

The Southwest ECONOMY

FEDERAL RESERVE BANK OF DALLAS

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The U.S. Economy: A Brighter Outlook After a Bumpy Ride

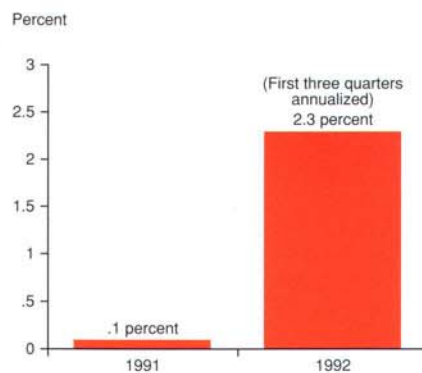
A look at U.S. economic performance in 1992 shows uneven economic activity across sectors and across time. The bumpy ride resulted in a modest increase in the rate of output growth, but employment growth was at a virtual standstill. During 1992, inflation moderated further. In 1993, we expect fourth-quarter-to-fourth-quarter real gross domestic product (GDP) growth in the 2.5- to 3-percent range, and we expect the inflation rate to fall slightly below its 1992 pace.

What effect will the new administration have on economic activity in 1993? The policy actions most often discussed as part of a stimulative fiscal program should have little impact on economic activity in the near term and, thus, have little bearing on our 1993 forecast. However, the policies are more likely to have significant long-term impacts as each fiscal action reshapes incentives.

The State of the Expansion

Recent GDP growth, shown in Chart 1, indicates that output grew at a substantially faster rate in 1992 than in 1991. GDP increased at a 2.3-percent annual rate between the fourth quarter of 1991 and the third

Chart 1
GDP Growth in 1991 and 1992
(Fourth Quarter to Fourth Quarter)



quarter of 1992 after increasing at only a 0.1-percent annual rate in 1991. A closer examination shows how bumpy this expansion has been.

Three characteristics of this recovery are evident in Chart 2, which plots GDP and employment growth by quarter since the second quarter of 1991. First, economic activity did a rather sharp turnaround in 1992 relative to 1991. As Chart 2 shows, GDP growth was below 2 percent and falling in 1991, indicating that the recovery had the potential to give way to another recession. In the first quarter of 1992, the economy strengthened as GDP grew at a 2.9-percent annual rate.

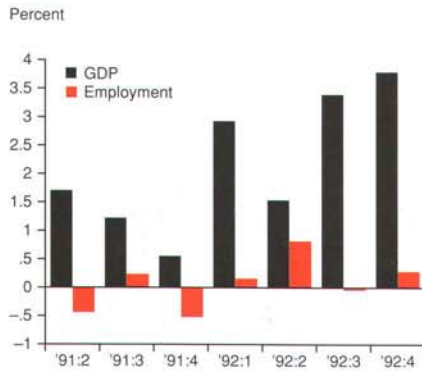
A second characteristic of the recovery that is evident in Chart 2 is somewhat uneven GDP growth during 1992. Even though GDP accelerated in the first quarter of 1992, many observers questioned whether the new-found strength was sustainable. These doubts were supported by a slowdown in output growth in the second quarter. The third quarter was a bit of a surprise as GDP grew at a 3.4-percent annual rate, led by stronger than expected consumer spending.

The third characteristic

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Chart 2
GDP and Employment:
Output Recovery, Jobs Recession



reflected in Chart 2 is the lack of employment gains during the past seven quarters. The data indicate that the expansion in output has not yet translated into a jobs recovery.

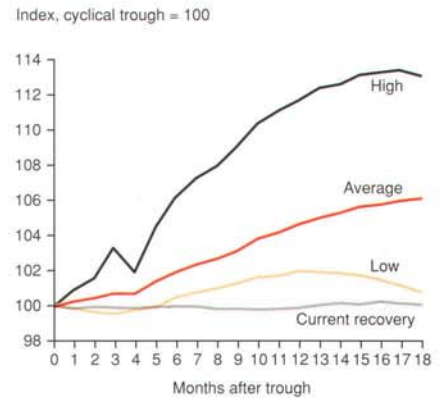
Employment. How do employment gains in this recovery compare with those of previous recoveries? Chart 3 plots the level of nonfarm employment relative to that reported in the trough month of seven post-World War II recessions. All values are indexed so that a value of 100 represents the ratio of nonfarm employment prevailing when each expansion began. The National Bureau of Economic Research has identified March 1991 as the date the most recent business cycle trough occurred.

For comparison, the "High" and "Low" lines on Chart 3 denote the maximum and minimum values recorded for the nonfarm employment index during the first 16 months of the previous seven postwar expansions. Similarly, the line labeled "Average" represents the mean value of the ratio for each of the 16 months. Note that when we constructed the "High," "Low" and "Average" reference lines, the most recent recovery period was excluded. Instead, the most recent experience is plotted by the "Current recovery" line. As Chart 3 indicates, the "Current recovery" line is at or near the bottom of the "Low" line, suggesting that employment gains in the current recovery

have been the weakest of any postwar recovery. This result further underscores the weakness in employment growth.

Another way this expansion differs from previous postwar recoveries is the unevenness of job growth around the country. Chart 4 shows the 10 states with the largest and smallest employment gains from March 1991 to November 1992.¹ Many Northeast and Mid-Atlantic states, as well as California, are still experiencing job losses 18 months after the national recovery began. Thus, the regions most responsible for job losses during the contraction (the Northeast and California) are continuing to drive employment losses during the expansion. Indeed, the Northeast and California account for almost two-thirds of the total U.S. job loss. From March 1991 to November 1992, job losses outweigh job gains by 414,000, according to state-level employment figures. Were it not for the losses in the Northeast and California, however, the economy would have shown a net job gain of 707,000. This analysis suggests that continued economic stress in these regions is dragging down the national recovery. In virtually all previous recoveries, most states enjoyed net job growth by the 18th

Chart 3
Nonfarm Employment
in Postwar Recoveries



month of national expansion. For example, 18 months after the end of both the 1974-75 and 1981-82 recessions, 49 states showed expanding employment. The large number of states suffering employment losses in the current expansion is unprecedented in postwar history.

Productivity. With output growing at a faster pace and employment holding steady in 1992, the implication is that output per worker, or productivity, increased. Chart 5 plots output per worker from the first quarter of 1962 through the third quarter of 1992. The shaded regions denote periods in which recessions occurred.

Chart 4
Ten Largest and Smallest States Ranked by Employment Growth,
March 1991–November 1992

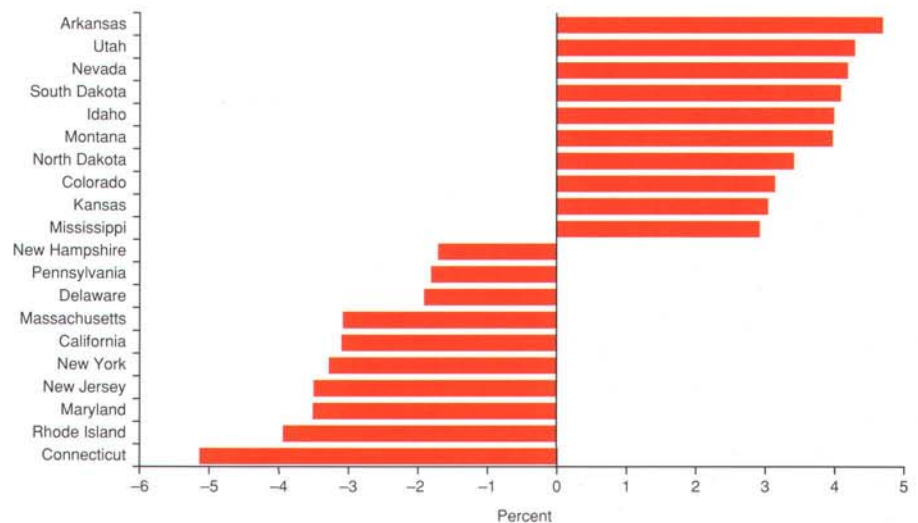
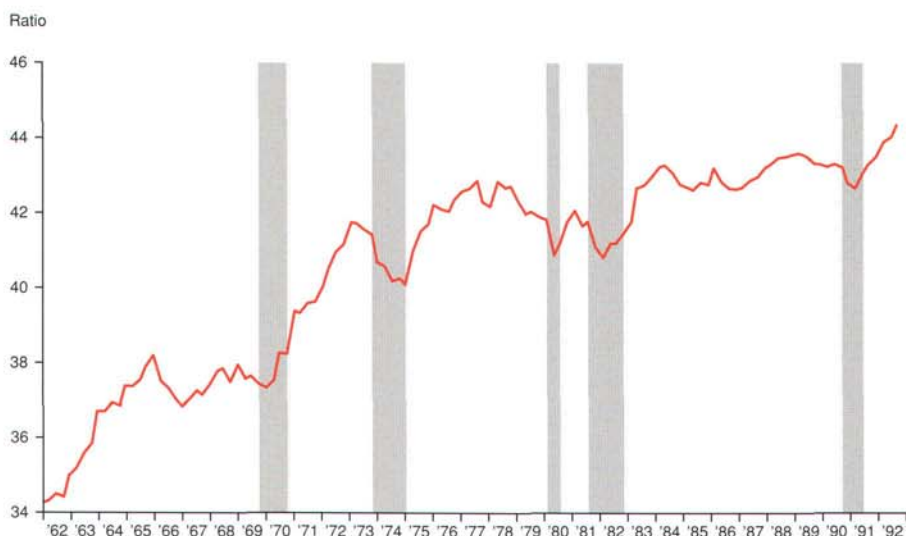


Chart 5
Output per Worker, 1962–92
(First Quarter to First Quarter)



“Recently, much has been made of the growing regulatory burden that limits businesses’ ability to increase output.”

Chart 5 shows that productivity typically falls during the late stages of economic expansion but grows sharply during periods of recovery. Chart 6 focuses on output per worker since the fourth quarter of 1990. In the current recovery, worker productivity has been steadily increasing, as shown in Chart 6. The upshot is that the output gains achieved during this recovery result almost entirely from increases in worker productivity.

Given that employment growth in this recovery is the weakest on record in the postwar period, it is worth comparing productivity gains from this and prior recoveries. Recently, much has been made of the growing regulatory burden that limits businesses’ ability to increase output. Chart 7 shows that private-sector productivity growth in this recovery has been a little below average. It is possible that output growth relative to labor input would have been higher had the private sector not been burdened by increasing regulations during this recovery.²

U.S. Economic Outlook for 1993

GDP. Economic activity was stronger in 1992 than in 1991 and somewhat stronger than many had forecast. Still, the economy’s pace of expan-

sion would be considered moderate by typical standards. Output growth is expected to continue its modest improvement. We expect GDP to grow at a 2.5- to 3-percent annualized rate between the fourth quarter of 1992 and the fourth quarter of 1993.

Three factors could result in economic growth below our projected rates. First, the dichotomy between output and employment growth thus far in this recovery imposes several risks. Consumers, facing continued employment uncertainty, may continue to pay off debts until their interest burdens are reduced to much more conservative levels, perhaps down to those levels that prevailed a generation ago. Since

Chart 6
Output per Worker

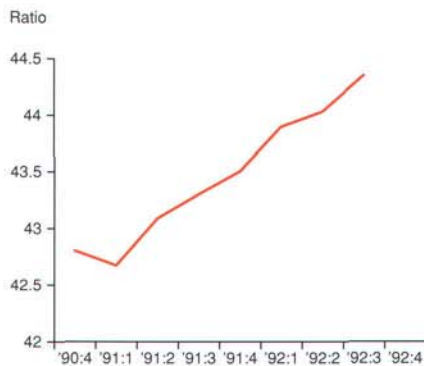
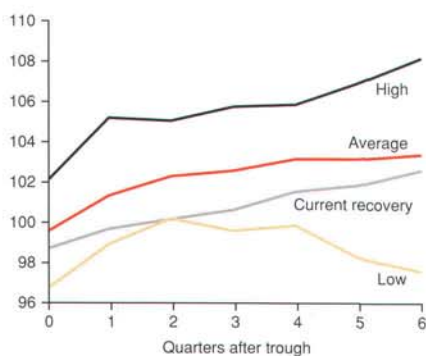


Chart 7
Output per Worker in Postwar Recoveries

Index, cyclical peak = 100



consumer spending accounts for approximately two-thirds of GDP, retrenchment by the consumer sector would mean smaller GDP gains.

A second risk factor is the potential for flat, even declining, U.S. exports. Many of our leading trading partners—Canada, Japan, Mexico and Western Europe—are either in recessions or periods of slow growth. The timing of recoveries in these countries has a crucial bearing on the U.S. growth path in 1993. In addition, all our trade negotiations are vulnerable to games of brinkmanship, which adds to business uncertainty. In short, sharper than expected recessions abroad would adversely affect GDP growth in the United States.

Additional uncertainty may result from debate about fiscal policy proposals. The three main fiscal packages under discussion—investment tax credits, infrastructure spending and changing marginal tax rates for middle-income versus upper-income households—will not affect the economy to any great extent in 1993. By the time any new programs could be enacted and take effect, the year will be over. However, as these packages are proposed and debated, the uncertainty surrounding them could exert a drag on economic activity in the short run.

Consumer Prices. The economy's inflation performance in 1992 was better than many forecasters expected. Consumer prices increased

at a 2.9-percent annual rate, slightly below the 3.1-percent rate recorded in 1991. Other measures of inflation, such as the fixed-weight GDP deflator, also showed lower inflation in 1992 than in 1991. Given slack levels of labor and capital resource utilization in the economy, we expect inflation to decline slightly in 1993. More specifically, we expect consumer prices to increase in the 2.7- to 3-percent range.

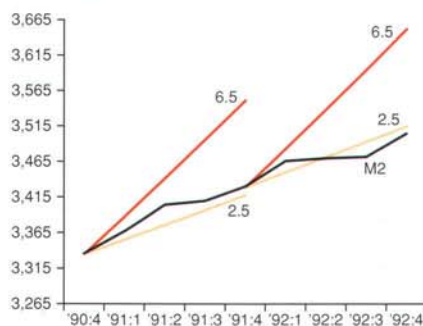
Slow money growth is another factor that signals moderating inflation pressures. Chart 8 plots the path of M2. The cones in Chart 8 represent the targets set for M2 and are plotted for 1991 and 1992. In each of the past two years, M2 growth has been very close to, and often below, the bottom end of its target range. Insofar as M2 growth is an indicator of the stimulus provided by monetary policy, the slow growth of M2 suggests little in the way of increasing inflationary pressures over the near term.³

Summary

Overall, the economy improved substantially in 1992, but the recovery remains quite modest by historical standards. The recovery in output has been quite bumpy and has not yet translated into a jobs recovery. The modest strength in 1992 appears sustainable, and as such, we expect GDP to grow in the 2.5- to 3-percent range in 1993. Inflation declined slightly in 1992, and we expect this

Chart 8
M2 Growth Cones

Billions of dollars



trend to continue. We expect consumer prices to increase in the 2.7- to 3-percent range in 1993.

—Joseph H. Haslag
Harvey Rosenblum

¹ Chart 4 and the subsequent analysis was inspired by an article in the *FRBSF Weekly* (Federal Reserve Bank of San Francisco, November 27, 1992 issue) by Brian Cromwell and Karen Trenholme. We look at employment changes for the period March 1991 to November 1992 (18 months), instead of the May 1991–September 1992 period used by Cromwell and Trenholme.

² The effects that increased regulatory burdens have on productivity can be further masked by subtle measurement issues. To illustrate this point, consider the effects of regulatory burdens on productivity in the banking industry. For banks, productivity gains, as measured by the National Income Accounts, could well be overstating "true" output per worker. To comply with the Federal Deposit Insurance Corporation Improvement Act, banks must reduce their traditional outputs. Although loans and other measures of bank output may decline, output as measured in the GDP accounts for the banking system and the economy will likely remain unchanged or increase—that is, output may appear to be growing, as measured in the GDP accounts but, if measured correctly, may not have grown. The implication is that output per worker in the banking industry records gains even though what one thinks of as the measurement of banking output declines. In addition, a host of problems is associated with measuring the value of the government services component of GDP because most government services are not traded in a market. We simply point out these problems to show how difficult it is to match our concepts of productivity with the "realities" of the data.

³ Recent research suggests that 1991–92 is a period in which econometric models of money demand repeatedly overpredicted the quantity of money. This run of overpredictions is referred to as "missing money." In addition, M2 velocity (the ratio defined by nominal GDP divided by M2) has been quite strong over the past two years.