

The Economy in 2005: Five Things to Watch

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The vast majority of economic forecasters see 2005 as a good year, with strong growth and growing employment. They base these forecasts on the expectation that oil prices will fall, the Federal Reserve will raise interest rates slowly and that employers will be more confident about the future. I agree that 2005 will probably see more economic growth, but I'm more pessimistic than most about the rate of economic expansion.

Regardless of what economists think, you need to live your own lives and make your own business plans. With that in mind, here are five things to watch in 2005. Unfortunately, each of them holds considerable risk of causing economic growth to fall below forecast.

- The price of oil. We have to start here, since it means so much not only to the cost of doing business, but also to consumer confidence. We cannot sustain growth on \$50 a barrel (or higher) oil. Consumers have to devote too much of their incomes to driving their cars and heating their homes. Companies that either are in the transportation business (airlines, bus companies, long-haul trucking lines, etc.) or simply use oil will find their cost rising. And we all feel bad about it. The forecasts of most economists assume the price of oil will retreat to \$35. The closer it gets to that the faster will the economy grow; if prices stay up or increase, the economy will be wounded.
- The dual deficits. Right now, we are running unconscionable deficits in the Federal budget and in our trade balance. Both of these are putting upward pressure on interest rates as we try to interest investors (particularly foreign investors) in holding more government paper. If foreigners begin to balk at this, rates will shoot up. This in turn will dampen the economy. But if foreign investors continue to play along, the falling dollar will increase American exports and add to growth.
- The rise of inflation. In late 2004, both the consumer and producer price indices began to rise at faster rates than in the recent past. This could be a straw in the wind, or a reaction to oil prices that will disappear if they fall. But it is an indication that prices are no longer bullet-proof. In the Nineties, we found that we could expand output without affecting prices, because productivity was growing. Now, productivity growth has slowed and the old relationships may be back. If inflation jumps, even to 4 percent per year, we will have problems with the economy.
- Tax and Social Security reform. The President, with a Republican Congress, will attempt to implement two of his major proposals, fixing

Social Security and reforming taxes. The former, widely expected to be first at bat, entails diverting some Social Security taxes into private accounts. In the short term, this will cause the budget deficit to balloon. If the investment community buys the argument that the change will make future deficits lower, the economy will be OK. Otherwise, see the second bullet above. Watch these carefully as the legislative debates unfold.

- Job quality. This has been a nagging problem with the American economy and may get worse. We need not only to create jobs, but create “career” jobs. If we cannot expand dramatically the number of technical jobs as we did in the Nineties, we run the risk of losing our economic leadership to countries that are doing just that. Both the long and short run consequences of this are unpleasant.

These issues are all intertwined, so it is difficult to treat them as separate entities. The best thing to do is to set your mental alarm clock to go off whenever you see or hear anything related to these five topics. They will tell you where the economy is going in 2005 and beyond, so that you can be your own forecaster.