

Forecast Update: Faster Growth, Higher Inflation, Higher Interest Rates

Recent economic data suggests real GDP growth is already accelerating out of the sluggishness we experienced in the last quarter of 2007 and the first quarter of 2008. In the past three months, “core” retail sales have increased at a 10.2% annual rate, exports are up at a 19.7% rate, and the construction of business buildings is up at a 16.8% rate.

Meanwhile, our models that use weekly data on unemployment claims are consistent with real GDP growth of about 2% in Q2.

Estimated Real GDP Growth - Q2		
GDP Components	% Change, Annual Rate	Contribution to GDP
Consumption	1.8	1.3
Business Investment	9.5	0.4
Home Building	-26.5	-1.0
Government	2.0	0.4
Trade	+\$23.4 Bln*	0.8
Inventories	-\$11.5 Bln*	0.1
Total	2.0	2.0

* Change, Annual Rate (Chained 2000\$)

As a result, we are lifting our forecast for Q2 real GDP growth to a 2% annual rate (previously 1.5%). The table above provides a breakdown of the sources of real GDP growth in Q2 in our forecast, by major component.

We also expect continued acceleration of real GDP growth into the second half of 2008. Not because of the tax rebate checks but because monetary policy is loose, the Fed has finally stopped cutting, tax rates are relatively low, and the long-term productivity boom continues.

As the table below shows, we expect the inflation problem to worsen in the quarters ahead, with GDP prices starting to catch up to the inflation that is already evident in the Consumer Price Index. As a result of faster growth and more widespread inflation, we are now making a more aggressive forecast that the Fed will start raising rates at the August meeting and push the federal funds target to 3% by year end, with more rate hikes in 2009. If the Fed ends up standing pat at the August meeting, that raises the odds of larger rate hikes in the meetings that follow.

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	Actual					Forecast		
	Q1.07	Q2.07	Q3.07	Q4.07	Q1.08	Q2.08	Q3.08	Q4.08
Real GDP Growth:								
Q/Q Annual Rate	0.6	3.8	4.9	0.6	0.9	2.0	4.5	3.5
Year-to-Year Change	1.5	1.9	2.8	2.5	2.5	2.1	2.0	2.7
Unemployment Rate*	4.5	4.5	4.7	4.8	4.9	5.3	5.4	5.4
CPI**	2.4	2.6	2.4	4.0	4.2	4.1	4.6	4.2
GDP Deflator**	2.9	2.7	2.4	2.6	2.2	2.4	3.2	3.3
Rates (End-of Period):								
Federal Funds Target	5.25	5.25	4.75	4.25	2.25	2.00	2.50	3.00
10-Year Treasury	4.65	5.03	4.59	4.04	3.45	4.15	4.40	4.65

*quarterly average ** year-to-year percentage change