

the Southwest ECONOMY

FEDERAL RESERVE BANK OF DALLAS

ISSUE 1 – 1994

Investment and Housing Drive 1994 Growth

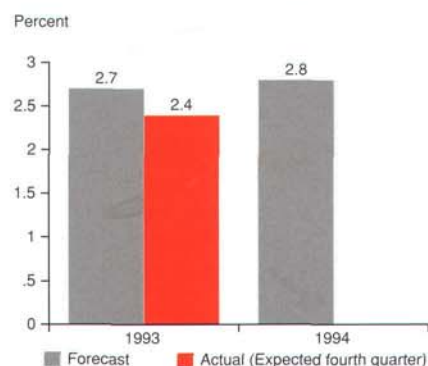
Strong business investment and a robust housing market will help the U.S. economy gain momentum in 1994. On a fourth-quarter to fourth-quarter basis, gross domestic product should increase at a 2.8-percent annual rate, up from an estimated 2.4-percent in 1993.

Weak exports and tight fiscal spending policies will restrain growth. While the pace of economic activity will increase moderately in 1994, inflation will remain in check, with a likely increase in consumer prices of about 3 percent.

The Nation's 1993 Performance and 1994 Outlook

Growth of real gross domestic product (GDP) accelerated in the fourth quarter of 1993 after a more sluggish performance during the first three quarters. Strong consumer spending, increased housing construction and the rebuilding of business inventories fueled the upturn. Early estimates of the fourth-quarter gains indicate that real GDP was growing at an annual rate of 4 to 5 percent, which would boost overall 1993 GDP growth to around 2.5 percent on a fourth-quarter to fourth-quarter basis (*Chart 1*). Increased auto production and the rebound effects from the Midwestern floods likely added about two per-

Chart 1
GDP Growth in 1993 and 1994



centage points to GDP growth in the fourth quarter.

At first glance, 1993 looks very much like 1992: a weak first half of the year, followed by a strong second half (*Chart 2*). However, the underlying forces driving economic growth in late 1993 suggest that this two-year pattern will not repeat itself to the same degree in 1994.

There are several reasons to expect the recent pickup in economic activity to persist well into 1994. First, in contrast to the fourth quarter of 1993, the fourth quarter of 1992 was strong primarily because of income shifting undertaken to avoid the higher tax rates that took effect at the beginning of 1993 and because of a temporary boost in consumer confidence following the presidential election. The unwinding of both effects then acted as a drag on economic growth in the first half of 1993.

Second, the 1993 bond market rally stimulated business investment and strengthened the housing market. Increased housing construction boosted the demand for consumer durable goods.

Third, employment growth was stronger in 1993 than in 1992, helping to increase personal

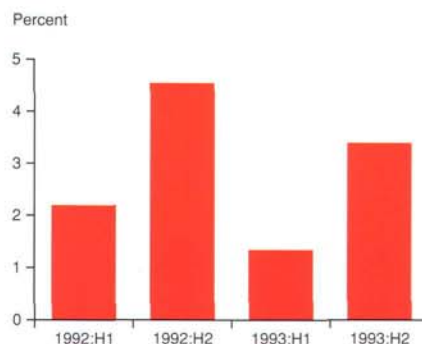
I N S I D E

Economic Commentary:
So What If GATT
Isn't NAFTA?

Southwest Outlook
Brighter in 1994

"The impetus for future growth has come largely from declines in long-term interest rates and a strong stock market, both of which have helped lower the cost of capital."

Chart 2
GDP Growth



income growth somewhat. Finally, currently lean manufacturing inventories, which in December were the lowest relative to sales in 12 years, almost ensure that production increases will continue into the first quarter of 1994, even if there is a deceleration of growth in the demand for goods.

These developments provide grounds for believing that the expansion is on firmer footing now than it was at the end of 1992.

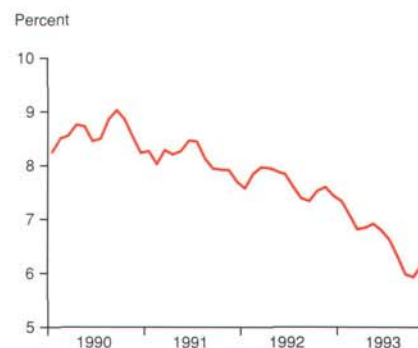
The Impetus for Future Growth: Lower Interest Rates

The impetus for future growth has come largely from declines in long-term interest rates and a strong stock market, both of which have helped lower the cost of capital (*Chart 3*).

Investment in producer durable equipment expanded at a 16.2-percent annual rate through the first three quarters of 1993, driven in large part by increased computer purchases (*Chart 4*). Since the expansion began in 1991, purchases of producer durable equipment have accounted for 30 percent of the total gains in GDP.

All indications are that business investment will continue to lead the economy. Increasing capacity utilization rates, which historically are highly correlated with increasing business investment, signal continued demand for investment in plant and equipment.

Chart 3
30-Year Treasury Rate



The housing outlook for 1994 is also bright, since still-low mortgage interest rates, coupled with additional rebuilding in the flood-stricken Midwest, are pushing up single-family starts. Residential construction spending has increased at an even faster rate than housing starts because many homeowners are renovating existing homes.

Consumption and Employment Growth Will Be Moderate

While the strong housing sector will help boost spending on consumer durable goods, the relatively low rates of employment growth experienced during this expansion will continue to moderate consumer spending (*Chart 5*). Although much of the weak employment growth can be accounted for by the

Chart 4
Housing Starts and Spending on Durable Equipment

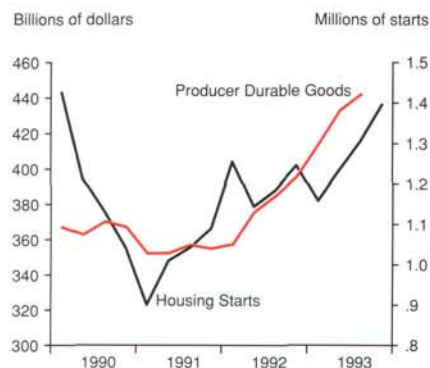
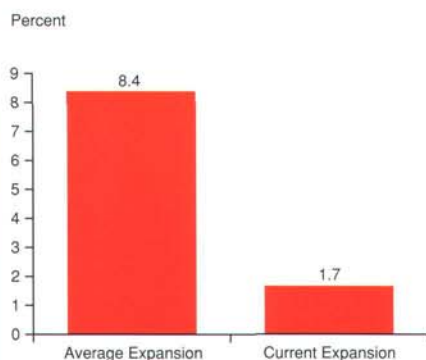


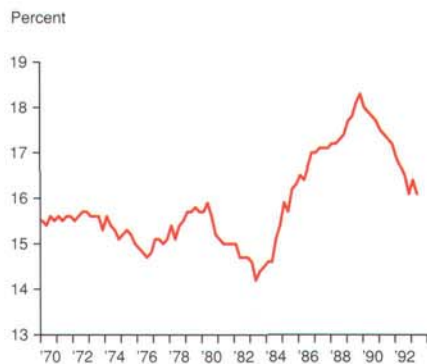
Chart 5
Employment Growth
(Trough to 10 Quarters Later)



slow nature of the recovery itself, a substantial portion is the result of the restructurings and automation drives that have been sweeping corporate America. The factors behind these changes include the falling cost of capital relative to labor, improvements in computer and information technology, future mandated benefits for workers, and increased global competition.

Employment growth will play a supporting, but not leading, role in economic activity during 1994. Corporate restructurings will continue, but the increased level of aggregate demand for goods and services will necessitate modest hiring, with nonfarm payrolls likely increasing at a pace of 175,000 workers a month. Similarly, consumer spending will also grow moderately, playing a supporting, but not leading, role in economic activity during 1994.

Chart 6
Mortgage and Consumer Debt Payments



Risks to Consumer Spending

Uncertainty about the strength of consumer spending poses the biggest threat to the 2.8-percent forecast for GDP growth in 1994. On the upside, improved household balance sheets may give more of a bounce to spending than we have assumed. Debt payments as a percentage of disposable income have been falling since reaching a peak in late 1989 (*Chart 6*).

Health reform could pose a downside risk to spending. Mandated employer contributions for health benefits could raise the cost of hiring workers for many firms, thereby restraining employment growth and consumer spending.

A further downside risk to our forecast is the impact of higher taxes on the 1 to 2 percent of the population in the top income tax bracket. The forecast is based on the assumption that the negative effects on consumption and on the availability of capital for business formation will be modest and partially offset by increased spending by families benefiting from the expanded income tax credit for the working poor.

Drags on the National Economy: Net Exports and Defense Cuts

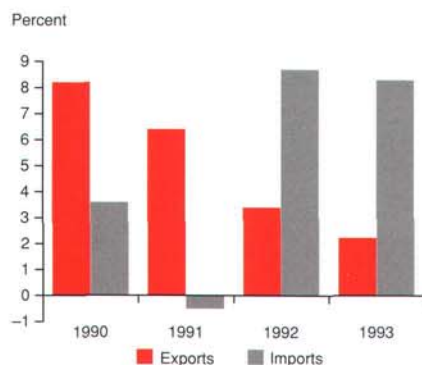
Net exports will be a drag on the economy during 1994. Weakness in the economies of Europe and Japan will keep export growth feeble until at least the end of the year. Although import growth should moderate in 1994, net exports still will likely restrain overall GDP growth.

In contrast to 1990 and 1991, when net exports added to GDP growth, net exports have subtracted half a percentage point from overall growth in each of the past two years (*Chart 7*). In 1994, net exports again will probably subtract close to half a percentage point from GDP growth.

Defense cutbacks and a tight fiscal policy will also act as a drag on economic activity in 1994. During 1993, declines in military spending

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Chart 7
Growth of Exports and Imports



subtracted approximately a half a percentage point from GDP growth, and defense cuts probably will have a similar effect in 1994.

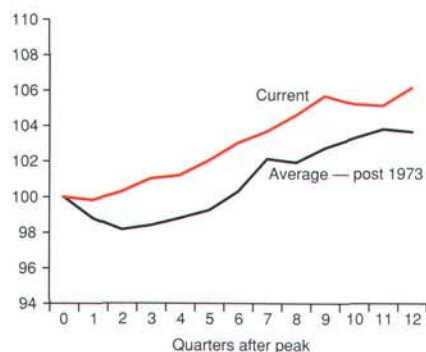
Will Recent Productivity Gains Persist?

While employment growth has been relatively weak during this expansion, productivity gains have been relatively strong when compared with recoveries since 1973 (*Chart 8*). 1973 is referenced here because after that year, the trend in U.S. productivity growth slowed substantially.

Because productivity gains are typically large in the early stages of expansions, it is much too early to say whether the U.S. economy is now entering a period of higher productivity growth, which would imply an increase in U.S. living standards.

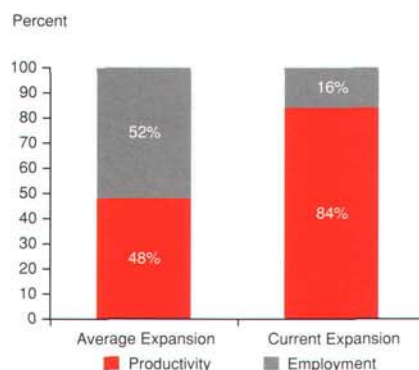
Chart 8
Productivity

Index, peak = 100



However, there is reason to believe that recent productivity gains are not being driven solely by normal business-cycle influences. One reason is the unusually large contribution that productivity gains are making to overall growth. By definition, output growth equals the sum of employment growth plus productivity growth. *Chart 9* shows the contribution of each to total output growth for the average of past expansions and the current expansion. As we can see, productivity gains are contributing a larger share to output growth in this ex-

Chart 9
Contribution of Employment and Productivity of Output Growth

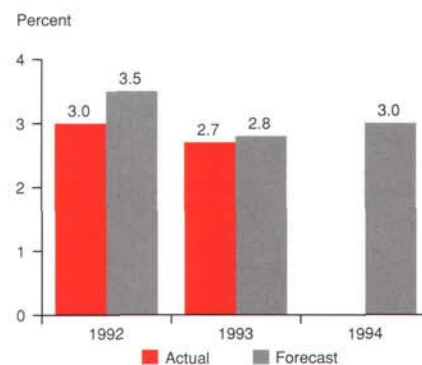


pansion than in the past. Another way of putting this is that, compared with past expansions, output growth in this expansion has been weak, but employment growth has been even weaker.

One interpretation of this development is that the falling cost of capital relative to labor is inducing firms to invest more in plant and equipment and hire fewer workers. This manifests itself as increasing labor productivity. If this is all that is occurring, productivity increases will continue until the capital-labor adjustment is complete.

However, if the recent productivity gains also reflect technological innovations (such as better computers) or innovations in organizational structures (such as corporate

Chart 10
Consumer Price Inflation



restructurings), then the recent productivity gains reflect increases in the potential output of the U.S. economy and imply better living standards in the future. An important implication would be that the economy is now capable of a higher growth path without an increase in inflation.

Inflation Outlook for 1994

Even if the recent productivity gains are being driven only by a substitution of capital for labor (and, therefore, are only temporary), weak employment growth and the associated small increases in workers' wages and benefits signal that inflation will remain under control in 1994.

Weak economies in many of the industrialized countries will also help keep inflation low by putting a lid on commodity price increases. Additionally, one-quarter of all non-oil goods sold in the United States are produced overseas, and this foreign competition is holding down price increases by many domestic companies.

Consumer prices increased 2.7-percent in 1993. In 1994, consumer prices probably will increase about 3 percent (*Chart 10*).

—Kenneth M. Emery