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 construc-