Economic Outlook: 
1st Quarter 2006

United States

Review of 2005. After expanding at an average annual rate of 3.7 percent for the first three quarters of 2005, the U.S. economy grew by only 1.1 percent in the fourth quarter, according to advance estimates. This was the slowest pace since the fourth quarter of 2002, when the economy grew by just 0.2 percent. For all of 2005, U.S. economic growth averaged 3.5 percent. The slowdown in the fourth quarter was primarily the result of declines in defense-related federal government spending and in business spending, as well as a significant cutback in consumer spending. Higher energy prices and rising interest rates both had an effect on consumer spending. Energy prices also pushed the inflation rate up to a five-year high of 3.4 percent. At the same time, inflation-adjusted average wages for production and nonmanagerial workers declined for the third consecutive year.

Consumer spending, which grew at an average annual rate of 3.7 percent through the third quarter of 2005, increased by only 1.1 percent in the fourth. This was its slowest pace since the second quarter of 2001, when the economy was actually in a recession. The fourth quarter weakness will bring growth in consumer spending, which accounts for about two-thirds of the U.S. economy, down to an average annual rate of 3.0 percent for 2005 as a whole. Spending on durable goods fell by 17.5 percent in the fourth quarter, following an increase of 9.3 percent in the third. This was the sharpest decline in purchases of durable goods, such as automobiles and major household appliances, since the first quarter of 1987. Spending on durable goods increased at an average annual rate of only 0.6 percent in 2005. Consumer spending on nondurable goods, including clothing and food, rose by 4.4 percent for all of 2005, while spending on services such as healthcare increased by 2.9 percent. Federal government expenditures declined by 7.0 percent in the fourth quarter, following a third quarter increase of 7.4 percent. Business spending on equipment and software grew 3.5 percent in the fourth quarter after experiencing an average annual increase of almost 10 percent for the first three quarters of 2005. For the year as a whole, business spending on equipment and software climbed more than 8 percent. With exports increasing by 7.0 percent and imports by 6.4 percent, the U.S. trade deficit reached $730 billion in 2005. It should be pointed out, however, that a significant portion of this deficit results from U.S. companies manufacturing products abroad and then importing them back into the country.

Despite a slowdown in the fourth quarter, the economy still managed to add 2.0 million new jobs, with unemployment averaging 5.1 percent, in 2005. Most of the gains were in service-related businesses, and in construction, retailing, and travel and tourism-related firms. The manufacturing sector continued to shed workers despite a 3.0 percent increase in industrial production. Manufacturing lost almost 45,000 jobs in 2005. Strong competition made it difficult for most manufacturers to pass higher energy and raw material costs through to their customers. Although manufacturing continued to experience job losses, professional and business services added over 500,000 jobs, while retailing created approximately 140,000 new jobs in 2005. Construction firms generated about 278,000 new jobs and state and local governments around the country added almost 185,000 workers to their payrolls.

Outlook for 2006. Given the current high rate of labor productivity, the U.S. economy is expected to expand by 3.4 percent in 2006, with first quarter growth averaging...
3.8 percent. In recent years, labor productivity has increased by close to 3.5 percent compared to its long-term average of around 2 percent. Hurricane-related reconstruction activity will help support economic growth in the first half of 2006. During the course of the year, as interest rates continue to rise gradually, the housing market will begin to lose steam. While this will have a negative effect on the overall level of economic activity, we do not expect a full-fledged recession. Another sign pointing to a pending slowdown in the economy was the inversion of the yield curve in late 2005, with short-term interest rates being slightly higher than long-term rates. The shape of the yield curve is a good predictor of the economy down the road, generally with about an 11 to 12-month lag. It should be pointed out that, although the yield curve is a fairly good predictor of the economy, it has also given some false signals over the course of recent history.

The housing market, which has been the main driver in the current economic expansion, will begin to cool in 2006, primarily due to rising interest rates and overextended price levels. Most housing indicators began slowing down in the fourth quarter of 2005 and are expected to continue to show some weakness. Housing prices for existing homes are still growing at a faster pace than prices for new homes, with homebuilders likely selling new homes at a discount, particularly in markets where home prices have soared in recent years. After growing by about 4.5 percent in 2005, residential construction is forecasted to increase 4.0 percent in 2006, and will probably slow to around a 2.8 to 3.0 percent rate by 2007. However, due to hurricane reconstruction, residential construction could grow by approximately 5 percent in the first two quarters of 2006.

As mortgage refinancing activity tapers off it will have an effect on consumer spending. Overall consumer spending is expected to increase by around 3 percent in 2006 and, after a very slow fourth quarter of 2005, first quarter 2006 expenditures could grow by 3.5 percent. Spending on home furnishings and appliances will slow considerably as home sales and construction decline. Auto sales are also expected to grow only modestly in 2006.

Business spending on equipment and software is forecasted to remain strong, offsetting some of the decline in economic activity resulting from slowing consumer expenditures. Investment spending for equipment and software is expected to increase by 9.5 percent in 2006, with growth for the first quarter estimated at close to 12 percent. Spending on industrial equipment will rise by 6.0 percent in 2006, with a first quarter increase of approximately 8 percent. Given relatively high energy prices, investment expenditures on mining and petroleum-related structures will climb by almost 30 percent in 2006, following an increase of 17.0 percent in 2005.

Energy prices will stay relatively high in 2006 as strong growth in the world economy continues to rapidly absorb existing supplies as well as any new supplies coming online. The price of West Texas Intermediate Crude is expected to hover around $60 per barrel. Higher energy prices, together with higher raw material prices, will keep the inflation rate around 2.5 to 3 percent for 2006. At present, energy prices remain the biggest risk to the forecast. A sharp spike in prices could have an adverse effect on the cost of doing business and further erode the consumer’s purchasing power.

**Alabama**

**Review of 2005.** During the 12-month period ending in December 2005, payroll employment in the state increased by 17,400. Most of the increase was in service-related businesses. Some of the largest gains were seen in administrative and support services, which added 4,100 new jobs. Relatively strong housing markets helped the construction sector gain approximately 800 jobs. Other sectors of the state’s economy that performed well included healthcare and social assistance, adding 2,300 new jobs from December 2004 to December 2005, and restaurants and drinking places, where payroll employment increased by 3,300. Businesses providing professional, scientific and technical services added 2,200 jobs to their payrolls in 2005. Some job gains were also seen in retailing. However, during the 12-month period ending in December, firms associated with the finance and insurance industries lost 1,100 jobs, while the telecommunications sector shed 100 jobs.

Alabama’s manufacturing sector had a relatively strong year. During the 12-month period ending in December, manufacturing
The upturn in economic growth over the last two years has had a significant impact on state tax receipts. During the first quarter of the current fiscal year, ending in December, state tax revenues totaled about $1.9 billion. This was an increase of 8.8 percent, or approximately $154 million, compared to the first quarter of the previous fiscal year. Over the same period, sales tax revenues increased by 13.4 percent to $494 million, almost $58 million higher than receipts from the same period of the previous fiscal year. First quarter corporate income tax receipts totaled $109 million, an increase of 5.7 percent, or $6 million, over the first quarter of the previous fiscal year. Individual income tax revenues of $654 million were up approximately 5 percent compared to the same quarter last year, for an increase of $31 million.

In the first quarter of the current fiscal year, ending in December, appropriations made to the Alabama Education Trust rose by over $46.9 million to total $1.2 billion, an increase of 4.0 percent. Appropriations made to the state’s General Fund amounted to $417 million, an increase of approximately $83.9 million, or over 25 percent, compared to the first quarter of the last fiscal year.

**Outlook for 2006.** In 2006 the state’s economy is expected to grow by slightly over 3 percent and add approximately 26,000 new jobs. Currently, higher interest rates and energy prices present the biggest risks to the forecast. Higher energy prices can place inflationary pressures on the economy, which in turn push interest rates higher and erode consumers’ disposable incomes. Furthermore, higher interest rates could adversely affect interest sensitive sectors of the economy.

Alabama’s manufacturing sector should grow by 5.1 percent, largely due to an almost 27 percent increase expected in the production or motor vehicles. Although the state’s economy is forecasted to slow slightly from 2005, some sectors of the economy, including retailing, construction, professional and business services, and health services...
Employment in professional and business services is expected to increase by slightly over 3 percent, with the addition of approximately 6,500 jobs. Most of these jobs will be in scientific and technical services and in administrative and support services. The educational and healthcare sectors of the economy will add about 3,400 new jobs to their payroll employment, primarily in healthcare and social assistance-related services. With higher energy prices, economic activity in Alabama’s natural resources and mining sector is also expected to improve.

If the state’s economy remains on its current trajectory, barring any unforeseeable exogenous shocks, Alabama’s tax revenues should rise by at least 8 percent in the current fiscal year. Sales tax receipts are expected to increase by over 5 percent.

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