

A Patchwork Economy?

By Kevin L. Kliesen

Real GDP rose at only a 3.1 percent annual rate during the first quarter, according to the advance estimate, which was released April 28. This growth was about 0.75 percentage points less than both the April *Blue Chip Consensus* forecast and the economy's growth rate in the fourth quarter of 2004, prompting concern in some quarters that the economy had fallen into a "soft patch." Especially worrisome was that the growth of real final sales (a measure of demand for domestically produced goods and services) slowed even more, by 1.5 percentage points to 1.9 percent—its slowest pace in more than two years. This meant that the remainder of first-quarter growth was due to an accumulation of newly produced goods that went unsold (business inventories), a development that spurred most forecasters to trim their estimates of second-quarter growth.

Soft Patch?

After the advance GDP report was released, a few key reports suggested that the Bureau of Economic Analysis had underestimated the strength of economic conditions in the first quarter. Thus, by the time the revised GDP estimate was published May 26, first-quarter real GDP growth was revised upward to 3.5 percent, while growth of real final sales was boosted to 2.7 percent.

Meanwhile, the April data that began to trickle in suggested that fears of a soft patch were overblown. First, nonfarm payroll employment surged by 274,000, about 100,000 more than expectations. Second, retail sales, domestic auto sales, housing starts, existing home sales and factory orders for manufactured durable goods all rose quite strongly in April. Third, crude oil prices had retreated modestly from their peak in early April, a development that helped push stock prices up a little more than 6 percent between mid-April and early June. Finally, the Federal Reserve's Senior Loan Officer

Opinion Survey showed continued strong demand for commercial and industrial loans by both large and small firms for the three months ending in April.

Tempering the improved outlook in April was a modest decline in industrial production. Some of this softness spread elsewhere in May, according to some of the regional manufacturing surveys. In addition, payroll employment rose by only 78,000, about 100,000 less than expected, and car and truck sales fell about 4.5 percent. Further adding to the uncertainty, oil prices rebounded, pushing past \$50 per barrel in early June.

The Inflation Outlook is . . . ? Exactly!

Slightly weaker growth in the first quarter was accompanied by a pick-up in inflation. The price index that is preferred by the Federal Open Market Committee rose at about a 2.25 percent rate in the first quarter.¹ That's the largest increase in a little more than three years. As the May FOMC minutes revealed, Fed policy-makers expressed concern that higher oil prices had worked their way into core inflation and perhaps were responsible for the "discernable upcreep" in some measures of inflation expectations in recent months. Still, the FOMC was confident that inflation would moderate over the remainder of the year and into 2006.

What makes policy-makers so sanguine about the inflation outlook? First, inflation-sensitive long-term interest rates have declined by about 75 basis points since their March

peak of just over 4.6 percent. Second, market-based measures of inflation expectations declined a bit further following the May 3, 2005, FOMC meeting. Third, labor productivity rose by more than expected in the first quarter, and the employment cost index (a measure of wage inflation) rose by less than expected. Fourth, the core CPI rose much less than expected in April (0.6 percent annualized) after rising at about a 3.25 percent rate over the first three months of the year. Fifth, the trade-weighted value of the U.S. dollar (broad index) rose to a more-than-seven-month high for the week ending May 27; if sustained, a stronger dollar should moderate recent gains in the prices of imports other than petroleum.

Although some analysts attribute falling long-term interest rates to a concern that higher oil prices and a less accommodative monetary policy are sapping the strength of the economy, forecasts for economic conditions over the second half of this year and into next year remain fairly upbeat and are mostly unchanged since the first of this year. In view of this, the FOMC seems determined to prevent a further rise in core inflation or inflation expectations by maintaining its regimen of a "measured pace" of interest rate increases.

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ENDNOTE

- 1 The FOMC's preferred index is the personal consumption expenditures (PCE) price index that excludes food and energy prices. It is from the national income and product accounts (NIPAs).

