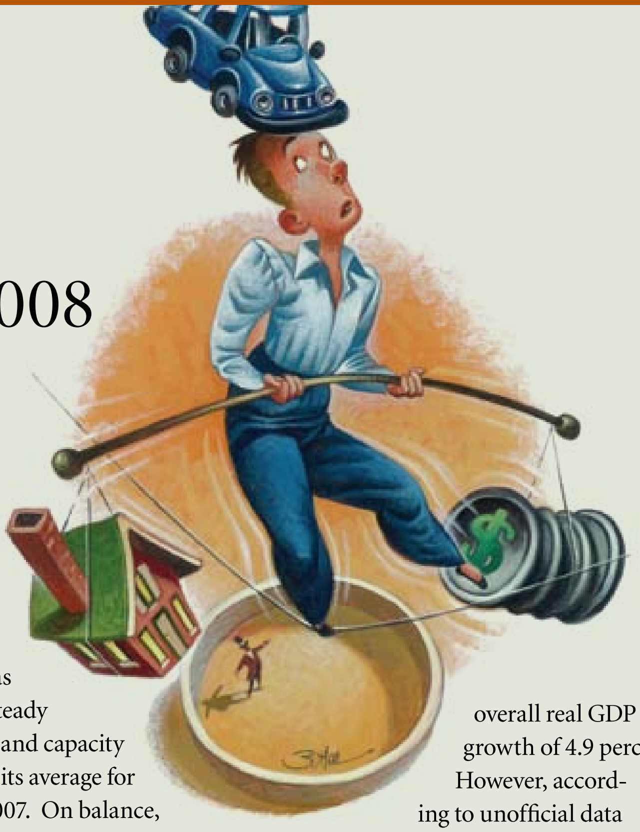
Walking a Tightrope into 2008



By Joshua A. Byrge and Howard J. Wall

The Federal Open Market Committee (FOMC) on Dec. 11 cut its target for the federal funds rate by 25 basis points again to 4.25 percent, citing continued housing-market weakness and tight credit conditions. Though oil and commodity prices remain a threat, incoming price data have indicated a reduction in inflationary pressure, suggesting that growth might once again dominate economic concerns heading into 2008. Despite strong estimates for growth in the second and third quarters of 2007—3.8 and 4.9 percent, respectively—the FOMC foresees growth between 1.8 and 2.5 percent for 2008, with core inflation expected to moderate to about 1.8 percent.

Inflationary Pressure Eases

Though the price of oil continues to be a key threat to the outlook for inflation and growth, spot oil prices fell from near $100 per barrel in mid-November to $92.30 per barrel Dec. 13. Over the same period, the price of regular-grade gas decreased from $3.11 to $3.06. Futures markets suggest that some additional oil-price moderation may be in store. On Dec. 13, the six-month futures contract for crude oil was priced at $91.20 per barrel. Further out, the one-year contract price was $88.80 per barrel. Though the spread between the spot price and 1-year futures price narrowed in mid-December, some additional relief for consumers might be in sight.

Rising productivity and falling labor costs have also helped ease the strain of high oil prices and the falling dollar. The revised estimate of third quarter productivity growth in the nonfarm business sector—an annual rate of 6.3 percent, up from a modest 2.2 percent in the second quarter—was well above expectations. Over the same period, unit labor costs fell by 2 percent. Despite strong gains in payroll employment in the fourth quarter of 2007, labor costs seem unlikely to rebound, as the employment rate held steady at 4.7 percent in November and capacity utilization remained below its average for the first three quarters of 2007. On balance, core consumer prices increased by 2.3 percent in November when compared with the year prior, remaining slightly above the FOMC's perceived comfort zone.

Housing Threatens Consumer Spending

The housing market shows no immediate signs of improvement, posing another key threat to growth for 2008. Over the third quarter of 2007, real residential fixed investment declined at an annual rate of 19.7 percent, compared with 14.1 percent over the first half of the year. As of mid-December, there was a four-month supply of single family houses on the market (that doesn't include homes which may be rented, temporarily occupied or held off the market altogether), and builders were on track to begin building 1.1 million more this year. Despite falling building permits, the continued swell of houses available suggests that residential investment will continue to be a drag on the economy well into 2008.

With house prices decelerating by some measures and falling by others, concerns that declining home equity will cause consumers to reduce spending are on the rise. Real personal consumption expenditure (PCE) accounts for roughly 70 percent of real GDP and has given the single largest boost to growth over the past several quarters. In the third quarter of 2007, PCE contributed 1.9 percentage points to overall real GDP growth of 4.9 percent. However, according to unofficial data based on work by Alan Greenspan and James Kennedy, equity extraction for the purpose of personal consumption may account for as little as 1.5 percent of PCE.[1] Thus, declining equity extraction may be offset by revolving consumer credit (excluding real-estate backed loans), which has increased by more than 12 percent since the beginning of 2006.

Tighter credit standards resulting from the contraction in the subprime mortgage market, along with decreased disposable income resulting from increased mortgage payments, present perhaps the most credible threats to the growth of spending and, thus, real GDP. With PCE expected to moderate in 2008, additional contributions to growth from business fixed investment and net exports might not be enough to offset further decreases in residential investment. With core inflation expected to remain in check and real GDP growth dependent on a strong contribution from consumer spending, the downside risks to growth may again be underscored going into 2008. Ω

Joshua A. Byrge is a research analyst and Howard J. Wall is an economist, both at the Federal Reserve Bank of St. Louis.

[1] Greenspan, Alan; and Kennedy, James. "Estimates of Home Mortgage Originations, Repayments, and Debt On One-to-Four-Family Residences." Federal Reserve Board, Finance and Economics Discussion Series No. 2005-41, September 2005.