



## 2006 Economic Outlook: Is the Expansion Sustainable?

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### The National Economy: Is the Peak Near?

#### Review of 2005

The national economy grew for the fourth straight year in 2005. Real gross domestic product (GDP), a measure of the quantity of goods and services produced in the economy, increased a healthy 3.6% during the year, slightly lower than in 2004 (Table 1). Commensurate with this growth, industrial production rose 3.2% and real (inflation-adjusted) consumer spending increased 4.1%.

The employment market improved much more in 2005 than in the previous year. Payrolls increased by almost 2 million (1.7% growth rate), and the unemployment rate fell by one-half percentage point to 5%.

Household budgets were strained in 2005 by a slow increase in real disposable (after-tax) personal income. This key measure increased only half as much (1.7%) as in 2004. One reason was the more rapid rise in prices during the year, primarily related to energy. Retail inflation (CPI inflation rate) was 3.8% in 2005, up from 2.7% in 2004. However, the core inflation rate, which excludes energy and food prices, rose only 2.1% in 2005, almost the same as in the previous year. Many economists think the core rate is a better indicator of long-run price pressures.

With spending rising significantly faster than income, households increased debt loads during the year. Household debt service payments as a percentage of disposable income rose over one-third percentage point. This was in contrast to a reduction in debt loads in 2004.

Short-term interest rates took a noticeable jump in 2005. The Federal Reserve raised its key interest rates several times, and other short-term rates followed. Yet long-term interest rates changed very little. The result was a “flattening” of the yield curve in 2005, meaning the difference between short-term and long-term interest rates narrowed.

Likely reflecting the uncertainty of the year, the stock market showed little overall change in 2005, rising less than 2%. On a positive note, federal government finances did improve, with the deficit to GDP ratio falling from 3.6% in 2004 to 2.7% in 2005. This was mainly the result of strong growth in federal revenues, which jumped from 16.3% of GDP in 2004 to 17.5% in 2005.

#### Issues

The U.S. economy was able to weather several challenges in 2005. One was the rise in short-term interest rates. Second was the massive destruction caused by hurricanes Katrina and Rita. Third was the steady rise in gasoline prices during the summer followed by the record high prices in the aftermath of hurricane Katrina. Despite these shocks, the economy managed a decent performance during the year.

But as 2005 ended, there was concern the economic expansion may be peaking. A flattening yield curve has been a good predictor of a slowing economy. If the Federal Reserve continues to

increase short-term interest rates, the yield curve may become inverted, which has been one of the better forecasters of an oncoming recession. So a recession in late 2006 or early 2007 is not out of the question.

Financing economic activity became a prominent issue in the economy in 2005. While the domestic personal savings rate hovered near zero during the year, foreign investors bought record amounts of U.S. government debt. At the same time, the gap between imports and exports — the trade deficit — hit a new high in 2005. Some analysts concluded these trends were unsustainable.

Measured personal savings was indeed low in 2005, but the real wealth of U.S. households reached a record high during the year. Households saved little out of current income because their savings were accomplished through rising capital gains on equity and real estate assets. There are also questions about the relevance of traditional counts of flows of imports, exports, and money in today's globalized economy.

International financial markets are now highly integrated, and multinational companies make the simple categorization of imports and exports problematic. Last, if unsustainable trade and financial imbalances exist, economists expect interest rates and currency exchange rates to eventually move to erase them.

Energy prices and housing prices round out the list of potentially troubling economic issues in 2005. When energy prices soared in the summer and fall, there was concern the economy would fall into a recession. Fortunately, this did not happen. One reason is the increased efficiency with which the economy is using energy, with the ratio of energy costs to the dollar value of output in the country falling by 50% in the last thirty years. Questions were also asked about the ability of oil supplies to fuel economic growth in the future. Answers are difficult to provide because the volume of oil supplies depends on the technology for discovering and processing oil reserves. Some analysts are optimistic new supplies will be forthcoming, while others are not.

Talk persisted in 2005 about the existence of a

**Table 1. Key U.S. Economic Measures<sup>a</sup>**

	2004	2005	2006 (forecast)
Real U.S. Gross Domestic Product (% chg.)	+4.2%	+3.6%	+3.4%
Payroll Employment (% chg.)	1.1%	+1.7%	+1.7%
Unemployment Rate (end of year)	+5.5%	+5.0%	+4.8%
Industrial Production (% chg.)	+4.1%	+3.2%	+3.0%
Real Disposable Personal Income (% chg.)	+3.4%	+1.7%	+3.0%
Household Debt Service (chg. in % point)	-0.80	+0.37	+0.10
Real Consumer Spending (% chg.)	+3.8%	+4.1%	+3.0%
Consumer Price Index (% chg.)	+2.7%	+3.8%	+2.5%
Core Consumer Price Index (% chg.)	+2.0%	+2.1%	+2.1%
3-Month Treasury Bill Rate (chg. in % points)	+0.36	+1.35	+0.75
10-Year Treasury Bill Rate (chg. in % points)	+0.25	+0.04	+1.50
S&P 500 Stock Index (% chg.)	+9.0%	+1.6%	+5.0%
Deficit to GDP Ratio (% chg.)	-3.6%	-2.7%	-2.4%

a. All percentage changes measured from year-end to year-end. Values for 2005 are annualized rates based on the latest available data. Sources: U.S. Dept. of Commerce, Federal Reserve System, author's forecasts

housing price bubble. Fortunately, close examination reveals these worries are overstated for most of the country. Abnormal, and potentially unsupportable, housing price increases have primarily occurred at coastal and resort areas. For other regions, the most likely forecast is a slowing of housing price appreciation, not an absolute drop in housing prices.

## 2006 Forecasts

National economic growth is expected to be positive, yet slower, in 2006 as the economic expansion moves toward its peak (Table 1, column 4). Growth in real gross domestic product and industrial production will be slightly lower than in 2005. Employment growth will be similar in 2006 as in 2005, and the unemployment rate will fall to under 5%.

Barring an unforeseen energy crisis, inflation should be much tamer in 2006, and as a result, real disposable personal income growth should be stronger. However, expected higher interest rates during the year will temper consumer spending and moderate the growth in consumer debt. Gains in the stock market will be modest, and the relative size of the federal deficit will continue to shrink toward its cyclical low.

As always, precise economic predictions must be taken in the context of the uncertain world in which we

live. At the head of the list of uncertainties are international events, including terrorism, the situation in Iraq and the wider Middle East, North Korea, Iran, China, and even the Soviet Union. Surprises, instabilities, or confrontations in any of these arenas could shake consumer confidence and cause an adverse reaction in markets.

Energy markets also remain tight and thus subject to dramatic fluctuations if unexpected events occur. The rollercoaster in prices which occurred in 2005 could easily be repeated in future years. On the positive side, energy consumers now appear to be taking steps to counteract high prices, and this behavior will lessen the negative impact of any future energy price shock.

Finally, it is important to remember that the economy is constantly restructuring, and there is evidence to suggest the restructuring is proceeding at a faster pace. Mass manufacturing of common consumer products, from vehicles to clothing, is increasingly moving off-shore, and this is causing dislocations for thousands of workers. The benefit is a wider variety of lower priced products available for consumers. This tension between the destruction of the old economy and the creation of a new one has never been greater.

## The North Carolina Economy: Resilient Growth

The North Carolina economy displayed surprising underlying strength in 2005. Despite losing 8000 traditional (textiles, apparel, furniture, tobacco) manufacturing jobs and 2% of the entire manufacturing job base, the state's economy expanded during the year. Real per-

sonal income increased 3%, and real retail sales surged 8.7% (Table 2). Even with the turmoil in manufacturing, the state managed to gain in overall payroll employment, and the unemployment rate held steady. Tax and non-tax revenues

**Table 2. Key North Carolina Economic Measures**

	2004	2005	2006 (forecast)
Real Personal Income (% chg.)	+5.1%	+3.0%	+3.5%
Real Retail Sales (% chg.)	+3.4%	+8.7%	+6.0%
Payroll Employment (% chg.)	+1.6%	+1.1%	+1.5%
Manufacturing Employment (% chg.)	0.0%	-2.0%	-1.0%
Unemployment Rate (end of year)	+5.3%	+5.3%	+5.0%
General Fund Revenue (% chg.)	+4.8%	+6.3%	+6.0%

Sources: U.S. Dept. of Commerce, N.C. Dept. of Revenue, Federal Reserve System, author's forecasts. Values for 2005 are annualized rates based on latest available data.

