Idaho Economic Outlook and Revenue Assessment Committee

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Chairmen and members of the Economic Outlook and Revenue Assessment Committee, thank you for this opportunity to share the national and Idaho economic outlooks for the next three years. For the record, I am Derek Santos, the Chief Economist in the Idaho Division of Financial Management. Joining me today is Nathaniel Clayville. He is my fellow economist in the Division.

The national and Idaho economic outlooks are important because they are the foundations upon which the Idaho's General Fund revenue forecasts for the next 30 months are built. Given their importance in determining the state's future fiscal health, it is our goal is to clearly describe these economic forecasts to help you assess the reasonableness of our forthcoming revenue forecast.

We will first review the national economic forecast. The forecast we are using here was prepared by IHS Economics in November 2015. The data from this national forecast was input into the Division of Financial Management's computer-based model to develop the Idaho economic forecast. Both forecasts begin in FY 2016 and end in FY 2018. Data from both economic forecasts were used to prepare the Idaho General Fund revenue forecast that will be covered next week.

If I were to summarize the economic forecasts for the next three years in one sentence, it would be: “You will live in uninteresting times.” I believe this is a good thing, especially when compared to the interesting times we experienced during and soon after the Great Recession.

Our first slide provides a 30,000-foot view of the economy. Real Gross Domestic Product measure is probably the most-watched indicator of the country’s overall economic health. It is defined as the inflation-adjusted value of all the goods and services produced in the US in a given fiscal year. The forecasted growth rates for the GDP are shown in the three bars at the right end of the chart As you can see, this measure is expected to grow between about two and three percent per year. This steady growth may appear unexciting compared to the growth swings on the opposite end of the chart, but the latter was the result of the Great Recession, something none of us want to go through again. Indeed, sometimes boring is better.

The next chart shows where this growth is expected to come from. To do this, it breaks out the growth rates in the first chart by the four major components of Gross Domestic Product. They are consumer spending (blue), which accounts for around two-thirds of the nation’s total output; investment (red), which includes the housing sector; government purchases (purple); and net exports (green), the difference between exports and imports. Combined, these four bars add up to each fiscal year’s total real GDP growth rate.

Please look at the right side of the chart that covers FY 2016, FY 2017, and FY 2018. Notice that in each year the blue bar representing consumer spending is the tallest bar. This means it is the largest contributor to expected future economic growth. Real investment and government purchases should also contribute to economic growth, but not to the degree of consumer spending. The green bars, net exports, are below zero. This means this sector should be a drag on economic growth over the next three years.

With so much riding on consumer spending, we'd like to share a few slides with you on why spending should expand over the near future.

First consumer balance sheets are healthier. For example:

> Household net worth net worth was about 5 times disposable personal income in CY 2008, but was more than six times personal income in CY 2015.
>
> Outstanding consumer debt has fallen from about 125% of disposable personal income to just over 100% of income in CY 2015.
>
> The number of personal bankruptcies peaked at over 1.5 million in CY 2010, but has since fallen well under one million in CY 2015.
>
> The household savings rate is holding near 5%.

Another reason consumers are expected to spend more is their incomes should increase over the forecast horizon. This can be seen in the current chart that shows inflation-adjusted national personal income growth. Personal income includes wage and salary payments; proprietors' income; income from interest, rent, and dividends; and

government transfer payments. Total personal income is projected to grow just over 3.3% annually through FY 2018. This may not be very exciting, but it is preferable to the back-to-back declines of FY 2009 and FY2010.

A major contributor to the personal income outlook is the expected steady wage and salary payments growth, which is the largest component of income. It is projected to grow just under 5% annually through FY 2018 thanks to steady employment growth and stronger wage growth.

Slow job growth was one of the biggest disappointments during the recent economic recovery. This can be seen in the current chart. The blue bars represent the number of nonfarm jobs in the US. The national economy shed about 8 million jobs in the two years from FY 2008 to FY 2010. But it took five years since then to regain eight million jobs. Payrolls are expected to expand by about 6.4 million jobs over the next three years, which is a 1.5% average annual pace.

The red line in the chart is the national unemployment rate. After peaking near 10% in FY 2010, it has been slowly declining. In FY 2015 an important milestone occurred: the unemployment rate fell to 5.7%. This marks the first time since FY 2008 it has been below 6.0%. The unemployment rate expected to drop further to about 5.0% in FY 2016 and hover near this level for the remainder of the forecast. This is very close to the level considered full employment, so further large drops are not anticipated.

The tightening labor market will put upward pressure on wages. This can be seen in the current chart. After a slight hesitation in FY 2016,

national annual nonfarm wage growth should be at least 3.7% in both FY 2017 and FY 2018.

Eventually these higher wages will put upward pressure on consumer prices because they are the largest costs facing businesses. As a result the inflation rate is expected to accelerate slightly, but it should remain tame by historical standards. As recently as FY 2008 inflation, as measured by the consumer price index, was nearly 4%. In comparison, it should be 0.5% in FY 2016 and average about 2.5% in both FY 2017 and FY 2018. FY 2016's soft inflation reflects weak energy prices. Energy prices are not expected to fall much further, so inflation is expected to inch up starting in FY 2017. However, inflation will be partially held in check by the stronger dollar that will both reduce the price of imported goods and cause domestic businesses to resist price increases in order to maintain market share at home and abroad. Low inflation means personal income will go further.

The low inflation, the healthy housing sector, and steady job growth convinced the Federal Reserve to raise its federal funds target to 0.5% in December 2015 after holding it at 0.25% for seven years. Last month's increase is assumed to be the first in a series of gradual increases that will raise the effective rate to about 2.4% in FY 2018. Other interest rates will rise gradually, also. The prime rate is expected to rise from 3.25% in FY 2015 to 5.4% in FY 2018 and the mortgage rate for existing homes should increase from 4.1% to 5.2%.

Despite the rise in mortgage interest rates, the nation's housing sector is forecast to continue expanding. This can be seen on the right hand side of the chart. After falling below 600,000 units in FY 2010 and FY 2011, housing starts topped one million units in FY 2015 for the first

time since FY 2008. There is a notable difference between these two years that is not clear in the chart, however. In FY 2008, housing starts were headed down towards 1.1 million units, but in FY 2015 they were headed up towards 1.1 million units. Housing should remain in expansion mode over the forecast period, gradually climbing to nearly 1.5 million units in FY 2018.

So far, the slides we've shared make the case for a healthy consumer economy. However, we need to mention that the trade sector will not fare as well. As was mentioned earlier, the trade sector is expected to be a drag on the economy.

The dollar's value against the country's major trade partners' currencies is expected to peak in FY 2016 and decline gradually in FY 2017 and FY 2018. The higher dollar raises the price of domestic goods and services relative to import goods and services, creating business challenges for American companies competing in the global market. In addition, international economic growth is expected to be relatively weak, which will put further negative pressures on US trade. For example, Japan's, South America's, and the Eurozone's economies are forecast to grow below 2% over the near term. Interestingly, China is expected to expand around 6.4% annually, which is disappointing by historical standards. The higher imports and lower exports reduce net exports which is a drag on national economic growth. While the trade sector will be a drag on economic growth, it will not derail overall US economic growth.

Now let's move on to Idaho. The expanding US economy is expected to fuel gradual Idaho economic growth. This can be seen in the next few slides.

This slide shows the forecast for Idaho nonfarm jobs over the next few years. Again, it makes the case for boring being better. During the "interesting times" from FY 2008 to FY 2010, Idaho shed about 52,000 jobs. During the boring times of the forecast, nonfarm employment should grow by around 16,000 jobs per year.

The sectors adding the most jobs during the forecast period are: Professional and business services (9,100 jobs). Health care and private education (11,400 jobs). Trade (8,800). Leisure and hospitality (4,900 jobs). Construction (3,500).

The next slide shows Idaho housing starts. It is important to look at starts because they are a good indicator of the construction sector that traditionally plays a large role in shaping the state's business cycle. Idaho housing starts hit an all-time high of about 23,000 units in FY 2006. They dropped deeply after the housing bubble imploded and hit bottom at about 4,100 unit in FY 2011—its lowest level since 1989. This sector is not expected to experience such a severe swing during the forecast period. As the chart shows, housing starts have been growing since FY2012 and in FY 2015 was just under its FY 2008 level. Housing starts are forecast to grow steadily and gradually over the forecast period to about 12,800 units in FY 2018. This is about half the number of units than in the FY 2006 peak. While the forecast may not be as exciting as what occurred during the lead up to the housing collapse, we believe our current forecast of gradual growth is more sustainable.

My last slide covers Idaho personal income growth. As this slide shows Idaho nominal personal income, which is not adjusted for inflation, has been growing since FY 2011 and is forecasted to grow over the next few years. This growth is encouraging because personal income is a

major determinant of the state's General Fund revenue. This makes sense. The largest single component of General Fund receipts is the individual income tax, which is driven by income. The sales tax is the second largest component of receipts. It too is influenced by income.

Thank you for your time. I will try to answer any questions you have.