

National Overview

Economy Overcomes Hurricanes, Rising Energy

By Kevin L. Kliesen

The U.S. economy performed admirably last year. Despite three major hurricanes that helped spur sharp increases in energy prices, real GDP increased by more than 3 percent for the third consecutive year, and the unemployment rate dropped to its lowest level in more than four years.

2005 Goes Out like a Lamb

The U.S. economy stumbled late last year, as real GDP grew at only a 1.6 percent annual rate in the fourth quarter. The economy's anemic rate of growth came on the heels of a 3.8 percent gain over the first three quarters of the year. For the year (percent change, fourth quarter of 2004 to fourth quarter of 2005), real GDP increased by 3.2 percent, which was roughly 0.5 percentage points less than 2004's increase.

Last year's slower growth can probably be attributed to hurricanes and rising energy prices. One rule of thumb is that each \$10 per barrel increase in crude oil prices reduces the level of real GDP by 0.4 percent after four quarters. Accordingly, the roughly \$13 increase in the refiners' cost of crude oil over the four quarters of 2005 may have trimmed real GDP by as much as 0.5 percentage points. The reduced level of economic activity and damages wrought from hurricanes Katrina, Rita and Wilma also contributed to the slowdown, though how much is difficult to determine at this time. Despite these hurdles, faster growth over the first three quarters of the year (relative to trend growth) caused the unemployment rate to fall to 4.9 percent in December 2005, half a percentage point lower than a year earlier.

Although energy prices paid by consumers rose for the fourth consecutive year, inflation edged lower last year. Following a 3 percent increase in 2004, the price index for personal consumption expenditures (PCE) rose by 3 percent in 2005. Excluding food and energy

Prices

prices—the core PCE—inflation declined from 2.25 percent in 2004 to 1.9 percent last year. The modest slowing in core inflation suggests that businesses found it difficult to pass along higher energy costs to the consumer.

2006 Comes In like a Lion

Many economists viewed the fourth-quarter slowdown as an aberration. Thus far, that appears to be an accurate assessment. In January, real consumer spending and new factory orders and shipments for nondefense capital goods excluding aircraft were both up strongly from three months earlier. Similarly, manufacturing production and nonmanufacturing business activity remained at a high level over the first two months of the year, according to the Institute for Supply Management surveys.

Accompanying the faster growth in sales and production has been a solid improvement in labor market conditions. Nonfarm payroll employment rose by 170,000 in January 2006 and 243,000 in February. With lower energy prices and Gulf Coast rebuilding efforts adding to the momentum, it is possible that real GDP growth could average 4 percent over the first half of this year.

The Prospects for 2006 Look Good...So Far

The beginning of each year brings a bevy of macroeconomic forecasts freely available to the public. Among the most watched are those from the Congressional Budget Office, the Council of Economic Advisers and the Federal Open Market Committee (FOMC). This year's forecasts are pretty simi-



lar: Real GDP growth is projected to increase by about 3.5 percent, and the unemployment rate is expected to remain about 5 percent. Most forecasters predict inflation using the growth in the consumer price index (CPI), which was 3.7 percent over the four quarters of 2005. Forecasters expect that an absence of energy price increases this year will push the CPI inflation rate down to just under 2.5 percent during 2006. In the February 2006 *Monetary Policy Report to the Congress*, the FOMC, which instead focuses on the core PCE, projects that core inflation will remain at about 2 percent.

As with any year, it is possible to identify several risks to the outlook. This year's list includes the possibility of a sharp fall in housing prices, which could crimp economic growth by slowing housing construction or limiting households' use of equity wealth to finance a portion of their consumption outlays. Other factors to consider are rising geopolitical risks that keep oil prices high and a further slide in productivity growth, which would raise the unit costs of businesses and cut into profits. For now, the prevailing view is that 2006 will bring a modest acceleration in economic growth, a dip in headline inflation, but no slowing in core inflation.

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