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2005 Economic Outlook: Modest Improvement for Most

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The National Economy: A Maturing Expansion

A Review of 2004

The current economic recovery widened and matured in 2004. The broadest measure economic growth, the increase in the price-adjusted value of all goods and services produced during the year (real U.S. GDP), rose one-third faster in 2004 than in 2003 (Table 1). This improvement was strong enough that the element missing in 2002 and 2003, job growth, was finally added in 2004. Employers increased jobs at a modest, yet healthy, 1.6% rate during the year, and the year-end unemployment rate dropped from 5.7% in 2003 to 5.4% in 2004.

An improvement in the job market is crucial for the overall health of the economy because jobs bolster both household income and consumer confidence. The impacts of the better job market can clearly be seen in the statistics for personal income and consumer spending. Real disposable (after inflation and after taxes) personal income and real (after inflation) consumer spending both increased at faster rates in 2004 than in 2003.

The biggest improvement in the 2004 economy was in the industrial sector. Industrial production in 2004 rose at double the rate of 2003. This is typical of an economic recovery for two reasons. During a recession, such as the one which occurred in 2001, industrial production declines more than other parts of the economy as buyers postpone purchasing manufactured goods. Also, manufacturers are motivated to sell out of inventories, and this also curtails production. However, as manufacturers become convinced the economy is back on a growth track, the stage is set for faster growth in the industrial sector.

Contrary to conventional wisdom, consumers actually improved their debt position in 2004 just as they did in 2003. Consumer debt service payments as a percent of disposable personal income fell by 0.14 percentage points in 2004, following a 0.21 percentage point drop in 2003. A big part of the reason for this improvement was the continued drop in long-term interest rates in both years, thereby allowing consumers to both finance new debt as well as refinance old debt at more favorable rates.

However, the inflation and interest rate indicators showed some negative signs for the economy in 2004. Average prices, here measured at the retail level, increased 3.2% in 2004 compared to 2.3% in 2003. Perhaps even more worrisome, even after omitting volatile food and energy prices the so-called "core" inflation rate jumped from 1.4% in 2003 to 2% in 2004.

This suggests there was a broad based faster rise in prices in 2004. Yet this shouldn't be surprising. As the economy improves and buying increases, there is increased demand for key inputs that tend to be more limited in supply (such as oil), and this leads to faster increases in prices. Also in the face of improved buying, sellers are less motivated to discount prices in order to reduce inventories.

Concurrent with the increased inflation rate, short-term interest rates (represented by the 3-month Treasury bill rate) increased almost one percentage point in 2004. The increase represents a combination of increased inflationary expectations, as lenders must recover in loan payments the inflation they expect, plus an increase in the demand for loans that goes with an improving economy.

Importantly, long-term interest rates on10-year Treasury notes did not rise in 2004; indeed, they fell slightly. Some interpret this as implying a moderating economy in future years which would dampen inflationary pressures.

Of course one of the biggest headline grabbing stories in 2004 was rocketing oil, and gasoline prices. Oil prices hit $55 a barrel and gasoline prices soared to over $2 a gallon during the year. However, by year's end, oil had backed off to near $40 and gasoline prices were trending downward.

Several complicated factors explain the movement of oil and gas prices in 2004. As world economic growth accelerated, the demand for oil increased and pulled prices with it. Although world oil supplies eventually also increased, the lag between demand changes and supply changes initially forced prices up. Additionally, supplies were temporarily disrupted by Hurricane Ivan in the fall.

The continuing turmoil in the Middle East added a "risk" or "fear" premium to oil prices in 2004. This fear premium is estimated to be between $5 and $10 per barrel. The premium existed because buyers wanted to buy oil now before possible terrorist-created supply curtailments in the future reduced available oil supplies and increased prices even more.

One puzzling indicator in 2004 was the stock market. After a strong performance in 2003, stock prices rose only 5% in 2004. Why, with the economy performing better in 2004, did the stock market not respond?

One factor is the presidential election. With the polls so close right up to election day, there was tremendous uncertainty about which candidate would win. And although it cannot be said stock investors necessarily preferred one candidate over the other, stock investors do *not* like uncertainty. So one interpretation of the stock market's tepid performance in much of 2004 was investors' reluctance to commit to the market until they knew who would be in the White House in 2005. Interestingly, in the weeks after the election the market performed much better.

But another way to look at the stock market is as a forecaster of the future. The strong increase in stock values in 2003 foretold the much improved economy in 2004. Therefore, the modest increase in stocks in 2004 may suggest a slower growing economy in 2005.

Looking Ahead to 2005

As the forecasts in Table 1 suggest, the economy is expected to continue improving in 2005, but the pace of improvement will slow compared to 2004. Some of the slower growth will be by design, as the Federal Reserve continues to inch interest rates higher in order to head off even faster increases in prices. Short-term interest rates are expected to rise by 1.5 percentage points in 2005, and

Table 1. Key U.S. Economic Measures[a]

	2003	2004	2005 Forcast
Real U.S. Gross Domestic Product (% chg.)	+3.0%	+4.0%	+3.5%
Payroll Employment (% chg.)	0.0%	+1.6%	+1.5%
Unemployment Rate (end of year)	+5.7%	+5.4%	+5.2%
Industrial Production (% chg.)	+2.3%	+5.2%	+3.8%
Real Disposable Personal Income (% chg.)	+1.3%	+2.7%	+2.5%
Household Debt Service (chg. in % point)	-0.21	-0.14	+0.1
Real Consumer Spending (% chg.)	+3.3%	+4.1%	+3.5%
Consumer Price Index (% chg.)	+2.3%	+3.2%	+2.8%
3-Month Treasury Bill Rate (chg. in % points)	-0.6	+0.9	+1.5
10-Year Treasury Bill Rate (chg. in % points)	-0.6	-0.2	+1.0
S&P 500 Stock Index (% chg.)	+35%	+5.0%	+7.5%

[a]All percentage changes measured from year-end to year-end
Sources: U.S. Dept. of Commerce, Federal Reserve System, author's forecasts

long-term interest rates will also climb by 1 percentage point.

Job growth will continue at a slightly slower pace than in 2004, and correspondingly, both personal income and consumer spending will expand at more modest rates. The Federal Reserve's efforts to contain inflation will be partially successful, with retail prices forecast to rise by 2.8% – slower than in 2004 but faster than in 2003.

With consumers continuing to spend and borrow and interest rates rising, relative household debt service payments will rise in 2005. For most households, the increase will be manageable. The households most vulnerable to debt problems will be those in the lower income ranges.

Predicting oil and gas prices is always hazardous, but there are good reasons to think both prices will trend downward in 2005. The year begins with oil supplies at record levels and economic growth moderating in many oil importing countries. Terrorists have not been successful at permanently limiting oil supplies from the Middle East. Thus, the conditions are in place for downward pressure on oil and gas prices. However, one unknown is the response of OPEC (Organization of Petroleum Exporting Countries) to falling prices. OPEC has already announced it will cut oil production in early 2005. Whether this happens, what the response of non-OPEC producers will be, and how this will affect the supply/demand nexus are still questions to be answered.

Other unknown events could also alter the economic picture in 2005. At the top of the list are international events, such as the situation in Iraq and the larger Middle East and the continuing tensions with North Korea. There is likely to be considerable domestic policy debate about the tax system and Social Security in 2005, and these deliberations and possible outcomes could have big impacts on economic markets too. Finally, the national economy is continuing to undergo significant restructuring, so there could very well be major corporate start-ups, shutdowns, and mergers which affect jobs and incomes during the year.

The North Carolina Economy: Ground Zero for Restructuring

The North Carolina economy brightened considerably in 2004. While real personal income increased at about the same pace as in 2003, consumer spending (real retail sales) and employment improved significantly. After barely increasing in 2003, real retail sales increased a very strong 6.4% in 2004 (Table 2). Meanwhile, after falling in 2003, payroll employment registered a healthy 1.4% increase in 2004. Consequently, the state's year-end jobless rate fell from 6.2% in 2003 to 4.8% in 2004.

Nevertheless, beneath these positive economic signs there is turmoil in the North Carolina economy. This is highlighted by the continuing decline in manufacturing employment in the state. Although the rate of decline slowed in 2004, it's widely expected that employment in the state's traditional manufacturing sectors - textiles, apparel, tobacco, and furniture - is on a long-run downward trend.

Perhaps more so than in any other state, economic restructuring is occurring in North Carolina. Jobs are increasing in the "knowledge" fields like education and health, professional and technical occupation, finance, and management, while employment is being cut in the furniture factories and textile mills. International competi-

Table 2. Key North Carolina Economic Measures

	2003	2004	2005 Forcast
Real Personal Income (% chg.)	+3.7%	+3.6%	+3.5%
Real Retail Sales (% chg.)	+0.4%	+6.4%	+4.8%
Payroll Employment (% chg.)	-0.5%	+1.4%	+1.5%
Manufacturing Employment (% chg.)	-6.1%	-2.4%	-2.0%
Unemployment Rate (end of year)	+6.2%	+4.8%	+4.5%

Sources: U.S. Dept. of Commerce, N.C. Dept. of Revenue, Federal Reserve System, author's forecasts tion certainly explains many of the job cuts in traditional manufacturing, but so too does increased labor productivity. Like agriculture, manufacturing *output* in the state is rising even though employment is falling.

This tradeoff between employment and productivity has actually been positive for the state. Average wages, even after adjusting for inflation, are rising. The state is trading lower paying jobs for higher paying ones. But the restructuring is creating a dual North Carolina in two ways.

First, it is creating a dual North Carolina in terms of education and training. Workers with greater educational attainment, especially those with a college degree, are better able to secure higher paying jobs in the current economy. Meanwhile, those with less educational attainment are increasingly finding lower paying service jobs as their major employment option.

Second, North Carolina is being split geographically. Employment opportunities are greatest in the metropolitan areas of the state plus the tourist and retirement destinations on the coast and in the mountains. Jobs are much harder to find in the remaining rural counties of the state, thereby prompting many individuals to commute long distances for work.

This economic divide is creating two forms of pressure in the state. One is to increase the availability of re-training options at the post-secondary level. The other is to attract new companies to the state that can offer jobs to displaced workers who have modest formal educational backgrounds.

Overall, the state's aggregate economic performance is expected to improve in 2005. Statewide, the number of jobs will increase and unemployment will fall. But the economy will continue to churn out new jobs while destroying others.

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