Below-Trend Growth Is Predicted for Most of 2007

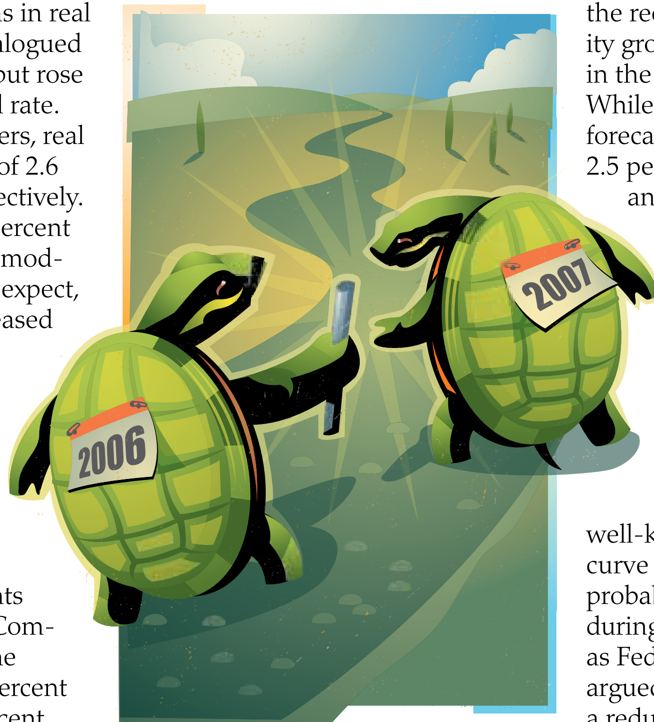
By Kevin L. Kliesen

At first glance, last year's economic performance was solid but not spectacular. As this article went to press in December 2006, actual year-to-date growth of real GDP and CPI were on track to finish near their January 2006 consensus forecasts of 3.3 and 2.2 percent, respectively. By contrast, through November, the unemployment rate was one-half percentage point better than expectations.

A closer inspection reveals that a significant portion of the gains in real GDP growth in 2006 was catalogued in the first quarter, when output rose at a robust 5.6 percent annual rate. Over the following two quarters, real GDP growth slowed to rates of 2.6 percent and 2.2 percent, respectively. If real GDP increases by 1.7 percent in the fourth quarter of 2006, modestly weaker than forecasters expect, then real GDP will have increased by at least 3 percent for the fourth consecutive year.

The slowing in real GDP growth over the latter part of last year can be attributed mainly to three developments. First, real short-term interest rates rose by about two percentage points as the Federal Open Market Committee pushed its target for the federal funds rate from 4.25 percent in December 2005 to 5.25 percent in June 2006; this increase helped to slow the demand for interest-sensitive consumption goods. Second, oil prices rose unexpectedly to more than $77 per barrel during the summer, pushing retail gasoline prices above $3 per gallon. Higher energy prices not only reduced the purchasing power of household incomes, but also raised operating costs for many firms and contributed to increased financial market uncertainty. Rising gasoline prices also decreased the demand for light trucks and SUVs, causing manufacturers to dramatically cut production.

The third and, perhaps, most significant development last year was the widely anticipated slowing in the housing sector, which followed the record-setting performance in 2005. Although conventional 30-year mortgage rates rose by only about 50 basis points over the first seven months of the year and then dropped back to their 2005 year-end levels, housing starts, new home sales and median prices of new homes fell sharply in 2006. With inventories of unsold new homes rising to record levels, builders significantly curtailed new construction. As a result, real residential fixed investment subtracted a little more than 1.75 percentage points from real GDP growth in the second and third quarters of 2006.



Strains in the housing sector continue to dominate the economic headlines, but the big picture looks better. Solid labor market conditions and growth of business capital outlays remain healthy, while the prospects for continued strong growth of U.S. exports appear good. Long-term inflation expectations remain relatively low and stable, and crude oil and gasoline prices have fallen significantly since August. Despite these favorable developments, there are some areas of concern. Two stand out.

Continued elevated rates of underlying price pressures are the first area of concern. The FOMC noted at its meeting of Oct. 24-25, 2006, that "current rates of core inflation remained undesirably high," according to the minutes. Although the FOMC expects core inflation to "moderate gradually," the timing and extent of that moderation is "quite uncertain." Complicating matters is the recent slowing in labor productivity growth in the face of an upswing in the growth of labor compensation. While worrisome, the consensus forecast is that the CPI will increase 2.5 percent in 2007. Excluding food and energy prices (core), the consensus expects CPI inflation to average 2.4 percent in 2007.

The second area of concern is the potential threat of much weaker growth in real GDP. This threat is manifested by the inverted Treasury yield curve, which has preceded every recession since the end of World War II. One well-known model based on the yield curve posits a more-than-50-percent probability of a recession sometime during 2007. Other economists, such as Fed Chairman Ben Bernanke, have argued that global capital flows and a reduced risk from holding longer-term securities have minimized the yield curve's importance as a business cycle indicator.

Although business cycle peaks and troughs remain difficult to predict, most forecasters see a much lower probability of a recession in 2007. Instead, they generally expect below-trend real GDP growth through much of 2007 and, then, trend-like growth (3 to 3.5 percent) over the latter part of 2007 and into 2008.

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