Since late last year, the U.S. economy has experienced a period of weaker-than-expected growth followed by a period of stronger-than-expected growth. Meanwhile, energy and commodity prices have continued to rise, inflation and long-term interest rates have picked up, and the dollar has continued to fall. Through it all, forecasts for real gross domestic product (GDP) growth, consumer price index (CPI) inflation, the unemployment rate and long-term nominal interest rates for 2006 and 2007 are little changed from a year earlier. The expansion continues for the foreseeable future.

Economic Headwinds

Real GDP rose at an impressive 5.3 percent annual rate in the first quarter of this year. Like most forecasters, Federal Reserve policymakers expect this to be the high-water mark for the year. In its May 10 press release, the Federal Open Market Committee said that economic growth is “likely to moderate to a more sustainable pace, partly reflecting a gradual cooling of the housing market and the lagged effects of increases in interest rates and energy prices.” This view seems consistent with the Blue Chip Consensus, which expects real GDP growth to average 3.1 percent over the final three quarters of this year. If this moderation occurs, then average monthly payroll employment gains would also be expected to step down modestly. Over the first five months of this year, payrolls grew by an average of about 150,000 per month.

The incoming data are generally consistent with the consensus view. First and foremost, the housing market appears to be losing some steam. Single-family housing starts, new and existing home sales and the growth of home prices through the first four months of 2006 are off significantly from their pace of a year earlier.

Second, gains in consumer spending, whether because of the drag to income growth from higher energy prices or rising interest rates, have slowed from the rapid growth seen in the first quarter of 2006.

Some developments suggest a more favorable outlook. First, if current trends in the growth of labor productivity (about 2.5 percent) and hours worked (about 2.5 percent) hold, then GDP growth may surprise on the upside. Second, the outlook for business capital spending (nonresidential fixed investment) remains quite good, according to the Philadelphia Fed’s forecasting survey and other business surveys. Business capital spending is important because its share in GDP (11 percent) is nearly double that of housing (6.2 percent). Finally, the latest forecasts from the International Monetary Fund and the Organisation for Economic Co-operation and Development predict continued strong global growth this year and next. Bolstered by the depreciation of the U.S. dollar, this should help spur the growth of real exports.

Outcroppings of Higher Inflation Appear

One of the consequences of a depreciating currency is that it can exacerbate domestic price pressures. Thus, a weaker dollar could be significant when viewed against the increases in crude oil and commodity prices, which have helped to push up inflation rates. Through the first four months of this year, the personal consumption expenditures (PCE) price index rose at a 4.2 percent annual rate, about 0.5 percentage points faster than the same period last year. Similarly, core inflation (excluding food and energy prices) increased at about a 2.75 percent annual rate over the first four months of the year, about 0.75 percentage points faster than a year earlier.

Although core PCE inflation has moved beyond the upper bound of Fed Chairman Ben Bernanke’s 1 to 2 percent comfort zone, forecasters and financial market participants remain convinced of the Fed’s commitment to long-run price stability. This commitment has helped keep long-run inflation expectations in check, and it has prevented long-term nominal interest rates from taking noticeably higher, which is a common occurrence during inflation scares.

Energy prices remain a risk to the forecast—both as a potential brake on growth and as a threat to higher inflation. Whether because of continued geopolitical concerns, strong global economic growth or the government’s forecast of a “very active” hurricane season this year, considerable volatility remains in the energy markets. This volatility can temper business enthusiasm for investment, which remains a bright spot in the outlook. But if the economy continues to surprise on the upside, then firms may become more aggressive in passing along higher energy and other costs to consumers. Such a development would threaten the sustainability of the current expansion, now into its fifth year.

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