Economic Growth Moderates in 1995

U.S. economic growth slowed in 1995 compared with 1994, with inflation up slightly. Rural areas likely benefited from strong export and durable goods growth. Consumer spending growth will determine the strength of Gross Domestic Product growth in 1996.

The U.S. economy slowed in 1995 as GDP growth fell to an estimated 2.1 percent, down from 1994's 3.5 percent. Industrial production—mining, manufacturing, and utility output—which had increased a strong 5.0 percent in 1994, still grew a healthy 2.5 percent in 1995. Growth in business equipment spending dropped to 7.5 percent—down from 1994's stellar 10.0 percent. Employment was up over a million jobs in the last half of 1995 compared with the end of 1994, while over 100,000 manufacturing jobs were lost. Rural jobs increased slightly by 1.3 percent in the third quarter of 1995 over the third quarter of 1994.

Consumer Spending Keeps Economy Growing

Consumer spending for 1995, based on the preliminary GDP estimate grew about 2.4 percent—down from 1994's 3.0-percent growth. Relatively low interest rates, strong consumer balance sheets, widely available credit, improved cash flow from 1994's mortgage refinancing boom, and good growth in employment and disposable income in 1995 kept consumer spending strong. The growth in durables spending came largely in furniture and appliances spending, as auto sales fell from 1994's high levels. Spending on clothing increased modestly, leading lackluster growth in nondurable spending. Services spending grew strongly, reflecting good disposable income growth and high levels of consumer confidence. Consumer prices increased about 2.8 percent, up only slightly from the 2.6-percent increase in 1994.

Investment, Government Spending, and Trade Present Mixed Picture

Business investment—inventory accumulation, business equipment spending, and business plant spending—was mixed in 1995. As most analysts expected, inventory accumulation slowed through most of the year. Because the inventory-to-sales ratios rose in 1995 from 1994's very high ratios, inventory accumulation is expected to slow more in the next several quarters. The boom in business equipment spending slowed from 1994, but outpaced other major spending categories due to favorable financial market conditions and high business profits. Business plant spending growth increased substantially as new plants were built responding to recent high capacity utilization rates. Producer price increases were modest for the year. Higher energy prices, induced by cold weather, brought a sharp end-of-year rise of 0.5 percent in producer prices. Few analysts saw this as a sign of accelerating inflation.

National economic indicators

GDP growth slowed in 1995; unemployment declined with modest inflation increase

Item	1994	1995
	Percent	
Real gross domestic product growth, percent, annualized[1]	3.5	2.1
Consumer Price Index growth, percent, annualized	2.6	2.8
Prime rate, percent	7.1	8.8
Unemployment rate, percent	6.1	5.6
Industrial production, annualized change in index	5.9	3.2
Industrial production, manufacturing, annualized change in index	6.6	3.5

[1] GDP growth is measured using the 1992 chain-weighted index.

Source: Calculated by ERS, based on data from the Bureau of Economic Analysis, the Bureau of Labor Statistics, and the Federal Reserve Board.

Lag in Real Wages Could Dampen Consumer Spending

Real wages have been linked both cyclically and secularly—along a trend—with productivity. Most economists agree that real wage increases come from productivity increases. That is, employers can only afford to pay higher real wages if labor productivity rises. In addition, productivity usually rises very sharply 1 or 2 years after the beginning of an economic expansion. After the 1981-82 recession, real wages rose 1.4 percent in 1983 while labor productivity rose 1.3 percent. Above-average real productivity gains were made during 1983-86. Although real wages actually declined, benefits rose. Some observers suggest that total labor compensation, wages and benefits, is a better measure of earnings. Indeed, the employment cost index, a measure of labor compensation, shows that real compensation growth matched the productivity increases of the 1980's. For rural areas, however, real compensation increases fell short of those experienced in urban areas, as measured by the employment cost index.

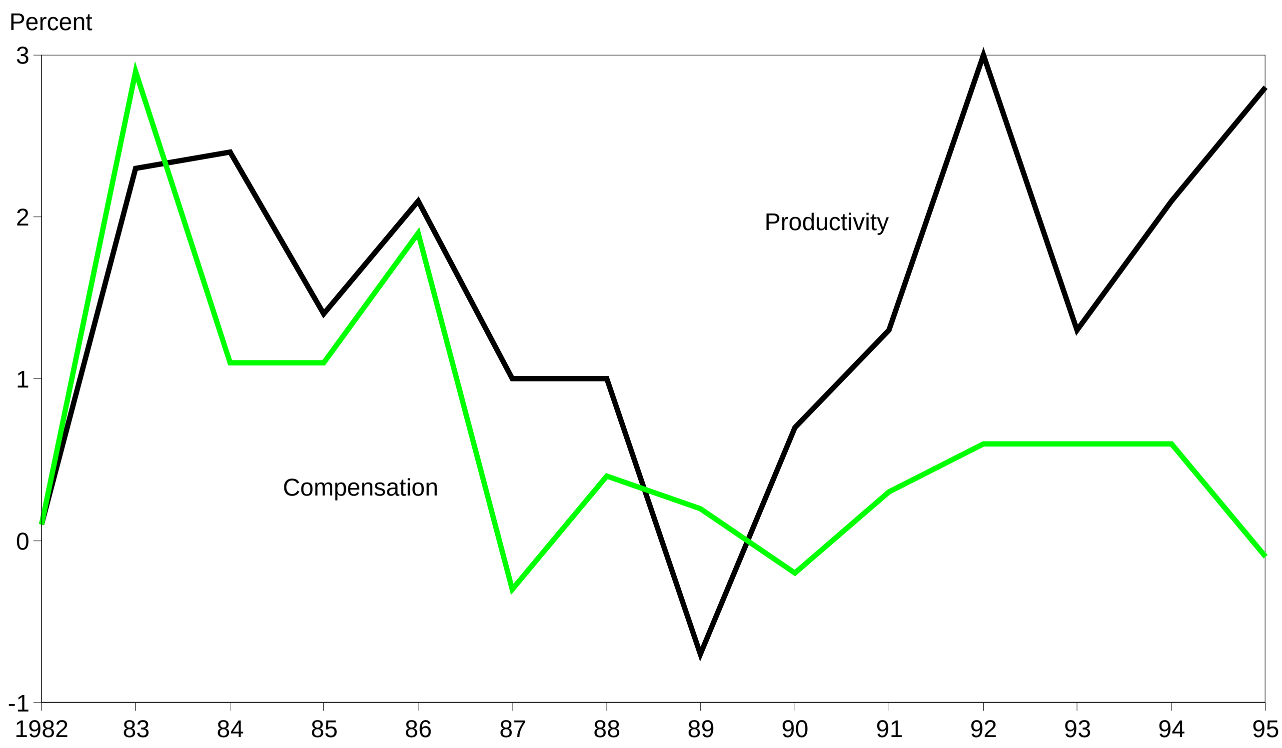
The current economic expansion has seen strong productivity growth but weak growth in real compensation. Real compensation growth has been only one-half a percent per year during 1991-94, while productivity growth has averaged about 2 percent per year. For the first half of 1995, real compensation declined by 0.1 percent versus the first half of 1994, while productivity rose 2.8 percent, yielding the largest excess of productivity gains over real compensation growth since the employment cost index was first reported in 1981.

This real compensation growth has been weak despite strong disposable income growth. Over 1991-94, real per capita disposable personal income grew an average of 1.0 percent a year, with a growth rate of 1.4 percent in 1994. Preliminary data indicate that real disposable income growth was stronger in 1995.

If indeed real compensation growth continues to be slight, it will probably hamper growth in consumer spending. Over the last year, aggregate consumption has been able to rise despite small real wage and benefit increases largely because employment has expanded.

Annual change in productivity and the Employment Cost Index, 1982-95

Since 1990, productivity has increased faster than compensation



1995 is first half only.
Source: Bureau of Labor Statistics

Government spending, despite a notable increase in the third quarter, slowed growth for the year. Exports, motivated by the strength of the German mark and the Japanese yen, grew 8.3 percent despite stagnation in the Japanese economy and in the economies of other major trading partners, such as Canada and Mexico. Concomitantly, sales of imports grew 7.9 percent. However, since the 1994 level of imports was substantially higher than exports, the real trade balance for 1995 deteriorated. This $5.5 billion-increase in the real trade deficit was a drag on domestic economic growth.

Rural Economy Sensitive to Changes in Trade, Manufacturing

Little rural data from 1994 and 1995 are currently available; however the data that are available indicate that the employment growth in rural areas continued over 1995, albeit at a slower pace than in 1994. In addition, rural unemployment appears to have held fairly steady over the first three quarters of 1995. It is very likely that the strong performance of U.S. exports has helped rural areas keep unemployment down over 1994-95. ERS research suggests that U.S. exports, being predominantly manufacturing and agricultural goods, have larger effects on rural unemployment than on general unemployment. Rural areas probably benefited from the good growth in consumer durables spending in 1995. Rural areas have a larger share of employment in manufacturing than urban areas, and in particular, rural areas had disproportionately more durable goods employment in 1993 (the latest data available), 8.4 percent of rural jobs are in durable manufacturing versus 6.8 percent of urban jobs. Although manufacturing jobs decreased nationally during 1995, durable-goods employment held steady.

Outlook Is for Modest Growth through 1996

Continued good financial market conditions as reflected in relatively low interest rates and a relatively weak dollar provide the background for the 1996 outlook. The near-term outlook is for moderate GDP growth of 2.2 percent. The trade deficit is expected to improve, although there may be some volatility from quarter to quarter. The improved trade situation will be driven by exports as the U.S. dollar continues to be soft and as the economies of the major U.S. trading partners experience slightly higher GDP growth than in 1995. Agricultural exports are among the areas expected to be strong. Larger exports in 1996 and stronger growth in the manufacturing sector should benefit rural economies.

Aggregate investment will boost overall growth, but less than it has in the last 3 years. Plant and equipment investment growth are both expected to continue, but more slowly than in 1995. The rate of inventory accumulation is likely to decrease. Given that investment and exports are expected to be strong, manufacturing output growth should be stronger than that of the overall economy. A final factor moderating GDP growth is that government spending will be down from 1995.

Consumer Spending Is the Major Question Mark

Consumption—the largest component of GDP—is expected to grow modestly in the near term. Many analysts expect that real wages per capita will grow, causing disposable income per capita to grow. Combined with an expected slight increase in employment, these factors should lead to modest growth in aggregate consumer spending. The increase in real wages is expected for two reasons. The U.S. economy has seen high productivity growth over the last 2 years without substantial real wage increases, despite shortages of workers in some labor markets. Real wage increases historically follow productivity increases. Since real wages have not yet risen substantially during this expansion, the coming year will likely see some increase. Recent high corporate profits increase the ability of firms to pay higher future wages.

The risk in the outlook is that if real wages do not increase as expected, and if indeed employment growth is modest, then consumer spending could stagnate. As consumption is two-thirds of GDP, stagnant consumer spending could significantly lower GDP growth in 1996. *[Data as of February 26, 1996. David A. Torgerson, 202-501-8447, dtorg@econ.ag.gov, and Karen S. Hamrick, 202-219-0789, khamrick@econ.ag.gov]*