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Economic Outlook

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Slower Growth

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The average forecast for 2005 U.S. growth is 3.5 percent, with some prognosticators hoping for 4 percent. This forecast is predicated upon the assumption that the economy is on a sustainable expansion path, where consumption will be supported by steady growth of employment and household incomes. The 3.5 percent growth forecast for 2005 is identical to the mean growth rate of the U.S. economy since 1947. However, there is good reason to believe that the consensus forecast is too high. This possibility has important consequences because U.S. growth must be sustained at least at average levels to avoid a sharp drop in global growth. There are no signs of higher growth in Europe and Asia. Growth in Japan is looking weaker, while Chinese growth is moderating.

The main reasons to doubt the 3.5 percent forecast for U.S. growth in 2005 include rising drags from the policy front, which has been highly stimulative over the past several years, and lagged negative effects of higher oil prices that look to be most pronounced during the first half of this year. Average oil prices of late have been about 40 percent higher than they were a year ago, and a substantial rise in average oil prices of that magnitude usually penalizes growth with a lag of six months to a year. Finally, slower global growth adds to the downward pressure on U.S. net exports, which, in turn, has a further depressing effect on growth. Falling exports subtracted about a percentage point from U.S. growth in the final quarter of 2004, taking estimates from 3.5–4 percent down to 2.5–3 percent.

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Examining U.S. Growth

Since December 2001, when the last modest recession officially ended, U.S. growth has averaged 3.3 percent. Even that slightly below-average growth rate has been accomplished only with substantial help from tax cuts and transfers, along with sizeable interest rate reductions that enabled massive contributions to household cash flow from mortgage refinancings. During 2002, when fiscal stimulus and tax cuts were at their strongest, disposable income rose at a 4.7-percent annual rate, far in excess of raw personal income growth, which rose at just a 1.9-percent rate. During 2003 as well, disposable income growth (5.9 percent) exceeded personal income growth (4.9 percent) by a full percentage point.

As a result of the substantial boost to disposable incomes for households from tax cuts and transfers, coupled with a brisk pace of mortgage refinancing, real consumer spending rose by 3.5 percent in 2002—a full percentage point above the 2.5 percent growth rate of real disposable income (household income after taxes and adjusted for inflation). During 2003, the relationship was reversed with real consumption spending at 3.6 percent, 0.7 percent below the 4.3-percent growth rate of real disposable income. Perhaps the sharp dip in stock prices through the first quarter of 2003 accompanied by a deflation scare made households temporarily more cautious about spending. However, during 2004, especially toward the end of the year thanks to rising equity prices and rising home prices, real consumer spending again surged above the growth rate of real disposable income. In the three months ending in November 2004, real

consumer spending was rising at a 3.9-percent annual rate—well in excess of the 2-percent growth rate of real disposable income. If stocks and housing prices stop rising, spending growth will slow toward income growth.

Special Monetary Policy

Monetary policy remained highly accommodative during 2004 despite a 1.25-percent increase in the federal funds rate during the second half of the year. Core consumer price inflation rose in lockstep with the Federal Reserve's increases in the fed funds rate, so that by the end of 2004, the real fed funds rate was still zero. Meanwhile, longer-term interest rates remained low, perhaps signaling slower future growth or lower inflation. (See last month's *Economic Outlook*, "What Determines Interest Rates?")

It is worth noting that during the two-and-a-half years between the end of 2001 and the middle of 2004, the real fed funds rate averaged minus 0.5 percent while real growth averaged 3.3 percent. Moderate growth in the presence of substantial policy stimulus during the recovery phase of a U.S. business cycle raises some serious questions about the level of interest rates that is consistent with long-term U.S. growth. The U.S. economy managed only slightly below trend growth with negative real fed funds rates and substantial fiscal stimulus. While growth during the second half of 2004 has held up well (at about 4 percent) with the real fed funds rate at about zero, the key question for the Fed now is whether another increase of 1 to 2 percentage points (the current consensus range) in the fed funds rate during 2005 will be consistent with sustained trend growth of the U.S. economy.

Consumption

Sustained U.S. consumption growth has been the primary driver of global growth, especially in the traded-goods sector, where excess capacity abounds. The fact that consumption has grown faster than disposable income, as the saving rate has fallen for households, has contributed about a percentage point to growth during the past several years. Positive wealth effects associated with housing and stock prices, together with the benign policy environment, have sustained spending growth in excess of income growth, but it appears that that cycle has come to an end. The U.S. housing market is already showing signs of weakness that may have a negative effect on consumption and consumer confidence. The growth rate of residential construction has decelerated sharply from a 10-percent year-over-year rate to a 1.5-percent annual rate during the three months ending in November 2004.

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A rising stock market since early 2003 helped to sustain consumer confidence and thereby to support spending growth above income growth during 2004. The stock market may encounter more substantial headwinds during 2005. Earnings growth is slowing and the Fed is raising interest rates; that is almost always a recipe for flat-to-lower equity prices.

Growth Outlook for 2005

A look at historical data suggests about a 2.4-percent growth outlook for the U.S. economy in 2005. This conclusion follows from a consideration of each of the components of GDP. The average contribution of consumption growth to overall growth since 1947 has been 2.3 percentage points with a standard deviation of 2.2 percentage points, meaning that two-thirds of the time, consumption growth has contributed between zero and 4.5 percentage points to overall growth. If the removal of heavy stimulus from fiscal and monetary measures coupled with stable to falling stock prices and a weaker housing sector reduces consumption spending by only one-third of the standard deviation, the result would be a 1.6 percentage point contribution from consumption to growth.

Spending by businesses on capital equipment (business fixed investment) contributes an average of 0.5 percentage points to growth, although last year the contribution was about double that because the economy was in a recovery phase and special tax incentives were in place to encourage more rapid investment spending. However, the tax incentives were removed at the end of 2004. Although the contribution to growth from investment could be below average, in the forecast being developed here we shall assume a 0.5 percentage point contribution to growth from business fixed investment.

Growth in housing (called residential investment) contributes an average 0.2 percentage points to growth. One could leave the contribution at that level as an optimistic assumption in view of the Fed's determination to boost interest rates and the slowdown in new mortgages and refinancing activity over the past year.

The other components of growth make little net overall addition. Inventory building, on average, adds about one-tenth of a percentage point. The combination of net exports and the government sector usually makes a zero net contribution to growth. That seems a reasonable assumption for 2005. Net exports are slowing as lower growth abroad produces slowing growth of U.S. exports while, even with a weaker dollar, spending on imports has continued to rise. During the twelve months ending in November, U.S. export growth was 6 percent, down sharply from 15 percent in 2003. U.S. import growth during that same period was about 20 percent—down from 27.8 percent in 2003, but still substantially above the growth rate of exports. Summing up the 2005 growth forecast, 1.6 percentage points of growth from consumption and a total of 0.8 percentage points of growth from business fixed investment, residential investment, and inventories gives an overall growth forecast of 2.4 percent.

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Needless to say, this estimate may not hit the mark exactly, but it is difficult to find a way to stretch the growth rate to 3.5 percent, which is the consensus, without boosting the consumption forecast substantially. Four percent consumption growth would mean that consumption was going to contribute about 2.7 percentage points to overall growth, and that would achieve the 3.5 percent growth forecast. But it is hard to imagine why consumption should make an above-average contribution to growth during a period when overall wealth may be static to falling, interest rates are rising, and households may be inclined to make modest increases in savings in the absence of tax cuts, transfers, and the benefits of refinancing. Beyond that, there may be downside risks from a fall in net exports as global growth slows and a fall in government spending growth as the Bush administration attempts to reduce future budget deficits. Already, the fiscal year 2005 budget deficit is running at a rate about $30 billion below last year's deficit.

Even without a downward drag from slower U.S. growth, the global economy looks set to slow during 2005. The Organization for Economic Co-operation and Development's (OECD) leading economic indicators have dropped sharply, as have leading indicators in Germany and parts of Asia. There are signs that the Chinese economy is slowing, Baltic freight rates are falling, commodity prices are weak, and credit growth within China is slowing. It is typical to see a surge in exports in China as the economy slows, driven by an attempt to cushion growth with stronger net exports. Indeed, China's efforts to avoid overheating have depressed its domestic sector. The surge in Chinese exports and a sharp decline in imports during the second half of 2004 suggest that China may be resorting to a mercantilist stance in order to increase the contribution from its traded-goods sector to overall growth. A rise in trade tensions and increasing pressure for the Chinese currency to float may result.

In a world that has essentially been driven by U.S. demand growth, a slowdown in U.S. consumption will add to the global slowdown and produce negative feedback effects, especially on export-driven economies such as Germany, Japan, and China. Consistent with that theme, the currencies of commodity-driven economies like those of Australia and Canada have weakened sharply as the outlook for growth in those countries has dropped. More broadly, less demand growth in a world with excess capacity in the traded-goods sector may produce increasing trade tensions during 2005.

Monetary Policy, Financial Markets, and Growth

The response of the U.K. economy to persistent tightening by the Bank of England may provide a glimpse of the future for the U.S. economy. The Bank of England's persistent rate increases totaling about 125 basis points from mid-2003 to mid-2004 have left its policy interest rate at 4.75 percent, far above the level of U.S. rates both in nominal and real terms. Currently, the nominal U.S. fed funds rate is 2.25 percent. The U.K's tighter monetary policy has burst the U.K. housing bubble, with the result that consumption growth and overall growth have slowed and the currency has begun to weaken. Of course there is one big difference between a U.K. slowdown and a U.S. slowdown. The U.K. economy can slow considerably without major global consequences while the U.S. economy cannot.

It is also important to understand that the U.S. Federal Reserve does not share the outlook of a slowing U.S. economy—quite the contrary. The Fed staff seems

convinced that U.S. growth will continue at about a 4-percent pace during 2005, thereby permitting continued rate increases. Some Fed members have even expressed concern that the Fed should stop telegraphing the pace of Fed rate increases and perhaps contemplate instead introducing to the market the possibility that the pace of rate increases could accelerate at some point. Such a change could produce a noticeable impact on financial markets and the housing sector. In any case, the Fed is firmly on a tightening path with the risk being that it will overtighten and be forced to backpedal if negative consequences appear suddenly.

A falling dollar in a world where growth is slowing results in a double negative impact on export-oriented economies in Asia and Europe.

Usually, when the Fed is tightening while economic growth is actually slowing, the pressure on weaker economies shows up first. Specifically, the Fed's tightening policy aimed at its perception of a robust U.S. economy may produce a substantial negative effect on emerging markets and perhaps even in export-supported advanced economies. The Fed tightening during 1994 negatively impacted Mexico, which resulted in a slowdown in the pace of tightening. Japan's less accommodative monetary and fiscal stance in 1997 helped to trigger the Asian crisis, as Japanese banks refused to roll over short-term loans to overextended borrowers in nearby emerging markets.

There are probably some parallels with the past embedded in financial markets today. 2004 was characterized by substantial compression of yield spreads, suggesting that market participants were more heedless than usual of normal risks as they pursued higher rates of return. As spreads have narrowed, the Fed's, so far, highly predictable stance on the course of monetary policy has emboldened some market players to increase leverage in order to maintain high rates of return. If the Fed continues to tighten as expected during 2005, a slowing of the U.S. and global economy will increase the risk that some "accident" may occur in financial markets before the real economy slows and causes the Fed to pause in its tightening path.

What to Expect in the Markets

This outlook for the economy and financial markets suggests that many of the themes that drove markets in 2004 will no longer be present this year. Compression of risk spreads will probably cease and reverse as yield curves flatten while the Fed tightens. Subsequently, yield curves may become steeper again if the Fed has to reverse its tightening stance rapidly in the face of a financial accident or a sharp slowdown in the U.S. or global economy. Stocks will struggle with higher interest rates, slower economic growth, and falling earnings growth. Once again, as in 2004 (at least during the early part of the year) bonds may outperform equities as longer-term rates are stable or slightly down in the face of a tightening Fed, slowing growth, and poor performance in competing asset markets like equities and lower quality debt.

Currencies are problematic in a slowing global economy. The slowing U.S. economy with a weakening housing sector and weakening stock prices would normally produce a weaker dollar. Indeed, this will probably be the case, especially relative to the currencies of Asian countries whose rapid reserve accumulation and relative strength in traded-goods sectors signal substantial undervaluation. If the Fed's tightening stance results in slower U.S. growth that, in turn, increases the pressure for Asian countries to artificially support their currencies, the incipient move in the dollar against those currencies will continue to be downward. Of course a falling dollar in a world where growth is slowing results in a double negative impact on export-oriented economies in Asia and Europe. The only way to turn slower U.S. demand growth into a positive-sum game would be for policymakers abroad to pursue measures that sharply boost the growth of domestic demand. That seems unlikely at present.

The upcoming meeting of G7 finance ministers in London on February 4 and 5 will probably produce a statement that calls for faster growth outside the United States and lower U.S. current account and budget deficits. Unfortunately, given the stubborn refusal of foreign governments to stimulate their economies other than through undervalued currencies, the result may be a reduction in the U.S. current account deficit the old-fashioned way, through a U.S. recession. This unpleasant possibility may lead the U.S. to press for further currency realignment—meaning, in effect, a weaker dollar—at the G7 meeting.

Now, that would make for an interesting meeting.

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