

National and District Overview

Despite Red Flags, Inflation under Control

By Kevin L. Kliesen



Since last fall, the U.S. economy has seen declining stock (equity) prices, rising unemployment, dwindling budget surpluses and erosions in consumer confidence. Now, the economy must deal with the effects of the World Trade Center disaster on Sept. 11. In light of this event and subsequent developments, some economic forecasters are proclaiming an end to the longest recorded U.S. economic expansion. They are also predicting that inflation is contained and is heading lower. Are they right?

Recovery Delayed

On Sept. 7, the Bureau of Labor Statistics reported that nonfarm payroll employment fell 113,000 in August, the third decline in the past five months. While disconcerting, what really grabbed people's attention was the sharp upswing in the civilian unemployment rate—from 4.5 percent in July to 4.9 percent in August. The August rate is one percentage point higher than the roughly 30-year lows reached toward the end of 2000.

Much of the recent rise in joblessness can be attributed to problems in the manufacturing sector. In particular, manufacturers of high-tech equipment, computers, telecommunications equipment and the like have seen demand for their products slip sharply. In the relatively manufacturing-intensive Eighth District states, for example, factory payrolls through July 2001 declined by an average of about

5 percent from their 2000 peak levels. Outside of manufacturing, conditions are somewhat better, as job growth in the U.S. service-producing industries remains about 1 percent year-over-year. In the District states, growth in service-producing jobs averages 0.5 percent.

These developments show how wide of the mark economic forecasts can be. In September 2000, for example, the widely followed consensus forecast published in the Blue Chip Economic Indicators showed that real GDP was expected to increase 3.5 percent in 2001, while consumer prices (CPI inflation) were expected to rise 2.6 percent. Forecasts published by the Congressional Budget Office, the Office of Management and Budget and the International Monetary Fund, among others, were of a similar tone. Once it became clear that the economy was slowing rapidly and that inflation appeared not to be accelerating, the Federal Open Market Committee (FOMC) acted aggressively to lower its interest rate target. In seven separate instances between Jan. 3 and Aug. 21, the FOMC pared its federal funds rate target from 6.5 percent to 3.5 percent.

Going forward, it seems probable that the World Trade Center tragedy, which spurred the FOMC to trim another 50 basis points Sept. 17 from its fed funds target rate and which severely disrupted the economy's financial markets

and transportation system, will leave a large footprint on the economy's path. Indeed, in a special survey taken a week after the tragedy, nearly 80 percent of Blue Chip forecasters agreed that the economy had entered into recession, with the consensus predicting negative real GDP growth for the third and fourth quarters of 2001. By contrast, two weeks earlier, only 13 percent of forecasters thought the economy was in a recession, and the consensus was that the economy would pick up speed toward the end of 2001 and then expand by 3 to 3.5 percent during 2002.

But with no precedent to judge the effects of the disaster, it seems far too early to speculate on the economy's future growth. Still, it seems likely that these events will further jar consumer and business confidence.

What Inflation?

At about 3 percent, CPI inflation has accelerated modestly since rising from less than 2 percent in 1997 and 1998. In historical terms, such an acceleration is quite mild this far into the business expansion. Certainly, inflation has picked up because of the run-up in energy prices. But once these are accounted for, inflation has accelerated less rapidly.

Still, higher energy prices exert substantial costs on the economy, and some percentage gets passed along to consumers and producers. And since inflation tends to take a while longer to both start and stop, there is always the lurking concern that higher-than-expected rates of inflation will show up in measures of inflation expectations, which Fed policy-makers watch extremely carefully. This is important, given the monetary stimulus that is already in train. At present, though, inflation expectations do not appear to be accelerating. Monetary policy-makers must make sure it stays that way.

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