AN ECONOMIC REPORT TO THE GOVERNOR OF THE STATE OF TENNESSEE

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PREPARED BY THE

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

IN COOPERATION WITH THE

Appalachian Regional Commission
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
Nashville, Tennessee

THE STATE’S ECONOMIC OUTLOOK JANUARY 2011
An Economic Report to the Governor of the State of Tennessee

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The preparation of this report was financed in part by the following agencies: the Tennessee Department of Finance and Administration, the 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.

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PREFACE

This 2011 volume of An Economic Report to the Governor of the State of Tennessee is the thirty-fifth 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 2013 and annual forecast through 2020 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 2011, 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 provides a discussion of the importance of transportation infrastructure to the state and its economic development.

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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CHAPTER 1: THE U.S. ECONOMY

In this chapter—

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   Consumption and the Labor Market
   Investment and Interest Rates
   Government Spending
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   Prices and Inflation

1.4. Alternative Scenarios

1.5. Forecast Summary and Conclusions

1.1. Introduction

The turnaround in the U.S. economy that started in the second half of 2009 continued through 2010 and into 2011. The growth rate of inflation-adjusted gross domestic product (GDP) was positive throughout 2010 with the fourth quarter expected to be quite healthy. The strong growth in the beginning of 2010 year cooled down mid-year, indicating that the economic recovery was still fragile and raising fears of a double-dip recession that never materialized. The Great Recession has been the longest downturn since the Great Depression and has left some sectors deeply depressed. A good example is the housing market which remains in a substantial trough.

After disappointing growth of 1.7 percent in the second quarter, the economy gained modest momentum in the second half of 2010. As the year progressed, recovery accelerated again in the third quarter with stronger growth emerging in the fourth quarter. All in all, however, the modest growth and weak employment gains could not bring down the unemployment rate. Fortunately, the U.S. unemployment rate finally dipped in December.

Although economic recovery faltered some in 2010, growth will be moderate and more stable in 2011. Consumer spending and employment will improve over the year while a weakening dollar and global recovery will boost the export sector. As the economic expansion solidifies, businesses will rehire, higher incomes and household formation will ease the glut in the housing market, and consumer spending will expand. The unemployment rate will drop gradually, however, and remain high through 2011 and 2012. Expect inflation-adjusted GDP to rise 3.2 percent in 2011 and 2.9 percent in 2012.
1.2. The U.S. Economy: Year in Review

The National Bureau of Economic Research’s (NBER) business cycle dating committee officially announced that the recession ended in June 2009. This date represents the trough of the business cycle and the beginning of a period of economic expansion. The Great Recession, which began in December 2007, lasted 18 months, making it the longest downturn since World War II. Although the trough in economic activity occurred in June 2009 and inflation-adjusted GDP growth picked up in the third quarter of 2009, the economy lost some momentum in the second quarter of 2010 (Figure 1.1). Weak demand and excess capacity has kept the unemployment rate high.

However, fourth quarter indicators for 2010 are projected to be much stronger because of the expected improvements coming from the labor market and marginal gains in consumer sentiment. Holiday shopping is expected to have increased by more than 5.0 percent year-on-year in nominal terms. Overall, inflation-adjusted GDP growth in 2010 is expected to come in at 2.9 percent. While the fourth quarter improvements are likely to continue into 2011 and beyond, the recovery is still fragile.

Components of GDP

By far the largest component of total GDP is consumer spending which accounts for two-thirds of total spending in the economy. A high jobless rate, tight credit conditions, losses in household wealth and higher savings rates have made households more hesitant in their spending habits. University of Michigan’s consumer sentiment index remained unchanged during the first two quarters of 2010, indicating grim job and income prospects for the year ahead. Although consumers believed the economic recovery was on its way, the weak economic outlook caused the consumer sentiment index to drop to 68.2 in

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**Figure 1.1. Inflation-Adjusted GDP Growth Remains Sluggish Compared to Previous Expansions**

Note: Seasonally adjusted at annual rates.
Source: Bureau of Economic Analysis.
1.2. The U.S. Economy: Year in Review, continued

September and to 67.7 in October (1966=100). This is about 20.0 index-points below its 2001-2007 average value. However, sentiment has gradually improved in anticipation of further economic recovery and the index increased to 71.6 in November and to 74.5 in December.

Consumer spending remains constrained by the factors noted above, along with modest gains in income. In 2010 household spending began growing at a moderate pace with a projected increase of 4.3 percent in the last quarter of 2010, up from 2.4 percent a quarter earlier (seasonally-adjusted annual rates). (See Figure 1.2.) After some faltering during 2009, inflation-adjusted consumer spending on durable goods will climb 7.7 percent in 2010. Spending on big ticket items increased at an annual rate of 8.8 percent in the first quarter, 6.8 percent in the second quarter, 7.6 percent in the third quarter, and is projected to increase by 21.9 percent in the final quarter of 2010. Consumer spending on durables has been surprisingly strong given low consumer confidence and credit constraints (See Figure 1.3). In this category, light vehicle sales, furniture and household equipment, and computer and software sales have been trending higher over 2010. One explanation for the relatively strong growth rates is that many categories of sales are at very depressed levels.

In the services category, spending remained weak in 2010. Consumer spending on services typically stays stable during recessions as in normal times, but inflation-adjusted services spending barely grew by just 0.1 percent in the first quarter of 2010. The third quarter annualized growth rate of 1.6 percent is expected to be followed by just 1.3 percent growth in the fourth quarter. The spending pattern on services reveals that consumers cut back spending on recreational and financial services.

Figure 1.2. Consumers Spending Remains Subdued

Note: Consumption growth is seasonally adjusted at annual rates.
Source: Bureau of Economic Analysis, Reuters/University of Michigan Surveys of Consumers, IHS Global Insight.
1.2. The U.S. Economy: Year in Review, continued

Inflation-adjusted consumption of nondurables rose by 4.2 percent in the first quarter of 2010 followed by 1.9 percent growth in the second, 2.5 percent growth in the third, and 5.5 percent growth in the fourth quarter. After a weak performance during 2009, consumer spending on nondurable goods is now in line with its long-run pattern. The better performance in the nondurables category is largely due to improved spending on food and beverages, and clothing and footwear. Household spending on clothing and footwear is the strongest since 2005 and was running at about 5.7 percent in 2010, up from a 4.4 percent decline in 2009.

The investment component of GDP includes three broad categories: residential fixed investment, nonresidential (business) fixed investment and changes in business inventories. In the residential fixed investment category, the effect of the expiration of first-time home buyer tax credit on housing sales was significant. The annualized percent change in inflation-adjusted residential fixed investment in the third quarter fell by 27.3 percent, a sharp fall from a 25.6 percent increase in the second quarter. The sustained housing glut is driven by slow employment growth and low household formation rates. Despite falling housing prices nationwide, home sales remain sluggish. The Federal Housing Finance Agency (FHFA) house purchase price is expected to fall by 2.6 percent in 2010, while the FHFA housing price index will fall by another 4.4 percent on a year-on-year basis. However, recent data show that housing starts may be stabilizing (Figure 1.4). At 590,000 units, housing starts are up from 554,000 units in 2009 though still below pre-2009 levels. Of the total, multi-family housing starts at about 113,000 units are still low by historical standards, while single-family

![Figure 1.3. Inflation-Adjusted Consumer Spending on Durables Has Been Relatively Strong](image-url)

**Figure 1.3. Inflation-Adjusted Consumer Spending on Durables Has Been Relatively Strong**

Note: Seasonally adjusted at annual rates.
Source: Bureau of Economic Analysis.
1.2. The U.S. Economy: Year in Review, continued

Housing starts at 477,000 units are up from 442,000 units in 2009. It appears that the housing market has finally bottomed out. But it is a deep trough. The expected 590,000 starts in 2010 are dramatically lower than the 2.1 million starts in 2005. Of course, in hindsight the figures from 2005 reflect an economy that was unsustainable.

Inflation-adjusted business fixed investment picked up in 2010 with an expected annual increase of 5.2 percent, a significant jump from 17.1 percent setback in 2009. Strong spending on equipment and software contributed the most to this surge. Equipment and software spending by business grew by more than 20.0 percent during the first two quarters, by 15.4 percent in the third quarter, and by 1.1 percent in the fourth quarter. In this category, firm purchases of transportation equipment, which was hit the hardest by the Great Recession, showed very solid growth: 61.1 percent annually compared to a 51.5 percent decline in 2009 and a 23.0 percent decline in the previous year. This indicates that businesses have made a concerted effort to address their replacement needs neglected during the recession. This strong replacement investment is partly to blame for the low rate of re-hiring.

Not all business investment categories showed steep improvement. In particular, the declining pattern in business structure spending has not yet been reversed reflecting excess capacity in the face of weak final demand. Inflation-adjusted spending on business structures dropped by 17.8 percent in the beginning of 2010, following a 29.2 percent decline in the last quarter of 2009. Quarterly spending on structures has been negative since 2008 and positive growth is not likely to resume until 2012 given the weak business outlook in manufacturing and other sectors.

In the inventory investment category, businesses have been shrinking their inventories since the recession began. This

Figure 1.4. Housing Starts Flattening Out

Note: Housing starts are seasonally adjusted at annual rates.
Source: Census Bureau, Federal Housing Finance Agency.
pattern was reversed in 2010. Businesses have been accumulating inventories throughout 2010, a clear indication of improved business confidence and an economy that is finally turning around.

Inflation-adjusted total government expenditures rose by only 1.2 percent in 2010. The federal budget deficit (on a unified basis) fell to $1.294 trillion or $121.5 billion lower than 2009’s record of $1.416 trillion. The budget situation has been hurt by falling revenues and higher spending. Lower outlays in 2010 are largely due to the cost savings from the three financial crisis programs: Troubled Asset Relief Program (TARP) and assistance to Freddie Mac and Fannie Mae. Both defense and nondefense spending, in inflation-adjusted terms, rose by 4.3 and 6.2 percent, respectively, while overall federal government spending in 2010 was 4.9 percent higher relative to 2009. Despite fiscal stimulus, state and local expenditures continue to decline due to the sharp fall in tax revenues. Inflation-adjusted expenditures in 2009 decreased by 0.9 percent and in 2010 it fell further by another 1.2 percent. The fall in state and local expenditures was driven by a steep decline in investment spending in the first quarter of 2010. The spending levels stabilized in the subsequent quarters as the federal government extended $26 billion in additional aid as capital spending benefited from the American Recovery and Reinvestment Act.

Net exports (exports minus imports) are the final component of GDP. Export growth throughout 2010 remained solid, as it had been since growth reemerged in the third quarter of 2009. Inflation-adjusted value of exports is expected to increase by 11.9 percent in 2010. Improvement in export volume growth is supported by economic expansions in emerging markets and a weak dollar (Figure 1.5). On the imports side, growth has been strong since the third quarter of 2009. However, recent data indicate that growth is likely to slow down in the second half of the 2010 due to the weak domestic demand and the fact that businesses have replenished their inventory stocks.

Inflation and Prices

Inflation, as measured by the consumer price index (CPI), has been erratic, with soaring prices in 2008 and plunging prices in 2009 (Figure 1.6). More recent monthly data show the CPI trending lower and lower. Because the CPI headline inflation measure includes food and energy prices, it has been volatile, especially since the start of the recession. As can be seen from Figure 1.7, the volatility in inflation is mainly driven by the erratic pattern in energy prices. As such, the Federal Reserve has focused more on core inflation, which excludes food and energy prices, in making its monetary policy. With low wage inflation and core inflation nearing 1.0 percent, the Fed’s main concern is the risk of ongoing disinflation turning into deflation (i.e. an overall fall in prices). Falling prices negatively influence consumer and producer expectations, which in turn lead to lower demand and investment—buyers will delay purchases as they await still lower prices in the future. Because the economic outlook is weak and the danger of the economy plunging into outright deflation is high, the Federal Open Market Committee (FOMC) announced at its November meeting to purchase an additional $600 billion of Treasury securities through the second quarter of 2011 (see Box). Quantitative easing (QE2) has proven to be controversial but is consistent with the Federal Reserve’s Congressionally-given dual mandate of promoting price stability and full employment. The QE2 program is intended to lower long-term interest rates and weaken the dollar, which should help speed up domestic economic recovery. However, the sovereign debt problem in Europe may drive interest rates and the dollar back up.

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1.2. The U.S. Economy: Year in Review, continued

Figure 1.5. Export Growth Boosted by Foreign Economic Growth…

- Inflation-Adjusted GDP Growth in Major Trading Partners (Left Scale)
- Inflation-Adjusted Export Growth (Right Scale)

[Graph showing export growth and inflation-adjusted GDP growth]

Note: Seasonally adjusted at annual rates.
Source: Bureau of economic Analysis, IHS Global Insight.

…And a Weaker Dollar

[Graph showing exchange rate]

Note: U.S. trade-weighted exchange rate.
Source: IHS Global Insight.
In normal times, the Fed buys and sells short-term debt to influence the federal funds rate — its usual monetary policy tool. With the federal funds rate already near zero, this policy instrument is of no further use. So the Fed has supplemented its conventional monetary policy tool with a less familiar one: buying long-term assets to reduce longer-term interest rates, a strategy dubbed quantitative easing (QE). By lowering interest rates and changing inflationary expectations, QE is expected to lead to economic stimulus and avert deflation. Technically, the two policy instruments — trading short-term debt and long-term debt — are similar. In the first case, the Fed purchases and sells short-term Treasury securities to fine-tune the federal funds rate to affect short-term rates. Under QE, it buys long-term Treasury securities and/or other types of assets to lower long-term rates. Because the market for long-term securities is very large, the Fed has to buy assets in larger quantities. While in the first case the Fed can directly observe the federal funds rate that it manipulates, in the case of QE it is difficult to disentangle how much of a change in long-term interest rates is due to Fed actions.

By purchasing long-term securities, the Fed will drive down their yields, which decreases longer-term interest rates in the economy. Lower interest rates and inflationary expectations discourage saving: households will want to spend now instead of sitting on cash. Lower rates may also make housing more affordable, and help more homeowners to refinance. For businesses, lower costs of borrowing and cheap credit are incentives to invest. Lower interest rates also weaken the exchange value of a currency. The weak dollar will help domestic exporters be more competitive in international markets. When interest rates are low stock prices will increase, boosting wealth and profits.

The first round of QE occurred in 2008 and 2009 during the depths of the financial crisis. In November 2008 the Fed announced the purchase of $600 billion of assets related to housing obligations of government-sponsored enterprises and mortgage-backed securities of Fannie Mae, Freddie Mac, and Ginnie Mae. In March 2009 it expanded the target to $1.7 trillion, of which up to $300 billion was longer-term Treasury securities. Since the recession the Fed’s balance sheet has grown significantly (see Figure). As was expected, the pumping of $1.7 trillion into the banking system was followed by a drop in long-term interest rates. The Fed claims the QE1 worked as was expected by lowering long-term interest rates and easing financial conditions.

Given the fiscal constraints of the federal government, the Fed’s policies have not been enough to pull the economy out of the ditch. The unemployment rate climbed to 9.8 percent in November 2010, sending fears that the economic recovery was stalling. Moreover, declining inflation has raised concerns that the economy might suffer from outright deflation, and if this occurred, it would be difficult to get out of the deflation trap as the Japanese experience shows. Given its dual mandate of promoting full employment and low inflation, the Federal Open Market

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1.2. The U.S. Economy: Year in Review, continued

What Is QE2 and How Does the Federal Reserve Influence the Economy?, continued

Committee (FOMC), the Fed’s monetary policymaking committee, announced in its November 2010 meeting another bout of QE to promote growth. QE2 involves the purchase of an additional $600 billion in longer-term Treasury securities through June 2011. The Fed will continue to reinvest repayments of principal on its security holdings, which is expected to be between $250 billion to $300 billion over the same period. Taken together, this would be equivalent to about $110 billion of purchases per month. While the Fed claims the QE1 was successful, there is some disagreement regarding the influence and risks of QE2 both inside and outside the Fed.

Some members of the Fed argue that QE2 will be ineffective because the economy is in a liquidity trap, in which additional pumping of money into the economy is not going to help lower interest rates. Even if it succeeded in lowering rates, some point out that banks are not extending loans even though they already have sufficient liquidity. Other critics are worried that the Fed might not be able to respond quickly to surging inflation by withdrawing the money it injected. If inflation picks up down the road that will further soften the already weak dollar. Other countries may intervene in the market to prevent their currency from appreciating further, leading to “currency wars”. However, the Fed dismisses most of the criticisms. It recognizes the risks the QE2 carries and asserts that the regular review of policy allows the Fed to adjust the policy.

Figure 1.6. Inflation Trends Lower

Note: Seasonally adjusted.
1.2. The U.S. Economy: Year in Review, continued

The Labor Market

As can be seen from Figure 1.8, employment is still a concern with over 7.4 million jobs lost in the recession and nonfarm employment growth still sluggish. With temporary Census payrolls gone, total nonfarm payroll was down by 24,000 in September. A solid improvement in October payroll employment (up 172,000) was followed by a mediocre improvement in November (up 39,000) and stronger growth still in December. Total nonfarm employment is expected to fall by 0.5 percent in 2010 relative to 2009. However, on a quarter-by-quarter basis, private employment growth is edging up and private payrolls will have grown by over 1 million in 2010. The construction industry, the hardest hit by the recession, continued to experience the biggest decline in employment in the private sector, down by 15.7 percent in 2009 and 7.0 percent in 2010. State and local governments faced intense budgetary pressure in 2010 and payrolls were reduced by 1.1 percent for the year.

The disappointing employment situation has translated into higher national unemployment rates. Although job growth resumed in 2010, it was not enough to keep the unemployment rate down. As a result, the unemployment rate (the ratio of unemployed people to the total labor force) has been revised upwards to 9.7 percent in the fourth quarter of 2010 from the 9.6 percent rate of the third quarter. The ratio of unemployed persons to job openings was 1.8 when the recession began in December of 2007; this ratio jumped to 5.8 when the recession ended in June of 2009 (Figure 1.9). Although the ratio has trended downward since the end of the recession and job openings in October 2010 are 44.0 percent higher than the series low in July 2009, uncertainty in the economic outlook and higher worker productivity are making businesses reluctant to increase hiring.

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1.2. The U.S. Economy: Year in Review, continued

Figure 1.8. Employment Slowly Bottoming Out (in thousands)

Note: Seasonally adjusted.

Figure 1.9. Number Unemployed per Job Opening Finally Trending Downward

Note: Seasonally adjusted.
1.3. The U.S. Forecast

Economic growth will continue through 2011 and 2012 with only a small risk of another economic slowdown. The new package of tax cuts and extended unemployment insurance benefits, negotiated between the administration and Congress, will boost growth in 2011. Of these provisions, the extension of unemployment benefits for an additional year will generate the biggest bang for the buck, while tax cuts will have a smaller multiplier effect because much of reduction in taxes will translate into higher savings. Growth will help improve business confidence and market demand so that businesses will accelerate hiring. Thanks to job growth, incomes and the household formation rate will rise, which will help boost the lagging housing sector, while swelling consumer confidence will help lift spending. The rise in consumer spending will prop up hiring even more. The additional stimulus will hopefully help the economy to advance to a self-sustaining, market-driven growth path. In the baseline outlook scenario, inflation-adjusted GDP is forecast to rise 3.2 percent in 2011 and 2.9 percent in 2012. Due to the tax incentives business equipment spending is expected to show strong growth, while spending on nonresidential buildings is likely to bottom out in 2011. Export growth will be boosted thanks to the weaker dollar and the economic recovery in major trading partner countries.

Consumption and the Labor Market

It is a chicken-egg problem. Businesses need to see consumer demand grow before hiring returns in force as consumers need jobs and incomes to support higher spending. Inflation-adjusted consumer spending will slow down during the first quarter as holiday sales end. However, on a year-on-year basis spending will grow by 3.2 percent in 2011, up from 1.8 percent in 2010. As such, job growth will be gradual, at least during the first half of the next year. Because businesses typically do not sharply increase hiring after the economy evolves into expansion, job openings and employment are not likely to reach their pre-recession levels until 2013. The biggest boost to total nonfarm employment, which is forecast at 1.4 percent, will come from the wholesale trade (2.8 percent), transportation and warehousing (4.5 percent), professional and business services (4.4 percent), and education and health care services (2.3 percent) sectors. On the other hand, employment in the construction sector will fall by another 1.6 percent in 2011 and positive growth will not resume until 2012 and then from very depressed levels. Thanks to the additional fiscal stimulus and QE2, the unemployment rate in 2011 is forecast at 9.3 percent. Because the recovery will be slow and unemployment typically lags other indicators, high unemployment rates will stay even several years after the economic recovery is underway. In fact, the pre-recession unemployment rate (4.6 percent) is not going to come back any time soon, perhaps not even in the decade.

The consumer sentiment index is projected to rise by 7.0 percent, from an index of 71.8 in 2010 to 76.9 in 2011, but remain very low by historical standards. Nevertheless, the gain in consumer sentiment will improve consumer spending next year. Growth in inflation-adjusted total consumption expenditures is expected to be back up to an annualized 3.2 percent rate relative to only 1.8 percent in 2010. Growth in consumer spending will be driven by steady growth in durable goods spending. Spending on durables generally leads the recovery, especially in its early stages, as consumers seek to satisfy their pent-up demands. While inflation-adjusted consumer spending on big ticket items will slow down for the first quarter of 2011 (2.2 percent), it will show solid growth again in the subsequent quarters (7.1, 7.7, and 8.9 percent). Consumer spending on nondurables, adjusted for inflation, will edge up to 3.3 percent, which is in line with its long run pattern. Consumer spending on services, after lackluster spending in 2010, is expected to grow at a rate of 2.4 percent next year.
1.3. The U.S. Forecast, continued

**Investment and Interest Rates**

Growth in inflation-adjusted residential fixed investment on a year-on-year basis is projected to turn positive for the first time since 2005. The growth rate of 2.7 percent from deeply depressed levels is too modest, posing downside risk for 2011. However, as the recovery accelerates, growth in residential fixed investment will be sustained in the second and subsequent quarters of 2011, reaching double-digits (12.0, 15.6, and 22.3 percent, seasonally-adjusted rates). Although the housing market is still deeply depressed, next year’s housing starts are forecast at 685,000 units, up from 590,000 in 2010. The gradual increase in housing starts is explained by gradually improving job growth and rising household formation rates. However, annualized housing starts are not expected to return to pre-recession levels for many years to come. The FHFA house price index (purchase only) is expected to fall again in 2011 by 4.4 percent because of continued glut in the housing market.

On the business fixed investment side, the overall picture shows a continued upward trend. Growth will progress at an annualized rate of 8.6 percent for the year, slight improvement over 2010 (5.2 percent). However, the picture looks mixed across the different categories of business fixed investment. Equipment and software spending will continue to show robust growth (up by 14.7 percent), while the outlook for business structures looks poor (down by 7.6 percent). The large drop in the business structures category will be driven by steep declines in the manufacturing (down by 21.8 percent) and power and communications industries (down by 9.8 percent) with slower setbacks in other sectors.

Lower interest rates are one of the factors that helps stimulate investment. However, when economic activity is weak or sluggish, low interest rates may be insufficient to spur investment. In such circumstances, business confidence and the outlook for consumer demand may trump the importance of low interest rates. Profits are pointing upward, many businesses are flush with cash and the Federal Funds interest rate is near zero and expected to hold at that level until 2012. Yet business investment in structures continues to contract because of excess capacity and weak near-term outlook for final demand. Moreover, there is additional uncertainty as consumer prices show a slower rate of ascent. Part of the goal of the Federal Reserve’s announced intention to purchase an additional $600 billion in government securities is to change inflationary expectations while also driving down long-term interest rates. This interest rate effect from quantitative easing will be small, only around 0.1-0.2 percentage points. However, the Fed might scale back the amount of QE2 given the recently passed additional fiscal stimulus by the Congress.

**Government Spending**

The $860 billion stimulus package signed by President Obama at the end of 2010 includes a 2.0 percentage point payroll tax cut for a year, estate tax reduction, an extension of Bush-era tax cuts for another two years, and an extension of unemployment insurance benefits through 2011. The package will stimulate economic growth, but due to large deficits ($1.4 trillion in 2011) the federal government’s fiscal options have become increasingly constrained. Inflation-adjusted federal government spending will flatten out with a projected 0.5 percent increase in 2011. This slowdown is driven by the dynamics of defense spending which is expected to peak in 2011. With some overseas contingency operations winding down, defense spending will increase by only 0.6 percent in 2011, but on a quarter-by-quarter basis, it will fall and continue to fall for several years after. Nondefense spending is forecast to increase by only 0.5 percent because of a freeze in federal government civilian pay. State and local government expenditures will essentially be flat with an expected increase of only 0.1 percent in 2011.
1.3. The U.S. Forecast, continued

International Trade

A mild growth slowdown among the U.S.’s key trading partners in 2011 will dampen export growth. However, given the weak dollar, which will increase the competitiveness of U.S. goods and services, the growth in exports, in inflation adjusted terms, will only ease to 8.7 percent in 2011 from 11.9 percent in 2010. Growth will be seen across all major export categories, with capital goods continuing to show solid growth for the second consecutive year (13.6 percent). On the other hand, given weak domestic demand, imports will grow at a moderate pace, 7.2 percent in 2011 relative to 12.8 percent in 2010. Import growth is driven, as in 2010, by capital good purchases as firms continue to replenish their inventories, albeit at slower pace. Because growth in exports will overtake the growth in imports in 2011, trade will be seen as a boost to domestic growth rather than a drag as in 2010.

Prices and Inflation

The current rate of core CPI inflation—a critical measure the Federal Reserve relies in its monetary policy considerations—is at a dangerously low 1.0 percent annualized rate. At this rate, the risk of the economy plunging into Japanese-type deflation is considerably higher. However, core inflation is expected to pick up in 2011, stabilizing at 1.2 percent year-on-year. Headline CPI inflation will move slightly lower (1.6 percent) in 2011, against 1.7 percent in 2010. In its December meeting, the FOMC confirmed its intention of purchasing $600 billion longer-term Treasury securities as noted above, which is equal to $75 billion per month, in order to stimulate the economic recovery and help keep the inflation at levels consistent with its mandate. This means the Federal Reserve is concerned about the risk of deflation and stepping up efforts to prevent that from happening. House prices will see another drop in 2011 and oil prices will average about $88/barrel.

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Deficit and Debt Reduction Commissions

The federal budget has not been in balance since 2001, a near-singular event in modern history. Deep fiscal stress exacerbated by the Great Recession has resulted in federal debt reaching 62.2 percent of GDP in 2010, a substantial rise from 33.3 percent in 2001. Although the deficit problem will ease as revenues increase during the economic expansion, the current fiscal situation is unsustainable and government will have to continue borrowing to make up the difference between revenues and faster rising spending. According to Congressional Budget Office estimates, the debt will gallop to nearly 100 percent of GDP by 2020 assuming future outlays grow with GDP and the 2001/2003 tax cuts are continued. Unless the fiscal situation is corrected, federal debt of this magnitude will be a drag on the economy and expose the nation to external risks. In order to address the looming fiscal challenges, two separate deficit and debt-reduction groups were created to identify policies to bring the nation into a fiscal course that is sustainable over the long run.

The National Commission on Fiscal Responsibility and Reform, created by President Obama and led by Erskine Bowles and Alan Simpson, was charged with presenting policy recommendations to balance the primary federal budget (i.e. excluding interest payments on the debt) by 2015 and to improve the long-run fiscal outlook. The 18 member bipartisan commission’s 11-7 vote in December 2010 to approve the plan came just three votes short of sending the recommendations to Congress for consideration. The Bowles and Simpson plan calls for spending cuts and tax system overhaul that would cut the deficit by $4 trillion through 2020, reduce the deficit to 2.3 percent of GDP by 2015, and stabilize and reduce debt to 60 percent of GDP by 2023.

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1.3. The U.S. Forecast, continued

Deficit and Debt Reduction Commissions, continued

The package would cap revenues at 20.6 percent of GDP and spending at 21.8 percent of GDP by 2020 (both at 21.0 percent by 2035), reduce income and corporate tax rates, and substantially cut spending levels. In particular, in the tax reform arena, the plan would enact three lower-income tax rates (8 percent, 14 percent and 23 percent), reduce the top income tax rate to between 23.0-29.0 percent from current top rate of 35.0 percent, eliminate virtually all tax expenditures for individuals, and abolish the alternative minimum tax. It will also cut the corporate tax rate to a single rate between 23.0 and 29.0 percent (the current top rate being 35.0 percent) and eliminate special subsidies to different industries. The lower corporate tax rate, along with the proposed exemption of active foreign-source profits from domestic tax, as they claim, will improve the competitiveness and attractiveness of U.S. businesses.

On the spending side, the Bowles-Simpson plan would eliminate or reduce low priority programs both in security and non-security areas, impose a three-year pay freeze on federal employees and cut the government workforce by 10.0 percent. To control spending growth on Medicare and Medicaid, the package proposes to raise copayments, reform malpractice law and physician payments, and limit federal health care cost growth to GDP plus 1.0 percent. The plan would also decrease spending on Social Security by increasing the retirement age to 68 by 2050 and to 69 by 2075.

Another deficit and debt reduction task force, launched by Bipartisan Policy Center and led by Pete Domenici and Alice Rivlin, prepared their version of a package of spending cuts and revenue increases to reduce long-term debt. If implemented, it will balance the primary budget by 2014 and stabilize the debt below 60.0 percent of GDP by 2020. The Domenici-Rivlin plan reduces spending to 23.0 percent of GDP with revenues capped at 21.4 percent of GDP by 2020, higher target levels than the Bowles-Simpson plan proposes. In the Bowles and Simpson plan about 1/3 of cost savings for 2012-2020 come from revenue increases and the rest from spending cuts, while in the Domenici and Rivlin plan deficit reduction will be achieved by roughly half of its savings coming from spending cuts and half from revenue increases.

The Domenici and Rivlin package proposes to contain Medicare and Medicaid costs by increasing premiums and copayments, limiting per-beneficiary cost growth, reforming malpractice law, freezing defense and non-defense discretionary spending for four-five years by eliminating ineffective programs. However, their health care proposal is more controversial than the Bowles and Simpson plan because of the proposed substantial hike in Medicare premiums and cost-sharing expenses (deductibles and coinsurance). If enacted, the plan will raise Medicare Part B premiums from 25.0 to 35.0 percent of total program costs. This is about a $500 increase a year according to the Center on Budget and Policy Priorities. The plan also calls for a transition to “premium support” starting in 2018, by charging higher premiums if costs rise faster. Alternatively, beneficiaries can opt out for a private plan, which is effectively equivalent to a voucher system. As for Social Security reform, the plan recommends gradually increasing the taxable base and switching to an alternative measure of inflation (which captures changes in consumer spending patterns, and hence does not overstate overall inflation) in indexing benefits each year. Because of the expected increase in life expectancy, the Domenici and Rivlin plan deficit reduction will be achieved by roughly half of its savings coming from spending cuts and half from revenue increases.

On the revenue side, the recommendations are similar in spirit to the Bowles-Simpson plan but less regressive. In particular, the proposed package would cut individual income tax rates and establish just two brackets, 15.0 percent and 27.0 percent. It would reduce the corporate income tax rate to 27.0 percent and eliminate almost all tax deductions for individuals and corporations. Also, the plan recommends enacting a payroll tax holiday for 2011, which they claim will help revive the economy and create up to seven million new jobs. Perhaps the most distinguishing feature of the plan is the proposal to enact a new national tax – Debt Reduction Sales Tax (DRST) of 6.5 percent – aimed, along with the spending reductions, at balancing the budget and reducing the national debt to a sustainable level.
1.4. Alternative Scenarios

In the baseline scenario presented here and used to drive the Tennessee forecast presented in chapter 2, the economy will continue to grow at moderate pace in 2011 after a bit of a roller-coaster ride in 2010. Gradual growth in incomes and consumer spending will reinforce each other as the labor market gradually improves. On the downside, the weak housing market and credit constraints will dampen the recovery.

While the recovery is on the way, the odds that it will falter are 20.0 percent. In this pessimistic scenario, the economy slips into a second recession. This scenario assumes lower consumer spending and investment due to weak consumer confidence and tight credit. Global growth slows down, the housing market remains depressed and the labor market deteriorates. The Eurozone sovereign debt problem deteriorates and sends the euro sliding against the dollar. The stronger dollar will reduce U.S. competitiveness, further dragging down the economy. Inflation-adjusted GDP grows at a mere 0.3 percent (annualized) rate under this scenario.

1.5. Forecast Summary and Conclusions

In the optimistic scenario (20.0 percent probability), the boost to growth from stimulative fiscal policy and quantitative easing will be more pronounced improving the odds of a vibrant recovery. The economy easily recovers from the recession and enters a phase of self-sustaining expansion. The accelerating recovery causes prices to rise more rapidly and CPI inflation moves higher in 2011 (2.0 percent). Inflation-adjusted GDP grows at or above 4.0 percent in 2011. This scenario also assumes faster global growth and a weaker dollar, which should boost the export volume.

• Inflation-adjusted GDP is forecast to grow at an annualized rate of 3.2 percent.
• Job growth will be gradual, at least for the first half of the year, and the unemployment rate is forecast at 9.3 percent.
• As consumer sentiment gradually improves, inflation-adjusted consumer spending will rise 3.2 percent. The rebound is fueled by higher spending on durable goods.
• Growth in fixed business investment will continue to trend upward, with equipment and software growth offsetting continued weakness in structures.
• Improvements in the housing market will be sluggish and housing starts will not attain their pre-recession levels any time in the near future.
• The new $860 billion fiscal stimulus package that includes a range of tax cuts and unemployment insurance benefit extensions will speed up the pace of recovery.
• Economic recovery in the U.S.’s major trading partners and a weak dollar will boost export growth.
• Deflation rather than inflation will be the main concern in the near term as the core inflation is falling to an uncomfortably low 1.0-2.0 percent.