

# Economy's Expansion Puts Down Roots

A view of the U.S. economic landscape in early 2005 suggests that conditions have improved modestly from three months earlier, when the economy was thought to be growing at a rate close to its long-run average of roughly 3.5 percent. Although inflation pressures have eased somewhat over the same period, measures that exclude food and energy prices generally have not. All in all, the expansion appears to be putting down roots at this point, which will allow the economy to better withstand the adverse shocks that periodically occur.

### 2004: A Good Year

Late-February revisions to the national income and product accounts data show that real GDP grew at a 3.8 percent annual rate in the fourth quarter of 2004, nearly three-quarters of a percentage point more than the advance estimate published in late January. For the year (fourth quarter of 2003 to fourth quarter of 2004), real GDP rose by 3.9 percent, surprisingly close to what forecasters had expected a year earlier, but moderately less than 2003's increase of 4.4 percent. The fourth-quarter inflation rates were virtually unrevised, so that the price index for personal consumption expenditures (PCE) less food and energy rose 1.6 percent in 2004, modestly faster than 2003's rise of 1.2 percent but still well below its average of the past 25 years of roughly 3.5 percent. Many economists believe that the modest deceleration in real growth and the equally modest acceleration in "core" inflation can be traced as much as anything to the roughly 50 percent rise in real crude oil prices last year.

### 2005 Off to a Good Start

One of the difficulties of current economic analysis is that price and expenditure data are always released weeks or months after the fact and often revised. This is why many economists also look at movements in financial market variables and monthly changes in forecasts to help



By Kevin L. Kliesen

gauge the economy's near-term growth path.

As this article went to press in mid-March, household and business expenditures were generally quite good in January and—for the most part—in February. In January, nonautomotive retail sales were up strongly and appeared to remain strong in February, while housing starts and private construction were all up strongly from three months earlier. Likewise, business capital spending remained robust, as new orders for nondefense capital goods in January were up by about 7.5 percent from three months earlier.

Faced with solid growth in demand by consumers and businesses, manufacturing production was up strongly in February and from three months earlier. Domestic producers also received a boost from overseas sales, as exports—probably helped by a further decline in the value of the dollar—rose strongly over the last three months of 2004.

Labor market conditions continued to improve. Over the first two months of 2005, nonfarm payrolls were up by 394,000, substantially larger than the 211,000 gain seen over the first two months of 2004.

Financial conditions early this year generally remained supportive of growth, except for the stock market, which, through mid-March, was trading near its 2004 year-end level. Long-term interest rates through mid-March remained relatively low, risk spreads were narrowing and banks were generally easing terms and lending standards on loans to businesses and consumers. Thus, coupled with solid economic growth, bank credit (loans and leases, and bank securities) grew by a relatively rapid 2.5 percent for the three months ending in February.

### 2005: The Song Remains the Same

Forecasts for real GDP growth, core inflation and the unemployment rate for this year have changed very little since the middle of last year. In the February 2005 *Monetary Policy Report to the Congress*, Federal Reserve governors and presidents (who make up the Federal Open Market Committee) projected that real GDP will grow by between 3.75 to 4 percent (central tendency) this year and that the unemployment rate will average 5.25 percent in the fourth quarter. (It measured 5.4 percent in February 2005.)

The FOMC remains quite sanguine about inflation pressures: The members project that the core PCE price index will rise by between 1.5 and 1.75 percent this year and next.

One risk to the inflation forecast is a reduction in labor productivity growth and faster growth of labor compensation, two developments which occurred over the second half of 2004 to the surprise of many forecasters. As yet, though, there appear to be many more productivity optimists than pessimists.

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