
AN ECONOMIC REPORT
TO THE
GOVERNOR
OF THE
STATE OF TENNESSEE

On the State's Economic Outlook

Matthew N. Murray, Associate Director and Project Director
Center for Business and Economic Research

Prepared by the
Center for Business and Economic Research
College of Business Administration
The University of Tennessee
Knoxville, Tennessee

In cooperation with the
Tennessee Department of Finance and Administration
Tennessee Department of Economic and Community Development
Tennessee Department of Revenue
and
Tennessee Department of Labor and Workforce Development
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The US Economy

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1.1. Introduction

The US economy continued its slow, steady progress in 2004. The often erratic and unpredictable recovery following the recession of 2001 continued throughout last year, eventually showing signs of greater stability later in the year. Inflation-adjusted Gross Domestic Product (GDP), perhaps the most widely used indicator of overall economic health, was growing at an annual rate of 4.0 percent as of the third quarter of 2004.

This chapter is intended to provide a brief overview of the current economic situation for the nation along with a short-term forecast of things to come.¹ To summarize briefly in advance, despite high oil prices and slow job growth, the US economy appears to be in good health. Strong labor productivity, low interest rates, and moderate inflation have worked together to help businesses and consumers maintain relatively strong spending patterns. Also, the Federal Reserve Bank (Fed) increased interest rates five times in 2004 to help keep the economy from overheating.

Economic growth will continue, although at a slower rate, in 2005. Specifically, inflation-adjusted GDP is expected to rise at a 3.6 percent seasonally adjusted annual rate (SAAR).² The sustainability of stronger economic growth will be ensured by robust business investment in all categories (equipment, software, and structures) and an improving international trade sector, combined with slightly slower but strong growth in consumer and government spending, all of which will offset a slight decline in residential investment.

1. CBER bases its US forecast on that provided by Global Insight, Inc.

2. Unless otherwise noted, all growth rates in this chapter are seasonally adjusted annual rates (SAARs).

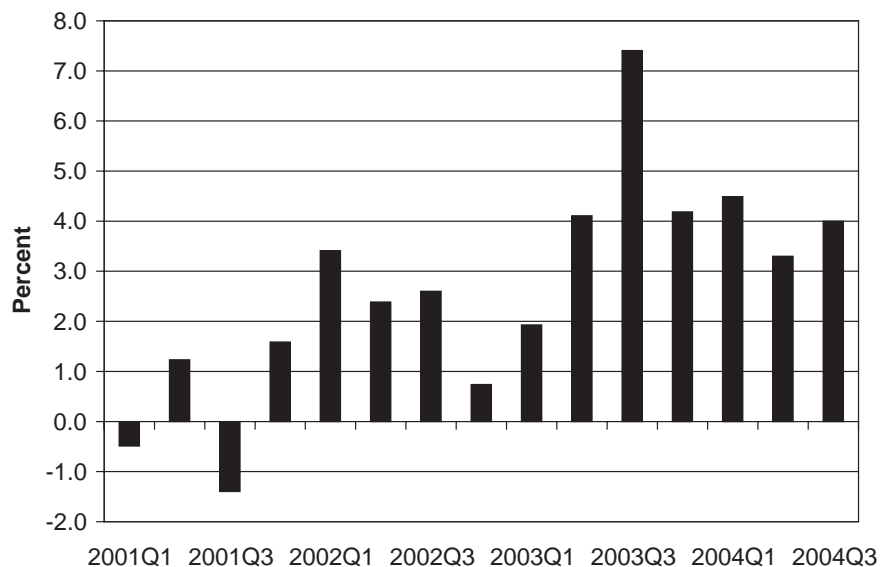
1.2. The Year in Review

Economists traditionally define a recession as at least two consecutive quarters of inflation-adjusted (real) GDP decline. As shown in Figure 1.1, real GDP growth has been positive since the third quarter of 2001. Growth has been generally slow and stable with the obvious exception of the third quarter of 2003 when real GDP grew by more than 7 percent.

The Business Cycle Dating Committee at the National Bureau of Economic Research (NBER) is responsible for officially determining the beginning and ending dates of US recessions. The NBER goes well beyond inflation-adjusted GDP in this process, looking instead at more detailed indicators of macroeconomic activity. Two critical elements in the NBER's determination include total nonfarm employment and inflation-adjusted personal income after all government transfers (disposable personal income), shown in Figure 1.2.³

Despite a slight adjustment in September 2003, total personal income has continued to grow since the 2001 recession. Fortunately, total employment turned the corner in late 2003 and has been growing slowly ever since. One of the main economic stories in 2004 was the slow rate of employment growth. Despite recent gains, total nonfarm employment is still not where it was before the 2001 recession. Fortunately, economic growth has continued alongside the sluggish job growth as a result of continued rises in labor productivity (see Figure 1.3). Another bright spot in the employment picture was the long-awaited addition of over 75,000 manufacturing jobs in early 2004 following long periods of job declines in this important sector.

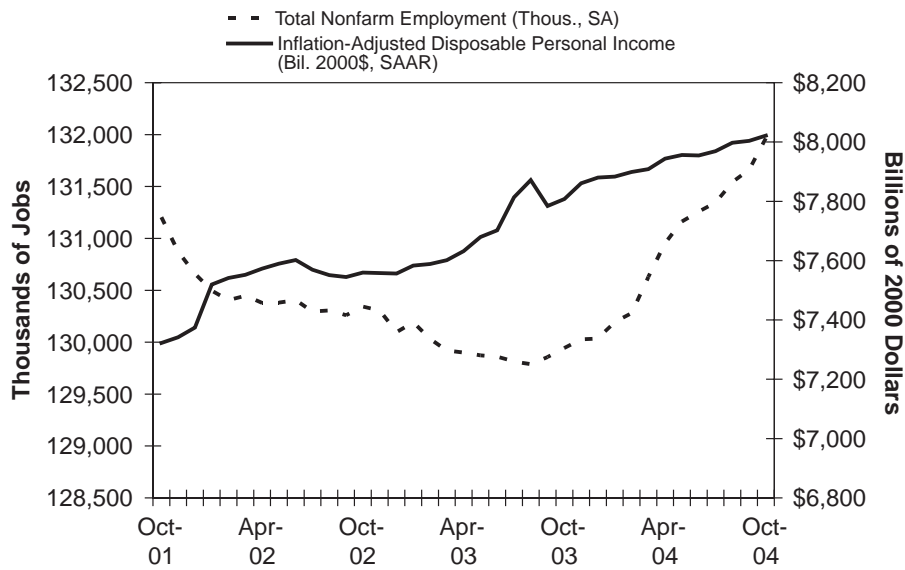
Figure 1.1. Inflation-Adjusted GDP Growth



Source: Bureau of Economic Analysis.

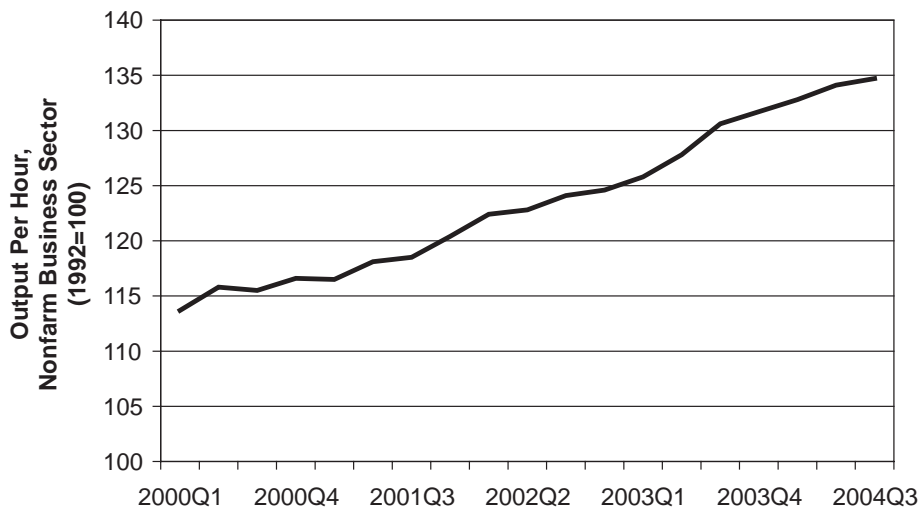
3. The employment series shown in Figure 1.2 is derived from Bureau of Labor Statistics survey of establishments, not households.

Figure 1.2. Employment and Personal Income



Source: Bureau of Labor Statistics and Bureau of Economic Analysis.

Figure 1.3. Worker Productivity



Source: Bureau of Labor Statistics.

1.2. The Year in Review, *continued*

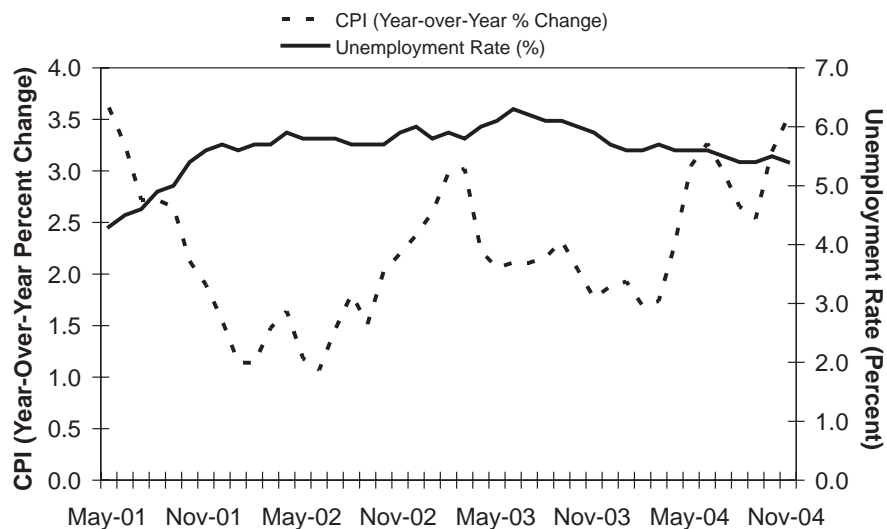
Inflation and Unemployment

Figure 1.4 shows recent movements in two other popular indicators of economic well-being, the Consumer Price Index (CPI) and the Civilian Unemployment Rate. The CPI measures the total cost of a typical market basket of consumer goods and services over time, relative to some base time period (1982-84). The percentage change in the CPI represents the general percentage increase in consumer prices, commonly referred to as inflation. The Civilian Unemployment Rate indicates the share of the national labor force that is either out of work or looking for work.

Maintaining low levels of inflation has become the primary goal of the Fed, the chief executor of monetary policy in the US. The CPI rose at an annual rate of 1.9 percent in 2004Q3, down from the 2003 increase of 2.3 percent and well below the conventionally acceptable rate of 3 percent. While prices grew slightly through 2002 and into 2003, a substantial reduction in inflation in the spring of 2003 raised fears of the possibility of widespread price reductions, or deflation. More recent data show gradually increasing inflation, however, driven mainly by the well-publicized and dramatic growth in oil prices during 2004 (see Figure 1.5).

Inflation remains largely in check due in part to a series of prudent increases in the Federal Funds Target Rate by the Federal Reserve Bank (see Figure 1.6).⁴ As the economy gathers steam and steady growth becomes the norm, consumers and businesses increase their purchases. This increased demand places upward pressure on prices, which can lead to increased overall inflation. The Fed acts to increase interest rates in times such as these in order to make it more expensive for consumers and businesses to borrow money to finance their purchases. Additionally, Fed actions have recently benefited from slow wage growth, which has placed only moderate upward pressure on prices.

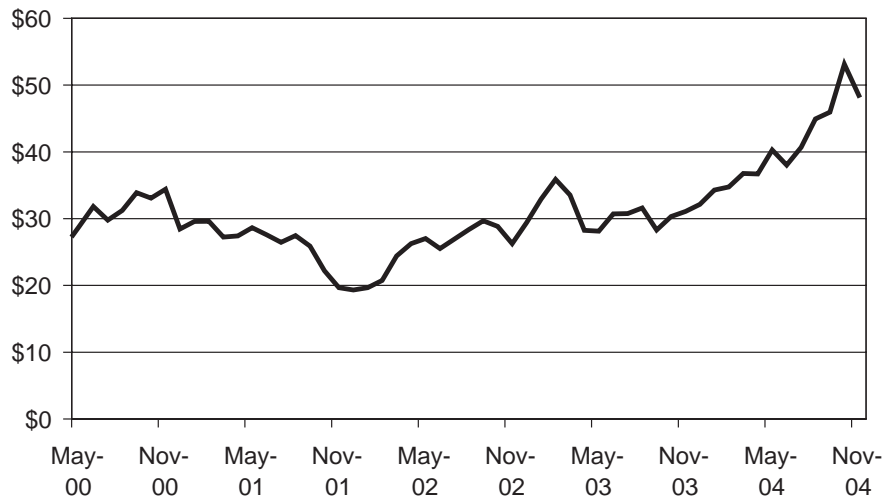
Figure 1.4. Inflation and Unemployment



Source: Bureau of Labor Statistics.

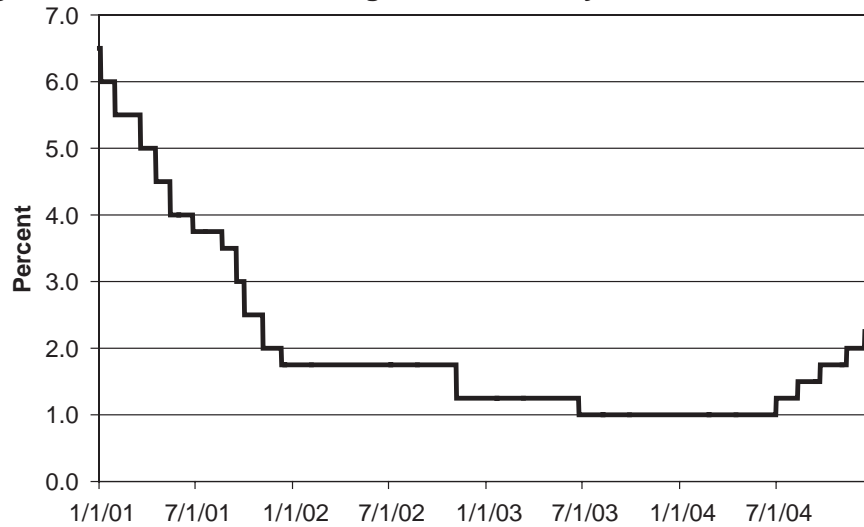
4. The federal funds rate is the interest rate charged when banks borrow from each other, either to meet reserve requirements or short-term demands for cash, usually on an overnight basis. It is changed, not directly by Fed policy but indirectly through actions of the Federal Open Market Committee.

Figure 1.5. Spot Oil Price: West Texas Intermediate, Dollars Per Barrel



Source: Federal Reserve Bank of St. Louis.

Figure 1.6. Federal Funds Target Rate, January 2001 to December 2004



Source: Federal Reserve Board of Governors.

1.2. The Year in Review, *continued*

The labor market improved slightly in 2004 with the unemployment rate continuing to fall from its mid-2003 high of 6.3 percent to a recent low of 5.4 percent. Wage inflation, nonetheless, was subdued. The Employment Cost Index, a popular leading indicator of inflationary pressure in the economy, rose by 3.5 percent on an annual basis through 2004Q3. This growth rate was down slightly from a 2003 increase of 4.0 percent. Growth in worker productivity (output per hour of work) has slowed rather dramatically, rising by only 1.8 percent as of 2004Q3, a significant fall from the 2003 growth rate of 4.5 percent. These two factors—slow wage growth and even slower productivity growth—suggest improved labor markets and lower inflation in the coming quarters as discussed below.

Components of GDP

Inflation-adjusted US GDP represents the total value of goods and services sold in the nation during a period of time. By definition, it is the sum of consumption spending, investment (including plant and equipment, structures, residential housing, and inventories), government spending, and spending on the international market (net exports, or exports less imports). It is important to examine the various components of real GDP in order to gain a more complete picture of economic health.

Consumption spending, which typically makes up about two-thirds of total inflation-adjusted GDP, increased at an annual rate of 5.1 percent in 2004Q3. This was much stronger than the impressive 2003 growth rate of 3.3 percent. This has been driven by robust growth in consumer purchases of durable goods, buoyed by low interest rates and attractive financing offers from major manufacturers.

Spending on residential housing finally started showing signs of a long-expected slow-down in 2004, driven in part by rising mortgage interest rates in the early part of the year. Residential fixed investment was up by only 1.6 percent as of 2004Q3. As shown in Figure 1.7, the average 30-year mortgage interest rate started 2004 near 5.9 percent and rose to a high of 6.3 percent in May. Interestingly, average mortgage rates reversed course soon thereafter and ended the year back in the neighborhood of 5.7 percent. Sales of new single-family homes followed nearly an opposite trend as expected, falling when mortgage interest rates increased and vice versa.

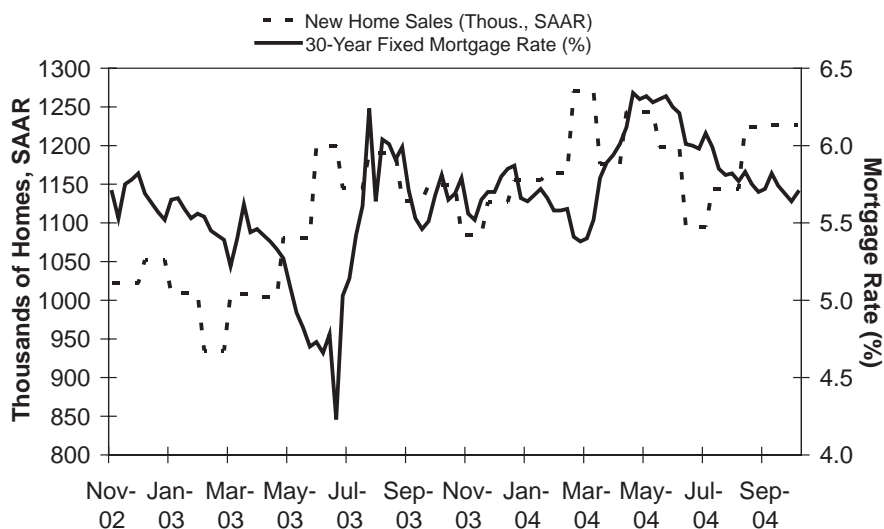
Business fixed investment rose at an annual rate of 13.0 percent as of the third quarter of 2004, up dramatically from the 2003 increase of 3.3 percent. Purchases of equipment and software (17.5 percent) were more than strong enough to offset the slight decline in investment in structures (-1.1 percent). One highlight of business fixed investment in structures, though, was strong growth in manufacturing structures (25.3 percent) following many years of declines. This trend, along with the marked increases in industrial and transportation equipment purchases in 2004, likely reflect significant rebuilding expenses in areas hit by the many hurricanes during the year.

Government spending was growing by 4.8 percent at the federal level and falling by 1.7 percent at the state and local level as of 2004Q3. Both represent slowdowns from 2003 (positive growth of 6.6 and 0.7 percent, respectively), due in part to the continued effects of federal tax cuts and the well-documented severe but diminishing fiscal strain at the state and local level.

1.2. The Year in Review, *continued*

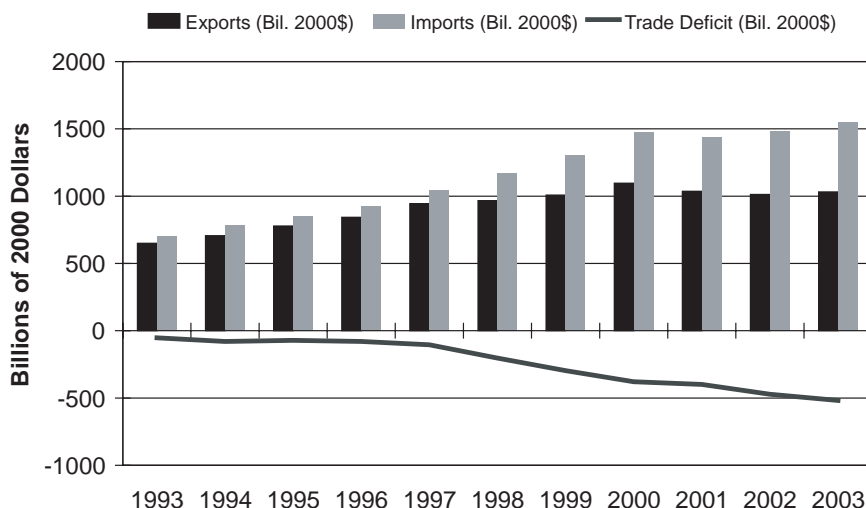
The biggest drain on domestic economic growth has typically come from the international market. Since spending by US consumers on imports is included in consumption, it is subtracted from export spending in order to avoid double counting and to gauge the true level of export spending that contributes to US economic growth. Imports have exceeded exports for well over a decade (see Figure 1.8), involving a net subtraction from inflation-adjusted GDP. The gap between exports and imports is known as the trade deficit.

Figure 1.7. Mortgage Rates and New Home Sales



Source: US Census Bureau and Fannie Mae.

Figure 1.8. Inflation-Adjusted Exports and Imports



Source: Bureau of Economic Analysis.

1.2. The Year in Review, *continued*

The trend of increasing trade deficits slightly reversed course in 2004Q3, with export growth of 6.0 percent outweighing import growth of 4.6 percent. Contributing to this was a dramatic reduction in real exchange rates, which made imports more expensive relative to domestic goods and services (see sidebar and Figure 1.9 below).

Two Sides of a Falling Dollar

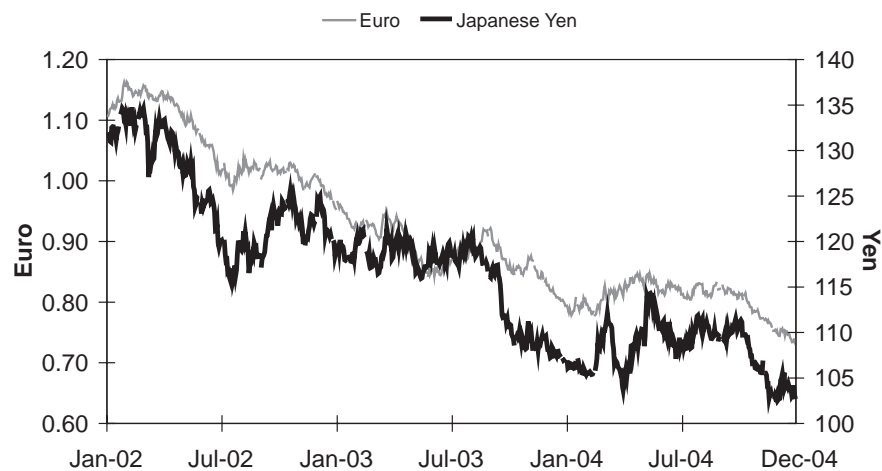
Figure 1.9 provides a clear picture of one of the most significant economic stories of 2004—the dramatic fall in the value of the US dollar relative to foreign currencies. Shown are three-year trends in two prominent nominal exchange rates: the value of the dollar relative to the euro and that relative to the yen. Both have fallen rather dramatically in recent years.

On one hand, a “weak” dollar is viewed as a negative from the standpoint of US residents, as travel to foreign countries becomes more expensive. On the other hand, residents of other nations traveling into the US enjoy relatively cheaper travel. A weaker dollar can often generate welcome increases in the flow of international visitors (and their spending money) into the US.

Similarly, in more macroeconomic terms, a falling dollar is good for overall GDP growth. If US exports are relatively cheaper and US imports from other nations relatively more expensive, we might expect to see increased export growth and slower import growth. Both of these trends would reduce the US trade deficit, leading to higher rates of overall real GDP growth. This is perhaps why most US officials have not expressed alarm at the falling dollar.

Of course, the combination of relatively more expensive imports and increased demand for US exports can result in greater rates of inflation. Indeed, the falling dollar is responsible for a significant share of the expected increase in prices in 2005, as well as the corresponding increase in interest rates as the Fed works to moderate inflationary pressures.

Figure 1.9. Foreign Exchange Rates (Units of Foreign Currency per US Dollar)



Source: Federal Reserve Bank.

1.3. The US Forecast

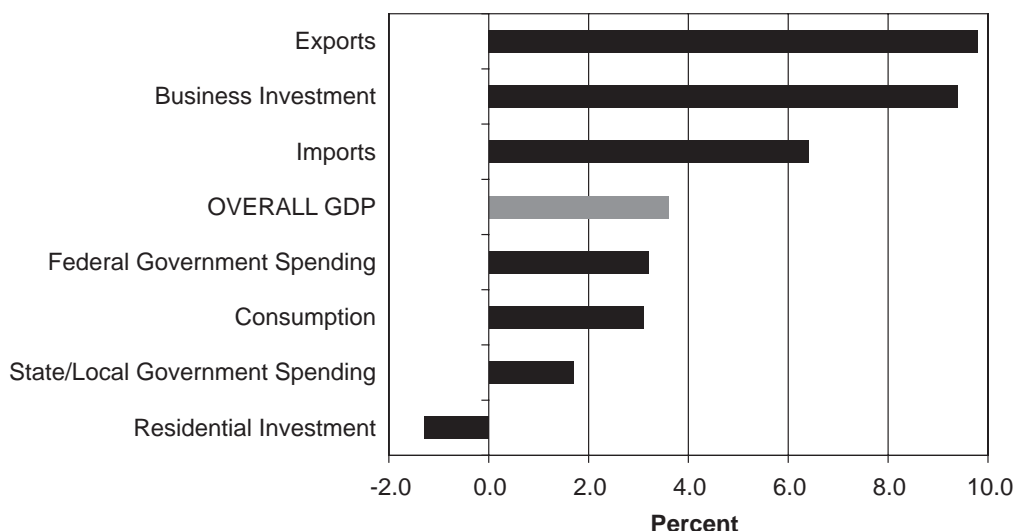
Economic growth will continue in 2005, although at a slightly slower rate than that observed in late 2004. Inflation-adjusted GDP will grow at a 3.6 percent annual rate. All segments of the economy are expected to increase, as shown in Figure 1.10, with the sole exception of residential investment (housing). Inflation and unemployment will both remain in check, and job growth will improve substantially. Each of these anticipated trends is discussed in more detail below.

Consumption and the Labor Market

Annual growth in consumption spending over the course of 2005 is expected to reach 3.1 percent. Prices will accelerate very slightly by 2.1 percent, as inflation remains largely subdued. While recent consumption growth has been fueled by low interest rates, moderate inflation, widespread mortgage refinancing, and significant federal tax cuts, future growth will be based primarily on strength in the labor market.

Labor market conditions are expected to improve, if only slowly, through 2005. Specifically, payroll employment will rise by 1.8 percent nationwide over the course of 2005, while the unemployment rate falls to 5.3 percent. Manufacturing jobs will be up at a 0.4 percent pace in 2005. A side effect will be continued slow growth in wages (as measured by the Employment Cost Index) at a rate of 3.7 percent. Productivity growth of 2.3 percent will offset inflationary pressure from this wage growth. Personal income is expected to grow at a 5.2 percent annual rate in 2005, up from its 3.4 percent pace in 2004Q3.

Figure 1.10. Expected Annual Percentage Growth in the Primary Components of Inflation-Adjusted GDP, 2005



Source: Global Insight, Inc.

1.3. The US Forecast, *continued*

Investment and Interest Rates

Residential investment will decline slightly, and business investment will continue to grow in 2005 with the slowdown on the residential side more than offset by robust growth on the business side. Beginning with residential fixed investment, housing starts will slow to an annual rate of 1.815 million units in 2005. Mortgage interest rates will be a contributing factor, with the effective 30-year fixed mortgage rate averaging 6.4 percent and rising throughout 2005. On net, residential fixed investment is expected to fall by 1.3 percent in 2005.

The slow growth in business fixed investment will pick up steam in 2005, leading to extraordinary growth of 9.4 percent. All segments of business investment, including equipment, software, and structures, will experience strong growth this year. Business investment in structures will finally rebound, growing at an annual rate of 6.6 percent. Investment of all types will be aided by persistent low interest rates. As economic growth gathers steam and the effects of fiscal policy play out in 2005, the federal funds rate is projected to continue its slow rise from the current rate of 2.25 percent to a year-ending value of 3.5 percent. This action should be enough to stave off inflation but should not seriously dampen investment spending. The prime interest rate should average 6.0 percent in 2005 versus 4.3 percent in 2004.

Government Spending

Expect slower growth in federal government spending of 3.2 percent in 2005 as recently-enacted tax and spending cuts take full effect. The Federal deficit will finally fall during 2005. State and local spending will also increase, but only at an annual rate of 1.7 percent due to sluggish revenue growth and structural imbalances that continue to constrain budgets.

Net Exports

Inflation-adjusted exports will rise at an annual rate of 9.8 percent in 2005, while inflation-adjusted imports will rise at a slower rate of 6.4 percent. Continued but slower reductions in exchange rates in 2005 will be helpful. The end result of all of this is that the trade deficit will become a slightly smaller drag on growth.

1.4. Alternative Scenarios

There exists widespread optimism that the current economic expansion will continue. Nonetheless, overall economic growth could be slower than the baseline forecast of 3.6 percent if a number of key risks materialize. Specifically, more rapid inflation and a rapidly declining dollar could lead to earlier and larger interest rate increases thereby squelching consumer and investor confidence. Higher oil prices could have similar effects on the aggregate economy. Nonetheless, even these more pessimistic scenarios would not involve outright recession, but merely slower economic growth than in the baseline forecast.

Alternatively, better-than-expected economic growth might result if productivity growth continues, oil prices fall, and businesses continue their recent investment spending. Such a scenario would likely involve lower rates of inflation, allowing interest rates to remain near current values. The slight slowdown in the housing sector would not materialize as quickly. A final factor that would contribute to faster-than-expected growth is international trade, where the declining dollar leads to even faster growth in net exports.