

# NC STATE ECONOMIST

COLLEGE OF AGRICULTURE & LIFE SCIENCES

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## 2017 ECONOMIC OUTLOOK: IS THE OPTIMISM REAL?

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### The National Economy: Are Happy Days Here Again?

What a difference a month made. In the four weeks after the 2016 elections, the stock market (measured by the Dow-Jones Industrial Average) soared 7%, close to the milestone 20,000 level. To put this number in context, at the bottom of the Great Recession the Dow-Jones average was 6600, having lost over half its value during that historic downturn.

The stock market has always been viewed as a barometer of the economy, rising when economic fundamentals suggest improvement and falling when challenges pull the economy down. So has the outlook for the economy suddenly and dramatically improved, and if so, why?

#### A Look at 2016

Before answering these questions, a review of the economy's track record in 2016 is presented. Table 1 shows several key indicators of the national economy's performance. Real GDP is the broadest measure of the economy, as it combines the output of all sectors of the economy—including goods and services—into one number. It improved in 2016 and actually accelerated in the second half of the year. Still, the growth rates in real GDP in both the years since the Great Recession (2009-2015) and in 2016 have been below the historical average (1960-2009).

Similar conclusions apply to the four labor market measures (labor force, payroll jobs, labor productivity, real wage rate). Each improved in 2016. However, with the exception of the real wage, all grew at rates below their long-run averages. Of particular concern is the continuing slow growth in labor productivity, which has a long-run correlation to improvements in the standard of living.

Economists debate the factors behind the sluggishness in worker productivity gains, with a focus on the contributions of demographics (younger, inexperienced workers replacing older experienced workers), shortcomings in worker training and skill development, and even the potential for distractions in the workplace from the use of social media and personal tech devices. The average real wage rate significantly improved in 2016 as a result of the tightening labor market, but there are questions about how far these gains can go without faster labor productivity improvements.

Business investment improved in 2016 but was still under its long-run average. Both the all-item and core inflation rates continued their recent trend in 2016 of being historically low, and the same result occurred for short-term and long-term interest rates. Analysts question whether these low rates are a result of plentiful supply or weak demand.

**Table 1. Performance of Key National Economic Measures**

Measure	Annual Average, 1960-2009	Annual Average, 2009-2015	2016	2017 Forecast
Growth rate of:				
Real GDP	1.6%	0.5%	1.3% <sup>2</sup>	1.4%
Labor force	1.8%	1.7%	1.6% <sup>2</sup>	1.7%
Payroll jobs	2.4%	0.8%	0.8% <sup>2</sup>	1.0%
Labor productivity	0.4% <sup>3</sup>	0.2%	0.5% <sup>2</sup>	0.5%
Real wages	3.1%	2.2%	1.6% <sup>1</sup>	2.5%
Business Investment (% of GDP)	17.6%	15.5%	16.3% <sup>4</sup>	17.0%
Inflation rates:				
All items	4.0%	1.7%	1.7% <sup>2</sup>	2.3%
Core inflation	4.0%	1.7%	2.1% <sup>2</sup>	2.2%
Interest rates:				
Short-term (3-month Treasury note)	5.4%	0.1%	0.3% <sup>5</sup>	0.8%
Long-term (10-year Treasury note)	6.9%	2.5%	1.8% <sup>5</sup>	3.1%

<sup>1</sup>2015III-2016III; <sup>2</sup>Nov. 2015-Nov. 2016; <sup>3</sup>1962-2009; <sup>4</sup>based on 2016 I, II, and III only; <sup>5</sup>through Nov. 2016

**Sources:** Federal Reserve Bank of St. Louis; U.S. Dept. of Commerce; author’s forecasts

*An Attitude Shift*

For most of 2016 there was continuing concern over a slowly improving economy that some feared was on the verge of stagnation. Then everything changed after the November election. As already noted, the stock market soared. The Federal Reserve raised their key short-term interest rate by 0.25 percentage points, and other short-term rates were poised to follow. Long-term interest rates, which are based on broader factors than just Federal Reserve policy, jumped almost a full percentage point. Even expectations for future inflation rose. Most analysts interpreted these moves as resulting from a new optimism about the future economy.

So what happened to warrant such optimism? The answer is that the stock market is looking forward and anticipating changes in national public policy under the new Trump Administration that will improve economic growth and business earnings. Specifically, the business

world expects substantial tax reductions, major investments in public infrastructure, an overhaul of key financial, energy, and environmental regulations, and a strong pro-business attitude from the new president that will significantly increase domestic production, sales, and incomes from the trend set since the end of the Great Recession.

This anticipated additional spending and economic activity is also expected to increase both public and private borrowing, which in turn led to the rise in interest rates at the end of 2016. Also, the increase in interest rates in the private market could cause some of the \$2 trillion in excess reserves banks have parked at the Federal Reserve to be withdrawn and invested in the economy. Higher interest rates will also motivate holders of money to spend that money faster. Both of these changes could lead to higher inflation rates, which the financial markets already anticipate.

It is important to note that the financial market changes in stock prices, interest rates, and expected inflation occurred at the end of 2016—before Donald Trump was inaugurated as President, and before any specific proposals were sent to Congress. Financial markets attempt to account for future changes and price those changes into current values.

Of course, expectations can be proven inaccurate, and there are still many questions about the content and impacts of the emerging Trump Administration agenda. While a tax reduction and infrastructure spending package are almost certain to be sent to Congress, the final forms of the Trump Administration plans are unknown. Nor do we know how Congress might change those plans. Tax plans are always contentious, with debates over rates, deductions and credits, and impacts for households of different income levels. The size of the infrastructure package, the designation of projects, and the speed of starting the projects will be debated both within the Trump Administration as well as between the Administration and the Congress.

There are also questions about the economic impact of the tax and spending proposals. Will President Trump's goal of 4% annual growth be achieved? In the 36 years since 1980, a 4% annual growth rate in GDP has occurred only nine times, and it has not happened at all since 2000. Some say the reason is not economic policy, but rather is demographics. Like most developed countries, the U.S. is aging. Historically, older societies have slower rates of economic growth.

President Trump has also vowed to reduce regulations by changing recent legislative acts in health care (the Affordable Care Act), the financial system (Dodd-Frank Financial Reregulation Act), and the environment (several recent Environment Protection Agency rulings). The speed—and costs—of making these changes are still unknown, as are their ultimate results.

Perhaps the biggest question mark for the Trump Administration will be its proposals on international trade. During the campaign, Mr. Trump forcefully talked about reducing the trade deficit by limiting imports and moving foreign production operations to the U.S. He said he would renegotiate trade treaties, sue countries that are alleged to be violating provisions of the treaties, and possibly even impose tariffs (taxes on imports) on some products as high as 35%.

In the short-run, substituting increased domestic production for imports could contribute to faster economic growth in the U.S. The question is whether the tactics used to do this (law suits, tariffs) would invite retaliation by other countries to do the same and thereby reduce their purchases of products made in the U.S. Exports from the U.S. to foreign countries currently total \$2.4 trillion annually, or 13% of the country's total economic production. Any significant reduction in U.S. exports would work against increasing the rate of economic growth. Indeed, U.S. exports are already facing the headwind of a rising international value of the dollar that has occurred with the growing expectation of faster U.S. economic growth. A stronger valued dollar makes U.S. exports more expensive to foreign buyers and imports to the U.S. cheaper.

#### *National Forecasts for 2017*

The right column of Table 1 gives 2017 forecasts for the nation on the key economic measures. Most of the growth measures show improvement over 2016, suggesting an economic bump from the likely combination of tax cuts and increased federal spending. However, "costs" of this program will be higher interest rates, higher inflation, and an increase in federal borrowing. These costs could be reduced or avoided if the economy grew sufficiently faster, or if federal spending was rearranged so as to not require additional borrowing.

**Table 2. Performance of Key North Carolina Economic Measures**

Measure	Annual average, 1987-2009	Annual average, 2009-2015	2016	Forecast 2017
Real GDP growth rate	3.3%	1.2%	2.3% <sup>1</sup>	2.6%
Labor force growth rate	1.5%	0.7%	2.2% <sup>2</sup>	1.8%
Payroll jobs growth rate	1.5%	1.8%	2.0% <sup>2</sup>	2.3%
Real wage growth rate	Not available	-0.2%	2.4% <sup>2</sup>	1.5%

<sup>1</sup> 2015 II – 2016 II; <sup>2</sup> November 2015-November 2016

**Sources:** U.S Dept. of Commerce, author’s forecasts

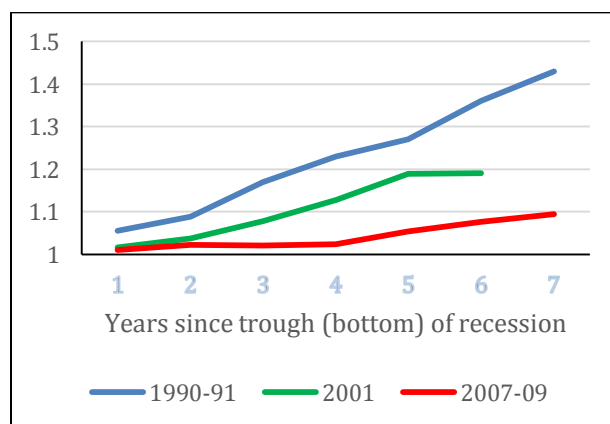
**The North Carolina Economy: Uneven Growth Continues**

Table 2 shows that North Carolina enjoyed a positive year in 2016 for four top economic measures. There were gains in real GDP, the labor force and payroll jobs, and each of these gains exceeded their counterparts at the national level.

Although the state did perform better than the nation in 2016, there is concern over recent trends. Figure 1 shows North Carolina’s rebound from recessions has become progressively less robust during the last three business cycles. For example, 2016 is the seventh year of recovery from the Great Recession, and the state’s real GDP in 2016 was 8% higher than at the beginning of the recovery. But the comparable “post-trough” gain in the the 1990-91 recession was 36%, and following the 2001 recession it was 19%. (The comparison to the 2001 recession is for the sixth year, the last year of that’s cycle’s recovery).

Furthermore, Figure 2 shows that the state’s recovery compared to the national recovery has narrowed over the last three recessions; indeed, it has been slower than the national recovery in the current recession. One possible explanation for North Carolina’s reduced performance compared to the national economy

**Figure 1. North Carolina Real GDP Relative to Recession’s Trough Value (trough=100)<sup>a</sup>**

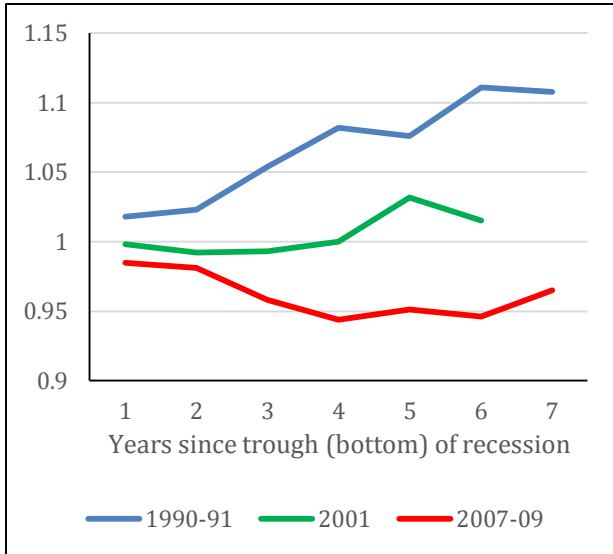


<sup>a</sup> Recovery from the 2001 recession lasted six years

**Source:** U.S. Dept. of Commerce

may be that it reflects a relative slowing of the state’s population growth rate, especially in the 21st century. During the 1991-97 economic recovery, the state’s population grew 67% faster than the rest of the nation; but North Carolina’s population growth has lagged the nation’s by 11% during the 2001-07 recovery and by 55% in the 2009-16 recovery. Adjustment to post-2000 globalization is likely another important reason, with downsizing in the state’s nondurable manufacturing continuing to take place in the state.

**Figure 2. North Carolina’s Real GDP to Trough Value Relative to US Real GDP to Trough Value**

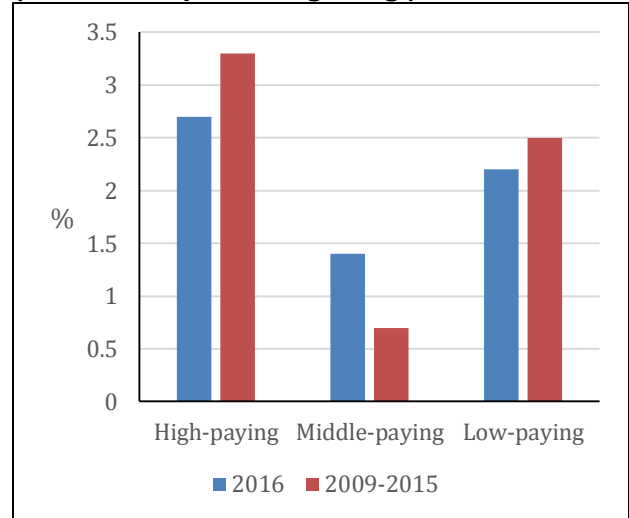


**Source:** U.S. Dept. of Commerce

Recent North Carolina economic growth has been characterized by two types of “unevenness.” One is between different types of workers, where those with more education and pay have done much better in the 21st century economy than those without these characteristics. The recent labor market has been characterized by a “hollowing out,” with slowest gains in middle-paying jobs.

The second unevenness is between geographic regions of the state. The state’s metropolitan counties, especially those around Charlotte and Raleigh, have raced ahead in the 21st century, capitalizing on their college-educated workforce and new-age industries in technology, medicine, finance, and professional services. For many of the state’s small-town and rural counties, achieving and sustaining economic growth remains a challenge.

**Figure 3. North Carolina Payroll Job Growth in High, Middle, and Low-Paying Sectors (annualized percentage chg.)<sup>a</sup>**

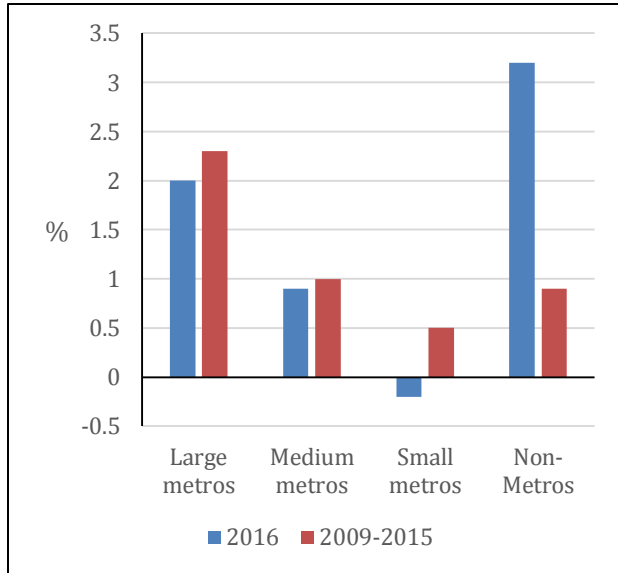


<sup>a</sup> High-paying sectors include financial services, information, and professional/business services. Middle-paying sectors include manufacturing, government, construction, and education/health care. Low-paying sectors include trade/transportation, leisure/hospitality, and other services.

**Source:** U.S. Dept. of Commerce

These two types of unevenness generally did not abate in the state in 2016. Figure 3 shows the continuing trends of faster job growth in the higher and lower paying employment sectors, with the slowest growth in middle paying sectors. There was one exception, however, in that some job growth shifted from lower-paying to middle-paying sectors. Figure 4 illustrates more rapid job growth in large and medium-sized metro areas especially compared to small metro areas. Very strong job growth was observed in non-metro (rural) areas in 2016—even greater than the job growth among large metro areas. This may mean that urban employers are hiring more workers residing in

**Figure 4. NC Payroll Job Growth in Large, Medium, and Small Metro Areas and in Non-Metro Areas (annualized percentage chg.)<sup>a</sup>**



<sup>a</sup> Large metros include Charlotte, Durham-Chapel Hill, Greensboro, Raleigh, and Winston-Salem. Medium metros include Asheville, Burlington, Fayetteville, Greenville, Hickory, and Wilmington. Small metros include Goldsboro, Jacksonville, New Bern, and Rocky Mount. Non-metros are counties not included in other categories.

**Source:** U.S. Dept. of Commerce

rural counties, as unemployment rates have fallen to low levels among workers residing in large metropolitan regions.

As indicated in Table 2, the North Carolina economy is likely to expand in 2017, and—like the nation—at a slightly faster clip than in 2016. One reason is faster population growth in the state compared to the nation. U.S. Census forecasts suggest North Carolina’s population will increase 30% faster than the nation’s population in 2017.

Of course, all the economic policies of the Trump Administration will have impacts on North Carolina, but two stand out. One is a

possible increase in military spending. North Carolina is the home to the largest military base in the world, at Ft. Bragg, as well as several other major installations. If greater military spending results in significantly more military personnel, then North Carolina—and especially the Fayetteville area—could see a big boost in economic activity. However, if the added military spending is mainly allocated to equipment, then the economic impact in the state will be modest.

The other policy area relates to energy exploration. The Trump Administration is expected to push for an easing of regulations on accessing energy deposits in the nation, both on-shore and off-shore. It is estimated the largest quantity of undersea oil deposits on the eastern seaboard are off the coast of North Carolina. These areas are not included in the ban on energy exploration in large parts of the Atlantic coast that were announced by President Obama in late December 2016. If these deposits were to be accessed and put into production, I have calculated that the annual economic activity could generate \$1.9 billion of income and 17,000 new permanent jobs (Walden 2013). Balanced against these potential benefits would have to be a consideration of potential costs to the environment and existing coastal industries (mainly tourism and fishing).

Like other states, North Carolina will be affected by the expected debate about new international trade policies in 2017. In 2015, 16% of the North Carolina economy was directly related to international trade (\$81 billion of export and import activity combined from a total economy of \$495 billion). If a “trade war” occurs that significantly reduces the state’s exports, then the state’s leading export sectors—including advanced manufacturing, agriculture, auto parts, and technology—could be adversely affected.

**Table 3. Regional Unemployment Rate Forecasts, % (not seasonally-adjusted)**

Region	October 2016 (Actual)	December 2017 (Forecast)
Asheville	3.8	3.4
Burlington	4.5	4.2
Charlotte	4.5	4.1
Durham	4.2	3.8
Fayetteville	6.2	5.9
Goldsboro	6.5	6.2
Greensboro-High Point	4.8	4.4
Greenville	5.6	5.2
Hickory	4.7	5.4
Jacksonville	5.2	5.0
New Bern	5.3	5.0
Raleigh	4.1	3.7
Rocky Mount	7.2	6.9
Wilmington	4.5	4.0
Winston-Salem	4.5	4.2
Rural areas	3.8	3.4
North Carolina: - No seasonal adjustment	4.8	4.5
- Seasonally adjusted	5.0	4.6

**Sources:** U.S. Dept. of Commerce, author's forecasts

Finally, large and medium-sized metro areas once again will have the lowest unemployment rates at the end of 2017 (Table 3). However, with the labor market expected to further tighten in 2017—and with an economic stimulus likely from the federal level—all regions should see improvement in the labor market, and the state should see 100,000 net new jobs generated.

**REFERENCE**

Michael L. Walden, 2013. *The Economic Potential from Developing North Carolina's On-Shore and Off-shore Energy Resources*, Dept. of Agricultural and Resource Economics, North Carolina State University.