The U.S. Economy in 2006:
Mixed Signals

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The U.S. economy grew at a moderate pace in 2006, despite slowdowns in the housing market and manufacturing industries. Strengths included stock market gains and low unemployment. In this article, I discuss the economic events of 2006 and their implications for 2007. I am cautiously optimistic that the economy will continue to grow at moderate rates into 2007.

Introduction

The economy was filled with mixed signals throughout 2006. Although bad news in the housing market and manufacturing industries (particularly the auto industry) filled the headlines, the stock market saw large gains in the second half of the year, unemployment remained low, and falling gas prices helped maintain consumer spending in the face of falling housing wealth.

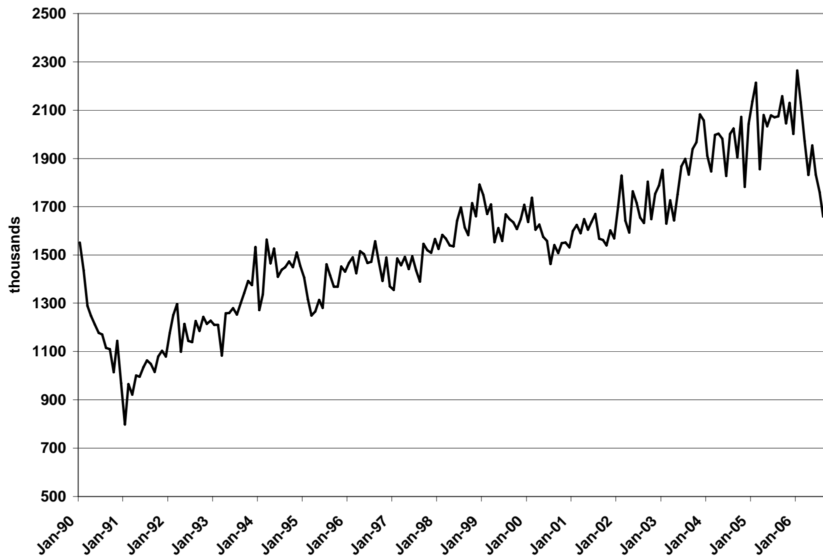
In addition, GDP growth was quite volatile over the first three quarters of 2006, sending further mixed signals. In the first quarter, GDP growth as estimated by the Bureau of Economic Analysis was at a remarkably healthy 5.6% annual rate, seasonally adjusted – quite a dramatic increase over the 1.8% growth of the fourth quarter of 2005. In the second quarter, growth in real GDP slowed to a 2.6% annual rate, due largely to a slowing of personal consumption and exports and a large decrease in residential fixed investment. The slowing continued somewhat in the third quarter, in which growth was estimated at 2.2%, although this was significantly above the advance estimate (released in October) of 1.6%. (If the advance estimate of 1.6% had held, it would have been the slowest growth rate in over three years.) The continued deceleration, although smaller than anticipated, was due mainly to a continued decrease in residential fixed investment and increased imports. In October, the Bush administration lowered its official forecast for GDP growth to 3.1% in 2006 and 2.9% in 2007. The forecasts in June had been significantly higher, at 3.6% and 3.3%, respectively.

First, the Bad News, Part 1: the Housing Market

The slowdown in the housing market was one of the biggest stories in the U.S. economy in 2006. After several years of rapidly appreciating home prices, particularly in parts of the South and West, sales stagnated for both new and existing homes. Industry analysts expect both markets to be down overall for the year, with existing home sales predicted to fall by 9% and new home sales to fall by 17%. In the market for existing homes, the number of homes for sale nationwide increased from 2.8 million in September 2005 to 3.7 million in September 2006, indicating a large increase in the average time to sell a property. The situation is unlikely to improve quickly, since housing starts (the number of residential units on which actual construction – not permits – began during the period) fell by 27% over the year ending in October 2006, which is the largest one-year decline since March 1991. Figure 1 illustrates both of these sharp drops in housing starts (monthly data at a seasonally-adjusted annual rate), as well as the fairly steady upward trend between 1991 and 2005.

The general consensus seems to be that the housing market peaked in August 2005, although with only a few exceptions, most local markets have seen only slight decreases in median prices. According to the National Association of Realtors, the median price of an existing home sold in October 2006 was $221,000, a drop of 3.5% since October 2005. This was a record decrease, and significantly larger than the previous record of 2.1% in November 1990.

Figure 1: Housing Starts



Seasonally adjusted, annual rate. Data source: U.S. Census

The record high median price of $230,000 was reached in July 2005, and the current median is only 4% below that level. This moderate decrease suggests that – at least so far – there is no evidence that there was a national "housing bubble," (a "bubble" is said to occur when increases in housing prices are due purely to speculation and unrelated to fundamentals).

The underlying reasons for the housing slowdown are hard to pinpoint. Realtors are inclined to blame the media for highlighting the slowdown and referring to a housing market bubble, leading consumers to be more cautious. Although interest rates have increased fairly rapidly – the Federal Reserve's interest rate target has increased from 2.5% in February 2005 to 5.25% today (a target set in June 2006) – mortgage rates are still near 45-year lows. Figure 2 shows average interest rates on 30-year conventional mortgages (the most commonly held mortgage). After a sharp increase in the late 1970s and early 1980s, the trend has been steadily downward, and the increase over the last year or so still leaves mortgage rates very low by historical standards.

Although many economists believe that the worst of the housing slowdown is over – indeed, the number of homes sold in November increased by 0.5% – the effects on the economy may continue for some time. In early October, Federal Reserve Chairman Ben Bernanke referred to the "substantial correction" occurring in the housing market, and predicted that the slowdown would continue to hurt the economy into the early part of 2007.

The most direct effect of a weak housing market on the economy is through reduced employment in the construction industry and associated suppliers (including the real estate and mortgage industries); construction (including non-residential construction) accounts for nearly 10% of U.S. GDP. In addition, changes in housing wealth have implications for consumption, since housing wealth constitutes a significant part of the average American's holdings of wealth. Although housing is an illiquid form of wealth, people can access that wealth fairly easily through instruments like home

Figure 2: 30-Year Conventional Mortgage Rate

Data source: Federal Reserve Bank of St. Louis

equity loans and mortgage refinancing. As a result, the decrease in housing wealth (as well as the associated reduction in perceived liquidity, as people come to believe that it would take longer to sell their home) has implications for consumption. Several recent studies find evidence that the effect of a change in housing wealth on consumption is significantly higher than a change in stock market wealth (see, for example, Case, Quigley and Shiller (2005)).

The Bad News, Part 2: Autos and Manufacturing

Demand for durable goods – large-ticket items expected to last for at least three years – plunged in October by 8.3%, according to the Commerce Department. Although this is the largest decline since July 2000, it partly reflects a significant decrease in commercial airplane orders, which had tripled in September, allowing for an 8.7% increase in that month. (Commercial aircraft orders, of course, are very volatile from month to month.) Durable goods orders have either fallen or remained essentially unchanged since July 2006, except in September. Excluding transportation, durable goods orders fell by 1.7% in October.

Both Ford and General Motors have continued to struggle this year. By the end of November, Ford had already lost approximately $7 billion in 2006, and forecasts a loss of around $10 billion on the year as a whole (and expects to lose $17 billion more over 2007-2009); GM lost over $10 billion in 2005. By 2007, manufacturing employment at domestic auto companies' plants is expected to be 130,000 less than in 2003. Ford's "Way Forward" plan called for 14 plants to be closed, and a reduction of 30,000 workers (38,000 had accepted buyouts by November). GM, whose reduction in the workforce began earlier than Ford's, has announced that 35,000 U.S. workers – nearly one-third of its hourly paid workers – have accepted their buyout options, and is in the process of closing 12 North American plants.

Now for the Good News, Part 1: The Stock Market

One of the bright spots in the second half of the year was the stock market. In October, the Dow Jones Industrial Average (DJIA) reached its previous closing high of 11,750.28 (set in January 2000), and quickly surged past 12,000 with a string of record-setting closes. The DJIA began the year at 10,739.75, and climbed over 11,600 in May before falling back to levels seen earlier in the year in June and July. In mid-July, however, the average began its climb upward to record levels.

Other widely followed indices – the more broad-based S&P 500 and the NASDAQ composite – were both up approximately 10% for the year, although (as of the end of November) the S&P 500 was more than 10% below its March 2000 record, while the NASDAQ composite was more than 50% below its March 2000 peak.

The Good News, Part 2: Unemployment

In other positive news, the unemployment rate has trended downward for some time. After remaining at over 5% from September 2001 through November 2005, the national unemployment rate has stayed consistently below 5% since then, ending at 4.4% in October 2006. This continues a downward trend since the unemployment rate hit 6.3% in June 2003. However, even here the news was somewhat mixed: at the end of November, new claims for unemployment benefits rose by 34,000 when they were expected to fall by 9,000. As of press time, it was unclear whether this was a random fluctuation or indicative of a trend upward in unemployment, perhaps due to layoffs in construction and manufacturing industries.

Interestingly, labor force participation rates have also fallen since 2001, after increasing fairly steadily since 1965, although not by enough to explain the decrease in unemployment rates (someone who is not actively looking for a job is considered to be not participating in the labor market, and so is not considered unemployed). Although the decrease in labor force participation has been small – the rate in October was 66.2%, relative to a peak of 67.2% in March 2001 – the rate has not risen above 66.5% since November 2002. Economists attribute this to primarily three reasons: (1) the aging of the population – although the oldest baby boomers have not (quite) reached official retirement age, and they are working more than earlier generations after age 55, labor force participation is generally lower among older workers; (2) the increase in women entering the labor force has slowed, and the

percentage of women working has actually decreased slightly from its peak in 1999; and (3) the employment rate of teenagers (age 16-19) has fallen dramatically. The percentage of teenagers working has fallen by approximately ten percentage points since the 1990s (from over 50% to slightly more than 40%).

Aaronson et al. (2006) suggest that these are structural changes, and that the trends are likely to continue (with the possible exception of the baby boom generation, whose labor force participation rate is hard to predict). Lower labor force participation rates could have effects on potential GDP growth (the growth rate at which output can expand without increasing inflation), as a reduced workforce would put upward pressure on wages.

The Good News, Part 3: Fuel Prices

By the end of November, the national average price of a gallon of regular gas stood at $2.24, almost exactly the level as of January 2006. Gas prices had remained elevated from April through the summer, and peaked at an average price of over $3.00 during August. Although the sustained high gas prices have had some effect on consumer behavior (for example, high gas prices are one of the most common explanations for the U.S. automakers' recent troubles, since Japanese and European cars tend to be more fuel-efficient than American ones), the decrease in gas prices since the summer months is also credited with reviving consumer spending during the fall months, and taking some of the edge off of concerns about overall inflation. On average, 3.6% of an American household's budget goes to gas and oil, a figure that has been remarkably constant for decades (Cambridge Energy Research Associates).

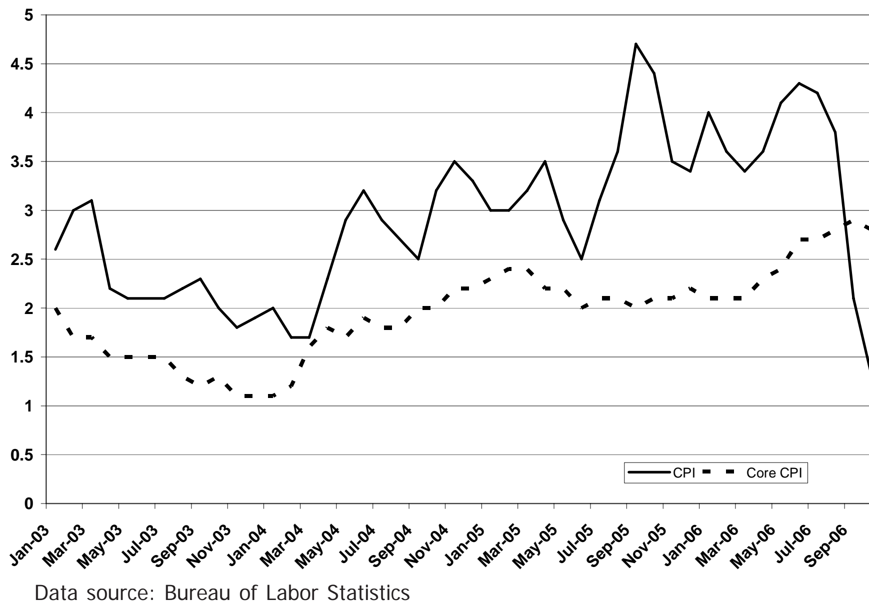
The Trade Deficit and the Value of the Dollar

One aspect of the macroeconomy that has multiple implications for the economy's overall performance in 2007 is our international position with respect to international trade, net foreign investment, and the value of the dollar. The (monthly) international trade deficit on goods and services decreased to $64.3 billion in September 2006, after reaching a record high of $69.0 billion in August, while the much-discussed deficit against China constitutes $23 billion of that. This large trade deficit has contributed to the falling value of the dollar: by the end of November, the dollar had fallen against the euro to a 20-month low of $1.318 per euro (in January, it traded at $1.198 per euro). The depreciating dollar is largely due to concerns about the size of the trade deficit: such a large trade deficit is sustainable only as long as foreigners are willing to purchase U.S. assets. When a country runs a trade deficit – importing more goods and services than it exports – it must sell domestic assets to foreigners to finance the difference. As long as foreigners are willing to purchase assets (real estate, financial assets, etc.), this also allows the country running the trade deficit to have investment higher than its domestic savings levels, allowing for increased economic growth. Investment financed by foreigners has benefited the U.S. tremendously over the last few decades, allowing for higher rates of investment and economic growth than would otherwise be possible given very low U.S. savings rates (a combination of high federal budget deficits and low personal savings rates). The falling dollar will, of course, have feedback effects into the trade deficit: as the dollar decreases in value, our exports become cheaper and imports become more expensive to us, which should reduce the size of the trade deficit. Reducing the trade deficit will also force the amount of net foreign investment to decrease.

Inflation

On the inflation front, the Federal Reserve aggressively raised its interest rate target from 2.5% in February 2005 to 5.25% in June 2006. Since then, the Fed has not made any changes, although members of the Federal Open Market Committee have continued to hint that they are carefully watching for signs of increasing inflation. Statements toward the end of the year by Federal Reserve Chairman Ben Bernanke suggest that he will continue to monitor inflation, even if GDP growth slows further. In late November, Bernanke stated that the risks to inflation were "primarily to the upside," causing second thoughts among the many Fed watchers whose predictions were that the Fed's next move would be a rate *cut* sometime in early 2007.

Although overall inflation has moderated as energy prices have decreased since the summer, core inflation (which excludes food and energy prices) has remained relatively high. Figure 3 shows both measures as 12-month changes. The solid line represents the overall CPI, while dashed line is the



Data source: Bureau of Labor Statistics

core CPI. Note that the large drop in the CPI in September and October of this year primarily reflects the high levels following Hurricane Katrina in those months of 2005, due largely to significant increases in fuel prices.

Housing costs make up nearly 40% of the core CPI, so one might expect that the cooling housing market would provide a damper on inflation. Paradoxically, the opposite seems to be true. Because of concerns about the housing market, increasing numbers of people are choosing to rent their homes instead of purchase them. This increased rental demand has driven up rents. In the construction of the CPI, the cost of housing to people who own their homes is imputed from rents on comparable properties. Although the actual cost of housing has not generally changed, the imputed rent has actually increased. Some have argued that imputed rent should be dropped from the CPI calculations because of this sort of statistical anomaly (indeed, European governments have done this), but such a significant change in the computation of the CPI would not be taken lightly.

Outlook for 2007

In short, the economy looks to continue on a path of relatively low – but not negative – growth into 2007. The Democrats newly in control of the U.S. Congress are unlikely to make drastic changes to economic policy: the most high profile economic legislation will likely be an increase in the federal minimum wage to $7.25, which incoming House Speaker Nancy Pelosi has vowed will be passed within the first 100 hours of the Democrats taking office in January. (The current federal minimum wage of $5.15 was established in 1997, although many states have higher minimum wages.) The higher minimum wage is unlikely to have a significant overall impact on wage costs or prices, as only about 5% of the U.S. labor force is directly affected by the minimum wage. In other legislation with economic ramifications, the Democrats are likely to be more protectionist with respect to trade policy, and to try to target tax cuts more at the middle class. They have also made fiscal responsibility part of their campaign platform, although many of their proposals would be expensive, and it is not clear how revenue would be raised to fund them without increasing the budget deficit. Divided governments, however, are often effective at introducing some discipline into the budget process. At any rate, the Democrats assuming control of Congress in January is unlikely to cause a significant change in course to the U.S. economy.

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