NC STATE UNIVERSITY

January / February 2015

NC STATE ECONOMIST

COLLEGE OF AGRICULTURE & LIFE SCIENCES

2015 ECONOMIC OUTLOOK: NEW GROWTH BUT OLD ISSUES

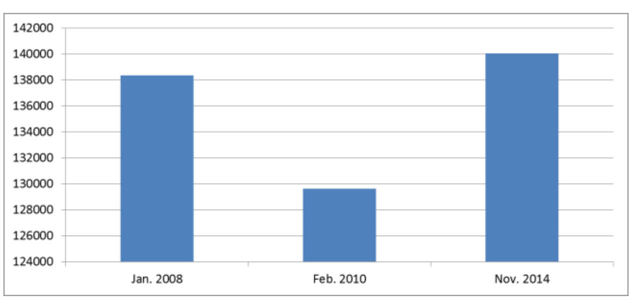
M.L. Walden, William Neal Reynolds Distinguished Professor and Extension Economist, North Carolina State University

The National Economy: New Highs Reached

The national economy celebrated a milestone in 2014. Employment (on payrolls) finally reached pre-recessionary levels (Figure 1). Yet, because the economy is bigger and more people are in the labor force, the various national unemployment rates (differing by the definition of unemployment) continued to be above pre-recessionary levels (Figure 2). Still, finally eliminating the job losses of the Great Recession was an achievement.

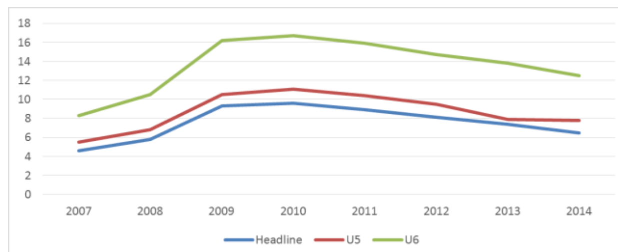
A major reason for the labor market improvements in 2014 was the acceleration in the growth of aggregate production (real GDP) during the year. It could be said that the economy finally began to "hit its stride." After straining to reach a 2% growth rate in the recovery, the annualized real GDP growth rate hit 3.5% or above in four of the five quarters between Fall 2013 and Fall 2014 (Figure 3).

Figure 1. U.S. Payroll Employment (millions)



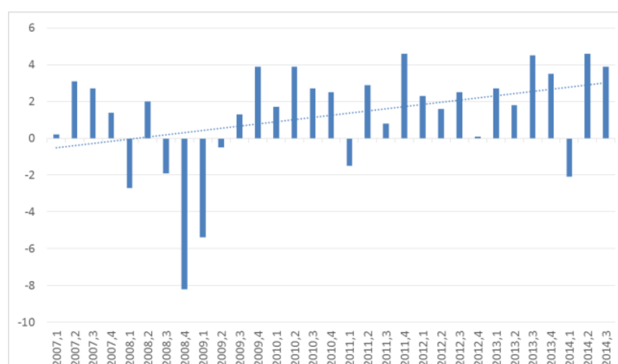
Source: U.S. Department of Commerce

Figure 2. National Unemployment Rates



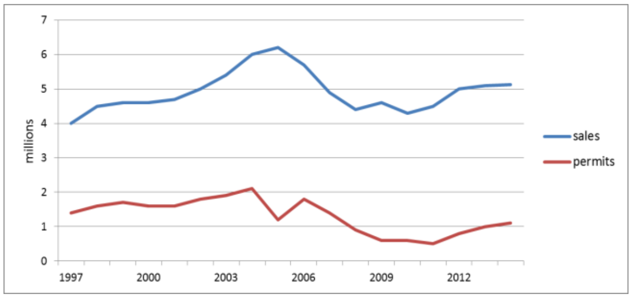
Source: U.S. Dept. of Commerce. The "headline" rate excludes as unemployed individuals who have not looked for a job in the last month. U5 includes such individuals as unemployed, and U6 further adds part-time workers who cannot find full-time work as being unemployed.

Figure 3. Real GDP Annualized Growth Rates



Source: U.S. Department of Commerce. Linear trend shown as dotted line.

Figure 4. Single Family Dwelling Unit Existing Sales and Residential Building Permits



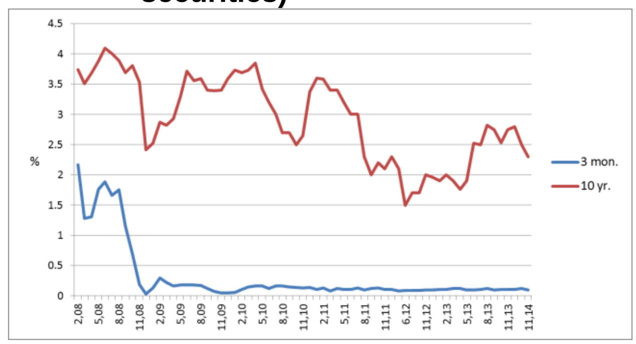
Sources: National Association of Realtors and U.S. Census. 2014 data are annualized through October.

The housing market has been closely watched by economists, since it was the sector that imploded during the Great Recession. The modest recovery in the housing market continued in 2014, with both sales and new construction rising for the third straight year (Figure 4). Housing prices also moved higher. It is important to note that the housing market is not back to pre-recessionary levels, and we probably don't want it to be. Looking back, we can now say the housing boom of 1997-2006 was an unsustainable "speculative bubble" which, once burst, led directly to the Great Recession.

To the surprise of many, inflation continued to be a non-issue in 2014, averaging near 2% by both government and private estimates. The "surprise" is based on the fact that the Federal Reserve has pumped large amounts of liquidity into the economy during the last five years. Theory and practice suggest this activity often leads to a faster rise in prices. However, a feature of the Great Recession and the slow recovery has been a lack of both business and consumer confidence in securing loans. Tighter governmental lending standards have also squeezed lending activity. As a result, much of the liquidity (cash) provided by the Federal Reserve has literally remained in the vaults of banks.

Interest rates—especially long-term rates—confounded many experts and fell during much of 2014 (Figure 5). Typically, when economic growth strengthens and economic confidence about the future returns, interest rates rise.

Figure 5. Interest Rate Trends (Treasury securities)



Source: Federal Reserve System

There are two reasons why this didn't happen in 2014. First, interest rates often rise during an economic recovery because the inflation rate rises. Higher expected inflation rates require lenders to receive more from future repayments. But with inflation remaining modest, this factor was not at play. Second, concerns over unexpected international "flare-ups"—particularly in Ukraine and in Syria and Iraq—motivated international investors to "flee to safety" by purchasing U.S. Treasury securities. Increased purchases of these securities raises their value and lowers their interest rates.

National Outlook

It's important to remember how extraordinary—in a negative way—the Great Recession really was. Yes, the stock market fell and unemployment rose, but these conditions always happen in a recession. What really set the Great Recession apart from others was the carnage created by the housing downturn. Homeownership has always been considered a stalwart of the economy. It was a safe investment that allowed owners to accumulate equity over time and move up the economic ladder.

The housing crash crushed this image of homeownership, and sent both consumer and business confidence about the economy into a tailspin. For many, everything they believed about the prospects for an improving standard of living—and the ability of the economy to deliver that standard of living—was dashed. It's taken a long time for us to regain our belief in the economy, and so it shouldn't really be surprising that economic growth has been tepid in recent years.

But with economic growth rates moving into the 3% to 4% range in 2014, a turning point may have been reached that will push the economy into a sustained higher gear of economic growth in 2015. Along with real GDP growth of between 3% and 3.25% during the new year, at least another 3 million payroll jobs will be added. This will be enough to lower the national (headline) unemployment rate to between 5% and 5.5% by the end of 2015. Importantly, with the tighter job market, wage and salary gains should outstrip inflation, thereby giving worker and households "real" (inflation-adjusted) income increases.

More jobs and higher incomes will give a boost to consumer spending, where higher growth rates should track the improved condition of GDP. Higher incomes will stimulate greater demand in the housing market, even after accounting for the fact that interest will likely drift upward in 2015. Despite the improved homeownership market of the past two years, the share of households choosing to rent has risen. However, the rental market should peak in 2015, with the pendulum swinging back toward greater home-buying. Developers will shift to building more single-family units than multi-family units during the year. Sales of "big-ticket" purchases, including vehicles, appliances, technology equipment, and furniture, will enjoy their best year since the end of the recession. Gas prices, which plunged in the second half of 2014, will likely rebound somewhat in 2015 but still remain under $3 per gallon for the year. There are some clouds on the international horizon that could take this positive assessment of the U.S. economy down a notch or two. Europe's economy is struggling to stay out of a new recession and its economic condition isn't helped by the on-going tensions with Russia over Ukraine. In Asia, Japan has been unable to jump-start its stagnant economy, and China's economic growth rate has been cut in half. There's also a concern about the potential for a real estate bubble implosion in China. If these situations in Europe and Asia worsen, they could produce a significant headwind against which the U.S. economy may have trouble penetrating.

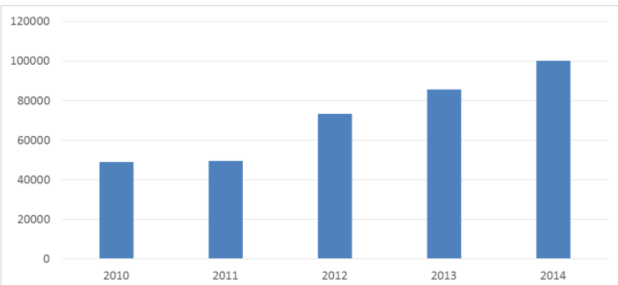
Perhaps the biggest domestic issue is the quality and sustainability of job growth. Job growth in recent years has been strongest for both higher-paying and lower-paying jobs, with the weakest growth for middle-paying positions. This has contributed to rising income inequality and to missing rungs on the income ladder. A major contributor to this situation has been technological advances allowing for the replacement of workers by machines and technology. This has particularly impacted manufacturing, where output is at a record high but fewer and fewer workers are needed on the factory floor.

Futurists say technological unemployment (the replacement of workers by machines and technology) will increasingly spread to the service sector: tablets will replace waiters and waitresses, robots will stock store shelves, and remote instructors will teach college classes online. This will make rapid re-skilling of displaced workers crucial for keeping the jobless rate low and productivity high.

North Carolina: A Good 2014 Followed by a Better 2015

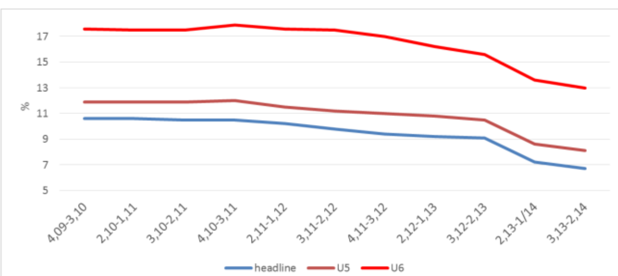
Like the nation, North Carolina's economy also accelerated in 2014. A year ago I predicted the state could add near 100,000 payroll jobs during the year, and it appears the actual gain will be close to that pace. Payroll job growth has steadily increased since the labor market began improving in 2010 (Figure 6). As job growth has increased in the state, the various measures of the unemployment rate have fallen (Figure 7). All measures were well under their peak set during the 2009-2010 recessionary period.

Figure 6. North Carolina Annual Payroll Job Gains



Source: U.S. Department of Commerce

Figure 7. North Carolina Unemployment Rates



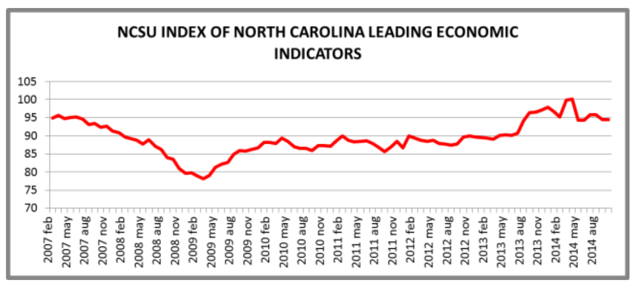
Source: U.S. Department of Commerce

A continuing issue in North Carolina is the geographical distribution of economic growth. Growth has been strongest in the state's large metropolitan areas and the corridors between those areas, and weakest in small towns and rural communities. Although this has been a long-term trend in North Carolina, it appears to have become stronger in the last decade. Forecasts from the State Demographer suggest as many as one-third of the state's counties my lose population in coming decades—with all of these counties being in rural areas. In contrast, some of the core metropolitan counties (Wake, Meck-lenburg) may double in population by the middle of the century. Economic opportunities for rural counties include tourism, attraction of retirees, agribusiness, and large-scale manufacturing.

North Carolina Outlook

The "NCSU Index of North Carolina Leading Economic Indicators" is a composite of five measures designed to indicate the path of the state economy four to six months ahead. It is pointing to continued faster growth in the state economy in 2015 (Figure 8). The Index has been at or above its pre-recession level for over a year. Payroll job growth in the state could top 125,000 during the year.

Figure 8. NCSU Index of North Carolina Leading Economic Indicators



Source: Author's calculations

Of course, most of North Carolina's growth will be dictated by national trends. With regard to attracting industry, the state continues to look favorable in terms of labor productivity, business costs, quality-of-life, and higher-education costs. The state is attempting to lure a new auto assembly plant that is looking for a site in North America. Bringing such a factory to a rural locality—as is likely— would be a major plus for the local economy. An announcement could be possible in 2015. State policy-makers will also be considering an updated transportation plan to improve and expand North Carolina's vital road system. The widened Panama Canal is also expected to be completed in 2015, bringing with it the likelihood of additional cargo shipments to east coast ports. This development could renew debates in the state about the building of a new deep-water port to service both imports as well as exports.

Table 1 shows the most recent unemployment rates for the state's metropolitan regions and forecasts of those rates at the end of 2015. The rates are comparable to the "headline rate" at the national and state levels, in that they only count as unemployed those individuals who are without a job and have actively looked for work in the last month. The October 2014 unemployment rates reflect the urban-rural divide in North Carolina. The rates are generally lower in the larger metropolitan areas and higher in the smaller, more rural areas. The spread in October 2014 is from a low of 4.1% in Asheville to a high of 8.1% in Rocky Mount.

All area unemployment rates are expected to decline in 2015, with some dropping below 4%. Still, the urban-rural divide is expected to continue, with the highest jobless rates being in "downeast" regions.

Table 1. End-of-Year Unemployment Rate Forecasts, % (not seasonally-adjusted)

Region	October 2014 (actual)	December 2015 (forecasted)
Asheville	4.1	3.5
Durham-Chapel Hill	4.5	3.9
Raleigh-Cary	4.5	3.7
Winston-Salem	5.1	4.6
Burlington	5.5	4.9
Wilmington	5.5	4.9
Charlotte	5.6	4.6
Greenville	5.6	4.9
Greensboro-High Point	5.7	4.8
Jacksonville	5.9	5.1
Hickory	5.9	5.3
Goldsboro	6.0	5.3
Fayetteville	6.5	6.1
Rocky Mount	8.1	7.6

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