ECONOMIC OUTLOOK FOR 1997

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Slow Growth in 1997

I expect the economy to grow slowly in 1997. I expect growth net of inflation to be at a rate near or just above 2 percent, and growth at this rate would be sufficient to keep unemployment low and the utilization of plant and other resources high. This relatively slow growth could continue for several years. In fact, the forecast has changed little in the last six months, and while some event or change in circumstances will eventually come along to disturb this comfortable pattern, I do not think such an event is likely this year.

Trouble Abroad Deepens

The major change in circumstance over the last three months comes from abroad. It is now clear that Germany's difficulties have a long-term structural element to them that will inhibit the bounce back that normally follows a recession. Big German corporations are abandoning the social partnership they once had with their workers and are becoming more like U.S. corporations. They are increasing employment abroad and reducing it at home. They are listing their stocks on the New York Stock Exchange and raising capital in international markets the way U.S. corporations do, rather than relying on their traditional long-term relationships with individual German banks.

Increasingly, the biggest German corporations view themselves as working for the benefit of their stockholders. This is a major change from the traditional approach which was to work in the interest of many stakeholders, including in particular the interest of German workers. As a consequence of the change in approach, German stock prices are soaring at the same time that the German economy remains mired in recession with an unemployment rate of about 12 percent.

This year, all the European economies hope to meet an ambitious set of previously agreed upon financial standards in order to qualify for admission to the Economic Monetary Union, an arrangement that would give them a common currency. One of these standards requires that the government budget deficit be no larger than 3 percent of GDP. In the United States, even though the deficit is a source of enormous concern, it is unlikely to exceed 2 percent of GDP this year. But because of the European recession, most of them are not expected to meet the 3 percent standard this year, and the future of the single currency is in doubt. In my view they are not likely to meet this standard unless they cheat. (An example of cheating would be to sell government real estate.) Europeans are extremely troubled about the outlook.

Meanwhile, Japan's problems have proven more intractable than most analysts anticipated. Hirohito won the recent election, promising reforms which would eliminate many of the restrictions that keep prices high for consumers. Big corporations who face international competition also favor these reforms. The reforms would make the Japanese economy more like the American economy. Opposing the reforms are farmers and small businesses who benefit from the restrictions, and government bureaucrats who exercise great power through their administration of these restrictions.

In recent years, the big Japanese corporations have been whipsawed. First they were told to invest overseas and the yen was allowed to soar. Now the yen has been brought down, making it profitable once again—but perhaps temporarily—to export from Japan. Land prices have fallen by 60 percent in recent years, which has substantially reduced the cost of producing in Japan, but the accompanying decline in stock prices and the uncertainty over future government policy seem to have paralyzed investment. Both bankers and their potential customers are afraid of the risks of increased lending.

The Underlying Strength of the United States Becomes More Evident

In contrast to Germany and Japan, the United States sits with both its current performance and its outlook better than they have been for years. Confidence is high and the stock market is booming. Physical investment by business is high and home building is strong. Flows of investment from abroad are increasing. Indeed, a major risk to the United States is that it may boom a bit too much and run into inflation. This is a legitimate risk in my view, a risk that is greater than the risk of stagnation.

In response to the sharp contrast between the performance of the U.S. economy and its major rivals, international investors have driven the value of the dollar up sharply. Recently, they have been encouraged in this behavior by the governments and central banks of the major industrial nations who view a higher dollar as a way to transfer strength from the United States to its ailing competitors.

Because of the continuing recessions in Japan and Germany, and because of the increase in the value of the dollar, the outlook for U.S. exports is worse now than it was a few months ago. This sector will provide a convenient safety valve in the event of overheating. At the first sign of overheating in the United States, Wall Street would drive up American interest rates, which would lead to a further strengthening of the dollar. The stronger dollar would weaken our international competitiveness and take some of the steam out of our momentum.

How Long Can the Expansion Continue?

While the present expansion is more vulnerable to a downturn than it was a few years ago, there is no reason this expansion must end soon. Among the risks that could lead to a recession are an outbreak of inflation or a collapse in stock values, events which could occur without a major change in the present direction of the economy. Another risk is a speculative surge in the value of the dollar to levels that would make many major U.S. producers uncompetitive.

Because the economy is so close to full employment an upward move is as much of a threat to the recovery as a downward move. An upward move could lead to inflation with a quick reponse by the Federal Reserve, and a downward move could be self-reinforcing through its effect on stock values and consumer spending. Hence the path of stable, continued growth remains a narrow one, and minor deviations on either side of the path could lead to a self-perpetuating decline.

While I would not quite characterize the economy as walking a tightrope, the image is a useful one in suggesting the dangers of deviation to either side. The downside risk is that consumer spending could peter out and the upside risk is that any surprising strength will bring higher interest rates quickly. The most likely cause of a downside move would be a restriction of consumer credit growth by lenders.

The Risk of Inflation

The upside risk for this economy is that growth at too rapid a rate will kick off inflation. If inflation appears, the Federal Reserve will move quickly to raise interest rates to cool the economy down.

The Federal Reserve has stated explicitly that it would be concerned primarily by an upsurge in inflation in non-food, non-energy products. The reason for less concern with food or energy inflation is that food and energy prices can rise for reasons other than a general overheating of the economy. We are unlikely to see inflation in non-food, non-energy products unless the economy overheats and widespread shortages appear. The main shortage at this time appears to be a shortage of labor. Because of this, the Federal Reserve is concentrating on wage inflation as its signal of an overheated economy. It will move quickly to restrain economic growth if wage inflation reappears. The Federal Reserve has stated that at this date it does not foresee inflation, and hence does not see the need to raise interest rates immediately, but Alan Greenspan, in testimony before Congreess in late February, warned how thin the margin is between the current level of performance and one that the Federal Reserve would consider to be inflationary.

Intelligently, in my view, the Fed decided not to try to restrain the food and energy price increases of 1996 with tight money. These increases did not spread from the food and energy sectors into the rest of the economy. While food and energy prices remain high at this date, further increases in these prices will be at slower rates, which means that food and energy inflation will decline somewhat in 1997.

Interest Rates

Long-term rates will follow the economy as they have in the past. Unexpected strength in economic activity would lead to increases in long-term rates, and surprising weakness would lead to decreases. Growth at the forecast rate of a bit more than 2 percent would be consistent with modestly declining long-term rates over the year, though temporary surges or declines in activity could make rates quite volatile.

Short-term rates, which are controlled by the Federal Reserve, will only decline in the face of substantial economic weakness, which is unlikely. Indeed, the Fed has been leaning toward raising rates, not lowering them. Increases in short-term rates could occur even in the face of a weakening economy if labor shortages lead to wage rate increases. Unfortunately, labor shortages are evident in some markets, so acceleration of wages remains a possibility that could cause the Fed to act. If an increase in wage inflation occurs, long-term rates would stop declining. Because the odds on this are almost even at this time, no declines in short-term rates can be expected in the near term.

Mortgage rates declined sharply in late 1996 after a period in which they had stayed high despite a decline in long-term bond rates. There remains room for a further modest decline in mortgage rates even if long-term bond rates stabilize at current levels.

Housing

I expect a continued modest decline in residential construction for another quarter, and then flatness for the rest of 1997. The peak in interest rates of mid-1996 is now well behind us and the recent decline in mortgage rates will help housing in 1997.

Most observers, myself included, were surprised by the strong showing of housing in early 1996. It appears that there is more underlying strength in this sector than had been expected. As a result, 1.4 million has come to seem like a normal year for housing starts rather than the boom it appeared to be in 1994. Starts near 1.4 million or even a bit above 1.4 million are likely in 1997.

An End to the Business Cycle?

Some analysts suggest that the business cycle is a thing of the past. This was also claimed in the late 1980s, but then came the recession of 1990-91. Certainly, recoveries have been longer in recent years than in the 1950s, and recessions have occurred as a consequence of identifiable shocks rather than simply as a spontaneous occurrence. But the cycle is not dead, even though we don't expect to see a decline in the near future. The risks that could lead to a decline are there, and declines that are accompanied by stock market crashes can be particularly nasty.

Summary of the National Outlook

Slow growth in 1997 is as good a performance as we can expect. My forecast, which is of growth at 2 percent or a bit better would be better for the nation than growth at 1 percent or 3 percent. Three percent would lead to inflation and 1 percent would entail unnecessary unemployment. Hence we should be gratified by the likelihood that growth will be modest , and we should hope that 1997 remains dull on the economic front.

The Outlook for Wisconsin

Wisconsin continues to underperform the rest of the nation, at least as far as employment growth is concerned. One of the main reasons for the underperformance is a shortage of labor. Wisconsin is so close to full employment that further growth is difficult without substantial in-migration.

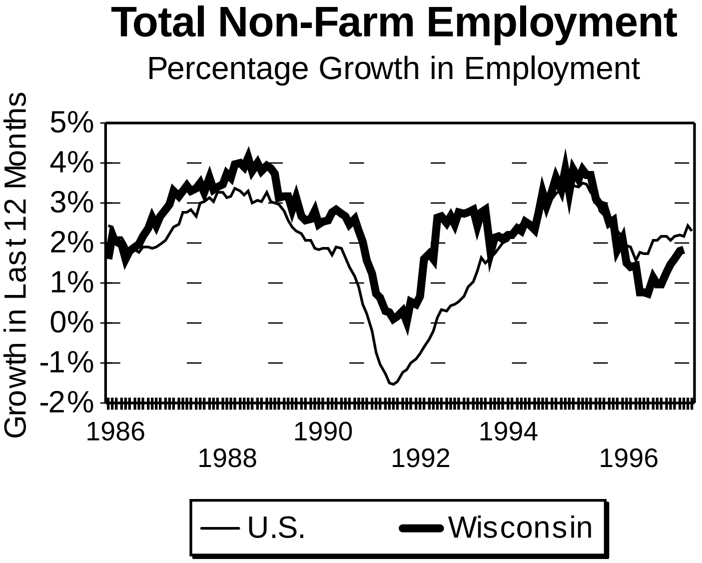
Wisconsin's growth will be hindered in 1997 because many of its major employers are near full capacity. Furthermore, the market for capital goods will be softer in 1997 as domestic demand slows and as international competition stiffens. The Wisconsin economy depends strongly on the strength of its capital goods producers. These producers have had a decade of strong growth. Growth in domestic demand in this sector in 1997 will be softer than in 1996, which in turn was substantially softer than it was in 1994 and 1995. International competition for those sales will become stiffer due to the strong dollar.

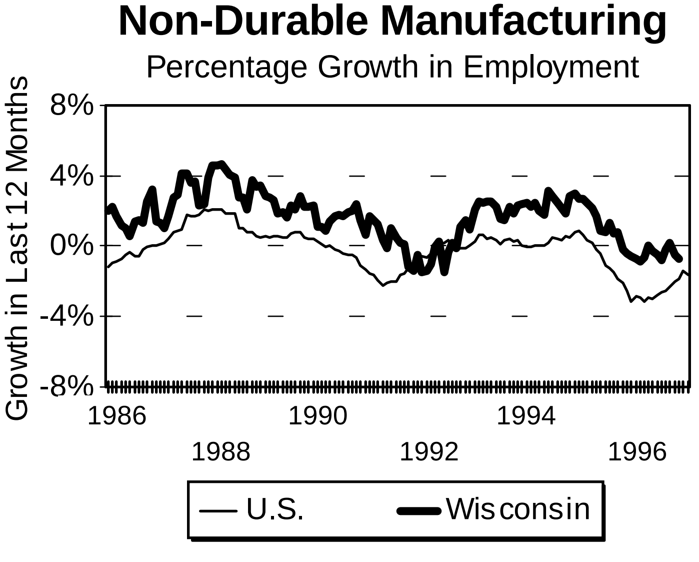
From a shorter-term perspective, several employers in the Milwaukee area have already announced major restructurings that will lead to substantial declines in local levels of employment.

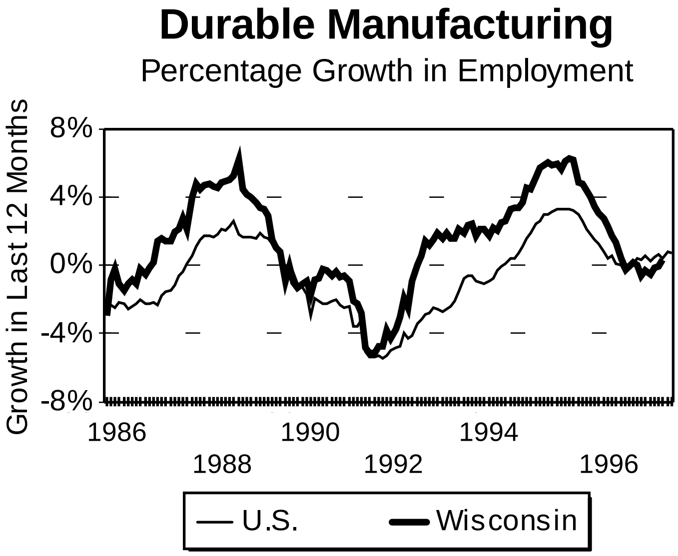
The accompanying charts show that growth of employment in Wisconsin outpaced the nation as a whole from 1987 to 1993, but performed at an average rate for 1994 and 1995. In 1996, growth in Wisconsin was less than in the rest of the country. I expect the gap that opened in 1996 to continue in 1997.

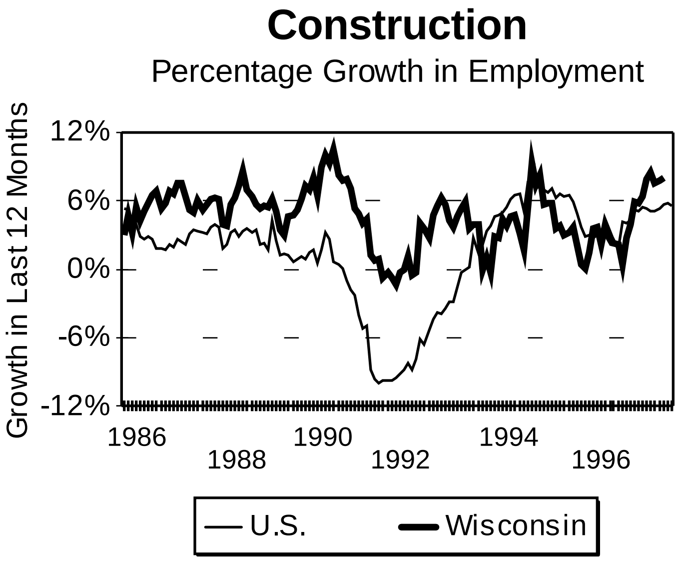
It will become more difficult to gauge the relative strength of the Wisconsin economy in 1997 because the employment statistics, which are the most reliable guide to economic trends in the short run, will be affected by new welfare reform programs, both in Wisconsin and in the United States. These programs will change the typical patterns of employment growth. Already there is evidence of a strong national and state response to the "end of welfare as we know it." The welfare rolls are shrinking across the country as many past welfare recipients seek work. This response is taking place even before the new programs go into effect, and even in states that have not yet enacted their own welfare reform programs. Because of the new welfare policies, it will be difficult for analysts to separate employment changes that are due to the differential impacts of welfare reform in each state from changes that are due to differences in the economic strength of each state.

Overall, the outlook for Wisconsin in 1997 is good. The economy is likely to remain at a high level of utilization, but growth will take place at a rate that is a bit below the national average.



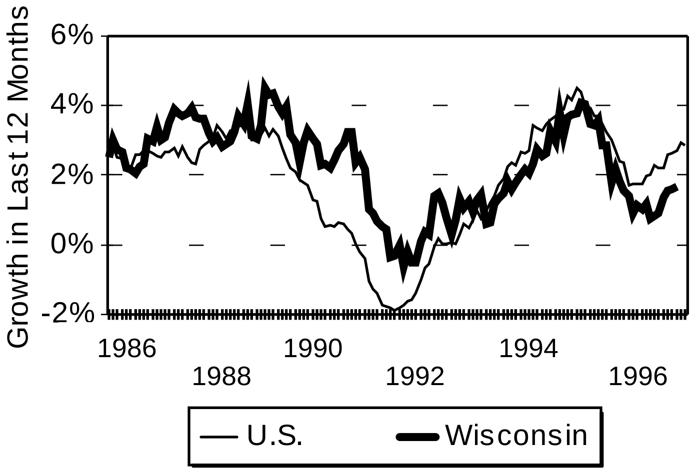



Durable Manufacturing
Percentage Growth in Employment
Growth in Last 12 Months
8%
4%
0%
-4%
-8%
1986
1988
1990
1992
1994
1996
U.S.
Wisconsin


Construction
Percentage Growth in Employment
Growth in Last 12 Months
12%
6%
0%
-6%
-12%
1986
1988
1990
1992
1994
1996
U.S.
Wisconsin

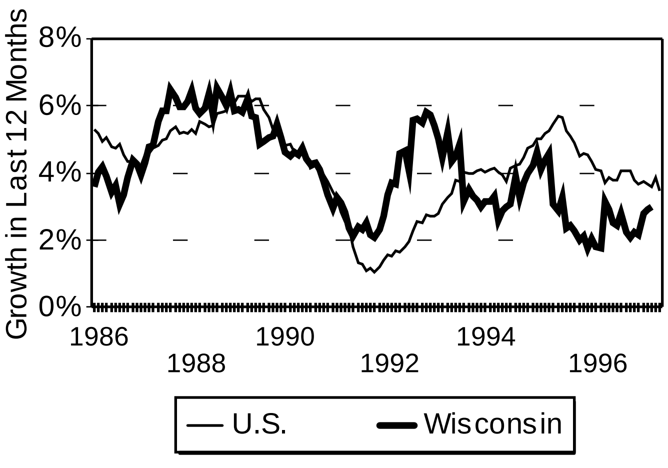
Wholesale and Retail Trade

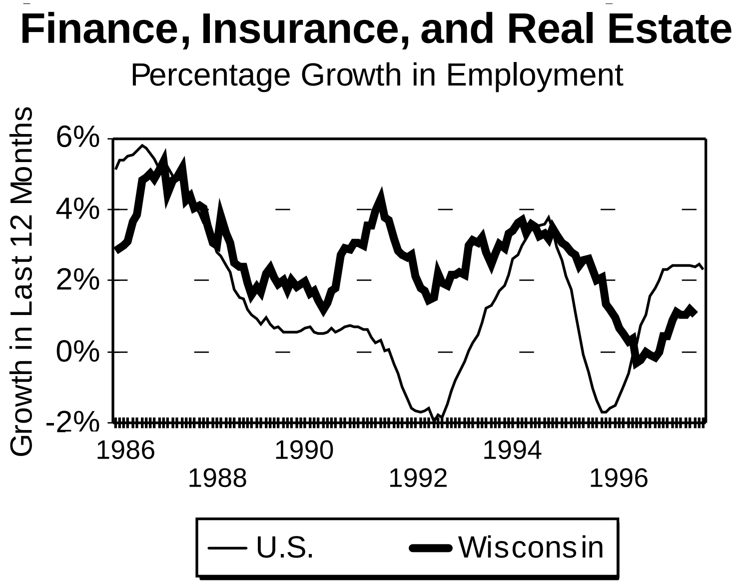
Percentage Growth in Employment



Services

Percentage Growth in Employment




Finance, Insurance, and Real Estate
Percentage Growth in Employment
Growth in Last 12 Months
6%
4%
2%
0%
-2%
1986
1988
1990
1992
1994
1996
U.S.
Wisconsin