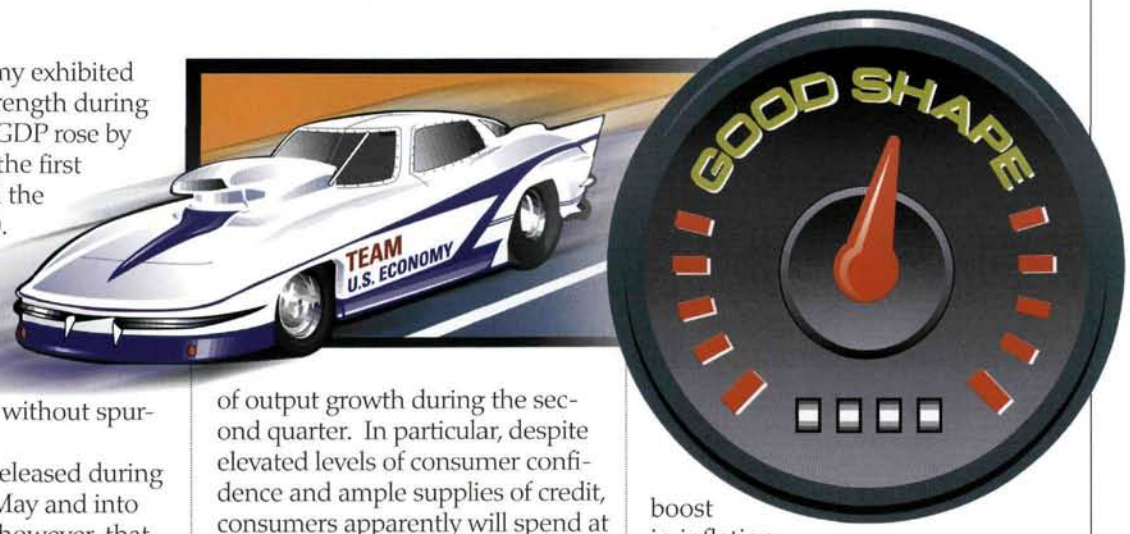
National and District Overview

FAST LANE, SLOW LANE OR CRUISING SPEED?



By Kevin L. Kliesen

The U.S. economy exhibited considerable strength during the past year: Real GDP rose by 5 percent between the first quarter of 1999 and the first quarter of 2000. This is about 1 to 1.5 percentage points higher than most economists think the economy can grow without spurring inflation.

Several reports released during the second half of May and into early June suggest, however, that the effects of higher interest rates, rising energy costs and—perhaps—weaker equity prices are beginning to slow the pace of economic activity somewhat. But considering that the economy grew at a 6.1 percent rate between the second quarter of 1999 and the first quarter of 2000, some slowing was inevitable. The report that garnered the most attention was the May employment report. Though *total* nonfarm payroll employment rose by 231,000 in May, well short of the 414,000 increase posted in April, *private* nonfarm payrolls actually fell by 116,000 because of the hiring of 357,000 temporary workers associated with the decennial census. Except for the weakness associated with the recession and the "jobless recovery" of 1990-91, this was the largest percentage decline in private payroll employment since June 1986.

Slowdown or Speed Bump?

The monthly employment report was puzzling given the exceedingly upbeat surveys of national labor demand. Indeed, the demand for labor regionally (in the Eighth District) remains rather strong according to the latest beige book. Anecdotal reports indicate that tight labor markets are still significant for most industries, and the average unemployment rate in the seven states that make up all or parts of the District continues to track below the national average.

Nonetheless, some expenditure data suggest a more measured pace of output growth during the second quarter. In particular, despite elevated levels of consumer confidence and ample supplies of credit, consumers apparently will spend at a rate only about one-half to two-thirds of their spectacularly fast 7.7 percent first-quarter growth rate. This pullback appears to be causing some retailers and wholesalers to scale back their orders to factories, although overall, new factory orders outside the defense and aircraft sector—particularly for information and communications equipment—are still piling in and unfilled orders are stacking up. Strengthening foreign growth should also help U.S. manufacturers. Indeed, industrial production registered a healthy gain in May.

On the construction front, sales of new and existing homes at both the national and District levels are clearly on a lower trajectory. But because of earlier labor and materials shortages, most builders reportedly have sizable backlogs of unfilled orders to work through. Relatively high interest rates do not appear to be sidetracking nonresidential construction, which is still recovering from the last few years' weakness—particularly at the national level.

Is Inflation Accelerating or Downshifting?

During the 1970s and 1980s, surging demand growth, accompanied by a spike in oil prices like we have seen during the past year and a half, would have probably led to rapid growth of wages and prices—not to mention a significant boost in inflation expectations. That does not appear to be the case this time around, though, as sharply higher rates of productivity growth have helped firms maintain profit margins without boosting output prices. Confidence in the Fed's ability to maintain low and steady inflation has also helped limit any rise in expected inflation.

During the past year, prices (as measured by the deflator for gross domestic purchases) have increased by about 2.25 percent, or by about 1.5 percent when food and energy prices are excluded, a measure often described as core inflation. While these rates are low compared with most post–World War II business expansions, they have nevertheless crept steadily upward since the lows for this expansion were reached in mid-1998. And while CPI inflation was less than 0.5 percent (annualized) during the April-May interval, most forecasters still expect it to accelerate modestly through 2001. This suggests that the risks going forward remain centered on faster rates of inflation, not lower growth. Policy-makers are confident, however, that the cumulative effects of the Fed's recent policy moves—or prospective policy actions—will extend this record-setting business expansion by more closely aligning the growth of aggregate demand and supply, thereby limiting inflationary pressures.

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