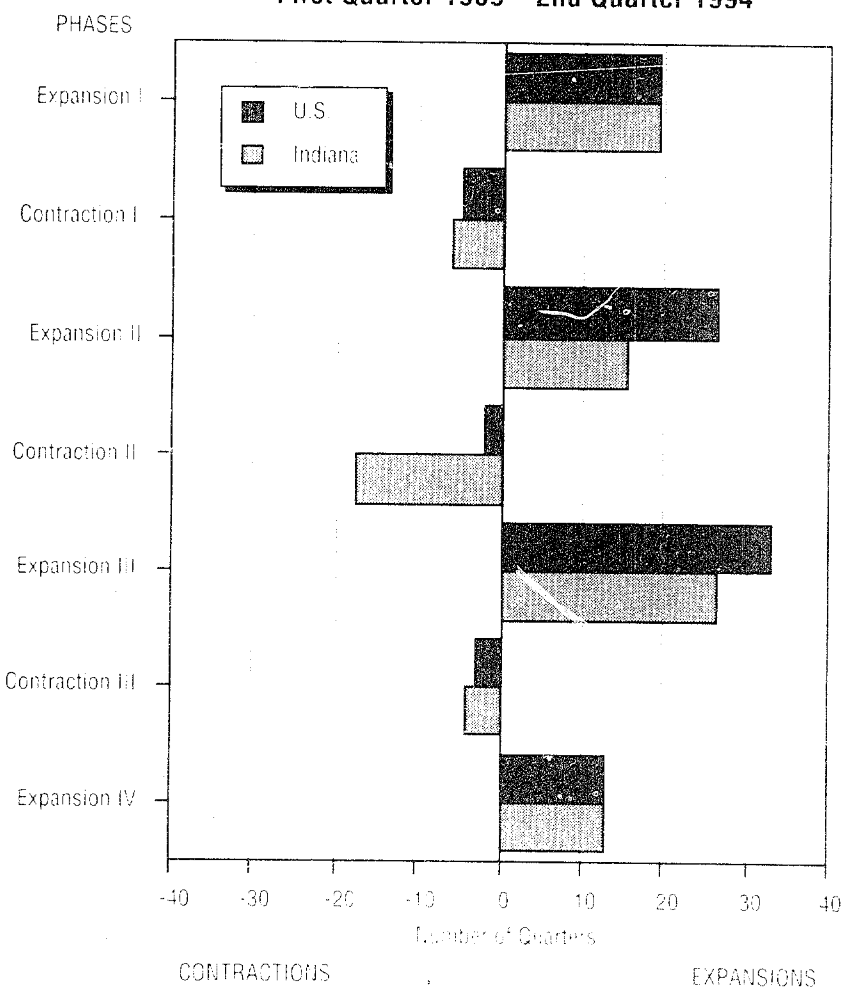
Indiana
Business Review

Duration of Expansions and Contractions in Indiana and the United States
First Quarter 1969 – 2nd Quarter 1994



The 1995 Outlook

A publication of the Indiana Business Research Center, Indiana University School of Business

Winter 1994-95

Contents

Indiana Business Review
Volume 69, Number 2
Winter 1994-95

Published by the Indiana Business Research Center, Graduate School of Business, Indiana University.

Unless otherwise noted, information appearing in the *Indiana Business Review* is derived from material obtained by the Indiana Business Research Center for instruction in the School of Business and for studies published by the Center. Subscriptions to the *Indiana Business Review* are available to Indiana residents without charge.

Subscribers!

Please note that this issue completes Volume 69.

The 1995 Outlook
Consumer Spending and Business Investment

R. Jeffery Green

Professor of Business Economics and Public Policy and Co-director, Center for Econometric Model Research, Indiana University School of Business

The total domestic demand for goods and services in the economy is the sum of consumer spending on goods and services and gross private domestic investment. In real terms, after adjusting for inflation, total domestic demand in 1993 amounted to more than 80% of real gross domestic product (real GDP). Over the last four quarters for which we have data, real total domestic demand has risen 5.9% while real GDP has grown by 4.3%. Clearly, the recent strength in the economy is being led by consumer and investment spending. Why the strength? Can it last?

Real Consumer Spending

Real consumer spending has increased by 3.6% in the past 12 months, led by an 8.5% increase in spending on durable consumer goods. Reflecting the strength in the new housing market, real spending on furniture and household appliances has been rising at more than a 10% annual rate. The strength in consumer spending, particularly on durable goods, is the result of good employment and income growth and relatively low interest rates. Employment has increased by more than 3 million jobs in the past year, producing a rise of more than 3% in real disposable personal income. Additional income is the prime determinant of consumer spending. The growth in employment has an added stimulative effect beyond increasing income. As employment expands and the unemployment rate declines, the risk of layoff declines. This reduction in uncertainty encourages consumers to expand their purchases of durable goods.

> *"Clearly, the recent strength in the economy is being led by consumer and investment spending. Why the strength? Can it last?"*

Interest rates have also been favorable for spending on durable consumer goods. While it's true that interest rates rose during 1994, a combination of fairly low but rising rates may be the most stimulative set of circumstances for durable goods spending. This is because interest costs remain moderate and consumers are encouraged to spend now before rates get much higher. As a result, consumer credit has been increasing at double-digit rates over the past year.

We expect the growth in real consumer spending to slow in 1995 for several reasons. Interest rates are expected to continue to increase through 1995; this will both raise borrowing costs for consumers and cool the housing industry, thus reducing additional demand for furniture and appliances. Consumers have been borrowing extensively through 1994, and we expect them to curb borrowing in 1995 as debt loads get larger. The recent spurt in spending on durable goods is classic. Precisely because these goods are durable, once consumers buy them they will not need to replace them for some time, so at least the growth in demand should slow.

Our forecast is for real consumer spending to rise at about 2.2% in 1995. That is a considerable slowdown from its recent performance but still represents a continuation of the recovery. In fact, a slower rate of growth for consumer spending in 1995 will actually increase the likelihood that the recovery will continue for an extended period. Slower growth in consumer expenditures will enable consumers to control borrowing and prevent excessive debt burdens from strangling the recovery.

Investment Spending

Real gross private investment spending can be disaggregated into four major components: real business spending on equipment, real business spending on structures, real residential investment spending, and the real change in business inventories. These four components usually exhibit very different cyclical behaviors, and this year has been no exception. In the last four quarters real gross private domestic investment has increased by an impressive 17.2%. Broken down into the four components, this translates into an increase of 15.5% for real equipment spending, 0.9% for real spending on structures, 8.8% for real residential investment spending, and more than triple the rate of real inventory investment.

More than half of total investment spending goes for nonresidential equipment. Within that sector, by far the fastest growing component is spending for computing and information processing equipment, which increased by almost 20% in the last year. Thus, one major story behind the acceleration of economic activity in the last year is the boom in computer and related spending. Why now, and why is it so strong? Two major factors are the recovery in profits and large declines in computer prices. Corporate profits have risen by more than 15% in the past year, and nonfarm proprietors' income has risen more than 8%, so firms have a growing source of funds with which to finance new capital. And computer prices have been declining sharply for years, with no end in sight. This combination of growing profits and declining prices enables firms to acquire large quantities of new computers and information processing equipment.

The price declines for computers and information processing equipment will likely continue over the next year, but with the economy growing more slowly profit growth will also slow. As a result, real spending on business equipment will grow, but at a slower rate than 1994. We expect that growth to be in the 7–9% range.

Real investment in structures has been weak since the end of the construction boom in the 1980s and the subsequent savings and loan scandal. Although the large declines appear to be over, there is little chance of significant growth in the coming year, particularly in light of our forecast of rising interest rates. We predict real investment in structures to show little or no growth. Residential investment has been very strong this past year, but with rising interest rates and slower income growth we expect the housing sector to show little or no growth in 1995.

Inventory accumulation has been spectacular this year. We have not seen this rate of stock building since the early days of the recovery from the 1981-82 recession. This rate is not sustainable, so we expect inventory accumulation to be lower this year.

Putting all these component forecasts together yields a picture of continuing growth in total real domestic demand to average 2–2.5% this year, but at a rate that is considerably slower than we saw last year. Nevertheless, this is a very favorable forecast because the economy is currently very near full employment. Consequently, a slowdown in growth next year will lower the likelihood of higher inflation rates while allowing economic recovery to continue.

A final note of caution is in order. Spending on durable consumer goods, business plants and equipment, and housing is interest-sensitive. If the Federal Reserve decides it must raise interest rates even higher than we expect in order to slow the economy and prevent a rise in inflation, it is precisely these interest-sensitive sectors that will feel the pinch. In that case, the rate of growth of total real domestic demand may be lower than we forecast.

Monetary and Fiscal Policy

Carol A. Lehr

Assistant Professor of Business Economics and Public Policy, Indiana University School of Business

Current trends in output growth, unemployment, and inflation are quite favorable. Since 1992, output growth has averaged 3.4%, compared to a disappointing 1.1% coming out of the 1990-91 recession. Moreover, the unemployment rate, after hitting a peak of 7.7% in mid-1992, has dropped steadily and is now below the 6% rate.

It should be noted that there was a break in the unemployment series in January 1994 due to changes in the survey technique. The alterations raised the measured unemployment rate by 0.5%, so current unemployment may be even lower relative to 1993 rates. Typical estimates for the "natural rate" of unemployment (that is, the rate of unemployment below which inflationary pressures accelerate) fall into the 6% range. The dip in the unemployment rate below this level, along with rising factory orders, increasing incomes, strong retail sales, relatively high-capacity utilization numbers, and a myriad of other strong signals, has made market participants nervous that inflation will soon pick up.

However, the most recent inflation numbers show no current tendency toward accelerating inflation. In fact, the CPI inflation rate for third quarter 1994 was 3.2%—virtually unchanged from the previous quarter. But the markets look forward and current third quarter numbers only reflect activity prior to September 30. Future inflationary pressures will depend on the Federal Reserve's decisions concerning interest rate movements as well as the economy's ability to increase productivity and capacity.

Monetary Policy

With this scenario in mind, the Fed made several moves this year to raise short-term interest rates. As is usually the case, the rate changes have been small and gradual as monetary policy attempts to balance possible future inflation costs against a slowdown in current growth arising from a higher cost of funds. At the last meeting of the Federal Open Market Committee (FOMC) in November, the committee voted to raise short-term interest rates yet again, by three quarters of a percentage point.

Although the Fed does not directly control nominal long-term interest rates, it can influence them indirectly through the yield curve and, more important, through its effects on expected inflation. The recently improved output growth rates are undoubtedly linked to lower long-term interest rates, which encouraged the investment-led growth spurt. Moreover, net investment in new machinery and equipment adds to capacity, which in turn helps keep inflationary pressures low in the long run.

Therefore, in an effort to keep currency spending within current capacity and to restrain expectations of inflation, the Federal Reserve will probably continue to raise short-term interest rates gradually into 1995. The outlook projection is that short-term rates, such as the three-month Treasury bill rate, will increase nearly 1%.

Fiscal Policy

As of March 1994, the federal debt totaled close to $4.6 trillion, which is 68% of GDP. In 1989 the federal debt was 55% of GDP. The 1992 elections brought the issue of the federal budget deficit and debt to the forefront of popular debate. High levels of government spending relative to revenue have limited fiscal authorities in their ability to manipulate spending and taxes to influence the business cycle. Therefore, the thrust of fiscal policy in this decade has not been to use the budget deficit to smooth out business cycle fluctuations. Instead, emphasis has been placed on budget reduction. The implementation of the 1993 budget plan reduces the deficit by $500 billion over a five-year period. These measures—along with a growing economy and, hence, growing tax revenues—helped bring down the deficit in 1993 and 1994. The government's fiscal year ended on September 30, and reports show that the deficit declined from the previous fiscal year, which is the second year-to-year drop.

The outlook for calendar year 1995 is for the deficit to increase slightly. The projection is based on slowing economic growth. However, the failure of health care reform this year helped keep the projected deficit lower than otherwise thought. If health care reform returns to the agenda, it is again unlikely that major initiatives could be put into place next year, thus delaying the initial increased cost to government. On the other hand, one of the major reasons for the explosion of the deficit in the 1980s was the sharp increase in health care costs. This drove spending on Medicare and Medicaid to unprecedented levels, and reductions in the deficit are inextricably tied to lowering the growth of health care expenditures.

Table 1
Growth of World Output, 1975–1994 (%)

	1975–89 Average	*1990*	*1991*	*1992*	*1993*	*1994 (est.)*
World	3.5	2.0	0.6	1.8	2.2	3.0
Industrial Countries	2.8	2.1	0.2	1.5	1.2	2.4
US	2.7	0.8	−1.2	2.6	3.0	3.9
Japan	4.2	4.8	4.0	1.3	0.1	0.7
Germany	2.0	5.1	1.0	2.0	−1.2	0.9
France	2.4	2.2	1.1	1.8	−0.7	1.2
Italy	2.7	2.1	1.3	0.9	−0.7	1.1
UK	2.3	0.5	−2.2	−0.6	1.9	2.5
Canada	3.4	−0.5	−1.7	0.9	2.4	3.5
Developing Countries	4.7	3.7	4.2	6.1	6.1	5.5
Asia	6.7	5.7	5.8	7.9	8.4	7.5

Source: International Monetary Fund, May 1994

The International Economy

Michele Fratianni

AMOCO Professor of Business Economics and Public Policy, Indiana University School of Business

Economic growth around the world improved in 1994. **Table 1**, based on data available in May 1994, indicates that world output is growing at 3%—still below the long-term trend. This performance, in turn, reflects the fact that several industrial countries are in a down phase of the business cycle. Over the period of 1975-1989, world output of goods and services grew at an average annual rate of 3.5 %. Industrial countries, which account for the lion's share of world output, grew at an average of 2.8 %. Of the so-called G7 countries—the elite of the industrial countries grouping—only Japan and Canada grew faster than the industrial average. Developing countries, which account for a relatively small share of world output, grew almost twice as fast as industrial countries. Asian countries grew faster than that, and Pacific Basin countries even faster.

In 1990 the United States went into a recession that lasted through part of 1991. During that year the growth of U.S. gross domestic product was approximately 4 percentage points below trend. Canada and the United Kingdom mimicked quite closely the U.S. business downturn. Continental Western Europe slid into hard times in 1991 and Japan in 1992.

Germany paid the front-loaded costs of German monetary unification. The policy goal of raising almost overnight the standards of living of the former East Germany put pressure on government spending and real rates of interest in the country. The Bundesbank, the German central bank, tightened monetary policy to offset the inflationary effect of the higher expenditures. Interest rates rose and stayed high as a consequence.

Countries participating in the European Monetary System had a choice of either maintaining existing exchange rate parities and thus importing the high interest rates, or adjusting the parities. Political leaders and central bankers opted for the credibility of the European Monetary System and had to tighten monetary policy. This was not a good choice, because of its deflationary implications.

In mid-September 1992 there was a currency crisis, the result of which was forced parity adjustments by some countries and the decision of Italy and the United Kingdom to abandon the exchange rate mechanism that kept exchange rates within a narrow