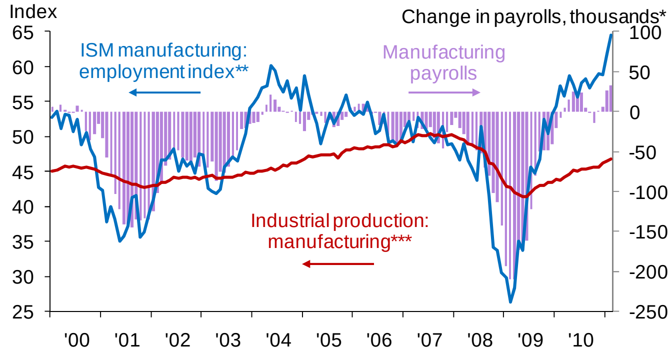
Economic Update NATIONAL
Federal Reserve Bank of Dallas

The Shifting Winds and Currents of Recovery

March 21, 2011

The outlook for U.S. economic growth has shifted from optimistically strong to cautiously remaining above trend. Recent data have continued to be relatively robust, with various measures of manufacturing, expenditure, exports, capital spending and labor suggesting solid underlying growth. However, as with a large ship buffeted by competing forces, emerging cross-currents complicate navigating the challenges posed by existing headwinds. The U.S. economy may suffer a modest drag to growth this year and next from geopolitical unrest in the Middle East and North Africa (MENA) and from the ongoing natural disaster and nuclear calamities in Japan, which tend to weigh on business sentiment.

Chart 1
Manufacturing Sector Showing Strength



*Seasonally adjusted, three-month moving average.
**Seasonally adjusted, diffusion index (50+ = increasing).
***Seasonally adjusted (50 = 2007 average).
SOURCES: Institute for Supply Management; Bureau of Labor Statistics; Federal Reserve Board of Governors; author's calculations.

The Good News: Tailwinds and Growth Momentum

The U.S. economy is benefitting from resilient factory output. In February, the Institute for Supply Management (ISM) composite manufacturing index rose to its strongest mark since December 1983, the 19th consecutive reading pointing to manufacturing growth. The new orders component was at the highest level since January 2004, while export orders recorded their best reading in 22 years, suggesting robust demand for manufactured goods, domestically and abroad. Further, the ISM manufacturing employment component hit a 33-year high, which corroborates the gains in manufacturing payrolls and factory hours worked in February. Those payrolls increased at a 1.6 percent year-over-year rate compared with overall payroll growth of 1 percent. Manufacturing activity has rebounded 6.9 percent from a year ago and is 13.1 percent above the June 2009 cyclical trough (*Chart 1*). Motor vehicle production and high tech have been primary growth drivers in recent months.

Other sectors of the economy have shown similar strength, with consumer spending particularly robust last quarter. Seasonally adjusted personal consumption expenditure (PCE) increased at a 4.1 percent annualized rate, while consumer durable spending—the most volatile component of PCE—grew at a 21 percent annualized pace. The surge in consumer durables added more than 1.4 percentage points to fourth-quarter gross domestic product (GDP) growth. U.S. exports have climbed 15.9 percent since January 2010, increasing especially rapidly over the past four months. Beyond a cyclical bounce-back attributable to pent-up demand from the recession, manufactured goods orders and capital spending should further expand, given the prospects for continued accelerating global activity and relatively healthy cash positions that many companies accumulated during the past several lean years. Additionally, many firms are poised to benefit from the business expensing provisions of a federal tax compromise reached in December.

Table 1
Labor Market Improving

	Unemployment rate (percent)	Underutilization rate (percent)	Change in the labor force (thousands)	Change in payroll-adjusted household employment (thousands)**	Change in total nonfarm payrolls (thousands)
Nov-10	9.8	17.0	-10	+31	+93
Dec-10	9.4	16.7	-260	+498	+152
Jan-11	9.0	16.1	-504	+153	+63
Feb-11	8.9	15.9	+60	+342	+192

*Includes total unemployed plus all marginally attached workers plus total employed part time for economic reasons
**Population-smoothed and adjusted to be equivalent with the nonfarm payroll survey.
SOURCE: Bureau of Labor Statistics.

A steady string of upward revisions to payrolls, a trend of falling initial jobless claims and gains in employment have suggested an improving labor market—a critical condition for a self-sustaining economic recovery. The unemployment rate has declined markedly since November due to a combination of a shrinking labor force and employment gains (*Table 1*). Backward-looking data show the economy is on a solid footing, while survey and forward-looking figures reveal prospects for strong growth; ISM surveys suggest continued above-trend GDP expansion (*Chart 2*).

The Bad News: Possible Storms Ahead

Geopolitical concerns and resulting higher energy prices along with increased investor uncertainty and risk aversion may dampen U.S. prospects. Many economists, using a macroeconomic rule of thumb, estimate a 10 percent sustained oil price shock yields a 0.2 percentage-point drag on GDP expansion. The duration of an energy price rise is a key determinant of the drag. As of now, forecasts suggest higher oil prices for several years in expectation of tighter supply amid expanding demand.

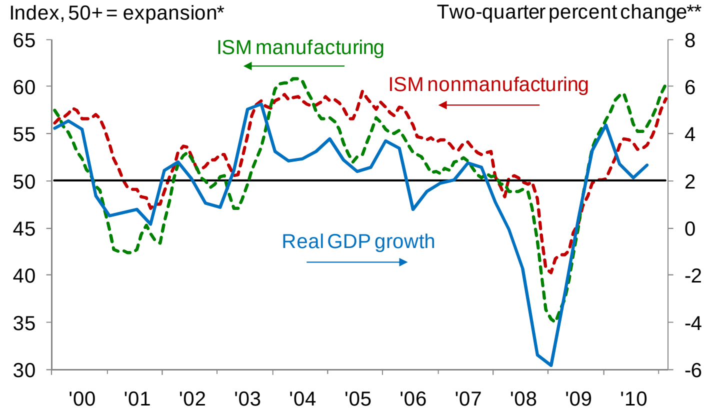
Key Organization of the Petroleum Exporting Countries (OPEC) members have indicated sufficient production will be brought to market to cover the still-limited supply disruption and expanding demand of recent months. Sustained higher gasoline prices act as a tax on consumption, denting household disposable income. If gas prices were to remain 50 cents higher than at the end of last year, $69.8 billion more would be spent on gasoline this year, given the same consumption and behavioral patterns. That averages out to be $621 per household (*Table 2*). The price hike may directly reduce spending on discretionary items, as well as negatively influence households' and businesses' confidence (*Chart 3*).

The state and local government sector, confronting budget shortfalls, faces cost cutting and job losses that will likely hamper overall output growth. However, barring unusual stress in the market for municipal bonds, state and local government reductions are expected to trim output by only a few tenths of a percentage point and are unlikely to present an outsized hindrance. Similarly, the engine of economic prosperity that was once homebuilding is not expected to impart a significant impact on the overall economy, as slow recoveries in both residential and nonresidential real estate markets will likely take several years. The portion of GDP attributable to nonresidential structures and residential investment has declined to less than 5 percent in recent quarters from more than 9 percent in 2006.

Moderate Cost Pressures Present

How do the recent oil and commodity price surges affect underlying inflation? Though headline consumer inflation has moved higher in recent months, oil prices have exerted little upward pressure on core inflation, given the extent of slack still present in the economy. Inflation expectations remain relatively well-anchored, reflecting oil's smaller share in overall economic pro-

Chart 2
ISM Surveys Point to Growth



*Seasonally adjusted, three-month moving average.
**Annualized percent change.
SOURCES: Institute for Supply Management; Bureau of Economic Analysis; Conference Board; author's calculations.

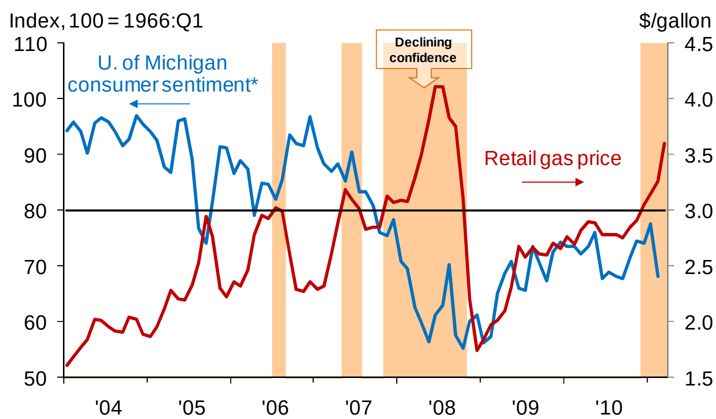
Table 2
Higher Gas Prices Tax Consumers

Incremental Expenditure on Gasoline Given Various Price Increases (Based on full year 2010 consumption and behavior)

Increase in gas ($/gal)	Incremental expenditure increase (billions)	Additional expenditure per household
$1.00	$139.6	$1,241
0.75	104.7	931
0.50	**69.8**	**621**
0.40	55.8	497
0.25	34.9	310
0.10	14.0	124

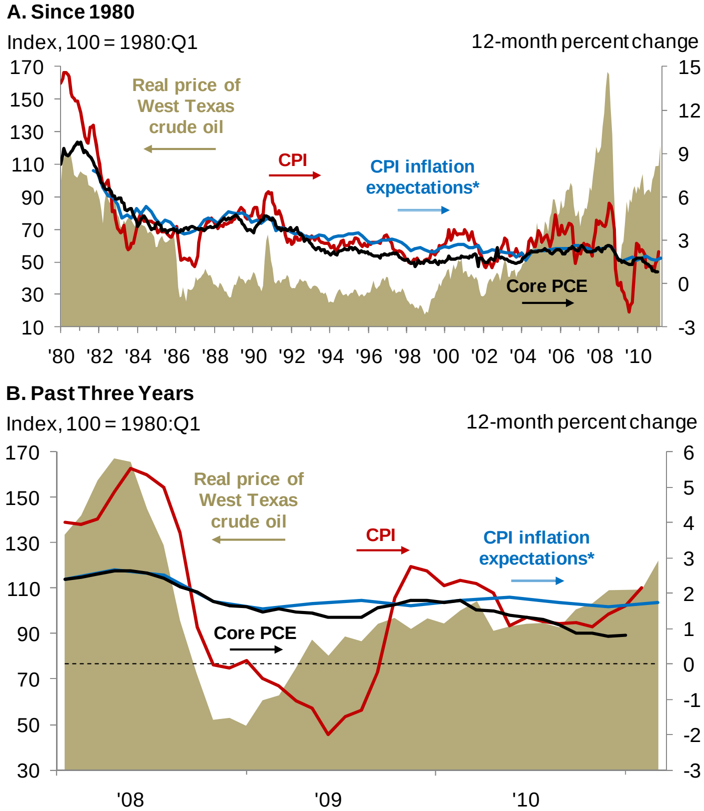
NOTE: Highlighted row shows the current level of elevated gas prices.
SOURCES: *Oil and Gas Journal*; Department of Energy; author's calculations.

Chart 3
Confidence Tends to Falter When Gas Prices Spike



*One-month lead.
NOTE: Shaded area denotes periods when gas prices are above $3/gal.
SOURCES: Department of Energy; University of Michigan.

Chart 4
Consumer Price Inflation Rising but Still Modest



*Survey of Professional Forecasters median 12-month ahead CPI inflation expectations.
SOURCES: *Wall Street Journal*; Bureau of Economic Analysis; Federal Reserve Board of Governors.

duction and consumption, as well as more flexible labor markets. Most economists suggest that oil and commodity price surges tend to be transitory and, for that reason, have little impact on core inflation (*Chart 4*). Specifically, the consumer price index (CPI) rose 0.5 percent in February and 0.4 percent in January. On a year-over-year basis, non-seasonally adjusted CPI rose 2.1 percent in February. The PCE price index rose 0.5 percent in December and 0.3 percent in January and was 1.2 percent higher than in January 2010. Core inflation, which excludes the effects of volatile food and energy prices, and the trimmed mean inflation rate have been more muted than the headline rates, though the core rates have accelerated slightly due to shelter costs. On a year-over-year basis, core CPI rose 1.1 percent in February, while core PCE gained 0.8 percent in January.

Conditions Still Favor Growth

Despite potential challenges from MENA turmoil, catastrophic events in Japan, European sovereign debt funding pressures and domestic drags to growth such as state and local government budget cuts and housing woes, the U.S. recovery should continue above-trend growth. Though current headwinds and cross-currents suggest cause for tempered optimism, it's too early to dismiss improved credit availability, factory growth, consumer and business spending and more robust job creation. Our heading remains along the charted course of recovery—the U.S. economy is expanding, unemployment is falling and moderate cost pressures that should accompany growth are slowly emerging.

—David Luttrell

About the Author

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Note

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