

National Overview

Despite Setbacks, the U.S. Economy *Steams* Forward

BY KEVIN L. KLIESEN

Hurricane Katrina ravaged New Orleans and surrounding areas, damaging and disabling a significant amount of the Gulf Coast's energy infrastructure. Immediately following the hurricane, most forecasters began to lower their estimates of U.S. economic growth for the third and fourth quarters of 2005 from their relatively upbeat pre-Katrina outlook. With crude oil and natural gas prices surging, forecasters also sharply raised their estimates of inflation. The economic outlook was further clouded by two additional hurricanes (Rita and Wilma) and the Boeing machinists' strike, which crippled commercial aircraft production.

Although some parts of the Gulf region will take years to recover, economic conditions at the national level three months later have, in many respects, turned out better than expected. The 4.3 percent growth in real GDP in the third quarter was much higher than most forecasters had expected. Manufacturing and labor market conditions have rebounded strongly. Moreover, crude oil and natural gas prices have fallen modestly from their hurricane-spawned peaks in September, while measures of core inflation have been fairly stable over the past year, at about 2 percent. Despite some significant countervailing forces in 2005, the U.S. economy looked to be heading into 2006 with a fair amount of forward momentum.

A Shockproof Economy?

Higher oil prices and hurricanes are merely the latest in a series of shocks that have hit the U.S. economy in recent years. Others have included:

- the stock market bust in 2000, which erased several trillion dollars in accumulated household net wealth over the next two years and greatly increased the cost of capital to firms,
- the corporate accounting scandals thereafter

- and the devastating terrorist attacks on Sept. 11, 2001.

Through it all, the economy has exhibited extraordinary resilience, experiencing only a relatively minor recession in 2001 and only a moderate recovery over the next year or so. But since mid-2003, real GDP has increased at a little more than a 4 percent annual rate. This rate is about one percentage point higher than the Congressional Budget Office's estimate of potential real GDP growth but a bit lower than other estimates. With actual growth exceeding potential growth, the unemployment rate has fallen to 5 percent (as of November 2005) and the manufacturing capacity utilization rate in October rose to its highest level in five years.

The U.S. economy's resilience reflects two key developments. First, growth of labor productivity (output per hour in the nonfarm business sector) remains historically elevated. Over the past five years, labor productivity has increased at a brisk 3.4 percent annual rate, far above the 50-year average growth of 2.2 percent. Second, financial markets and the business community are confident that the Federal Reserve will keep inflation low and stable. This credibility not only reduces risk premiums that are embedded in interest rates, but it enables the Fed to offset potentially damaging economic disturbances without the markets calling into question its inflation-fighting bona fides.

As long as long-term inflation expectations remain low and stable and labor productivity growth stays strong, the economy should continue to grow at or slightly above its estimated potential rate of growth in 2006. Economic activity in 2006 should also receive a boost from the rebuilding efforts in the Gulf Coast and, hope-



fully, from the absence of further large increases in crude oil and natural gas prices. The rebuilding and relative stability in energy prices would help boost business investment and help produce a more moderate headline inflation rate in 2006. The end result would be an improvement in household purchasing power. With this outcome, the economy in 2006 should add jobs at a rate of about 150,000 to 175,000 per month.

One risk to the economy in 2006 is the potential for a slower pace of housing investment, threatening to end the multiyear housing boom. Growth of real residential fixed investment (RFI) is expected to decline about 1.75 percent during 2006, according to the Federal Reserve Bank of Philadelphia's November 2005 Survey of Professional Forecasters (SPF). It should be noted, though, that in November 2004, these forecasters predicted that RFI growth would average about -0.25 percent (annualized) over the first three quarters of 2005; instead, it averaged a little more than 9.5 percent.

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