Peterson Institute for International Economics

THE US ECONOMIC OUTLOOK

A Soft Takeoff with Downside Risk

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Forecast: A soft takeoff.
Slow GDP growth for the first half
followed by a resumption of trend growth.

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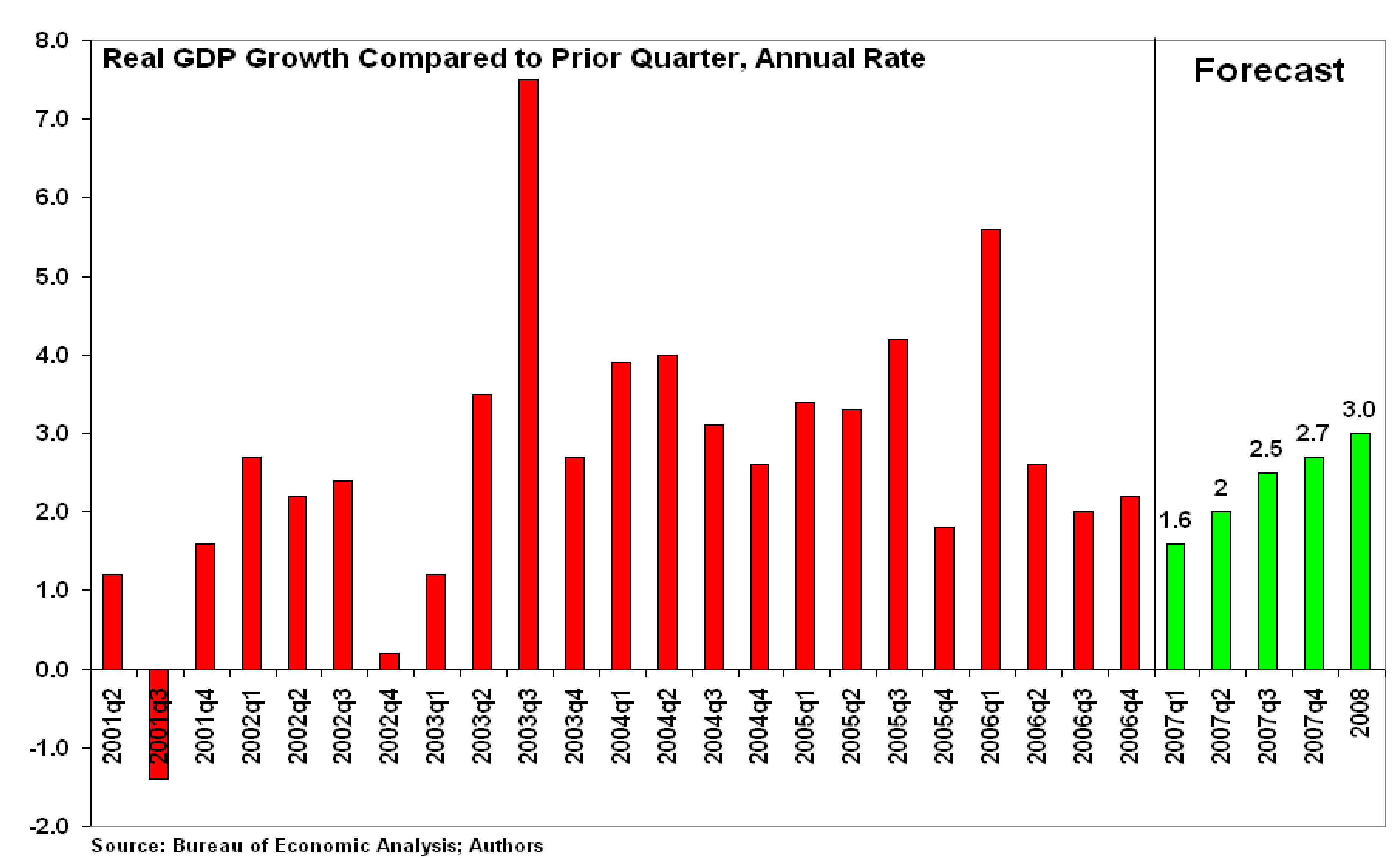


While a return to trend growth is likely, there is significant recession risk.

- There are risks to this forecast and two of these are explored here:

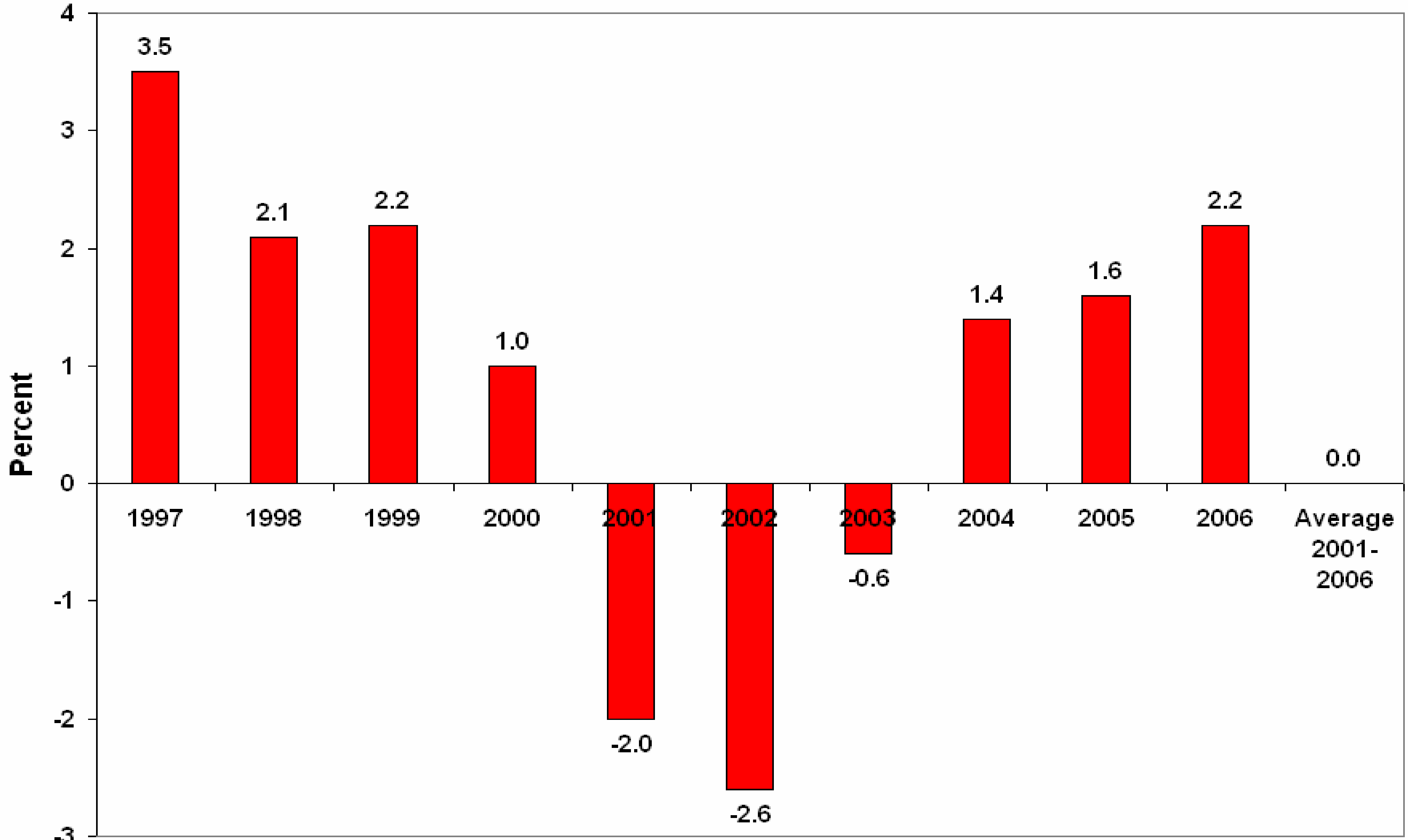
  - There may not be enough slack in the economy, and inflation stays too high.

  - The housing and mortgage markets may push the economy into recession.

- Look first at the first risk: potential GDP growth and level.

Private sector restructuring, 2001–03
Hard to estimate the current trend in hours.
Growth—0.6 to 0.9 percent

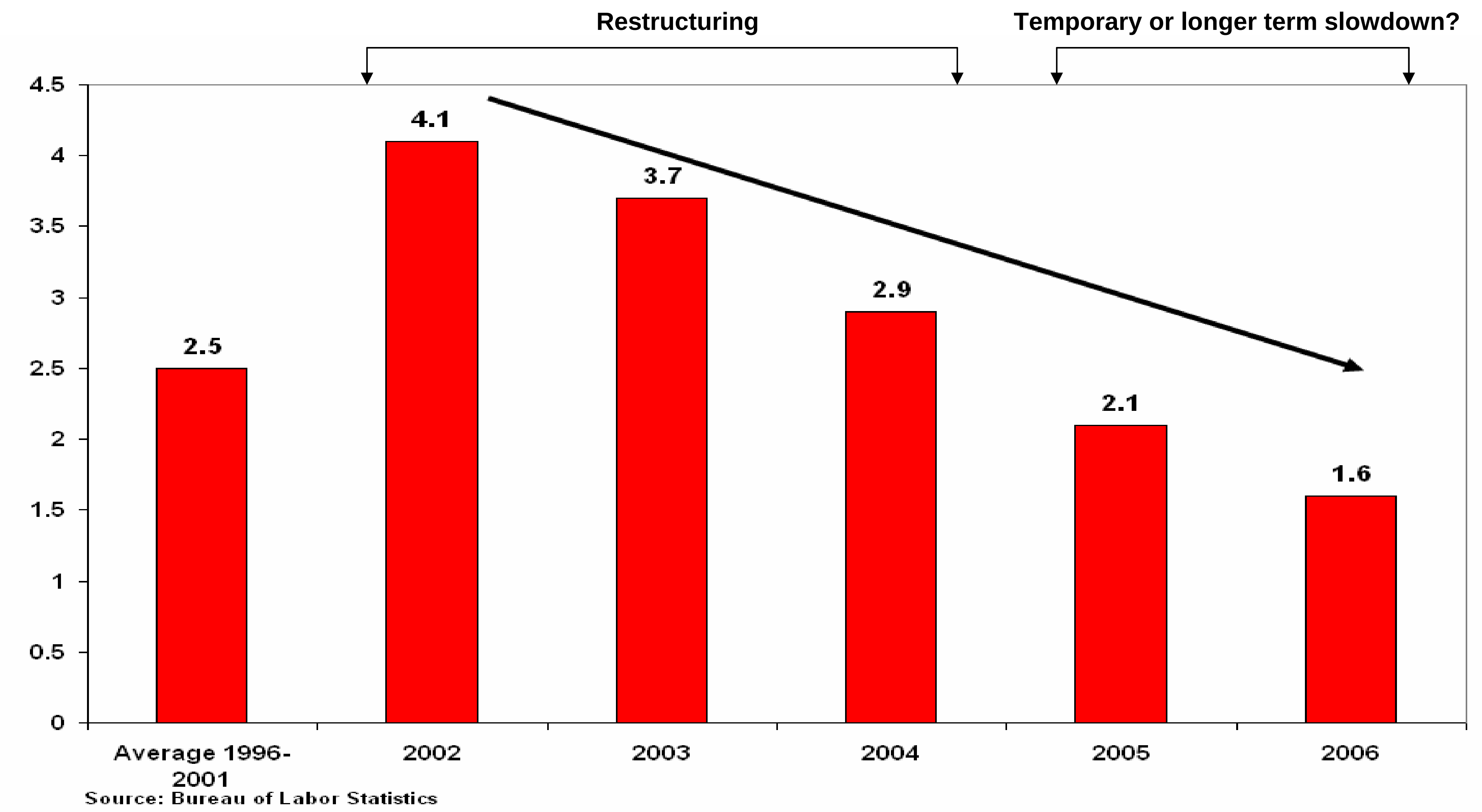
Growth of total hours worked, nonfarm business



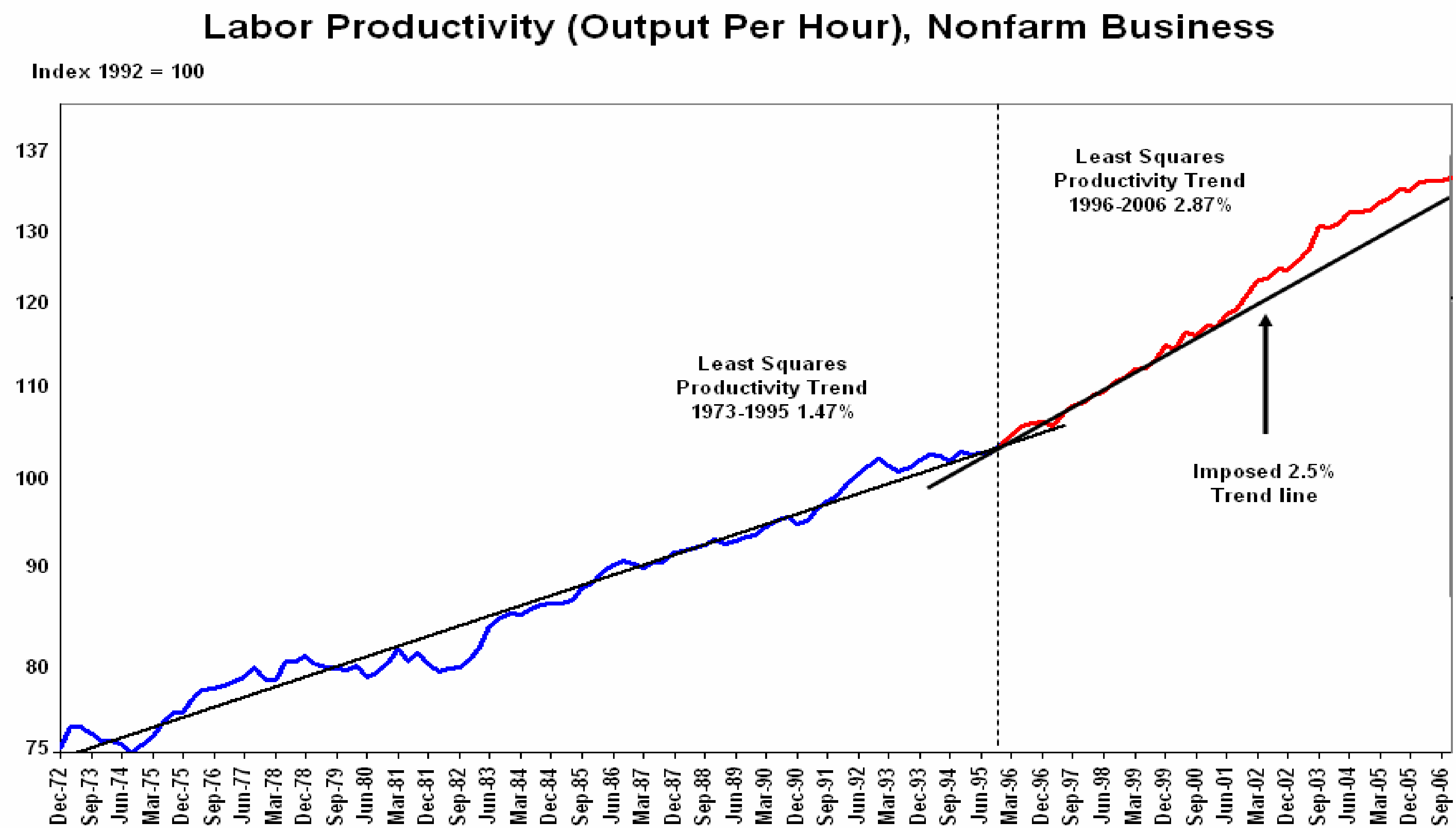
Source: Bureau of Labor Statistics

Has the productivity boom ended?
Restructuring boosted productivity above trend, followed by below trend growth.

Output per hour, nonfarm business



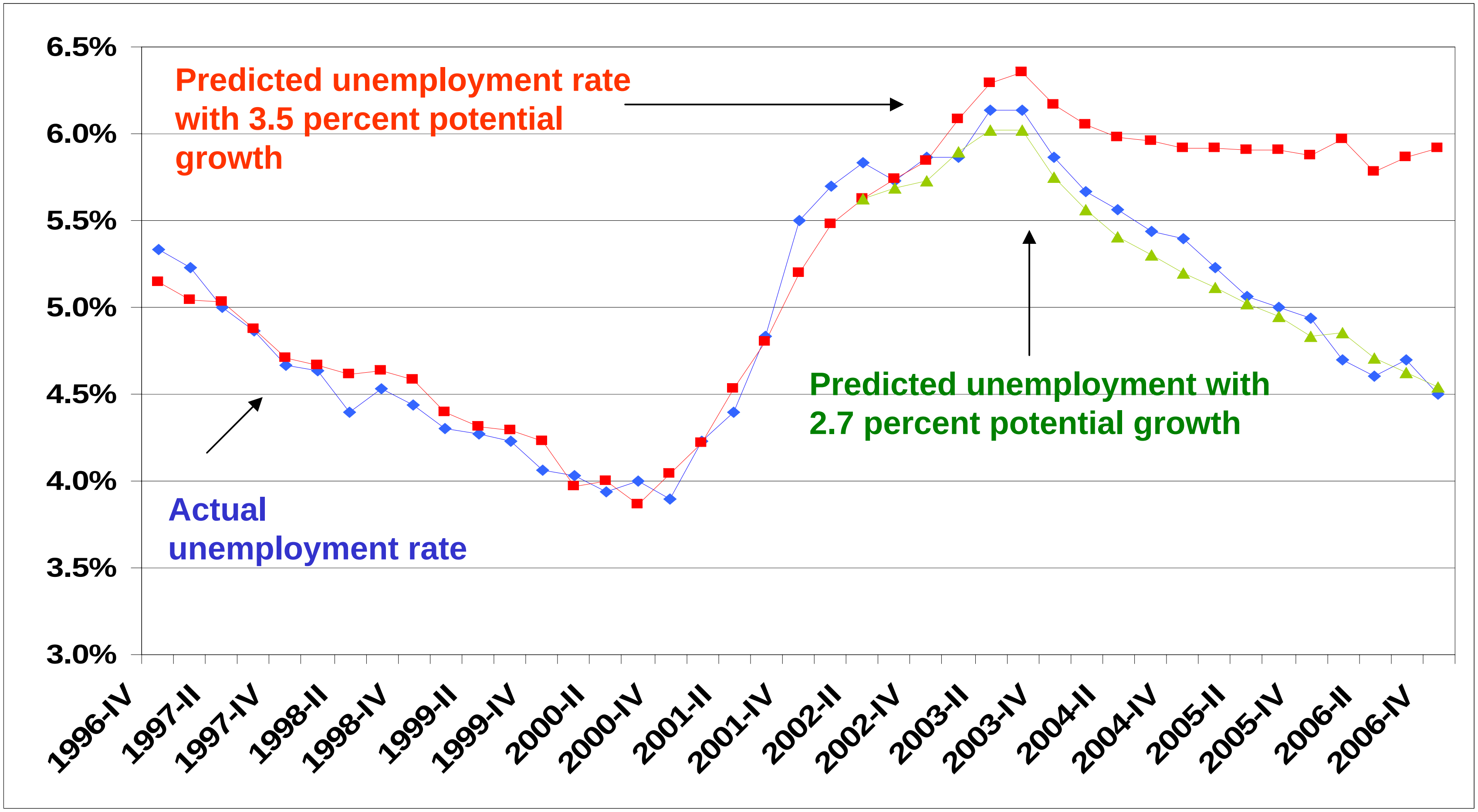
Productivity is converging to the 2.5 percent trend line. This implies potential GDP growth of 2.7 to 3 percent.



Source: BLS Major Sectors Productivity and Costs Index

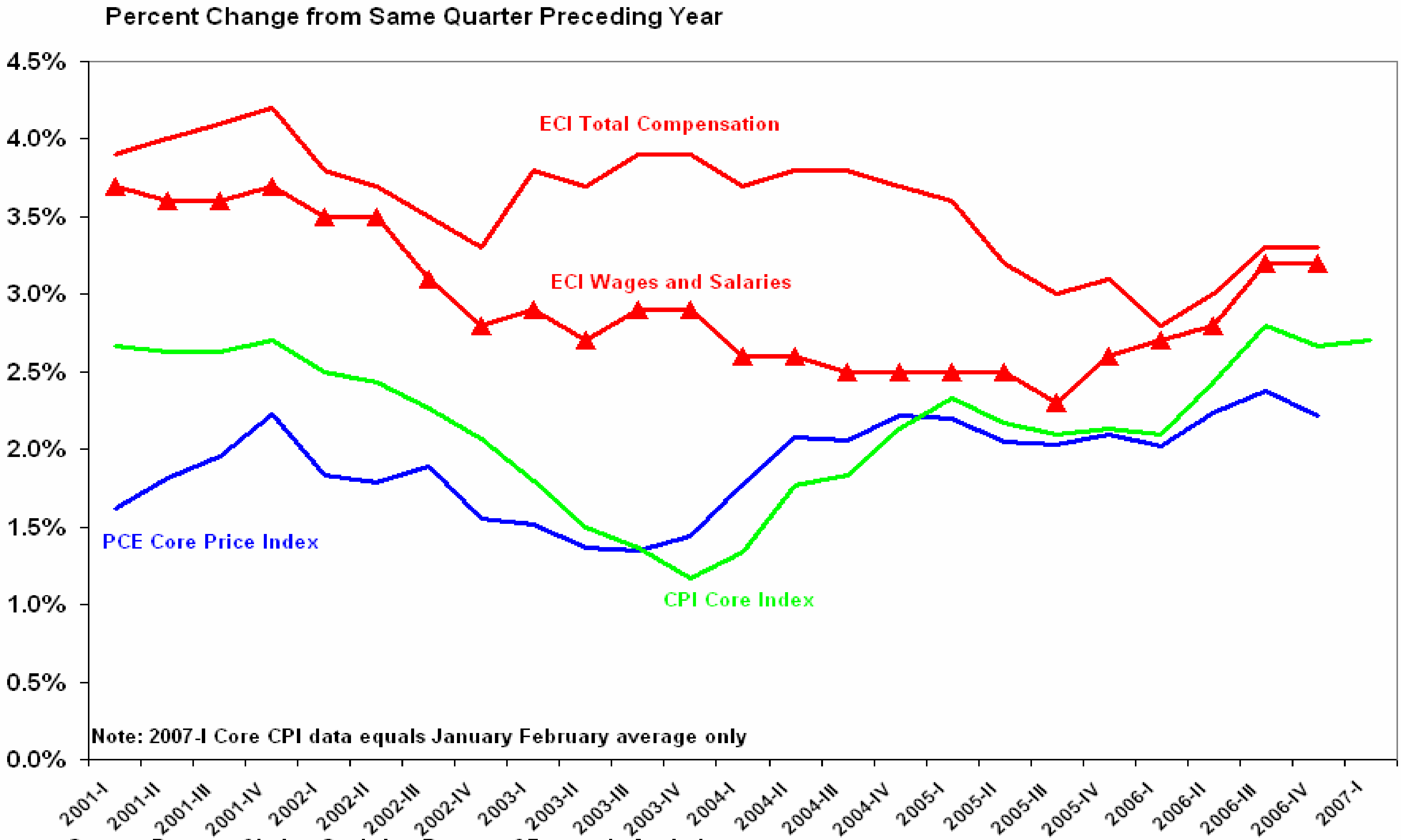
Tracking unemployment:

1. **signals low end of the range on potential GDP growth, and**
2. **with unemployment below 5 percent, there may be overheating.**



Sources: Bureau of Labor Statistics and Bureau of Economic Analysis.

Inflation has been rising since 2003.
Wages/compensation started rising in 2005.
On track to return to the comfort zone?



Source: Bureau of Labor Statistics; Bureau of Economic Analysis

Getting inflation down with slack in the economy: This requires a period with the *level* of actual GDP below potential GDP.

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Conditions that would allow the soft takeoff.

- Potential GDP growth is 3 percent.
- Actual GDP was equal to potential in 2006Q2.
- GDP growth follows the forecast in 2007, with the fall in housing ending by mid-year and exports helping.
- Energy prices stabilize or fall.

Enough slack to reduce core inflation by 0.3–0.4 percentage points. Inflation dividend from energy prices. The Fed eases by summer or fall as inflation is well inside the comfort zone.

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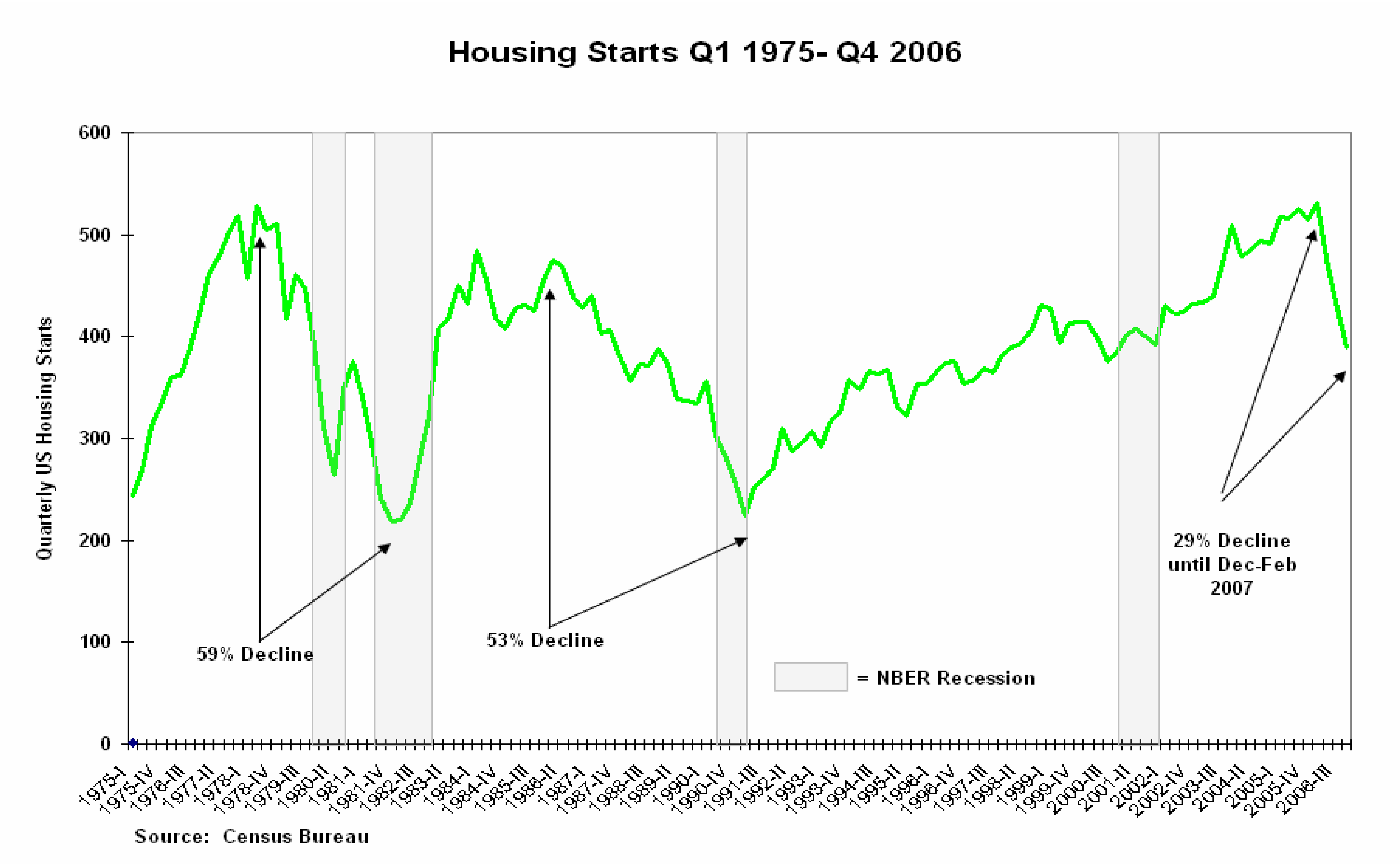
Conditions that could lead to an inflation-induced recession

- Potential GDP growth is 2.7 percent (or below).
- The economy was overheating in 2006 (actual is 1 percent above potential in 2006Q2).
- Growth is as forecast. Excess demand persists, pushing up core inflation by 0.1 to 0.2 percent.
- Energy prices rise again, so no further inflation dividend.
- A falling dollar adds to inflation.

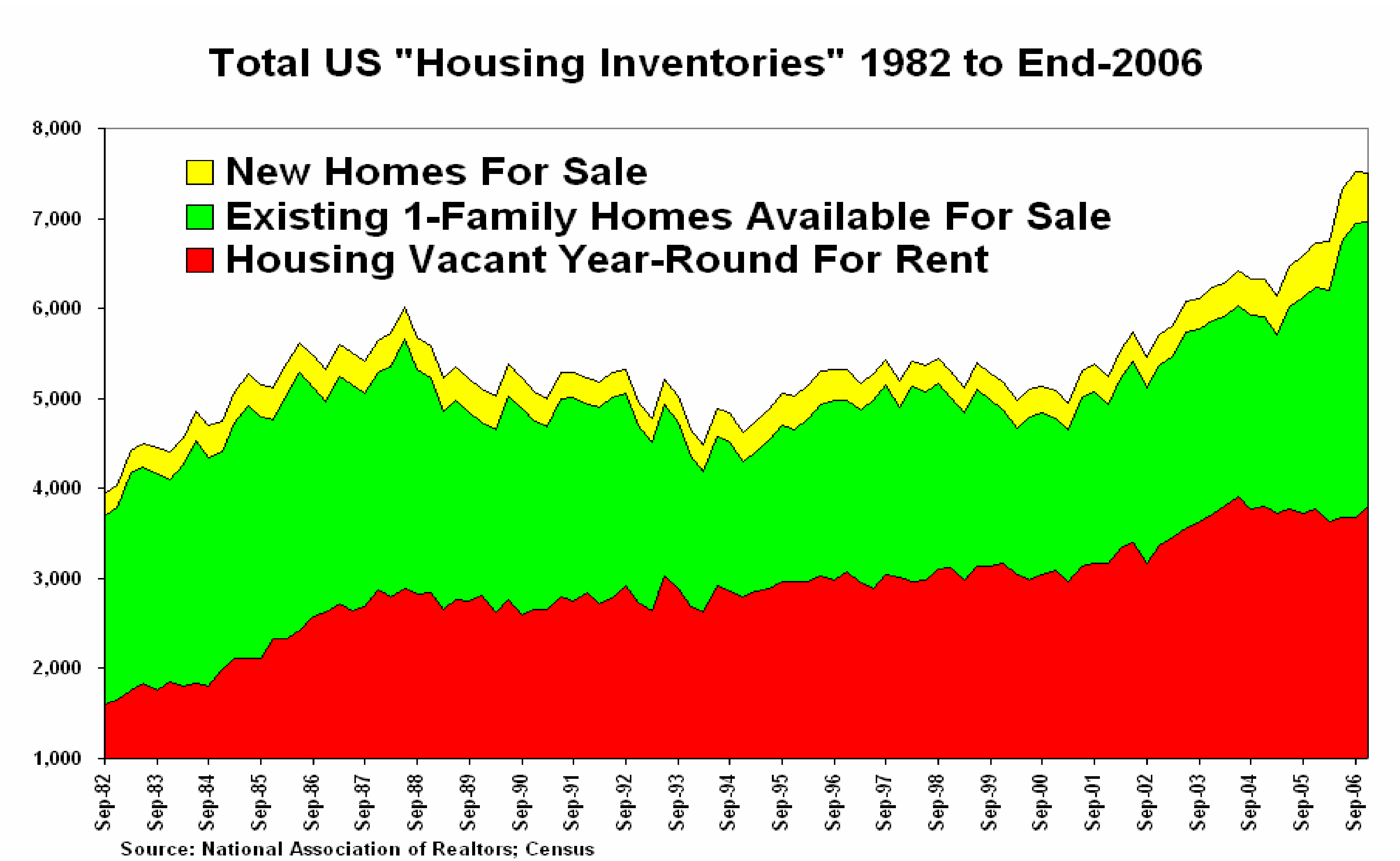
No Fed easing, maybe rates are increased further.

- Economic growth was slow in the second half of last year and will be slow in the first half of this year. If unemployment starts to rise, this is a sign that slack is emerging, helping to keep inflation down.
- Now a look at the housing and mortgage markets and whether they will push the economy into recession.

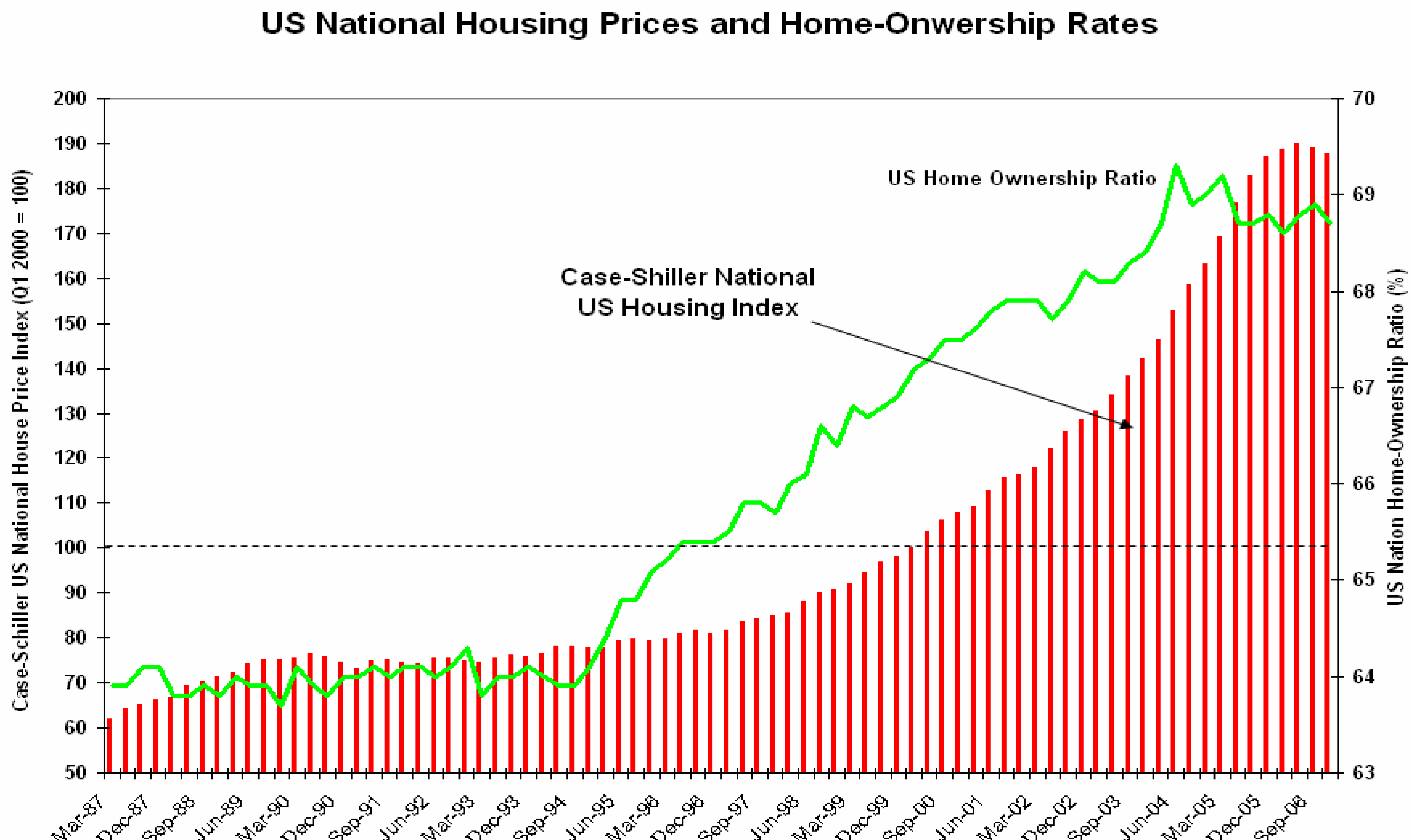
So far, the fall in residential construction has been smaller than in the past.



But total US housing inventories are high. Housing has further to fall.

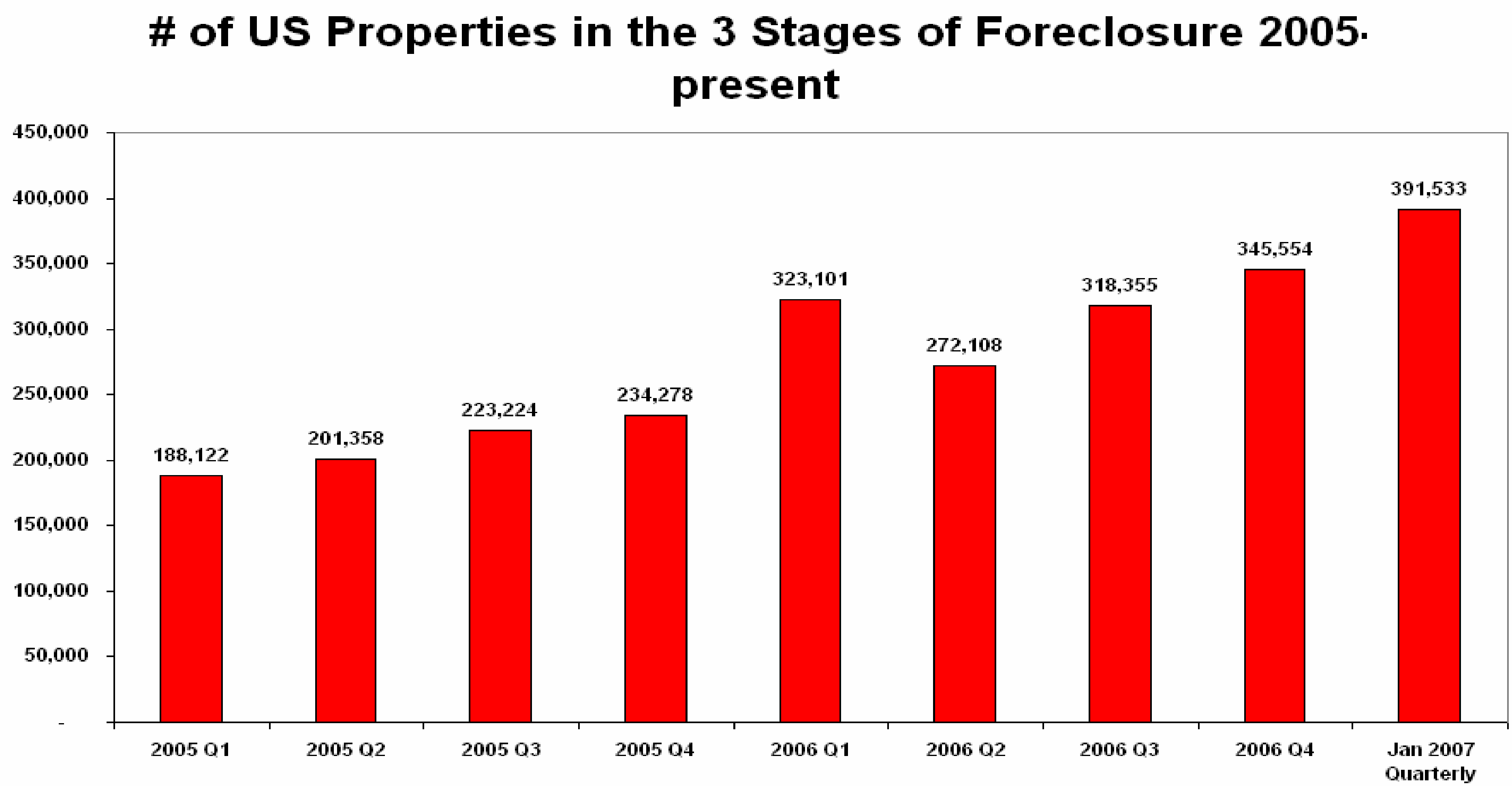


House prices are falling but remain very high.
Good news, household wealth remains high.
Bad news, prices may fall further.



Source: S&P; US Census

Foreclosures now near “recession levels,” while nearly half of mortgages issued in 2006 were low or no documentation loans.



Source: RealtyTrac. Note: Foreclosure data include all three phases of foreclosure; Defaults — Notice of Default (NOD) and Lis Pendens (LIS); Auctions — Notice of Trustee Sale and Notice of Foreclosure Sale (NTS and NFS); and Real Estate Owned, or REO properties (that have been foreclosed on and repurchased by a bank)

- The resetting of rates on ARMs could trigger further defaults.
- However, mortgages with very low “teaser” rates have mostly reset already.
- Subprime lenders New Century and Fremont are in financial difficulty, but most of the top lenders are well-financed. A financial crisis is unlikely.

- Housing will reduce GDP growth in the first half of 2007. Absent a spike in interest rates, the market should then level off.
- If the housing slump leads to a drop in consumption, then a recession becomes likely, which would, in turn, lead to further weakness in housing and business investment.

Soft takeoff with significant downside risk.

- Greenspan has pegged the risk of recession in 2007 at one-third, which seems about right, with housing as the main risk, spilling over to consumption.
- Two-thirds probability of no recession in 2007. Consumption keeps growing, housing bottoms out, and net exports are no longer a drag on growth.
- The risk of recession is increased if inflation remains too high. This could force the Fed to raise rates again or sit on their hands as the economy weakens.
- This presentation explored two risks, but there are others: a weak auto sector, sluggish business investment, and a possible oil price surge. A dollar decline could raise US interest rates.
- The Fed will not and should not encourage a return to above trend growth any time soon.