Speech to the Emeryville Chamber of Commerce
Emeryville, CA
By Janet L. Yellen, President and CEO of the Federal Reserve Bank of San Francisco
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Prospects for the U.S. Economy

Thanks, Tom, for the very kind introduction. Good afternoon, everyone. It's a real pleasure to be here in "my own backyard," so to speak. I was delighted that the Chamber invited me to be part of your annual Outlook Conference, and I thank you all for coming.

As you may know, next week the Federal Open Market Committee meets in Washington, D.C. The Committee is charged with setting the nation's monetary policy to achieve its dual mandate of maximum sustainable employment and price stability. Naturally, I'm now in the midst of preparations for that meeting, so my focus today will be mainly on the national economy.

Of course, I'm also keenly interested in what is going on at the local level around the District. One of the great strengths of the Federal Reserve is its connection to the citizenry of the country. In this respect, the twelve Reserve Banks play a particularly important role. Through our directors, our advisory councils, and through meetings like this one, we can get some insight into the public's viewpoint on issues that are vital to the conduct of monetary policy—issues like labor market conditions, expectations about inflation, and industry-specific developments, to name just a few. So I'm very much looking forward to the question and answer session that will follow my remarks, because I'm sure that I'm going to learn from you as much as you're going to learn from me!

Before I begin, let me note that my comments represent my own views and not necessarily those of my colleagues in the Federal Reserve System.

At the last meeting of the Committee, in August, something unusual happened. After raising short-term interest rates at every one of its 17 meetings beginning in June 2004, the Committee decided not to tighten the stance of monetary policy. As a matter of fact, the August meeting was the first since I became President of the Federal Reserve Bank of San Francisco that the Committee didn't raise rates. The August pause may seem a bit puzzling to some, since we had some rather bad news on inflation for several months in a row. Today, I'd like to focus my remarks on why I think the pause was a good idea, and, of course, in following that theme, I'll need to get into the economic outlook.

I'll start with a quick review of recent developments. The U.S. economy has suffered some significant shocks in the past couple of years: in particular, a sustained surge in energy prices and the devastation from the twin hurricanes just over a year ago. Despite these challenges, the economy grew at a solid clip, averaging just over 3¼ percent for the past two years.

This pace of growth is moderately above current estimates of the growth rate that is sustainable in the long run, and it has lasted long enough to eliminate much of the slack in labor and product markets that was apparent a year ago. Over that time, both the rate of unused capacity in the industrial sector and the civilian unemployment rate have fallen noticeably. Indeed, the unemployment rate dropped by about three-fourths of a percentage point, coming in at 4¾ percent in August. This rate is actually a little bit lower than conventional estimates of so-called "full employment," and therefore suggests that there may be some tightness in labor markets. Here in the Bay Area, we're also seeing some tightness in labor markets, as the unemployment rate is just below the nation's at about 4-1/2 percent.

Turning to inflation, the recent news, as I said, hasn't been what I'd like to see. Headline inflation, as measured by the personal consumption expenditures price index, showed an increase of three and a half percent over the twelve months ending in July. While this is an important and comprehensive index of changes in the cost of living, the Committee also focuses on a different measure—the core number, which excludes the volatile food and energy components—because it is a better indicator of underlying trends in inflation. This measure rose at an uncomfortably high rate of nearly 2½ percent over the past year. Although it is encouraging that the rate has edged down recently, it has remained a bit above my "comfort zone"—a range between one and two percent that I consider an appropriate long-run inflation objective for the Fed.

With labor and product markets close to full utilization and inflation above the comfort zone, one of the key questions for policy is whether economic growth will proceed at a moderate enough rate, and stay there long enough, to avoid a sustained buildup of inflationary pressures. And that is my next topic.

Prospects for Economic Activity

Recent data suggest that the needed slowdown is indeed underway. After hitting a rapid 5½ percent pace in the first quarter, real GDP growth slowed in the second quarter to a rate of just under 3 percent. In looking ahead to the rest of the year, I see factors working both to support economic activity and to restrain it somewhat. Taken together, these lead me to expect that we'll probably see growth that is healthy, but somewhat below the rate that is sustainable in the long run.

The factors working to support growth include ongoing strength in business demand, fueling relatively rapid growth in spending on nonresidential structures as well as in business investment in equipment and software. This sector, of course, includes high-tech industries, which are important to the Bay Area economy. To the extent that business investments in computer equipment continue to grow, this will help sustain the local economic expansion, which has picked up over the past few years as conditions in the high-tech sector have improved.

As for factors that could restrain the nation's growth, one immediately thinks of energy prices, which have surged over the past couple of years. This increase has been due to developments on both the demand and the supply sides of the market. Demand for energy has been quite strong, not only from industrial economies, but also from emerging markets, most notably, China. On the supply side, there are reports of limited capacity to expand production, not to mention extraordinary events that threaten to restrict supply, like disruptions in the Middle East.

It appears that the resulting higher energy prices have restrained consumer spending, even while offsets from job gains, as well as growth in wages and wealth have kept it rising overall. Of course, further increases in energy prices could imply some additional restraint. However, futures markets expect energy prices to stabilize around current levels. If they do, then the restraint we've felt this year should evaporate over 2007, and that could actually contribute to a pickup in growth next year. But that's a very big "if." The fact is that futures markets haven't done such a hot job at predicting where these prices are headed. Ever since energy prices started to rise in 2004, futures markets have usually predicted a relatively flat path going forward. When oil was $30 a barrel, they implied the price would flatten out. At $40 a barrel, they implied the price would flatten out. At $50 a barrel—well, you get the picture. And here we are with oil fluctuating around $70 a barrel. So energy prices are a bit of a wildcard.

Another factor restraining growth is the rise in interest rates over the past couple of years as the Fed has removed monetary policy accommodation. Since this process began in mid-2004, short- and intermediate-term interest rates are up substantially. Long-term rates present a more mixed picture, with some—such as mortgage rates—up slightly, and others down slightly. The overall effect of these rate changes should be to reduce demand, particularly in interest-sensitive sectors, such as autos, consumer durables, and housing.

Indeed, we already have seen clear evidence of cooling in the housing sector. Nationally, housing permits are down noticeably—by more than 20 percent—from a year ago. In addition, inventories of unsold houses are up significantly, sales of new and existing homes are off their peaks, and surveys of homebuyers and builders are showing much more pessimistic attitudes. This slowdown has been amply in evidence here in the Bay Area, where sales of existing homes have dropped by about 20-30 percent from a year ago.

The national data on residential investment reflect all of these developments and enter directly into the calculation of real GDP growth. After adjusting for inflation, (real) residential investment dropped at nearly a 10 percent annual rate in the second quarter following two small declines in the prior two quarters.

The effects of the housing slowdown go beyond their direct contribution to GDP. In particular, what happens to house prices could have important effects on consumer spending, which is a very big part of the economy—roughly 70 percent. As we all know, the pace of house-price appreciation has definitely moderated, after rising at heart-stopping rates in recent years. Here in the Bay Area, the pace of appreciation has fallen into the single digits, after reaching about 20 percent in 2005. And there are signs that slower price growth nationwide may continue. For example, rents are finally moving up more vigorously after a long period of stagnation. This may reflect, in part, expectations that house-price appreciation will continue to slow, as landlords raise rents to try to maintain the total rate of return on rental properties and as those in the market for housing grow more inclined to rent than to buy.

Slower increases in house prices could weaken consumer spending in a couple of ways. Both of them have to do with what I'm going to call the "piggy bank" phenomenon. To be honest, I've stolen this term from some news stories I've seen, but I think the crime is worth it because the description is apt. Back when house prices were rising so fast, people saw that more and more equity was being built up in their house values; in other words, they saw their houses as piggy banks that got fuller and fuller, faster and faster, by just sitting there. Insofar as the piggybank of house value makes up a good chunk of many households' portfolios, they might well have felt that they could afford to spend pretty freely. In economic terms, this is called the "wealth effect." A second factor stimulating spending relates to the ease with which households can now pull money out of the piggy bank. With home equity loans, refinancings, and so on, the piggy bank is now pretty simple to access. So it's no surprise that homeowners seized the opportunity and drew some of the money out to support their spending. Now, with the pace of house-price appreciation slowing, of course, the piggy bank is not getting so full so fast anymore, which may weaken the growth in consumer spending.

While it’s likely that the slowdown in the housing sector will have only moderating effects on economic activity and will continue to unfold in an orderly way, I should note that we can’t ignore the risk that a more unpleasant scenario might develop. In particular, we have heard a lot in recent years about the possibility that there is a house-price “bubble,” implying that prices got out of line with the fundamental value of houses and that the current softening could be just the beginning of a steep fall. While I doubt that we’ll see anything like a “popping of the bubble”—in part because I’m not convinced there is a bubble, at least on a national level—it is a risk we have to watch out for.

Another risk has to do with household saving behavior. In the U.S., the personal saving rate has been declining for more than a decade. During the 1980s, it averaged 9 percent. This July, it was all the way down to minus 1 percent. Frankly, it’s hard to see how it could go much lower. So the risk is that a sustained rise could occur, which would put a real crimp in consumer spending and therefore in overall economic activity. Though there’s some uncertainty about why the saving rate has fallen into negative territory, I strongly suspect that part of it is related to the growth in consumer wealth over the last several years both through rising housing values and through rising stock values. Therefore, the more recent softening in both of those sources of wealth may provide a bit more impetus for a reversal in the saving trend; in other words, it is conceivable that people will shift gears and try to build up savings the old-fashioned way, by spending less. Whatever its source, the very low—in fact, negative—saving rate represents a downside risk for the economy, with the chance of sizeable drop-off in consumer spending likely to be bigger than a surge in spending.

Prospects for Inflation

This brings me to the outlook for inflation. As I've indicated, core consumer inflation has been a bit above my comfort zone recently. Therefore, in keeping with the Committee's responsibilities for promoting price stability for the nation, I believe it is critical that inflation trend in a downward direction over the medium term. Indeed, my expectation is that this is the most likely outcome.

That said, I must admit that I'm also less sanguine than I was a month ago about one particular factor in the inflation process—namely, labor compensation. This factor is a major component of business costs and can therefore affect the prices that firms charge for their products. A month ago it appeared that compensation was growing quite modestly. Moreover, for nonfarm businesses, markups of product prices over costs have been near historic highs, which means that businesses have had room to absorb higher costs rather than passing them on to their customers. These two developments together gave me considerable comfort in thinking about the inflation outlook. However, recently revised information on compensation per hour suggests that wages and benefits are growing rapidly. This blurs the picture considerably, since another measure, the Employment Cost Index, shows only moderate growth. Blurry though the picture may be, it remains true that markups are very high. So I do draw some comfort from that, because it means that, even with more wage and cost pressures, firms would have the room to absorb the increases without fully passing them on into their prices if competitive conditions in product markets induced them to do so.

Beyond this, I would point to several factors that could make inflationary pressures recede. The first factor I want to discuss is a somewhat technical point. Try to bear with me on this, because it does matter. In statistical analyses of inflation, the data historically have exhibited persistence. This basically means that, when you're forecasting inflation, it works pretty well to assume that the rate in the future will be the same as it is today. The implication of persistence is frankly worrisome: Since inflation is too high today, persistence implies it could *stay* too high for an extended period.

However, recent research at the Federal Reserve Bank of San Francisco has shed new light on this issue.[1] It finds less evidence of persistence during the past ten years. That is, rather than sticking at a certain rate, inflation has tended to revert to its long-run average, which, over that period, is within my comfort zone. Admittedly, the past ten years constitute a relatively small sample from which to draw definitive conclusions. Nonetheless, this evidence is important because, if it holds up, it implies that inflation may move down from its elevated level faster than many forecasters expect.

Interestingly, this apparent decline in the persistence of core inflation has occurred at roughly the same time that long-run inflation expectations appear to have become well anchored. The behavior of long-run inflation expectations can serve as a kind of proxy for the Fed's credibility as an inflation-fighter. For example, in the face of the large energy price increases we've seen in recent years, this credibility shows up in the stability of survey and market measures of inflation expectations covering the period

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[1] John C. Williams, "The Phillips Curve in an Era of Well-Anchored Inflation Expectations," unpublished paper, http://www.frbsf.org/economics/economists/staff.php?jwilliams.

five-to-ten years ahead. This may not be a coincidence. Research suggests that if a central bank's commitment to price stability has gained credibility with the public, then the persistence observed in the inflation data will tend to be dampened.

I would like to stress that our Bank's recent research on persistence concerns simple correlations in the inflation data that can be used for forecasting only, and it does not necessarily inform us about how policy decisions affect the economy or about the best course for policy. In other words, low persistence is no reason for the Fed to rest on its laurels of credibility. Rather, credibility is something that neither I—nor my colleagues—take for granted for a moment. We know full well that maintaining credibility requires that we act when necessary to keep inflation under control.

Another reason to expect inflationary pressures to lessen has to do with energy prices and what is called "passthrough." Even though higher energy prices do not seem to have boosted long-term inflation expectations, the energy shock may have been passed through to recent results for core inflation itself. This might seem surprising, since core inflation excludes energy prices. But even so, it is possible that higher energy prices have passed through into the prices of core goods that use energy as an input to production—airfares are a good example. Now it's true that recent research suggests that the extent of passthrough for any given rise in energy prices has been lower in the past twenty-five years than it was back in the 1970s. However, it seems likely that energy passthrough probably has played at least some role in recent core inflation movements. In this case, if energy prices level out, as expected by futures markets, this upward pressure on core inflation is likely to dissipate at some point, and this would help on the inflation front.

Finally, as I've explained, the economy appears to have entered a period of slightly below-trend growth. If it continues, as I think is likely, it would tend to moderate any underlying inflationary pressures over time. This factor, together with the others I've discussed, provides reason to think that the most likely outcome is that inflation will move gradually lower. However, I am keenly aware that this pattern has yet to show up in the data. The inflation outlook remains highly uncertain, and until we actually see inflation begin to slow down, I will be focused on the notable upside risks in the outlook.

Policy issues

This leads me to the concluding topic in my presentation today—monetary policy. As you know, in August the FOMC decided not to raise the funds rate for the first time in more than two years. I think this was the prudent course of action that properly balances the dual mandate given to the Fed by Congress—to foster price stability and maximum sustainable employment.

Given that inflation is outside of my comfort zone, why do I think it makes sense to pause? In these circumstances, it might be thought that policy should continue to tighten until the inflation data move back to a rate consistent with price stability. But I would argue that a gradual approach is likely to be better because there is a need to incorporate lags between policy actions and effects on the economy. We don't know what the lags are with precision, but we still need to do the best we can to take them into account. We simply don't get the necessary feedback on the effects of our policy actions for a long time. So if we kept automatically raising rates until we saw inflation start to respond, we most likely would have gone too far, which would unnecessarily endanger the economic expansion. Instead we need to be forward-looking.

And, by a variety of measures, it appears that the current stance of policy will move inflation gradually back to the comfort zone while giving due consideration to the risks to economic activity. By a variety measures, I'm referring to my forecast that I have outlined today, as well as the recommendations from commonly used monetary policy rules that are used to gauge the stance of policy. Taken as a whole, these rules indicate that the funds rate is currently within the range that appears appropriate, given the current condition of the labor market and the position of inflation relative to my comfort zone.

However, since all such approaches are inherently imprecise, policy must be responsive to the data as it emerges. The advantage of pausing is that it allows us more time to observe the data. When I say that policy should be responsive to the data, I mean that any additional firming should depend on how emerging developments affect the economic outlook. And when I say data, I don't just mean data on inflation, output, and employment. I also mean data on factors that might affect those variables in the future—such as energy prices, the dollar, the stock market, long-term interest rates, housing prices and inflation expectations.

The bottom line is this. With inflation too high, policy must have a bias toward further firming. However, our past actions have already put a lot of firming in the pipeline. With the lags in policy we haven't yet seen the full effect of our past actions. These will unfold gradually over time. By pausing, we allowed ourselves more time to observe the data and more time to gauge how much, if any, additional firming is needed to pursue our dual mandate.

Thank you for having me today, and I will be pleased to address your questions.

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