Economic Outlook: 2nd Quarter 2004

United States

Overview. The U.S. economy grew at a solid 4.1 percent annualized rate in the fourth quarter of 2003, fueled mainly by consumer expenditures, exports, increased spending on equipment and software, and housing markets. Economic growth is expected to be as strong or better in the first half of 2004. Growth rates of 4.5 percent in the first quarter and 4.6 percent in the second quarter are expected, fueled mainly by tax refunds and improving employment conditions. Payroll employment seems to be rebounding, with a strong showing in March and a significant slowdown in layoffs. However, the lack of widespread employment gains, particularly in the manufacturing sector, remains a concern.

Economic growth in the second half of 2003 showed the fastest back-to-back quarterly increase since the first two quarters of 1984. Another encouraging sign about the recovering economy is the significant increase in business spending in recent months—spending on equipment and software grew 14.9 percent in the fourth quarter, following a 17.6 percent rise in the third quarter. However, business spending on plants and buildings declined again in the fourth quarter and could remain weak through 2004. Consumer spending, which rose 3.2 percent in the fourth quarter, is expected to increase by 3.5 percent and 4.5 percent in the first two quarters of 2004, respectively. Real business spending on equipment and software should also continue to post double-digit growth through the rest of 2004.

The risk of deflation is clearly out of the picture now and inflation might begin to be an issue. Although inflation at the consumer level remains low, commodity prices at the wholesale level have seen recent sharp increases, mainly due to rising demand for oil and raw materials as a result of surging economic growth in China and other countries. Gasoline and raw material price increases are real concerns for the economy. Some of the oil price increase is due to the declining value of the U.S. dollar since oil is priced in dollars. The Organization of Petroleum Exporting Countries (OPEC) views dollar declines as profit contraction and sometimes cuts back on oil production as a result. This time, however, increasing demand is the main cause of the spike in crude oil prices. In the past three months alone, prices of steel scrap are up 80 percent, lumber up 26 percent, nonferrous metals up 22 percent, and oil and ocean shipping rates have increased by 17 percent. While consumers are quite accustomed to price increases in services, manufacturers and retailers are finding it increasingly difficult to pass higher input prices on to consumers while combating excess worldwide capacity and operating in a very competitive environment. Higher gasoline prices tax both consumers and businesses. While it might be difficult
for businesses to pass additional energy costs along to consumers, the higher gasoline prices consumers are hit with at the pump can reduce consumer expenditures for other commodities and services. Weak increases in labor costs (as measured by the employment cost index) in recent months are making it relatively easier for firms to absorb the higher energy and raw material costs.

The U.S. services sector also remains fairly strong. The recent ISM (Institute for Supply Management) report on business activity showed a 12th consecutive monthly expansion. The ISM's non-manufacturing activity index increased from 60.8 in February to 65.8 in March; a reading higher than 50 indicates expansion. New order activity was also up, an indication of further growth in the near term. The fastest performing sectors are expected to be retailing, healthcare-related services, and computer and software-related services.

**Consumer Spending.** Consumer spending has remained strong throughout the recovery; low interest rates and mortgage refinancing have been the main catalysts. Refinancing has begun to decline and will continue to do so as interest rates increase. On the bright side, consumer spending should stay strong as more jobs are created and income levels begin to rise. Real disposable income will begin to increase with improving employment conditions. Rising income should help households lower their debt levels. This is important because households piled on debt to keep spending strong in the most recent recession and subsequent recovery. Consequently, households have become increasingly vulnerable to delinquencies and bankruptcies. Historically, households have retrenched spending levels, creating pent-up demand, during economic downturns.

**Employment.** Although job cuts have significantly decreased in the last two months, layoffs still continue in the manufacturing, financial, and information sectors. This is mainly due to high productivity and excess capacity in manufacturing and an increase in merger activity in the financial industry. Telecommunications is experiencing intense competition and high levels of excess and unused capacity.

It has been more than two years since the recession ended and although employment in some sectors of the economy has begun to pick up, most sectors are still not hiring. The U.S. economy added over 300,000 new jobs in March 2004, the largest gain in four years. The economy has added an average of 171,000 new jobs over the last three months. Construction contributed over 200,000 jobs in the past year, including 71,000 in March. After experiencing a net loss of jobs since the beginning of the recession in 2001, retailing added 47,000 jobs in March; the sector has added almost 132,000 jobs since December. Professional and business services, another strong segment of the economy, gained 42,000 jobs in March and has added over 210,000 jobs during the past twelve months. Manufacturing payroll losses have significantly moderated in recent months; the sector’s employment was unchanged in March. This is the first time in 43 months that manufacturing payroll employment did not fall.

**Manufacturing.** Manufacturing activity accelerated in March, with hiring activity hitting a 16-year high. The ISM’s manufacturing activity index rose to 62.5 in March from 61.4 in February. A reading above 50 indicates expansion in the sector. With the index of new orders showing an increase and low levels of inventory, production will have to increase in the coming months to meet rising demand. ISM’s supplier delivery index jumped to 67.9 in March, the highest reading recorded since 1979. However, manufacturers are facing surging costs and limited supplies of raw materials. With substantial excess capacity, it will be difficult for some manufacturers to add jobs or pass along increasing input costs to their customers. After rising by just 0.3 percent in 2003, industrial production is estimated to increase by almost 5 percent in the first two quarters of 2004. However, just a few industries are expected to show improvement, mainly manufacturers of big-ticket items related to residential construction, home furniture and fixtures, automotive, and defense spending.

**Outlook.** GDP is estimated to grow by slightly over 4 percent in 2004, following a 3.1 percent annual increase in 2003. Consumer expenditures will rise 3.9 percent versus 3.1 percent in 2003.
Spending on durable goods, which grew 7.4 percent in 2003, is expected to increase 7.1 percent in 2004. Consumer spending on nondurable goods is forecasted to grow by 4.7 percent, following a 3.8 percent increase in 2003. Business spending on equipment and software will grow by almost 14 percent in 2004, after a modest 5.5 percent increase in 2003. If the payroll employment data continues to show strength, the U.S. economy could add 2.0 million or more jobs in 2004. However, if the March payroll data was just an anomaly, and employment growth retreats again, the economy may add 1.0 to 1.5 million new jobs in 2004. Manufacturing employment is expected to shrink by about 200,000 jobs in 2004; a very optimistic scenario for manufacturing would be that employment remains flat over the year.

**Alabama**

**Employment.** Similar to national employment trends, payroll layoffs in the state have slowed in recent months. Another plus for the state is the substantial increase in automotive manufacturing-related jobs, which have provided a cushion for layoffs in other manufacturing industries. During the twelve-month period ending in February 2004, the state gained almost 1,000 jobs. The state’s manufacturing sector lost about 9,900 jobs in that same period. Durable goods manufacturers lost 1,800 jobs, a much smaller decline than in the last couple of years. This is good news for state tax revenues since durable goods manufacturing includes many capital-intensive industries, with higher productivity rates and wage levels. The automotive industry added almost 900 jobs in the last twelve months, out of a total of 2,200 net new jobs for all transportation equipment manufacturers. While job gains are being recorded for some durable goods manufacturing industries, employment in a number of key manufacturing industries continues to shrink. In the twelve months prior to February 2004, the state’s steel industry lost almost 3,400 jobs; textile mills, textile products, and apparel lost 5,200 jobs; paper manufacturing lost another 300; and electronic components and products manufacturing, including computer and appliance manufacturers, lost 1,400 jobs.

Between February 2003 and February 2004, the services sector gained 10,200 jobs. The leisure and hospitality industry added 3,500 jobs, split between
eating and drinking places and accommodations and food services-related businesses. It should be noted, however, that these industries have relatively low wage rates. The retail sector, after losing a significant number of jobs since 2001, added almost 7,000 in the past year, primarily in the major metropolitan areas of the state.

Information and telecommunications industries continue to shed payrolls, with employment dropping 1,800 in the twelve months to February. Healthcare and social assistance services added 1,900 new jobs. Overall, employment has significantly improved compared to the prior two-year period and indicates that the Alabama economy is indeed showing signs of a sustained recovery. However, significant additions to payrolls are not expected until late 2004 or even 2005.

**Tax revenues.** After one of the worst fiscal years in decades, the first two quarters of the current fiscal year (FY2004) recorded a significant improvement. The state tax structure faces long-term structural problems, but revenues for the current fiscal year will easily surpass FY2003 as business spending and payrolls are improving and consumer spending remains strong. For the first two quarters of the current fiscal year, total tax receipts are up 6.4 percent over the same period of the previous fiscal year, from $3.2 billion to slightly over $3.4 billion. Individual income tax receipts are 5.2 percent higher, increasing from $1.16 billion to $1.22 billion. Corporate income tax revenues, at $137.3 million, are almost 40 percent higher than the previous period’s $98.5 million. An almost 8 percent rise has taken sales tax collections to about $838 million for the first two quarters of FY2004, up from $778 million a year ago.

For the first two quarters of FY2004, the Alabama Education Trust Fund received approximately $2.2 billion, an increase of about $133 million. However, appropriations made to the General Fund declined by almost 6.9 percent or $44 million to slightly more than $588 million.

**Outlook.** The state’s economy is expected to grow by 3.8 to 4.0 percent in 2004 with payroll employment rising by 0.6 to 0.7 percent, adding approximately 9,000 to 10,000 jobs. Most of these job gains will be in services and residential construction. The automotive-related sector of the economy, including the suppliers associated with major manufacturers is forecasted to add a significant number of jobs in both 2004 and 2005. Both services and retailing sectors of the economy are expected to grow by slightly more than 5 percent in 2004, while financial activity is forecasted to grow 3.2 percent or better. With the U.S. economy also showing considerable strength, it is only a matter of time before interest rates rise, perhaps by the second half of the year. Some slowdown is expected in both refi-nancing activity and new home sales as a result.

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