

Economic Review



NICHOLAS S. PERNA
Economic Advisor

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THE NATION: soft landing or soft thinking?

I'm basically in agreement with the consensus forecast of slow, but positive, economic growth for the coming year. Inflation is showing some signs of moderating, and the Fed is finished tightening. However, the odds of recession are high enough to warrant some caution.

Both the private economic forecasters and the policy makers at the Federal Reserve are saying that the economy will slow but still grow during the coming year. In essence, they're predicting a "soft landing." Borrowed from space exploration projects, this is a popular label rather than a precise economic concept. It usually refers to what (we hope) happens to the economy when the Federal Reserve raises interest rates to combat the threat of inflation. Gross Domestic Product (GDP) growth slows, but does not decline as in a recession. However, unemployment may rise somewhat and some sectors may fall hard, such as housing. Unlike recessions, which are identified by a committee at the independent National Bureau of Economic Research, there's no official declaration of when a soft landing starts and ends. As the old adage goes, "You'll know one when you see one."

Are soft landings wishful thinking on the part of forecasters and policymakers? I don't believe they're as rare as the skeptics claim. During the past twenty years, there were one unambiguous soft landing (1994-95) and two near misses that were worse than expected largely for reasons beyond Fed policy (1990 and 2000-01).

In 1994-95, the Greenspan Federal Reserve raised the Fed funds rate from 3% to 6% to forestall inflation. Real GDP growth slowed from 4 1/2% to 2% for a near-perfect landing.

Unemployment barely rose and the stock market was largely unaffected. Wow!

In 1986-89, the Fed hiked the funds rate from 5 3/4% to 10%. The memorable 1987 stock market crash, when values fell 30% in October, was due more to the big jump in bond yields precipitated by the drop of the dollar exchange rate than to Fed policy. Importantly, the economy didn't decline until 1990. A substantial portion of the 1990 GDP shrinkage resulted from the spike in oil prices and the collapse of consumer confidence after Saddam Hussein invaded Kuwait.

During 1999-2000, Greenspan raised Fed funds from 4 3/4% to 6 1/2%. What followed was a significant slowing of GDP growth sprinkled with a couple of modestly negative quarters. The recession, which started in March of 2001 and ended the following November, was aggravated by the tragic events of 9/11. Nonetheless, it was one of the mildest on record. Without the effects of 9/11, it would have been even milder.

My point: during the past 20 years, there have been one clear soft landing (1994-95) and two "bumpy" landings that would barely have qualified as recessions were it not for negative non-economic events. Maybe we should label those two episodes "semi-soft landings."

The case for moderate growth during the coming year is as follows. Oil prices have dropped from \$78/bbl in late July to near \$60 in early December, thereby reducing inflation and boosting consumer purchasing power. Importantly, core CPI inflation (the Consumer Price Index minus food and energy) has not been accelerating recently. Rather, it has slowed

Musings & Amusings: Political Humor

David Letterman:

"Vice President Dick Cheney visited Saudi Arabia ... He's known as Lawrence of Arrhythmia."

Al Gore on the 2000

election: "You know you win some. You lose some. Then there's that little known third category."

President George W.

Bush upon getting an honorary degree at Yale: "To those of you who received honors, awards and distinctions, I say well-done. And to the "C" students I say: you too can be president."

to less than a 2 ½% annual rate during the past 4 months from 3% in the preceding 8 months. The recent decline of the dollar exchange rate will be good for exports. Car sales have softened but are running only slightly below last year's annual average

I've changed my mind about short-term interest rates and now believe the Fed will ease cautiously in late 2007. The economy will have slowed. Most important, inflation will be within a tolerable range. Although core CPI at 2 ½% - 2 ¾% is above the Fed's long-term goal of 1 - 2%, it is somewhat below 2005 and relatively stable. This will enable the Fed to "declare victory," a phrase that those of us of a certain age will recall with respect to the debate over the war in Viet Nam.

However, I'm still predicting that long-term yields will rise. This is mostly due to the need to compensate foreigners for the growing risks attached to their financing the large U.S. trade deficit.

U.S. FORECAST: 2007				
	2004	2005	2006	2007
REAL GDP % CH	3.4	3.2	2.9	2.4
CPI % CH	3.3	3.7	1.9	2.7
UNEMPLOYMENT %	5.4	4.9	4.5	5.0
FED FUNDS %	2½	4½	5½	4½
10-YR TREASURY %	4.2	4.5	4.5	5.5

SOURCE: PERNA ASSOCIATES. GDP AND CPI ARE % CHANGE FROM 4TH Q TO 4TH Q. OTHER DATA ARE YEAR-END LEVELS.

Various surveys of economists put the probability of recession at about 25-30% over the coming year -- roughly double the odds of late 2005. Housing is the biggest immediate risk. Although prices have held up well overall, new construction activity has plunged. My forecast is that housing starts may be close to stabilizing, but prices will soften further. If homebuilding and prices drop much more, recession could ensue as consumer wealth and confidence are undermined.

Another oil price rise could also start the recession ball rolling. Keep your eye on the dollar exchange rate, which has been falling lately. If it takes a nosedive as foreigners get nervous about lending us the huge sums needed to finance our trade deficit, the result could be a rapid rise in interest rates, particularly bond yields, that would cause a recession.

The best advice I can give is for people to at least begin thinking about what they might do in their business and personal lives if a recession unfolds. It is worth noting that recessions have gotten shorter and milder during the past twenty years in addition to occurring less frequently. This partly reflects the shift towards services in the U.S. economy. In the past, the buildup of manufacturing inventories during the early stage of the cycle and the subsequent reduction of unwanted goods

through layoffs made recessions longer and deeper. Recessions are also less severe and less frequent because the Federal Reserve has become more nimble in dealing with cycles.

THE REGION: catching up ... sort of. The latest batch of forecasts for southern New England and New York also show modest growth during the coming year. Importantly, the gap between the performance of these four states and the nation will narrow in 2007, which amounts to a catching up of sorts.

I've picked only two of the many available indicators to summarize the outlook: jobs and incomes. As discussed in the last issue, jobs are the most closely watched gauge of how well an economy is performing.

Incomes don't get anywhere near the same amount of attention, probably because the data are available less frequently (quarterly vs. monthly) and with a considerable lag. Yet, incomes are more comprehensive than jobs because they not only include how many people are at work but also how much they earn. Incomes are a more complete measure of both household purchasing power and business activity in a state.

As shown in the table, inflation-adjusted income gains in 2007 are predicted to be larger for Connecticut and Massachusetts than in 2006 but not in Rhode Island and New York. However, in all four states, the gap vis-à-vis the nation is considerably smaller than in 2006.

REGIONAL FORECAST: 2007				
	% CHANGE FROM PREVIOUS YEAR			
	2004	2005	2006	2007
U.S.				
INCOMES	3.5	2.3	3.9	3.1
JOBS	1.1	1.5	1.4	1.0
CONNECTICUT				
INCOMES	3.9	2.9	1.5	2.8
JOBS	0.3	0.8	0.6	0.6
MASSACHUSETTS				
INCOMES	3.1	2.0	2.0	2.3
JOBS	-0.1	0.4	0.8	0.9
RHODE ISLAND				
INCOMES	3.1	2.4	2.3	2.1
JOBS	0.9	0.7	0.5	0.4
NEW YORK				
INCOMES	4.1	3.0	2.6	2.1
JOBS	0.7	0.9	1.0	1.0

SOURCES: NEEP, ECONOMY.COM. AND PERNA ASSOCIATES. NOTE: DATA ARE % CHANGE FROM PREVIOUS CALENDAR YEAR. PER CAPITA INCOMES ARE ADJUSTED FOR INFLATION.

The regional forecasts for 2007 are based on moderate growth for the United States as a whole. A national recession would cause economic activity in the region to decline as well. As noted in our last issue, we might get hit somewhat harder than the rest of the country but not nearly as badly as in the early 1990s.

Happy New Year.