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Prospects for the Economy

This Economic Letter is adapted from remarks by Janet L. Yellen, President and CEO of the Federal Reserve Bank of San Francisco, delivered to the Bay Area Council 2006 Outlook Conference in San Jose, California, on April 18, 2006.

In this assessment of prospects for the U.S. economy, I will paint the outlook in three parts—economic growth, labor markets and resource utilization, and inflation. I'll start each one with fairly broad brushstrokes, and then I'll fill in the highlights and shadows—that is, the factors that add uncertainty to my views on the future. I'll conclude with some thoughts on how I view this picture from my perspective as a monetary policymaker.

I'll start with the broad brushstrokes on the outlook for economic activity. Prospects for growth in the year ahead are solid at the national level, and of course, this can only be good news for the Bay Area and California as well. The U.S. economy has shown remarkable resilience in the face of some severe shocks—in particular, the surge in energy prices that began a couple of years ago and the devastation wrought by the twin hurricanes last summer. Although economic growth came in pretty weak in the fourth quarter of last year, it appears to have roared back in the first quarter of this year.

If growth were to continue to roar—that is, to keep running at an unsustainable pace for too long, raising the risk of building inflationary pressures—monetary policymakers like me would start getting those frowny lines in their foreheads. But, at the moment, my brow is fairly smooth. My best guess is that economic activity will remain healthy, supported by strong productivity growth and continued strength in consumer spending and business investment, especially investment by the vital high-tech sector. But I don't think we will get a repeat of the very rapid first quarter growth. Rather, I expect economic activity to settle back to a more trend-like and sustainable rate as the year progresses.

One reason why is that part of the strength in the first quarter is likely just the flip-side of some temporary factors that made the economy weak in the fourth quarter—things like the immediate disruptive effects of the hurricanes and harsh winter weather that held back consumer spending. Another reason

is that the Fed's gradual removal of monetary policy accommodation should tend to damp the pace of activity. This effect is likely to be reinforced by a related development—a significant moderation in the rate of appreciation of house prices. This could well restrict not only the pace of residential construction but also the pace of consumer spending. For example, some observers believe that consumer spending has been bolstered by the withdrawal of equity from housing, and, of course, this source of funds would be smaller if the pace of appreciation abated. Furthermore, there is the so-called wealth effect on spending, because houses are such an important part of many people's portfolio of assets. With this asset appreciating more slowly, consumers are likely to pull back on spending.

Now let me fill in the highlights and shadows—some of the factors that could make economic activity either stronger or weaker going forward. First, house prices could surprise us in either direction. In other words, instead of the significant moderation I've built into my forecast, house price appreciation could either slow much more than I expect, or it could continue at its current pace. If it slows much faster—or, worse yet, reverses course—the impact could be very restrictive for both residential construction and consumer spending. Alternatively, house prices might go on climbing as fast as ever. If so, the continued stimulus to spending could keep economic activity growing at an unsustainable pace, creating inflationary risks.

So far, the early signs of cooling in U.S. housing markets are broadly consistent with the degree of moderation I've envisioned. Home sales, especially new home sales, are off their peaks, and mortgage refinancing is way down. Moreover, the available evidence suggests that the rate of increase of selling prices for new homes has slowed over the last several months. Looking ahead, the ratio of new houses for sale to those sold—a kind of inventory-to-sales ratio for homes—has risen rather sharply since the summer, suggesting that other signs of cooling in the housing market may become more evident.

Of course, housing markets are a big issue in the Bay Area, and we have seen the same kind of cooling as in the nation. The question of whether the housing stock here is overvalued and therefore particularly vulnerable to downside risk, however, is one I can't

answer with any certainty. I would note that there are some special things about the Bay Area on both sides of the question. For example, consider some tentative evidence on the side of greater vulnerability. First, average house prices in the Bay Area are now about six times what they were in 1982, versus only 3½ times in the U.S. as a whole. Moreover, the ratio of house prices to rental rates—a measure of the price of houses relative to the flow of housing services they provide—has more than doubled since 1982, far outstripping the national average.

But, even considering these features, there are well-known and unique features of this area that lend some justification to its high housing values. First, there is not much land available for new home building, so the supply of new homes is fairly limited. In addition, this area enjoys very favorable lifestyle amenities and it has a job base that attracts high-income residents.

Related to the house price story is another risk factor for the growth forecast, namely, the so-called “bond rate conundrum.” Essentially, long-term interest rates have been surprisingly—and inexplicably—low relative to the path of short-term rates expected by the markets. If the relationship were to return swiftly to something closer to the historical norm—that is, if long-term rates were to rise suddenly—economic growth might slow more than my forecast suggests.

In fact, so far this year, bond rates have climbed some, although even now they are only modestly higher than when the Fed began raising the federal funds rate, back in June 2004. Does this rise in long-term rates pose a downside risk to growth? Frankly, I think it’s too soon to tell, but I’ll give you a flavor of the views pro and con. On the “pro” side, the rebound in longer-term rates may partly reflect an unwinding of the conundrum due to an increase in the “term premium” toward more normal levels. It might also reflect a strengthening of economies abroad: specifically, greater spending on goods and services in Europe and especially Japan may be absorbing more of the supply of worldwide savings and driving up bond rates in the U.S. and everywhere else. On the “con” side, the rise in U.S. bond rates might itself reflect expectations of even stronger growth in the U.S. While we don’t have an answer yet, I hope this discussion at least conveys a sense of why developments relating to the yield curve will definitely be on my radar screen.

The final factor that could alter the forecast for economic growth—one that I will return to when I discuss inflation—is energy prices. So far, at least, the near doubling of energy prices has not been reflected in slower consumer spending—possibly

because of a stimulatory offset from rising house prices. My assumption, based on the forecasts embodied in futures markets, is that energy prices will stabilize around their current levels. If so, the negative effect on spending should dissipate over 2006, and, as it does, this would actually contribute to higher overall economic growth. Of course, predicting energy prices is an exercise fraught with uncertainty, and any sustained rise or fall in these prices could either depress or spur economic activity beyond my current expectations.

Now to the next part of the picture—labor markets and resource utilization. My broadbrush view is that the economy is now operating in the vicinity of “full employment.” Looking ahead, if the growth rate of economic activity returns to its trend, as seems likely, then labor markets are likely to remain at this level.

This brings me to the inflation part of the picture itself. Over the past twelve months through February, inflation, as measured by the core personal consumption expenditures or PCE price index—is up 1.8%. This measure, which FOMC participants forecast semiannually for Congress, is an index of consumer prices that excludes the volatile food and energy component. This rate is in my “comfort zone”—a range between 1 and 2%. I consider core PCE inflation in this range an appropriate long-run inflation objective for the Fed.

What are the prospects for inflation over the next year or two? When I look at all of the elements that influence inflation, it seems that the most likely outcome over the next year or so is that inflation will remain contained, although there are risks, and I think they are tilted slightly to the upside. First, there is the possibility that inflation could intensify if labor and product markets continue to tighten. Next, there are risks relating to energy and commodity prices. Apparently, we haven’t had much in the way of pass-through from past increases in energy and commodity prices to core inflation yet, but I wouldn’t be surprised if some modest amount were evident in the next couple of quarters. Assuming, however, that energy and commodity prices level out, and, importantly, that longer-term inflation expectations remain stable, I would expect any pass-through of earlier increases to boost core inflation only temporarily. We learned from history that inflation expectations that are well-anchored to price stability are critical to maintaining low inflation. And, indeed, research suggests that they are well-anchored, because people are confident that the Fed will act to limit any sustained rise in inflation. In the current setting, this result shows up in the stability of our measures of core inflation as well as various survey and market measures of inflation expectations.

In concluding my remarks, I want to step back from the easel, where I've been painting this picture of the economy, so that I can take it in as a whole, the way a monetary policymaker should. What I see is essentially pretty positive. The economy appears to be approaching a highly desirable trajectory. First, real GDP growth currently appears to be quite strong, but there is good reason to expect it to slow to around its potential rate as the year progresses. If it does, the degree of slack should remain within range of full employment and have little effect on inflation going forward. Although inflation is in the upper portion of my comfort zone, it appears to be well contained at present, and my best guess for the future is that it will remain well contained.

Moreover, this desirable trajectory appears to be within reach at a time when the Fed's key policy interest rate—the federal funds rate—is close to a neutral stance, one that neither stimulates the economy nor restrains it. Before I seem to make this picture too rosy-looking, I want to remind you that there are a lot of uncertainties on both the upside and the downside—those highlights and shadows I've discussed. And any of them could certainly be disruptive, especially if the Fed does not react quickly and appropriately.

So, the key question for policy is: What interest rate path will help the economy achieve the desirable trajectory? As you know, the Fed has raised the federal funds rate by 25 basis points at each of the last 15 FOMC meetings for a total increase of 375 basis points and indicated that further policy firming may be needed. Until recently, the funds rate was low enough that it seemed rather clear that this path of gradually removing accommodation had some way to go.

However, enough has been done by now that I view decisions about the path of policy going forward as quite data-dependent. This phrase—"policy will be data-dependent"—is all the rage right now in policy circles, but I think it's worth a moment to clarify what I mean when I use it. To me, it means that we should interpret the implications of incoming data for

our forecast and evaluate whether resulting changes in the forecast call for a change in the policy path.

For example, as I mentioned, there is little evidence thus far of pass-through into core inflation of previous hikes in energy and commodity prices. But I would not be surprised to see some modest transitory pass-through over the next few quarters. I would, however, be surprised to see evidence suggesting that labor markets had tightened enough to boost inflationary pressure. I also expect longer-term inflation expectations to remain well contained.

Similarly, I expect first quarter real GDP growth to be quite strong, and I've already factored that into my views. The accumulation of more and more monthly data supporting that expectation does not necessarily alter my views on policy. I will, of course, be quite alert to any signs that the hot pace of growth may not slow after the first quarter. That would constitute a surprise.

But, by the same token, I am increasingly concerned about the well-known long and variable lags in monetary policy—specifically, that the delayed effects of our past policy actions might impact spending with greater force than expected. This could show up especially in the housing market and via housing prices and balance sheet effects on consumer spending. While I expect the housing sector to slow somewhat, I will be highly alert to the possibility of the policy tightening going too far. So, I'm watching the data for confirmation of my forecast and for surprises that would make me alter my forecast. It's not really data-dependence, but more accurately, data-surprise dependence.

In summary, I would not want to prejudge future decisions to raise rates—or to hold them steady—but rather I will be highly sensitive to the implications of incoming data for the forecast for economic growth, employment, and inflation.

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