THE US ECONOMIC OUTLOOK:
DATA REVISIONS AND ECONOMIC UNCERTAINTY

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Successive Data Revisions Now Show a Smaller Boom and Deeper Recession than Originally Thought

Productivity Growth Estimates Have Also Been Lowered

Annual Percentage Change in Output per Hour Nonfarm Business

Nevertheless, the fundamentals still look good: Inflation is low

Seasonally Adjusted Price Index for Personal Consumption Expenditure Excluding Food and Energy

Percent Change from Same Quarter of Previous Year


Unemployment remains moderate by historical standards

Source: Bureau of Labor Statistics
Note: Data for 2002 January through July only
The Productivity Acceleration Remains Important

Current Productivity Trend Suggests Potential GDP Growth of 3 to 3.5 percent a year.

Budget Deficits are Sustaining Demand Now:
But the threat of future deficits could raise long interest rates

Federal Budget Balance

Billions of Dollars


Source: Congressional Budget Office. Projections released August 27, 2002. They exclude proposed tax cuts and spending increases.
Monetary Policy Remains Expansionary too

Federal Funds Rate

Source: Federal Reserve
The Economy Bounced Back From Recession: But the strength of the recovery is uncertain

Seasonally Adjusted GDP Growth

Source: Bureau of Economic Analysis, Macroeconomic Advisers, Blue Chip Indicators
The Main Reason for Mid-Year Weakness Was the Soft Equity Market

Household Net Worth, Stock Value, and Real Estate Value

Source: Federal Reserve, New York Times Analysis
Why Did the Equity Market Decline?

The Economic Downturn and Phony Accounting Caused a Reality Check in a Market That Went from Undervalued in 1980 to Overvalued in 2000

Earnings/Price Ratio

<table>
<thead>
<tr>
<th>Year</th>
<th>Ratio</th>
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<tbody>
<tr>
<td>1960</td>
<td>5.9</td>
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<tr>
<td>1970</td>
<td>6.45</td>
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<tr>
<td>1980</td>
<td>12.66</td>
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<tr>
<td>1990</td>
<td>6.47</td>
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<tr>
<td>2000</td>
<td>3.63</td>
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<td>2002</td>
<td>2.15</td>
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Source: Standard and Poor's 500
Corporate Profits Look Disappointing: Revised NIPA Data

Corporate Profits with Inventory Valuation and Capital Consumption Adjustments

Source: Bureau of Economic Analysis, www.bea.gov, Table 6.16c.
The Economy is Currently Giving Mixed Signals: Consumer Confidence is Falling Again

Source: University of Michigan, The Conference Board
But New Orders are Up, Suggesting a Recovery in Investment

Durable Goods New Orders

Total New Orders
Non Defense New Orders

Source: US Census Bureau. Manufacturing, Mining, and Construction Statistics
Note: Seasonally Adjusted
Foreign trade usually mitigates slumps and helps recoveries. But in this recovery, a strong dollar and a weak world economy are dragging down US growth.

Contribution of Net Exports to GDP Growth

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<tbody>
<tr>
<td>Value</td>
<td>-1.5</td>
<td>-1</td>
<td>-1</td>
<td>-1</td>
<td>-0.5</td>
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<td>0.5</td>
<td>0.5</td>
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<td>-1.5</td>
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The current consensus is for 2.5 to 3 percent growth in the second half of 2002 and around 3.5 percent in 2003, based on several positive factors:

• Autos and housing remain strong
• Stock market may be coming back
• Equipment investment and industrial production are rising
• Policy is expansionary
• Inflation is low
• Productivity growth remains good with the trend at 2% to 2.5%
But this is a time of political and economic uncertainty

- War with Iraq now seems probable

  - will boost federal spending over the next 12 months - from $50 billion (Pentagon estimate) to $100-200 billion (Lawrence Lindsay). This could help recovery.

  - a short successful war is unlikely to boost oil prices much beyond current levels around $30, up from around $20 last year.

  - a wider or longer conflict could result in much higher prices (up to $100). Verleger estimates this as a 5% probability.

  - each $10 increase in the price of oil costs US consumers $120 billion and hurts oil consuming industries (4% profit decline)

  - Strategic petroleum reserve will very likely be used if prices go up from current levels
Other economic uncertainties include:

• Overall business spending is still weak – office vacancy rates are high.

• Renewed weakness in the stock market, consumer spending or business spending could produce mutually reinforcing downward pressure on the economy.

• In the short run, strong productivity means weak employment growth. Unemployment may rise again.

• Sustained weakness in the Rest of the World, together with a still strong dollar, may be a drag on US Growth.

On balance, the chances of a “double-dip” are roughly twenty percent. The chances of a recovery that is significantly weaker than the consensus is 30 to 40 percent.