

## **Solid Economic Fundamentals and a Temporary Upward Drift in Inflation**

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The constant stream of real-time data releases by the government and several private sources diverts attention away from the very sound fundamentals that support strong sustainable U.S. economic expansion and provide substantial flexibility to withstand external shocks. Standard estimates of U.S. potential growth far exceed estimates for most other large industrialized nations. The sound fundamentals also are the basis for the attractiveness of U.S. dollar-denominated assets that generate net foreign capital inflows. Concerns about the “impending doom” posed by the large and widening trade deficit and the low rate of personal saving are overstated.

Real GDP growth is projected to moderate in 2005Q2 and Q3 and average approximately 2.75 percent annualized in response to the persistently high oil and energy prices, resulting in an estimated 3.2 percent growth in 2005 and 2.9 percent 2005Q4/2004Q4 (compared to 3.9 percent Q4/Q4 in 2004). Business investment and profitability will continue to grow, but at slower rates than in 2004. Inflation pressures are projected to remain relatively low, and the recent upward drift in core inflation is expected to be modest and temporary, based on trends in monetary thrust, which point toward slowing demand growth, and continued gains in productivity that constrain operating costs.

An unanticipated rise in inflation and inflationary expectations, however, poses a key risk to economic and financial market performance, and it is critical that the Federal Reserve respond appropriately to keep inflation low and maintain its inflation-fighting credibility. Prices of financial assets are expected to respond to further hikes in short-term interest rates as the Federal Reserve continues to remove its accommodative monetary policy, and reverse some of the key trends that were associated with the Fed’s low rate policy of 2002-mid 2004.

### **Healthy Fundamentals and High Sustainable Growth**

A number of factors underlie the U.S.’s sound economic fundamentals and distinguish its performance from other large industrialized nations. U.S. production processes are relatively more efficient and its labor markets are more flexible. Labor market regulations, while protecting workers and providing moderate income support, facilitate sufficient flexibility to allow businesses to rapidly adjust production and labor inputs in response to changing conditions and to increase efficiencies. The scope of the U.S. government in terms of spending and tax burdens is relatively low as a percent of GDP, and the wedge between employers’ costs of employment and workers’ after-tax take home pay, while high, is still smaller than the tax wedge in virtually every other industrialized nation. Growth in business investment has far exceeded other major industrialized nations, embodying technological innovation and contributing to healthy gains in productivity that constrain production costs. U.S. unit labor costs are among the lowest among industrialized nations. Inflation is relatively low and the Federal Reserve maintains high inflation-fighting credibility, which keeps interest rates and costs of capital low. U.S. capital markets efficiently reallocate saving into attractive investment opportunities, facilitate international capital flows and provide myriad financial instruments for managing and redistributing risk, while the banking system is well capitalized. Entrepreneurship thrives and is rewarded, and capital is attracted to risk-taking investments. Although difficult to measure, these key factors underpinning the U.S. economy suggest that “potential growth”, whose standard estimates center around 3.5 percent, is significantly higher than most large industrialized nations.

### **Cyclical Trends: Look for Moderately Slower Growth**

Following a period of strong performance through 2004Q4—real GDP growth had exceeded 3.8 percent annualized in six of the last seven quarters—growth slowed to 3.1% annualized in 2005Q1, and is projected to average approximately 2.75 percent annualized in 2005 Q2 and Q3. This would result in 3.2 percent

growth for 2005 (2.9 percent Q4/Q4). This anticipated slowdown stems primarily from the persistently higher oil and energy prices.

Through 2005Q1, the sharp increases in oil and energy prices did not deter consumer spending: real consumption rose at a 4.5 percent annualized pace in the second half of 2004 and 3.5 percent in 2005Q1 (see Chart 1). The negative impact of higher energy costs on real disposable personal income was offset by healthy increases in wages and salaries, reflecting expanding employment and modest increases in wages, along with low interest rates and rising wealth. Nevertheless, the sustained rapid spending growth suppressed the already low rate of personal saving. The persistent increases in energy costs—in the last year, crude oil prices have increased about 40 percent and natural gas prices about 25 percent—are beginning to slow spending. Measured from a strong base and healthy growth of disposable income, the price increases to date are expected to slow consumption growth to approximately 2.5 percent annualized in Q2 and Q3 from its robust 3.8 percent average quarterly annualized growth pace in 2003-2004.

Positive fundamentals underlie sustained consumer spending growth, higher energy prices notwithstanding. Moreover, consumer balance sheets remain healthy and there has been no material rise in consumer loan defaults. Rising real interest rates associated with healthy economic performance, including growth in employment, personal income and profits, are not a risk to overall consumer credit quality; in contrast, significantly rising rates due to higher inflation would pose a serious risk.

Concerns about the low rate of personal saving are overstated. It is ironic that as the rate of personal saving dropped from 11.2 percent in 1982 and 7.7 percent in 1992 to 1.2 percent in 2004, real household net worth rose dramatically (see Charts 2 and 3). If people don't save, how does their wealth rise? The seeming puzzle is resolved by noting that the rate of personal saving is measured as a flow (changes in disposable personal income minus changes in consumption) that does not capture key factors that historically have been the primary sources of additions to the stock of wealth, including appreciation of stocks, bonds or real estate held in either cash or pension accounts. In this regard, the near-zero rate of personal saving is misleading: more likely, rising wealth (stocks, bonds and real estate) and confidence in sustained economic expansion and job availability lead households to spend a high proportion of their cash flows. In contrast, Germany's 10+ percent rate of personal saving likely reflects cautionary behavior in response to sustained poor economic performance, weak wealth creation and uncertainty about future prospects; not surprisingly, Japan's rate of personal saving is even higher.

Business responses to aggregate demand have been very disciplined, resulting in healthy growth in profits and cash flows (see Chart 4). Business top-line revenue growth has picked up with sustained growth in aggregate demand. Industrial production has increased 3.8 percent in the last year, but inventories remain low relative to sales, even with the jump in inventory building in 2005Q1. Employment gains have been modest relative to increases in output, although total labor inputs have increased at a much healthier pace (in the last year, aggregate hours worked have risen 2.5 percent compared to the 1.8 percent rise in private nonfarm payrolls) as businesses have extended hours worked per employee. Although the earlier cyclical spurt in labor productivity has slowed, productivity has risen 2.7 percent in the last year (see Chart 5). These productivity gains have constrained ULCs: in the last year (through 2004Q4), ULCs have declined 0.5 percent in manufacturing and have risen a scant 1.4 percent in the overall nonfarm business sector (see Chart 6). This has been a particularly important factor allowing businesses to maintain margins despite sharp increases in non-labor costs, including costs of materials and energy. Additionally, the lower U.S. dollar has boosted the value of net profits repatriated from overseas operations. As a result, operating profits increased 12.4 percent in the past year, reaching an all-time high; in contrast, cash flows have flattened out.

Business investment spending rose 11.0 percent during 2004Q4/2003Q4 but it slowed significantly in 2005Q1 to 4.7 percent annualized growth rate. Investment in structures fell 2.6 percent while investment in equipment and software decelerated sharply to 6.8 percent, less than one-half of its prior year average. This deceleration may have reflected the expiration of the 50 percent bonus depreciation of new capital at year-end 2004. However, sustained increases in product demand, profits and cash flows, and low costs of capital point to further increases in capital spending. Business investment spending is projected to rise approximately 6-7 percent 2005Q4/2004Q4.

Housing activity remains strong, supported by rising employment and personal income, low mortgage rates and the large stock of financial assets accumulated by households. New home sales reached an all-time high in March, while existing home sales hover near record levels. After reaching an all-time high in February, new housing starts slipped but remain near year-ago levels. Residential investment has had a cushioning influence on GDP growth throughout the business cycle, with energy-induced decelerations in consumer demand prompting lower mortgage interest rates that have boosted housing strength. This pattern is likely to recur this spring and summer. The real value of residential construction has risen 6.6 percent in the last year, contributing positively to GDP, while nonresidential construction has remained essentially flat. Is there a real estate “bubble”? Valuations of long-lived assets, including real estate, received a one-time boost from the sustained decline in inflation, inflationary expectations and bond yields since the early 1980s. Although real estate prices are at all-time highs, and dramatic appreciation in select regions may have been excessive, at current interest rate levels, on average, real estate prices are not dramatically high relative to fundamentals. A significant rise in interest rates would generate downward price adjustment, but that is not our forecast.

The U.S. trade deficit has continued to widen, as real exports have risen 5.8 percent in the year through 2005Q1 while imports have increased 10.8 percent. The real trade deficit totaled \$584 billion, or 5.4 percent of GDP in 2004 (up from \$518 billion and 5.0 percent of GDP in 2003) and reached \$663 billion annualized or 6.0 percent of 2005Q1 real GDP (see Chart 7). The rising share of domestic demand supplied by foreign production suppresses GDP relative to domestic demand (it is inappropriate to say the wider trade deficit “subtracts from GDP” insofar as international trade contributes positively to domestic demand growth).

### **Putting the Widening Trade Deficit into Perspective**

This widening trade gap has generated great consternation, but in reality it is largely a reflection of the relative strength of the U.S. economy and the attractiveness of U.S. dollar-denominated assets that underlie the large net capital inflows. As such, it is not a threat to U.S. economic or financial performance and is sustainable under economically rational conditions.

Contrary to the commonly-held notion that the trade deficit reflects primarily profligate U.S. consumers who borrow too much to purchase too many foreign-made goods, in reality the composition of imported goods suggests a fairly even balance between imports of consumer-oriented goods and business-oriented goods used for production, expansion and capital spending. Imports of capital goods and industrial supplies—even excluding petroleum products and automobiles—constitute a roughly similar share of total imported goods as imports of consumer goods (see Chart 8). Certainly, U.S. households benefit from the imports of consumer goods and automobiles (combined 41.4 percent of all imported goods), but business import of industrial supplies and capital goods lowers costs of production and heightens efficiencies, which contributes to higher U.S. and global standards of living. The share of imports for industrial supplies and capital goods (41.8 percent of all imported goods in 2004) rose significantly during the business investment boom of the 1990s, fell during the slump in production and business investment around the 2001 recession, and has resumed its earlier rise as this economic expansion has matured.

The widening U.S. trade deficit largely is a function of strong U.S. economic performance compared to other industrialized nations, its continued reliance on petroleum products and increasing reliance on low-cost imports from China, and rising net capital inflows. For well over a decade, U.S. real GDP and industrial production have grown significantly faster than every major industrialized nation except Canada, and growth differentials versus Europe and Japan have been dramatically larger for business fixed investment (see Charts 9 and 10). These differences in economic performance explain much of the variance in national demand for goods and services, and have more than offset the relative price impact on the demand for imports and exports. As long as U.S. economic performance remains healthy while other major industrialized nations sustain far slower trend growth rates, a significant narrowing of the trade deficit is not anticipated.

The U.S. current account deficit has widened along with the trade deficit as net capital inflows have bridged the gap between national saving and national investment. International capital flows and the trade of goods and services are jointly determined. Capital flows internationally seeking the highest risk-adjusted rates of return. Strong U.S. economic performance, low inflation and the Federal Reserve's inflation-fighting credibility, the relative reliability and predictability of U.S. policymakers and its strong rule-of-law all contribute to the attractiveness of dollar-denominated assets. Excess global savings and the rising net capital flows keep real interest rates and the costs of capital lower than they would be otherwise, contributing to strong U.S. domestic demand and business expansion. The resulting global imbalances are large, but they are not threatening so long as governments and financial markets behave in an economically rational fashion; absent a significant change in the economic and/or inflation fundamentals at home or abroad, a jarring change in capital flows is not expected.

### **Inflation: Any Upward Drift will be Modest and Temporary**

From cyclical lows reached in late-2003, sharp increases in oil and energy prices have pushed up headline inflation while core measures of inflation excluding the volatile food and energy components have risen modestly in lagged response to the earlier acceleration in nominal spending growth. In the last year, the CPI and PCE deflator have risen 3.2 percent and 2.3 percent, respectively while their core measures have increased 2.4 percent and 1.6 percent (see Charts 11 and 12). It is likely the upward drift in core inflation will continue as a natural consequence of the sustained monetary stimulus and excess demand, but the magnitude of the rise is limited. Indications of peaking core producer prices and core consumer commodity prices in recent months are a favorable sign. Nominal GDP growth has moderated from its peak, but at 6.2 percent year-over-year through 2005Q1, it remains well in excess of potential growth and points toward further price pressures. However, prices of many tradable goods continue to fall, reflecting rising production and export from low-cost producers such as China and India. A growing number of services are now tradable, putting downward price pressure on those industries. Although it is impossible to measure the impact of such low cost production of goods and services on U.S. productive capacity, the rise in global aggregate supply implies rising global real output, including faster trendline growth in the U.S., and less inflation, and the influences are likely to continue.

The Fed is hiking interest rates with the purpose of slowing growth of liquidity and aggregate demand. The monetary aggregates, whose moderate growth in 2002-2004 did not indicate the "excess liquidity" that many market participants suggested characterized financial markets, have decelerated, and are consistent with slowing aggregate demand and low inflation. The Fed's central tendency forecasts, which increasingly have become a signaling device for indicating the Fed's comfort range on key variables, projects nominal GDP growth to decelerate to 5.5%-6% in 2005 (Q4/Q4) and 5.0%-5.5% in 2006, and maintains 1.5%-1.75% core PCE inflation for 2005 and 2006 (see Table 1). The Fed is expected to raise rates toward 4 percent in its attempt to constrain inflation. The Fed's recent public statements underline its intention to keep inflation low.

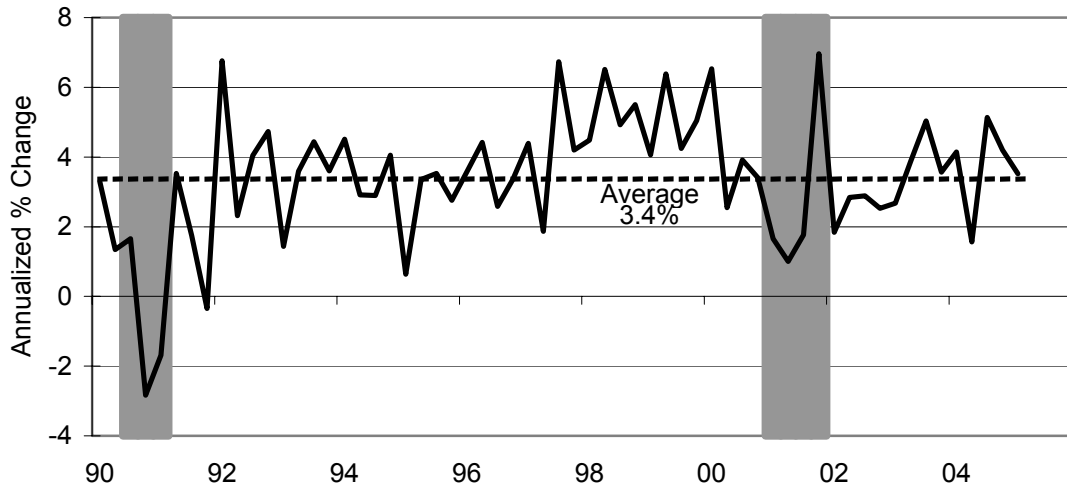
### **Federal Reserve Behavior and Financial Market Implications**

As the Fed hikes rates, many financial variables and relationships will reverse trends that developed as the Fed was lowering rates and maintaining an accommodative monetary policy during 2002-2004. With the Fed constraining inflationary expectations, further rate hikes are projected to generate a flatter yield curve over time, although the depressing impact of higher energy costs on real interest rates can be a short-term steepening influence. Although rising corporate profits underlie high creditworthiness of corporate bonds, higher costs of funding portfolios and developing constraints on liquidity imply wider credit yield spreads and higher real costs of capital. Stock valuations likely will chop roughly sideways, as profits rise but higher real interest rates exert downward pressure on P/Es. While the timing is highly uncertain, oil and commodity prices should fall from present levels, despite further increases in global demand. Looking down the road, a peaking in energy costs, as well as the successful completion of the Fed's removal of its earlier policy accommodation, are potential positives for financial market valuations.

The Fed has clearly stated its intentions of hiking rates to eliminate monetary accommodation, but nobody knows with any confidence what level of rates would be "neutral". The moderate pace of growth of the

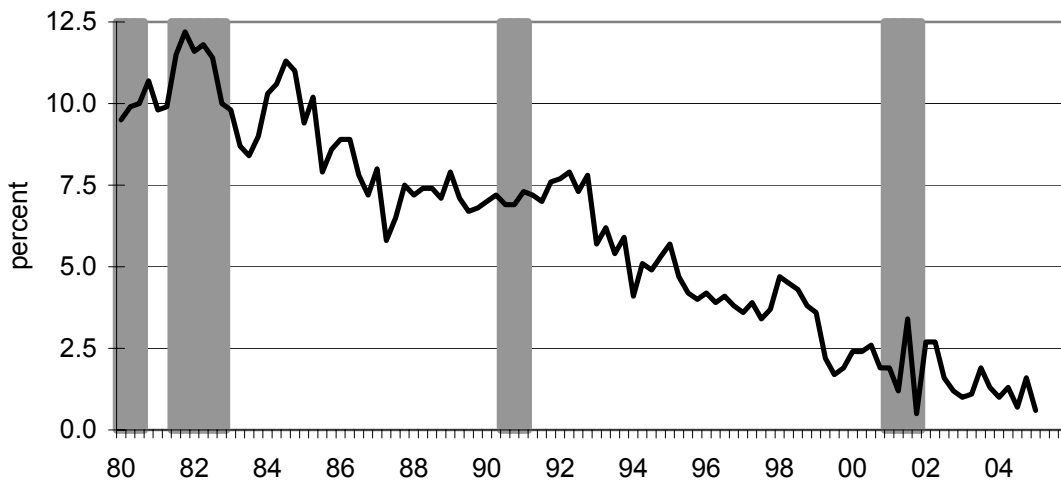
monetary aggregates suggest the Fed is close to neutral with respect to a 2 percent inflation target, according to the McCallum Rule, while according to the Taylor Rule, an approximate 3.75 percent Federal funds rate would be consistent with a 2 percent inflation objective. Based on core measures of inflation, the real federal funds rate, now positive, would need to rise to roughly 4 percent to be close to historic standards. The Fed fully recognizes the importance of keeping inflation low and maintaining its inflation-fighting credibility. By its nature, this Fed is not rule-bound, rather favoring discretion and judgment in its conduct of monetary policy. As such, as it continues to hike the Federal funds rate, it will likely become increasingly data-dependent in its monetary policy deliberations. In this regard, the Fed must remember that monetary policy affects the economy and subsequently inflation with significant lags.

**Chart 1: Real Personal Consumption**



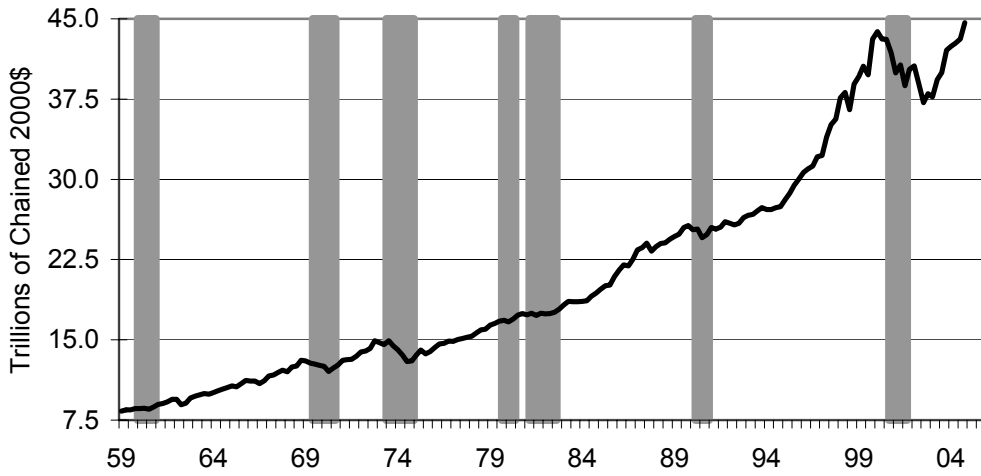
Source: Bureau of Economic Analysis / Haver Analytics

**Chart 2: Rate of Personal Saving**  
(Real Disposable Personal Income Minus Real Consumption)



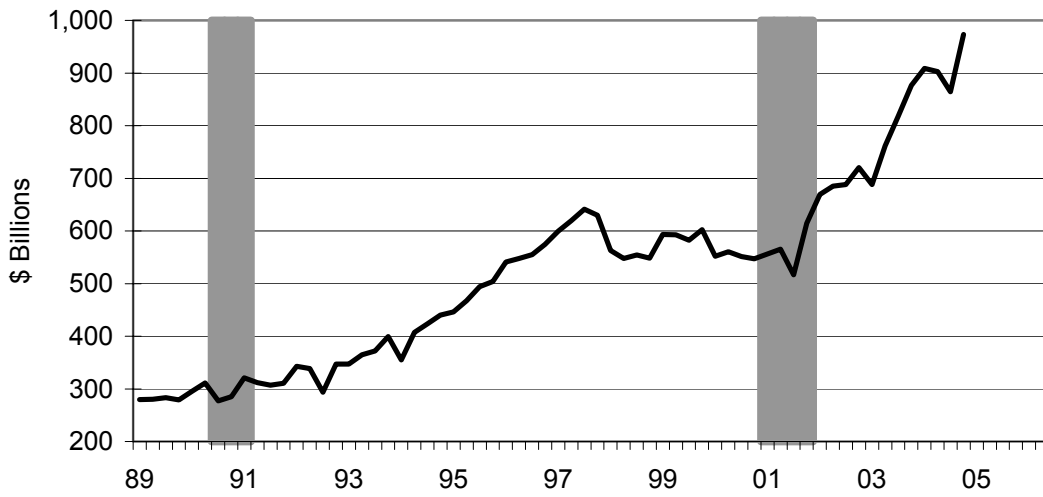
Source: Bureau of Economic Analysis / Haver Analytics

**Chart 3: Real Household Net Worth**



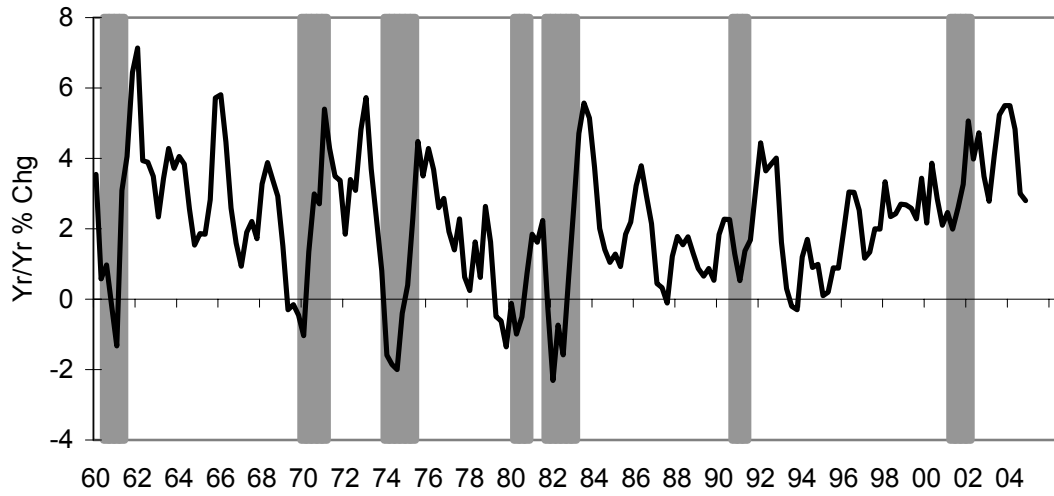
Source: Federal Reserve System / Bureau of Economic Analysis / Haver Analytics

**Chart 4: Operating Profits**  
(Corporate profits after-tax with IVA & CCAdj)



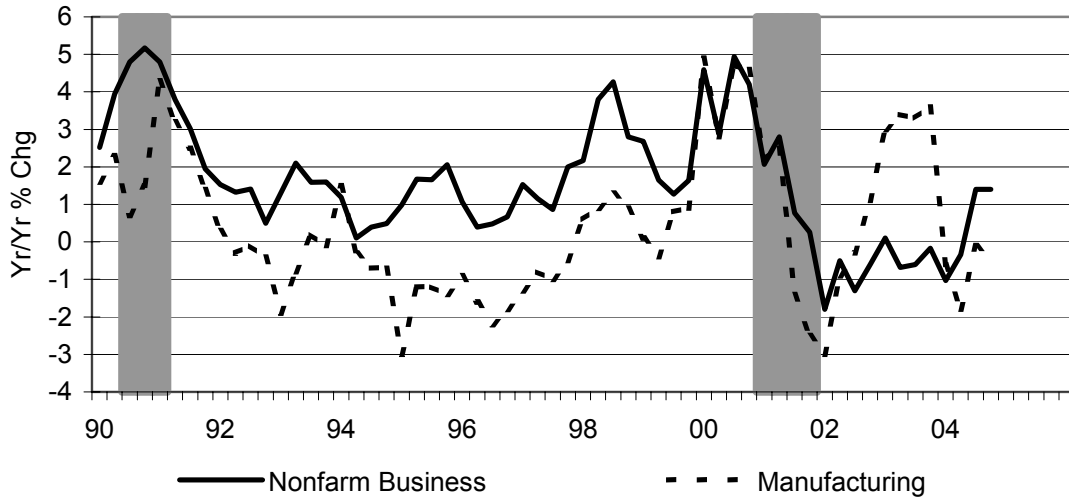
Source: Bureau of Economic Analysis / Haver Analytics

**Chart 5: Labor Productivity**  
(Nonfarm Business Sector)



Source: Bureau of Labor Statistics / Haver Analytics

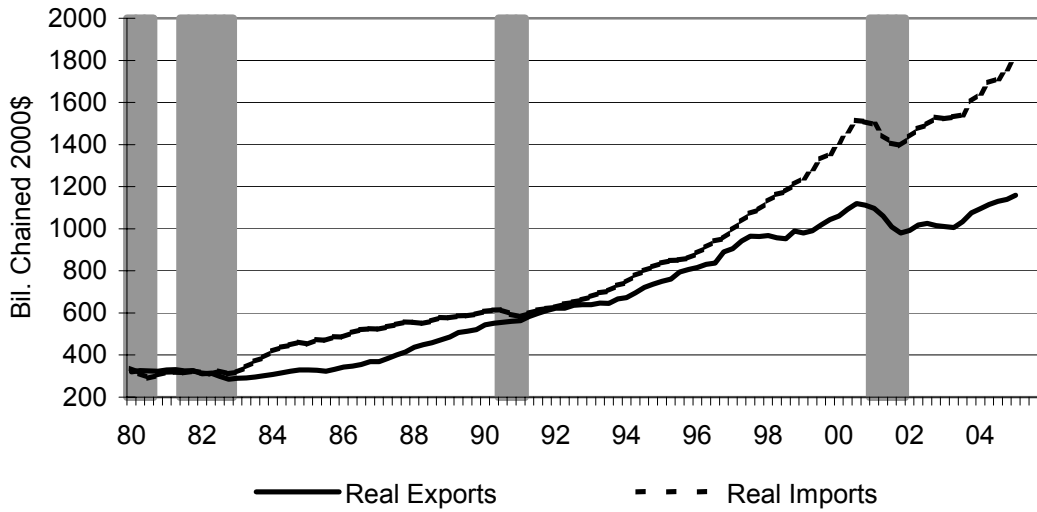
**Chart 6: Unit Labor Costs**  
(Nonfarm Business Sector)



Source: Bureau of Labor Statistics / Haver Analytics

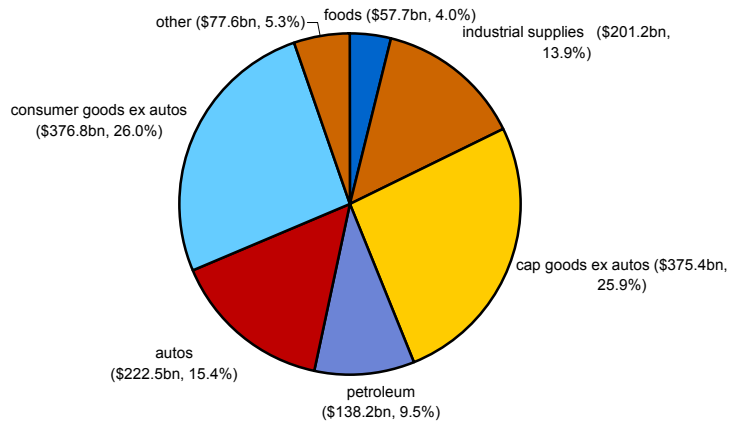


**Chart 7: Real U.S. Imports and Exports**



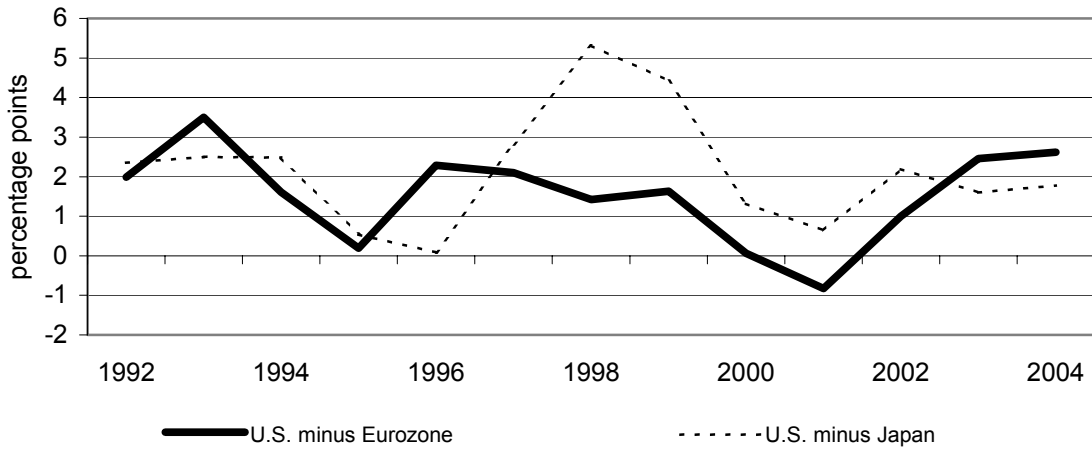
Source: Bureau of Economic Analysis / Haver Analytics

**Chart 8: Composition of U.S. Goods Imports  
(2004, in chained-\$2000)  
(Total \$1.448 trillion)**



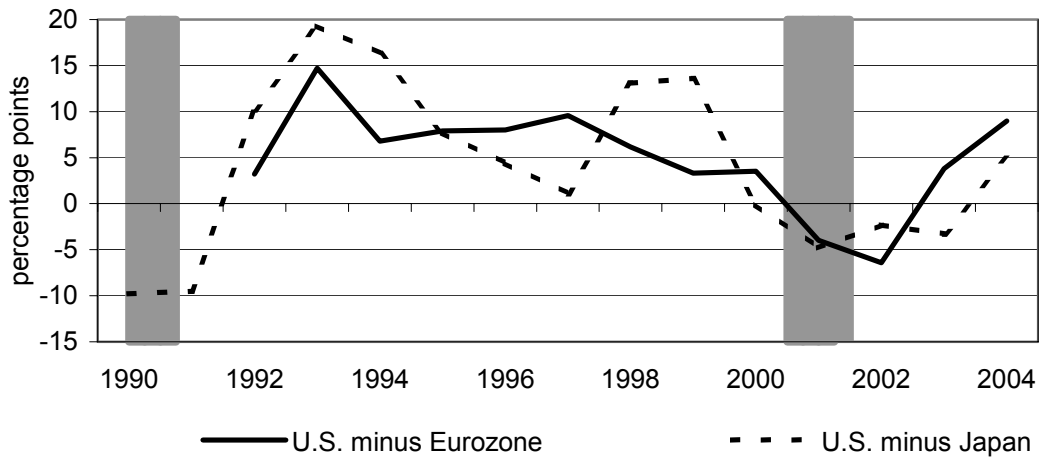
First term is value of imports, second term is the share of real goods imports  
Source: Bureau of Economic Analysis / Haver Analytics / Bank of America

**Chart 9: The U.S. Advantage:  
Real GDP Growth Differentials**



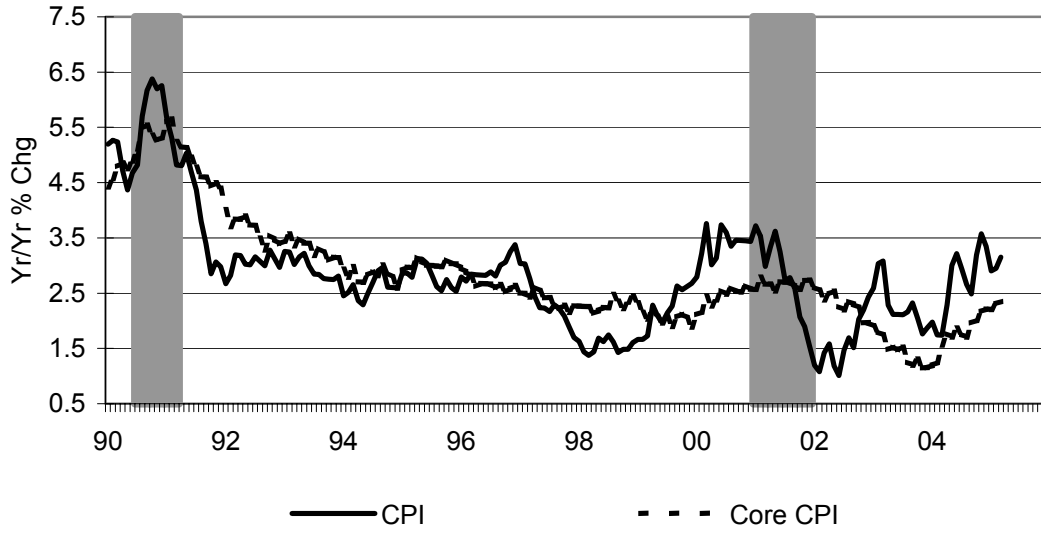
Source: Bureau of Economic Analysis / Eurostat / Japan Cabinet Office / Haver Analytics

**Chart 10: The U.S. Advantage:  
Business Investment Differentials**



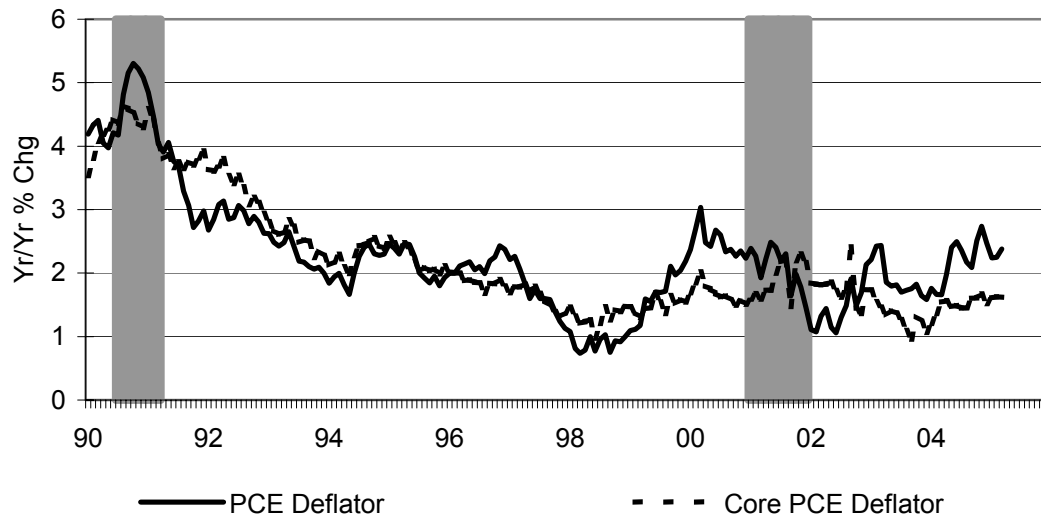
Source: Bureau of Economic Analysis / Eurostat / Japan Cabinet Office / Haver Analytics

**Chart 11: Consumer Price Inflation**



Source: Bureau of Labor Statistics / Haver Analytics

**Chart 12: PCE Deflator**



Source: Bureau of Economic Analysis / Haver Analytics

## Table 1: Fed's Central Tendency Forecasts

(Q4/Q4 Percent Change)

	Central Tendency for 2005:		for 2006:	Actual
	July '04	Feb '05	Feb '05	4Q03-4Q04
<b>Real GDP</b>	3.5-4.0	3.75-4.0	3.5	3.9
<b>Nominal GDP</b>	5.25-6.0	5.5-5.75	5.0-5.5	6.4
<b>Core PCE Deflator</b>	1.5-2.0	1.5-1.75	1.5-1.75	1.6
<b>Unempl. Rate(Q4)</b>	5.0-5.25	5.25	5.0-5.25	5.4

Source: Federal Reserve System / Bureau of Economic Analysis / Bureau of Labor Statistics / Haver Analytics