SPECIAL ISSUE
THE FEDERAL RESERVE BANK OF CHICAGO
FEBRUARY 2005
NUMBER 211a

Chicago Fed Letter

Economic Outlook Symposium: Summary of 2004 results and forecasts for 2005

William Strauss, senior economist and economic advisor, and Emily Engel, associate economist

The forecasters expect more moderate economic growth during 2005, with some reduction in activity in the housing sector and a slower pace of consumer spending growth than in the past several years.

Real gross domestic product (GDP) growth started 2004 at a robust pace, rising 4.5% in the first quarter, but then growth eased to 3.3% in the second quarter as the economy entered a "soft patch" of economic activity. While third quarter growth improved to 4.0%, this was just a bit above our consensus panel's potential growth for the economy, and some were disappointed that activity did not rebound more significantly following the weaker reading in the second quarter.

1. Median forecast of GDP and related items

	2003 (Actual)	2004 (Forecast)	2005 (Forecast)
Real gross domestic product[a]	3.0	4.4	3.3
Real personal consumption expenditures[a]	3.3	3.6	3.2
Real business fixed investment[a]	3.3	10.1	8.3
Real residential investment[a]	8.8	9.7	–0.2
Change in private inventories[b]	–0.7	49.9	46.4
Net exports of goods and services[b]	–518.5	–582.4	–611.2
Real government consumption expenditures and gross investment[a]	2.8	2.1	1.9
Industrial production[a]	0.3	4.4	4.0
Auto & light truck sales (millions of units)	16.6	16.7	16.8
Housing starts (millions of units)	1.85	1.93	1.83
Unemployment rate[c]	6.0	5.5	5.4
Consumer price index[a]	2.3	2.7	2.4
1-year Treasury rate (constant maturity)[c]	1.24	1.84	2.91
10-year Treasury rate (constant maturity)[c]	4.02	4.31	4.72
J.P. Morgan Trade Weighted Dollar Index[a]	–6.7	–4.2	–3.2
Oil price (dollars per barrel of West Texas Intermediate)	31.14	41.57	43.24

[a]Percent change from previous year; [b]billions of chained (2000) dollars; [c]percent.
SOURCES: Actual data from Haver Analytics; median forecasts from Economic Outlook Symposium participants.

Employment, which has experienced job losses over the past several years, showed gains beginning in September 2003. The U.S. added nearly 2.3 million jobs between September 2003 and November 2004, averaging over 150,000 jobs per month. While the gains in the labor market have been positive, when looking at GDP and the labor market, the gains seem to be a bit more disappointing.

The economy faced a key challenge during 2004 in the form of significant increases in commodity prices. Oil prices played havoc with the economy, placing tremendous financial pressure on airlines, manufacturers, and the transportation industry. Oil prices, which ended 2003 at just over $32.00 per barrel, had jumped to over $53.00 per barrel by October 2004 (subsequently easing to $48.46 in November). Metals were another commodity whose prices rose unexpectedly in early 2004 and remained high throughout the year. With low inventories for many metals and improving economic conditions in the U.S. and the rest of the world, particularly China, steel prices surged. Steel mill product prices began to increase in late 2003 and continued to increase throughout 2004, to end the year up nearly 50% from a year earlier.

Housing continued to perform very well in 2004, with housing starts averaging 1.95 million units for the first ten months of the year, nearly 8% higher than the comparable period in 2003. In addition, housing prices increased nearly 8% over this period, adding to consumers' wealth.

Vehicle sales averaged 16.6 million units during the first 11 months of 2004, just a bit ahead of the 16.5 million unit average over the comparable period in 2003. While the past six years have been the industry's highest selling years, the amount sold has shown no growth, ranging between 16.6 and 17.2 million units each year.

Against this backdrop, the Federal Reserve Bank of Chicago held its eighteenth Economic Outlook Symposium on December 3, 2004. More than 90 economists and analysts from business, academia, and government attended the conference. This *Chicago Fed Letter* reviews last year's forecasts for 2004 and summarizes the presentations at this year's conference (see figure 1).

Looking back to 2004

Last year's forecasters were anticipating that the economy in 2004 would begin the year with growth slightly above potential (a growth rate associated with a stable unemployment rate and no inflationary pressures) and then moderate to growth near potential as the year ended. In general, the forecasts were more accurate for the first three quarters as a whole than the forecasts for each individual quarter. The economy started off a bit faster than forecasted, rising 4.5% in the first quarter compared with the 3.9% predicted. Second quarter output, which was expected to increase by 3.7%, grew by 3.3%. Third quarter GDP expanded by 4.0%, slightly above the 3.7% forecasted. The unemployment rate was forecasted to gradually trend down from 6.0% in the first quarter of 2004 to 5.7% by the fourth quarter. In fact, the year started off with a more marked reduction in the unemployment rate; it fell to 5.7% in the first quarter and trended lower, averaging 5.4% in the fourth quarter.

Real GDP is expected to have increased by 4.4% in 2004 and then rise 3.3% in 2005, just slightly above what the consensus group regards as potential.

The consensus forecast missed the mark on several key series. West Texas Intermediate oil prices were forecasted to average $29.00 per barrel in the first quarter and fall to $26.50 per barrel by the fourth quarter. Oil prices averaged just over $35.00 per barrel in the first quarter and rose to average over $48.00 per barrel in the fourth quarter. This underestimation of the rise in oil prices led to an under-prediction of inflation during 2004. Inflation was forecasted to average 2.2% during the first three quarters of 2004, but in fact averaged 3.4% during this period. Housing starts were expected to average 1.77 million in the first quarter and fall to average 1.70 million by the third quarter. But housing starts were stronger than expected, averaging over 1.92 million in each of the first three quarters of 2004.

The consensus forecast was more accurate when it came to the industrial sector. Industrial production was forecasted to average 4.3% growth for the year, very close to the 4.2% that actually occurred. Light vehicle sales were forecasted to average 16.8 million units during 2004, in line with the actual 16.9 million units pace recorded for the year.

Looking ahead to 2005

Real GDP is expected to have increased by 4.4% in 2004 and then rise 3.3% in 2005, just slightly above what the consensus group regards as potential.

While virtually all sectors are predicted to experience more moderate performance during 2005, the housing sector is expected to experience the most significant reduction in activity. Housing starts are forecasted to average 1.83 million units in 2005 after averaging 1.93 in 2004. This will lead to a substantial weakening in residential investment during 2005. After rising by nearly 10% in 2004, residential investment is expected to remain virtually unchanged in 2005. A predicted increase in interest rates will play a role in slowing the housing market. Forecasters expect the ten-year Treasury rate to rise to nearly 5% by the final quarter of 2005, a 79 basis points increase from the fourth quarter of 2004.

The forecasters expect spending growth in the consumer sector, which has performed solidly over the past several years, to moderate in 2005, easing from 3.6% growth in 2004 to 3.2%. The slower pace reflects a flat outlook for light vehicle sales, which are forecasted at 16.8 million units in 2005, just under the 16.9 million units recorded in 2004.

The business sector is expected to have another solid year, with growth in business fixed investment rising by 8.3% in 2005, slightly less than the 10.1% level in 2004. Inventories are forecasted to rise by $43 billion, a pace that is roughly in line with the gains in 2004. Industrial production, which is expected to rise 4.4% in 2004, should increase 4.0% in 2005, a somewhat faster pace of growth than the overall economy.

Government spending is anticipated to rise by 1.9% in 2005, a slower pace than in 2004. The international trade deficit is forecasted to increase somewhat, rising from $582.4 billion to $611.2 billion.

Oil prices are expected to have peaked in the fourth quarter of 2004 and then fall throughout 2005, reaching $40.00 per barrel by the end of the year. With a slower pace of economic activity, inflation is forecasted to moderate in 2005. Prices are predicted to rise by 2.6% in the first quarter and then gradually slow their rate of growth, rising by 2.3% in the second half of the year.

Outlook by sector

Carl Tannenbaum, chief economist for LaSalle Bank/ABN AMRO, delivered the outlook on banking and consumers. One of the first points he discussed was the notion that many people still believe that consumer spending is substantially down, but actually it has increased year over year.

The savings rate has been decreasing for many years, but Tannenbaum said he does not view this is a real setback, because these numbers do not reflect all the aspects where people have spending capital, including homes, stocks, or retirement funds. Additionally, the savings rate does not take into account weather-related problems, for example, hurricanes, when income decreases and spending increases, therefore making a person's savings rate decline sharply. Tannenbaum put forth a positive outlook for 2005, arguing that consumers will still spend despite these factors.

Robert J. DiCianni, marketing manager for Ispat Inland Inc., delivered the outlook on steel. As he did the previous year, DiCianni began his presentation by quoting Fed Chairman Alan Greenspan, "Uncertainty is not just an important feature of the [current] landscape; it is the defining characteristic of [this] landscape." DiCianni said that Greenspan's words still hold true today.

DiCianni explained that his 2004 forecast for U.S. consumption of flat rolled steel was an underestimate (56.1 million tons versus the actual 60.8 million tons) because 2004 ended up surpassing most people's expectations instead of simply being a "rebound" year as expected. Additionally, analysts failed to foresee the huge steel price hike from 2003 to 2004. The price increases could be attributed to many key factors, but the strong steel consumption in China has been the main driving factor. Furthermore, China's consumption of steel is still increasing and has been for the past ten years (they are a net importer of steel), making China a major force in the global steel industry.

DiCianni said he had a positive outlook for 2005, but was not expecting a repeat of the rapid growth of 2004. For 2005, he estimates U.S. consumption of flat rolled steel of close to 58.6 million tons. Scrap metal has been in short supply because only three regions source a major quantity of scrap: the U.S., Japan, and Western Europe. Additionally, while the prices for all types of steel will stay high for the upcoming year, DiCianni said, these prices are not expected to increase.

Higher gasoline prices do not seem to have dampened consumers' appetite for gasoline-intensive vehicles (light trucks), which have continued to outpace car sales.

David P. Teolis, senior economist in North America for the General Motors Corporation, delivered the automotive sales outlook. The most surprising aspect of vehicle sales over the past several years, Teolis said, is the increased demand for luxury vehicles, both cars and light trucks. In fact, luxury trucks, which did not exist until approximately ten years ago, are selling at a rapidly growing pace. Because the luxury market has been increasing, the pre-owned luxury vehicle market is competing very aggressively against the non-luxury vehicle market.

To date, higher gasoline prices do not seem to have dampened consumers' appetite for gasoline-intensive vehicles (light trucks), which have continued to outpace car sales. When prospective buyers were questioned about issues to consider when buying a car, Teolis said, gas prices rated number 13 on the list—well below safety, vehicle pricing, style, etc. Therefore, Teolis argued that vehicle sales will be positive regardless of gas prices.

Donald Hanson, manager and programmer for technology, economic development, and policy at Argonne National Laboratory, delivered the energy outlook. Discussing ongoing efforts to find acceptable substitutes for oil to meet U.S. energy needs, Hanson noted that important progress has been made in natural gas. Recent technological advancements are improving researchers' ability to find natural gas in more remote and previously inaccessible locations, through directional drilling and 3D visualization. In addition, larger turbines have been developed for wind power, which are capable of harnessing and producing more energy then in the past. This environmentally friendly power alternative is rapidly expanding in Europe as "green" legislation is tightening energy regulations throughout the continent. In its attempt to harmonize issues ranging from the economy to the environment, the European Union is setting an aggressive agenda in its approach to alternative sources of energy, looking to free itself from the dependency on oil from the Middle East.

Petroleum prices for the U.S. are forecasted to stabilize by the end of 2005, due to the inelastic response of price to oil shocks this year. However, China's demand for oil is growing, thereby increasing prices across the board. China's seemingly insatiable appetite for energy is driving up demand around the globe.

Don Johnson, chief economist from Caterpillar Inc., delivered the outlook on heavy machinery. By September 2004, sales were already twice what he forecasted for the year as a whole. Johnson expects the full year to be up by at least 30% from 2003. These increases are being recorded both globally and industry-wide.

Michael H. Moskow, *President;* Charles L. Evans, *Senior Vice President and Director of Research;* Douglas Evanoff, *Vice President, financial studies;* David Marshall, *Vice President, macroeconomic policy research;* Richard Porter, *Senior Policy Advisor, payment studies;* Daniel Sullivan, *Vice President, microeconomic policy research;* William Testa, *Vice President, regional programs and Economics Editor;* Helen O'D. Koshy, *Editor;* Kathryn Moran, *Associate Editor.*

Chicago Fed Letter is published monthly by the Research Department of the Federal Reserve Bank of Chicago. The views expressed are the authors' and are not necessarily those of the Federal Reserve Bank of Chicago or the Federal Reserve System.

ISSN 0895-0164

Johnson argued that U.S. infrastructure is expanding fast and has not been adequately supported in recent years. As the number of vehicles increases, so does the number of miles traveled, leading to more congestion. This situation is costing approximately $70 billion yearly, through the expenditure for gasoline, construction, etc. Furthermore, fleets are becoming obsolete and less productive. Technological innovation is being outpaced by the number of soon-to-be obsolete vehicles on the road, resulting in sharp increases in costs to maintain and improve the nation's infrastructure. Demand, Johnson said, is rapidly outpacing supply. Johnson concluded that 2005 will see a dwindling supply of raw materials. However, construction, mining, machinery, and engine industries should improve over the coming year.

Conclusion

The year 2004 proved to be a strong one with GDP, employment, and housing doing well. However, markets saw a spike in commodity prices. Despite a significant increase in the price of fuel, mainly as a result of the unstable political environment in the Middle East, vehicle sales remained stable throughout 2004. Furthermore, the general underestimation of the rise in oil prices led to an under-prediction of inflation during 2004. The overarching consensus within the individual sectors shows optimism for 2005, but growth is expected to be at a more moderate pace than was seen in 2004. The housing industry is anticipated to soften because of the higher interest rate forecasts. Vehicle sales are predicted to remain at high levels, with little growth, throughout the year. Additionally, both inflation and energy prices are forecasted to fall throughout 2005.