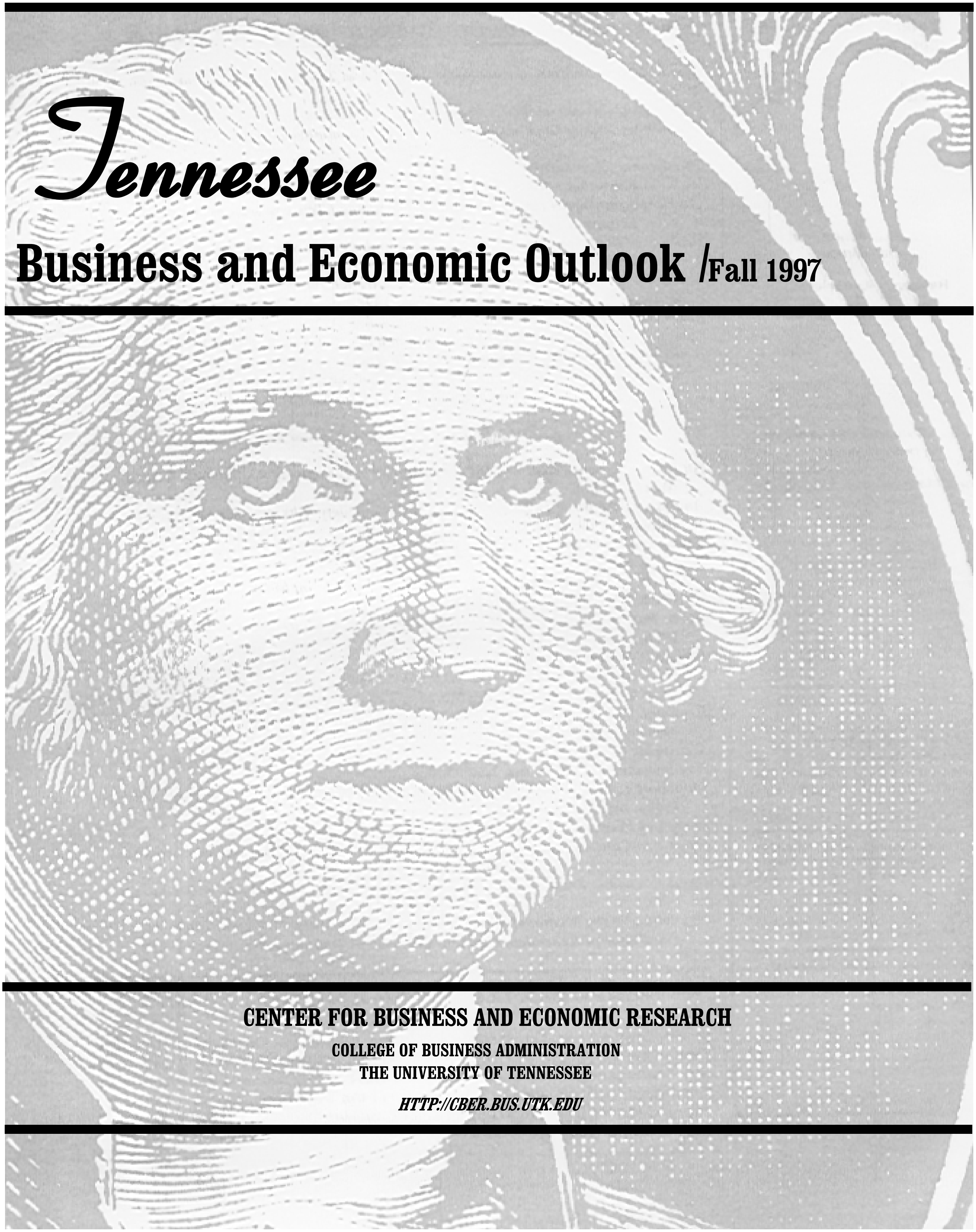

Tennessee

Business and Economic Outlook /Fall 1997

CENTER FOR BUSINESS AND ECONOMIC RESEARCH

COLLEGE OF BUSINESS ADMINISTRATION
THE UNIVERSITY OF TENNESSEE

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Center for Business and Economic Research/The University of Tennessee, Knoxville

Overall U.S. Economic Growth Remains Strong

U.S. FORECAST

Current Economic Conditions

The national economy continues to enjoy a strong economic expansion dating back to 1991. Many observers are now discussing a "new paradigm," wherein strong and sustained growth can be engineered absent traditional inflationary pressures. Proponents of this view point to a number of forces, including relatively strong productivity gains; increased product, commodity and labor market competition from abroad; and deregulation and increased competition in certain domestic product markets (most notably utilities and telecommunications). These (and other) forces are believed to keep inflation in check as the economy expands, enabling stronger noninflationary growth, hence forestalling Federal Reserve (Fed) intervention in the form of higher interest rates to slow the economy. While there is validity to this new perspective on the economy, the story should not be pushed too far: the potential for inflation to rise as the economy approaches and operates at full employment will continue. Moreover, few would argue that the traditional boom-bust business cycle has become an historical artifact. For the time being, however, the new paradigm will continue to characterize the nation's economic growth.

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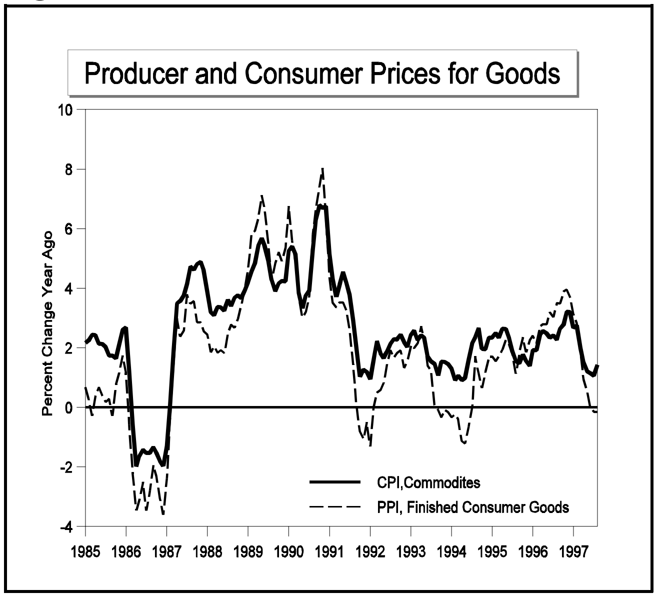
Figure 1



As shown in Figure 1, inflationary pressures have been modest during the current expansion. Figure 1 also reveals the exceptionally tight relationship between growth in producer prices and subsequent growth in consumer prices for *commodities*. After showing some acceleration in 1996 (sparking concerns of a wave of interest rate increases on the part of the Fed), inflation is now decelerating. But the data in Figure 1 pertain to goods, as opposed to services. Since services are an increasingly large share of the nation's economy, increases in the prices of services can have a significant impact on overall prices increases. This is in fact where many current inflation fears are focused, and this is why many are not willing to fully embrace the new paradigm. The reason is that many *services* are not traded in the international community, and accordingly, services don't confront the same competitive pressures as commodities and final *goods*. Moreover, productivity gains in the service sector are lackluster at best, meaning that wage gains have a greater likelihood of impacting final prices. Wage growth in the service sector is now showing signs of acceleration, raising the specter of higher consumer prices in the coming quarters.

Industrial production has remained strong in recent quarters, growing by 2.8 percent in 1996 and accelerating to 4.0 percent growth in 1997. Capacity utilization is expected to inch forward from 82.1 percent in 1996 to 83.1 percent in 1997. While this is a small increase, the operation of the nation's factories and mines at this level does raise some concerns regarding inflation. But nonresidential fixed investment has been dominated by double-digit increases in producer's durable equipment, which jumped 23.8 percent in 1997:II. These investments remove some inflationary pressures through expansions and improvements in productive capacity.

The nation's international sector has fared quite well in the face of an appreciating dollar in global currency markets. One reason is that while the dollar is strong on average, there are other strong currencies as well (including the Canadian dollar and the British pound). Reasonably strong growth (outside of Japan and southeast Asia) has helped sustain foreign purchasing power for our exports. Stronger growth is anticipated for the international community in the near term, which should help prop up our export markets.

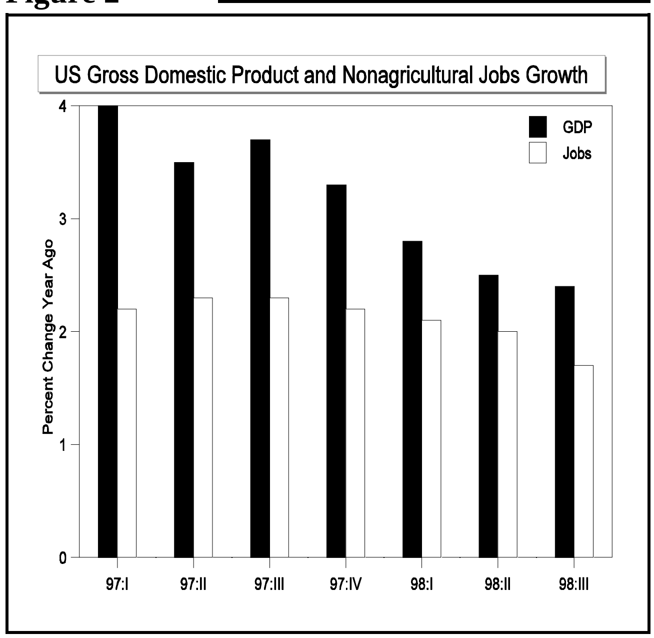
Labor markets appear to be tightening, as the unemployment rate has remained under 5 percent since June. Job growth has slowed, however, from the rather frenetic 3.1 percent pace of 1994, settling in closer to the 2.5 percent mark. Manufacturing employment contracted 0.4 percent in 1996 and is expected to grow 0.4 percent in 1997. The rate of job creation in durable goods manufacturing has shown acceleration in 1997 while the rate of job decay in nondurable goods manufacturing has slowed.

U.S. Forecast Summary

Overall economic activity is expected to remain strong through 1998. As shown in Figure 2, the rate of inflation-adjusted gross domestic product (GDP) will slowly subside. Expectations are for 3.6 percent growth in 1997 and then 2.5 percent growth in 1998. Employment gains will exhibit a similar trend, closing out 1997 with growth of 2.2 percent, then slowing to 1.9 percent growth in 1998. Employment growth in manufacturing will slow in 1998 as the durable goods sector slows; nondurable goods manufacturing will eke out a 0.1 percent gain in 1998. All in all, the economy is expected to remain at or near full employment. One piece of evidence is the expectation that the unemployment rate will remain under 5.0 percent through 1998.

Growth in nonresidential fixed investment will

Figure 2



continue to be dominated by producer's durable equipment, although growth will slip to single digits by 1998:II. Growth in structures investment will be an anemic 1.0 percent in 1998. Housing starts are expected to slip slightly in 1998, while inflation-adjusted investment in housing will expand only 1.6 percent. This slowdown in housing will likely translate into slower growth in the construction sector, building material sales, furniture and fixtures sales, and so on.

Consumption spending will remain strong, buoyed by consumer sentiment, good job growth and the wealth effect arising from exceptionally strong gains in the stock market. Consumer's debt burden will remain a hindrance, although relatively low interest rates have accommodated much lower monthly installment payments. Consumer spending growth is expected to hover in the 3 percent range in 1997 and 1998.

The sustained expansion has gone a long way towards eliminating the federal budget deficit. While the Congressional Budget Office expects balance by the year 2002, the WEFA Group expects a balanced budget in 1998. This should take some pressure off of financial markets, potentially supporting lower interest rates. As the federal government has restrained its spending growth, federal employment has actually been contracting since 1992. However, overall government employment has continued to expand due to growth at the state and local level.

Growth in inflation-adjusted personal income will slow from 3.5 percent in 1997 to 2.8 percent in 1998. Inflation-adjusted per capita personal income growth will advance 2.5 percent in 1997, slowing to 1.9 percent in 1998. Inflation, measured by the implicit deflator for GDP, will increase slightly in 1998 to 2.2 percent. Interest rates are expected to inch up slightly in 1998.

U.S. Forecast at a Glance

- ☞ **The U.S. economy will enjoy sustained growth through 1998. The chances for a sharp upturn or downturn in economic activity are slim. Inflation-adjusted GDP, the broadest measure of economic activity, will grow 3.6 percent in 1997 and 2.5 percent in 1998.**

- ☞ **Job growth will advance 2.2 percent in 1997, slowing to 1.9 percent growth in 1998. Manufacturing employment will be up 0.4 percent in 1997 and up 0.3 percent in 1998.**

- ☞ **Inflation will inch forward, with the implicit deflator for GDP rising 2.0 percent in 1997 and 2.2 percent in 1998.**

- ☞ **Interest rates will show modest upward movement through 1998. The likelihood of interest rate increases by the Fed appears to be slim through the next several quarters.**

Tennessee Economy is Slow but Stable

TENNESSEE FORECAST

Current Economic Conditions

Tennessee's abrupt economic slowdown seems to have firmly gripped the state economy. Earlier in the decade the state was on the forefront of regional and national economic growth. Now Tennessee finds itself trailing the region and the nation. As shown in Figure 3, Tennessee's per capita personal income growth stacked up quite well in 1993-1995. But a sharp turnaround took place in 1996 when Tennessee's income growth trailed all southeastern states and came in 47th in the nation.

A careful and detailed examination of each component of personal income reveals that the weakness is broad based, not confined to a single sector of the state's economy nor a single category of personal income. Wage and salary income, "other" labor income, proprietor's income and rent, interest and dividend income all showed weaker growth in 1996 than the U.S. and southeast averages. Proprietor's income was hit especially hard by a sharp contraction in farm income. Nonetheless, nonfarm income was only able to match average growth across the southeast, and was only 0.1 percentage point above the U.S. average.

The slowdown in economic activity is evident elsewhere. Job growth in Tennessee has surpassed the rate of job creation for the national economy throughout most of the current economic expansion. However, as shown in Figure 4, job growth has now slowed appreciably relative to the U.S.

No broad sector of the state economy has been spared. Overall job growth in 1994 was 4.1 percent, slowing to 3.1 percent in 1995, and slowing further to 1.5 percent in 1996. Growth for 1997 is likely to come in at 1.1 percent. Service sector employment, which represented 25.9 percent of nonagricultural jobs in 1996, enjoyed growth in excess of 5 percent in 1994 and 1995, slowing to 2.9 percent growth in 1996. Data for 1997 show a further deceleration, with year-over-year growth in the second quarter amounting to only 1.5 percent.

Manufacturing has endured exceptional hardship. Employment losses in nondurable goods manufacturing totaled 6.0 percent in 1996. But the pace of job loss seems to be subsiding. In 1997:II, year-over-year job losses were at 2.4 percent with losses concentrated in textiles, apparel and leather manufacturing. Durable goods manufacturing employment declined in 1996 as well. Unfortunately, employment in durable goods manufacturing in 1997:II was lower than any quarter in recent history.

One bright spot has been sustained strength in the construction sector, where job growth has remained above 3 percent since 1996. But even this bright spot is fading, as year-over-year employment growth in 1997:II slipped below 3.0 percent.

As the national economy has retained its vigor, the national unemployment rate has moved downward. At the same time, the Tennessee unemployment rate has been moving up. Having averaged 4.8 percent in 1994 (1.3 percentage points below the U.S.), the Tennessee unemployment rate has now crept above 5 percent. The state's unemployment rate moved above its national counterpart in 1997:II, the first quarter in recent history.

Tennessee taxable sales have remained surprisingly strong in the face of a slowing state

Figure 3

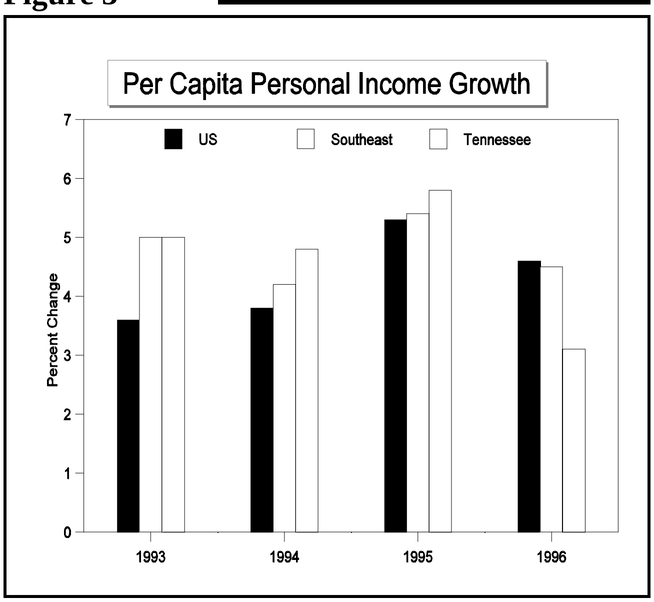
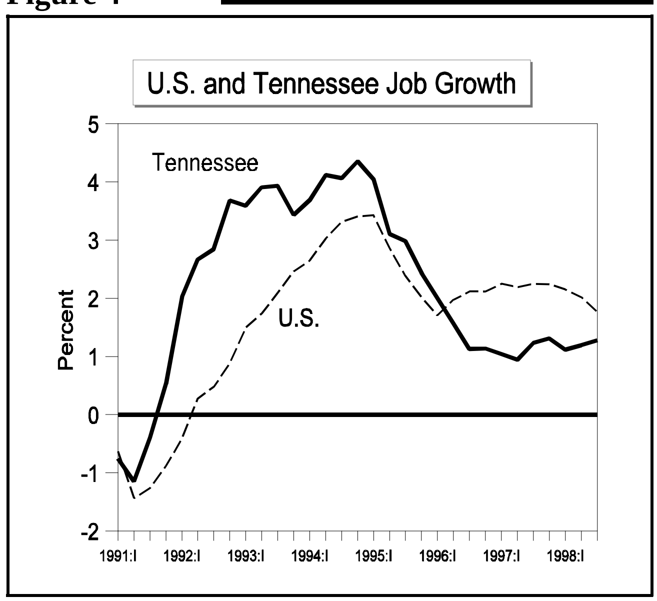


Figure 4



economy. In fact, while the state economy cooled off in 1996, producing taxable sales growth of 4.7 percent for the calendar year, growth has accelerated in the first two quarters of 1997. In light of broader economic forces, this pace of growth cannot likely be sustained through the near term.

Tennessee Forecast Summary

The Quarterly Tennessee Econometric Model projects no appreciable deterioration in statewide economic conditions in the near term. Generally, the economy will remain on its lower flight trajectory through 1998 and into 1999. Nominal personal income is expected to close out 1997 with 4.9 percent growth and experience 4.8 percent growth in 1998. Inflation-adjusted personal income will likely expand 2.7 percent in 1997 and 2.4 percent in 1998. Unfortunately, Tennessee per capita personal income growth will lag the U.S. in 1997 and 1998.

Tennessee's employment situation should stabilize itself through the short-term forecast horizon. Following 1.5 percent job growth in 1996, growth should come in at 1.1 percent in 1997, improving marginally to 1.2 percent in 1998. Further job losses are expected in the state's manufacturing sector. Following 3.1 percent contraction in 1996, job losses are projected to come in at 1.1 percent in 1997 and 0.9 percent in 1998. Job growth in the trade sector will be largely unchanged in 1997, with marginal improvement in 1998. Service sector growth is expected to remain in the 2.2 percent range through 1998.

A stabilized state economy should forestall further increases in the state unemployment rate. It is projected that the unemployment rate will remain at about 5.2 percent through the forecast period.

Taxable sales growth is expected to weaken for the remainder of 1997 and into 1998. But nominal taxable sales will still advance in excess of 4.5 percent into 1999.

Tennessee Forecast at a Glance

☞ **No sharp improvement nor deterioration in state economic conditions is expected in the near term. The state's economy appears to have settled on a stable but slower path of economic progress. Expect nominal personal income to grow 4.8 percent in 1998 and inflation-adjusted personal income to expand 2.4 percent.**

☞ **Tennessee nonagricultural jobs will expand 1.2 percent in 1998. Jobs in the state's manufacturing sector will fall by 0.9 percent in 1998, a dramatic improvement relative to the 3.1 percent loss in 1996. Jobs in services and trade will be up 2.2 percent in 1998.**

☞ **The Tennessee unemployment rate will remain above its national counterpart in 1998, averaging 5.2 percent.**

☞ **Tennessee nominal taxable sales will grow by 4.9 percent in 1998. Growth for fiscal year 1997/98 is projected at 4.8 percent. Inflation-adjusted taxable sales will be up 2.5 percent in 1998.**