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Economy to cruise at speed limit through 2006

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The U.S. economy experienced solid growth in 2004, with light-vehicle sales rising to 16.8 million units. What can we expect in 2005 and 2006? At a recent Chicago Fed symposium, auto industry experts came together to analyze the sector's performance and discuss the outlook for next year and beyond.

Inflation in 2005 and 2006 is expected to remain unchanged from its rate in 2004.

After expanding by 4.4% in 2003 (measured as gross domestic product, or GDP), the U.S. economy grew at a somewhat slower pace in 2004, increasing by 3.9%. This growth is considered to be above trend growth for the U.S. economy, leading to the unemployment rate falling from 5.9% in the fourth quarter of 2003 to 5.4% in the final quarter of 2004. Inflation (measured by the Consumer Price Index), which grew by 1.9% in 2003, increased at a more rapid pace in 2004, rising by 3.4%. This increase in inflation is not too surprising given that oil prices rose from just over $31 per barrel in the fourth quarter of 2003 to over $48 per barrel in the fourth quarter of 2004—a 55% increase.

As we entered 2005, economic indicators began to suggest some further moderation in economic activity. In the first quarter of 2005, real GDP rose by 3.8%, the unemployment rate edged down to 5.3%, and the inflation rate increased by a more moderate 2.4%, after oil prices rose by $1.40 to over $49 per barrel.

Employment gains were solid in 2004, with the addition of over 2.1 million jobs, which averaged to 183,000 jobs per month. This was above the trend growth rate of between 140,000 and 150,000 jobs per month. Job growth for the first five months of 2005 has been slightly lower, averaging just under 180,000 jobs per month.

After a flat performance in 2003, manufacturing output expanded at a robust pace in 2004, increasing 5.1%. In July 2004, manufacturing output surpassed the previous peak set in June 2000. Manufacturing output growth slowed in the first quarter of 2005, rising by 3.5%.

Vehicles continued to sell at a solid rate last year. After selling 16.6 million units in 2003, light-vehicle sales rose to 16.8 million units in 2004, although market share for the Big Three continued to deteriorate. The Big Three's market share, which averaged 60.9% in the fourth quarter of 2003, had fallen to 57.3% by the final quarter of 2004. This translated into a sales loss of 600,000 units in 2004. This amount represents a loss that is equivalent to the annual output of roughly three assembly plants. The Big Three have a total of 44 assembly plants in the United States.

Against this backdrop, the Federal Reserve Bank of Chicago held its twelfth annual Automotive Outlook Symposium on June 2 and 3, 2005, at its Detroit Branch. More than 90 economists and analysts from business, academia, and government attended the conference. This *Chicago Fed Letter* reviews last year's forecasts for 2004; analyzes the forecasts for 2005 and 2006 (see figure 1); and summarizes the presentations at this year's conference.

Last year's participants forecasted economic growth components based upon an annual number—the mean for the year. This year's comparisons are based upon annual results. (That is, this year's forecast approach looks at growth on a fourth quarter over fourth quarter basis, more appropriately reflecting activity for that given year.) At the 2004 Automotive Outlook Symposium, participants were anticipating that the economy in 2004 would expand at a 4.5% rate, virtually in line with the 4.4% GDP growth that did occur. With an accurate economic growth forecast, they were also quite close in their forecast for the unemployment rate. They expected that the unemployment rate would fall to average 5.6%, slightly above the 5.5% rate that unemployment averaged in 2004. Inflation was predicted to average 2.4%, lower than the 2.7% inflation rate actually recorded. This higher actual result was in part due to a tamer outlook for oil prices in 2004. Last year forecasters expected oil prices to average $35.90 per barrel in 2004, but oil prices ended up averaging over $41. Light-vehicle sales were predicted to come in at 16.8 million units, exactly matching actual sales. However, when it came to forecasting the housing sector, this group did not do as well. While housing starts were expected to ease to 1.83 million units in 2004, housing starts actually soared to 1.95 million units.

1. Median forecast of GDP and related items

	2004 (Actual)	2005 (Forecast)	2006 (Forecast)
Real gross domestic product[1]	4.4	3.2	3.3
Real personal consumption expenditures[1]	3.8	3.3	3.3
Real business fixed investment[1]	10.6	7.1	6.8
Change in private inventories[2]	45.7	56.0	55.0
Net exports of goods and services[2]	–583.7	–654.7	–629.4
Real government consumption expenditures and gross investment[1]	1.9	1.8	1.9
Industrial production[1]	4.1	3.5	3.7
Car & light truck sales (millions of units)[3]	16.8	16.7	16.8
Housing starts (millions of units)[3]	1.95	2.00	1.84
Unemployment rate[4]	5.5	5.2	5.2
Consumer Price Index[1]	2.7	2.7	2.7
1-year Treasury rate (constant maturity)[4]	1.89	3.80	4.45
10-year Treasury rate (constant maturity)[4]	4.27	4.90	5.21
J. P. Morgan Trade Weighted Dollar Index[1]	–5.0	–0.7	–0.1
Oil price (dollars per barrel of West Texas Intermediate)	41.44	49.00	47.22

[1]Fourth quarter over fourth quarter percent change.
[2]Billions of chained (2000) dollars.
[3]Fourth quarter average.
[4]Percent.
SOURCES: Actual data from Haver Analytics; median forecasts from Automotive Outlook Symposium participants.

The forecasts for 2005 and 2006 are for growth to moderate in almost every sector but still expand at a rate regarded as close to trend. Real GDP is anticipated to rise by 3.2% this year and by 3.3% in 2006. Being so close to trend growth, the pace over the forecast horizon is expected to lead to very little change in the unemployment rate from current levels; over the next year and a half, it should average around 5.2%. Inflation in 2005 and 2006 is expected to remain unchanged from its rate in 2004, 2.7%. Oil prices are predicted to average $49 per barrel in the final quarter of this year and edge down to just over $47 by the end of 2006. Personal consumption expenditures are forecasted to ease down from 3.8% in 2004 to 3.3% in both 2005 and 2006.

Light-vehicle sales are expected to remain steady, with sales edging down to 16.7 million units this year and then edging back up to 16.8 million units next year. Business fixed investment growth is predicted to rise at a strong pace but to moderate over the next two years. After rising 10.6% in 2004, business fixed investment is expected to increase 7.1% in 2005 and 6.8% in 2006. Industrial production is forecasted to increase at a slightly faster rate than GDP growth, rising 3.5% this year and 3.7% next year. With this increased pace, business inventory increases are expected to rise to a level that is slightly higher than in the past several years.

The housing sector is expected to take a step back over the next year and a half. With long-term interest rates forecasted to increase by 63 basis points in 2005 and by an additional 31 basis points in 2006, housing starts will rise slightly in 2005 to 2.00 million units and then decline to a level of 1.84 million units in 2006. After rising by 9.7% in 2004, residential investment is expected to rise 1.0% this year and then decline 2.1% in 2006.

The dollar's value has been declining over the past three years. The dollar is predicted to decline slightly this year by 0.7% and remain unchanged in 2006. The trade deficit is predicted to worsen in 2005 and then show some slight improvement next year.

Auto sector outlook

Ellen Hughes-Cromwick, the director and chief economist for Ford Motor Company, delivered the outlook for 2005–06 light-vehicle sales. There were three main topics for her presentation: the fundamentals for vehicle buying from the demand side; the relationship between housing and autos; and the trend in the vehicle stock and scrappage rates. While gas prices may discourage many potential automotive buyers, Hughes-Cromwick argued that the positive factors to buying a new vehicle outweigh this negative factor. Income growth is strong, above 3%, and interest rates are low, which make purchasing a car more realistic. Additionally, the new base vehicle prices are decreasing, and therefore, new vehicles are more affordable for the average buyer. In recent years, the housing and auto markets have been moving independently. Hughes-Cromwick saw their decoupling as a positive occurrence because auto sector pricing has been stable, while housing market costs have been increasing substantially. Housing expenditures are now taking up a greater share of GDP than vehicle spending. Within the framework of the whole economy, vehicle spending did not shift considerably. This is evidenced by the fact that the vehicle market did not respond to the interest rate declines, whereas the housing market did. In addition, the United States vehicle stock growth and scrappage rates are edging downward. The scrappage rates are lower in part because vehicles are lasting longer than they have in the past.

Oil prices are predicted to average $49 in the final quarter of this year and edge down to just over $47 at the end of 2006.

Opening with the statement, “Transportation is the industry that drives the economy,” Ken Vieth, co-principal for the Americas Commercial Transportation Research Company, presented the heavy truck industry outlook. Historically, there has been a strong correlation between the economy and the demand for truckers. Currently, there are enough trucks to keep up with the demand, but there are not enough drivers. Truck drivers are driving more miles and making more money than they have in the past because they are now being paid by the shipper on their way to pick up their freight when their trucks are empty. This has not been the case in the past. However, the heavy truck industry is not without its challenges. There were new emission standards implemented in 2002, and there will be more in 2007. These regulations add to the cost of purchasing and operating trucks. They also impose a cyclical process when it comes to buying trucks. There will be more trucks sold before the prices rise approximately $6,000 per vehicle in 2007; a similar thing happened before the October 2002 regulations were introduced. This, for the most part, guarantees that commercial vehicle sales will be strong through 2006.

The next speaker, Paul Taylor, the chief economist at the National Automobile Dealers Association, talked about the sales outlook from the dealers’ perspective. With gas prices being consistently high, sales of truck-based sports utility vehicles (SUVs) are not doing as well as they have in the past. However, large cars and cross-over utility vehicles (CUVs—utility vehicles built on passenger car platforms) increased 14% and 18%, respectively, in 2004. Year to date, as of April, these two types of vehicles, large cars and CUVs, are up 33% and 13.2%, respectively, while truck-based SUVs are down 15.1% during the same period. The fluctuation in the vehicle market has been partially due to automakers offering and then withholding incentives. When incentives were available, vehicle sales increased, whereas when incentives were not given, vehicles did not sell as rapidly. Consumers want the newest cars they can get, and if the base price is lower, then they can add more amenities to their cars. Despite the fluctuation, the vehicle number per household has been increasing steadily since 2002. This is a positive pattern, but some of these cars are merely hobby cars or collectibles. Still, dealers seem to be optimistic about the future, especially for the pre-certified used car market. Taylor noted that approximately 94% of all dealerships have a website. Many of these were introduced in 2000 to sell cars, but since then, they have been used more for financing and servicing vehicles than for the actual buying. While the Internet has not been advantageous to car dealerships for selling cars, it has made buyers more informed about vehicles and options.

Finally, Thomas Klier, senior economist at the Federal Reserve Bank of Chicago, and James Rubenstein, a professor at Miami University, Ohio, gave a presentation on the impact of geography on the auto parts supplier industry. In 2004, the U.S. auto parts supplier industry had four times as many employees as the auto assembler industry. These 740,000 workers are highly clustered in the heart of the industry (around Detroit). While for now, many auto parts suppliers remain close to the heart of the auto industry, they appear to be moving slightly farther away. Auto body parts, which include sheet metal to plastic trim, are mostly made within a day’s drive (approximately 450 miles) from Detroit. A quarter are made in plants that are less than 91 miles away, half are made less than 203 miles away, and three-quarters are made less than 486 miles away. However, each of the remaining parts is made at a greater distance from the automotive heartland. The parts made next closest to Detroit are drivetrain parts, followed closely by engine parts. And then, air and fluid handling parts, interior parts, and chassis parts are made successively farther away from the hub of the industry. Electrical parts are produced close to Detroit, but they are also made in Mexico, which is over 1,500 miles away from the automakers. With this shift to the south by suppliers, assembly plants are also starting to move southward. Before 1990, most assembly plants in the United States were in proximity to Detroit.

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Since then, they have moved farther away, throughout the South and into Mexico. Therefore, the speakers concluded that geography does matter for certain segments of the automotive industry. Still, the Detroit area will continue to expand, even though many of the foreign-owned and electrical parts suppliers are moving south.

Conclusion

The outlook for 2005 is for the economy to expand at a somewhat slower pace, growing at a rate around potential, leading to a slight fall in the unemployment rate. Inflation is expected to be at the same rate as in 2004. Economic growth in 2006 will be little changed from the rates expected this year, with GDP growth, the unemployment rate, and inflation virtually identical with 2005. In this economic environment, light-vehicle sales are forecasted to remain flat in both 2005 and 2006.