Economic Outlook: 3rd Quarter 2005

United States

Overview. The U.S. economy grew at an average annual rate of 3.8 percent in the first quarter of 2005, adding almost 500,000 new jobs. Strong consumer spending, record growth in the housing market, and an increase in investment spending by businesses on equipment and software fueled the increase. During the second quarter of 2005, the economy slowed, mainly due to sluggish growth in manufacturing as the sector worked off excessive inventories. Second quarter growth is now estimated to be around 3.3 percent. However, all current economic indicators point to relatively stronger gains in the second half of the year than were previously anticipated. Once the second quarter inventory correction is out of the way, growth in the third quarter should pick up to around 3.6 percent. For 2005 as a whole economic growth is forecasted to be around 3.6 percent. The expansion could lose steam in 2006 though as higher energy prices and rising interest rates take their toll.

For the first half of this year, real personal spending by consumers increased 3.4 percent, with spending on durable goods rising 7.3 percent. The Conference Board’s Consumer Confidence Index hit a three-year high of 105.8 in June, up from 103.1 in May. Consumer spending has been slowing in recent quarters, however, with spending growth slipping from 4.7 percent in the second half of 2004 to an average of 3.4 percent in the first half of 2005. For the second half of 2005, consumer spending is forecasted to increase by approximately 3 percent as high energy prices take a larger bite out of incomes, forcing consumers to curtail spending. And even though job growth has been relatively good, the economy is still not generating as many jobs as it should for this stage of the recovery.

Fixed nonresidential investment by firms increased 4.8 percent in the first half of 2005, with spending on equipment and software growing at an average annualized rate of 6.4 percent. At the same time, spending by businesses on information processing equipment increased by slightly over 15 percent. For the second half of 2005, spending by firms on equipment and software is forecasted to grow approximately 9 percent with expenditures for information processing equipment increasing by close to 14 percent. One of the strongest areas for growth has been computers and peripherals—expenditures increased almost 35 percent in the first half of 2005, and are expected to post a second half increase of at least 24 percent. Orders for communications-related equipment have been up by almost 10 percent over the last several years, for the strongest increases since the industry went bust in 2000.

Since the late 1990s housing prices in the United States and in many other
parts of the world have skyrocketed. Strength in the housing markets in 2005 suggests that we could see yet another year of record home sales. Despite the fact that the Federal Reserve has raised short-term interest rates by 225 basis points over the past 12 months, mortgage rates are only slightly higher than they were in 2003, when they were at their lowest level in almost 40 years. However, the rapid rise in home prices in some U.S. markets is making housing less affordable. To lower payments, more buyers are taking on interest only or adjustable rate mortgages that are highly susceptible to interest rate changes. Residential fixed investment increased by over 9 percent in the first half of 2005, and is expected to remain relatively strong at least through the remainder of this year. Still, any marked upturn in mortgage interest rates could have a severe dampening effect on home sales. It would also result in a sharp decline in refinancing, which has been supporting consumer spending. According to a study by Global Insight, a 10 percent decline in home prices will result in the loss of $1.8 trillion in household wealth nationwide.

The Federal Reserve is expected to continue to raise rates by 25 basis points at every meeting from now through November, pushing the federal funds rate to 4.0 percent by year-end. Long-term interest rates generally increase with an increase in short-term rates, but recently they have declined instead. The demand for U.S. treasury securities, particularly by Asian central banks, could be depressing long-term yields. Furthermore, a glut of global savings is exerting downward pressure on U.S. interest rates.

**Manufacturing.** From April 1998 to May 2005, manufacturing employment in the United States declined from 17.6 million to 14.3 million, a loss of 3.3 million jobs. Manufacturing employment is currently at its lowest level since the 1950s, despite the fact that output has been expanding since June 2003, after stagnating for almost three years. The last time manufacturing saw no growth for three consecutive years was during the Great Depression of the early 1930s. After a surge in 2004, the sector is again showing signs of weakness, primarily due to a high level of inventories related to automobile production. Although the Institute for Supply Management’s manufacturing index has remained above 50, indicating expansion, for nearly 24 months, it posted a steady decline during the first half of 2005. However, now that inventories are mostly worked off, the sector is beginning to show improvement, as evidenced by an increase in the index in July. Much of the growth in manufacturing has been concentrated in industrial equipment and other non-electrical machinery manufacturing. The transportation sector and electrical machinery manufacturing have also rebounded strongly.

According to the Census Bureau, U.S. manufacturers have increased spending on new plants at the fastest pace seen in several years. However, while spending on plant construction rose 24.3 percent, or $28.1 billion, during the 12-month period ending in May 2005, it was still below the $40 billion record set in the mid-1990s. Overseas investment by U.S. manufacturing firms increased 92 percent in 2004 to $54 billion, up from $28 billion in 2003. Despite the decline in the U.S. dollar in recent years, manufacturing exports have not increased significantly. The U.S. trade deficit has continued to balloon and could reach close to $700 billion this year. The fact that approximately 40 percent of the nation’s imports are from the overseas subsidiaries of American companies contributes substantially to the trade deficit.

**Employment Growth.** After creating approximately 2.1 million jobs in 2004, the U.S. economy has added 546,000 and 542,000 jobs, respectively, during the first two quarters of 2005 for a monthly average of 181,000 jobs. At the current pace, payroll employment is expected to increase by 2.2 million this year. Most of the new jobs added in 2005 will be in services-related industries, primarily in business and administrative services, healthcare and related services, and retailing. Among goods producing firms, only construction and mining are adding to their payrolls. In manufacturing, fast-paced productivity and output growth will keep payroll employment on the decline, at least in the near future. From the first quarter of 2004 to the first quarter of 2005, productivity in manufacturing industries increased by 5.5 percent and output grew by 4.7 percent, but only 29,000 new manufacturing jobs were added. In contrast, construction has added more than a million jobs in just two years alone. Given higher energy prices, payroll employment in the min-
The manufacturing sector is expected to increase significantly in 2005—at the current pace, these firms could add almost 45,000 new jobs this year.

**Alabama Employment.** Compared to the same time last year, payroll employment conditions in the state have improved significantly. During the 12-month period ending in May 2005, the state gained 30,300 net new jobs. The construction sector added 3,500 jobs; manufacturing 5,700; and the services producing sector, including government entities, contributed 20,500 new jobs. Durable goods manufacturing gained 5,600 workers while nondurable goods manufacturers netted only 100 new jobs, primarily in plastics and rubber products (1,400) and animal slaughtering and processing (400). Textile mills and apparel manufacturing lost a total of about 700 jobs. With the expiration of quotas on textiles and apparel at the beginning of 2005, there is a strong possibility that more jobs could be lost to either off-shoring or to competition from countries with relatively cheaper labor costs. According to the U.S. Department of Commerce, during the first quarter of 2005 textile exports to the United States increased by 60 percent over the first quarter of 2004. Transportation equipment, which includes motor vehicle production, remains one of the strongest manufacturing industries in the state. These firms, including both OEMs and their suppliers, added 4,300 new jobs during the 12-month period ending in May 2005.

In the services producing sector, professional and business services remained one of the strongest industries, adding 8,100 jobs during the 12-month period through May 2005, with almost 5,700 of these jobs in administrative support and related services. Healthcare and social assistance-related services contributed another 5,300 new jobs between May 2004 and May 2005, while government entities, including federal, state, and local governments, added another 1,400 jobs during the same period.

Of the total 30,300 new jobs added in the state during the 12-month period ending in May 2005, 26,400 were in Alabama’s metropolitan areas while the non-metro areas netted 3,900 jobs. The Mobile metro area created 5,500 new jobs and Huntsville and Tuscaloosa.
added 4,500 and 4,900 jobs, respectively. Job gains were distributed across the state with every metro area except Decatur (which was flat) adding jobs.

**Tax Revenues.** With the state’s economy showing significant improvement during the second half of 2004 and the first half of 2005, tax revenues continue to climb. During the first three quarters of the current fiscal year, tax receipts in Alabama rose approximately 11 percent, increasing by $586 million to total $5.8 billion. Sales tax revenues during the first three quarters amounted to $1.3 billion, an increase of 5.8 percent, or $74 million, over the first three quarters of the previous fiscal year. Both individual and corporate income tax revenues showed considerable improvement. During the first three quarters of the current fiscal year, corporate income tax revenues jumped almost 39 percent to $330 million, an increase of $93 million over the first three quarters of last fiscal year. During the same period, receipts from individual income taxes climbed from almost $2.1 billion to about $2.3 billion, an increase of approximately 11 percent, or $224 million, compared to the first three quarters of the last fiscal year.

During the first three quarters of the current fiscal year, appropriations to the state’s General Fund increased by almost $158 million, or about 20 percent, to $971 million.

**Outlook.** For 2005 as a whole, Alabama’s economy is expected to grow by close to 3.5 percent with employment increasing by 1.4 to 1.6 percent. Approximately 30,000 to 35,000 new jobs will be created during the year. The manufacturing sector in the state is forecasted to add jobs, primarily in automotive production-related firms. However, the bulk of the new jobs will be in service-related industries, particularly retailing, professional and business services (with a focus on administrative support), educational and health services (primarily health care and social assistance), and food services.