Another Try at Comfortable Deceleration

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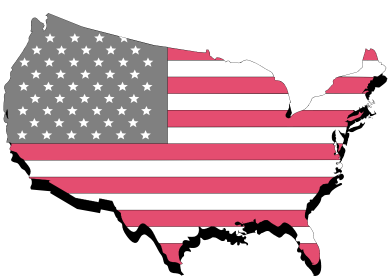

You move into the passing lane, push the accelerator a little harder, make your pass, and then return to a comfortable, sustainable speed. The pass may have been necessary or exciting but it is good to be traveling at the right speed again. With the United States economy growing at more than 4 percent per year for four years, the forecasting community is once again predicting a deceleration of economic growth under the belief that conditions dictate a more sustainable rate of change for Gross Domestic Product (GDP) in the year 2001.

Strong growth above 4 percent has been very important to the U.S. The unemployment rate dipped below 4 percent in more than one month in 2000. With the increased employment have come higher incomes and reductions in crime and poverty. The 10-year national economic expansion has benefited consumers, armed firms with newer and better technology, and facilitated an expansion in spending on Medicare and other social programs. Clearly, gains have been widespread and significant for most groups.

But traveling so fast sets off alarms. This year saw wages and prices start to accelerate. The Federal Reserve (the Fed) raised interest rates to try to cool the economy. Spending on housing and durable goods slowed. The U.S. trade deficit soared to over $400 billion as the dollar strengthened against the new euro. Consumers reached deep into pockets to sustain spending on both imported and domestically produced goods. Equities markets drifted lower and have not recovered as of the end of the year.

As we move into the New Year the expected slowdown scenario is complicated by an energy imbalance. World economic recovery increased the demand for petroleum products. Supply was not forthcoming and prices spiked. The gray hairs remember the 1970s but they are not sure how what we learned will come into play in 2001. Perhaps energy prices are relative prices and should not be the concern of the Fed. If the economy slows, the Fed might allow interest rates to fall to prevent a deceleration from turning into a decline. But if inflation spikes, the Fed might, instead, worry about inflationary expectations. In that case, they might try to raise interest rates to prevent a temporary surge of prices from turning into a sustained cycle of rising wages and prices.

In the new year, we have concerns about a bear market, the impacts of the oil crisis, the large trade deficit's impact on the value of the dollar, and the onset of other seemingly negative events. But these ruminations should not overshadow what looks like another year of excellent sustained economic growth. Some of the highlights of our 2001 forecast include:

- GDP growth of 3.5 percent in the 11th year of the economy expansion
- CPI inflation of 3.3 percent
- Unemployment rate of 4.3 percent
- Stable short- and long-term interest rates
- Housing starts of 1.5 million units
- A trade deficit of approximately 4 percent of GDP
- A declining value of the dollar
- 20,000 new jobs for Hoosiers
- Return to double-digit growth of Indiana exports to the world

The U.S. Economy

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There is some controversy whether 2000 is the last year of the 20th century or the first year of the 21st. In economic terms, if it is the former, the century ended with a bang. If it is the latter, it set a standard that will be very hard to match. Figures 1 and 2 illustrate why. **Figure 1** shows the broad economic situation as indicated by output growth and inflation for the past eight years.[1] Bear in mind that at the beginning of the period shown there was a solid consensus among economists that the U.S. economy could sustain growth of about 2.5 percent per year—anything higher, it was thought, would eventually lead to accelerating inflation. But over these eight years growth has exceeded the 2.5 percent speed limit in every year except 1995, and has been well above 4 percent for the past five. Inflation, however, has been notable mainly by its absence. Recently, of course, energy prices have shot upward, but there is scant evidence to date that inflation is spreading more broadly.

Figure 1
United States Output Growth Vs. Inflation, 1993-2000

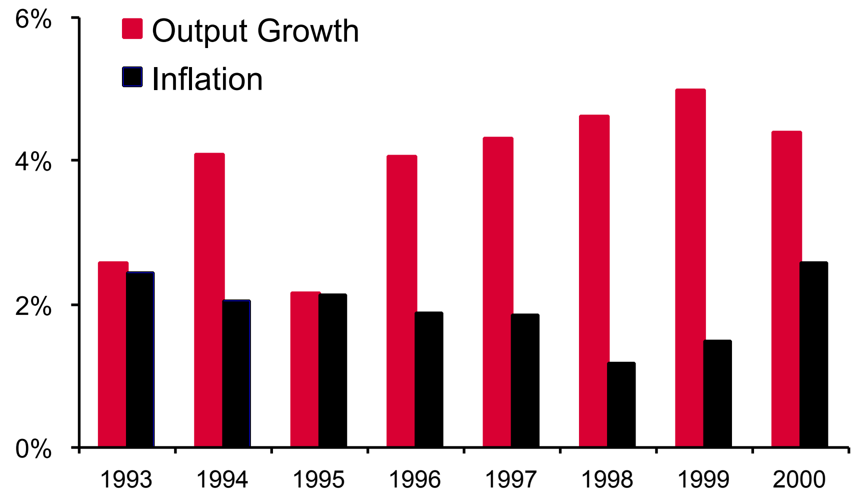


Figure 2
United States Job Creation Vs. Umemployment Rate, 1993-2000

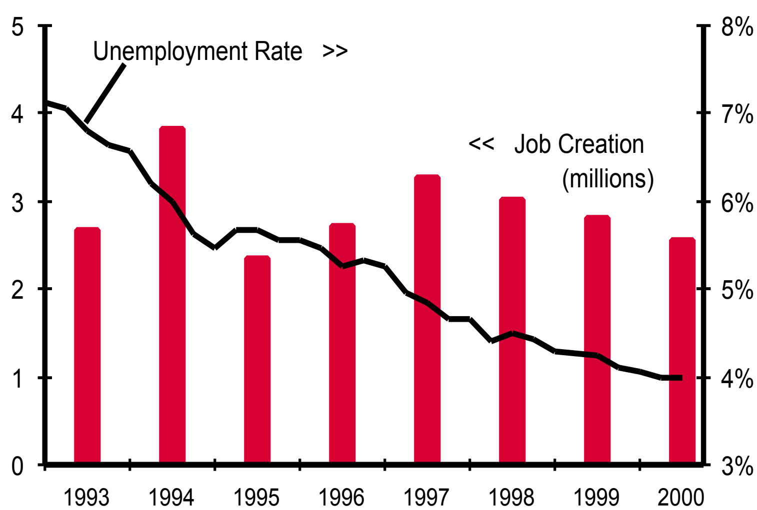


Figure 2 depicts the labor market situation. The U.S. economy's ability to create jobs has been and continues to be remarkable. Over the past eight years payroll unemployment has risen by nearly 23 million, an average of above 2.8 million per year.[2] This substantially exceeds the underlying growth in the population, causing a nearly steady fall in unemployment. During the past six months the rate has been bouncing around 4 percent, a level not seen in 30 years. Like rapid growth, low unemployment has long been perceived as a precursor of inflationary pressure via rising wage rates. But as with inflation itself, there has been little pressure on labor costs.

The list of credits for this remarkable performance is a long one, but several get special billing. In the starring role is an historic surge of new technology. In addition to providing an avalanche of new products, new business application of the advances is pushing productivity at an accelerating pace. Higher productivity both raises output and—via lower costs—holds down inflation.

The second lead goes to international influences in a multi-faceted role. Expansion of free markets and the trade they engender is another force behind productive efficiency. The end of the cold war has allowed a major shift of resources away from defense toward civilian uses, including in particular investment in high tech. Access to foreign capital has allowed the U.S. economy to invest at levels far beyond what could be financed solely from domestic saving. The strength of the dollar has been an important factor in holding inflation in check.

A major supporting role has been played by the government sector. There has been an unprecedented shift in the fiscal situation. A decade ago the federal government was running large deficits that most forecasters expected to continue indefinitely. Instead, during the 1990s the budget has swung 180 degrees with forecasts now for increasingly large surpluses as far as the eye can see. The budget is now a source of funds for private investment, rather than a competitor for financing. Finally, the Federal Reserve under Alan Greenspan has done a masterful job of keeping the economy from veering off course.

The bottom line of all of this is that the past couple of years have been probably about as good as it can get. The best we can hope for is more of the same. But a more realistic expectation is that the economy will decelerate to some degree. The question is how much? Will the economy slow down or turn down? We think the former. We expect that output growth over the next year will be between 3 percent and 4 percent. This is significantly below the past year, and a little below the previous three. It would mean that unemployment would not decline further and might edge up a little. On the other hand, it would mean that the slight rise in inflation over the past year remain contained below 3 percent.

For the next year any impact from the outcome of the presidential election will be mainly psychological. Whatever the outcome, any policy changes will not be enacted until well into 2001 with their effect on economic conditions stretching out from then. If our expectations of continuing—albeit less rapid—expansion does not materialize the causes will lie elsewhere.

A central area of concern is the saving balance in the economy. A high level of saving is essential to finance the high technology investment boom. There are three potential sources—from households, from government surpluses, and from abroad. During the past two years the first of these has essentially disappeared. American households are spending all of their after-tax income on consumption. Part of the slack is being made up with the large government surpluses mentioned previously. The rest comes from foreign investment in the U.S. The mirror image of the latter is our huge trade deficit.

Looking ahead, for the near term the government budget surplus seems secure (although the talk of multi-trillion dollar surpluses over ten years should be taken with a grain of salt). However, at some point it is reasonable to expect that household saving will recover and that the trade deficit will shrink. In terms of total saving these two will offset one another, and if the adjustment is gradual, the economy as a whole could come through fine. But if the adjustment is unbalanced or abrupt there could be problems. A sudden increase in household saving would imply a decline in consumer spending. Since consumption is two-thirds of total spending, the prospects for the economy as a whole could darken. Any quick reversal in the trade situation would likely be associated with a decline in the value of the dollar in the foreign exchange markets. While this might stimulate output in the short run, it would also greatly raise the risks of inflation.

Another area of potential concern is the world energy market. This sector saw considerable turmoil in 2000 and what happens there will have a big influence on the outlook for 2001. Certainly the most noticeable recent development has been the more than 50 percent increase in world petroleum prices in the last year.

During most of the last decade, world oil production exceeded demand putting downward pressure on prices. In 1998, total world demand for petroleum was constrained by the recession in parts of Asia and by very favorable weather conditions in North America. At the same time, there was a significant increase in OPEC production. As a result, supply exceeded demand by an average of over a million barrels per day throughout the year. During 1999, by contrast, demand rose as Asia recovered and OPEC production returned to its 1997 level. This combination caused demand to exceed supply by almost a million barrels a day resulting in declining inventories and increasing prices.

During 2000, demand continued to grow, and while both OPEC and non-OPEC production increased, the added output to date has not been sufficient to close the gap between demand and supply. The result has been even higher prices.

What is likely for 2001? If our economic forecast is correct and growth continues both in the U.S. and internationally, then world demand for petroleum will continue to increase. This will be particularly true if weather returns to normal in North America. Under these conditions, petroleum prices are likely to remain quite high unless producers significantly increase supplies. Some increase in output may happen since the high prices are a stimulus to production, development and exploration. There will also be a small draw from the Strategic Petroleum Reserve. However, new supplies will not come on line quickly so prices are likely to remain high for some time. Unless there is a mild winter, heating oil costs in the Northeast will be high this winter.

Other much less attractive scenarios are possible. The political turmoil in the Middle East could reduce OPEC production. Any such supply cuts coming now, when demand is high, would put tremendous upward pressure on prices. A colder than average winter in North America would have a similar, though smaller, effect.

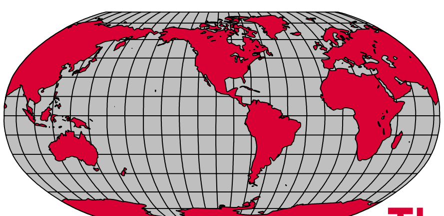
The situation is similar with respect to other energy sources. Electricity demand has grown by about 2.5 percent this year as a result of continued economic growth. The growth of the internet has produced a significant new source of demand for electricity. The industry has responded with expanded capacity but almost all the new facilities are fueled by natural gas, which has put strong upward pressure on gas prices. Wellhead prices have increased over 60 percent this year. As a result, home heating costs in the Midwest, where gas is the fuel of choice, will be much higher this winter.

The economy appears to be at a crossroads. It is currently performing at a record pace. The outlook for the immediate future is reasonably good, but significant problems are building. Any significant changes in consumer saving behavior, in the value of the dollar, or in international energy markets could significantly alter the outlook in a negative way.

Endnotes

[1]Output is measured by real gross domestic product. The inflation measure used is the GDP deflator. The data shown are averages of annualized quarterly rates of change for the four quarters of the year. The data for 2000 are for the first three quarters only.

[2]Job creation is the increase in total nonfarm payroll employment measured from fourth quarter to fourth quarter. The value for 2000 is third quarter to third quarter.



The International Economy

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Economic growth around the world in 1999 rose above trend, as the effects of the 1997 Asian crisis were unwinding. The year 2000 looks even better. The International Monetary Fund forecasts world economic growth at 4.7 percent, one and half percentage point above 1999 growth. Both the advanced and developing economies are contributing to this performance, with the former marching at 4.7 percent and the latter at 5.6 percent. Clearly, booms are becoming increasingly synchronized; and with this synchronization comes the fear that rising inflation may prompt monetary authorities to reduce money growth and raise short-term interest rates. To complicate matters, the world is suffering from an oil price shock similar in size to the one that took place at the end of the seventies. The convergence of business cycles and the oil price shock represent the most significant risk to this year's forecast.

Consensus Forecast

The International Monetary Fund projects that the world in 2001 will be growing at 4.2 percent, down a half percentage point from 2000 growth. The advanced economies are forecasted to grow at 3.2 percent –down one percentage point from 2000—and the developing countries at 5.7 percent –virtually unchanged from last year--. *The Economist*'s poll of forecasts (see **Table 1**) suggests that the world has now many growth locomotives, in contrast to last year when the United States and the 11 countries that have formed the European Monetary Union (France, Germany, Italy, Spain, Portugal, Belgium, Luxembourg, Netherlands, Austria, Finland, and Ireland) were pulling the world train of economic growth.

The United States is still going strong. For 2001 the percentage increase in real GDP is projected to fall towards trend values. Stock market and consumption developments are signaling a landing of sorts. The Euro-11 continues its expansion phase, with virtually all of the eleven economies registering declines in unemployment. Good news at the moment is overshadowed by a weak euro, a subject of significant controversy. The depreciation of the euro relative to the dollar is boosting the competitiveness of euro-based export companies. On the other hand, a weak euro is threatening inflation via the import channel. In particular, a depreciating euro is magnifying the local effects of the higher dollar price of oil. Furthermore, the depreciating euro and the inflation threat has led the European Central Bank to keep its guard up and raise short-term interest rates, thus keeping the expansion in check.

Japan is doing better, but growth there is still anemic. Japanese policy makers have applied and continue to apply archetypal Keynesian pump-priming stimulus. Government debt as a proportion of GDP