

U.S. Economic Report 1H-2007

(Source: Board of Governors of the Federal Reserve System's Monetary Policy Report to the Congress, July 18, 2007)

Summary

The U.S. economy generally performed well in the first half of 2007. Activity continued to increase moderately, on average, over the period; businesses added jobs at a steady pace; and the unemployment rate remained at 4-1/2 percent. Overall inflation, however, picked up as a result of sizable increases in energy and food prices. At the same time, core inflation (which excludes the direct effects of movements in energy and food prices) held at about the same rate as in 2006; this measure smoothes through some of the volatility in the high-frequency data and thus is generally a better gauge of underlying inflation trends.

Gross Domestic Product

Although real gross domestic product appears to have expanded at about the same average rate thus far this year as it did in the second half of 2006, the pace of expansion has been uneven. In the first quarter, consumer expenditures and business fixed investment, taken together, posted a solid gain. However, homebuilding continued to contract, and manufacturing firms adjusted production to address stock imbalances in that sector that had emerged over the course of 2006. In the second quarter, housing activity declined further in response to the continued softness in home sales and still-elevated inventories of unsold new homes; personal consumption expenditures (PCE) also slowed. Even so, the available data point to solid gains overall in other components of final sales, and with manufacturing inventory imbalances significantly reduced, growth in real GDP apparently sped up.

Job Markets

Job growth in the first half of 2007 was driven by sizable increases in service-producing industries. In the goods-producing sector, manufacturing employment contracted, especially at firms closely tied to the construction industry and at

producers of motor vehicles and parts. Employment in residential construction, which had turned down in mid-2006, decreased only modestly further over the first half of 2007 despite the substantial decline in homebuilding.

Real hourly compensation increased over the year ending in the first quarter, the most recent period for which complete data are available. In the second quarter, however, gains in real compensation were probably curtailed by a steep, energy-driven rise in consumer prices. Employment continued to rise apace in the first half of 2007 in the face of moderate growth in output. As a consequence, growth in labor productivity--which had slowed in 2006 from the rapid rate observed earlier in the decade--appears to have remained modest. The cooling of productivity growth in recent quarters likely reflects cyclical or other temporary factors, but the underlying pace of productivity gains may also have slowed somewhat.

Financial Markets

Financial market conditions have continued to be generally supportive of economic expansion thus far in 2007, though there was a notable repricing in the subprime-mortgage sector. In recent weeks, the deterioration in that sector has been particularly marked, and markets for lower-quality corporate credits have also experienced some strains. Nonetheless, spreads on such corporate credits have remained narrow on the whole, and business borrowing has continued to be fairly brisk. On balance, equity markets posted sizable gains through mid-July, in part because of continued robust corporate profits and an upward revision to investors' outlook for the economy. The improved outlook led market participants to mark up their anticipated path for the federal funds rate, and intermediate- and long-term interest rates rose significantly. The foreign exchange value of the dollar has declined moderately this year as the pace of economic activity abroad has strengthened.

Inflation

Overall consumer price inflation, as measured by the PCE price index, picked up noticeably in the first half of 2007, largely because of a sharp increase in energy prices. After moving down over the second half of 2006, the prices households pay for energy subsequently turned up and by May were 14 percent (not at an annual rate) above their level at the end of last year. Food prices also contributed to the step-up in overall inflation this year. The faster rate of increase in overall prices has had only a modest effect on inflation expectations: Surveys suggest that near-

term inflation expectations have risen somewhat in recent months, but measures of long-term inflation expectations have remained within the range of recent years.

The rate of increase in the core PCE price index ticked down from 2.1 percent over the twelve months of 2006 to an annual rate of 2.0 percent over the first five months of 2007, primarily accounted for by more-favorable readings between March and May. Although higher energy prices this year added to the cost of producing a wide variety of goods and services that are included in the core index, these effects were offset by other factors--most notably, a slowdown in the rate of increase in shelter costs from the very high rates seen in 2006.

Outlook

The U.S. economy seems likely to continue to expand at a moderate pace in the second half of 2007 and in 2008. The current contraction in residential construction will likely restrain overall activity for a while longer, but as stocks of unsold new homes are brought down to more comfortable levels, that restraint should begin to abate. In addition, the inventory correction that damped activity in the manufacturing sector around the turn of the year appears largely to have run its course. Thus, stock adjustment is unlikely to be a drag on production in coming quarters. Consumer spending should also keep moving up. Employment and real wages are on track to rise further, and, although the difficulties in the subprime-mortgage market have created severe financial problems for some individuals and families, the household sector is in good financial shape overall. Businesses are also continuing to enjoy favorable financial conditions, which, along with a further expansion in business output, should support moderate increases in business investment. The positive outlook for economic activity abroad bodes well for U.S. exports.

Core inflation is expected to moderate a bit further over the next year and a half. Longer-run inflation expectations are contained, pressures on resource utilization should ease slightly in an environment of economic expansion at or just below the rate of increase in the nation's potential to produce, and some of the other factors that boosted inflation in recent years have already receded or seem likely to do so. As noted, increases in shelter costs, which helped push up core inflation in 2006, have slowed appreciably this year. In addition, the paths for the prices of energy and other commodities embedded in futures markets suggest that the impetus to core inflation from these influences should diminish. And although unit labor

costs in the nonfarm business sector have been rising, the average markup of prices over unit labor costs is still high by historical standards, an indication that firms could potentially absorb higher costs, at least for a time, through a narrowing of profit margins.

Nonetheless, the possibility that the expected moderation in inflation will fail to materialize remains the predominant risk to the economic outlook. The more-favorable readings on core inflation in recent months partly reflect some factors that seem likely to prove transitory. Moreover, the economy appears to be operating at a high level of resource utilization, which has the potential to sustain inflation pressures. In addition, an upward impetus to costs could emanate from other sources, including higher prices for energy and other commodities or a slower rate of increase in structural productivity. Another concern is that high rates of headline inflation, if prolonged, could cause longer-run inflation expectations to rise and could thus become another factor sustaining inflation pressures.

Significant risks also attend the outlook for real economic activity. On the downside, the fall in housing construction could intensify or last longer than expected. In addition, persistent weakness in the housing sector could spill over to other sectors, especially consumption. But upside risks also exist. For example, consumer spending appears to be rising less rapidly of late after a period of large increases that pushed the personal saving rate into negative territory; increases in consumption could return to their earlier pace. Exports could also boost aggregate demand more than anticipated, especially if economic conditions abroad continue to exceed expectations.