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2008 Economic Outlook: Storms or Drizzle?

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The National Economy: Housing is calling the shots

Review of 2007

The economy registered another year of growth – the seventh in the current expansion – in 2007. The "gold standard" of economic growth, the production of goods and services termed *real gross domestic product*, improved by 2.4%, lower than in 2006 but above the important 2% rate needed for employment growth (Table 1). Indeed, jobs were added during the year, but again at a slower pace than in 2006. The year-end unemployment rate was actually a shade above the previous year's level. The theme of slower growth extended to the industrial sector, where expansion was at a rate one-third slower than in 2006.

One piece of good news was that consumers strengthened their financial position during 2007. Real disposable personal income per capita – personal income per person after subtracting taxes and the impact of inflation – increased one-third faster in 2007 than in the previous year. Yet consumer spending (also adjusted for inflation) increased at a slower rate (2.9% in 2007 compared to 3.1% in 2006). Consumers used their saved resources to lower their debt exposure (the household debt ratio fell 0.1% points).

Two factors may have been behind this shift in consumer finances. The slower economy – especially the more slowly expanding job market – may have led consumers to become more financially frugal. Also, the decline in home appreciation rates reduced growth in capital gains associated with this asset and encouraged households to add to other savings and to reduce relative debt service payments.

The conclusions about inflation in 2007 differ according to which inflation gauge is used. The total retail-level inflation rate measured by the consumper price index (CPI) was higher in 2007 than in 2006, but the reverse was the case for the core inflation rate. The core rate excludes energy and food prices, which are typically more volatile than other prices. The fact that the core inflation rate declined while the total rate increased (comparing 2007 to 2006) suggests inflation concerns have been limited to food and energy markets rather than all markets.

One of the biggest economic changes in 2007 was the different direction in interest rates from 2006. Both short-term (3-month T-bill rate) and long-term (10-year T-note rate) jumped significantly in 2006, but retreated in 2007. Significantly, short-term rates fell over six times more than long-rates. The larger drop in short-rates reflected a reduction in the key interest rates controlled by the Federal Reserve, which in turn reflected the relative weakness in the economy. The fact that long-rates fell, rather than rose, in 2007 is interpreted by some to suggest investors expect no longer term run-up in inflation.

Corresponding to the more slowly growing economy, the stock market rose at a much more modest rate in 2007 than in 2006. Fiscally, the federal government's financial position improved during the year with a modest reduction in the budget deficit's share of the national economy (deficit/GDP ratio).

Issues

Three issues were in the forefront of the economy in 2007: the housing market and associated home mortgage market; energy prices (particularly gasoline prices), and the dollar's international exchange value.

The housing market was clearly a drag on the economy in 2007, with some economists estimating problems in the sector were responsible for reducing economic growth by 1.5 percentage points. The housing sector had issues on both the demand and supply sides. On the demand side, record foreclosures and tighter borrowing conditions stifled sales. On the supply end, plunging new construction led to worker layoffs and reduced work in supplier industries. Both conditions put downward pressure on prices, with some national indices registering a decline in average home prices for the first time in decades.

Housing's current turmoil had its origins earlier in the decade when, to fight the dip in business activity caused by the aftermath of 9-11 and the 2001 recession, the Federal Reserve reduced interest rates to levels not witnessed in a generation and greatly expanded the supply of credit available to lenders. Money freely flowed into the home mortgage market, stimulating lenders to progressively seek borrowers with lower and lower credit standards. Consequently, home ownership rates rose to all-time high levels, housing prices continually moved higher, and builders rushed to construct new homes.

But when the Federal Reserve began increasing interest rates in 2004, the number of homeowners – particularly those with adjustable rate mortgages – who found they could no longer make their mortgage payments dramatically rose, and as a result, mortgage default and home foreclosures jumped. Excess supply of homes began to develop, and this condition put downward pressure on housing prices. The whole attitude of investing in homes changed from one of euphoria to one of despair. By 2007, average price appreciation was near zero and new construction was down over 20% from 2006.

Gasoline prices continued their decade long climb in 2007, but fortunately two factors blunted their negative impact. First, in constant-dollar terms the increase in gas prices was much less than it appeared. In fact, real gas prices in 2007 were at the same level as in 1981. Second, the nation's use of energy per-

Table 1. Key U.S. Economic Measures

	2006	2007	2008 (forecast)
Real U.S. Gross Domestic Product (% chg.)	+2.9%	+2.4%	+2.2%
Payroll Employment (% chg.)	+1.7%	+1.1%	+0.8%
Unemployment Rate (end of year)	4.5%	4.6%	5.0%
Industrial Production (% chg.)	+2.8%	+1.8%	+1.7%
Real Disposable Personal Income (% chg.)	+2.1%	+2.8%	+2.0%
Household Debt Service (chg. in % point)	+0.40	-0.10	-0.10
Real Consumer Spending (% chg.)	+3.1%	+2.9%	+2.7%
Consumer Price Index (% chg.)	+3.2%	+3.5%	+3.1%
Core Consumer Price Index (% chg.)	+2.5%	+2.2%	+2.1%
3-Month Treasury Bill Rate (chg. in % points)	+1.63	-2.00	+0.25
10-Year Treasury Bill Rate (chg. in % points)	+0.69	-0.30	+0.30
S&P 500 Stock Index (% chg.)	+13.7%	+5.5.%	+5.0%
Deficit to GDP Ratio (% chg.)	-1.7%	-1.5%	-1.8%

Sources: U.S. Dept. of Commerce, Federal Reserve System, author's forecasts. Values for 2007 are annualized rates based on the latest available data.

dollar of income has been cut in half since 1970, so higher prices have been dulled by this greater efficiency. Combining these two effects, spending on gasoline and oil products as a percentage of total consumer spending only has increased from 3% in 1990 to 3.5% in 2007.

The dollar's exchange value against foreign currencies also declined in 2007, and most headlines painted this trend as a negative event. However, economists are quick to point out a double-edged impact of a currency losing relative value against other monies. A "weaker" currency value makes the domestic country's exports relatively less expensive while, at the same time, making foreign imports to the domestic country relatively more expensive. Thus, a weaker currency value contributes to an increase in a country's exports and a decrease in its imports.

The decline in the dollar's international value has helped accomplish just this. The U.S. trade deficit, as a percentage of the economy, peaked at 6.5% in 2006 and declined to 5% in 2007. With relatively fewer dollars circulating in the world's money supply, many economists look for the dollar's international value to first stabilize in 2008 and then possibly move higher.

2008 Forecasts

The driving forces behind the economy's path in 2008 are the housing and credit markets. For the housing market, in particular, to stabilize and begin positively contributing to economic growth, it must move from a situation of excess supply to one of supply being closer to demand.

Unfortunately, the volume of subprime (high-risk) mortgages having their interest rate reset will increase through the third quarter of 2008 before falling. As these rates reset to higher levels, the number of mortgage defaults and home foreclosures will likely increase. Consequently, economists expect the drag on the wider economy from the housing and mortgage markets to continue at least through the middle of 2008. Therefore, the forecasts for broad economic measures in Table 1 all reflect a less positive economy in 2008 than in 2007.

However, the forecasts do not signal a recession. A recession would be indicated by a contraction in some of the broad measures, particularly in real U.S. gross domestic product. At this point, the consensus view is that the economy will escape an official recession, but instead will experience noticeably slower growth in the year ahead.

Nevertheless, it should be said that this year's forecasts carry more uncertainty than previous projections: In recent years, the nation has not experienced today's levels of excesses in the housing market and losses in the credit market. So while the majority view is that no recession will occur in 2008, surveys of economists and business executives indicate the probability of a recession being between 30% and 40%. Plus, as always, there are sources of risk from the international stage, with disruptions of oil supplies from the Middle East and terrorist attacks being the major concerns.

Regarding other major economic factors, inflation should remain at bay during 2008. Interest rates are expected to trend downward in the first half of 2008, but if the economy regains strength in the second half of the year, rates could be marginally higher at year's end. Households will continue to moderate their debt loads, especially in light of the struggling housing market and a lukewarm stock market.

The North Carolina Economy: Better News, But Same Challenges

Like the nation, North Carolina's economy posted a slower performance in 2007 compared to 2006 (Table 2). Real personal income, real retail sales, payroll employment, and public (General Fund) revenue all increased at more modest rates during the year. The year-end unemployment rate, however, did hold steady. The reduction in manufacturing employment indicates the state's economic transformation, from an economy based on traditional industries like tobacco, textiles, and furniture, to a new economy centered on professional and financial services, technology, and health care, is not yet complete.

Fortunately for the state, the rise and fall in the

Table 2. Key North Carolina Economic Measures

	2006	2007	2008 (forecast)
Real Personal Income (% chg.)	+4.1%	+3.8%	+3.4%
Real Retail Sales (% chg.)	+5.0%	+1.4%	+1.2%
Payroll Employment (% chg.)	+2.7%	+1.7%	+1.5%
Manufacturing Employment (% chg.)	-1.4%	-1.8%	-1.5%
Unemployment Rate (end of year)	4.9%	4.9%	5.2%
General Fund Revenue (% chg.)	+12.3%	+6.4%	+5.0%

Sources: U.S. Dept. of Commerce, N.C. Dept. of Revenue, Federal Reserve System, N.C. Controllers' Office, Fiscal Research Division of the N.C. General Assembly, author's forecasts. Values for 2007 are annualized rates based on latest available data.

housing sector has been less dramatic in North Carolina than in the nation. The run-up in prices and construction was not as great, and so the run-down has not been as severe. Still, new construction was off 15% in 2007, and the slowdown in the construction and home buying markets has had a tempering effect on overall growth.

A special issue for North Carolina is the potential economic impact of the drought. It's estimated the lack of sufficient rainfall has already cost the state economy approximately $500 million in agricultural and green industry losses. If the drought persists into 2008, losses will spread to more industries and the dollar value will mount.

The forecasts for North Carolina in 2008 assume a return to normal water supplies in the year. Even with adequate water, the North Carolina economy is on track to grow more modestly in the year, with further losses in manufacturing employment and a rise in the unemployment rate. With General Fund revenue rising only 5%, legislators will face challenging decisions for the state budget.

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