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## U.S. economy poised for big gains in 2015



By Mark Zandi, December 28, 2014

This has been, in general, a good year for the U.S. economy, and 2015 should be even better.

The most encouraging development of the last year was the rapid decline in unemployment. At the current pace of job growth, the economy is fast approaching full employment, in which everyone who wants a job has one.

The next critical step in the economy's return to full health is a meaningful acceleration in wage growth, which appears imminent. For much of the recovery, wages have grown only at about the rate of inflation. This means workers' living standards have stagnated.

But as the economy reaches full employment, pay should grow much more quickly, boosting consumer sentiment and spending. Perceptions about the economy have been lackluster despite the better job market. Americans judge the economy based on whether their pay is rising faster than inflation, and whether this year's average pay increase was bigger than last year's. This has not been the case until now.

Improved moods among consumers should mean more purchases of big-ticket items such as vehicles, whose sales are already back to near record-high levels because of easy credit and lower gas prices.

Although falling oil prices will take a toll on future energy development, the United States produces a lot more energy than it used to because of the shale revolution. The country is still a significant net consumer of oil, so the surprising slide in oil prices will lift more than the vehicle industry.

Consumers stand to get a huge windfall. Gasoline prices have plunged more than a dollar a gallon since the summer. If this is sustained, consumers will put \$125 billion less in their gasoline tanks next year. For context, that is about what consumers spend on electronics and appliances annually. It should be a very good year for retailers.

Arguably the biggest disappointment in 2014 was the sideways housing market, but that is expected to change in 2015. Housing has been held back by the heretofore tough job market, which has been especially hard on millennials, who have been slow to form households.

More than three million more 18- to 34-year-olds are living with their parents today than before the recession. Many of these 20- and early-30-somethings will form households and move into apartments as the job market expands. Apartment construction is already the bright spot in the housing market, and it is sure to get brighter.

Tight mortgage credit combined with a previous jump in mortgage rates significantly crimped first-time home buyers. The lack of first-timers makes it difficult for trade-up buyers to sell their homes, ultimately hurting sales of new homes and single-family construction.

But mortgage rates have receded, and getting a mortgage will soon be easier. Mortgage finance giants Fannie Mae and Freddie Mac recently signaled a greater willingness to lend by lowering their minimum down payment requirement from 5 percent to 3 percent.

This highlights a key threat to the economy in the coming year: the likelihood that the Federal Reserve will begin to raise interest rates. The Fed needs to engineer short- and long-term rates higher, consistent with the improving job market, in a way that keeps the housing recovery on track.

Policymakers have all the tools they need and have gained valuable experience in communicating with financial markets. Yet the process of normalizing monetary policy may not be as graceful as we hope.

The United States is also vulnerable to a softer global economy. With the euro zone and Japan flirting with recession, and China's growth steadily throttling back, U.S. trade will erode. This will be made worse by the dollar's recent surge, which is sure to continue. If conditions don't deteriorate further overseas, the U.S. recovery should hold firm. This is a big if.

Russia's economic problems are by themselves not a reason to worry, but the pressure they put on President Vladimir Putin could be. Sharply lower oil prices, Western economic sanctions due to Russia's incursion into Ukraine, and the collapsing ruble and resulting higher inflation and interest rates are suffocating Russia's economy.

How Putin will respond is difficult to forecast. It is equally easy to imagine him reining in his adventurism or ramping it up. His choices could have large implications for the global economic conditions.

The other developing concern is the U.S. economy's weak potential growth rate - that rate of growth that can be sustained long term. Weak labor force participation and new business formation, the fodder for innovation and productivity growth, don't augur well.

A poor potential growth rate has allowed unemployment to be absorbed more quickly. But once full employment is achieved, unless potential picks up, economic growth will slow sharply. This will hurt living standards, particularly for lower-income households, and undermine the government's precarious fiscal situation.

Despite these reasonable concerns, betting against the American economy remains a bad strategy. The United States has clearly had a difficult run over the last 15 years, and has been scarred by terrorism, wars, and technology and housing bubbles.

But the bad times are ending. Many of the economic wrongs have been righted. Households have de-leveraged, the financial system has recapitalized, and U.S. businesses have reduced their cost structures and are highly competitive. Serious problems remain and politics complicate our ability to address them. But if history is any guide, we will.

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