

San Diego Community Leaders' Luncheon
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Views on the Economy and Implications for Monetary Policy

It's a pleasure to be here with you in San Diego. My remarks today will focus on the nation's economy and the implications for monetary policy. As I was preparing for this event a few weeks ago, I originally had in mind a fairly upbeat talk about an economy that was in reasonably good shape. Since then, of course, a great deal has happened. The country has come face to face with a natural disaster of enormous proportions, particularly in terms of the human tragedy that has occurred in its wake. Our thoughts and best wishes are with those in the Gulf Coast and with their families, and, indeed, with those who have gone to help.

With a disaster of this magnitude, the economic effects go well beyond New Orleans, Gulfport, Biloxi, and all the other devastated towns and cities in the hurricane's path. Clearly, there are national implications, since that region is an important hub for exports and imports and an important center for the oil and gas industries. Since the effects of Hurricane Katrina are of national economic significance, I certainly plan to discuss how I believe they might factor into decisions about monetary policy.

But there is more to the story of the Federal Reserve's response than just monetary policy. And I'd like to take a moment to tell you a little about it. First let me note that the Federal Reserve itself was among those institutions that felt this disaster directly. The Federal Reserve Bank of Atlanta has a Branch Office in the city of New Orleans. The building was closed after safely evacuating all but a small crew to maintain security. That Branch Office, like others around the country, plays an important role in

keeping cash and checks moving through the nation's payments system. Though that building is closed for business, the functions are definitely ongoing thanks to the efforts of Fed staff in neighboring locations, including Birmingham, Memphis, and Houston. The Federal Reserve Bank of San Francisco is involved, too, because the national responsibility for the Fed's cash operations resides with the Cash Product Office of our Bank, directed by Mark Mullinix, who heads our Los Angeles office. Obviously, the immediate job is to make sure that there are adequate cash inventories available to meet demand. This has involved bringing into play many contingency plans, such as extending the hours of the cash shops involved to include weekends, beefing up the inventory of currency available for payout by drawing on excess currency in other parts of the country, and freeing up currency that was stored in a non-Fed location in the event of just such an emergency. All told, nearly three quarters of a billion dollars have been paid out through these alternative arrangements. For the check business, similar contingency plans have been put into place, as well as some extension of credit for banks in the area that have not been able to reopen.

Another way that the Fed is working to keep the financial system in that region on a sound footing is by joining with other regulators and affected financial institutions to identify customer needs and monitor institutions' restoration of services. Along with other regulators, the Fed recently issued a statement urging depository institutions to consider all prudent and reasonable actions that could help meet the critical financial needs of their customers and their communities. This includes allowing loan customers to defer or skip some payments, easing credit card limits and credit terms for new loans,

raising ATM withdrawal limits, and relaxing restrictions on cashing out-of-state and non-customer checks.

Now let me turn to the economy and monetary policy. Even before Hurricane Katrina and all that has followed, I would have said that the conduct of monetary policy had reached a challenging phase. We had gone through a period in which inflation was well contained but the economy had a lot of slack. In that phase, it was obvious that policy needed to be highly accommodative. Then, as slack diminished, it seemed equally obvious that the Fed needed to gradually remove policy accommodation—“normalizing” the stance of monetary policy. The goals of these policy actions, of course, are to set the economy on track so that inflation stays low and excess slack in the labor market is absorbed. As that occurs, real output growth must converge toward its potential rate for inflation to remain under control, which, in turn, requires that monetary policy reach a so-called neutral stance. Such a trajectory still remains a plausible, even probable, scenario. However, as we’ve come closer to these goals, the appropriate policies are not as obvious as they were before, as the potential for undershooting or overshooting the goals looms larger. Indeed, uncertainties and risks that could complicate things considerably were evident even before the havoc unleashed by Hurricane Katrina, so our approach during this phase must be particularly dependent on information from incoming data.

As for the impact of the situation in the Gulf Coast on policy, there are a couple of ideas I’ll expand on later in my remarks, but I’d like to state them briefly here. In my view, the greatest contribution monetary policy can make is to keep the national economy on an even keel. Monetary policy, unfortunately, has little scope to cushion the immediate economic fallout from such a severe and sudden blow to a region, because

monetary actions can't be directed at a particular area of the country, and their effects take time to be felt. It is fiscal policy—government spending and transfers—that is necessary to address the immediate needs of the affected areas. Monetary policy may come into play, however, in counteracting those impacts from the hurricane that continue over time and affect the country as a whole. I'm thinking particularly of the hurricane's effects on energy prices, which could be a threat if their effects are long-lasting. The Gulf Coast is important to our nation's energy supplies, and the associated problems are coming at a time when oil prices were already high. I'll come back to this issue after briefly reviewing recent economic developments—indicating where the economy has been and how policy has responded.

Beginning on the real side of the economy, the nation's output growth has averaged about three and one-half percent over the past year, a rate that is moderately above trend, which is now probably around three to three and a quarter percent. The national unemployment rate has gradually dropped to 4.9 percent, which is near conventional estimates of the natural rate consistent with “full employment.”

This growth has been achieved in the face of some significant drags on economic activity—a growing trade gap, a very cautious environment around business investment, and, of course, high oil prices. That is why, as I mentioned earlier, the Committee kept its main policy instrument, the federal funds rate, very low for quite some time in the wake of the last recession.

Focusing on oil prices, they have more than doubled in the past year and a half and recently spiked above \$70 a barrel. Over the last several decades, most fluctuations in oil prices have proven to be “transitory” and, not surprisingly, the view that oil price

jumps will be temporary is typically reflected in futures prices. During the run-up of spot oil prices over the past year and a half, in contrast, far-dated oil futures prices also have increased sharply, suggesting that high oil prices may be here to stay. This is a highly unusual development. It probably reflects the perception that global demand will remain strong in an environment where there is little excess supply of oil available in the world and where geopolitical uncertainty creates risks to existing supplies. High oil prices, of course, impose a tax on consumers that erodes their spending power while impinging on businesses' bottom lines. The perception that the on-going oil price shock is more permanent tends to intensify its negative spending impacts. However, it is worth emphasizing that, after adjusting for inflation, the current price of oil is still well below the inflation-adjusted peak price reached during the oil shocks in the early 1980s. Moreover, the energy intensity of the U.S. economy is far lower than it was in those days.

To offset the negative impact on spending stemming from oil and the other drags I mentioned, monetary policy had to remain highly accommodative for a substantial period—stimulating interest-sensitive sectors, particularly consumer durables and housing. Over time, however, as slack in resource use diminished—that is, jobs have grown and capacity utilization has risen—the FOMC has gradually been able to lift its foot off the accelerator, removing policy accommodation. At each of its last ten meetings, the FOMC raised the federal funds rate by a quarter of a percentage point, bringing it to three and a half percent today.

As I said, during the process of removing accommodation, incoming data have become increasingly influential in my own assessments of the further policy measures that are needed to move the economy toward this desirable trajectory.

For example, data during the late spring and early summer suggested that aggregate demand was stronger than had been previously thought, implying greater momentum in spending. Moreover, the data showed a drop in the pace of inventory accumulation, especially for autos. Therefore, most forecasters were predicting fairly rapid growth for the second half of the year, as firms rebuild their inventories, with a return to trend-like growth in 2006. This potential for a bulge in growth in the second half of 2005—with labor markets apparently already near full employment—was seen as raising inflationary risks.

Now, of course, developments in the Gulf Coast come into play, altering the expected pattern for the national output data. Disruption of production in the Gulf will undoubtedly slow growth somewhat in the second half—a common estimate is that it will depress national real GDP growth by around one-half to three-quarters percent. This is likely to be followed by a surge in growth as the government-assisted rebuilding kicks in—hopefully before too long.

In addition to these effects relating directly to the Gulf Coast area, however, there has been the potential for negative impacts on national spending due to the spike in energy prices that occurred right after the hurricane. The Gulf Coast plays a significant role in the country's energy supply because of its extensive drilling, refining, and distribution infrastructure. For example, offshore crude oil and natural gas production in the Gulf of Mexico account for approximately 29 percent and 19 percent respectively of total U.S. production levels. Importantly, Gulf Coast refineries account for a whopping 47 percent of total U.S. refining capacity.

Higher energy prices, as I mentioned, sap the spending power of both households and businesses over other goods and services. These effects tend to hit the economy gradually with long lags and are one of the factors that the Fed routinely takes into consideration in conducting monetary policy. Like all so-called negative supply shocks, an energy shock presents complex choices for monetary policy. It reduces output and employment for a time, which calls for easier policy, but it also temporarily raises inflation, which calls for tighter policy. Moreover, the size of these two effects is difficult to gauge in advance. Part of the difficulty is that the impact depends on whether people see the latest rise in oil prices as short-lived or longer-lasting. The longer-lasting the effects are seen to be, the bigger the effect on spending.

Fortunately, there is growing evidence of recovery in the energy infrastructure along the Gulf Coast. Although many refineries and pipelines were affected initially, reports indicate that more and more are coming on line. In addition, after the steep run-up in energy prices, both spot and futures prices have retreated significantly.

Let me now turn from the real side of the economy to inflation, again emphasizing how incoming data have influenced my own assessment of the appropriate path for monetary policy. I'll focus particularly on something called the personal consumption expenditures price index, excluding food and energy. I realize I just said a mouthful, and I apologize. But it's important to mention it, because it's a comprehensive measure of core consumer inflation that the Fed carefully monitors. That measure rose by 1-3/4 percent over the last 12 months, suggesting that inflation has been relatively well-contained over the past year. And core inflation has dipped a bit over the last few months.

Of course, the issue for policy is not so much where inflation was in the past, but rather where inflation is headed. In this regard, it seems likely that, even with inflation expectations well contained—which they have been according to most indicators—higher oil prices may be partly passed through to core inflation at least for a time. Supply disruptions emanating from the Gulf Coast disaster may also affect the prices of building materials and transportation services. Two further key influences on inflation are productivity growth and the pace of compensation growth, since both affect the behavior of business costs. Recent data revisions lowered estimates of productivity growth over 2001 to 2004 somewhat and reveal a deceleration in productivity growth over the past year or so. These revisions probably warrant a modest decrease in our estimates of *structural* productivity growth—the underlying noncyclical portion of productivity which is most relevant in assessing inflationary pressures. That said, it’s very encouraging that even after a downward adjustment, structural productivity still appears to be growing somewhat faster than the robust rates achieved in the second half of the 1990s, and it remains quite strong by historical standards.

With respect to labor compensation, my sense from the data and our business contacts is that cost pressures remain in check, although recent data also give conflicting signals. One key measure, the Employment Cost Index, has recorded only modest increases over the past year. A second more inclusive measure of compensation shows a more substantial rise. It is also worth noting that, over the last few years, an unusual situation has emerged in which profits have risen at an exceptionally rapid pace in comparison with labor income, pushing up capital’s share of GDP to a very high level by historical standards. A more rapid rise in compensation per hour could be part of the

process by which labor's share of income returns to more normal levels, hence unthreatening from an inflation standpoint. As we assess the likely behaviour of wage pressures going forward, we must also factor in the influence of slack in labor and product markets. The decline in the unemployment rate to 4.9 percent in August, coupled with some improvement in measures such as the employment-population ratio and industrial capacity utilization, suggest that while a "whisker" of slack may still remain, we probably can't count on slack to hold inflation down.

Taking all of these factors into account, my overall assessment is that core inflation—that is, excluding food and energy—seems relatively well contained at the present time. However, there are a myriad of uncertainties about how things will unfold over the next year or two, and the uncertainties on the upside have only gotten bigger since Hurricane Katrina slammed into the Gulf Coast.

In addition to the uncertainties I've already mentioned, there is, of course, the housing market. With the share of residential investment in GDP now at its highest level in decades, a key question is whether this source of strength in the economy could reverse course and become instead a source of weakness. One common way of thinking about housing valuations is to consider the ratio of housing prices to rents. The price-to-rent ratio is equivalent to the price-to-dividend ratio for stocks. Historically, the ratio for the nation as a whole has had many ups and downs, but over time it has tended to return to its long-run average. Thus, when the price-to-rent ratio is high, housing prices tend to grow more slowly or fall for a time, and when the ratio is low, prices tend to rise more rapidly. I want to emphasize, though, that this is a loose relationship that can be counted on only for rough guidance rather than a precise reading.

In the San Diego area, the very rapid increase in house prices over the past few years has pushed the ratio well above its long-run average, making it among the highest in the nation. Of course, a high ratio in this area does not *necessarily* mean that one should expect a commensurately large price adjustment going forward. There are striking regional variations in house-price appreciation, and some areas may have high relative prices for good fundamental reasons. For example, an area like San Diego may not have much room to expand the housing stock as demand grows. And given how attractive San Diego is, demand may be expected to keep rising in the future as well. Of course, I'm not making any predictions about house prices here or anywhere else. I'm only pointing out some issues that should be considered.

For the nation, the price-to-rent ratio is higher than at any time since data became available in 1982. The natural question to ask is can such a high value be explained by fundamentals? Probably the most obvious candidate for a fundamental factor is low mortgage interest rates. And the phenomenon of low long-term interest rates raises some issues of its own because there is a controversy about just why they have stayed so low. As I've said, over the past year, the Fed has raised the federal funds rate significantly. Normally, long-term interest rates also rise with increases in the expected path for the federal funds rate. But, long-term rates—such as those on 30-year fixed rate mortgages—have actually fallen over the period. This is what Chairman Greenspan has labelled a conundrum because there seems to be no convincing explanation for it.

While low mortgage rates explain part of the unusually high price-to-rent ratio nationally, the consensus seems to be that mortgage rates are not low enough to explain much of the run-up in the ratio. Moreover, with controversy over exactly why long-term

interest rates have remained so low, we can't rule out the possibility that they would rise to a more normal relationship with short-term rates, and this obviously might take some of the "oomph" out of the housing market. So, while I'm certainly not predicting anything about future house price movements, I think it's obvious that the housing sector represents a risk to the outlook.

Let me close by summarizing where I think the economy is now heading and the role of monetary policy in guiding its evolution. I have emphasized in this talk that a number of risks cloud the outlook. The tragic disaster in the Gulf region tops the list of risks to the national economy at this stage, given the importance of this area to energy, trade, and transportation. I have also discussed risks relating to housing markets and the current configuration of interest rates. Even taking these risks into account, the economy overall, in my estimation, is doing reasonably well and could settle into a highly desirable pattern of full employment, trend-like real GDP growth, and well-contained inflation. The job of monetary policy is to foster exactly such an outcome.

It is worth recognizing that the U.S. economy has shown great resilience in the face of other disasters with national impacts, such as 9/11, Hurricane Andrew, and the Northridge earthquake. Of course, the toll from Hurricane Katrina has already proved to be staggering in human terms and, in this instance, the national economy will be affected through the region's key role in trade and energy markets. The size of these impacts depends in part on how quickly the vast energy infrastructure in the region can be brought back to operating condition. While recent indicators provide room for optimism, we are still at an early stage in the process of assessing the effects of the hurricane.

There are no easy answers as this stage. I hope I've given you some insight into what kinds of things we will be looking at over the period ahead.