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NC State Economist

Agricultural and Resource Economics • January/February 2007

2007 Economic Outlook: Soft or Hard Landing?

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The National Economy: Has the Fed's Medicine Worked?

Review of 2006

The current economic expansion, begun in 2002, continued in 2006. The broadest measure of national economic activity – the quantity of goods and services produced in the country during the year (real gross domestic product, or GDP) – increased a robust 3.4%, slightly faster than the growth rate in 2005 (Table 1). However, national economic growth certainly was not steady in 2006. Growth started very high in the early part of the year, moderated in mid-year, and then stalled toward year's end. By the close of 2006, economists were asking a very fundamental question: would the economy be growing in 2007, or would it begin the new year in a recession?

Other indicators confirmed the economic expansion during 2006. Payroll employment grew by 1.5%, about the same as in 2005, and the unemployment rate dropped one-half of a percentage point. Industrial production rose almost 5%, better than in 2005, and aided by a lower than expected inflation rate, real (inflation-adjusted) disposable income of consumers increased faster in 2006 than in 2005. Households added to their debt loads, but more slowly than in 2005, and real consumer spending rose slightly less in 2006 compared to 2005. The slowdown in the national housing market and the consequent moderation in the buildup in home equity were probably the major factors behind consumers being more cautious with their wallets.

There was both good and bad news on the inflation front in 2006. Gas prices jumped in the summer on the fears of another dire hurricane season. Then, when the hurricane season passed with hardly a "peep," fuel prices fell in the fall and winter and carried with them the overall inflation rate. Consequently, the total retail (total CPI) inflation rate came in at a very modest 1.3% for the year, less than half of 2005's rate.

But the plunge in energy prices masked what was happening to prices in the rest of the economy. Inflation outside of the volatile energy and food markets (so-called "core" inflation) actually was higher in 2006 than in 2005 (2.7% vs. 2.2%). This suggests inflation was still a concern during the year, and pronouncements from the Federal Reserve certainly seemed to indicate so.

Perhaps the most unusual economic pattern displayed during 2006 was the movement in interest rates. Short-term interest rates (3 month T-bill rate) continued their rise in 2006, increasing another 1 percentage point after a jump of almost 1.75 percentage points in 2005. But long-term interest rates (10 year T-note rate) barely budged.

The performance of investment markets surprised many in 2006. The stock market (here measured by the Standard and Poor's 500 Stock Index) rose a very strong 12% during the year, much faster than credible forecasts had predicted. As always, many interpretations were offered for why stocks performed so well. Some saw the gain as simply a reflection of good business profits during the year. Others attributed the rise to the good news from energy markets. Still others saw stocks benefiting from what looked like a successful Federal Reserve policy of steering the economy to an acceptable point accommodating the twin goals of economic growth and low inflation.

Last, the federal budget situation improved in 2006. Mainly as a result of strong revenue growth sparked by corporate profits and investment gains, the federal budget deficit as a percentage of gross domestic product was cut in half from the previous year.

Issues

As 2006 wound down and 2007 began, the major question hanging over the national economy was this: would the economic slowdown, which was apparent at the end of 2006, turn into a full fledged recession in 2007, or would the economy rebound and post a solid growth rate in the new year?

In many ways, the economic slowdown in the second half of 2006 was not a surprise for several reasons. The first was timing. The economic expansion, begun in 2002, was now five years old. Historically, expansions this old tend to "run out of steam." Rapid growth rates occur earlier in the expansion, and growth naturally tapers off as the expansion ages.

The second reason was economic policy. Through its influence over interest rates and credit availability, the Federal Reserve bank (the Fed), can use its power to either speed-up or slow down the economy. In the early part of this decade, the Fed's main goal was ensuring economic growth. Hence the bank relentlessly reduced interest rates and poured credit and money into the economy. In recent years, the Fed has shifted its attention to its other dominant policy objective – maintaining moderate inflation. Inflation has been rising faster than many think the Fed feels is desirable. Therefore, beginning in 2004, the Fed began increasing short-term interest rates and slowing the rate of growth of credit in an effort to moderate the pace of economic activity and arrest the rise in inflation. Since the Fed's policies operate with a considerable time lag, it was not surprising to see the resultant economic slowdown appear only in 2006.

Third, two important sectors in the economy – autos and housing – detracted from economic growth in 2006. Slammed by higher gas prices and foreign competitors, the domestic auto industry has been struggling. Layoffs, plant shutdowns, and production curtailments have taken some punch out of the national economy. Meanwhile, the housing market has become

Table 1. Key U.S. Economic Measures[a]

	2005	2006	2007 (forecast)
Real U.S. Gross Domestic Product (% chg.)	+3.2%	+3.4%	+3.3%
Payroll Employment (% chg.)	+1.5%	+1.5%	+1.3%
Unemployment Rate (end of year)	+4.9%	+4.4%	+4.3%
Industrial Production (% chg.)	+3.5%	+4.9%	+3.3%
Real Disposable Personal Income (% chg.)	+1.2%	+2.0%	+2.5%
Household Debt Service (chg. in % point)	+0.70	+0.30	+0.30
Real Consumer Spending (% chg.)	+3.5%	+3.4%	+2.4%
Consumer Price Index (% chg.)	+3.4%	+1.3%	+2.4%
Core Consumer Price Index (% chg.)	+2.2%	+2.7%	+2.4%
3-Month Treasury Bill Rate (chg. in % points)	+1.74	+1.09	-0.25
10-Year Treasury Bill Rate (chg. in % points)	+0.24	+0.10	no chg.
S&P 500 Stock Index (% chg.)	+6.0%	+12.0%	+6.5%
Deficit to GDP Ratio (% chg.)	-2.5%	-1.2%	-2.0%

a. All percentage changes measured from year-end to year-end. Values for 2006 are annualized rates based on the latest available data. Sources: U.S. Dept. of Commerce, Federal Reserve System, author's forecasts "soft" and residential construction has dropped. Additionally, the buildup in home equity, which had been funding a significant part of consumer spending, has stopped.

International trade is a final factor behind the sputtering economic engine. Although the U.S. has typically run a trade deficit in the last three decades, it has never been as large as it is today (7% of gross domestic product). Effectively shifting this much production to foreign countries puts a drag on domestic growth and has certainly contributed to a weakening economic pulse.

2007 Forecasts

As we stand on the brink of 2007, the national economy can go one of two ways. It can further decelerate and crash into a full fledged recession – this is the so-called "hard landing." Or it can softly land on the runway, rest and refuel, and then takeoff for a new round of economic growth – a "soft landing" scenario. Which will it be?

The consensus view right now is for the "soft landing" approach, mainly because the economic fundamentals are good. Although interest rates are higher than two years ago, they are still low by historical standards. Likewise, inflation is moderate and has been moderating in recent months. Jobs are being created, the unemployment rate is low, and household net worth is high and rising. None of the classic predecessors to a recession are present.

Industry experts expect the housing market slump to end in 2007 and for housing and construction to begin again to contribute to economic growth. Even the trade deficit may shrink as a lower-valued dollar makes U.S. exports more attractive to foreign buyers.

If the Federal Reserve perceives that labor costs and general inflation are increasing at acceptable levels, their current pause in interest rate policy may actually lead to cuts in rates by mid year. Such cuts would give a boost to economic activity and to both consumer and investor confidence.

Therefore the 2007 forecasts in Table 1 are cautiously optimistic. Growth is expected to continue and be slightly lower than in 2006. Both total and core inflation rates are projected to be acceptable to policy makers, and the quarter point reduction in short-term interest rates reflects expected Fed easing of monetary policy by year's end. The stock market will gain, but not as much as in 2006, and with slowing federal revenues, the budget deficit will widen modestly.

The North Carolina Economy: Running Faster, But in Different Directions

True to form, the North Carolina economy bounced back from a hard-hitting recession and outperformed the nation in 2006. Growth in payroll employment, real (inflation-adjusted) retail sales, and real personal income were all stronger than their corresponding measures at the national level. State tax revenues, as reflected in monies going to the General Fund, rose at a double digit rate (Table 2).

This strong performance was recorded despite the fact that the basic structure of the state economy is still in flux. The decline in

Table 2. Key North Carolina Economic Measures[a]

	2005	2006	2007 (forecast)
Real Personal Income (% chg.)	+3.3%	+5.4%	+3.5%
Real Retail Sales (% chg.)	+6.2%	+5.1%	+4.5%
Payroll Employment (% chg.)	+2.0%	+1.6%	+1.5%
Manufacturing Employment (% chg.)	-1.9%	-2.3%	-2.0%
Unemployment Rate (end of year)	+5.2%	+4.5%	+4.3%
General Fund Revenue (% chg.)	+9.5%	+12.5%	+7.0%

a.Values for 2006 are annualized rates based on latest available data. General Fund Revenue were adjusted for tax law changes and based on the fiscal year. Sources: U.S. Dept. of Commerce, N.C. Dept. of Revenue, Rederal Reserve System, author's forecasts.

manufacturing employment actually accelerated in 2006. The key economic sectors of the state's economy in the 20th century (tobacco, textiles, and furniture) have had their share of the overall economy cut in half in the past thirty years. Pharmaceuticals, finance, and meat processing are each now more important economic sectors in North Carolina than is tobacco. With the entry of China into the World Trade Organization in 2000, globalization's effects have been fully felt in North Carolina this decade. Since 2000, the only workers in North Carolina whose wage rates have exceeded inflation have been individuals with college degrees.

Just as in the nation, an economic slowdown appeared to have taken hold in North Carolina at the end of 2006. This suggests that although growth will likely continue in the state in 2007, the pace will be a step or two slower than in 2006 (see forecasts in Table 2).

Going forward, two major economic challenges confront the state. One is managing the on-going economic transformation, which requires a two-front approach of attracting good paying jobs while also upgrading the skills and academic talents of the workforce.

The second challenge is building and maintaining the necessary public infrastructure – including roads, bridges, and schools – that is a key to economic growth. Here, financing – at both the state and local levels – is an issue. A new state level commission will be studying the state's entire fiscal system and making recommendations for changes.

N.C. State Economist

Published bi-monthly by the Department of Agriculture and Resource Economics and the Cooperative Extension Service. Address correspondence to:

The Editor, N.C. State Economist
The N.C. State Economist is now on-line at: http://www.ag-econ.ncsu.edu/extension/economist.html

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