While data revisions and second quarter updates continue to trickle in, the national economy enters the fall of 1996 with a considerable head of steam, slightly tempered with the early signs of a more moderate course of future economic growth. Moderation, however, has been slow to materialize as second-quarter growth estimates have exceeded earlier expectations. Following a slow start to 1996, first-quarter inflation-adjusted gross domestic product (GDP) grew at a seasonally adjusted annual rate (SAAR) of 2.0 percent, followed by a revised 4.7 percent (SAAR) estimate for the second quarter. Employment growth was also strong throughout the early part of 1996, posting a 1.9 percent (SAAR) increase in the first quarter and a revised preliminary growth rate of 2.8 percent (SAAR) in the second quarter. Both employment and GDP growth exceeded earlier predictions and are at their highest levels since the expansionary period following the 1992 recession.

GDP growth was equally spread among the major components of national income. Inflation-adjusted consumption expenditures increased by 3.4 percent (SAAR) in the second quarter, while government spending climbed 7.7 percent (SAAR). The U.S. housing market remained very strong as residential investment surged 16.3 percent (SAAR). Meanwhile, business investment slowed as predicted after a strong first
quarter, but the replenishing of business inventories, up 7.1 percent, partially offset the downturn in fixed investment.

Strong second-quarter GDP growth took place in the absence of any noticeable inflationary pressures, as shown in Figure 1. Inflation has been on a slow decent since the last recession, in turn accommodating lower interest rates. Capacity utilization has not been strained, keeping inflation in check since factories have the excess capacity to increase production. Wage inflation has now become the primary source of concern, especially in the face of low rates of unemployment. Even though the national unemployment rate, currently about 5.2 percent, is low by historical standards, unit labor costs and wage rates have not experienced excessive growth. Modest gains in productivity have also helped keep wage inflation in check.

Signs of lower and sustainable growth began to surface in economic data for the summer months. Retail sales have shown signs of slowing, especially in auto sales and a recent downturn in housing starts. Consumers will be reluctant to buy new automobiles for the remainder of 1996 due to fewer dealers’ incentives, high household debt levels, and a tightening of credit markets as rising delinquency rates make creditors more cautious. Similarly, rising mortgages rates will likely retard growth in residential investment as consumers delay home purchases until mortgage rates subside. The terms of international trade have also worsened in recent months, causing an upward revision in the second-quarter estimate for imports and a downward adjustment for exports. The United States continues to run a trade surplus in services and a substantial trade deficit in goods with the rest of the world. The terms of trade with China suffered the most noticeable setback, as our annual trade deficit of imports purchased to exports sold rose from $2.34 billion in April 1996 to a revised estimate of $3.06 in May. Moreover, the U.S. trade balance with our major trading partners could worsen as foreign countries try to balance their domestic budgets and manage existing debt burdens.

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Economists are quick to paint a silver lining on the gray cloud of slower growth, as most analysts fear that unfettered growth would lead to renewed inflationary pressures and trigger an increase in interest rates by the Federal Reserve Board (Fed). The Fed prescription for inflation is to nudge up interest rates to cool off the economy by exerting downward pressure on consumer demand and, hence, prices.

Forecast Summary

The forecast for the second half of 1996 indicates that the U.S. economy will experience the moderation in economic activity that was expected in the early summer months. Figure 2 illustrates the economic trend expected for U.S. employment growth over the forecasting period relative to growth in preceding years. A fear in the process of moderation is that the economy will correct too far and slip into recession. While the possibility exists for a cyclical downturn in 1997, the probability for such an occurrence is low, especially in light of the Fed’s recent decision not to hike
interest rates. Look for inflation-adjusted GDP to weaken in the third and fourth quarters, rising 1.9 and 1.7 percent (SAAR). Growth in calendar year 1996 will come in at 2.3 percent, followed by 2.2 percent growth in 1997. Consumer expenditures and residential investment will trigger the slower pattern of growth. Employment growth at the national level will also slow over the fall quarters, finishing 1996 2.0 percent higher, followed by 1.7 percent growth in 1997. Slower growth in GDP will nudge up the U.S. civilian unemployment rate to 5.4 and 5.6 percent in 1996 and 1997, respectively. Look for interest rates to fall over the forecast horizon as inflation remains under control.

Highlights of the U.S. Forecast:

- Growth in inflation-adjusted GDP will slow to 1.9 percent in 1996:Q3 and 1.8 percent in 1996:Q4, closing out 1996 with 2.3 overall growth. Expect real GDP to grow 2.2 percent in 1997.

- The civilian unemployment rate will dip to 5.4 percent in 1996 and inch back up to 5.6 percent in 1997.

- With the aid of a strong second quarter, employment growth will average 2.0 percent in 1996 but taper off to 1.7 percent in 1997.

- Inflation will remain under control, with growth in the implicit price deflator expected to average 2.0 percent in 1996, with a slight bump to 2.3 percent in 1997.

Decline in Nonagricultural Employment Signals Slowdown in State Economy

TENNESSEE FORECAST

Current Economic Conditions

Tennessee’s economic fortunes are closely tied to the performance of the national economy, as illustrated in Figure 3 below, which depicts the close relationship between U.S. and Tennessee employment growth. Accordingly, the moderation in economic activity that is predicted to impact the national economy in the third and fourth quarters of 1996 will influence growth in Tennessee as well. An indication that a slowdown has already taken place in Tennessee lies in the second-quarter
decline in total nonagricultural employment, the first quarterly decline since the second quarter of 1992.

Continued declines in manufacturing employment, specifically in industries that produce nondurable goods, contributed greatly to the overall decline in second-quarter total employment. Figure 4 depicts the recent trends in manufacturing jobs, showing the pronounced decline in the nondurable goods manufacturing sector and the leveling of growth in the durable goods sector in late 1994 and thereafter. Tennessee suffered net losses of 17,300 manufacturing jobs between April 1995 and June 1996, despite slight increases in durable goods manufacturing employment during the period. The tobacco, textiles, apparel, paper, chemicals, and leather sectors had net job losses in 1995 and the first half of 1996. Since many goods manufactured in Tennessee are purchased in other states or countries, a shrinking manufacturing base tends to limit the amount of growth a region can experience from outside sources.

Setbacks in manufacturing employment were not the lone culprits in the state’s weak employment performance in the second quarter, as rates of growth in the services and trade sectors were well below the pace set in 1995. The service sector, Tennessee’s largest industrial classification representing approximately 25 percent of all nonagricultural jobs, experienced first and second quarter SAAR growth rates of 1.3 and 1.1 percent respectively, far below the robust growth in excess of 5 percent over the past three years. Trade sector employment, roughly 23.5 percent of total nonagricultural employment, has also experienced lower growth rates in 1996, though the slowdown is not as pronounced as in the services sector. The combination of lower growth in the traditionally strong services and trade sectors, coupled with continued job setbacks in nondurable manufacturing, created a

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climate of negative job growth in the second quarter.

Softening employment growth, however, did not trigger a second-quarter bump in the Tennessee unemployment rate. In fact, the seasonally adjusted unemployment rate dipped from a revised first-quarter rate of 5.3 percent to 4.8 percent in the second quarter. Personal income growth, however, slowed to a SAAR of 4.3 percent (or 0.9 percent in inflation-adjusted 1992 dollars). Inflation-adjusted taxable sales growth slowed to 1.3 percent (SAAR) following an encouraging first-quarter surge of 7.3 percent (SAAR). A sharp decline in automobile sales contributed greatly to the second quarter downturn. These data suggest that reductions in employment and personal income growth may have caused many Tennesseans to postpone purchases until their family incomes stabilize and interest rate speculation dies down. Business responses to this chain of events, as well as the spending patterns of final consumers, will help determine whether the economy rebounds quickly from the current slowdown or slips into recession.

Forecast Summary

While positive economic growth is expected over the next few quarters, improvements will be tempered by slower growth for the national economy and Tennessee’s battered nondurable goods manufacturing sector. Total nonagricultural employment will rebound slightly in the third and fourth quarters of 1996 as the exodus of manufacturing jobs begins to slowly dissipate. Personal income will finish the year on a positive note, with year-over-year growth of 4.0 percent in inflation-adjusted 1992 dollars. Employment and personal income growth will refire service and trade sector employment and produce a slightly improved taxable sales picture for the remainder of 1996 and into 1997. The Tennessee unemployment rate will hover around the 5.0 percent level, with no significant deviations predicted through the forecast horizon.

Tennessee’s economic condition could worsen into a cyclical downturn if the U.S. economy experiences a larger-than-expected correction. Such a national downswing might impede Tennessee’s ability to refortify its manufacturing base and further retard statewide employment growth. The probability of significant national slowdown became more remote recently when the Federal Reserve Board opted not to intervene with contractionary monetary measures. Stable interest rates and low inflation will help alleviate consumer trepidations and keep the national economy from turning its period of moderation into a more serious downward spiral.

Highlights of the Tennessee Forecast:

- Nominal Tennessee personal income will grow 6.3 percent in 1996 and 5.5 percent in 1997. Inflation-adjusted personal income will increase 4.0 and 2.9 percent over the same time period.

- Nonagricultural jobs will increase by 2.5 percent in 1996 and 2.6 percent in 1997. The manufacturing sector will lose 9,600 jobs in 1996, but the Tennessee Econometric Model predicts the erosion of manufacturing jobs to end in 1997.

- The Tennessee unemployment rate will average 4.9 percent in 1996 and not increase significantly in 1997.

- Tennessee taxable sales will advance 5.0 percent in 1996 and 5.1 percent for 1997. Fiscal year 1997 will experience 5.3 percent growth in taxable sales.