Among Ugly Houses, Ours Is Prettiest

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The Federal Reserve Bank of Atlanta's research staff projects economic growth this year will improve after a sluggish close to 2015. But that outlook raises the question: what will change from the second half of last year? So said Atlanta Fed Research Director Dave Altig, who couched the outlook with ample caveats.

In a recent presentation at the Atlanta Fed's annual Banking Outlook Conference, Altig said the Reserve Bank research staff foresees U.S. gross domestic product (GDP) growth climbing to 2.5 percent this year, from 1.7 percent in 2015. That's not particularly robust by America's historical standards. But if GDP expands at that pace in 2016, it would be just the second year since 2006 that growth has reached 2.5 percent, and it would likely be better than the economic performance in most industrialized nations.

Last year's GDP showing was "something of a disappointment," Altig noted. The fourth quarter was especially lackluster, with 0.7 percent growth. Particularly in the second half of 2015, the economy was slowed by factors including elevated levels of corporate inventories, a dip in the growth rate of consumer spending, and global economic and financial market uncertainties. This year, the situation with inventories and consumer spending might well improve, Altig said.

Cautious consumers constrain GDP growth
Start with consumer spending. It accounts for about two-thirds of U.S. GDP, so is critical to the nation's economic welfare. Growth in consumer spending generally mirrors growth in incomes, Altig explained. Sure enough, as income growth trailed off in the last quarter of 2015, so did growth in spending. Still, he added, income growth for the full year was decent at above 3 percent.

But starting in the fourth quarter, cautious consumers saved more of their wages, Altig said. A rise in savings is not a bad thing in the long term. However, if consumers keep saving rather than spending, the Atlanta Fed forecast for 2015 GDP growth is unlikely to hold.

"If it remains part of the story, erase 2.5," Altig said.

Similar to consumer spending, Atlanta Fed economists say the inventory buildup probably will not pose a long-term problem. Yet it's an issue that is difficult to decode. Big stockpiles of inventories could mean businesses are preparing for what they expect will be better times. Or the negative interpretation: sales simply are not keeping pace with the volume of inventories companies have amassed.

Altig is optimistic on inventories. Through data analysis and conversations with business contacts, he and his researchers at the Atlanta Fed conclude that the more hopeful interpretation is probably correct. Like the fate of consumer spending, the ultimate answer to the inventories question will be critical, especially for GDP performance in the first half of the year, Altig said.

Global uncertainty persists, but China's not the biggest concern
One drag on growth that is likely to persist is global uncertainty. Don't look only to the Far East, though. For the U.S. economy, the most problematic source of potential turmoil overseas is likely to be Europe and not China, Altig said.

China's economic trajectory doesn't much influence the economy in the United States, but Europe's does, Altig explained. He cited an experiment by the firm Macroeconomic Advisers. According to that research, a severe downturn in China—annual GDP growth falling to 3 percent and the yuan devalued by 10 percent against the dollar—would shave only 0.25 of a percentage point off American GDP growth. The point, Altig stressed, is that China's economic performance is not closely correlated with that of the United States.

By contrast, America and Europe are "joined at the hip" economically, Altig observed. Between 1995 and 2014, real GDP growth in the euro area and in the United States was measured with a correlation of 0.77, basically meaning that when one was doing well, the other was almost always doing well. A level of 1 would mean a perfect match. The correlation with China, on the other hand, was negative, -0.05, based on data from the U.S. Bureau of Economic Analysis, China National Bank Statistics, and Eurostat.

Europe might do a bit better in 2016, Altig noted. "Even with some improvement in the European economy, and the global economy outside of Europe in most places," he said, "we still are anticipating that the United States remains the prettiest ugly house on the block."

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