THE US ECONOMIC OUTLOOK

Growth has slowed because of high oil prices and a weak labor market, but it should continue. How much slack remains in the economy?

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Following signs of strong recovery in 2003Q3-2004Q1, growth seems to be slowing

Quarterly Change in Real GDP over Previous Period

- Authors’ Projection
- Average Growth 2003 II - 2004 I = 5.1%
- Average Growth 2004 II - 2004 IV = 3.3%

Source: BEA NIPA Table 1.1.1, Authors
Why is growth slowing?

• Oil prices have risen and are expected to remain high

• Slow job and wage growth result in slow income growth

• Low interest rates kept housing and auto sales strong after 2000 – borrowing future growth

• No new stimulus from monetary or fiscal policy

• The Iraq war and the terrorism threat may be a drag on confidence. Because 9/11 did not have significant macroeconomic effects, the impact of the war and terrorism seems to be mostly on oil prices
Oil prices have risen rapidly in the last 12 months

NYMEX WTI Light Crude Spot Price, $/Barrel

1990s Peak: $52, in 2000$

1980s Peak: $75, in 2000$

DOE estimates a sustained 50% price increase (from $30 to $45/barrel) would lower US GDP by 0.25-0.50 percent

Source: Energy Information Administration/DCE
Oil consumption has been rising very rapidly with a big boost from China

1H2003-1H2004, first time since 1997 that oil consumption has risen in all regions and total demand growth at the highest level since early 1980s.
The futures prices hardly moved above $25 prior to 2004, but this time futures indicate that oil prices will stay high.

Source: Energy Information Agency/DOE, BP
Refining (upgrading) capacity shortages and environmental restrictions mean that increased supply of heavy crude does not lower the price of sweet crude.

Price Spread Between Heavy Crude (Canadian Bow River) and Sweet Crude (Nigerian Bunny Light) in 2004, $ per barrel in Landed Costs of Imported Crude Oil to US

Source: EIA Table 30, Landed Costs of Imported Crude Oil for Selected Crude Streams
Conclusions on oil prices

- There seems to have been a structural shift upward in the price of oil. Strong Asian demand, a lower dollar and declining supplies from older fields.

- Adjusted for inflation, however, the new equilibrium price is lower than in the 1970s and early 1980s. It should not be a barrier to long-term growth – provided it does not keep rising.

- Oil prices could jump higher with supply disruptions (DOE estimates that the price rises by $4-$6/barrel for every 1million barrels a day of oil supply disrupted, given the current lack of spare capacity). Prices could fall if Chinese demand slows down.
Why has job growth been weak?

- Rapid productivity growth “raised the bar”, but need not have resulted in weak employment
  - It did not do so 1996-2000
  - In any case productivity growth seems to be slowing to a trend rate of 2.5 to 3 percent

- Trade and offshoring account for only a modest fraction of the job loss (314,000 manufacturing jobs 2000-03 out of a total of 2.85 million*)

- Job growth has been weak because US domestic demand growth has been inadequate. As well as the reasons given earlier, there was an overhang from the 1990s, limits on the power of monetary policy, and tax cuts that had lousy bang for the buck

* See Baily and Lawrence, Brookings panel, September 10, 2004
Why has wage growth been weak? Because of weak job growth and rapid increases in health costs

Source: BLS Employment Cost Indexes
Provided oil prices are moderate, growth should continue and eventually restore Full employment.

How much slack remains in the economy?

This can be measured with two closely related metrics:

• How many payroll jobs per month to get back to full employment

• How much GDP growth to get back to potential
Employment increases needed to reach potential in 2006 and sustain it thereafter

Non-Farm Payroll Employment 2000-2009

Average Monthly Job Change in Period

Thousands

2000a: 159
2001a: -149
2002a: -47
2003a: -5
January-August 2004: 180
September-December 2004: 306
2005: 300
2006: 192
2007: 167
2008: 158
2009: 158

= Job growth required to reach full employment

Projections 2004-08 refer to forecast nonfarm payroll employment in ERF 2004, table 3.1. (a) Data at Year-End. Historical Data from BLS
There was 2.3 percent of GDP slack in the economy in 2004 II* 

- If potential growth is in line with CBO’s long-term estimates, there is room for 4.5 percent growth after 2005 until 2006Q3
- If potential growth is 3.5 percent a year, there is room for 4.5 percent growth after 2005 until 2007Q3

* Based on CBO potential growth estimates from 1990-2004 II
Conclusions

- Growth is projected to be 3.5 percent in the 3rd and 4th quarters of 2004, and 4 percent in 2005, 4th to 4th

- This forecast assumes a moderation of oil prices and no major deterioration in the geopolitical situation

- There is a substantial downside risk from another oil price spike. Continued weak job growth is a threat to the recovery

- Potential GDP growth is 3.5 percent a year. There is currently just above 2 percent of GDP slack room for growth faster than 4 percent for a while if the recovery gains momentum