THE US ECONOMIC OUTLOOK:

US Economy is currently growing strongly but there are risks:
- inflation
- oil prices
- the trade deficit

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US Growth in 2004 Was Better Than Expected

The prospects for growth in 2005 and 2006 are good—but with significant risks on the downside.

Quarterly Change in Real GDP over Previous Period

Projected: 2005 3.8% 4th to 4th
Projected: 2006 3.5% 4th to 4th

Source: BEA NIPA Table 1.1.1
The 2004 Soft Patch Was Not So Soft

- Second quarter growth was revised up.
- Consumption rebounded strongly in Q3 and Q4.
- Investment grew at around 9.4 percent for the year (4th to 4th).
- Growth was achieved even though net exports subtracted 0.6 percent from the total (compared to only 0.4 in 2003), and high oil prices subtracted about 0.25 percent.

The Drivers of Growth Going Forward

- Continued consumption growth with rising employment.
- Net exports should shift from a large negative to a small positive.
- Investment growth will continue—albeit more slowly.
- Housing and autos will depress growth, but not by that much.
Risks to US Growth

• Slower productivity growth and the elimination of slack in the economy could result in faster core inflation and higher interest rates.

• Oil prices might surge again.

• Net exports may fail to turn around.
Trend Growth Since 1995 Remains Around Three Percent, and the Current Level Is Still Above the Trend Line

Labor Productivity (Output Per Hour), Nonfarm Business

Index 1992 = 100

Source: BLS and Institute for International Economics
But Productivity Growth Is Slowing From Its Exceptional Pace in 2002-2003

Nonfarm Business Output per Hour, 1990 to 2004; percent change from same quarter in prior year.


Quarter to quarter changes

2004 Q3 1.3
2004 Q4 2.1
2005 Q1 3-4 (est.)
The Payroll Jobs Data Suggest There Is Still Slack in the Economy, but the Unemployment Rate is Low. Will Labor Force Participation Recover?

US Labor Force Participation Rate After Recessions, Percent Change From Trough Month

The labor force decline is from the under 55s, older workers are working more

Payroll employment in March 2005 = 132.936mn,
only 380 thousand more than in February 2001
Core Inflation is Edging Up, but Compensation Growth Remains Restrained—So Far

Source: Bureau of Labor Statistics; Bureau of Economic Analysis.
• Much of the inflationary pressure has been driven by oil and commodity prices.

• The sharp upward movement in oil prices was the result of a surge in demand in 2004 and constrained supply.

• There may be some speculative premium in current prices, but the main story is simple supply and demand.

• Oil prices are likely to remain high as demand continues to increase. A further price spike is possible because price hikes have not curbed demand so far, and there is no spare capacity.
The US and Asia Are Driving Demand Growth

<table>
<thead>
<tr>
<th>Region</th>
<th>Demand</th>
<th>Annual Change</th>
<th>Annual Change (%)</th>
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<tr>
<td>North America</td>
<td>25.18</td>
<td>0.47</td>
<td>0.61</td>
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<td>Europe</td>
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<td>OECD Pacific</td>
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<td>China</td>
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<td>Other Asia</td>
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<tr>
<td>World</td>
<td>82.51</td>
<td>1.85</td>
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Source: IEA Monthly Oil Market Report March 2005
A Structural Shift in the Oil Market—From the Underlying $20/Barrel to Maybe $35/Barrel (WTI)
Oil Prices Are High Because:

• Exploration and production costs have risen. The pace of discovery has been disappointing in many areas.
• For environmental reasons and because of refinery limits, the demand for light sweet crude has outpaced the demand for heavy grades of oil.
• Demand has not yet responded much to higher prices—there may yet be some speculative demands in the market.
• For political and strategic reasons, governments in some OPEC and non-OPEC countries have not allowed best-practice oil companies to use their technology and expand production.

Oil prices will likely cut US growth by about 0.5 percent in 2005.
Will Trade Turn Around?

- Optimistic forecasts for US GDP growth assume a turnaround in real net exports.
- So far, there is not much sign that this is happening (net exports subtracted 1.35 percentage points from GDP growth in the fourth quarter of 2004).
- US producers are passing through the lower dollar into lower export prices.
- But import prices, so far, have not risen much.
- US net national saving should rise to help rebalance the economy.
The US Trade Deficit Continues to Grow, Especially with China and the Rest of (Non-Japan) Asia

Source: Bureau of Economic Analysis, International Transactions Accounts; Catherine Mann.
Oil Price Increases Have Contributed to the Increase in Total Imports

Costs of Landed US Crude Imports, $USmn

Cumulative Difference in Costs of US Landed Crude Imports
January 2002 - January 2005: $134.1bn

Actual Costs of Landed US Crude Imports

Implied Costs of US Landed Crude Imports If Price Fixed at January 2002 Level

Source: EIA
US Export Prices Have Remained Stable in Dollar Terms—For Manufactured Goods

Prices set in competitive commodity markets

US producers have held prices stable as the dollar has declined—there is pass-through.

Import Prices Have Not Fully Reflected the Dollar’s Decline—Although They Are No Longer Falling

Source: Federal Reserve Board; Bureau of Labor Statistics.
Reducing the Current Account Deficit Requires Either More Saving or Less Investment—Reducing the Budget Deficit Is Necessary if not Sufficient.

**US Savings and Investment as Percent of GDP**

- **Net Household Savings**
- **Net Corporate Savings**
- **Net Public Savings**
- **Net National Savings**
- **Net Investment**
- **Net Foreign Savings**

Source: Bureau of Economic Analysis, National Income and Product Accounts; International Transactions Accounts; Catherine Mann.
Conclusions

- The recovery now seems firmly established, with 3.9 percent growth in 2004 (4th to 4th); 2 million payroll jobs added (March to March); and strong investment growth.
- Productivity growth is slowing. As long as the trend stays in the range of 2.5-3.0 percent, this should keep unit labor costs down (4% compensation growth and 2.5% productivity growth imply only 1.5% growth in unit labor costs).
- Potential GDP growth is 3.25-3.50 percent. The United States is moving close to full employment.
- The oil supply is expanding only very slowly, keeping prices high. Much of the supply is from unstable countries or regions so it’s easy to see events that could trigger another price spike.
- Now is a good time to work on fiscal consolidation as a necessary step towards a smaller current account deficit.