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A Slower-Growth Economy in 2005

The U.S. economy is expected to experience a solid year in 2005, according to research and forecasts from Economy.com. Real GDP growth is projected to come in at 3.5% and inflation close to 2%. That compares to GDP growth in 2004 expected to be 4.5% with inflation at 1.5%. GDP growth is expected to be driven by increases in capital spending, but the pace of consumer spending will slow.

Capital investment in new equipment and buildings leads to expanded production, which generates growth in jobs, incomes, and demand. Longer term, it also forms the base for gains in productivity and living standards. Fifty percent of CEOs that the Business Roundable surveyed in late 2004 said they expect their companies to increase capital spending in the next six months. That percentage is well above the 35% from this time last year, and it has risen steadily in each quarter of 2004. Similarly, 33% of chief executives surveyed by The Conference Board in the third quarter of 2004 said they've increased their plans for capital spending since January 2004. Only 6% said they had plans to scale back. This is an improvement from the same time last year when only 12% of CEOs had increased their capital spending plans and 31% had made cuts.

Data from the U.S. Department of Commerce shows that, in the past year, companies have gone beyond replacing short-lived high-tech equipment to spending on more traditional machinery and equipment. Third-quarter business outlays for all types of equipment and software, adjusted for inflation, increased at a sturdy 17.2% annual rate. Outlays for information-processing equipment slowed in the third quarter, but spending on nontech items accelerated sharply. Industrial machinery was up 27.2%, the best showing since the Commerce Department started keeping quarterly records on such spending in 1990. Transportation equipment soared 35.4%, the largest quarterly gain in nearly six years. Spending on all other nontech items jumped 22.9%. As a result, nontech equipment has accounted for nearly 60% of the growth in all equipment outlays in the past year.

On the expense side, CEOs surveyed by the Business Roundtable said for the second year in a row that their top three cost pressures are healthcare costs, cited by 43% of the respondents, litigation costs (20%), and energy prices (19%). Materials prices were reported as the greatest cost pressure by 11% of the CEOs, followed by labor costs (4%), and pension costs (4%). In the December 2003 Business Roundtable survey, the top cost pressures reported by the CEOs were healthcare costs (58%), litigation costs (24%), energy costs (7%), pension costs (6%), and labor costs (4%).

Despite the recent interest-rate hikes by the Federal Reserve Board, financing this spending won't be a problem for many companies because they're cash flush. Internally generated cash flow of U.S. companies climbed from about $750 billion in mid-year 2003 to $925 billion in mid-year 2004, according to the

Federal Reserve. Although profits are growing more slowly as costs rise, that's compared to an unusually strong pace of recent quarters. Third-quarter profits from current production fell 2.4% from the second quarter, and the growth from the previous year slowed to 8.4%, according to the Commerce Department. In the second quarter of 2003, profits were 19% less than the second quarter of 2003.

But consumer spending—which accounts for roughly two-thirds of the nation's economic activity—is predicted by economists to slow in 2005 from a robust pace in 2004, although consumers don't seem to see it that way. "Personal consumption expenditures," as the Commerce Department calls them, rose 0.6% in October 2004 over September 2004, which increased 0.6% over August, the Commerce Department's Bureau of Economic Analysis reported. This compares to 0% change in October 2003 over September 2003, which declined 0.3% over August 2003.

U.S. consumer sentiment in November 2004 rose to its highest level since May 2002, according to the University of Michigan's survey on consumers' assessment of present and future economic conditions for themselves and the country. The survey's index stood at 93.7 at the end of November, compared to 93.5 in November 2003.

But economist Mark Zandi of Economy.com predicts consumer spending will slow in 2005 because the personal savings rate is near zero and higher debt burdens will weigh more heavily on consumers, he wrote in a December 2004 report. The most recent slide in the savings rate is due to the spurt in energy prices, continued robust mortgage borrowing, and the end of the tax cutting. Lower-income households have dipped into their savings to help pay for higher gasoline and home heating prices. They have also begun to scale back their energy and other consumption, Zandi says. ■