Economy slows sharply, inflation heats up

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The economy's growth in the second quarter was less than half that of the prior three months as consumers tightened their belts and spending on home building nose-dived. Inflation, however, shot up.

The latest snapshot released by the Commerce Department on Friday showed that that gross domestic product grew at an annual rate of just 2.5 percent in the April-to-June period. That marked a big slowdown from the January-to-March quarter, when the economy zipped along at a 5.6 percent annual rate, the fastest in 2 1/2 years.

Gross domestic product measures the value of all goods and services produced within the United States and is considered the best barometer of the country's economic standing.

"The economy has significantly throttled back but inflation pressures are developing more fully," observed Mark Zandi, chief economist at Moody's Economy.com

On Wall Street, though, stocks rallied on the hope that slowing growth would convince the Federal Reserve to take a break from raising interest rates. The Dow Jones industrials were up 84 points and the Nasdaq gained 25 points in morning trading.

The second-quarter's performance — which reflected the bite of high energy prices and rising interest rates on people and businesses as well as a cooling in the once red-hot housing market — was weaker than the 3 percent pace analysts were forecasting.

The 2.5 percent pace was the slowest since a 1.8 percent growth rate in final quarter of 2005, when the economy was suffering fallout from the devastating Gulf Coast hurricanes.

Even though the economy cooled in the second quarter, inflation heated up.

An inflation gauge closely watched by the Federal Reserve showed that core prices — excluding food and energy — jumped at a 2.9 percent annual rate in the second quarter — far outside the Fed's comfort zone. That was up from a 2.1 percent growth rate in the first quarter and marked the highest inflation reading since the third quarter of 1994, when core inflation rose at a 3.2 percent pace.

The inflation reading was taken before the latest run-up in energy prices. Oil prices hit a record closing high of $77.03 a barrel on July 14. Gasoline prices also have marched higher, topping $3 a gallon in many areas.

In a separate report from the Labor Department, employers' costs to hire and retain workers picked up in the second quarter, a development that also could raise some inflation concerns.

Compensation costs — including wages and benefits — rose by 0.9 percent in the April-to-June period, up from a 0.6 percent increase in the first quarter. Economists were calling for a 0.8 percent rise.

Although Federal Reserve Chairman Ben Bernanke said he is concerned about rising inflation, he told Congress last week that the Fed believes moderating economic activity will eventually lessen inflation pressures.

That assessment raised hopes on Wall Street that the Fed might take a breather in its two-year-old rate-raising campaign at its next meeting, on Aug. 8. Some economists, however, continue to predict that rates will be bumped up again at the August meeting to ward off inflation; after that, they think the Fed may move to the sidelines.

The report comes as President Bush is getting low marks from the public for his handling of the economy, according to a recent AP-Ipsos poll.

With energy prices and borrowing costs rising, consumers turned cautious in the second quarter. They boosted their spending at just a 2.5 percent pace, down from a 4.8 percent growth rate in the first quarter. Much of the weakness was in consumers' appetite for big-ticket goods, such as cars and appliances.

Businesses also tightened the belt.

Spending on home building was cut by 6.3 percent in the second quarter, the deepest dip in nearly six years — since the third quarter of 2000. Rising mortgage rates are clipping demand.

Businesses sliced spending on equipment and software at a 1 percent pace, the first cut in just over three years.

Government spending also was more subdued, growing at a pace of just 0.6 percent in the second quarter, compared with a 4.9 percent growth rate in the first quarter. The federal government cut spending in the second quarter, while state and local governments boosted spending.

As the economy has moderated, so has job creation.

For the April-to-June quarter, employers added an average of 108,000 jobs a month, the government reported earlier this month. That's down from the average of 176,000 a month for the January-to-March period.

Along with the latest GDP report, the government issued annual revisions that showed economic growth was slightly less than previously estimated for 2003, 2004 and 2005. The main reason for the downgrade: business investment in computer equipment and software wasn't as strong as previously thought.

As a result, the economy last year grew by 3.2 percent, rather than 3.5 percent. In 2004, economic activity expanded by 3.9 percent, instead of 4.2 percent. And in 2003, the economy's growth was 2.5 percent, versus 2.7 percent.

The revisions also showed that core inflation rose by 2.1 percent for all of 2005, a tad higher than the 2 percent reading previously estimated. Core inflation for 2004 was unchanged at 2 percent but was pushed up a notch to 1.4 percent for 2003.
