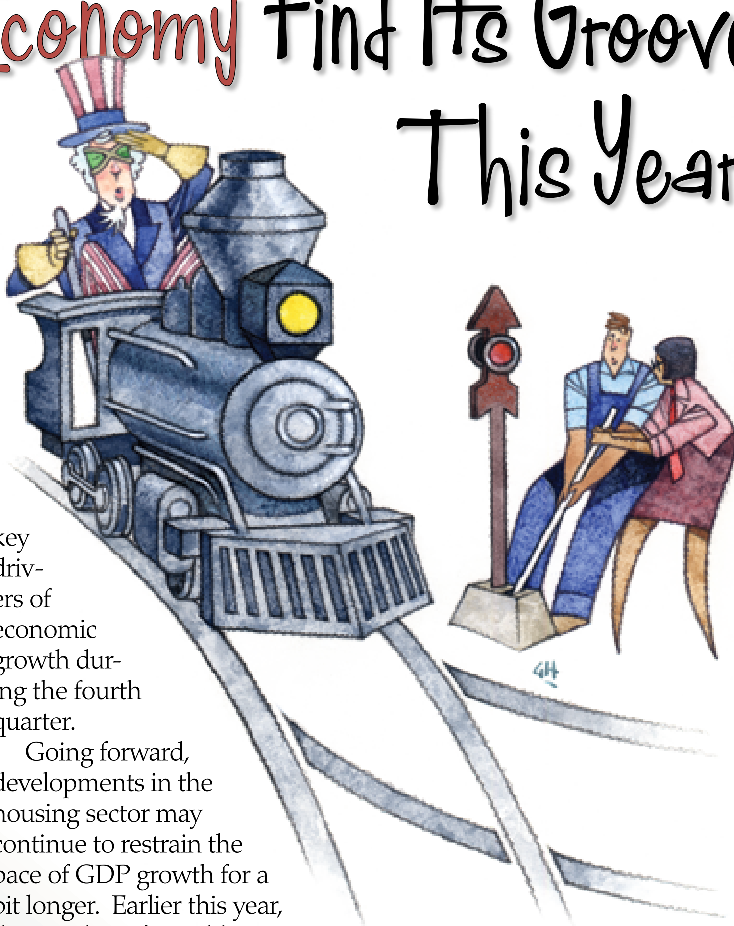
Will the U.S. Economy Find Its Groove This Year?

By Kevin L. Kliesen



Data over the past few months remained consistent with an economy that is growing below its trend and with a level of core inflation that is slightly above what policymakers desire.

Below-trend output growth largely reflected the ongoing slowdown in the housing and automotive sectors. As these imbalances wither away, the economy should begin to rebound, and the pace of growth should return to its trend rate—about 3 percent, say most economists—sometime toward the end of this year. Bolstered by lower energy prices and past efforts by the Federal Open Market Committee (FOMC) to keep inflation and inflation expectations from accelerating, core inflation is expected to recede slowly from last year's 2.3 percent rate, which most policymakers have deemed unacceptably high.

When the advance estimate (released Jan. 31) indicated that real GDP had increased at a better-than-expected 3.5 percent annual rate in the fourth quarter of 2006, some economists saw that as an indication that the economy was faring quite well outside of the housing and auto sectors. This increase was even more impressive given that real business fixed investment declined slightly. The housing slowdown, it seemed, had not affected other key parts of the economy.

Fast forward one month to when the "preliminary" report on fourth-quarter growth was released. This update of the "advance estimate" indicated that real GDP rose at only a 2.2 percent annual rate in the fourth quarter. What happened? First, the Bureau of Economic Analysis (BEA) reported that there was a much larger decline in business inventory investment than it had originally assumed. Second, a smaller decline in imports caused the BEA to lower its contribution from net exports. However, a closer examination revealed only a slight downward revision to consumer outlays, but a healthy upward revision to real exports, which were key drivers of economic growth during the fourth quarter.

Going forward, developments in the housing sector may continue to restrain the pace of GDP growth for a bit longer. Earlier this year, the number of unsold, new single-family homes remained quite high relative to the pace of sales. As a result, the number of new housing starts will probably continue to wane a bit longer. This situation may be exacerbated by the sharp deceleration in new home prices that has occurred over the past year in most major urban areas. Accordingly, Blue Chip forecasters expect that real GDP, following a 3.1 percent increase last year, will increase by about 2.75 percent this year and then by 3 percent next year. This forecast is little changed from late last year. One risk, noted earlier, is that the step down in the pace of business capital outlays over the second half of last year will persist. In this vein, January's larger-than-expected drop in new orders for nondefense capital goods was worrisome.

In the Federal Reserve's biannual Monetary Policy Report to Congress, Chairman Ben Bernanke noted that the governors and Reserve bank presidents projected that real GDP would increase by between 2.5 percent and 3 percent this year and by between 2.75 percent and 3 percent next year. These projections are broadly in line with those of the Blue Chip forecasters noted earlier.

Bernanke also revealed that Fed policymakers project that core PCE (personal consumption expenditure) inflation was expected to continue falling slowly. Following a 2.3 percent increase last year, core prices are projected to increase by between 2 percent and 2.25 percent this year and then by between 1.75 and 2 percent next year. However, policymakers continue to note that the "predominant policy concern" is that inflation will not ease to the degree most expect.

Several developments will probably exert some restraint over the near-term inflation rate. First, with oil prices no longer on an upward trajectory, firms may face less pressure to raise prices to offset higher energy costs. Second, the slower pace of economic activity may spur firms to compete more aggressively on the price side. Third, the FOMC's commitment to price stability should help temper future price increases. If, however, core inflation plateaus at a rate above 2 percent, then many policymakers would likely press for further action.

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