

**Maneuvering Past Stagflation: Prospects for the U.S. Economy
In 2007-2008**

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Overview

The growth rate of the U.S. economy has slowed to barely more than 2 percent in the second half of 2006, after three years of nearly 4 percent annualized real GDP growth. The most likely prospect for 2007 is that growth will continue at its current subdued pace, followed by a modest acceleration in 2008.

Meanwhile, core consumer price inflation appears to be abating somewhat from the uncomfortably high rates recorded last spring, but the Federal Reserve rightly remains concerned that inflation is still, on balance, more worrying than the slowdown in growth. Indeed, within the range of what is feasible, the most desirable outcome skirts the edge of stagflation. The growth slowdown is deep enough and long enough to bring underlying inflation back into the comfortable range, but not so deep that the U.S. economy tips into recession,

The drop in world oil prices since their peak of over \$75 per barrel last summer is raising the likelihood of this relatively favorable outcome. It is helping to cushion consumer spending at precisely the moment when the

economy is absorbing a sharp decline in residential investment and when consumer spending would otherwise be highly vulnerable to stagnating or declining house values. It is also taking the edge off of headline inflation and thereby making the Federal Reserve more relaxed about the need for any further monetary tightening.

Nevertheless, with an economy growing at barely more than a 2 percent rate and with monetary policy tied up with concerns about inflation, the risks that we might stumble into recession in 2007 are significantly greater than they have been for the past five years.

Elsewhere in the world economy, growth is also likely to be somewhat slower in 2007 than it has been, on average, during the past three years of exceptionally good performance. The industrial economies of Western Europe and Japan, as well as Canada and Australia, are all now generally operating at their levels of potential output. Monetary policies have been or are being tightened to avoid overheating. Growth rates will likely slow to no greater than potential.

Among developing countries, which have shown consistently strong growth for the past four years, some slowdown should also be expected. This includes China and India where policy measures have been taken to cool overheating economies.

On balance, however, the slowdown of demand growth in the U.S. economy is expected to be somewhat greater than that in its most important export markets. This, together with the real effective depreciation of the U.S. dollar since its peak in early 2002, should contribute to a modest improvement in U.S. real net exports in 2007 which, in turn, will help to cushion the slowdown in U.S. output growth.

Factors Behind the U.S. Slowdown

After a four-year boom stimulated by exceptionally low mortgage costs, residential investment began to turn downward late last year. The downturn gathered considerable pace since this spring and is likely to continue until next spring when new home construction should level out at about 75 percent of its recent peak. On a year-over-year-basis this will mean about a 10 percent drop in residential investment for 2007.

In contrast, spurred by recent strong gains in corporate profits and high capacity utilization rates in many sectors, business investment in equipment, software and structures should continue to show some buoyancy next year, turning in a year-over-year rise of about 6 percent. With inventory investment expected to be essentially flat, all this means that real gross private domestic investment should register between a 1 and a 2 percent gain next year.

Real government purchases of goods and services will probably post only about a 2 percent rise, as public spending for disaster relief abates and as state and local governments feel some pressure on revenues from slowing economic growth and softening real estate values.

The federal budget deficit will likely show a modest increase this fiscal year, after two years of surprisingly large declines. Mainly this reflects less spectacular gains in federal revenues from the corporate profits tax. Corporate profits (after tax) are projected to post about a 6 percent year-over-year gain for 2007, after more than a 20 percent (estimated) gain for 2006.

Real consumer spending is forecast to grow only 2 percent in 2007 (both year-over-year and fourth-quarter-to-fourth quarter). This will be the smallest rise in this dominant component of GDP since recession of 1991. Indeed, my forecast for consumption spending growth is $\frac{3}{4}$ of a percentage point below the consensus at this stage, and is the principal reason why my real GDP growth forecast is below the consensus.

As I see it, the leveling off in house prices after several years of substantial gains, together with a slowing in employment growth and a modest rise in the unemployment rate (from 4.4 percent at present to an average of 4.9 percent for 2007), will significantly blunt the rise in real consumer spending relative to the $3\frac{1}{2}$ percent annual gains that we have seen over the past three years.

The decline in oil prices since their peak this summer should cushion consumer spending through the Christmas season. But, I fail to see why, with a household saving rate that is already negative and with home prices stagnating, even the ebullient U.S. consumer would continue to increase spending meaningfully in excess of income growth.

The U.S. economy has a large trade deficit and is an exceptionally large net importer of consumer goods. With a significant projected slowing U.S. economic growth and particularly of consumer spending growth, it is reasonable to expect that growth of U.S. imports will also slow considerably.

With demand growth expected to be better sustained in key U.S. export markets, and in view of the gain in U.S. competitiveness in these markets from depreciation of the U.S. dollar, it is reasonable to expect that recent buoyant growth of U.S. exports will be reasonably well sustained.

Because the real volume of imports exceeds that of exports by about 50 percent, U.S. exports must grow significantly faster in percentage terms than U.S. imports in order to hold the real trade deficit constant. This is what has happened late 2004. Now, with U.S. import growth likely to slow more substantially, I expect that the real trade balance will show modest improvement in 2007. (The nominal trade balance and the current account balance may also show some improvement, reflecting partly the benefit from lower energy import prices.)

A modest positive contribution for improving real net exports suggests that U.S. real GDP growth in 2007 will run a little above 2 percent.

For 2008, I anticipate that U.S. real economic growth will pick up by about half of a percentage point to between 2 ½ and 3 percent. This moderate up-tick reflects the expectation that the downward correction in residential investment will be complete in 2007, that business investment spending will continue to grow moderately, that consumer spending will rise about in line with household incomes, and that improving real net exports will make a further modest contribution to real GDP growth in 2008.

Main Risks to the Central Forecast

Thus, my central forecast scenario for the U.S. economy over the next two years is a relatively rosy one—albeit not quite as rosy as the consensus forecast or, even more so, the forecast just released by the Bush Administration. What could go wrong with my forecast to make it either too rosy or not rosy enough?

On the upside, it is notable that there is a good deal of non-OPEC oil production that is scheduled to come on stream over the next year or so. This could put significant downward pressure on world oil prices unless OPEC is able to manage the discipline to scale back its production. Lower world oil prices, in turn, would provide a boost to consumption (and probably investment) in the United States and other oil importing countries.

More generally, even without lower oil prices, my forecast of U.S. consumption growth is somewhat below the consensus and thereby allows room for U.S. consumers to remain somewhat more buoyant than I anticipate. Business investment spending could also somewhat exceed my forecast; and there is room for the improvement in U.S. real net exports to exceed my forecast.

There is, however, an important barrier to U.S. economic growth rising to 3 percent or higher next year.

Since mid 2003, the U.S. unemployment rate has declined from a cyclical peak of 6.3 percent to 4.4 percent at its most recent reading. During this period, U.S. real GDP growth has averaged a little below 3 $\frac{3}{4}$ percent

per year. The clear implication is that U.S. potential output growth (as determined by underlying labor force growth and productivity growth) is meaningfully below $3\frac{3}{4}$ percent and probably somewhat below 3 percent. Moreover, the current levels of U.S. output and employment appear to be somewhat above those consistent with a stable, non-accelerating core inflation rate.

Meanwhile the core inflation rate for consumer prices has risen by about a percentage point from its low in 2003 and is currently running at a rate that is moderately above the Federal Reserve's comfort zone. The slowdown in U.S. economic growth that is (at least partly) the result of the Fed's considerably tightening since mid 2004 is expected to bring core inflation back down to an acceptable rate.

But for this to happen, there usually must be a period during which actual U.S. output growth falls below potential in order to allow margins of slack to rise. A couple of quarters of growth modestly below potential is not likely to be enough. Barring exceptionally good luck (for example from a substantial fall in world oil prices), something close to my forecast of barely

more than 2 percent real GDP growth through 2007 is likely to be needed to bring inflationary pressures down to an acceptable level.

Worse outcomes, including an outright recession, are clearly possible. The downturn in home building could be steeper and longer than I have assumed. Consumer spending could react more negatively to weakening home prices and slowing employment growth. Business investment might not show much continued buoyancy. Growth in the rest of the world could slow more than I have forecast, with negative implication for U.S. export growth. When the growth rate of the U.S. economy slows to barely more than 2 percent, a number of things could go wrong that would tilt the outcome toward recession.

A Whiff of Stagflation?

On top of all of this is the uncertainty about inflation and about Federal Reserve policy. Headline consumer price inflation has dropped under the impact of lower energy prices, and recent data for core inflation indicate moderation after the upsurge last spring. But, the six- and twelve-month measures of core inflation (for both the CPI and the PCE price index)

are still running above the Federal Reserve's comfort range and may well do so for some time.

With wage gains showing some signs of acceleration and productivity growth apparently abating, there is reason to worry that, barring a virtual recession, core inflation may not be headed down very fast and might even tick upward again. Various Fed officials, including Chairman Bernanke, have made clear that the Federal Reserve remains focused on this worry about inflation—more so than the worry about the slowdown in growth which they see as essential to keep inflation reasonably well contained.

Financial markets seem to have a more benign and not entirely consistent view of the situation. The stock market apparently expects that the economic slowdown will be very mild and that corporate profits will continue to grow, albeit at a more moderate pace than recently. The bond market, where 2-year Treasuries now yield less than 4.5 percent, seems to be pricing in a substantial easing of monetary policy next year—a cut of at least 100 basis points in the federal funds rate. This could happen, but only if the economy slows to the brink of recession and inflation fears abate. And, for this situation, corporate equities seem to be significantly over-valued.

In sum, my central forecast is that U.S. economic growth will slow to just above 2 percent in 2007. This implies modest increases in slack that will help push core inflation back to a comfortable rate without much action (either easing or tightening) by the Federal Reserve. But, the risks around this central forecast are significantly greater than they have been for the past four years.

Key Figures from U.S. Economic Forecast of Michael Mussa

Nominal GDP (% change)	4.8
Real GDP (% change)	2.2
Real Consumer Spending (% change)	2.2
Real Private Investment (% change)	1.5
Real Government Spending (% change)	2.0
Real Trade Balance (level)	- \$615 billion
Consumer Prices (% change)	2.7
Unemployment Rate (year average)	4.9
Corporate Profits After Taxes (% change)	6
Federal Surplus or Deficit (fiscal year)	- \$275 billion

Notes:

The “% changes” refer to year over year figures, 2007 over 2006.

“Real Private Investment” refers to Gross Private Domestic Investment in the NIPA.

The level of the “Real Trade Balance” refers to the average level of real net exports in the NIPA for 2007, measured in 2000 chained dollars.

“Consumer Prices” refers to the Consumer Price Index (CPI-U).

Corporate profits after taxes include the inventory valuation and capital consumption adjustments as reported in the NIPA

