

U.S. Outlook for 2016

Willard E. Witte, Ph.D. Professor Emeritus, Department of Economics, Indiana University Bloomington

A year ago, I was upbeat about the recent behavior of the U.S. economy, which I felt had finally broken out to the upside from its postrecession 2 percent slog. Although there were risks, I was optimistic about the outlook for 2015. Foolish me. The “improvement” during 2013 now seems to have been an illusion, and 2014 was weaker than it originally appeared. It now looks like 2015 will struggle to register 2 percent growth, nearly a full percentage point below our year-ago expectation. There may be a little improvement in 2016, but it is likely to be modest.

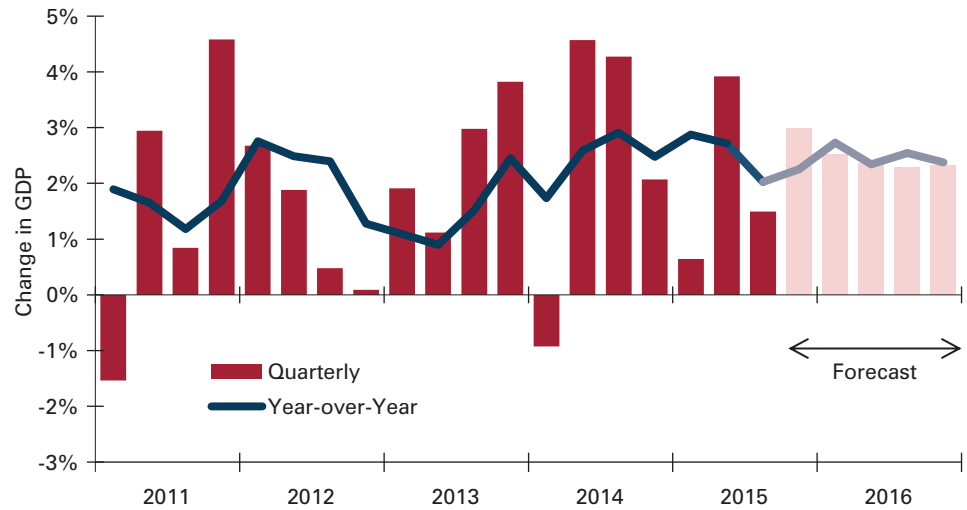
So, what went wrong? Three major things:

First, the U.S. Bureau of Economic Analysis revised the data. Growth in output (real GDP, shown in **Figure 1**) was lowered significantly for 2013 and rearranged for 2014 with spending by households on consumption being raised, and the growth rate for residential investment (housing) more than doubled. This was offset by lower estimated growth from business investment and from government.

Second, the international situation has been a significant negative. The slowdown in Chinese growth is driving a general slowing in growth throughout emerging economies. That, together with a dramatic appreciation in the dollar caused in part by financial instability in China, has severely hampered our exports. We expected the trade balance to be a small positive during 2015. Instead, it has been a large negative.

Third, oil prices fell far more than we anticipated, and this proved to be a net negative. In particular, investment and employment in the energy sector have fallen drastically. Part of this (but only part) was offset by a positive effect on consumption. Domestic crude production has started declining. (This is another

FIGURE 1: Rate of Change in U.S. Real Output



Source: U.S. Bureau of Economic Analysis

source of pressure on the trade balance—less production means more imports.)

As 2015 wound down, recent data were discouraging, with a few exceptions. Output in the third quarter increased at an annual rate of just 1.5 percent, less than half of the second quarter rate. The manufacturing sector has been sputtering, with little if any growth, and orders for new capital goods have been especially weak. In both cases, the strong dollar is producing a strong headwind. The 2015 labor market over the past three months (through October) saw average job increases of 187,000 per month. This is down over 40 percent from the rate at the end of 2014.

There are a few brighter spots. Consumer spending is good, with auto sales especially strong. Housing is also doing well, and builders are very optimistic about the outlook.

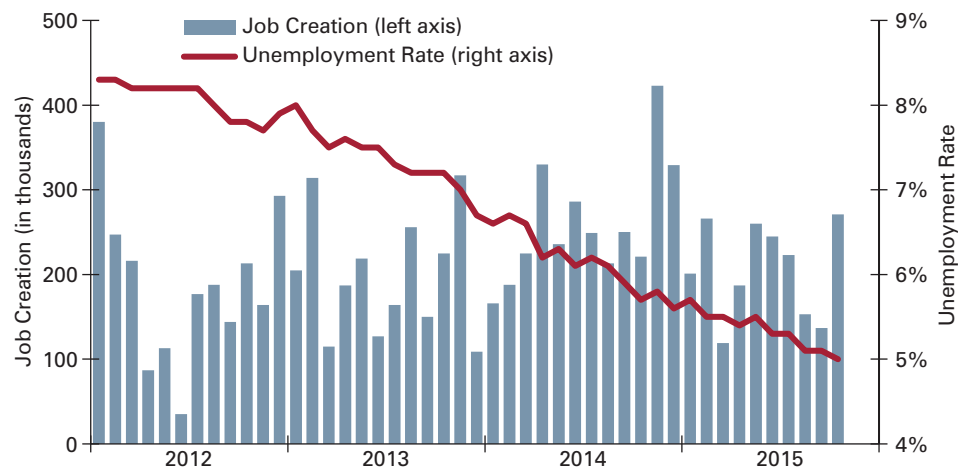
Looking to the year ahead, however, we see little reason for any real optimism. We think the economy can match the past year, or perhaps a little better. For growth to move significantly higher, some sectors would need to improve

relative to this year. The sectors that have been solid (consumer spending and housing) could remain so, but realistically they have limited upside. Other sectors (business investment, international trade, government) seem unlikely to fill the void.

Some specifics about the outlook:

- We expect output growth in 2016 to average about 2.5 percent. This will be somewhat better than the past year, but only equal to 2014. It represents a continuation of the pattern that has been in place since 2011.
- The labor market will about match its recent performance, but stay well below that of earlier months in 2015 (see **Figure 2**). Job gains will average well below 200,000 per month. In part, this deceleration will reflect a labor market that is approaching full employment. This also means that the steady decline in the unemployment rate, which has been in place since late 2011, will slow. By the end of 2016, the rate will be below 5 percent, but only by a tick or two.
- We expect inflation to remain well contained again in 2016,

FIGURE 2: U.S. Monthly Job Creation and Unemployment Rate, January 2012 to October 2015



Source: U.S. Bureau of Labor Statistics

although higher than 2015 as the impact of lower energy prices fades.

- Consumer spending will continue to advance at 2015 rates. The same will apply to government expenditures. Business investment and housing will also grow, but somewhat less than in 2015. The trade balance will experience further deterioration.
- A year ago, we thought the Federal Reserve would start to raise interest rates by mid-2015. We still think this would have been the best course, but the Fed obviously feels differently. In our forecast, we now put the first increase in March, but we have little confidence in this judgment. When (if) the Fed does move, the direct effects on the economy will be small.
- We see no hope for any real progress on the fiscal or regulatory policy fronts.

This is far from the optimism we felt a year ago, and our concern is compounded by two further considerations.

First, we see little upside potential. As already mentioned, consumption and housing are already quite strong. We see nothing that would cause

business investment to improve significantly. Government spending is limited by budgetary constraints (and political deadlock). The trade deficit is not likely to be smaller than in our forecast.

Second, there are significant risks in the current environment that could cause a worse outcome than we expect. A short list:

- The international state of affairs contains a multiplicity of potential problems. The Chinese situation, as mentioned above, is already having a negative impact. If their slowdown were to accelerate, that impact would get worse. Europe has been doing a little better recently, but mostly due to monetary stimulus. There is little, if any, progress being made on their underlying structural problems. In addition, the migrant crisis seems to be producing political pressures whose ultimate effects are highly unpredictable—but unlikely to be productive for the economy. Finally, the Middle East situation is going from bad to worse.
- We continue to feel that Federal Reserve policy has produced significant distortions in the financial sector that at some point will be corrected. While a Fed

Looking to the year ahead, however, we see little reason for any real optimism. We think the economy can match the past year, or perhaps a little better.

move on rates would, by itself, have little effect, the economic consequences could be far more dramatic if it triggered a broader financial market event.

- The budget deal reached in late October 2015 has probably taken a government shutdown off the table, which is a positive, but it also probably means that there will be no meaningful reforms for the next two years (for example, to corporate taxes). Regulatory policy, while perhaps positive in terms of social goals, has had negative effects on the economy. Further regulatory moves could worsen these effects.

The U.S. economy during 2015 was disappointing by most measures, especially relative to our optimism a year ago. Our outlook is for some improvement during 2016, but only a little. Unfortunately this may be a best-case scenario, and there is a long list of risks that could make our mild pessimism end up being wishful thinking. ■