

# Triple Whammy Fuels Economic Doubts

By Kevin L. Kliesen



Escalating oil and commodity prices, a sharp contraction in the housing market, and recent financial market turbulence have increased the odds of a recession this year, according to most forecasters. A return to trend-like real GDP growth (3 percent) toward the middle of 2009 seems the most likely scenario, but recent stimulative actions undertaken by the monetary and fiscal authorities could provide a kick-start to growth in the second half of 2008. However, a quicker rebound, while welcome, might also exacerbate the upward pressure on inflation, which in 2007 was at its highest rate in 17 years, as well as on inflation expectations.

## Is Inflation Gaining Steam?

Measures of actual and expected consumer price index (CPI) inflation have risen sharply since late last year. This development stems mostly from the extraordinary increases in crude oil and commodity prices. Six months ago, the CPI was expected to increase by about 2.25 percent this year after increasing 4.2 percent last year. But in the first quarter of this year, CPI increased at about a 4.25 percent rate.

With oil prices skyrocketing to more than \$135 per barrel in May, average U.S. retail gasoline prices rose to nearly \$4 per gallon. The summer driving season is expected to put some additional upward pressure on prices. Moreover, in April the food component in the CPI had increased by more than 5 percent from a year earlier—its largest increase since late 1990. Thus, it is conceivable that the inflation rate will remain high in the second and third quarters of 2008. In its May report, the Survey of Professional Forecasters (SPF) expects that the CPI will increase by a little more than 3.25 percent in 2008.

Forecasters and the FOMC remain hopeful that the sharp increase in food and energy

prices will not worsen the inflation expectations of households, firms and financial market participants. Keeping inflation expectations low and stable is a key pillar of a successful monetary policy. At this juncture, the evidence is mixed. On the one hand, expected inflation over the next 12 months rose to more than 5 percent in May, according to the University of Michigan consumer sentiment survey. This level was the highest in the survey since 1982. On the other hand, the average yield on inflation-sensitive 10-year U.S. Treasury securities remains below 4 percent, and SPF's forecasts of inflation over the next 10 years have been exceptionally stable at about 2.5 percent for more than a decade.

## Is This a Recession?

Housing continues to exert a sizable drag on real GDP growth. Rising foreclosure rates, exceptionally high levels of unsold new and existing homes, continued declines in house prices, and lack of financing in the nontraditional mortgage market suggest that the housing slowdown has a ways to go.

The SPF projects that real residential fixed investment will continue to decline through the first quarter of next year, but some in the housing industry are even more pessimistic. Since housing's peak in the fourth quarter of 2005, real GDP growth has averaged 2.4 percent per quarter, whereas the contribution from real residential fixed investment has averaged -0.9 percentage points per quarter. Hence, a silver lining is that real GDP growth excluding housing has averaged about 3.25 percent during this two-year period. Nevertheless, labor market conditions have

deteriorated noticeably this year. Over the first four months, nonfarm payroll employment has declined by an average of 65,000 per month.

To help counter the fallout from the housing bust, the Federal Reserve has taken two major steps. First, it enacted several new forms of direct lending to financial institutions; this lending is designed to counter strains in the financial markets and to assist depository institutions that may not have an adequate amount of financial capital to lend to credit-worthy customers. Second, the FOMC has reduced its target rate for federal funds from 5.25 percent to 2 percent since August. These stimulative actions, by and large, will not produce an immediate payoff.

All in all, increasing energy prices will likely impart further downward pressure on the growth of real household income and expenditures, and, thus, also business sales, earnings and capital outlays for the remainder of this year. These drags on economic growth—financial, housing and oil—have increased the risk of a recession this year. Although the recently passed fiscal stimulus package may provide a modest, albeit temporary, boost to growth, forecasters and the FOMC expect real GDP growth this year to be 1 percent or less. 

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