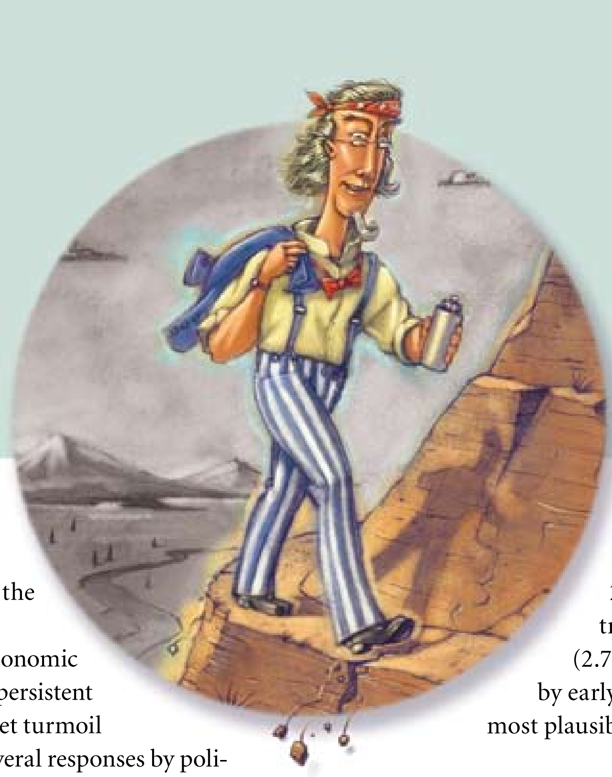
Skirting the Edge?

By Kevin L. Kliesen



The pace of economic activity in the United States slowed sharply over the final three months of 2007. Real GDP managed an anemic 0.6 percent rate of growth in the fourth quarter. In January and February, growth appeared to weaken further. The primary contributors to this downshift have been continued sharp declines in the rate of new home construction (which helped to cool the pace of consumer spending and, thus, production of consumer durables), high and rising oil prices, and lackluster growth of new equipment and software purchases by firms.

With growth slowing and financial market uncertainty still high, banks and other depository institutions began to tighten terms and standards on loans to households and firms.

Recession Forecasts

A key development in the near-term economic outlook occurred in early January 2008 when the Bureau of Labor Statistics (BLS) reported that private nonfarm payroll employment declined unexpectedly in December 2007 and the unemployment rate rose by more than expected. Over the next two months, the BLS reported further declines in private nonfarm employment.

Because employment is an important indicator in dating business cycle peaks and troughs, some forecasters dramatically raised the odds of a recession to about 50 percent. By March 2008, the Blue Chip consensus forecast for the first half of 2008 had been cut to about 0.25 percent, while growth over the second half of the year had been trimmed to about 2.25 percent. Seven months earlier, forecasters had expected real GDP growth to average about 2.75 percent over the first half of this year and by about 3 percent over the second half.

Emerging economic weakness and persistent financial market turmoil engendered several responses by policymakers. First, the Federal Open Market Committee lowered its federal funds target rate from 5.25 percent to 3 percent. Many forecasters and financial market participants expect further cuts in the first half of 2008. To help meet the increased demand for short-term financing by depository institutions and to help alleviate market uncertainty, the Federal Reserve also enacted what it's calling the Term Auction Facility and the Term Securities Lending Facility. Next, the administration signed into law a fiscal policy stimulus package totaling approximately $150 billion. The centerpiece of this legislation is a one-time tax rebate for households; this rebate comprises about two-thirds of the total package, with most of the rest going to a business investment tax credit.

The majority of forecasters seem to believe that these fiscal actions will have only a modest, temporary effect on aggregate demand growth. However, a few noteworthy forecasters believe that consumer and business outlays will increase dramatically in the second half of 2008, providing a sizable stimulus to real GDP growth.

As the effects of the fiscal stimulus package wane, the economy might also receive a boost from the FOMC's actions to boost economic growth and stabilize financial markets. In addition, as conditions in the housing industry begin to stabilize, a key drag on the economy's pace of growth will be removed. However, with the economy slowing by more than expected in early 2008, a return to trend-like growth (2.75 to 3 percent) by early next year seems most plausible.

Concerns about Inflation

An abiding concern of some economists is that much of this monetary and fiscal stimulus is hitting the economy at a time when inflation pressures—led by rising oil and commodity prices—are uncomfortably high. In 2007, overall PCE (Personal Consumption Expenditures) inflation measured 3.6 percent, the highest rate in 17 years. Last year brought especially large increases in food and energy prices for consumers. Although most forecasters expect overall inflation to drop back to about 2.5 percent this year, some economists and a few Fed policymakers have warned that this forecast is subject to considerable uncertainty. In fact, the slowing in the growth of economic activity over the past six months has not yet produced a slowing in inflation that many were expecting.

Should inflation continue to rise, the FOMC might find itself fighting an unwelcome increase in inflation expectations. Already, long-term inflation expectations started to creep up in early March. If this development persists, larger future increases in the federal funds target rate might be necessary, perhaps leading to a more pronounced downturn later. Ω

Kevin L. Kliesen is an economist at the Federal Reserve Bank of St. Louis. *Joshua A. Byrge provided research assistance.* *For more on Kliesen's work, go to http://research.stlouisfed.org/econ/Kliesen/index.html.*