National and District Overview

WAITING ON THE FED

BY KEVIN L. KLIESEN

The U.S. economy continues to improve, although a palpable rise in inflation, driven in part by sharp increases in energy prices, has put a damper on an otherwise favorable outlook for the remainder of the year. With economic growth expected to remain about 4 percent over the final three quarters of 2004 and with firms starting to hire new employees at a faster rate, financial markets and forecasters expect the Federal Open Market Committee to unwind its self-described accommodative policy.

Help Wanted

Real GDP rose at a 4.4 percent annual rate in the first quarter—modestly stronger than the 4.1 percent growth seen during the fourth quarter of 2003. Over the past four quarters, real GDP has increased 5 percent—the strongest four-quarter growth in almost 20 years. Economic activity in the first quarter was paced by solid increases in consumer outlays for nondurable goods and services, by business expenditures for equipment and software, and by real defense outlays. The first quarter also saw a pickup in job growth—nonfarm payrolls rose at their fastest rate in nearly four years—and continued robust labor productivity growth (3.5 percent). Despite improving economic conditions, firms remain reluctant to boost their inventories relative to their sales.

Nonfarm payroll employment rose in May by more than expected (248,000) for the third consecutive month, while in the same month, despite the marked rise in gasoline prices, automobile and light truck sales rose by 9 percent, and large retailers reported better-than-expected sales. Prospects for fixed investment by businesses remain solid, as new orders for nondefense capital goods were up about 12.5 percent in April from a year earlier. In response to increased expenditures by households and businesses, industrial production rose in April at a 10 percent annual rate, and the Institute for Supply Management's manufacturing and nonmanufacturing business indexes showed further gains in economic activity in May. Finally, foreign demand for U.S.-produced goods and services remains strong; exports in March were up almost 15 percent from a year earlier.

Although housing starts and new home sales slipped in April and forecasters expect a less ebullient housing market for the rest of the year in response to rising mortgage interest rates, real GDP growth is expected to average roughly 4 percent over the final three quarters of 2004, according to the Blue Chip forecast. This forecast also assumes some moderation in crude oil prices during the remainder of the year. Thus, if oil prices head higher, forecasters will probably temper their enthusiasm.

Rate Hike: When and How Much?

Noting improving economic conditions at their May 4 FOMC meeting, Fed policy-makers said that their accommodative policy stance "can be removed at a pace that is likely to be measured." In other words, the days of a 1 percent federal funds target rate are drawing to a close. One concern is that inflation is running at a pace that is modestly more than what Fed policy-makers were expecting at the beginning of the year. Reflecting a sharp rise in oil prices, the personal consumption expenditures (PCE) price index has risen at a 3 percent annual rate over the first four months of 2004, after rising at only about a 1.5 percent rate over the second half of 2003. However, price increases have not solely been an energy event, as the core PCE inflation rate (which excludes food and energy prices) has risen at about a 1.75 percent rate over the first four months of 2004 after rising at a 1.1 percent rate over the second half of 2003.

Another concern is keeping long-term inflation expectations in check. On this score, the evidence is mixed. Although participants in the Survey of Professional Forecasters continue to expect CPI inflation to average 2.5 percent over the next 10 years, where it has mostly remained since 1997, market-based measures (yield spreads between nominal and inflation-protected 10-year Treasury securities) have been creeping steadily higher over the past year and are currently, as of early June, at about 2.75 percent vs. 1.6 percent a year earlier.

With employment rising, economic growth expanding at a robust rate and inflation tacking modestly higher, it seems clear that a 1 percent target rate for federal funds is inconsistent with low and stable inflation. Based on current federal funds futures rate yields, the financial markets appear to agree.

Kevin L. Kliesen is an economist at the Federal Reserve Bank of St. Louis. Thomas A. Pollmann provided research assistance.