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Contents

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The annual outlook edition of the *Indiana Business Review* has been published for more than a quarter of a century. We believe you will find this year's edition among the most geographically comprehensive (combining global and national trends with local analysis) and one of the more insightful. We hope to increase the number of regional articles for the 1997 outlook, bringing readers news from areas of the state not represented in this issue.

For those readers who may not have noticed, the *Indiana Business Review* is now published monthly. It comes to you in the form you now hold in your hands, in the form of the *Update* (a four-page review of current trends in the national and state economies), or both together, with the *Update* as an insert. Quite simply, content determines what form the IBR will take in a given month. Suggestions? Comments? Criticism? Please let us know by e-mail (rogersc@indiana.edu) or by mail: C.O. Rogers, IBRC, IU School of Business, 10th and Fee Lane, Bloomington IN 47405.

The 1996 Outlook: Introduction and Overview

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The short and generally mild recession of 1990-91 has now been followed by four years of recovery and expansion. In 1995 we have seen solid growth led by business investment in equipment, coupled with low inflation, rising personal incomes, and near full employment. Though the growth rate in the overall economy is expected to slacken to about 2.5% in 1996, we generally see a continuation of most current trends into next year. In one sense, this "more of the same" forecast is not very exciting. On the other hand, a fifth year in a row that is recession-free, near capacity, with inflation under control, is an enviable record. Our forecast is summarized in the **Table** below.

The key "driver" of the economy in 1996 is likely to be business equipment spending. Although the 10% expected growth rate in this investment category is below 1995's approximately 15% rate, it is still impressive. Housing investment is likely to be up only slightly, while business construction will likely grow by 4%, albeit still from very low levels as it recovers from overbuilding in the 1980s and the corporate downsizing and consolidation of the 1990s.

The large consumer spending sector is another key to the performance of the overall economy in 1996. Moderate but solid levels of consumer confidence, an increase in real disposable income of 2.3%, modest declines in interest rates, and small but positive wealth effects from the spectacular performance of the stock market in 1995 all presage solid growth in consumer spending.

The international sector will probably continue to grow in importance for the U.S. in 1996. The vote against separating Quebec from Canada and the recovery and stabilization of the Mexican economy, at least haltingly, are good news for the outlook for trade with those key trading partners. Growth will be modest but positive for all major industrial economies. Japan still has serious financial and real estate problems, but the worst is probably over.

The big uncertainty for 1996 is the federal budget. A budget compromise will be reached, of course, and there will be another plan to balance the budget. The new plan will be more credible (and painful) than its progenitors, but the Holy Grail of *revenue = expenditure* will not be reached until sometime in the future. Ironically, the impact of the plan will be small in 1996 and will probably add to the deficit and contribute fiscal stimuli in 1996, as tax cuts take hold before spending reductions.

Monetary policy will be an area to watch closely in 1996. The Federal Reserve engineered (or watched over, depending on your perspective) a soft landing to the economy in early 1995. Interest rates remain high relative to expected inflation. The Fed is likely to leave them there unless it sees both stronger-than-expected economic growth and what it considers to be an effective budget agreement.

Table
Summary of U.S. Forecast

	1994 ($billion)	*1995*	*1996*
Gross Domestic Product (GDP)	5.344	3.0%	2.5%
Personal Consumption Expenditures	3.580	2.9	2.3
Investment	952	8.7	6.6
Government Purchases	923	-0.3	0.0
Exports	657	10.0	6.8
Imports	767	11.1	7.8

NOTE: All GDP components are in 1987 dollars or are inflation-adjusted changes from the previous year.

Private Domestic Demand

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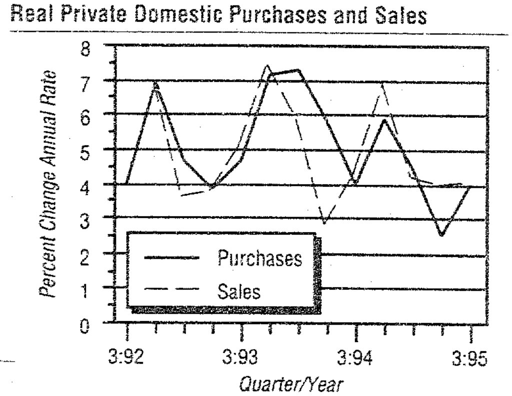
Gross Private Domestic Purchases (PDP) is total demand less government purchases and exports. It is also the sum of consumer and investment expenditures. PDP was just under 85% of Gross Domestic Product (GDP) in 1994. Gross Private Domestic Sales (PDS) is defined as PDP less inventory investment and so represents the sum of consumer purchases, purchases of plant and equipment by firms, and new residential construction. The **Figure** below shows the quarterly movements in PDP and PDS over the past three years.

Figure
Real Private Domestic Purchases and Sales



Over the last three years, the growth rate for PDP has averaged 4.9%, whereas that for PDS has averaged 4.7%. This is a very strong performance. From 1959 through 1994, growth in PDP and PDS averaged 3.2%. Because consumer spending is an important measure of the standard of living, and because investment spending is important for future growth and productivity improvements, the recent rapid growth of PDP and PDS is great news.

One note of caution is in order. Whenever relative prices change dramatically, our conventional measures of growth, including PDP and PDS, will overstate the actual rate of growth. The large decline in computer prices in recent years has introduced this bias into the conventional measures, and the Bureau of Economic Analysis of the U.S. Department of Commerce plans to release new measures that correct for this bias by year-end. Even with this caution, the new measures will likely continue to show strong growth in PDP and PDS over the last three years

Consumer Spending

In the last year, real consumer spending rose 3.2%, which was more or less in line with the growth in real GDP. The consumption growth was fueled by a 3.7% rise in real disposable personal income. This [illegible]n, was a product of a rise in both real compensat[illegible] per hour and in hours worked.

The pattern of growth across categories of consumer spending has shown great variation this last year. For example, expenditures on autos have fluctuated greatly from quarter to quarter, but have not shown sustained growth. The level of real spending on autos was lower in third quarter 1995 than in first quarter 1994. Expenditures for furniture and household appliances, on the other hand, have grown 12.4% over the last year in real terms.

Investment Expenditures

Led by a 27.5% increase in real business spending for information processing and related equipment, overall real spending on business equipment rose more than 16% in the last year. This was the main reason private domestic purchases have been so strong. Real expenditures on structures rose 10.2% in the last year, the strongest performance for structures since the commercial real estate boom and bust of the 1980s. Businesses also added to inventories this year with accumulation in excess of $40 billion over the last year.

The Forecast

What does all this imply for the rest of 1995 and 1996? The economy is now at full employment and inflation remains moderate. We see no great shocks in store for the economy. Even the major fiscal policy moves being contemplated by Congress will not have much effect in 1996. Thus, we expect continued growth without a recession through the coming year.

Because the economy is at full employment, growth will slow to something like the rate of growth of capacity for the economy, which we estimate is close to 2.5%. Real disposable income and real consumer spending are expected to rise by about 2.3% in 1996. Hence, there will be little change in the saving rate. We expect autos to show steady but not growing demand, with unit sales of new autos averaging 8.9 million in 1995 and 9.0 million in 1996.

Investment expenditures should again lead the economy in 1996, with real spending on business equipment rising more than 10%. Spending on structures will also show some strength, growing at a 4% rate in 1996. The inventory accumulation that was observed through most of 1994 and 1995 should slow in 1996, as the pipeline becomes full and growth in demand slows.

Finally, overall real PDP should increase 3.2%, faster than the growth of overall GDP. This is primarily because the government sector, which is part of GDP but not part of PDP, is expected to show little or no growth in 1996.

Fiscal and Monetary Policy

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At the time of this writing it remains unclear what form the deficit reduction will assume as Congress and the Administration battle over the final form of the fiscal year 1996 budget. Currently, it appears as though Congress will send to the White House a bill that seeks to balance the budget over a period of seven years, with a combination of tax cuts and deep cuts in projected spending. Though the House has passed a resolution budget, many differences still remain between the House and Senate versions of the budget. It remains to be seen which portions of either version will be contained in the final piece of legislation that will be presented to the President.

However, the major outline of the landmark legislation is similar across the House and Senate versions. The centerpiece of each bill is a cut in the capi-