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Economic Outlook Symposium: Summary of 2007 results and forecasts for 2008

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According to participants in the Chicago Fed's annual Economic Outlook Symposium, the nation's economic growth in 2008 is forecasted to be roughly in line with the pace recorded over the past two years, with inflation moving lower and the unemployment rate edging higher.

The Federal Reserve Bank of Chicago held its twenty-first annual Economic Outlook Symposium on November 30, 2007. More than 100 economists and analysts from business, academia, and government attended. This *Chicago Fed Letter* reviews last year's forecasts for 2007 and analyzes the forecasts for 2008 (see figure 1).[1]

1. Median forecast of GDP and related items

	2006 (Actual)	2007 (Forecast)	2008 (Forecast)
Real gross domestic product[a]	2.6	2.5	2.5
Real personal consumption expenditures[a]	3.4	2.5	2.2
Real business fixed investment[a]	5.2	6.1	3.7
Real residential investment[a]	–12.8	–15.9	–4.0
Change in private inventories[b]	17.4	17.3	25.4
Net exports of goods and services[b]	–597.3	–514.4	–507.3
Real government consumption expenditures and gross investment[a]	2.5	2.3	2.0
Industrial production[a]	3.5	2.6	2.5
Car & light truck sales (millions of units)[c]	16.5	16.1	16.0
Housing starts (millions of units)[c]	1.81	1.35	1.21
Unemployment rate	4.5	4.7	5.0
Consumer Price Index[a]	1.9	3.6	2.6
1-year Treasury rate (constant maturity)	4.99	4.11	4.28
10-year Treasury rate (constant maturity)	4.63	4.50	4.80
JPMorgan trade-weighted dollar index[a]	–3.6	–4.2	–0.7
Oil price (dollars per barrel of West Texas Intermediate)	60.09	90.19	82.50

[a]Fourth quarter over fourth quarter percent change.
[b]Billions of chained (2000) dollars in the fourth quarter at a seasonally adjusted annual rate.
[c]Fourth quarter average.
Sources: Actual data from authors' calculations and Haver Analytics; median forecast from Economic Outlook Symposium participants.

In 2007, the economy is forecasted to expand by 2.5%—a rate that our consensus group would consider to be slightly below potential growth for the U.S. economy. This led to the unemployment rate edging higher from 4.5% in the fourth quarter of 2006 to 4.7% in the final quarter of 2007.

While economic growth during 2007 was close to what it was in 2006, the quarterly pattern was quite volatile. In the first quarter, real gross domestic product (GDP) growth was only 0.6%, but then surged to 3.8% and 4.9% in the second and third quarters, respectively. However, according to the consensus forecast, this strong performance is expected to be short-lived, with economic growth predicted to slow to 1.7% by the final quarter of 2007.

While most sectors continued to expand during 2007, the housing industry fell by a significant amount. For the first 11 months of the year, housing starts averaged 1.37 million units at a seasonally adjusted annual rate (SAAR)—nearly 25% below the level in 2006. Hence, residential investment subtracted a full percentage point off of GDP growth between the third quarter of 2006 and the third quarter of 2007. The inventory of unsold single family homes remained at more than nine months' supply at the end of 2007.

The turmoil in the housing sector contributed to significant losses in the mortgage market, particularly in the subprime adjustable rate products. This contributed to financial market disruptions from the middle of 2007 onward. In order to offset the tightening credit conditions, the Federal Reserve lowered its targeted short-term interest rate beginning in September; the latest cut brought the rate to 4.25%.

Rising energy costs put additional strain on the economy in 2007. Energy prices spiked toward the end of 2007, with

West Texas Intermediate crude prices averaging nearly $92 per barrel in December, much higher than the $66 price oil averaged during 2006. This contributed to inflation, as measured by the Consumer Price Index (CPI), which rose by 4.3% in November 2007 compared with a year earlier—much higher than the 1.9% increase from the fourth quarter of 2005 to the fourth quarter of 2006.

With weakness in housing and gas prices high, light vehicle sales fell to 16.1 million units in 2007—380,000 units below the 2006 level and the slowest selling rate since 1998.

> The struggling housing sector is not predicted to reach bottom until near the end of 2008, with residential investment predicted to fall by an additional 4.0%.

Still, many sectors continued to grow. Monthly job growth averaged nearly 111,000 jobs during 2007, adding over 1.3 million jobs for the year. Consumer spending, which rose by 3.4% during 2006, expanded by a slower 3.0% rate in the third quarter compared with a year earlier. Business fixed investment was 5.1% higher in the third quarter than a year earlier, the same rate it expanded by in 2006. Manufacturing output growth slowed from 3.4% in 2006 to 1.8% in the third quarter of 2007.

International demand for U.S. goods was quite strong in 2007, helped by a weaker dollar. The dollar's value was 7.1% lower in the fourth quarter of 2007 than a year earlier, and is down more than 23% from its recent peak in early 2002, making U.S. products very competitive with foreign-made goods. While exports rose 10.3% in the third quarter compared with a year earlier, imports rose by a more restrained 1.7% year over year. This led to a marked improvement in the international trade deficit. Net exports increased by $100 billion dollars, reducing the deficit from $633.8 billion (or 6% of GDP) in the third quarter of 2006 to $533.1 billion (5% of GDP) in the third quarter of 2007.

Performance versus forecasts

At the 2006 Economic Outlook Symposium, participants expected the economy to expand at a 2.8% rate in 2007; while this is in line with data though the third quarter, slower growth is predicted for the fourth quarter, and that would bring GDP growth for the year down to 2.5%—a bit below what was anticipated. (The remaining comparisons for GDP components apply to the consensus estimate for the fourth quarter of 2007.) The unemployment rate was expected to rise to 4.9% in the final quarter of 2007—just above the 4.8% realized. Inflation was predicted to average 2.5% during 2007, lower than the 3.6% rate now expected for the year. In part, the gap is explained by oil prices. Oil prices were forecasted to edge lower through the year, averaging just over $59 in the fourth quarter. While the first quarter of 2007 was accurately predicted, oil prices began to move significantly higher, averaging $90.85 in the fourth quarter. Light vehicle sales were predicted to come in at 16.4 million units (SAAR), a bit higher than the 16.1 million units (SAAR) actually sold during 2007. While most sectors were fairly accurately forecasted, the weakness in the housing sector was far more significant than expected. Housing starts were predicted to fall to 1.60 million units in 2007; however, housing starts actually decreased to 1.37 million units (SAAR) for the first 11 months of 2007. Similarly, residential investment was forecasted to decline by 4.2%, but it actually fell by a much greater 15.9%. One-year and ten-year Treasury rates were predicted to fall to 4.80% and 5.00%, respectively, by the end of 2007, versus the actual rates of 3.62% and 4.26%, respectively.

Economic outlook for 2008

The forecast for 2008 is for economic growth to continue to be restrained by a weak housing sector. In 2008, the economy is expected to expand at a rate just below trend. Real GDP is anticipated to rise by 2.5% in 2008, the same rate as expected for 2007. With economic growth below trend, the unemployment rate is expected to edge higher to average 5.0% in the fourth quarter of 2008. Inflation (measured by the CPI) is predicted to ease to 2.6%. Oil prices are anticipated to fall somewhat, but still remain above $82 a barrel by the end of 2008. Personal consumption expenditures are forecasted to expand by a slower rate of 2.2% in 2008. Light vehicle sales are expected to edge lower, to 16.0 million. Business fixed investment is expected to increase 3.7%. Industrial production is forecasted to increase 2.5% in 2008, in line with GDP growth.

The housing sector is not predicted to reach bottom until near the end of 2008. Residential investment is predicted to fall 4.0% in 2008, a smaller decline than in 2007, therefore being less of a drag than in 2007. The quarterly pattern of the forecast helps to identify when the consensus group expects the housing market to stabilize. After falling by a predicted 12.2% in the first quarter of 2008, residential investment is predicted to decline by a more moderate 4.7% and 1.3% in the second and third quarters, respectively. It is then expected to edge higher in the fourth quarter, rising by 0.4%. Housing starts are anticipated to bottom out in the first and second quarters of 2008 at 1.17 million starts (SAAR) and then move up slightly to 1.20 million and 1.26 million starts in each of the final two quarters of the year.

Long-term interest rates on ten-year Treasury notes are forecasted to increase by 30 basis points in 2008, while short-term interest rates on one-year Treasury bills are expected to rise by a smaller 17 basis points.

The U.S. dollar is predicted to edge lower in 2008, with a decrease of 0.7%, and the trade deficit is predicted to decline further.

Banking and housing

Diane Swonk, Mesirow Financial, delivered her outlook for the banking, housing, and investment sectors. She argued that the financial turmoil of recent months created a compression of the housing slowdown, which she forecasted to bottom out in the second half of 2008.

Still, she expected that both nonresidential investment and net export strength would pick up the slack from residential investment, thereby avoiding an economic recession. Swonk noted that the large difference in wage income between lower- and higher-income households has been magnified during the recent housing downturn. In a recent report, she wrote that "middle- and lower-income households are expected to feel particularly squeezed as the subprime debacle exacerbates the sense of inequality generated by the skills premium."[2]

In terms of financial markets, Swonk characterized the current situation as a "crisis of confidence" and not a "liquidity crisis." According to Swonk, effective liquidity provision and risk management appear to be the main concerns for investors with sufficient liquidity who are waiting on the sidelines; they are poised to reenter the market once confidence is restored.

Automotive sector

Paul Ballew, formerly of General Motors Corporation and currently with Nationwide Insurance, forecasted a domestic automotive recession due primarily to global competitive pressures. The U.S. market share of the Detroit Three decreased from over 70% in 1997 to less than 55% in 2006. Because of the current state of the industry, domestic automakers have begun to make needed changes, including expanding into new and underdeveloped markets; cutting costs while also shifting some of their production from the U.S. (because of the flat market) to markets overseas that are expanding more rapidly; and increasing investment to develop and improve both performance and content of new product lines.

Ballew said that, while the domestic market will remain stagnant in 2008, global demand will continue to rise, with China becoming an ever more key market. The increasing income gap cited by Swonk is also affecting the automotive industry. With the rising prices of both food and energy, lower-income households are postponing purchases of automobiles. This trend has been partially offset by higher-income households' purchases of luxury vehicles, one of the few areas of remaining strength.

Ballew expressed concern that overall vehicle sales would be cut back approximately 100,000–150,000 units because of recent high gasoline prices. He added that the potential exists for oil prices to hit $100 per barrel and thus to drag GDP growth down from 2.3% in 2007 to 2.1% in 2008. Given the potential for higher energy prices, he also predicted a slight increase in the unemployment rate, to 5.3% over the same period, as well as an increase in inflation, to 3.4%.

Steel industry

Robert DiCianni, ArcelorMittal, said he expected the demand for steel to increase in 2008 despite a relatively soft U.S. market. The steel industry is currently operating at near full capacity in order to meet the recent rise in demand for steel; for the first time, some domestic suppliers are creating export businesses because of the weakness of the U.S. dollar. Not only are the exports rising but, because of higher prices outside the U.S., imports of steel into the U.S. have fallen quite dramatically. However, costs for raw material used to produce steel are increasing and are remaining higher than historic levels. For example, iron ore prices have doubled since early 2006 and ferromolybdenum prices have increased 1,145% since March 2004. Nickel's prices have fluctuated widely since the beginning of 2006, between approximately $15,000 per ton to $51,000 per ton.

The increase in steel demand at the beginning of 2008 is anticipated because of increases in export growth; strength in nonresidential investment (highways, bridges, office furniture, and U.S. railcar production); and more steel-intensive energy-related projects (pipeline and wind power). Additionally, the consumer-related appliance, automotive, and service center industries may become other sources of increased demand for steel conditional on the housing and consumption sectors in 2008.

Consumer sector

Richard Curtin, director of the Reuters/University of Michigan *Surveys of Consumers*, said that the weak housing market, along with increases in food and energy prices and rising credit standards, is having a negative impact on consumer expectations and consumption. In addition, recent record low savings rates coupled with record high debt levels have left consumers with a limited capacity to deal with economic adversity. Uncertainty over job and wage growth also remains a concern. Given these issues facing consumers, Curtin expected the economy to proceed "just above stall speed." He also predicted that the housing downturn would bottom out in mid-2008. Curtin noted that, overall, current consumer sentiment numbers are consistent with slow growth in 2008, just above standard definitions of a recession.

Curtin acknowledged four major risks to his forecast for the coming year. First, the impact from the decline in the housing market could turn out to be greater than expected. Second, oil and food prices could continue to surge, requiring higher interest rates to curb a potential rise in core inflation; higher interest rates would then reduce access to credit, which could even further stifle consumption. Third, the U.S. consumer's current record low savings rate and record high level of debt could further constrain the consumer to deal with future

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economic adversity. Fourth, there is continuing uncertainty about both job and wage growth.

Drawing on findings from the *Surveys of Consumers*, Curtin explained that consumers have begun to build into their forecasts expectations of falling home prices and increasing food and energy prices, and these three price trends are affecting consumption decisions. Discussing the effects of recent market turmoil across the income distribution, Curtin noted that references to income gains in assessments of personal finances have recently recorded not only their widest gap between the top third of the population and the bottom third, but also the longest sustained gap over time.

Heavy machinery

Frank Manfredi, Manfredi & Associates, explained that, in the heavy machinery sector, the agricultural markets are currently very strong, while the construction and mining markets are weaker.

The agricultural equipment industry is doing well in part because old fleets are being replaced and direct payments by government programs are continuing. Manfredi expected 2008 sales to be strong for most agricultural equipment markets, but he predicted weakness in the market for the under-40-horsepower two-wheel drive tractors; he expected a decrease of 1.0% in this segment partly because of the weakness in housing. The strongest agricultural equipment markets will be the 100-horsepower-and-over two-wheel drive tractors, estimated to increase 10.0% in 2008, and the four-wheel drive tractors, forecasted to increase 15.0%. Overall, Manfredi predicted total farm wheel tractors (for the U.S. agricultural equipment market) to increase 2.4% in 2008.

However, Manfredi anticipated a less positive outcome for the construction machinery industry, based on the housing slump. He predicted that the mining machinery industry would remain steady even with the high commodity prices (e.g., for copper, iron, and coal) and lack of available tires for some of the mining equipment. There are currently plans in the works to build new tire plants. In his overall assessment of mining and construction equipment (construction machinery estimated for the U.S. market), Manfredi predicted a 9.1% decrease from 2006 to 2007, as well as a 7.5% decrease from 2007 to 2008.

Conclusion

In 2007, the U.S. economy was challenged by the ongoing slowdown in housing and large increases in energy prices. With continuing weakness in the housing market, economic growth in 2008 is expected to stay below potential. A slight rise in the unemployment rate is predicted for 2008, and inflation is expected to move lower.

[1] Also see www.chicagofed.org/news_and_conferences/conferences_and_events/2007_eos.cfm.

[2] Diane C. Swonk, 2007, “Taking the tradition out of holiday sales,” *Mes on the Economy*, November 7.