THE U. S. ECONOMIC OUTLOOK AND MONETARY POLICY: UNDER AN INFLATION WATCH?

Thomas M. Hoenig
President
Federal Reserve Bank of Kansas City

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It is a pleasure to be here today and to have this opportunity to share my perspectives on the outlook for the U.S. economy and monetary policy in the period ahead. I would like to start by noting that in my view the economy is generally healthy and should continue to experience good growth over the remainder of this year and into 2006. My focus remains with the fact that, in an environment where monetary policy has been accommodative for some time, inflationary risks may begin to rise.

As I was traveling to Wichita, it occurred to me that a weather analogy might be a good way to describe my message today. As you know, the transition between spring and summer around here tends to be bit stormy. In monitoring weather conditions, the National Weather Service distinguishes between a weather "watch," when conditions exist in which there is an increased risk of severe weather, and a "warning," when severe weather is imminent. In the current economic environment, I believe that it is appropriate to issue a "watch" as conditions exist in which inflation pressures could build over time. However, by taking appropriate actions to bring policy rates to neutral, I am reasonably confident that we can avoid any such "warnings" in the future.

In my remarks today, I would like to begin with a brief overview of the recent performance of the U.S economy and the outlook for 2005 and 2006. Then, I will take a closer look at some of the risks to the economy. I will close with my assessment of the appropriate course for U.S. monetary policy in light of these on-going risks. In this regard, I would note that I am expressing my own views and not those of the Federal Reserve System.

Recent Performance of the U.S. Economy

The U.S. economy is now in the fourth year of its recovery from the 2001 recession. Although it took some time for the recovery to get going, the last two years

have seen strong growth of real GDP of around 4 percent, well above most estimates of potential growth. Consequently, we have made considerable progress in reducing the output gap, and unemployment has fallen from a peak of 6.3 percent to 5.1 percent most recently.

Fiscal and monetary policy have been highly accommodative during much of this period, helping to moderate the 2001 recession and cushion the economy from the effects of September 11th, the dotcom and telecom collapse, and other negative shocks to the economy. Fiscal policy provided stimulus through discretionary tax cuts and greater spending for defense and homeland security. And, as you know, the Federal Reserve pushed short-term interest rates down and provided additional liquidity to the financial system.

An especially noteworthy feature of the recovery has been the performance of productivity. Indeed, nonfarm business productivity has averaged over 4 percent in the past three years, more than double the rate of growth from 1995 to 2000. This surge in productivity has raised potential growth and kept inflationary pressures low. A side effect has been that businesses have been able to produce more output with fewer workers, and so, until recently, employment gains have been weaker than many would want.

Last year, as the economy continued to strengthen and the pace of hiring finally began to pick up, the Federal Reserve began the process of removing monetary policy accommodation, raising the federal funds rate target from 1 percent to 2.25 percent by year end. As you know, this process has continued this year, and the federal funds rate target currently stands at 3 percent.

The Outlook for 2005 and 2006

At the beginning of this year, most private sector forecasters thought that growth in 2005 would be somewhat slower than the previous two years, largely because of a less accommodative monetary policy and diminishing stimulus from fiscal policy. Indeed, most estimates for growth of real GDP were in a range of 3.5 to 4 percent. Forecasts have been scaled back more recently as a result of first quarter growth that was somewhat weaker than expected. My sense is that most forecasters are now looking at growth around 3.5 percent (Q4/Q4) for 2005 and similar growth next year.

The major factor leading to a change in the economic outlook this year has been the unexpected strength in energy prices, which has contributed to weaker consumer confidence and lower spending, especially on automobiles. There has likely been an additional feedback effect through exports as higher energy costs have reduced growth in many of our trading partners.

We have also seen the effects of higher energy costs on measures of inflation. The May CPI numbers show overall CPI inflation in the United States up 4.4 percent over the past three months and up 2.8 percent over the past year. Of course, much of this increase reflects the higher energy prices of recent months. Indeed, core CPI, which excludes food and energy, has risen a more modest 2.2 percent over the past year.

Other measures of underlying inflation pressures also show evidence that inflation is picking up. For example, a statistically-based, trimmed mean measure of the CPI constructed at our bank shows underlying inflation up 2.5 percent over the past year and up 3.2 over the past three months. This suggests to me that energy costs are beginning to be reflected in the basic costs of doing business, such as transportation and utilities, and these higher costs are starting to be pushed through to consumer prices.

Risks to the Outlook

Let me turn next to a discussion of some of the major risks to the U. S. economic outlook. Over the past few months, incoming data have raised concerns about the near-term economic outlook. As I indicated earlier, the initial estimate of first quarter GDP growth came in lower than expected, and other data pointed toward some softening in economic activity in the early spring. As a result, some analysts suggested that the economy might turn out to be considerably weaker than expected. However, first quarter growth was revised upward because of a more favorable trade report, and recent data, while somewhat mixed, on balance do not suggest any significant slowing in the pace of economic activity.

In the current environment, I believe it is especially important to maintain a longer-term perspective on the economy and look at trends rather than reacting to highly volatile, short-term data releases. In this regard, it is interesting how views on the economy have varied markedly in recent months after the release of the employment reports. First, when the March employment numbers were weaker than expected, we heard concerns about a slowing economy. Then, when the April employment report was much stronger than expected, these concerns dissipated. Finally, when the May report was weaker than expected, we heard renewed concerns about economic weakness. From a longer-term perspective, however, it is important to recognize that the average employment gain of 180,000 in the first five months of 2005 is right in line with the average monthly gain of 183,000 last year, suggesting no fundamental weakening of labor markets.

Looking beyond the short-run volatility of the economy, I am quite comfortable with a growth forecast of 3.5 percent or somewhat higher over the next year and a half.

However, I remain alert to the potential for inflation to come in higher than expected. The source of my attention is not just the potential for higher energy costs; there are other factors as well. Indeed, it is the confluence of these factors that leads me to believe that inflation risks have increased over a longer-term horizon. Let me articulate my concerns by highlighting three factors that may contribute to elevated inflation risks.

First, the view is emerging that energy costs, while continuing to be quite volatile, may remain elevated for some considerable period of time. This is reflected in the behavior of energy futures prices and in the perception that energy supplies and refining capacity may not keep up with growing world demand over an extended period of time. If energy prices continue to fluctuate around a higher trend, they are likely to put upward pressure on consumer prices until such time that the higher energy prices lead to increased supply or energy conservation.

Second, going forward, businesses may face higher labor cost pressures, and depending on competitive conditions, these costs may increasingly be passed on to consumers. Over the past three quarters, nonfarm business productivity has slowed to a 2 percent rate of growth. Combined with higher compensation as labor market slack is reduced, we are starting to see rising unit labor costs. Indeed, the first quarter increase in unit labor costs of 4.3% over the previous year was the largest increase in over four years. While some of this increase may reflect transitory factors, such as one-time bonuses, I believe that labor costs bear increased scrutiny in the period ahead.

A third factor raising inflation risks is the behavior of prices of imported goods. Over the past year, prices of non-petroleum imports have risen 3 percent, due at least in part to the depreciation of the dollar in 2003 and 2004. Not too many years ago, declining import prices were contributing to lower inflation.

Taken individually, higher energy costs, increases in labor costs, and stronger import prices are not especially alarming. Taken together, however, they suggest to me an environment where the risks to inflation are increasingly on the upside, especially with an accommodative monetary policy. Thus, going forward, I think that it will be especially important to position U.S. monetary policy so that it can respond if inflation pressures emerge and prevent these pressures, even if temporary, from affecting inflation expectations.

Perspectives on Monetary Policy

In my remaining time today, I would like to offer my thoughts on the appropriate course for U.S. monetary policy in the period ahead. While I cannot comment or speculate on the specifics of future policy actions, I hope to provide you with a sense of how I would approach this difficult task. My comments reflect both my view that the outlook for growth remains quite favorable and my view that inflation risks can be kept in check without significantly disturbing this growth outlook.

As I indicated earlier, over the past year the Federal Reserve has embarked on a course of removing accommodation in the stance of monetary policy by raising its federal funds rate target from 1 percent to 3 percent. The two key questions now being debated in financial markets and the media are how much further the target will be raised and how fast. Currently, financial futures markets expect the target to be raised to 3.75 percent by year end and then believe the FOMC will pause for several months before the next increase. There is a somewhat greater divergence of opinion about next year. Financial futures markets currently expect the target to be raised to about 4 percent next year. However, some private sector forecasts see the target reaching 4.5 percent by the end of 2006.

In thinking about these two questions, I find it helpful to use the concept of a "neutral" or "equilibrium" federal funds rate. This is the rate consistent with the economy operating at full employment and with low and stable inflation. This neutral rate can be broken down into two parts: a measure of the economy's long-run real rate of interest and a measure of long-run inflation expectations. Generally speaking, it is hard to give a precise number for this neutral rate because of difficulties in estimating the real rate component and because of difficulties in measuring long-run inflation expectations. In the United States, most estimates of the neutral fed funds rate fall within a range of 3.5 to 4.5 percent.

Using the neutral rate as a guidepost, the basic strategy of monetary policy is to raise the target rate above the neutral rate in response to inflationary pressures and to reduce the target below the neutral rate when the economy weakens and output falls below potential. In this framework, we can think of policy as being restrictive when the target is above the neutral rate and accommodative when the target is below the neutral rate. Clearly, the 1 percent fed funds rate target in May 2003 was quite accommodative and the current 3 percent target, while still accommodative, is much less so.

While an accommodative policy is quite appropriate when the economy is operating significantly below potential, I am sure you would agree that the same policy could be highly inflationary if maintained as the economy approaches its potential. Ideally, then, we would like to unwind policy accommodation in pace with the rebound in aggregate demand that moves the economy back toward its potential.

In the current circumstances, I believe that the environment for inflation can be made most stable if we continue to remove the remaining monetary policy accommodation as soon as practical. While I am comfortable with continuing the recent

pattern of 25 basis point increases in the federal funds rate target, I would not rule out larger steps if circumstances warrant. More importantly, perhaps, I would be reluctant to pause in this endeavor until the funds rate target is clearly within the estimated range for the neutral rate. Once the funds rate target is back within the neutral range, I believe the Federal Reserve will be better positioned to achieve its long run inflation goals while maintaining the flexibility to address signs of weaker economic activity should they occur.

Concluding Comments

Let me conclude my remarks with a brief summary of my perspectives on the U.S. economic outlook and monetary policy. The overall outlook for the U.S. economy for the balance of this year and into 2006 appears quite favorable, with growth somewhat above potential and improving labor market conditions. While I expect price pressures to remain moderate over the near term, I also believe that there are upside risks to inflation. In this environment, I believe it would be prudent for the Federal Reserve to continue its move from an accommodative monetary policy to a more neutral stance.

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