THE ECONOMIC OUTLOOK AND MONETARY POLICY: CHALLENGES IN THE PERIOD AHEAD

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Omaha, Nebraska
July 19, 2006

It is a pleasure to be in Omaha today to discuss the national economic outlook and monetary policy. Over the past three years, the U.S. economy performed very well. Strong output and employment growth led to a significant drop in the unemployment rate, and inflation remained relatively low despite higher energy costs.

Recently, however, we have seen increasing signs that economic conditions are becoming less favorable. Continuing high energy costs and rising interest rates appear to be slowing economic growth. At the same time, inflationary pressures are beginning to emerge. These developments have been associated with increased volatility in commodity markets and in financial markets around the world.

The changing economic environment has important implications for the Federal Reserve's monetary policy. Since June 2004, the Federal Reserve has systematically raised its federal funds rate target from 1 % to its current level of 5 ¼ %. Over this period, as credit costs have increased, the stance of monetary policy has moved from being extremely accommodative to a setting I would characterize as somewhat restrictive.

Going forward, however, the outlook for policy is much less clear, and uncertainty about the future policy path appears to be one factor behind some of the recent volatility in financial markets. Indeed, as you are aware, there is currently a lively debate among financial market participants about whether the Fed will need to raise rates further to ward off inflationary pressures or whether the Fed has already tightened sufficiently to maintain its commitment to long-run price stability and stable economic growth.

In my remarks, today, I would like to provide my assessment of current economic conditions and the outlook for the economy in the period ahead. I would also like to offer my perspective on the challenges facing monetary policy in this difficult economic environment. In this regard, I would emphasize that my views are my own and do not represent the official position of the Federal Reserve System or the Federal Open Market Committee.

Current Economic Conditions

Let me begin by taking a closer look at the performance of the economy in recent months. 2006 started out on a very strong note. First quarter GDP growth rose 5.6 %, a considerable improvement from the sluggish pace at the end of 2005. As you may recall, growth was held down in the second half of last year by a combination of the effects of the Gulf hurricanes, higher energy costs, and reduced auto incentives. So, part of the surge in growth in the first quarter was a bounce back from the economic weakness last year.

Most forecasters believe that the pace of economic activity slowed in the second quarter of this year to around 3 % due to weaker consumer spending and slower residential investment. The most recent round of energy price increases seems to be hitting some consumers very hard, and the effects are being felt both in purchases of autos and other retail sales. There is also growing evidence that housing is slowing in most parts of the country as higher interest rates and rising home prices have reduced affordability. At the national level, single family permits have declined for several

months. Signs of a softening housing market are also showing through in weaker housing starts and sales of new and existing homes in many parts of the country.

We are also seeing signs that hiring is slowing. Nonfarm payroll employment averaged 176,000 over the first three months of the year but only 108,000 in the second quarter. Much of this slowdown has been in retail trade and construction, no doubt reflecting the softness in consumer spending and housing.

Amid the signs of slower growth, recent inflation news has been somewhat disturbing. While higher energy costs have caused broad inflation measures to rise over the past few years, most core measures of inflation, which exclude volatile energy and food prices, have remained low. In the past few months, however, we have seen sizeable increases even in core measures of inflation. For example, core CPI rose 3.8 % over the three months from March to May while the core PCE deflator increased 3.25 % over a similar period.

One explanation for the pickup in inflation is that energy costs are now being passed through to prices of other goods and services to a greater extent than previously. When energy costs increased a few years ago, the lack of pass through to the general price level was somewhat surprising. Now the surprise seems to be going in the opposite direction.

Alternatively, these increases could also reflect fact that the economy has been operating at high levels of resource utilization for a period of time. The current unemployment rate of 4.6 % is below the level many economists believe is consistent with full employment and stable prices. And, capacity utilization has been rising in many industries. In any event, if these recent elevated inflation readings persist, they could

make it difficult for the Federal Reserve to maintain price stability over a medium-term time horizon.

The Outlook and Risks to the Outlook

So far, I have discussed where the economy has been and our best estimates of the current economic situation. From a monetary policy standpoint, however, it is the economic outlook over the next several quarters that is most important in determining the future path of policy. Let me move next to a brief discussion of the outlook and some of major risks to the outlook in the period ahead.

Many economic forecasters see somewhat slower growth continuing in the second half of this year and into 2007. Indeed, most estimates of GDP growth over the next six quarters are about 3 % or slightly lower, which seems quite reasonable to me. In looking at these numbers it is important to keep them in perspective. Many economists believe that the U.S. economy's potential growth rate is around 3.25 %, so a 3 % growth rate, while somewhat below potential, may be a desirable development to keep the economy from overheating.

A more detailed look at the outlook suggests that the major areas of slowing in most forecasts are housing and consumer spending, reflecting the continuing effects of high interest rates, high energy costs, and slower employment growth. In addition, weak housing prices and stock prices could act as a drag on consumer spending.

Offsetting the weakness in these sectors are healthy business investment spending on plant and equipment and increased exports due to strong growth in our major trading partners. Also, when we look beyond the consumer and housing sectors, there

appears to be considerable strength in manufacturing, much of it aimed toward export markets, that is likely to provide ongoing support to the economy.

As to the outlook for inflation, most forecasters see elevated inflation levels for the next few months. Over the longer term, however, slowing economic growth and a moderation in energy costs are expected to put downward pressure on both overall and core inflation measures. Indeed, most forecasters see both overall and core measures of inflation somewhat lower next year.

While I am in general agreement with the consensus outlook that I have described, I recognize there are both upside risks to inflation and downside risks to growth. If either should materialize, the future course of monetary policy could be quite different than we now expect.

As to inflation risks, the main concern is that inflation could stay elevated for a considerable period of time and could feed into higher inflation expectations in financial markets and labor markets. If so, the Federal Reserve might have to tighten policy further to insure that inflation expectations are contained and price stability is maintained over the long term. Thus far, inflation expectations have remained fairly subdued, but they will require continued scrutiny in coming months.

However, there is also some likelihood that the economy could slow more than we currently expect. The last several policy moves by the Federal Reserve are still working through the economy and may have a bigger effect in restraining growth than we are forecasting. Growth could also be weaker if energy prices do not moderate as expected. In addition, consumers in the U.S. have been living beyond their means in recent years, tapping into savings and home equity to finance current consumption. Any

retrenchment by consumers from recent spending patterns could lead to weaker economic growth. Finally, central banks in a number of other industrialized countries are currently tightening policy, and slower growth abroad could limit some of the anticipated improvement in U.S. exports over the next year.

<u>Challenges for Monetary Policy</u>

With this discussion of the economic outlook as a backdrop, I would like to use my remaining time today to explore the challenges facing monetary policy in the period ahead. In doing so, I am not in a position to speculate about the future course of policy. Rather, what I hope to convey is some of my thinking about the design of monetary policy strategy in the current economic environment.

At the present time, financial markets place a fairly high probability on another increase in the federal funds rate target from 5 ¼ % to 5 ½ % at the August FOMC meeting. The downward slope to the Treasury yield curve, however, suggests that markets believe the Federal Reserve is close to completing the tightening cycle and is likely to reduce rates somewhat over a longer time horizon.

The primary reason markets expect further tightening in the near term is the expected response of the Federal Reserve to higher core inflation. Indeed, this morning's release of the June CPI numbers is consistent with the view that inflation pressures are continuing. The overall CPI for June was up .2 % and core CPI was up .3 %. The June numbers imply a three-month rate of 5.1 % for overall CPI and 3.6 % for core CPI and twelve-month rates of 4.3 % and 2.6 % respectively.

In interpreting these inflation measures, it is helpful to keep a couple of points in mind. First, monetary policy decisions are not driven by individual data releases. Rather, they depend on the implications for the economic outlook of the accumulation of data over time. Second, monetary policy influences inflation only with fairly long lags. Generally speaking, a change in the federal funds rate today may take an estimated 12 to 18 months to affect inflation measures. As a consequence, monetary policy must be forward-looking in design.

The existence of lags in monetary policy has two important implications. First, the Federal Reserve should only respond to high current inflation to the extent that inflation is expected to be very persistent. Indeed, to the extent inflation pressures are seen as temporary and policy is currently restrictive, maintaining the current policy stance may be consistent with a reduction in inflation over time. Of course, the other aspect of this is that if inflation pressures remain elevated, then they will affect inflationary expectations requiring more forceful action later.

Second, given the existence of policy lags, the actions that the Federal Reserve took over the past year in moving the federal funds rate target from 3 ¼ % in June 2005 to 5 ¼ % last month have not yet had their full effects on the economy or inflation. This is one reason why most forecasters predict lower growth and inflation in the future even while current growth and inflation are quite strong.

Based on this discussion, I believe a reasonable case can be made that the current stance of monetary policy is likely to be consistent with a reduction in inflation pressures over the next few quarters as energy costs moderate and economic growth slows. At the same time, I recognize that further policy tightening could be warranted should the

expected slowing in inflation not materialize. As economic data accumulate over the next few months, hopefully some of the current economic uncertainty will dissipate, and we will have a clearer view of the path of monetary policy going forward.

Concluding Comments

To conclude my remarks, today, I would like to briefly summarize my views on the economic outlook and monetary policy. My reading of the incoming data and economic forecasts is that the U.S. economy is beginning a gradual transition to a somewhat slower path of economic growth. At the same time, inflation pressures have risen to the point that they cannot be easily dismissed. In this environment, the future course of monetary policy is uncertain and will depend, to a large extent on how the economy evolves in coming months. In this regard, I can assure you that the Federal Reserve will continue to maintain its commitment to price stability and economic growth.