District Economy Takes Off in '94

by Kevin L. Kliesen

By several yardsticks, the pace of economic activity in 1994 in the seven states of the Eighth Federal Reserve District was the strongest in several years.[1] Unemployment rates fell to record or near-record lows in many District states, while brisk sales at retailers and robust gains in employment contributed to real (adjusted for inflation) income gains in the District that exceeded those for the nation. All was not wine and roses, however, as the interest-sensitive construction sector waned considerably in the face of rising interest rates.

Like other Fed Districts, the Eighth District economy is influenced by the tugs of economic forces not only at the state and local level, but also at the national and international level. There are several reasons for this. First, credit markets are well-integrated, meaning that they are influenced by a host of national and international factors. Among these are: domestic fiscal and monetary policies, the supply of and demand for financial capital, cross-country inflation rates, interest rates and exchange rates. Second, many District firms produce goods and services that are also traded outside of our boundaries. Income growth in Florida, Texas or California, for example, influences the demand for goods and services produced in St. Louis (autos), Louisville (appliances) or Memphis (package delivery services).

These influences can also extend across international borders. The recent devaluation of the Mexican peso—because it makes Mexican goods less expensive in the United States and U.S. goods more expensive in Mexico—is an example of a foreign disturbance that adversely affects the demand for U.S. goods and services, such as rice and poultry from Arkansas.

An Overview of 1994

National output of final goods and services (real gross domestic product, or GDP) increased 4.1 percent last year, the largest jump since 1984. Several factors combined to produce a powerful tonic for economic growth in 1994. A nonaccelerating inflation rate, strong productivity gains in the business sector and the delayed effects of an expansionary Federal Reserve monetary policy from late 1991 to early 1994 were among the most important.

The table at right lists several measures that depict the strength of economic activity logged in the nation and in the District last year. Unlike GDP estimates, which are available on a quarterly basis, gross state product (GSP)—the state-level equivalent of GDP—is an annual measure and available only with a two- to three-year lag. Accordingly, we must look at other measures of economic activity at the state level that are released on a more timely basis.

One such measure is real nonfarm personal income (NFPI), which is a reasonable proxy for real GSP. NFPI is basically the sum of all income accrued from: (1) wages and salaries; (2) interest and dividend income of individuals; (3) income earned by business owners of the nonfarm sector; and (4) transfer payments, such as veterans benefits or health insurance benefits, to individuals from the government. In 1994, District NFPI rose 4.6 percent—double the 2.3 percent rate of increase experienced over the three-year period from the fourth quarter of 1990 to the fourth quarter of 1993 (1991 to 1993 in the table). Income increases in District states last year exceeded the national rate of 4 percent, led by Arkansas (up 5.2 percent), Indiana (up 5.5 percent) and Missouri (up 4.9 percent), with Tennessee (4.8 percent) and Mississippi (4.6 percent) not far behind. The remaining two District states, Illinois and Kentucky, also posted solid real income gains, rising 4 percent and 4.3 percent, respectively.

When consumers earn more income, they can do one of two things: spend it or save it. In 1994, consumers decided to spend it. Last year's real retail sales in the District and in the United States rose at the fastest pace in several years, increasing 5.2 percent (at both levels). The 1994 increases were well ahead of the pace set during the previous three-year period. Spending on durable goods like automobiles, appliances, computers and furniture was particularly strong last year, increasing 9.2 percent in the District and 9.6 percent in the nation. This spending pattern especially benefited Eighth District states, which have a larger share of durable goods manufacturers compared with the nation as a whole.

Because wages and salaries make up nearly 60 percent of NFPI, employment gains and real income gains tend to move in tandem. District nonfarm payroll employment rose 3.3 percent in 1994, or by about 536,000, slightly exceeding the 3.1 percent increase registered for the nation.

Payroll employment growth varied considerably by state, although growth in most District states exceeded the national rate. For example, nonfarm payrolls increased 4.8 percent in Arkansas, making it the eighth consecutive year that the state exceeded the national rate. In Kentucky, nonfarm employment rose 3.8 percent last year, while employment increased 3.5 percent in Missouri and 4 percent in Tennessee. Employment gains in the remaining three states—Indiana (3.1 percent), Illinois (2.5 percent) and Mississippi (2.9 percent)—while still strong, did not match those in other District states.

Strong payroll employment growth led to tight labor markets last year, as many firms struggled to fill available openings. The District unemployment rate averaged 5.5 percent in 1994, down 1.2 percentage points from the average over the previous three-year period and more than half a percentage point below the U.S. average for the same period. In some District states, the unemployment rate was the lowest in years. For example, by the fourth quarter of 1994, Missouri's unemployment rate, at 4.4 percent, was the lowest since mid-1979, while Tennessee's unemployment rate, of 4.2 percent, was the lowest since early 1974.

The table also shows that one of the few weaknesses in the District last year was the construction sector. It should be pointed out that, because 1993 was a record year for the construction industry in many areas, a decline in construction will tend to overstate any weakness because construction activity still remains at a relatively high level. The value of real construction contracts in District states fell 9.7 percent in 1994, after rising nearly 48 percent over the 1991-93 period. Most of this decline stemmed from a 14.5 percent drop in the value of residential construction contracts.

Certainly, increasing interest rates had some effect on last year's construction numbers: The average interest rate on 30-year fixed-rate mortgages rose from 7.05 percent in the third quarter of 1993 to 9.10 percent by the fourth quarter of 1994. An additional explanation for the slowdown is that the pace of growth in the District construction sector—particularly homebuilding—simply was not sustainable.

The Outlook for 1995

There is some concern about where the economy is headed at the national level, which will ultimately affect the District economy. As shown in the table, real retail sales for the United States declined in the first quarter for the first time in two years, while District real retail sales, although still growing, have slowed considerably. This is a development that, unless reversed, could adversely affect economic growth for the remainder of 1995. Another area of concern is the residential housing sector, which continues to languish. While few expect a return to the heady days of 1993, there may be some upside potential given recent declines in long-term interest rates. Disconcertingly, however, year-to-date housing starts and building permits at the national level are running well below last year's pace, suggesting possible further weakness in the short term. On the other hand, nonresidential construction in the District rebounded nicely in the first quarter, bolstering construction employment growth, while growth slowed nationally.

Another bright spot remaining in the District is employment growth, which accelerated to a 3.7 percent annual rate in the first quarter, while employment growth nationally ebbed slightly, rising at a 2.8 percent annual rate. Employment growth, however, is usually a lagging indicator, meaning that it begins to wane only after the economy begins to weaken and not before. Given the unexpected weakness in U.S. payroll employment in the second quarter, the national economy may be softer than many realize. If this is true, then it is only a matter of time before the slowdown filters through to the District economy. Why? Because economic trends at the District and national levels typically do not diverge from one another for any extended period of time.

In summary, although few forecasters are predicting a recession this year, many economists believe that economic growth in 1995 will probably be markedly slower than last year's, with a slight uptick in unemployment rates and a further acceleration in consumer prices. If these predictions pan out, then economic growth in the seven District states will also lag behind 1994's pace—but perhaps still exceed the pace nationally.

Selected Economic Indicators (percent)

Indicator	United States 1991-93	United States 1994	United States I/1995	District 1991-93	District 1994	District I/1995
Real Nonfarm Personal Income Growth	1.9%	4.0%	na	2.3%	4.6%	na
Real Retail Sales[1]	2.0	5.2	-0.7%	2.7	5.2	2.1%
Durables	5.0	9.6	-4.3	7.2	9.2	-0.8
Nondurables	0.3	2.5	1.7	0.5	2.6	1.2
Payroll Employment Growth	0.7	3.1	2.8	1.5	3.3	3.7
Goods Producing	-1.7	2.3	2.8	0.2	3.3	3.8
Manufacturing	-1.6	1.3	2.2	0.2	2.4	3.4
Construction	-1.5	6.3	5.9	0.9	7.8	6.5
Mining	-5.0	-1.7	-3.7	-7.7	1.4	-5.4
Service Producing	1.3	3.3	2.8	2.0	3.3	3.7
Wholesale/Retail Trade	0.2	3.6	3.5	1.0	3.9	6.2
Services	3.1	5.1	4.6	4.1	4.2	4.2
Government	1.0	1.4	-0.0	1.1	2.0	0.2
Finance, Insurance and Real Estate	0.2	0.4	-0.1	1.1	1.3	0.7
Transportation and Public Utilities	-0.1	1.6	2.7	1.1	2.6	3.8
Unemployment Rate[2]	6.9	6.2	5.5	6.7	5.5	4.8
Real Value of Building Contracts[3]	19.6	-2.4	-0.9	47.8	-9.7	-0.1
Residential	48.5	-10.3	-3.9	77.0	-14.5	-11.3
Nonresidential	-7.3	9.4	2.7	16.5	-1.9	15.7

Note: na = not yet available

[1] District retail sales data are deflated and seasonally adjusted by this Bank. Data for Mississippi are not available; data for durable and nondurable sales are not available for Arkansas.

[2] Unemployment rates are the average of quarterly data over the period indicated.

[3] Excludes nonbuilding construction. Changes over the indicated period are simple percent changes (not compounded annual rates) and are based on current dollar data from DRI/F.W. Dodge. This data is deflated and seasonally adjusted by this Bank.

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ENDNOTES

[1] The seven-state area comprises Arkansas, Illinois, Indiana, Kentucky, Mississippi, Missouri and Tennessee. See back cover.