The Economic Outlook
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It is a pleasure to speak on the economic outlook this morning, in part due to this distinguished Ohio Valley audience, and in part because the outlook is so encouraging. Growth is proceeding on a solid pace this year, and inflation is low and stable. Moreover, our economy has withstood several substantial shocks over the last several years, and yet has remained on course. So, I think we have abundant reason to be grateful for a quite positive economic outlook. Before I begin reviewing that outlook, however, I would like to note, as usual, that the views expressed are my own and are not necessarily those of my colleagues in the Federal Reserve System.

It has now become uncontroversial to say that the outlook for overall economic activity is quite healthy. But six months ago, you may recall that many pundits were decidedly less optimistic. In the wake of the destruction caused by two hurricanes, energy prices had surged. From the end of 2004 to the peak last fall, crude oil prices rose 56 percent, wholesale natural gas prices rose 129 percent, and retail gasoline prices rose 70 percent. To some, it seemed obvious that the high energy prices would lead to a significant and persistent reduction in consumer spending, which would bring overall economic activity to the edge of recession. That didn't happen. It is true that the growth rate of real GDP in the fourth quarter fell by about 2 percentage points from its trend over the previous two years, but a closer look reveals that transitory factors played a large role there. Other data have remained robust, and the consensus forecast is now that real growth in the first half of this year will be at about a 4 percent rate.

Let's take a closer look at some of the recent data that support this healthy outlook. Starting with the national labor market, payroll employment has grown rapidly, adding almost a million new jobs in the last four months, through February. This is more than double the rate that would simply keep pace with population growth. As you might expect, this has driven the overall unemployment rate down under 5 percent. Another indicator of a strong demand for labor is wage growth, which has been steadily increasing lately. Over the same four months, average hourly earnings have risen at a 3.5 percent annual rate, markedly above the 3 percent growth we had seen in the previous 12 months.

The combination of rising employment and rising wage gains has supported substantial income growth – over the last four months for which we have data, real personal income has risen at a healthy 5.4 percent annual rate. And that, in turn, helps explain the resilience of consumer spending. The conventional view of economists has long been that consumer spending is governed predominantly by a household's assessment of their own future real income streams. Thus, despite rising energy prices and surveys last fall that suggested sagging consumer confidence, inflation-adjusted consumer spending increased at a booming 8.0 percent annual rate over the holiday season, and now runs at about 3.2 percent ahead of a year ago.

Looking ahead, to assess the outlook for consumers' spending, you begin with their income prospects. Expectations are that the overall labor market will continue to be strong: continued job growth, a moderate unemployment rate, and further real wage gains should lead to healthy advances in incomes and, thus, overall consumer spending.

Before turning away from households, I'd like to touch on residential housing activity. As I'm sure you know, the housing market has had an amazing run in recent years. To cite one measure, new housing starts rose from 1.57 million units in 2000 to 2.07 million units in 2005, a remarkable 5.7 percent average annual rate of increase. And that's just the number of housing units; on top of that, the size and quality of the average new home has been steadily increasing. Another indicator of strong demand was rising prices for existing homes. For the nation as a whole, the price of a typical single-family home rose 55 percent over the same time period.

You won't hear me use the B-word to describe this remarkable activity. Instead, I believe fundamental factors can fully explain the expansion we've seen in the demand for housing, particularly rising incomes, rising population, favorable tax treatment, and very low interest rates. At the present time, mortgage interest rates are not as favorable as they were a few years ago, and so it is not surprising that we are seeing some signs of a tapering off of residential activity in many markets. For example, there were 1.28 million new single-family home sales last year, but so far this year the sales rate has averaged 1.14 million. I see this not as a precipitous decline, but rather as a return to more normal conditions in many markets. This return to normalcy is especially pronounced in the informal evidence we receive. The multiple first-day bids and final sales at above-asking prices that were observed in many markets have become increasingly rare. Also, the amount of time that a home remains on the market has risen back up to more typical levels. Looking ahead, it seems reasonable to expect the housing market to remain strong, even as some further tapering off in sales and production takes place.

The key point I would like to emphasize is that the housing phenomenon was <u>not</u> a mysterious, independent boost to the economy, driven by some sort of animal spirits, but instead was a rational response by households to the economic fundamentals, especially very low real interest rates. Thus, going forward, the adjustment of the housing market to evolving fundamentals will continue to fit comfortably within the standard economic framework. My assessment is that plausible rates of moderation in housing activity will not pose a problem for overall activity this year or next. Moreover, I don't see diminished housing price appreciation as a major problem for consumer spending, since again, the primary determinant of spending is income, and we see solid and improving prospects for real incomes for the nation as a whole.

Turning to firms, the fundamentals for business investment appear to be quite sound. Capital formation, particularly investment in information and communications technology, played an instrumental role in the widely noted surge in productivity growth that took place in the late 1990s. The unique fundamental driving force then was the rapid and sustained fall in the relative price of new computing equipment and associated products. This investment boom resulted in a growing capital stock, and as a result rising productivity growth. Indeed, productivity growth had only averaged 1.38 percent per year for over two decades, but from 1995 to 2000 averaged 2.52 percent per year. That may sound like a small difference, but remember that over time, productivity growth is the foundation of rising standards of living, and that compounding over many years can transform small differences in growth rates into substantial differences in incomes. Thus if productivity growth remained at 1.38 percent, it would take around 50 years for average incomes to double. But with productivity growth at 2.52 percent, the doubling time is cut to almost 28 years.

Looking at more recent numbers, productivity growth since 2000 has averaged 3.3 percent per year, which incidentally would double average incomes in less than 21 years. This is an astonishing performance over a time period with significantly lower rates of capital formation than in the late 1990s. Thus, recent productivity gains appear to owe somewhat more to the re-organization of business processes than to the application of additional capital. But as business investment continues to grow, productivity growth is likely to be driven more by capital formation. We should therefore pay special attention to current prospects for investment spending.

In my view, the fundamentals for investment are encouraging. In the high-tech area, we are still seeing declining relative prices for many products. Business sales are strong. New orders for capital equipment have been on a pronounced uptrend for 2 ½ years. The cost of capital remains favorable. Capacity utilization in manufacturing has recovered from the recession and any capital overhang is largely behind us. And business profitability is unusually high. Putting these all together, I expect investment spending to be quite robust this year. Falling relative prices should continue to support technology upgrades that enhance efficiency for many firms. In addition, rising capacity utilization rates suggest that many firms will need to add capacity to keep up with demand growth. And if I am correct, this capital spending should be enough to support overall demand in the economy, even as the housing market cools down.

This is a good time to review the bidding. It looks like we’re on track for continued expansion, with real GDP growing at about a 3 ½ percent annual rate this year. Consumer spending should grow in line with GDP and will be supported by job growth and real wage gains. Residential investment will flatten or slow, but business capital spending should remain robust. And that capital spending will support productivity growth going forward, which in turn will support the future income growth that keeps household spending healthy. And while there are risks to this forecast, as there are with any forecast, I do not see any single scenario that is compelling enough to alter the central tendency of this outlook.

Let's turn now to the inflation picture, where again things are looking better now than many had expected six months ago. Back then, the energy price surge had led some observers to expect to see those prices pass through to a broad range of prices of goods and services, much like what happened in the 1970s. But that hasn't happened. Core inflation has been low and relatively steady in the last several years. Our preferred inflation measure, the price index for core personal consumption expenditures, has risen 1.8 percent over the last 12 months. Despite rising energy prices, core inflation actually fell slightly last year, since the core price index had risen 2.2 percent in 2004. Similarly, we are not seeing any sign of rising inflation in the most recent data. Over the last two months, for example, the core index has increased at a 1.8 percent annual rate as well. To put that number in perspective, it lies close to the 1 ½ percent figure that I and several others have proposed as an announced numerical objective for inflation.

Why haven't high energy prices boosted other prices as much as many had feared? Probably because those fears are based on looking back at the 1970s and seeing that similar energy price increases had been followed by broader increases in overall inflation. I would argue that any analogy with the 1970s is badly flawed. Back then, monetary policy failed to respond effectively to rising inflationary pressures and the public's expectations of future inflation had consequently become unanchored. Thus, at that time, higher energy prices became a signal for firms to raise prices and for workers to demand higher wages in order not to fall behind a prospective inflationary surge.

Today, however, the Fed places its highest priority on keeping inflation low, and our ability and willingness to follow through on our announced intentions appears to be widely understood. Thus, longer-term expectations of inflation have remained moderate even as energy prices have moved up over the last couple of years. Looking ahead, short-term movements in the inflation rate can be hard to predict. But what is important is to stabilize inflation over medium- and longer-term horizons. And here the indicators about what the public expects look fairly good. Both survey data and the market prices of inflation-protected Treasury securities tell us that the public expects inflation to continue to be contained. I am confident that we at the Fed have the knowledge and the will to validate those expectations.