



Threats to the Economy Don't Let Up

By Kevin L. Kliesen

Despite the economic turmoil emanating from rising oil prices, the collapse in housing activity and financial market turbulence, the U.S. economy expanded at a modest pace over the first half of 2008. But larger-than-expected increases in inflation, continued declines in payroll employment and a marked slowing world economic growth have further raised the threat level facing the economy. Most Federal Reserve policymakers and forecasters expect that a gradual slowing in inflation will commence later this year, followed by a return to trend-like economic growth by mid-2009. But others warn that the cumulative effects of past actions to strengthen aggregate demand growth have the potential to further destabilize an economy being buffeted by rising price pressures and elevated inflation expectations.

Not Price Stability

Most of the inflation news is bad, not just in the United States, but globally. After increasing last year at a 17-year high of 4.1 percent, the all-items Consumer Price Index (CPI) has increased at about a 5.25 percent annual rate over the first eight months of this year. An important factor behind this acceleration was the more than 40 percent increase in the price of crude oil between January and June. Further compounding the economic woes facing U.S. households, prices of food and imported goods are accelerating at their fastest rates in several years. Accordingly, some measures of consumer inflation expectations have risen sharply this year.

Likewise, many firms, which are also battling higher fuel and transportation costs, have also been hit by sharp increases in the prices of commodities and certain finished

products, such as steel and petrochemicals. Throttled by pressures on their profit margins, producers are increasingly willing and able to pass along input price increases to their customers, business surveys suggest. As a result, price increases outside of food and energy have started to accelerate. After increasing at a 1.8 percent annual rate over the first four months of 2008, the core CPI (minus food and energy) has increased at a 3.2 percent rate over the four months ending in August.

Many forecasters remain confident that both the headline and the core inflation rate will begin to moderate in the fourth quarter of this year. Moreover, a key inflation barometer—the yield on the 10-year U.S. Treasury security—remains relatively low and stable. Some favorable developments, if sustained, enhance the credibility of this forecast. First, crude oil and commodity prices have retreated significantly from their summer peaks. Second, the value of the dollar has posted an impressive rebound, which will help to reduce import price inflation. Third, labor productivity growth has been quite strong for the past several quarters, helping to constrain the growth of unit labor and nonlabor costs.

The Fed's Dilemma

The pace of U.S. economic growth has gradually accelerated since the fourth quarter of 2007, when real GDP—according to newly revised estimates—declined at a 0.2 percent annual rate. Following a 0.9 percent rate of growth in the first quarter of 2008, the Bureau of Economic Analysis reported that real GDP grew at a healthy 3.3 percent annual rate in the second quarter—much stronger than expected. The consensus of most forecasters is that the second quarter will be the high-water

mark for growth this year: The August Survey of Professional Forecasters projects that real GDP growth will slow to 1.2 percent in the third quarter and then slow even further over the final three months of 2008 (0.7 percent).

Much of the economy's recent strength stems from a robust export sector. But with the renewed strength in the U.S. dollar and weakening economic growth in Japan and many European countries, the outlook for exports is unsettled.

And then there is housing. Overall, residential housing construction and sales remain moribund, and national house price indexes continue to decline on a year-to-year basis. Most forecasters do not expect a rebound in construction to commence until next year, while the bottom in national home prices could extend even longer. With little or no lending in the nontraditional mortgage market and with the inability of some buyers to secure funding for higher-priced homes (jumbo mortgages), new and existing home sales this year are on a pace to be the weakest in more than a decade.

Federal Reserve policymakers face a dilemma: how to counter the threat from rising inflation in the face of an expected slowing in economic growth and unsettled financial market conditions. The consensus of most forecasters is that economic conditions may spur the Federal Open Market Committee to reduce its federal funds rate target by the end of this year. However, this outcome will most likely depend on a sharp slowing in the inflation rate. 

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