Donald L Kohn: The economic outlook

Remarks by Mr Donald L Kohn, Vice Chairman of the Board of Governors of the US Federal Reserve System, at the Atlanta Rotary Club, Atlanta, 8 January 2007.

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Thank you for inviting me to fill in for Jack Guynn today to discuss the economic outlook for the new year. Those are big shoes to fill. Jack played a prominent and constructive role in the Federal Reserve System, as I know he did in the Atlanta community, bringing his vast experience and uncommonly good sense to bear on a wide variety of important policy issues.

As we enter 2007, the current economic expansion is now more than five years old. Although it got off to a slow start, the expansion was quite strong from mid-2003 through mid-2006. Over that period, a good deal of the slack in our nation's utilization of resources was taken up, and the unemployment rate reached its lowest level in five years. At the same time, however, core inflation - that is, inflation without potentially volatile food and energy prices - as measured by the price index for personal consumption expenditures, moved up from less than 1-1/2 percent to about 2-1/2 percent. To safeguard the gains made over the past quarter century in the achievement of price stability and to promote sustained economic expansion, the Federal Reserve in mid-2004 began removing the considerable monetary accommodation it had earlier put in place.

More recently, led by a sharp pullback in housing activity, economic activity decelerated in the second half of 2006 to a pace that was probably a bit below the long-term rate of growth in our nation's productive capacity. At the same time, decreases in energy prices have substantially reduced overall consumer price inflation of late, and core inflation has showed signs of slowing.

My expectations for 2007 quite naturally rest on an assessment of how recent trends are likely to play themselves out. How long will the decline in housing activity hold back overall economic growth? What about spillovers from housing to other sectors? What are we to make of the recent weakness in manufacturing activity? Will the recent good news on inflation persist? Before venturing some guesses on these questions, I need to issue two caveats. First, events will probably unfold differently than currently seems likely, and the range of uncertainty around any forecast is considerable. That uncertainty does not, however, diminish the value of having and discussing an outlook. Monetary policy must be based on our best estimate of future developments, and the effectiveness of policy is aided when the public understands the outlook of policymakers. But the uncertainty does underscore the value of monitoring the incoming information closely, as we always do, and of being prepared to adjust our expectations accordingly. Second, the views that I will express today are my own and not necessarily those of my colleagues on the Federal Open Market Committee (FOMC).[1]

Economic activity

The deceleration in economic activity in the second half of 2006 was concentrated in the housing and motor vehicle sectors and in the production of related materials and supplies. The slowing of activity has been most acutely felt in the real estate market, where the sales of new and existing homes contracted sharply beginning in the fall of 2005. Residential construction has slowed dramatically as well. As of November, single-family housing starts had fallen about 30 percent from their peak in January 2006. Tentative signs have begun to emerge that the housing market may be stabilizing. Home sales appear to have flattened out since midyear, mortgage applications have been increasing, and consumers' perceptions of homebuying conditions, as reported in the Michigan survey, have improved. Nonetheless, even if the demand for housing is leveling off, housing activity may not yet have found a floor, given the sizable overhang of unsold houses.

Uncertainty about where we stand in the housing cycle remains considerable. In part, that is because this housing downturn has differed from some of those in the past in important ways. It was not triggered by a restrictive monetary policy and high interest rates; indeed, relatively low intermediate and long-term interest rates are helping to support the stabilization of this sector. But the current

[1] John Stevens and Joyce Zickler, of the Board's staff, contributed to these remarks.

contraction in housing did follow an unusually large run-up in sales and construction and, even more so, in prices relative to the returns on other financial and real assets. Our uncertainty about what pushed home prices and sales to those elevated levels raises questions about how the market will adjust now that expectations of the rate of house price appreciation are being trimmed. And changes in the organization of the construction industry, with activity more concentrated in the hands of large, publicly traded corporations, may also affect the dynamics of prices and activity in response to the inventory overhang.

In my own judgment, housing starts may be not very far from their trough, but the risks around this outlook still are largely to the downside. Although house prices nationally have decelerated noticeably and appear to have fallen in some markets, they are still high relative to rents and interest rates. Building permits decreased substantially again in November, and inventories of unsold homes have only started to edge lower. We also do not know whether the possible stabilization that seems to be taking hold would be immune to a rise in longer-term interest rates should term premiums increase or the federal funds rate fail to follow the downward path currently built into market expectations. Even if starts stabilize at close to current levels, those levels are sufficiently low that overall construction activity would remain a negative for the growth of economic activity in the first half of this year.

While the downturn in housing was steepening during the third and fourth quarters, domestic producers of cars and light trucks slashed output in an effort to reduce their elevated inventories, particularly of light trucks (minivans, SUVs, and pickups). In October, light motor vehicles were assembled at the slowest pace in more than eight years. However, production rebounded in the final two months of the year, and, with inventories having come down from their highs last summer, available monthly schedules suggest that vehicle manufacturers anticipate maintaining the pace of assemblies during the first quarter at about the average rate in November and December. Thus, with sales reasonably well maintained through December, the drag from this sector's inventory correction should be ending.

Although much of the weakness in industrial production toward the end of 2006 can be readily traced to the housing and motor vehicle sectors, production in other manufacturing industries also softened from September through November, and this development raised concerns that the deceleration in economic activity was becoming more broadly based. Some of the industries reporting lower output late last year included those that produce intermediate goods for the housing and motor vehicle sectors, but others have only tenuous links to those two sectors. Evidently, other industries have experienced a small buildup of inventories, prompting production adjustments. These inventory and production developments may reflect in part a slowing in the growth of business capital spending that has become evident in recent data on orders and shipments of equipment other than high-tech and transportation equipment.

In my view, however, what we are seeing in the recent information on factory output and capital spending is not the leading edge of general economic weakness but instead an adjustment to a sustained pace of expansion that, necessarily, is less rapid than that from mid-2003 to mid-2006. A number of indicators continue to suggest that economic activity outside the housing and motor vehicle sectors is likely to post continuing healthy gains over coming quarters. Although several regional manufacturing surveys have suggested that the weakness in factory production extended into December, the national purchasing managers' survey rose a notch last month. Prices of many industrial commodities are typically sensitive to developments in the manufacturing sector, and these prices generally remain firm, as is consistent with sustained demand here and abroad. More broadly, last Friday's employment report suggested no signs of cumulating weakness either in manufacturing or private service-producing industries. New job creation has remained relatively brisk in recent months; over the fourth quarter, private businesses added an average of 119,000 jobs to payrolls each month - only a little below the pace of hiring earlier in the year. And the unemployment rate remained in the neighborhood of 4-1/2 percent.

On the whole, businesses seem to be reasonably upbeat. The Reserve Bank Districts, including Atlanta, report that most firms are anticipating good gains in sales over the coming year. The semiannual economic forecast of the Institute for Supply Management, released in mid-December, was optimistic - perhaps surprisingly so in light of the recent slowdown in industrial activity. Respondents indicated that capital spending in 2007 would increase at a robust pace similar to that for all of 2006. That businesses are beginning the year with a positive outlook is not surprising: Profits have been high, encouraging business expansion, and external funding for capital projects remains readily available on favorable terms. And as I noted, firms in their hiring decisions seem to be acting on plans to increase output.

Most importantly, the data we have in hand suggest that consumer demand for nonhousing goods and services has been well maintained. The retail sales report for November was strong across the board, and surveys of consumer confidence show that, in the final months of 2006, households' views about business conditions and about their financial situations improved noticeably. Spending and attitudes have been supported over recent months in part by solid gains in household income and employment.

One caution is that some of the recent buoyancy in household attitudes and strength in consumer demand also may reflect the unwinding of earlier increases in gasoline prices, in which case part of the strong gain in spending in recent months may be transitory. Another cautionary note is that the strength in consumer spending throughout 2006 received a considerable boost from the earlier rise in household wealth. In the wake of the current slowdown in house price gains, I expect that, over time, households will find it necessary to build their net worth by holding back on consumption, and thus, consumer spending will rise a little less rapidly than income for a while. I do not anticipate that the gap between the growth rates in consumption and income will be large, however, and I believe that the recent data on consumer spending provide some very tentative evidence that the cooling of the housing market will have a limited effect on other forms of spending.

Ongoing gains in household consumption and in business capital spending to meet that expected demand and to take advantage of the cost-saving benefits of new technology form the foundation for a moderate pace of economic activity going forward. Continued solid economic expansion among our major trading partners should also provide support to production here at home. To be sure, as I already noted, a low level of housing starts and production adjustments in some manufacturing industries will remain a drag on growth in output in the near term, but these effects will wane during the first half of 2007 as excess inventories are worked off. When this process is completed, the rate of economic growth should pick up to something in the neighborhood of the growth rate of the economy's potential.

Inflation

I believe that a path for output like the one that I have just described is likely to be associated with a gradual decline in core inflation from the elevated levels of last spring and summer. Importantly, measures of long-term inflation expectations are no higher than they were before the rise in core inflation. In addition, some of that earlier price acceleration probably resulted from the pass-through of sharp increases in energy prices in the first half of the year that have been partly reversed; increases in rents and imputed rents for owner-occupied housing may ease back as a portion of the oversupply of homes for sale is shifted into the rental market; and a period of below-trend economic growth should relieve some pressures on labor and product markets.

Certainly, the recent data on consumer prices have been encouragingly consistent with the downward tilt to inflation that the FOMC has been expecting. However, we need to be cautious about extrapolating trends from a couple of months of data. The data themselves are noisy - subject to month-to-month variations that are unrelated to more-persistent developments. And we need to recognize that some of the very recent disinflation may represent one-time influences. Energy costs have moved down markedly in recent months, and those declines have fed through to prices for a number of intermediate goods and probably for some final goods as well. But futures markets anticipate that prices of crude oil will increase gradually, which suggests that, once the adjustment to the current level plays out, energy prices will no longer work to restrain total and core inflation. And if a portion of the weakness in goods prices reflects efforts by producers to forestall or correct inventory imbalances, that restraint on pricing will dissipate as firms' corrective actions take effect.

So, despite the recent favorable price data, I believe it is still too early to relax our concerns about whether the run-up in price pressures in the spring and summer of last year is truly unwinding and whether it is unwinding rapidly enough to forestall a pickup in inflation expectations. Even with the opening of some slack in the manufacturing sector and in homebuilding, labor markets generally seem to have stayed fairly tight, with the unemployment rate at only 4-1/2 percent. Although recent data indicate that labor costs were not rising as rapidly in 2006 as first estimated, labor compensation does appear to have increased more quickly over 2006 than over 2005. Last year's increase in compensation also appears to have outpaced overall consumer price inflation. That development in and of itself does not necessarily indicate an increase in inflationary pressures, especially if it represents a process in which real compensation begins to catch up with the rapid increases in labor productivity earlier this decade. What would be problematic would be a pickup in the growth of nominal hourly labor compensation that was passed through to prices over the next several quarters, or one that was not matched, over a sustained period, by a comparable pickup in the growth of productivity. Eventually, the resulting faster growth of unit labor costs would pose a serious threat to price stability.

Core inflation is still higher than it was just a year ago, and, as I noted, some of the very recent decline may result from one-time changes in relative prices rather than an easing in underlying inflation pressures. A very gradual decline in the trend rate of inflation continues to be the most likely outcome, but that path is still by no means assured, and in my judgment such a decline remains critically important to the sustained prosperity of the U.S. economy.

In sum, conditions appear to be in place for a good year for the U.S. economy, one marked by growth that is moderate and sustainable and by inflation that will be lower than last year's. The economy appears to be weathering the downturn in housing with limited collateral effects, and inflation appears to be easing with the aid of lower energy prices, well-anchored inflation expectations, and competitive labor and product markets. I am a central banker to my core, so I know that somewhere, somehow, something will go wrong, but you will have to rely on the new president of the Federal Reserve Bank of Atlanta to explain to you next January just what happened and what the implications are for 2008.