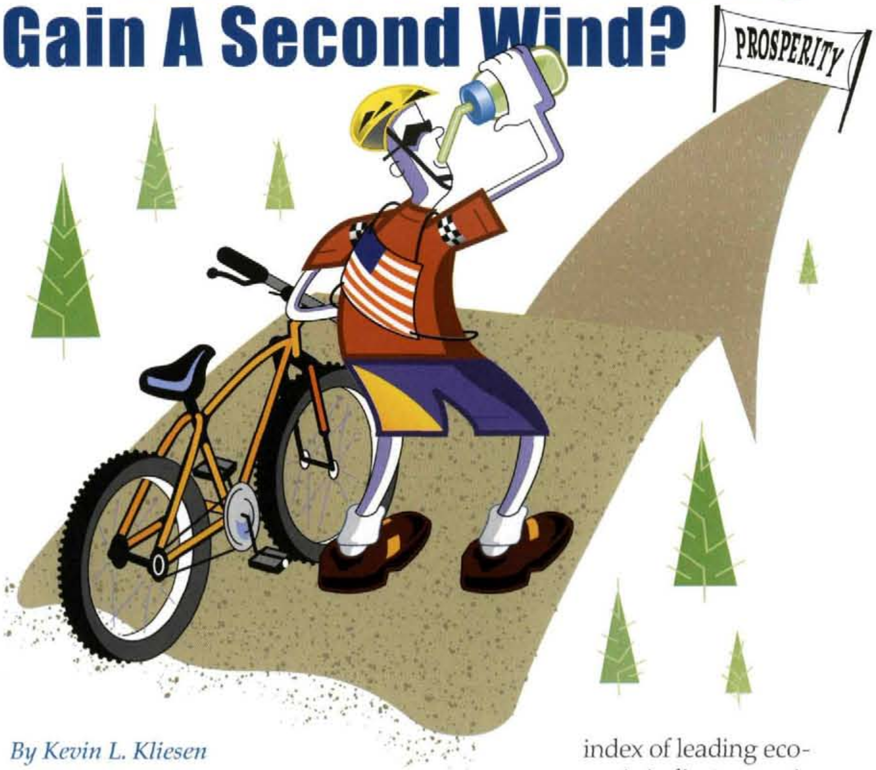
National and District Overview

Will the U.S. Economy Gain A Second Wind?



By Kevin L. Kliesen

After increasing at a 5.2 percent annual rate during the first half of 2000, real GDP grew at a 1.6 percent annual rate during the second half of the year. Indeed, fourth-quarter growth was the weakest since the second quarter of 1995. Although the proximate cause of this slowdown is difficult to pinpoint, the Federal Reserve's efforts to curtail mounting inflationary pressures in 1999 and into the first half of 2000, and the sharp run-up in energy prices are surely significant.

Poised on the Precipice?

Most forecasters expect real GDP growth to decline a bit more during the first quarter and remain relatively weak into the second quarter. Still, at least three signs hint that growth might turn out better than expected. First, 343,000 jobs were added during the first three months of the year, about 50 percent more new jobs than were added over the last six months of 2000. Second, light vehicles (passenger cars and light trucks) sold much better than expected in the first quarter, averaging 17.2 million units (annualized). Third, in January, real construction spending, existing home sales and housing permits also posted healthy increases, while the index of leading economic indicators registered its largest increase in more than two years.

Other indicators are not so bright. For example, most manufacturers are still paring production to trim inventory buildups. This production slowdown has resulted in sizable declines in measures of manufacturing production and capacity utilization during the last three months of 2000 and first two months of 2001. Financial turmoil has added to the uncertainty: Recent declines in equity prices have put a dent in household wealth and, perhaps, tempered the growth of real consumer outlays and eroded measures of consumer confidence. A plethora of earnings warnings during the first three months of 2001—mostly from the tech sector—suggests that the near-term outlook for equities is not particularly bright. While some stresses will take longer than others to work through, however, most forecasters still expect the economy to grow by roughly 2.5 to 3 percent during the second half of the year.

Paralleling the contours of the nation's performance, the pace of Eighth District economic activity slowed noticeably in early 2001, with "little or no employment growth and slowing demand" (for goods and services), as reported in the latest *Beige Book*. This is unsurprising since the District economy does not typically deviate from the nation's performance. That said, parts of the District are doing better than others. Through January 2001, payroll employment growth in the Louisville and Memphis metropolitan statistical areas (MSA) was above the nation's; employment growth in the Little Rock MSA was roughly equal to the nation's, while in the St. Louis MSA, job growth continues to be about half the national level. On average, state and MSA unemployment rates are about equal to the U.S. rate of 4.3 percent. Still, unemployment rates in early 2001 remained below 4 percent in the Little Rock and Louisville MSAs and in the states of Indiana and Missouri.

Where's Inflation Headed?

Unlike previous energy price shocks, core price pressures and inflation expectations *appear* tamer this time around. Although year-to-year inflation in the consumer price index (CPI) is running at 3.5 percent, which is pretty worrisome, the CPI that strips out the volatile but temporary direct effects of higher energy prices shows much less acceleration (see chart on Page 18). But when the prices of more than just consumer goods and services are included, such as prices of investment goods, government services and imports, aggregate core price inflation has actually decelerated from a 2.2 percent rate during the first half of 2000 to a 1.5 percent rate during the second half of last year.

Measures of inflation expectations suggest that consumers and financial markets remain confident that the Fed will douse any nascent inflationary embers. This confidence, which keys off the Fed's commitment to price stability, has given the FOMC considerably more latitude to adjust policy in response to the evolving pattern of slowing growth of sales and employment. Thus, in conjunction with the steady decline in crude oil prices so far in 2001, most forecasters expect consumer price inflation to retreat to about 2.5 percent by the end of the year. Of course, they said this a year ago.

Kevin L. Kliesen is an economist at the Federal Reserve Bank of St. Louis. *Thomas A. Pollmann provided research assistance.*