Modest U.S. Economic Growth in 1995 Provides Support for Industries Using Agricultural Materials

The U.S. Gross Domestic Product and industrial production are expected to grow 3.9 and 5.6 percent, respectively, in 1994. Growth, however, is forecast to slow in 1995. Inflation is expected to be 3.4 percent in 1995, up from an anticipated 2.7 percent in 1994. Industrial markets for agricultural products should continue to grow, albeit more slowly.

The consensus of private forecasters is that the U.S. Gross Domestic Product (GDP) will grow by 2.9 percent in 1995. Industrial production is expected to be up between 4 and 4.5 percent, along with strong export and investment growth. Analysts forecast housing starts to decline and consumer-durable growth to slow, dampening advances in both GDP and industrial production. Housing starts are expected to decrease from a likely 1.42 million units in 1994 to 1.36 million units in 1995.

In addition to a decline in residential construction, most forecasters expect weak plant investment in 1995, reducing overall construction for the year. Some analysts, however, pointing to high use of factory capacity, expect substantial growth in plant construction that will offset the expected decline in housing starts, making 1995 a growth year for the construction industry in most areas of the country. Most analysts expect strong business-equipment spending because profits have been increasing and are expected to continue rising in 1995.

Consumer prices are expected to rise 3.4 percent in 1995. Given this anticipated inflation and continued strength in industrial production, the Federal Reserve Board (Fed) is expected to put more upward pressure on short-term interest rates to restrain GDP growth to the 2.5- to 2.7-percent range.

Economic Growth Was Strong in Third Quarter

In the third quarter of 1994, growth was initially estimated at 3.9 percent, higher than most analysts expected. Strong growth in consumer durable goods, exports (at an annualized rate of 12.2 percent), and government spending, along with substantial gains in business-equipment spending, led to the high rate. Increased consumer disposable income, especially from wages, combined with readily available bank loans (albeit at higher interest rates), fueled the demand for consumer durables and business equipment. Although real (adjusted for inflation) car and truck spending was flat for the quarter, durables grew at an annualized rate of 6.3 percent because of strong furniture and appliance sales. Nonfarm business inventories, which were expected to drop, grew by some $6 billion.

Imports rose at an annualized rate of 15.6 percent during the third quarter, increasing the real trade deficit. Spending on business construction rose slowly at an annualized rate of 1.1 percent and residential investment fell at an annualized rate of 3.9 percent. Oil prices stabilized and spending on nondurable consumer goods increased 8.9 percent during the quarter.

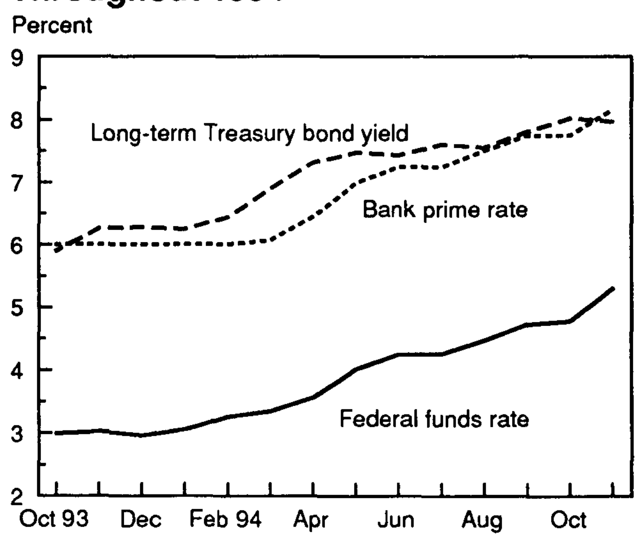
Interest Rates and Employment Increase

Since the economy was on a solid recovery path in early 1994, the Fed decided to institute a neutral monetary policy to prevent a resurgence of inflation. As a result, the Federal funds rate (the rate which banks charge each other for loans to cover reserve requirements) increased six times in 1994 from 3 percent in January to 5.6 percent in early December. Other rates went up (figure 1), reflecting the rise in the Federal funds rate, expected future tightenings, and increases in credit demand as our major trading partners recover. Most analysts expect the Fed to push up interest rates again next year.

Because of these interest rate hikes, GDP growth was slightly slower than it would have been otherwise in the third quarter of 1994. But the economy and the industrial

Figure 1

Interest Rates Have Risen Throughout 1994



sectors have been surprisingly resilient. Overall GDP growth for 1994 is expected to be 3.9 percent. The year is likely to be as strong as any since 1988. The economic strength was driven by productivity growth, providing very strong employment growth and some modest wage increases. Industrial production for the year grew at about 5.8 percent. Despite higher interest rates, most interest-sensitive sectors, including housing and furniture that rely on forest products and textile production, were profitable and grew during 1994. Home sales fluctuated more from quarter to quarter than other interest-sensitive sectors, but are expected to be higher in 1994 than in 1993. Housing starts are anticipated to be about 1.42 million, up from 1.29 million in 1993, an increase of 10.1 percent.

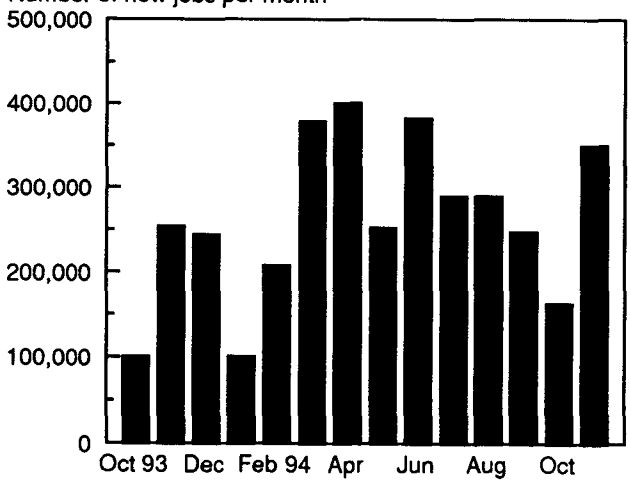
Employment grew an average of nearly 279,000 per month for the first 11 months of 1994, including an unexpectedly large increase of 350,000 in November (figure 2). The manufacturing sector added 50,000 new employees in November, also higher than expected. Except for California, every region is in recovery. Some areas of the Midwest recently reported bottlenecks in the labor market with wage increases above inflation. Overall labor markets appear to have substantial slack, which, coupled with higher productivity growth, likely will restrain 1994 inflation to 2.7 percent. Unemployment is expected to average about 6.4 percent for 1994.

Refined crude oil prices rose this year from $13 per barrel in January to $16 by the end of October, with a run up in the middle of the year to almost $18. Prices for gasoline and diesel fuel are expected to rise at the end of the year, reflecting the carbon monoxide provisions of the Clear Air Act. The U.S. Department of Energy's Energy Information Administration and most other analysts expect higher crude oil prices in 1995, reaching $18 per barrel by next fall. The forecast is based on expected growth in developed countries, which will increase demand with no great shift in supply.

Figure 2

Employment Growth Increased in 1994

Number of new jobs per month



Manufacturing Use of Agricultural Products Will Grow More Slowly in 1995

With GDP expected to grow 2.7 percent in 1995, industrial markets for agricultural products should continue to grow, albeit more slowly than in 1994. Although net exports are expected to drop in 1994, the growth in exports of manufactured goods will likely reach double digits. Modest increases in agricultural exports are expected next year, which will likely generate more demand for food and kindred products and industrial products that use agricultural materials. The expected rise in investment and personal spending should bring further growth in manufacturing sectors: furniture, plastics and rubber, corn milling and oilseed crushing, textiles, and leather-related products.

Production of fabricated metal products is important to industrial rapeseed and crambe oils, which are used as raw materials for lubricants in rolling and stamping metal products. Given the good outlook for industrial production in 1995, use of fabricated metal products is expected to expand. Domestic textile production, which has been robust in 1994 compared with 1993, will likely remain strong. Growth in printing and publishing expected for next year will raise the demand for paper and petroleum and vegetable-oil inks.

Even an increase in the demand for food and kindred products will (with some lag time) expand industrial uses of agricultural materials. For example, higher demand for meat products in 1995 would increase input use of fats and oils; paper and allied products; chemicals and selected chemical products; plastic and synthetic materials; and transportation, communication, and utility services. More specifically, a $1 increase in the final demand for meat products would require, directly and indirectly, 11 cents worth of fat and oil products and 20 cents worth of other manufactured products, such as paper, chemicals, and plastics. Use of transportation services would increase 8 cents, personal and business services would rise by 17 cents, and the wholesale and retail trade sector would generate an additional 12 cents of business activity.

Because of the expected slowdown in residential construction, wood and lumber use will likely decline. 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. If, as some analysts suggest, plant investment grows enough to offset the expected decline in residential housing starts, lumber and wood product demand could still grow in 1995. [David Torgerson, (202) 501-8329; and Chin Lee, (202) 501-8340]