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Expansion picks up steam

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While the U.S. economy has been expanding for the past two years, it hasn't felt all that robust. What can we expect in 2004? Can the acceleration in economic growth that followed the end of major fighting in Iraq be sustained? A recent Chicago Fed symposium brought economists from academia and business together to discuss the outlook for 2004.

After suffering through a mild recession during most of 2001, the U.S. economy has been expanding for the past two years. Yet when one looks back over this period, it feels like the economy has continued to struggle and has not performed as well as it should. In fact while output rose in each of the past eight quarters, employment declined in all but one of them. Furthermore, the manufacturing sector has struggled during this two-year expansion. Industrial output was virtually unchanged in the third quarter of 2003 compared with its level two years earlier.

Still, the economy has performed impressively in light of all of the negative economic shocks it has experienced over the past three years: the stock market collapse, oil and natural gas price hikes, the September 11, 2001, attacks, a war in Afghanistan, corporate governance scandals, and a war with Iraq.

1. Forecasts from Annual Economic Outlook Symposium

	2002 (Actual)	2003 (Forecast)	2004 (Forecast)
Real gross domestic product[a]	2.4	3.0	4.1
Real personal consumption expenditures[a]	3.1	3.1	3.6
Real business fixed investment[a]	–5.7	2.4	9.3
Real residential investment[a]	3.9	8.6	2.1
Change in private inventories[b]	5.2	–8.8	35.0
Net exports of goods and services[b]	–488.6	–529.2	–550.6
Real government consumption expenditures and gross investment[a]	4.4	3.3	2.6
Industrial production[a]	–0.6	–0.3	3.7
Auto & light truck sales (millions of units)	16.7	16.6	16.8
Housing starts (millions of units)	1.71	1.79	1.71
Unemployment rate[c]	5.8	6.0	5.8
Inflation rate (Consumer Price Index)[a]	1.6	2.3	2.2
1-year Treasury rate (constant maturity)[c]	2.00	1.24	1.71
10-year Treasury rate (constant maturity)[c]	4.61	4.03	4.69
J. P. Morgan Trade Weighted Dollar Index[a]	–0.4	–6.2	–1.3
Oil price (dollars per barrel)[d]	26.10	30.52	27.72

[a]Percent change from previous year; [b]billions of chained (1996) dollars; [c]percent; [d]West Texas Intermediate.

SOURCES: Actual data from Haver Analytics; median forecasts from Economic Outlook Symposium participants.

As 2002 drew to a close and 2003 began, it appeared increasingly likely that the U.S. would go to war with Iraq. This caused businesses to hold off on making spending decisions until the situation with Iraq was resolved. The U.S. economy (measured as gross domestic product or GDP) expanded by a meager 1.4% in both the fourth quarter of 2002 and the first quarter of 2003, respectively. With the conclusion of major fighting in Iraq occurring in April, the delayed business decisions were exercised and the economy expanded by 3.3% in the second quarter. With no apparent major negative economic event occurring since April, the economy truly began to move forward—it grew by 8.2% in the third quarter of 2003, the strongest rate of growth in nearly 20 years. By the end of 2003, the economy's expansion appeared to be gaining traction. We have even seen some improvement in the employment data since August 2003.

Against this backdrop, the Federal Reserve Bank of Chicago held its seventeenth Economic Outlook Symposium on December 12, 2003. More than 90 economists and analysts from business, academia, and government attended the conference. This *Chicago Fed Letter* reviews last year's forecasts for 2003 and summarizes the presentations at this year's conference (see figure 1). We begin with an overview of the economy's performance in 2003 and the consensus forecasts for the year ahead.

Last year's forecasters were anticipating that the economy in 2003 would begin with growth below potential (a growth rate associated with a stable unemployment rate and no inflationary pressures) for the first half of the year and then rising as the year progressed to just slightly faster than potential growth. The economy started off slower than forecasted as the uncertainty associated with the impending war dampened business activity. However, it continued to improve in the second quarter, rising 3.3%, just above the forecasted rate. Then, the economy shifted into high gear in the third quarter, growing by over 8%. The forecasted decline in the unemployment rate did not occur as labor markets continued to struggle throughout the year. A slight rebuild in inventories was expected but inventories continued to be cut, leading to a substantial plunge in the inventory to GDP ratio. Industrial production was expected to rise during 2003 but, after a slight gain in the first quarter, fell sharply in the second, although it rose in the third quarter. The vehicle sector was forecasted to sell 16.5 million units, just below what occurred. Housing starts were expected to be fairly flat during 2003, but continued to perform much better than predicted. This is explained in part by a lower actual path for the ten-year Treasury rate. While generating a volatile pattern, inflation was close to what was forecasted.

Real GDP is expected to have increased by 3.0% in 2003 and then rise to a strong 4.1% in 2004, largely reflecting a significant improvement in the business sector. Business fixed investment is forecasted to increase from a 2.4% gain in 2003 to 9.3% in 2004. Inventories are predicted to rise by $35 billion, an improvement from the anticipated $8.8 billion decline in 2003, but this would still lead to a continued decline in the inventory to GDP ratio. Industrial production, which is expected to fall 0.3% in 2003, should increase 3.7% in 2004, a slower pace than the overall economy, consistent with a fall in the inventory ratio.

The forecasters expect spending in the consumer sector, which has been the most solid performer over the past few years, to improve in 2004, rising from 3.1% growth in 2003 to 3.6%. Some of this is expected to reflect a slightly better selling rate for light vehicles, which are forecasted to improve from 16.6 million units in 2003 to 16.8 million units in 2004. The improvement in the consumer sector should be supported by an improving labor market, with the unemployment rate anticipated to average 5.8% in 2004, 0.2 percentage points lower than in 2003. Residential construction growth is forecasted to rise by a much slower pace of only 2.1% in 2004 after a very strong 8.6% rate in 2003. The consensus group estimates that housing starts will slow to 1.71 million units in 2004, about 800,000 units lower than in 2003. A predicted increase in interest rates will play a role in slowing the housing market. Forecasters expect the ten-year Treasury rate to average 4.69% in 2004, 66 basis points higher than in 2003.

Government spending is anticipated to rise by 2.6% in 2004, a slower pace than in 2003. The international trade deficit is expected to increase somewhat, rising from $529.2 billion to $550.6 billion.

Inflation is expected to remain relatively unchanged at 2.2% in 2004, with oil prices falling from an average $30.52 a barrel in 2003 to $27.72 in 2004.

Forecasts for consumer spending and banking

According to Carl Tannenbaum, senior vice president and chief economist of LaSalle Banks/ABN AMRO, consumer spending is expected to be strong in 2004, although some risks may persist in the economy. Over the past few years, consumer spending and retail sales have remained strong as consumers kept spending through the downturn. Some of the more recent stimulus for this spending has been reduced—e.g., interest rates are now trending upward and the tax cuts have been completed. However, Tannenbaum does not foresee a major cutback in spending. For example, some people's withholding schedules did not change, meaning they will experience the tax cut in 2004 in the form of a refund. Moreover, even the slightly higher interest rates this year remain low by historical standards, so housing remains affordable.

Some of the determinants of consumer spending are mixed. For example, consumer confidence is improving, as is the stock market. However, there are fears that the stock market has risen too rapidly and may be approaching another bubble. Furthermore, wage growth and employment have not picked up significantly.

Despite these mixed factors, Tannenbaum forecasts continued strength in consumer spending. Consumers are not so overburdened with debt that they are likely to reduce their spending drastically in the near future.

Vehicle sales outlook

Ellen Hughes-Cromwick, senior economist at Ford Motor Company, spoke about her forecast for vehicle sales. She believes the overall economy is strengthening, and the improving macroeconomic environment will help vehicle sales remain strong.

Historical data on global vehicle sales shows that average annual growth of vehicle sales globally fell by half between the periods 1990–99 and 1999–2003. Despite this, the U.S. vehicle market is still strong. Some other trends include enormous pricing pressure and a growth in demand for premium content in vehicles. Real vehicle prices have fallen over the past few years, with a 4% decline from 2002 to 2003, reflecting competitive pressures. Also, as the nation becomes wealthier, U.S. consumers are purchasing more premium vehicles. The average vehicle transaction price has risen approximately 15% since 2000, and the premium brand share increased from about 6% in 1995 to 10.6% in 2003. With increased competition and economic growth in the U.S., both of these trends are expected to continue.

Some issues about the auto industry include the sizable excess capacity and the strengthening of the yen. Global excess capacity was estimated at 12 million units in 2002, and the yen's strengthening already appears to have reduced U.S. vehicle imports from Japan.

Despite these factors, the North American market is expected to do well in 2004. Canada's macroeconomic environment has been moderately strong, and this is expected to contribute to good auto sales in Canada. Mexico's economy has been weak, and sales have flattened. However, vehicle sales in Mexico are expected to increase by 2005. With the U.S. market expected to continue to be strong, 2004 is likely to be a good year for North American vehicle sales overall.

Steel sector forecast

Robert DiCianni, manager of marketing at Ispat Inland, began his outlook with a quote from Alan Greenspan: "Uncertainty is not just an important feature of the [current] landscape; it is the defining characteristic of [this] landscape." This view was echoed by nearly all of the speakers at the symposium, many of whom highlighted geopolitical concerns, in particular, as a source of uncertainty.

DiCianni attributed the steel price increases in early 2002, especially in hot-rolled steel, to a major steel firm, LTV, stopping production in December 2001, rather than to the steel tariff imposed by President Bush. Prices have declined recently, but an increase is expected in 2004. With recent declines in inventory, there is an impetus for rebuilding inventory in 2004.

Many of the users of steel, such as the auto, appliance, and residential investment industries, did not reduce demand significantly in 2002 and 2003 as consumers of these goods continued to spend, despite the economic downturn. While non-residential construction spending experienced a slight dip between 2002 and 2003, it is expected to pick up in 2004.

The removal of the steel tariff is not expected to increase imports significantly, because China, which accounts for most of the increase in world consumption, remains a more attractive market than the U.S. There have been increasing demand and higher prices in China relative to the U.S. Indeed, U.S. steel consumption has fallen since 2000.

Other trends include increased consolidation in the industry, with some sectors such as electric machinery moving offshore almost completely. Some risks include Chinese growth stalling or U.S. manufacturing not recovering. However, the outlook is for a slight recovery in demand as the economy improves.

Fiscal policy

Rudolph Penner, a former director of the Congressional Budget Office and currently a senior fellow at the Urban Institute, provided his thoughts on U.S. fiscal policy. He began with a historical perspective, saying this current period of fiscal stimulus has been the largest in over a half-century. The tax cuts have been large, as have spending increases. For example, discretionary spending increased 11% in 2002 and 16% in 2003.

In Penner's view, the efficiency of the stimulus, i.e., the return for each dollar, is low for several reasons. First, much of the stimulus went abroad, especially to reconstruction spending in Afghanistan and Iraq. Second, the most recent tax cut on dividends was on the supply side. Third, the tax cuts were so confusing that the average taxpayer does not understand the actual benefit. Finally, he argued that much of the tax cut was used to pay down debt rather than for additional spending.

While the fiscal policies may not have been efficient, they did help stabilize the economy due to the sheer volume of tax cuts and increased spending. Moreover, the fiscal stimulus was well timed, even if it was not intended to address the recession.

Penner also mentioned several similarities between the current deficits and those of the 1980s. First, the trend is similar. There was a mild deficit in the late 1970s and a mild surplus in the late 1990s, but then the fiscal situation deteriorated rather sharply. The second similarity is related to the first; the rapid fiscal deterioration was completely unexpected and caught everyone by surprise.

The government's fiscal policy does not bear full responsibility for the fiscal deterioration. The slowdown of the economy and especially the collapse of the stock market played a major role in the reversal from a surplus to a deficit as income tax revenue and capital gains revenue declined.

Penner argued that today's deficits are much more worrisome than those of the 1980s because the baby boomers are approaching retirement age. He expressed concern about Social Security finances and the possibility of a budget crisis that will necessitate the overhaul of the Social Security system.

Machinery outlook

Frank Manfredi, from Manfredi & Associates, said farm equipment in the U.S. experienced a strong year in 2003, with sales of some products up 28%. Much of this growth comes from tractor sales not to corporate farms but to consumers, due to a recent trend of individuals purchasing large estates and using tractors to maintain their property. The macroeconomic environment, with increases in the

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stock market and low interest rates, has contributed to this phenomenon.

Sales of larger tractors to farmers dropped in 1998–99, coinciding with a downturn in the farm sector, and have never really recovered. However, a slight improvement is forecasted in 2004, with low stocks and a mild rise in commodity prices expected to help farmers. Farm equipment sales are expected to do well in 2004, although not as well as in 2003.

Construction machinery is another major sector of the machinery industry. Construction machinery growth in 2003 was 7.5%, although there was a lot of variation among individual products. One of the major trends in the construction machinery sector is the growth of rentals. The vast majority of manufacturers sell directly to rental companies.

One of the major products of construction machinery is earthmoving equipment, which is strongly correlated with housing starts. Residential construction has enormous ripple effects for the construction machinery sector, with increased construction of schools, strip malls, and other commercial development projects that are correlated with residential growth. The extremely strong housing starts market has helped the construction machinery sector and this is expected to continue in 2004, with construction machinery growth forecasted at 8.9%.

International trade: Winners and losers

Trade between the U.S. and the world has increased 127% since 1990, with increases in nearly every industry. Laura Spingola, president of Trade Resources Ltd., discussed the winners and losers in the U.S. (using the harmonized classification system).

Sectors that experienced major growth in exports include tobacco, perfume and cosmetics, plastics, wood, paper, textiles, machinery, and vehicles. There was large import growth in many sectors, including oil, plastics, wood, textiles, machinery, vehicles, and iron and steel.

Since industries that increased their exports may have also increased their imports, it is important to examine net exports to see which industries benefited and lost from international trade. Spingola classified those industries with a mean of over $1 billion in net exports per year since 1990 as winners and those with less than $1 billion in net exports per year since 1990 as losers.

Some of the sector winners in trade were cereals, miscellaneous chemicals, plastics, aircraft and spacecraft, and optical, medical, and surgical instruments. The losers include oil, knit apparel, woven apparel, footwear, iron and steel, machinery, and vehicles.

Conclusion

The economic expansion will continue into 2004, when the U.S. economy is expected to have its best year since 1999. With growth above potential, the unemployment rate is expected to decline each quarter, reaching 5.7% by the end of the year. Prices are expected to remain stable, and the business sector is forecasted to have its best year since 1998.