

THE US ECONOMIC OUTLOOK

Inflation: how serious a problem?

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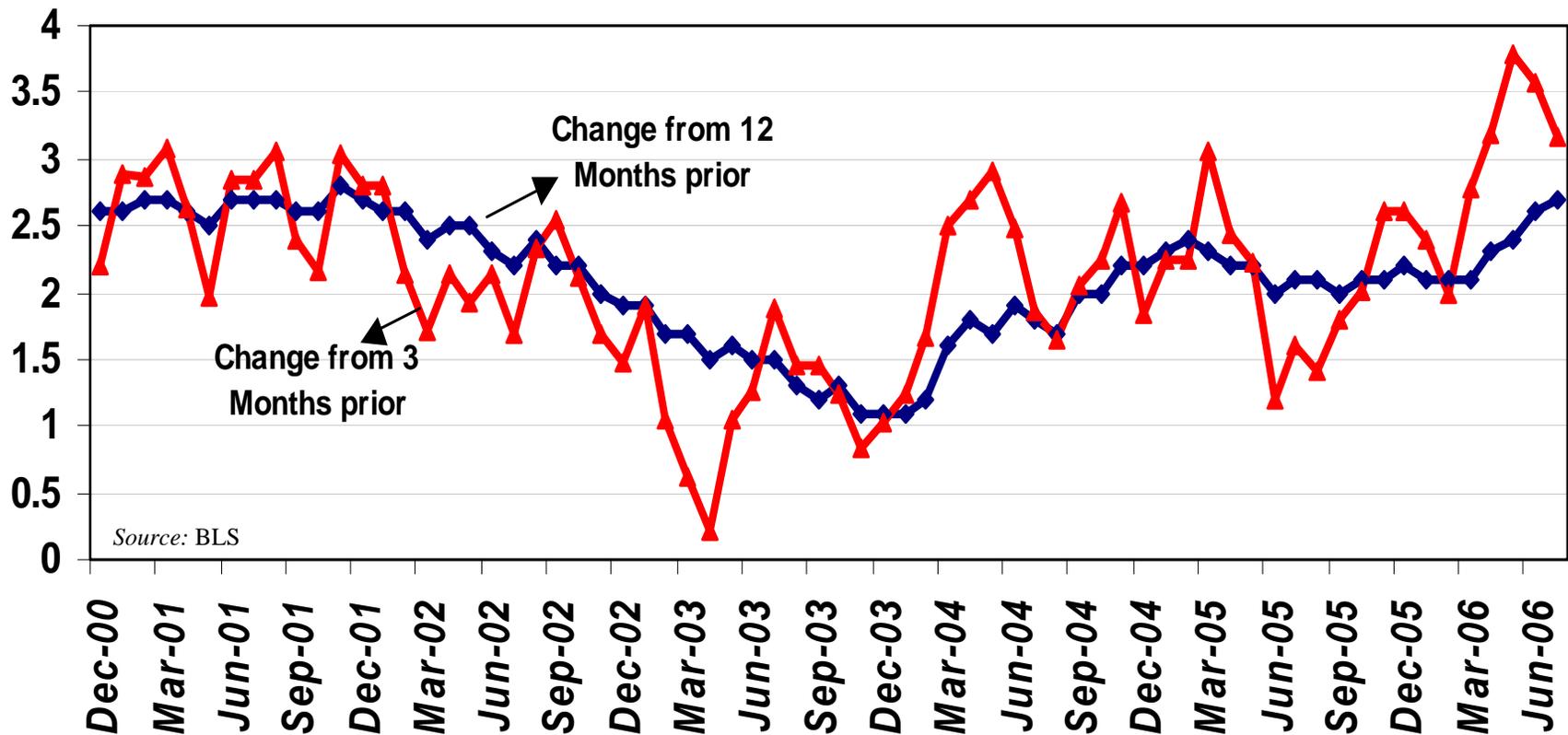
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Core inflation has been rising.

Core Consumer Price Index (CPI) percent change at an annual rate

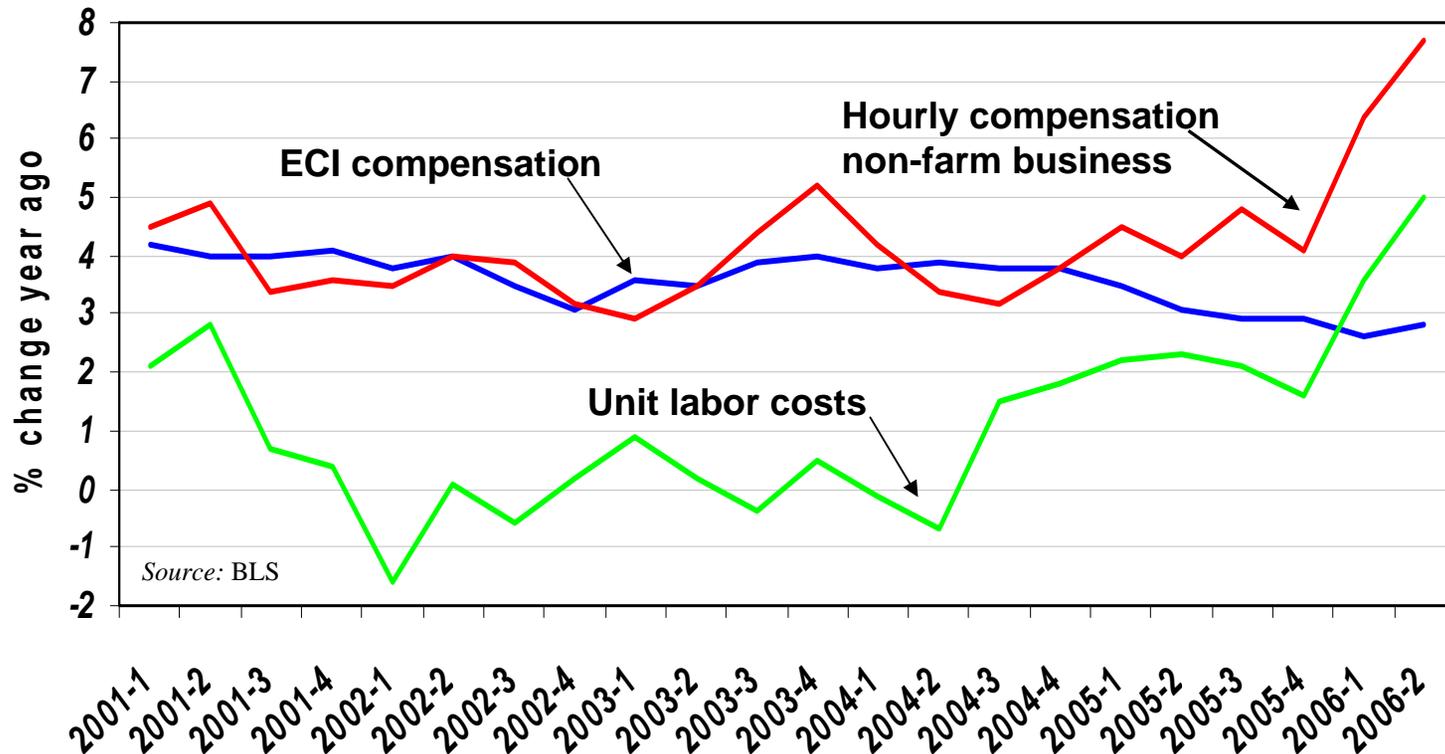


Why has core inflation been rising?

- Unit labor costs are rising.
- Rental costs are catching up to house prices.
- There is no more slack in the economy.
- Energy costs are pushing up core inflation.

Unit labor costs are rising, mixed picture on compensation per hour

Hourly compensation non-farm business, employment cost index (ECI) compensation, and unit labor costs



With trend productivity growth at 2.5 percent, compensation per hour growth must be below 4.5 percent to keep unit labor cost growth below two percent.

Rising rents have added to core inflation in 2006.

From December 2005–July 2006 (at an annual rate):

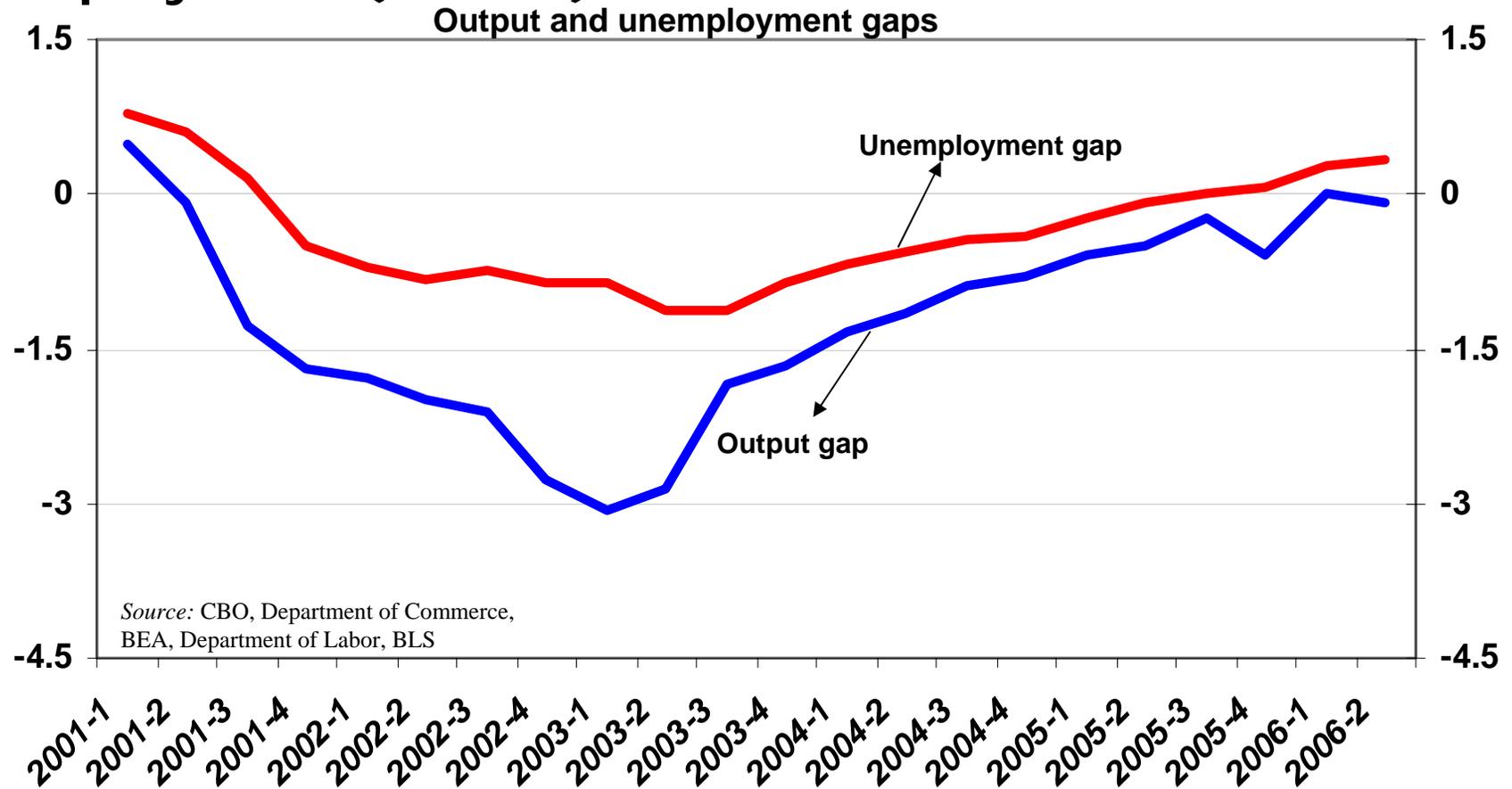
- Owners' equivalent rent rose 4.7 percent.
- Rent of primary residence rose 3.9 percent.
- These two factors made up nearly 50 percent of core inflation for 2006.

Will they rise further?

	Increase in Price Index	
	1996Q2–2001Q2	2001Q2–2006Q2
House prices	31 percent	57 percent
Owners' equiv. rent	16 percent	16 percent
Rent of prim. res.	18 percent	18 percent

A price gap has opened. Rents will likely rise further. House prices may fall.

No more slack: GDP is close to potential, unemployment is below the non-accelerating-inflation rate of unemployment (NAIRU)



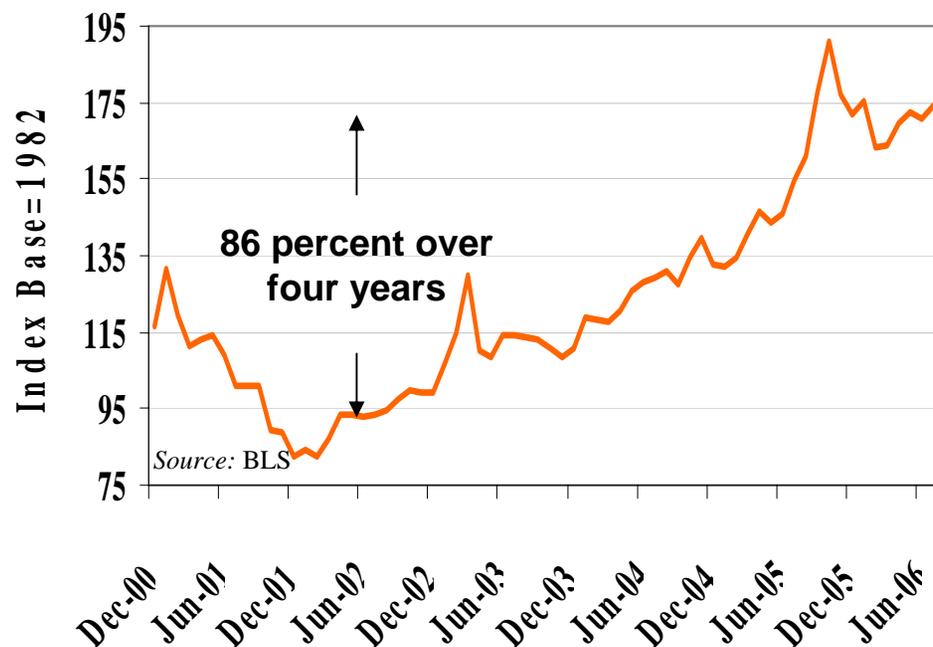
Output gap = Actual GDP minus estimated potential GDP

Unemployment gap = five percent minus the unemployment rate

Five percent is the unemployment rate consistent with stable inflation (NAIRU).

Rising energy costs have increased business costs.

Producer price index (PPI) for fuel and power



- Core inflation takes out the direct effect of energy but not the impact on business costs.
- Energy was about 2.5 percent of 2002 costs. Energy price increase has added 2+ percent to costs (86×0.025) or about 0.5 percent per year.
- Lags are uncertain, effect could be 0.7 percent this year.
- CBO says energy is adding 0.5 percent per year to core inflation. Regression analysis suggest 0.6 percent.

Energy is adding 0.5-0.7 percent to core inflation.

Should the FED look at overall inflation or core inflation?

- The European Central Bank and the Bank of England look at overall inflation, which matters to consumers. Energy prices have been on an upward trend, rather than moving up and down. Core inflation, they argue, does not predict overall inflation.
- The argument for targeting core inflation:
 - energy prices are not driven primarily by US demand.
 - why adjust to a rise in the relative price of energy by forcing all other prices down?
 - energy prices may fall again--to \$50 if not to \$20.
- Best to look at a variety of data in setting policy. For any given value of core inflation, higher overall inflation strengthens the case for monetary tightening.

- The dollar is falling—needs to fall 20 percent to restore sustainable trade balance.
- There is uncertainty about the inflation impact; Bergsten suggests a dollar crash could add two percent to the inflation rate. Kohn suggests the dollar is not a major inflation risk.
- Traditional rule of thumb: a ten percent depreciation adds 0.5 percent to CPI after one year, 0.7 percent after three years (direct effect without expectation or wage-price feedback effects). Thus, dollar adjustment would be expected to add 1 to 1.5 percent to the price level over the next few years (about 0.3 percent a year for three years), more if it feeds into expectations.

What would be needed to slow inflation with slack in the economy?

- The output gap is the difference between the level of GDP and of potential GDP and is a measure of slack in the economy. Such slack will lower core inflation (absent other inflation shocks).
- To reduce core inflation by 0.5 percent with demand restraint, there would need to be 1.5–2 point-years of output gap (for example, GDP could be one percent below potential for 1.5–2 years).*
- If the output gap is zero today and potential growth is three percent, then this could be achieved by 5–7 quarters of growth averaging two percent, followed by a year of growth at four percent.

* Based on estimates by Robert Gordon and Steven Braun

The soft landing scenario:

- 2.25 percent growth in the second half of 2006, two percent in the first half of 2007, 2.5–3 percent range resumption of growth in the second half of 2007.
- Core inflation is close to three percent this year, but energy prices fell, and the dollar declined slowly. Growth below potential keeps wage inflation restrained, and core CPI inflation eases to 2.25 percent.
- The Fed lowers rates in 2007, and trend growth resumes in the latter part of the year.

The stagflation scenario:

- Energy prices stay high or go higher. A faster dollar decline and rising labor costs add to inflation pressure (the positive effects of a dollar decline on growth come very slowly).
- There is a recession (comparable in depth to 2001), bringing core inflation back to the two percent range—the recession comes either from more rate hikes or from housing (or both).

What are the probabilities?

- 40 percent probability of recession or near recession