STATE BOARD OF EQUALIZATION

ECONOMIC PERSPECTIVE

Summary of Recent Economic Developments *February 2001*

❖ *U.S. Economic Developments*

Slowing Economic Growth in Late 2000

U.S. economic growth slowed sharply during the second half of 2000. In the third quarter (July through September) real gross domestic product (GDP) increased 2.2 percent, according to the final estimate released by the U.S. Department of Commerce in late December, 2000. This is the slowest quarterly growth in four years, and stands well below average real GDP growth of 5.2 percent recorded for the first half of 2000. The Department of Commerce revised third quarter growth downward from an "advance" estimate (released in October) of 2.7 percent growth, and from a preliminary estimate (released in November) of 2.4 percent. Monthly data released for several economic indicators, including employment, industrial production, retail sales, and consumer confidence, continue to suggest that weak growth persisted into the fourth quarter. The advance estimate shows that real GDP increased just 1.4 percent in the fourth quarter. The final estimate of fourth quarter 2000 real GDP is scheduled to be released in late March.

Weak Growth Expected to Continue

Many economists are predicting that growth will continue to be sluggish throughout 2001. The consensus forecast from a survey of 48 economists polled in January by *Blue Chip Economic Indicators* calls for real GDP to increase 2.6 percent in 2001. Growth on this order of magnitude would be similar to 1995, when real GDP rose 2.7 percent. It would be slightly below the long-term average of 3.0 percent growth for the ten-year period from 1990 through 1999.

Economists expect weaker growth to continue in 2001 for several reasons. For consumers, deteriorating consumer confidence, unstable financial markets, and uncertain electricity and natural gas prices in certain areas of the nation are expected to lead to continued weakness in spending. For businesses, in addition to facing the same unstable financial and energy markets affecting consumers, declining earnings and difficulty in obtaining credit are additional factors contributing to reduced spending and hiring of employees. Consumer and business spending together typically account for about 80 to 85 percent of gross domestic product.

Higher Natural Gas Prices May Reduce Consumer Spending

Rising electricity and natural gas prices are particularly relevant for California, and these price increases may be serious enough to have a discernible impact on real GDP growth for the nation, according to some economists. Natural gas is used to heat 53 percent of U.S. homes and to generate 16 percent of the nation's electricity. Prices of natural gas have more than tripled compared to those of a year ago. These higher energy prices reduce consumers' real incomes and spending, which are components of gross domestic product. An article in *Businessweek* reports that economists at Goldman, Sachs & Co. estimate that the U.S. average annual household heating bill could more than double to over $1,000 this year, with higher energy prices and a relatively cold winter in many areas of the country. As a result of the higher heating costs, they estimate that the overall consumer price index will rise by an additional 0.5 percent in the first quarter of 2001 compared to what it would have been without these energy cost increases. They also estimate that real GDP growth will decline by about one percent in the first quarter compared to what it would have been without these energy cost increases.

U.S. Unemployment Rate Holding Steady

The weaker economy did not have a discernible impact on the U.S. unemployment rate in late 2000. The U.S. unemployment rate was 4.0 percent in both November and December, 2000. This is the same as the average for the entire year of 2000.

(Information derived from; U.S. Department of Commerce, STAT-USA website: www.stat-usa.gov; "Economists' Survey Shows Steep Cutback in Growth Predictions," *Wall Street Journal*, January 10, 2001, "How Federal Policies, Industry Shifts Created A Natural-Gas Crunch," *Wall Street Journal*, January 3, 2001; "Natural Gas Will Deflate Wallets," *Businessweek*, January 15, 2001.)

❖ *California Economic Developments*

Employment Growth Remains Strong in 2000

The late 2000 weakness of the U.S. economy has not yet been obvious in data currently available to us for California. One of the most comprehensive measures of economic well being available for states on a timely basis is monthly nonagricultural employment. The average of October through December 2000 California nonagricultural employment increased 3.7 percent compared to the same period of 1999. This is down slightly from the comparable July through September growth of 3.9 percent.

Summing the preliminary monthly data indicates that annual California nonagricultural employment rose 3.8 percent in 2000. This is above 1999 annual growth of 3.1 percent. For the five-year period 1995 through 1999, nonagricultural employment increased an average of 2.9 percent per year.

Employment Growth Expected to Slow in 2001

Slower national economic growth will likely result in slower California economic growth, since a large portion of California output is sold in national markets. The *Governor's Budget*, released January 10, 2001, forecasts California nonagricultural employment to increase 2.8 percent in 2001. This forecast is more optimistic than the 2.5 percent growth for 2001 published in the December 2000 *Western Blue Chip Economic Forecast,* which is an average of seven California forecasts. However, the December 2000 UCLA Anderson economic forecast is much more pessimistic than the *Governor's Budget*. UCLA predicts that California nonagricultural employment will increase just 1.9 percent in 2001.

Unemployment Rate Declines in Late 2000

During the fourth quarter of 2000 the California unemployment rate averaged 4.7 percent. This rate is slightly below the annual average of 4.9 percent for 2000, and lower than the 5.2 percent average for 1999. The California unemployment rate was approximately one percent above the U.S. unemployment rate in both 1999 and 2000.

Double-Digit Taxable Sales Growth Continues for First Three Quarters of 2000

The Board of Equalization's preliminary estimate shows that taxable sales increased 10.3 percent in the third quarter of 2000 compared to the third quarter of 1999. This is the fourth consecutive quarter in which taxable sales have grown at double-digit rates compared to prior-year quarters. To put these numbers in perspective, annual taxable sales rose 6.2 percent in 1997, 5.2 percent in 1998, and 10.0 percent in 1999.

(Information derived from; California Employment Development Department (EDD), "California Interim Industry Employment Series," Labor Market Conditions in California, January 16, 2001, EDD Labor Market Information website: www.calmis.ca.gov; California Department of Finance, *California Governor's Budget Summary,* website: www.dof.ca.gov; *Western Blue Chip Economic Forecast,* Bank One Economic Outlook Center, Arizona State University; *The UCLA Anderson Forecast,* December 2000; Board of Equalization, News Release #61, December 20, 2000, website: www.boe.ca.gov.)

❖ *BLS Methodological Changes Since December 1996 Reduce CPI*

The U.S. consumer price index (CPI), which is reported monthly by the U.S. Bureau of Labor Statistics (BLS), is one of the most widely analyzed measures of inflation. Four years ago, the bipartisan Advisory Commission to Study the Consumer Price Index (also widely known as the Boskin Commission, after the chairman of the commission) issued its final report to the U.S. Senate Finance Committee. In this report, the commission estimated that the CPI overstated inflation by an average of approximately 1.1 percent per year. Whether or not the CPI is overstated as estimated by the Boskin Commission can never be known, and estimates will always be subject to intense political scrutiny, since the CPI directly or indirectly affects the taxes or incomes of nearly everyone in the economy. This article is not taking a position as to whether or not the CPI is accurately estimated. What it will do is discuss changes made to the CPI in response to the Commission's report. The main source of the discussion is a study published last year by Dr. Robert Gordon, one of the five Boskin Commission members. Dr. Gordon's paper discusses the difficulties in estimating consumer prices, the Commission's recommendations, criticisms of their recommendations, and what Dr. Gordon views as the BLS response to them.

Through June 1999, the BLS implemented seven methodological changes that addresses issues raised by the Commission. In addition to these methodological improvements already made, the BLS announced three more changes they planned to make that also address these issues. Dr. Gordon estimated that implementation of these changes has reduced the downward bias from 1.1 percent to approximately 0.7 percent. Alternatively, today's reported growth in the CPI is about 0.4 percent lower, on average, than it was four years ago. One of the most important changes in response to the recommendations became effective in January 1999, when the BLS began using a "weighted geometric mean estimator" for index categories that comprise approximately 61 percent of total consumer spending in the CPI. This method effectively results in the index using a more recent representation of the "market basket" of goods that typical households purchase. In the past, the BLS updated their market baskets about every ten years. Such infrequent updates fail to reflect changes in consumption patterns such as product substitution during the ten-year period. For example, if the price of apples increased relative to the price of oranges, consumers are likely to purchase fewer apples and more oranges. Their total spending would be less than if they continued to purchase the same quantities of each before substitution. However, these changes in consumption and spending were not reflected in the CPI prior to 1999. The use of the geometric mean is a method of accounting for such substitutions. Dr. Gordon estimates that this one change reduced his estimate of CPI bias by 0.2 percent, about half of the total 0.4 percent reduction.

The other changes made were of more minor importance, and they are discussed in the report. Some changes affect the market basket as a whole, while others reflect changes in pricing of specific products, such as hospital services, personal computers, and televisions. The BLS has plans to continue to improve its methods and Dr. Gordon is hopeful that more improvements will be made in the future.

Information derived from: *The Boskin Commission Report And Its Aftermath,* Robert J. Gordon, National Bureau of Economic Research, Inc., Working Paper 7759, June, 2000; *Consumer Price Index: Update of Boskin Commission's Estimate of Bias,* U.S. General Accounting Office, February, 2000, website: www.gao.gov.

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