

# Examining the U.S. Economic Outlook

*A Professor's Guide to The Changing U.S. Economy*

February 16, 2005



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Not an official Document

*Views expressed do not necessarily reflect official Federal Reserve positions.*





# Outline of Talk

- A Resilient Economy
- A Look Back at 2004
- Current Conditions
- The Outlook for 2005: Previewing the Fed's Monetary Policy Report to the Congress
- Risks to the Forecast



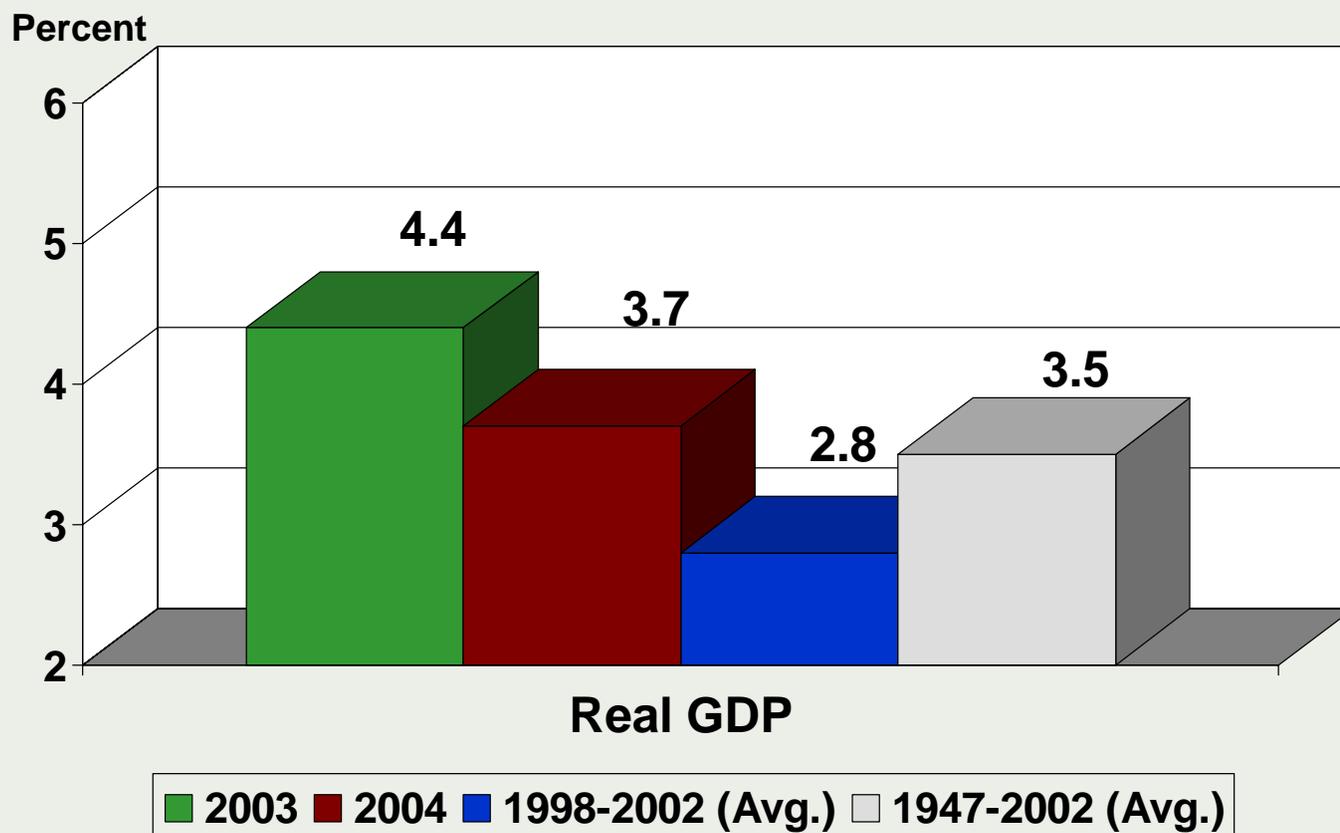
# Resilience of the U.S. Economy

- The U.S. economy has been buffeted by numerous shocks over the past several years:
  - The capital investment boom and bust—particularly in high-tech—that was partially the result of the stock market boom and bust and precautionary spending to mitigate Y2K concerns.
  - Sept. 11, 2001: threat of additional terrorist acts elevated business and household uncertainty; government and the private sector boost spending on security-related goods and services; increased delays for air cargo and passenger travel.
  - Corporate accounting scandals; record-high (nominal) prices of crude oil; war in Iraq and Afghanistan (“geopolitical concerns”).



# A Look Back at 2004

- Continued solid economic growth.





# A Look Back at 2004

## 2004 Economic Performance: Forecasts vs. Actuals

*Percent Change, Q4/Q4*

	<u>Projected</u>	<u>ACTUAL</u>	<u>Error</u>
Gross Domestic Product	3.9	3.7	-0.2
PCE	3.5	3.9	0.3
Durables	3.1	6.3	3.1
Nondurables	4.3	4.3	0.1
Services	3.2	3.2	-0.1
GPDI	5.6	10.6	5.0
BFI	8.7	9.9	1.2
E&S	11.9	13.6	1.7
Structures	-2.5	-1.6	0.9
Residential	-6.4	5.7	12.1
CBI <sup>1</sup>	30.6	37.2	6.6
Net Exports	-14.1	-103.6	-89.5
Exports	10.8	4.1	-6.8
Imports	8.1	9.2	1.1
Government	3.7	1.6	-2.1
Federal	5.2	4.0	-1.2
Defense	5.5	5.5	0.0
Nondefense	4.7	1.0	-3.7
State & Local	2.7	0.2	-2.5

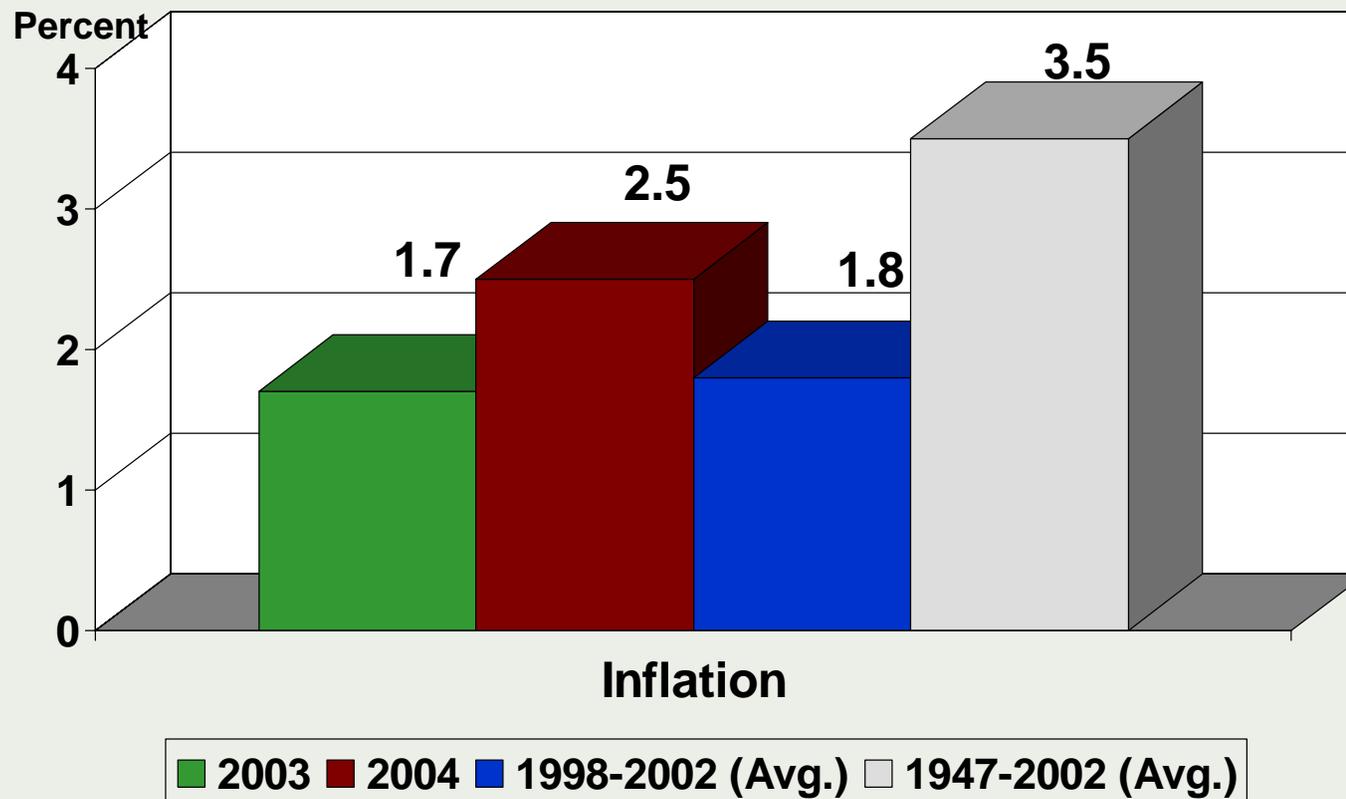
<sup>1</sup> Change, 2003:Q4 to 2004:Q4

NOTE: 2004 Forecasts published in the Dec. 10, 2003, Blue Chip Econometric Detail.



# A Look Back at 2004

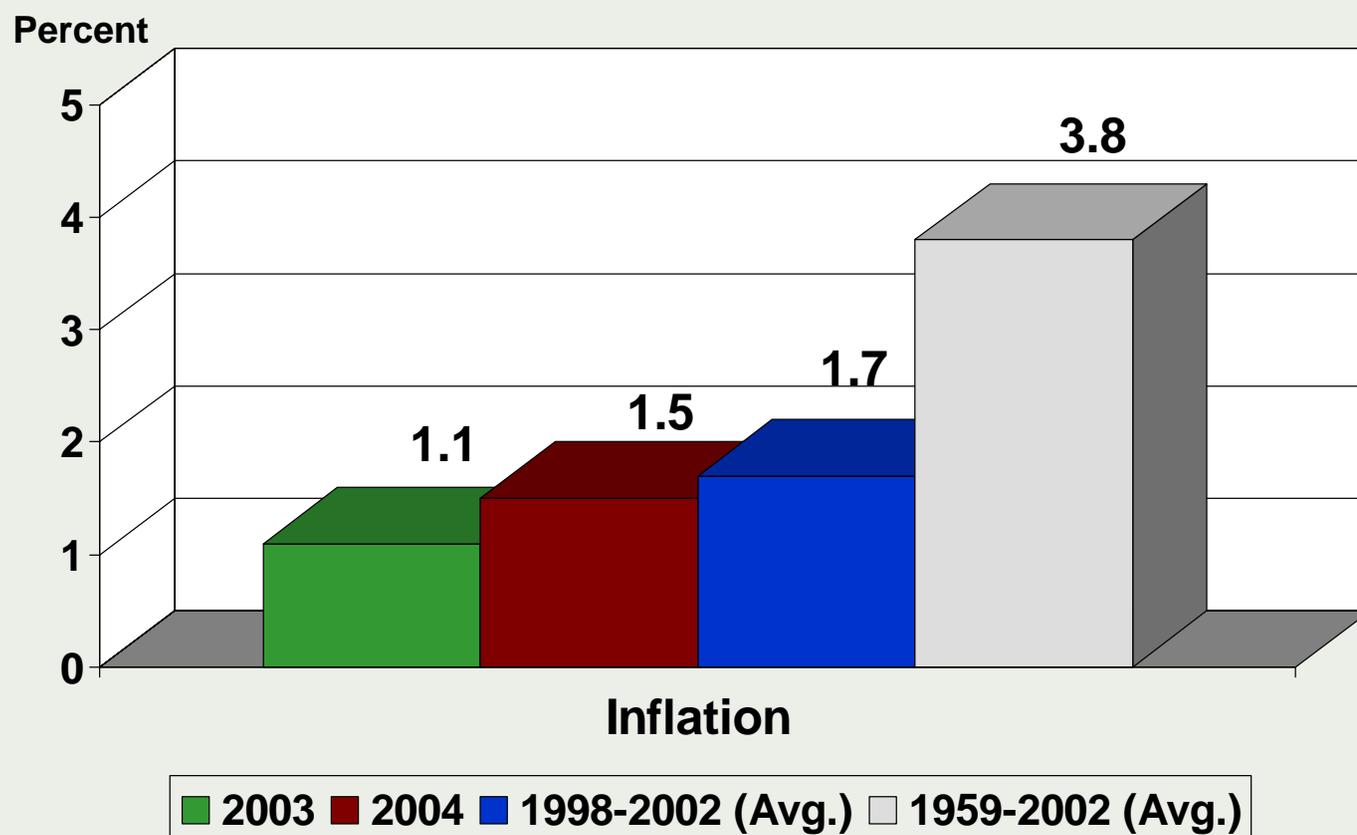
- PCE Inflation edges up in 2004





# A Look Back at 2004

- Core PCE Inflation also edges higher in 2004





# A Look Back at 2004

- Inflation Developments in 2004:
  - Price of crude oil paid by refiners rose nearly 30% in 2004.
  - Firms were able to pass along some of their higher energy costs onto consumers, as “core” inflation rose from 1.1% in 2003 to 1.5% in 2004.
  - Falling dollar increased the prices of imported goods and services; effect not thought to be large.



# A Look Back at 2004

## Productivity, Prices and Costs: Forecasts vs. Actuals

*Percent Change, Annual Averages*

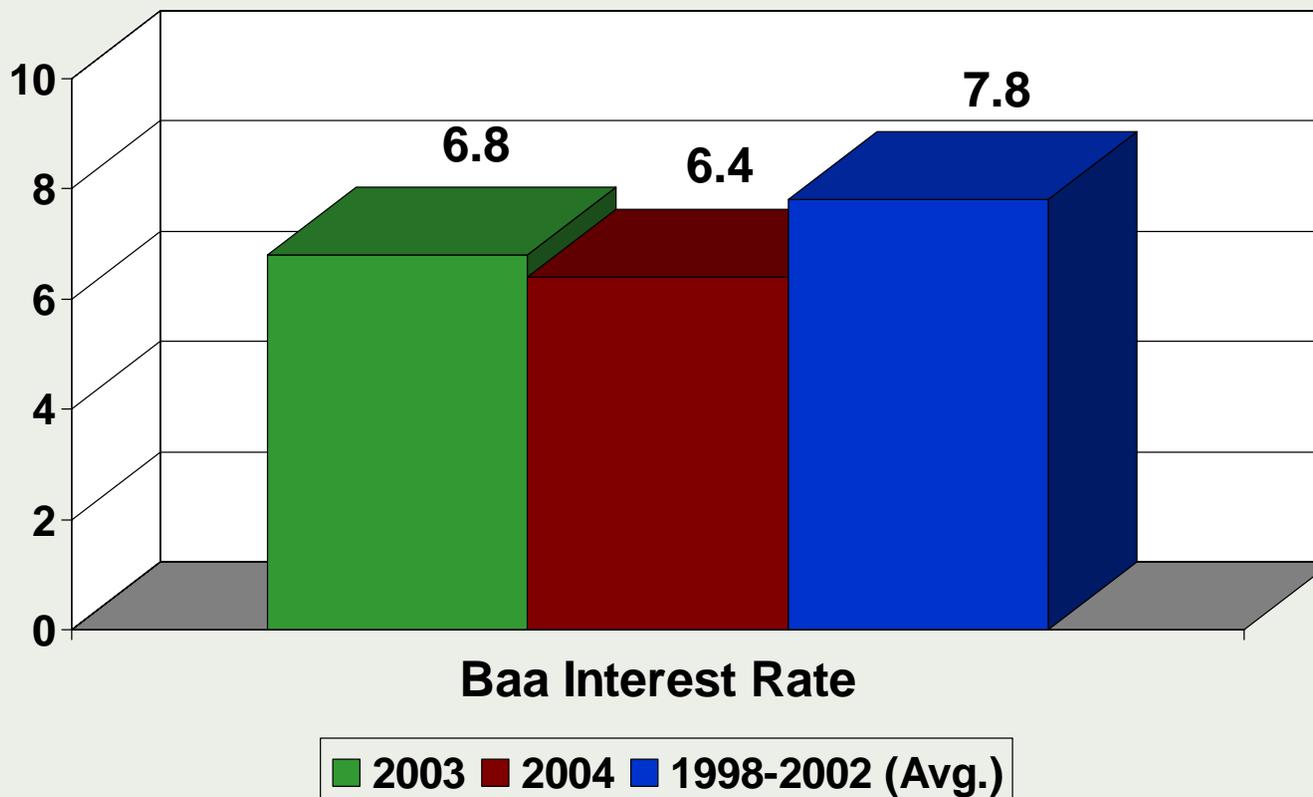
	<u>Projected</u>	<u>ACTUAL</u>	<u>Error</u>
Compensation Per Hour	3.2	4.2	1.0
Productivity	3.2	4.0	0.8
Unit Labor Cost	0.0	0.1	0.1
GDP Price Index	1.5	2.1	0.6
Consumer Price Index	1.9	2.7	0.8
CPI Inflation (Q4/Q4)	1.9	3.3	1.4
Producer Price Index	1.4	3.6	2.2

NOTE: 2004 Forecasts published in the Dec. 10, 2004, Blue Chip Econometric Detail. Productivity and Costs are for the private, nonfarm business sector.



# A Look Back at 2004

- Longer-term interest declined slightly in 2004



NOTE: Fourth-quarter averages for years indicated.



# A Look Back at 2004

- Interest Rates in 2004:
  - Most forecasters expected long-term interest rates to rise in 2004 . . . but they fell instead:

## Interest Rates in 2004: Actuals and Forecasts

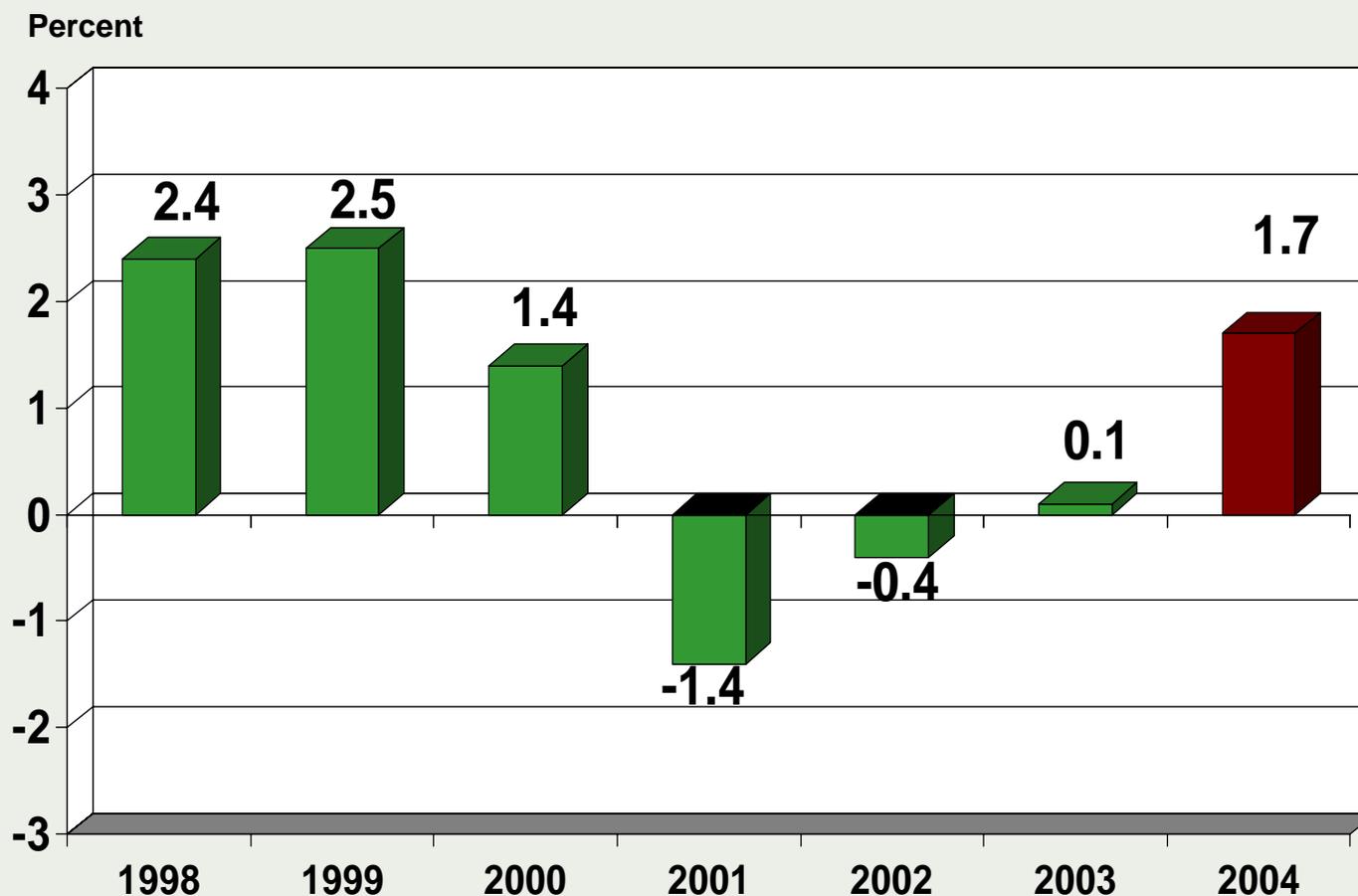
	Actual 4Q 2003	Forecast 4Q 2004	Actual 4Q 2004
Prime Rate	4.0	4.8	4.9
Treasury note, 2 yr.	1.9	2.9	2.8
Treasury note, 5 yr.	3.3	4.1	3.5
Corporate Baa bond	6.7	7.3	6.2

**SOURCE: Blue Chip Financial Indicators, Jan. 10, 2004**



# A Look Back at 2004

- Payroll employment finally gets going . . .

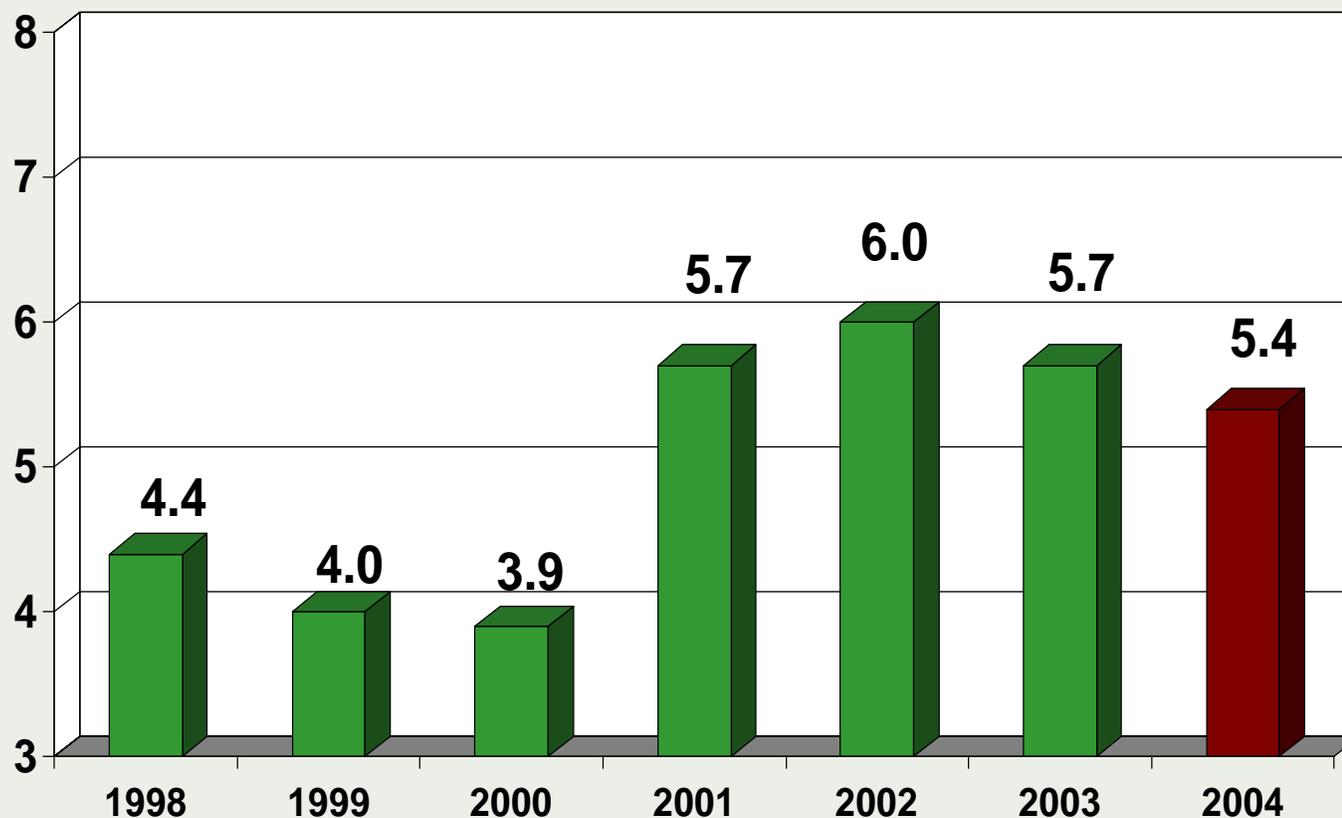


NOTE: Percent change for the 12 months ending for years indicated.



# A Look Back at 2004

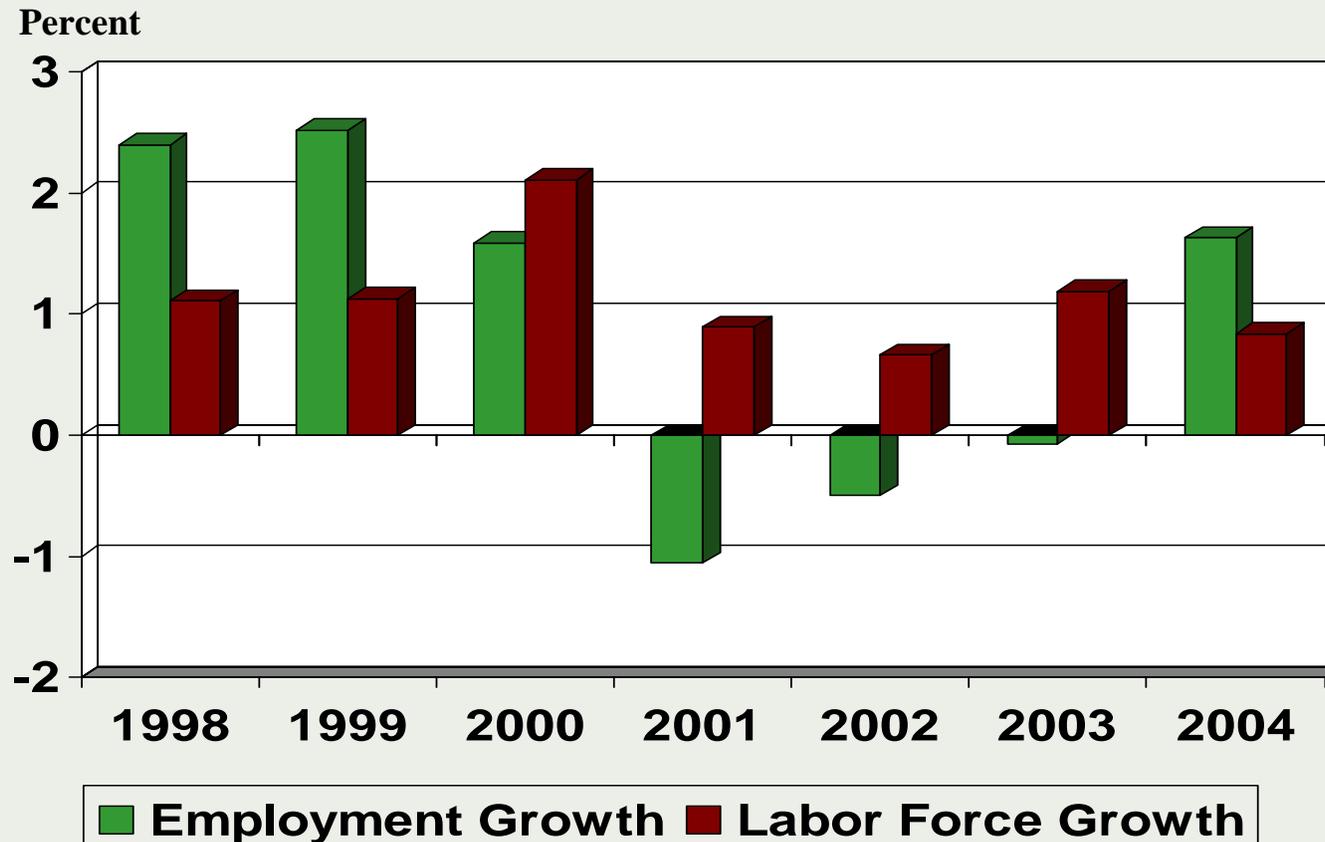
- . . . And the Unemployment Rate drops modestly



**NOTE: Fourth-quarter values for years indicated.**

# A Look Back at 2004

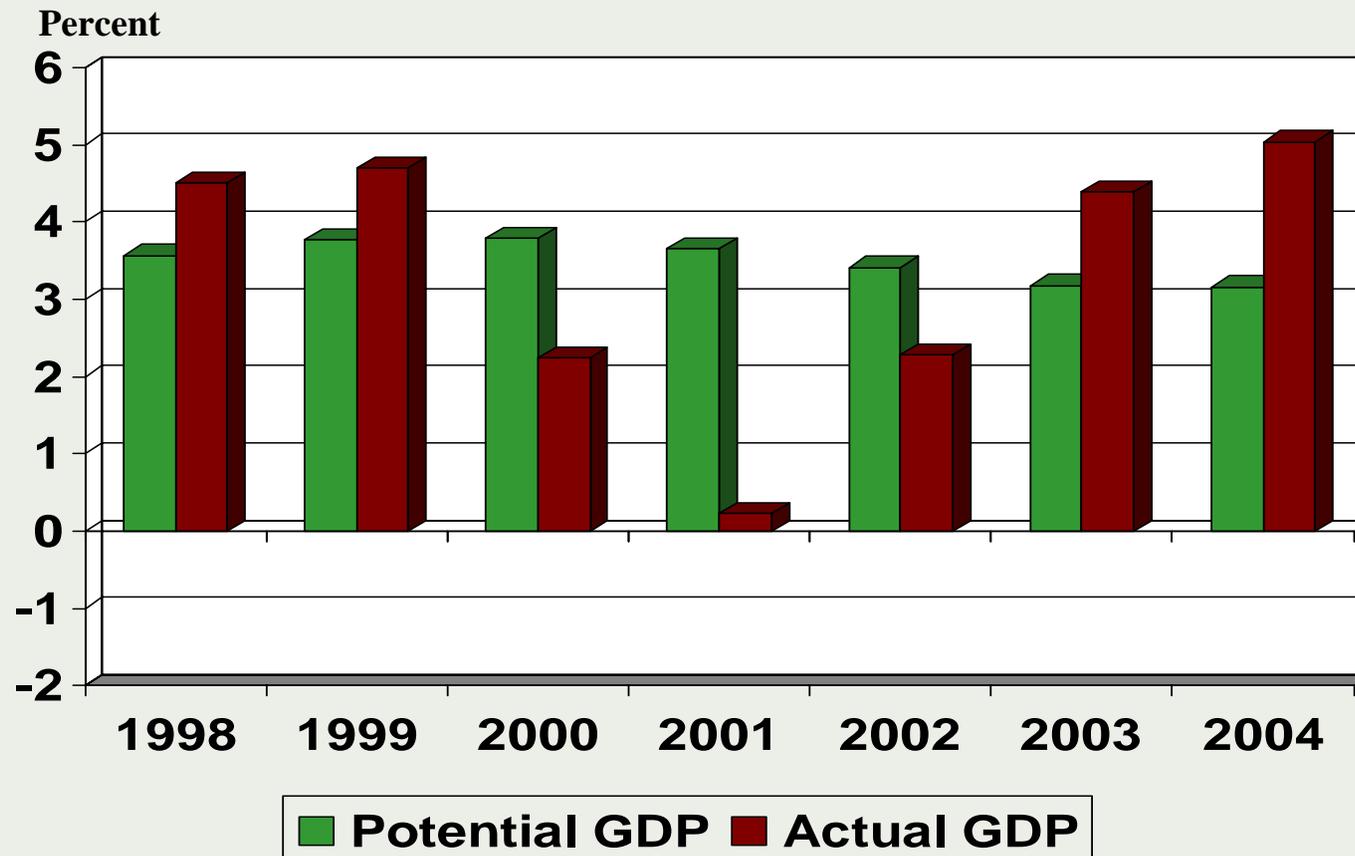
- The Unemployment Rate in 2004:
  - In 2004, employment growth surpassed labor force growth for the first time since 1999.





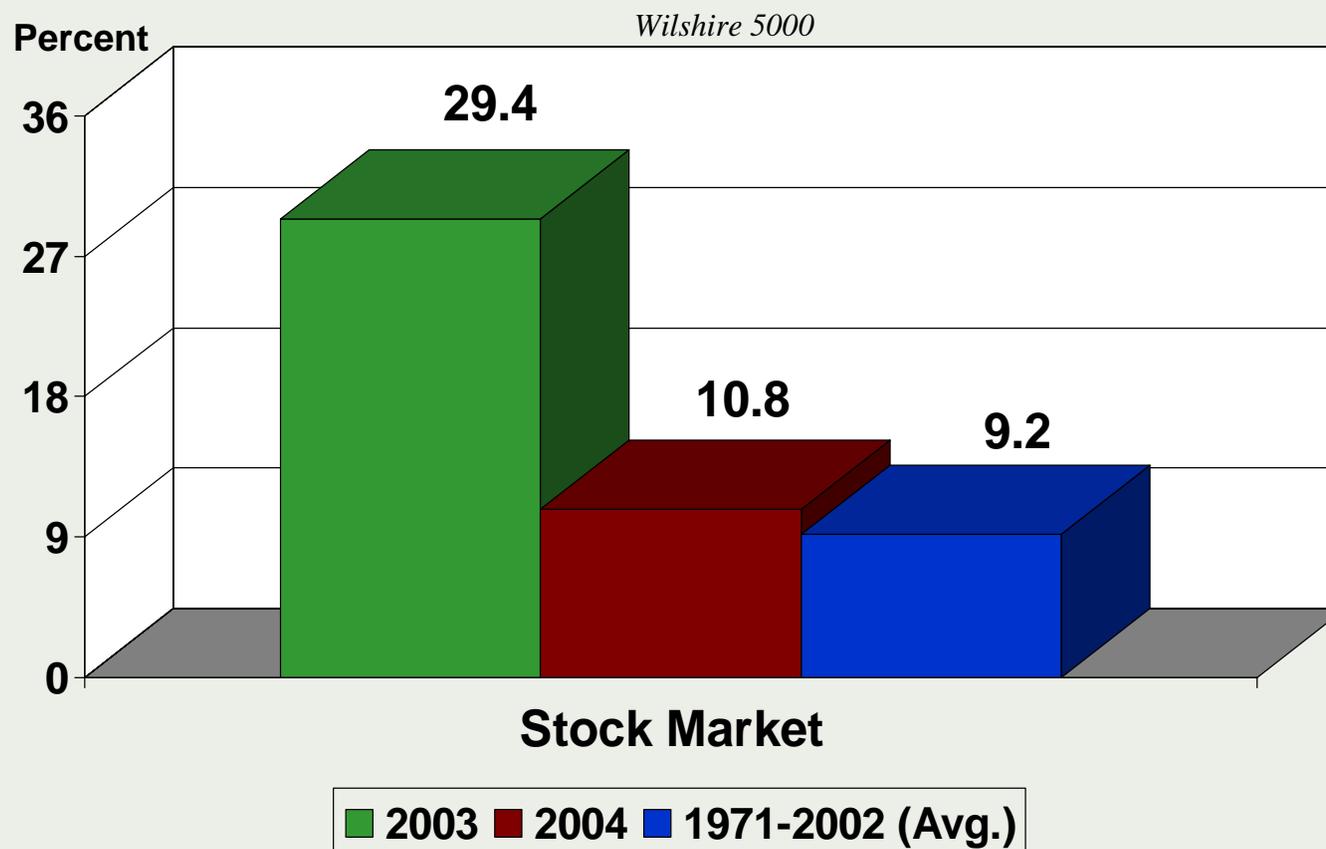
# A Look Back at 2004

- The Unemployment Rate in 2004:
  - The economy starting to soak up unused capacity (real GDP growth > potential real GDP growth).



# A Look Back at 2004

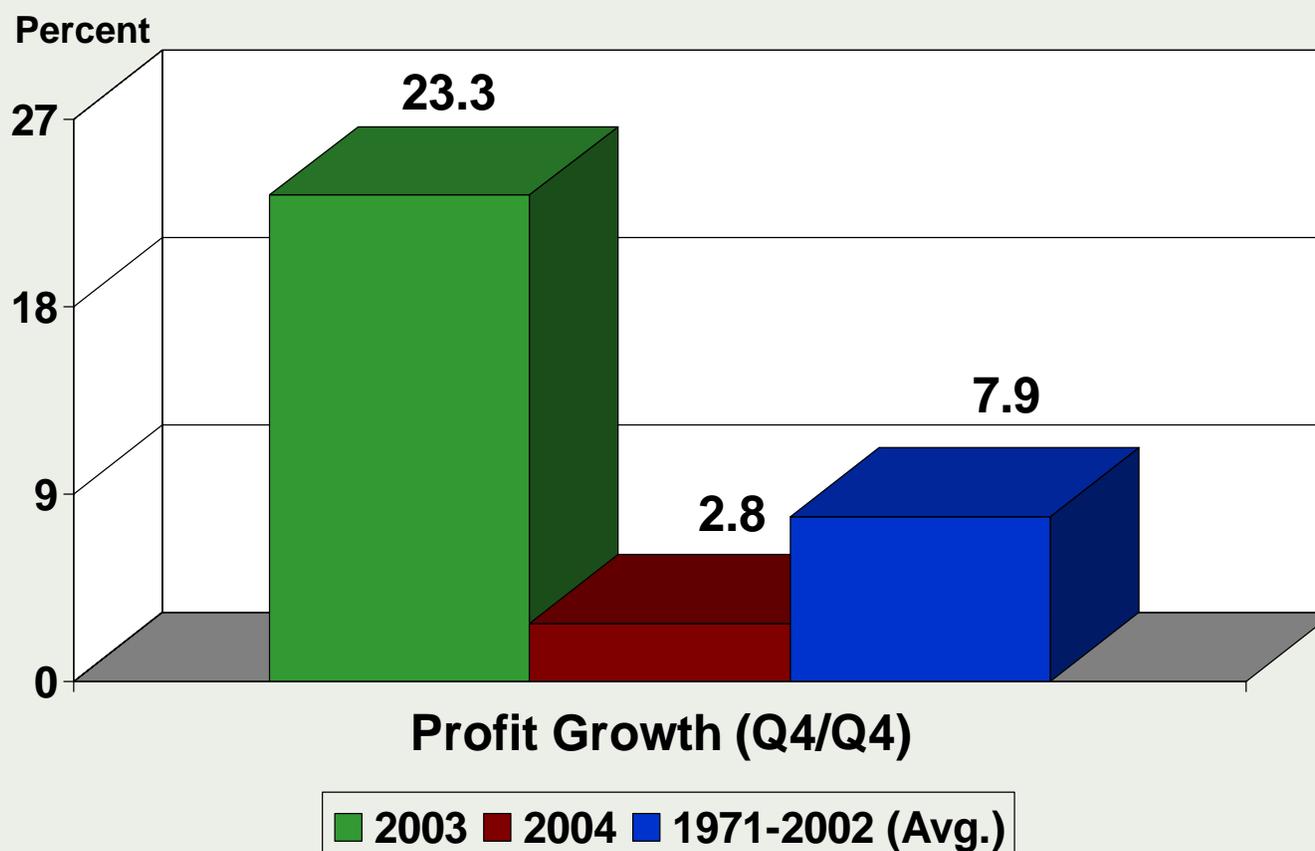
- Stock market gains in 2004 were closer to “normal.”





# A Look Back at 2004

- Sharply weaker profit growth in 2004





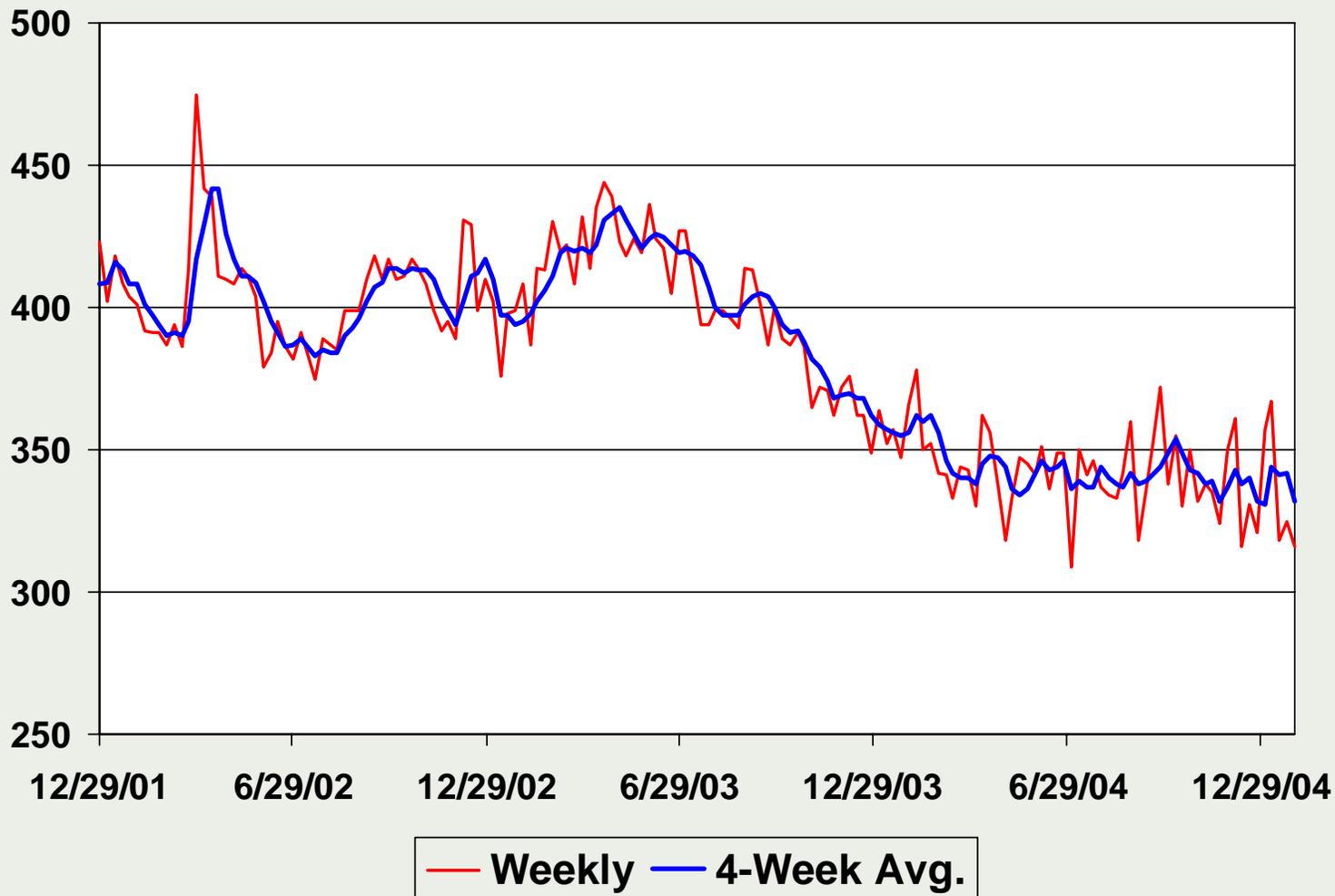
# Current Conditions

- Available data used to gauge first-quarter real GDP growth is sparse at this point:
  - Jan. Payrolls: 146,000 (Actual) vs. 185,000 (Forecast)
  - Jan. Unemp. Rate: 5.2% (Actual) vs. 5.4% (Forecast)
  
  - Jan. ISM (Manuf.): 56.4 (Actual) vs. 57.1 (Forecast)
  - Jan. ISM (Non-Manuf.): 59.2 (Actual) vs. 61.5 (Forecast)
  
  - Jan. Retail Sales: -0.3% (Actual) vs. -0.4% (Forecast)
  - Jan. Domestic Light Vehicle Sales: 13.0 million (SAAR) vs. 14.7 million (Dec. 2004)
  - Jan. Ex.-Auto Retail Sales: 0.6% (Actual) vs. 0.5% (Forecast)



# Current Conditions

## Initial Claims for Unemployment Insurance Benefits





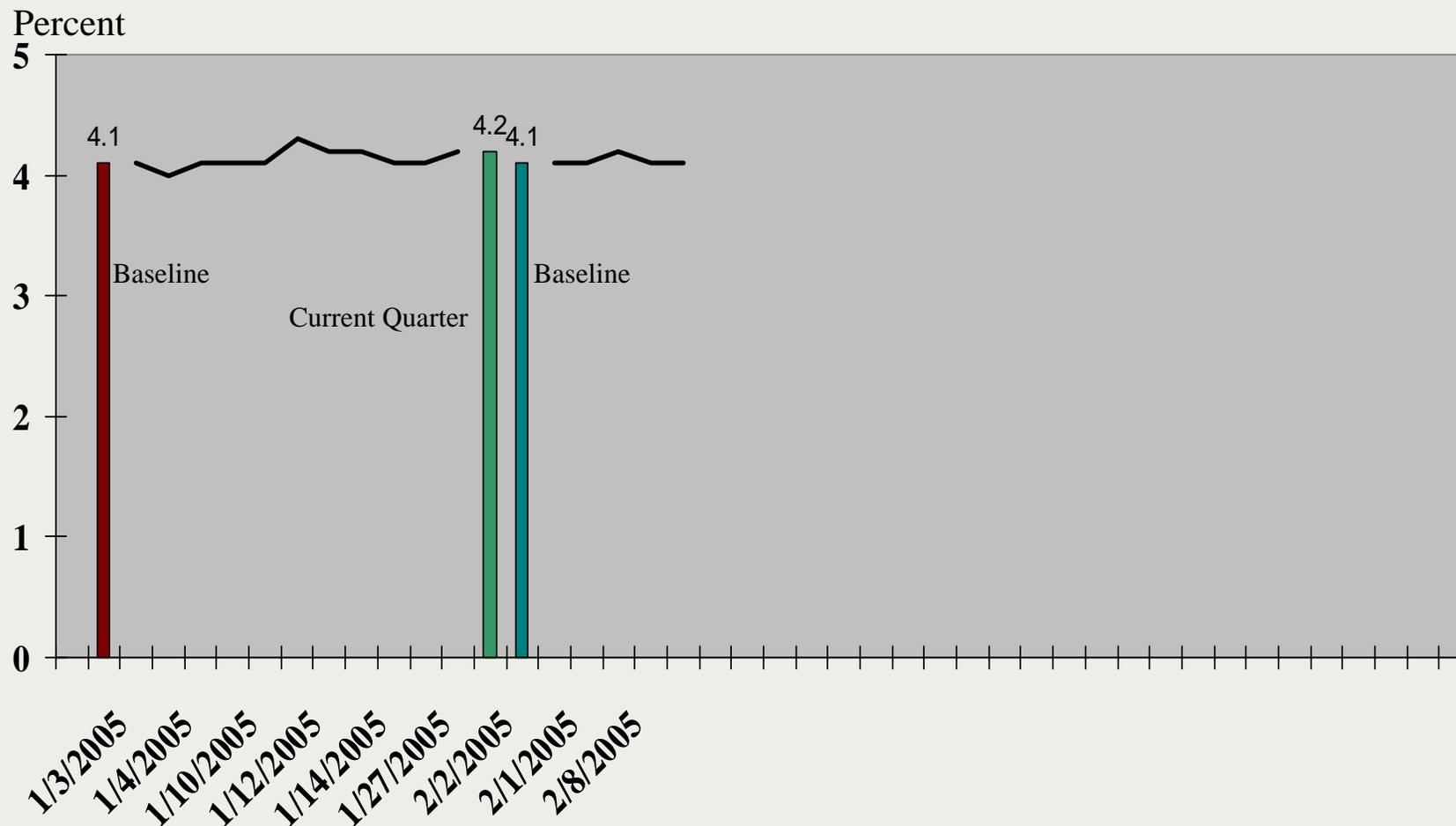
# Yield Spread Between 10-Year Treasury Securities and Corporate Baa Bonds





# Current Conditions

- Macroeconomic Advisers' Tracking Forecast for 2005:Q1 Real GDP Growth





# The Outlook for 2005

- Forecasts for real GDP growth and inflation are conditioned on certain exogenous assumptions:

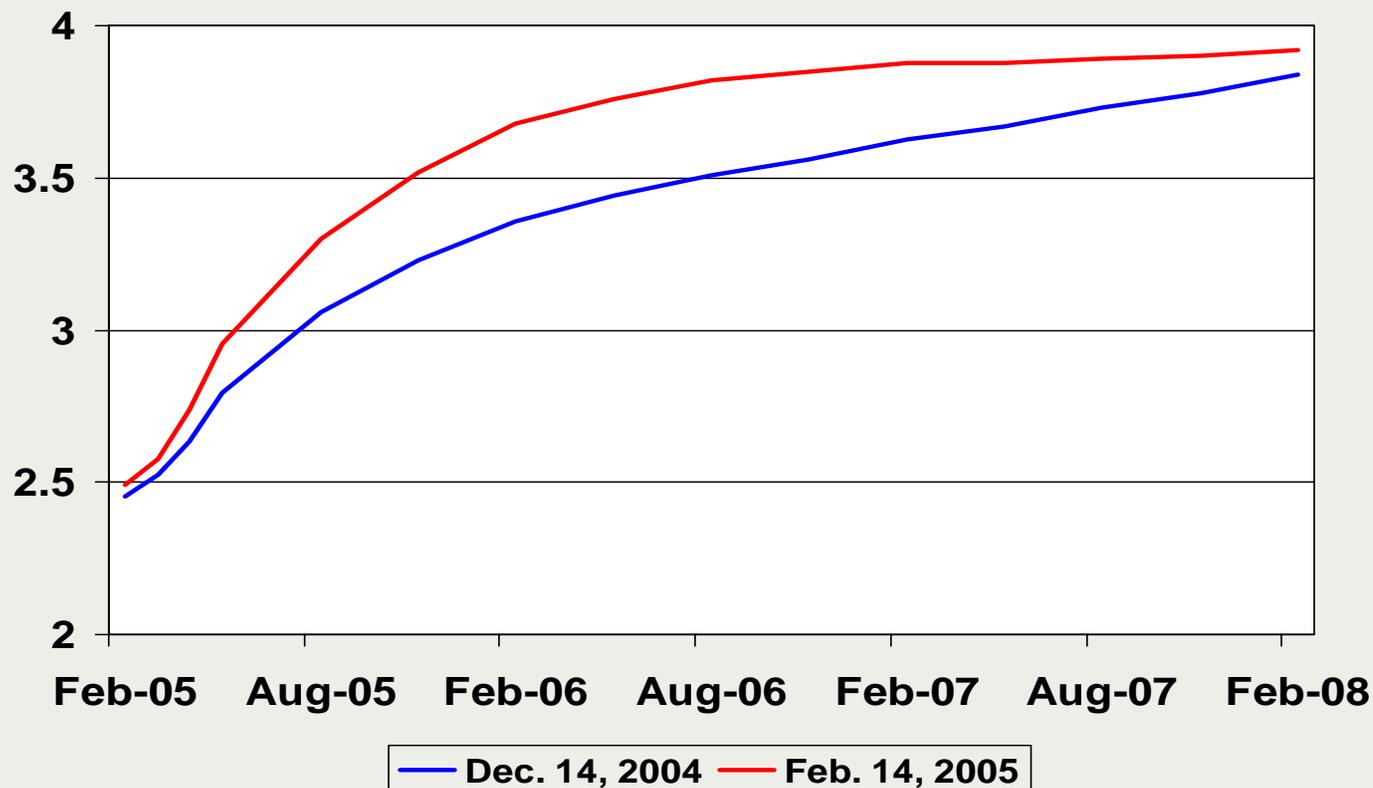




# The Outlook for 2005

- Forecasts for real GDP growth and inflation are conditioned on certain exogenous assumptions:

*Federal Funds and Eurodollar Futures Yields*





# The Outlook for 2005

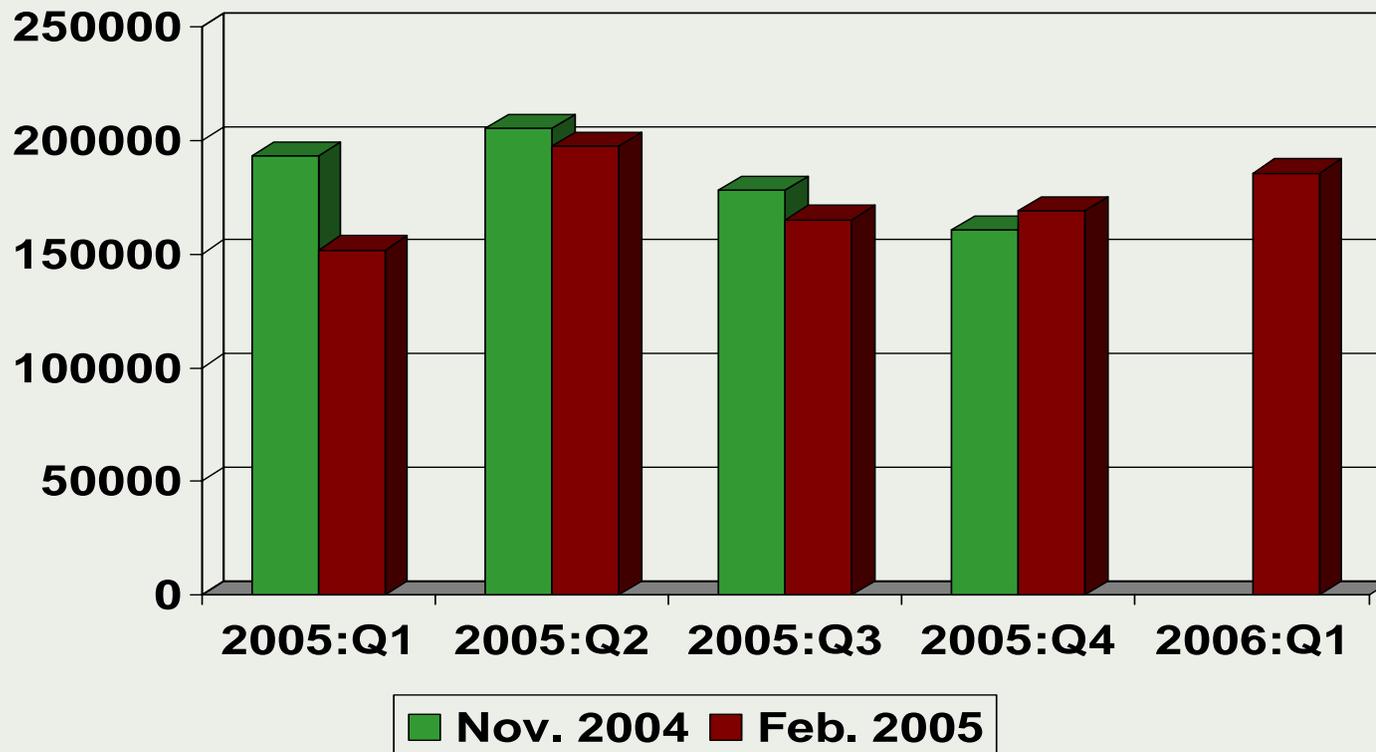
- Forecasts for real GDP growth, inflation, and the unemployment rate have been remarkably stable over the past six months:
  - Economic growth: Around 3.5%
  - Inflation: Around 2%
  - Unemployment Rate: Around 5% by the end of the year



# The Outlook for 2005

- Forecasts for growth of nonfarm payrolls have diminished modestly, . . . :

*Average Change per Month*

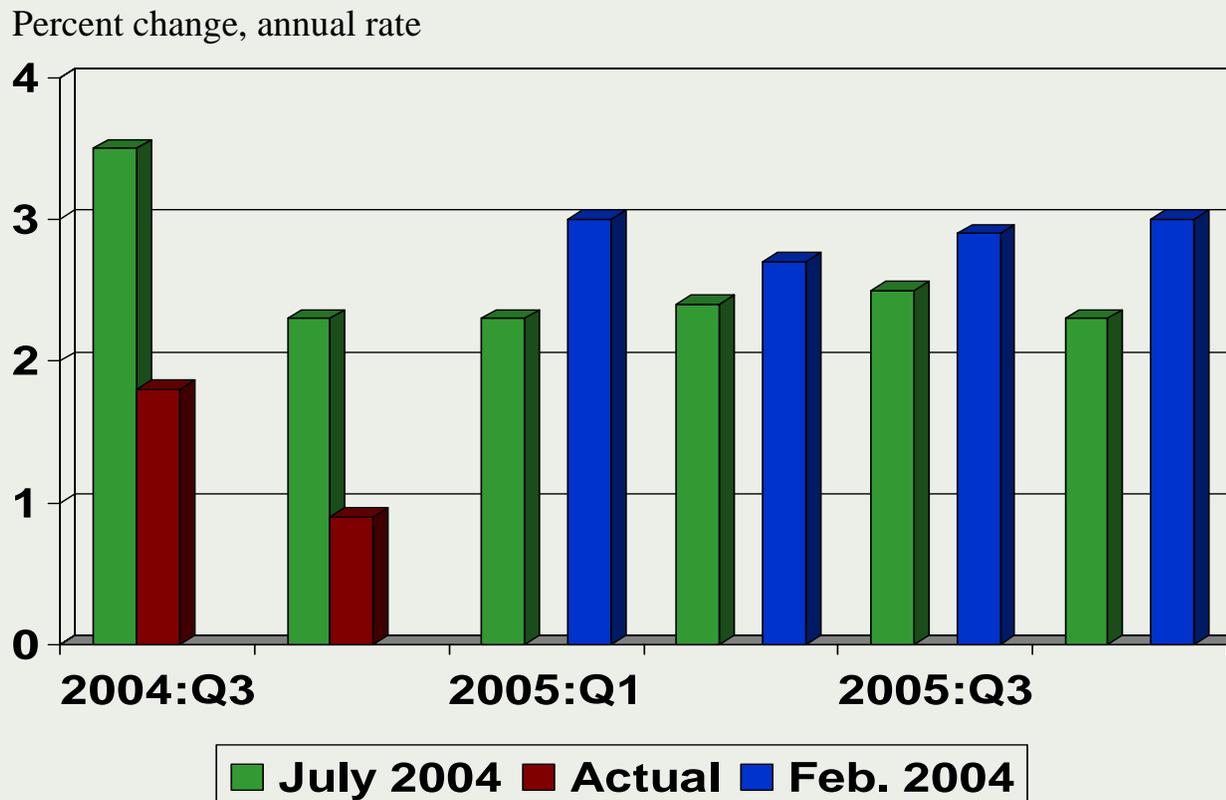


SOURCE: Survey of Professional Forecasters



# The Outlook for 2005

- ... Forecasts for growth of nonfarm productivity growth have not – despite much weaker productivity growth over the second half of 2004.

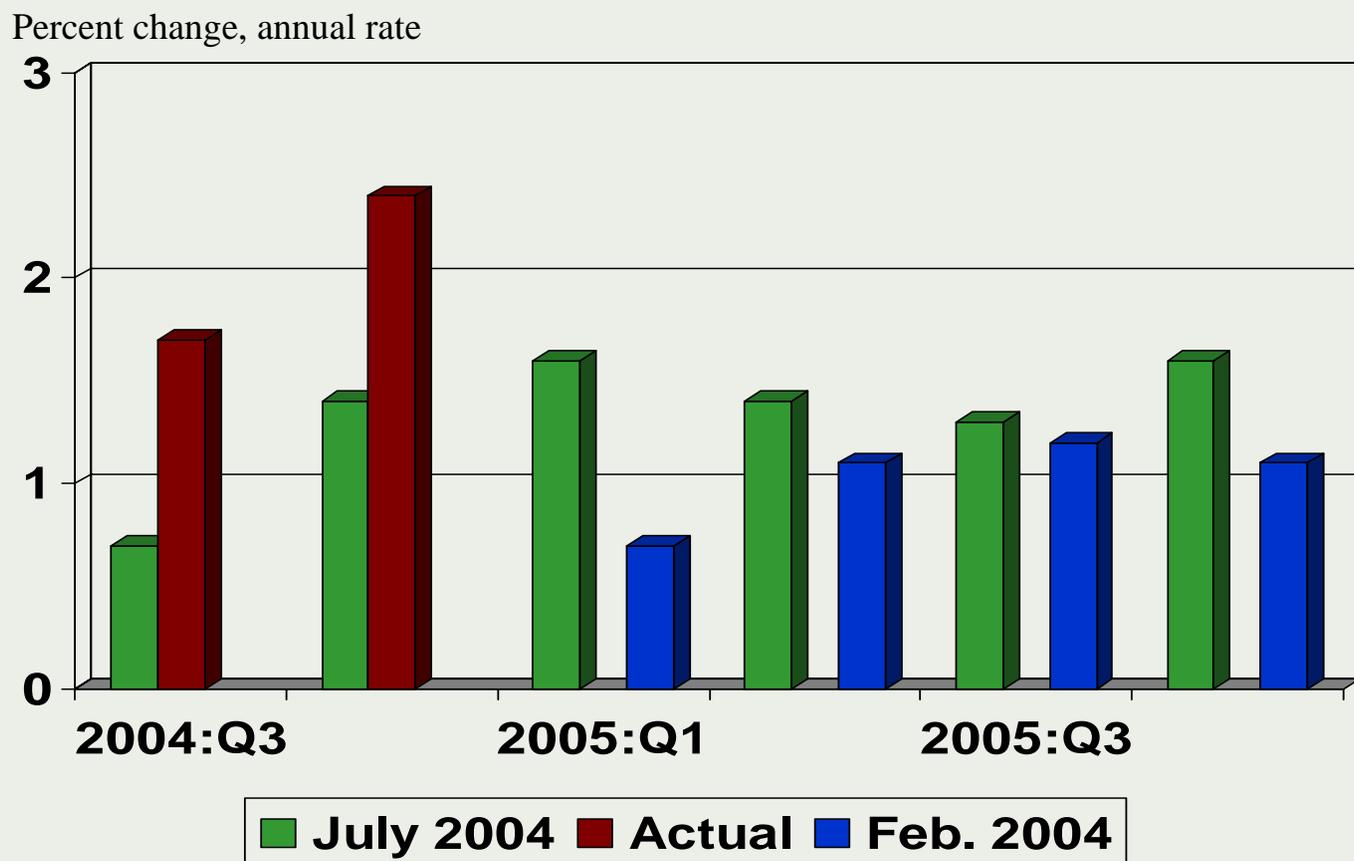


SOURCE: Macroeconomic Advisers



# The Outlook for 2005

- ... Forecasts for continued slow growth of unit labor costs.



SOURCE: Macroeconomic Advisers



# The Outlook for 2005

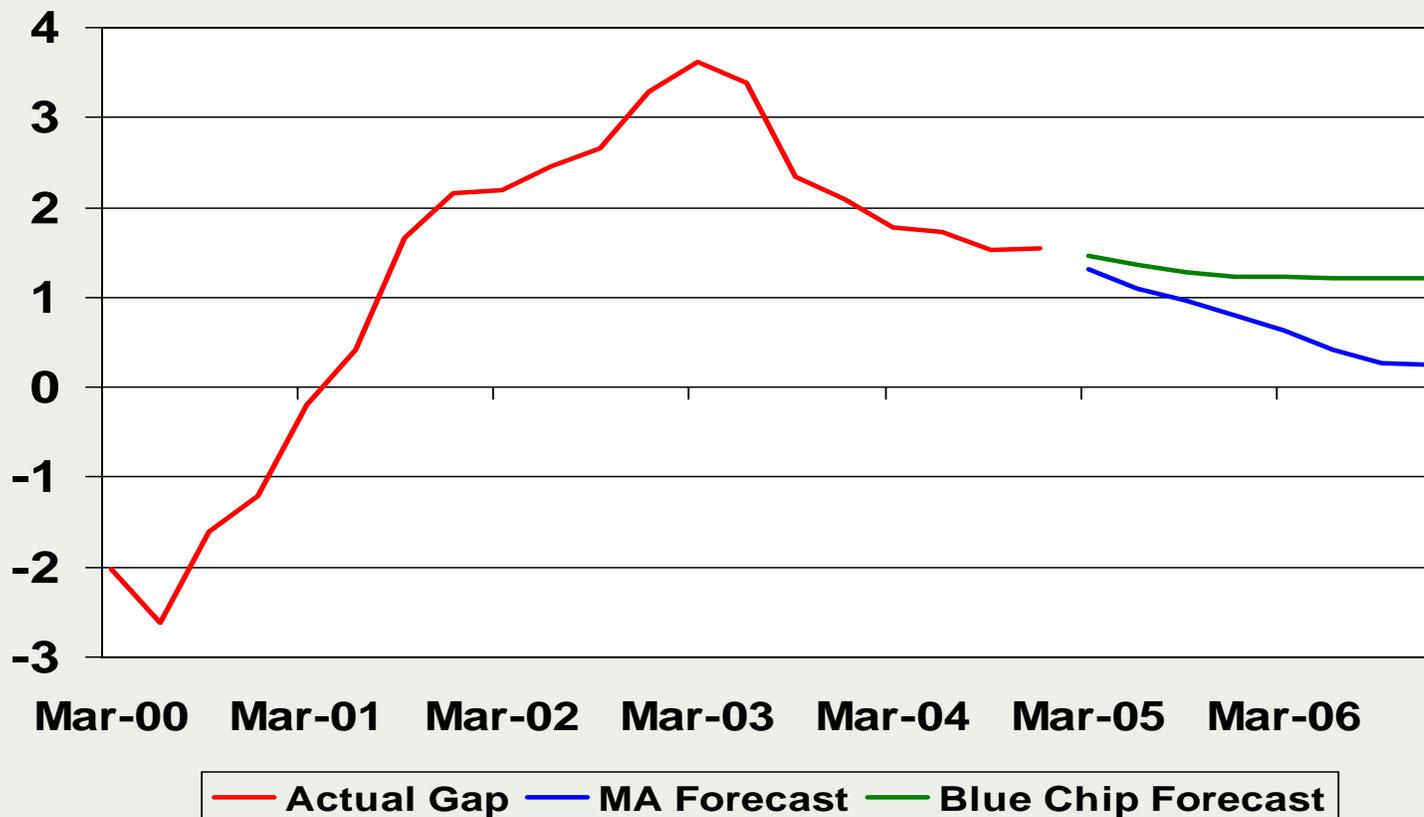
- To quote my boss, St. Louis Fed President William Poole:
  - Overall, I expect that this year's economic growth will be boosted to an important extent by continued strong business fixed investment.
  - In addition, augmented by continued strong labor productivity growth, improvements in the labor market, and a recovery in household purchasing power reflecting lower energy prices, growth of consumer spending should also remain healthy.
  - Peering into 2005, it seems likely that labor market conditions will continue to improve and that monthly employment gains will probably exceed by a comfortable margin the roughly 125,000 per month necessary to keep the unemployment rate constant.
  - Real GDP growth of between 4 and 4.5% seems pretty reasonable, plus or minus 1¼ percent.



# The Outlook for 2005

- The GDP Gap: Slack in the economy—how accurate is our forecast?

Percent of Potential Real GDP



SOURCE: Macroeconomic Advisers



# Latest FOMC Press Release

Federal Reserve Release



## Press Release

Release Date: February 2, 2005

For immediate release

The Federal Open Market Committee decided today to raise its target for the federal funds rate by 25 basis points to 2-1/2 percent.

The Committee believes that, even after this action, the stance of monetary policy remains accommodative and, coupled with robust underlying growth in productivity, is providing ongoing support to economic activity. Output appears to be growing at a moderate pace despite the rise in energy prices, and labor market conditions continue to improve gradually. Inflation and longer-term inflation expectations remain well contained.

The Committee perceives the upside and downside risks to the attainment of both sustainable growth and price stability for the next few quarters to be roughly equal. With underlying inflation expected to be relatively low, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured. Nonetheless, the Committee will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.



# Latest FOMC Press Release

Federal Reserve Release



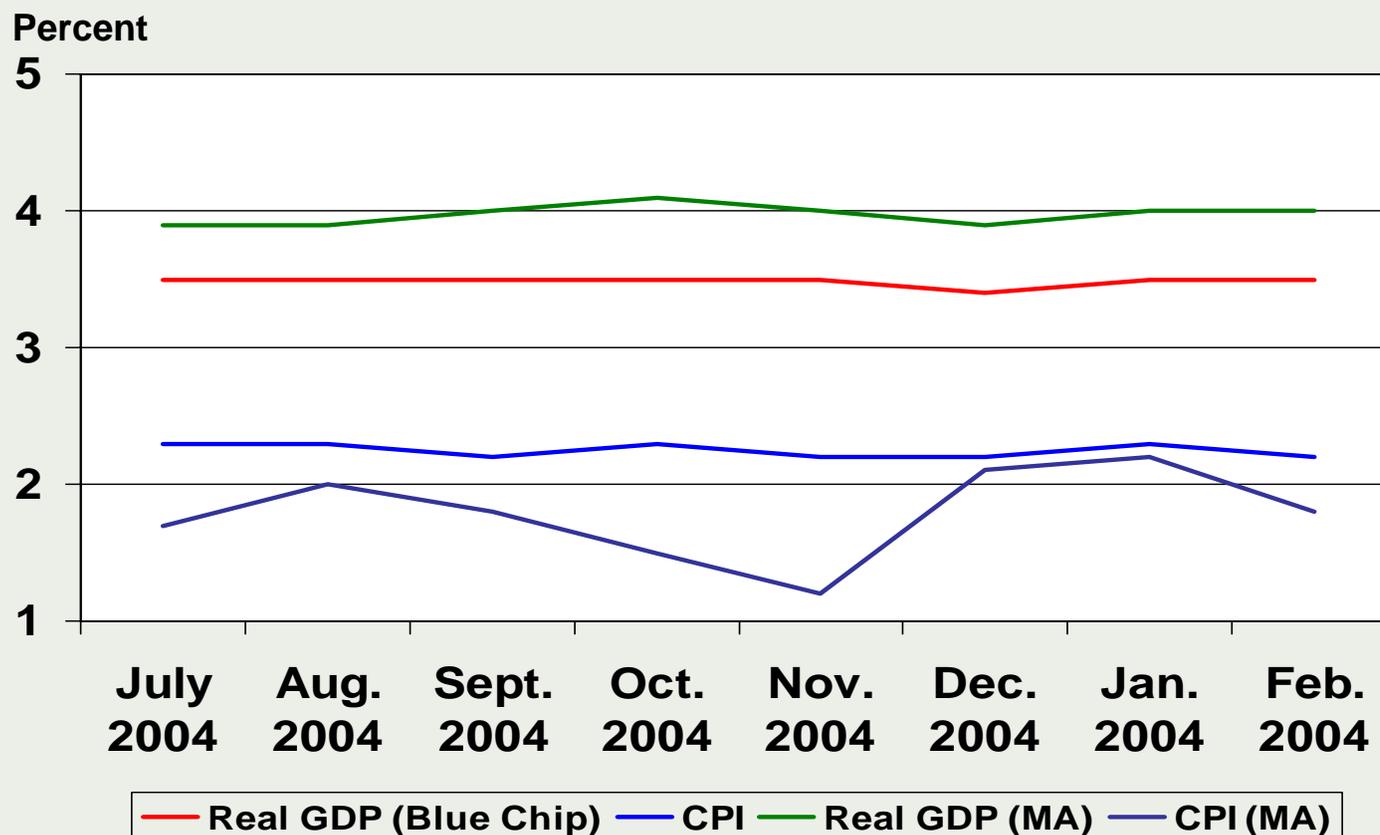
## Press Release

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# The Outlook for 2005

- Since the June FOMC meeting, Blue Chip forecasts for real GDP growth and CPI inflation in 2005 (Q4/Q4) have been remarkably stable:





## The Federal Reserve Board

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### **Testimony of Chairman Alan Greenspan**

*Federal Reserve Board's semiannual Monetary Policy Report to the Congress*  
**Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate**  
**July 20, 2004**

- If economic developments are such that monetary policy neutrality can be restored at a measured pace, a relatively smooth adjustment of businesses and households to a more typical level of interest rates seems likely.
- Even if economic developments dictate that the stance of policy must be adjusted in a less gradual manner to ensure price stability, our economy appears to have prepared itself for a more dynamic adjustment of interest rates.
- Of course, considerably more uncertainty and hence risk surrounds the behavior of the economy with a more rapid tightening of monetary policy than is the case when tightening is more measured. In either scenario, individual instances of financial strain cannot be ruled out.



# Risks to the Forecast

- Oil prices remain high, fostering uncertainty among households and businesses.
- Long-term interest rates finally begin to rise to the degree forecasters thought they would in early 2004.
- Expiration of investment tax credits produces an investment “pothole” in 2005.
- Productivity growth starts to slip, potentially causing firms to raise prices to offset increased pressure on labor and non-labor costs.



# Questions?