

RECENT ECONOMIC DEVELOPMENTS
AND PERSPECTIVES ON LONG-TERM GROWTH

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I am pleased to be in Cody today to speak with you about the prospects for the U.S. economy in the period ahead. As you know, the U.S. economy has been through a difficult period over the past year, with slower economic growth and higher inflation. I am optimistic, however, that economic conditions will improve in coming months. Indeed, as the year progresses, I expect to see a notable pickup in economic growth, and I am hopeful that we will also see lower inflation. Realistically, though, there are some important risks to both outlook and inflation, and the path for monetary policy this year will depend importantly on how these risks play out.

Moving beyond the near-term outlook, I would also like to discuss some significant challenges the U.S. economy will face over the longer term. In recent years, the U.S. economy has performed very well, with strong growth in employment and output coupled with low interest rates and inflation. However, the future may not be as rosy. Indeed, ongoing demographic changes combined with slower productivity growth could lead to a reduction in the economy's potential growth rate and make it more difficult to continue to increase our living standards. These changes will pose important challenges for policymakers during the next several decades.

Let me begin with a closer look at recent economic conditions and the near-term outlook and then provide some perspectives on these longer term economic issues.

Recent economic conditions

During the past four quarters, the U.S. economy slowed considerably, with growth in real gross domestic product averaging less than 2 percent. This is well below the economy's estimated potential growth rate of around 3 percent. At the same time, inflation moved higher. Overall CPI inflation, measured on a 12-month basis, rose to

more than 4 percent last summer before declining somewhat last fall. Core CPI, which removes volatile food and energy prices, was close to 3 percent last summer and currently remains at 2.3 percent.

The slowdown in growth resulted primarily from weaker investment spending, both residential construction and, more recently, business investment spending. The slump in housing, by itself, reduced GDP growth by a full percentage point over the past four quarters. Indeed, absent the housing slowdown, the economy would have grown very near potential last year.

The weakness in business investment spending resulted from several sources. Some of the weakness in housing activity spilled over into business investment spending in industries that supply the housing market. In addition, declining auto sales, caused by higher energy prices, led to cutbacks in auto production and inventories. Business spending on new plant and equipment weakened as well, for reasons that are not entirely clear, but may reflect the general slowing in economic activity.

Although there has been considerable talk in the media in recent months about the possibility of recession, such talk ignores some of the fundamental underlying strengths in the economy. In particular, even though investment has been weak, consumer spending, government spending, and exports have remained strong and have cushioned the effects of weaker investment. Indeed, despite the slowdown in GDP growth, we continue to see solid job gains, and unemployment remains very low.

When we look more closely at the recent behavior of inflation, we see two main factors. First, higher energy prices last spring pushed up overall CPI inflation, and may have spilled over into core inflation as well. When energy prices declined last fall, we

saw considerable improvement in overall CPI inflation and a somewhat smaller improvement in core inflation. The second key factor affecting inflation last year was a large increase in the cost of homeownership, which was caused by the housing boom during the past few years. After rising sharply last spring, increases in homeownership costs have moderated, contributing to the slowing in inflation in recent months.

The near-term outlook

Turning to the near-term outlook, most forecasters see a pickup in growth for the balance of this year and some moderation in core inflation. I share this outlook. Indeed, I believe growth is likely to average 2.5 percent to 3 percent over the balance of this year and turn in a similar performance next year.

This improvement comes from several sources, including: solid consumer spending, strong export growth and government spending, higher business inventory and fixed investment, and a diminishing drag from residential construction. Because growth is likely to remain below the economy's potential growth rate, however, we may see unemployment rise somewhat by year-end. I also believe that we will see some gradual improvement in core inflation, especially as homeownership costs continue to moderate.

Realistically, however, there are some important risks to the outlook, and the anticipated pickup in growth may be delayed. Growth may not rebound quickly if the housing slump turns out to be deeper or more prolonged than expected. As you know, much of the recent weakness in housing markets is due to the contraction in subprime lending. Many of the new home loans made in recent years were to borrowers who did not qualify for conventional mortgage financing. And, a large number of these loans had features, such as low teaser rates, short adjustment periods and interest-only payments,

that made them vulnerable in a higher interest rate environment. Indeed, a rise in short-term interest rates and reduced home price appreciation have made it difficult for some subprime borrowers to continue to make mortgage payments or refinance their mortgage, leading to a rise in delinquencies and increased foreclosures.

These developments have caused highly publicized difficulties for some lenders specializing in subprime lending and have resulted in some tightening of credit terms in the subprime sector. Moreover, in the past few weeks, we have also seen some upward pressure on conventional mortgage rates, which may put additional pressure on housing markets. Most forecasters believe it will be several more months before conditions stabilize and even longer before we see a housing recovery.

Another risk is that consumer spending may turn out weaker than anticipated. Consumer spending has been the primary engine of growth during the past several years. However, many consumers have been spending beyond their incomes by tapping into home equity. With lower house price appreciation, this spending stimulus may diminish. We have also seen somewhat weaker employment growth and retail spending in the past few months, which may be a harbinger of weaker consumer spending going forward. The recent uptick in energy prices may contribute to slower spending as well, especially for autos.

A third risk is that business investment spending may remain sluggish. Weak investment spending would not only result in lower economic growth in the near term but could also reduce growth in productive capacity, leading to lower potential growth and higher inflationary pressures over the long term. I will have more to say about the connections among investment, productivity and growth in a few minutes.

Not all of the growth risks are on the downside, however. Growth could be stronger than expected due to stronger exports and greater fiscal stimulus. Export growth will benefit from the weaker dollar during the past several years as well as stronger economic growth abroad. In fact, much of the recent improvement in manufacturing activity, both in the Tenth District and nationally, is being driven by stronger export orders. There is also likely to be significant fiscal stimulus coming from the improved budget situation of state and local governments as well as continued strong defense spending.

There are also risks that inflation may not moderate as expected. Recently, we have seen renewed strength in energy prices, which may pass through temporarily into core inflation. In addition, there may be additional cost pressures coming from tight labor markets, rising commodity input prices and the lower dollar. Of special concern is the recent slowdown in labor productivity, which, if it continues, would lead to additional cost pressures in the future.

As to monetary policy in the period ahead, the Federal Reserve faces some difficult decisions in balancing the risk of weaker growth against the risk of higher inflation. In my judgment, the current stance of policy, with a federal funds rate at 5 ¼ percent reflects an appropriate balancing of these opposing risks. I believe that the current policy stance is somewhat restrictive and, if maintained, will bring core inflation back to acceptable levels over time. While I can envision a set of circumstances in which the funds rate is lowered, I can just as easily see circumstances in which policy might need to be tightened further. Consequently, any future change in the stance of policy will likely depend on the evolution of the economy in the coming months.

Longer term growth and monetary policy challenges

In my remaining time here, I would like to shift from a discussion of the near-term economic outlook to examine the longer run growth prospects for the U.S. economy. Specifically, I would like to focus on some of the important factors that will determine our potential rate of growth in coming decades and the challenges they pose for monetary policy.

Economists define potential output as the output that an economy can produce with fully employed resources and with low and stable inflation. The growth in potential output is a key determinant of how fast our living standards improve over time. Currently, many economists believe that the potential growth rate of the U.S. economy could slow over the next decade from current estimates of around 3 percent to 2 to 2 ½ percent. I would like to examine why this might happen and some of the difficulties this could create.

Growth in potential output stems from two main sources: growth in the labor force and growth in the productivity or the amount of output than can be produced per worker. Labor force growth depends mainly on demographic factors such as the size of the working age population. Productivity growth depends on amounts of capital equipment, technology, and the education and skills of the labor force. Forecasts of slower growth in potential output are based primarily on estimates of a sizable slowdown in labor force growth and partly on estimates of declining productivity growth over the next several years. To see what lies behind these projections, let me take a closer look at these two factors.

Labor force growth

The projected slowing of labor force growth is largely based on the anticipated retirement of baby boomers over the next decade. It also reflects a continuation of the lower labor force participation rates of younger age groups in recent years. As you know, population aging is not unique to the United States. Most industrialized countries and even some developing countries, such as China, will experience rapid population aging and lower labor force growth in coming decades.

Three factors might mitigate the expected slowing of the labor force. One possibility is that many workers may postpone retirement. In fact, we have seen some signs of increasing labor force participation rates for older age groups in recent years. In addition, increased shortages of labor could lead to rising wages and increased participation rates for those not currently in the labor force.

However, the largest factor is likely to be the role that immigration plays in labor force growth. Immigration has been an increasingly important part of the labor force in recent years and potentially could make up a significant portion of the expected shortfall in labor force due to population aging. However, recent immigrants have generally had less education and job skills than the overall labor force and so would need significant improvement in these areas to be as productive as other workers.

Productivity trends

While some slowing of labor force growth is inevitable, the outlook for productivity growth is much less certain. As we look back over the past several decades, we see both periods of strong productivity growth and periods of weak productivity growth. During the 1960s and early 1970s, for example, growth of output per hour in the

nonfarm business sector averaged a strong 2.8 percent. Then, from the mid-1970s to the mid-1990s, productivity growth dropped by half to only 1.4 percent. Corresponding to this slowdown in productivity growth was a significant slowing in the growth of potential output to around 2 percent to 2 ¼ percent.

Beginning in the mid-1990s and continuing to 2004, however, productivity growth rebounded to around 2.9 percent, and estimates of potential growth increased to 3 to 3 ½ percent. Economists have attributed much of this surge in productivity to business investments in information and telecommunications technology.

More recently, we have once again experienced much lower productivity growth. Since 2005, productivity growth has averaged only 1.8 percent. It is this recent slowing that is starting to concern policymakers because, if it continues, it could exacerbate the reduction in potential output growth coming from slower labor force growth.

As I noted earlier, productivity growth is closely tied to factors such as the amounts and types of capital workers use as well as the skills that workers apply to their jobs. Worker skills, of course, depend on education and on-the-job training. The quantity of capital goods and the technology incorporated in those goods depends primarily on research and development and investment decisions made by firms. The recent weakness in business investment spending that I discussed earlier is potentially worrisome because it could exacerbate the recent productivity slowdown and so lead to slower growth in potential output over the longer run.

Challenges for monetary policy

Let me conclude with a brief discussion of the implications of these developments for monetary policy. To begin, it is important to recognize what monetary policy can and

cannot do with regard to growth in potential output. Monetary policy can play a major role in assuring that the economy operates close to its potential. For example, the Federal Reserve can push interest rates up to head off inflationary pressures when the economy is operating above potential. And, the Fed can push rates down to provide economic stimulus when the economy is operating below its potential.

To be effective in stabilizing the economy, however, policymakers must have a reasonably accurate measure of the economy's potential growth. Without this information, there is the risk that policy could be unnecessarily tight if potential growth is underestimated or too inflationary if potential growth is overestimated. In fact, some economists attribute the surge in inflation during the 1970s to policymakers' failure to recognize the slowdown in productivity growth and potential growth that I discussed earlier. Consequently, the behavior of productivity and potential growth over the next few years could have important implications for monetary policy.

Finally, it is important to recognize that while monetary policy can help provide short-run economic stability, it cannot affect the rate of potential output growth directly. As we have seen, the economy's potential growth rate depends mainly on demographic factors and productivity. Monetary policy can influence potential growth indirectly by providing a stable, noninflationary economic environment. Such an environment reduces uncertainty about the economic outlook. In doing so, it provides a more favorable framework for households to plan their lifetime savings and spending decisions and for businesses to make long-term investment decisions. And, as businesses are encouraged to pursue research and development and introduce new technology, productivity and potential growth increase. Thus, by providing an environment of economic stability and

price stability in the short run, monetary policy can contribute to the economy's potential growth in the longer term.

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