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An Economic Report to the Governor of the State of Tennessee

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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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EXECUTIVE SUMMARY

The U.S. Economy

The U.S. economy has been on the recovery path since mid-2009. The robust growth in the beginning of 2010 cooled down mid-year before picking up again in the second half of the year. Inflation-adjusted gross domestic product (GDP) is expected to grow 3.2 percent in 2010. The mid-year relapse caused the consumer sentiment index to drop to 67.7 in October of 2010 (1996=100). This is about 20.0 index-points below its 2001-2007 mean value. Total consumption expenditures grow only by 1.8 percent for the year. Spending on durable goods has been strong throughout 2010, with overall growth of 7.7 percent. Spending on nondurables stood at 2.8 percent which is in line with its long-term pattern. In the services category, spending has been unusually weak with a growth rate of only 0.5 percent. Nonresidential fixed investment grew at a 5.2 percent rate, improvement from a 17.1 percent decline the previous year. The growth in this sector was buoyed by a solid recovery in the equipment and software category (up by 14.8 percent), but was driven down by continued fall in business structures (down by 14.5). Residential fixed investment (housing) declined by 3.2 percent due the housing glut driven by slow employment growth and a low housing formation rate. Relative to last year’s drop of 22.9 percent, the slower rate of decline in this sector is a sign that the housing market may stabilize. Government spending increased by only 1.2 percent, largely due to the fall in state and local expenditures. A weakening dollar and growth in major trading partners boosted export growth. Exports are expected to have grown 11.9 percent in 2010.

Total nonfarm employment is expected to fall by 0.5 percent in 2010. In the second half of the year, employment data unexpectedly worsened slightly. The insufficient growth in employment translated into a higher unemployment rate. Unemployment first stayed stable at 9.6 percent, but then jumped to 9.8 percent in November 2010. Inflation based on consumer price index (CPI) has been erratic due to the fluctuations in energy and food prices. However, core CPI inflation (excluding food and energy) has stayed at low levels for an extended period of time and a recent downward trend is worrisome. At current rate of around 1.0 percent, declining inflation, known as disinflation, increases the risks of turning into deflation or an outright fall in prices. Given high unemployment and low inflation, as well as a federal funds rate that is pegged near zero, the Federal Reserve announced its intent to engage in another round of “quantitative easing.” Through its open-market operations, the Fed plans to purchase additional longer-term Treasury securities to bring long-term interest rates down.

Economic growth is forecast at 3.2 percent in 2011. All major components of GDP are expected to produce positive growth. Consumer spending is projected to increase by 3.2 percent. Spending on durables and nondurables will continue to grow at similar magnitudes as in 2010, while spending on services is expected to improve to 2.4 percent. Nonresidential fixed investment will grow 8.6 percent, while investment in business structures is expected to fall further by 7.6 percent. Relative to 2010, the decline in business structures investments is slowing down as the prospects of economic recovery improves. Headline CPI inflation is projected at 1.6 percent, while core CPI inflation (excluding food and energy) will stabilize at 1.2 percent in 2011. At these low rates, deflation will be the main concern in 2011. Growth in exports will ease to 8.7 percent as global growth slows down in 2011. Government spending will flatten out as some overseas contingency operations wind down in 2011. As such, federal government spending is expected to increase by a mere 0.5 percent, while state and local spending will essentially be flat with only 0.1 a percent increase next year. An additional $860 billion fiscal stimulus package signed in December is expected to boost...
spending and stimulate job creation. Despite improvements in employment prospects and the overall economic outlook, unemployment will remain high at 9.3 percent in 2011.

Because unemployment typically lags other indicators, it is projected to remain high for several years into the economic expansion.

The Tennessee Economy

The last year was a bit of roller coaster ride, with decent growth in the first quarter followed by more sluggish growth that raised concerns of a double-dip recession. The double-dip never materialized and the state economy enjoyed its strongest showing since the onset of the recession. Growth was admittedly sluggish compared to previous post-recession expansions, but there was nonetheless something good to talk about for a change. The third quarter of the year produced the first year-over-year gain in employment and the unemployment rate had fallen to 9.4 percent by the close of 2010. To put the gains in perspective, at the close of 2009 there were mounting concerns that the state unemployment rate would climb above 11 percent. An unemployment rate of that magnitude is now highly unlikely given the emerging momentum of the state and national economies.

Despite improved economic conditions, the Tennessee economy nonetheless saw jobs fall 0.5 percent in 2010 with a comparable setback for the nation. All in all, much welcomed improvement from the 5.6 percent pace of job losses in 2009. The state’s manufacturing sector experienced another 1.8 percent loss in employment in 2010 on the heels of a 14.2 percent withering in 2009. Like the overall nonfarm sector, manufacturing witnessed year-over-year employment gains in the third quarter of 2010. Inflation-adjusted personal income, which fell 1.7 percent in 2009, rebounded with 2.3 percent growth last year. As the economy has showed signs of renewed strength, so too have sales tax collections, having advanced for nine consecutive months.

Most measures of economic activity—including employment and taxable sales—remain well below their pre-recession peaks. For some sectors of the economy, like residential housing, pre-recession levels of activity were artificially inflated. The state and national economies are embarked upon a fundamental restructuring that will take many years to full resolve. Taxable sales will not fully rebound until at least fiscal year 2013/14, employment will not recover until 2014 and the unemployment rate will remain elevated above its pre-recession low through the decade. But growth is underway and should be sustained into 2013.

The forecast for Tennessee calls for nonfarm employment to grow 1.3 percent in 2011 with manufacturing jobs expected to rise 1.4 percent. The state unemployment rate will drift down yielding an annual average of 9.1 percent in 2011, falling to 8.8 percent in 2012. Nominal personal income will advance 4.5 percent for the year with inflation-adjusted personal income coming in at 3.3 percent—the difference reflecting expectations of modest inflation through the near-term outlook horizon. Taxable sales should see 4.3 percent growth in fiscal year 2010/11 and 4.7 percent growth in fiscal year 2011/12.

TN Agriculture Outlook

A combination of excessive drought in some areas of Tennessee and torrential rains in others provided a challenge for farmers in 2010. As a result the Tennessee production of corn and soybeans were below 2009 levels while cotton production increased. In 2009 agriculture-related activities accounted for 10.5 percent of Tennessee’s economy. Because of high crop prices in 2009, crop production
accounted for 60 percent of Tennessee agricultural receipts while livestock accounted for 40 percent. Usually crops and livestock each account for 50 percent of farm receipts. With a change in agricultural policy in 1996 intended to make agriculture more market oriented, Tennessee net farm income has become more dependent upon federal farm program payments. Over the ten year period, 2000-2009, direct government payments accounted for 50.2 percent of net farm income in Tennessee compared to 19.5 percent for the 1990-1999 period. If the high crop prices seen in late 2010 continue into 2011, it could be another good year for Tennessee crop farmers, but will put pressure on the livestock sector as higher crop prices increase input costs for livestock producers. Tennessee’s investment in biofuel research continues to hold out promise for agriculture’s future and put Tennessee at the forefront of the production of renewable energy. Tobacco production continues to be affected by lower smoking rates and is not as profitable as it once was. It is expected that Congress will begin work on the 2012 Farm Bill, late in 2011. More than in the past, budget constraints will be a major driver in the process.

**Long-Term Outlook**

Long-term forecasts generally focus on the expected trend performance of the economy rather than the outlook for short-term fluctuations of the business cycle. The reason is that traditional recessions are fairly short in duration and have modest effects on long-term patterns of performance. The Great Recession, however, has proven to be unique. In this recent recession, a series of short-term events and outcomes, including growing federal debt and a surplus of pre-recession construction, will persist creating long-term consequences for national and state economic performance. Some measures of economic activity (like the unemployment rate) will take years to recover, while others like (such as housing starts) may not fully rebound even by the end of the decade. Nonfarm employment, which is now growing, will not return to pre-recessionary levels until 2014. While the economic outlook to 2020 is largely positive, the national and state economies will undergo a slow and long period of adjustment and transformation in the years ahead.

Ongoing economic restructuring means the emergence of new products and services along with new jobs and occupations. Many of the jobs in greatest demand today simply did not exist 10 years ago within Tennessee. Nonfarm employment is expected to grow at a 1.3 percent compound annual growth rate from 2010 to 2020. Manufacturing will see some modest gains in employment in 2011, 2012 and 2013, but these gains will not erase the losses experienced over the course of the recession. By 2014 the state’s manufacturing will return to its trend pattern of ongoing job losses.

Professional and business services along with health and education services are expected to realize the strongest rate of job growth over the long-term horizon.

Tennessee’s unemployment rate was 4.0 percent in 2000. While the 2010 annual average was 10.0 percent, by December the rate had fallen to 9.4 percent. However, unemployment is expected to remain elevated for many years to come. Large numbers of individuals in Tennessee and across the country will remain “structurally unemployed” because their skill set does not match the skills requirements of employers. There is also the practical challenge of absorbing large numbers of discouraged workers, underemployed workers and new entrants to the full-time work pool.

Nominal personal income in Tennessee is expected to grow at a 4.9 percent compound annual growth rate between 2010 and 2020 compared to slightly higher 5.0 percent growth for the nation. Tennessee per capita income should grow 4.1 percent over the same time period while U.S. per capita income will rise at a 4.0 percent rate. Because per capita income in Tennessee lags the nation, there will be no convergence of per capita incomes over the course of the decade.
Passenger and Freight Mobility in Tennessee: An Economic and Policy Overview

Tennessee’s passenger and freight transportation networks are a fundamental and highly functional element within the state’s economy. These assets provide mobility to residents and visitors, facilitate local and regional commerce, and efficiently connect Tennesseans to an ever more global market place. Moreover, in the course of accomplishing these outcomes, the transportation sector (and associated manufacturing) directly provides tens of thousands of jobs and nearly a billion dollars in annual incomes to Tennessee residents. Unarguably, the state’s roadway system is its chief transportation asset, but Tennessee also benefits from commercial airline, freight railroad, and inland navigation services that (at least collectively) are rivaled by few other states.

Preserving this high degree of personal and commercial mobility is increasingly difficult. A growing population and relatively robust state economy demand continual increases in transportation capacity that must be achieved without sacrificing environmental quality or compromising other community goals. Also, the fuel-based revenue streams used to support transportation infrastructure are both increasingly volatile and less predictable, so that the fiscal environment is, at best, fragile. Thankfully, these transportation challenges are no more extreme in Tennessee than elsewhere. Nonetheless, preserving a desirable degree of mobility will require continued vigilance and active public policy initiatives.