The U.S. Economic Outlook: Soft Patch, Sink Hole, or Springboard?

Kevin L. Kliesen
Economist, Federal Reserve Bank of St. Louis
Not an official Document
Outline of Talk

- Current Conditions (are we past the soft patch?)
- The Consensus Forecast
- Risks to the Consensus Forecast
Current Conditions

- Economic conditions firm in the third quarter, following the second-quarter “soft patch”

  “Economic activity hit a soft patch in late spring after having grown briskly in the second half of 2003 and the first part of 2004. . . That softness in activity no doubt is related, in large measure, to this year's steep increase in energy prices.”

  Chairman Greenspan, Congressional Testimony, September 18, 2004
“Tracking” Forecast: 2004/Q3 Real GDP Growth

Source: Macroeconomic Advisers
Current Conditions

- Economic conditions firm in the third quarter, following the second-quarter “soft patch”

- Payroll employment growth weakened in 2004:Q3, but hours growth accelerated at fastest rate in more than 7 years
Payroll Employment During the Current & Average Business Cycle

Percentage Difference from Peak Value

NOTE: Average excludes the 1980 peak; post-WW II period.
Real GDP Growth and the Hours Growth Gap

NOTE: Hours gap is the four-quarter growth of nonfarm hours less the four-quarter growth of aggregate nonfarm employment.
Current Conditions

- Economic conditions firm in the third quarter, following the second-quarter “soft patch”

- Payroll employment growth remains relatively weak, but hours growth accelerates

- Monetary policy remains accommodative; FOMC moving in a “measured” pace toward neutrality

- Oil prices move past $50/bbl, but inflation expectations remain stable
Financial Market
Inflation Expectations

NOTE: Yield spreads between nominal and inflation-indexed U.S. Treasury securities.
Consensus Forecast

- Key assumptions
Rates on Federal Funds Futures on Selected Dates

Percent


Contract Month

08/24/04  09/22/04  10/20/04
Crude Oil Futures Prices
West Texas Intermediate

Dollars per barrel

55 --
54 --
53 --
52 --
51 --
50 --
49 --
48 --
47 --

Nov | Dec | Jan | Feb | Mar | Apr | May | Jun | Jul | Aug | Sep | Oct

10/13/2004
10/20/2004
Consensus Forecast

- Key assumptions

- Continued strong structural productivity growth boosts real incomes, spending, and holds down growth of unit labor costs and prices
Four- and 40-Quarter Growth Rates of Nonfarm Labor Productivity

Percent


4-Qtr 40-Qtr
Consensus Forecast

- Key assumptions
  
  - Continued strong structural productivity growth boosts real incomes, spending, and holds down growth of unit labor costs and prices

  - Robust profits, low cost of capital keeps business capital spending growing briskly

  - Weaker foreign growth in 2005
U.S. & Foreign Economic Growth Rates

SOURCE: Blue Chip Economic Indicators (October 10, 2004)
## Forecasts for 2004 and 2005

<table>
<thead>
<tr>
<th></th>
<th>Real GDP Growth</th>
<th>Core Inflation</th>
<th>Unemployment Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Blue Chip Consensus (Oct.)</td>
<td>3.8</td>
<td>3.5</td>
<td>2.2*</td>
</tr>
<tr>
<td>Macroeconomic Advisers (Oct.)</td>
<td>3.9</td>
<td>4.1</td>
<td>1.9*</td>
</tr>
<tr>
<td>FOMC (July, central tendency)</td>
<td>4.5 - 4.75</td>
<td>3.5 - 4.0</td>
<td>1.75 - 2.0**</td>
</tr>
<tr>
<td>Business Council (Sept.)</td>
<td>N/A</td>
<td>2.1 - 3.5</td>
<td>N/A</td>
</tr>
</tbody>
</table>

*Core CPI
**Core PCE
Forecasts of Major GDP Components

**Consumer Spending**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Forecast</td>
<td>1.6</td>
<td>4.4</td>
<td>3.2</td>
<td>3.6</td>
</tr>
</tbody>
</table>

**Fixed Investment**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Forecast</td>
<td>13.4</td>
<td>2.9</td>
<td>6.4</td>
<td>9.0</td>
</tr>
</tbody>
</table>

**Govt. Spending**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Forecast</td>
<td>2.2</td>
<td>1.7</td>
<td>1.7</td>
<td>1.9</td>
</tr>
</tbody>
</table>

**Net Exports**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Forecast</td>
<td>-580.3</td>
<td>-584.0</td>
<td>-585.6</td>
<td>-520.6</td>
</tr>
</tbody>
</table>

Source: Macroeconomic Advisers
Risks to the Forecast

- Oil prices continue to rise, weakening consumer spending and heightening business uncertainty
Cumulative 12-Month Percent Changes in Real WTI Prices During Oil Shock Episodes (Zero Otherwise)
## Average Growth, Six Quarters Before and After Five Oil Shock Episodes

<table>
<thead>
<tr>
<th>Series</th>
<th>Avg. Growth Before</th>
<th>Avg. Growth After</th>
<th>Delta</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP</td>
<td>3.8</td>
<td>1.2</td>
<td>-2.6</td>
</tr>
<tr>
<td>Real PCE</td>
<td>4.1</td>
<td>2.0</td>
<td>-2.1</td>
</tr>
<tr>
<td>Real Business Fixed Investment</td>
<td>7.5</td>
<td>-0.3</td>
<td>-7.8</td>
</tr>
<tr>
<td>Real Residential Fixed Invest.</td>
<td>1.1</td>
<td>-4.6</td>
<td>-5.7</td>
</tr>
<tr>
<td>Industrial Production</td>
<td>3.2</td>
<td>-1.4</td>
<td>-4.6</td>
</tr>
<tr>
<td>CPI Inflation</td>
<td>4.5</td>
<td>6.6</td>
<td>2.1</td>
</tr>
<tr>
<td>Core CPI Inflation</td>
<td>4.1</td>
<td>5.9</td>
<td>1.9</td>
</tr>
<tr>
<td>PCE Price Inflation</td>
<td>3.9</td>
<td>5.6</td>
<td>1.7</td>
</tr>
<tr>
<td>Core PCE Inflation</td>
<td>3.5</td>
<td>4.9</td>
<td>1.3</td>
</tr>
<tr>
<td>Nonfarm Employment</td>
<td>2.6</td>
<td>0.1</td>
<td>-2.5</td>
</tr>
<tr>
<td>Unemployment Rate</td>
<td>5.2</td>
<td>6.0</td>
<td>0.8</td>
</tr>
<tr>
<td>Consumer Confidence</td>
<td>113.7</td>
<td>87.4</td>
<td>-26.4</td>
</tr>
<tr>
<td>10-Year Treasury Yield</td>
<td>6.8</td>
<td>7.2</td>
<td>0.4</td>
</tr>
<tr>
<td>Real Federal Funds Rate</td>
<td>2.9</td>
<td>1.2</td>
<td>-1.7</td>
</tr>
</tbody>
</table>

**Addenda:**

- Real Spot WTI Price ($): 23.40 - 35.00 = 11.6

**Episode 1:** 1973/Q4 (T=0)
**Episode 2:** 1979/Q1 (T=0)
**Episode 3:** 1990/Q3 (T=0)
**Episode 4:** 1999/Q1 (T=0)
**Episode 5:** 2002/Q1 (T=0)
Effects of $50/Bbl Oil on Real GDP Growth (Hamilton's methodology)

Percent change, annualized


Real GDP Growth (Baseline)

Real GDP Growth (Adjusted for Change in Oil Prices)

Increased Energy Efficiency: Partial Offset to Higher Prices

**Figure 2. Energy Consumption per Person**

Energy use per person stood at 215 million Btu in 1949. The rate generally increased until the oil price shocks of the mid-1970s and early 1980s when the trend reversed for a few years. From 1988 on, the rate held fairly steady. In 2003, 338 million Btu of energy were consumed per person, 57 percent above the 1949 rate.

**Figure 3. Energy Use per Dollar of Gross Domestic Product**

After 1970, the amount of energy consumed to produce a dollar’s worth of the Nation’s output of goods and services trended down. The decline resulted from efficiency improvements and structural changes in the economy. The level in 2003 was 48 percent below that of 1970.

**SOURCE:** U.S. Energy Information Administration
Simulating the Effects of Higher Oil Prices Using a Structural Forecasting Model

SOURCE: Macroeconomic Advisers (October 2004)
Risks to the Forecast

- Oil prices continue to rise, weakening consumer spending and heightening business uncertainty.

- Low real interest rates cause demand growth to increase faster than expected— inflationary effects from tighter labor and product markets offset.

- Output gap not as large as consensus forecast suggests; in actuality monetary policy too accommodative.
Hypothetical Neutral Federal Funds Target Rates

**NOTE:** Hypothetical fed funds target rate is the sum of the 40-quarter annualized growth rates of labor productivity and labor force growth, plus an assumed inflation target of either 1 or 2 percent.
Year-to-date Core PCE inflation rates and the FOMC’s inflation projection for 2004 made in July 2004

Core inflation, Jan. – Aug.

FOMC Central Tendency
(1.75 to 2.0%)

Percent
3
2
1
0

Jan
Mar
May
Jul
Sep
Nov

2004

1.4
Questions?