensuring that higher food and energy prices do not cause inflation expectations to become unanchored and lead to a more widespread inflation problem. While the current accommodative stance of monetary policy reduces the risk of recession, it almost certainly raises the risk of higher inflation.

In the next few minutes I want to develop these points by providing my perspectives on current economic conditions, the outlook for the economy over the second half of the year, and the difficult challenges for monetary policy in the current economic environment.

#### Current Economic Conditions

Over the past two quarters, we have seen a significant slowing of economic growth. Real GDP growth was just .6 percent in the final quarter of last year and improved only slightly to 1 percent in the first quarter of this year. Second quarter estimates, which will be released at the end of this month, are likely to be somewhat

higher, perhaps in the neighborhood of 2 percent. These numbers, while better than many expected, still fall short of the economy's estimated potential growth rate of approximately 2.5 percent.

As growth has slowed, we have seen rising layoffs and a higher unemployment rate. Over the first six months of this year, payroll employment growth has declined by over 400 thousand jobs, with the largest job losses in construction and manufacturing. From a low of 4.4 percent in March 2007, the unemployment rate has risen to 5.5 percent currently.

There are three primary factors behind this weaker growth. First, the slump in housing construction, now in its third year, has taken almost a full percentage point off growth over the past eight quarters. Second, higher energy prices have led to a marked slowing in consumer spending, with purchases of autos especially affected. Third, the financial distress following the collapse of subprime mortgage lending has led banks and other financial intermediaries to restrict the availability of credit, not only for mortgage lending, but for other business and consumer lending.

With these negative factors, many economists and financial analysts believed a recession was inevitable in the first half of this year. However, a recession has not materialized because of strengths in other parts of the economy which have helped sustain growth. In particular, with the sizable decline in the dollar over the past few years, U.S.-made goods have become more competitive, and we have seen a boom in U.S. exports. In addition, federal defense spending and state and local government spending have continued to provide a boost to growth and employment. The Federal Reserve also has taken significant steps to limit the economic slowdown by providing

increased liquidity to financial institutions affected by the subprime crisis and by lowering the federal funds rate target to its current level of 2 percent.

Complicating this picture has been the fact that as we have eased policy to counter the slowing economic growth, we have seen inflationary pressures rise. Price increases in energy, food and many industrial commodities are accelerating. Oil prices have more than doubled over the past two years, and food price inflation is the highest in many years. Overall inflation, as measured by the personal consumption expenditures deflator, has increased by 3.1 percent over the past year. Core PCE, which looks at the prices of non-energy and non-food goods and services, has increased a more modest 2.1 percent over the past year. But, price pressures appear to be building. Indeed, business and household surveys indicate rising inflationary expectations over the near term, a development that bears close scrutiny over the next several months.

### The Near-Term Outlook

Turning from where we are to the near-term outlook, I expect only modest improvement in the second half of this year, with GDP growth in a range of 1 to 1.5 percent. Growth will be supported over this period by the fiscal stimulus from the tax rebates, from further strength in exports and government spending, and from the current accommodative stance of monetary policy. Indeed, growth is likely to be relatively strong in the third quarter because of the rebates and then may soften noticeably in the fourth quarter.

Housing will continue to be a drag on growth for the balance of this year and into 2009. Inventories of new and existing homes remain very high in many parts of the

country, which will put additional pressure on home prices and dampen new housing construction. In addition, higher mortgage rates and reduced credit availability are likely to impede a housing recovery. Still, there are some very tentative signs of improvement in existing home sales, and my expectation is that housing will be less of a drag on growth as we move through 2009.

Two other factors limiting second half growth are the ongoing strength in energy prices and continuing restrictions on credit availability. High oil and gasoline prices are continuing to sap consumer spending, forcing households to cut back spending on discretionary items and especially autos. There has been a sharp decline in sales of new autos, especially SUVs and light trucks, which is likely to continue unless there is a dramatic reversal in oil prices.

Credit availability also is likely to restrain growth in the near term. Going forward, the fallout from the subprime debacle is likely to lessen as the institutions involved in securitization of mortgages and other asset-backed securities move to clean up their balance sheets and raise new capital. However, as the economy has slowed, loan delinquencies on other types of loans have increased, and banks are restricting credit and raising the price of credit to many of their customers.

Putting the positive and negative factors together, I think that we are likely to see positive but subdued growth over the balance of the year. Strength in exports and government spending, the tax rebates, and a reduced drag from housing should help counter the effects of higher energy prices and financial stress. While I believe we can avoid a recession, I recognize that there are significant risks that growth could turn out weaker than I suggest here.

I am, disappointingly, even less optimistic about the inflation outlook over second half of the year. Indeed, I expect both overall and core inflation measures to rise further over the next several months. The most recent surge in energy prices that began in May has not yet been fully reflected in inflation measures. Moreover, my sense in talking to many businesses is that it has become much more difficult for businesses to hold the line on prices generally as energy and other materials prices continue to climb. And, with rising import prices, especially from China, businesses are finding that they have more pricing power than in recent years.

While I have been encouraged by the small pass through of food and energy prices to core inflation thus far, I am worried that this pattern could change quickly. As I noted earlier, short-term inflation expectations have moved higher over the past few months. Over time, if an inflation psychology becomes embedded in household and business behavior, this current rise in food and energy prices could lead to a much more persistent inflation problem.

#### Challenges for Monetary Policy

Let me close with my perspectives on the challenges facing monetary policy in the period ahead. As you know, over the past year the Federal Reserve has responded aggressively to the financial market disruptions associated with the subprime mortgage crisis. It put into place a number of liquidity facilities to improve the functioning of financial markets, and it lowered the federal funds rate from 5 ¼ percent to 2 percent to help cushion the broader economy from these disruptions.

The continuing rise in energy and food prices over the past several months has made the current monetary policy environment considerably more challenging, however.

While a 2 percent federal funds rate may be appropriate in a period of extreme economic weakness, if maintained for too long it could allow inflationary pressures to build over time.

You may recall the last time we had very large increases in energy and food prices was in the 1970s, and these increases contributed to the rise in inflation rates to double-digit levels in the late 1970s. You will notice that I said “contributed” – not “caused”. Increases in food, energy and other commodity prices can cause a temporary increase in inflation but cannot cause a permanent increase. Indeed, markets work, and commodity price increases invariably lead to reduced demand and increased supply of the commodities that cause their prices to decline.

Commodity price increases can contribute to a more long-lasting inflation problem, however, if they occur in the context of an accommodative monetary policy that allows these increases to pass through into the prices of other goods and services, and into higher wages. This pass through is more likely when money policy remains accommodative for an extended period, and inflationary psychology becomes entrenched in consumer and business behavior and every price increase leads to expectations of further increases.

If we look back to the 1970s, the reason food and energy price increases had such a large effect was that inflation had become entrenched in the economy. Inflation expectations had become unanchored because monetary policy had been too accommodative and had kept interest rates too low for too long in an attempt to stimulate economic growth. Indeed, inflation had risen to more than 5 percent in the late 1960s and

early 1970s, and the Nixon administration had made an unsuccessful attempt to bring inflation down through wage and price controls even before the first oil price shock.

While the comparison to the '70s can be useful, the present economic situation is also different from that period. The current increases in commodity prices are occurring in an environment in which inflation has been low and inflation expectations have been better anchored. However, like the 1970s, monetary policy is currently accommodative, not only in the United States but in many other countries around the world. In this environment, there is a significant risk that inflation and inflation expectations could move higher in coming months. Thus, it will be important for the Federal Reserve to monitor inflation developments and inflation expectations closely, and to move to a less accommodative stance in a timely fashion. When to begin the process, and how fast to move, will be difficult decisions for the Federal Open Market Committee in the period ahead. I can assure you, however, that the Federal Reserve takes both parts of its "dual mandate" seriously and will walk that fine line to maintain stable economic activity and low inflation.

Thank you, that concludes my prepared remarks, and I would be happy to respond to your questions.