

National and District Overview

Economy Finally Takes Off

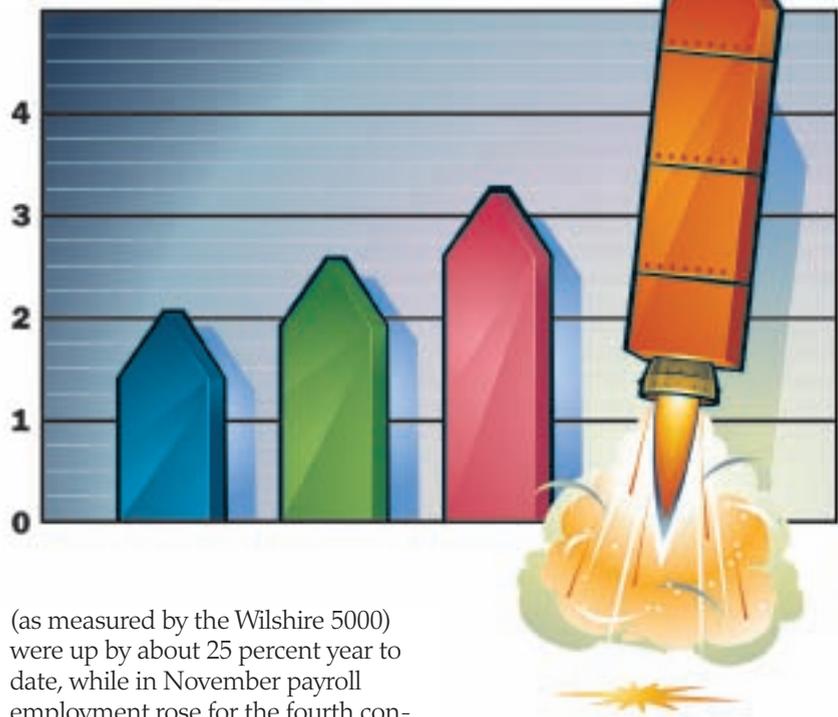
By Kevin L. Kliesen

Since the end of the recession in November 2001, the economy's pace of growth has not been fast enough to generate much job creation. Instead, increased economic growth has come about through continued strong productivity gains. Rising oil prices, the uncertainties associated with the Iraq war and with corporate governance scandals, and the fallout from the stock market's boom and bust were seen as significant developments that had hindered economic growth and job creation.

By August 2003, with inflation still relatively low and stable—and continuing to fall by some measures—the FOMC believed that it could continue to maintain its federal funds target rate at its low level (1 percent) for a “considerable period.” All along, the committee and most forecasters thought that the powerful combination of low interest rates and strong productivity growth would eventually produce vigorous growth. Well, that forecast appears to have been correct.

Paced by strong increases in consumer purchases of durable goods and new homes and in business outlays for equipment and software, real GDP rose at an 8.2 percent annual rate in the third quarter—its strongest growth in nearly 20 years. Economic activity during the third quarter was also enhanced by the Jobs and Growth Tax Relief Reconciliation Act of 2003, which included additional fiscal stimulus designed to boost consumer spending and business outlays for equipment and structures. While the economy will continue to benefit from expansionary monetary and fiscal policies over the next several quarters, forecasters expected real GDP growth to settle down to about 4 percent (annualized) during the fourth quarter and into 2004.

Recent surveys of business executives and households also reveal increased optimism about the strength of the economy going forward. Rising stock prices and a willingness among firms to add employees are two key indicators of an improving outlook. Through early December, equity prices



(as measured by the Wilshire 5000) were up by about 25 percent year to date, while in November payroll employment rose for the fourth consecutive month and the unemployment rate dropped to 5.9 percent. Ultimately, though, faster economic growth and improving financial market conditions stem from increased expenditures by firms and households.

Heading toward the end of 2003, it appeared that most of the indicators were pointing in the same direction and were consistent with the aforementioned forecasts. The positive signs included an upbeat assessment of the nation's business conditions in October and early November by the Fed's *Beige Book*; better-than-expected reports of U.S. manufacturing activity in November and of new residential construction activity in October; and retailer reports of strong post-Thanksgiving holiday sales. A good part of this growth might have reflected increased production to replenish the depleted stock of inventories held by firms. Those inventories have been sharply reduced since late 2001.

Comments by several Federal Reserve officials suggest that the FOMC is in no hurry to raise its target federal funds rate. This is probably not too surprising given that inflation and long-run inflation expectations generally remain at low levels and that the unemployment rate is expected to fall only modestly over the next year. The 12-month percentage change in the core PCE price index has slowed from a little more than

2 percent in mid-2001 to a little less than 1.25 percent through October 2003. Many forecasters and financial market participants generally believe the Fed will keep its current 1 percent federal funds target rate intact until spring 2004.

When assessing the risks to price stability and sustainable growth, the FOMC first assesses its forecasts for inflation, output, employment and key financial market variables. From this, the committee gets a sense of how its policies are expected to affect economic activity over the next several quarters (perhaps in conjunction with unforeseen events that have shaped the economic landscape). Next, the FOMC views the evolving path of the economy (as seen by current economic indicators) within the context of this forecast. From this exercise, the committee hopes to assess whether, for example, the risks of rising inflation or faltering growth have changed—and if so, whether a change in policy is required.

Presumably, in the current environment of stronger growth, the FOMC will be unusually circumspect in its assessment of the evolving risks to the economy.

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