

U.S. Economy Won't Avoid Global Slowdown

The economic recovery that began in 1991 will continue into 1999, though at a slower pace. The U.S. economy behaved oddly in the last five years, befuddling economists enough to be called the "new economy" because of its ability to grow rapidly sans rising interest rates and inflation (see **Figure 1**). Strong foreign and domestic demand propelled growth, while a strong dollar, fierce global competition, and rising manufacturing productivity kept inflation at bay.

A world financial and economic crisis ended all that in mid-1998, and will continue to affect the U.S. economy in 1999. U.S. exports have contracted while imports continued to grow, leaving the country with what will be its largest trade deficit ever. Consumers dug deep into savings this year and can dig no deeper. Heightened risk in equity markets reduced consumer confidence and spending. The upshot is that spending in 1999 will grow more slowly, despite falling interest rates and a depreciating dollar. Expect GDP to grow by 2% and the unemployment rate to rise to 5%.

Other highlights of the 1999 outlook include:

- payroll employment increases by 1 million;
- short-term interest rates average less than 4.5%, while long-term rates average 25 basis points lower than the average for 1998;
- lower corporate profits and declining interest rates have offsetting influences on equity markets;
- housing starts average 1.5 million units, while existing home sales reach 4.4 million;
- consumer and business spending will grow, but at less than half the growth rates of 1998;
- exports will increase by 2%, but imports will grow by at least twice that rate;
- employment growth in Indiana compared to 1998's increase of approximately 35,000 will be re-

duced noticeably, although the picture will become brighter as the year progresses;

- Hoosier exports will grow by about 3%, largely because of trade to Canada, Mexico, and Europe.

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The National Real Outlook

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During the past year, the U.S. economy has continued its remarkable performance, extending the current expansion into an eighth year. The outlook for the coming year, however, includes some significant potential risks, and we think that a year of sluggish output and employment growth is a prospect.

Figure 1 presents the core of the current situation. The heavy line shows the year-over-year growth rate of real GDP on a quarterly basis; the light line is the year-over-year change in the GDP deflator. Despite a few minor fluctuations, for the most part the U.S. economy has grown at a rate well in excess of 2.5% for the past six years. Since the end of the last recession in 1991 (now over 90 months ago), output growth has averaged 3% per year. For the three-year period ending with third quarter 1998, growth has

Figure 1
U.S. Economy: Year-Over-Year Growth Rate of Real GDP and Change in GDP Deflator

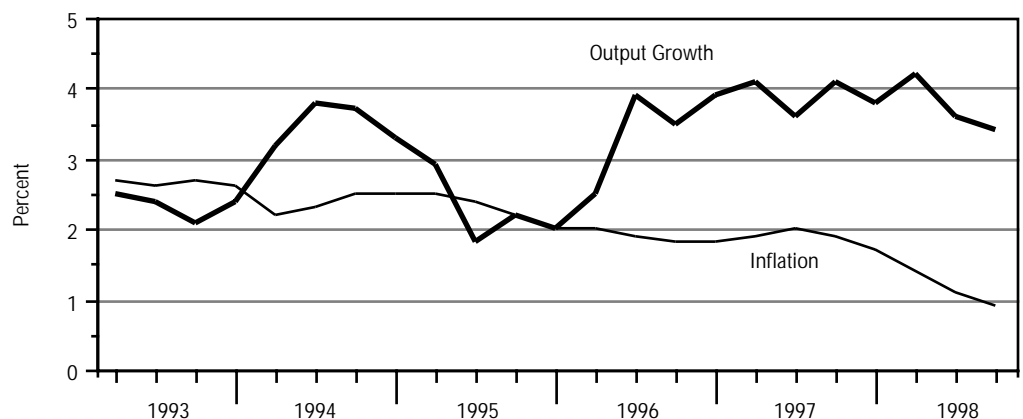
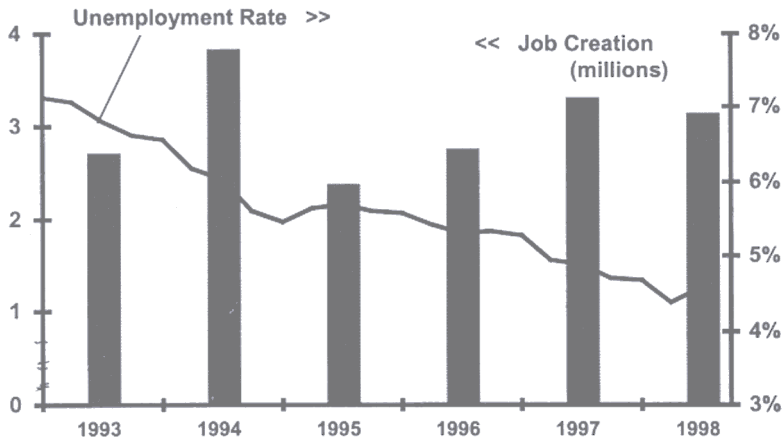


Figure 2
U.S. Labor Market Data



NOTE: Bars are 4th quarter to 4th quarter, except 1998, which is 3rd quarter to 3rd quarter.

averaged 3.7%. At the same time, inflation has steadily declined. During the first three years of the expansion, the GDP deflator rose at a 2.7% annual rate; over the past three years, the average rate has been 1.6%; and over the past four quarters, only 1.0%. This combination of strong growth and low inflation was recently described by Alan Greenspan (chair of the Federal Reserve Board) to be as impressive as any he had witnessed in nearly a half-century of closely observing the American economy.¹

The labor market situation has been similarly repetitious, as shown in Figure 2. The bars depict the increase in payroll employment. Since its low point in 1991, the economy has added an average of more than 2.3 million jobs per year, even with a slow start in 1992 and a lull in 1995. Over the past four quarters, 3.1 million jobs have been created—a remarkable performance for a recovery more than seven years old. This rising employment has been about 1.1 million per year above the growth of the working age population. About half of this difference has come from reductions in measured unemployment (people who are actively seeking work), producing the steady drop in the unemployment rate shown by the solid line in Figure 2. From its cycle high of 7.8% (reached in June 1992), the jobless rate has declined over 3 points, reaching a low of 4.3% in April and May before experiencing a slight recent uptick. The remainder of the gap has been closed by a rise in labor force participation, including a significant number of people who have entered the labor market as a result of the recent welfare reforms.

This combination of rising output, low inflation, and low unemployment represents the best economic

performance in the past three decades. On the surface, it is a replay of the situation in 1996 and 1997, only more so: output growth has been a little stronger, inflation has fallen a little lower, unemployment is a little lower. But under the surface, the situation has become less sound over the past year in several regards. The three most important are pressures on prices, the international situation, and the enhanced role of consumer spending in the expansion.

By any standard measure, the economy is now at or very close to “full” employment. Over the past three decades, its growth has averaged about 2.3%. We have been well above that long-run benchmark for much of the past six years, including the last three. Unemployment below the mid-5% range tends to put pressure on wages, ultimately pushing prices up. So far, though, this has not happened; labor costs have been creeping up over the past couple of years, but most of this has been offset by higher productivity. Moreover, strength in the value of the dollar in the foreign exchange market has lowered import prices (including raw material prices) and restrained the ability of domestic producers to raise prices.

Looking ahead, a key issue is productivity. While we think a reasonably good performance is likely, we do not expect it to entirely offset the pressure on wages from a tight labor market. In addition, the dollar has reversed course since late August, falling by nearly 10% against an average of 10 other industrial countries (through mid-October). We do not expect this depreciation to continue, but even relative stability in the value of the dollar could lessen the restraint on domestic prices. If the depreciation does continue, inflation could become a more serious concern.

Internationally, the past year has seen a dramatic turn for the worse. A year ago, and for several years before, exports were growing at a double-digit rate, providing one of three primary supports of the overall expansion (together with consumer spending and business investment). Problems had surfaced in the Far East, but they seemed to be related mainly to financial and currency markets. During the past year, these problems have become far worse, producing continuing turmoil in financial markets, but also severe downturns in the real economies of the affected countries. Further, there has been concern recently that difficulties may spread to Latin America. Combined with dollar appreciation, the effect on U.S. exports has been dramatic, with a 2.8% rate of decline in the first quarter of 1998, followed by decreases at a 7.7% rate in the second quarter and 2.9% in the third. At the same time, imports have grown rapidly, causing the trade deficit to nearly double over the past year, reaching \$263 billion in the third quarter.

The collapse of exports has left the economy leaning increasingly on household spending for con-

tinued expansion. Over the past year, consumption has risen 4.7%, with the rate of increase rising above 6% in the first two quarters of this year. This spending spree has outstripped the growth in household income (as measured by the Commerce Department), causing the personal saving rate to fall to only 0.1% of disposable income in the third quarter.² Clearly this surge has been driven partly by the enormous increase in wealth resulting from the remarkable stock market advance of the past three years. The question for the immediate future is how consumers would react to market performance more in line with historical norms, or even to a period of market weakness. At the least, a continuation of the recent rapid growth in consumption seems unlikely.

In the face of these problems, we expect economic growth to slow in 1999. We also expect inflation to worsen a little from its current very low level. To be more specific, we expect real GDP to rise about 2% during 1999, with inflation rising back over 2%. If this is the case, employment will increase about 1 million, considerably below the rate of recent years and slow enough to boost the unemployment rate back to about 5%.

In part, this scenario is premised on our expectation that the Fed will continue its easing of monetary policy begun in late September. The Fed will probably feel constrained from a drastic reduction in short-term rates by the potential inflationary pressures mentioned above. If, however, the economic picture becomes darker than we foresee, more significant easing by the Fed would certainly occur.

Our outlook presumes that the international environment, though remaining weak, does not experience significant further deterioration, allowing U.S. exports to stabilize and then begin growing again later in the year. Households should be more restrained next year, leading to a retrenchment in purchases of durable goods and in residential investment. If households pull back more drastically than we anticipate, or if the international situation continues to worsen, the outlook for the U.S. economy will be darker and an end to the expansion cannot be ruled out.

In summary, the past year has been a very good one for the U.S. economy. Output has grown strongly, leading to rapid job creation and falling unemployment. Inflation, already low, has come down even more. Interest rates have fallen to very low levels. We think the next year will be one of continued growth, though not at recent rates. Growth will decelerate, while unemployment and inflation will edge up a little.

We do not, however, view this as a pessimistic outlook. At some point, a continuation of growth like that of the past three years would lead to excess, requiring a potentially painful correction. Given the problems in other parts of the world economy, and

the imbalances in the domestic situation, a slowdown seems better than the possible alternatives.

Notes

1. Alan Greenspan, statement before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, July 21, 1998. Reprinted in *Federal Reserve Bulletin*, Sept. 1998, pp. 735-742. The testimony and accompanying report can be accessed at: <http://www.bog.frb.fed.us/boarddocs/hh/>.

2. Income, as defined in the National Income and Product Accounts, does not include capital gains on security holdings. Recently, the definition was revised to also exclude capital gains dividends paid by mutual funds.

The Financial Markets

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The past few years have been kind to the investor. It hardly mattered if your choice was bonds or common stocks; both provided favorable performance. Now, unfortunately, some fundamental questions are hanging over the financial markets like a black cloud:

- Are the problems in Asia, Russia, and Latin America behind us? Or will these economies, particularly those in Russia and Southeast Asia, continue to be a drag on the world financial markets?

- Will interest rates continue to slide downward, generating solid returns on long-term bonds and common stocks? Or, in the process of interest rate declines, will we catch the "Japanese disease" of low interest rates and no economic growth characteristic of an economy in deflation?

- Will the establishment of trading in the euro, the common European currency, be a positive or negative influence on U.S. financial markets?

- In light of all the turmoil around the world, will the profits of U.S. corporations hold up? What will this mean for the stock market?

- How will the risk in the markets be perceived by investors? Will there be a flight to quality?

Economic Problems Around the World

The Asian, Russian, and Latin American economies continue to suffer. Southeast Asia grew fast, expanded capacity, and watched currencies collapse last year. Just recently, however, hopeful signs of recovery have