Chicago Fed Letter

Economic Outlook Symposium: Summary of 2006 results and forecasts for 2007

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In 2007, the nation’s economic growth will soften slightly, inflation will decrease, and the unemployment rate will edge higher, according to the median forecast of the participants at the Federal Reserve Bank of Chicago’s Economic Outlook Symposium.

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<th>1. Median forecast of GDP and related items</th>
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*Fourth quarter over fourth quarter percent change.


*Fourth quarter average.

*Percent.

Sources: Actual data from authors’ calculations and Haver Analytics; median forecast from Economic Outlook Symposium participants.

So how did the U.S. economy perform over the past year? Real gross domestic product (GDP) growth was 1.8% in the fourth quarter of 2005. Growth in this quarter was held down by a sharp reduction in energy production following Hurricanes Katrina and Rita and a significant drop in vehicle sales that followed the surge in the summer from “employee pricing” incentive programs by the Big Three automakers. Without the drag from these two events, GDP growth surged to 5.6% in the first quarter of 2006. Growth moderated to 2.6% in the second quarter and to 2.0% in the third quarter. In the second and third quarters of 2006, growth would be considered by our consensus group as below potential for the U.S. economy. However, the weakness was in large part attributable to the pullback in the residential sector. This reduction lowered GDP growth by 0.7 percentage points and 1.2 percentage points in the second and third quarters, respectively.

The unemployment rate remained fairly stable at around 4.7% over the first three quarters of 2006. Employment expanded by over 1.8 million jobs between November 2005 and November 2006. An average of 151,300 jobs were added each month—an impressive gain.

Inflation edged higher during 2006. The Personal Consumption Expenditures Price Index increased 2.0% in the first quarter, 4.0% in the second quarter, and 2.4% in the third quarter. This was in large part due to significant increases in energy prices that peaked in the summer. West Texas Intermediate oil prices averaged just over $59 per barrel in December 2005 and increased to $74 by July 2006—approximately a 25% increase over this short period. Oil prices backed off from these elevated levels, falling to $59 per barrel by November 2006.

Removing food and energy, core inflation rates were higher during 2006, with prices rising 2.1%, 2.7%, and 2.2% during the first, second, and third quarters of the year, respectively.

Higher energy prices during the first half of 2006 put increasing pressure on consumer spending. Spending on energy goods and services as a share of total spending was 5.7% for the first 11 months of 2005 and rose to average 6.0% for the comparable period in 2006. Yet, when viewed from a historical perspective, it
With a slower pace of economic activity and flat oil prices, inflation is forecasted to moderate in 2007.

Light vehicle sales averaged 16.5 million units during the first 11 months of 2006—2.2% below the average of 16.9 million units over the comparable period in 2005. While the past eight years have been the industry’s highest selling years, the amount sold has shown no growth, ranging between 16.5 million and 17.3 million units each year. Yet the Big Three automakers’ market share fell from an average of 70.1% in 1998 to 54.3% for the first 11 months of 2006—a 2.7 percentage point reduction from the comparable period of 2005.

Against this backdrop, the Federal Reserve Bank of Chicago held its twentieth Economic Outlook Symposium on December 1, 2006. A severe winter storm swept into Chicago on the day of the symposium, yet more than 60 economists and analysts from business, academia, and government attended the conference. This Chicago Fed Letter reviews the previous year’s forecasts for 2006 and summarizes the presentations at the 2006 conference (see figure 1).

Performance versus the forecasts
In 2005, forecasters were anticipating that the economy would grow near potential in 2006 (a growth rate associated with a stable unemployment rate and no inflationary pressures). GDP growth started off a bit faster than forecasted, rising 5.6% in the first quarter compared with the 3.5% predicted. Second quarter output was expected to increase by 3.4%, but it grew by 2.6%. Third quarter GDP expanded by 2.0%, slower than the 3.0% forecasted. The unemployment rate was forecasted to remain fairly stable at around 5.0%. The year started off with a more marked reduction in the unemployment rate: It fell to 4.7% in the first quarter and ended the year averaging 4.5% in the fourth quarter. In general, the consensus forecast was fairly accurate, with the exception of a few sectors. West Texas Intermediate oil prices were forecasted to average $59.24 per barrel in the first quarter and then fall to $55.69 per barrel by the fourth quarter. In fact, oil prices averaged over $63 per barrel in the first quarter and rose to average over $70 per barrel in the second and third quarters and eased to $60 per barrel in the fourth quarter. Housing starts were expected to average 1.95 million in the first quarter and fall to average 1.86 million by the third quarter. In fact, housing starts averaged a stronger 2.12 million starts in the first quarter, but then fell off more sharply than anticipated, averaging 1.71 million units in the third quarter of 2006. According to the consensus forecast, the industrial sector should have expanded by an average of 3.3% for the first three quarters of the year. However, industrial production rose more robustly, increasing by 5.2%, 6.5%, and 3.9% for the first, second, and third quarters of 2006, respectively. Light vehicle sales were forecasted to average 16.8 million units during 2006, higher than the 16.5 million units that were sold.

Economic outlook for 2007
According to the consensus group, real GDP is expected to have increased by 3.0% in 2006 and then rise 2.8% in 2007—a rate that the consensus group regards as a bit below potential. While virtually all sectors are predicted to experience more moderate performance, the housing sector is expected to have the most significant reduction in activity. Housing starts are forecasted to average 1.60 million units in 2007 after averaging 1.85 million units in 2006. This is predicted to lead to continued reductions in residential investment during 2007. After falling by 10.4% in 2006, residential investment is forecasted to decline 4.2% in 2007.

The inverted yield curve is predicted to correct itself, although it should still be relatively flat. Forecasters expect the ten-year Treasury rate to rise 20 basis points to 5.0% by the final quarter of 2007. They also expect a 22-basis-point reduction in the one-year Treasury rate to 4.8% by the end of 2007.

Spending growth in the consumer sector is predicted to expand at a slower pace in 2007, edging down from 3.4% growth in 2006 to 2.8%. The easing on spending growth is expected to translate into a slight decline in light vehicle sales, which are forecasted at 16.4 million units in 2007.

The business sector is expected to have another solid year, with growth in business fixed investment rising by 5.9% in 2007, although less than the 8.6% in 2006. Industrial production, which is expected to have risen 4.3% in 2006, should increase 2.6% in 2007.

Government spending is anticipated to rise by 1.7% in 2007, a slower pace than
in 2006. The international trade deficit is expected to decrease somewhat, falling from $638.4 billion in 2006 to $630.1 billion in 2007.

Oil prices are expected to remain around $60 per barrel throughout 2007. With a slower pace of economic activity and flat oil prices, inflation is forecasted to moderate; inflation, as measured by the Consumer Price Index, is predicted to rise by 2.5% in 2007.

Residential investment as a share of GDP has reached levels that have not been seen for about 50 years.

A shift toward upscale automobiles and crossover utility vehicles (CUVs) is anticipated, while the number of traditional sport utility vehicles (SUVs) sold is expected to decrease.

Despite these predictions, Hughes-Cromwick said that she had some reservations about the future of the U.S. auto sector. For example, the U.S. economy has recently seen the largest gap between the personal savings rate and gasoline prices. Indeed, since mid-2005, the three-month moving average of personal savings has been negative, while gasoline and fuel oil spending has exceeded 3% of consumer incomes.

Steel outlook
Robert DiCianni, marketing manager, Mittal Steel USA, presented his outlook on the steel industry for 2007. While the 2007 forecast for the economy as a whole anticipates a slight decrease in growth, it is falling from a strong year in 2006 and a very strong year in 2005.

With this expected slower pace of growth, housing is anticipated to taper off from record levels, accompanied by a slight decrease in inventories. DiCianni said he expected automotive production to continue at a steady rate. However, with the number of imported vehicles increasing, the U.S. manufacturers may be using less steel in 2007. On the other hand, the nonresidential construction sector—one of the largest users of steel—is expected to stay strong, as well as the manufacturing sector.

Housing outlook
Jonas Fisher, economic advisor and team leader of the macroeconomics group at the Federal Reserve Bank of Chicago, discussed his paper, "The great turn-of-the-century housing boom."

Over the past decade, residential investment as a share of GDP has reached levels that have not been seen for about 50 years. Also, during this period, the number of people who own homes has increased to record levels (68% in the current decade). This ownership rate encompasses a broad base of people of all income levels, as the ready availability of mortgages and relatively low interest rates have made it much easier for everyone to own a home. The low effective mortgage rates may be leading to the higher levels of housing starts. With monetary policy having tightened, a slowdown is expected, but, Fisher concluded, housing is not expected to be a major drag on the economy going forward.

Heavy machinery outlook
Donald Johnson, chief economist, Caterpillar Inc., presented the outlook on heavy machinery for 2007. The U.S. economy is in for a weaker year, with housing, automotives, and trade expected to slow down somewhat. However, Johnson pointed to strong growth in other economies throughout the world in 2007. Currently, Europe is on the road to recovery, and the developing countries are staying strong.

For 2007, Caterpillar Inc. is forecasting a slight increase of up to 5% for its own sales. This is because dealers are expected to reduce their inventories in

Consumer and banking outlook
Carl Tannenbaum, chief economist, LaSalle Bank/ABN AMRO, said that, on the consumer side, the housing correction continues, with existing home prices dropping, home equity withdrawals falling from previous high levels, and home equity loans flattening out. Credit card delinquencies are also creeping back up from the recently low levels. However, gasoline prices have dropped from unusually high levels, and the economy is currently seeing one of the strongest job markets.

On the banking side, some deterioration in the Midwest has been seen in credit quality, especially in the state of Michigan. We are in a period of a flat yield curve, Tannenbaum explained, but it is not necessarily an indicator of a recession. Commercial and industrial loans (in the billions of dollars) are higher than they have been in recent years, and they have been in recent years, and they have helped make 2006 a strong year for banks. Credit spreads are narrowing between corporate bonds and ten-year Treasuries, which means that, in general, participants are assessing less risk in the market.

Auto outlook
Ellen Hughes-Cromwick, director and chief economist, Ford Motor Company, presented the vehicle industry and sales outlook for 2007. She expected the auto sector to remain firm, though U.S. light vehicle sales are predicted to edge lower. This projection is based on the positive global economic and industrial conditions that the market has recently seen.

Michael H. Moskow, President; Charles L. Evans, Senior Vice President and Director of Research; Douglas Evanoff, Vice President, financial studies; Jonas Fisher, Economic Advisor and Team Leader, macroeconomic policy research; Richard Porter, Vice President, payment studies; Daniel Sullivan, Vice President, macroeconomic policy research; William Testa, Vice President, regional programs and Economics Editor; Helen O’D. Koshy, Kathryn Moran, and Han Y. Choi, Editors; Rita Molloy and Juiia Baker, Production Editors.

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response to new truck emission standards and waning market demand in North America. However, this weakness in demand is expected to be offset by demand in other countries. Additionally, some growth is expected from the mining sector, which is responding to growing demand (and rising prices) for metal; this should boost sales of trucks used at mine sites.

Conclusion

The year 2006 was challenged by a sharp slowdown in housing and large increases in energy prices. Housing and energy prices are expected to add less drag to the economy in 2007. The outlook for 2007 is for GDP growth to moderate further; growth is expected to stay below potential for the U.S. economy.

The unemployment rate is predicted to edge higher, remaining near a rate considered to be full employment. Inflation is expected to moderate in 2007.