

The Unemployment-Inflation Tradeoff

Edmund Phelps won this year's Nobel Prize in Economic Sciences in large part for his insights on the unemployment-inflation tradeoff that confronts policy makers. He realized that the benefit of very low unemployment was transient and led to accelerating inflation if maintained too long. The economic debate centers on what level of unemployment is consistent with stable inflation.

October's labor market report resurrected concerns that the labor market may be too tight. The unemployment rate dipped to 4.4 percent, the lowest in five years. While nonfarm private employment rose only 92,000 in October, a large upward revision to prior months' data showed that the economy added an average of 157,000 jobs over the last three months, more than sufficient to nudge unemployment down. Employment in interest-rate-sensitive sectors, however, continued to weaken, as further job losses in the auto sector contributed to a decline of 39,000 manufacturing jobs in October, while construction payrolls fell 26,000.

At the same time, labor costs, indicia of product-price inflation, are up in real (that is, inflation adjusted) terms. Average hourly earnings rose 3.9 percent from a year earlier, and the employment cost index – a broad measure of labor costs that includes benefits – was 3.3 percent higher in the third quarter compared with a year earlier. Such real wage gains can be accommodated with stable inflation as long as labor productivity continues to rise. However, the third quarter saw no gain in labor productivity, and the increase over the past year slowed to 1.3 percent, less than half the annualized productivity gain of 2.8 percent experienced over the decade ending with 2005. A pick-up in labor-cost growth raises the specter of further increases in “core” consumer price inflation (netting out food and energy). The core of the Personal Consumption Expenditures measure increased 2.4 percent over the 12 months through September while the core Consumer Price Index rose 2.9 percent over this period, above the rate that most policymakers would like to see.

The housing market slowdown may help offset these inflation pressures. A 17 percent decline in residential fixed investment sliced more than a percentage point off real GDP growth in the third quarter, to a lackluster 1.6 percent annualized rate. This deceleration of economic activity will likely cause the unemployment rate to edge up, buffering inflation pressures. With housing starts down 17 percent from a year earlier, moreover, the sector apparently continues to weaken. The downturn in housing has led to a sharp deceleration in house price appreciation, which may damp consumer spending. Indeed, there have been outright price declines in some markets. For example, the S&P/Case-Shiller[®] index indicates an August-over-August decline in average home values in the Boston and San Diego markets, and their ten-market composite index has slowed to a 5.2 percent annual gain, the slowest in nine years and well below the peak appreciation of 20.5 percent recorded over the year ending July 2004.

Other factors may also help keep inflation under control, most notably the drop in energy prices. In addition, with corporate profit margins at post-war highs, firms have scope to absorb the modest rise in labor costs without fueling inflation. Trend productivity growth also may be better maintained than the latest figures indicate, as economic slowdowns are often associated with a temporary dip in productivity growth. Finally, inflation expectations appear well anchored, whether measured by consumer surveys or by break-even spreads on Treasury inflation-indexed securities.

The challenge in the new year will be to determine where the economy stands in relation to the unemployment-inflation tradeoff: is unemployment “too low”, is inflation “too high”, and does the federal funds target need to be altered? One perspective is that the unemployment-inflation tradeoff is well balanced; indeed, prices on federal funds futures contracts (as of November 6) suggest a 3-in-4 likelihood that the rate will remain where it is through the first quarter of 2007.

Details

- *Real GDP growth.* The housing cool-down subtracted 1.1 percentage points from the rate of real GDP growth in the third quarter, leading the economy to advance by its slowest annualized rate in three years at 1.6%. We forecast that the economy will return to a moderate rate of growth in 2007 as the drag from housing and energy prices fades, averaging a 3.1% annualized rate.
- *Consumer price inflation.* The substantial moderation in consumer price inflation that occurred during the third quarter is expected to continue through the end of the year, as energy prices continue to trend downward. In response, we lowered our fourth quarter projection of inflation as measured by the Consumer Price Index (CPI) to 1.0% from 1.5% in the October Outlook. Our prediction is that energy prices will rise moderately in early 2007, returning headline CPI growth to 2.5% for the year.
- *Unemployment rate.* We lowered our forecast of fourth quarter unemployment rate by 30 basis points to 4.5% as a result of the Department of Labor's recent upward revision to nonfarm payrolls, which showed that 470,000 new jobs were created from August to October of this year. With the economy growing more slowly than potential, the unemployment rate is expected to rise to 4.9% by midyear and average 4.9% in 2007.
- *Mortgage rates.* Rates on 30-year fixed rate mortgages are expected to be steady at 6.5% next year. We also anticipate the slight inversion in the Treasury yield curve to persist in 2007, with the 10-year Treasury and the 1-year Treasury rates forecasted to average 4.9% and 5.1%, respectively.
- *ARM share.* October posted the largest discount rate on adjustable-rate mortgages (ARMs) since March 2000 at 2.2% due to the flat yield curve. Even so, the ARM share of loans (as measured by the Federal Housing Finance Board's Monthly Interest Rate Survey) is forecasted to decrease from an average of 21% in 2006 to 14% through most of next year. With some \$500 billion in ARMs scheduled to reset in 2007, the narrower spread between short and long-term mortgage rates may provide more impetus for these borrowers to choose fixed-rate products.
- *Housing starts and sales.* Housing starts are expected to continue to decline in the fourth quarter before bottoming out in the first quarter of 2007 at an annualized rate of 1.62 million units. Total home sales are forecasted to average 6.3 million units in the fourth quarter, representing a 20,000 unit decrease from last month's forecast.
- *Home value appreciation.* With recent housing market reports showing further weakness in prices of new and existing homes, we cut our forecast of home price growth in the 3rd quarter by nearly 2 percentage points from our October Outlook, to a 3.5% annual rate. House price appreciation is expected to edge down to 2.9% (annualized) in early 2007 and then average 3.3% for the year.
- *Mortgage activity.* Given the past increases in mortgage rates, refinance activity continues to be strong due to continued incentives to cash-out home equity and refinance ARMs scheduled to have a payment reset in the next several months. The refinance share of loan applications for the next two quarters is projected to average 44%. Mortgage debt will grow by a rate of 9.1% in the last quarter of this year and drop to 5.8% in early 2007.

Frank Nothaft
Chief Economist
November 8, 2006

Amy Crews Cutts
Deputy Chief Economist

Calvin Schnure
Economic Analysis Director

Nela Richardson
Senior Economist

www.freddiemac.com/news/finance

chief_economist@freddiemac.com

Opinions, estimates, forecasts and other views contained in this document are those of Freddie Mac's Office of the Chief Economist, do not necessarily represent the views of Freddie Mac or its management, should not be construed as indicating Freddie Mac's business prospects or expected results, and are subject to change without notice. Although the Office of the Chief Economist attempts to provide reliable, useful information, it does not guarantee that the information is accurate, current or suitable for any particular purpose. © 2006 by Freddie Mac. Information from this document may be used with proper attribution. Alteration of this document is strictly prohibited.

Office of the Chief Economist
Economic and Housing Market Outlook
November 2006

| <i>Revised 11/08/2006</i> | Major Economic Indicators | | | | | | | | | | | | | | | | | | | |
|--|----------------------------------|-----|-----|-----|------|-----|-----|-----|------|-----|-----|-----|---------------|------|------|------|------|------|------|--|
| Indicator | 2005 | | | | 2006 | | | | 2007 | | | | Annual Totals | | | | | | | |
| | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | |
| Real GDP (%) | 3.4 | 3.3 | 4.2 | 1.8 | 5.6 | 2.6 | 1.6 | 2.6 | 2.9 | 3.1 | 3.2 | 3.2 | 1.9 | 3.7 | 3.4 | 3.1 | 3.1 | 3.1 | 3.5 | |
| Consumer Prices (%) a. | 2.5 | 3.7 | 5.5 | 3.2 | 2.2 | 5.0 | 2.9 | 1.0 | 2.5 | 2.5 | 2.5 | 2.5 | 2.2 | 1.9 | 3.3 | 3.7 | 2.8 | 2.5 | 2.5 | |
| Unemployment Rate (%) b. | 5.2 | 5.1 | 5.0 | 4.9 | 4.7 | 4.6 | 4.7 | 4.5 | 4.7 | 4.9 | 5.0 | 5.0 | 5.8 | 6.0 | 5.5 | 5.1 | 4.6 | 4.9 | 5.0 | |
| 30-Year Fixed Mtg. Rate (%) b. | 5.8 | 5.7 | 5.8 | 6.2 | 6.3 | 6.6 | 6.6 | 6.4 | 6.5 | 6.5 | 6.6 | 6.6 | 6.5 | 5.8 | 5.8 | 5.9 | 6.5 | 6.5 | 6.7 | |
| 1-Year Treas. Indexed ARM Rate (%) b. | 4.2 | 4.2 | 4.5 | 5.1 | 5.3 | 5.7 | 5.7 | 5.6 | 5.6 | 5.6 | 5.6 | 5.6 | 4.6 | 3.8 | 3.9 | 4.5 | 5.6 | 5.6 | 5.6 | |
| 10-Year Const. Mat. Treas. Rate (%) b. | 4.3 | 4.2 | 4.2 | 4.5 | 4.6 | 5.1 | 4.9 | 4.8 | 4.8 | 4.9 | 4.9 | 5.0 | 4.6 | 4.0 | 4.3 | 4.3 | 4.8 | 4.9 | 5.1 | |
| 1-Year Const. Mat. Treas. Rate (%) b. | 3.1 | 3.3 | 3.8 | 4.3 | 4.6 | 5.0 | 5.1 | 5.1 | 5.1 | 5.1 | 5.1 | 5.1 | 2.0 | 1.2 | 1.9 | 3.6 | 5.0 | 5.1 | 5.2 | |

| <i>Revised 11/08/2006</i> | Housing and Mortgage Markets | | | | | | | | | | | | | | | | | | | |
|---|-------------------------------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|---------------|---------|---------|---------|---------|---------|---------|--|
| Indicator | 2005 | | | | 2006 | | | | 2007 | | | | Annual Totals | | | | | | | |
| | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | |
| Housing Starts c. | 2.07 | 2.06 | 2.10 | 2.06 | 2.12 | 1.87 | 1.74 | 1.63 | 1.62 | 1.63 | 1.64 | 1.67 | 1.70 | 1.85 | 1.96 | 2.07 | 1.84 | 1.64 | 1.65 | |
| Total Home Sales d. | 7.33 | 7.56 | 7.56 | 7.34 | 7.07 | 6.96 | 6.51 | 6.30 | 6.00 | 5.90 | 5.95 | 6.00 | 5.95 | 6.53 | 7.16 | 7.46 | 6.71 | 5.96 | 5.87 | |
| House Price Appreciation (%) e. | 10.8 | 15.4 | 13.9 | 13.0 | 9.1 | 4.9 | 3.5 | 3.7 | 2.9 | 3.2 | 4.1 | 2.8 | 7.2 | 8.0 | 11.9 | 13.3 | 5.3 | 3.3 | 4.5 | |
| 1-4 Family Mortgage Originations f. | | | | | | | | | | | | | | | | | | | | |
| Conventional | \$650 | \$815 | \$920 | \$782 | \$600 | \$715 | \$659 | \$585 | \$552 | \$592 | \$595 | \$528 | \$2,697 | \$3,630 | \$2,776 | \$3,167 | \$2,559 | \$2,268 | \$2,086 | |
| FHA & VA | \$21 | \$21 | \$22 | \$19 | \$17 | \$21 | \$21 | \$21 | \$23 | \$25 | \$25 | \$22 | \$186 | \$230 | \$135 | \$83 | \$81 | \$94 | \$110 | |
| Total | \$671 | \$836 | \$942 | \$801 | \$617 | \$736 | \$680 | \$606 | \$575 | \$617 | \$620 | \$550 | \$2,883 | \$3,860 | \$2,911 | \$3,250 | \$2,640 | \$2,362 | \$2,196 | |
| ARM Share (%) g. | 32 | 33 | 28 | 29 | 28 | 25 | 19 | 14 | 14 | 14 | 14 | 15 | 17 | 19 | 34 | 31 | 21 | 14 | 15 | |
| Refinancing Share - Applications (%) h. | 45 | 42 | 44 | 45 | 44 | 42 | 41 | 46 | 41 | 31 | 29 | 28 | 59 | 65 | 46 | 44 | 43 | 32 | 22 | |
| Residential Mortgage Debt (%) i. | 10.1 | 14.8 | 16.3 | 13.6 | 10.0 | 9.6 | 11.1 | 9.1 | 5.8 | 8.3 | 8.5 | 6.9 | 11.8 | 12.7 | 14.0 | 13.7 | 9.9 | 7.4 | 7.7 | |

Note: Quarterly and annual forecasts (or estimates) are shown in shaded areas; totals may not add due to rounding; quarterly data expressed as annual rates.

Annual forecast data are averages of quarterly values; annual historical data are reported as Q4 over Q4.

- a. Calculations based on quarterly averages of monthly index levels; index levels based on the seasonally-adjusted, all-urban consumer price index.
- b. Quarterly average of monthly unemployment rates (seasonally-adjusted); Quarterly averages of monthly interest rates (not seasonally-adjusted).
- c. Millions of housing units; quarterly averages of monthly, seasonally-adjusted levels (reported at an annual rate).
- d. Millions of housing units; total sales are the sum of new and existing detached single-family homes; quarterly averages of monthly, seasonally-adjusted levels (reported at an annual rate).
- e. Annualized growth rate of Freddie Mac's Conventional Mortgage Home Price Index (CMHPI); not seasonally-adjusted.
- f. Billions of dollars (not seasonally-adjusted).
- g. Federal Housing Finance Board (FHFB); quarterly averages of monthly shares of conventional, home-purchase mortgage closings (not seasonally-adjusted).
- h. Primary Mortgage Market Survey[®]; quarterly averages of monthly shares of all single-family mortgage applications (not seasonally-adjusted).
- i. Federal Reserve Board; growth rate of residential mortgage debt, the sum of single-family and multifamily mortgages (not seasonally-adjusted, annualized rate).

Prepared by Office of the Chief Economist (MS 11/08/2006); Send comments and questions to chief_economist@freddiemac.com.

Opinions, estimates, forecasts and other views contained in this document are those of Freddie Mac's Office of the Chief Economist, do not necessarily represent the views of Freddie Mac or its management, should not be construed as indicating Freddie Mac's business prospects or expected results, and are subject to change without notice. Although the Office of the Chief Economist attempts to provide reliable, useful information, it does not guarantee that the information is accurate, current or suitable for any particular purpose.