

## Recovery Continues despite New Risks, Old Problems

By Kevin L. Kliesen

The macroeconomic environment continues to improve, although the pace of economic activity has been bumpy and somewhat lackluster. In particular, the unexpected slowing in real GDP growth during the first quarter (1.8 percent from the fourth quarter's 3.1 percent) occurred against the backdrop of healthy increases in private-sector employment and a modest decline in the unemployment rate.

As policymakers, businesses and consumers grapple with the lingering effects of the financial crisis and recession, some additional risks have emerged. Chief among these are sharply higher energy prices and the uncertainties stemming from developments in Europe, the Middle East and Japan. Still, most forecasters continue to believe that the economy will shake off the first-quarter doldrums of unexpectedly high inflation and subpar output growth and will soon transition to lower inflation rates and a stronger pace of economic activity.<sup>1</sup>

### Help Wanted

Among the most notable developments of late has been the sharp rebound in monthly private-sector payroll employment. Although the pace of hiring slowed in May, private employment increased by 182,000 jobs per month over the first five months of 2011. Average monthly gains in total nonfarm payrolls were a bit smaller because state and local governments reduced employment to help correct their fiscal imbalances. However, the economy's growth has not been brisk enough to bring about dramatic reductions in the unemployment rate, which remained quite elevated in May (9.1 percent). Professional forecasters generally expect total nonfarm job gains to average about 190,000 per month through the first half of 2012, with the unemployment rate slowly falling to about 8.25 percent by June 2012.

### The Return of Oil at \$100 per Barrel

Perhaps surprisingly, the rise in oil prices and the resulting surge in average gasoline prices to near \$4 per gallon nationally have not yet derailed consumer spending or impinged on planned capital expenditures by businesses. The previous surge in oil prices, in 2007-2008, helped push the economy into recession, but today's dynamics are much better: Equity prices are rising, real interest rates are lower, real household incomes are strengthening, and housing construction and household wealth are no longer plunging at a rapid rate. In addition, the rebound in global growth has benefited many firms, especially manufacturers. This development, in conjunction with a weaker dollar, has kept U.S. exports expanding at a rapid clip. Relatively strong business expenditures on equipment and software are a key signal that firms expect solid economic conditions going forward.

The construction sector remains the fly in the ointment, as housing starts and new home sales continue to linger near record lows, and office and commercial construction languishes. Moreover, house prices continue to drift lower because of the large number of unsold houses on the market and high foreclosure rates—although the latter have been trending lower. The growth of federal government outlays has also weakened because of the waning federal stimulus program and pressures to reduce the extraordinarily large budget deficit.

The rise in oil prices and some of the lingering uncertainties spawned by events overseas have not shaken the confidence of financial markets either. Equity prices have risen sharply since late August 2010, and the St. Louis financial stress index has returned to its prefinancial-crisis levels. Improving economic and financial market conditions have begun to increase the demand for bank



loans by businesses, and consumer credit has started to rise modestly.

### Inflation Increases

Sharply higher energy prices, as well as rising food prices, have pushed headline inflation rates to levels last seen during the 2007-08 oil price shock. Over the past year, the CPI rose by 3.4 percent. A key worry associated with an oil shock (or higher food prices) is the impact that “pass-through” effects may have on prices of nonfood and nonenergy goods and services. If long-term inflation expectations are viewed as low and stable and if monetary policy is viewed as credibly committed to long-term price stability, then these pass-through effects tend to be modest and temporary.

Accordingly, most economists and Federal Reserve policymakers view the sharp rise in inflation as a temporary deviation from a low and stable inflation environment. As long as this expectation persists, the unemployment rate remains high and the pace of growth uneven, most forecasters and financial market participants believe that the Federal Open Market Committee will maintain its existing federal funds rate target of 0 to 0.25 percentage points for the remainder of 2011—and maybe into the first half of 2012. <sup>1</sup>

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### ENDNOTE

<sup>1</sup> References in this article to inflation are to “headline inflation,” which factors in food and energy prices.