

Ben S Bernanke: The economic outlook

Remarks by Mr Ben S Bernanke, Chairman of the Board of Governors of the US Federal Reserve System, before the National Italian American Foundation, New York, 28 November 2006.

* * *

Thank you for inviting me to speak today. I will take this opportunity to present an update on the economic outlook.

This month marks the fifth anniversary of the beginning of the current expansion. Frequently, the early stages of an expansion include a period of above-trend growth, as underutilized resources are put back to work. As slack in the economy is reduced, however, economic growth tends to moderate. Indeed, at that stage, some slowing of growth to a pace consistent with the rate of increase in the nation's underlying productive capacity is necessary if the expansion is to be sustained without a buildup in inflationary pressures. In my testimony to the Congress in July, as part of the Federal Reserve's semiannual monetary policy report, I noted that the U.S. economy had entered this transition phase, and that some moderation of economic growth over the remainder of the year seemed likely.

The deceleration in economic activity currently under way appears to be taking place roughly along the lines envisioned in the Federal Reserve's July report. As anticipated, the slowdown primarily reflects a cooling of the housing market. Most other sectors of the economy appear still to be expanding at a solid rate, and the labor market has tightened further.

Inflation, which picked up earlier this year, has been somewhat better behaved of late. Overall inflation was pushed up this spring by a surge in energy prices, but the recent declines in energy prices have largely reversed those effects. Price inflation for consumer goods and services excluding energy and food, the so-called core inflation rate, has also moderated a bit in the past few months. But the level of the core inflation rate remains uncomfortably high.

Over the next year or so, the economy appears likely to expand at a moderate rate, close to or modestly below the economy's long-run sustainable pace. Core inflation is expected to slow gradually from its recent level, reflecting the reduced impetus from high prices of energy and other commodities, contained inflation expectations, and perhaps further reductions in the rate of increase of shelter costs and some easing in the pressures on capital and labor resources. However, substantial uncertainties surround this baseline forecast. The Federal Open Market Committee (FOMC), the committee that sets monetary policy, will continue to monitor the incoming data closely. In its latest statement, the FOMC reiterated its view that the upside risks to inflation are the predominant risks to the forecast and indicated that it is prepared to take action to address inflation if developments warrant.

Economic activity: recent developments and prospects

As I have just noted, the pace of economic activity has moderated over the course of the year. According to the latest estimates by the U.S. Department of Commerce, real gross domestic product (GDP) increased at an annual rate of 2.6 percent in the second quarter of 2006 and at a rate of only 1.6 percent in the third quarter. These figures are down noticeably from the 3-1/2 percent average pace of growth of the preceding two years. We will receive an updated estimate of third-quarter GDP growth tomorrow. At this juncture, information about economic activity in the fourth quarter is limited, and the range of plausible outcomes remains wide. But the indicators in hand suggest that real GDP growth this quarter is likely to be in the same general range that it was in the second and third quarters.

Housing has played a significant role in the recent slowing of overall activity, and developments in this sector are likely to have an important influence on economic growth going forward as well. As you know, the correction in the housing market that is now in train follows a boom during the first half of this decade. Between 2000 and late 2005, the pace of construction of single-family homes rose more than 40 percent, and sales of both new and existing homes increased by a similar amount. Nationally, home prices increased about 60 percent over that period - an average figure that masks considerable variation in the rate of price appreciation across cities and regions, as home prices rose exceptionally rapidly in some "hot" locations but only modestly in others.

No real or financial asset can be counted upon to pay a higher risk-adjusted return than other assets year after year, and housing is no exception. Thus, a slowing in the pace of house-price appreciation was inevitable. Moreover, the sustained rise in prices, together with some increase in mortgage interest rates, sowed the seeds of the correction by making housing progressively less affordable. Declining affordability ultimately served to limit the demand for housing, leading to a deceleration in house prices and slowing home purchases.

The drop in home sales that began earlier this year has led homebuilders to curtail the rate of new construction. Indeed, single-family housing starts are down about 35 percent since their peak earlier this year. Obtaining a precise read on home prices is difficult: During a period of weak demand, potential sellers often choose to leave their homes on the market longer or even to remove them from the market, rather than accept price offers that are below their expectations. The timeliest data on house prices do not fully account for changes in the composition of home sales by location, size, and other characteristics. Moreover, the data do not capture hidden price cuts, as when builders try to stimulate sales through the use of "sweeteners" such as paying the customer's mortgage points or upgrading features of the house at no additional cost. Nevertheless, there can be little doubt that the rate of home-price appreciation has slowed significantly for the nation as whole. Some areas have continued to experience gains - albeit smaller ones than before - while other markets have seen outright price declines.

Notwithstanding the sharp reduction in starts of new single-family houses, inventories of both new and existing homes for sale have increased markedly this year. For example, according to the most recent data, homebuilders currently have about 550,000 new homes for sale, roughly half again the number that has been typical during the past decade. Moreover, the official statistics likely understate the full extent of the inventory buildup, as many homebuilders have reported a sharp increase this year in the number of buyers canceling signed contracts. A home for which the sales contract is cancelled becomes available for sale once again but is not included in the official data on the inventory of unsold new homes. To reduce this inventory overhang, builders are likely to continue to limit the number of new homes under construction.

Although residential construction continues to sag, some indications suggest that the rate of home purchase may be stabilizing, perhaps in response to modest declines in mortgage interest rates over the past few months and lower prices in some markets. Sales of new homes ticked up in August and increased a bit further in September. The University of Michigan's survey of consumers shows an increase in the share of respondents who believe that now is a good time to buy a home, from 57 percent in September to 67 percent in November. Meanwhile, an index of applications for mortgages for home purchases has been trending up since July. Although these developments are encouraging, we should keep in mind that even if demand stabilizes in its current range, reducing the inventory of unsold homes to more normal levels will likely involve further adjustments in production. The slowing pace of residential construction is likely to be a drag on economic growth into next year.

Growth in some manufacturing industries has also slowed of late, and data prepared by the Federal Reserve show that aggregate manufacturing production declined in September and October. The motor vehicle sector in particular has experienced weaker demand and an accompanying buildup in stocks of unsold cars and trucks over the past year. Energy prices have contributed to these developments, as consumers have responded to high prices at the pump by reducing their demand for less fuel-efficient vehicles. The decline in sales caused inventories of these vehicles to surge this past spring. Since then, automakers have cut production to reduce the overhang of inventories; on a seasonally adjusted basis, the pace of light vehicle assembly in October was about 10 percent below the pace in the second quarter. The growth of production in some other manufacturing industries, notably those closely tied to the housing and automobile sectors, has also been slowing. Elsewhere in the industrial sector, though, production in high-tech industries has been growing rapidly, and high prices for energy and other commodities have stimulated drilling and mining activity. The global economy continues to be strong, with cyclical recoveries under way in Europe and Japan and ongoing growth in the emerging-market economies; this growth abroad should support the continuing expansion of U.S. exports of goods and services.

Outside of the housing and motor vehicle sectors, economic activity has, on balance, been expanding at a solid pace. Perhaps the clearest evidence of this broader economic strength comes from the labor market. Although the number of jobs in manufacturing and construction fell in October, most other sectors of the economy experienced solid job gains. Private employers in industries outside of manufacturing and construction added nearly 125,000 workers to their payrolls last month, following an average increase of 140,000 jobs per month during the preceding three months. With labor

demand continuing to expand over the past several months, the national unemployment rate fell to 4.4 percent in October, its lowest level since May 2001.

The strength of the labor market and the associated increases in wage and salary income have supported consumer spending. The data in hand indicate that, the slowdown in housing notwithstanding, inflation-adjusted outlays for personal consumption increased in the third quarter at about the average rate seen since the current economic expansion began in late 2001. The latest retail sales figures suggest an increase in consumption at roughly that pace in the current quarter as well. Other factors that are positive for consumer spending include the recent declines in energy prices, which have boosted household purchasing power and consumer confidence; increases in stock prices, which have added to household wealth; and relatively low long-term interest rates.

In the business sector, capital investment has continued to expand at a healthy pace. Spending on nonresidential construction - a component of business investment - has been particularly robust, reflecting higher outlays for new office and commercial buildings as well as a rapid increase in expenditures on drilling and mining structures. Outlays for equipment and software, which grew briskly from mid-2004 through the early part of this year, have moderated somewhat, though order backlogs for capital goods such as industrial machinery and other types of heavy equipment remain substantial. Moreover, financial conditions continue to be favorable for investment spending, as profitability is high, the cost of capital is relatively low, and significant cash reserves remain on firms' books.

Overall, the economy is likely to expand at a moderate pace going forward. A reasonable projection is that economic growth will be modestly below trend in the near term but that, over the course of the coming year, it will return to a rate that is roughly in line with the growth rate of the economy's underlying productive capacity. This scenario envisions that consumer spending - supported by rising incomes and the recent decline in energy prices - will continue to grow near its trend rate, and that the drag on the economy from the motor vehicle and housing sectors will gradually diminish. The motor vehicle sector may already be showing signs of strengthening; after having cut production significantly in recent months in response to the rise in the inventory of unsold vehicles, automakers appear to have boosted the assembly rate a bit in November, and they have scheduled further increases for December. The effects of the housing correction on real economic activity are likely to persist into next year, as I have already noted. But the rate of decline in home construction should slow as the inventory of unsold new homes is gradually worked down.

Like all economic forecasts, this one is provisional, and risks exist in both directions. On the downside, the correction in the housing market could turn out to be more severe and widespread than seems most likely at present. A deeper correction would directly affect economic activity through additional cutbacks in housing starts and through its effects on employment in construction and housing-related industries. More indirectly, it might also impose greater restraint on consumer spending by reducing homeowners' equity and thus household wealth, and perhaps by affecting consumer confidence as well. Because consumption makes up more than two-thirds of aggregate expenditure, any significant effect on consumer spending arising from further weakness in housing would have important implications for the economy.

On the other hand, economic growth could rebound more vigorously than now expected. The solid rate of job growth, the decline in the unemployment rate, and the healthy pace of capital investment could be signals that underlying economic fundamentals are stronger than generally recognized. Moreover, to date there is little evidence that the weakness in housing markets is spilling over more broadly to consumer spending or aggregate employment. If these trends continue, growth in real activity might return to a pace that could intensify upward pressures on resource utilization.

Potential output

In my remarks today, I have alluded to the economy's underlying productive capacity - in the jargon of economists, "potential output." The growth rate of potential output is the rate of growth that the economy can sustain in the long run. I will briefly discuss the factors determining potential output and the implications that the growth rate of potential output has for the economy and monetary policy.

Growth in potential output is determined to a large extent by two factors: the trend growth rates of the labor force (that is, the number of individuals available to work) and of labor productivity (that is, the amount of output that each worker can produce).

With regard to the labor force, research by the Board's staff highlights the role of demographic factors in determining the number of people available to work in the years just ahead. Most notably, the impending retirement of the baby boomers and the fact that women are no longer increasing their participation in the labor force at the rate they were in the past will tend to restrain the future growth rate of the U.S. labor force. All else being equal, these developments translate into a slower rate of growth of potential output. Estimates of the magnitude of the likely slowdown in labor force growth, particularly in the longer run, are subject to significant uncertainty. For example, to a degree that is hard to predict, improved health and increased longevity may increase the interest of older workers in remaining in the labor force, perhaps on a part-time basis, and an increasing scarcity of labor may prompt changes in labor-market institutions and employer behavior that facilitate the participation of older workers. But those adjustments are likely to take time, and some slowing in the growth of the labor force thus seems likely over the next few years at least.

With regard to productivity, I remain optimistic that the recent favorable trends will continue. The price of computing power continues to fall sharply, having declined by nearly half between 2000 and 2005. Increased computing power has contributed, in turn, to the development and growth of other commercially relevant technologies, such as biotechnology, and has led to improvements in efficiency, through better supply-chain management, for example. Moreover, whatever the pace of future technological progress, further diffusion of already-existing technologies and applications to more firms and industries should continue to increase aggregate productivity for a time.

That said, longer-run trends in the growth of productivity are very difficult to predict. During the first half of the decade, productivity in the nonfarm business sector increased at an unusually high average annual rate of about 3 percent. However, according to current estimates, productivity growth slowed in the second quarter of this year and came to a halt in the third quarter. Moreover, the strength of recent hiring raises the possibility of subpar productivity growth in the fourth quarter as well. When all is said and done, however, I expect that the latest numbers will turn out to have been a reflection of the typical volatility in the data and some cyclical response to the slowing in economic activity, not a signal of a sea change in the longer-run outlook for productivity growth.

Even if productivity growth is sustained at a reasonably good rate, the slower expansion of the labor force will imply some moderation in the rate of growth of potential output over the next few years. In the very near term, that slower growth in the labor force needs to be taken into consideration when assessing the sustainability of given rates of expansion in economic activity. In the medium term, because the factors that affect potential output and thus aggregate supply also tend to affect aggregate demand, slower growth of potential output does not necessarily mean that inflation will be higher or that monetary policy will have to be tighter. Rather, the implications for monetary policy of a possible slowing in the growth of potential output depend on the extent to which such a slowing alters the balance of supply and demand in the economy. For example, as we saw in the second half of the 1990s, changes in expected productivity growth and potential output can significantly affect aggregate demand through their influences on income expectations and asset prices. The problem for policymakers is to identify, in real time, any changes in the prospective growth rate of potential output and to anticipate the accompanying effects on the balance of supply and demand.

Inflation and monetary policy

Overall (or "headline") inflation has slowed significantly since earlier this year; indeed, in October the consumer price index fell by 1/2 percent for the second consecutive month. This improvement is largely the result of the recent declines in energy prices. The price of crude oil has fallen about one-fourth since its recent peak, reflecting some easing of geopolitical concerns and other factors. In particular, participants in crude oil markets - still mindful of the devastating effects on energy supplies of the hurricane season in 2005 - appear in retrospect to have incorporated a substantial risk premium into spot prices earlier this year. In the event, no damaging storms occurred this hurricane season. As the good news about the weather unfolded, spot prices of crude oil fell from August through early October.

Readings on the core inflation rate - that is, the inflation rate excluding the energy and food components - have improved modestly since the spring, but core inflation nevertheless remains uncomfortably high. Core CPI inflation over the most recent twelve months was 2.7 percent, up from 2.1 percent over the previous twelve months. Another measure of core inflation that we monitor, the price index for personal consumption expenditures excluding food and energy, is available only

through September; that index was up 2.4 percent over the past year, compared with a 2.1 percent rise in the preceding twelve months.

Several factors underlie the increase in core inflation over the past year, although the relative contributions are impossible to estimate precisely. Increased pressure on resource utilization as the economic expansion matured and slack was reduced has likely played some role. The sharp increases in energy and materials costs figured in the rise in core inflation as well, as some suppliers of non-energy goods and services may have been able to pass through their higher input costs into final prices.

More-rapid increases in shelter costs also boosted core consumer inflation over the past year. In the broad measures of consumer prices that we follow, substantial weight is given to an item called owners' equivalent rent (OER). OER is a measure of the price of the dwelling services enjoyed by people who own their homes; conceptually, if homeowners were to rent their homes from themselves, OER would be the market rent that they would pay. Economic statisticians estimate OER by using prices in the rental housing market. Over the past twelve months, the consumer price index for OER has risen about 4 percent, compared with 2-1/4 percent during the preceding twelve months. The acceleration in OER may reflect in part a shift in demand toward rental housing as families judged homeownership to have become less financially attractive of late. The most recent monthly increases in OER generally have been smaller than those earlier in the year, and further slowing may occur as the supply of rental units increases and the demand for owner-occupied housing stabilizes. However, the future evolution of this measure is difficult to know with any certainty.

Looking forward, core inflation seems likely to moderate gradually over the next year or so. Some of the factors that pushed up core inflation in the recent past - in particular, energy prices and shelter costs - appear likely to be more neutral in the coming year, and inflation expectations remain contained. Moreover, if, as seems most probable, the economy grows at a rate modestly below its potential for a time, pressures on resource utilization should ease a bit.

However, as with the outlook for economic activity, there are substantial uncertainties about the inflation forecast. In the case of inflation, the risks to the forecast seem primarily to the upside. Given the current level of inflation, a failure of inflation to moderate as expected would be especially troublesome.

One factor that we are watching carefully is labor costs, which depend on both the compensation received by workers and labor productivity. Although the available indicators give somewhat different signals, it seems clear that labor costs - which account for roughly two-thirds of firm's total costs - have been rising more quickly of late. Some part of this acceleration no doubt reflects the current tightness in labor markets. For example, anecdotal reports suggest that businesses have been finding it difficult to recruit well-qualified workers in certain occupations.

What implications does the pickup in labor costs have for price inflation? One possible outcome is that increases in labor costs will largely be absorbed by a narrowing of firms' profit margins and not be passed on to consumers in the form of higher prices. The fact that the average markup of prices over unit labor costs is currently high by historical standards suggests some scope for this outcome to occur. If higher labor costs are mostly absorbed by firms and not passed on, then workers will see the gains in their nominal compensation per hour of work translated into greater real compensation per hour; in the process, workers would capture a greater share of the fruits of the high rate of productivity growth seen in recent years. The more worrisome possibility is that tight product markets might allow firms to pass all or part of their higher labor costs through to prices, adding to inflation pressures. The data on costs, margins, and prices in coming months may shed some light on which of these two scenarios is likely to be the better description of events.

During the early part of this decade, the Federal Reserve sharply eased the stance of monetary policy to help bring the economy out of recession and to foster a durable economic expansion. Once the expansion had clearly gained firm footing, the FOMC began a process of normalizing interest rates that involved seventeen consecutive increases in overnight rates of 25 basis points each. In August of this year, and again in September and October, the Committee left interest rates unchanged so as to assess the effects of its previous policy actions, and because of indications that economic growth was moderating and that inflation pressures might be diminishing somewhat. At the same time, the Committee has continued to emphasize the upside risks to inflation and the high costs that would be associated with a failure of inflation to moderate gradually as expected. Needless to say, we will continue to monitor the inflation situation closely. Whether further policy action against inflation will be

required depends on the incoming data and in particular on how these data affect the FOMC's medium-term forecasts of both inflation and output growth.

I have focused today on the near-term prospects for the economy and the risks to the economic outlook. However, in reviewing the economic developments of recent years, one cannot help but be impressed by the dynamism and resilience of the U.S. economy. I have confidence, therefore, that however events play out in the short term, in the longer term the economy will grow at a healthy pace, raising living standards in the process. The Federal Reserve will continue to play its part by implementing policies designed to achieve its mandate of fostering price stability and maximum sustainable employment.