



Remarks to the Federal Reserve Bank of St. Louis
Professors Conference
March 1, 2007

An Update on the U.S. Economy

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Disclaimer



A Review of 2006

How Accurate Were Blue Chip Forecasters in 2006?

	2005 (A)	2006		Error
		Forecast	Actual	
→ Real Gross Domestic Product	3.1	3.2	3.1	-0.1 ←
Personal Consumption Expenditures	2.9	3.0	3.6	0.6
Durables	2.5	5.4	7.4	2.0
Nondurables	4.4	2.1	3.7	1.6
Services	2.3	3.0	2.8	-0.2
Nonresidential Fixed Investment	5.6	7.2	6.2	-1.0
Equipment & Software	7.0	7.5	4.4	-3.1
Structures	1.8	6.5	10.7	4.2
Residential	9.0	-4.4	-12.6	-8.2
CBI (billions, \$2000, annual avg.)	19.6	34.8	41.9	7.1
Net Exports (billions, \$2000, annual avg.)	-619.2	-639.9	-618.7	21.2
Exports	6.7	6.3	9.3	3.0
Imports	5.2	4.4	3.4	-1.0
Government Consumption & Gross Investment	1.2	3.2	2.6	-0.6
Real Personal Disposable Income	0.3	3.7	2.9	-0.8
Personal Saving Rate (% Annual Avg.)	-0.4	-0.3	-1.1	-0.8

NOTE: Unless otherwise noted, percent changes are fourth quarter-to-fourth quarter.
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Unit Labor Cost	1.6	2.2	2.8	0.6
Chain-Type GDP Price Index	3.1	2.3	2.5	0.2
Consumer Price Index	3.7	2.3	1.9	-0.4
Producer Price Index	5.2	1.4	0.2	-1.2
Employment, Civilian	1.9	1.3	2.1	0.8
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Themes in the Outlook

1. Resilience in the face of numerous economic challenges; transition from soft patch to trend growth.



The Resilient Economy

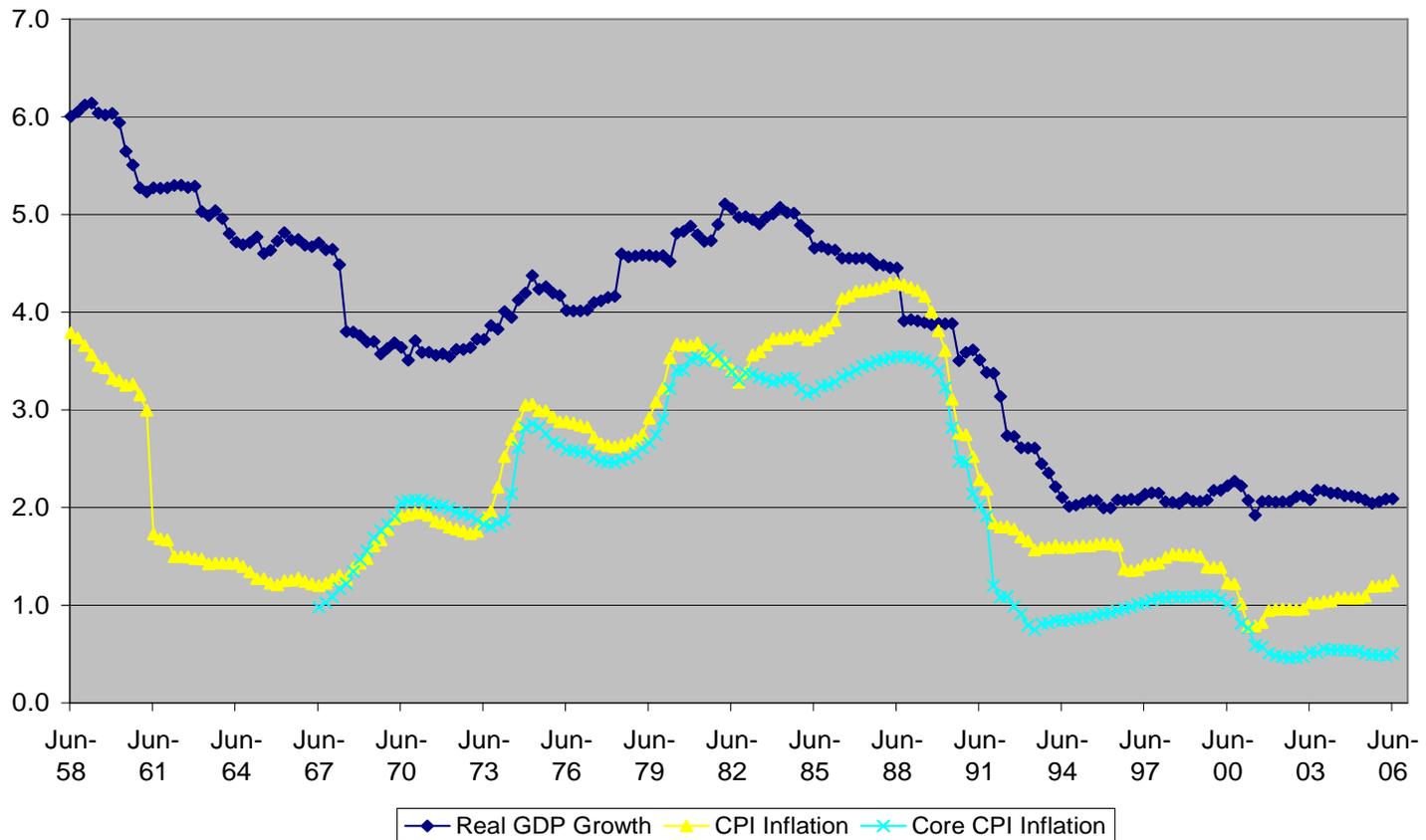
Significant economic shocks over the past few years:

- The stock market bust in 2000;
- Corporate governance issues;
- September 11, 2001;
- Military conflicts in Afghanistan and Iraq;
- Major hurricanes in 2004 (Ivan) and 2005 (Katrina);
- Housing (prices and quantities)



The Great Moderation

**Economic Volatilities:
Output Growth and Inflation**
Rolling 40-Quarter Standard Deviations





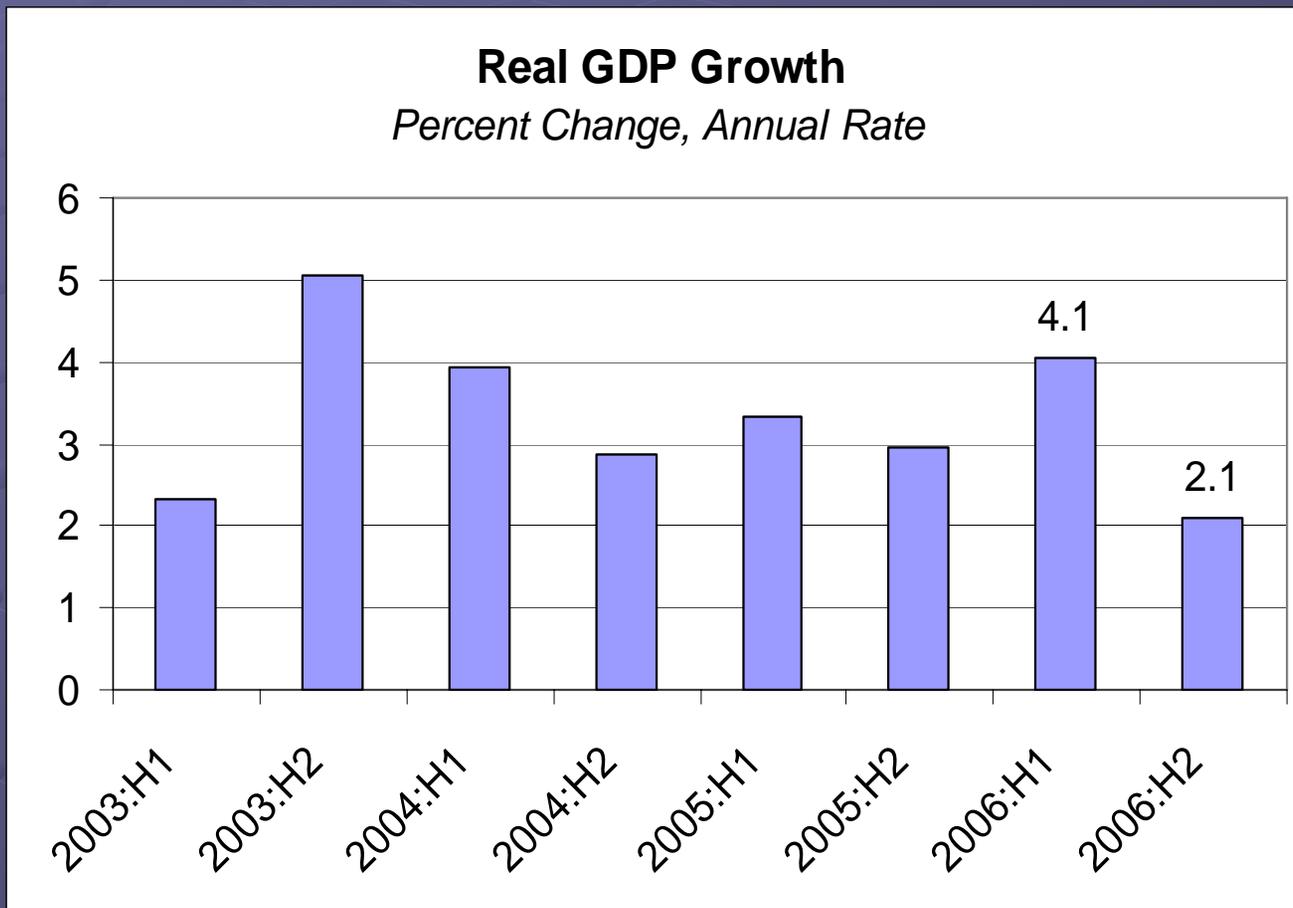
Themes in the Outlook

“I see an economy that appears to be transitioning quite nicely from last year’s slow patch to more sustainable growth.”

President Poole, 2-9-2007



Themes in the Outlook

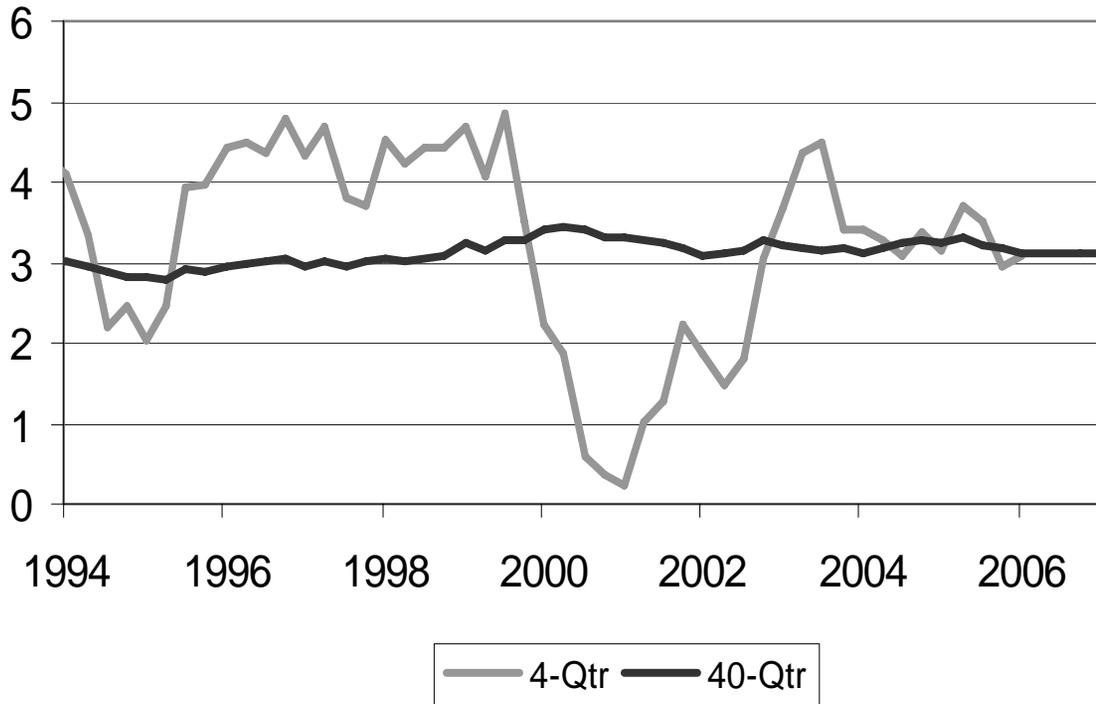




Themes in the Outlook

Growth of Real GDP

Percent



No signs of significant imbalances: Bouncing along around the economy's trend rate of growth.



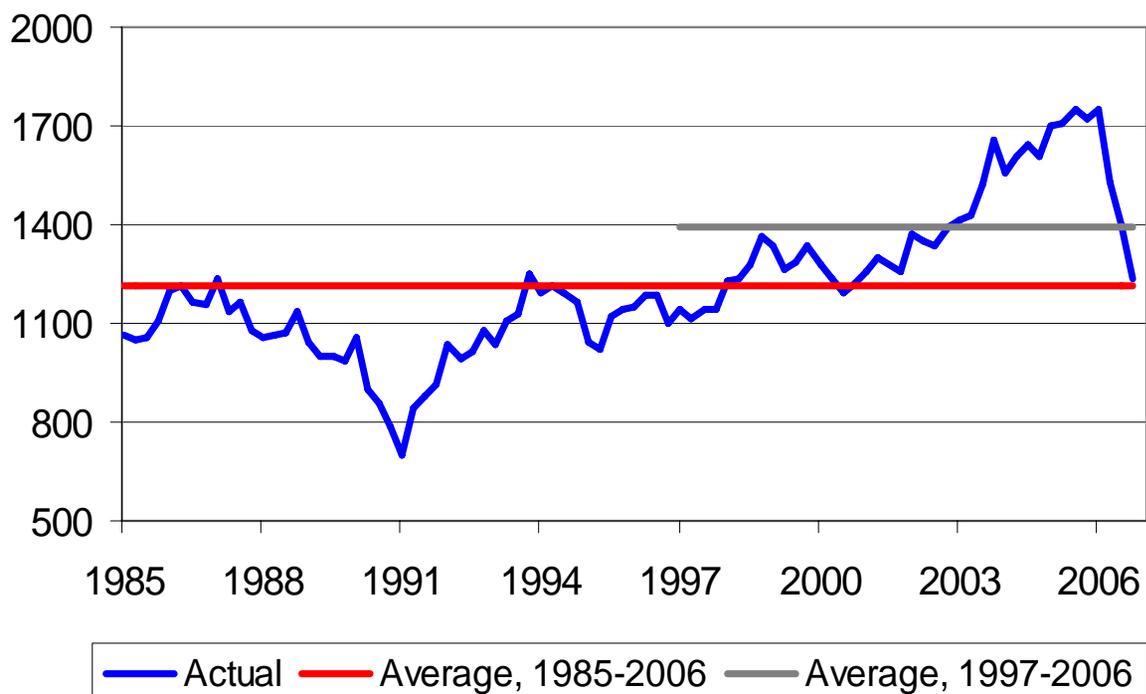
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2. Two economies: Housing and everything else.



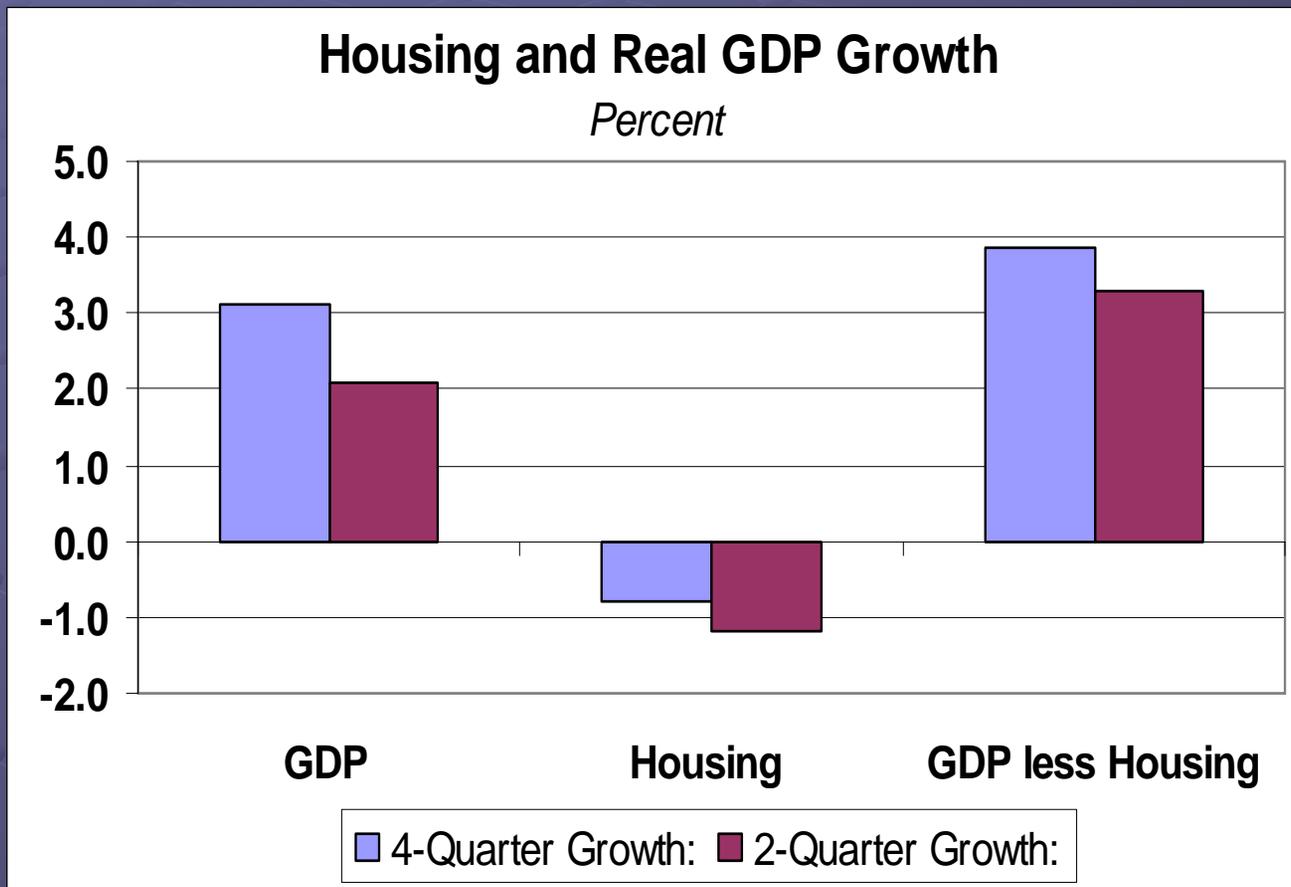
Themes in the Outlook

Single-Family Housing Starts





Themes in the Outlook





Themes in the Outlook

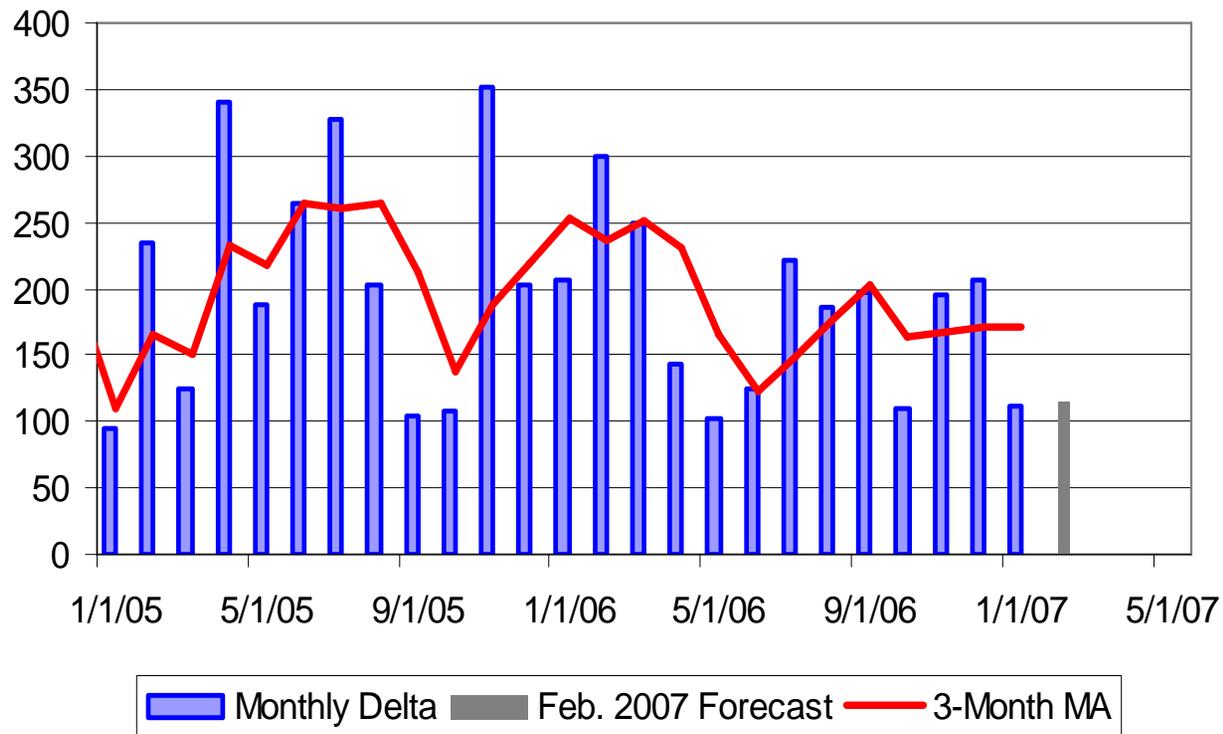
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2. Two economies: Housing and everything else.
3. Solid labor market conditions.



Themes in the Outlook

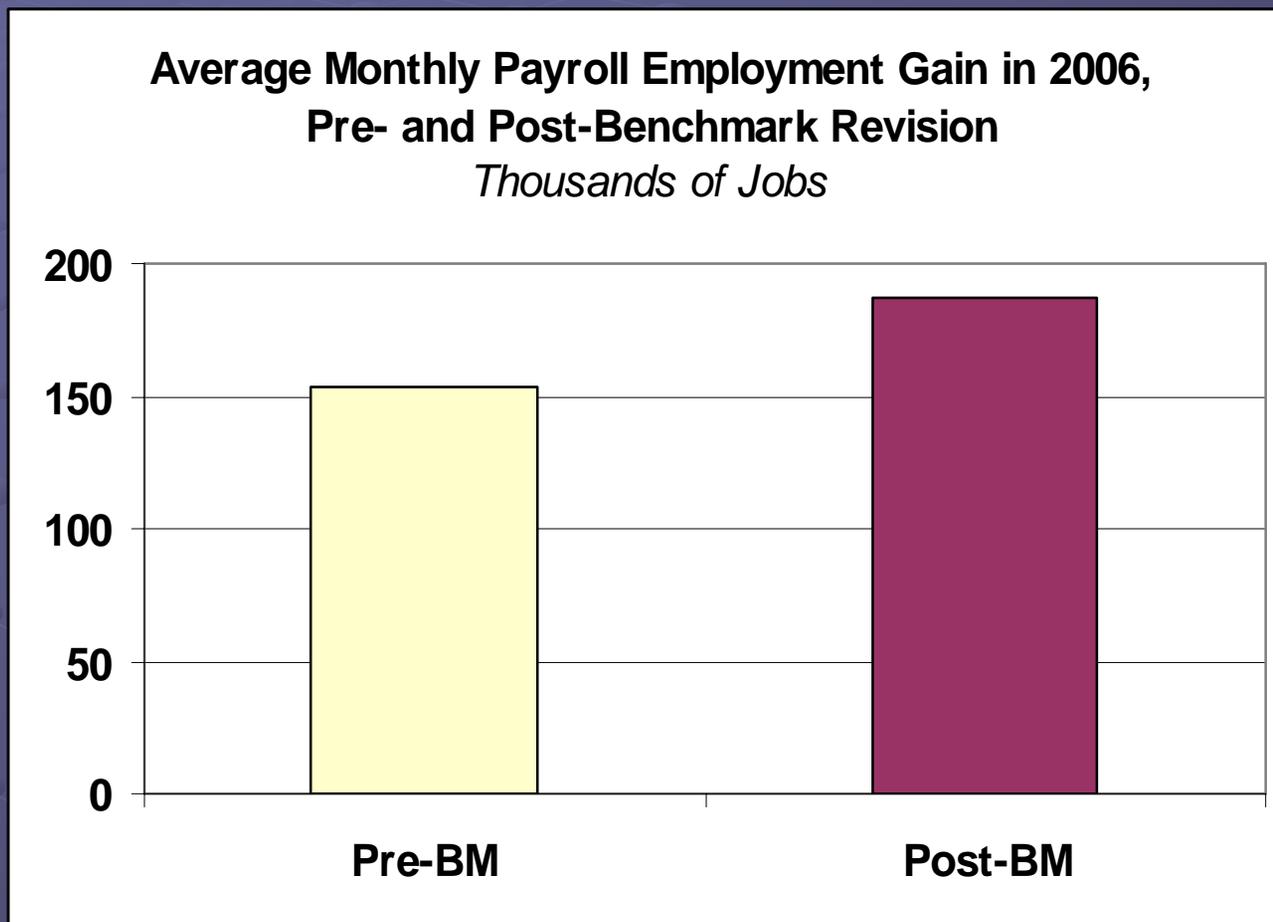
Monthly Employment Gains

Thousands





Themes in the Outlook

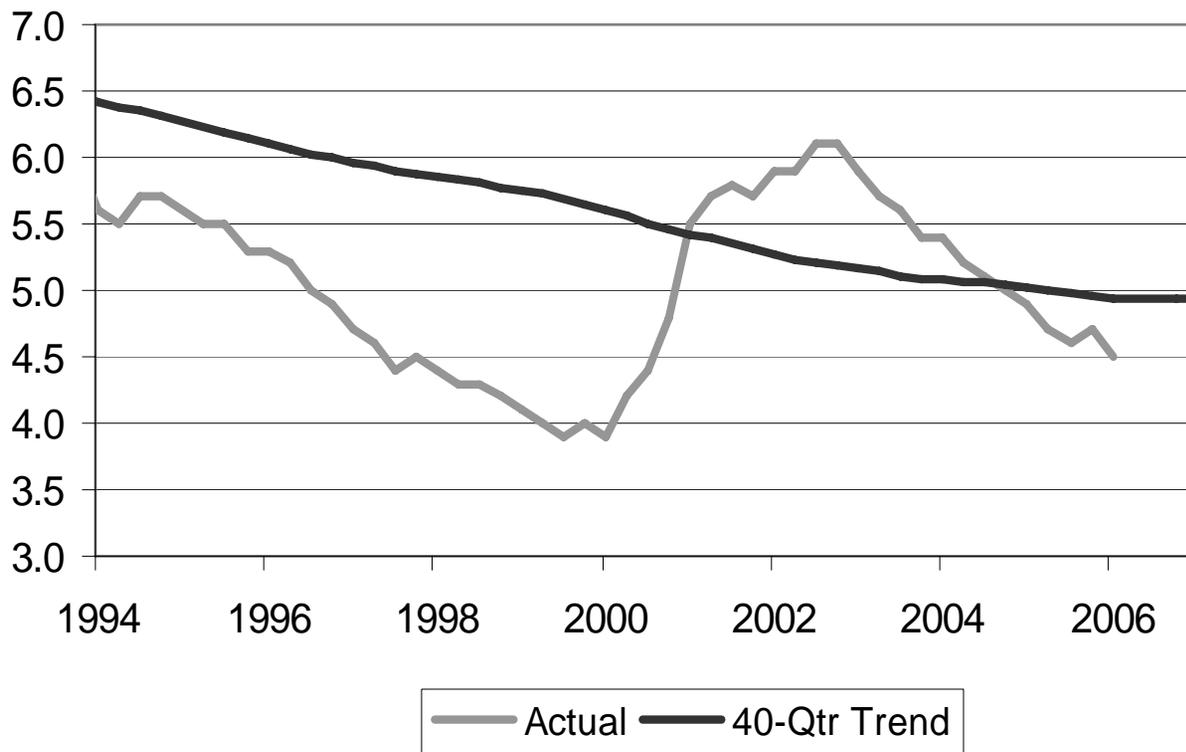




Themes in the Outlook

Civilian Unemployment Rate

Percent





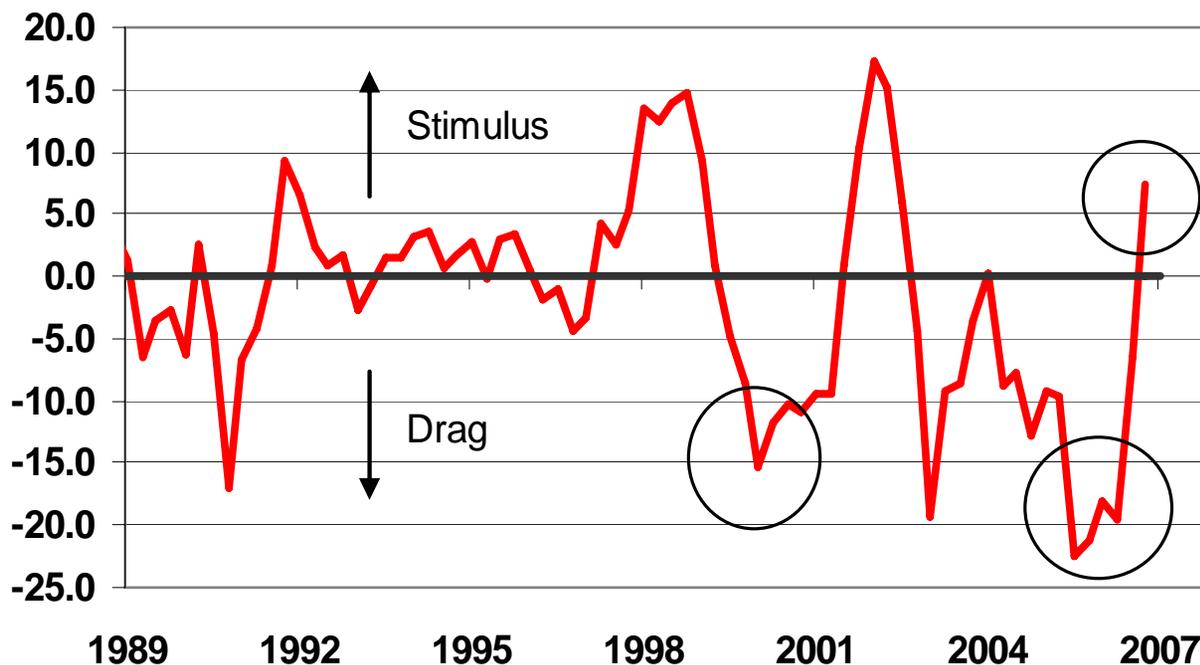
Themes in the Outlook

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3. **Solid labor markets.**
4. **Partial unwinding of energy prices. Repealing the tax hike.**



Themes in the Outlook

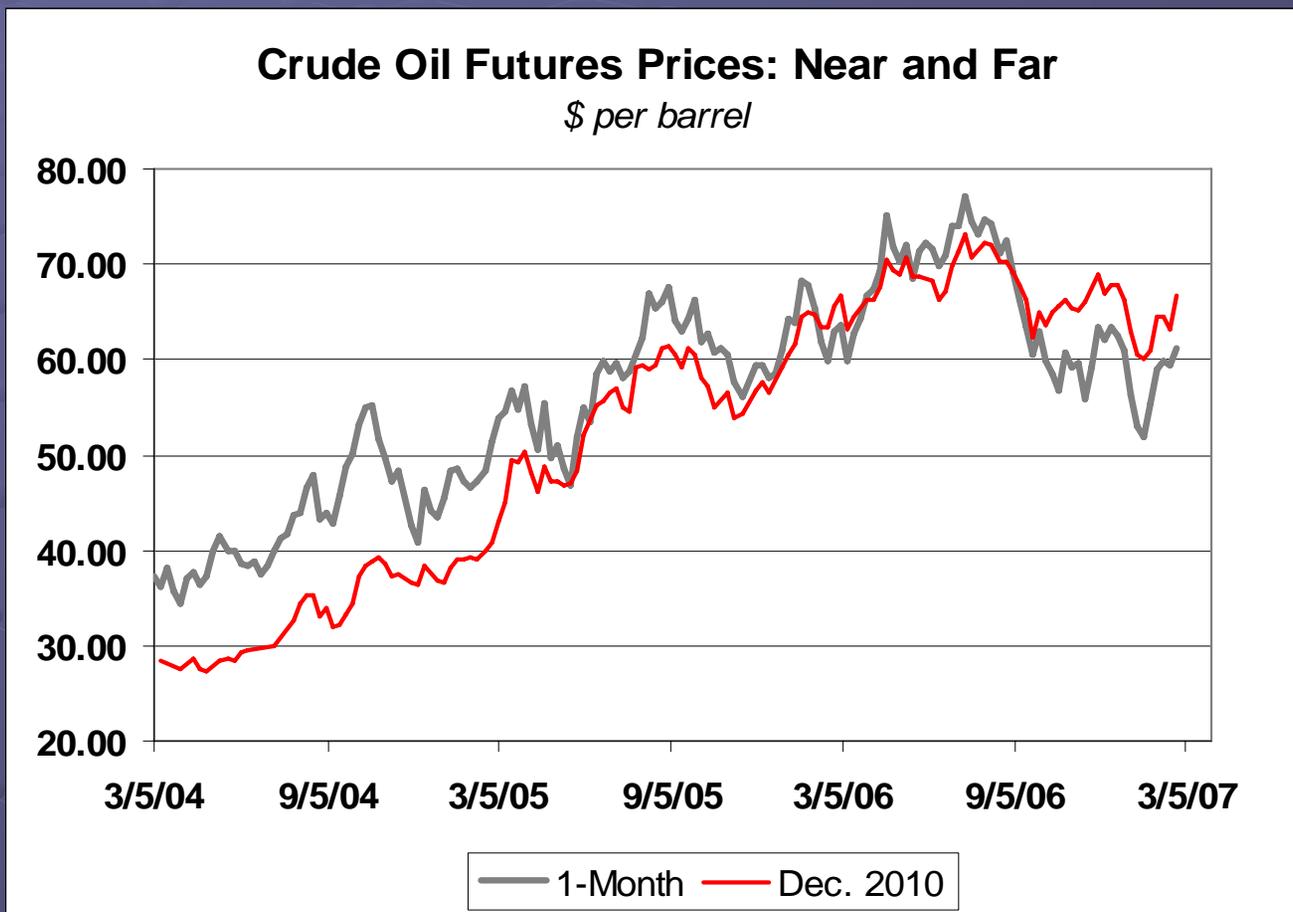
Energy Drag on Real After-Tax Income
Percent



NOTE: 4-Qtr growth of real DPI less 4-Qtr growth of consumer energy prices.



Themes in the Outlook





Themes in the Outlook

Factors Affecting Consumer Spending, 2002-2005

	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>
Household Owners' Equity	8.5	8.1	11.3	12.6	6.4
Financial Assets	-7.3	15.4	8.7	6.5	6.9
Real Compensation	1.5	3.0	2.8	2.4	2.7
Real Consumer Outlays	1.9	3.4	4.0	2.9	3.6
Personal Saving Rate	1.8	2.2	2.3	-0.3	-1.2

NOTE: Tangible and financial asset data through 2006:Q3.

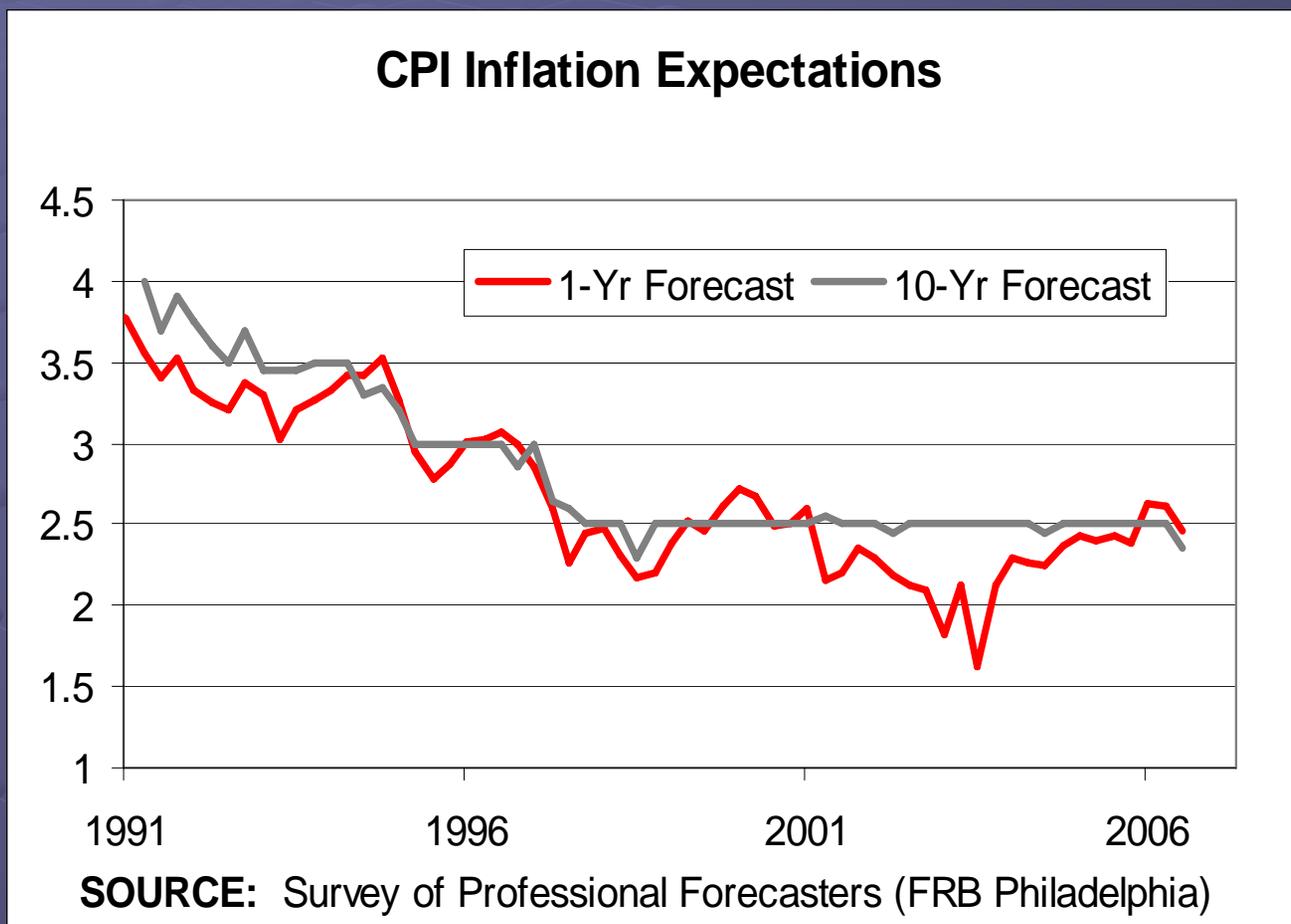


Themes in the Outlook

1. **Resilience in the face of numerous economic challenges; transition from soft patch to trend growth.**
2. **Two economies: Housing and everything else.**
3. **Solid labor markets.**
4. **Partial unwinding of energy prices. Repealing the tax hike.**
5. **Stable inflation expectations.**



Themes in the Outlook





Let's Turn to the Consensus Forecast



The Consensus Forecast

A period of steady but below-trend growth of the economy characterized by:

- A steady or gently rising unemployment rate.
- No recession.
- The vaunted soft-landing



The Consensus Forecast

Forecasters Anticipate a Soft Landing

Forecaster	Forecast Date (2007)	Real GDP Growth		Unemployment Rate		Inflation		
		2007	2008	2007	2008	2007	2008	
FOMC	Feb.	2.5 - 3.0	2.75 - 3.0	4.5 - 4.75	4.5 - 4.75	2.0 - 2.25	1.75 - 2.0	(Core PCE)
Blue Chip	Feb.	2.7	3.0	4.8	4.8	2.3	2.2	(Core CPI)
M.A.	Feb.	3.0	3.1	4.8	4.8	2.3	2.4	(Core CPI)
SPF	Feb	2.8	3.0	4.7	4.8	2.0	2.1	(Core PCE)
CEA	Feb	2.9	3.1	4.6	4.8	2.6	2.6	(CPI)
NABE	Feb	<u>2.8</u>	<u>3.1</u>	<u>4.7</u>	<u>4.8</u>	<u>2.3</u>	<u>2.3</u>	(Core CPI)
Averages		2.8	3.0	4.4	4.5	2.4	2.4	

NOTE: Real GDP forecasts from the SPF are annual average percent changes. Where possible, the unemployment rate forecast is the average of the fourth quarter for the year indicated.



The Consensus Forecast

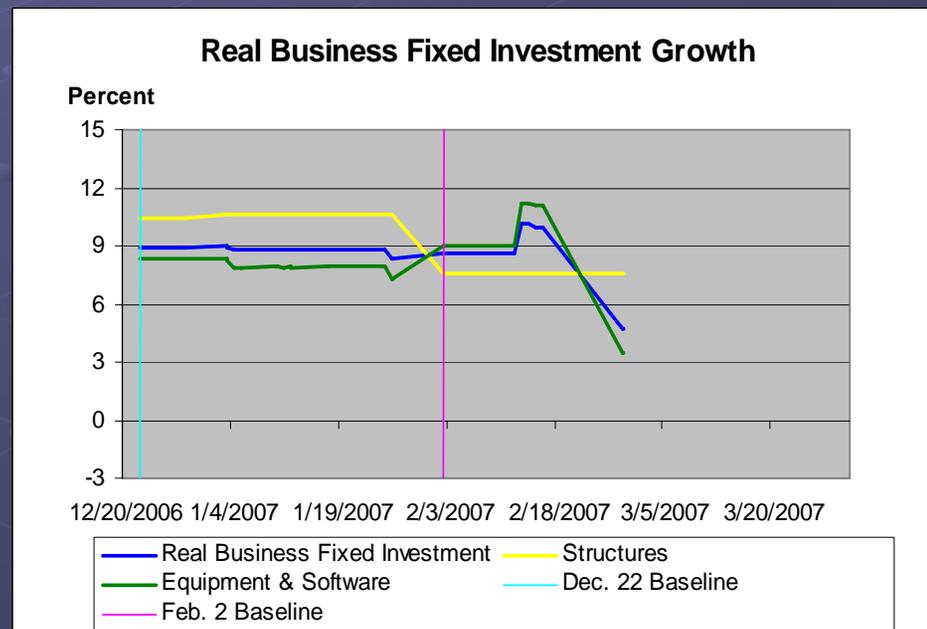
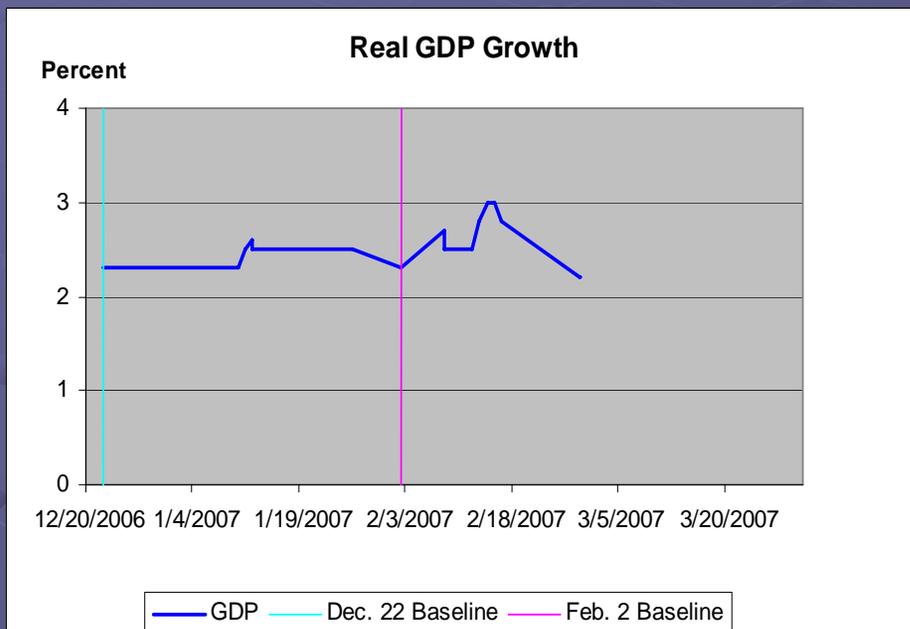
What a difference a month makes!

- 2006:Q4 real GDP growth was revised down by 1.3 percentage points to 2.2%



The Consensus Forecast

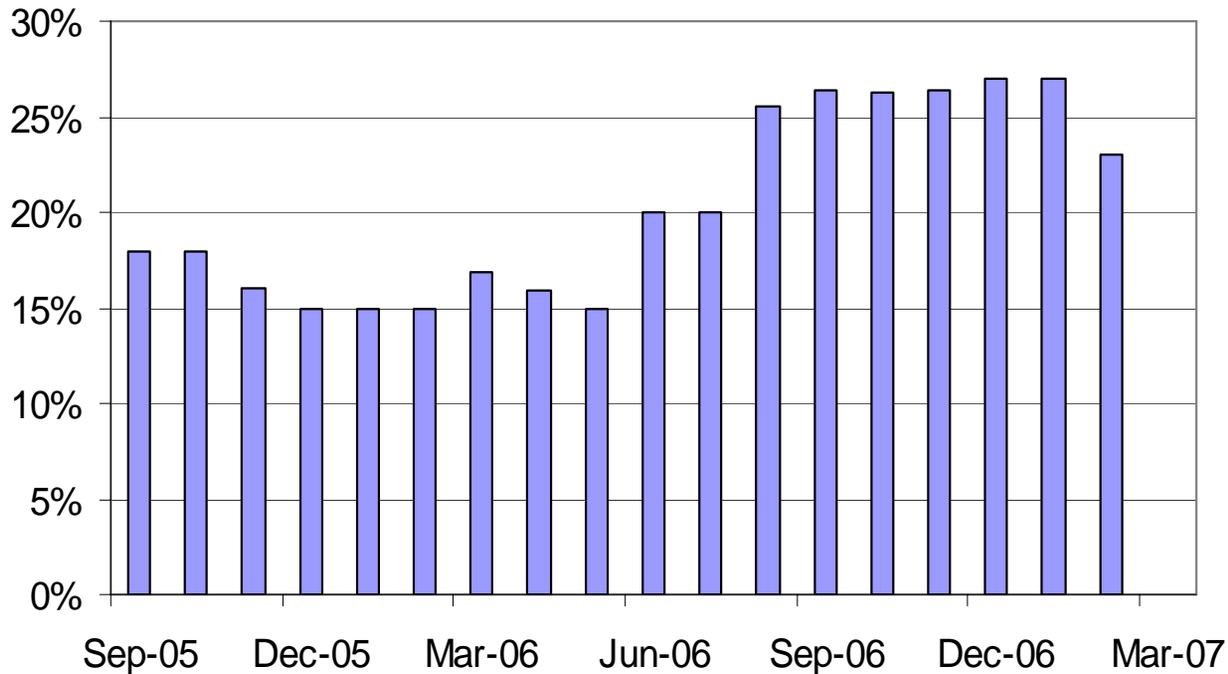
Macroeconomic Advisers 2007:Q1 Tracking Forecast





Recession Probabilities

**Recession Probability in the Next 12 Months
According to WSJ Forecasters**

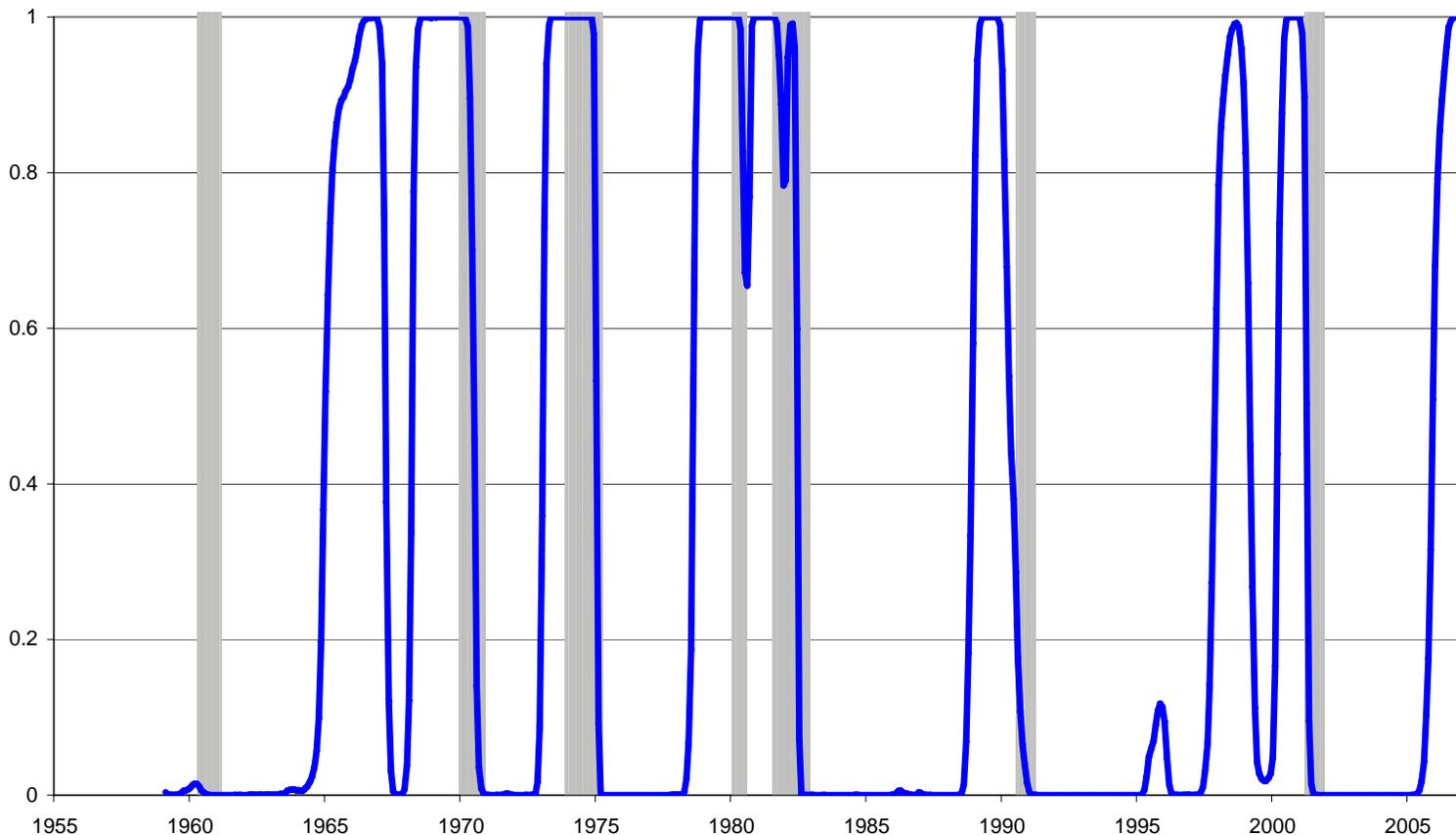




Recession Probabilities

Based on the term structure

Probability of Recession from Markov-Switching Model with Term Structure



Note: Term structure is the 10 year constant maturity Treasury security yield less the effective federal funds rate. Feb. data is estimated using the average of the daily data.

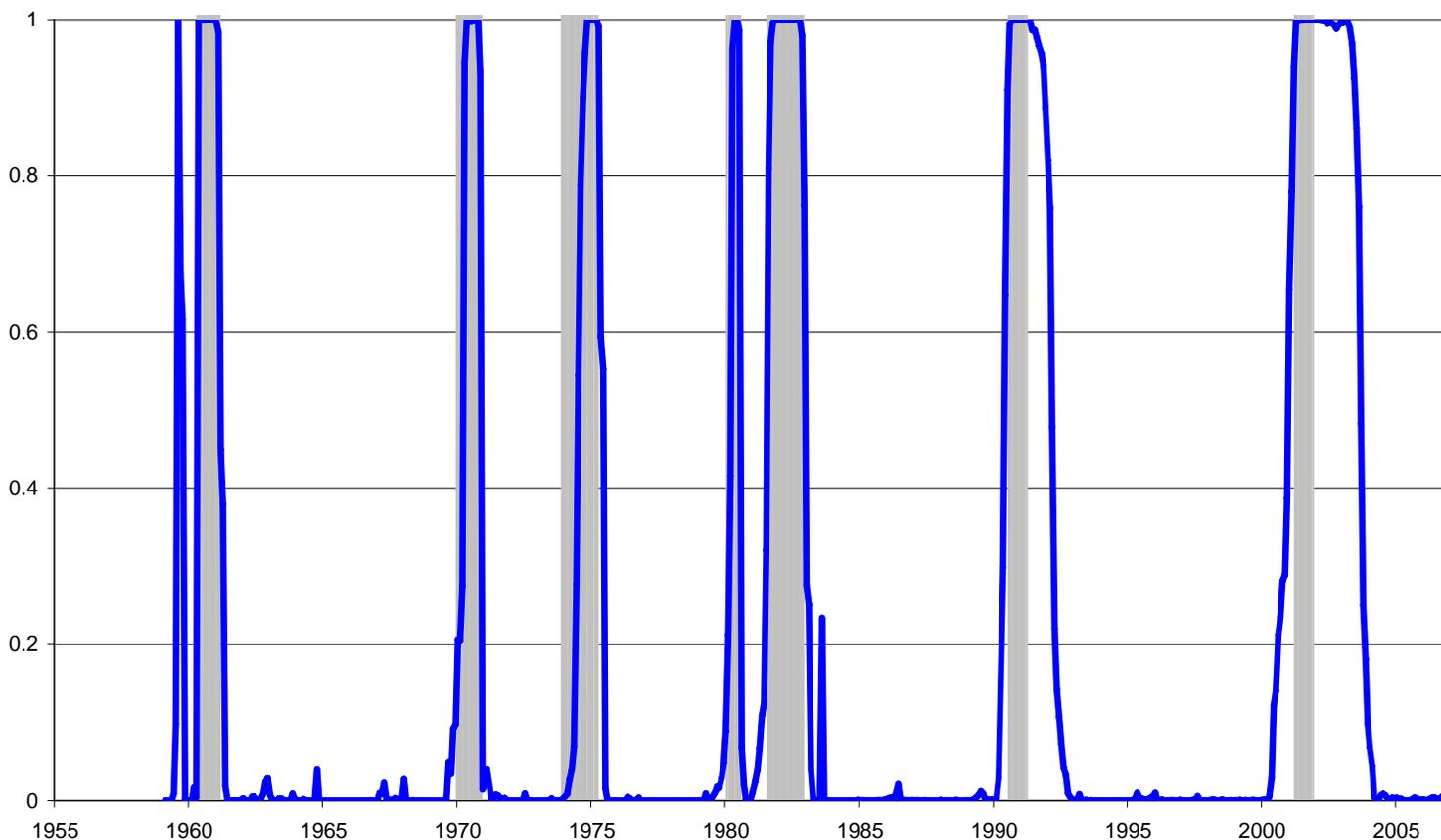
Source: Haver/U.S. Treasury, author's calculations.



Recession Probabilities

Based on payroll employment

Probability of Recession from Markov-Switching Model with Employment Data

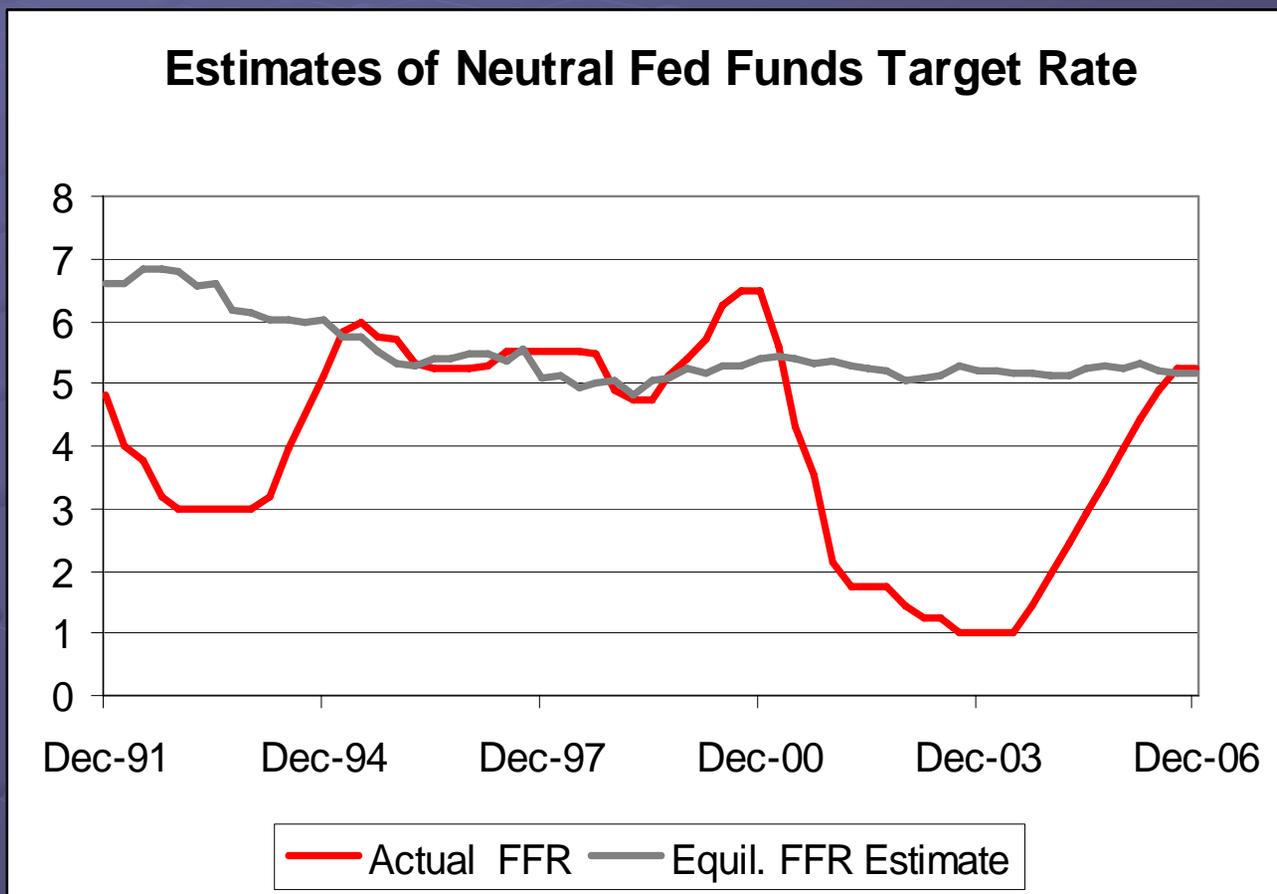


Note: February 2007 is forecasted.

Source: Haver/BLS, author's calculations.



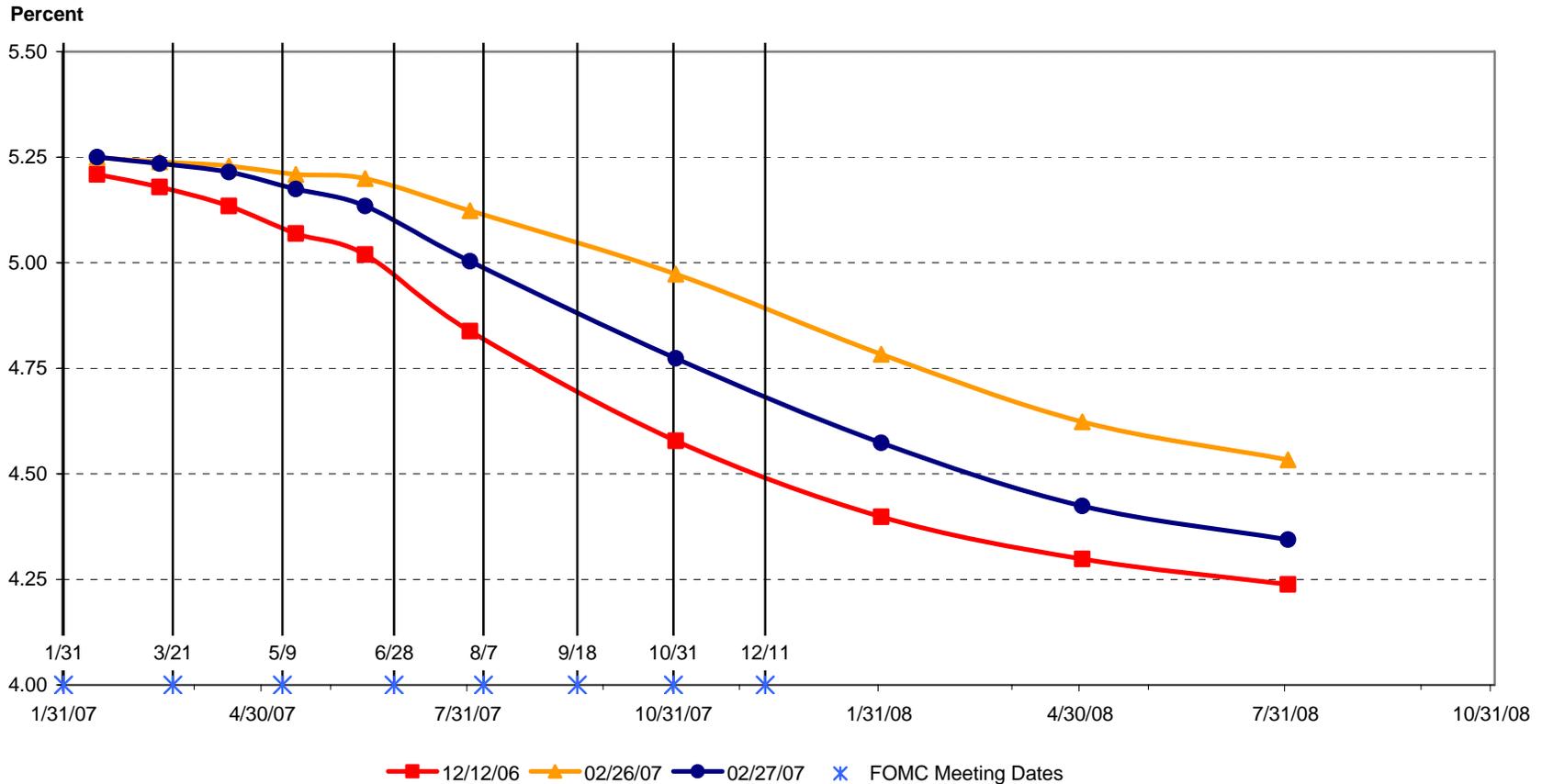
The Consensus Forecast





Market Expectations of the FOMC Federal Funds Target Rate

Expected Federal Funds Rates Estimated from Financial Futures





The Consensus Forecast

Inflation recedes back into the Chairman's "comfort zone."

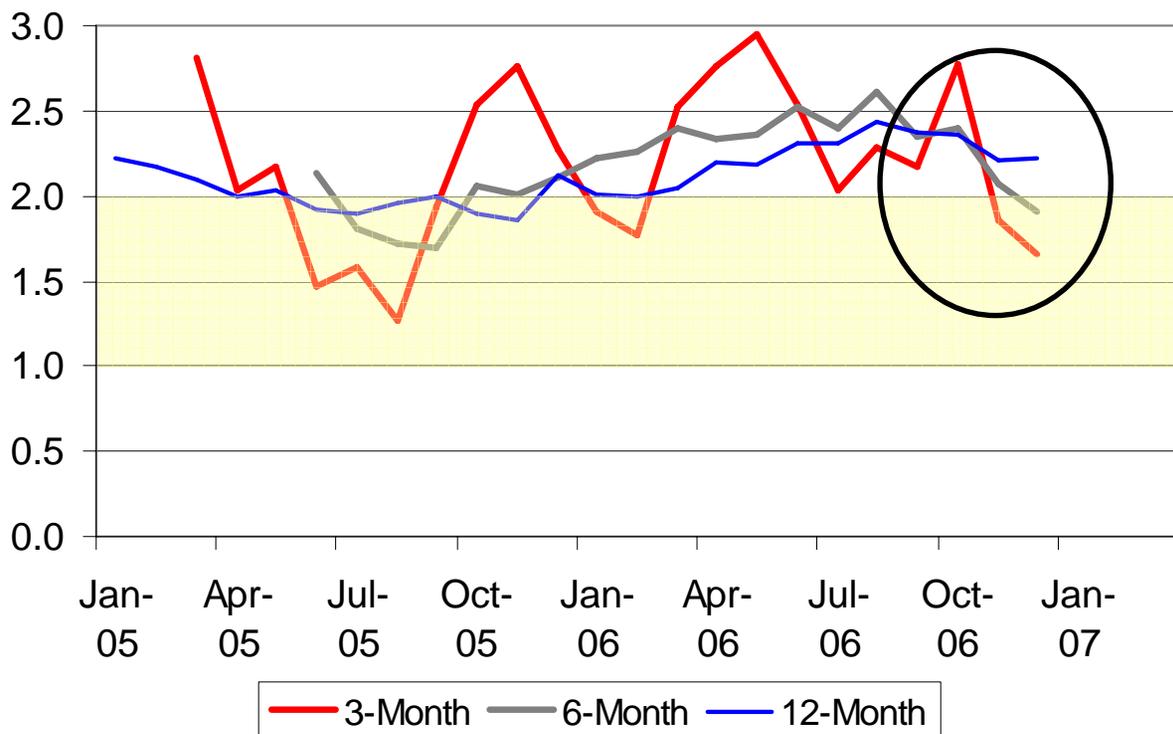
- Comfort zone is 1-2% year-over-year growth of the PCE price index that excludes food and energy prices (core inflation)



The Consensus Forecast

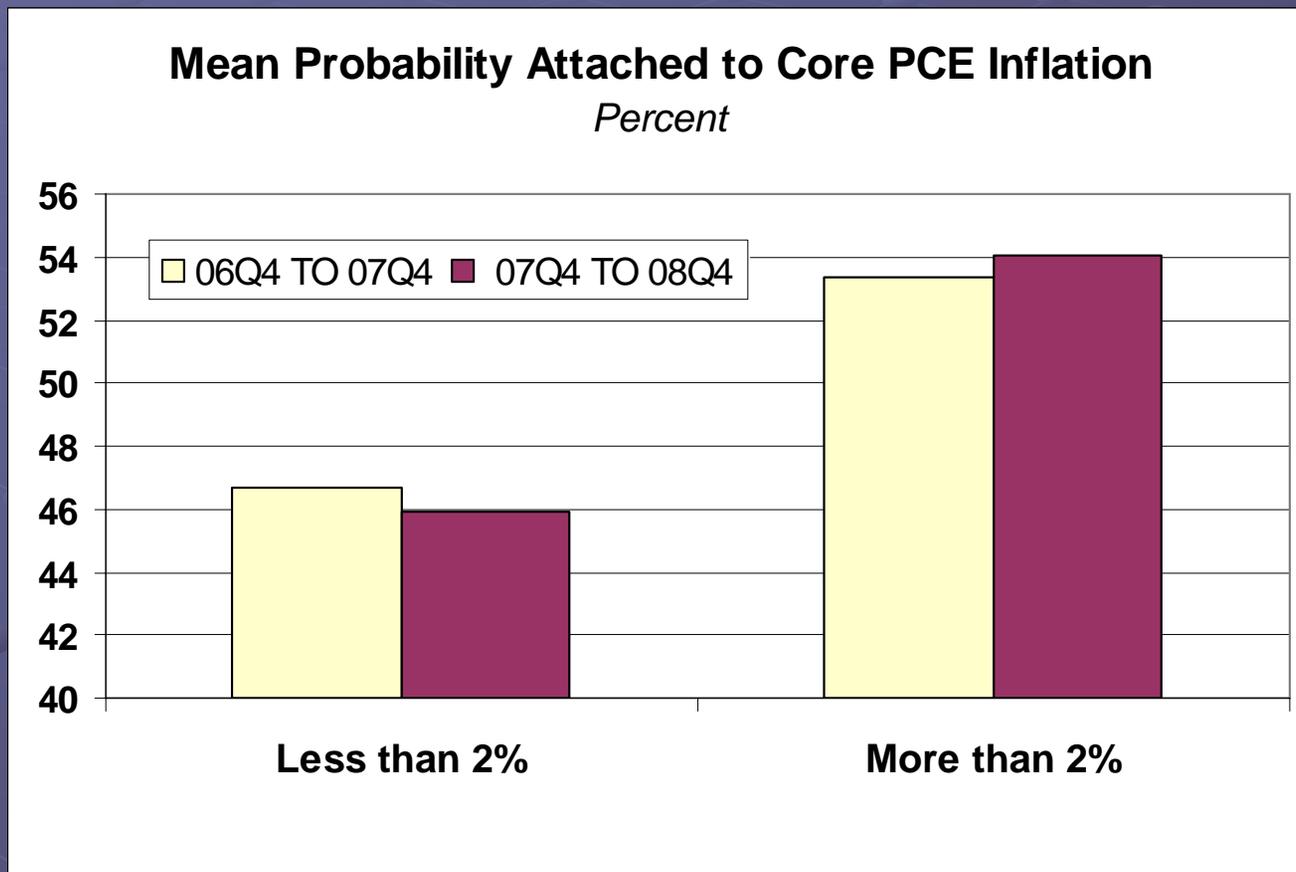
**3-, 6-, and 12-Month Core PCE Inflation and
Chairman Bernanke's "Comfort Zone"**

Percent





The Consensus Forecast



Forecasters see a higher probability that core inflation will be above 2% in 2007 and in 2008 than less than 2%.



Risks to the Outlook



Two-Sided Risks to the Outlook

- 1. Housing correction intensifies by more than expected and spills over to other aspects of the economy.**



Two-Sided Risks to the Outlook

- 1. Housing correction intensifies by more than expected and spills over to other aspects of the economy.**
- 2. Housing correction over; consumer and business spending pickup as energy prices fall and foreign demand growth strengthens; wage growth begins to outpace gains in labor productivity; inflation expectations trend upward. Bond yields on the upswing.**



Two-Sided Risks to the Outlook

3. Energy prices spike again. Instability in the Middle East (Iraq and Iran), Nigeria, Venezuela, etc.; Chinese authorities fail to slow economic growth;



Two-Sided Risks to the Outlook

- 3. Energy prices spike again. Instability in the Middle East (Iraq and Iran), Nigeria, Venezuela, etc.; Chinese authorities fail to slow economic growth.**
- 4. Low household saving rate; slower growth of household equity; no cushion to soften another significant demand shock.**



Questions?