



## Recession in 2007?

By John H. Makin

To the dismay and amazement of optimistic market players, not to mention Federal Reserve chairman Ben Bernanke, early in March former Fed chairman Alan Greenspan publicly assessed the probability of a recession this year to be one in three. This was a shock to those who had been carefully avoiding use of the “r word” while intensifying problems in the subprime mortgage market heralded the news that the housing correction, which had been declared “over” in January, was instead moving into a second, more intense, and unpleasant phase. Weaker investment (capital spending was actually a drag on fourth quarter growth) and an 8.7 percent drop in January durable goods orders further undercut hope for sustained general growth. The Fed’s own economic outlook has looked to firmer capital spending as part of an economic recovery scenario.

Greenspan’s recession comment, like most well-targeted insults, was made all the more unwelcome by its accuracy. He might even have been a little too optimistic. His bold prognosis opened the floodgates for the use of the “r word.” By Sunday, March 11, the *New York Times* saw fit to feature on page one, above the fold, an article about the rapidly spreading problems in the subprime sector. (For analysis of those problems, see last month’s *Economic Outlook*, “Risk and Return in Subprime Mortgages.”)

Especially awkward for the Fed, and perhaps discomforting to Chairman Bernanke, is its current—and appropriate—policy stance, whereby it declares itself to be more concerned about inflation pressures than about slower growth. Unfortunately, the

inflation pressures have not abated as growth has slowed, and the Fed is probably not yet prepared to abandon its forecast of gradually strengthening growth. At the very least, Bernanke can blame Greenspan for unhelpful comments at an awkward time should the U.S. slip into a 2007 recession. Bad luck always plays a role in bad outcomes.

### Growth Is Weak and Falling

As spring arrives, it is important to look objectively at the recent path of the U.S. economy and at its likely path in 2007. Although largely unnoticed, growth has been quite weak, at just over 2 percent, and looks likely to drop close to 1 percent in the first half of this year. Such a loss of momentum makes the economy more vulnerable to a recession in the second half of the year.

U.S. growth averaged 2.1 percent at an annual rate over the second half of 2006. Sustained consumption growth was the mainstay supporting that modest, overall rate, which was well below the average 3.1 percent rate in 2005 and early 2006. Continued income and wealth gains supported consumption. Residential investment subtracted 1.2 percentage points from growth during the second half of 2006, accounting for the bulk of the growth shortfall.

It is not difficult to make a case for a growth rate of about 1 percent during the first half of 2007. Even if we posit that consumption continues to grow at 3 percent (an optimistic assumption, as weaker equity prices and continued falling home prices suggest an end to wealth gains), that pace produces only 2 percentage points of growth, since

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consumption is two-thirds of the economy. If the housing sector continues to subtract a percentage point from growth, as seems likely given the recent intensification of the housing slowdown, the net impact leaves 1 percentage point of GDP growth. Any move above that would have to come from stronger business fixed investment, inventory investment, a rise in net exports, or stronger government spending.

Business fixed investment has been supported by outlays on nonresidential structures (commercial real estate) and equipment and software. However, equipment and software spending weakened in the fourth quarter, falling at a 3.1 percent annual rate. Nonresidential investment tends to weaken with a lag behind residential investment and so may not provide much support to the business-fixed-investment category. A near-zero impact of investment on GDP growth in the first half of the year looks most likely. The remaining categories—inventories, net exports, and government spending—taken altogether are unlikely to contribute more than 0.2 percentage points to growth.

Granting that consumption growth holds up and continues to contribute 2 percentage points to growth, the drag from housing and weaker investment, together with all the other categories, puts the expected growth rate in the first half of 2007 at 1.2 percent. Following on 2.1 percent growth during the second half of 2006, such a modest growth rate creates substantial risks for a further slowdown in the second half of this year. If weaker housing and static-to-weaker stock prices are accompanied by weakening employment growth, the risks of a second-half recession rise above 50 percent.

U.S. employment growth has supported the income growth and the confidence that helped substantially to contribute to sustained consumption growth over the second half of 2006. There are signs, however, that employment growth is slowing. During 2006, employment grew at an average monthly rate of 189,000. During the first two months of 2007, monthly employment growth averaged 122,000, with the year-over-year growth rate of employment dropping from 1.78 percent on average over the past twelve months to 1.49 percent. The February employment increase of 97,000 was down sharply from the 146,000 in January and 226,000 in December. Although the February unemployment rate fell to 4.5 percent from 4.6 in January, the decrease was due to a sharp reduction in

the labor force, which effectively boosted the employment rate or equivalently reduced the unemployment rate. Employment is, of course, a lagging indicator and its loss of momentum early in 2007 probably reflects the modest 2.1 percent GDP growth rate during the second half of 2006.

## Stock Prices May Fall Further

The sharp rise in market volatility that arrived late in February was accompanied by a drop in equity prices that more than wiped out the gains seen during the first seven weeks of 2007 while the upward trend in equities that began last summer was continuing. There are sound fundamental reasons for U.S. equity prices to weaken further in 2007. Nominal growth

of GDP, the growth of the total current dollar value of U.S. goods and services from which profits must be extracted, has slowed sharply. Nominal GDP growth rose at a 3.9 percent annual rate during the fourth quarter—down considerably from the average growth rate of over 6 percent during the previous two years. The more significant year-over-year nominal growth rate of GDP will probably drop to well below 5 percent during the first quarter of 2007, a level usually associated with flat to falling profits.

The strong growth of productivity that has helped contain labor costs since 1995 has begun to fall and is thereby placing upward pressure on unit labor costs. Unit labor costs are defined as the growth of real wages less the growth of productivity, and they measure the negative pressure on corporate profits arising from higher payments to labor. Over the second half of 2006, year-over-year productivity growth slipped to about 1.3 percent—half of the five-year average. Consequently, unit labor costs grew at a 3 percent rate—double the five-year average increase of 1.5 percent.

A combination of falling nominal GDP growth and rising unit labor costs will sharply depress the growth of profits during the first half of 2007. If unit labor costs continue to rise at a 3 percent annual rate, with nominal GDP growth at about 4.5 percent, profits growth will probably turn negative in the second half of 2007. This change would represent a sharp turnaround from the spectacular growth of corporate profits (after inventory evaluation adjustments and capital consumption adjustments) at an average rate of well over 20 percent in the

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middle of 2006. Profit growth forecasts have already begun to be revised down as growth slows early in 2007, but no analysts have yet suggested the possibility of negative profits growth later in the year. Rather, the current expectation, along with the Fed forecast, is for profits growth to recover in the second half of 2007.

## The Fed's Dilemma

The outlook for continued slowing of growth during the first half of 2007 and the rising possibility of recession in the second half of the year conflict with the Fed's call for moderate growth followed by a pickup in the second half. Growth has moderated as the Fed expected, but inflation has not. As a result, after its January meeting, the Fed indicated that it was more concerned about inflation pressures than it was about slowing growth. That call was a comfortable and appropriate one with growth holding above 2 percent and inflation expectations stuck firmly at about 2.5 percent. The Fed's situation will become more uncomfortable, however, if growth drops to 1 percent or lower while inflation fails to moderate further.

Currently, markets are expecting the Fed's Open Market Committee to cut the federal funds rate by a total of 50 basis points, to about 4.75 percent, by the end of this year. That expectation is based, no doubt, on the slowdown in growth and concerns about the outlook for profits and equity prices as well as on the extended concerns about weakness in the housing sector. Thus far, the Bernanke Fed has not been forced to confront a situation in which its goal to slow inflation conflicted with its desire to avoid a rapidly escalating chance of recession. In fact, until early in 2007, the Fed's outlook calling for a moderation of growth and inflation looked brilliant. While it may still turn out to be the right call, the tension surrounding the Fed's stated desire to keep the federal funds rate unchanged at 5.25 percent has risen as the growth outlook has weakened. A modest increase in market turmoil, such as has been experienced since late February, will not push the Fed away from its current stance of "steady as she goes," with a primary emphasis on lowering inflation rather than supporting growth. But a lower year-over-year nominal GDP growth rate at 4.5 percent in 2007, well below the 5.25 percent Fed funds rate, is a danger sign that, along with an

inverted yield curve, raises warning flags of a slowdown or recession.

The awkward reality is that, at least in the past, the Fed has only been moved away from a conservative stance by extraordinary market volatility and attendant systemic risk that force the Fed to ease, as it did after the Long-Term Capital Management crisis in 1998 and during the deflation scare of 2002–03. But at that time, the Fed chairman was the highly market-sensitive Greenspan, who began his long and successful career at the helm of the Fed by successfully navigating past the

1987 stock market crash. Markets simply do not know what Chairman Bernanke's response to turbulent financial markets will be. We do know that Bernanke is serious about inflation targeting and anxious to bring inflation expectations, currently rock-solid at 2.5 percent, to a level below 2 percent before initiating an ease to monetary policy.

A large part of the problem facing markets and the Fed in coming months will be the tricky task of communicating and executing an appropriate policy path through

what may be a treacherous minefield of slowing growth and stubborn inflation. Fed inaction will come under increasingly intense criticism, especially from a Democratic Congress that may start to complain about a Federal Reserve Board consisting largely of Republican appointees.

## Help from Abroad?

Growth in Europe and Asia is holding up well and may provide some support for U.S. exports, thereby providing a possible modest boost for U.S. growth. Higher Asian growth, however, is more supportive of European growth than U.S. growth since exports from Europe to the Asian region, especially from Germany, have grown strongly, helping to support Germany's export-oriented economy. However, the European Central Bank has expressed an intention to continue tightening monetary policy in order to keep European inflation rates below 2 percent. That, plus some likely moderation of Asian growth during the first half of this year, will probably contain overall foreign growth to modest levels.

Broadly, U.S. demand growth, driven by steady consumption growth, has been the primary engine for sustaining growth in export-oriented Asia and Europe. Sustained U.S. consumption growth helps to boost Asian, especially

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Chinese, exports to the U.S. China's continued high growth rate helps to encourage export-led growth in Europe and Japan. A slowdown in U.S. demand growth would slow Chinese growth and thereby reduce demand in the People's Republic for additional capital equipment. The result would be slower export growth in Europe and Japan and a likely global slowdown in 2008.

## **The Fed's Challenge**

Over the past fifteen years, the U.S. has enjoyed a steady economic expansion with only one brief recession in 2001. The economy has become virtually self-stabilizing with periods of slower growth and attendant lower interest rates followed by a resumption of growth at close to trend levels. The result has been a mild oscillatory pattern of positive U.S. growth with contained inflation. However, over the past year, while growth has moderated to a level below the trend rate of about 3.2 percent, average core year-over-year inflation rates have drifted slightly higher while inflation expectations have remained stuck at 2.5 percent.

The Fed has clearly signaled that it is prepared to wait patiently for measures of inflation and inflation expectations to fall below 2 percent before easing. To do otherwise would validate inflation rates that are above the Fed's desired range of 1 to 2 percent inflation.

Now that growth appears to be moderating while the wealth supports for household balance sheets from real estate and the stock market are no longer increasing, the strength of the Fed's desire to lower inflation may be tested by markets in coming months. Chairman Bernanke's testimony to Congress this July on the state of the U.S. economy may be somewhat more difficult than his highly successful and cordial February testimony was. But he will remind Congress that the low and stable inflation since the mid-1980s has been the key to the sustained growth and healthy financial markets that have generated unprecedented wealth creation. A brief recession may be a small price to pay to retain the low and stable inflation required for long-run, sustained growth and wealth creation. Let's hope Congress understands this as well as the Fed does.