SPECIAL ISSUE
THE FEDERAL RESERVE BANK OF CHICAGO
FEBRUARY 2001
NUMBER 162a

Chicago Fed Letter

Economy shifts to a lower gear in 2001

In the midst of a slowing economy, one can be deceived into thinking economic activity is slowing more than it actually is. The economic experience of the past several years has been similar to riding in a car driven at a very high speed, say 90 miles per hour. When the car slows down to 60 miles per hour, which is still reasonably fast, we might feel that we are traveling slower than we actually are. As the economy shifts to a lower gear—from 4.2% growth in 1999 and 5.9% in the first half of 2000 to 2.7% in the third quarter of 2000—it can be very difficult to discern whether this slowdown is a prelude to more significant declines in economic output or merely an adjustment to a lower growth path. Against this backdrop, the Federal Reserve Bank of Chicago held its fourteenth annual Economic Outlook Symposium on December 1, 2000. More than 60 economists and analysts from business, academia, and government attended the conference. This *Chicago Fed Letter* reviews the accuracy of last year's forecast for 2000 and summarizes the presentations at this year's conference.

1. Actual 1999 and median forecasts of GDP and related items

	1999 (Actual)	2000 (Forecast)	2001 (Forecast)
Real gross domestic product[a]	4.2	5.2	3.5
Real personal consumption expenditures[a]	5.3	5.3	3.4
Real business fixed investment[a]	10.1	13.3	8.3
Real residential construction[a]	6.4	–0.2	–1.4
Change in private inventories[b]	45.3	62.7	50.0
Net exports of goods and services[b]	–322.4	–402.0	–428.8
Real government consumption expenditures and gross investments[a]	3.3	2.6	2.2
Industrial production[a]	3.5	5.5	3.5
Auto & light truck sales (millions of units)	16.8	17.4	16.3
Housing starts (millions of units)	1.68	1.60	1.52
Unemployment rate[c]	4.2	4.0	4.2
Inflation rate (Consumer Price Index)[a]	2.2	3.4	2.8
1-year Treasury rate (constant maturity)[c]	5.08	6.15	6.09
10-year Treasury rate (constant maturity)[c]	5.64	6.10	6.00
J. P. Morgan trade-weighted dollar index[a]	–2.3	4.3	0.0

[a]Percent change from previous year.
[b]Billions of chained (1996) dollars.
[c]Percent.
Note: Data as of November 27, 2000.

Looking in the rear view mirror

Last year's symposium participants expected real gross domestic product (GDP) to increase by 3.3% during the first three quarters of 2000. The actual growth was a much more robust 5.6%. This underestimation was repeated for most of the subcategories of GDP and related items. The 5.7% growth rate of industrial production for the first three quarters was higher than the 2.7% rate forecast last year. Light vehicle sales were forecast to slow from 1999's record pace, but instead increased by over a half a million vehicles. Housing starts were expected to moderate to 1.54 million units following a very strong year in 1999. Instead housing starts for the first three quarters of 2000 averaged 1.62 million units, though starts fell to 1.53 million units in the third quarter, a level last seen in 1997. An overestimation of 0.3 percentage points occurred for the unemployment rate forecast, as the rate leveled off at about 4.0%. Inflation was expected to rise from 1.6% in 1998 and 2.2% in 1999 to 2.5% for the first three quarters of 2000. The rate actually rose 3.4% on average, largely due to higher energy prices. While the one-year interest rate forecast fell short by approximately 70 basis points, the ten-year rate was right on target. So, overall, the economy expanded faster, inflation was higher, and unemployment was lower than the forecasts.

Looking down the highway

For 2001, the forecasters expect the economy to successfully shift into a lower gear, but not be put in reverse. Figure 1 summarizes the forecasters' expectations both for 2000 and for 2001. Most forecasters believe that the growth rates experienced in 2000 are unsustainable and that real output growth during 2001 will be lower than 2000's growth rates for every subcategory of GDP. The typical forecaster expects 2000 real GDP growth to be 5.2% and 2001 real GDP growth to be 3.5%. Personal consumption expenditures, business fixed investment, residential construction, and government spending growth are forecast to slow in 2001. Change in business inventories is expected to moderate slightly from $62.7 billion in 2000 to $50.0 billion in 2001. Net exports are forecast to decline from –$402.0 billion in 2000 to –$428.8 billion in 2001.

The forecast group expects economic activity to hold fairly constant throughout the year with a very slight increase as the year winds down. In the first quarter, real GDP growth is forecast at 3.5%, easing to 3.4% in the second quarter, rising to 3.5% in the third quarter, and reaching 3.7% in the fourth quarter of 2001.

Industrial production growth is anticipated to decrease from 5.5% in 2000 to 3.5% in 2001. After a back-to-back record year with 17.4 million units of sales, the light vehicle market is expected to sell 1.1 million fewer vehicles in 2001. Housing starts are forecast to moderate to a still robust 1.52 million units in 2001. The unemployment rate during 2001 is expected to be just two-tenths of a percentage point above that of 2000. The 2001 rate of inflation is forecast to be 2.8%, 0.6 percentage points lower than in 2000. Short-term interest rates are forecast to fall by 6 basis points during 2001, while longer term rates are expected to fall by 10 basis points. Finally, the trade-weighted dollar is anticipated to remain unchanged.

Consumer spending and credit

The chief economist from a large bank presented the outlook for credit conditions and consumer spending. The presentation addressed three of the most pressing questions in the economy.

Will we have a soft landing? There are signs that the Fed has succeeded in slowing the economy, but there are still risks for a hard landing, particularly in labor market conditions. Strong growth has thinned the labor pool and there are few signs that demand for labor has slackened; one group even reports increased hiring plans for 2001. Efficiency and productivity gains might not completely cover the increasing wages due to tight labor markets, and the higher labor costs could be damaging to inflation. Some easing in labor demand will be needed to ensure that the expansion keeps going. However, in general, it appears that a soft landing is settling in, the likelihood of another sprint by the economy is falling, and the risks to the economy are balanced.

Can we avoid a credit crunch? Financial markets are becoming more cautious in the slowing economy. The bond market is showing signs of concern: Credit spreads are widening, the ratio of bond rating downgrades to upgrades is not good, and junk debt defaults are up. The stock market is showing new respect for risk; recent initial public offerings have done poorly and venture capitalists have become more cautious. All of these factors are taking a bite out of the wealth effect. Banks are tightening lending standards, but reserves remain very strong. A big source of risk in the financial industry, however, is the inexperience of the typical lending officer, mutual fund manager, and bank regulator—many have not worked through a recession or severe economic slowdown.

What will the election mean for the economy? In this year's election, apart from the recent past, the debate about fiscal policy centered on what to do with the budget surplus, rather than how to cope with a huge deficit. President-elect Bush campaigned on a large tax cut, but given that the Fed has been acting to slow economic growth, this might not be the best time to add stimulus to the economy. Many observers argue that rather than spending the surplus on a tax cut, the more appropriate policy is to continue to reduce the nation's $5.8 trillion debt in order to save interest payments. Realistically, given the delicate balance of power in Congress, it will be extremely difficult for the new administration to push through a tax cut of the scale promised during the campaign.

Automotive sector

While a strong economy has supported record auto sales for the past two years, an economic slowdown is underway and the wealth effect is less supportive than in recent years. Oil prices remain within historical norms, but are high and will have a negative effect on vehicle segmentation: Automakers will sell fewer high-profit large vehicles. However, while vehicle sales will likely decline next year, as the chief economist from one of the Big Three automakers noted, a collapse in sales is unlikely.

Vehicle sales have peaked and have been running about 14% above trend. The slowdown has been modest so far because the pricing environment has been very attractive; new vehicle prices have fallen for the past two years. Furthermore, consumers have been very optimistic: the percentage of consumers who say that it is a bad time to buy a vehicle—a better leading indicator than the percentage of consumers who say that it is a good time to buy—remains near record lows. Interest rates at auto financing companies also have been low. In 2001, high (but moderating) oil prices, higher interest rates, and low consumer savings will likely offset high consumer confidence and solid job and income growth. Additionally, fewer consumers will look to upgrade their existing vehicles in a weaker economy.

Heavy duty trucks

The manager of forecasting and sales analysis from a large truck maker said that, after three strong years, the new truck business declined during 2000. New orders fell to recession levels, order backlogs fell below critical levels, build rates dropped 50% and plant shutdowns became necessary, inventories for new and used trucks rose too high, and customer financials weakened. The class 8 truck market was in worse shape than the medium trucks, but both markets show signs of bottoming out in the near term.

New orders for class 8 trucks declined steadily from 35,000 units a month in early 1998 to about 10,000 a month in October 2000. The industry is very cyclical: When the overall economy is good and shipping activity is growing fast, customers tend to overbuy and producers tend to overbuild. The big problem for class 8 trucks is the large inventory of used trucks, though the severity of the problem varies across manufacturers.

The long-term indicators for the industry are mixed. The share of intercity shipments by truck is near 50%, up from about 40% in the mid-1980s. Motor carrier financials are down currently, but they are correlated to the slowdown in new truck orders. There are some costly new emission regulations scheduled for enforcement in 2002 and 2007, but historically the implementation of new standards has had little effect on new truck orders. In the near to mid-term, it is most likely that fuel prices should normalize at about $25/barrel by mid-2001,

interest rates should come down as the economy slows, and truck freight growth should use up slack capacity in the industry. In this climate, class 8 truck orders would bottom out in 2001 to around 40% below the peak in 1999 and steadily recover by 2005 to reach just below the previous peak. However, in the event of a recession in 2001, orders in 2001 would be half what they were in 1999 and not bottom out until 2003.

The medium truck market (class 5–7 trucks) is slightly less volatile, because the customers are smaller and generally need to make truck purchases regardless of the economic conditions or their business will fail. Medium duty truck orders are down from peaks in 1998, but flat with 1999, and actual sales are peaking in 2000. Fuel prices have had a smaller impact on the medium truck business, the e-commerce phenomenon has added about 3,000 units in sales, and used truck inventories are not a problem. Near term, the likely scenario is that sales should decline about 20% next year, but should recover soon and reach above-peak levels by 2004. In the case of a recession in 2001, sales could fall until bottoming at 45% below peak in 2003.

Current and trade accounts

A senior fellow from an international trade think-tank discussed the U.S. trade deficit and its sustainability. In 1999, the current account deficit, relative to GDP, was at its highest point since 1985. The U.S. economy in 2000 continued to grow faster than the world economy, contrary to some analysts' expectations. Noting that the increase in the current account deficit coincided with a boom in technologic improvements, the economist called for a change in thinking about the current account deficit and its sustainability.

Essentially, so long as the deficit has a small impact on asset prices, relative to the impact of other economic forces—such as income growth and inflation—it is sustainable. Traditionally, the deficit was seen as unsustainable if its share of GDP got too large (a level assumed to be around 4%) and sparked weakening in the dollar, or the net international investment position became large relative to GDP and the net service payments on that investment crowded out spending on consumption or domestic investment. In 1999 and 2000, the current account deficit was over 4.0% of GDP, but did not lead to a weaker dollar and weaker economy because the nature of foreign investment in the U.S. kept net service payments very small relative to GDP.

An alternative, and perhaps better, approach to thinking about the current account considers the increasingly global role of the dollar, integrated international capital markets, and a larger impact of international investments on global growth. This approach asks whether there is enough increased demand from international investors, considering their risk, return, and diversification tradeoffs, to buy U.S. exposure compared with what the U.S. offers in terms of net assets.

In each approach, technology plays a role in changing the dynamics of the U.S. current account. In the traditional approach, technology contributes in two ways. Productivity growth falls in line with strong economic growth, which leads to higher import growth; and the purchase of the hardware necessary for the technologic improvements boosts imports as well. Additionally, if information technology takes off in the rest of the world, that will lead to capital deepening elsewhere. Couple that with liberalization of services, and exports from service providers, as well as from U.S. high-tech equipment makers, will increase. In the second approach, technology changes the financial instruments investors may seek and makes financial market integration easier; both factors will affect global investors' portfolio allocations.

Looking to 2001, the current account seems sustainable, given continued growth from higher productivity, the low value of service payments, and the characteristics of international financing. The sustainability of the capital account, however, is questionable. If financial market integration moves forward in Europe, that would reduce the cost of obtaining exposure to the European market, raise returns on euro securities, and attract portions of international portfolios and increase investment in the euro zone. The dollar would gradually depreciate against the euro, but the U.S. trade deficit would improve. If U.S. growth slows moderately and the rest of the world fails to pick up the slack, then financial markets would likely have few good choices for investing, the dollar would strengthen, and there would be increased capital flows into the U.S. The trade deficit would worsen and international portfolios would increase investments in the U.S., only because they would not want to invest anywhere else, which would increase the U.S.'s vulnerability to changes in investor sentiment and increase the risks for a hard landing of the currency.

Construction and agricultural machinery

The director of marketing economics at a large machinery manufacturer generally expected the construction and agricultural machinery sectors to moderate along with the overall economy. Though both fared quite well during 1998 and 1999, residential and nonresidential construction took divergent paths during 2000. Housing starts moderated from the two previous strong years, and machinery sales have correlated closely with housing starts since the late 1980s. Strong nonresidential construction activity has offset

Michael H. Moskow, *President;* William C. Hunter, *Senior Vice President and Director of Research;* Douglas Evanoff, *Vice President, financial studies;* Charles Evans, *Vice President, macroeconomic policy research;* Daniel Sullivan, *Vice President, microeconomic policy research;* William Testa, *Vice President, regional programs and Economics Editor;* Helen O'D. Koshy, *Editor;* Kathryn Moran, *Associate Editor.*

Chicago Fed Letter is published monthly by the Research Department of the Federal Reserve Bank of Chicago. The views expressed are the authors' and are not necessarily those of the Federal Reserve Bank of Chicago or the Federal Reserve System. Articles may be reprinted if the source is credited and the Research Department is provided with copies of the reprints.

Chicago Fed Letter is available without charge from the Public Information Center, Federal Reserve Bank of Chicago, P.O. Box 834, Chicago, Illinois 60690-0834, tel. 312-322-5111 or fax 312-322-5515. *Chicago Fed Letter* and other Bank publications are available on the World Wide Web at http://www.frbchi.org.

ISSN 0895-0164

the weakness in the housing sector. But, the outlook for construction equipment sales in 2001 hinges on three issues: the direction of interest rates, the equipment replacement cycle, and rental fleets. If interest rates stay at current levels, sales would likely fall 5% to 10% during 2001. If the Fed continues to tighten the money supply, sales could decline more. Replacement demand is falling because many firms have already upgraded their equipment. Finally, rental companies have spent much of the past couple of years updating and expanding their fleet and will not need to do as much of that as the economy and construction activity slows.

Agriculture has had five good years of harvests worldwide and restrained demand growth, helping to keep commodity prices low. However, government payments have helped solidify farmers' financials. A couple of factors point to better times ahead. World carryover stocks of wheat and feed grains are down, setting up the possibility of positive price movements. Corn prices have been moving higher since late summer, due to speculation that China's entry into the World Trade Organization would cause them to curb export activity. The mad cow scare in Europe has led to calls for a ban on using ground bone meal as a protein source for livestock; such a ban would improve demand (and prices) for soybeans. In this improved atmosphere, row crop machinery sales should increase in 2001.

Steel industry

The market for steel remains strong, but domestic steel makers face some financial troubles and intense competition from imports. In this environment, a consulting economist presented an uncertain outlook for the industry.

Steel consumption is at an all-time record rate, estimated to end 2000 at 131.3 million tons, up 1.9% from 1999. However, when domestic producers tried to push through price increases early in year, cheaper imports flooded the market. The imports came from all over the world, but the largest increases came from Russia, the Ukraine, and the European Union. Euro-zone sellers have been helped by the decline in the euro, and Ukrainian producers are supported by loans from the International Monetary Fund. Though the economy in the rest of the world is improving and U.S. exports of steel were strong in 2000, the import problem remains. As a result, many domestic steel makers are in financial trouble. The stock prices of ten major domestic steel companies are down an average of 70.4% from their respective interim peaks in late 1998 and early 1999; two companies have gone bankrupt and at least one has a market capitalization that is lower than the value of its net assets. Some of these companies may benefit from decisions in ongoing trade dumping cases. However, it will be 2002 before these cases have any effect.

Though the consensus forecast calls for the U.S. economy to grow 3.4%, an analysis of specific sectors suggests that forecast is optimistic; only the energy and construction sectors seem likely to show increased demand for steel in 2001. As a result, steel production and consumption will probably moderate. Even if strong demand continues and the import problem subsides, the industry has significant inventories to work off.

Conclusion

After an incredible performance during the early part of 2000, the economy began to shift to a lower, more sustainable path in the latter part of the year. Symposium participants expect the slower pace to continue during 2001. Importantly, none of the forecasters expect a recession in 2001. This is a very positive sign for an economy that is in the process of slowing. Determining a bottoming out of the growth path can be tricky. However, the forecast group anticipates that, while the pace of growth will moderate, the current expansion will add another year to its already impressive record in 2001.

— William A. Strauss
Senior economist and economic advisor

—Michael Munley
Associate economist

Chicago Fed Letter

FEDERAL RESERVE BANK OF CHICAGO
Public Information Center
P.O. Box 834
Chicago, Illinois 60690-0834
(312) 322-5111

Return service requested

PRESORTED
FIRST CLASS MAIL
US POSTAGE PAID
CHICAGO, IL
PERMIT 1942