

THE US ECONOMIC OUTLOOK:

Optimism With Some Uncertainties,
a Productivity Puzzle and a Job Loss Recovery

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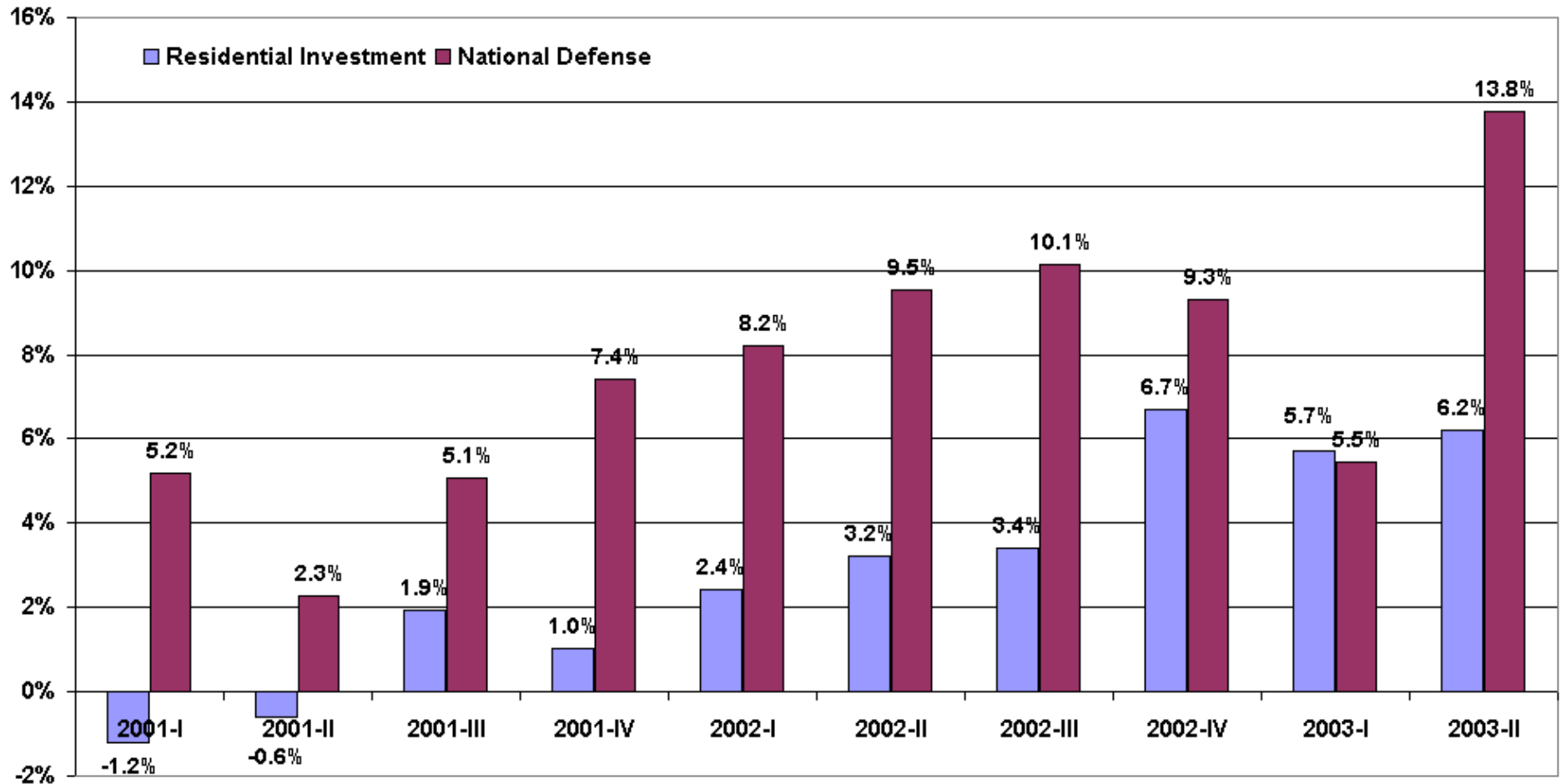
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Prospects for Rapid Growth in the Second Half of 2003 and into 2004 Have Greatly Improved

- Americans are buying: Real final sales to domestic purchasers rose by 5 percent in the second quarter
- Most recent indicators look good; retail sales, housing starts, existing home sales, the stock market, durable goods orders and the ISM
- Forecasters are now expecting over 5 percent growth in the third quarter
- Corporate profits are picking up, which should sustain capital spending

Defense Spending and Residential Investment Have Boosted Growth

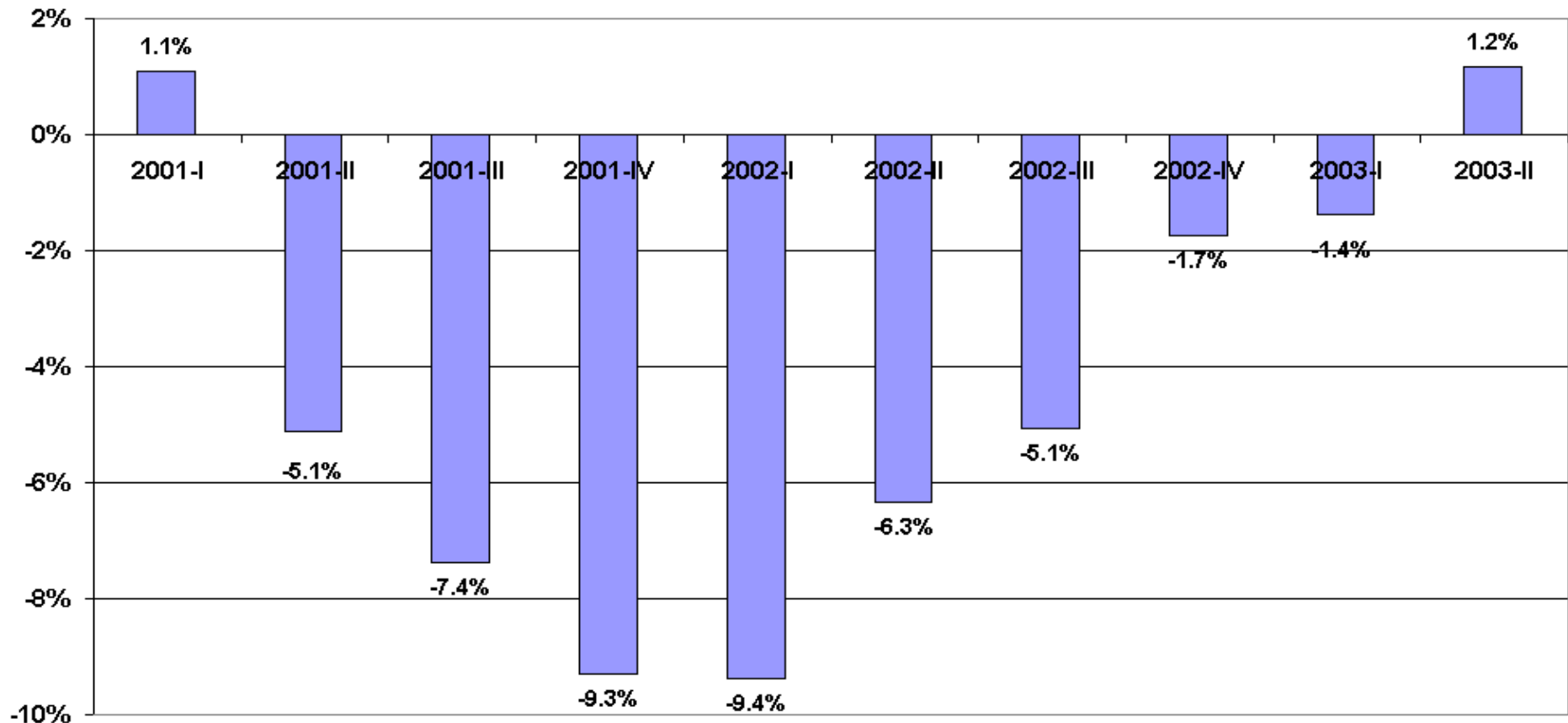
Percent Change From Same Quarter One Year Earlier



Source: Department Of Commerce, NIPA Table 1.2

Business Has Been Very Cautious About Investment. That Now Seems To Be Changing. Investment Picked up in Q2 and Orders are Good. Investment in 2004 is a Question-mark

**Non-residential Fixed Investment,
Percent Change From Same Quarter One Year Earlier**



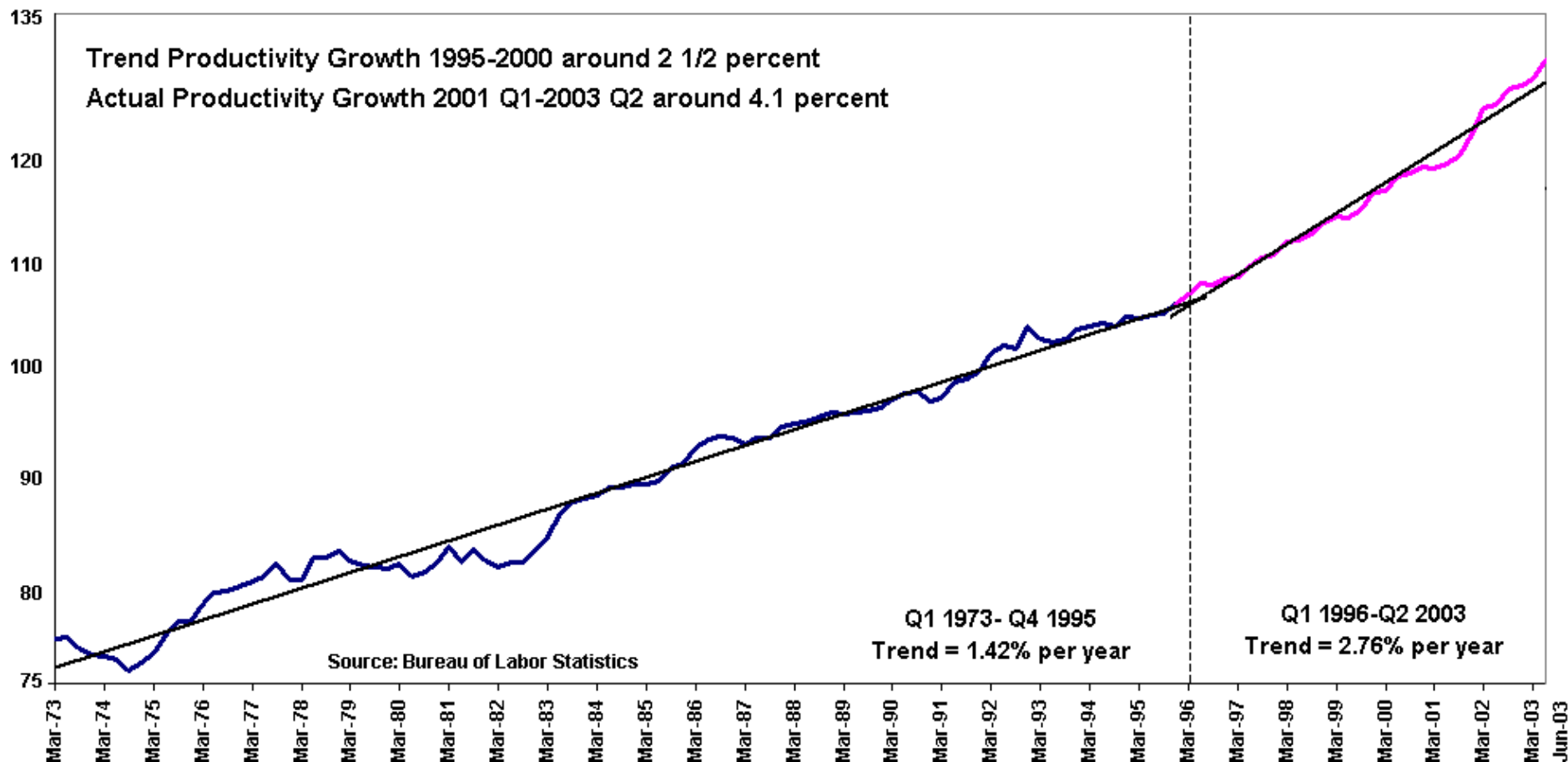
Source: Department Of Commerce, NIPA Table 1.2

Computer hardware investment is growing rapidly in real terms. Dollar spending is still well below 2000 levels.

Productivity Has Been Rapid Since 1995. The Most Recent Data Suggests a Possible Acceleration in the Past Two Years

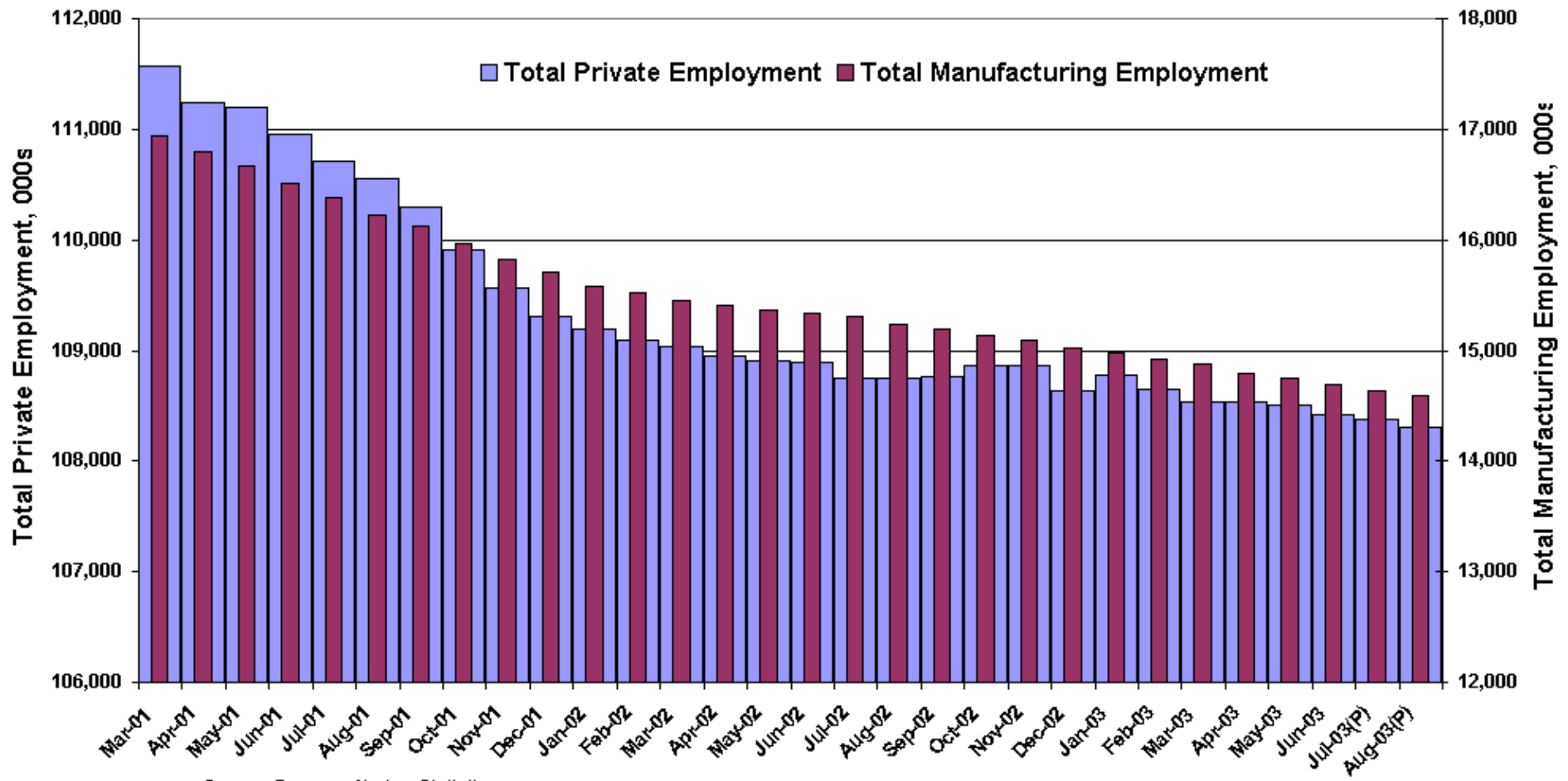
Output Per Hour, Nonfarm Business

Index 1992 = 100



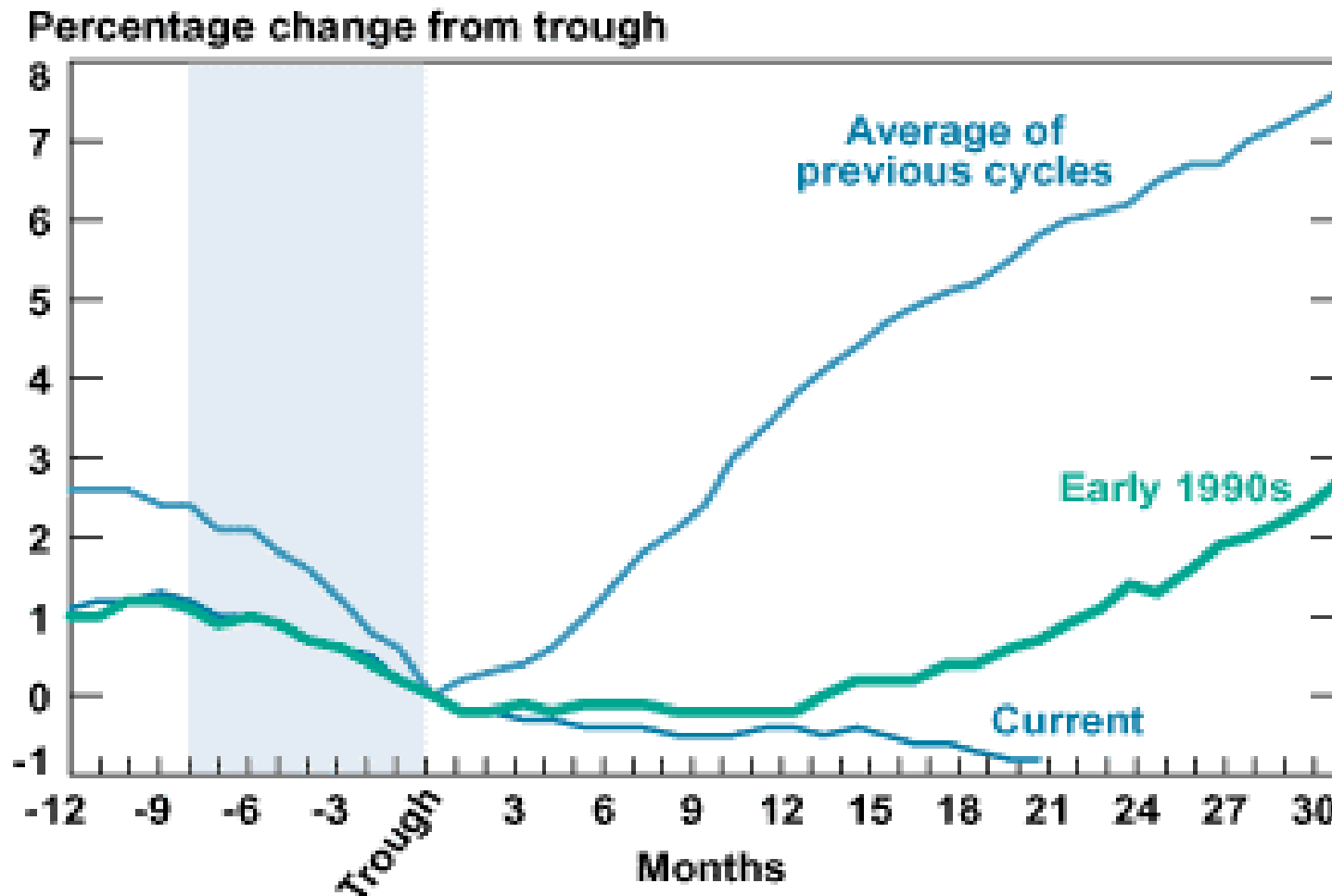
One Result is That - The Labor market Remains Weak

Total Private and Manufacturing Employment



Source: Bureau of Labor Statistics

Payroll Job Growth in This Recovery Is Much Weaker Than in Earlier Recoveries

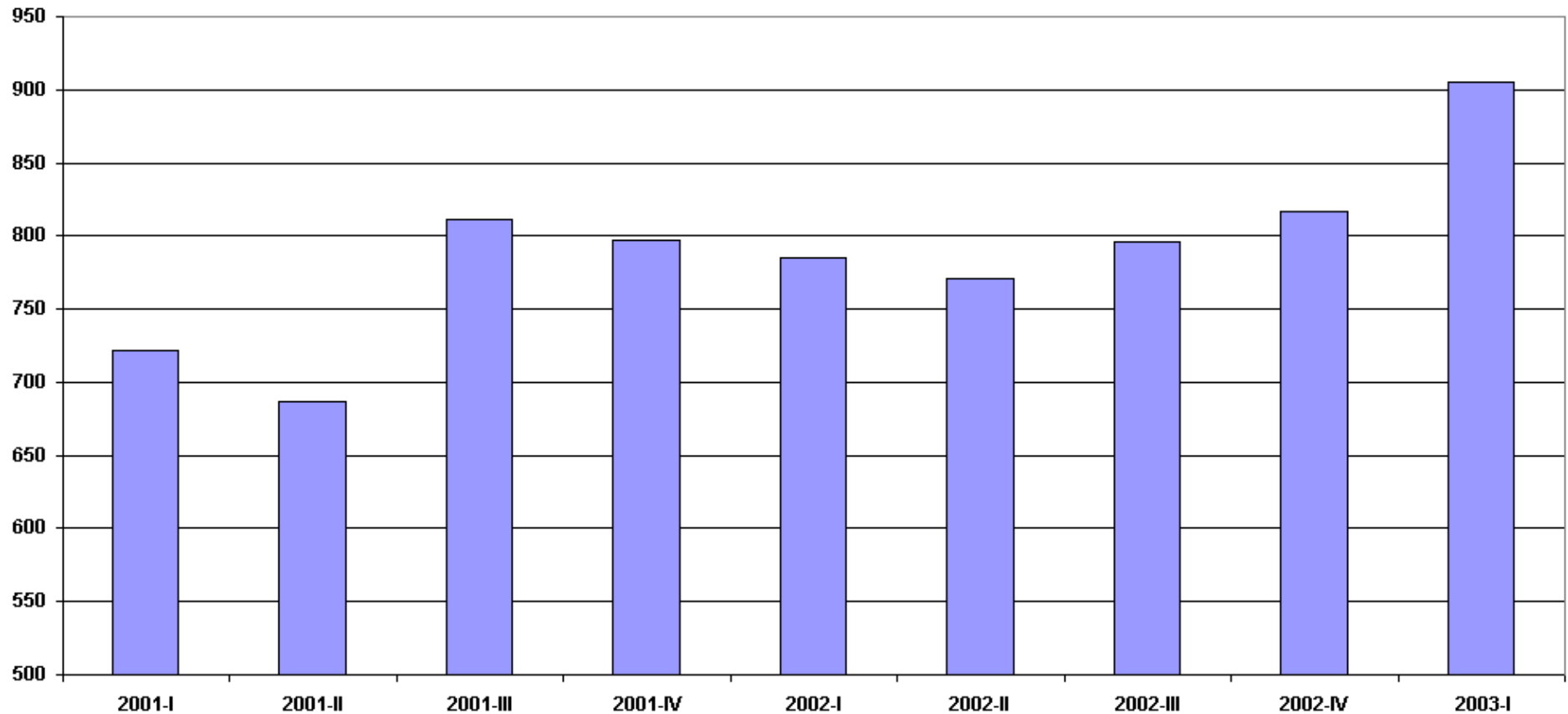


Note: The shaded area indicates the length of the 2001 recession.

Source: Erica L. Groshen, Simon Potter, "Has Structural Change Contributed to a Jobless Recovery?", NY Federal Reserve, August 2003

While Corporate Profits Have Grown

**Corporate Profits with Inventory Valuation and Capital Consumption Adjustments,
US\$bn**



Source: Department of Commerce/BEA, NIPA table 6.16c

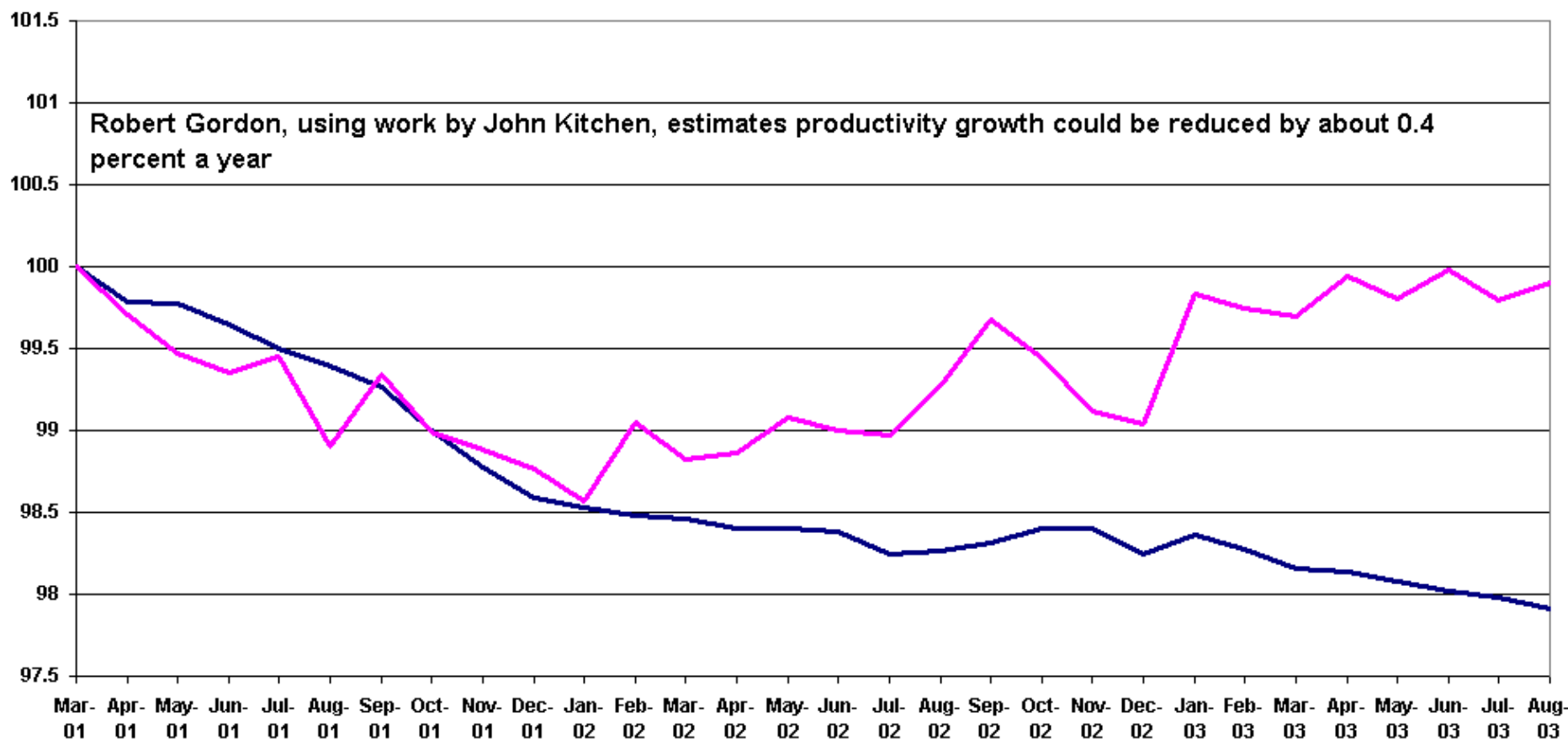
Can We Believe the Productivity Numbers?

- GDP growth may have been misstated
 - Downward revision occurred in 1999, 2000 and 2001
 - New revised benchmark data are due in December. BEA says the revisions could go in either direction
- Employment from Household Survey has grown faster than the payroll employment

Can We Believe the Productivity Numbers?

Employment After the Peak of the Last Cycle, March 2001 = 100

— Payroll Numbers, Total Non-farm Employment — Household Survey, Total Civilian Employment



Source: Bureau of Labor Statistics

How Fast Will Productivity Grow Going Forward?

- There was uncertainty about the post-95 acceleration for two main reasons.
 - It might have been caused just by rapid demand growth (cyclical)
 - it might have been a temporary surge coming from the technology boom
- Both of these uncertainties have been reduced or eliminated. Productivity growth stayed strong through the downturn and the technology slump

How Fast Will Productivity Grow Going Forward?

- Business uncertainty has made companies work hard to cut out costs, quick to lay off, and reluctant to hire. This may have caused a temporary surge in productivity in the past couple of years
- Some productivity benchmarks: Output per hour growth, non-farm business, annual data:
 - 20th Century 2 percent a year
 - 1948-1973 2.8 percent a year
 - 1973-1995 1.4 percent a year
 - 1995-2002 2.8 percent a year

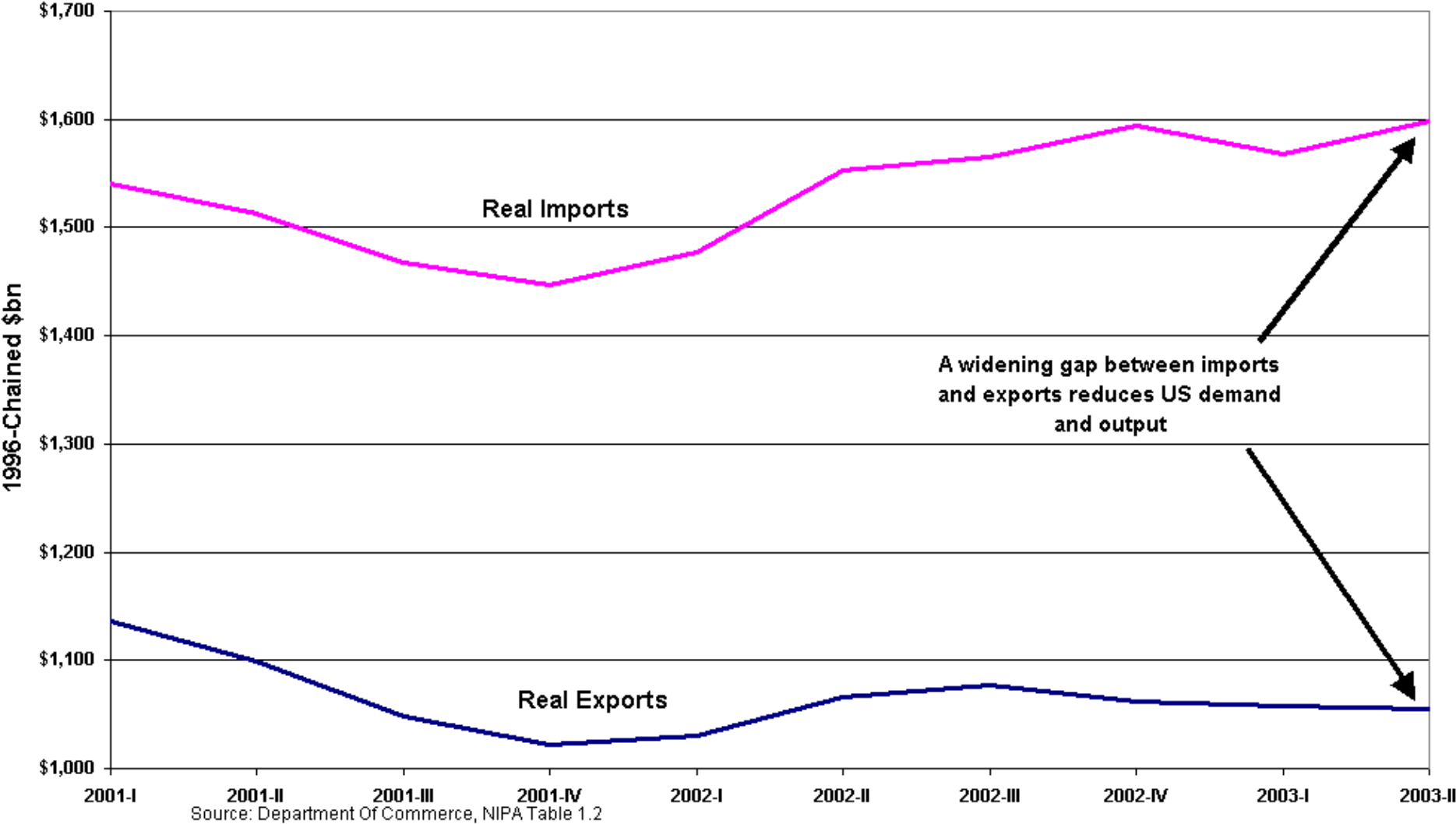
Implications of Faster or Slower Productivity Growth

- If trend productivity growth falls back to 1½ percent, potential GDP growth falls to 2-2½ percent a year. Short-term benefit in increased jobs. Long-term costs in terms of lower real wage and income growth, higher unemployment and a weaker stockmarket.
 - Not impossible, but the chances look low for now
- If the trend stays at around 2½ percent, potential GDP growth is 3-3½ percent a year. Projected GDP growth over the next year should be fast enough to generate jobs. Overall a good economic outcome with rising incomes, wages and profits. Faster growth than the EU and Japan
 - The most likely outcome
- If the trend rises to 2¾ -3 percent, potential GDP growth is closer to 4 percent. Unemployment would likely stay high for the next year. Over the long run the economic and budget prospects would benefit.
 - A possible outcome. But wait until the December revision
- Labor force growth will drop from 1 percent a year to around ½ percent a year over the next ten years. This will reduce potential GDP growth

Three Questions Remain About The Recovery And Its Sustainability

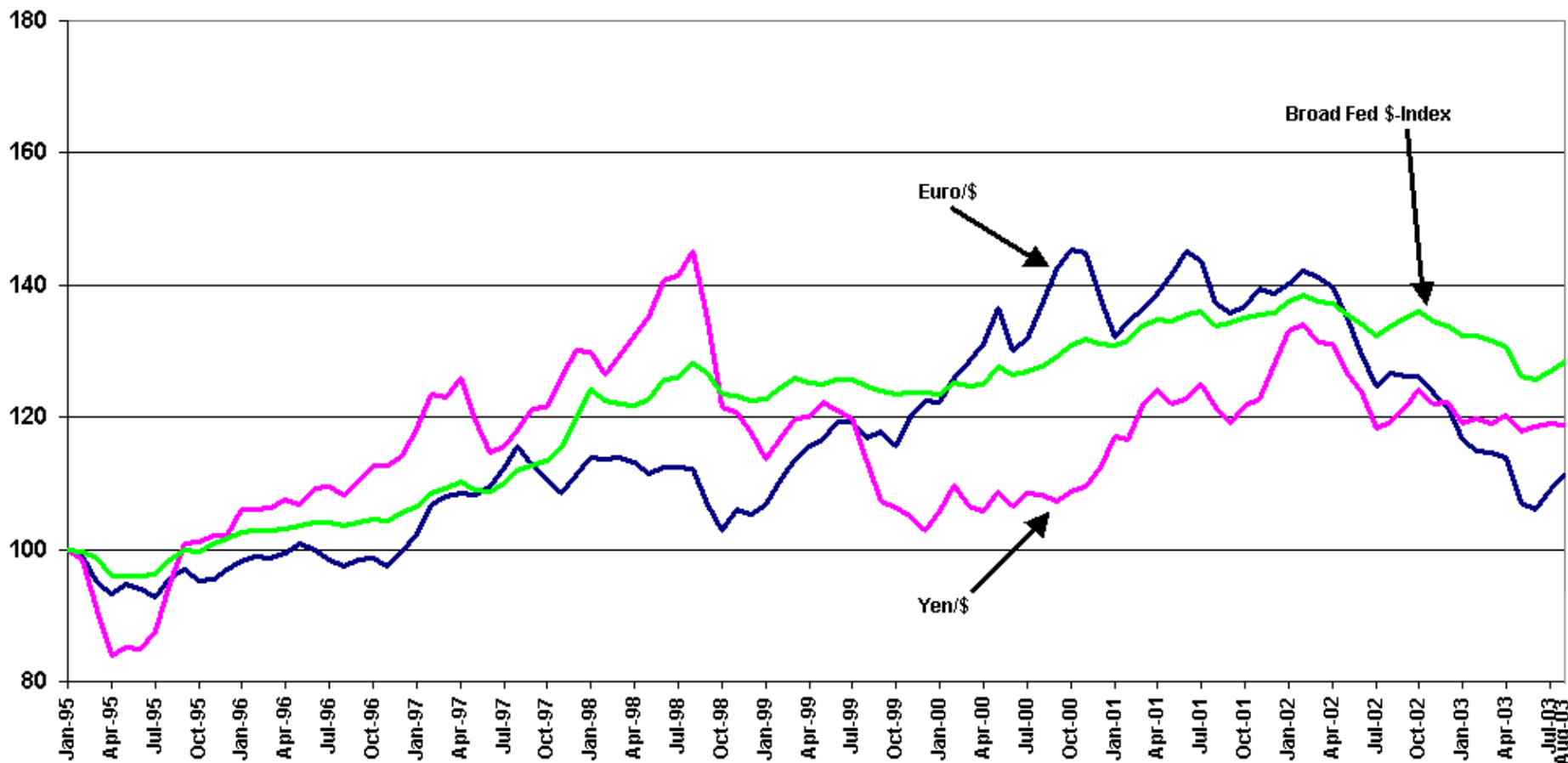
- Weakness in the rest of the world has slowed US growth. With global pick-up, that drag on the US will lessen
- Energy prices are high and sharp reductions are not forecast
- Very large budget deficits are helping the recovery now, but may hurt growth in the future

US Growth is Increasing Faster than the Rest of the World, Keeping Imports Up and Reducing Exports



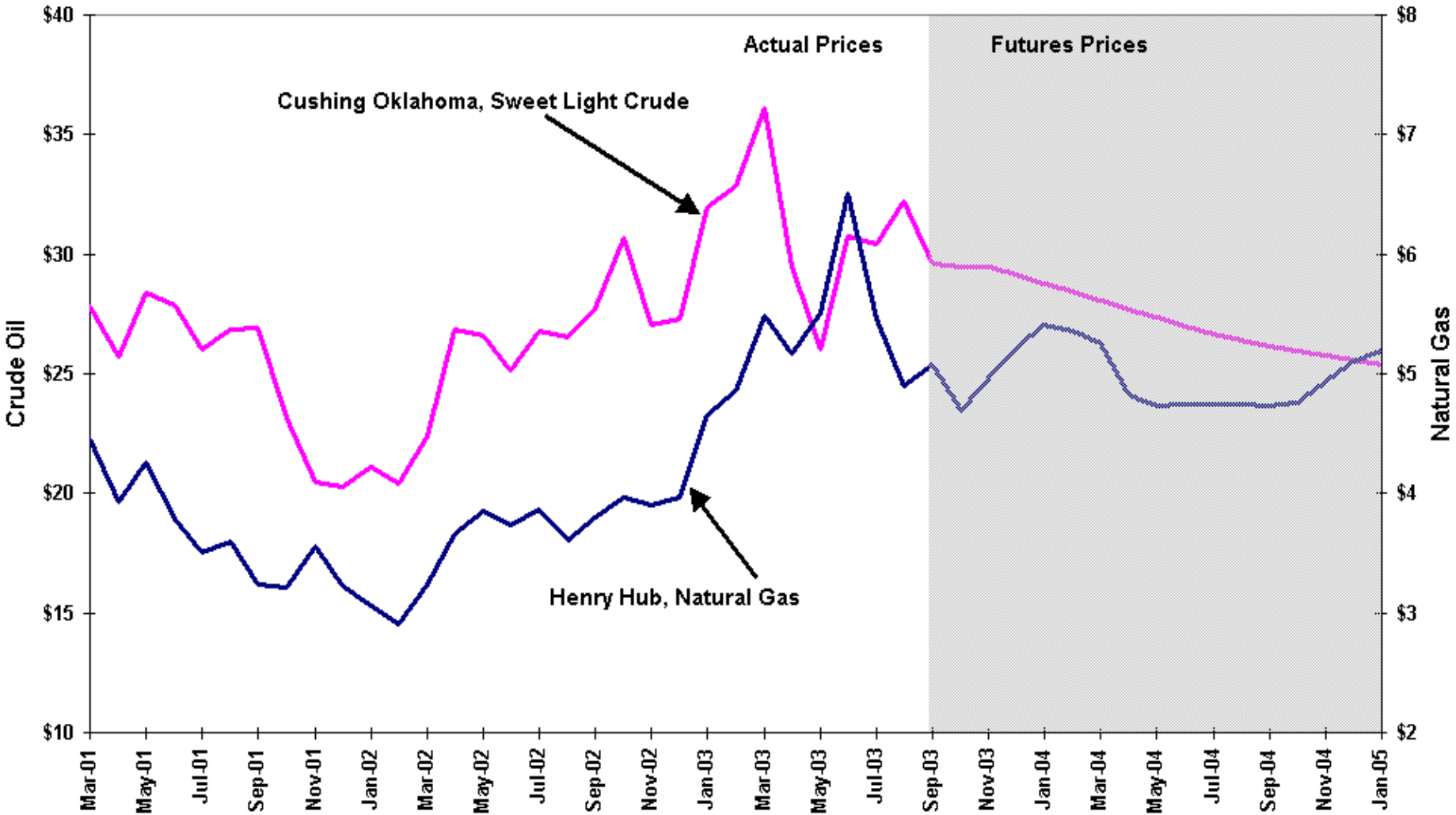
The Dollar Has Fallen Against the Euro, But Less Against the Yen and a Broad Exchange Rate Index

Nominal Exchange Rate Movements January 1995- August 2003
(Jan 1995 = 100, increase in value on chart equals a strengthening US\$)



Sources: Federal Reserve, Pacific Exchange Rate Services

Energy Prices Have Remained High and are Expected to Decline only Slowly



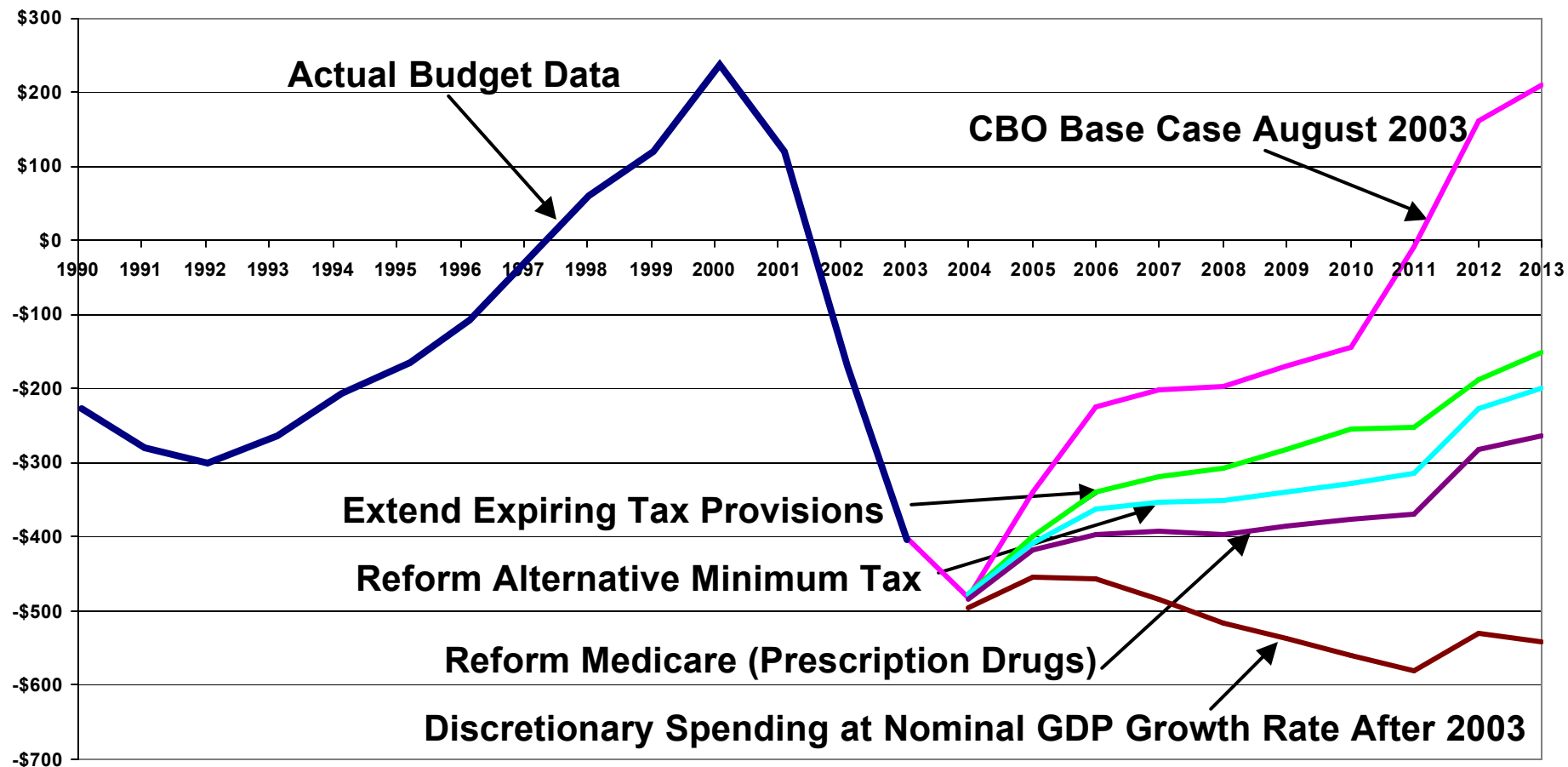
Source: NYMEX, US Department of Energy/Energy Information Administration

Fiscal Policy and the Automatic Stabilizers Have Sustained Growth and Recovery So Far, But There is Trouble Ahead

- CBO predicts deficits until 2011, even under current law
- Extending the tax cuts, adding a prescription drug plan and allowing discretionary spending to rise could push the deficits much higher
- Large budget deficits in a full employment economy will raise interest rates, push up the dollar, worsen the trade deficit and hurt manufacturing jobs
- Baby boomers born after 1945 will start collecting Social Security in 2008 and Medicare in 2011

US Government Budgetary Developments 1990-2013

US Government Budget Balance, Historical and Projected, \$bn



Source: Congressional Budget Office, August 2003

Conclusions:

- With war anxieties lessening, the natural forces of recovery in the US economy are taking hold, with help from monetary and fiscal stimulus. Recoveries tend to be self-reinforcing
- The economy will likely grow at closer to a 4 percent rate in the next eighteen months. This should be enough to generate jobs.
- If Japan and Europe fail to recover, this will trim US growth prospects. Over the period 2001 Q4 through 2003 Q2, net exports have trimmed 0.64 percentage points off US growth
- New terrorism and a spike in energy prices remain as dangers
- Strong growth prospects provide an opportunity for a return to fiscal discipline. This opportunity must be seized