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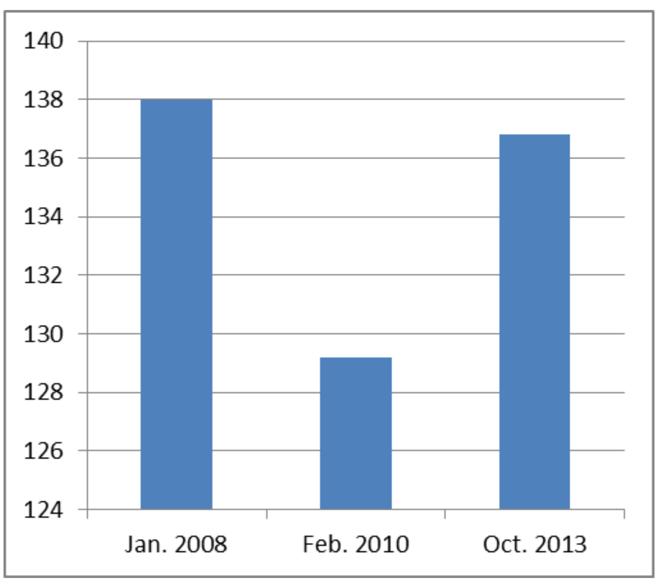
2014 ECONOMIC OUTLOOK: *SHIFTING TO THE NEXT GEAR?*

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

The National Economy: Growth Accelerates

It is always good to end the year on a high note, and this appeared to be the case for the national economy in 2013. Third quarter annualized growth in aggregate output (Gross Domestic Product) hit almost 3%, factory production surged, and the unemployment rate fell to 7%. As a result, payroll jobs ended the year just shy of pre-recessionary levels (Figure 1).

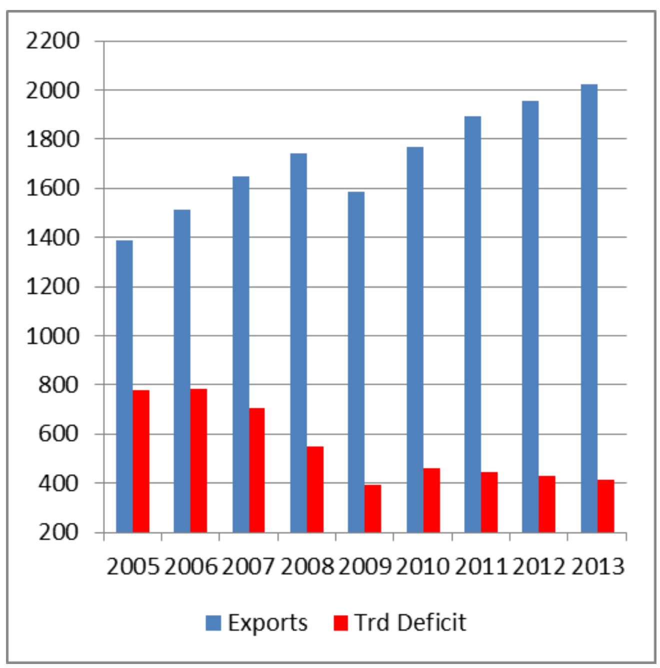
Figure 1. U.S. Payroll Employment (millions)



Source: U.S. Department of Commerce

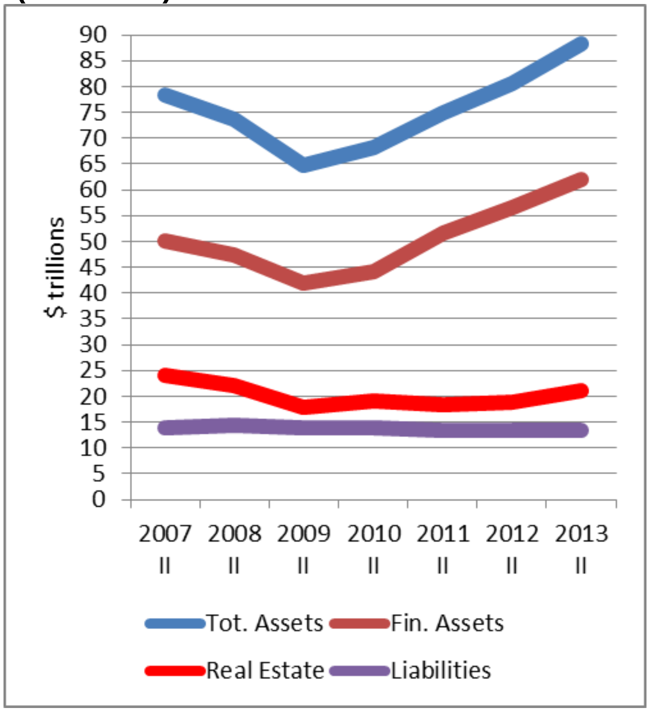
Gains were also made in other key sectors during the year. Export sales to foreign countries grew and—combined with growth in domestic energy supplies and reductions in energy imports—the trade deficit shrunk to almost a third of its value in 2005 (Figure 2).

Figure 2. U.S. Exports and Trade Deficit (2009 $ billions)



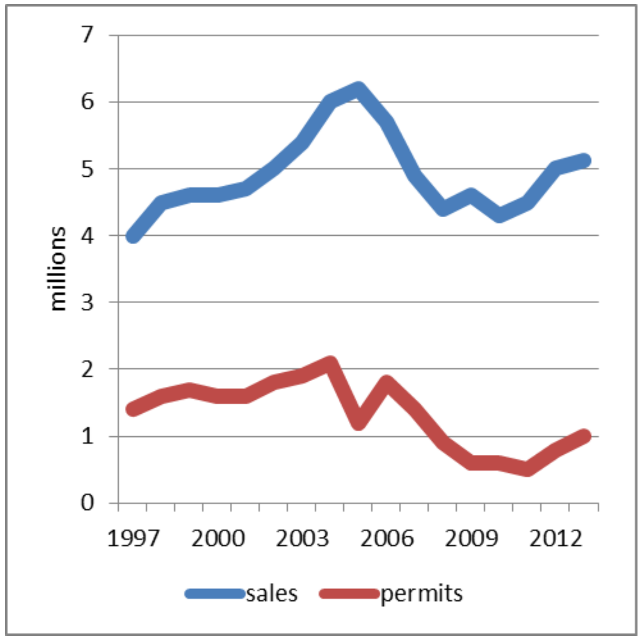
Source: Federal Reserve System; 2012 value is for September.

Figure 3. Household Assets and Liabilities (nominal $)



Source: Federal Reserve System.

Figure 4. Single Family Dwelling Unit Sales and Permits



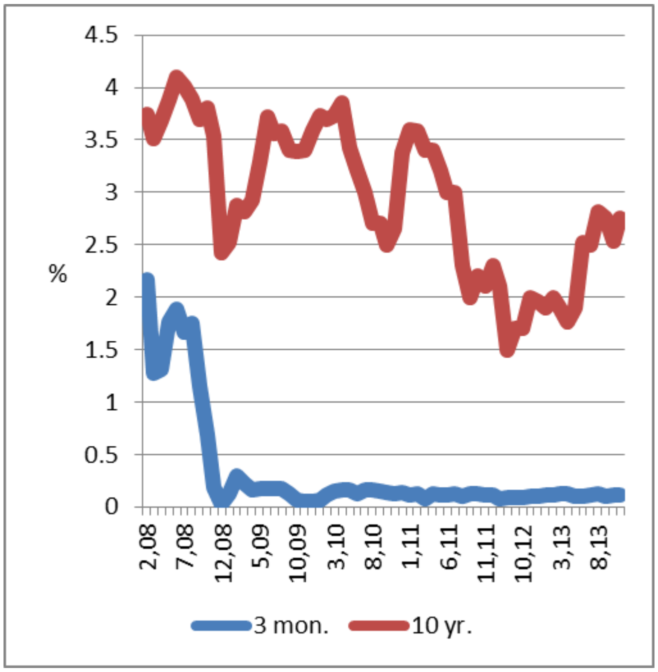
Source: National Association of Realtors and U.S. Census . 2013 data are annualized through August.

Household balance sheets recovered from their recessionary lows with strong gains in assets and continued moderation in liabilities (Figure 3). But perhaps the most important element to the economy's growth in 2013 was the sustained rebound in the housing market. For the second consecutive year, housing prices gained and sparked three positive trends. First, buyers returned to the market and regenerated real estate sales (Figure 4). Second, increased sales prompted a revival in construction and construction-related jobs. Lastly, increased prices bolstered owners' home equity and significantly reduced the number of "underwater" homeowners (owners whose mortgage balance exceed their home value) and delinquent homeowners. These developments increased household confidence and created a positive "wealth effect" on spending—meaning household spending increased as household wealth improved.

Inflation remained at bay in 2013 at just below a 2% annual rate; but the direction of interest rates took a dramatic change during the year. While short-term interest rates remained at near zero level—compliments of Federal Reserve monetary policies - long-term interest rose a full percentage point (Figure 5). Most economists viewed this as a positive—not a negative—sign, suggesting a rise in loan demand and increased optimism about the economic future. Forecasts of long-run inflation rates still remain tame, so the jump in long-term interest rates does not reflect a higher inflation premium. Still, interest rate levels remain historically low and conducive to borrowing.

National fiscal policy "tightened" in 2013, a result of strong gains in federal revenues and the constraint on federal spending due to the sequester agreement. While the federal deficit shrunk to under 5% of Gross Domestic Product

Figure 5. Interest Rate Trends (for Treasury securities)



Source: Federal Reserve System.

in 2013 (off its high of 10% at the height of the recession), a long-term budget deal still remained beyond the grasp of Congress and the President.

Monetary policy remained "stimulative" in 2013, but the rate of money growth moderated and discussion increased about possible Federal Reserve plans to pull-back—or "taper"—its efforts in light of the improved performance of the economy.

National Outlook

Continued economic growth is expected for the national economy in 2014, possibly at a slightly accelerated rate. There are several reasons for cautious optimism. With a recovering housing market, mended personal finances, and better job and income prospects, consumer spending will be a strong plus for the economy. With their sales rising and expansion from productivity gains likely used up, businesses will increasingly need to add workers in order to boost production. Lastly, the improved competitiveness of U.S. companies in world trade will lead to above-average export growth and a positive impact on the overall economy.

Real Gross Domestic Product will average a 2.75% growth rate in 2014, and between 2.5 and 2.8 million net payroll jobs will be added during the year. The national unemployment rate will be between 6.0% and 6.5% by year's end.

Certainly, however, several economic challenges will linger in 2014. Chief among them is the labor market. At the end of 2013 the jobless rate for the "short-term" unemployed—those jobless for under 15 weeks—had almost returned to pre-recessionary levels. However, the unemployment rate for the "long-term" unemployed—persons without a job for 15 weeks or more—still was about three times higher than prior to the recession. This suggests a skills-match problem, with many of the long-term unemployed not having the skill sets desired and needed by employers. Creative approaches such as a revival of apprenticeship programs, expansion of high school vocational and technical training programs, and online training and certification efforts, have been suggested as possible solutions to this problem.

There also appears to be a continuing widening of income inequality resulting from the types of jobs being created. Jobs are being generated at the fastest rate at both the high-end of the income ladder and the low-end of the ladder, with the slowest growth for middle-income jobs. Many middle-income—especially routine-oriented—jobs are being replaced by machinery and technology. Higher-pay jobs are expanding for college educated workers with analytical and reasoning skills, as are lower-pay jobs for personal service tasks that cannot (at least not yet) be done by machines and technology. These trends will likely continue—and may even intensify—with advancing innovations in artificial intelligence and advanced robotics.

Personal investing could become more challenging in 2014. In 2013 the stock market made strong gains based on a growing economy, outstanding profits, and stimulative Federal Reserve policies supporting a relatively low interest-rate environment. While economic growth is expected to continue, there may be changes in the other components. Businesses will still make profits, but the profit rate may slip. Also, the Fed is expected to begin reducing its bond-buying activities, which will result in an upward trend in interest rates. Investors will need to closely monitor these potential “game-changing” moves.

There may also be changes in macroeconomic policy. At the end of 2013 there was optimism that a modest budget agreement would be reached in Congress which would avoid the battles over spending and the debt limit for a year or possibly more. While no major changes to tax policy or entitlement programs are expected to emerge from such an agreement, even a short-run consensus on spending would likely be viewed positively by both businesses and households.

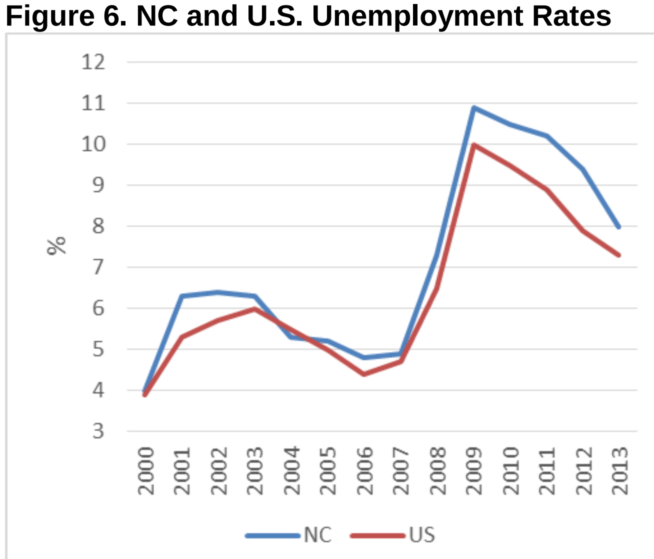
Possibly more dramatic change is expected at the Federal Reserve. First, the Fed will have a new leader—Janet Yellen. Dr. Yellen is a well-regarded economist and the previous holder of several high-level positions at both the Fed and the White House. Nonetheless, any leadership change at the nation’s central bank always introduces an element of uncertainty. If the Yellen-led Fed does begin its anticipated “pull-back,” the raising of the Fed’s interest rates and the selling of assets from its portfolio will have to be managed very carefully in light of the still historically-slow rate of growth in the economy.

North Carolina: A Faster Return of Jobs in 2014?

North Carolina’s economy out-performed the national economy in 2013. Total labor compensation—a proxy for Gross Domestic Product—grew substantially faster in North Carolina than in the nation. Also, payroll jobs in the state were up an estimated 2% during the year, compared to 1.7% for the nation—meaning 80,000 net jobs were added to the state’s payrolls. As a result, the gap between the state’s jobless rate and the national jobless rate was cut in half in 2013 compared to its peak during the recession (Figure 6).

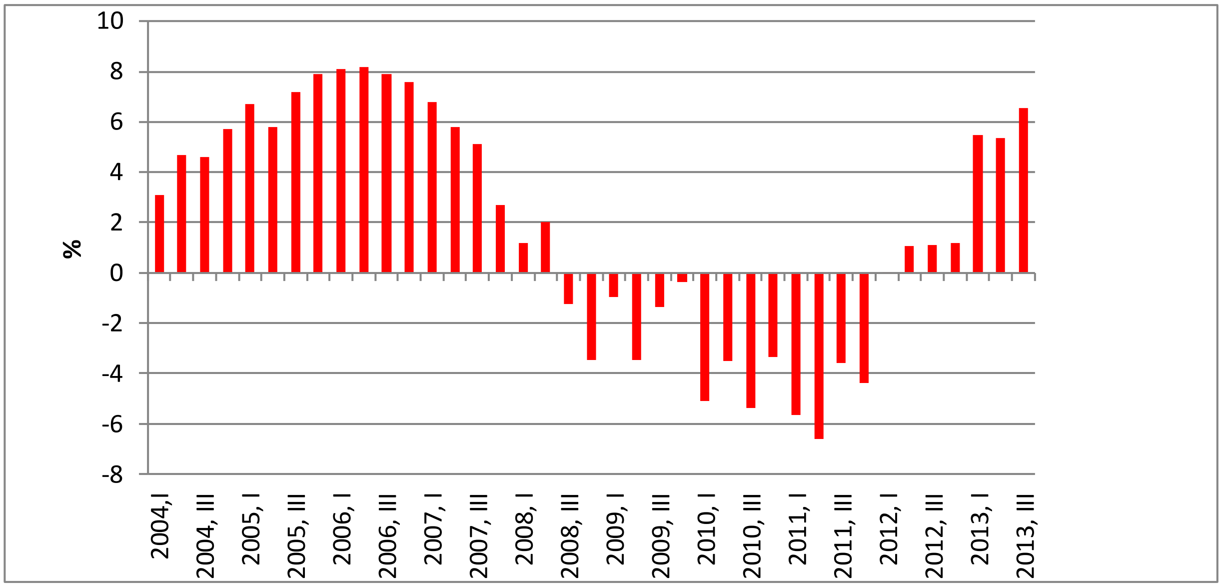
Like the nation, the state’s housing market also improved. At the end of 2013, average home prices were rising over 6% on an annualized basis (Figure 7). This gain was also associated with improvements in both sales and starts. However, one difference from the national trends was the lack of any gains in construction jobs in North Carolina in 2013. This may be due to cautiousness by the state’s real estate developers, which should subside as both the economy and housing market make further gains in 2014.

Figure 6. NC and U.S. Unemployment Rates



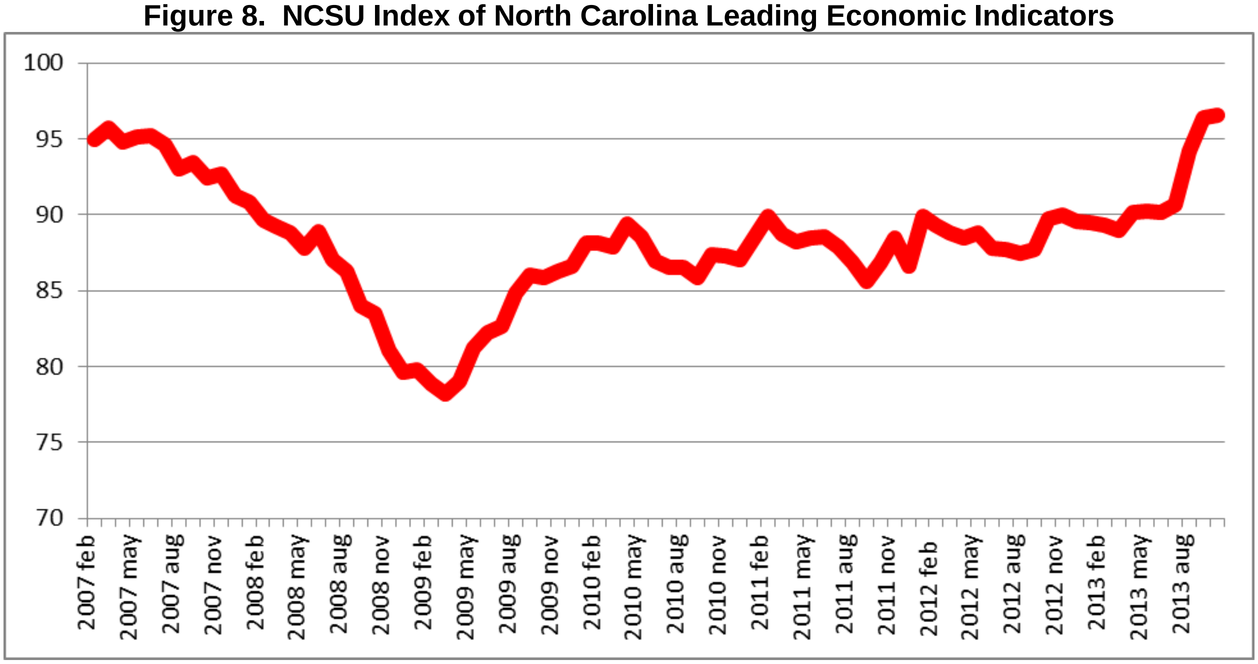
Source: U.S. Department of Commerce; figures are seasonally-adjusted rates in October of each year.

Figure 7. North Carolina Single-Family Dwelling Unit Annualized Appreciation Rate



Source: Federal Housing Finance Agency. Price changes are for homes with the same characteristics.

Figure 8. NCSU Index of North Carolina Leading Economic Indicators



Source: Author's calculations.

North Carolina's economic growth has not been geographically balanced. Over 70% of thet net new payroll jobs created since early 2010 have been in three regions of the state—Charlotte, the Triangle, and the Triad. These areas benefit from modern road and air transportation networks, dynamic universities and colleges, and large college-educated workforces. At the same time, many rural and small-town economies still face challenges in replacing their traditional economies centered around the tobacco, textile, and furniture sectors.

North Carolina Outlook

The NCSU Index of North Carolina Leading Economic Indicators, a composite of five measures designed to indicate the path of the state economy four to six months ahead, points to a faster-growing state economy in 2014 (Figure 8). It is forecasted that at least 100,000 net additional payroll jobs will be added, thereby lowering the seasonally-adjusted statewide unemployment rate to between 6.5% and 7.0% by the end of the year. Contributing to the state's economic improvement will be its competitive cost structure, location in the southeast, attractive amenities, and favorable status of its two "racehorse" regions: Charlotte and the Triangle. However, the state will continue to be challenged by the lower average educational attainment of its workforce (compared to the rest of the nation), a shift in manufacturing production from labor inputs to capital (machinery, technology) inputs, and the re-making of many of its rural counties.