

## National and District Overview

### National and District Economies Maintain Cruising Speed



The U.S. economy strengthened measurably in the third quarter. Although tough times are still evident in parts of the farm economy, and indications are that the construction industry is losing steam, the U.S. and Eighth District economies continue to operate at what appears to be full capacity.

#### Pedal to the Metal

Real GDP increased at a 4.8 percent annual rate in the third quarter, nearly 2 percentage points faster than its growth during the first half of the year. Consumer spending, paced by strong demand for durable goods like motor vehicles and household appliances, advanced at a brisk 4.3 percent rate, while business fixed investment—in particular, spending on capital goods like computers, software (recently reclassified as fixed investment) and other information processing equipment—grew at blistering 14.9 percent rate. Besides continued strong U.S. growth, investment spending is getting a boost from strengthening economic growth in Canada, Europe, Asia and parts of South America, which is, not surprisingly, spilling over to a resurgence in foreign demand for U.S. exports.

To some extent, factories are increasing production to rebuild inventories, which have become quite lean recently. It may also be the case that firms are building in a cushion to offset potential disturbances stemming from Y2K. This may help to explain why new factory orders for manufactured durable goods registered their largest gain in five and a half years in the third quarter.

#### Speed Bumps Ahead?

The growth of real GDP has exceeded 4 percent for the past four years. Some monetary policymakers, thus, are concerned that

aggregate demand for goods and services continues to grow at a pace that exceeds the economy's capacity to expand (otherwise known as potential GDP growth), which some economists believe is now around 3 percent.

At some point, demand growth that continues to exceed supply begins to boost prices. Indeed, there are some indications that it is already in train. Through the first three quarters of this year, the inflation rate, as measured by the CPI, is running about 1 percentage point faster than last year's 1.6 percent, which was the low for this expansion. Growth in the GDP price index, a broader measure,

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shows a similar pattern. The spike in oil prices no doubt accounts for a large share of this run-up in prices: When energy prices are removed from the CPI, year-to-date price increases (1.9 percent) are actually running a bit less than last year (2.4 percent). Thus, if oil prices retreat, and non-oil price increases remain subdued, then inflation might return to where it was in 1998.

Aggregate price pressures, however, have been restrained to a considerable degree by favorable developments on the supply side during the past couple of years. These include a strengthening U.S. dollar, which has helped tamp down import prices, a sharp drop in oil prices, a substantial slowing in health care costs and, perhaps most important, strong labor productivity gains. The latter has helped firms to offset increased labor and non-labor costs, while keeping a lid on retail prices and protecting profit

margins. Although productivity growth remains rather strong, most other favorable developments have withered away. From this perspective, then, it appears that the risk of higher future inflation has increased.

#### District Labor Shortages Continue

For the most part, strong demand growth at the national level has gone hand-in-hand with the demand for goods and services produced in the Eighth District. Accordingly, labor utilization rates remain exceptionally high. In three states, Indiana, Missouri and Tennessee, the third-quarter unemployment rate was well below the U.S. average of 4.2 percent, with the unemployment rate in the four largest cities in the District even lower. At the same time, growth of nonfarm payroll employment in several states has slowed measurably from last year. Whereas third-quarter U.S. nonfarm payroll increased 2.2 percent, the seven-state average growth was much less, 1 percent. One reason, as most regions of the country continue to report, is that widespread labor shortages are hampering many firms' ability to expand production. By necessity, this has forced firms to boost productivity or lure employees away from marginal firms who might not otherwise be able to compete.

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