## Ben S Bernanke: The US economic outlook

Remarks by Mr Ben S Bernanke, Member of the Board of Governors of the US Federal Reserve System, at a Finance Committee luncheon of the Executives' Club of Chicago, Chicago, 8 March 2005.

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In my remarks today I will share my thoughts on the U.S. economic outlook for this year, focusing particularly on the prospects for economic growth and inflation. I will then turn to some implications of the outlook for current monetary policy. As always, my comments are my responsibility alone and do not necessarily reflect the views of my colleagues at the Federal Reserve.[1]

The U.S. economy has certainly come a long way in the past two years. As of spring 2003, nearly a year and a half after the formal end of the 2001 recession, the expansion seemed at risk of petering out. During 2002 and the first half of 2003, although consumer spending and residential construction remained reasonably strong, businesses seemed exceptionally reluctant to make new capital investments or hire new workers. Capital investment and economic growth finally took off in the second half of 2003, responding to powerful injections of monetary and fiscal stimulus. But the recovery remained "jobless" throughout 2003, in large part because of remarkable gains in labor productivity, which allowed firms to meet the growing demands for their output without expanding their workforces.

The economic recovery became more balanced in 2004. Real gross domestic product (GDP) continued to expand, growing at a vigorous 3-3/4 percent clip last year despite sharp increases in energy prices and a significant drag from net exports. But perhaps more importantly, the labor market finally began to show signs of life despite continuing gains in the efficiency of business operations and some remaining caution on the part of employers. The national unemployment rate, which stood at 6.3 percent in June 2003, had declined to 5.4 percent by December 2004, where it currently stands. In 2004, monetary and fiscal stimulus once again aided growth; but for the first time since the 2001 recession, the expansion began to take on a self-sustaining character last year, as increases in profits, employment, wage income, and household wealth became the principal drivers of rising spending. Headline inflation picked up noticeably in 2004 because of a continuing surge in energy prices, but core inflation (that is, inflation excluding the direct effects of food and energy prices) rose only modestly from the unusually low levels seen in 2003. Core inflation as measured by the chain price index for personal consumption expenditures (core PCE inflation) was a moderate 1.6 percent last year.

Economic activity appears to be off to a solid start in 2005. The data surprises in recent months have tended toward the upside, and real GDP growth in the vicinity of 3-3/4 to 4 percent looks attainable this year despite the ongoing reduction in monetary and fiscal stimulus. In stark contrast to the situation of a couple of years ago, both business investment and hiring should support growth in 2005. Business investment, which finished 2004 on a high note, promises to remain strong, buoyed by favorable financing rates, sound corporate balance sheets, and rising business confidence in the durability of the recovery. Notably, the available data suggest that the expiration of partial expensing provisions at the end of 2004 has done little to reduce the momentum of investment. The pace of hiring also strengthened toward the end of last year, following a summertime lull, and I expect healthy employment gains in the coming quarters, albeit with possibly large month-to-month variations. Despite the growth in employment, however, the unemployment rate should decline relatively slowly, as a strengthening job market attracts people back into the labor force.

Consumer spending has been well maintained both during and after the recession, as I mentioned earlier, and continued growth in household expenditure should complement expected increases in business spending in 2005. Some observers have expressed concern about rising levels of household debt, and we at the Federal Reserve follow these developments closely. However, concerns about debt growth should be allayed by the fact that household assets (particularly housing wealth) have risen even more quickly than household liabilities. Indeed, the ratio of household net worth to household income has been rising smartly and currently stands at 5.4, well above its long-run average

1 I thank Board staff members William Wascher and Charles Fleischman for excellent assistance.

of about 4.8. With real disposable income having risen over the past few quarters, most consumers are in good financial shape - a positive indication for household spending. One caveat for the future is that the recent rapid escalation in house prices - 11 percent in 2004, according to the repeat-transactions index constructed by the Office of Federal Housing Enterprise Oversight - is unlikely to continue. A plausible scenario is that house prices will either move sideways or rise more slowly during the next few years, eventually bringing the rate of return on housing in line with the relatively low prospective rates of return that we currently observe on virtually all assets, both real and financial. If the increases in house prices begin to moderate as expected, the resulting slowdown in household wealth accumulation should lead ultimately to somewhat slower growth in consumer spending.

That said, residential construction should remain reasonably strong in 2005, supported by a growing population, rising employment and incomes, and mortgage rates that remain historically low. However, homebuilders will be hard pressed to much exceed the record level of starts seen in 2004. Thus, residential investment seems likely to make a diminishing contribution to overall economic growth. Investment in nonresidential structures, such as office buildings and industrial and commercial space, appears poised to improve this year after several years in the doldrums, though a full recovery in this sector will have to await further declines in office vacancy rates and increases in factory utilization rates.

You may have heard the story of the fellow who, when asked why he was hitting himself on the head with a hammer, replied that he did it because it felt so good when he stopped. A couple of hammers that pounded the U.S. economy in 2004 (not at our volition, of course) were the sharp increase in energy prices and the widening trade deficit, each of which subtracted a significant amount from growth last year. High energy prices and a large trade deficit will very likely remain with us in 2005, unfortunately. However, some small comfort may be taken from the likelihood that these problems will not worsen this year at the rate that they did last year. By the magic of output growth accounting, so long as the energy and trade situations do not deteriorate substantially further this year, as I do not expect they will, the net effect will be to provide a boost to this year's growth relative to last year's. On the energy front, increased non-OPEC production, a more moderate rate of increase in oil consumption in China, and (I say this with my fingers crossed) some possible reduction in geopolitical uncertainties may help to limit further increases in crude oil prices this year. Moreover, although natural gas prices have risen recently, inventories of natural gas appear plentiful, and major shortfalls do not appear imminent. With respect to trade, we may reasonably hope that cumulative past declines in the real exchange value of the dollar plus economic growth abroad will at least begin to stabilize the U.S. trade balance.

The inflation forecast presents its own challenges. My own guess is that core PCE inflation in 2005 will be slightly higher than its 2004 rate of 1.6 percent, though likely remaining within what I think of as the "comfort zone" of 1 to 2 percent. I will briefly comment on some of the factors that bear on the inflation forecast.

First, although core inflation excludes the direct effects of energy prices, energy prices exert some indirect effects on the core inflation rate by raising costs in non-energy industries, such as air travel and trucking. Rising commodity prices and increases in import prices (the result of a weaker dollar) likewise raise costs of production as well as some prices paid directly by consumers. These factors all contributed to the pickup in core inflation in 2004. I expect the net inflationary effect of these cost drivers to be less in 2005 than in 2004. Specifically, although energy and commodity prices will probably remain *high*, they are unlikely to continue *rising* at last year's pace, and they consequently should contribute less to core inflation this year than they did last year. (The principle here is the same as that illustrated by the man who stops hitting himself on the head with a hammer or, at least, hits himself more gently.) Another consideration is that producers' markups of prices over costs remain relatively high, leaving some scope for firms to absorb any further cost increases.

The course of the dollar is likewise very challenging - probably impossible - to predict. However, despite the decline in the dollar of the past two years, core import prices excluding fuels rose only 2-1/2 percent in the second half of 2004 and increases could well continue to be moderate.[2] The pass-through of the effects of the declining dollar on import prices has remained remarkably low, all things considered.

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[2] As defined, core import prices exclude semiconductors and computers, whose prices tend to fall rapidly, as well as energy.

Although moderating rates of increase in nonwage costs should help on the inflation front in 2005, I acknowledge the considerable uncertainty that surrounds this prediction. The potential volatility of energy prices, commodity prices, and (to a lesser extent) import prices has been dramatically demonstrated in recent years and so unexpectedly rapid increases - or decreases, for that matter - in producers' nonwage costs can by no means be ruled out. Cost increases that are both large and sustained would, of course, create inflationary pressure. Lagged effects on inflation of the nonwage cost increases that occurred in 2004 are also possible, particularly if the firming of demand increases pricing power and the ability of producers to pass on their higher costs. I can assure you that the Federal Reserve will monitor closely any developments affecting producers' costs.

The second principal factor affecting the inflation outlook is the degree of slack in the economy - the so-called output gap. Research at the Board and elsewhere suggests that measuring the output gap in real time can be quite a treacherous undertaking, particularly when the economy is near full employment. The natural rate of unemployment is probably better thought of as a zone rather than as a single number, however. In particular, inflation does not appear to rise sharply or discontinuously when the economy reaches a specific rate of unemployment or capacity utilization but instead responds more gradually to variations in the degree of resource utilization (in economics lingo, the Phillips curve is fairly flat). Thus, relatively modest errors in estimating the output gap may not prove too harmful. My own judgment is that some slack remains in the U.S. economy, although that slack is diminishing as growth continues above its long-run trend. Evidence that the labor market is not yet at its potential includes subdued wage growth, the failure thus far of labor participation rates to increase from cyclical lows, the relatively large number of people who say they are working part-time for economic reasons, and the impression gleaned from surveys and anecdotes that the supply of potential employees in most occupations remains plentiful. Measures of industrial capacity utilization below historical norms are also consistent with the presence of underutilized resources. As resource slack is progressively eliminated, however, and as labor productivity growth settles in near its longer-run trend of 2 to 2-1/2 percent, increases in unit labor costs may begin to put some upward pressure on prices, offsetting possible moderation in nonwage costs.

A third factor determining inflation is long-term inflation expectations. If inflation expectations are well anchored, in the sense that the public has confidence that inflation will remain low in the long run, the central bank's task of actually keeping inflation low becomes easier. For example, presumably because of well-anchored inflation expectations, the increases in oil prices last year appear to have had few second-round effects - that is, firms and households apparently viewed the inflation bulge associated with the oil price increases as temporary and did not build a higher expected inflation rate into wages and prices. Likewise, stable inflation expectations probably help to explain the low observed rate of exchange-rate pass-through into domestic prices. Of course, the benefits that flow from well-anchored inflation expectations make keeping inflation low (and thus validating those expectations) all the more important.

On the whole, inflation expectations do appear to be stable. For example, according to the University of Michigan's Surveys of Consumers, since 2003 median expected inflation for the next five to ten years has fluctuated in a narrow range. On the other hand, the spread between ten-year nominal and ten-year inflation-indexed bond yields, known as inflation compensation, has risen some 30 to 35 basis points since this time last year. I am inclined to believe that this rise in inflation compensation does signal some near-term increase in expectations of headline inflation, although part of the increase may also reflect changes in risk and liquidity premiums in the market for inflation-indexed debt. Worth noting also is that inflation compensation for the period five to ten years in the future - a measure of long-run inflation expectations - has remained essentially flat during the past year.

In summary, with all the caveats mentioned today firmly in mind, I look for 2005 to be a good year for the U.S. economy: real growth at 3-3/4 percent or slightly better, core PCE inflation in the range of 1-1/2 to 2 percent, and a slowly declining unemployment rate. Private-sector forecasters are a bit more pessimistic than I am, but not by much. For example, the Blue Chip consensus forecast released yesterday looks for real growth of 3.6 percent this year, a bit below my projection, and for overall inflation, as measured by the consumer price index (CPI), of 2.2 percent. If we adjust for the distinction between overall and core inflation and for the fact that, for technical reasons, CPI-based inflation measures tend to be higher than those based on the PCE price index, the Blue Chip inflation forecast is only slightly higher than mine.

Indeed, these differences in projections are hardly meaningful given the wide error bands on economic forecasts in general - which leads us naturally to the question of what could go wrong with the relatively sunny outlook I have described today. Unfortunately, unless we are prepared to extend the

meeting for several more hours, I cannot give a detailed analysis of all the risks to this forecast. Many things could go wrong, of course, and as Murphy warned us, something almost certainly will. Some of the more obvious possibilities include oil supply disruptions that send the price of crude much higher, a slowdown in foreign economic growth that reduces the demand for U.S. exports, or the realization that less economic slack remains than I currently believe, which would increase the risk of higher inflation. Not all risks to the forecast are adverse, of course; for example, the growth rate of labor productivity has surprised us to the upside almost every year of the past decade and could do so again. The lesson here is that economic forecasts, and consequently policy plans, can be only provisional. New events and new data must trump preconceived notions about the future evolution of the economy and of policy.

I will conclude with some comments about monetary policy, reminding you once again that I speak only for myself and not for other members of the Federal Open Market Committee. As I have discussed today, the baseline forecast for the U.S. economy in 2005 and indeed beyond this year appears quite favorable. In particular, in the past few quarters the evidence that the recovery is self-sustaining has become more persuasive, while inflation pressures appear contained. The labor market has not yet reached its potential, but the improvement on that front in the past year and a half has been substantial, and slack in resource utilization continues to be reduced, albeit slowly.

For some time now, the Federal Open Market Committee has indicated that it expects to remove policy accommodation at a pace that is likely to be measured. The "measured pace" language was always intended to indicate the Committee's provisional view of how policy was likely to evolve, given the economic forecast made at each meeting and our understanding of the transmission mechanism of monetary policy. In short, this language was always meant to convey a policy forecast, not a policy commitment. However, in the event, the Committee's policy expectations have largely been realized, and in my view the results have been good. With the economy strengthening, with inflation stable, and with the federal funds rate still at a relatively low level, at this point my expectation is that the Committee will continue to remove policy accommodation in a measured way. Of course, in light of the imprecision of economic forecasts and the certainty that the economy will face new shocks, the pace at which the policy interest rate is normalized will of necessity be sensitive to unexpected events and data. Because well-anchored inflation expectations are critical to achieving both of the Federal Reserve's mandated goals of maximum sustainable employment and price stability, I think it particularly important that policy react as needed to maintain price stability.

One may reasonably ask when this process of removing policy accommodation will stop. This question is not straightforward to answer. In particular, it is not helpful, in my view, to imagine the existence of some fixed target for the funds rate toward which policy should inexorably march. Instead, the correct procedure for setting policy requires the FOMC to continually update its forecast for the economy, conditional on all relevant information and on a provisional future path for monetary policy. The funds rate will have reached an appropriate and sustainable level when, first, the outlook is consistent with the Committee's economic goals and, second, the slope of the term structure of interest rates is approximately normal, as best as can be determined. With this definition in mind, one can search for indications of where the "neutral" funds rate is likely to be at a given point in time. For example, the fact that far future short-term interest rates have recently declined fairly significantly suggests that, in the view of the markets at least, the neutral funds rate may be somewhat lower today than it was in the past.[3] The most important lesson, however, is that the neutral policy rate depends on both current and prospective economic conditions. Accordingly, the neutral rate is not a constant or a fixed objective but will change as the economy and economic forecasts evolve.

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[3] The one-year nominal rate nine years ahead implied by the Treasury term structure has fallen about 1-1/4 percentage points since its recent peak in May 2004, to about 5-1/2 percent today. This rate may be thought of as the sum of the market's expectation of the short-term interest rate nine years from now plus a variable term premium. Disentangling the two components is difficult, and indeed some part of the downward trend in far future short rates plausibly reflects a decline in the term premium. Overall, however, it seems likely that the market expectation of the future short-term rate has declined during the past few years.