AN ECONOMIC REPORT TO THE GOVERNOR OF THE STATE OF TENNESSEE

On the State’s Economic Outlook

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Preface

This 2007 volume of *An Economic Report to the Governor of the State of Tennessee* is the thirty-first in a series of annual reports compiled in response to requests by state government officials for assistance in achieving greater interdepartmental consistency in planning and budgeting efforts sensitive to the overall economic environment. Both short-term, or business cycle-sensitive forecasts, and longer-term, or trend forecasts, are provided in this report.

The quarterly state forecast through the first quarter of 2009 and annual forecast through 2016 represent the collective judgment of the staff of the University of Tennessee’s Center for Business and Economic Research in conjunction with the Quarterly and Annual Tennessee Econometric Models. The national forecasts were prepared by Global Insight, Inc. Tennessee forecasts, current as of January 2007, are based on an array of assumptions, particularly at the national level, which are described in Chapter One. Chapter Two details evaluations for major sectors of the Tennessee economy, with an agriculture section provided by the University of Tennessee Agricultural Policy Analysis Center. Chapter Three presents the long-run outlook and forecast for the state. Chapter Four discusses the environmental challenges confronting Tennessee today, including issues relating to air pollution, water pollution, and preservation of the Great Smoky Mountains National Park.

The primary purpose of this annual volume—published, distributed, and financed through the Tennessee Department of Finance and Administration, Tennessee Department of Economic and Community Development, the Tennessee Department of Revenue, the Tennessee Department of Labor and Workforce Development, and the Appalachian Regional Commission—is to provide wide public dissemination of the most-current possible economic analysis to planners and decision-makers in the public and private sectors.

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The U.S. Economy

1.1. Introduction: Navigating the Soft Landing

No one promised that a “soft landing” meant “no bumps along the way.”

Such is the case for the national economy. We may be looking at a soft landing for the aggregate economy in 2007, but there may be rough going in the quarters ahead as well as turbulence for some sectors. Projections are for a slowdown in overall economic activity through 2007 and continued cooling of the housing market. From the perspective of the Federal Reserve’s Federal Open Market Committee—the policymaking body that sets interest rates—the slowdown is needed if we are to achieve a soft landing for the overall economy while fighting inflation. While a slowdown is in store, the chance of recession remains slim. And following the slowdown of this year, the economy should return to a stronger pace of growth in 2008.

Overall 2007 economic growth is projected to be positive, but below a 3 percent trend. Gross domestic product (GDP) growth should average 2.3 percent over the year, with the pace improving as the year progresses. After double-digit downdrafts for housing in 2006, the housing sector is projected to stabilize in 2007. Overall consumption spending should slow, but still grow 2.8 percent in 2007. Durable goods will bear the brunt of the spillover impacts and actually decline the first half of 2007 before rebounding. Exports and business capital spending are projected to support growth in 2007, but not enough to fully offset the slowdowns in housing and consumption spending.

1 CBER bases its forecast on that provided by Global Insight, Inc.
1.1. Introduction: Navigating the Soft Landing, continued

The nation’s labor market will feel the pinch of the slowdown. The unemployment rate will drift up to 5.0 percent by the last quarter of the year and payroll employment growth will total 1.0 percent versus 1.4 percent in 2006.

Federal Reserve actions on interest rates will depend on how things settle out between the risks of inflation versus slow growth for the economy. If core inflation is contained to 2.0 percent or less, as is assumed here, the Federal Reserve (Fed) can turn attention to assisting output growth via some rate cutting. The forecast for interest rates assumes that the Fed will make three federal funds rate cuts (25 basis point each), beginning in May. Recent evidence suggests strong underlying growth in the economy which may temper, if not reverse, the Fed’s anticipated rate cutting.
The big picture: gross domestic product
In 2006, the year started strong. First quarter inflation-adjusted GDP growth was well above trend with 5.6 percent growth (seasonally-adjusted annual rate or SAAR). This followed on the heels of 2005 growth that was slightly stronger than trend growth at 3.2 percent. By the second quarter of 2006, the growth pace slowed substantially, and this continued the remainder of the year. Growth rates were 2.6 percent in the second quarter and 2.0 percent in the third quarter (SAARs).

Projections are for continued slow growth of inflation-adjusted GDP through 2007. Overall GDP growth is seen as averaging just 2.1 percent across the mid-2006 to mid-2007 period. For the end-of-2006 performance, forecasts vary among economists only as to whether the 2006 fourth quarter data will be very weak or merely mediocre. The key issue in the minds of many is whether weakness is confined to the housing sector or if it has spread to the broader economy. Recent data revisions indicate fourth quarter consumption spending was solid (4.1 percent SAAR growth for inflation-adjusted consumption spending), and evidence suggests the housing sector is stabilizing. The forecast here is for fourth quarter GDP to come in at 2.4 percent (SAAR).

Calendar 2007 growth is expected to average only 2.3 percent compared to 3.3 percent in 2006. The first quarter may be particularly slow (projected at 2.0 percent, SAAR), but GDP growth should get stronger as the year progresses culminating with 2.8 percent (SAAR) growth in the fourth quarter.

As Figure 1.1 shows, after we move through the projected slow growth of 2007, the outlook for 2008 is more optimistic. The economy is projected to grow at, or slightly above,
1.2. The U.S. Economy: Review and Forecast, continued

3 percent through 2008 and 2009. This is the whole goal of a soft landing. The Fed is aiming to defuse what they see as inflation pressures accumulating now in the economy, to achieve sustainable growth later. That means several quarters of below-trend growth are on the near-term horizon to help tame inflationary pressures.

Housing sector slows the overall economy

Through 2006, the contraction in the housing sector has accounted for much of the drag on growth of the overall economy. Towards the end of 2006, a widely heard quote was that “the housing sector took 1 percent from GDP growth.” By any measure, the housing sector boomed from mid 2003 to late 2005. (See Figure 1.2.) Activity in this sector was instrumental in helping solidify economic growth following the 2001 recession. But by 2005, the housing sector was moving at a breakneck pace; many viewed it as an unsustainable pace. For example, the residential fixed investment (RFI) component of GDP grew at an average pace of almost 11 percent per quarter (SAARs) over the extended period 2003Q2 to 2005Q3.

The housing sector’s breakneck pace could not last forever. In fact, the concern in 2005 was the question of when the inevitable housing sector slowdown would occur. Through 2005, some unexpectedly low long-term interest rates and innovations in mortgage financing (some questionable, such as “negative amortization” loans) continued to fuel housing activity.

In 2006, the much anticipated cooling of housing activity finally hit. In the second and third quarters, strong declines in RFI took place, including an 11.1 percent decline in the second quarter and an 18.6 percent decline in the third quarter (SAARs). Comparable declines are expected for the fourth quarter (a drop of 19.0 percent, SAAR). New home
1.2. The U.S. Economy: Review and Forecast, continued

and existing home sales also fell in 2006. The new home market started the correction earlier than did the existing home market, and sellers of new homes were quicker to react to the altered 2006 housing market, via price cuts and other incentives. The weakness in housing dampened construction activity and hurt building material and furniture sales.

A near-term question is the impact of some of the higher risk mortgage lending. Through the early 2000s, innovations in housing finance prolonged the momentum, pulling in new buyers: “Zero-down” mortgages, negative amortization loans, and other innovations allowed people to enter the market who formerly could not have afforded to buy. In some cases, mortgages were extended to those with marginal credit, which presents risks both for the borrower and the lending institution. As housing sector conditions cooled, some of these borrowers already have had to exit the market. In 2007, we can expect continued consequences from some of these mortgage loans, as additional marginal borrowers hit the wall, and some adjustable rate loans hit their three year rate-adjustment calendar—now in an environment of increased short-term rates and slow/no house price appreciation. In the coming year, some mortgage lenders and holders of mortgage-backed securities will experience the downside of higher risk lending patterns. The questions arise: how strong will be impacts and how broadly will they extend?

The housing sector news is not totally pessimistic. It appears that first-time buyers may be re-entering the market. Sellers of existing homes were slow to react to the slowing market, but by the end of 2006, they were showing greater flexibility on price and other incentives. Latest data show signs that home sales are stabilizing. Even if this holds, housing starts will remain depressed in 2007 until inventories of unsold homes are reduced further.

Into 2007, continued contraction in the housing sector is expected, especially the first half of the year. RFI forecasts have two more quarters of double-digit downdraft, a decline of 19.7 percent in the first quarter and 13.7 percent decline for the second quarters (SAARs). New home and existing home sales are expected to decline another 10 percent in 2007, again with stronger corrections in the first half of the year. Housing starts will decline more strongly, with 20 to 30 percent SAAR losses in the first two quarters of 2007, moderating later in the year to yield an average annual decline of 16.8 percent, as builders work down their inventories of unsold homes. An unprecedented, but small, decline in national nominal home prices is expected for 2007.

Figure 1.2 puts the residential housing sector in perspective, with history extending back to 2001. Residential investment is projected to return to a positive and sustainable growth path in 2008, though activity will fall below the strong performance of the first part of the decade.
1.2. The U.S. Economy: Review and Forecast, continued

**Business investment**

As the 2006 housing sector slowed, there was stronger performance of business investment activity. Typically, business investment expands later than the overall economy. Business investment has been slower than normal to rebound after the 2001 recession, but it did show acceleration beginning in 2004 with a 5.9 percent gain. In 2006, business investment activity accelerated further with 7.5 percent growth, including 10.0 percent (SAAR) growth in the third quarter. Fourth quarter growth is seen as temporarily flat, driven by short term factors affecting business investment in equipment.

As Figure 1.3 shows, overall investment is projected to grow at a solid pace through 2007 and to be a positive component for overall economic growth. Business investment is forecast to average 5.6 percent annualized growth through 2007, with an over 7 percent annualized growth rate in the first half of the year. Business investment is projected to remain positive through 2008 and 2009. Despite the flat performance in the fourth quarter of 2006, business investment has been a source of strength in the economy, and this is expected to continue.

High capacity utilization rates and the need to remain competitive have fueled business equipment investment in recent years. Business investment in equipment was strong through most of 2006, particularly for information processing equipment. For the fourth quarter, business fixed investment in equipment was flat, so it’s worth keeping an eye on that investment component. Some attribute the flat fourth quarter outcome to stalled business spending on equipment, and see short-term aberrations as the source (perhaps

![Figure 1.3. Inflation-adjusted private fixed nonresidential investment](source: Global Insight, Inc.)
1.2. **The U.S. Economy: Review and Forecast, continued**

delays in computer orders awaiting release of a new operating system). After-tax profits grew strongly the past few years, and many corporations are sitting on cash, but the question is whether they will commit it to equipment investment. Projections are that the fourth quarter outcome will end up being one flat quarter and not a new trend for the sector. Equipment investment is expected to rebound in 2007 with growth of 4.6 percent, again led by investment in information processing equipment.

Business construction activity was the big story in 2006. As some have cast it, in 2006, non-residential construction finally joined the expansion. New business construction increased over 15 percent (SAARs) in the second and third quarters of 2006. For the year, it was nearly 9 percent higher than the year prior. In 2007, projections are for continued strength of business construction activity, with the greatest strength occurring in the first half of 2007. (Growth of 10.7 percent SAAR in the first quarter and 8.1 percent average annual growth are projected.) Strong growth in business construction in 2006 absorbed some of the workers released from housing construction activity. However, this could not fully offset the residential construction declines.

Several factors play into the strong pace of business construction. In general, business investment revives after the overall economy; investment is not quick to respond to low interest rates, instead being more responsive to cash flow or profit measures, so its response lags the overall economic cycle. As noted, after-tax profits grew solidly over the past several years; this growth helps support investment activity. Returned affordability of building materials costs is another factor making business construction more appealing to firms. The residential housing boom, along with the post-hurricane construction of 2005 and global pressures, pushed up the cost of building materials. A cooling of residential construction activity and an advancing of business investment construction activity are typical to the maturing of an economy’s expansion. Unusual to this episode is the delayed cool down of the housing sector and delayed revival of business investment.
1.2. The U.S. Economy: Review and Forecast, continued

*Labor market conditions—On the Fed’s radar*

Data suggest tightness in the labor market, and this is a concern for policymakers and the business sector alike. The official Bureau of Labor Statistics (BLS) unemployment rate fell throughout the autumn, to 4.4 percent in October. The November rate ticked up to 4.5 percent, and the December rate also held at 4.5 percent, but this still registers as a tight labor market. Both the November and December BLS reports show strong job creation in the economy. Anecdotal reports from the business community note that employers in some sectors are having difficulty finding qualified workers at current wage rates. (See the Federal Reserve’s *Beige Book* report for November.) In fact, this is a source of concern. Tight labor markets can translate to rising labor costs which in turn can lead to rising prices and inflation. This is on the radar screen as the Fed’s policy making group looks at resource cost pressures in the economy and the upside threats for inflation pressures.

Wage pressure shows up in the average hourly earning data. Since mid year, average private hourly earnings have run about 4 percent higher than the same month of 2005, ahead of productivity gains and inflation. (For comparison, hourly earnings grew 2.1 percent in 2004 and 2.8 percent in 2005.) In the past, productivity gains helped firms to offset wage costs. But 2006’s third and fourth quarter productivity gains were tepid, at best, up only 0.2 percent in the third quarter and 1.2 percent in the fourth quarter (SAARs). The jury is out whether this productivity slowdown is a short-term cyclical aberration or longer-lived. Nonfarm unit labor costs took a big jump at the start of the year (growing by 3.1 percent, SAAR), which corresponded to a start-of-year spike in compensation costs. The second and third quarters came in at 2.4 percent and 2.3 percent, though a 3.0 spike is expected for the fourth quarter (SAARs).

The forecast for the 2007 labor market is for an upward drift in the unemployment rate, moving to 4.7 percent for the first quarter, and rising to 5 percent by the end of 2007. The anticipated slow growth for the overall economy (in part, orchestrated by the Federal Reserve) accounts for the predicted updrift in the unemployment rate. In fact, the labor market easing should alleviate some wage pressures in the economy. Payroll employment is expected to grow by 1 percent or less in the first three quarters of the year, improving to 1.3 percent growth in the fourth quarter.

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**The Fair Minimum Wage Act**

The U.S. House of Representatives voted on January 10, 2007, to raise the minimum wage from $5.15 to $7.25 per hour. The increase will be phased in over the course of the next two years, beginning with a first step to $5.85 per hour. The Senate passed a similar bill, but the House and Senate versions will require reconciliation. If signed by President Bush, this increase would be the first since 1997 when the minimum wage was moved from $4.75 to $5.15 per hour. A primary goal is to raise earnings for low-income households, though it will translate into higher labor costs for some employers.
1.2. The U.S. Economy: Review and Forecast, continued

**Government revenues up in 2006 but deficit pressure remains**

The economy’s recent growth has benefited the federal budget deficit. In 2006, revenues improved more than anticipated, so the fiscal 2006 deficit came in below $250 billion (compared to a $321 billion deficit reported for 2005). The deficit for 2007 is expected to widen (projected at $276 billion), due to slower growth in the economy and insufficient checks on spending.

In fiscal year 2006, federal government receipts were up 11.8 percent. Federal budget outlays grew 7.4 percent in fiscal year 2006, about the same growth as the previous year. This helped reduce the deficit in 2006, but this is not projected to continue into 2007. For fiscal year 2007, federal on-the-budget outlays are expected to grow 5.7 percent (a slowdown from 2006). Outlays still will outpace federal receipts, which are expected to grow 5.2 percent in 2007.

The deficit does not get the same attention as short-term issues like the recent contraction of residential investment. Chronic deficits—even in a growing economy—can be persistently overlooked. But the longer term consequences can be very important to the health of the economy. At some future point, congressional attention and hard decisions will have to be directed at deficit reduction. However, the 2006 narrowing of the deficit likely will make the task seem less immediately pressing. Most believe that higher taxes, as well as spending controls, eventually will be needed to rein in the Federal government’s debt. Near-term federal spending may be restrained some by a congressional continuing resolution on discretionary spending, as well as a move to “pay as you go” rules.

**Exports continued strong**

Export growth has been a bright spot in 2006. Export growth in 2006 was 8.7 percent compared to 6.8 percent in 2005. Projections are for continued strength in this sector over the next several years. Improved economic growth around the world and a declining dollar are projected to favor this sector for some time. As Figure 1.4 shows, export growth should average 8.6 percent in 2007 and 9.3 percent in 2008. Continued strength in the export sector is seen as a key driver of growth for the economy in the next year.

The dollar dipped in 2006 after showing some appreciation in 2005 (see Figure 1.4). Until recently, the U.S. dollar had the pull of opposite forces: a huge current account deficit pulled the dollar down while strong growth of the U.S. economy and higher interest rates (compared to other major trading partners) pulled the dollar up. Now U.S. economic performance no longer offsets the impacts of the large and deteriorating current account deficit. But the lower value of the dollar will nonetheless support narrowing of the trade deficit in 2007 and 2008 before it begins to widen again in 2009.

The weaker U.S. economy stands against improved strength in the rest of the world (especially the Eurozone). The European Central Bank (ECB) raised rates multiple times in 2006, and rate increases are expected to continue into 2007—this at a time when the Federal Reserve is “on pause” with interest rates. For globally-mobile financial investors,
1.2. The U.S. Economy: Review and Forecast, continued

Eurozone investment now seems increasingly attractive. The dollar stood at around $1.33 against the euro in December. Given influences of slowing U.S. growth, further rate hikes from the ECB, and continued U.S. current account deficits, the dollar is projected to move to a little more than $1.40 against the euro in 2007.

The dollar’s decline is not confined to the eurodollar. It also stands weaker relative to the British pound and the Japanese yen, compared to a year ago. Figure 1.4 shows the value of the dollar, as a trade weighted index against major currencies. The dollar, which dropped about 5 percent relative to other major currencies in 2006, is projected to continue its decline, sliding about 6 percent further in 2007, reaching rates of $1.42/euro, 105 yen/dollar, and C$1.21 at the end of the year.

Probably the most politically sensitive exchange rate is that with China. China began the renminbi revaluation process, with a small move (2.1 percent appreciation) in July 2005. The currency has climbed around 3.9 percent since then. Future rate moves are expected to remain very gradual, with the renminbi appreciating about 5 percent further against the dollar in 2007. In high-level trade talks between the U.S. and China in late 2006, exchange rate concerns were addressed. Fed Chairman Bernanke called for greater currency flexibility in China. A statement issued at the end of trade talks said that China is committed to exploring continued exchange rate reform, and the U.S. to improving the national savings rate. Both likely will happen only slowly. Some domestic businesses that purchase inputs and supplies from Chinese firms will be hurt by renminbi appreciation.

Continued adjustments in the value of the dollar, relative to other currencies, are part of a “global rebalancing” process. In the near term, the decline in the dollar is a source of the

Figure 1.4. Exports and trade weighted index

Inflation-adjusted exports of goods & services (left scale)
Trade weighted index, major currencies (right scale)

Source: Global Insight, Inc.
1.2. The U.S. Economy: Review and Forecast, continued

Export sector’s projected growth. It is projected that net exports will contribute nearly 1 percentage point to GDP growth in the fourth quarter of 2006. That would be the largest contribution of net exports to GDP growth in over ten years. This could offset nearly half the drag to GDP growth from the contraction in residential investment slowdown. Export gains are expected to be in the high single digits in 2007. Although slower growth is predicted for some major trading partners’ economies, a weaker dollar will offset the slower foreign growth. Export strength should continue to be an important driver for the 2007 economy, providing some offset as other sectors move to a more sustainable course.

Inflation

Measured inflation picked up during the first half of 2006. Based on the consumer price index (CPI), inflation was running over 4 percent through mid year (year-to-year performance). In the first half of the year, firms appeared to be testing their ability to pass on cost increases to consumers. Year-over-year CPI growth moderated in the second half of the year, particularly as oil prices dropped in autumn. In November, overall CPI growth was seen as benign, rising only 2.0 percent compared to the year prior.

However, throughout 2006, “core” CPI—which excludes the volatile food and energy components—remained well above 2 percent, even in the last half of the year. Year-over-year core CPI inflation rates were 2.4 percent in both September and October. November core prices rose 2.6 percent, compared to the previous year. Even if using an alternate measure of core inflation (the core consumption price deflator), core inflation was running 2.2 percent or higher in the last months of 2006. Thus, throughout the year, core inflation has remained above the Fed’s “comfort level,” seen as in the 1 to 2 percent range.

As the Fed looks at the economy, it sees the cooling housing market. They also see that, while the housing market is weak, other elements of the construction sector remain strong and there has not been a collapse in jobs in the economy. Another key element in the picture the Fed views are several sources of potential inflation pressure. Oil prices are one wild card for the economy. For example, crude oil prices rose strongly through the first half of the year, running over $74 a barrel by July, 2006. A relatively calm hurricane season (and slowing economy) resulted in strong refined oil supplies. Through early autumn and into winter, oil prices fell. The reduced energy costs certainly helped household budgets and profit margins, helped contain inflation after mid year, and buoyed consumer attitudes. Mild winter weather into January, particularly in the Northeast, held down heating oil demands, and prolonged the oil price respite. However, projections are for oil prices to move higher in 2007. The forecast presumes crude oil prices moving back above $65 a barrel in 2007. More moderate or more aggressive oil price increases will have an impact on both the Fed’s policy choices and the path of the economy. Issues here will be the strength of global demand for oil, capacity constraints, and potential supply disruptions. Energy costs remain a caution point for the economy.

Other cost concerns also exist in the economy. As noted earlier, firm’s labor costs increased through the year, and for many firms, labor costs are the biggest component of variable costs. The impact of tight labor markets on wages will play against productivity gains. So, for those monitoring business cost (or inflation) issues, labor market issues should be on the radar.
1.2. The U.S. Economy: Review and Forecast, continued

A risk to the forecast is the productivity picture. The latest productivity numbers for the third quarter of 2006 were grim. According to Bureau of Labor Statistics (BLS) reports, third quarter productivity growth was 0.2 percent, compared to the third quarter of 2005. Data over the last five years show productivity growth consistently has slowed. In 2002, growth was 4.1 percent, but by 2005 productivity slowed to 2.3 percent; 2006 productivity growth is expected to be 2.1 percent and 2007 projections are even lower. Productivity growth is a means for firms to contain costs, even in a rising wage environment; it also tends to benefit workers through higher earnings.

Many commodity prices have steadily increased over the recent past contributing to inflation pressure, fueled by rapid growth in a number of nations. While prices have recently eased, this is viewed as temporary. China’s inflation-adjusted GDP growth recently slowed to 10 percent. Looking ahead, futures markets project a moderating of base metal prices (such as copper) in 2007, and continued increases in precious metal prices. (December 2007 gold futures are near $650.) Natural gas prices moderated in early 2006 from their near-doubling in 2005 ($13/mmbtu in December 2005). They have recently ticked up from their mid-2006 values ($6.75/mmbtu in December). Projections are for natural gas to remain near this recent level into 2007. Commodity prices, in general, could affect the cost picture for a number of industries.

The Producer Price Index (PPI) for commodities and for finished goods rose strongly in early 2006, but moderated as the year progressed. Projections for 2007 are for PPI (finished goods) to fluctuate through 2007, as the economy settles to its new course. After a projected decline in PPI for the fourth quarter of 2006, producer prices are projected to increase strongly (7.0 percent) at the start of 2007, then settle to a 2.5 percent average annual pace. By 2008, the economic slowdown is projected to ease core cost pressures. The PPI in 2008 is projected to slow to a 2.2 percent pace.

The bottom line is that measured overall inflation has moderated in recent months, but core inflation still is above the Fed’s tolerable zone. Projecting forward, cost pressures will remain in the economy. This is a source of the Fed’s holding pattern on interest rates and tough talk on inflation. Overall, inflation is projected to moderate through 2007. Barring big cost surprises, overall inflation may have already peaked. For 2007, overall CPI inflation is projected to start the year at a 3.1 percent pace, sliding to 2.2 percent in the fourth quarter (SAARs).

Figure 1.5 shows the CPI annual inflation performance and the near-term fluctuations that are anticipated as the economy settles to its new course. As Figure 1.5 shows, inflation is forecast to be steady around 2 percent through 2008. Core inflation also is seen as easing in 2007, settling just below a 2 percent pace by the end of the year. If this forecast is realized, the Fed will have successfully engineered its soft landing. ■
1.2. The U.S. Economy: Review and Forecast, continued

Figure 1.5. Consumer prices

Source: Global Insight, Inc.
1.3. **Summary and Conclusions**

Expect the economy to grow, but below the 3 percent benchmark pace, in 2007.

- Inflation-adjusted GDP will increase at an annual rate of 2.3 percent.

- The housing sector will continue to drag on economic growth in 2007. A key to re-acceleration in the economy is stabilization of the housing market.

- Residential housing investment will decline by 15 percent, as this sector continues its long anticipated correction.

- Business capital spending will support growth in 2007, with business investment growing 5.6 percent. Business construction will grow (8.1 percent), but not enough to fully offset the housing downturn.

- Exports will be a source of strength going forward. Exports will grow nearly 9 percent in 2007. This pace will continue into 2008 and 2009.

- Labor market tightness will ease some in 2007, as the economy moves to slower growth. The unemployment rate will rise to 5 percent by the end of 2007.

- The inflation rate, as measured by CPI growth, will slow to 1.8 percent.