

Donald L Kohn: Economic outlook

Remarks by Mr Donald L Kohn, Member of the Board of Governors of the US Federal Reserve System, at the Bankers and Business Leaders Luncheon, Federal Reserve Bank of Kansas City, Oklahoma City Branch, Oklahoma, 13 April 2006.

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I am pleased to have this opportunity to talk with the business leaders of Oklahoma City. The Federal Reserve has deep roots in this community: The Federal Reserve Bank of Kansas City has had a Branch here since 1920. Consistent with the experience of most other enterprises these days, the Federal Reserve is having to change the way we do business in response to rapid changes in technology. We can see the effects of these changes on the payment system every day and all around us as we make and receive payments that depend less and less on the use of checks. To hold down costs, we have been required to reduce the number of our offices delivering payments services to banks, including check and cash operations at Oklahoma City.

But closing those operations by no means implies that we are reducing our commitment to the community. Indeed, Tom Hoenig and his colleagues at the Federal Reserve Bank in Kansas City are taking steps to strengthen our roots here. Our most important ties to local communities have never been primarily through the services we deliver to their banks. Rather they are established through the exchange of information between those communities and the Federal Reserve, and the Oklahoma City Branch will remain our eyes and ears in this region. Tom will continue to bring to our policy deliberations the information he gathers from Tyree Minner and his colleagues on the board of directors of the Oklahoma City Branch, from Bob Funk and his colleagues on the head office board, and from many other contacts in the region. The Federal Reserve Bank of Kansas City and the Oklahoma City Branch are increasing their efforts to reach out to this community to make sure that we are listening as effectively as possible to your impressions of the current economic circumstances, to explain our policies, to help educate the public in the use of the increasingly complex financial instruments available to them, and to work with community leaders to identify strategies that will help sustain a vibrant economy. The Board of Governors in Washington strongly supports these efforts by Kansas City and other Reserve Banks to deepen their ties to their communities, and I am pleased to be here as tangible evidence of that support.

I thought I would take advantage of this opportunity to discuss the U.S. economy and the conduct of monetary policy. We are at an especially interesting juncture, so this is a good time to take stock of where we are and to peer ahead through the prognosticator's always murky lens. I must emphasize that these views are my own and do not necessarily reflect those of my colleagues on the Federal Open Market Committee.¹

On balance, the economy has been performing quite well in recent quarters, with growth strong and underlying inflation stable despite the considerable rise in energy prices over the past few years. I say "on balance" because a number of unusual factors have been influencing the pattern of economic activity lately, adding to the normal difficulty of discerning underlying trends from inherently volatile data and other information. These factors include not only last year's devastating hurricanes but also the unusually warm weather in the early part of this year, which very likely provided a fillip to housing construction and consumer spending. Smoothing through these events, however, the economy has been expanding at a pretty good clip by historical standards--probably an annual rate of about 3-1/2 percent since midyear 2005.

Several factors have propelled reasonably strong economic growth. A critical element has been supportive financial conditions. Despite the tightening of monetary policy that began in mid-2004, short-term interest rates were at fairly low levels until recently, and the effects of those low rates have continued to spur household and business spending. In addition, although longer-term yields have moved up notably in recent weeks, they too have been low by historical standards. Moreover, credit to businesses and households has remained readily available at narrow spreads in markets and on favorable terms and conditions at banks, reflecting, in part, robust earnings and strong balance sheets at businesses along with good performance on outstanding household and business loans.

¹ [Wendy Dunn](#) and [Lawrence Slifman](#), of the Board's staff, provided valuable assistance in the preparation of these remarks.

The pace of economic growth in the United States has also been supported by a firming of activity abroad and the associated increases in demand for our exports. Among industrial countries, expansion of output has become more firmly established in both Japan and the euro area, while growth continues at a solid pace in the United Kingdom and Canada. Furthermore, economic growth in most of the emerging economies of Asia has been robust. U.S. exports were disrupted by last summer's hurricanes in the Gulf, but smoothing through this volatility, exports appear to have been contributing substantially to the growth of gross domestic product (GDP).

Our economy has been able to register this good performance despite rising energy prices. This audience knows well that since late 2003 the price of West Texas intermediate crude oil, for delivery at Cushing, has soared from about \$30 per barrel to nearly \$70 recently. Nonetheless, the rise in energy prices has apparently had only a limited negative effect on the national economy. Energy costs are not nearly as important today as they once were. Since the 1970s, the energy intensity of production in the United States has fallen dramatically; indeed, on an inflation-adjusted basis, it takes roughly half as many Btu of energy to produce a dollar of GDP today than it did at the time of the 1973 oil crisis. This sharply reduced share of energy costs in total business expenses has likely limited the influence of these costs on profits, on overall consumer prices and real income, and on the economy more generally. A rough estimate puts the reduction in real GDP growth from the increases in energy prices since late 2003 at between 1/2 percent and 1 percent per year. Of course, reactions to higher energy prices are hard to predict, but the measured response of activity over the past couple of years suggests that the most recent price increases will have, at most, only a small effect on economic growth during this year.

The good performance of the economy has led to a further narrowing in the margin of unutilized resources. For example, the Federal Reserve's measure of capacity utilization in manufacturing has moved up 2 percentage points during the past nine months, to around 80-1/2 percent, a touch above its longer-run average. Similarly, the unemployment rate has fallen almost 1/2 percentage point from early 2005 to around 4-3/4 percent last month.

Nevertheless, the underlying rate of inflation has remained moderate. Headline inflation, of course, has been boosted by the jump in energy prices. However, the run-up in the prices of energy and other commodities appears to have had only a modest effect on prices for non-energy goods and services. The inflation rate for prices of consumer goods and services excluding food and energy, as measured by the core personal consumption expenditures (PCE) price index, has been running a bit under 2 percent, only about 1/2 percentage point above its rate two years ago before the spurt in energy prices began.

Inflation has been restrained, in part, by the margin of slack in labor and product markets that has persisted through much of this period. Another reason for this favorable outcome is that longer-term inflation expectations remain well contained. For example, the median expected inflation rate during the next five to ten years, as reported in the University of Michigan's survey of consumers, has barely edged up in recent years, even as short-term inflation has been boosted by rising energy prices. Meanwhile, inflation compensation for investors implied by the spreads between the rates on nominal and CPI-indexed Treasury notes at both five- and ten-year maturities also has not shown any tendency to move higher on balance.

In recent years, declining prices of imports and the threat of import competition have also probably held down costs and prices to a degree. Moreover, increases in compensation costs have generally been modest. To be sure, average hourly earnings of production and nonsupervisory workers have been accelerating in recent quarters. However, the broadest measures of compensation have not picked up, suggesting that competition in labor markets has been intense. Nonetheless, with labor markets tightening, some pickup in compensation increases for the broad measures would not be surprising. Nor would a pickup necessarily be inflationary, given the very good growth in labor productivity that we have experienced in recent years.

Despite the relatively moderate increases in prices and costs that we have observed lately, the capacity utilization rate and the unemployment rate have recently reached zones that on occasion in the past have been associated with the beginnings of upward pressure on inflation. Of course, the past is not always a good guide to the future, in part because a great deal of uncertainty surrounds the relationship of resource utilization and inflation. For instance, we cannot directly observe full capacity of either labor or production resources; consequently, we can never be certain what level of activity represents the full utilization of capacity.

In addition, measurement issues aside, the empirical evidence of the past half-century suggests that the relationship between utilization and inflation can shift over time. Unfortunately, we typically are only imperfectly aware of the changes and their magnitudes in real time. In the 1990s, that relationship was affected by, among other things, changing trends in the growth rate of productivity and innovations in the structure of labor markets, such as increased use of temporary help supply.

These uncertainties mean that we, as policymakers, need to keep not only an open mind about estimates of the economy's potential but also a close eye on the various indicators of costs and prices so that we can recognize incipient price developments and react to them as early as possible. But we also must recognize that, by the time evidence of accelerating prices becomes definitive, containing inflation pressures could entail disruptive economic adjustments. So despite the uncertainties, we must evaluate all the evidence and make our best judgments about the oncoming risks to sustained good economic performance. In the current circumstances, as the Federal Open Market Committee has said, the economic climate appears to be one in which further increases in resource utilization, in combination with the elevated prices of energy and other commodities, have the potential to add to inflation pressures.

The available evidence suggests that the pace of economic expansion may moderate a little from its average over recent quarters, keeping resource utilization in line with recent levels. Maintaining economic growth around this pace will likely reflect a balancing of opposing forces. The rise in interest rates we have experienced will tend to restrain demand, offsetting the effects of sustained economic expansion in our trading partners and the reduced drag on U.S. growth from oil prices, assuming that those prices roughly flatten out as participants in futures markets seem to expect.

If the past is any guide, the effect of rising interest rates is likely to be felt most visibly in housing markets. The rate for a thirty-year, fixed-rate mortgage is up 70 basis points from its level in the middle of last year, and one-year adjustable-rate mortgages have risen more than 100 basis points over the same period. In addition, house prices have increased considerably relative to rents, incomes, and returns on alternative assets. Already there have been signs that housing demand has begun to moderate. Sales of both new and existing homes are down substantially from their levels last summer, and information on mortgage applications and pending home sales point to further softening in the next few months. With demand slowing, house prices also seem likely to decelerate. Indeed, we are beginning to see hints of moderation in some of the data on housing prices.

As a consequence, spending for new housing construction, after contributing nearly 1/2 percentage point to overall GDP growth last year, may not increase much this year. Moreover, the slowdown in house price increases could well hold back growth in consumption spending on a wide variety of goods and services. The rapid run-up in prices over the past few years and hence in household wealth, perhaps combined with the increasing ease of tapping that wealth, probably has been a major reason that households have been saving so little of their current flow of income. As house-price appreciation slows, the personal saving rate likely should begin a gradual ascent.

To be candid, however, the behavior of the housing market and the response of spending are among the great uncertainties about the economic outlook. I have sketched a benign scenario of gradual adjustment that lines up very nicely with the Federal Reserve's assessment that overall growth should slow to a sustainable pace. But our ability to predict asset prices is very limited, especially when the trajectory of those prices is shifting, as that of house prices appears to be doing right now. Moreover, we have particular difficulty in assessing how consumers will respond to changes in their perceptions of future capital gains and actual home prices. The housing market and its effects on spending will be among the areas that Tom and I and our colleagues on the FOMC will be monitoring most closely as we try to discern the emerging pattern of economic activity and inflation.

At this time, even with housing markets cooling, the fundamentals remain favorable for solid gains over the coming months and quarters in both consumer spending and business investment. In part, that assessment reflects the sizable increases in employment that we have been seeing over the past year or so. Just last week, the Labor Department reported that payroll employment rose 211,000 in March. If the growth of aggregate demand moderates as we expect, increases in employment should also slow but still be sufficient to absorb new entrants into the labor market. Moreover, the gains in wage and salary income associated with those employment increases should provide ongoing support to household spending. The purchasing power of those gains will go further than it has in recent years if, as anticipated in futures markets, energy prices level out.

Meanwhile, in the business sector, order books for nondefense capital goods are full, sales prospects appear good, profits have been strong, balance sheets are in healthy shape, and companies are flush

with cash. As the growth of consumption eases back a little, so too should the increase in capital spending as firms come to anticipate slower growth in sales. But judging from rising global commodity prices and equity valuations abroad, foreign demand looks to be increasing, and rising exports should offset some of the scaling back of domestic sales prospects. In addition, technological advances will continue to boost demand for capital equipment by reducing its costs and increasing its usefulness in improving efficiency.

If, as I anticipate, economic growth moderates a touch and pressures on labor and product markets do not intensify substantially further, I believe that underlying inflation should remain roughly stable. That sanguine picture is reinforced if crude oil prices do, in fact, turn out to be relatively flat over the remainder of this year. Such a flattening of oil prices would reduce headline inflation directly and would diminish the threat of higher energy prices becoming more deeply embedded in the inflation process by raising inflation expectations. And, to date, inflation expectations have been well anchored. As I have already mentioned, it would not be surprising to see some pickup in hourly compensation, but such an acceleration may not add to price pressures. In today's competitive environment, and with profits generally robust, some of the cost increases might well be absorbed in margins. Moreover, further productivity gains should act to damp the effects on overall unit costs.

Like all forecasts, this expectation of stable inflation is only the middle of a wide range of possible outcomes. For example, a further spurt in energy and commodity prices could be passed through into core inflation to a greater extent than seems to have been occurring recently; the threat of that outcome probably is especially great when the economy is already operating at a high level. If the economy does not moderate somewhat, pressures on resources will increase, further raising the odds of higher inflation. And as I discussed earlier, historical patterns suggest that resource utilization is already in a zone that at times has been associated with the emergence of inflation pressures. But the risks are not all one-sided. Price and compensation inflation have, in fact, remained moderate at high levels of resource utilization, despite rapid increases in energy and commodity prices, suggesting that some forces not yet fully identified may be helping to keep them contained. Those forces might include robust underlying productivity growth here at home or competition from abroad. It is also possible that the economy could cool more than expected if housing markets weaken quite substantially, consumption is cut back significantly, and as a consequence businesses pare capital spending plans.

My job as a policymaker is to work with my colleagues to identify the path of short-term interest rates that has the best chance of realizing that favorable central-tendency forecast of solid growth and continued low inflation. I do not know how much policy firming will be needed to accomplish this objective.

My forecast is that the economy is in transition to a sustainable pace of growth, in which case policy likely will be in transition as well. At this juncture, given the apparent strength in demand and the narrowing margin of unused resources, I am focused on making sure that inflation and inflation expectations remain well anchored. A tendency for inflation to move higher would put economic stability and the long-term performance of the economy at risk. Accordingly, for me, the critical indicators in the time ahead will be the ones that signal whether growth is indeed likely to proceed at a sustainable pace and whether inflation remains on a favorable track. This is a judgment my colleagues and I will need to make meeting by meeting as the incoming information--both the data and, critically, the timely feel for developments that we get from the Reserve Banks' contacts in the community--help us assess the paths for the economy and price pressures.