

U.S. Economic Prospects 2008/09

Squeaking Past Recession—With a Little Help from Our Friends

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Overview

Aided by a surge in exports that boosted third quarter (annualized) real GDP growth to almost 5 percent, the U.S. economy will achieve slightly better than 2 percent real growth year-over-year in 2007—about in line with last year's forecast. Falling home values and high energy costs, however, point to very sluggish growth of real consumer spending in the final quarter of 2007 and the first half of 2008, with only a modest pick-up thereafter. Continued declines in homebuilding, partly reflecting difficulties in mortgage markets, will add negative impetus to the U.S. economy at least through the middle of next year.

The key offsetting factor will be further improvements in U.S. net exports. Although moderately below this year's pace, reasonably rapid economic growth in most of the rest of the world will keep U.S. real exports expanding vigorously, while weak U.S. consumption growth sharply limits increases in U.S. imports. The result next year, as in 2007, will be that improvements in U.S. net exports will add almost one-half percentage point to U.S. GDP growth.

In addition to this direct effect, businesses will be stimulated to invest to meet actual and prospective export demands. The rise in business investment, in turn, will slightly more than offset declines in homebuilding, leaving a small positive contribution to GDP growth from total gross private domestic investment.

With gains in government purchases of goods and services expected to make small positive contributions to GDP growth, the baseline forecast is that U.S. real GDP will grow 2 percent in 2008, on both a year-over-year and a Q4-to-Q4 basis. For 2009, 2 ½ percent real growth is projected, reflecting modestly stronger consumption spending and a leveling out of residential investment.

With real GDP growth running somewhat below the potential growth rate of the U.S. economy throughout 2008, the unemployment rate is expected to rise gradually to 5.4 percent during 2008 and average just over 5 percent. The CPI is expected to rise at about a 2 ½ percent annual rate as food and energy prices show modest further gains and as the effects of larger margins of slack are counterbalanced by pass through effects from past increases in energy prices and a weaker dollar.

The Balance of Risks

In the face of weak economic data, the Federal Reserve will likely reduce the target federal funds rate below 4 percent by next spring, but not below 3 ½ percent unless there are concrete signs that the economy is actually falling into recession. Thus, market interest rates of barely more than 3 percent on two-year treasuries may be interpreted as indicating significant perceived risks of recession.

Like Alan Greenspan, I would estimate that the risk of the U.S. economy entering recession during the next year at about one-third, with the most acute risk during the first half of 2008. This risk reflects the danger that when the U.S. economy is reasonably expected to grow at only a 2 percent rate during 2008 (and barely more than a 1 percent rate during the first half), there are a number of things that could go wrong and slow the economy below its stall speed. Consumer spending growth could poop out under the combined weight of falling home values, mortgage refinance problems, rising energy costs, and slackening employment and income growth. Exports could disappoint. The recent boom in commercial construction could reverse and add to rather than counteract declining home building.

On the other hand, not all of the risks are on the downside. In the 25 years that I have forecast the performance of the U.S. economy, my largest

error was in the forecast at the end of 1998 when, in the face of the global financial market turbulence flowing from Russia's default and the failure of the hedge fund LTCM, I helped persuade the IMF to reduce its 1999 growth forecast for the U.S. economy down to 1.8 percent. The actual outcome was growth of 4.2 percent!

On the present occasion, concern about negative spillovers to the real economy from turbulence in financial markets is once again a key reason why we expect sluggish growth and fear the possibility of recession. Clear evidence of deepening problems in the housing sector add substance to these concerns. Nevertheless, it could turn out that, as in some past episodes, write-downs in the values of already existing financial assets on the balance sheets of banks and brokerages have relatively little real economic effect. U.S. economic growth in 2008 could surprise on the upside and achieve or even exceed the Bush Administration's recently released forecast of 2.7 percent rise in real GDP.

There is a practical limit, however, to the magnitude of such an upside surprise. If the U.S. economy appeared to be growing at 3 percent or better—which is above the Federal Reserve's estimate of the potential growth rate of the U.S. economy—monetary easing would soon come to an end and some tightening might be in order. The economy would rapidly cool off.

Conversely, if the economy began to fall into recession in early 2008, monetary policy would react by cutting the federal funds rate down to 2 ½ or even 2 percent. As in 2001, the recession would likely be shallow and brief. Real GDP growth in 2008 (year-over-year) would probably still be positive but somewhat below 1 percent, while GDP growth of 2009 would likely fall somewhat below 2 percent.

Thus, there are important risks for U.S. economic growth over the next year or so, but the magnitude of these risks should not be exaggerated. The plausible range of outcomes is for growth to be somewhere between one-half percent and three percent in 2008.

The Main Components of GDP

Additional insight into both the baseline forecast and the risks surrounding it may be obtained by examining the likely performance of the four main components of U.S. GDP: consumption, investment, government spending, and net exports.

For consumption, the baseline forecast of 2 percent real GDP growth in 2008 implies that household's real disposable income will also be rising at about a 2 percent annual rate, that employment will be growing by an average of 75,000 to 80,000 jobs per month, and that the unemployment rate will rise gradually and modestly. In such an environment, an outright decline in real consumption spending appears very unlikely.

Indeed, during the past sixty years when we have endured ten recessions, there are only three occasions when real consumption spending actually fell on a year-over-year: By 0.9 percent in the inflationary upsurge and steep recession that followed the 1973 oil shock; By 0.3 percent in 1979-80 when the economy went into a sharp recession, inflation surged to over 12 percent, the federal funds rate hit 22 percent, and the Carter Administration imposed controls on consumer credit to help contain inflationary pressures; And by 0.2 percent in 1990-91 when consumers were hit by the combined effects of recession, rising inflation, surging oil prices, and the uncertainties of the first Gulf War. In 1981-82, despite a deep recession in which residential investment collapsed and unemployment rate surged to a postwar peak of 10.8 percent, real consumption spending nevertheless continued to grow.

While nothing of the magnitude that would induce an outright decline in consumption now appears likely, it is reasonable to expect that real consumption spending will grow somewhat more slowly than real disposable income. Declining home values and difficulties with mortgage finance will operate in this direction, while high energy prices erode the real value of disposable income. Accordingly, the baseline forecast assumes that real consumer spending will rise at barely more than a one percent annual rate from the third quarter of 2007 through the third quarter of 2008, with some acceleration thereafter.

Real government purchases expanded somewhat more rapidly than the 2 percent rate anticipated for 2007, reflecting a pick up in national defense spending and continued buoyancy in state and local spending. In contrast,

modest budget tightening in Washington and constraints on state and local spending from revenue losses associated with weaker home building and home values will likely keep the real growth of government spending in 2008 and 2009 slightly below the growth rate of the economy. With the economy growing sluggishly and revenues from corporate profit taxes likely to take a hit from losses of financial sector firms, it may be anticipated that the federal budget deficit may be a little larger in FY 2008 than the \$163 billion reported for FY 2007.

Turning to investment, real residential investment has been falling for two years, and is now down 25 percent from its peak in mid 2005. Further declines in residential investment (rather than the earlier anticipated leveling out) are clearly in train through the middle of 2008. By the end of next year, it is anticipated that residential investment will be down another 15 percent from its already depressed level. Allowing for the fact that repair and renovation are a significant part of total residential investment and are relatively less affected by the downturn, the decline in the new home building component of residential investment (from its 2005 peak) is expected to reach about 45 percent by the end of 2008, consistent with housing starts of only about 1.1 million units.

In recent quarters, an upsurge in non-residential construction has offset an important part of the downturn in residential construction. This upsurge in non-residential construction is expected to abate but not reverse over the forecast horizon. Meanwhile, business investment in equipment and software is reasonably expected to show continued moderate growth as U.S. businesses expand capacity to meeting rising domestic and export demands. Inventory investment will likely turn in a very small gain without becoming excessive. All told, the rise in business investment for 2008 should slightly more than offset the further contraction of residential investment, leaving a small positive contribution to GDP growth from the investment sector.

Corporate profits will likely show a highly confusing picture for 2008 as financial sector firms recognize losses on their diverse asset portfolios. The translation of these losses into the measures of corporate profits reported by the Department of Commerce in the National Income and Product Accounts will involve further complexities. Judging from how these issues

have been treated in the preliminary report for the third quarter of 2007, it may be guessed that the measure of “corporate profits after tax with inventory valuation and capital consumption adjustments” will show a moderate declines for the next couple of quarters, probably followed by some recovery by the second half of 2008. On a year-over-year basis for 2008, this suggests that the Department of Commerce measure of after tax corporate profits will show a very modest gain.

Such a result, however, would be somewhat deceiving. Outside of the financial sector (and residential construction), most corporations will likely see moderate profit growth from both their domestic and foreign operations. In the financial sector, losses that are attributed to “current operations” will probably include a significant element of losses that are more correctly attributable to past mistakes. As far as the profit incentive for business investment is concerned, it should remain reasonably strong for a wide range of American businesses.

Reverse Coupling

For the export component of real net exports, the key driving forces are demand growth in the rest of the world economy and the relative cost competitiveness of U.S. exporters. For the rest of the world economy, demand growth in 2008 and 2009 is likely to be a little slower than during the past four years (when global growth has run about 5 percent), but still sufficiently strong to keep demand for U.S. exports rising briskly. Relative cost competitiveness for U.S. producers has improved significantly in recent years, as the foreign exchange value of the U.S. dollar has declined against other industrial country currencies (except the Japanese yen) and against the currencies of some emerging market economies, notably excluding China and some other Asian countries. The influence of these two factors is reflected in the real growth rate of U.S. exports that has averaged over 8 percent per year for the past four years and may reasonably be expected to show similar performance in 2008 and 2009.

Consumer spending is a key determinant of U.S. import demand. Not surprisingly, as growth of consumer spending has slowed somewhat since early 2006, growth in demand for imports has also slowed to barely more than 2 percent at an annual rate for the past six quarters. With consumption spending growth expected to be even more sluggish going forward, it is

reasonable to anticipate that import demand growth will also remain quite sluggish. Imports related to residential investment, including purchases of consumer purchases of furniture and appliances and spending on building materials (lumber from Canada), will be part of this continuing slowdown. Imports of automobiles and light trucks will also absorb some of the expected slowdown in consumer purchases of these durables.

With U.S. exports continuing to expand reasonably vigorously and U.S. imports growing very sluggishly, net exports should make a positive contribution to U.S. GDP growth. This contribution is expected to amount to about one-half percentage point of GDP in 2008—about the same as in 2007—and a similar contribution is projected for 2009.

These developments should not be thought of as a “decoupling” of the U.S. economy from the rest of the world economy. As expected, the economic slowdown in the United States is having some effect on slowing growth in other economies, especially Canada and Mexico, by slowing the growth of their exports to the United States. But, the more fundamental truth is that economic coupling between the United States and other countries continues—but is now operating in reverse.

From the early 1990s through 2005, generally rapid growth of domestic demand in the United States, somewhat in excess of the growth rate of actual and potential U.S. GDP, was reflected in a widening U.S. real trade deficit. In the rest of the world, this showed up as a useful addition to total demand at times when domestic demand in the rest of the world was generally somewhat below potential output.

This process began to operate in reverse over the past year as slackening of domestic demand growth in the United States was partly offset by improvement in the U.S. real trade balance. A similar outcome is forecast for 2008. Despite weak growth of U.S. domestic demand, especially consumption, the U.S. economy will most likely get past a significant near-term risk of recession—with a little help from our friends.

Main Components of the Mussa Forecast

For the GSB Forecast Scorecard

Forecast for 2008, as of December 5, 2007

Nominal GDP (% change, year-over-year)	4.2%
Real GDP (% change, year-over-year)	2.0%
Real Consumer Spending (% change, year-over-year)	1.5%
Real Private Investment (% change, year-over-year)	1.2%
Real Government Spending (% change, year-over-year)	1.8%
Real Trade Balance (billions of chained-2000 \$, average level)	- 512
Consumer Prices (% change, year-over-year)	2.5%
Unemployment Rate (year average)	5.2%
Corporate Profits after Taxes (% change, year-over-year)	2.0%
Federal Surplus (billions of \$, fiscal year)	- 210