the Southwest ECONOMY

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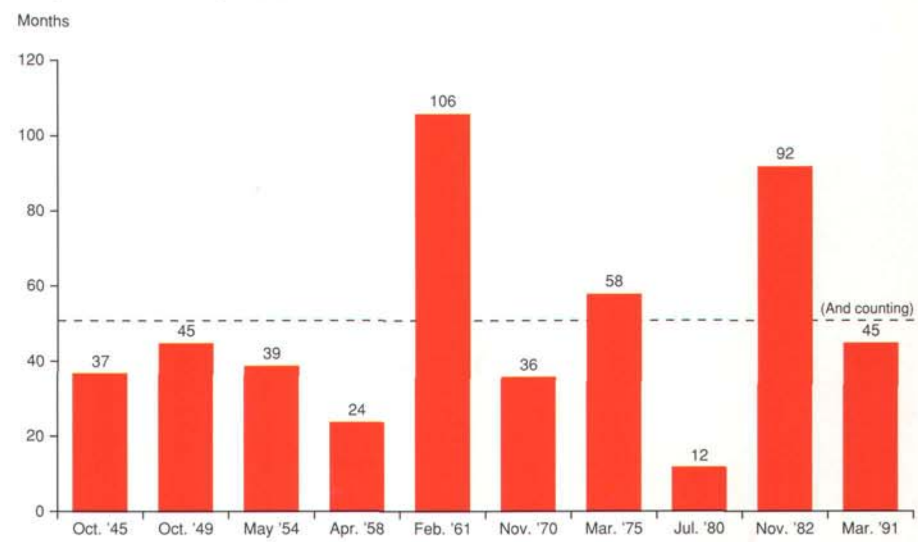
U.S. Economic Forecast Calls For Slightly Slower Growth

Chart 1
Length of Postwar Expansions



The economic forecast for 1995 calls for slightly slower growth and slightly higher inflation. Consumer and investment spending, the fuel behind U.S. economic growth in 1994, will likely grow at a more moderate pace in 1995 as the impact of higher interest rates becomes clear. Expanding exports to Europe, Mexico and Japan should partially offset more moderate domestic spending growth. On balance, real gross domestic product (GDP) is likely to grow at a 2.8-percent pace.[1] The inflation rate is likely to rise somewhat, with consumer prices increasing by 3.5 percent. In short, the economy should touch down for a soft landing and settle into a long-run growth rate with only a slight bounce in the inflation rate.

Reviewing 1994

Provided the fourth quarter presents no dramatic surprises, the U.S. economy's 1994 performance will be judged very favorably in coming years. If private forecasts of 2.8-percent growth in the fourth quarter hold true, real GDP growth for the year will be 3.4 percent. Meanwhile, inflation has continued steadily along the 3-percent path it has held for four years. Thus, according to broad measures of economic performance, the 1994 picture is one of solid economic expansion for the United States.

How does this expansion compare with previous ones? Though it may not seem so, the current expansion is 45 months old and counting. Chart 1 compares the duration of this expansion to those of the other nine postwar U.S. expansions. The current expansion is approaching the average duration for a U.S. expansion in the postwar period and is already longer than all but

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Southwest Expansion To Continue in 1995

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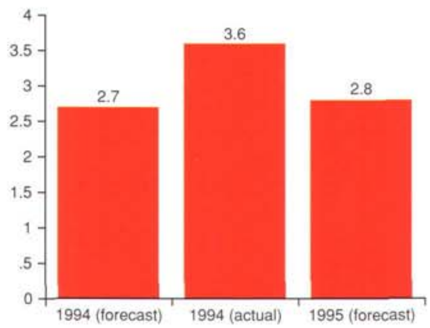
NAFTA: One Year Later

"Since the middle of 1993, the trend rate of growth in consumer spending has been about 4 percent."

Chart 2
GDP Growth Rates, 1994–95



three of the nine other expansions that have started since 1945. By this measure, the expansion is nearing the average life span.

The economy's performance in 1994 differed from that in both 1992 and 1993. Output growth showed considerably less variation during 1994 than during the previous two years. In the first half of both 1992 and 1993, growth started very sluggishly but gained momentum in the second half to reach a fourth-quarter crescendo. No such stop-and-go pattern emerged in 1994. Indeed, the economy has recorded above-trend growth within a fairly narrow range, increasing at annualized rates between 3.4 and 4.1 percent in each of the first three quarters.

The U.S. economy's 1994 performance was a bit stronger than *Southwest Economy* had predicted. (See Issue 1, 1994.) Chart 2 reports the rate of growth in real GDP between 1993:4 and 1994:3 together with the 1994 forecast and the 1995 forecast. Since the fourth quarter of 1993, real GDP has increased at a 3.6-percent annual rate, nearly one percentage point greater than predicted.[2]

The *Southwest Economy* forecast for 1994 correctly predicted that business investment and housing would contribute to growth in 1994. Chart 3 shows the contribution each major component of spending made to real GDP growth since the fourth quarter of 1993. Both consumer and investment spending have contributed the lion's share to output growth since fourth-quarter 1993. Consumption grew at a 3-percent annual rate, adding nearly two percentage points to real GDP growth. Investment spending grew at a 15.9-percent annual rate, adding slightly more than 2.5 percentage points to output growth. As predicted, both net exports and government spending have been modest drags on U.S. economic growth.

The strength in consumer spending in 1994 was a bit of a surprise. The 1994 forecast called for moderate growth in both consumption and employment. Indeed, between June 1993 and October 1994, nonfarm payroll employment increased at a 2.6-percent annual rate.[3] Since the middle of 1993, the trend rate of growth in consumer spending has been about 4 percent. The implication is that with moderate employment growth, disposable income growth has not kept pace with consumption growth. Consumers financed their spending by drawing down savings and by increasing their borrowing. As Chart 4 shows, consumer borrowing has been increasing faster than disposable income since early 1993. Insofar as the strength in consumption was unexpected, these stronger than expected changes can be traced to consumer borrowing.

As 1994 progresses, there are signs that spending growth is slowing a bit. In particular, the quarter-to-quarter movements indicate that

Chart 3
Contributions to Growth of Real GDP, 1993:4 to 1994:3

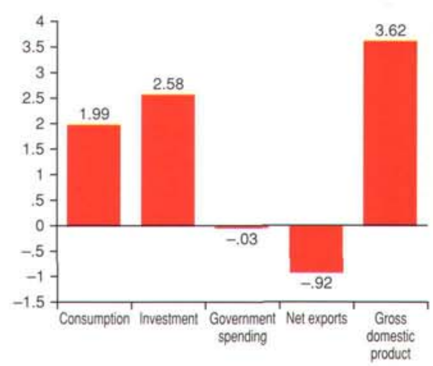
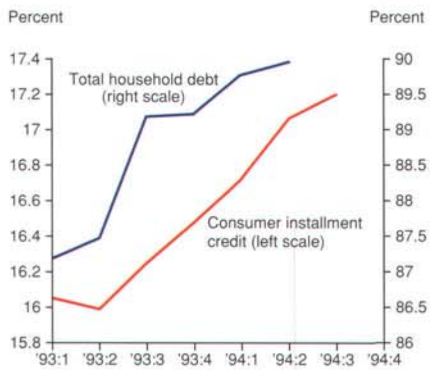


Chart 4
Consumer Installment Credit
And Total Household Debt as a Share
Of Disposable Income



growth in final sales of domestic product has slowed somewhat. For the past two quarters especially, what has been supporting real GDP growth has been stronger inventory investment.[4] The early year gains and subsequent moderation in consumer spending has been followed by some inventory rebuilding. Final sales data suggest that a modest slowdown in spending growth may have already begun, perhaps signaling a descent toward a soft-landing trajectory.

The 1995 Forecast

From the fourth quarter of 1994 to the fourth quarter of 1995, real GDP should increase at a 2.8-percent rate. Economic growth will likely moderate in 1995 as higher interest rates discourage consumer borrowing. In addition, employment growth will probably be moderate. As Chart 5 shows, both long- and short-term interest rates hit bottom in late 1993. For example, the yields on 30-year Treasury bonds have risen nearly 200 basis points over the past year, to about 8.1 percent from 6.1 percent. Interestingly, long-term rates have been increasing worldwide. In addition, the Federal Reserve has pushed the federal funds rate up about 250 basis points between February and late November 1994.

What is relevant for the forecast is that the combination of moderate employment growth and higher interest rates should keep the growth of consumption at a rate below 4 percent. The higher interest rates will also make some capital improvement projects unprofitable, which could reduce the growth of investment spending. Stronger net exports should soften the effects of the falloff in consumption and investment spending. As growth in the U.S. slows, import growth will likely slow in 1995. Meanwhile, Europe can expect stronger economic growth in 1995, which should boost spending on U.S. exports.

Risks to the Forecast

Like all forecasts, these economic predictions are subject to surprises that can alter real outcomes. Surprises in productivity—weather and natural disasters, for instance—may affect the actual 1995 growth rate in the United States. These risks are symmetrical in the sense that bad things are just as likely to occur as good things. Several other risks also could make growth higher or lower than forecasted.

The first risk is that consumer and business spending may react more dramatically than expected to the recent higher interest rates. The relationship of output growth and other measures of economic activity to changes in interest rates is not constant. No one knows for sure that an *x*-percentage-point change in interest rates will have a *y*-percentage-point change on real GDP, consumer spending or investment spending. Because consumer spending accounts for nearly two-thirds of U.S. spending, consumer behavior can drastically change the economic landscape. To date, there is little indication that higher interest rates have affected consumer spending. However, there are lags between the time interest rates rise and the time markets feel the impact of the higher rates. The effect of higher interest rates on consumer and investment spending is still uncertain. Greater than expected interest-rate sensitivity may cause the U.S. economy to grow less than the predicted 2.8-percent rate. The opposite is also true. Lower sensitivity could cause greater growth.

The second major risk to this forecast is that the economy's landing may be bumpier than predicted. The forecast calls for a soft landing as real GDP growth slows to a 2.8-percent pace. But instead of a gradual slowdown from fourth-quarter 1994 to fourth-quarter 1995, the economy could achieve 2.8-percent growth at

Chart 5
Treasury Bond Rates

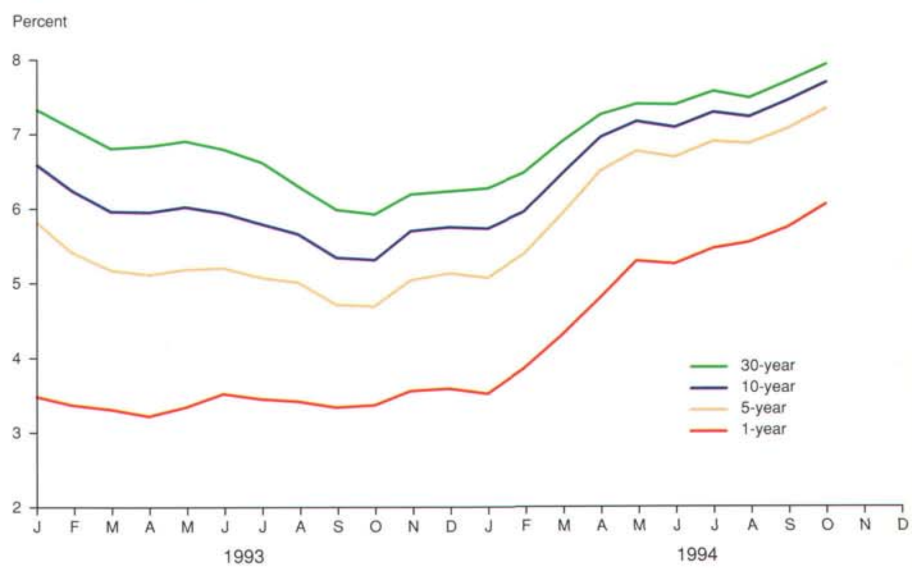
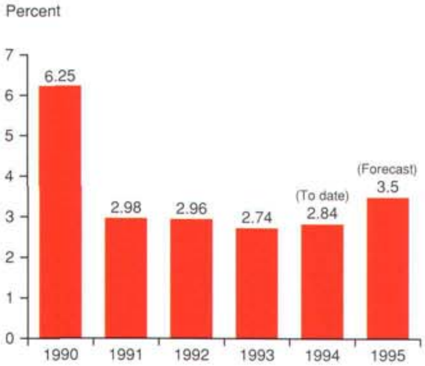


Chart 6
Consumer Price Index
(Annual percent change)



a highly uneven pace. Soft-landing forecasts are inherently risky, especially when coupled with uncertainty about higher interest rates. If the U.S. economy fails to slow down soon enough to calm inflation fears, bond traders may bid up long-term rates. If that happens, higher interest rates may help achieve a soft landing, but the even higher long-term interest rates could further discourage consumer and investment spending. In the near term, the economy would flatten more sharply than expected but economic activity would rebound in the second half of 1995. In other words, the year-end growth rate could be the same as in the soft-landing scenario but only after a much bumpier ride.

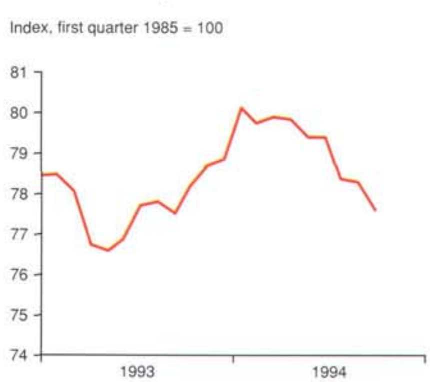
Government trade policy could also significantly affect economic growth in 1995. In particular, failure to pass the General Agreement on Tariffs and Trade treaty could damage sensitive bilateral relationships or, even worse, encourage trade restrictions. In this worst-case scenario, export activity would be stifled and economic growth could slow sharply.

Forecasting Inflation

Chart 6 shows the December-to-December consumer price index inflation rate for the period 1990–94.[5] Since the oil-price hike that accompanied the Gulf War in 1990, there has been very little fluctuation in the rate of inflation. However, the inflation rate is expected to edge up to 3.5 percent in 1995. With output growing at rates above the economy's long-run average, rates of unemployment and capacity utilization are approaching levels that have historically been associated with rising inflation. A modest slowdown in the rate of output growth should help ward off inflation increases in 1995. Still, upward pressure on prices will likely gain some momentum unless output growth falls below the 2.8-percent rate forecasted.

One risk to this forecast is the impact the falling foreign exchange value of the dollar could have on inflation. As Chart 7 shows, the real value of the dollar has steadily declined during 1994. This shift makes the price of imports rise. In the past, import prices have not contributed significantly to the U.S. inflation rate, in part because imports constitute only about 12 percent of final sales in the U.S. economy. Perhaps more importantly, many importers have adopted a price-to-market strategy. When the dollar depreciated in the mid-1980s, there was no corresponding increase in the U.S. inflation rate as many firms elected to price their goods competitively in the U.S. market. Of course, this strategy meant that for the same volume of dollar sales, the foreign companies suffered smaller profits valued in their home currencies. It is not guaranteed that importers will adopt this strategy again.

Chart 7
Real Trade-Weighted Value of the Dollar



SOURCE: Federal Reserve Bank of Dallas, RX-101 Real TWVD.

A reasonable guess is that the dollar will trade at its current level. If the dollar's devaluation to date is passed through, the U.S. inflation rate would probably rise to about 3.8 percent, only slightly higher than the 3.5-percent rate forecasted.

In summary, real GDP growth should moderate and inflation will probably edge up in 1995. The economy will likely undergo an even-paced slowdown—a soft landing—as output growth moves toward its long-run trend rate of growth. Slower economic growth should reduce pressures for price increases. In addition to the usual risks that qualify economic forecasts, there is the added risk that the economy's changing sensitivity to movements in interest rates could be associated with a bumpy ride.

—Joseph H. Haslag

Notes

1 Forecasts are made on a fourth-quarter-to-fourth-quarter basis.

2 If real GDP grows at the average of rates predicted by private forecasters in the fourth quarter of 1994, the difference between the predicted growth rate for 1994 and the actual rate will be only about three-fourths of a percentage point. The statistics quoted here are subject to change because GDP estimates will be revised several times.

3 Employment growth may have been much stronger. Recent reports and statements by Laura Tyson, chairperson of the Council of Economic Advisers, suggest that employment may have been undercounted by as much as 700,000 jobs. To the extent that such employment gains were undercounted during the June 1993–October 1994 period, descriptions regarding job growth would be more than just "moderate."

4 Inventory investment is included in the measure of the investment spending component reported in Chart 3.

5 For 1994, the inflation rate is the annualized rate of change from December to October.