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THE ECONOMIC SIGNS ARE GETTING BETTER EVERY DAY

As a native Texan and, partly for that reason, a congenital optimist, it is always enjoyable for me to watch the purveyors of gloom and doom as they regularly discover their dire prognostications to be grossly incorrect as awkward facts come to light. One of the best characterizations of these people ever written was by William Safire, who retired at the end of 2004 from his position as an op-ed columnist for *The New York Times*. Earlier in his career, he was a speechwriter in the Nixon administration. He wrote a speech that was delivered by then Vice President Spiro T. Agnew in which these folks who always think the worst of all possible outcomes is just around the corner were called “nattering nabobs of negativism,” a description that remains apt in 2005.

The single best example is easy for you to test. Just think back to 2004, and remember how most analysts, commentators and media people referred to the United States and world economies. They gave us a nearly unrelenting diet of bad news and pessimistic forecasts.

“The world economy turned in its best economic performance in 29 years.”

Now look at the facts. The world economy turned in its best economic performance in 29 years. This was despite very low growth in Japan and in the countries that make up the Euro Zone (Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain). These laggards were more than offset by stellar performances by China and most

of the rest of the Asia-Pacific region outside of Japan, as well as Canada, Mexico, the United States and Argentina. Increases in world trade to record levels above \$10 trillion (about \$8 trillion of goods and \$2 trillion of services) contributed a great deal to this outstanding growth record in 2004. Trade will add a lot to global output in 2005, too.

Real gross domestic product (GDP)¹ grew by 4.4 percent in the United States in 2004 according to the Bureau of Economic Analysis (BEA) of the U.S. Department of Commerce. This was the strongest growth performance for the U.S. economy since 1999 and one of the three best growth years since 1984.

¹ The total value of all goods and services produced for final demand within the borders of the United States after adjusting for price changes.

PRODUCTIVITY GAINS HAVE BEEN AMAZING IN RECENT YEARS

Productivity growth is the single most important economic variable in any capitalist, free-market economy. This is because it is the only way to make the size of the economic pie larger.

Labor productivity is defined as output per worker or output per hour worked. On Feb. 3, the Bureau of Labor Statistics reported that labor productivity growth in the nonfarm business sector was 4.4 percent in both 2002 and 2003 and 4.1 percent in 2004. This is the best three-year growth in labor productivity since at least 1900. No one predicted productivity growth this high, but the benefits are enormous.

A primary benefit is unit labor costs. These fell 1.1 percent in 2002 and 0.4 percent in 2003 and rose by only 0.1 percent in 2004. This means that the costs of producing the GDP in the United States today are no higher than it was in 2000.

In the manufacturing sector, labor productivity gains have been even stronger. Productivity growth was 7.6 percent in 2002, 5 percent in 2003 and 4.9 percent

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Productivity Gains (continued)

in 2004. This means that for every \$100 of manufacturing output per worker in real terms in 2001, the average output was \$107.60 in 2002, \$112.98 in 2003 and \$118.52 in 2004. This is hugely beneficial to the global competitiveness of the United States.

It turns out that over the past decade, the United States has had both the highest absolute level of productivity in the world as well as the highest growth rate. This has already made us the world's largest exporter, and the lagged effects of the decline of the dollar in 2003 and 2004 should lead to a very large increase in exports in 2005.

Economic growth is the sum of three factors — growth in the civilian labor force, growth in hours worked and productivity increases. The civilian labor force — which is defined as all those people between the ages of 16 and 65, inclusive of those who want a job — is projected to grow at only 0.9 percent a year for the next decade. Hours worked, for reasons that no one has ever satisfactorily explained, have

consistently increased 0.1 percent a year on average since 1880. Combining these two factors would produce real GDP growth of only 1 percent a year. This would lead to great frustration and disappointment.

Labor productivity in the United States has grown in three quite distinct patterns since World War II. From 1948 to 1973, it averaged about 2.5 percent a year. Something dramatic changed in 1973 — labor productivity stopped growing. Economists used to think that the sharp increase in oil prices was the culprit, but subsequent oil price shocks, both upwards and downwards, have had no such impact. A more plausible explanation was the long learning curve of the baby boomers. These are the 77 million people born in the United States between 1946 and 1964 inclusive. They have changed every aspect of U.S. society since they were born and will probably do so until they die, as they are the major factor behind the looming financial debacles facing Medicare and, to a lesser extent, Social Security.

In any event, there was essentially no labor productivity growth from 1973 to 1991. As the economy came out of the

recession that lasted from July 1990 to March 1991, labor productivity began to increase. It was 4 percent in the nonfarm business sector in 1992 but only 0.4, 1.2 and 0.5 percent in 1993, 1994 and 1995, respectively. However, there must have been one amazing series of national New Year's Eve parties on Dec. 31, 1995, because, beginning in 1996, labor productivity in the nonfarm business sector came back to the range of the 1948-1973 period to average 2.5 percent a year through 2001.

As mentioned above, the 2002-2004 productivity performance was the best in at least 105 years. It could be the best ever for any three-year period. No one expects that we'll keep seeing numbers above 4 percent, but averaging 3.2 percent a year for the next few years is quite doable. That would produce economic growth of 4.2 percent a year, which is my forecast through 2008. The consensus forecast of the forecasting panel of the National Association for Business Economics released on Feb. 22 is for somewhat lower growth of 3.6 percent a year for this period. This would still be good news.

INDUSTRIAL PRODUCTION HAS FINALLY MADE A FULL RECOVERY AND IS SETTING NEW RECORDS

Every month, the board of governors of the Federal Reserve System releases new data on total industrial production (IP) in the United States. This index, compiled since 1918, covers output of the nation's factories, mines and utilities.

The Federal Reserve issued a major revision on Dec. 22, 2004. This contained revised data for industrial production, capacity and capacity utilization back to January 1972. The previous peak in industrial production was 116.4 (1997=100), which was the level in both May and June of 2000. The bottom, or trough, was 109.2 in both November and December of 2001. After rising to 111.8 in

June 2002, industrial production declined or was flat in 10 of the next 13 months, skidding to 109.5 in April 2003. From there, it rose more or less steadily to a new peak of 116.6 in October 2004.

On Feb. 16, the Federal Reserve released new data showing that industrial production began 2005 at a new record level of 117.7 in January. It is expected that each month this year will be a new record,

finally getting past the sluggishness of the July 2000-April 2003 period.

The pattern for manufacturing IP, which makes up 81.92 percent of the index, is similar. This index also peaked in May and June of 2000 at 118.5 (1997=100). It did not exceed this level until it reached 119 in October and again in November 2004. The January 2005 level was 120.1, up 5.3 percent from a year earlier.

EMPLOYMENT DATA ARE FINALLY QUITE FAVORABLE, TOO

The Bureau of Labor Statistics released big revisions to the national employment data for the last few years on Feb. 4, 2005. Perhaps the most politically significant part of these revisions and the simultaneous release of the January 2005 data for nonfarm payroll employment were to show that during his first term President Bush had barely missed being the first president since Herbert Hoover to see a decline in this closely watched statistic during his four years in office. The new data showed an increase of 119,000 such jobs over 48 months.

The total number of nonfarm payroll jobs was 132,573,000 in January 2005. This was up 2,746,000 jobs from the most recent low of May 2003 (this low was previously thought to have occurred in August) and 27,000 above the previous peak in February 2001 (which was previously thought to have happened in March).

This meant that it took 46 months for nonfarm payroll employment to recover from a recession. This is 24 months longer than the average for all previous postwar recessions.

The separate household survey, which is the basis for the calculation of the unemployment rate and the source for data on employment by age, race, sex and educational attainment, has shown much more robust growth since the previous 2001 peak. It shows 2,328,000 more people employed in January 2005 than in March 2001. However, its growth has been much slower over the year ended in January 2005. Total employment growth was 1,760,000, while nonfarm payroll growth was 2,201,000 jobs during that period.

The household survey still has a March 2001 peak of 137,913,000 people employed on a seasonally adjusted basis. There were 140,241,000 people employed in January 2005 on a seasonally adjusted basis.

The unemployment rate was 5.2 percent. For men 20 years of age and above, it was only 4 percent. For women 20 years of age and older, it was 3.9 percent. Teenagers of both sexes had an unemployment rate of 14 percent in January.

As is usually the case, the differences

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in labor force participation rates and unemployment rates were dramatic when sorted by educational attainment. There were 12,575,000 people age 25 and over in the civilian labor force in January 2005 who did not have a high school diploma or equivalent. That was a labor force participation rate of 44.7 percent. A total of 11,637,000 of them were employed, and 938,000 (7.5 percent) were unemployed.

Among high school graduates age 25 or more who never went to college, 62.2 percent (37,729,000) were in the labor force in January. Some 35,943,000 were employed, and 1,788,000 (4.7 percent) were unemployed.

Those high school graduates who attended some college or earned an associates degree age 25 and above in

the civilian labor force in January 2005 numbered 34,524,000, which represented a 70 percent participation rate. A full 33,117,000 of them were employed, and 1,407,000 of them (4.1 percent) were unemployed.

There were 40,907,000 college graduates age 25 and above in the civilian labor force in January on a seasonally adjusted basis for a labor force participation rate of 78.4 percent. A total of 39,925,000 of us were employed and 982,000 (2.4 percent) were unemployed.

The really good news here is that the undergraduate and graduate school classes of 2005 will find the best labor market in at least five years. This will not only bring smiles to their faces but also to the career counselors and college placement officials who've had some tough times finding positions for new graduates and alumni in recent years.

There has also been good news so far in 2005 on new claims for unemployment insurance. The report released on Feb. 24 showed that new claims for the week that ended Feb. 19 numbered 312,000. The more stable four-week moving average was 308,750. This was the lowest since August 2000. A number this low is consistent with very strong job growth going forward. That's extremely good news for the economy.

HOUSING REMAINS VERY STRONG

On Feb. 16, the Bureau of the Census reported that total housing starts in January 2005 were running at a seasonally adjusted annual rate of 2,159,000 units. This was up a huge 11.6 percent from a year earlier and was the highest number reported since February 1984.

Single-family housing starts in 2003 were 1,499,000 units, which finally broke the old record of 1,451,000 units set in 1977. As if to conclusively prove that discussions

of the idea that 1.5 million units might be capacity for the industry were foolish, a new record 1,610,700 single-family homes were started in 2004.

Sales of existing homes set a new record in 2004 for the fifth year in a row. Levels of housing activity today are far higher than people even dared to dream about a decade ago.

Rising incomes, growing employment, high levels of consumer confidence and

Housing Remains Very Strong (continued)

relatively low mortgage rates are all major factors driving this strong demand for housing. Also very important are demographic trends.

Home ownership hit a record 69 percent of households in the United States in 2004. While this is far below the 96 percent of Singapore, it is still one of the four of five highest levels in the world. No one knows how high the home ownership rate in the United States might go. Many housing experts think that 75 percent is a realistic ceiling given basic demographics and mobility trends.

Some analysts are concerned about the possibility of a housing “bubble” in the United States. This seems like a very far-fetched possibility to me.

If you are interested in the details of why this is unlikely, please go to www.nabe.com and read my article on the subject in the April issue of *Business Economics*. It's full of charts and information that should cause you to find something else to worry about in the future.

The basic argument is that demographic pressures and the outlook for long-term interest rates make it likely that demand for single-family homes will stay strong for many years to come. The peak home ownership rate in the United States in 2004 was among households age 70-74 at 83.4 percent and that was followed closely by the 83.2 percent rate among households age 65-69. The baby boomers start reaching age 65 in 2011.

Other demographic demand pressures come from immigrants. For reasons that no one has yet satisfactorily explained, immigrants tend to buy houses 10 years later than their U.S.-born countrymen with the same income and family size. Given the boom in immigration over the past 15 years, this source of housing demand will also remain strong for many years into the future.

WORRYING ABOUT INTEREST RATES IS SILLY

The Wall Street Journal has a panel of some 55 economic forecasters that it queries regularly on various aspects of the economic outlook. The newspaper puts the monthly results on its Web site, but the results of its two longer surveys are always published in the newspaper on the first business day of January and July.

On page A-2 of its Jan. 3, 2005, edition, the newspaper noted that “Fifty-four of 55 economists predicted bond yields would rise [in the June survey]. Instead, the yield fell and ended the year at 4.22 percent. ... James Smith, a University of North Carolina economist, was the only forecaster who predicted that bond yields would fall.”

It's always satisfying for me to beat all the high-powered Wall Street economists on any aspect of the economic outlook, but it's especially fun to do it on long-term interest rates. Any investor who put money into bonds based on my July 2004 forecast made money in the last half of the year.

In any case, it's not too difficult to predict long-term interest rates. In all major countries around the world, the benchmark interest rate, which is usually for 10-year government securities, is normally 300 basis points, or three full percentage points above the anticipated rate of inflation.

Central bankers all over the world understand that the major contribution they can make to maximizing long-term economic growth is to pursue price stability. Most of them define this as an inflation rate of 2 percent or less.

If investors expect long-term inflation in the United States to be 1 percent, then

10-year Treasuries should yield 4 percent. If they think 2 percent is more likely, then 10-year Treasuries should yield 5 percent. Thus, long-term Treasuries should typically yield 4 to 5 percent.

This suggests that the interest rate on 30-year fixed rate mortgages should remain well below 7 percent for the long run. It is estimated it would take a fixed rate above 8 percent to put a major dent in housing demand in the United States.

That is not a likely development. The main reason is because that would mean that the Federal Open Market Committee (FOMC), the part of the Federal

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Reserve System that sets monetary policy in the United States, would be far behind the curve. Of course, the current posture of the FOMC with regard to “measured

steps” to increase its target for short-term interest rates is likely to last for a while.

Some forecasters think that the FOMC will stop when it gets the Federal Funds rate² up to 3.5 percent, with each move being 25 basis points, or one-quarter of one percent. Others agree with the size of the increase, but that it will go to 4.5 percent. My forecast is 3.5 percent. That would imply a continued flattening of the yield curve, but it should be enough to restrain inflationary pressures in the 2006-2008 period.

Supposedly, in the same cemetery in Springfield, Ill., that contains the tomb of Abraham Lincoln is a monument to a leading local banker of the late 19th century. The epitaph is said to read as follows: “Death was Nature's way of telling him that interest rates weren't his biggest problem.” There are more important things to worry about, for sure. Good examples are how to expand world trade as well as Medicare and Social Security.

² The interest that banks and other depository institutions charge each other for overnight loans.

THE PRESIDENT'S BUDGET IS A GOOD START

As required by law, President Bush sent his budget to Congress on Feb. 7. It called for total spending by the federal government of \$2.56 trillion for the fiscal year that begins Oct. 1. This is a very small increase from the \$2.47 trillion of government spending anticipated for 2005.

There's an old saying in Washington that "The president proposes, and the Congress disposes." Nowhere is this truer than with regard to the budget.

Most government spending is on autopilot. There is no separate appropriation for such huge expenditure items as Medicare and Social Security. All of the wrangling in Congress is over the 13 appropriations bills that fund government agencies and departments as well as a big part of the District of Columbia budget. Congress has not finished this process before the start of the new fiscal year since the Truman administration. They're unlikely to do any better this year.

Bush has proposed significant increases for defense and homeland security while holding all other areas below the inflation rate. It would be better if he actually had a plan to cut a few hundred billion dollars out of government spending, which has grown 36 percent since he first took office, but this is a good start.

He may have to use his veto pen to enforce his stand. That would be a first for him, as he did not veto a single bill in his first term. The last president to do that was John Quincy Adams, interestingly enough.

SOCIAL SECURITY WILL PROBABLY BE REFORMED IN THE 109TH CONGRESS

In his Feb. 23 *Washington Post* column titled "Journalistic Malpractice," respected commentator Robert J. Samuelson wrote, "In 2004, these programs [Social Security, Medicare and Medicaid] cost \$965 billion, or 8.4 percent of GDP. The Congressional Budget Office (CBO) projects that by 2030 their costs will rise to 14 percent of GDP, or more than \$1.6 trillion in today's dollars. Avoiding a nearly \$700 billion annual increase in taxes or deficits would require comparable spending cuts in other government programs. It won't happen."

Samuelson goes on to explain that CBO estimates that personal savings accounts limited to \$1,000 a year would only reduce Social Security spending from 5.71 to 5.27 percent of GDP. Clearly, more has to be done.

George Will has famously said, "Demography is destiny for the welfare state." The basic problem with Social Security is that it is a Ponzi scheme. This is named after a notorious Italian immigrant, Carlo (Charles) Ponzi, who victimized millions of people, mostly in the Boston area, in 1920 by promising "investors" they could double their money in just 90 days. It was

a plan based on an unworkable investment in foreign postal coupons, and it only worked for a while by paying original investors with funds received from later ones.

Social Security has always worked this way. Ida Mae Fuller, the first recipient of a check, paid a total of \$24.75 into the system during her last three years of employment. Her first check was \$22.34, so in two months she had already received more than she paid in taxes. By the time she died in 1975 at age 100, she had received over \$22,000.

At the time Social Security was enacted, there were over 40 people paying taxes for each recipient. That fell to 16 people in 1950 and is down to three people today. It will be down to two people paying in for each recipient by 2030.

The solutions are obvious if painful. Congress has made promises it cannot keep, so it must change them.

The most important change needed is to raise the retirement age to 73 for people currently less than 55. This would simply match the expansion in expected life spans since Social Security began paying benefits on Jan. 31, 1949.

Another useful adjustment is to change the calculation of initial benefits to reflect past trends in prices rather than wages. This sounds trivial, but it will pay big dividends over time. It would also save a lot to reduce the annual cost-of-living adjustment. It is currently indexed to the consumer price index, which most economists believe overstates actual inflation.

Personal accounts that people actually get to "own" in some fashion would help sell the changes politically. Currently, you have no claim whatsoever to any of the money you've contributed to Social Security.

Raising the base for Social Security taxes (currently \$90,000 and indexed to inflation) wouldn't help much. This is because the amounts eventually due to these high earners would also rise a lot. Also, tax increases of any sort are anathema to the Republican leaders in Congress.

Rep. Sam Johnson, R-Texas, has introduced H.R. 530, the "Individual Social Security Investment Program Act," which would allow workers to invest their entire 6.2 percent of wages and salary that they currently pay as Social Security tax into personal accounts. They would not re-

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Social Security (continued)

ceive any Social Security payments when they retire but would receive immediately tradable "recognition bonds" based on the benefits they had already accrued. In addition, a new minimum benefit would be set at 100 percent of the poverty level to make sure no people of retirement age or above would fall into poverty.

The Social Security Administration has evaluated this proposed legislation and concluded it would transform the current \$3.7 trillion unfunded liability over the 75-year actuarial window into a \$1.8 trillion surplus at the end of the period. It is also estimated that once all the short-term debt associated with these changes has been paid off, the employer contribution to Social Security would drop from the current 6.2 percent to 3.04 percent to pay for disability and survivor's benefits.

No one knows whether this bill will become the main one for Social Security reform. Johnson is a member of the Ways and Means Committee and its Social Security subcommittee, which have jurisdiction over the issue.

In any event, reform is quite likely. It has to happen to avoid bankruptcy in a system important to all of us. It is far simpler to take action now than to wait until the system is actually out of money to pay all its obligations.

GENERAL MANGAEMENT

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Nov. 1 - 4

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Finance for Executives
NEW

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June 22 - 24

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Three-day program:

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THE TRADE DEFICIT SHOULD GET MUCH BETTER IN 2005

The lagged effects of the decline in the dollar in 2004 should show up in a significant increase in exports in 2005 and 2006. At the same time, the rise in the prices of goods and services from Europe and Japan should cause the growth in imports to slow dramatically.

This combination of factors should shrink the trade deficit a lot from the record-shattering \$607 billion of 2004 reported by BEA on Feb. 25. That was 5.2 percent of GDP.

A decline in oil prices should also help. It is always good to remember that high oil prices never last. We always find new sources and new ways to conserve our use of oil, so you shouldn't worry much about \$50-a-barrel oil being around for very long.

THE OUTLOOK IS STILL TERRIFIC

On Feb. 15, the Census Bureau released data showing that total retail and food services sales for January were \$347.7 billion on a seasonally adjusted basis, an increase of 7.2 percent from a year earlier. For the three-month period that ended in January, they were up 7.6 percent from a year before.

This confirms a phenomenally strong holiday shopping season by any measure.

Consumers had money and were feeling good, and they spent well over \$1 trillion during the period.

On Feb. 16, the Federal Reserve Board reported that total industrial production in January was up 3.9 percent from a year earlier. Manufacturing output was up 5.2 percent from January 2004.

Employment and industrial activity should both grow steadily through-

out 2005. Corporate profits and the stock market should rise as well.

All of these factors will result in the U.S. economy posting another strong performance in 2005. My forecast is that we should see 4.2 percent real GDP growth with stable, long-term interest rates; relatively low inflation; and rising employment, income levels, retail sales and industrial production.

It should be a wonderful year. Here's hoping it's a great one for you.