

# **THE U.S. ECONOMIC OUTLOOK:**

## **Investment, Productivity, Deflation**

Martin Neil Baily

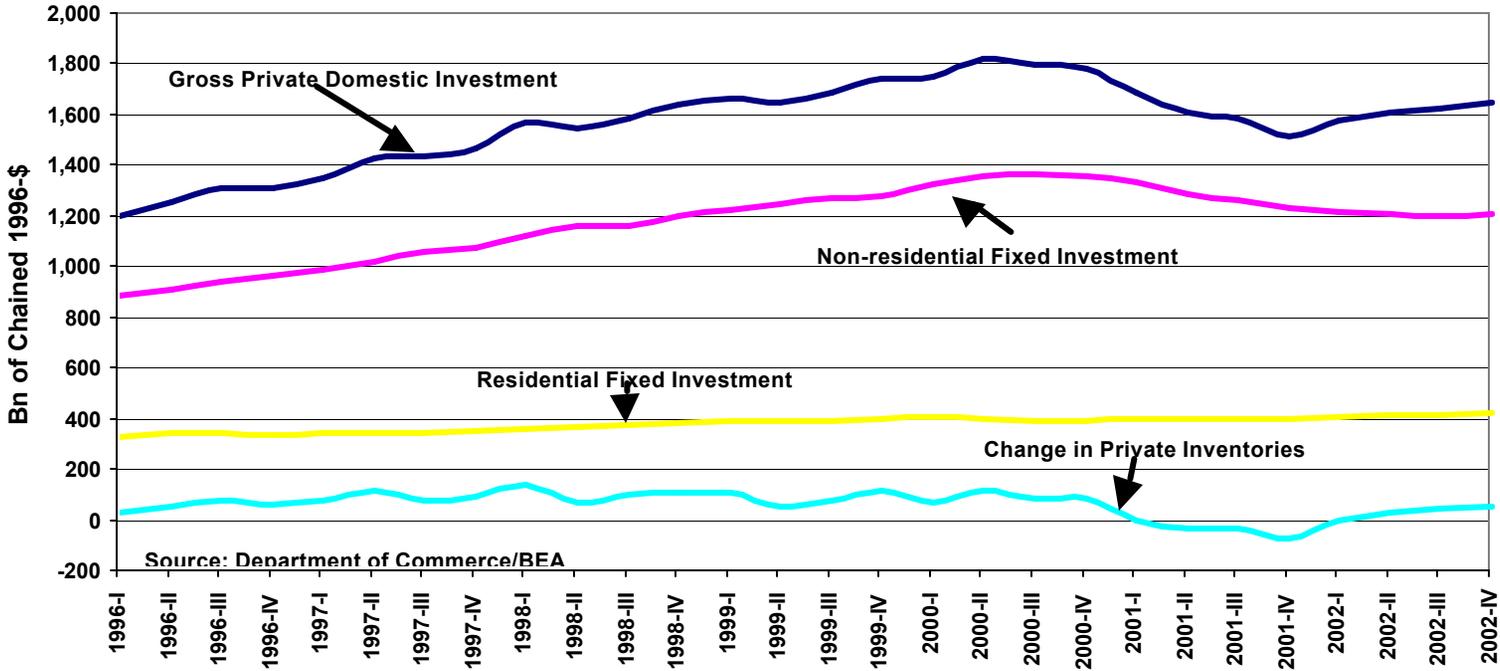
Senior Fellow

Institute for International Economics

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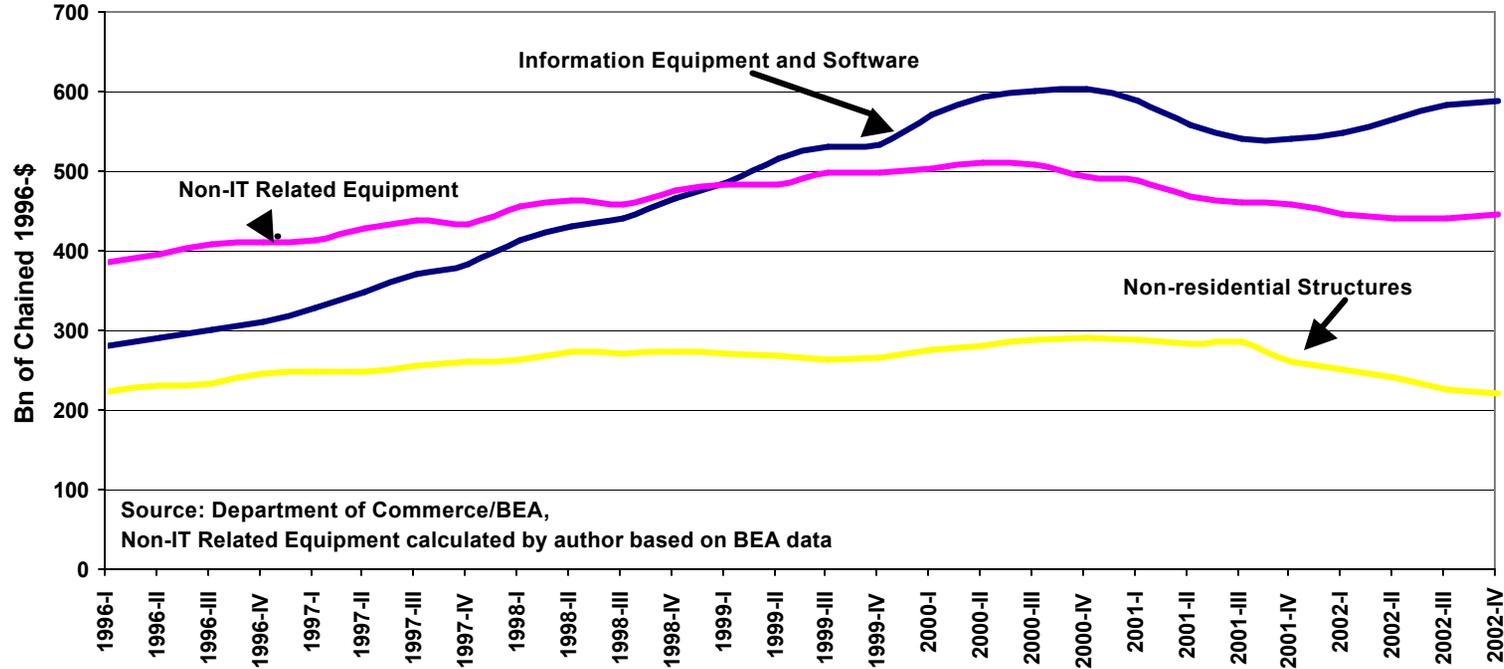
# Investment has stopped falling, but future growth is likely to be moderate.

## Real Gross Private Domestic Investment



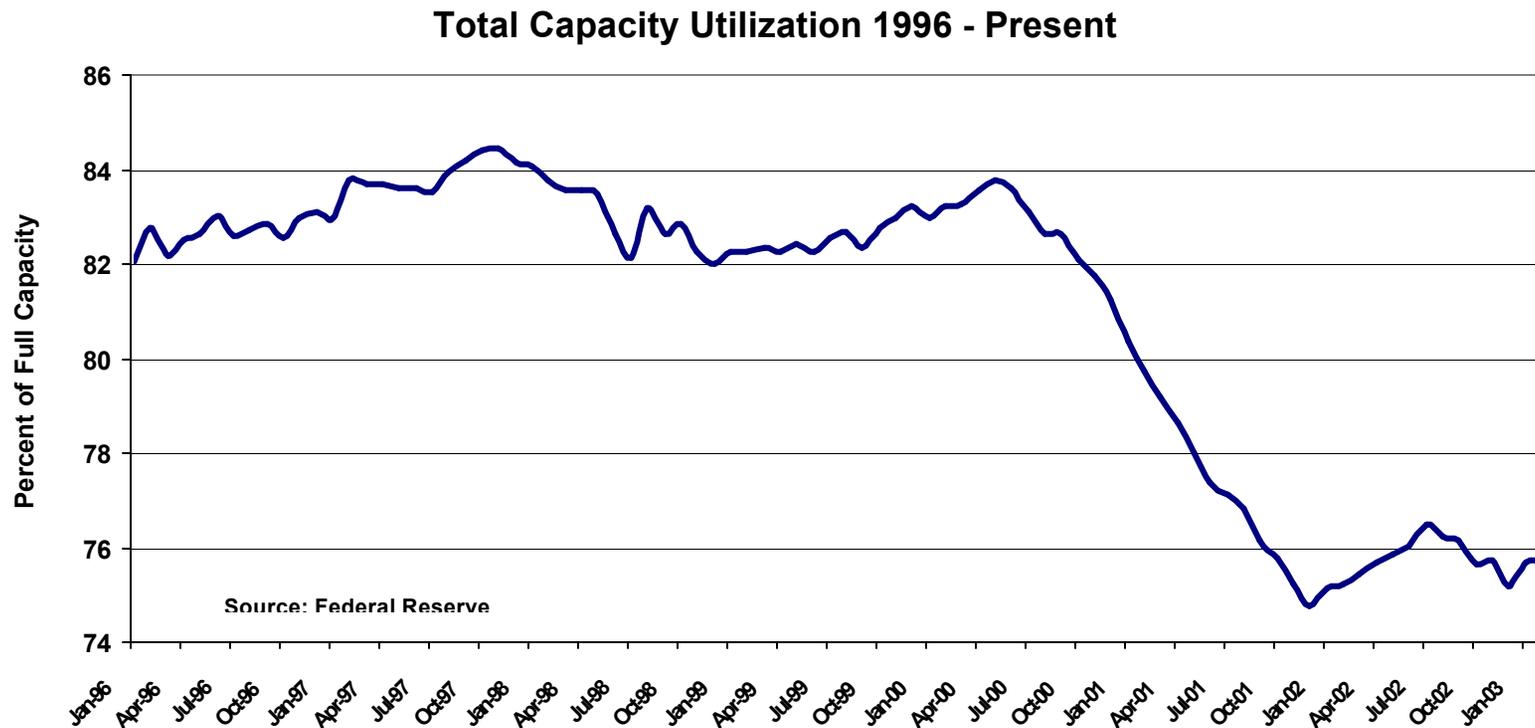
# Real IT investment is growing. Non-IT equipment is turning. Non-residential structures investment is weak

## Real Non-residential Fixed Investment



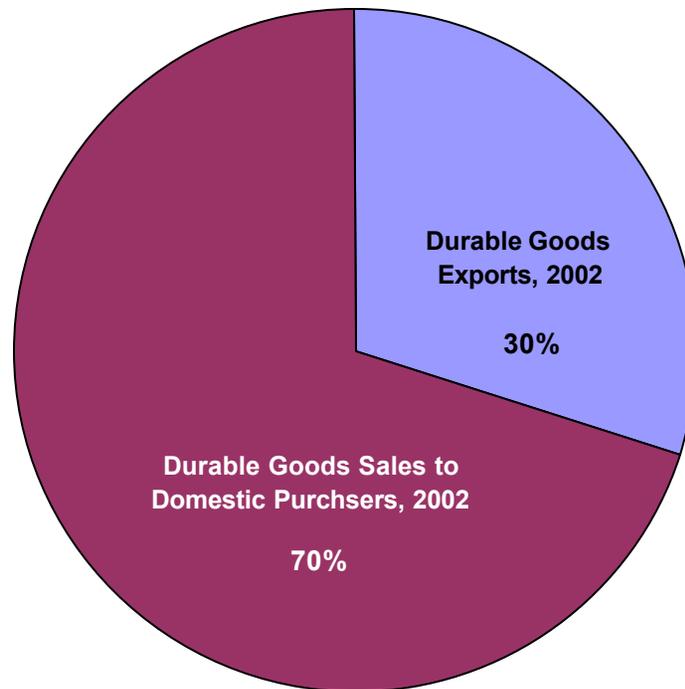
# Capacity Utilization Remains Low

- Although much of the “excess capacity” is old capital held in reserve
- And the service sector is now the largest purchaser of capital goods



**30 percent of durable goods production is exported.  
The dollar is still strong and world demand is weak**

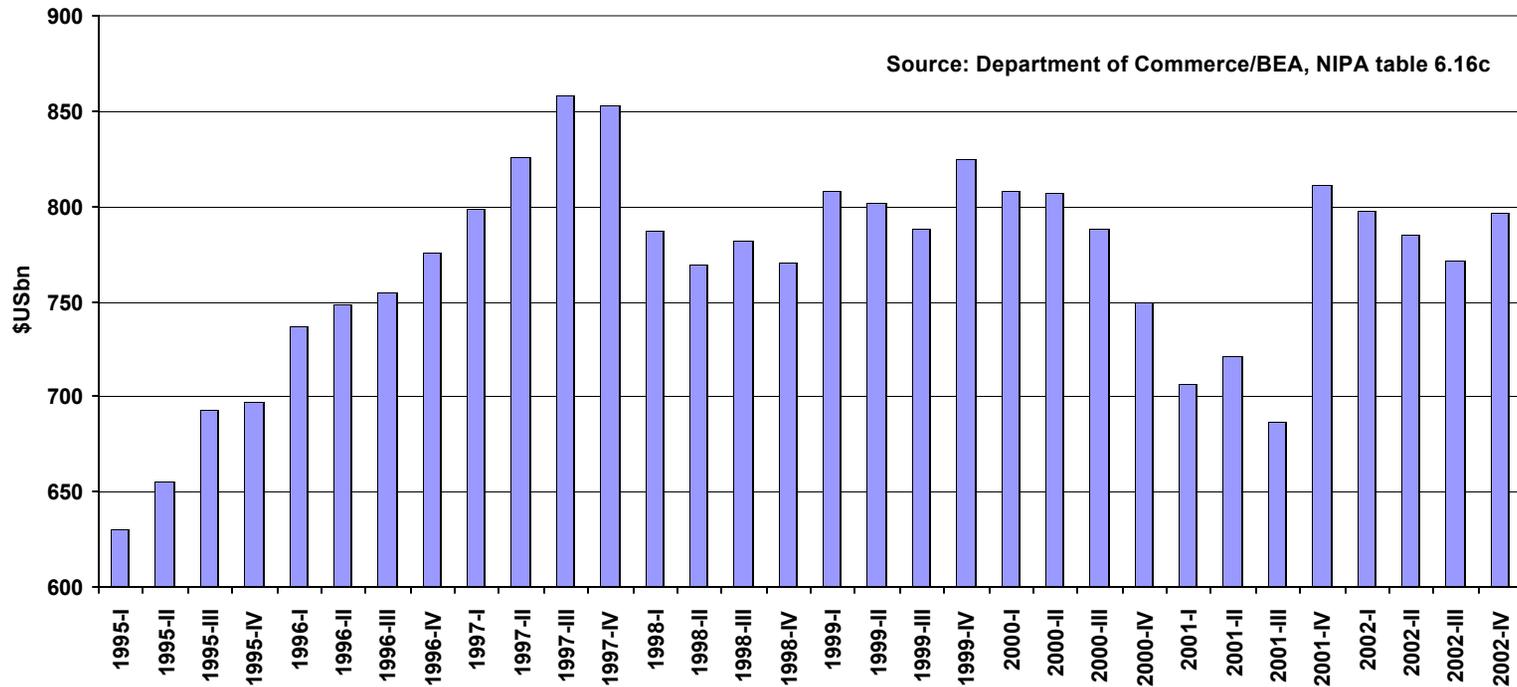
**Total amount: \$1,664.8bn**



**Source: Department of Commerce/BEA**

# The level of profits recovered after the recession, but the growth remains weak

Corporate profits with inventory valuation and capital consumption adjustments



- **Hence sluggish investment is not just the result of war uncertainty. There is still excess capacity in manufacturing. The rest of the world is a drag on US demand. Manufacturing still has excess capacity. The dollar is still too strong. Profit growth remains weak**
- **Given that services are so important, investment should pick up in the second half as structures investment stops falling, IT grows and other investment grows slowly. But a strong surge in investment is unlikely.**
- **This assumes oil prices stabilize or fall and war-time uncertainty eases.**

**Productivity performance is an important positive for the economy, with a short-term downside.**

- **Despite weak investment, productivity has grown rapidly recently even though investment and IT spending have slumped:**

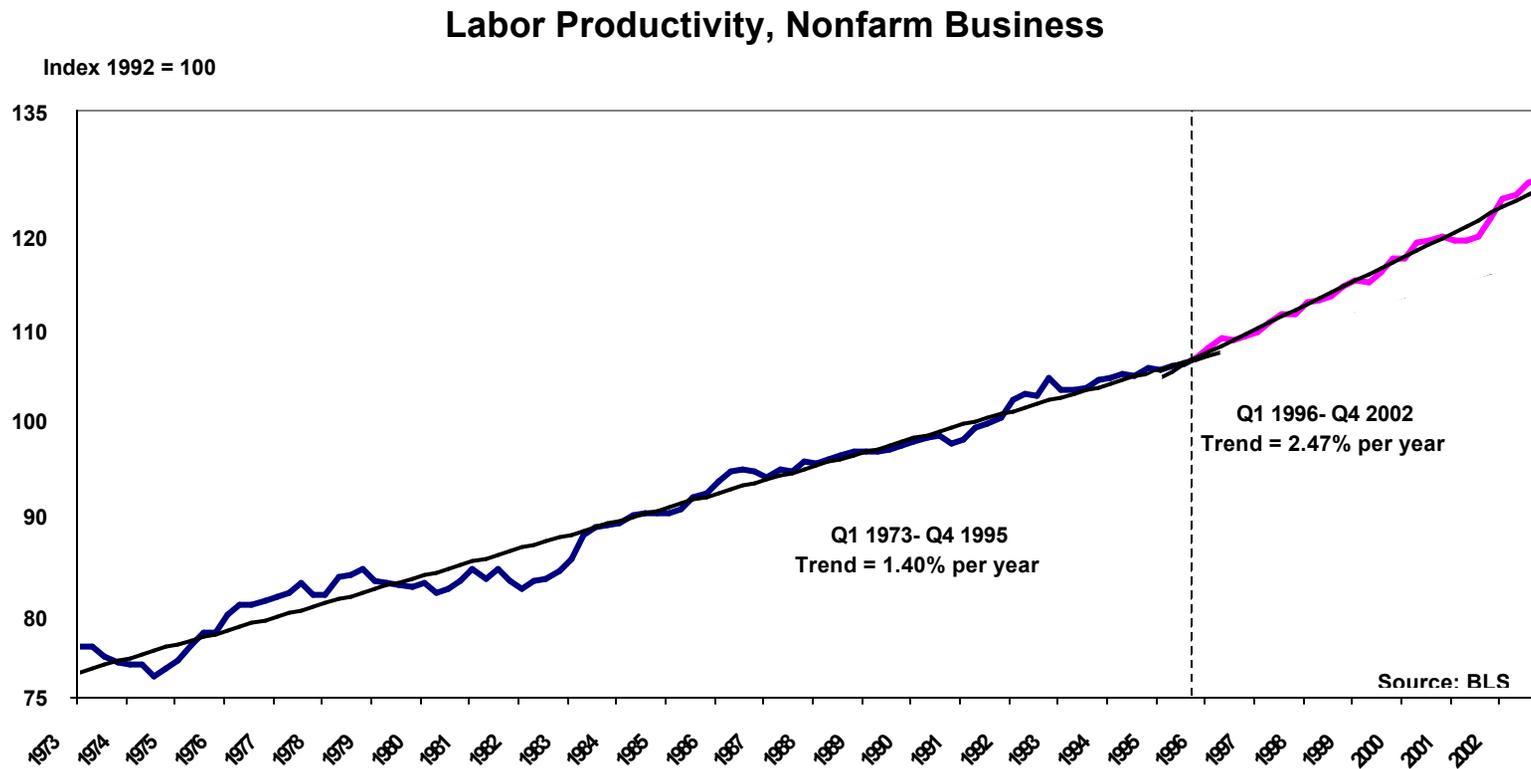
**2000QII – 2002QIV: 2.63 percent**

**2001QI – 2002QIV: 3.62 percent**

**at annual rates**

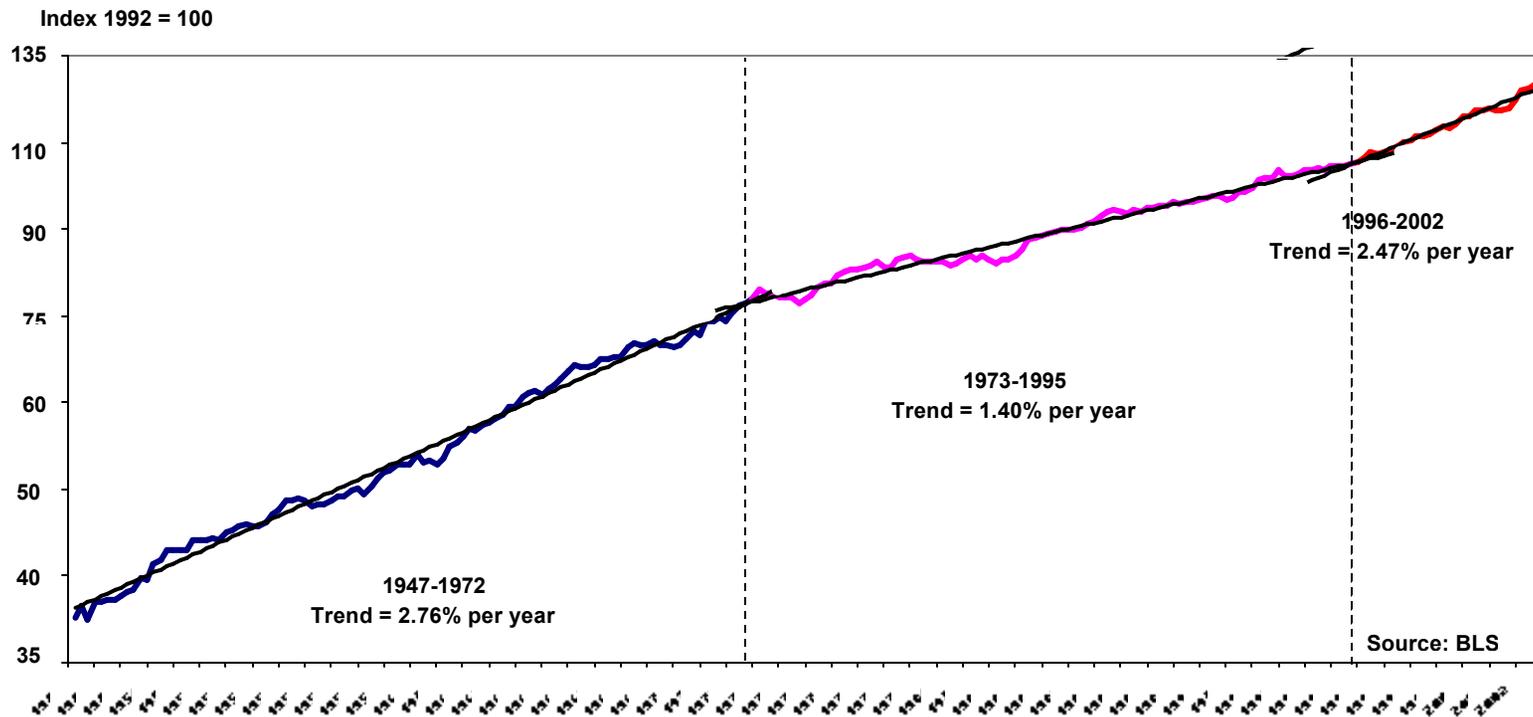
- **Why is this?**

# The current productivity growth trend is around 2.5 percent a year



**Since World War II, capital investment has been only one of the drivers of trend growth in labor productivity—and not the most important**

**Labor Productivity, Nonfarm Business**



- **Industry level data further support this conclusion**
- **The slowdown in productivity growth in the 1970's was associated with a collapse of productivity growth in services**
- **The post-1995 acceleration has reversed the service sector slowdown**
- **Triplett and Bosworth find that this recovery in services was driven by more rapid total factor productivity growth after 1995, not by a larger contribution of IT capital.** Brookings, September 18, 2002

- **Industry case studies show that business process innovation is the key to productivity growth. Some, but not all, such innovations are enabled by IT.**
  - **Business process innovation is driven by strong competitive intensity**
  - **IT only contributes to productivity growth when accompanied by business process innovation**

**McKinsey Global Institute 2002**

- **Analysis of establishment and firm data in the retail sector suggests that that competitive pressure and structural change drive productivity increases**

*“Our results show that virtually all of the productivity growth in the U.S. retail trade sector over the 1990’s is accounted for by more productive entering establishments displacing less productive exiting establishments. Interestingly, much of the between establishment reallocation is a within, rather than between, firm phenomenon”*

**Foster, Haltiwanger and Krizan.**

**NBER Working Paper 9120**

- **IT contributes to industry restructuring, but computerizing existing establishments was not the main source of productivity increase in retail.**

## **Productivity and the Economy**

- **Strong productivity growth is good for employment over the long term – for example, the periods 1948-73 and 1995-2000.**
- **In the short term, however, strong productivity growth with only modest demand growth will result in a weak labor market—for example 2002 and early 2003.**
- **The labor-market weakness, together with high oil prices and war time uncertainty, have resulted in a plunge in consumer confidence.**
- **Over time, however, rising productivity leads to rising incomes and profits, and these encourage consumption and investment.**

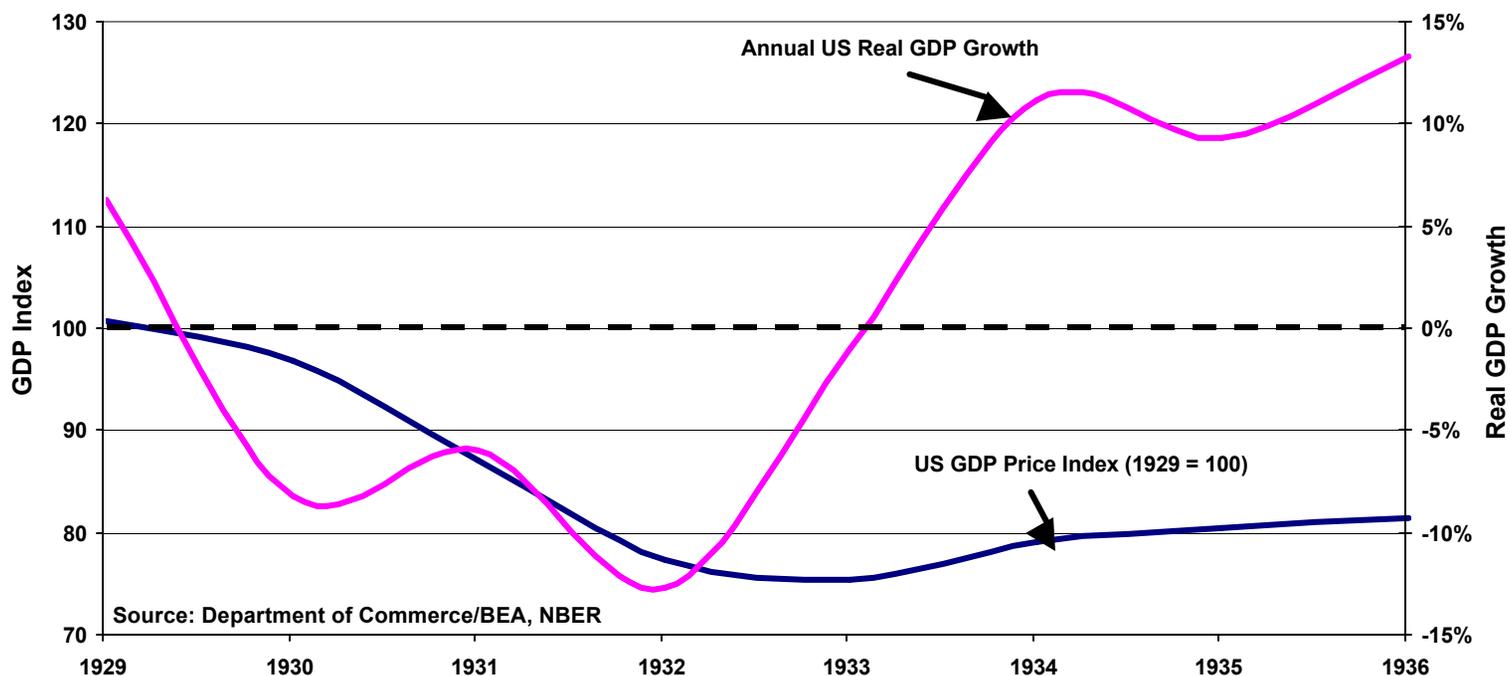
# **Deflation:**

**How big a threat?**

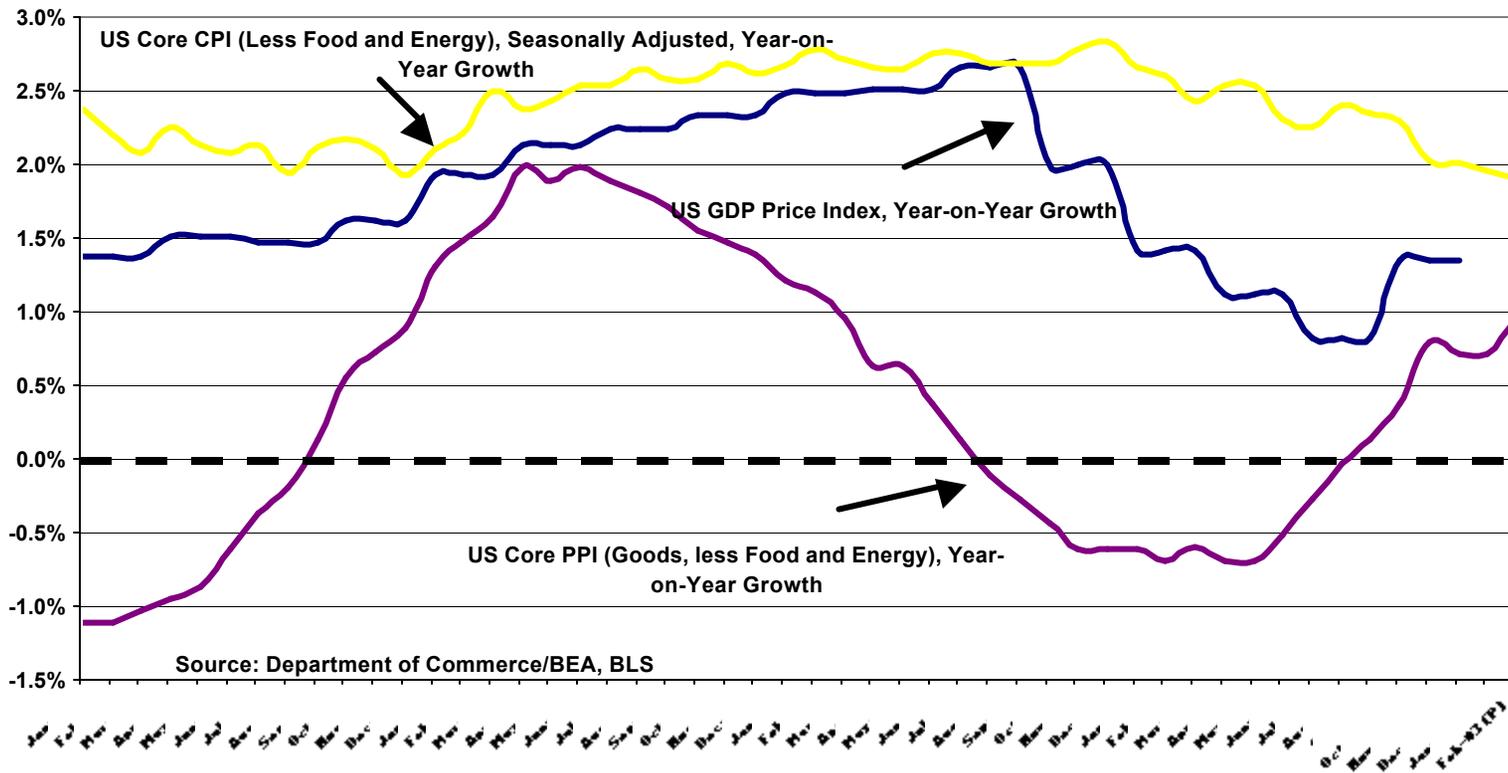
**How serious a problem?**

**There was sharp deflation in the US (1929-33),  
but a strong recovery as the price level stabilized.**

**US Deflation 1929-36**

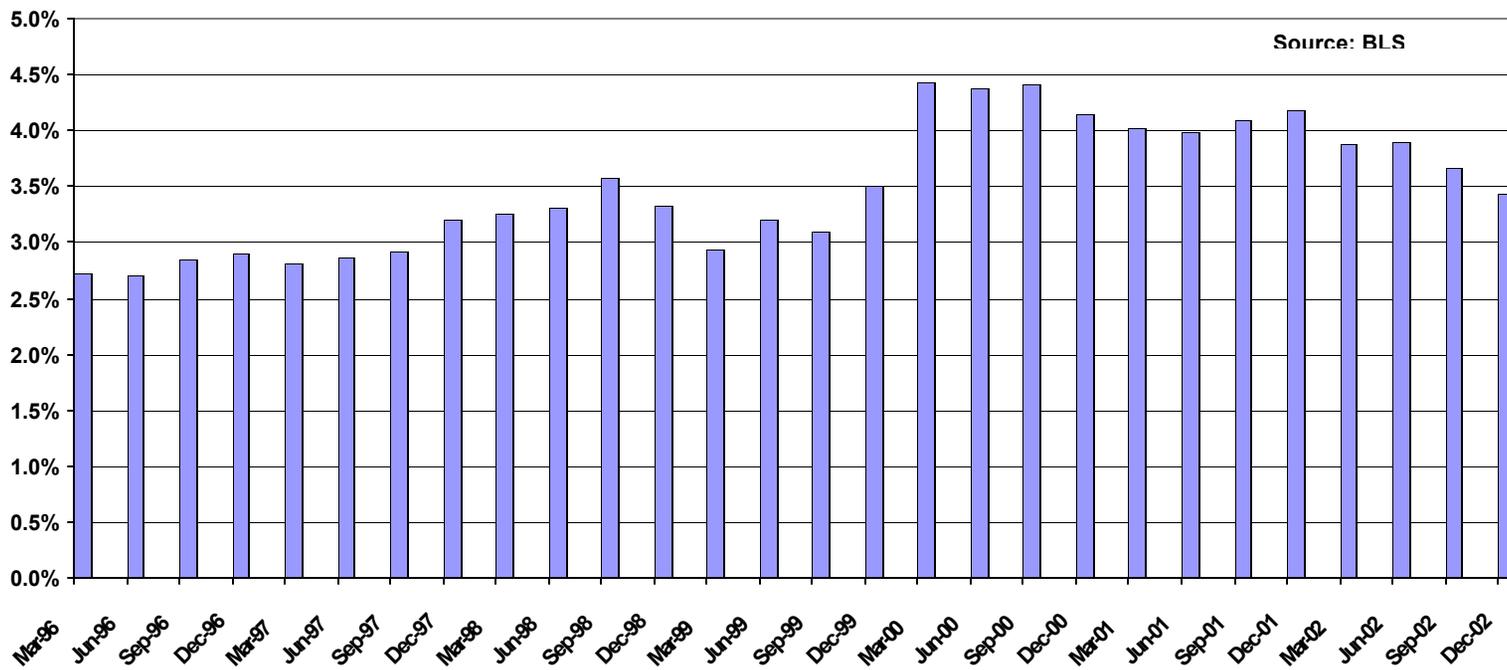


# US inflation today is low, but not negative



# Compensation is still rising strongly

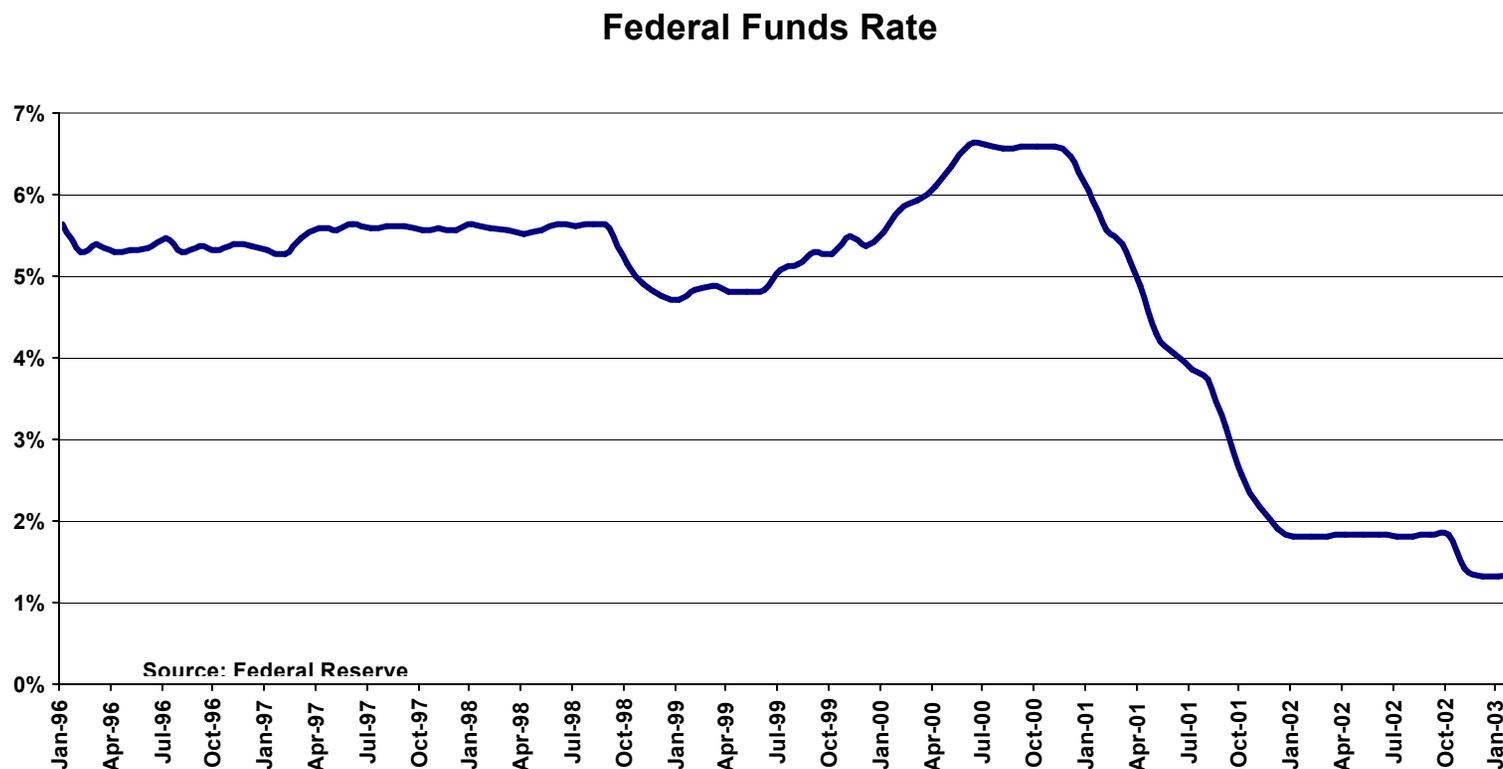
Employment Cost Index, Total Compensation All Civilian Workers,  
Seasonally Adjusted 4-Quarter Growth



- **Inflation is low for three reasons:**
  - **Demand is weak**
  - **We have changed the way we measure inflation**
  - **Productivity growth is faster**
- **The first is bad, the second is immaterial, the third is good**
- **Deflation accompanied by other serious problems, as in Japan, surely discourages spending. But the pure effect of a slow decline in prices in discouraging spending is not all that great—intertemporal substitution elasticities are not high.**

**The Fed has limited room to lower the FF rate, but it does have other policy tools—buying longer-term bonds, printing money**

**-Uncertainty about effectiveness, and how to unwind down the road**



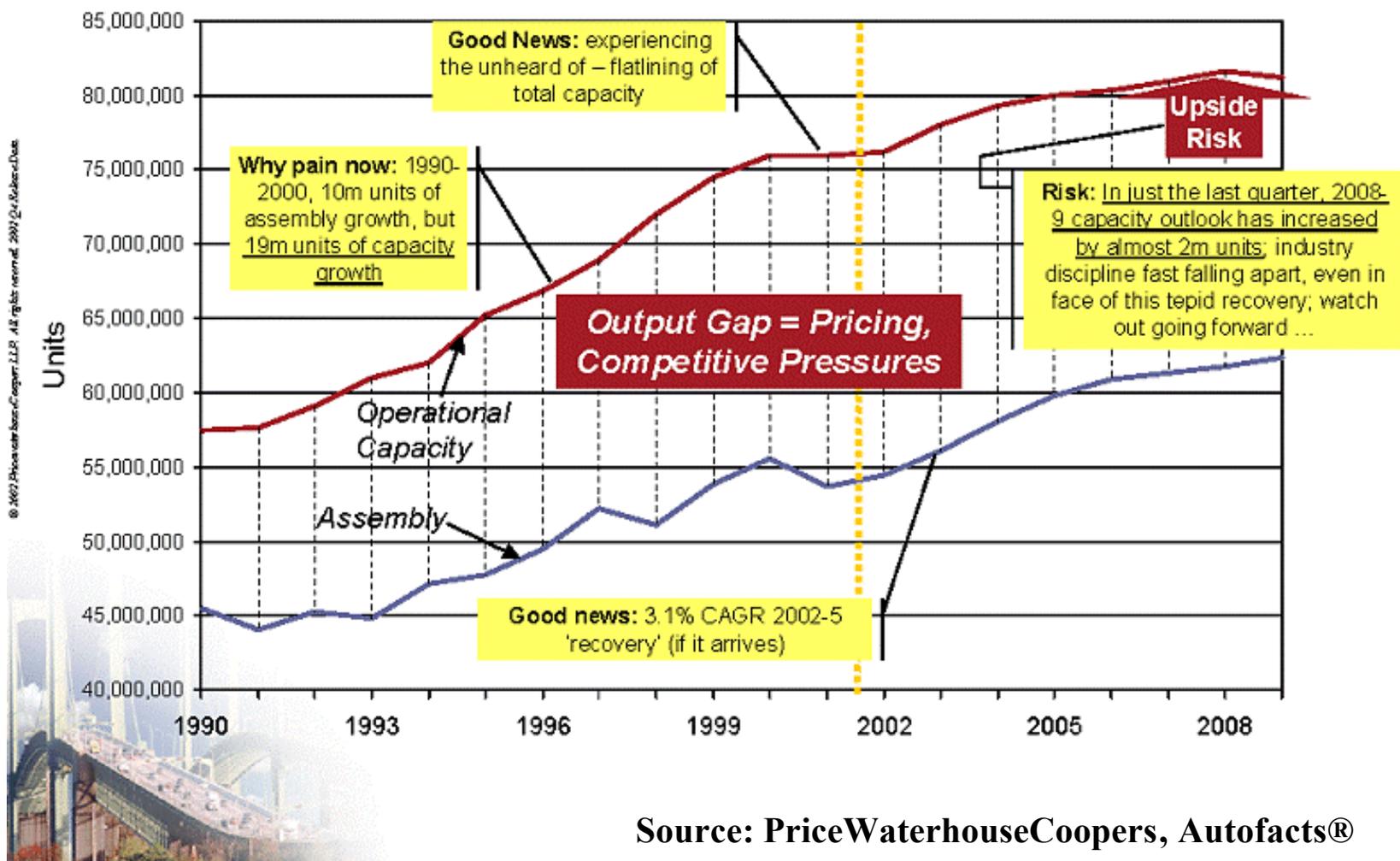
**Which takes us back to the real problem for investment to recover**

## **Why have many US companies been concerned about deflation?**

- There is no stable competitive equilibrium in industries with high fixed costs and low marginal costs – steel, autos, chemicals, software, computer chips, airlines and others.**
- Unless companies can achieve a stable pricing structure or establish unique products, they will lose money. The airline industry has never earned a normal return on its capital. DRAM makers are likely in the same situation.**
- Increased global competition has undermined established pricing practices in many industries. Things have been changing for several years, but a weak world economy and a strong US dollar have intensified the effects.**
- The result has been a “loss of pricing power” and downward pressure on a range of goods prices.**
- Some service companies face the same issues because competitors such as Southwest and Wal-Mart put strong competitive pressure on incumbents.**

# Auto Industry Long-Term Outlook and Structural Challenges

## Global Light Vehicle Assembly & Capacity



Source: PriceWaterhouseCoopers, Autofacts®

- **The overcapacity and downward price pressure in a range of industries have weakened stock prices, discouraged investment, made companies reluctant to hire, and slowed the recovery**
- **There is a benefit from this downward pressure on prices. It has forced companies to cut costs and increase productivity. Increased global and national competition has been an important driver of improved US productivity growth**
- **A recent OECD study found that raising trade exposure by 10 percentage points increased output per employee by 4 percentage points**

# Conclusions on the outlook

- **Most forecasters expect a slow first half of 2003 and then growth of 4 percent or more in the second half**
- **A modest pick up in investment, strong growth in federal government spending, low interest rates, and falling oil prices should be enough to offset areas of weak demand**
- **If there had been significant damage to Iraq's oil fields or to other nearby oil facilities, the chances of a double dip would have been higher. That outcome seems to have been avoided.**
- **Despite some statements to the contrary, Iraq cannot sustain an all-out war for much longer. They do not have the fire power.**
- **This forecast anticipates continued weakness, but not collapse, in Europe and Japan.**