Agricultural Economy

Slower Growth for U.S. Economy In 2001

U.S. economic growth slowed markedly in the second half of 2000, ushering in the "soft landing" many analysts had hoped for. From a breakneck rate of 6 percent in the first half of 2000, forecast growth in Gross Domestic Product (GDP) decreased significantly in the second half of 2000, resulting in an average annual growth rate expected at 5.2 percent.

In 2001, GDP growth is expected to drop further, averaging 3 percent, owing to continued tightness in labor markets, a slowing of consumer income growth, and tightening credit that will slow business investment. Inflation, which rose moderately in 2000 to 2.3 percent according to the GDP deflator, will increase slightly in 2001 to around 2.5 percent due to higher labor and energy costs. Despite these trends, it is unlikely the U.S. economy will experience a recession; overall increases in productivity and investment, a reduced trade deficit, and continued gains in consumer income and jobs all point to economic growth in the coming year.

Consumer spending will likely increase by 3 percent in 2001, but it will be held in check by a tight labor market, more limited credit, and higher energy prices. Consumer spending grew at a slower rate in 2000 than in 1999; in particular, spending on durable goods such as cars, appliances, and furniture deteriorated throughout 2000 as a consequence of relatively heavy consumer spending in 1996-99. Major appliance manufacturers saw sharp declines in earnings, and auto manufacturers were forced to offer aggressive price rebates and credit discounts to prevent steep drops in sales.

Overall, consumer spending in the third quarter of 2000 grew at an annualized rate of 3.8 percent, which outpaced growth of 3.1 percent in consumers' disposable income. Although the savings rate fell, it was the smallest decline in 2 years. In 2001, growth of income from labor will be about the same as in 2000 (largely due to higher wages), and a decline in income from other sources, such as stock dividends, will be offset by lower capital gains taxes paid. This will result in disposable income growing at 3 percent, the same rate as in 2000 and directly in line with consumer spending.

Despite consistent growth in wages, workers are likely to face a slowdown in employment growth in 2001 as businesses' profit growth slackens and difficulties in finding appropriate workers persist. The trend became evident in 2000, as the low U.S. unemployment rate (4 percent) and a dearth of skilled workers led to higher labor costs for many U.S. companies. Workers' total compensation packages, which include wages plus benefits, rose at an annualized rate of 4.6 percent for the first 9 months of 2000 as employers, hamstrung by the tight labor market, were forced to absorb much of the rise in health insurance costs.

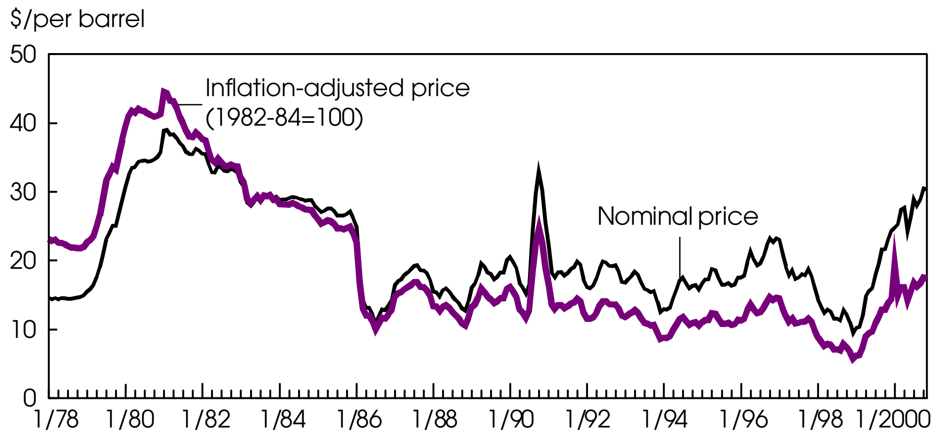
Rising energy prices remained a persistent concern for businesses and consumers alike in 2000. Although the markets for other raw materials remained relatively static, crude oil prices finished the year near $30 per barrel, up sharply from $9.39 per barrel of December 1998. The high price of oil not only drove up consumer and corporate energy bills; it also contributed to increased trade deficits. Rising natural gas prices will further contribute to rising consumer and business energy expenses.

Fortunately, the impact of oil price increases on the U.S. economy will be relatively small in 2001, thanks to a general lack of upward pressure on prices of raw materials, increased domestic competitiveness in the U.S. economy, a relative drop in the size of energy expenditures in the economy, and oil prices that, in real terms, are only $5 per barrel above the 1985-99 average. In fact, the impact of the 2001 oil market on the economy should be smaller than that of the 1974, 1979, or even 1990 oil shocks. Growth has slowed about 0.2 percent and overall inflation is about 0.3 percent higher than it would have been compared with a year with normal real crude prices.

As consumer spending dropped off in the last half of 2000, investment spending by businesses slowed. Tighter credit standards, a slowdown in profit growth, falling equity prices, and higher commercial interest rates brought the third quarter's business investment growth down from more than 19 percent in the first half of the year to low single digits. Solid consumer spending combined with strong profits should bring growth of 5 to 6 percent in business investment spending in 2001, and the profits from such investment are expected to remain substantial. However, the tight credit situation, higher commercial interest rates, and slowing profit growth will keep business investment spending below the recent double-digit growth rates of 1995-99.

Growth in business spending in 2001 will be partly offset by smaller additions from Government spending. Commercial interest rates will rise, reflecting an increase in the market risk premium. From early 2000 to the third quarter, the risk premium on junk bonds compared with Treasury bonds rose to 8 percentage points. A recent Federal Reserve survey of lending officers showed

Real Oil Prices Are Edging Up



Refiners' acquisition cost of crude.
Source: U.S. Department of Energy.
Economic Research Service, USDA

that businesses must now meet higher credit standards when they apply for loans. These new, more stringent requirements in the private market, coupled with the tight labor market, will slow capital and employment expansion.

As a result of slowing economic growth, moderate inflation, and expected easing of short-term interest rates by the Federal Reserve, yields of Treasury and AAA bonds will drop in 2001. However, the general tightness in credit markets seen in the last half of 2000 should persist in 2001, resulting in higher interest rates for junk bonds and commercial loans.

The View from Abroad

The U.S.'s powerful economic growth was reflected overseas throughout 2000. Overall, world average GDP increased by 4 percent in 2000, enhanced by a spectacular growth spurt of 7 percent in Asia. In North America, Mexico's GDP growth registered more than 6 percent; Canada's GDP came in at just under 5 percent. Profiting from rising crude oil prices, the economies of the Middle East grew nearly 5 percent. The economies of South America grew a solid 3.4 percent, despite problems in Argentina, Venezuela, and Peru.

Despite this robust global performance, growth rates of most developed nations (with the exceptions of Japan and Germany) should decline by 0.5 to 1 percent in 2001. The economies of many Asian nations will slow as well because growth rates seen in 2000, which reflect a sharp turnaround from the 1998 financial crisis, are unsustainable. High crude oil prices in early 2001 will be a major factor stunting growth not only in the developed countries and Asia, but in some of the more vulnerable developing nations as well. Higher world interest rates, a smaller U.S. trade deficit, and a weaker dollar will have a marginally negative impact on world growth.

World demand for agricultural exports played a key role in offsetting the strengthening of the dollar in 2000; even though they became more expensive in relative terms, U.S. agricultural exports saw a modest increase. The demand for dollars stemmed from uncertainty associated with the recovering economies in Asia and Latin America and a lack of confidence in Asian and developing economy stock markets, as well as foreign investors' view of the U.S. as a safe haven. However, the U.S. trade deficit (more than $400 billion in 1996 dollars), a weak U.S. stock market, and improving financial conditions in other developed countries and Asia will all serve to weaken demand for dollars in 2001. The resulting decrease of funds flowing into the U.S. will boost long-term private interest rates, even as short-term U.S. Treasury bonds stabilize and long-term U.S. Treasury bill yields fall slightly. A weaker dollar and ongoing, if slower, world growth will lead to a slight improvement in the U.S. trade deficit in early 2001. The deficit should decrease further in the second half of 2001, when slower world growth is likely to result in lower oil prices.

Challenges for U.S. Agriculture In 2001

Slower domestic and world growth in 2001, coupled with the lingering impact of a strong dollar, mean a more expensive and potentially more problematic business environment for U.S. farmers in 2001. Agricultural exports in particular will be affected, much as they were in 2000. Although the value of the dollar rose less than 2 percent in 2000, its value relative to the currencies of other countries that export farm products rose even more. As a result, prices of U.S. farm exports rose considerably compared with those of foreign competitors.

Even though the dollar is expected to weaken somewhat in 2001, agricultural exports will grow at a slower rate than exports of manufactured products. If the domestic economy were to experience a recession in 2001, world growth would decrease sharply and U.S. farm exports would decline. On the domestic front—again, barring a recession—growth in after-tax personal income will ensure that U.S. consumers keep buying domestic agricultural products at a healthy rate.

Although higher energy prices will not have a dramatic effect on the overall U.S. economy, they have triggered increases in farm expenses. While fuel prices will not likely rise as dramatically in 2001 as they did in 2000, fuel expenses for many farmers will be up from 2000. Peak farm diesel use is in the spring when prices will be up from a year earlier. Electricity and natural gas prices should rise as well, and increasing natural gas prices will in turn raise the cost of nitrogen-based fertilizer. The fertilizer price index should be up in 2001 more than it was in 2000. The tight labor market is expected to push the cost of farm labor higher in 2001 than in 2000.

Projections for farm credit in 2001 are mixed. A tighter credit market will make it harder for less financially sound farmers to get commercial credit, and interest rates for average borrowers who do qualify for short-term loans will be higher than in past years. Good customers with sound balance sheets may pay slightly less for credit. Average long-term real estate loans may be cheaper depending on institutional lending practices, as yields on Treasury bonds fall compared with 2000. AO

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