The Economic Outlook for 2006

Charlotte Chamber of Commerce
Annual Economic Outlook Conference
Charlotte, North Carolina
December 21, 2005

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It is a pleasure to be with you today to discuss the economic outlook for 2006 and beyond. It is a pleasure, in part, because the economic outlook is fairly encouraging. Growth is on a solid footing, despite this year's run-up in energy prices and the disruptions of a devastating hurricane season. After a brief pause this fall, employment has resumed expanding at a healthy pace, consumer spending continues to grow briskly, and business investment spending is robust. Granted, housing activity seems to be softening, and at least some potential price level pressures remain, so it may be too soon to break out the eggnog. But inflation expectations remain contained, and we at the Fed are well-positioned to resist inflation pressures, should they emerge. So all in all, it is quite a good outlook. In fact, in the spirit of the holiday season, I am tempted to say that I bring you tidings of comfort and joy, but I am afraid that might strike you as uncharacteristically exuberant for a central banker, so let me just say that tidings appear to be improving at a measured pace.

In my remarks today, I would like to review the economic outlook in a bit more detail, and then talk about monetary policy. As always, my remarks reflect my own views, and not necessarily those of my colleagues in the Federal Reserve.

The really striking feature of the current outlook is the extent to which economic activity in general and consumer spending in particular has rebounded from the shock of the hurricane season. In the immediate aftermath of Hurricane Katrina, fears were widespread that consumers might pull back sharply on spending, both in response to sharply higher retail gasoline prices and out of a general sense of heightened anxiety about potential fallout from the storm damage. Survey measures of consumer confidence, which plummeted in September, seemed to bolster this view. But the effect of the storms on consumer outlays have turned out to be far more limited than expected, exemplifying the oft-cited resilience of the U.S. economy. Apart from auto sales, which slid following expiration of the summer's "employee discount" promotions, retail sales have held up well and overall consumer spending has continued to advance. And on the whole, holiday spending appears to be coming in stronger than many feared a month or two ago. I would argue that this episode illustrates quite well how consumption expenditures are governed predominantly by households' assessment of their own future income prospects, rather than by any general economic nervousness, despite how they respond to telephone pollsters. With healthy income growth ahead and a reasonably strong overall job market, the outlook for consumer spending looks good.

Housing market activity has been very strong over the last several years. The historically low level of inflation-adjusted mortgage interest rates explains much of that strength. The fall in interest rates that began early in 2001 stimulated spending in interest-sensitive sectors like housing and durable goods and partially offset the emerging weakness in business investment spending. As the latter has recovered in the last two years, and real interest rates have had to rise as a consequence, a gradual "handoff" from housing investment has been expected. That handoff has yet to occur; the ratio of business to residential investment outlays fell from around 2.75 in 2000 to about 1.75 last year, and has been fairly constant since then. Instead, the combination of low inflation-adjusted interest rates and sustained real income gains have continued to provide a strong stimulus to housing demand.

In recent months, we have received widespread anecdotal reports of what one informant of ours called "a return to normalcy" in several housing markets in our District. The multiple first-day bids and final sales at above asking prices that were observed in some markets seem to have become less common. And in some markets the amount of time a home stays on the market has returned to more typical levels. At the same time, the aggregate measures of housing activity have so far shown only limited pull-back from their peaks and remain at historically high levels. Still, mortgage rates are likely to stay somewhat above their recent lows in the coming year, so I would expect housing price appreciation to flatten out next year and aggregate residential investment to stop growing or perhaps even decline.

The fundamentals for business investment in equipment and software look quite sound. Business output is expanding steadily and real funding costs are relatively low, both because inflation-adjusted, risk-free rates have been low and because corporate risk spreads are relatively narrow. Evidently, there has been a sufficient flow of opportunities to deploy new capital profitably. Business investment in equipment and software has grown at over 11 percent in real terms since the first quarter of 2003, and it appears poised to grow at rates almost that strong next year.

Capital formation, particularly investment in information and communications technology (ICT), played an instrumental role in the widely noted surge in productivity growth that took place in the late 1990s. The fundamental driving force was the sustained and rapid fall in the relative prices of these technologies. Although initial productivity growth figures for that period were revised downward in subsequent data releases, our best estimates now are that productivity accelerated significantly in the mid-1990s from the relatively stagnant pace of 1.5 percent seen over the previous 20 years to 2.6 percent. Productivity has grown at surprisingly strong rates since then – 3.4 percent since the end of 2000 – despite significantly lower rates of capital formation.

Gains in labor productivity, whether due to capital deepening or improved business processes, ultimately pass through to real incomes. As a result, total real personal income has grown recently: over 2 percent per year since the rebound in employment in mid-2003, despite significant energy price increases. If productivity growth continues at or above trend, as seems likely, then we should see healthy growth in real income next year, anticipation of which should continue to support consumption growth in 2006.

Labor markets have recovered from the recession of 2001. Although employment was stagnant for a time following the downturn, hiring picked up in 2003. Of course, Hurricane Katrina disrupted labor markets by forcing the displacement of close to a million people from the Gulf Coast region. That separated a substantial number of workers from their employers, and damaged a substantial portion of the capital stock in the affected areas. As a result, U.S. employment growth was noticeably depressed in September and October, although quantitative estimates of the storms' effects are imprecise. Payroll expansion resumed in November, however, and one would expect most of the gap to be made up over the next several months as reconstruction efforts get under way.

The overall outlook therefore is for a healthy expansion next year. Real GDP should grow at about 3.5 percent. Household spending should grow at about the same rate in real terms. Business investment should expand substantially faster than overall output and residential investment should expand more slowly, perhaps even falling in real terms. I expect employment to track the growth in the working age population.

This is a fairly balanced picture, but naturally there is some uncertainty attached to it. Economic fundamentals could depart from their anticipated trajectories in any number of ways that could leave a mark on U.S. economic aggregates. For example, spot oil prices – or other commodity prices for that matter – could well turn out either above or below the path embodied in futures prices. Many global commodity markets have been affected by the unanticipated surge in worldwide demand over the last several of years; those for which supply elasticities are low have experienced significant price run-ups. Commodity price surprises in either direction could alter aggregate supply conditions and either add or subtract from output growth.

On the demand side, there is some uncertainty regarding the rate at which housing activity is likely to cool in the coming year. Although I do not think that a sharp fall in housing investment is likely, a range of forecasts from flat to moderately declining seem reasonable. And while continued growth in the share of output devoted to business investment seems highly probable, it is difficult to foresee with any certainty the scale of investment that businesses will find profitable to undertake, so spending growth in this category could well deviate from expectations. In contrast, growth in household spending is easier to forecast, because both economic theory and empirical evidence indicate that consumption growth is tied closely to income growth over time. The range of likely outcomes for real consumption growth is correspondingly more narrow.

Core inflation has been low and relatively steady in the last several years. The inflation measure that is widely preferred on methodological grounds, the price index for core personal consumption expenditures, has averaged 1.8 percent over the 12 months ending in October. That is within the 1-to-2 percent range that I and others have proposed as an announced target.[1]

Even before Katrina, overall inflation, including food and energy prices, was elevated due to the run-up in energy prices in the spring and summer. Hurricanes Katrina and Rita severely disrupted energy production in the Gulf and led to sharp increases in refining margins and prices for gasoline and natural gas. U.S. natural gas production and petroleum refining are still down 5 percent since Katrina, and crude oil production is down 10 percent.

Monetary policy should respond to energy shocks by remaining focused on price stability. That way, the economy can respond to energy price shocks the way it should – the relative price of energy increases, but core inflation remains anchored. In the immediate aftermath of Hurricanes Katrina and Rita, monetary policymakers naturally have focused on the risk that the attendant energy price increases would "pass through" to an acceleration in core inflation. While the lack of an upsurge in the core PCE inflation figures for September and October is somewhat encouraging, I think it is too soon to declare that pass-through risk is entirely behind us. This assessment is consistent with the statement released by the FOMC following its meeting last week, which noted that: "…elevated energy prices have the potential to add to inflation pressures." To my mind, any energy price pass-through to core inflation that is more than marginal and transitory would be unwelcome.

Thus far, market participants appear to believe that core inflation will remain contained. Survey measures of expected inflation rose sharply in September when retail gasoline prices reached their peak, but have come back down since. Measures of expected inflation derived from market prices of inflation-protected U.S. Treasury securities drifted up a bit this fall, but they too have returned to mid-summer levels. To maintain credibility for price stability, it is essential that monetary policy should respond vigorously to any visible erosion in inflation expectations.

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[1] Lacker, Jeffrey, "Inflation Targeting and the Conduct of Monetary Policy," University of Richmond, March 1, 2005; and Yellen, Janet, "Policymaking and the FOMC: Transparency and Continuity." *FRBSF Economic Letter*, Sept. 2, 2005.