Settling Into a Sustainable Pace of Economic Growth

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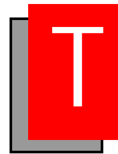

he world suffered an economic slowdown in 1999 but the United States economy powered ahead, almost entirely unscathed by the lingering effects of the Asian crisis. Though the demand for U.S. goods and services from abroad did slow in 1999, any resulting decrease in external aggregate demand was more than compensated by a healthy increase in domestic consumer and business spending.

On the eve of the new millennium, the U.S. economy is strong, but set to return to a slower and more sustainable pace of growth. As we move closer to the New Year, we find interest rates moving up and equity prices stabilizing. There is speculation that the Federal Reserve will increase interest rates again in the near future. As the economies of our trading partners continue their recoveries from the Asian crisis, they should also attract more foreign investment-money that temporarily flowed in record amounts into the U.S. in 1999. In short, expected domestic monetary policy and world financial flows in the coming year could lead to financial conditions that will rein in spending and growth.

The upshot is that we expect GDP to increase by 2.8% in 2000, considerably slower than the 4 percent plus rate that prevailed over the past three years. The unemployment rate should be little changed, averaging 4.3% for the year. Other highlights of the 2000 outlook include:

- GDP inflation of no greater than 2%
- An employment increase of more than one million jobs
- A modest deterioration of the U.S. balance of trade in goods and services
- Short-term interest rates rising to 5.5%
- Interest rates on long-term treasuries approaching 7%
- Housing starts down to 1.56 million units
- Indiana nominal income growth of 4.7%
- Indiana job growth of 25,000 jobs
- Indiana exports growing by nearly 10%

Y2K: The U.S. Economy at the Millennium

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The final years of the old millennium will go down as one of the most remarkable and impressive periods in United States economic history. Since the end of the last major recession in 1982, real GDP growth has averaged 3.5 percent per year, well above the 2.9 percent per year rate recorded in the preceding seventeen. Once the great recession of 1980-1982 was completed, only one very short recession was recorded in the next seventeen years, an achievement unprecedented in the more than 150 years over which recessions have been measured.

The good news goes far beyond real economic growth. The unemployment rate has generally fallen over the period to low levels not seen in decades. Inflation, which had been particularly severe in the 1970s, has also generally fallen from near double-digit levels to less than two percent per year, a level generally consistent with the notion of price stability. This development is all the more remarkable, and frankly unexpected, because it accompanied swift economic growth and a declining unemployment rate.

The three major keys to these positive economic trends are the emergence of a truly global economy, the fall of Communism, and the explosion of technology, particularly in communications and information processing. These trends are related. The new forms of communication helped bring about the fall of Communism, as did the emergence of a world economy. The fall of Communism in turn accelerated the globalization of industry.

A few statistics give a feel for the strength of these events. Globalization can be measured in a variety of ways, but one simple measure is the share of constant dollar exports in constant dollar GDP. This ratio rose from 6.7 percent in 1982 to an estimate of 12.9 percent in 1999 as real exports grew at an average rate of 7.6 percent per year, making exports one of the key engines of economic growth.

Likewise, the fall of Communism has led to many changes. One of the most dramatic has been the opportunity for the Federal government to reduce defense expenditures. Right after the Gulf War in 1991, defense expenditures were 6.1 percent of GDP.

By 1999, we estimate the ratio has fallen to 3.8 percent. This change represents over a $200 billion per year reduction in the level of Federal government spending by 1999 and is a big part of the shift in the Federal budget from deficit to surplus.

Finally, the explosion of communication and information processing technologies has profoundly changed the economy in the last two decades. One dramatic measure of the magnitude of this force is growth in real investment by firms in these technologies. Since 1982, real expenditures for communication and information processing equipment have grown at an average annual rate of almost 13 percent. Clearly, it has been the lead sector throughout this extraordinary period.

These three forces remain important for the future as well as an explanation of the past. The growth of information technologies and the trend to globalization of business are far from complete. The fall of Communism will not be reversed, and while further defense cuts are problematic, major increases seem unlikely as well. That means that the good news powering the current expansion is not over and, as a result, the fundamental outlook for next year and several years thereafter is bright. Our estimate is that the trend rate of growth of real GDP has risen to the 2.75 to 3.00 percent range from just over 2 percent a decade ago.

The past few years real GDP has grown at a rate well above trend. Last year the economy grew almost 4 percent and we estimate that growth for all of 1999 will average just under 4 percent. The basic reasons are that the underlying growth in the economy has been augmented by a surge in consumer spending and a residential investment boom. Real consumer spending is expected to grow by over 5 percent in 1999 with consumers spending virtually all of their non capital gains income. Part of this growth is undoubtedly due to the extraordinary increases in consumer wealth brought about by the stock market boom of the 1990s. The housing boom, which produced an increase of real residential investment of nearly 9 percent in 1999, is probably also related to the rise in equity markets.

We believe both the consumer goods and housing sectors will slow next year. The Fed has engineered two increases in interest rates this year and one or two more moves are likely. Housing markets are already beginning to show signs of slower growth. Predicting where equity markets will go is always hazardous, but interest rate increases typically cool equity markets, and the tremendous growth seen in the past few years seems unlikely to continue.

With housing weakening and consumer spending growth slowing, we anticipate real GDP growth will slow to around 2.8 percent next year, very close to a trend rate. Any inventory accumulation in late 1999 in anticipation of Y2K troubles will be worked off in early 2000 thus lowering the year 2000 growth rate. Since the underlying sources of growth continue, particularly for investment in computer and information technologies and for exports, we believe a recession is not in the cards,

The Bureau of Economic Analysis in the U.S. Department of Commerce released a set of major revisions to the National Income and Product Accounts in late October. Included in the revisions were several changes in methodology that produced significant changes in GDP over the past few years. Business and government expenditures on software are now included in GDP. They had been treated as intermediate goods in the past and not included in GDP. The effect is to raise the level of real GDP. Government retirement programs are now treated in a similar fashion as private plans. The result is to raise measured income and saving. Improved methods of measuring the real value of bank services have been adopted which tends to raise real GDP.

The net effect of these revisions is to raise estimates of real GDP for the past several years and to raise our estimate of the trend rate of growth in the U.S. economy. In summary, the new economic notion show an economy stronger through out the 1990s, with a greater capacity for growth. Our outlook for 2000 is that we will reach but not exceed that growth rate and so continue the expansion without producing major inflationary pressures.

Financial Outlook for 2000

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After taking a year off to atone for my sin of caution in a world of exuberance I am back attempting to peer into the future.

First, we must appreciate the past five years. The operating earnings for the Standard and Poor's 500 is up nearly 60% and the P/E ratio on trailing 12 month earnings have expanded from 15.3 to 29.3 and the P/E on 12 month future earnings have grown from 12.7 to 25.2. Thus operating earnings have grown at a 13.9% rate while the multiple has doubled!! The 13.9% is well above the long-term growth rate and is