

U.S. Economic Outlook For 2006-2008



State of the Region/PEO Meeting

Vancouver, BC, Canada

December 15-16, 2005



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For Release: 12/13/2005

***The U.S. Economic Outlook for 2006–2007:
Executive Summary: December 2005***

3rd Quarter Growth Marked Up

The July–September quarter of this year, 2005q3, included the major hurricanes which devastated so much of the economic infrastructure of the Gulf Coast region of the nation. Comfort was taken, therefore, when the "advance" estimate of economic activity released on October 28th pegged the 3rd quarter growth rate of real GDP at a solid 3.8 percent.

Turns out that estimate was on the low side. The more reliable "preliminary" estimate released on the 30th of November marked the 2005q3 growth rate up to 4.3 percent—the 2nd highest quarterly growth rate since the recovery from the 2001 recession began 4 years ago.

And That Bodes Well for 2006

Moreover, the mark-up showed that it was domestic final demand in the private sector that was so much stronger than originally thought.

Changes in Real GDP & Components in 2005q3 "Advance" vs "Preliminary" Estimates (Billions of Chained 2000 \$s)		
	Advance (10/28/05*)	Preliminary (11/30/05*)
Real GDP	104.0	116.9
(% Change, AR)	(3.8)	(4.3)
Final Sales to Domestic Purchasers	116.9	136.0
(% Change, AR)	(4.1)	(4.7)
Consumption	75.2	81.9
Nonresidential Fixed Investment	19.4	27.1
Residential Construction	7.0	12.2
Government	15.8	15.6
Net Exports	2.4	-7.0
Exports	2.2	2.5
Imports	-0.2	9.5
Change in Business Inventories	-14.9	-11.7

* Data Release Date

While real GDP rose by \$12.9 billion more than originally estimated (\$116.9 billion vs \$104 billion) in the 3rd quarter, final sales to domestic purchasers

went up by \$19.1 billion more than first thought. And none of that was due to the government sector.

Net export demand held GDP growth down compared with the earlier estimate, due almost entirely to imports being stronger than first measured.

On balance, these revisions imply even better economic momentum pushing the economy forward than first appeared to be the case.

Monetary Policy to Move Rates a Bit Higher

The federal funds rate is now up to 4 percent, and we expect that the Fed will push it to 4½ percent by early 2006, after which we expect the Fed to hold off on any further increases until at least the middle of next year.

Our forecast suggests that economic conditions will warrant further increases in interest rates next summer, and we assume that the fed funds rate will then be advanced to 5 percent, where we expect it to remain through 2007.

Fiscal Policy To Be Expansionary in '06

Fiscal policy is likely to be expansionary in 2006, due primarily to significantly higher federal spending.

The spending demands from our sustained military actions abroad, the continuing needs of homeland security, the launch of the Medicare prescription drug plan, and the federal commitment to provide substantial aid to the persons and areas impacted by the summer hurricanes assure a significant increase in federal expenditures in fiscal 2006.

Thereafter, the budget is much more likely to reach a roughly neutral position—neither expansionary nor contractionary—as our force commitment in Iraq begins to wind down.

Rest-of-World Influences

The major economic factors coming from the international arena are likely to be supportive of economic growth in the U.S. during 2006–2007.

These include:

- *Declining oil prices, expected to hit \$56/barrel a year from now and \$52 by late '07,*

over

- The U.S. dollar depreciating by 2½ percent during 2006 and another 4½ percent during the 2007, and
- Near-trend growth among our major trading partners.

The Economy in 2006-2007

Following an anticipated 3.4 percent growth rate in the closing quarter of this year, real GDP is forecast to register growth rates of

- 3.8 percent during the 1st half of next year,
- 2.7 percent during the 2nd half of 2006, and
- 3 percent during 2007 (measured 4th-qtr-to-4th-qtr).

The acceleration in the first half of '06 reflects the rebuilding efforts in the Gulf region and a return to more nearly normal sales of light vehicles following especially weak sales in the closing months of this year.

The dip in the growth rate in the 2nd half of next year reflects a slower pace of inventory accumulation, declining homebuilding activity, and only moderate further gains in the pace of light vehicle sales.

The forecast path of economic growth implies a gain of 2.2 million payroll jobs in calendar 2006 and another 2.1 million in 2007, little different from the 2.2 million new jobs now expected for calendar '05. The unemployment rate is forecast to average 4.8 percent next year and 4.7 percent in 2007, compared with a 5.1 percent average this year.

The rate of capacity utilization in industry is expected to improve over the next two years, reaching an 82.8 percent average for calendar 2007, compared with the 79.8 percent estimated for 2005.

Sales of light vehicles are forecast to total 16.9 million units next year and 17.1 million in 2007, little different than in 2004 and 2005, but behind the record 17.3 million units sold in 2000.

Homebuilding activity shows the effects of rising mortgage interest rates and slips from the 33 year high of 2.06 million housing starts expected for this year to a still-strong 1.9 million units next year and 1.8 million in 2007.

The core CPI rises by 2.1 percent in 2006—matching the core inflation of this year—but then posts a 2.4 percent increase in 2007. The all-items CPI runs only half a point above the core rate next year—well under the energy-induced 1.3 percentage point differential of 2005.

	Actual	RSQE Forecast		
	2004	2005	2006	2007
GDP (Billions of Current \$s)	11734.3	12495.4	13297.8	14041.7
Real GDP (Billions of Chained 2000 \$s)	10755.7	11148.7	11549.2	11892.1
% Change: Year-Over-Year	4.2	3.7	3.6	3.0
% Change: 4th-Qtr-to-4th-Qtr	3.8	3.7	3.3	3.0
Nonfarm Payroll Employment (Millions)	131.5	133.6	135.8	137.9
Civilian Unemployment Rate (%)	5.5	5.1	4.8	4.7
Capacity Utilization, Total Industry (%)	78.5	79.8	81.4	82.8
Inflation (Private Nonfarm GDP Deflator, % Change)	2.1	2.7	2.8	2.3
Inflation (CPI-U, % Change)	2.7	3.4	2.6	1.9
Inflation (Core CPI, % Change)	1.8	2.1	2.1	2.4
Light Vehicle Sales (Millions)	16.9	16.8	16.9	17.1
Private Housing Starts (Thousands)	1950	2060	1915	1795
3-Month Treasury Bill Rate (%)	1.4	3.2	4.4	4.7
10-Year Treasury Bond Rate (%)	4.3	4.3	5.3	5.7
Conventional Mortgage Rate (%)	5.8	5.9	6.8	7.2
Real Disposable Income (Billions of Chained 2000 \$s)	8004.3	8121.8	8501.6	8848.0
% Change	3.4	1.5	4.7	4.1
Corporate Profits After Tax (Billions of Current \$s)	788.2	1049.1	1255.0	1306.0
Value of U.S. \$ (FRB Broad Index), % Appreciation	-4.6	-2.4	0.2	-4.3
Current Account Balance (NIPA Basis, Billions of Current \$s)	-651.7	-765.0	-826.7	-820.3
Federal Surplus (FY, NIPA Basis, Billions of Current \$s)	-414.8	-342.6	-340.4	-319.1

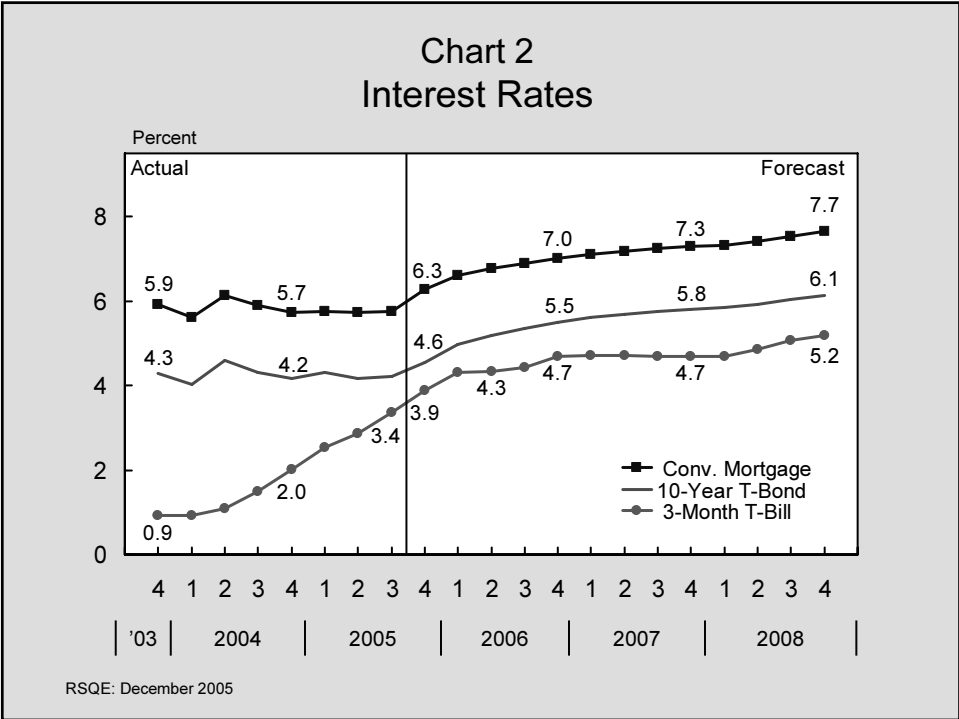
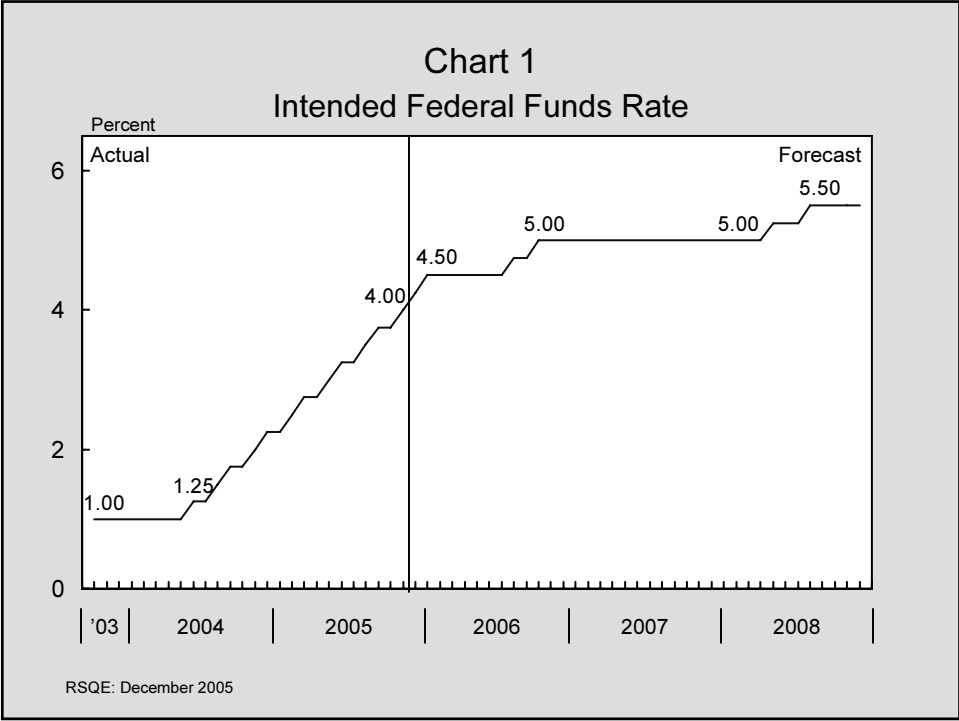


Table 1
Federal Government Budget in the National
Income and Product Accounts

(Billions of Dollars)

	FY'04	FY'05	FY'06	FY'07	FY'08
Current Expenditures	2348.0	2503.1	2724.8	2874.7	3004.3
% Change	6.0	6.6	8.9	5.5	4.5
Defense	474.2	510.0	549.3	567.0	585.7
% Change	11.5	7.6	7.7	3.2	3.3
Other Expenditures	1873.8	1993.1	2175.6	2307.7	2418.7
% Change	4.6	6.4	9.2	6.1	4.8
Federal Receipts	1933.1	2160.5	2384.4	2555.7	2705.5
% Change	3.9	11.8	10.4	7.2	5.9
Surplus (+) or Deficit (-)	-414.8	-342.6	-340.4	-319.1	-298.8
Percent of GDP	-3.6	-2.8	-2.6	-2.3	-2.0

RSQE: December 2005

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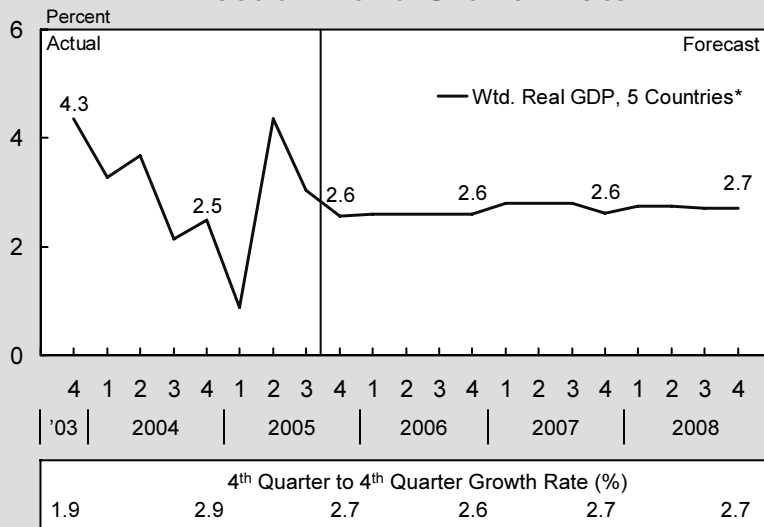
Table 2
Real GDP Growth:
Rest-of-World 5* and U.S., 1980-2004
 (Average Annual % Growth)

<u>Period</u>	<u>ROW 5</u>	<u>U.S.</u>
1980-1990	2.8	3.3
1990-2000	2.6	3.3
2000-2004	1.9	2.3
1980-2004	2.6	3.1

RSQE: December 2005

* Canada, Mexico, Japan, U.K., Germany

Chart 3
Rest of World Growth Rate



RSQE: December 2005

*Canada, Mexico, Japan, UK, Germany

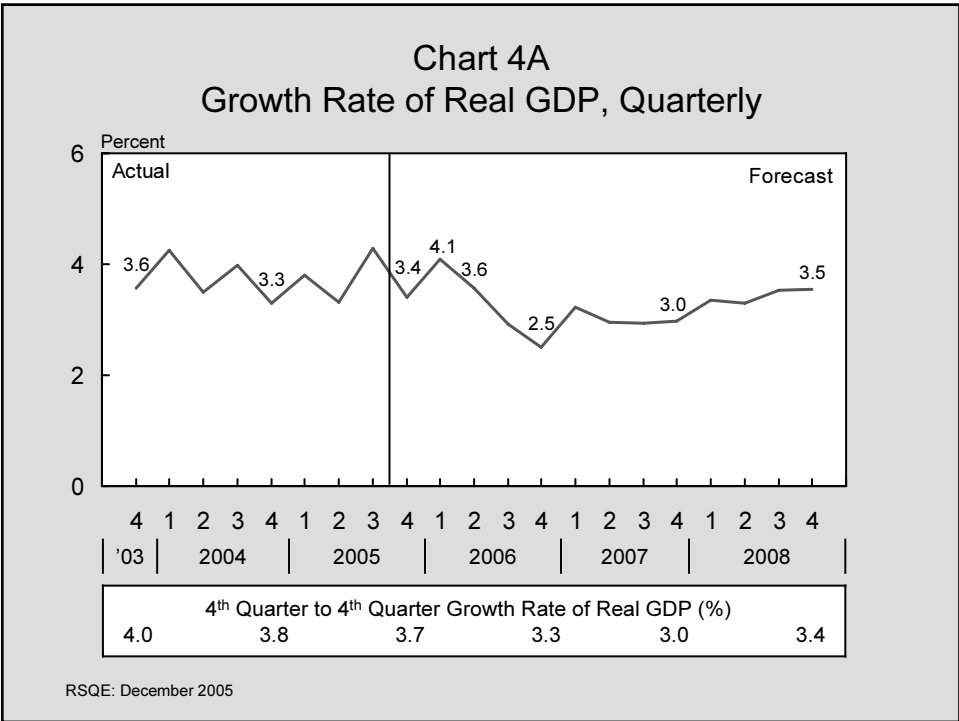
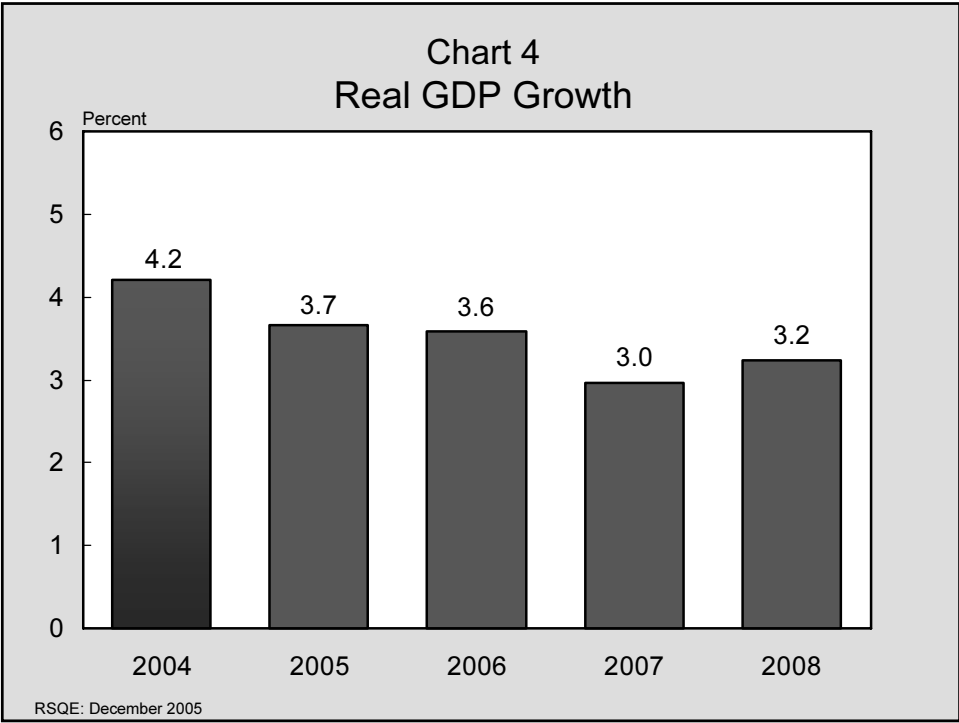


Chart 5

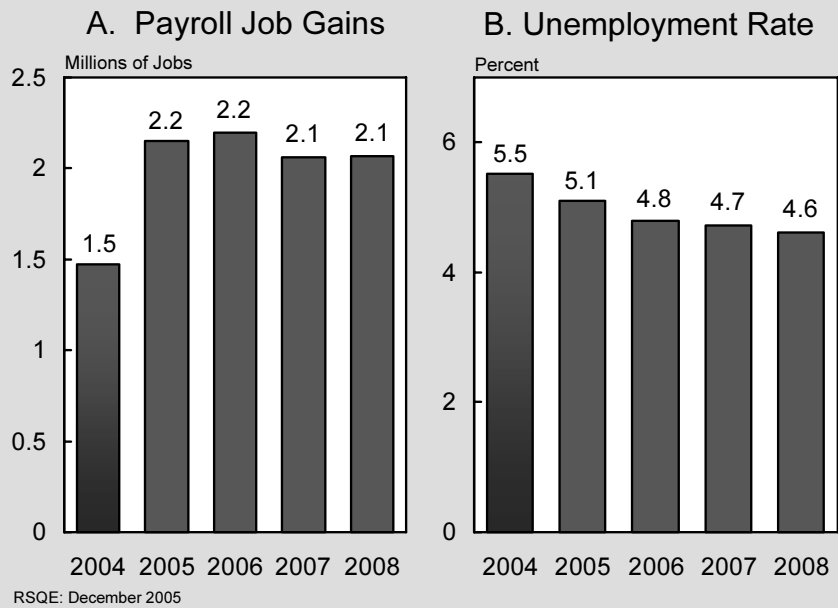


Chart 6 Commodity Prices

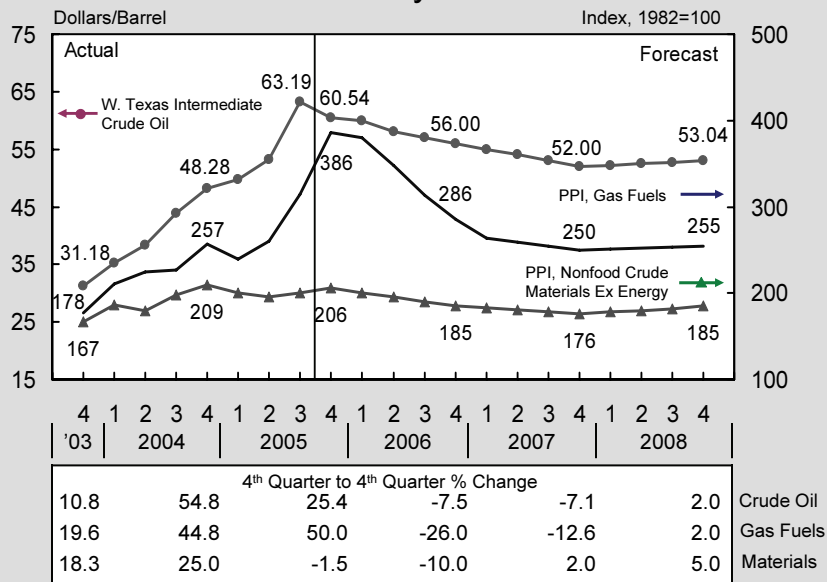
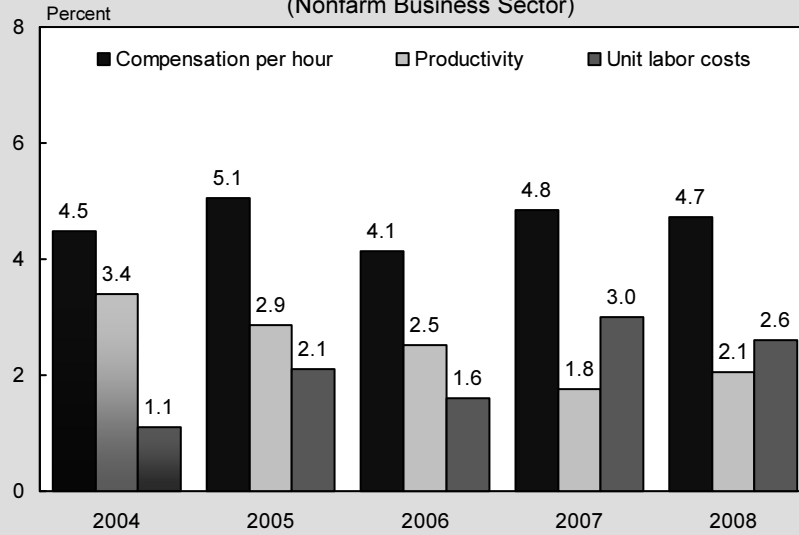
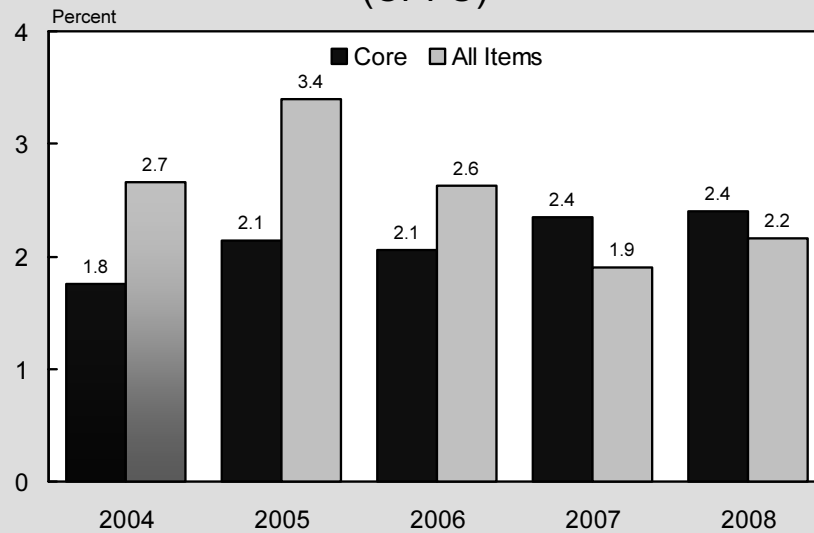


Chart 7
Productivity and Unit Labor Costs
 (Nonfarm Business Sector)



RSQE: December 2005

Chart 8
Consumer Prices
 (CPI-U)



RSQE: December 2005

Chart 9 Housing Starts

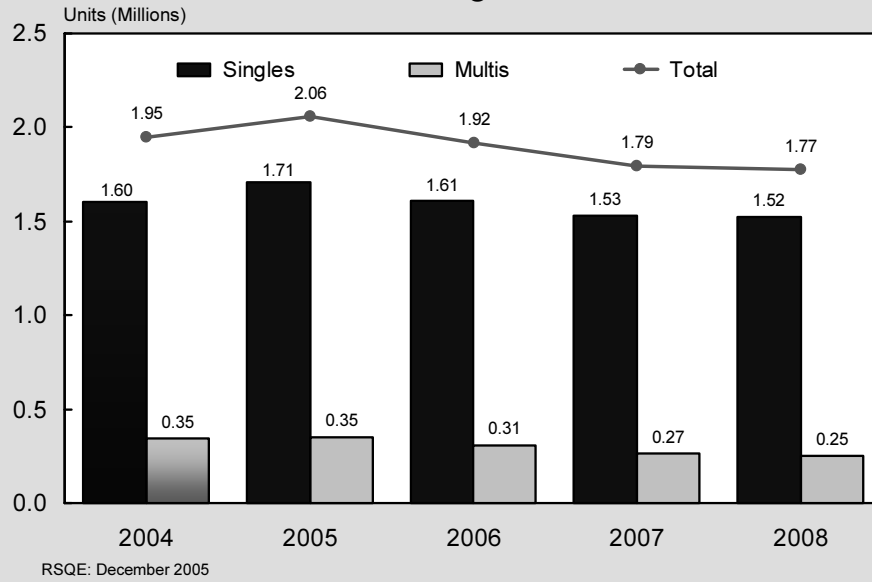


Chart 10 Light Vehicle Sales

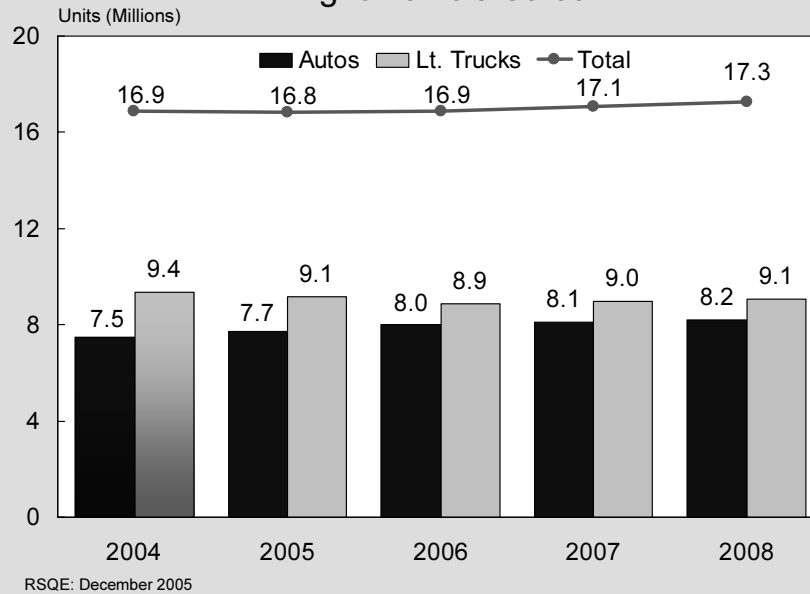
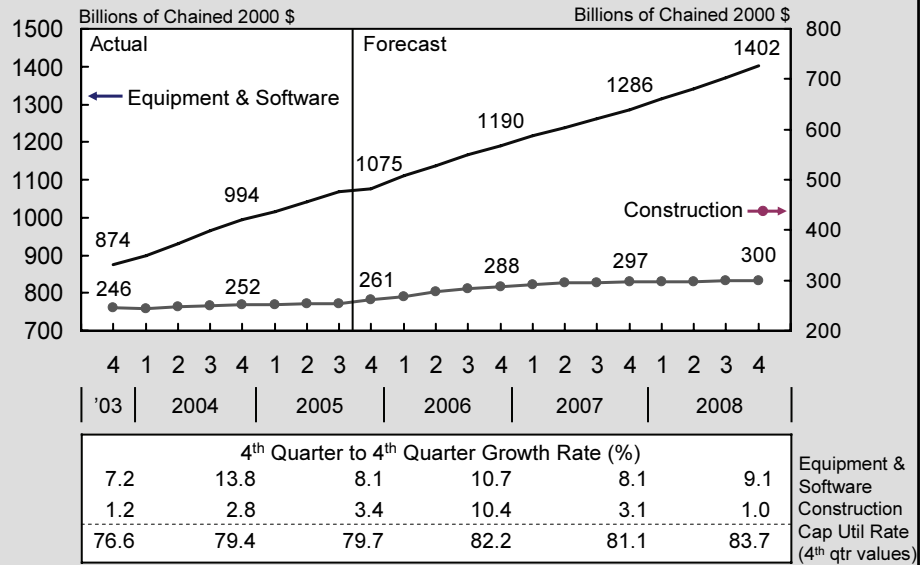
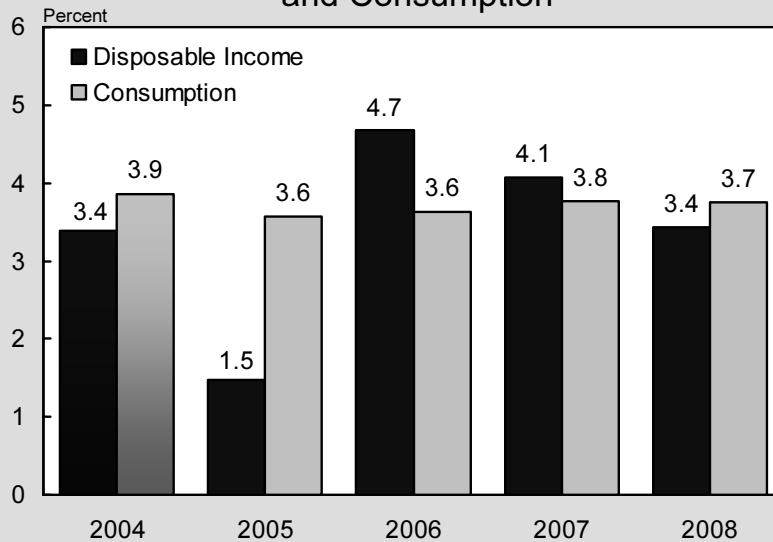


Chart 11
Nonresidential Fixed Investment



RSQE: December 2005

Chart 12
Growth of Real Disposable Income
and Consumption



RSQE: December 2005

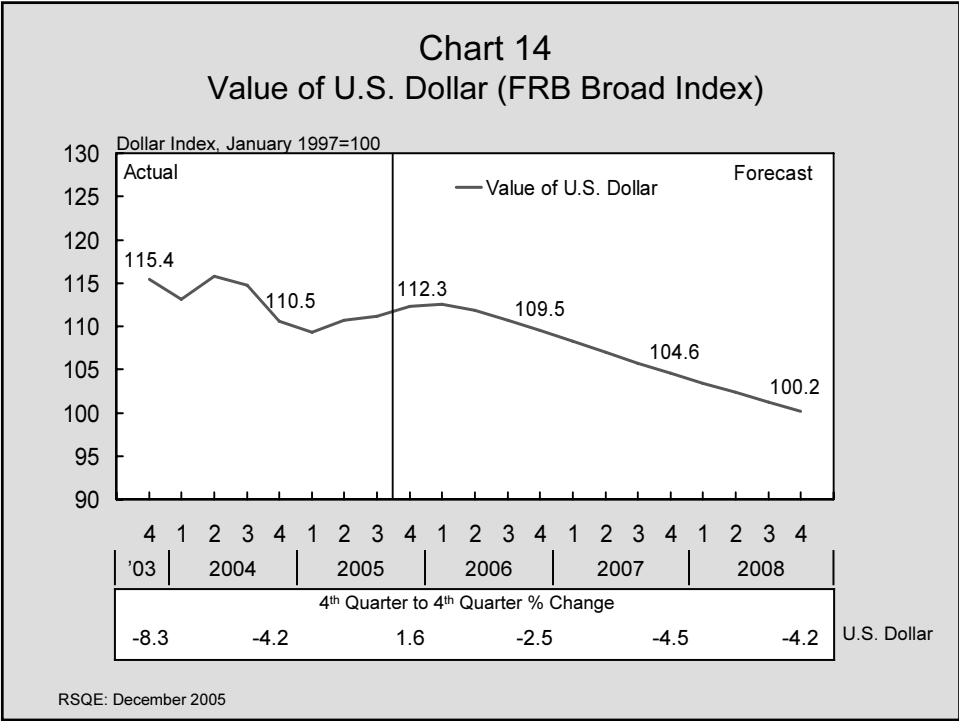
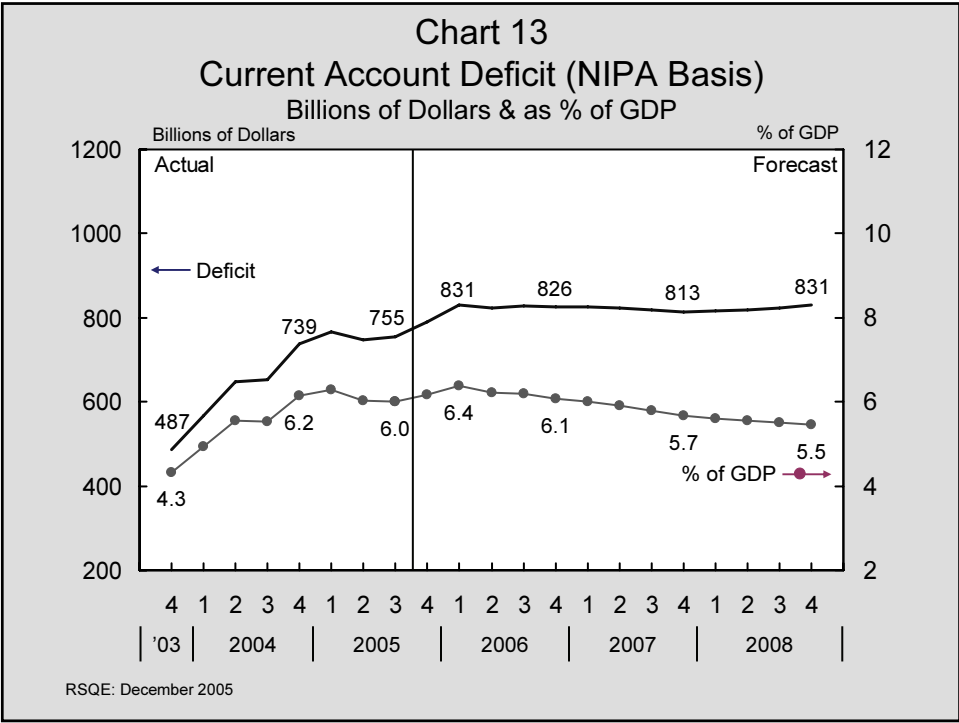


Table 3
Contributions to the Growth of Real GDP
 2005h2–2008 (Percentage Points at Annual Rate)

	Forecast				
	2005h2	2006h1	2006h2	2007	2008
Real GDP (% Change, AR)	3.8	3.8	2.7	3.0	3.4
<u>Contributions to Real GDP Growth</u>					
Final Sales to Domestic Purchasers	3.3	4.1	3.2	3.3	3.7
Consumption, Ex New Light Vehicles	2.4	2.7	2.5	2.6	2.6
Bus. Fixed Invest., Ex New Light Vehicles	0.8	1.1	0.9	0.7	0.7
Bus. & Consumer New Light Vehicles	-0.6	0.6	0.1	0.1	0.1
Residential Construction	0.2	-0.3	-0.3	-0.2	0.1
Federal Government	0.4	-0.1	-0.1	-0.1	-0.1
State & Local Government	0.2	0.1	0.2	0.2	0.2
Net Exports	-0.5	-0.7	-0.3	-0.1	-0.1
Inventory Investment	1.0	0.4	-0.2	-0.1	0.0

RSQE: December 2005

Risks to the Forecast

- **Geopolitical Risks**
- **The Price of Oil**
- **The Foreign Exchange Market**
- **An Inflation Surprise**