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# A Soft Landing and a Long Layover

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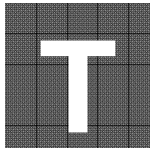
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JULY 2007

## A Soft Landing and a Long Layover

*By the Nebraska Business Forecast Council*

### U.S. Macroeconomic Outlook



The U.S. economy achieved a soft landing in 2006. This was a desirable outcome. The economy needed a break from its rapid, and potentially inflationary, growth in 2004 and 2005, before taking off again. But, that new flight has been delayed. The aggregate economy has remained mired in slow growth in the first half of 2007. Pockets of the economy, such as the labor market, have been strong, but a weak housing sector has limited overall growth. Further, signs point to one or two more quarters of weaker growth, before the economy is able to take off again.

This outcome is disappointing, and has been difficult for many individuals and businesses in the construction industry, and related sectors. There was a 25% decline in the number of building permits nationwide between June 2006 and June 2007, a nearly 20% decline in housing starts. This decline had a ripple effect not only in construction but in related industries such as real estate, and segments of manufacturing and finance.

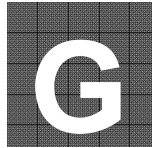
Many workers, however, have been unaffected by the decline. The overall labor market in fact has been quite strong. Total employment increased by 1.4% nationwide between June 2006 and June 2007, and the unemployment rate currently sits at 4.5%. This pattern of solid employment growth despite weak growth in gross domestic product is typical of the later stages of the business cycle. In many ways, it is the mirror image of the “jobless recovery” that occurred in 2002 and 2003 when the national economy pulled out of the 2001 recession. At that time, firms squeezed productivity out of the economy, expanding output

rapidly without increasing employment. Expenses were cut and employees worked long hours. By now, many of these opportunities have been exhausted and firms must expand employment to increase output. Thus, there is solid employment and earnings growth even when economic growth is tepid. Nationwide, 1.2% job growth is expected for 2007. But, job growth will need to accelerate as the economy returns to trend growth in 2008 and 2009. Job growth of 1.4% is expected for 2008 and 1.7% for 2009%. Growth in real (inflation-adjusted) gross domestic product will reach only 1.9% in 2007 before rising to 2.8% in 2008 and 3.1% in 2009. We see only a small chance of a recession in the next four quarters.

Given expectations that the economy will return to trend growth next year, the Federal Reserve will have little incentive to lower interest rates. But, there also will be no need to increase rates as inflationary pressures recede. The consumer price index was up 2.5% in the first half of 2007 versus 3.8% in the first half of 2006. Inflation rates should stabilize at this level. For all of 2007, we expect inflation of 2.3%. Inflation is expected at 2.5% in both 2008 and 2009.

Gasoline prices are expected to remain steady over the next few years. To be sure, prices will continue to fluctuate seasonally, spiking in the summer and declining in the spring and fall. But, a permanent decline is not expected. Unfortunately, we are currently experiencing the “new normal” price for gasoline in the summer. Commodity prices in general are expected to stay strong. In many ways this will benefit states such as Nebraska where commodity production is an important part of the economy.

## Nebraska Outlook



Given strength in the commodity sector, and related industries such as manufacturing and transportation, the panel remains optimistic about the outlook for the Nebraska economy.

Employment will continue to expand in Nebraska. Aggregate farm income is expected to grow rapidly in 2007 and remain high in 2008 and 2009.

**Table 1— Key Economic Growth Rates**

	Non-farm Employment	Non-farm Personal Income (nominal)	Net Farm Income (nominal)
2005	1.4%	4.3%	-24.7%
2006	1.3%	5.6%	1.2%
2007	1.4%	5.8%	27.8%
2008	1.8%	6.3%	2.9%
2009	1.9%	6.5%	4.2%

Note: nominal income growth is the sum of real income growth and the inflation rate.

Solid employment growth, rising proprietor incomes, and strong growth in dividend and interest incomes will lead to strong overall growth in non-farm personal income in Nebraska. In nominal terms, non-farm income is expected to grow by an average of 6.2% per year over the outlook period. Adjusting for an average inflation rate of 2.5%, income growth will average 3.7% in real terms. A summary of the Nebraska outlook is reported in Table 1.

### Employment

Nebraska will experience broad-based employment growth over the next three years. Construction employment will decline in 2007, but should grow in both 2008 and 2009. Sectors such as manufacturing and transportation will benefit from nationwide strength in the commodity sectors such as agriculture and mining. Employment will grow rapidly in cyclically sensitive sectors such as business and professional services. As is seen in Table 2, this outlook is similar to our previous outlook from December 2006, except that lower growth is expected in 2007, due to weakness in construction.

**Table 2— Comparison of Non-Farm Employment Forecasts**

	December 2006 Forecast	Current Forecast
2007	1.8%	1.4%
2008	1.9%	1.8%
2009	1.9%	1.9%

## Construction and Mining

There are three components of the Nebraska construction industry: residential, commercial, and infrastructure (mostly roads). The performance of the construction sector reflects all three components. The first component, the residential sector, is weak at the moment, and continues to decline in Nebraska. According to the National Association of Home Builders, building permits were down 15% in Nebraska in the first 5 months of 2007 relative to the first 5 months of 2006. While income growth is solid and interest rates are low, the market continues to be affected by past overbuilding. Housing construction activity will decline in 2007 and is not expected to recover until 2008 and 2009.

The two other components of the industry are fairing better. Construction activity is strong for hospitals and other health care, and for hospitality buildings, such as hotels and restaurants. Retail space is expanding steadily, and new ethanol plants continue to be built. These commercial activities should grow steadily throughout the 2007 to 2009 period.

High gasoline prices have led to a small reduction in gasoline consumption, which implies weaker gas tax revenues. This may limit growth in road construction activity going forward. However, gasoline consumption should expand during the forecast period as fuel prices are not expected to increase further. State government (LB305) also recently reallocated some state funds to road building.

As seen in Table 3, overall construction employment will decline 2% in 2007, but then recover as residential construction recovers. Construction employment will rise 2% in 2008 and 4% in 2009.

### Manufacturing

Recent data indicate an upturn in employment in the manufacturing sector. Total manufacturing employment (durable plus nondurable) was steady in 2005 and grew modestly in 2006. There are several reasons this trend should accelerate over the next few years. First, Nebraska should continue to benefit from further decentralization of manufacturing activity away from the industrial mid-West towards smaller cities and non-metropolitan areas, such as those found in Nebraska.

**Table 3—Number of Nonfarm Jobs and Percent Changes by Industry Annual Averages (in thousands of jobs)**

	Nonfarm Total	Construction, Mining & Natural Resources	Durables	Non- durables	Wholesale Trade	Retail Trade	Trans- portation and Utilities	Info	Financial	All Services	Federal Gov't	Local Gov't
1997	857.1	40	57.3	55.4	41.2	105.3	41.6	25.1	55.7	283.5	16.1	136.1
1998	879.9	42.4	58.5	55.9	42.2	107.5	43.3	26.3	58.8	294.2	16	134.9
1999	897.4	44.3	57.7	55.7	42.5	110.2	44.5	27.1	60.9	303.1	15.9	135.6
2000	914	45.2	58.9	55.4	41.9	111.3	45.1	26.9	60.5	314.3	16.6	137.9
2001	919.7	45.3	54.6	56.2	42.5	110	45.2	25.8	60.2	323	16	140.8
2002	911.5	46.1	50.6	55.4	41.5	108.5	44.9	23.2	61.4	321.2	16.3	142.6
2003	914.2	47.4	47.3	55.1	41	106.7	46.4	21.5	62.4	327.3	16.7	143.1
2004	922.3	48.4	47	54	40.8	106.5	48.9	21.1	63.2	332.2	16.5	143.6
2005	935	47.8	48.4	52.9	40.6	107	52.3	20.2	64.5	340.1	16.3	144.9
2006	946.9	48.4	49.5	52.2	40.8	106.5	53.4	19.5	65.7	348.5	16.2	146.2
<b>Forecast Number</b>												
2007	960.3	47.4	50.2	52.4	40.6	106.7	55.4	19.1	66.7	357.9	16.2	147.7
2008	977.6	48.4	50.8	53.0	41.0	107.5	57.1	19.1	67.9	367.9	16.1	148.8
2009	996.2	50.3	51.3	53.7	41.3	108.2	58.8	19.1	69.1	378.2	16.1	150.0
<b>Forecast Number</b>												
2007	1.4%	-2.0%	1.4%	0.4%	-0.6%	0.2%	3.8%	-2.0%	1.5%	2.7%	-0.2%	1.0%
2008	1.8%	2.0%	1.2%	1.2%	1.0%	0.7%	3.0%	0.0%	1.8%	2.8%	-0.2%	0.8%
2009	1.9%	4.0%	1.0%	1.2%	0.8%	0.7%	3.0%	0.0%	1.8%	2.8%	-0.2%	0.8%

Source: <http://data.bls.gov/cgi-bin/dsrv>, 2007

Second, opportunities should continue to improve in the food processing sector. Capacity and production in the ethanol sector will continue to expand. Asian markets for Nebraska beef also should slowly continue to open. As a consequence, non-durable manufacturing employment is expected to increase in 2007, by 0.4%. Job growth should top 1% in both 2008 and 2009.

Third, the strong farm economy should continue to provide opportunity for growth in farm machinery and equipment production. This is a large component of Nebraska's durable goods sector. Durable goods employment is expected to grow 1.4% in 2007, 1.2% in 2008, and 1.0% in 2009.

### Transportation and Warehousing

Strength in the commodity sector continues to favor expansion of the transportation industry in Nebraska. Strong demand for coal continues to support growth in the rail industry. A strong farm economy and construction of additional ethanol plants in the state stimulates additional freighting demand in shipping corn to new plants. More generally, solid growth in the

goods-producing industry in the national economy continues to provide a favorable setting for increasing employment and business activity in the transportation sector. Aside from strong demand, Nebraska firms are also competitive suppliers of transportation services. The state hosts the headquarters for Union Pacific, and large facilities of BNSF Railway. Nebraska also is home to several rapidly growing national trucking firms, including two of the largest firms in the U.S. Further, favorable demographics and infrastructure and low entry cost favors continued growth by small trucking firms. State government also promotes trucking and warehousing as a target industry.

These factors suggest that the Nebraska transportation and warehousing industry can continue to expand rapidly. Employment growth will reach 3.8% for 2007, and 3.0% in both 2008 and 2009.

### Wholesale Trade

Wholesale trade employment in Nebraska has grown little over the last decade, despite a growing economy in the state. Such a pattern is characteristic of industries

with rising labor productivity, where rising productivity causes employment to remain steady even as total industry activity increases. The industry is expected to lose employment in 2007 as well but will be able to add a few hundred jobs per year as employment expands rapidly in 2008 and 2009. The forecast calls for wholesale trade employment to drop by 0.6% in 2007, but grow by 1.0% in 2008 and 0.8% in 2009.

## Retail Trade

As with wholesale trade, retail trade employment also has not grown in recent years, despite steady increases in retail sales. The reason again is rising productivity in the industry, as growth in the number of big box retailers, and internet sales reduce the labor requirements of retailers. These trends are expected to continue into the near future, though the industry should see modest employment growth, in line with state population growth, as the economy accelerates in 2008 and 2009. Employment is expected to be flat in 2007, but then job growth will be modest in 2008 and 2009. Retail job growth is expected to average around 0.2% in 2007, and 0.7% in 2008 and 2009.

## Information

The information industry contains a diverse group of industries included newspapers, movie theatres and sound studios. These locally-oriented portions of the industry are stable. The industry also contains high technology or information processing industries such as telecommunications, data processing, web site development, and web publishing. These industries have consolidated and downsized in recent years, losing 6,000 jobs since 2001. We anticipate the loss of a few hundred additional jobs in 2007 before employment stabilizes in 2008 and 2009.

## Financial Services

The financial services industry comprises finance, insurance, and real estate. The industry has grown consistently over the last 10 years, as Nebraska banks and other loan providers have expanded, along with the ranks of insurance agents, realtors, and financial advisors. However, several factors are expected to limit growth over the next few years. Slow job growth is expected for insurance carriers and businesses involved in home finance and real estate. But, overall industry job growth will reach 1.5% in 2007, and 1.8% in 2008 and 2009.

## Services

Accounting for one-third of employment in the economy, the diverse and rapidly growing service industry is a key to our employment forecast. As is evident in Table 3, 65,000 of the approximately 90,000 jobs added to the Nebraska economy from 1997 to 2006 were added in the services sector. When service sector employment grows by more than 2%, as is has in the last few years, total Nebraska employment growth handily exceeds 1%.

Over the next three years, we expect strong growth in services employment. Overall services employment is forecast to grow by 2.7% in 2007, and 2.8% in 2008, and 2009. Strong employment growth is possible since the services industry contains two of the largest and most rapidly growing portions of the economy: health services, and business and professional services. Other portions of the services industry include education services, personal services, accommodations, food and drinking places, and arts, entertainment, and recreation.

Health care and social assistance is the largest part of the services industry and expands steadily as Nebraska's population grows and ages. Ambulatory health care services such as home health care services, ambulance services, blood donor stations, and health screening services are the fast growing portion of health care. Health care and social assistance employment will grow from 2.5% to 3.0% annually over the next three years, employing 120,000 Nebraskans by 2009. Food services and drinking places is another industry that consistently generates job growth as population grows, and households spend more of their rising disposable income on dining out. Employment will grow by between 1.5% and 2.0% per year in this segment of the industry from 2007 through 2009.

Business and professional services is the pro-cyclical portion of the services industry, and it is expected to grow very rapidly over the next three years. From 2007 to 2009, annual employment growth in business and professional services will reach 3.5% to 4.0%. Many of these new jobs will be in high wage occupations such as management, legal services, accounting and bookkeeping, architecture and engineering, computer systems design, management consulting, research services, advertising, market research, and veterinary services.

## Government

Our outlook calls for a modest decline in federal government employment through 2009. This is a familiar pattern. Federal employment has been stagnant or in decline in Nebraska for the last decade. A slight decline is expected since the U.S. Department of Agriculture plans to consolidate offices in rural Nebraska for administering farm programs.

Growth in state and local government employment has tended to exceed, though only slightly, the rate of population growth in Nebraska. State and local government employment historically has grown 1% per year on average. This makes sense, as the need for teachers, police, fire, and other state and local employees who work directly with the public rises with population. As the economy expands, the state tax revenue base should be growing strongly over the next few years, which also will encourage new employment. However, a major tax cut package passed by state government in 2007 may modestly reduce available revenue in the out years of 2008 and 2009. Our expectation is that state and local government employment will grow 1.0% in 2007, and the rate of growth will fall slightly to 0.8% in 2008 and 2009.

## Personal Income

Personal income growth will be strong in Nebraska over the outlook period from 2007 through 2009. Both non-farm and farm income will grow rapidly. Table 4 below compares the current forecast for the two major components of personal income to our last forecast, which was made in December 2006.

**Table 4— Comparison of Forecasts for Nominal Personal Income**

<b>Non-Farm Personal Income</b>		
	December 2006 Forecast	Current Forecast
2007	5.9%	5.8%
2008	5.9%	6.3%
2009	5.9%	6.5%

<b>Farm Income</b>		
	December 2006 Forecast	Current Forecast
2007	25.0%	27.8%
2008	2.9%	2.9%
2009	2.8%	2.8%

Note: nominal income growth is the sum of real income growth and the inflation rate.

There are some differences. Our current outlook for non-farm personal income calls for slower growth in 2007 than our last forecast. This is due to our lowered expectation for employment growth this year. Our outlook for non-farm personal income growth is higher in the later years. This is because we have raised our estimate of growth in income from dividends, interest, and rent throughout the 2007 to 2009 period. The outlook for farm income is quite similar in the current forecast and the last forecast.

## Non-Farm Personal Income

Non-farm personal income is expected to grow rapidly over the forecast period, as it did in 2006. The keys to growth will be solid increases in wage and salary income as well as strong growth in both proprietor's income and income from dividends, interest, and rent. Strong job growth expected for the outlook period will underpin solid growth in aggregate wage and salary income. More jobs mean more wage earners. Wages and salaries per job also are expected to grow solidly, given the strong labor market.

As seen in Table 5, we expect non-farm wages and salaries to grow by 4.9% in 2007, 5.3% in 2008 and 5.4% in 2009. This is forecasted despite an expectation of moderate inflation, between 2.3% to 2.5% per year. Employee benefits (other labor income) are expected to grow by 6.4% to 6.9% per year, driven by increasing health care costs.

Non-farm proprietor income is an income component that gains strength as the economic expansion continues. Non-farm proprietor income is expected to increase by more than 7% per year.

Dividend, interest, and rent income will grow rapidly during the forecast period. Growth will be solid at 6.5% in 2007. But, the largest increases are expected for 2008 and 2009. Long-run interest rates on bonds and certificates of deposit are expected to rise in 2008 and 2009 from current low levels. This will raise interest income. Dividend income also is expected to rise. The capital gains tax cuts of 2001 are slated to expire at the end of 2009. Unless these are extended, this will create great incentive to take dividend income as the deadline approaches in 2008, and especially 2009.

**Table 5—Non-farm Personal Income and Selected Components and Net Farm Income (USDA) (\$ millions)**

	Consumer Price Index	Non-farm Personal Income	Dividends, Interest, & Rent	Total Personal Current Transfer Receipts	Non-farm Wages & Salaries (Wages & Salaries — Farm Wages)	Other Labor Income	Contributions to Social Insurance	Residential Adjustment	Non-Farm Proprietor Income	Net Farm Income (USDA)
<b>Millions of Dollars</b>										
1997	160.5	\$38,754	\$8,272	\$5,132	\$21,936	\$4,456	\$3,462	-\$653	\$3,073	\$2,023
1998	163.0	\$41,591	\$9,096	\$5,477	\$23,343	\$4,744	\$3,686	-\$684	\$3,300	\$1,816
1999	166.6	\$43,644	\$9,148	\$5,822	\$24,796	\$4,999	\$3,874	-\$762	\$3,517	\$1,707
2000	172.2	\$46,366	\$9,991	\$6,075	\$26,186	\$5,317	\$4,032	-\$825	\$3,654	\$1,440
2001	177.0	\$48,103	\$9,998	\$6,667	\$26,908	\$5,612	\$4,200	-\$833	\$3,952	\$1,894
2002	179.9	\$49,731	\$10,023	\$7,069	\$27,713	\$6,363	\$4,350	-\$869	\$3,782	\$857
2003	184.0	\$51,414	\$10,002	\$7,427	\$28,660	\$6,753	\$4,520	-\$911	\$4,003	\$2,785
2004	188.9	\$53,869	\$10,188	\$7,728	\$30,014	\$7,172	\$4,720	-\$928	\$4,415	\$3,542
2005	195.3	\$56,191	\$10,603	\$8,118	\$31,016	\$7,664	\$5,018	-\$936	\$4,744	\$2,667
2006	201.6	\$59,316	\$11,497	\$8,540	\$32,574	\$8,075	\$5,328	-\$996	\$4,954	\$2,700
<b>Forecast Number</b>										
2007	206.2	\$62,783	\$12,224	\$9,095	\$34,174	\$8,593	\$5,590	-\$1,005	\$5,321	\$3,450
2008	211.4	\$66,744	\$13,199	\$9,650	\$35,988	\$9,178	\$5,886	-\$1,121	\$5,737	\$3,550
2009	216.7	\$71,082	\$14,348	\$10,229	\$37,931	\$9,811	\$6,204	-\$1,193	\$6,161	\$3,700
<b>Forecast % (nominal growth)</b>										
2007	2.3%	5.8%	6.5%	6.5%	4.9%	6.4%	4.9%	5.9%	7.4%	27.8%
2008	2.5%	6.3%	7.8%	6.1%	5.3%	6.8%	5.3%	6.3%	7.8%	2.9%
2009	2.5%	6.5%	8.7%	6.0%	5.4%	6.9%	5.4%	6.4%	7.4%	4.2%

Source: <http://www.bea.gov>, 2007

Note: nominal income growth is the sum of real income growth and the inflation rate.

## Farm Income

Rising grain prices over the past year and good crop yield levels are expected to lead to a sharp increase in farm income in 2007. These price increases have been driven by the dramatic expansion of ethanol production in America's heartland. This has led directly to rapid increases in corn prices, and corn acreage. Further, ethanol production and higher corn prices are expected to be maintained throughout the outlook period. Nebraska's prominence in corn production (rank 3<sup>rd</sup> in the nation) combined with the complement of being a major cattle feeding state (rank 2<sup>nd</sup> in nation) makes the state well situated to capture economic opportunities in ethanol production. This is because distiller's grain, a cattle feed, is a by-product of ethanol production. Areas with both corn and feeder cattle production have a competitive advantage as a location for ethanol plants.

While income from crop production will increase, income from livestock production is expected to remain steady. Higher production costs for livestock producers will in part be passed on to final consumers.

Further, the cattle industry is going through a transition as cattle feeders adjust to greater reliance on distiller's grain in their rations. As a result, Nebraska producers have a distinct advantage over other major cattle feeding states. The state's cattle industry could even experience some future production expansion given the synergy between corn-based ethanol production and feedlots. The full effect of the ethanol boom and corn price increases will be realized in 2007. Nebraska farm income is expected to jump by nearly 28% in 2007, from \$2.7 billion in 2006 to \$3.45 billion in 2007. This increase will be maintained in 2008 and 2009. Nebraska farm income is expected to grow further in those years, by 2.9% in 2008 and 4.2% in 2009. By 2009, farm income will be 70% above its 10-year average for the 1997 to 2006 period (\$2.14 billion).

This will all occur despite a substantial drop in direct government payments. These stood at \$1.5 billion in 2005, and are expected to fall to \$300 million by 2008 and 2009, with the new farm bill.



## Net Taxable Retail Sales

In Table 6, data on net taxable retail sales are divided into motor vehicle sales and non-motor vehicle net taxable retail sales. The distinction is important. Motor vehicle net taxable sales are growing over time, but from year to year are affected by cyclical sales. Non-motor vehicle taxable sales rise steadily, but are affected by periodic changes to Nebraska's sales tax base.

Table 6 shows a steady increase in non-motor vehicle taxable sales over the 2007 to 2009 period. Growth is muted in 2007 because in late 2006 Nebraska exempted from taxation sales of contract labor. As a result, comparisons between the year 2007 and 2006 reflect a smaller tax base in 2007 relative to the first half of 2006. This reduction in the sales tax base does not affect growth rates for 2008 and 2009. Non-motor vehicle taxable sales are expected to rise 4% to 5% during those two years.

Growth in motor vehicle net taxable sales is much more variable. Sales grew rapidly from 2001 to 2003, but have fallen since then. This pattern is familiar in Nebraska: motor vehicle sales periodically grow rapidly one year and then growth slows or sales decline in the years that follow. Vehicles purchased during the sales peak years of 2001 through 2003 will have reached six years of age by 2008, and we anticipate strong sales growth in 2008 due to replacement of older vehicles. The increasing importance of automobile will limit motor vehicle taxable sales throughout.

Overall growth in net taxable sales is expected to reach 3.1% in 2007. This is only slightly above the expected inflation rate of 2.3%. Growth is expected to increase to 4.1% in 2008, as the rate of growth in non-motor vehicle taxable sales increases. By 2009, growth in overall net taxable sales is expected to reach nearly 4.8%.

**Table 6—Net Taxable Retail Sales, Annual Totals (\$ millions)**

	Consumer Price Index	Total Net Taxable Sales	Motor Vehicle Net Taxable Sales	Non Motor Vehicle Net Taxable Retail Sales
<b>Millions of Dollars</b>				
1997	160.5	\$17,815	\$2,205	\$15,610
1998	163.0	\$19,005	\$2,417	\$16,588
1999	166.6	\$19,806	\$2,520	\$17,286
2000	172.2	\$20,443	\$2,605	\$17,838
2001	177.0	\$21,057	\$2,897	\$18,160
2002	179.9	\$21,426	\$2,926	\$18,500
2003	184.0	\$22,092	\$2,894	\$19,199
2004	188.9	\$23,618	\$2,885	\$20,733
2005	195.3	\$24,443	\$2,751	\$21,691
2006	201.6	\$24,978	\$2,661	\$22,317
<b>Forecast Number</b>				
2007	206.2	\$25,760	\$2,661	\$23,099
2008	211.4	\$26,822	\$2,799	\$24,022
2009	216.7	\$28,101	\$2,925	\$25,176
<b>Forecast % (nominal growth)</b>				
2007	2.3%	3.1%	0.0%	3.5%
2008	2.5%	4.1%	5.2%	4.0%
2009	2.5%	4.8%	4.5%	4.8%

Source: Nebraska Department of Revenue

Note: nominal taxable sales growth is the sum of real growth and the inflation rate.

# Our Thanks ...

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Serving this session were

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- Fiscal analysis
- Policy analysis

For more information on how BBR can assist you or your organization, contact us (402) 472-3188; send email to: [ethompson2@unl.edu](mailto:ethompson2@unl.edu); or visit the website at: <http://www.bbr.unl.edu>