Economic Forecast 2006
(Forecast as of December 2, 2005)

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Overview

Under the impact of higher energy prices, Federal Reserve tightening, and a waning housing boom, U.S. economic growth will moderate during 2006 from the rapid pace of the preceding two years. On a year-over-year basis U.S. real GDP will advance about 3 percent for 2006, following gains of about 3 ½ percent for 2005 and 4 ¼ percent for 2004. On a fourth-quarter-to-fourth quarter basis, growth is likely to fall a little below 3 percent, reflecting economic weakening as the year progresses.

Meanwhile, inflation will remain reasonably well contained. Overall consumer price inflation will recede to 3 percent (year-over-year) under the plausible assumption that the sharp energy price increases of the past three years will not be repeated in 2006. Core consumer price inflation, however, will probably nudge up slightly to 2 ½ percent as higher energy costs pass through and as businesses continue to take advantage of modest increases in pricing power.

With growth moderating and inflation in check but not abating, the Federal Reserve will end the present cycle of monetary tightening next spring at a federal funds rate of 5 percent. Yields on ten-year treasuries will notch up to over 5 percent, partly reflecting diminished enthusiasm of foreign investors for further accumulation of U.S. based assets. As 2006 progresses, the dollar will likely reverse its 2005 appreciation against the euro and the yen; but I do not anticipate a dollar crash.

More broadly for the world economy, global real GDP growth will slow modestly below the 4 percent rate now estimated for 2005, following growth of 5 percent in 2004 (all measured using the IMF’s World Economic Outlook PPP-based exchange rates). This projected slowdown reflects the cumulating effects of higher world energy prices, the spillover from weaker growth and higher interest rates in the United States, normal slowdowns in some rapidly growing economies including China, and the lack of a much of a pick-up in the more slowly growing countries of Western Europe and Japan.

With the slowing of global growth and hence of growth of world energy demand, world energy prices are unlikely to show further large increases—barring unanticipated supply disruptions. At the global level, as in the U.S., inflation should remain well contained. The European Central
Bank (ECB) will push up policy interest rates modestly and the Bank of Japan will cut back on its quantitative easing, but these policy moves will not be so aggressive as to pose a significant further threat to global growth.

With this overview of global economic prospects for 2006, it is relevant to address two key questions: How much of a slowdown should we now expect in the U.S. and the global economy? And, what forces might generate risks to the upside or the downside to this central forecast?

**Slowing Growth in the United States**

Strong growth of real consumer spending and real residential investment kept the recession of 2001 mild and brief and sustained the moderately vigorous expansion of the past four years—despite sluggish employment growth and a tripling of energy prices. Now, however, the boost from the Bush tax cuts is wearing thin, the Federal Reserve has reversed much of its aggressive monetary easing, and the impetus to consumer spending from rapidly rising home values and gains from mortgage refinancing is beginning to wane.

Accordingly, it is reasonable to expect that growth of real consumer spending (which accounts for 70 percent of real GDP) will slow significantly from the roughly 4 percent pace of recent years to 2 ½ percent in 2006. This will include a considerable slowdown in consumer durables purchases, notably automobiles.

Home prices will likely decline somewhat in some high-flying markets, while nationwide real estate prices moderate considerably their pace of advance. Real residential investment will record an outright decline of about 3 percent on a year-over-year basis for 2006 and about a 10 percent decline on a fourth-quarter-to-fourth quarter basis. This is a comparatively modest correction in view of the present escalated level of home building activity.

Business investment in equipment and software was hard hit in 2001 and 2002, but has recovered strongly for the past three years. The downturn of investment in (nonresidential) structures came later, and the recovery has lagged and been less vigorous. Very strong corporate profits and the drive to contain costs as output expands, together with some positive effect from
rebuilding after recent hurricanes, should sustain solid 8 percent real growth of these components of private investment for 2006.

Inventory investment will probably show a considerable bulge in the final quarter of 2005, after substantial negative contributions to GDP growth earlier in the year. During 2006, inventory investment is forecast to be flat, implying a modest positive contribution to private investment growth on a year-over-year basis. Altogether, real gross private domestic investment (residential, business fixed, and inventory) should register a 5 percent gain for 2006.

Rising revenues will again support modest increases in real spending by state and local governments in 2006. Real federal purchases of goods and services, including direct spending on hurricane relief and recovery, will also record modest gains. Overall, real government spending should advance about 2 ½ percent in 2006.

The surge in hurricane related federal spending will be largely offset continued buoyancy of federal revenues that are linked (with a slight lag) to the performance of the economy. Spending on the principal new (non-hurricane-related) federal program—the prescription drug benefit under medicare—will get off to a slow start. Hence, on a fiscal year basis, the federal deficit will rise only slightly (to about $340 billion) in FY 2006 from FY 2005 result. With nominal GDP projected to grow almost 6 percent, the ratio of the federal deficit to GDP will remain constant at about 2.6 percent.

Real growth of domestic demand (the sum of consumer, investment, and government spending) will slow to 3 percent in 2006, after rising 4 ¼ percent in 2004 and about 3 ¾ in 2005. The difference between real domestic demand and real GDP is the real trade deficit, or more precisely, the deficit of real net exports.

Over the past decade, the U.S. real trade deficit has expanded from about 1 ½ percent of GDP in 1995 to about 6 ½ percent of GDP this year—to an estimated level of $630 billion (of chain-linked 2000 dollars). This massive deterioration of the U.S. real trade balance reflects three key factors: (1) the generally strong growth of demand in the U.S. (averaging about ½ percent per year above the annual growth of actual and potential U.S. real GDP); (2) the relatively weak growth of demand in the rest of the world economy (somewhat misleadingly described as the “global savings glut”);
and (3) the substantial real appreciation of the U.S. dollar from 1995 through 2001.

The lagged effects of the downward correction of the dollar since early 2002 and the recent narrowing of the demand-growth gap between the U.S. and key trading partners blunted further deterioration of the U.S. real trade balance this year. (In current dollar terms, however, the trade deficit continued to widen due to rising imports prices, particularly for energy.)

For 2006, further moderation of U.S. domestic demand growth will slow the growth of import demand, but the recent upsurge in the foreign exchange value of the dollar against the euro and the yen will be a modest negative for U.S. export growth. This will leave real net exports virtually unchanged in 2006 at a level of $640 billion (in chained 2000 dollars). In nominal terms, however, the trade balance (of goods and services) is likely to deteriorate somewhat further to $760 billion from about $720 billion in 2005.

With a negligible contribution from (the change in) real net exports, year-over-year growth of U.S. real GDP should come in at about 3 percent, following slightly better than 3 ½ percent growth for 2005. The projected slowing of growth during the course of 2006 implies that on a fourth-quarter-to-fourth-quarter basis real GDP growth will be modestly below 3 percent.

With real GDP growing slightly below potential during 2006, the unemployment rate should edge up marginally, leaving the average unemployment rate for the year essentially unchanged at 5.1 percent. Meanwhile, corporate profits (after tax) should enjoy another strong year, rising about 10 percent (including a 2 percent allowance smaller insurance casualty losses than in 2005). With GDP deflator rising nearly 3 percent on a year-over-year basis, nominal GDP should show nearly a 6 percent gain for 2006 over 2005.

Steady or Slower Growth Abroad

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1 This is a slight upgrade of my September 2005 forecast (available on the IIE website at iie.com) for U.S. economic growth in 2006. The easing back of energy prices since September and evidence that the U.S. economy is performing a little stronger than expected in late 2005 accounts for this modest upgrade.
There is somewhat less reason to expect a slowing of growth in the rest of the world than in the United States, but there is little reason to expect a growth pick-up abroad—especially not a strong pick up. In particular, higher world energy prices are negative factor for growth in most countries, and the effects of slower U.S. demand growth will somewhat impair export growth for other countries. But, the effects of Federal Reserve tightening and the taming of the U.S. housing boom will be felt more heavily in the U.S. than in the rest of the world. On balance, it is prudent to expect that global real GDP growth for 2006 will be at least ¼ percent to ½ percent below the 4 percent rate I now estimate for 2005.

Looking to the main regions of the world economy, in the Americas, both Canada and Mexico will feel a meaningful negative impact from slower growth in the U.S., and both countries should anticipate somewhat slower growth in 2006. High domestic real interest rates and a strong exchange rate are likely to keep Brazilian economic growth subdued. After three years of very strong recovery, the Argentine economy is likely to expand somewhat more slowly, and policy measures will need to be taken at some point to restrain rising inflationary pressures. Chile should continue to do well and Venezuela is benefiting from high world oil prices, but growth is unlikely to pick up from recent levels.

In Western Europe growth has recently accelerated modestly in the euro area; and after several years of dismal performance, the German and Italian economies should reasonably be expected to grow somewhat more strongly in 2006. Elsewhere, growth may ease off a bit under the impact of higher energy costs and other adverse factors, including the possibility that the ECB may precede too aggressively. For Western Europe as a whole, growth of about 1 ½ percent this year looks likely to be repeated next year.

In Central and Eastern Europe, I would look for somewhat slower growth in 2006, as the pace of advance moderates from fairly high rates in Russia and Turkey, and as Poland and Hungary face problems with their budget and current account deficits.

In Asia, Japan now appears set for about 2 ½ growth in 2005 after a mini-recession last year; but growth next year is likely to come off somewhat due to higher energy import prices weaker export growth (especially if the yen reverses its recent depreciation). In China, a rapidly widening trade surplus is helping to sustain real GDP growth at 9 percent
this year, despite a substantial weakening of domestic demand growth. Policy efforts may boost domestic demand growth somewhat next year, but another substantial widening of the Chinese trade surplus is unlikely to be tolerated. Chinese real GDP growth should be expected to slow to 8 percent or less. Elsewhere in emerging Asia, the picture is mixed with India likely to continue strong growth, but other countries heavily dependent on energy imports and exports to the U.S. and China are facing headwinds (and possible risks from the bird flu).

Led by the oil exporting countries, the Middle East should continue strong growth in 2006, but there is little reason to expect an acceleration after a very good year in 2005. Africa also should continue to enjoy much better growth than its average over the past three decades, but there is no reason to anticipate a pick up and the weight of the region in global GDP remains very small.

The Balance of Risks

These forecasts for U.S. and global economic growth are, as always, subject to both upside and downside risks. The central forecast reflects the balance of these risks.

Regarding upside risks for growth, it is noteworthy that world energy prices have pulled back from their highs of last September, and further weakening of these prices is surely possible if global growth slows as forecast. This, in turn, would tend to induce somewhat stronger growth than in the present forecast. On the other hand, world energy prices could surge upward again if the northern hemisphere experiences an abnormally cold winter or if there are disruptions to energy supply. This would tend to induce growth somewhat below the present forecast.

Uncertainty about the strength of underlying inflationary pressures in the U.S. and the world economies is another, probably more important, source of risk. If, as many financial sector analysts appear to believe, underlying inflationary pressures (outside of the energy sector) are and will remain quite subdued, then U.S. monetary tightening is unlikely to proceed much farther and the ECB and the BOJ are likely to be quite cautious in tightening their policies. Moreover, there is plenty of room for consumers in Europe and Japan to boost their spending at the expense of somewhat lower saving rates. And, with an early end to Federal Reserve tightening, it
is even possible that U.S. consumers would extend their spending spree despite already negative household saving rates. All of this would tend to produce U.S. and global growth above the present forecast.

On the other hand, if underlying inflationary pressures are somewhat stronger than the optimists hope, tighter monetary policies and weaker consumer spending would tend to produce growth below forecast.

Recognizing that there are risks on both sides of the central forecast, it is relevant to note that the upside risks tend to be naturally self-limiting. U.S. growth much above 3 ½ percent and global growth much above 4 percent, are likely to mean higher rather than lower world energy prices and are more likely to be associated with stronger inflationary pressures and greater monetary tightening. Thus, stronger growth now is likely to imply weaker growth later.

This process also tends to work in reverse, but probably less strongly so as far as 2006 is concerned. If there is early evidence of a sharp slowdown in the U.S. economy (and inflationary pressures are not rising), the Federal Reserve will call an early halt to monetary tightening and might shift to easing. But a moderation of U.S. demand growth to 2 ½ percent will not push the Fed off of its assumed policy path.

The experience of the past decade, since the acceleration of U.S. productivity growth in the mid 1990s, is that the potential growth rate of the U.S. economy is about 3 ¼ percent; it is not plausibly as high as 4 percent or even 3 ½ percent. For the past decade, U.S. demand growth has outpaced potential output growth on average by ½ percent per year. This was possible without a dramatic upsurge of inflation because there was a modest degree of slack in the U.S. economy a decade ago, because a variety of special factors (including a strengthening dollar and the surprise effects of the unanticipated acceleration of productivity growth) helped to keep U.S. inflation subdued, and most importantly because an expanding trade deficit absorbed most of the excess of demand growth over potential output growth.

The U.S. economy is now operating essentially at potential (with some sectors such as housing overheating and others with some slack remaining). The decline of the unemployment rate to 5 percent and the percentage point rise in the rate of core consumer price inflation from its trough two years ago are important evidence of this situation.
In contrast with the situation for most of the past decade, however, it is now not plausible to assume that further substantial deterioration of the U.S. trade balance can continue to absorb significant and persistent excesses of U.S. demand growth above potential GDP growth. Instead, demand growth needs to slow to something moderately below potential output growth in order to allow room for the U.S. trade balance to improve.

This process need not begin in 2006. Indeed, the central forecast assumes only that the real trade balance ceases to deteriorate (with the trade balance in value terms still deteriorating), and even such stabilization is not essential for next year. Nevertheless, U.S. monetary policy needs to recognize that slowing of demand growth to somewhat less than 3 percent is not an undesirable outcome that should be resisted by a premature end to monetary tightening. Thus, the monetary policy response to a moderate slowing of U.S. growth is not symmetric with the appropriate response to an acceleration of growth.

Finally, some prominent commentators worry that a “crash of the dollar” could induce a world recession, perhaps as early as 2006. The worry is that a sudden refusal of foreign investors to accumulate U.S. assets at the prodigious rate necessary to finance the U.S. external deficit would force a large increase in U.S. longer-term interest rates pushing the U.S. economy down at the same time that sharp appreciations of other countries’ currencies against the dollar undermine growth in the rest of the world.

While not absurd, this worry seems to me to be overblown. The U.S. economy remains an attractive place for foreign savers to place resources not needed to finance investments in the rest of the world (where investment demand remains relatively weak). While there is undoubtedly some limit to the level of U.S. net international indebtedness that we and the rest of the world would find acceptable, there is no indication that we are now near that limit. Thus, the worry about a “dollar crash” is more appropriate as a spur to begin the necessary process of gradually reducing the U.S. trade deficit than as a likely cause of world recession in the near term.