Survey of the Global Economic Outlook
at the Meeting of CEMLA and the ECB

Vincent Reinhart
Division of Monetary Affairs
Board of Governors of the Federal Reserve System

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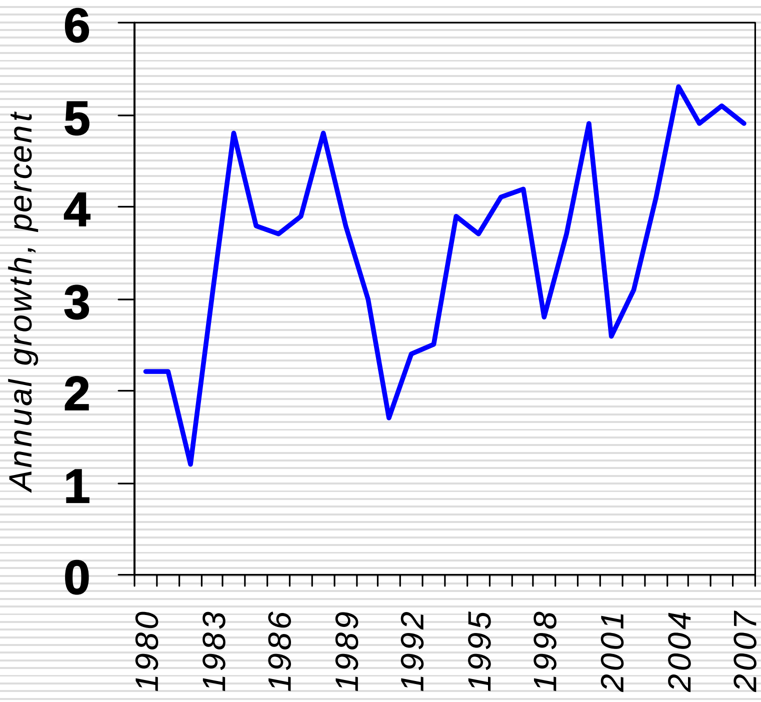
My plan

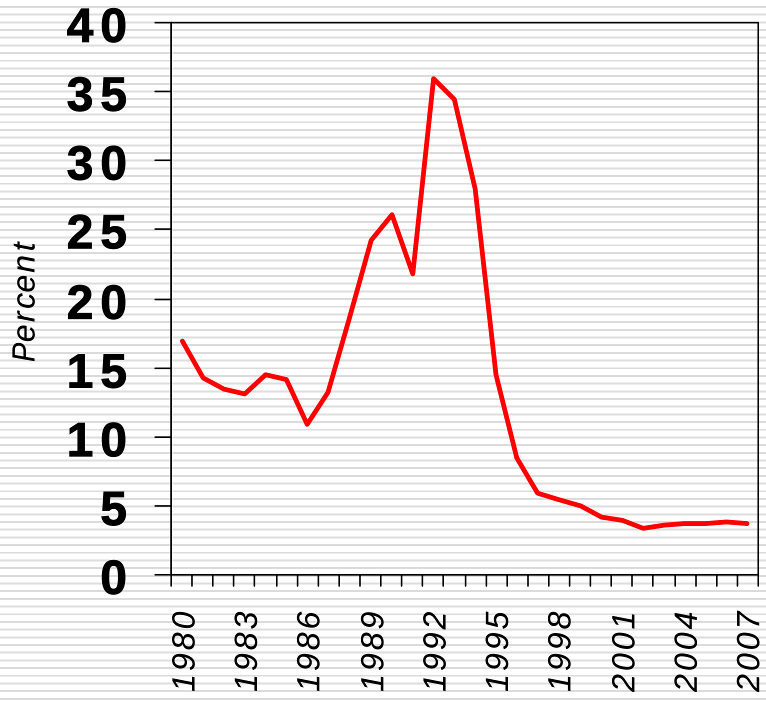
- Survey developments
  - Global economy generally
  - U.S. economy more specifically
  - With special emphasis on the risks to the outlook
- Use the IMF's World Economic Outlook (9/06) as a starting point
  - Carefully made to be internally consistent
  - Someone else's responsibility
- Remind everyone that the views expressed are my own

The global economic outlook appears favorable …

World Real GDP



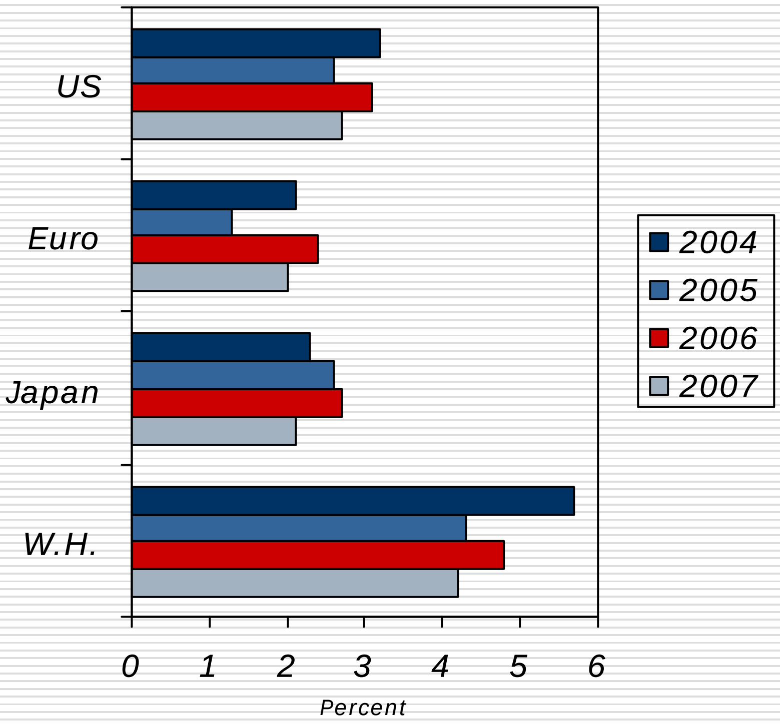
World CPI Inflation



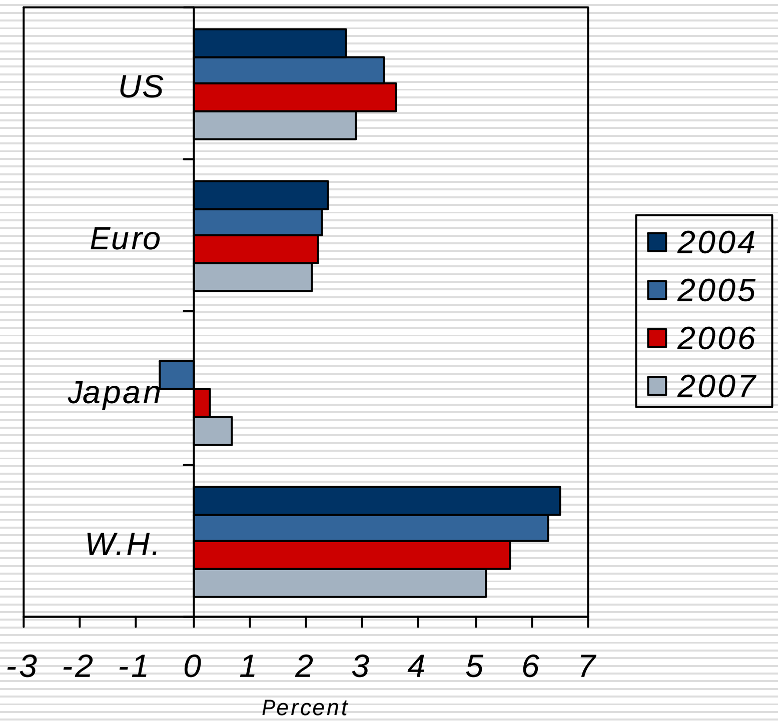
Source: IMF, WEO (9/06)

Economic expansion seems solid across the globe and inflation mostly declining …

Real GDP growth

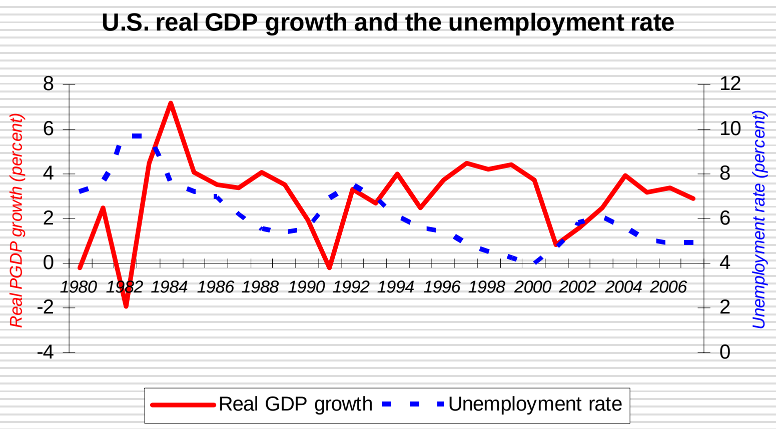


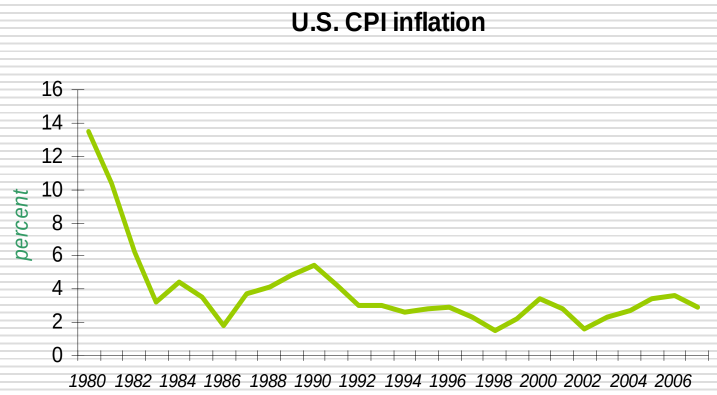
Consumer price inflation



Source: IMF, WEO (9/06)

The outlook for the United States is relatively benign. In this soft landing, …

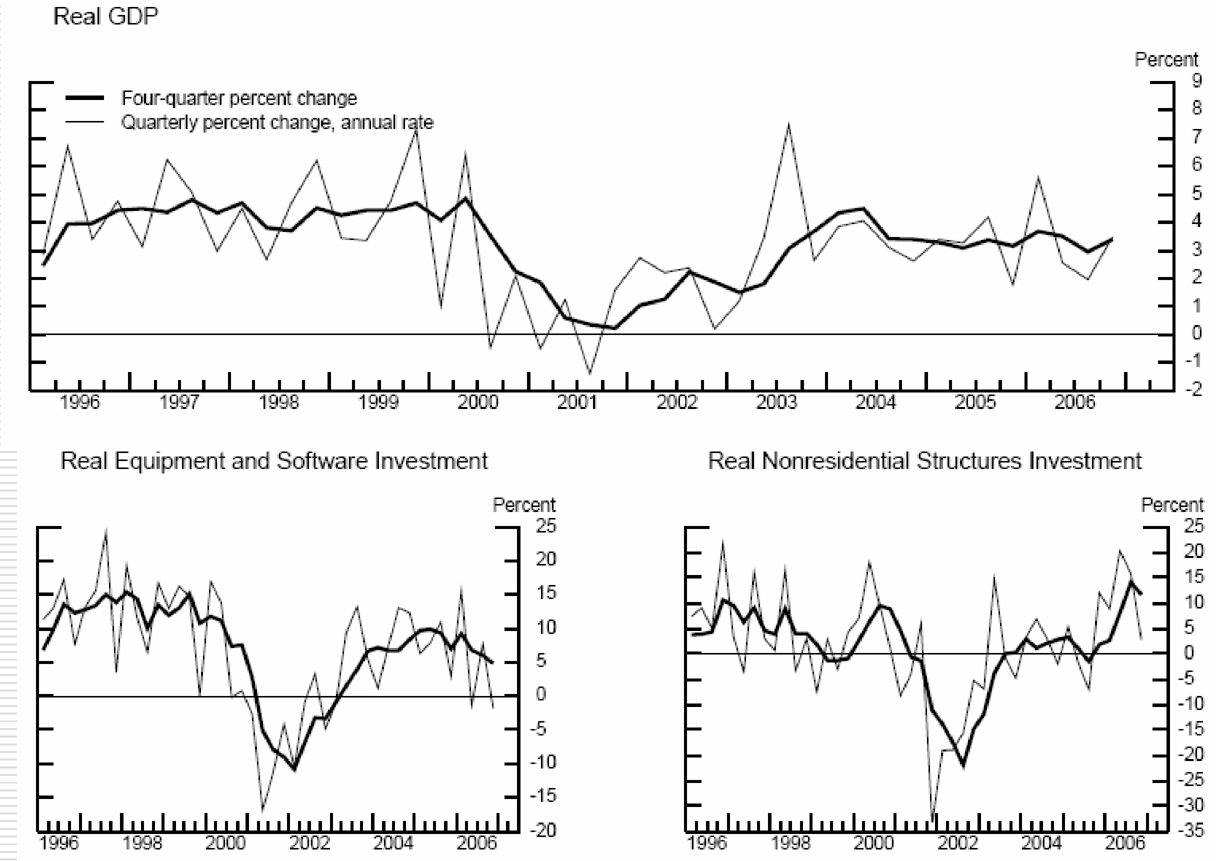




- Real GDP expands at just under 3 percent
- Keeping resources about fully used
- While CPI inflation falls back below 3 percent
  - As the prior run-up in energy prices works through the system

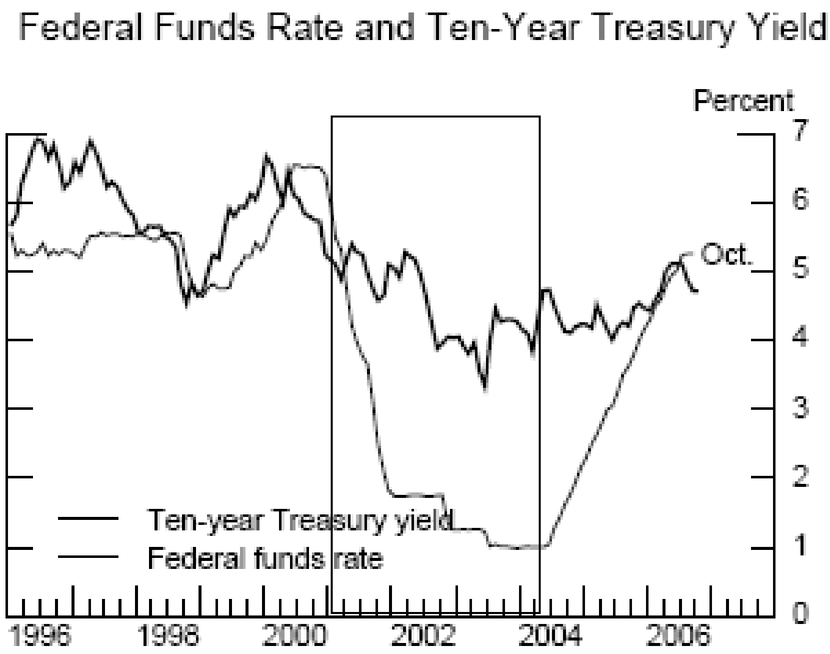
Source: IMF, WEO (9/06)

Some important background …



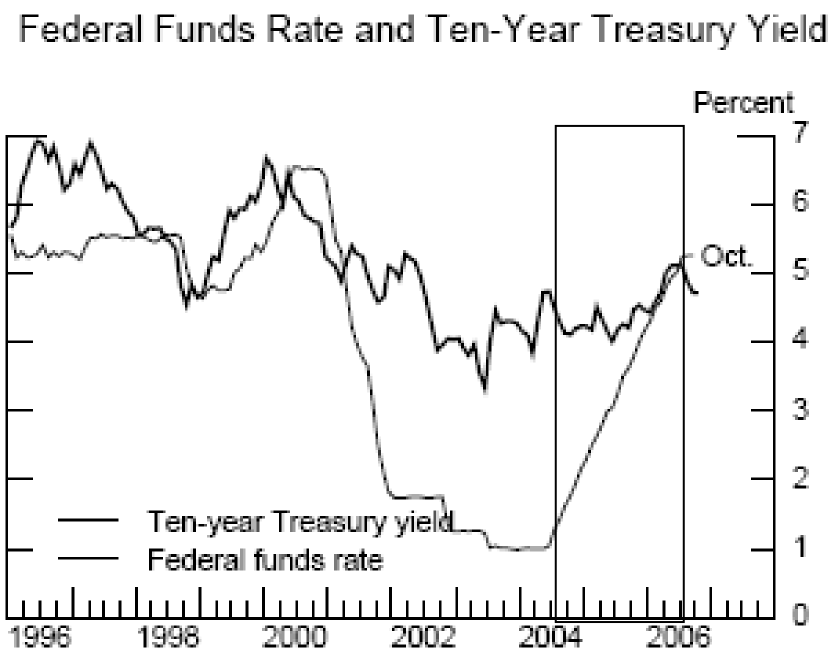
- The recession of 2001 owed importantly to a retrenchment in investment
  - As businesses worked to correct an overhang of capital
  - Household spending remained well maintained

The easing episode ...



- Was aggressive by historical standards
- Brought the nominal federal funds rate to 1 percent
- Where it was held for about one year
- FOMC communication increasingly provided reassurance about the expected future path of policy

As resource slack eased and pressures on inflation emerged, the FOMC embarked on a tightening episode. That tightening episode was ...



- Well-telegraphed
  - In that investors anticipated about 3-1/2 percentage points of firming in advance of action
- Gradual, with 17 quarter-percentage-point firmings
- First included guidance about interest rates and later emphasized risks to the outlook

The last tightening was in June, when the FOMC had a forecast that...

Economic projections for 2006 and 2007

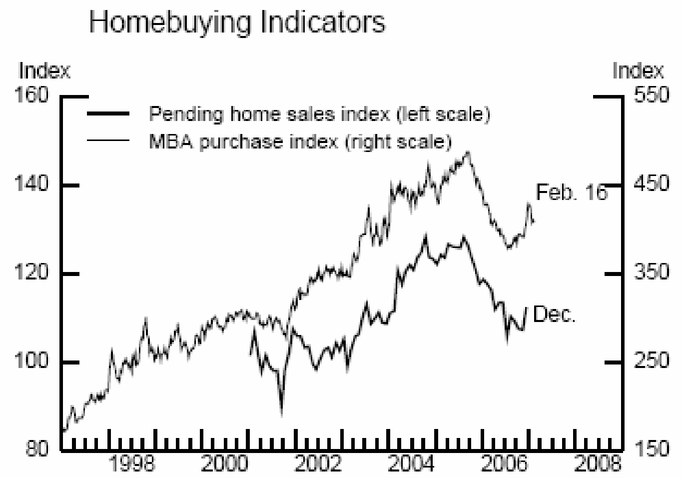
Percent

Indicator	Federal Reserve Governors and Reserve Bank presidents: Range	Federal Reserve Governors and Reserve Bank presidents: Central tendency
	2006	
Change, fourth quarter to fourth quarter[1]		
Nominal GDP	5½–6½	6–6¼
Real GDP	3–3½	3¼–3½
PCE price index excluding food and energy	2¼–3	2¼–2½
Average level, fourth quarter		
Civilian unemployment rate	4½–5	4¾–5
	2007	
Change, fourth quarter to fourth quarter[1]		
Nominal GDP	4¾–6	5–5½
Real GDP	2½–3¼	3–3¼
PCE price index excluding food and energy	2–2½	2–2¼
Average level, fourth quarter		
Civilian unemployment rate	4½–5¼	4¾–5

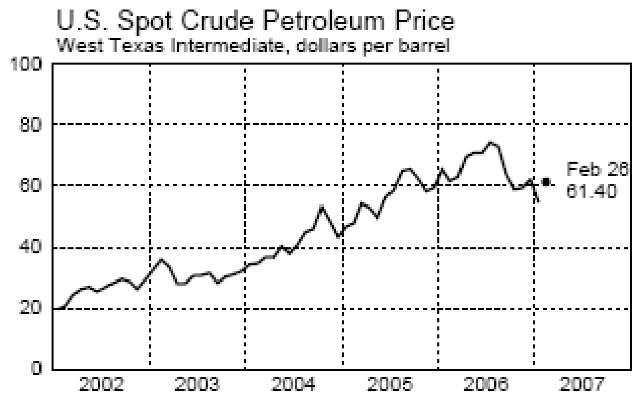
1. Change from average for fourth quarter of previous year to average for fourth quarter of year indicated.

- The growth of aggregate demand would slow some
  - As the housing market cooled
- Some modest resource slack would emerge over time
- With energy prices leveling out as anticipated in futures markets,
  - inflation would be headed downward.

Since then …



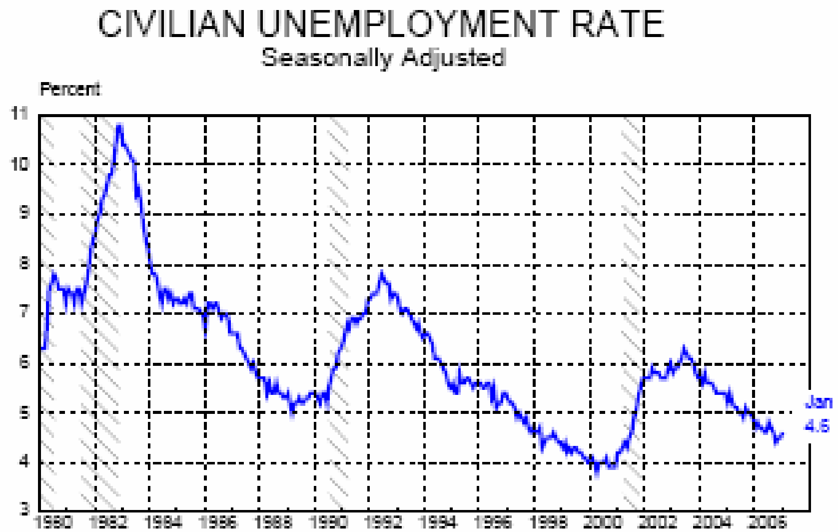
Housing activity has slowed sharply, but oil prices have moved lower on balance—providing offsetting stimulus to aggregate demand and a drag on headline inflation.



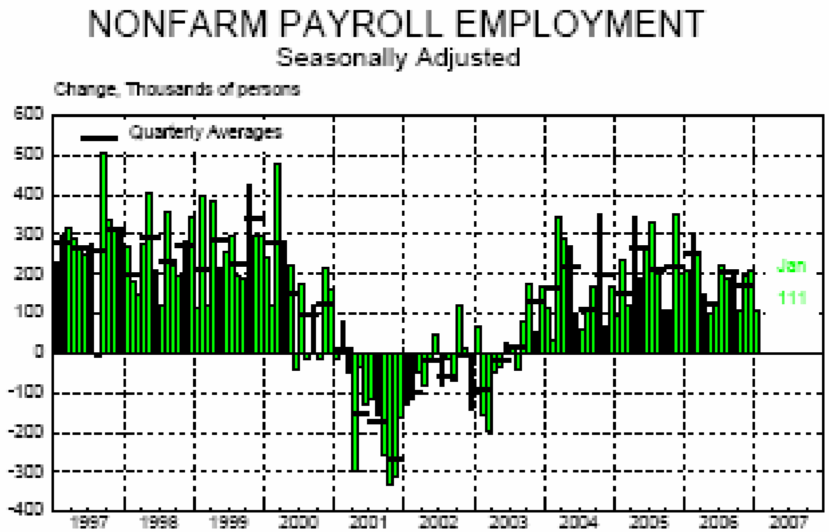
Governors and Reserve Bank presidents outlook for 2006 by forecast vintage

	as of Jun-06	Actual as of Jan-07
Change, fourth quarter to fourth quarter		
Real GDP	3-1/4 to 3-1/2	3.4
PCE price index excluding food and energy	2-1/4 to 2-1/2	2.3
Average level, fourth quarter		
Civilian unemployment rate	4-3/4 to 5	4.5

Employment gains have been more substantial and the labor market tightened more than expected . . .



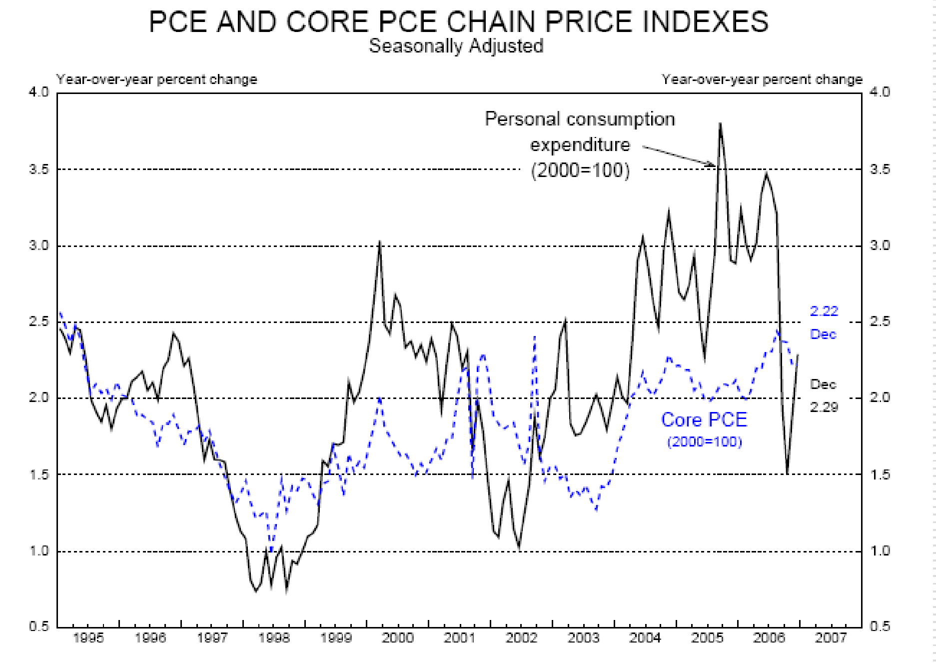
Note: Household data beginning January 1994 are based on a comprehensively redesigned survey and are not directly comparable with previously published estimates.



Source: Bureau of Labor Statistics.

This has led policymakers to question:

- The trend to productivity
  - since they've seen the expected growth in output with more-than-expected hours worked
- The natural rate of unemployment
  - Since inflation has behaved as expected at a lower unemployment rate



Governors and Reserve Bank presidents outlook for 2007 by forecast vintage

Percent

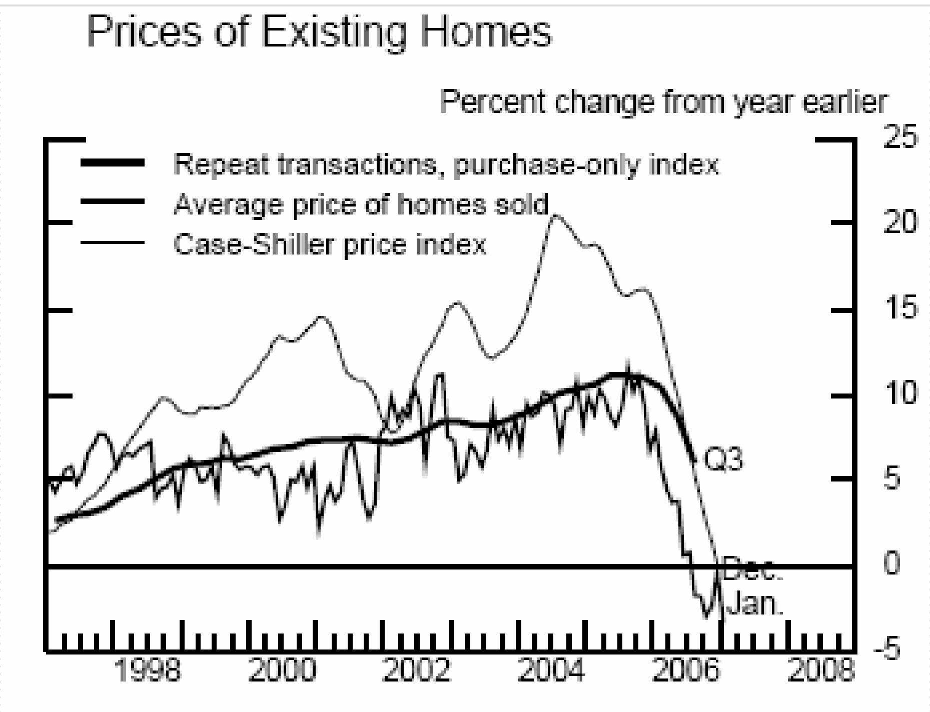
	as of Jun-06	as of Jan-07
Change, fourth quarter to fourth quarter		
Real GDP	3 to 3-1/4	2-1/2 to 3
PCE price index	2 to 2-1/4	2 to 2-1/4
excluding food and energy		
Average level, fourth quarter		
Civilian unemployment rate	4-3/4 to 5	4-1/2 to 4-3/4

Governors and Reserve Bank presidents outlook for 2008

Percent

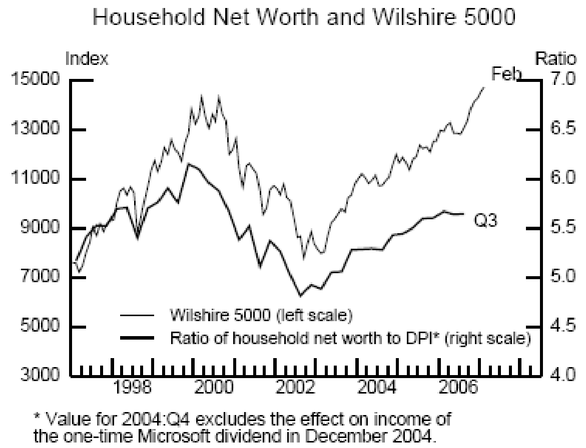
	Range	Central tendency
Change, fourth quarter to fourth quarter		
Real GDP	2-1/2 to 3-1/4	2-3/4 to 3
PCE price index	1-1/2 to 2-1/4	1-3/4 to 2
excluding food and energy		
Average level, fourth quarter		
Civilian unemployment rate	4-1/2 to 5	4-1/2 to 4-3/4

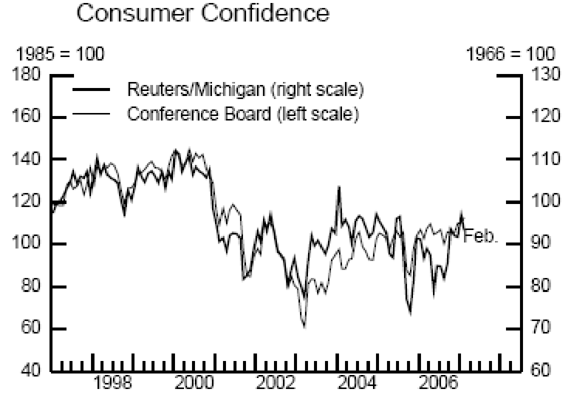
Did the FOMC stop too late?
Housing



- Perhaps,
  - "The sharp correction of a sectoral imbalance" seems reminiscent of the 2000-01 capital overhang experience
  - Residential construction activity has fallen off markedly
  - House prices have softened
- The contraction in housing could be considerable, or there could be spillovers to the behavior of households or intermediaries

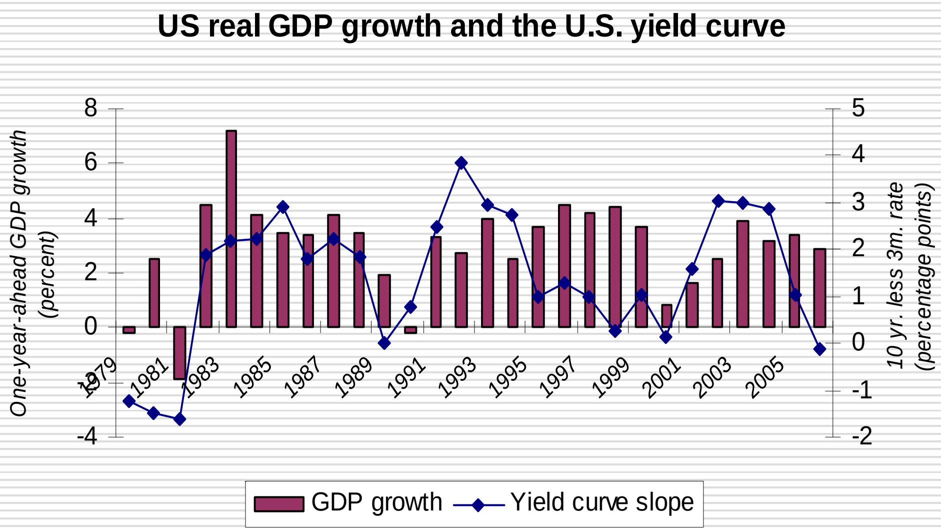
Did the FOMC stop too late? *Housing*





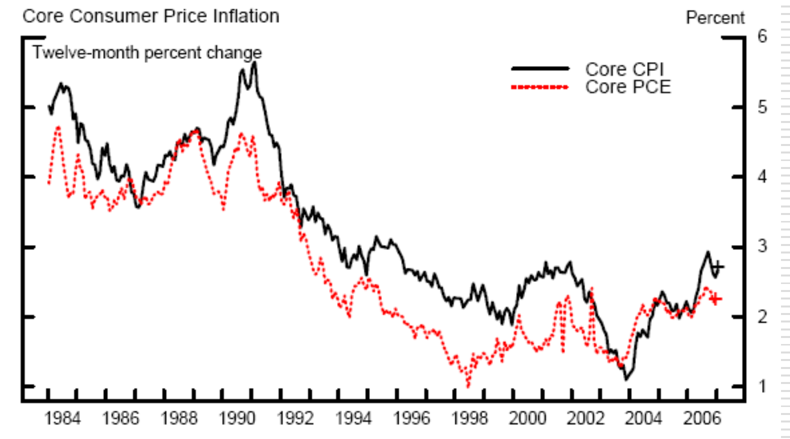
- Perhaps not,
  - Household income prospects seem well maintained and the unemployment rate low
  - Wealth continues to expand
  - Consumers seem confident
  - Financial intermediaries are diversified and well capitalized
  - Less of an international dimension to a housing correction than the capital-overhang experience
  - Nonresidential construction spending is brisk

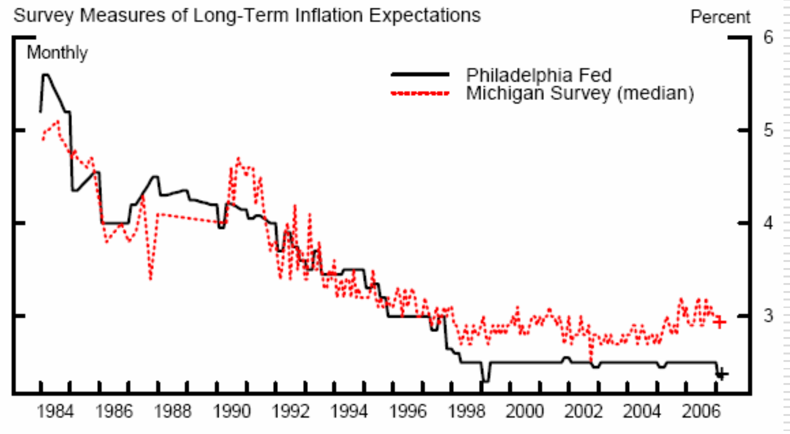
Did the FOMC stop too late? *The yield curve*



- Perhaps,
  - The term structure of Treasury yields is inverted
  - Historically, inversions of the yield curve have preceded slowdowns
    - As in 2001
- Perhaps not,
  - As the level of interest rates is lower than in prior inversions
  - Some of the flattening of the yield curve probably owes to lower term premiums, which wouldn't seem to have the same implications

Did the FOMC stop too soon?
Inflation

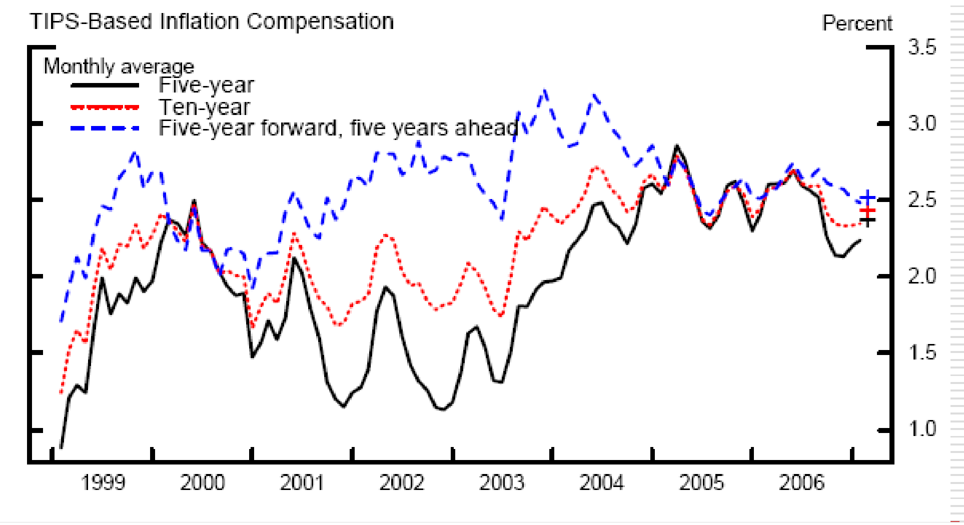




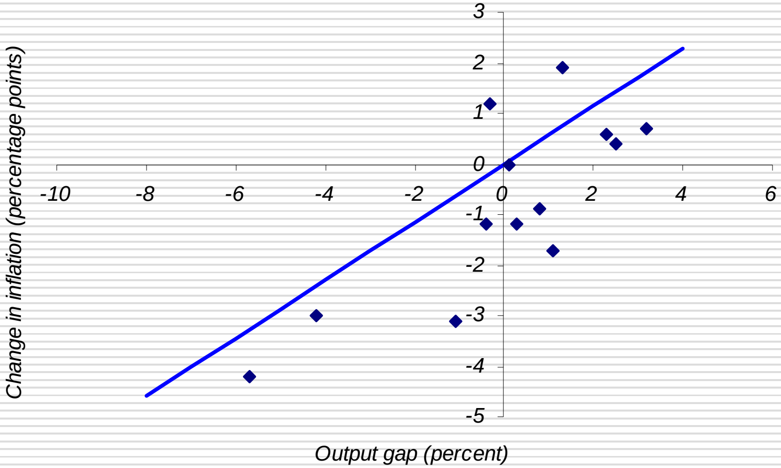
- Perhaps,
  - Core inflation has picked up over the course of the year
  - And remains above what some FOMC members refer to as their “comfort zone” of 1 to 2 percent
    - So even if potential outcomes are symmetric, policy makers may way upside shocks as more serious
  - Some measures of longer-term inflation expectations have risen

Did the FOMC stop too soon? *Inflation*

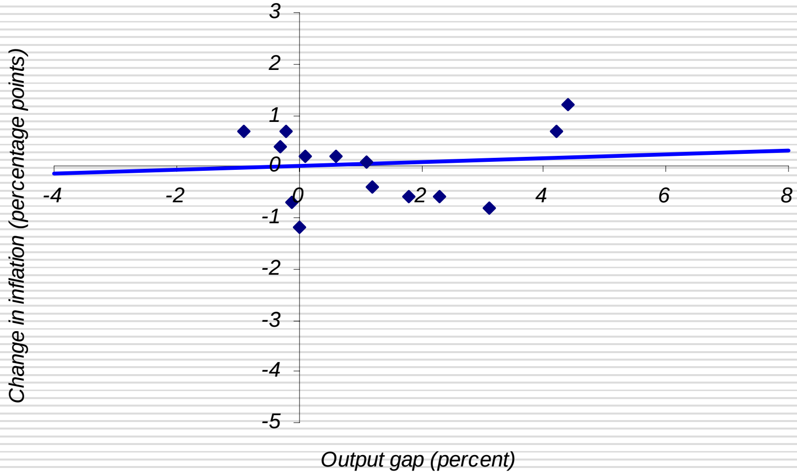
- Perhaps not,
  - Because market-based measures of inflation compensation have been better behaved
  - And key relationships determining inflation have shifted over time …



(1) The Phillips curve seems to be flatter,



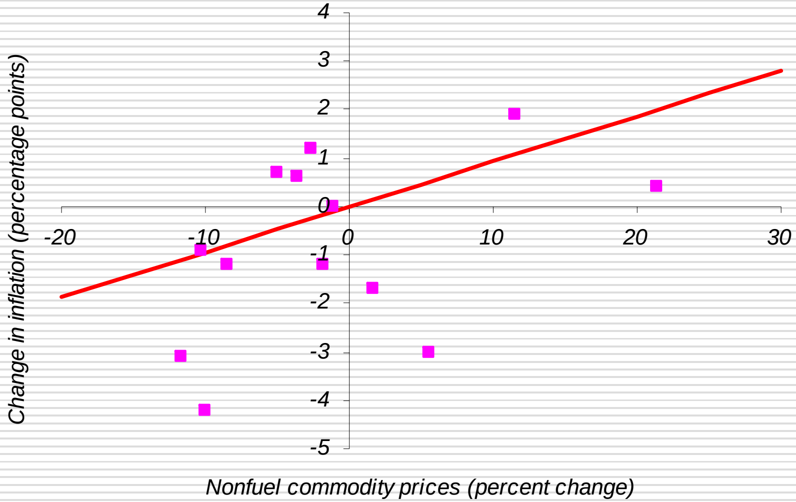
1981 to 1993



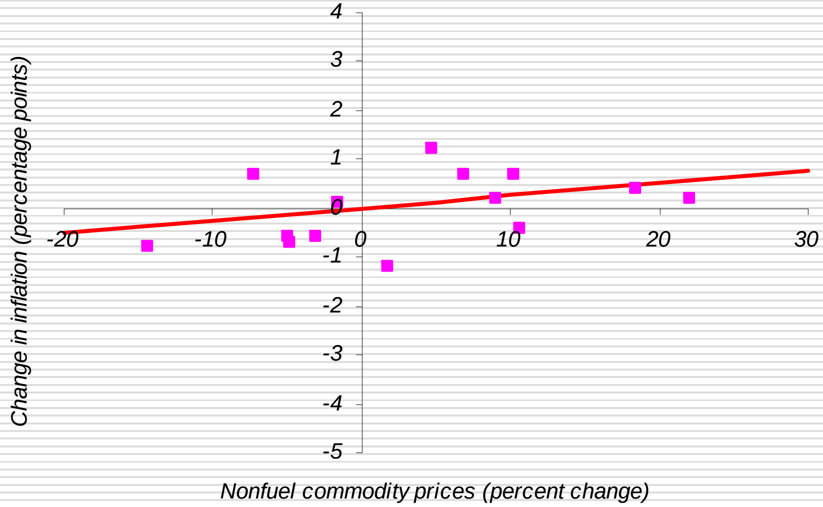
1994 to 2007

Source: IMF, WEO (9/06)

(2) The pass-through of commodity prices to inflation seems to be smaller,



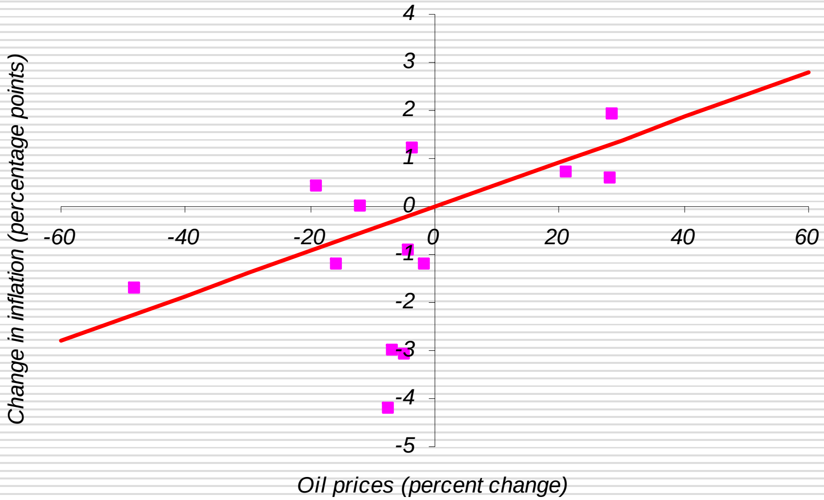
1981 to 1993

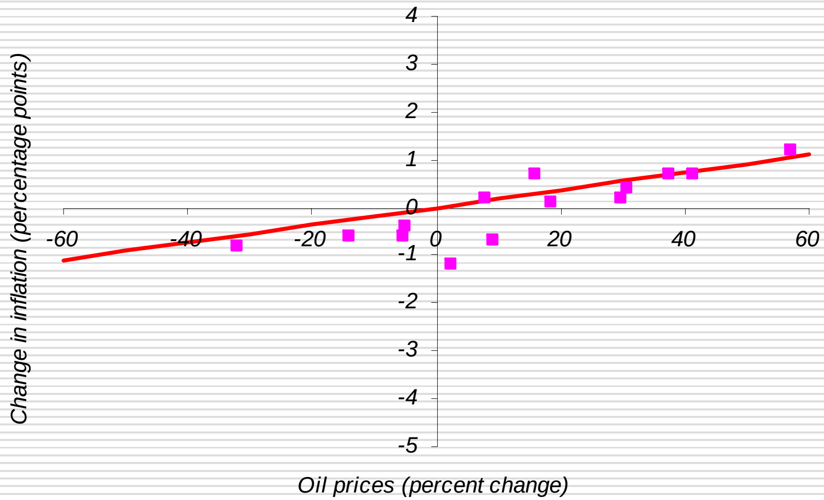


1994 to 2007

Source: IMF, WEO (9/06)

(3) And the pass-through of energy prices to inflation has also fallen.



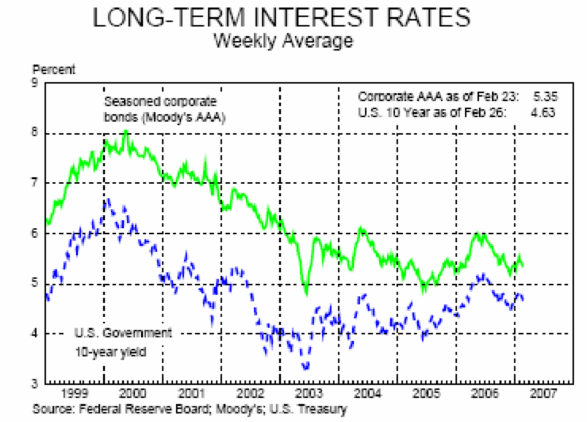


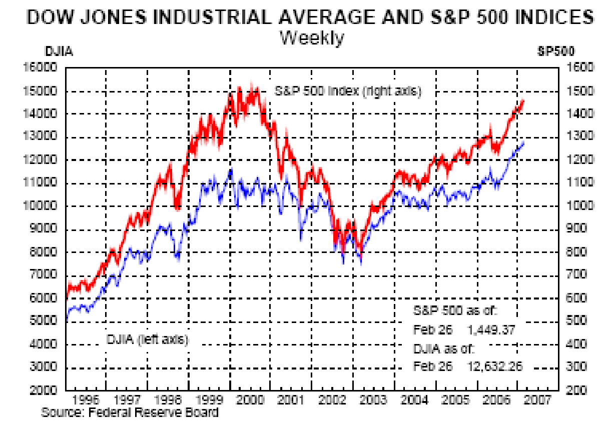
1981 to 1993

1994 to 2007

Source: IMF, WEO (9/06)

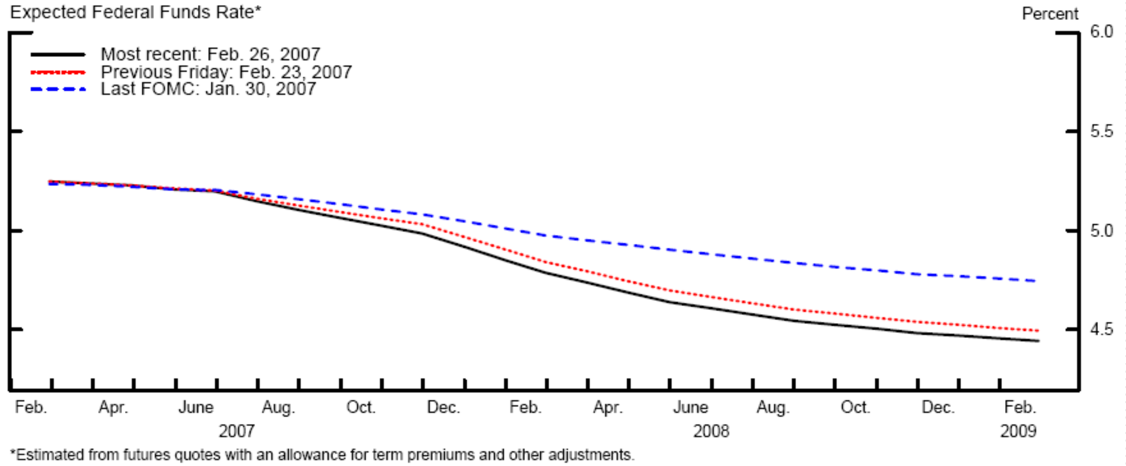
Did the FOMC stop too soon?
Financial market conditions

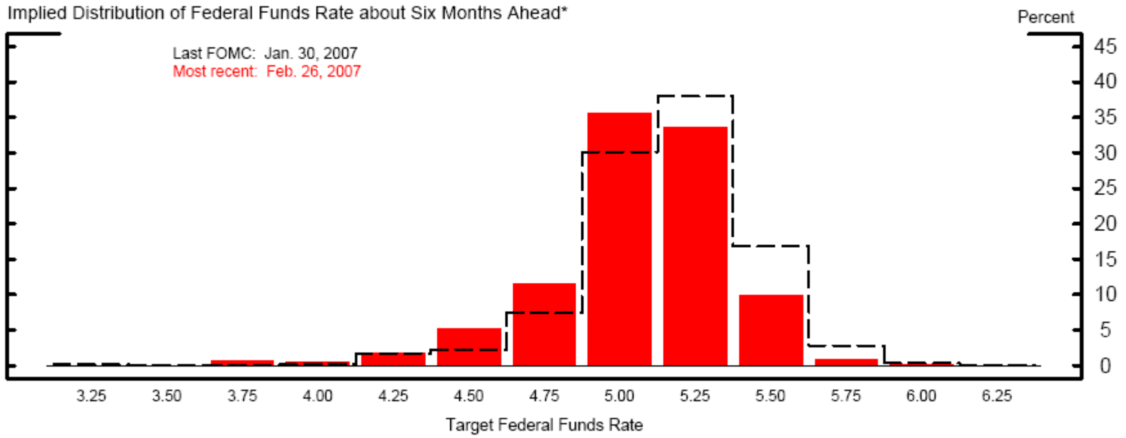




- Perhaps,
  - Since the onset of tightening
    - Long-term yields are unchanged to lower on net
    - Equity prices have risen
- Perhaps not,
  - Term premiums seem to be lower
  - Firms are liquid and balance sheets healthy
  - Financial conditions have adjusted in response to changes in the outlook
    - In that equilibrium real rates may be lower

What is more difficult to understand ...



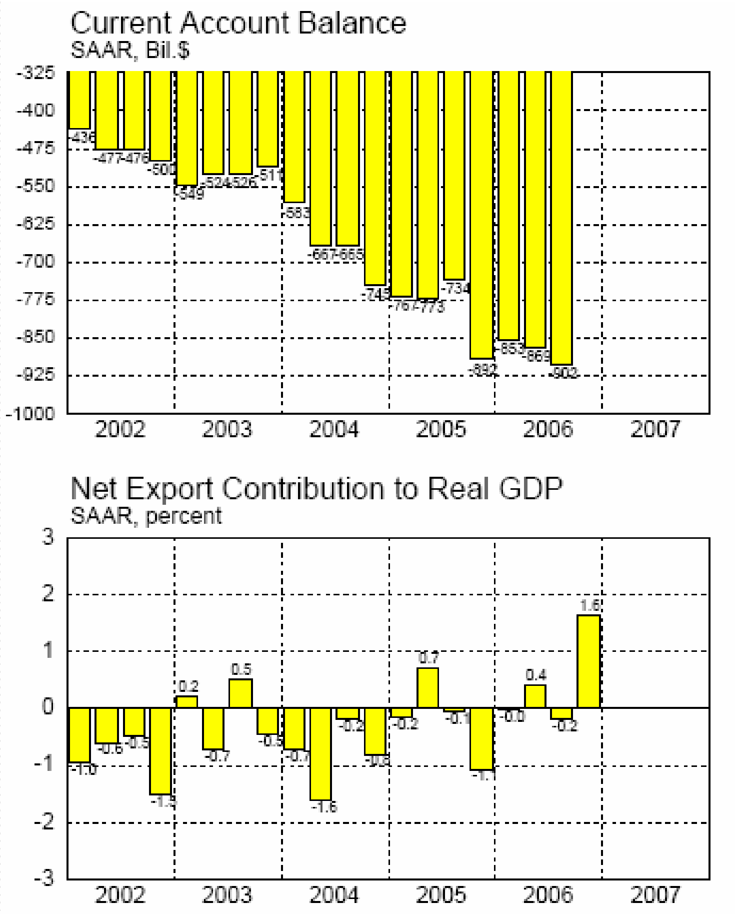


is the widespread expectation of policy ease and the confidence associated with that forecast

From the FOMC's perspective ...

... the Committee judges that some inflation risks remain. The extent and timing of any additional firming that may be needed to address these risks will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

The other key risk that preoccupies analysts ...



- Is related to an imbalance of saving and investment
  - and creates uncertainty about the outlook
- But is not an objective of monetary policy