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U.S. Slowdown: Self-Correcting or Self-Reinforcing?

By John H. Makin

The U.S. economy has slowed to a level below its trend growth rate during the second half of 2006. Trend growth, the rate that can be sustained over time without rising inflation, is probably about 3 percent, having been reduced by a quarter of a percentage point by weaker productivity data. As has often been the case over the past five years, the slowdown itself has set into motion market adjustments that may mitigate or even reverse it. Since August, interest rates on benchmark ten-year treasuries have dropped by about 60 basis points. That reduction, coupled with a stock market that is rising in part because of lower interest rates, has caused an easing of financial conditions equal to nearly 100 basis points since late June on the Goldman Sachs Financial Conditions Index. Meanwhile, since August, the price of oil has dropped by about $18 per barrel—which, if sustained, would be enough to add about 0.7 percentage points to U.S. growth over the next year.

Self-Correcting Forces

The U.S. economy's capacity for self-correction, whereby a slowdown of the real economy creates financial conditions that support an economic rebound, has been in no small part responsible for its remarkable resilience—especially over the last half-decade. Shocks such as the September 11 attacks on New York and Washington, D.C.; the persistence of higher oil prices; and the devastating Hurricane Katrina in August 2005 have all failed to depress U.S. growth for more than a quarter, after which, a sharp rebound has usually occurred.

John H. Makin (jmakin@aei.org) is a visiting scholar at AEI.

Sometimes even a crisis has not slowed U.S. growth. The economy grew at a 5.5 percent annual rate during the second half of 1998 as the Russian debt crisis and the Long-Term Capital Management collapse were unfolding. More broadly, the reduced variability of U.S. growth since 2001 is evidence of either more self-correcting forces in the U.S. economy, better macro policy implementation or, more likely, both. Since December 2001, growth has averaged 3.1 percent with a standard deviation of 1.6 percent. For the postwar period as a whole, from 1947 to the present, the figures are 3.5 percent and 4.1 percent.

Market forces adjust prices of financial assets in a way that produces countercyclical movements in aggregate demand: slower GDP growth leads to lower interest rates that, in turn, boost demand growth, causing GDP growth to revive. Those market forces have not operated alone; monetary and fiscal policy have also helped to stabilize U.S. growth. The Federal Reserve eased by 75 basis points during the eight weeks following September 29, 1998, as the Russian debt crisis and the implosion of Long-Term Capital Management unfolded, including a 25 basis-point inter-meeting move that underscored the Fed's commitment to avoid systemic risk after Long-Term Capital Management collapsed. The fed funds rate was cut in half from 3.5 percent to 1.75 percent over three months following the September 11 attacks, including a 50 basis-point inter-meeting cut on September 17. The sharp rate cuts helped consumption to grow at a 7 percent annual rate during the fourth quarter of 2001. During the same quarter, government spending contributed 1.5 percentage points to growth, three times the average boost.

Now, in 2006, the Fed is hoping growth will slow below trend—2 percent would be nice—in order to lower core inflation. However, it has been difficult for the Fed to engineer tighter financial conditions. The Fed boosted the fed funds rate by 425 basis points between June 2004 and June 2006, yet financial conditions remained broadly accommodative. The yield on the benchmark ten-year Treasury note stood at about 4.75 percent at the end of June 2004—almost exactly where it stands today. The real yield (adjusted for inflation) is about 2.4 percent today, very close to its June 2004 level. The real ten-year yield actually fell below 2 percent during the year following July 2004.

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Financial Conditions Still Boosting Growth

Financial-market activity has been highly unusual over the last few months. Since August, ten-year yields have dropped about 50 basis points from 5.25 percent to 4.75 percent with the Fed holding its target for the federal funds rate at 5.25 percent. Stocks have rallied. The S&P Index has risen by nearly 9 percent since its mid-July lows. Meanwhile, core inflation has drifted higher to a 2.5 percent year-over-year rate for the Fed's favorite inflation index (the Personal Consumption Expenditures deflator) and the unemployment rate has held steady at 4.6 percent to 4.7 percent, its low for this cycle. Labor markets are tight, core inflation is drifting higher, and markets are betting on the Fed to cut rates by about 50 basis points during 2007. While lower energy prices have helped to assuage inflation fears, they cannot provide the whole explanation because the move to lower interest rates began in July, before energy prices fell.

As we enter the fourth quarter of 2006, the economy's self-correcting mechanism is easing financial conditions and mitigating the drag from an intensifying slowdown in the housing sector, even though the Fed has signaled that it may continue to raise the fed funds rate if inflation persists. The operation of those opposing forces has created considerable uncertainty about the outlook for U.S. growth. After a weak August, core retail sales (excluding autos and cheaper gasoline) rose at a healthy annualized rate of 7.2 percent during the three months ending in September. Weekly purchase and refinancing data for the housing sector suggest some rebound in mortgage activity and home buying, but it is too soon to discern a trend. Manufacturing surveys are mixed, but the broadest survey, the Institute for Supply Management survey, suggests a slowing of growth in the U.S. manufacturing sector, but not an outright fall in activity. The Fed's October 12 Beige Book economic survey reported signs of resilience in retail spending despite weakness in the housing sector. Further complicating the outlook, September employment was reportedly up only 51,000, but simultaneously, data through March 2006 showed that payrolls expanded at an average of 236,000 per month in the year through March, during which GDP grew at a 3.75 percent rate. Still, over the last six months, employment has grown at only 118,000 jobs held per month while GDP has probably grown at about a 2.5 percent annual rate. The economy and employment growth have slowed, but the results have been lower interest rates and a stock market rally driven by those lower interest rates that may sustain future growth. Lower oil prices are also linked to a slowdown in demand growth.

Housing Depresses Growth

The self-reinforcing part of the slowdown is clearly centered on the housing sector and its impact on residential construction activity and consumption. An acceleration in the slowdown already underway in housing construction represents a drag on second-half U.S. growth of about 1 percentage point, up from earlier estimates of a drag of about half a percentage point. Falling home prices may also negatively affect consumption, adding to the drag on growth. The median price of existing U.S. homes declined on a year-over-year basis for the first time during August.

The notion that the slowdown may be self-reinforcing is underscored by the fact that actual weakness in the housing sector is probably more pronounced than the official data suggest. New home sales have been overstated because of a rise in the cancellations of sales contracts as market conditions have deteriorated. (Cancellations are not subtracted from official home sales data.) Beyond that, even the falling U.S. home prices we see are upwardly biased because they do not accurately reflect the prices of actual transactions, nor do

they allow for price reductions necessary to sell new homes on which original contracts to purchase have been cancelled.

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The other self-reinforcing danger in the slowdown lies with inflation data. Core inflation rates at 2.5 percent to nearly 3 percent on a year-over-year basis are above the Fed's comfort zone of 2 percent. Fed speakers including Chairman Ben Bernanke and Vice Chairman Donald Kohn have cautioned the markets that the current assumption of cuts in the fed funds rate during the first half of 2007 may be too optimistic. The Fed's models call for growth below trend for at least a year before core year-over-year inflation rates would move back down to the top of the target range of about 2 percent.

Financial markets, probably with some justification, are confident that as long as growth is below trend and possibly slowing further, the Fed will not raise interest rates. Under those conditions, and as the risks of slower growth and higher unemployment increase while substantially lower oil prices reduce headline inflation and expected core inflation, the Fed may even be inclined to cut rates. Beyond that, any financial accident tied to the housing slowdown or other economic weakness that caused widespread financial distress could prompt the Fed to ease rates based on the notion of "systemic risk" cited by the Fed in easings after the 1998 failure of Long-Term Capital Management and the turmoil in the post–September 11 period.

Shifting Balance on Growth Outlook

The balance between self-correcting and self-reinforcing slowdowns appears recently to have shifted slightly in the direction of self-correcting. As already noted, signs of a modest uptick in September retail sales and increased activity in the mortgage market, along with stabilization of initial unemployment claims, may have lifted the outlook for growth over the balance of the year. The picture is somewhat clouded, however, by the employment data for September, which included large revisions to earlier employment growth—resulting in an unusually weak number for September—along with a contradictory drop in the unemployment rate based upon a separate survey used to calculate that figure. The lower unemployment rate and the tight labor market it signals along with low unemployment claims will likely reduce the Fed's inclination to ease.

Paradoxically, the recent appearance of signs that the improving financial conditions were helping to stabilize the economy may mean that financial conditions stop improving. Any sign that the economy is stabilizing at slightly below trend growth will reinforce the Fed's disinclination to cut rates in 2007. That, in turn, will cause interest rates to rise and may even negatively impact equity prices. The Fed signaled its concern that further rate increases may be needed during 2007 in the minutes of its September 20 meeting that were released on October 11.

What then is the likely outlook over the next year? Will self-correcting or self-reinforcing economic slowdown forces dominate? The two opposing forces have to remain about balanced with a tilt toward a self-reinforcing slowdown to validate the market's current assessment that the Fed will start easing during the first half of 2007. Perhaps the most likely outcome will see growth oscillate gently around an underlying negative trend tied to a persistent drag from the housing sector. In the very short run, self-correcting forces may support spending enough to cause interest rates to rise perhaps by 25 or 30 basis points in the near future. The same forces will probably support equity prices at about current levels or slightly higher, even as interest rates rise modestly.

Modestly higher interest rates will, however, slow the self-correcting forces operating on the economy to a point where the housing sector slowdown will become a heavier drag on growth. If a 1 percent growth rate appears on the horizon (perhaps early in 2007), interest rates will fall again as the need for further Fed easing becomes obvious. In short, the self-correcting scenario must not become too successful because that would invalidate the notion of easing that is currently supporting financial markets and the economy.

A Cybernetic Economy?

The moving balance between the self-correcting and self-reinforcing slowdown scenarios suggests a self-regulating, almost cybernetic, economy in which the path of growth oscillates around an underlying trend. During 2006, the underlying trend growth rate has shifted from about 3.5 percent downward toward 2 percent. That change is a desired result of the Federal Reserve's effort to slow growth in order to return core inflation to its "comfort zone" of one to two percent.

Markets for fixed-income investments and stocks will continue to respond positively to progress along the slower growth path if and until easier financial conditions boost expected growth and threaten higher inflation. If the upward growth oscillation that results is too intense (at or above 3 percent trend), the Fed will tighten further (about a 15 percent chance). Alternatively, if growth stays below trend, the Fed will wait patiently for a drop in core inflation (about a 60 percent chance). If growth drops below one percent due to a powerful negative impact on demand growth from a sharp drop in house prices (about a 25 percent chance), the Fed will reduce interest rates as currently expected (50–75 basis points during 2007).

Notwithstanding the Fed's desire to caution markets that further rate increases may be needed or at least that expected rate cuts may not materialize, financial conditions remain broadly accommodative. The signs are pervasive. Plenty of liquidity is available to support financial asset markets with stocks rising and real interest rates remaining low. Risk spreads are narrowing again, and large-scale buyouts are moving forward at an accelerating pace, fueled by cheap money.

It is possible that the Fed's policy stance aimed at cushioning the negative impact on growth of the housing sector slowdown will still support rising prices for financial assets. Bank of England governor Mervyn King suggested in January of this year that monetary policy settings for equilibrium of the real economy may be too easy for financial asset markets and thereby, ultimately destabilizing.[1] If that condition sustains demand growth at a level that causes a continued rise in core inflation, the Fed will face a difficult choice between further harming the weakening housing sector with a rate increase and letting core inflation rise further above the comfort zone. Such a difficult choice may not arise until early 2007, but virtually all members of the Fed's rate-setting Open Market Committee have made it clear that their response to persistent inflation will be to raise interest rates again. The balance of 2006 will be an especially interesting time to keep a close eye on the heretofore cybernetic U.S. economy.

Note

1. John H. Makin, "Bond Market Bubble?" *Economic Outlook* (February 2006), available at www.aei.org/publication23794/.