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Remarks on the U.S. Economy and Monetary Policy

Good afternoon. And thank you, George, for that kind introduction. This is my first public speech as President of the Federal Reserve Bank of San Francisco, and it's a pleasure to be making my debut here in Seattle. Thank you all very much for coming. While it would be a privilege to serve as the head of *any* Reserve Bank, I'm especially happy to have the chance to head the San Francisco Fed—and not only because the West has been my home for many years. As you probably know, this Reserve District is the largest of the twelve in terms of geography and population. It comprises about 20% of the nation's economy. And it's also home to a number of industries and innovations that have significant impacts on the nation's economy. Like my predecessor, Bob Parry, I think it's important for a Fed President to learn about the District by actually traveling around in it and getting to know the economy and the people first-hand. And it's very nice that part of getting that first-hand knowledge in this job involves visiting great cities like Seattle.

As George said, this is not my first stint as a Fed official. Now that I've returned, I've been very glad—though not at all surprised—to find that the high standards of public service I've always associated with the Fed remain solidly in place. There have been some changes, however. One in particular—and it's a change for the better, I believe—is the FOMC's effort at communication. The Committee has been placing a great deal of

emphasis on explaining the logic of its decisions concerning the nation's monetary policy.

For example, the June and August FOMC statements made clear that the current policy stance is highly accommodative, so short-term interest rates have to go up to prevent an eventual increase in inflation. The policy challenge is to consider the question: "how fast?" At this point, we still face some uncertainties about the strength of the economic expansion and the strength of job creation. At the same time, we've had some reassuring indications that the surge in core inflation a few months ago was a short-lived phenomenon, although rising oil prices have pushed up measures of overall inflation. In light of these conditions, it made sense that the Fed engineered only modest increases in the federal funds rate in both June and August.

My aim today is to elaborate on these points a bit and to lay out some context for thinking about the issues facing monetary policy going forward. I should add that my remarks reflect my own opinions, and they are not necessarily those of others in the Federal Reserve System.

The current economic situation

Let me begin by trying to characterize the current economic situation. Although we're nearly three years past the official date of the end of the last recession, in some important ways, I think the economy is still operating in its wake. One of the hallmarks of the 2001 recession was the "investment bust," which seems to have stemmed from a case of "too much of a good thing." The extraordinary productivity surge in the second half of 1990s—plus the buildup to Y2K—led to an investment boom that apparently went too far. The effects of the investment bust on the economy were compounded by the

tragic events of 9/11 and the wars in Afghanistan and Iraq. Added to this was disquieting news about corporate governance scandals, which undermined confidence. As a result, businesses seemed to be extremely cautious about their spending and hiring decisions.

To counter these developments, monetary policy responded aggressively, slashing short-term interest rates to their lowest levels in forty years. The series of sizable tax packages passed by Congress, along with a pickup in spending on defense and homeland security, provided additional stimulus to spending. In the spring of 2003, the Fed again responded when the specter of deflation seemed to loom. It took out an “insurance policy” to address this grave risk by lowering the federal funds rate to 1 percent.

These actions helped support consumer spending, which fortunately stayed strong despite the 2001 recession and the “soft patch” that followed for the next year and a half. In early 2003, the economy finally seemed to kick into gear, with growth averaging a robust five percent between the first quarter of 2003 and the first quarter of 2004. And with this strength in the economy, we started seeing healthy growth in jobs again: from March to May of this year, payroll employment rose at an average of nearly 300,000 jobs per month.

But in the second quarter of this year, growth slowed to under 3 percent, and the partial data available on the current quarter suggest perhaps only moderately faster growth—somewhere in the range of the economy’s long-run potential growth rate. It appears that businesses and consumers have, in a sense, “switched places,” with business investment in equipment and software now growing rapidly, while the consumer is showing some sluggishness. Notably, the labor market stumbled, too, generating only 85,000 jobs per month in June and July. The August data on employment were better—

about 144,000 jobs were added—but that’s still just barely enough growth to keep pace with increases in the size of the labor force.

The August 10th FOMC statement said that the slowdown “... likely owes importantly to the substantial rise in energy prices.” In terms of the outlook, the statement says that “the economy nevertheless appears poised to resume a stronger pace of expansion going forward.” A basic premise of the statement is that a rise in oil prices to a new higher *level* is likely to have only a transitory effect on output *growth*. In other words, even if oil prices remained at a high level, real GDP growth would be expected to bounce back. In addition, the economy continues to benefit from substantial monetary policy stimulus and a continuing need for businesses to rebuild their capital stocks after the “investment bust.”

I want to spend a few moments discussing the oil price increases, because their role in the economy has important implications for the conduct of monetary policy.

The role of the oil price increases

The price of oil rose from around \$30 per barrel last summer to around \$45 recently. As the wholesale and retail markups over crude oil prices surged, gasoline prices rose even more sharply, although these margins have fallen substantially over the past couple of months. Not surprisingly, the oil price increases have spilled over into other energy markets like natural gas.

This oil shock is connected to concerns about the supply of oil, given all the political instability in the Middle East, Venezuela, Russia, and Nigeria—each seemingly for different reasons. At the same time, demand for oil is very strong—not only in the

U.S. but also in emerging Asia, especially China—and that's leading to a sharp increase in oil consumption.

While oil prices are certainly high enough to grab our attention, the situation is a far cry from what happened when oil prices shot up in the 1970s. It's true that oil prices have hit all-time highs in nominal terms; but, if we adjust them for the general price level, they're only about half of what they were thirty years ago. And over these thirty years, the U.S. economy has become much less dependent on oil. In fact, oil consumption as a fraction of overall income is only about two-thirds of what it was back then.

Nonetheless, a hike of this size can restrain economic growth for a time. An intuitive way to think about it is to view the price increase as a kind of "tax" that U.S. households and businesses pay to foreign oil-producing countries. Essentially, an increase in oil prices can absorb income that could have been spent on other items.

How big might that "tax" be? A back-of-the-envelope estimate suggests that the recent increase amounts to a "tax" of about \$65 billion. The more important question is, how much of an effect would a "tax" of that size have on real GDP growth. Economic models—which, as always, are at best approximations—suggest that the size of the effect is likely to be modest, reducing real GDP growth in 2004 by somewhere in the range of less than a quarter percent to about half a percent.

It might seem surprising that the effect of this "tax" is so small, but a major reason has to do with the way households and firms typically respond to the tax. When they face reduced incomes from this tax, they tend to change their spending patterns in a couple of ways that mitigate its impact on demand and therefore on growth. First, they usually try to avoid the tax by consuming less oil, and this response gets bigger as time

passes. Second, they typically cut back their spending on things other than oil only gradually; that is, they try to maintain their spending for a while by dipping into savings and profits, so this also cushions the oil price effect.

If people see the price increase as temporary, they're likely to cut back spending rather less; and if they see the price increase as permanent, they'd tend to cut back spending more. Developments in the oil futures market suggest that people may see a large portion of the recent oil shock as permanent, since the futures prices a year or so ahead have risen by almost as much as the current price. This is unusual; generally, when oil prices spike, the futures market expects a quick reversal. So there's reason to think that households and businesses may cut back spending more, indicating that the higher end of the range of estimated effects may be more appropriate.

The oil price hikes could be taking an even bigger chunk out of real GDP growth if they were undermining confidence, because that, in turn, would hold consumer spending down as well. This phenomenon has been observed in some other instances; the 1990 oil shock associated with the first Iraq war is a good example. However, at least as measured by surveys, consumer confidence has held up reasonably well. Finally, there's another reason to question whether this oil shock has had exceptionally large effects on U.S. output; namely, other industrialized countries that depend on foreign oil have exhibited only modest effects so far.

So, my overall assessment of the oil shock is that it undoubtedly played a role in the current slowdown, but exactly how much it accounts for is a complicated question. To the extent that it is playing a larger, rather than a smaller, role, we might expect more of a bounceback in growth once the oil shock effect passes through the economy.

The outlook

This brings me to the outlook. In my view, it wouldn't be surprising to see growth pick up enough to exceed the rate that can be sustained in the long run, thus gradually moving the labor market toward full employment. This would be a desirable result, because, by my calculations, considerable slack is still left in labor markets. Some recent data support the notion that growth may be rebounding. For example, much of the slowdown from the first quarter to the second quarter is accounted for by auto production. Auto sales have picked up so far in the third quarter after dropping in the second quarter, which suggests that more production may follow. Other data, including manufacturing output, housing construction, and consumer spending on goods and services, also have rebounded from their weak performances in June. And, as I mentioned, the labor market data for August did pick up moderately. These results are encouraging.

However, there are some issues that have the potential to be troublesome going forward. As "risk managers" for the nation's economy, I think monetary policymakers need to pay attention to these issues, so I'd like to take a moment to touch on some of them.

One concern is the personal saving rate. Over the past decade or so, the personal saving rate has fallen from the 7 to 8 percent range to a range of ½ percent to 2 percent. With interest rates rising and equity prices declining this year, households may try to get their finances in order and bring the saving rate up to more normal levels by cutting spending. A noticeable increase from today's historically low levels could have important adverse consequences for the pace of economic expansion going forward.

Such a development could be made more likely if household confidence is undermined by another spate of weakness in the jobs market—or, indeed, by a jobs picture that isn't showing a pretty strong upward trend.

In addition, with the major declines in mortgage rates behind us, the volume of mortgage refinancings has plummeted over the past year or so. Conceivably, equity withdrawals from cash-out refinancings provided a greater boost to spending in recent years than was commonly recognized, and the loss of this source of funds could undermine demand.

Finally, though business investment has been strong, it has been less than one might expect, given the very high corporate profits and cash flow that we've seen in recent years. In fact, for the first time in decades, business cash flow has actually exceeded total capital investment. This suggests a continuation of the caution that has marked business decisionmaking in the wake of the terrorist threats and the issues surrounding corporate governance. This caution could be behind the inability of the labor market to establish sustained strength. As the impetus to the economy from fiscal stimulus wanes next year, strength in consumer and business spending will prove critical to the sustainability of the expansion.

The inflation situation

Now let me turn to inflation. We had a bit of scare earlier this year. After rising by only 1-1/2 percent in 2002 and then increasing at an even lower rate in 2003, the core PCE price index showed increases of around 2 percent in the first half of this year. The FOMC was faced with the question of whether this uptick was a one-off phenomenon or the beginning of a new higher trend. It now looks more likely that it was one-off for a

couple of reasons. First, the surge could simply have been an offset to the unexplained and exceptionally low rate in 2002. This possibility now seems more likely given that core inflation from May through July has dropped back to the lower rates seen earlier.

Second, some of the uptick undoubtedly was due to higher oil prices being passed through to prices of core goods and services. A higher price of oil can lead to a permanently higher overall price level, and this can show up in inflation rates for a while. Moreover, if oil prices were to keep rising for a time, the boost to inflation could be extended. But ultimately, a higher price of oil is unlikely to raise the rate of inflation permanently unless it gets built in to expectations of future inflation and therefore into wage bargaining. In any event, both inflation expectations and actual inflation remain well contained, at least for now.

Moreover, while significant risks to the inflation rate remain, they seem well balanced on both the high side and the low side. On the high side, the obvious risk is that oil prices could rise even further. They have been surprising most forecasters for over a year now. If this pattern continues, it would tend to boost core inflation for a time.

On the low side, profit margins have been extraordinarily large, and the mark-up of goods prices over unit labor costs has risen to a new high. Basically, the rapid productivity gains we've seen have held down business costs, and most of these gains have gone into higher profits rather than higher compensation for labor. This large mark-up could return to more normal levels through falling inflation or through faster growth in labor compensation. We saw such a run-up and rapid reversion toward normality during the second half of the 1990s. It's possible that if prices and wages share the adjustment

over the next year and a half—consistent with typical historical experience—the restraint on inflation could be quite significant.

Monetary policy implications

What does all of this mean for monetary policy? As I've pointed out, policy is still very accommodative, with the federal funds rate at one and half percent and inflation at about the same rate so that the “real” or inflation-adjusted federal funds rate is close to zero. To get an idea of how far we are from a neutral stance, economists compare the funds rate to a benchmark called the equilibrium rate. This is the rate that would be consistent with full employment of labor and capital resources over the intermediate run, after incorporating the inflation rate and taking into account the rate of productivity growth in the economy, various demand factors like fiscal policy, international developments, and other factors. Estimates of the equilibrium rate are highly uncertain and may change over time. That said, most estimates put the current equilibrium rate in the range of 3-1/2 to 4-1/2 percent. In other words, according to these estimates, the funds rate would need to rise considerably above its current level for policy just to have a neutral effect on the economy. With the actual funds rate currently as low as it is, there is thus reason for a strong presumption that rates will need to keep going up as we move forward.

In both June and August, the Federal Open Market Committee tightened policy slightly. The Committee indicated in its statement that, based upon what it then knew, removal of policy accommodation at a “measured pace” would most likely prove appropriate to promote the outlook for the economy that I've described—a moderate acceleration in growth with well-contained inflation.

Of course, the Committee must remain very watchful as developments unfold, and be prepared to consider modifications in its course of action as needed to ensure price stability. For example, there could be a need to consider moving more aggressively if inflation showed signs of rising significantly. But as I said, there is reason to feel somewhat more comfortable than I did a few months ago that core inflation is still well contained. On the other hand, there might be a need to consider pausing in the process of raising rates if slower growth in demand caused economic activity to slow down. This concern seems less acute than it did a month or so ago. But I still see it as a significant issue, warranting careful attention.

The Committee would face a particularly tough policy choice if higher oil prices were to exact a continuing toll on economic activity. We know from history that oil shocks put monetary policymakers on the horns of a dilemma, because those shocks both raise inflation *and* reduce output. The dilemma is: Do we fight inflation and risk weakening the economy even more? Or do we boost the economy and risk even higher inflation? Fortunately, we have the benefit of hindsight to give us some guidance. We learned some bitter lessons from the oil crisis of the 1970s; in particular, we learned that monetary policy should not be so accommodative that higher inflation gets built in to inflation expectations and wage bargaining. Once this happens, it can be extremely difficult to rein inflation in without creating a severe recession. Therefore, it would make sense to react to concerns about *both* inflation *and* weak activity. If the Committee were to face that situation, given the low level of the funds rate today, the policy response could involve moderate increases in the funds rate that restrain inflation while continuing to provide some support to the economy.

Let me end where I began. As I said at the outset, a key feature of current monetary policy is the emphasis on communication and transparency. This effort has been ongoing for a long time, and it has intensified over the past year. The reason for the focus on communication is that economic developments are affected by longer-term interest rates, equity values, the exchange rate, and other asset values—and these factors depend not only on the current funds rate, but more importantly on the expected *future* path of the funds rate. Clear, straightforward language that helps explain to markets and the public what the Fed is looking at, and why, can make policy more effective by fostering the appropriate expectations and decisions. Clear communication can also help avoid financial disruptions when policy enters a new phase. I think that what happened in June is a perfect case in point. It was my first meeting, and the Committee voted to raise rates a quarter point for the first time in three years. Some people asked me afterwards if the discussion at the meeting had been kind of uninteresting, because the outcome had been very well anticipated by market participants. I responded, “On the contrary. I take this as a mark of success of the FOMC’s new strategy.”

I hope that my comments today have done their part to communicate my thinking as a Fed policymaker. Now I’ll be glad to take any questions.

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