



2001 Economic Outlook - General Trends

National and North Carolina

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The National Economy: Is a Slowdown Here?

The year 2000 will likely be called a year with two economic faces. The first half of the year had a face of strong economic growth, falling unemployment, and economic optimism.

However, the second half of 2000 had a face of much slower economic growth, increasing inventories, rising unemployment, and falling consumer confidence. As we move into 2001, the concern is what economic face will characterize the new year.

The numbers clearly show the dichotomy in the 2000 economy. Economic growth, as measured by the inflation-adjusted increase in the output of goods and services, surged at an annual rate of 5.7% in the first two quarters of 2000. However, in the third quarter, the growth rate dropped to 2.5%. After falling in 1999 and remaining stable in the first half of 2000, the inventory-sales ratio jumped to its highest level in a year in the third quarter of 2000. And, a measure of consumer sentiment fell to its lowest level in two years at the end of 2000.

These numbers point to an economic *slowdown*. An economic slowdown differs from an economic recession in a very important way. In a slowdown, the economic growth rate is reduced but it is still positive. That is, the economy is still growing in a slowdown, although at a slower rate. In contrast, in a

recession the economic growth rate turns negative. This means the economy is actually contracting and producing fewer goods and services.

A Game Plan Designed by the Federal Reserve

If, in fact, the economy is in a slowdown, then the question is why. Is the slowdown the result of higher oil and gas prices, concern over the presidential election stalemate, or recent declines in the stock market? Although all these factors certainly have an impact on the economy, most economists point to the Federal Reserve's interest rate policy as being the major cause of the slowdown. Bluntly speaking, many economists argue the slowdown has been engineered and desired by the Federal Reserve.

Although the Federal Reserve (the *Fed*) has many goals, one of its main objectives is the maintenance of a low and stable inflation rate. With this purpose in mind, the Fed has been concerned that statistics show a steady upward trend in various measures of the inflation rate. For example, the broadest measure of the inflation rate, the Gross Domestic Product Price Deflator, steadily

increased from an annual rate of 1.2% in late 1998 to 2.1% in late 2000. Similarly, retail inflation, as measured by the Consumer Price Index and *excluding* food and fuel prices, jumped from an annual rate of 1.9% in early 1999 to 2.7% in late 2000.

The Federal Reserve, especially under Chairman Greenspan, has desired to move against inflation before higher inflation rates become ingrained in the economy. The Fed realizes that the higher the inflation rate becomes, the more difficult it is to reduce the rate. For example, it took a severe recession in the early 1980s to reduce the double-digit inflation rates that prevailed in the late 1970s and early 1980s.

The Fed's concern has been that rapid growth in the economy is resulting in an upward trend in the inflation rate. To bring the inflation rate back to the range desired by the Fed (thought to be an annual rate of 1% to 2% as measured by the Consumer Price Index), the Fed has been increasing short-term interest rates and slowing monetary growth for over a year. For example, the Fed has increased its key short-term interest rate, the *federal funds rate*, from 4.75% in mid-1999 to 6.5% in late 2000. Likewise, the growth rate in most measures of the money supply has been cut by one-third during the past year.

Impacts of a *Soft Landing*

It is thought that what the Fed wants to achieve is a *soft landing* in the economy. A soft landing means the growth rate in the economy is successfully reduced without causing a recession. It is speculated the Fed would be happy if the economic growth rate for inflation-adjusted Gross Domestic Product would settle in the range of 2.5% to 3.5%.

Is such a soft landing possible? Actually, the Fed achieved a soft landing for the economy as recently as 1995. In 1994 the Fed was also concerned the economy was growing too fast and low inflation was threatened. Consequently, the Fed

doubled short-term interest rates (from 3% to 6%). As a result, economic growth was reduced from 4% in 1994 to 2.7% in 1995. Thereafter, the Fed lowered interest rates and economic growth accelerated.

A soft landing can be interpreted as a period of rest for the economy. During this period, businesses experience slower growth in demand for their goods and services. Consequently, the demand for business inputs, including labor, slows, and this reduces upward pressure on prices. To use an analogy, the soft landing turns down the heat in a red-hot economy before it blazes out of control - that is, before permanently higher inflation results. However, the soft landing seeks to avoid dousing the economic fire altogether - in other words, it wants to avoid a recession. When the heat and flames of the economic fire are under control, the fire can be stoked to a higher growth rate.

The costs of a soft landing should not, however, be minimized. Slower economic growth means higher unemployment, a reduction in the growth of consumer income, and a slowdown in business activity. This results in an increase in loan defaults, and, indeed, there's already been a rise in the percentage of non-performing loans at banks. With consumer debt payments taking a record percentage of consumer income, there will also be an increase in the difficulty of some consumers meeting their debt obligations. Higher business inventories will cause factories and firms to reduce overtime hours and part-time work. Homeowners and builders will find homes taking a longer time to sell.

Implications for 2001

Does this mean 2001 will be a bad year, economically speaking? My forecast for 2001 is that it will also have two faces, similar to 2000. The economic slowdown will continue, and may worsen, in the first half of 2001. But, if the Fed

is satisfied that national economic growth has settled into the 2.5% to 3.5% range for several quarters, then, I think, the Fed will take its foot off the economic brake and lower short-term interest rates in late spring or early summer. Such a move would cause economic growth to accelerate in the second half of 2001.

Part of this forecast is based on the performance of the Fed the last time it achieved a soft landing in the economy. Then, there was a two-year time period from the time the Fed first increased short-term interest rates to the time it reversed course and lowered short-term interest rates. In the current cycle, the Fed first began raising short-term interest rates in mid-1999. Adding two years puts us at mid-2001 when the Fed will start to lower interest rates.

The concerns increasingly expressed about the economy should not be overstated. Fundamentally, the economy is still in *good shape*. Jobs are being added, inflation and interest rates are still in a reasonable range, businesses are investing in new equipment and technology, and the federal government's fiscal position has moved from deficit to surplus. The long run prospects for the economy are still good once we get past this *dip* of a slowdown.

The North Carolina Economy: Following the National Trend?

North Carolina has enjoyed faster economic growth than the nation for several years. For example, from 1992 to 1998, the output of goods and services in North Carolina increased an average annual rate of 4.9% compared to 3.9% for the nation. In the Southeast, North Carolina's average growth rate was second only to Georgia's rate.

Yet it appears economic growth is slowing in North Carolina as it is in the nation. Job

growth in the state increased 3% during the first nine months of 1999 but rose only 2% in the first nine months of 2000. Also, job growth has slowed even in the fast-growing metropolitan counties of the state. Job growth in the first nine months of the year fell from 4% in 1999 to 2% in 2000 in the Triangle region, from 3% to 1% in the Charlotte area, and from 3% to -0.5% in the Triad.

Although the state's economic engine apparently slowed in 2000, the slowdown did not affect all sectors equally. During the year measured from August 1999 to August 2000, seasonally adjusted jobs in manufacturing fell 3.4%. The manufacturing sectors leading in job losses were textiles, apparel, transportation equipment, furniture and fixtures, electronic equipment, and tobacco products. These job losses reflected two factors at work in North Carolina. The first is continuing restructuring in the textile, apparel, and tobacco industries. The second factor is a reduction in industries making durable products, a change that is typical during economic slowdowns.

In contrast, jobs continued to increase in the service sector in the state during 2000. Over 67,000 jobs were added during the past year. Leading gainers were wholesale and retail trade, financial services, educational services, and the federal government.

The urban/rural disparity in job creation in North Carolina narrowed in 2000. From January to August 2000, 30% of the statewide increase in jobs occurred in fifteen urban counties. This percentage is considerably lower than in previous years and indicates a more significant economic slowdown in urban counties compared to rural counties.

The slowdown will likely hit North Carolina harder than the nation due to North Carolina's greater investment in the manufacturing sector. An Economic Activity Index developed at North Carolina State University forecasts composite activity in retail sales, construction, and employment falling 1.5% in the state during the second half of 2000 and the first half of 2001 after rising 2.7% in the previous year.

This forecast of an economic slowdown will have several implications, and one of the most important is implications for public finance. An economic slowdown will result in slower growth in government revenues and a potential *shortfall* between planned government spending and actual government revenues.

So North Carolina should expect a bumpy economic ride in 2001, especially during the first half of the year. However, if the national economy revives in the second half of 2001, smoother economic sailing should be in store for the state after mid-year.

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