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2018 ECONOMIC OUTLOOK:

A SHIFT TO A HIGHER GEAR?

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The National Economy: Has The Corner Been Turned?

After experiencing modest economic growth in the recovery since the Great Recession, optimism took over in late 2017 as growth hit an annual rate of 3 percent or better for two consecutive quarters. Other measures also indicated renewed vitality, including consumer spending, manufacturing production, and both consumer and business optimism.

Is this optimism for real, and if so, will it extend into 2018 — and perhaps beyond? What are the factors behind the late 2017 surge in economic performance, and how much is due to private factors versus policy initiatives?

A Look at 2017

Table 1 compares national economic performance in 2017 on major measures to the average since the end of the recession in 2009 to 2016, and to the prior long-run annual average from 1960 through 2009. Compared to the long-run 1960-2009 average, most of the measures in 2017 were weaker. Growth in real GDP, labor force, payroll jobs, the real (inflation-adjusted) wage rate and labor productivity were all lower than in the 1960 to 2009 period. Business investment as a share of GDP was also more than a percentage point lower.

On the positive side, real growth in the stock market (measured by the Dow-Jones Industrial Average), and the multiple measures of inflation and interest rates all posted better performances in 2017 than during the 1960 to 2009 period.

Yet comparing 2017 to the post-recessionary averages for 2009 to 2016 gives the conclusion that on most measures, 2017 was a better year. Growth in real GDP, labor force, payroll jobs, labor productivity and the stock market were the same or better in 2017 compared to 2009 to 2016. Business investment as a percentage of GDP was almost a percentage point higher, and inflation and the long-term interest rate were almost unchanged. The significant jump in the short-term interest rate mainly reflects the Federal Reserve's goal of moving back to a more normal interest rate level after years of near-zero short-term interest rates during and immediately after the Great Recession of 2007 to 2009.

Table 1. Performance of Key National Economic Measures

Measure	2017	Annual avg. 1960-2009	Annual avg. 2009-2016	Forecast For 2018
Growth rate in:				
Real GPD	2.4%[1]	3.1%	1.9%	2.7%
Labor Force	0.5%[2]	1.6%	0.4%	0.7%
Payroll Jobs	1.4%[2]	1.8%	1.4%	1.6%
Labor Productivity	1.5%[2]	2.4%	0.8%	1.4%
Real Wage Rate	0.3%[2]	0.4%[3]	0.4%	0.5%
Stock Market	15.6%	12.6%	12.3%	5.0%
Business Investment (% of GDP)	16.5%[5]	17.6%	15.6%	17.0%
All-Items Inflation Rate	1.7%[2]	4.0%	1.6%	2.1%
Core Inflation Rate	1.7%[2]	4.0%	1.8%	1.9%
Short-Term Interest Rate	0.9%[8]	5.4%	0.1%	1.7%
Long-Term Interest Rate	2.3%[8]	6.9%	2.4%	2.8%

Source: U.S. Dept. of Commerce; Federal Reserve
1 annualized through quarters I, II, and III; 2 October 2016 – October 2017; 31962 – 2009; 4 Dow-Jones Industrial Average; 5 based on 2017 quarters I, II, III; 6 3-month Treasury bill rate; 7 10-year Treasury note rate; 8 through November

National Forecasts for 2018

The right column of Table 1 provides 2018 forecasts for the nation on the key economic measures. The estimates are based on on-going optimism about the economy and continuation of the current economic expansion. Broad measures such as real GDP growth, labor force, payroll, and real wage growth will improve modestly. Business investment will increase. The stock market will gain, but it will be off its torrid pace set in 2017. Inflation and interest rates—especially short rates—will edge higher, but still be within historically low ranges.

The "wild card" for 2018 will be the impact of the federal income tax overhaul. With little consensus on the estimated impacts, the tax changes could range from a non-event to a substantial stimulator. Although economists might agree on the direction of the incentives from the tax changes, there is substantial disagreement on the size of the impacts. At the low end are estimates that the tax plan will add only a few tenths of a percent to the annual growth rate in real GDP. But at the other end of the spectrum are forecasts of increases in the real GDP annual growth rate of a full percentage point or more.

There is also debate over who specifically will benefit from the large cut in the federal corporate income tax rate. Economists have long argued that some combination of three groups effectively pay the corporate income tax—shareholders, workers, and customers. Research has found shareholders (investors) traditionally gained the largest benefits from a corporate tax rate cut in the form of bigger dividends or increases in stock prices. However, some more recent research has argued workers could also gain from higher wages.

The 2018 forecasts also imply no recession will hit the economy during the year. One benefit of relatively slow economic growth has been the lack of excesses developed in the economy from rapid growth. While some worry the stock market may be overvalued, at worst a standard "correction" may occur, but not a crash.

Policy or Position?

There are two competing explanations for the improved performance of the economy during 2017, with one based on policy and the other based on where the economy in 2017 lies within the current economic growth cycle.

The policy explanation is straightforward. The Trump administration enacted or proposed policies favorable to the business and investor community. Despite their failure to enact an infrastructure improvement program, the Trump Administration and the Republican-controlled Congress made several moves in 2017 that could be interpreted as increasing business and investment optimism. Chief among these were several executive orders signed by President Trump reducing federal regulations in the energy, environmental, and financial sectors. While controversial over their long-run impacts, businesses and investors likely interpreted the initiatives as reducing costs in these three important sectors in the near term, thereby increasing the rates of return from investments and expansions in the industries. The result was faster economic growth and a more upbeat economic outlook.

Legislatively, the key national initiative in 2017 was passage of major changes to the federal income tax. The legislation broadens the tax base and lowers tax rates. While the details certainly will result in some filers paying more and some paying less, lower marginal tax rates would be expected to increase both business and individual incentives to invest, produce, and work more. In addition, while the changes induced by tax reform will only become operative in 2018, most economists agree that anticipation of impending reductions in taxes—particularly corporate income taxes—would have provided a stimulus to the economy.

The alternative explanation for the economy's improvement in 2017 is simply that it was time for the improvement to occur! The largely unexpected and almost catastrophic drop in both the U.S. and worldwide economies during the Great Recession of 2007-2009 left business and consumer confidence shattered. Even once the economy began improving, households were reluctant to spend and businesses were hesitant to invest and hire. Consumers became misers, increasing the personal savings rate to almost 10 percent; and spending on many big-ticket items like homes limped along for several years. Key foreign economies, such as Europe and Japan, continued to endure almost recession-like conditions.

However, as the economic recovery continued, memories of the bad times faded and more normal spending patterns eventually returned. Indeed, by mid-2018 the current economic expansion will become the second-longest in the nation's history. Households are now spending more and saving less. While this behavior raises concerns about over-indebtedness, continued low interest rates have kept the carrying-costs on debt as a fraction of household income at normal levels. Similar economic improvement has also occurred in Europe and Japan.

There is also a beneficial demographic dynamic beginning to occur. The older millennials (born between 1980 and 1990) are starting to move from the stifled spending associated with entry-level employment to more the generous spending of experienced workers. Homeownership among that generation is increasing, particularly in less-dense suburban locations. Homeownership usually carries with it major expenditures on appliances, furniture, and even landscaping. Thus, if this trend continues among the millennials—now the largest generation in the country—it will add significantly to the nation's economic expansion.

The North Carolina Economy:

How Strong, How Broad?

A Recent Acceleration

Table 2 shows the comparative performance of the North Carolina and U.S. economies during the current economic expansion. Major changes were enacted to the North Carolina individual and corporate income tax codes in 2013, with the primary change being the reduction in income tax rates during future years. Specifically, the state corporate income tax rate was reduced from 6.9 percent to an eventual rate of 2.5 percent, and the highest individual income tax rate was decreased from 7.75 percent to 5.25 percent. Hence, it is interesting to examine if there has been a perceptible change in North Carolina's relative economic performance after 2013.

From 2009 through 2013, North Carolina underperformed the nation in real GDP growth and also in real GDP growth per capita and payroll job growth per capita. The average annual real GDP growth rate per capita was actually negative. Only aggregate payroll job growth exceeded national growth during this period.

However, from 2013 to 2016, the state matched the nation in real GDP growth and exceeded the nation in payroll job growth and both real GDP growth per capita and payroll job growth per capita. In 2017, North Carolina matched or exceeded the nation in real GDP growth, payroll job growth, and real GDP growth per capita. Only for payroll job growth per capita did the state's performance fall substantially short of the nation.

Can we therefore conclude that the tax changes enacted by North Carolina spurred economic growth in the mid-to-latter part of the 2010 decade? The changes likely were a factor, as research has shown that business expansion and location decisions at the state level are especially sensitive to state corporate income tax rates.

However, beginning with the recession of 2001, North Carolina's economy has taken several years for its pace of economic growth to match national growth during the recovery from a recession. A big reason is the continuing restructuring of the North Carolina economy caused by globalization, which began in earnest in 2000. Manufacturing usually is a sector that leads an economy out of a recession, as the pent-up demand of buyers propels manufacturing sales once optimism returns to the economy. But especially after the Great Recession of 2007-2009, this did not happen. Manufacturing output in the state did not rise until after 2014, and then only modestly.

Table 2. Comparative Performance of the North Carolina and U.S. Economies, 2009-2017

	North Carolina, Annual Avg.			United State, Annual Avg.		
Measure	2009-2013	2013-2016	2017	2009-2013	2013-2016	2017
Growth rate in:						
Real GPD	0.9%	2.2%	2.5%[1]	1.7%	2.2%	2.4%[1]
Payroll Jobs	1.6%	2.3%	1.7%[3]	1.4%	1.9%	1.4%[2]
Real GDP per Capita	-0.4%	1.6%	1.4%[1]	1.0%	1.5%	1.4%[1]
Payroll Jobs per Capita	0.4%	1.2%	0.6%[2]	0.7%	0.7%	0.7%[2]

Source: U.S. Department of Commerce.

1 Estimated from comparing national and North Carolina trends in quarters of comparable data in 2016 and 2017; 2 based on October to October data.

A key factor here is the continuing downsizing of nondurable manufacturing in the state. Non-durable manufacturing comprises over half of the state's total manufacturing output, and over 10 percent of total state economic output. The on-going restructuring of key nondurable manufacturing sectors like tobacco, textile, and apparel products has made North Carolina's economic recoveries weaker: From 2008 to 2015 (latest year of available data), tobacco, textile and apparel products GDP declined by $6.4 billion (2009 dollars). This is 18 percent of the combined industries' GDP total in 2008 and 1.5 percent of total North Carolina GDP in 2008.

A State Divided

Figures 1 and 2 provide updates on North Carolina's two "divides" —the divide in the labor market and the divide in the state's economic geography. Figure 1 shows job creation in the state in 2017 continued to occur primarily in the high-paying and low-paying categories, with a very modest increase in the middle-paying category. This extended the trends seen in the period since the end of the Great Recession (2009-2016).

Figure 2 illustrates the on-going dominance of the state's largest metropolitan areas in job growth. In 2017, the five largest metropolitan regions in North Carolina accounted for 83 percent of the state's total increase in employment. Medium metro areas managed modest job gains during the year, while small metros continued to lose jobs and non-metro regions registered only tiny improvements in employment in 2017.

State Forecasts for 2018

Like most states, North Carolina's economy in 2018 will be strongly influenced by national economic events. With most economists seeing continued national economic growth during the year, a recession is not likely to occur in either the nation or state during the year.

With a new national income tax plan in place in 2018, North Carolina could see some added economic growth motivated by the plan's lower marginal tax rates. If a national infrastructure plan is submitted and passed during the year, more state construction programs could be planned. However, there are rumors that a national plan would require 80 percent funding from states. If true, there would be a challenge about how the state would generate its contribution.

Additionally, the North American Free Trade Agreement (NAFTA) is currently being renegotiated by treaty partners Mexico, Canada, and the U.S. If negotiations fail, there is a likelihood NAFTA would be terminated. While a termination would create both winners and losers in North Carolina, a recent study suggested that the overall short-run impacts on total state economy would be relatively minor (Walden 2017).

For 2018, it is forecasted that North Carolina's real GDP will increase by 2.8 percent — one-tenth percentage point faster than the nation; and that payroll employment in the state will grow by 1.6 percent — the same rate as the nation. The payroll job growth rate will translate to approximately 71,000 net new positions.

Predicting the most-used unemployment rate — the so-called "headline rate" — is more difficult. The rate would drop as more jobs are added and nothing else changes. But if some individuals who had dropped-out of the labor force because they could not find work — and therefore are not officially counted as unemployed — resume looking for work as labor market conditions improve, the jobless rate can remain the same, or perhaps rise, even as the total number of jobs increases.

The lowest state unemployment during the economic expansion of the 2000s decade was 4.6 percent; the lowest state rate during the economic expansion of the 1990s decade was 3 percent. With continuing globalization, economic conditions today are much more like the 2000s than the 1990s, with an estimated 100,000 to 300,000 able-bodied, working-age individuals having left the labor force in North Carolina. As labor market conditions continue to improve, it would be expected that significant numbers of this "hidden labor force" will actively look for work, thereby moderating any reductions in the unemployment rate. Therefore, a year-end statewide unemployment rate of 3.6 percent is expected in 2018. This would represent half the drop seen in the 2017 jobless rate with a comparable number of payroll jobs added.

With a tighter labor market, real (inflation-adjusted) wage growth should accelerate from its 0.8 percent rate in 2017 to 0.9 percent in 2018. Both figures are considerably better than the average annual real rate of only 0.3 percent for the 2009-2016 period.

There is no expectation that either household income or the geographic divides in North Carolina will significantly change in 2018. The forces providing advantages to large metropolitan areas — transportation linkages, vibrant downtowns attracting a college-educated workforce, international ties, and a 21st century economy based on higher education, technology, finance — will still give those regions strong advantages. Also, technology will continue to "disrupt" the occupational market by producing machinery and programs that can increasingly substitute for a broader range of human-performed tasks. Individuals with skills and cognitive abilities not able to be performed by technology will be rewarded in the job market, while those workers competing with technology-based applications will face continuing difficulties.

In sum, then, 2018 will be a further year of economic growth in North Carolina. Overall, both income and employment will continue to grow. But beneath the generally positive. broad statewide picture will linger economic disparities that are yet to be closed.

Research Cited

Michael L. Walden, 2017. "How Would Ending NAFTA Impact the North Carolina Economy?" Studies in the North Carolina Economy, November 2017. https://ag-econ.ncsu.edu/wp-content/uploads/2015/11/nceconomy-nafta2.pdf.