U.S. Economic Outlook

Forecast Update—Second Quarter Data, Third Quarter Preliminary Analysis, and Revised Fourth Quarter and 2005-2006 Projections

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Gross Domestic Product (GDP) growth averaged 4.2 percent in 2004 (after the U.S. Department of Commerce's summer 2005 benchmark revisions) and 3.8 percent in the First Quarter 2005. (GDP is the sum of all goods and services produced in the U.S. and is a key measure of economic gain or loss.)

In Second Quarter 2005, GDP growth decelerated to 3.3 percent.

- Reasons for the slowing economic growth rate in 2005:
  - Fuel prices have more than doubled since 2002, diverting money from other spending.
    - The world per-barrel oil price was $26 in 2002 and over $60 by June 2005.
    - Unleaded regular gasoline at the pump was $1.00 per gallon in 2002 and $2.25 per gallon by June 2005.
    - The climb in fuel prices resulted from:
      - Skyrocketing world demand
      - Political unrest in Iraq, Iran, OPEC, Russia, and Venezuela
      - Supply chain problems
  - The rise in fuel prices in the first half of 2005 was costing the U.S. economy about 0.8 percent potential GDP growth.
  - The continuing wars in Iraq and Afghanistan and combatting the threat of terrorism were also costing the U.S. economy another almost 0.8 percent potential growth. (Virginia's economy, however, benefits from defense activities because of the many military installations in the state and the military supplies shipped through the Hampton Roads port.)
  - Depreciation tax incentives to businesses that had boasted GDP growth in 2004 were not extended into 2005.
  - The Federal Reserve, now more concerned with fighting inflation than boosting growth, had raised the Fed Funds rate, and in turn, interest rates, from 1.00 percent in June 2004 to 3.25 percent in June 2005.
  - U.S. job growth remained slow due to automation, productivity, and offshoring, but some large states that did not grow in 2003 and 2004, started to bounce back in 2005. The U.S. unemployment rate edged down to 5.0 percent (which many experts consider to be "full employment).

> ***The first half of 2005 sees fairly good, but decelerating, growth as oil prices rise.***

  - The rising fuel cost had caused light vehicle sales, especially for the less fuel-efficient sport utility vehicles to fall off.

- Some Third Quarter 2005 events:
  - High world demand at the peak of the U.S. summer driving season caused per barrel oil prices to spike to $68 and unleaded regular gasoline prices to climb to $2.35 per gallon at the pump.
  - In July, the domestic vehicle makers, who were dismayed at falling sales and a large build-up in inventory of left-over 2005 models, instituted "employee discounts" to everyone. This scheme really worked as most dealers' lots were emptied of the 2005 models by Labor Day. "Employee" or "other" types of discounts are being extended to the 2006 models to keep the sales momentum going.
  - The Federal Reserve continued its path of 0.25 percent basis point rises in the Fed Funds rate at its 6-week open market committee meetings in August and September. At the end of the third quarter, the Fed Funds rate was 3.75 percent.
  - What is turning out to likely be the Biggest Economic Event of 2005, happened on August 28 though 30. Hurricane Katrina (a Category 4 hurricane) slammed into New Orleans, Louisiana, and the Gulf Coast. At first, the news reports were that New Orleans had missed the full fury of the storm, but then hours after the storm had passed, the levees, holding back Lake Pontchartrain and keeping New Orleans dry, broke, causing 80 percent of New Orleans to be flooded.

- Katrina is the worst hurricane ever to hit a major U.S. city, causing many deaths and over 100,000 persons homeless or displaced, and the cost of the hurricane could exceed $100 billion.
  - The New Orleans area only contributes 0.4 percent to U.S. GDP, but:
  - damage has been done to the region's vast energy infrastructure
    - the Port of New Orleans is the nation's second-largest; most mid-west farm products are shipped though New Orleans, and most imports from South and Central America enter the U.S. through New Orleans
    - The Port of New Orleans, however, handles mainly bulk cargo. It *is not* a critical container port.

- Just before we went to press, another monsterous storm, Hurricane Rita, hit Louisiana and Texas. Although fears were for the worst, and parts of New Orleans were flooded again, Rita overall was less damaging than Katrina. Beaumont, Texas, and Lake Charles, Louisiana, were hard hit, and the nation's natural gas suppliers were more damaged.

The hurricanes' impact will likely produce lower growth until the end of 2005, but rebuilding makes 2006 now look stronger.

- The likely impact of the storms on the U.S. economy in coming months, is expected to be:
  - The quick repair and return to operation of the energy infrastructure will cause oil prices to drop from the $70+ per barrel of early September, to $65 per barrel by year's end. Gasoline prices that were well over $3.00 per gallon will fall to about $2.70 per gallon for unleaded regular by year's end.
  - GDP growth will be reduced in Third and Fourth Quarters 2005. Third quarter was expected to have 4.4 percent GDP gain because of all the "employee discount" vehicle sales and a still very strong housing market, and should now see 3.4 percent GDP gain. Fourth quarter, which was expected to only have 3.3 percent GDP gain anyway, will now grow just 2.3 percent. GDP growth for all of 2005 should now average 3.4 percent versus the 3.7 percent projected originally.
  - The reverse will be true in 2006 as reconstruction begins and oil prices slide even more. GDP growth in the U.S. should average 3.6 percent in 2006 versus the previously projected 3.1 percent. Oil prices will average about $59 per barrel and regular unleaded gasoline should average about $2.50 per gallon. Because of storm-related dislocations and still high world demand, the gasoline price will not quite go back to the pre-Katrina level. Also, due to the damage to natural gas-producing facilities, natural gas prices will remain very high during most of 2006.
  - Consumer spending growth will dip from 3.9 percent in the third quarter to only 0.8 percent in the fourth quarter as the result of all the money spent on new vehicle payments and gasoline, which will not make a "happy holiday" for many merchants. Since merchants had already ordered much merchandise, "sale events" may appear very early in this year's holiday season.
  - Employment and industrial production numbers will be weak at the end of 2005 and will not fully revive before mid-2006.
  - The nation's unemployment rate is expected to remain close to the 5.0 percent third quarter level as Katrina refugees are dispersed over the country. States like Texas, Arkansas, and Tennessee that have taken in lots of refugees will undoubtedly see higher jobless figures. Relatively few Katrina refugees have migrated to Virginia.
  - The Federal Reserve will take a "wait-and-see" attitude—not raising the Fed Funds rate until into 2006, although energy costs will spike inflation through the end of 2005. Higher oil prices will push the inflation rate to 3.5 percent for 2005, but inflation is expected to drop back to 2.3 percent in 2006.
  - More airlines may go bankrupt because of the high fuel costs.
  - Increased revenues with the fairly prosperous economy were beginning to reduce the $300+ billion federal deficit, but to pay for the hurricane recovery will ultimately cause higher federal user fees and taxes.

The probability of the baseline forecast is 60 percent.

Alternate Scenarios

- The U.S. economy quickly recovers from the oil and hurricane damage with the technology boom accelerating, raising employment and income, and reducing the federal deficit. Also, foreign economic growth is stronger and alternative energy sources are developed. (probability is 10 percent)

- Doubling oil prices, anemic expansion, accommodative monetary policy, and loose fiscal policy cause a reacceleration of inflation that the Federal Reserve is slow to contain. The housing price bubble ends and consumers lose confidence. The economy does not sink into recession, but lulls along in the 1 to 2 percent growth range until 2008. (probability is 25 percent)

- There is still another severe shock to the economy coming on the top of high oil prices and the hurricanes, and the economy sinks into recession. (probability is 5 percent)

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"Employee discounts" on vehicles and the booming housing market promised a better third quarter, but Hurricanes Katrina and Rita dashed expectations.