Outlook for 2005

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In October 2004, a group of economists gathered at the Kelley School of Business to discuss the economic outlook for the nation and the state. The discussion began with an analysis of the October forecast from the U.S. model developed at the Center for Econometric Model Research (CEMR) at Indiana University. A consensus was then generated concerning assumptions behind the forecast and adjustments to the model forecast. Thus, the U.S. outlook presented here reflects the combined thinking of almost a dozen IU faculty members. The CEMR model of Indiana was used to translate the economic forecast for the United States into a forecast for Indiana.

These and other faculty then traveled throughout Indiana presenting the forecast and answering questions. They were joined by a local economist who discussed the outlook for that part of the state. The articles that follow summarize the 2005 outlook and in some cases expand upon what was presented by the traveling panel.

The forecast we made last year was quite accurate. Real growth will likely come in at 3.9 percent for 2004, only slightly above the 3.5 percent rate we forecast last December, and inflation will be near 2.2 percent again, only slightly above the 2 percent forecast last December. The biggest surprise this year was the sharp increase in world oil prices.

The key economic assumption for the coming year is that world oil prices will remain high. This assumption is based on the premise that demand (particularly among emerging economies) will remain strong and supply will be constrained by continuing political turmoil in many oil-producing regions.

In the articles that follow, economists discuss various aspects of the outlook. Bill Witte explains why the U.S. outlook for 2005 will be less rosy than what we've experienced in 2004. It's not a recession by any means, but it is a slowdown in the rate of growth. Andreas Hauskrecht reports on the world economy and analyzes many of the risks to our forecast. These risks are very real and could darken the outlook next year. John Boquist, Robert Neal, and William Sartoris analyze where financial markets are likely to go next year, making for a challenging year for policy makers. Jeffrey Fisher looks at housing markets and the outlook remains quite good. Jerry Conover discusses how the national and international outlook will affect Indiana. Finally, a key group of economists from around the state offer views and forecasts for their metropolitan economies. ◄

The U.S. Economy

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The U.S. economy during 2004 brings to mind Charlie Brown, Lucy, and the football. From experience, Charlie knows he should temper his enthusiasm. But the possibility of putting the ball through the uprights seems to be there, and he thinks maybe now is the time. And then Lucy snatches the ball away and Charlie is flat on his back (again).

For the economy, the past several years certainly counsel caution. But as things unfolded in the latter stages of 2003 and the first part of 2004, the possibility of the economy soaring upward on a perfect trajectory into a clear blue sky was hard to resist. More recently, sadly, reality has intervened. To be sure, the Charlie Brown metaphor is not perfect. The economy is not flat on its back by any means. But the dream of perfect trajectory is probably not in the cards, at least not in 2005.

Earlier this year, a broad range of economic indicators were sending out positive signals. By March, output had registered four straight quarters of growth above 4 percent, with the full period over 5 percent. **Figure 1** shows the growth rate for real output both quarter by quarter and relative to the same quarter a year earlier. At the sectoral level, the growth of business spending on equipment accelerated over the same period from about zero to well into double-digits, while growth in consumption spending went from below 3 percent to above 4 percent. In the labor market (which tends to lag slightly), employment began to expand in September and increased by an average of 225,000 per month during the first five months of this year. **Figure 2** shows employment growth and the unemployment rate. Rising employment is a manifest indication of business optimism. It implies rising income and does wonders for consumer confidence. It seemed that finally the economic football was ready to really take off.

But as the weather turned warmer, signs that the ball might be snatched away started to appear. The initial problem was the labor market. In June, payroll employment rose

Figure 1
U.S. Real Output: Annual Rate of Change