## National and District Overview

# The Party Heats Up

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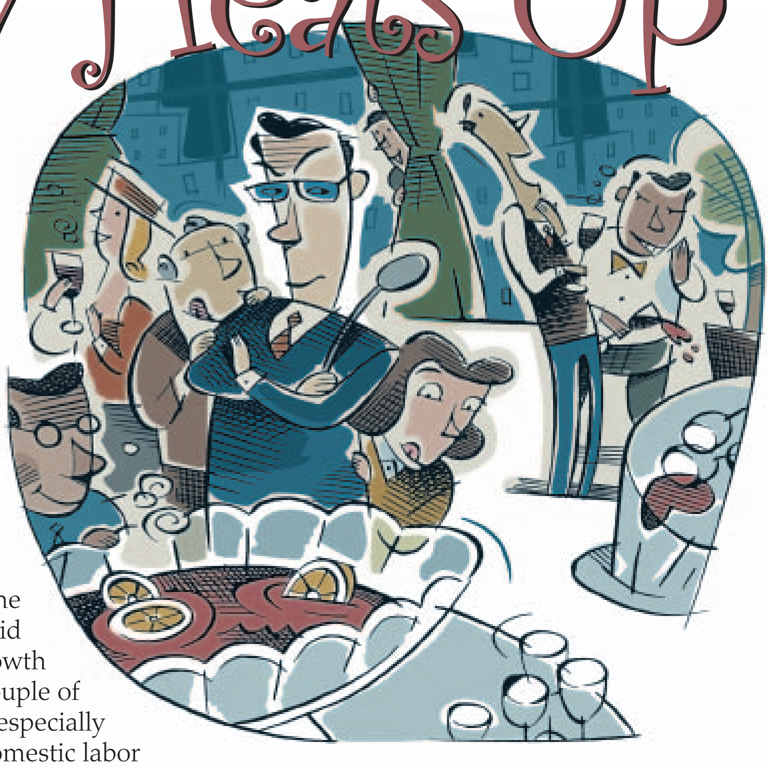

Helped along by a healthy dose of stimulative monetary and fiscal policies, 2003 turned out to be a pretty exceptional year for the U.S. economy. Compared with 2002, last year saw stronger economic growth, continued low and stable inflation, modestly lower interest rates, rising corporate profits and a robust rally in the stock market. To cap it off, labor productivity (output per hour in the nonfarm business sector) increased at its quickest pace since 1965. Though subject to revision, preliminary estimates show that real GDP increased by 4.3 percent in 2003, while CPI inflation measured 1.9 percent (both measured by the percentage change from the fourth quarter of 2002 to the fourth quarter of 2003). In 2002, real GDP increased about 2.75 percent, while the CPI rose about 2.25 percent.

In the face of this heartening performance of the economy, employment gains remained hard to come by. (See related article on pp. 10-11.) Despite modest increases over the last five months of 2003, U.S. nonfarm payroll employment declined by less than 0.1 percent from December 2002 to December 2003. As a result, the civilian unemployment rate was little changed in 2003. After inching up over the first half of the year from 6 percent in December 2002 to 6.3 percent in June 2003, the unemployment rate then fell modestly over the second half of the year, to 5.7 percent in December. In the Eighth District of the Federal Reserve System, four states saw declines in their unemployment rates from December 2002 to December 2003, while the other three states experienced slight increases. On average, the District's seven-state unemployment rate fell from 5.7 percent to 5.4 percent. Only three states posted positive growth in nonfarm payroll employment from December 2002 to December 2003: Indiana, 0.4 percent; Missouri, 1.7 percent; and Tennessee, 0.1 percent.

One of the most important developments in 2003 was the continued strong growth of labor productivity. Instead of averaging 2 percent over the four quarters of 2003, as Blue Chip forecasters had expected in December 2002, labor productivity growth averaged a little more than 5.25 percent. The influence of rapid productivity growth over the past couple of years has been especially strong in the domestic labor market. In essence, firms (on average) have found that they have not needed to hire more workers to boost output. Whether through improved production processes, better equipment or supply chains, or enhanced worker training programs, the private sector has experienced tremendous growth in labor productivity over the past few years. That said, historical experience suggests that labor productivity growth cannot continue to outstrip the growth of real GDP indefinitely when population growth remains about 1 percent. Ultimately, strong labor productivity growth means rising real incomes, lower costs, higher profits and, yes, rising employment.

Twice a year, typically in February and July, the Federal Reserve releases its Monetary Policy Report to the Congress. Each report publishes projections by the Federal Reserve governors and Bank presidents for a few key economic variables. In the February 2004 report, Fed policymakers reported that their belief is that the "economic expansion will continue at a brisk pace in 2004." Specifically, the most likely scenario is for real GDP to increase by between 4.5 to 5 percent between the fourth quarter of 2003 and the fourth quarter of 2004. Consumer prices, as measured by the personal consumption expenditures chain-type price index, are expected to increase by between 1 and 1.25 percent, while the unemployment rate is projected to fall to about 5.5 percent. In general, Fed policy-makers are expecting modestly faster real GDP growth in 2004 than does the Blue Chip Consensus forecast, but slightly lower inflation and a lower average unemployment rate by the end of the year. Although the Fed does not forecast employment, the general consensus of private-sector forecasters is that nonfarm payroll employment gains will average about 150,000 a month. In all likelihood, continued strong productivity growth will continue to limit the pace of job creation.

A former Federal Reserve chairman once said that the Fed's job was to take away the punch bowl before the party got out of hand. As events over the past few years have demonstrated, though, one of the insurmountable difficulties of economic forecasting is the inability to predict the unpredictable. If, however, as forecasters suggest, the party's starting to heat up, then pulling the punch bowl will be a matter of when, not whether.

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