

The Economy Continues to

Take a Punch

BY KEVIN L. KLIESEN

U.S. real GDP growth was quite weak in the first quarter, a continuation of the below-trend growth that has been seen for the past year. Still, a return to trend-like growth by the end of the year remains the most likely scenario. At the same time, resurgent crude oil and gasoline prices since mid-January have caused an unwelcome rebound in headline inflation pressures. The headline measure that excludes food and energy prices (core inflation) has eased modestly since the third quarter of 2006, providing Fed policymakers some degree of comfort.

From mid-January to late May 2007, U.S. average retail gasoline prices rose by 48 percent to \$3.22 per gallon. Driven by seasonal demand, by refinery outages that have dramatically reduced inventories and by strong global demand for gasoline, retail gasoline prices are expected to hover around \$3 per gallon this summer. The government's forecast of an above-average hurricane season this summer raises the risk that energy prices could increase further. Forecasters, nevertheless, expect Consumer Price Index (CPI) inflation to average about 2.5 percent during the second half of this year, about one percentage point less than that projected for the first half of the year.

Price pressures have eased modestly outside of the food and energy complex. Since September 2006, the year-to-year percent change in the core Personal Consumption Expenditures (PCE) inflation rate has declined by a little more than 0.25 percentage points to 2 percent. Although the Federal Open Market Committee (FOMC) expects some additional moderation, forecasters are more skeptical. The Survey of Professional Forecasters (SPF) expects that the core PCE will increase by 2.1 percent this year and next.

Rising energy prices, the housing correction, and an unexpected weakening in the pace of business equipment and software purchases have been key factors pushing the pace of real GDP over the past year below its trend rate of growth (roughly 3 percent). This slowdown culminated with an anemic 0.6 percent growth rate in the first quarter of this year, the smallest increase in a little more than four years and well short of the 2.5 percent gain posted in the fourth quarter of last year. Forecasters, by and large, still see the economy steadily gaining strength after the weak first-quarter performance.

Compared with their projections at the end of last year, SPF forecasters have become a bit more pessimistic about the strength of real personal consumption expenditures for the remainder of this year, perhaps in response to increased gasoline prices. The unexpected weakness in business capital outlays (equipment and software) over the past year, as well as uncertainty in energy markets, has also caused some forecasters to expect a somewhat weaker rebound in real business fixed investment for the rest of this year than what was expected at the end of last year. In any event, business capital spending appears to be improving after declining during the fourth quarter of last year, as evident by the strong rebound in new orders for manufactured nondefense capital goods (excluding aircraft) in March and April.

Some signs of stabilization have appeared in the housing sector, as seen by a modest rebound in housing starts since January and the sharp jump in new-home sales in April. That said, home builders are still trying to pare the sizable inventory of unsold homes,



chiefly through price reductions or sales incentives. Accordingly, the stabilization of the housing market might be several months away, but it is nonetheless a key factor in the expected return to trend-like real GDP growth toward the end of this year. Also key is the continued favorable outlook for commercial construction spending and the foreign demand for U.S. goods and services.

Labor market conditions have weakened modestly this year. First, payroll employment gains thus far in 2007 have averaged only 133,000 per month, about 55,000 per month less than last year. Second, labor productivity growth in the nonfarm business sector has slowed from 4.1 percent in 2002 to 1.6 percent last year. This development, which is being watched closely, has caused some forecasters to lower their estimate of potential real GDP growth to below 3 percent. In the short run, the threat posed by higher energy prices could intensify if labor productivity growth weakens further. If so, core inflation may not moderate as much as the FOMC expects. In view of the consensus forecast for real GDP, policymakers are likely to remain focused on keeping inflation and inflation expectations in check.

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