

National and District Overview

Recovery Isn't As Easy As in the Past

BY KEVIN L. KLIESEN

More than three-quarters of forecasters believe that the recession ended in the first quarter of 2002, when the economy grew at more than a 5 percent annual rate. Hence, economists have turned their attention to the recovery period, which is typically characterized by strong economic growth and modest inflationary pressures. But with the pace of economic activity slowing in the second quarter, the usual post-recession bounce appears flatter this time around.

A Second-Quarter Pause?

Real GDP grew at a 5.6 percent annual rate in the first quarter, the fastest growth in nearly two years. Household expenditures on durable and nondurable goods increased briskly, as did business expenditures for computers. Low mortgage rates and warmer-than-usual winter weather contributed to an upswing in housing construction, while the war on terrorism boosted federal defense expenditures. On the downside, business fixed investment fell for the fifth consecutive quarter, as demand for software and communications equipment remained weak and outlays for business structures fell for the fourth consecutive quarter. A sizable part of first-quarter real GDP growth (3.5 percentage points out of the 5.6) reflected restocking of depleted business inventories. Accordingly, final sales (GDP less the change in private inventories) grew at a sluggish 2 percent rate.

The consensus of Blue Chip forecasters in early June was that the U.S. economy would grow at about a 3 percent annualized rate during the second quarter and then accelerate to about a 3.75 percent rate by the first quarter of 2003. Reports of economic activity in April and May seem consistent with this projection. Despite a sizable gain in household purchases of new motor vehicles, real personal consumption expenditures rose just 1.9 percent at an annual rate in April



and were only about 1.5 percent (annualized) above their first-quarter level. Even though the pace of consumer spending appears tepid, the nation's factories continue to ramp up production: In April, new orders to manufacturers for non-defense capital goods rose 2.2 percent, the second increase in three months. Activity appeared to accelerate further in May, as the Institute for Supply Management's index of manufacturing activity posted its highest reading since February 2000. In all likelihood, some of manufacturing's rebound reflects a further replenishment of business inventories. On a brighter note, real nonresidential construction spending posted a healthy gain in April, the first in three months.

The upswing in production is generating only a modest increase in payroll employment and hours worked, which is consistent with the early stages of the recovery. In May, U.S. nonfarm payrolls rose 41,000, after rising only 6,000 in April; payroll employment growth remains negative as measured from a year earlier. Somewhat surprisingly, the unemployment rate fell 0.2 percentage points in May to 5.8 percent. Employment growth is generally weaker in the District states, but the unemployment rates are modestly lower on average. Reflecting the weaker tenor of activity in the second quarter, the most recent Beige Book noted that "economic activity in the District is continuing to pick up, although slowly."

The Benefits of Strong Productivity Growth

One reason for the optimism of forecasters is that U.S. firms seem to have skated through the 2001 recession with their post-1995 productivity gains intact. During the first quarter, output per hour in the nonfarm business sector surged upward at an 8.4 percent annual rate, much stronger than the brisk 5.5 percent gain seen in the prior quarter. Besides powering the growth of real labor compensation and, hence, consumer spending, accelerating productivity growth has enabled firms to keep a lid on unit labor costs, thereby helping to temper aggregate price inflation and improve profit margins. Between the third quarter of 2001 and the first quarter of 2002, corporate profits rose nearly 19 percent, while the price index for gross domestic purchases rose by only a little more than 0.5 percent at an annual rate. But with final sales growth still relatively weak and with price pressures apparently languid, monetary policy-makers have refrained from raising their federal funds target rate, which has stood at a nearly 40-year low of 1.75 percent since December 2001. If the recovery takes hold as forecasters expect, then monetary policy will need to adjust to keep price pressures at bay.

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