State Board of Equalization

Economic Perspective

Summary of Recent Economic Developments *April 1999*

❖ *U.S. Economic Developments*

Extremely Strong Growth in Late 1998

The U.S. Department of Commerce reported that real GDP rose 6.0 percent in the fourth quarter of 1998. This is an unusually rapid growth rate, the fastest quarterly gain since early 1996. With this fourth quarter data, the annual figures show that real GDP increased 3.9 percent in 1998, matching that of 1997. In both 1997 and 1998 the economy expanded much faster than the ten-year average growth rate of 2.6 percent per year. (For an explanation of major factors causing this exceptional economic growth, see the last section of this newsletter, "Why Was U.S. 1998 Economic Growth So Far Above Consensus Forecasts?".)

Slowing First Quarter Gains?

First quarter 1999 real GDP is generally not expected to match its fourth quarter increase. However, monthly economic figures released so far in 1999 indicate that economic growth in early 1999 is continuing at a rate that is much faster than the long-term average. Retail sales increased an average of 1.1 percent per month for the first three months of the year, about the same as the average monthly gains from October through December. Nonagricultural payroll employment increased by an average of 187,000 employees per month for the first three months of 1999, compared to the fourth quarter average gain of 252,000 employees per month. (Sources: U.S. Department of Commerce, STAT-USA Economic Bulletin Board.)

Above Average Growth Also Expected in 1999

The strong fourth quarter and the relative strength of early 1999 monthly indicators have led many economists to sharply increase the forecasts they were making only a few months ago. In early January, *Blue Chip Economic Indicators*, a publication which averages about 50 economic forecasts, reported a 1999 consensus forecast of a 2.4 percent increase in real GDP. In April, the *Blue Chip* consensus forecast for 1999 real GDP growth jumped to 3.5 percent.

❖ *California Economic Developments*

Strong Employment Growth in 1998 Continuing into 1999

Similar to the U.S. economy, the California economy continued to perform well overall throughout 1998 and into early 1999. One of the most comprehensive measures of economic well being available for states on a timely basis is nonagricultural employment. California nonagricultural employment increased 3.5 percent in 1998, the fastest growth the state has had in the 1990s. This gain in jobs was also well above the 1998 U.S. nonagricultural employment growth rate of 2.6 percent. California nonagricultural employment has increased at growth rates close to the 3.5 percent annual average in the first three months of 1999 when compared to the corresponding months of 1998. (Sources: California Employment Development Department, Interim Industry Employment; U.S. Council of Economic Advisors, *Economic Indicators*.)

Growth Led by Construction and Business Services

Construction and business services were among the fastest growing economic sectors in 1998, and this pattern has generally continued into early 1999. In 1998, construction employment increased 9.4 percent, faster than any other industry. Business services payrolls rose 8.8 percent.

UCLA Expects Similar Employment Growth in 1999

In March 1999, the UCLA Anderson Forecasting Project released its quarterly economic forecasts for the nation and California. UCLA expects California nonagricultural employment to increase 3.4 percent in 1999, about the same growth as the 3.5 percent gain of 1998.

Slower Taxable Sales Increases in 1998

The Board of Equalization's preliminary estimate shows that taxable sales increased 4.6 percent in the fourth quarter of 1998 compared to the fourth quarter of 1997. For 1998 as a whole, taxable sales rose 5.3 percent over 1997 according to the preliminary estimates. The 1998 annual growth rate is below the 6.3 percent rate for 1997 as a whole. However, adjusting for inflation is likely to increase the 1998 quarterly and annual figures by almost 2 percent. In 1997, the California Taxable Sales Deflator measured a negative inflation rate (deflation) of 0.4 percent. Therefore, in 1997 real taxable sales rose 6.7 percent (6.3 percent plus 0.4 percent to adjust for deflation). Preliminary figures show that the taxable sales deflator averaged negative 1.9 percent for the first three quarters of 1998. If this rate continues for the fourth quarter, real taxable sales will have increased approximately 7.2 percent in 1998 (5.3 percent plus 1.9 percent). Therefore, after adjusting for inflation, it is likely that taxable sales rose somewhat faster in 1998 than 1997 (7.2 percent, compared to 6.7 percent). As an economic indicator, this faster growth is consistent with the slightly higher nonagricultural employment growth that California had in 1998.

❖ *Why Was U.S. 1998 Economic Growth So Far Above Consensus Forecasts?*

U.S. economic growth was much stronger in 1998 than many economists had predicted. A poll of over 50 economists taken by *Business Week* in December 1997 showed that they predicted real GDP to rise 2.2 percent in 1998. Instead, real GDP increased nearly twice as fast, 4.1 percent (growth rates are expressed as fourth quarter 1998 over fourth quarter 1997).[1] What happened?

In late 1997 there was much concern about the likely impacts of the Asian financial crisis. Since such a deep and widespread crisis had not happened within recent memory, few analysts could reliably forecast the impacts. Many economists predicted a widening trade deficit would significantly reduce real GDP growth. On that score, many of these predictions were fairly accurate; the trade deficit widened sharply in 1998. Net exports reduced real GDP growth by 1.1 percent in 1998, compared with a 1997 reduction of 0.3 percent.

What many economists failed to sufficiently reflect in their 1998 forecasts was an accurate quantification of the extent of some of the significant *benefits* of the Asian crisis. The weak Asian economies helped to keep the rate of inflation extremely low. Weakened demand from Asia contributed to lower world prices of oil and other commodities. At the same time, the Asian crisis caused many manufactured goods imported from these countries to have falling prices. As a result, consumer prices increased just 1.6 percent in 1998, the smallest increase since 1986. With the weak worldwide economic conditions and lower inflation, interest rates declined. The average rate for thirty-year U.S. government treasury bonds ranged from 6.6 percent to 6.9 percent from 1995 through 1997. In 1998, the rate averaged 5.6 percent, a one percent drop from its 1997 average.

The lower prices and interest rates boosted consumer spending directly by reducing the costs of goods and financing. In addition, the lower interest rates, along with other factors, benefited the stock market. In December 1997 few economists expected the 24 percent annual average increase in the Standard and Poor's Index of 500 stocks in 1998 after seeing much evidence of an overvalued stock market. The increase in stock market values is generally credited with improved consumer confidence and increased consumer spending. According to a recent San Francisco Federal Reserve Bank study, the robust stock market gains added nearly one percentage point to real GDP growth in 1998.[2]

Another major factor that contributed to faster real growth was a continuation of strong productivity gains in 1998. Increases in productivity are associated with additional real personal income, which enhances both consumption spending and overall real GDP growth. For the five-year period from 1991 through 1995 productivity per worker increased an average of 1.0 percent per year, which is also close to the average annual gain since 1973. (For the 20-year period from 1976 through 1995, productivity growth per worker increased an average of 1.2 percent per year.) But productivity increased 2.4 percent in 1998, which was double the long-term average. For the three-year period from 1996 through 1998, productivity per worker has increased an average of 2.2 percent per year. According to the San Francisco Federal Reserve Bank publication cited earlier, this increase in productivity could be one of the major factors responsible for adding close to another percentage point to real GDP growth in 1998.

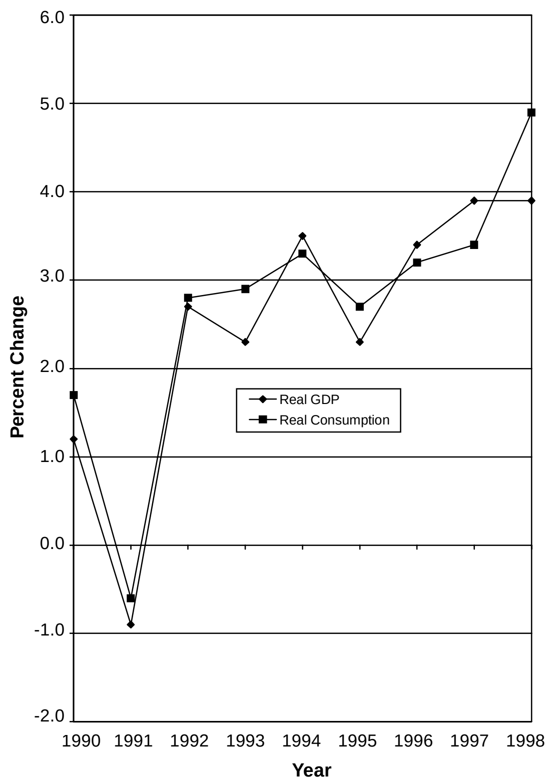
Lower inflation, a robust stock market, and increased productivity growth all contributed to strong consumer spending in 1998, which also kept real GDP rising briskly since consumer spending is about two-thirds of gross domestic product. The chart in the next column shows annual growth in real consumer spending and real gross domestic product for the past nine years. The chart shows just how strong consumer spending was in 1998, both in relation to the rest of the 1990s. and in relation to real GDP. Typically, real consumer spending has tracked real GDP fairly closely in most years. In 1997, real consumer spending rose 3.4 percent, well above its 10-year average growth rate of 2.7 percent (1989 through 1998), but below real GDP growth of 3.9 percent. In 1998, real consumer spending jumped 4.9 percent, the fastest growth since 1984, and far above real GDP growth of 3.9 percent.

Will low inflation, strong stock markets, high productivity growth, and rapid increases in consumer spending continue this year? Pessimists argue that strong productivity gains and low prices are due more to chance than they are to long-term changes in the economic environment. They also argue that consumer spending rose much faster than incomes in 1998, which is an unsustainable long-term trend. In addition, they believe the stock market remains overvalued, and is due for a major correction. Others believe that low inflation and strong productivity growth will continue for the foreseeable future because we are in a new economic era brought about largely by technological advances and increased globalization. For 1999, most analysts believe that real GDP growth will slow from that of 1998, but will still remain fairly strong by historical standards. As mentioned earlier, the April *Blue Chip* consensus forecast calls for real GDP to increase 3.5 percent in 1999, which is below the 3.9 percent gain of 1998, but well above the long-term average of 2.6 percent per year.

[1] "There's New Life in the Old Boom," *Business Week*, February 15, 1999.

[2] *How Did the Economy Surprise Us in 1998?*, Economic Letter Number 99-08, Federal Reserve Bank of San Francisco, March 5, 1999.

Growth in Real GDP and Real Consumption in the 1990s



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