SPECIAL ISSUE

THE FEDERAL RESERVE BANK OF CHICAGO

JANUARY 2003
NUMBER 185b

Chicago Fed Letter

Any bounce in the economy in 2003?

by William Strauss, senior economist and economic advisor, Michael Munley, associate economist, and Scott Walster, research intern

The U.S. economy is growing, albeit at a sluggish pace. What can we expect in 2003? After an impressive performance through the recent recession, will consumer spending continue to drive growth in the year ahead? A recent Chicago Fed symposium brought economists from academia and business together to discuss the outlook for 2003.

The U.S. economy entered a recession beginning in March 2001 and, while the turn has yet to be determined by the National Bureau of Economic Research, most economists believe that the trough occurred either late in 2001 or early in 2002. Still, growth, as measured by real gross domestic product (GDP), was very bumpy in 2002 at 5.0%, 1.3%, and 4.0% for the first three quarters; current expectations for fourth-quarter growth are below 2%. GDP in the third quarter of 2002 was 3.3% higher than it was in the third quarter of 2001. This growth is in the range that many economists believe represents potential growth for the U.S. economy. However, the past year certainly lacks the feel of an economy growing at its potential.

1. Median forecast of GDP and related items

	2001 (actual)	2002 (forecast)	2003 (forecast)
Real GDP, chained dollars[a]	0.3	2.4	2.7
Personal consumption expenditures[a]	2.5	3.0	2.4
Business fixed investment[a]	–5.2	–5.6	3.3
Residential investment[a]	0.3	3.4	0.3
Change in private inventories[b]	–$61.4	$0.9	$24.8
Net exports of goods and services[b]	–$415.9	–$478.7	–$495.1
Government consumption expenditures and gross investment[a]	3.7	4.2	2.8
Industrial production[a]	–3.7	–0.4	2.8
Car & light truck sales[c]	17.0	16.6	16.5
Housing starts[c]	1.60	1.69	1.64
Oil price (West Texas intermediate)	$25.92	$26.12	$25.00
Unemployment rate[d]	4.8	5.8	5.8
Inflation rate (Consumer Price Index)[a]	2.8	1.6	2.3
Treasury constant maturity, 1-year rate[d]	3.48	2.00	2.11
Treasury constant maturity, 10-year rate[d]	5.02	4.60	4.53
J.P. Morgan trade-weighted OECD dollar[a]	6.5	–1.2	–2.3

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

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

Against this backdrop, the Federal Reserve Bank of Chicago held its sixteenth Economic Outlook Symposium on December 13, 2002. More than 80 economists and analysts from business, academia, and government attended the conference. This *Chicago Fed Letter* reviews last year's forecasts for 2002 and summarizes the presentations at this year's conference.

Part of the economy's strength over the past year comes about from the change in inventories. During 2001, the nation cut inventories by over $60 billion, and in the first three quarters of 2002 inventories fell an additional $2.8 billion. While inventories during the first three quarters of 2002 did not increase, the fact that they did not decline by as much as in 2001 contributed 0.9 percentage points of real GDP growth for the year ending in the third quarter. Taking inventories out of the equation, real GDP increased by a much more moderate 2.4% over the past four quarters.

As has been the case for several years, consumer spending during 2002 continued to do well, while the business sector struggled. While personal consumption expenditures were 3.7% higher in the third quarter of 2002 than a year earlier, business fixed investment was 5% lower. Manufacturing has been the hardest hit business sector in the current cycle. Typically when a sector falls significantly, it can be expected to recover with some gusto. Some economists liken this effect to the bounce of a dropped tennis ball. This past year has seen the manufacturing sector perform less like a tennis ball and more like a dropped watermelon, with virtually no rebound.

Industrial production for manufacturing fell 7.5% from its peak in June 2000 to its trough in December 2001. It has managed only a very slight gain of 2.1% over the first eleven months of 2002. On average, industrial production recovers its loss within 11 months. However, this time it has only recovered a quarter of its decline, making this the slowest recovery by far.

Consumer resilience

Last year, symposium participants expected growth in real GDP to average 2.5% for the first three quarters of 2002. In fact, growth was a much stronger 3.4%. This underestimate was in large part due to an expectation that consumers would pull back on spending. The growth in consumer spending was anticipated to taper off to average 2.0% over the first three quarters of the year, but actual growth was a full percentage point higher.

Expected slowing in both light vehicle and housing sales did not materialize. Light vehicle sales for the first three quarters were forecast to average 15.3 million units, significantly lower than the actual figure of 16.8 million units. Housing starts were expected to slow to 1.52 million starts, but rose to a quite robust 1.70 million. Lower-than-expected interest rates contributed to the stronger performance in these sectors. The group had forecast both short- and long-term interest rates to rise during 2002, but they fell instead. Business sector spending was forecast to do a bit better than it did; the forecast group expected business spending to remain flat during the first three quarters of 2002, but spending actually declined 3.0%. The consensus forecast for the change in inventories was right on target. Businesses were expected to add just $1.7 billion to inventories during the first three quarters, and they cut inventories by $2.8 billion, a trivial difference for this very volatile series. Industrial production was forecast to increase by 2.4% over the first three quarters of 2002 and the actual increase was a somewhat stronger 3.1%. The unemployment rate was expected to average 6.0% during the first three quarters of 2002, but with a somewhat stronger economy, actual unemployment averaged 5.7%. Inflation for the first three quarters averaged 2.2%, slightly more than the 1.9% predicted.

The moderate recovery that the economy experienced during 2002 is expected to continue during 2003. The typical forecaster expects 2002 real GDP growth to be 2.4% and 2003 real GDP growth to be 2.7% (see figure 1). Personal consumption expenditures, residential investment, and government spending are forecast to slow in 2003. Business fixed investment is expected to reverse its decline in 2002 and increase by 3.3% in 2003. Change in private inventories is forecast to rise by $24.8 billion in 2003 after no change in 2002. Net exports are anticipated to decline from –$478.7 billion in 2002 to –$495.1 billion in 2003.

The forecasters expect industrial production growth to rise by 2.8% in 2003 compared with a drop of 0.4% in 2002. Light vehicle sales are expected to remain at very solid levels in 2003 at 16.5 million units. Housing starts are forecast to moderate to a still robust 1.64 million units. The unemployment rate is expected to average 5.8%, the same as in 2002. Oil prices are anticipated to ease to an average price of $25.00 per barrel in 2003. Inflation is forecast to rise to 2.3% in 2003.

Consumer spending

During the recent economic slump, consumers defied history—for the first time ever in a postwar recession, they refused to cut back on their spending. One reason, according to the chief economist at a large bank, is that consumers were still relatively flush with healthy incomes. Couple that with high incentives to purchase vehicles and extremely low mortgage rates and there is a recipe for healthy spending.

However, some of the dynamics for consumers began to change by the end of 2002. Vehicle sales slowed as automakers tried to take back some of their incentives. The boost from mortgage refinancing activity seemed to be dissipating. Other risk factors existed too, notably a potential war with Iraq and the possibility that a stagnant stock market would begin to drag down spending.

Many of these risks are worth discounting. While uncertainty about a war with Iraq has hampered business spending, consumers do not scare as easily; in a recent survey from the Cambridge Credit Index, 71% of consumers said that a war with Iraq would have no effect on their use of credit. Furthermore, even though mortgage refinancing activity may level off, the recent boom has allowed many consumers to use cash from their homes to restructure their debt, which has kept them from becoming overextended.

The speaker believes that the unemployment rate is low enough, even if it moves up some, to generate real income gains for consumers, and the supply of credit to individuals remains high. "Never bet against a consumer who's got money in their pocket to burn," the speaker argued, and forecast consumer spending to grow at 2.9% in 2003, roughly the same as in 2002.

Vehicle sales

Despite a relatively pessimistic outlook for vehicle sales at the start of 2002, consumers continued to snatch up vehicles at high rates. The corporate economist for one automaker asserted that thanks to high incentives by automakers, vehicle affordability rose to its highest level since the mid-to-late 1970s. Fiscal and monetary stimulus to the economy further enhanced consumers' ability to buy: disposable income continued to grow, interest rates were low, and inflation remained tame. The amount of household debt was a slight drag on the ability to buy, but low interest rates kept debt payments from being too burdensome.

All of those variables outweighed the negative factors, which included high unemployment insurance claims and the declining or flat workweek. The slumping stock market, as well as concerns about war with Iraq, weighed heavily on consumer attitudes. However, because vehicle incentives were so high, consumers still indicated in surveys and through their actions that it was a good time to buy a car. Sales had been so strong that many in the industry began to worry that incentives were taking purchases away from the future, and that maybe the slowdown in the fourth quarter of 2002 was the start of the payback. The speaker argued, however, that there are no signs of a severe pull ahead in sales: the mean and median vehicle ages remain relatively flat, and vehicle scrappage rates continued to increase—despite the recession. The slowdown in the fourth quarter was simply a sign that the negative psychology was beginning to affect consumers.

There is potential for the stock market to turn around, which would improve willingness to buy going forward: the speaker argued that the market is undervalued by about 35%. With a stock market turnaround, the outlook for the next three years is fairly positive. The most likely scenario—in which incentives stay high and keep sales strong, the U.S. has a short, successful operation in Iraq, and oil prices and interest rates are steady—calls for GDP growth averaging around 2.75% and light vehicle sales averaging 17.0 million units. However, the speaker acknowledged an unlikely, negative outlook scenario: oil prices surge, while a long, messy war in Iraq disrupts oil supply chains, leading to sluggish GDP growth and a decline in light vehicle sales to 15.0 million units.

Heavy truck

Due to an October change in engine emission regulations, 2002 was a volatile year in the heavy truck market. According to the partner and general manager of a commercial vehicle research firm, after a surge of orders for Class 8 trucks ahead of the regulation change, orders and build plummeted at the end of the year, and the industry became depressed.

Truckers are hesitant to buy trucks with the new engines, partly because they are reluctant to try the unproven vehicles but mostly because, for many, the more expensive engines would seriously erode their per-mile profit margins. As a result, the speaker forecasts that the depression in the truck market will continue at least through the first half of the year. There is some upside potential, if the economy rebounds and generates significant growth in freight traffic, but most likely build and sales of class 8 trucks will fall to low levels in 2003. Looking further ahead, demand for trucks should build up in 2003 and 2004, and 2005 and 2006 have the potential to be record years—especially given that stricter engine emission regulations are due in 2007 and likely to pull ahead sales.

Housing

The chief economist and vice president of a large mortgage finance company said the housing market had again set sales records for 2002 as it did in 2001. The booming housing market can be credited to mortgage rates reaching their lowest level since 1965. The forecast for 2003 shows a slight pull back from the 2002 numbers; however, the market should still be robust, reaching its second or third highest year ever.

The speaker gave two scenarios for the housing market in 2003. The first scenario pictures a negative supply shock to the housing market, such that uncertainty in the Middle East leads to an increase in oil prices and inflation, an increase in unemployment, and a fall off in the housing market. The second, and more likely, case shows a modest recovery, with GDP growth reaching 3.5%, unemployment decreasing, and interest rates rising slowly over 2003. This scenario would lead to a small drop in sales but, overall, a healthy housing market, where the increase in interest rates would be offset by gains in economic growth and consumer sentiment.

New home sales are expected to decrease by 2% in 2003, the consequence of some sales being pulled ahead to 2002 by consumers who did not want to miss out on once-in-a-lifetime mortgage rates. Inventories of new homes are anticipated to remain at a level close to their all-time low, stemming from better planning by builders and lenders being wary of financing too far ahead. Existing home sales should follow a similar pattern as new home sales, with totals falling back slightly.

Lenders in the refinance market were believed to have reached their full capacity in 2002, leaving room for some additional financing for homeowners in the beginning of 2003. Overall, mortgage originations are forecast to fall to $2.0 trillion in 2003 from $2.5 trillion in 2002. All of the decrease in originations should be caused by a decrease in refinancing if, as is expected, mortgage rates start rising. As a replacement to refinancing, home equity loans will become an attractive source of financing for homeowners. On the other side of originations, new mortgage purchases should remain close to 2002 levels.

The speaker noted that since the late 1990s home price gains have been unsustainably high, and they should moderate over the next few years. Some metro areas may even see declines in home price values; however, underlying data, such as low inventories, do not suggest there is a nationwide bubble in home values. Home prices should average a growth rate of 5% for the rest of the decade.

Small business

The president of a nationwide organization of small businesses, which conducts monthly surveys of its members' spending budgets, hiring plans, and sales expectations, reported that 42% more of the surveyed members predict general business conditions to be better six months from now. Given this

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.chicagofed.org.

ISSN 0895-0164

optimism, the speaker said, “we can’t see any double-dip in these numbers.”

The inability of businesses to raise prices has kept nominal revenues down over the past year; however, almost 20% more of the surveyed members believe they will see higher real sales through the beginning of 2003. As a result, many members plan to lift up their inventory levels. The November survey reported the percentage of firms planning to increase inventory levels through the beginning of next year was the highest since the mid-1980s.

Despite rising unemployment rates, labor-intensive small businesses are finding it hard to locate high-quality workers to fill vacant positions, forcing employers to continue increasing wages. Currently, 21% of surveyed businesses report they have at least one job opening; though down from its peak in 2000, this is a high share given the sluggish economy. The speaker mentioned that lagging employment growth will begin to pick up toward the middle of 2003, once higher sales and GDP growth start to become realized and businesses need more capacity.

The percentage of firms making and planning capital expenditures in 2003 is higher than at the end of the 1990–91 recession. With a sufficient supply of credit being made available to small businesses and positive consumer spending forecasts, the speaker forecasts capital outlays to improve by the middle of the year. As a result, GDP should grow around 3.5%, and employment should rebound.

Heavy equipment

According to the president of a consulting firm for heavy machinery, farm equipment sales in 2003 should increase by 4%, led primarily by smaller equipment sales to part-time farmers. Commodity prices are anticipated to increase slightly in 2003 and, coupled with low interest rates and high incentives from machinery companies, should encourage farmers to replace older equipment. Investment in large tractors has been slumping since the late 1990s. While farm equipment sales should rise in 2003, construction equipment sales are expected to decrease by 3% to 4%. The decline comes from a softer housing market and lackluster non-residential construction. The construction industry has been hampered by over capacity and slumps in investment projects, but the speaker argued that the declines in 2003 should not be quite as severe as in the previous two years.

Conclusion

At the end of 2002, there are significant risks in the economy, most notably mounting international political uncertainty and a stagnant stock market. Despite these risks, economists still expect the economy to expand near its trend growth rate in 2003. But, only time will tell how much bounce it has in it.