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## ECONOMIC NEWS UPDATE

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The calendar is an artifact, a 12-month period unrelated to the fundamental movements in the US and world economies. For that reason, and because so many others feel confident enough to offer detailed and precise forecasts of what is in store for us in 2007, I am inclined to leave such chores to economists willing to provide guidance to those who need such information to help them earn their daily bread by trading, making and selling. After all, if the much-experienced Vice Chairman of the Fed, Donald Kohn, can say, "We are uncertain about where the economy has been, where it is now, and where it is going," I can certainly be forgiven for not adding still another detailed annual forecast to the many already before you. If some take this as an excuse for vagueness, so be it.

We are coming off a 12-month run that can best be described as the tale of two economies -- the hot one in the first half of the year (growth at 5.6% and 2.6% in the first and second quarters), and the cooler one in the last half (2% in the third quarter and perhaps about that in the final quarter, although

some economists are, with good reasons, predicting a bounce-back to a 2.7% rate in the fourth quarter of last year). On average, not bad, but then again a person can drown in a river with an average depth of four feet, which is what some property speculators loaded with Florida condominiums are doing as mortgage payments on unsold and unrented flats come due.

The slower pace of the next twelve months will feel especially uncomfortable, more than merely cooler, after our long period of rather torrid growth -- like going out into a not particularly cold day directly from a hot tub. But because economies don't organize themselves in 12-month cycles, I am inclined to look forward to 2007 as just what the doctor ordered, a correction of imbalances, as painful as a tooth extraction, but with great relief once the procedure is completed.

For a long time economists have worried about imbalances: too much consumer spending, based on too much debt; an unsustainable US trade balance as the American consumer shored up the world economy by

snapping up the output of developed and developing economies; imbalance between high- and lower-earners; and an imbalance between American foreign policy commitments and the forces available to carry them out.

The year that we enter tomorrow is one in which these imbalances will begin to unwind, leaving a healthier world economy in place. Consumers are no longer riding the wave of steadily rising house prices, which seem to be falling (the data are too imperfect to permit firm conclusions: houses withdrawn from sale because of low or no offers are not included in average price data) and are likely to fall still more -- by 1.7% according to the consensus of Business Week's 58 forecasters, or by 3% if you are a fan of Goldman Sachs's economists, or by 5%-10% if the housing bears are right in predicting that potential home buyers will hibernate in 2007 -- with wide regional variations in performance. That fall, if it occurs, as seems likely, must be weighed against the doubling of prices that has enriched households in the past seven years, and the offsetting record level of share prices (up about 10% this year, as measured by the S&P 500-share composite) that will add to the wealth of many householders.

I wish I could give loyal readers, or even casual ones, some clue as to the likely level of activity in the housing industry in 2007, but I can't. We do know that almost two million privately owned housing units were completed in 2006, and that an unusually large proportion remains unsold. We also know that official statistics show that sales of new homes rose in three of the past six months, encouraging some observers to believe the market has bottomed out. Alas, as with so many

other housing statistics, sales data can mislead the casual student. The problem is that a completed contract is counted as a sale, and some buyers who have watched the value of their prospective residences decline, are walking away from contracts. All that can be said with certainty is that some observers think the market has bottomed out: Richard Yamarone, chief economist at Argus Research, says "certainly the worst seems to be behind us." Never mind the odd juxtaposition of "certainly" and "seems"; the market is bidding up shares of house builders, as if you believe in an all-knowing market, and have a house for sale, be of good (if delayed) cheer. More important, for the longer term the demand for housing seems likely to rise steadily as immigrants put their feet on the first rung of the housing ladder, and increasingly affluent consumers conjure up a need for more and more space in which, among other things, to cook and enjoy their huge flat-screen television sets.

Consumers will also find the 2007 jobs market less buoyant, but not markedly so, as rising employment in the health care and other service industries offsets most of the declines in the construction trades. But not all: the number of building permits issued is down about 30% from year-ago levels, so construction activity is unlikely to recover until further inroads are made in the 7.3 months inventory of unsold existing homes. That construction slowdown, plus the knock-on effects on manufacturers of building materials and household equipment, lends weight to some forecasts that the unemployment rate will rise to and perhaps past 5%. So consumer spending, which grew at its peak in 2004 at an annual rate of 4%, fell to about 3% this year, and will likely

grow at only about 2-2½% in 2007. I say “likely” rather than “certainly” not only out of regard for the fallibility of forecasters’ tools, but because the American consumer has repeatedly surprised the experts. Some regard the continued increases in spending as profligacy, while others say consumers are showing good sense by gearing their spending to the rising wealth associated with the increased value of their real estate and financial assets.

In any event, before counting the consumer out, consider that with the gloom of Iraq pervading the atmosphere, gasoline prices remaining high by historic standards, inflation at a level that has the Fed nervous, Americans spent about 6.5% more this Christmas season than last. Some Wall Street wags continue to warn that no one has ever gotten rich betting against the American consumer. That seems particularly good advice in light of the latest consumer confidence figures, which jumped in December to their highest level since July.

Still, spending is down a bit, and borrowing also seems to be headed in that direction: in the third quarter of 2006 household borrowing was 5.8% below year-earlier levels, the fastest decline since the energy crisis of 1980. This lowering of spending growth is not on such a scale as to trigger a major downturn, but it is enough to cool the economy in early 2007, before a revival later in the year, bringing the total growth in GDP to 2.6% according to an average of Business Week’s gaggle of economists (forecasts range from 3.7% to 0.7%), somewhat above the 2.4% predicted by the Organization for Economic Co-operation and Development (OECD). For economists to quibble over the difference between

2.4% and 2.6% in a figure as uncertain as GDP, and future GDP at that, only proves that economists use decimal points to prove they have a sense of humor.

Fewer trips to the malls mean a slowing of the growth in the flow of imports, which will be helped by the weaker dollar, already making imported goods more expensive. The dollar is down about 20% against the currencies of its major trading partners, helped in its fall by the decision of American enemies Iran and Venezuela to reduce their dollar holdings, and by some oil producers to prefer payment in euros to payment in dollars.

Experts have always said that it would take a 40% drop in the value of the greenback to begin to bring America’s current account deficit down from its current supposedly unsustainable level of about 7% of GDP to a more sustainable level, so we are half way there, and headed in the right direction. Fewer Americans will find their way to Harrods and Claridge’s in London, or to the fleshpots of Paris and the museums of Rome, and we will see more foreign visitors in Saks and Macy’s in New York, and Neiman Marcus and Bloomingdales in Tyson’s Corner, and strolling the beaches of Florida and the aisles of the National Gallery. The world will get the rebalancing it has been demanding of America, and foreigners will weep as their goods become more expensive and less attractive in America. They wished for rebalancing, and will get their wish. No pain, no gain, as health club entrepreneurs are so fond of telling us.

The coming year might -- just might -- see a beginning of the correction of still another imbalance -- the disparity between economic growth

and the ability of many workers to cash in fully on America's prosperity. Concern about the plight of the average worker is overdone, and often backed with seriously flawed data. For example, wage data don't include benefits, which have been rising, and therefore understate total compensation; and the averages conceal the fact that in a growing labor market there will be lots of new entrants, many of whom start at the bottom rung. Diana Furchtgott-Roth, the Hudson Institute's labor market expert, says that "most measures suggest that tight labor market conditions are permitting less-skilled workers to get a somewhat larger share of the pie than they have been getting in recent years," and points out that the unemployment rate for workers without a high-school degree is declining. It is encouraging that workers are responding to the growing skills premium by enrolling in training courses and community colleges, and if these trends continue what I have called an imbalance -- a term Furchtgott-Roth thinks a bit of an overstatement -- should gradually correct itself. A good sign might be the rise of 2.6% in the real weekly earnings of non-supervisory workers (note problems with this measure, above), making up for some of the ground lost since 2000.

Finally, in a belated realization that his neoconservative critics and John McCain have been right all along, President Bush -- whatever he decides to do about Iraq -- will begin the long process of correcting the imbalance between the nation's foreign policy goals and the resources devoted to achieving those goals. Not by redefining those goals, but by expanding the military. This reduction of the imbalance between ends and means should make

the world a safer place in 2007 than it would otherwise be.

None of these adjustments will fit neatly into the 12-month period we call 2007, but will extend beyond it, making the data we will be studying one year hence mere markers on the road to a more balanced national and global economy. Call it a soft landing, if your taste runs to such phrases, or growth at the economy's noninflationary potential, if you prefer the language of the International Monetary fund. Or not bad, if you want to be jargon-free, but equally accurate.

I would be remiss were I to allow the year to end without thanking all the readers who have taken the time to inform me of my errors and, even, at times to cheer me on, and to my estimable Hudson colleague, Xiuyue Zhu, who on painfully short notice never fails to come up with the data I like to think makes these columns informative even to those readers who disagree with my conclusions.

Have a healthy and, if that is your wish, prosperous New Year.



## **THE SUNDAY TIMES**

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