The Economy [1/]

National Outlook Key Points:

- Higher than expected productivity gains and consumer spending growth result in improved outlook for the U.S. economy in CY 2000.
- Higher interest rates and a stabilization of the stock market are expected to temper economic growth in CY 2001.
- A recession is unlikely over the forecast horizon but cannot be ruled out.

The national outlook for CY 2000 is better today than forecast in January. WEFA, the international forecasting consulting group, now expects the real (i.e., inflation-adjusted) Gross Domestic Product (GDP) to grow by 5.2% in CY 2000 compared to 3.6% last January. This positive outlook is also shared by the 50 prominent U.S. economists who make up the forecast panel of the *Blue Chip Economic Indicators*. There are at least two reasons for this positive forecast revision. First, there is a growing consensus that the productivity gains stemming from the investment in new information technology have enabled the economy to grow at a faster rate without producing higher inflation. Faster productivity growth offsets wage increases by preventing unit labor costs from rising. This eliminates the necessity for businesses to pass on increased costs to their customers by setting higher prices on their goods and services. The following table displays some key national economic indicators.

Table 1: Key National Economic Indicators

% Change	CY 99	CY 00	CY 01
Real GDP	4.2	5.2	3.7
CPI	2.2	3.2	2.3

A higher "speed limit" for the economy is important as it affords the Federal Reserve Board the opportunity to take a more "hands-off" approach to monetary policy than otherwise would be required. Arguably, if it were not for the fact that productivity growth was at a 17-year high in the first two quarters of this year, the Fed would likely have opted for even more aggressive rate hikes than what we have witnessed so far. The fact that even Fed Chairman Greenspan now publicly acknowledges an emerging "New Economy" has also allowed economic prognosticators to upwardly adjust their forecasts as reflected in recent revisions.

The second reason for the positive forecast revision is that three separate interest rate hikes by the Fed this year have had a less dampening effect on the U.S. economy than anticipated. This is true even though the federal funds rate (the primary tool used by the Fed to conduct monetary policy) now is at its highest level in almost 10 years. Economic analysts have once again, in disbelief, marveled over the strength and resiliency of U.S. consumer demand, and have continually been forced to reassess their forecasts.

However, most economists now believe that the pace of the U.S. economy will slow somewhat in the second half of CY 2000 and then continue along the same trend in CY 2001. Subsequently, WEFA expects real GDP to grow by 3.7% in CY 2001, which is still four-tenths of a percent higher than the *Blue Chip Economic Indicators'* consensus forecast for the same period. The principal reason for the projected slowdown is that the Fed's half-percent interest rate hike on May 19, the largest one-time increase in five years, is expected to affect the economy more directly in the second half of CY 2000. It is a commonly held view among economists that the effects of monetary policy are not instantaneous, but instead occur over time. Another reason to expect a gradual slowing of the economy is that the stock market now appears to have stabilized somewhat, which suggests that the large capital gains that fueled consumer spending in the past are less likely to reappear in the next year or so.

Although the signs of a "soft-landing" economy are still tenuous at best, recently released key economic data point to a slower and more sustainable growth path in the near future. For example, the labor market, which is still tight by historical standards, is nonetheless showing some signs of easing. Both initial and continuing jobless claims are slowly increasing and the unemployment rate in August edged up for the first time in three months.

The housing market is maybe the clearest indication of a slightly decelerating U.S. economy. In July, housing starts fell for the third consecutive month and were 11.3% below last year's level. Reductions in construction spending and sales of existing homes serve as further indications of moderating growth. While retail sales are still demonstrating a healthy growth rate, consumption has clearly slowed from the first quarter's spending spree. This is also evidenced by a slight drop in consumer confidence and the fact that the composite index of leading indicators (a measure used to predict future economic activity) has decreased three months in a row.

Slower growth is expected, but no recession. Inflation is likely to remain low, but has probably bottomed out for the current business cycle. Most importantly, consumer spending is expected to moderate due to higher interest rates and slower job growth. While a recession is unlikely, the risk of shocks or unforeseen economic events can never be discounted. A sharp stock market correction is an example of an event that could trigger the onset of a recession. Future actions, or maybe lack thereof, by the Federal Reserve Board could likewise inadvertently create imbalances in the economy.

The growing trade deficit is also a cause of concern as it simultaneously increases the U.S. debt to foreigners. If

1/ *This section is excerpted from the October 4, 2000 Revenue Forecast Update prepared by the JLBC Staff.*

foreign investors decide to pull back their U.S. holdings due to revised growth prospects in Europe and Japan next year, the dollar could weaken considerably. A deterioration of the dollar's value makes imported goods and services more expensive, which often leads to higher inflation, a common indicator of a future recession. However, these risks are still considered small enough to not wreak havoc on what is presently the longest economic expansion in U.S. history, at least not until CY 2002 or beyond.

The outlook for Arizona's economy has also improved slightly since the forecast in January. Most noticeably, taxable retail sales are now expected to grow by 9.0% in CY 2000 and 7.0% in CY 2001. This should be compared with the JLBC Staff's January forecast of 7.3% and 6.0%, respectively. The CY 2000 forecast for employment growth has likewise been revised upward from 3.1% to 3.5%, and for CY 2001 it has been revised upward from 2.5% to 3.1%. This improved outlook for the labor market is also reflected in a reduction of the projected unemployment rate in CY 2000 from 4.4% to 4.2% statewide.

The *Arizona Blue Chip Forecast*, which is published by Bank One Economic Outlook Center at Arizona State University, has also adjusted its projections of key economic indicators to reflect a more positive outlook for the state economy for both CY 2000 and CY 2001. However, it is noteworthy that the forecast panel, which is comprised of 18 state economists from both the public and private sector, has generally adopted a less optimistic view than the JLBC Staff. The JLBC Staff's reassessment of the Arizona economy reflects the fact that recent revisions to both personal income and employment data reveal an even better picture of the economic landscape than previously believed. This is also obvious when we consider that Arizona was ranked number one in the nation in nonfarm employment growth in June this year, with a considerably higher growth rate than the U.S. average. The following table displays some key Arizona economic indicators.

Table 2: Key Arizona Economic Indicators

% Change	CY 99	CY 00	CY 01
Nominal Personal Income	7.1	6.7	6.2
Wage and Salary Employment	3.5	3.5	3.1

Furthermore, the U.S. Department of Commerce reported recently that Arizona's gross state product (a measure of total economic output) grew at an average annual rate of 7.5% between 1992 and 1998, faster than any other western state, and 3.6% above the national average for the same period. This impressive record is attributable to Arizona's rapid population growth over the past several years, as well as its strength in semiconductor and electronics manufacturing, and business services.

Arizona Outlook Key Points:

- The outlook for the state's economy in CY 2000 has improved due to faster growth in job creation and personal income.
- Arizona's employment growth is the fastest in the nation.
- The outlook for CY 2001 remains positive but expect slightly slower growth since the Arizona economy generally mirrors the national economy.

Although Arizona has generally outperformed the U.S. average over the course of the current economic expansion (the longest in U.S. history), it has still closely mirrored the national economy. Therefore, since the U.S. economy is expected to moderate somewhat, we believe that the state's economy will follow suit. However, Arizona is facing risks that are unique to this state as a number of citizen initiatives currently on the ballot present additional uncertainties to our forecast. Barring any adverse impact of such initiatives, which is a critical assumption, Arizona's economy should continue to grow, albeit at a slightly lower rate than in the recent past.