Economy Is Nearing Cruising Altitude

By Kevin L. Kliesen

Although the trajectory has been flatter and the ride a little bumpier than usual, the U.S. economy continues to gain momentum. Real GDP has increased for three consecutive quarters (through 2010:Q1), private-sector hiring is picking up, and inflation and inflation expectations generally remain low and stable. Still, the unemployment rate remains stubbornly high because of continued weakness in the residential and commercial construction sectors and because of lingering strains in the financial markets. Moreover, as the developments in Europe suggest, the huge accumulation of government debt in the advanced economies poses risks to the world economy. Minimizing these risks will be key to maximizing the economy's growth potential.

Turbulence Is Limited So Far

Real GDP, which measures the production of final goods and services in the economy, rose at an annual rate of 2.7 percent in the first quarter of 2010. A key part of the economic recovery recently has been the inventory cycle, which traditionally boosts growth during the early stages of a business expansion. As rising employment and real incomes boost the demand for goods and services, economic activity eventually surpasses its pre-recession levels, production and hiring pick up, and the expansion becomes self-sustaining—until another shock pushes the economy back into recession.

As the U.S. economy heads into the second half of 2010, the expansion appears to be following this self-sustaining pattern. In particular, outlays by consumers and businesses generally continued to strengthen, and the pace of U.S. exports remained brisk, consistent with the projected strengthening in the global economy outside of Europe. More broadly, other key measures of economic activity also augured well for the economy. These include the manufacturing and nonmanufacturing purchasing managers indexes, the index of leading indicators, and rising levels of confidence by large-company CEOs. (Confidence among small firms was much less buoyant.)

Housing and the commercial real estate industry have been a festering problem, but there are some signs that the worst has passed. One lingering worry is the strength of the housing industry without the support of the homebuyers tax credit. But with the economy strengthening and mortgage rates still low, home sales and construction activity should begin to increase from their low levels, albeit modestly.

Labor markets are improving. In May, total nonfarm payrolls rose by 431,000, but private nonfarm payrolls rose by only 41,000; the increase in private employment was less than the market expected. At the same time, the unemployment rate remained near 10 percent in May, and the percentage of the labor force unemployed for 27 weeks or longer remained at record-high levels. With a relatively lean work force coming out of the recession, the gradual strengthening of the economy should cause firms to continue adding to their work force.

Turbulence rose anew in May and June, as actions taken to address large and protracted budget deficits in Greece and a few other European countries caused financial markets to reassess the prospects for Europe's recovery. These concerns soon migrated to the United States, causing some to worry about the potential effects of a European slowdown on the U.S. economy. At this point, it is too soon to say how large these effects might be, but U.S. exports to the euro area countries comprised only 15 percent of total U.S. exports in 2009. Still, the sovereign debt crisis comes at a time when stresses to the U.S. financial system are keeping bank failures and nonperforming loans at elevated rates.

Inflation under Control

The news on the inflation front remains good, and Fed policymakers continue to see low and stable inflation over the next few years. Accordingly, the FOMC appears to be in no hurry to depart from its extraordinarily accommodative policy. If anything, low inflation, continued high unemployment and developments in Europe may keep the Fed on hold for a longer period of time than some analysts had anticipated a few months ago. That said, an unexpected surge in economic activity, coupled with the huge amount of excess reserves on bank balance sheets, may lead to an unwanted acceleration in money growth, which could destabilize financial markets and cause an increase in inflation expectations. Fed officials are keenly aware of these risks, but they believe they have put in place policies to keep inflation low. Forecasters generally agree: They expect inflation of 2 percent or less over the next year and a half. Ω

Kevin L. Kliesen is an economist at the Federal Reserve Bank of St. Louis. Go to http://research.stlouisfed.org/econ/kliesen/ for more on his work. Douglas C. Smith provided research assistance.

BRUCE MACPHERSON@DONNAROSENARTISTS.COM