

U.S. Economic Report 1H-2006

(Source: Board of Governors of the Federal Reserve System's Monetary Policy Report to the Congress, July 19, 2006)

Summary

The U.S. economy continued to expand at a brisk rate, on balance, over the first half of 2006. Spending in the first quarter, which was especially robust, was temporarily buoyed by several factors, including federal spending for hurricane relief and the effects of favorable weather on homebuilding. The pace of the expansion moderated in the spring, to some degree because the influence of these special factors dissipated. More fundamentally, consumer spending slowed as further increases in energy prices restrained the real incomes of households. In addition, home sales and new homebuilding dropped back noticeably from the elevated levels of last summer, partly in response to higher mortgage interest rates. Outside of the household sector, increases in demand and production appear to have been well maintained in the second quarter. Demand for U.S. exports was supported by strong economic activity abroad, and business fixed investment remained on a solid upward trend. Early in the year, as aggregate output increased rapidly, businesses added jobs at a relatively robust pace, and the unemployment rate moved down further. Since April, monthly gains in payroll employment have been smaller but still sufficient to keep the jobless rate steady.

Gross Domestic Product

Taking a longer perspective, the U.S. economy appears to be in the midst of a transition in which the rate of increase in real gross domestic product (GDP) is moving from a pace above that of its longer-run capacity to a more moderate and sustainable rate. An important element in the transition is the lagged effect of the changes in monetary policy since mid-2004, changes that have been intended to keep inflation low and to promote sustainable economic expansion by aligning real economic activity more closely with the economy's productive potential. Moreover, longer-term interest rates have risen, contributing to increased borrowing costs for both households and businesses. Over time, pressures on inflation should abate as the pace of real activity moderates and, as futures markets suggest, the prices of energy and other commodities roughly stabilize. The resulting easing in

inflation should help contain long-run inflation expectations.

Consumer Spending

Even as the rate of increase in real economic activity moderates, the prospects for sustained expansion of household and business spending appear favorable. Higher energy prices have put strains on household budgets, but once that effect fades, households should experience gains in real income consistent with the ongoing expansion of jobs. Household balance sheets remain generally sound; although some pockets of distress have surfaced, average delinquency rates on mortgages and other consumer debt are still low. Similarly, in the business sector, balance sheets are strong, credit quality is high, and most firms have ready access to funds. Sustained expansion of the global economy, along with the effects of the earlier depreciation of the foreign exchange value of the dollar, should support demand for U.S. exports. The potential for efficiency gains, as well as further declines in the relative cost of capital, are likely to continue to spur capital spending. Indeed, the ongoing advances in efficiency should sustain solid growth of labor productivity, providing support for gains in real wages and income.

Inflation

Thus far in 2006, inflation pressures have been elevated. Higher prices for crude oil contributed to a further run-up in domestic energy costs; this year's increases, combined with the steep increases in 2004 and 2005, not only boosted the prices of gasoline and heating fuel but also put upward pressure on the costs of production for a broad range of goods and services. Partly as a result of these cost pressures, the rate of core consumer price inflation picked up. Nevertheless, measures of inflation expectations remained contained, and the rate of increase in labor costs was subdued, having been held down by strong gains in productivity and moderate increases in labor compensation.

Outlook

As always, considerable uncertainties attend the outlook. Regarding inflation, the margin between production and consumption of crude oil worldwide is quite narrow, and oil markets are especially sensitive to news about the balance of supply and demand and to geopolitical events with the potential to affect that balance; adverse developments could result in yet another surge in energy costs. Indeed, futures markets provide only imperfect readings on the prospects for

energy markets, as witnessed by the fact that the surprises in crude oil prices during the past few years have been predominantly to the upside. In addition, a further rise in prices of other, non-energy materials and commodities, if it materializes, could also intensify cost pressures. Another risk is that the effect on imported-goods prices of earlier declines in the foreign exchange value of the dollar, which has been limited to date, could become larger. More broadly, if the higher rate of core inflation seen this year persists, it could induce a deterioration in longer-run inflation expectations that, in turn, might give greater momentum to inflation. However, the risks to the inflation outlook are not entirely to the upside. In the current environment of elevated profit margins, competitive forces, both in domestic markets and from abroad, could impose significant restraint on the pricing decisions of businesses.

Regarding risks to the outlook for real activity, rates of increase in real GDP have been uneven during the past year, complicating the assessment of whether the pace of the economic expansion is moving into line with its underlying potential rate. One possible risk to the upside is that the softer tone of the recent data on real activity will prove transitory rather than mark a shift to a more sustainable underlying rate of expansion. For example, slower spending and hiring in recent months may represent a shorter-lived adjustment to a higher level of energy prices or to the unusually robust increases in economic activity earlier in the year. In coming months, a sharp rebound in consumer spending accompanied by an acceleration of capital spending could return real activity to a pace that would be unsustainable over the longer run. But downside risks also exist. In particular, the slowing in real estate markets since last summer has been moderate, and the easing of house-price inflation has been gradual. If the softening in the demand for housing and in real estate values becomes more pronounced, the resulting drop in construction activity and the erosion of household wealth could weaken aggregate demand noticeably. Consumer spending might be depressed by the loss of income and wealth, and that effect could be amplified if the downturn is abrupt enough to shake households' confidence about their ability to finance spending or manage their current financial obligations.