Modest U.S. Economic Growth Ahead for 1994

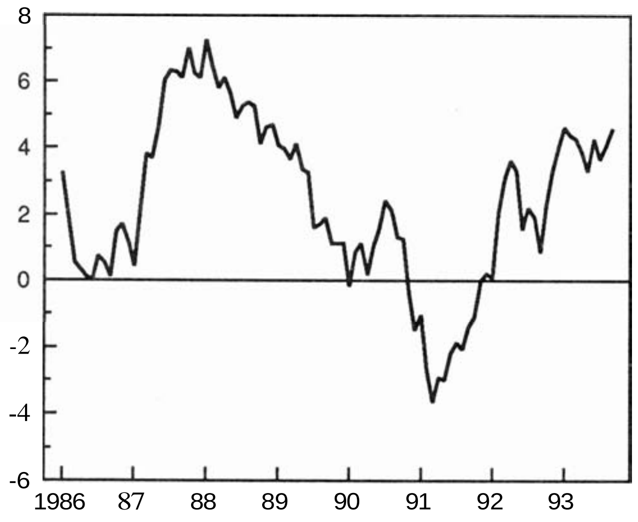
An accelerating but moderate recovery means solid U.S. economic growth for 1994. This will give a lift to many agricultural producers selling to the industrial sector--especially for goods going to housing, industrial equipment, and consumer durables. Inflation and interest rates are expected to remain low, although picking up slightly.

Most analysts expect that inflation-adjusted Gross Domestic Product (GDP) will grow at about a 3-percent annual rate in 1994. They have revised forecasts upward after seeing surprisingly good third quarter growth, 2.7 percent, even after adjusting for the impacts of the Midwestern flood. An improved fourth quarter, with GDP growth well above 3 percent, is foreseen. The strong growth in employment and industrial production in October and November have led many analysts to expect 4-percent GDP growth in the last quarter of 1993. Few anticipate growth as high as the 5.7-percent gain of 1992's fourth quarter, however.

Analysts see a slightly higher than 4-percent annual growth in industrial production (figure 1) for 1993. Although faster growth will increase employment, the unemployment rate will decline erratically as individuals are coaxed back into the labor force in particular months. Rural unemployment is likely to remain close to urban rates for the fourth quarter of 1993. Many analysts expect continued growth in manufacturing employment in December and into 1994, consistent with strong growth in industrial production.

Moderate employment growth and low industrial-capacity use coupled with strong business investment have kept inflation near 2 percent for overall producer prices and under 3 percent for consumer prices for 1993. Despite some initial concern about the impact of the Midwestern flood on inflation, 1993 has been a year of low inflation. Interest rates are expected to rise slightly in the last quarter. They still remain very low by historical standards, leaving 1993 average rates well below those of 1992. Most analysts expect only a modest increase in inflation in 1994. A few analysts, however, are projecting lower inflation in 1994 due to the sharp drop in oil prices at the end of 1993.

Figure 1
Industrial Production
Percent change form previous year



Business spending on plant and equipment and, recently, consumer spending on housing and durable goods have led overall GDP growth during the last few months. In the third quarter of 1993, business investment rose over 10 percent from a year ago. Further, after starting slowly, housing starts are expected to be up 10 percent in 1993 over 1992 and then rise another 8 to 9 percent in 1994. Residential investment for the third quarter was up 5.4 percent from a year ago.

The growth in 1993 was hampered by two major factors: declining Federal spending, particularly on defense, and a sharply increasing trade deficit brought on by stagnant exports and the usual growth in imports as U.S. income increased. The stagnant Japanese economy, the Canadian recession, and a mild decline in the German economy accounted for weak exports, despite a weakening dollar.

The Key to 1994 Is Low Interest Rates

The key to the outlook for 1994 is higher, but still low, interest rates. The consensus has short-term rates rising from 60 to 100 basis points (10 basis points is 0.1 percentage points) above 1993 and long-term rates rising between 40 to 80 basis points. As short-term rates have been flat and long-term rates have taken an unanticipated dive during August to October, most see an average T-bill rate of about 3.8 percent for 1994. Yle 10-year bond rate is forecast to be about 6 percent by the end of 1993. The 10-year bond yield will rise slightly to make the projected 6.5-percent yield average for 1994. By recent historical standards, these low rates will give strength to the continued recovery.

Why will interest rates remain low? Most analysts note that (1) inflation and inflation expectations have abated; (2) growth in Germany and Japan are expected to be about 1 and 2 percent, respectively; (3) the budget accord has credibly reduced out-year deficits and, thus, future demand for credit; and (4) while increasing more than in 1993, U.S. growth will not likely induce a sharp expansion in credit demand. Despite some concern about a resurgence of inflation, recent modest wage growth, low but increasing capacity utilization, strong business investment that indicates future productivity improvement, and slow world growth will likely keep inflation from accelerating.

While business investment was strong throughout 1993, consumer spending is likely to grow at the same rate as GDP, since consumers have used lower interest and mortgage rates to reduce monthly payments--leaving more spendable income. In recent months, consumers have been willing to take on additional non-mortgage debt, contrary to earlier in the recovery. This suggests moderate-to-good growth into 1994 for sales of consumer goods. Continued low interest rates lead most analysts to expect strong growth in consumer durables, with continued good-to-strong growth in auto sales and parts, consumer textiles, and furniture. Government purchases are expected to decline modestly in 1994. The trade deficit will be a drag on U.S. economic growth in 1994, exacerbated by an expected small appreciation of the dollar.

Cost increases are slated to be small in 1994. Low interest rates should keep interest expenses down, and will present opportunities to expand production cheaply. Wage increases have been modest, and with a relatively high unemployment rate, are not likely to accelerate. Unit labor costs in manufacturing should be flat in 1994. The strong investment we have seen suggests good productivity growth in 1994.

Most analysts expect the downsizing of the last 2 years to continue, albeit at a slower pace, as large companies restructure to become more competitive. Industrial production and capacity should move up faster than in 1992 and early 1993. Employment in relatively high-wage manufacturing should continue to rise. So, the pace of the recovery will likely pick up.

With consumption picking up, investment will not have to be the major engine driving growth. The recovery up to mid-1993 had extremely strong growth in business plant and equipment investment. Since then, housing and consumer spending on durables have come in as secondary factors. The typical recovery would have housing starts and consumer durables leading the economy, with business investment picking up sometime thereafter. Most analysts expect to see a pattern more like this in 1994.

Declines in Government Spending and Exports Drag Down Growth?

From the third quarter of 1991 through the third quarter of 1993, spending on defense goods and services fell almost 14 percent (figure 2). while overall and Federal purchases declined 8.3 percent. Most analysts expect this drop to continue, albeit at a slower rate. They also anticipate that lower Federal government spending in 1994 will be the largest drag on economic growth.

This year, net exports have dropped dramatically through the first three quarters, leading some analysts to expect the trade deficit to severely hamper U.S. GDP growth in 1994.

Figure 2

Production of Defense and Space Equipment

Percent change from previous year

The answer to their concern lies in world economic recovery. An expected modest recovery by our trading partners will likely raise U.S. exports enough to prevent the trade deficit from increasing as sharply as it did in 1993. Given the dollar's value, many American manufactured goods are priced very competitively relative to foreign goods of comparable quality. If foreign income increases, more U.S. goods will be exported. This will mitigate the expected rise in imports, which comes with growth in U.S. income.

U.S. export growth slowed in 1992 and stagnated in 1993. A large surge in imports led to a large trade deficit in the United States. Although the foreign-exchange value of the dollar remains low and has risen slightly since the beginning of the year--keeping U.S. exports competitive in foreign markets--economic growth abroad has slowed substantially. The developed economies, excluding the United States, have hardly grown. So, were it not for some pickup in our exports to less-developed countries, U.S. exports would have declined instead of stagnated. Large growth in imports, because of strong growth in consumer demand, and no growth in exports has resulted in three consecutive quarters of rising trade deficits--starting with $60 billion in the first quarter of 1993 and expanding further to $80 billion in the third quarter.

The very modest growth expected in developed countries other than the United States implies a modest upturn in U.S. exports in 1994. This will likely be enough to keep the trade deficit from being as large a drag on U.S. growth as it was in 1993. But the deficit probably will be a drag, nonetheless. With growth in Japan expected up 2 percent and Germany expected up only 1 percent, U.S. export growth will likely be muted and, because of expected high imports, the trade deficit will increase moderately in 1994. Agricultural exports in 1993194 are forecast at $42.5 billion, virtually unchanged from a year earlier.

Outlook for Industries Using Agricultural Products

Construction governs the demand for many forestry products, particularly lumber. The housing market was hit significantly during the recession. Housing starts fell 13 percent in 1990 and 15 percent in 1991. In 1992, housing starts rose 18 percent, and most analysts expect them to rise an additional 10 percent by the end of 1993. Other indicators suggest a continued rebound in construction activity. For example, building permits--an indicator of future construction activity--rose 12 percent for the 12 months ending in September. Continued relatively low long-term interest rates should prove beneficial for further growth in the housing market, which will boost the demand for lumber and related forestry products. Most housing analysts forecast a continued 8- or 9-percent increase in housing starts in 1994.

This solid growth will fuel the demand for lumber and wood products, and hence the demand for timber. The residential construction industry uses 21 percent of the output from the nation's saw and planing mills. These mills used 89 percent of the timber harvested in 1987.

While the overall demand for petroleum products is forecast to grow at approximately 2 percent in 1994, the increased demand for lubricants is expected to exceed 5 percent. This presents opportunities for industrial oilseeds, such as castor, industrial rapeseed, and crambe. Wholesaling and retailing, construction, and domestic petroleum and natural gas production are major industrial users of lubricants (table 1). All but domestic petroleum production are expected to grow in 1994. Final demand elements also account for significant shares of lubricant use: 27 percent for personal consumption expenditures and 8.8 percent for gross exports. Light vehicle sales are expected to grow by 5.8 percent in 1994 from the previous year.

Plastics are produced from petrochemicals (natural gas liquids and aromatics produced during petroleum refining). Large amounts of plastic products are used in the packaging, building and construction, and automobile-parts industries. The pickup in housing construction forecast for 1994, fueled by low long-term interest rates, and the expected strong demand for domestic automobiles throughout 1994, translates into strong demand for plastic products and, hence, the petrochemicals from which they are made. These are market opportunities for businesses selling fats, vegetable oils, and starches as ingredients in or substitutes for plastics.

Petroleum Prices Are Declining

Energy markets are important for industrial markets and for industrial uses of agricultural materials. A sharp rise in the price of oil, for example, would stimulate production of alternatives to petroleum-based fuels and lubricants, including those derived from agricultural materials. However, the outlook is for lower petroleum prices in 1994.

The price of crude oil is the key determinant of petroleum-based product prices. Weather and world growth are important secondary factors. A common proxy for aggregate crude oil prices is the weighted-by-sales cost of crude oil imported into the United States--known as the refiner acquisition cost (RAC).

The most commonly reported prices, such as West Texas intermediate crude oil or the New York Mercantile Exchange price, will often be $1 per barrel (42 U.S. gallons) more than the RAC. The Energy Information Administration's (EIA) short-term forecast has the RAC averaging $17.13 per barrel in 1993 and $17.18 in 1994. The RAC was $18.20 in 1992 and, in the first half 1993, it was down to $17.67 per barrel.

The late-November OPEC meeting failed to halt the recent decline in crude oil prices. West Texas crude fell from $18.75 per barrel in mid-November. The oil markets either do not believe that OPEC will adhere to agreed upon quotas andor that the world recovery will gather enough momentum to greatly increase the amount of crude demanded in 1994. As a result, most analysts are expecting that crude oil prices will be about 10 percent lower in 1994 than in 1993--corresponding to EIA's low-price scenario of the RAC averaging about $13 per barrel in 1994. If these analysts are correct, gasoline price should average about $1.20 per gallon and diesel fuel should average about $1.18 in 1994 despite the motor fuel tax increase. [David Torgerson and Arthur Wiese (202) 219-0782]

Table 1--Major industrial users of lubricants and their projected 1994 growth 1/

Industry	Share of lubricant use 2/	Expected 1994 growth 3/
	--Percent--	
Coal mining	3.4	+4.1
Crude petroleum and natural gas	3.9	-4.9 for domestic crude +2.0 for domestic natural gas
Construction	4.3	+3.0
Primary iron and steel	2.7	+3.0
Wholesale and retail trade	5.5	+2.2 for wholesale +2.5 for retail
Automobile repair and service	2.7	N.A.

N.A. = Not available.
1/ Based on the U.S. Department of Commerce's 1982 Input-Output Tables and U.S. Industrial Output 1993. 2/ Industrial users only, does not include commercial or service industries. 3/ From the 1993 base.