THE US ECONOMIC OUTLOOK:

• Strong investment is needed to sustain strong growth in 2004-05.
• Weak job growth is associated with productivity; trade and health costs are secondary.
• To sustain long-term growth, the tax cuts should be allowed to expire.

Martin Neil Baily

with assistance from Jacob F. Kirkegaard

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- Real GDP growth will be between 4 and 4½ percent in 2004 and 4 percent in 2005 (Q4 to Q4).
- Under this scenario, consumption will be a main driver of growth, increasing between 3½ and 4 percent in both years.
- Inventories will rebuild.
- Trade will likely be a modest drag on US growth for the first half of 2004 but should start to contribute to growth after that, as the lower dollar helps export growth – with the expected time lag.
- Government spending growth will moderate in the second half of 2004 and in 2005.
- There are significant risks around this forecast.

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Short-term Risks:

– Investment is now growing, but sustainability is a question. If investment growth slows, GDP growth will be closer to 3½ percent in 2004.

– High oil prices are a drag on consumer spending.

Longer-term Risks:

– The twin deficits (budget and trade) present a challenge for the US and the rest of the world.

Upside Potential:

– If jobs and investment kick in, and productivity growth continues, there could be growth of over 5 percent.

Geopolitical risks remain high

The Growth Contribution from Housing Is Tapering Off, Equipment and Software Are Growing, but Structures Investment Remains Weak

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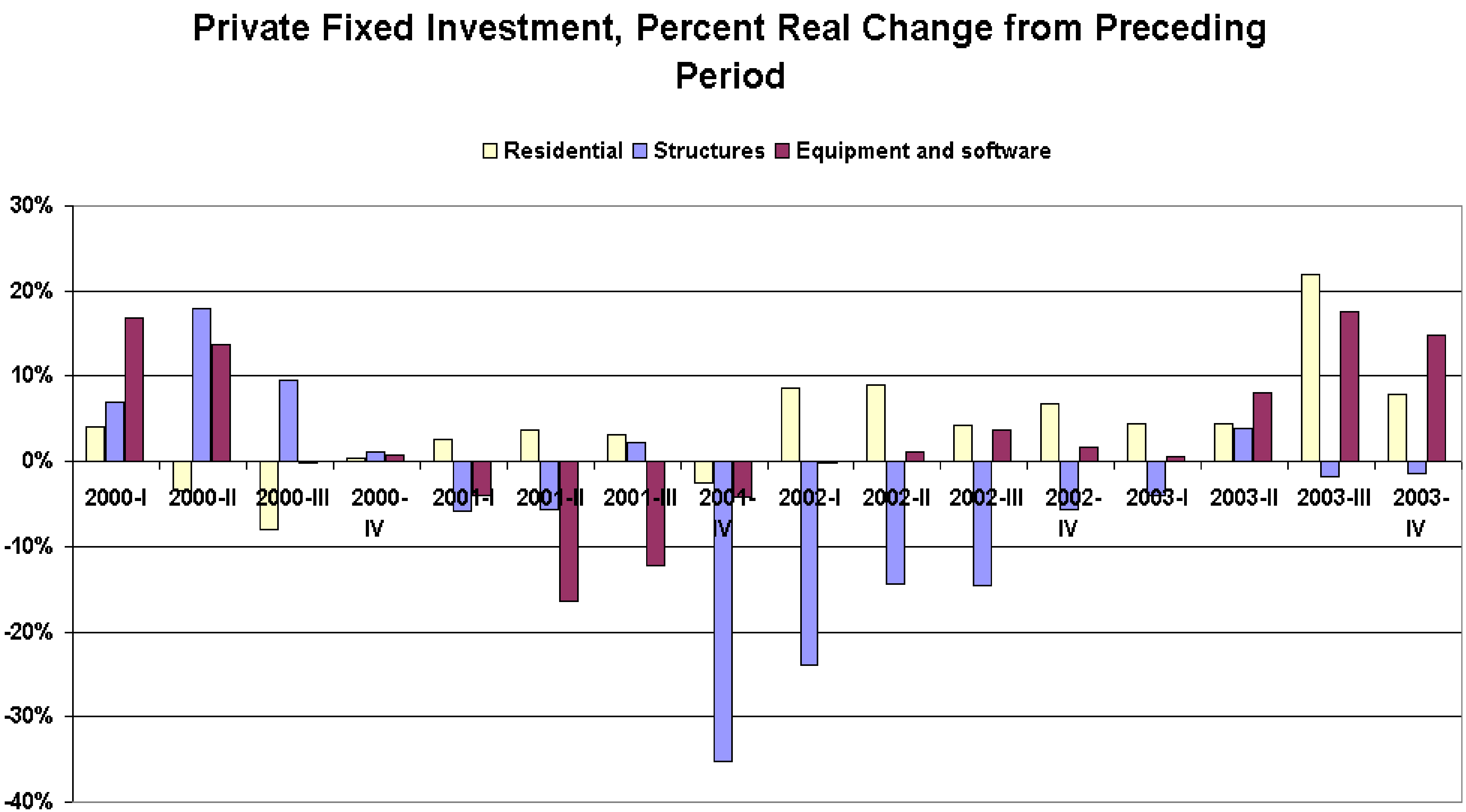

Source: Bureau of Economic Analysis, NIPA Table 5.3.1

In Current Dollar Terms, Nonresidential Investment Is Rising – Very Slowly

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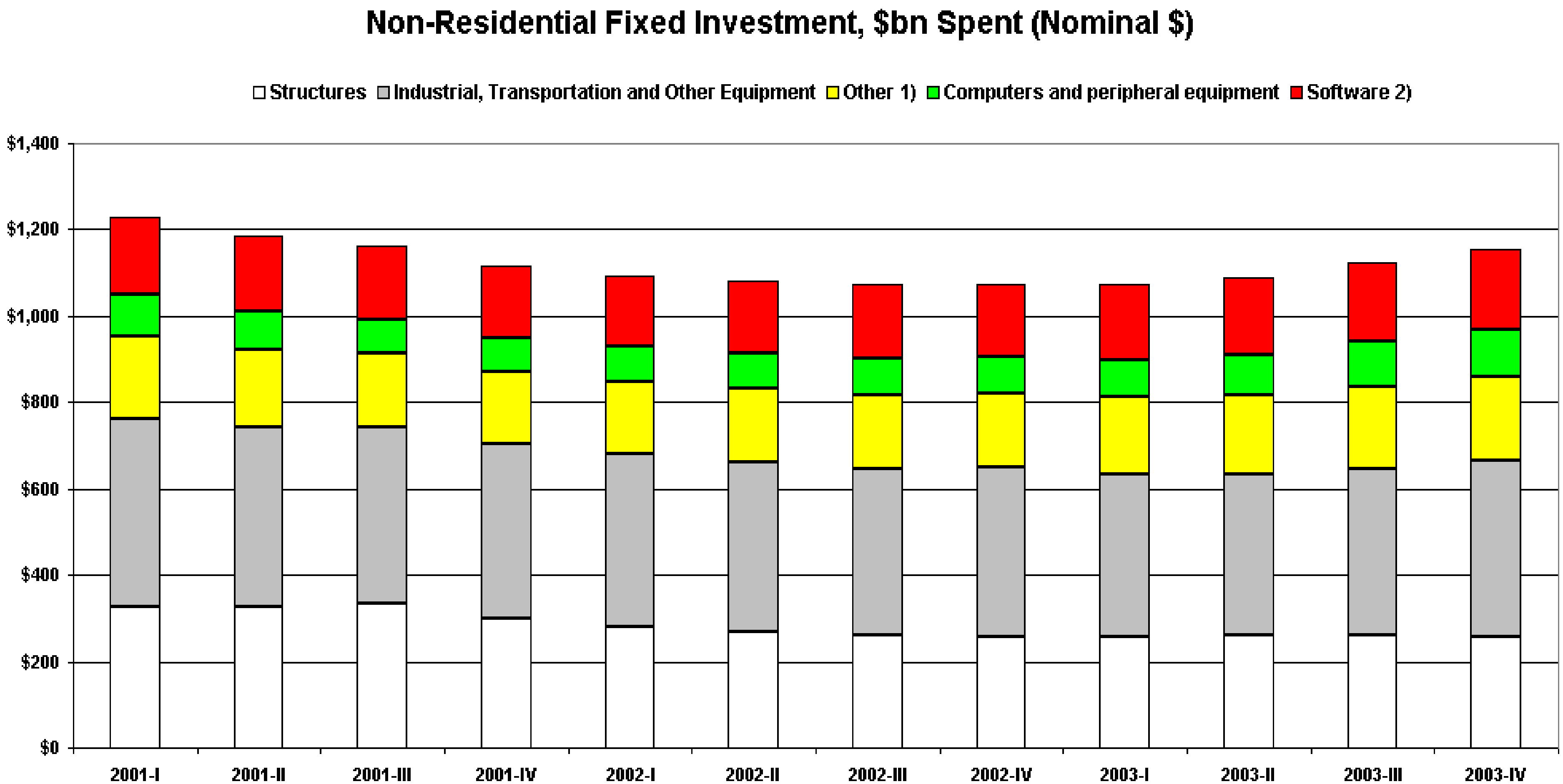

Source: BEA NIPA Table 5.3.5

1) Includes communication equipment, nonmedical instruments, medical equipment and instruments, photocopy and related equipment, and office and accounting equipment

2) Excludes software embedded or "bundled in computers and other equipment."

Payroll Employment Has Been Much Weaker Than in Previous Cycles

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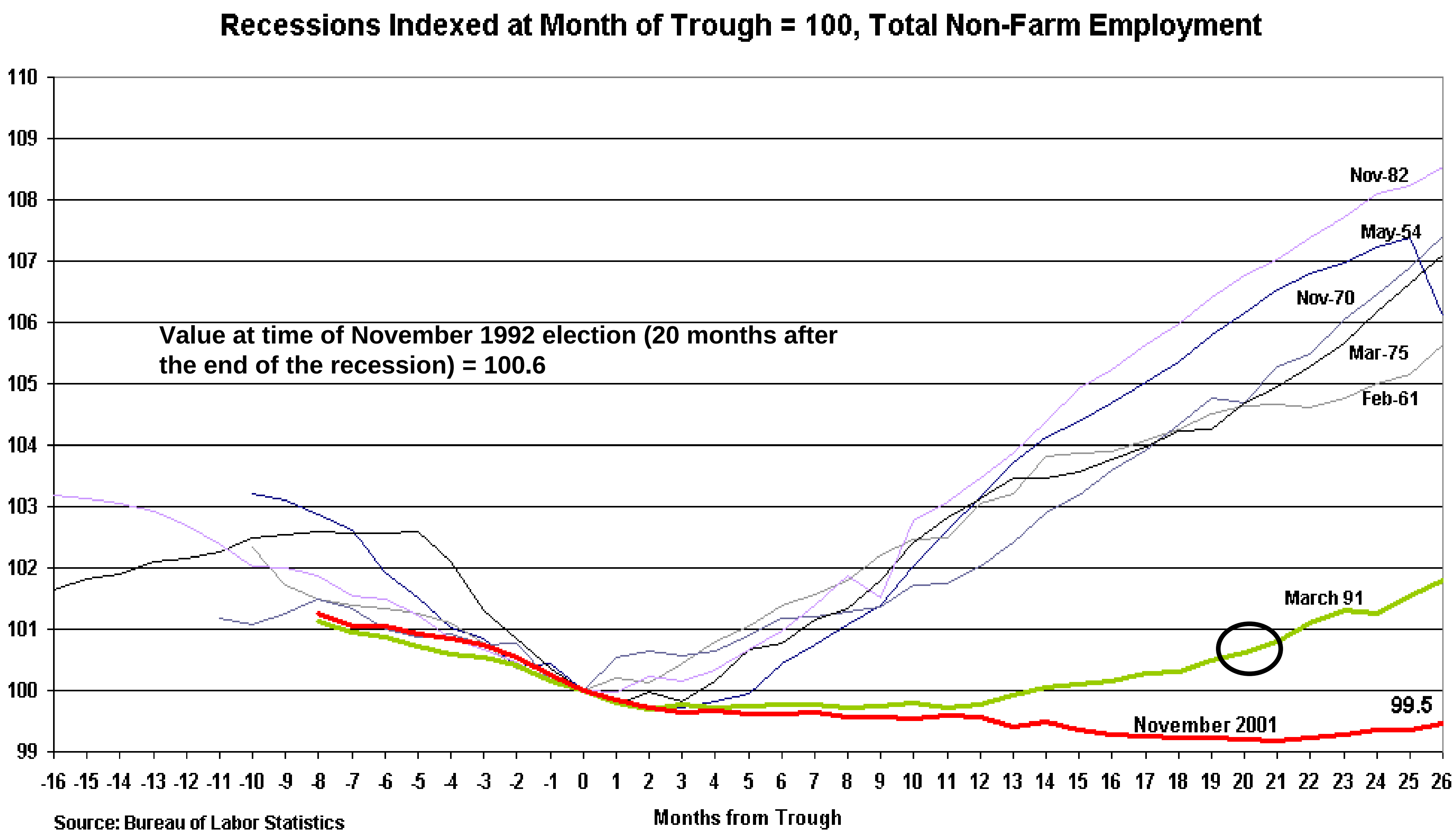

Weak Employment Growth Results from Modest GDP Growth and Blockbuster Productivity Gains

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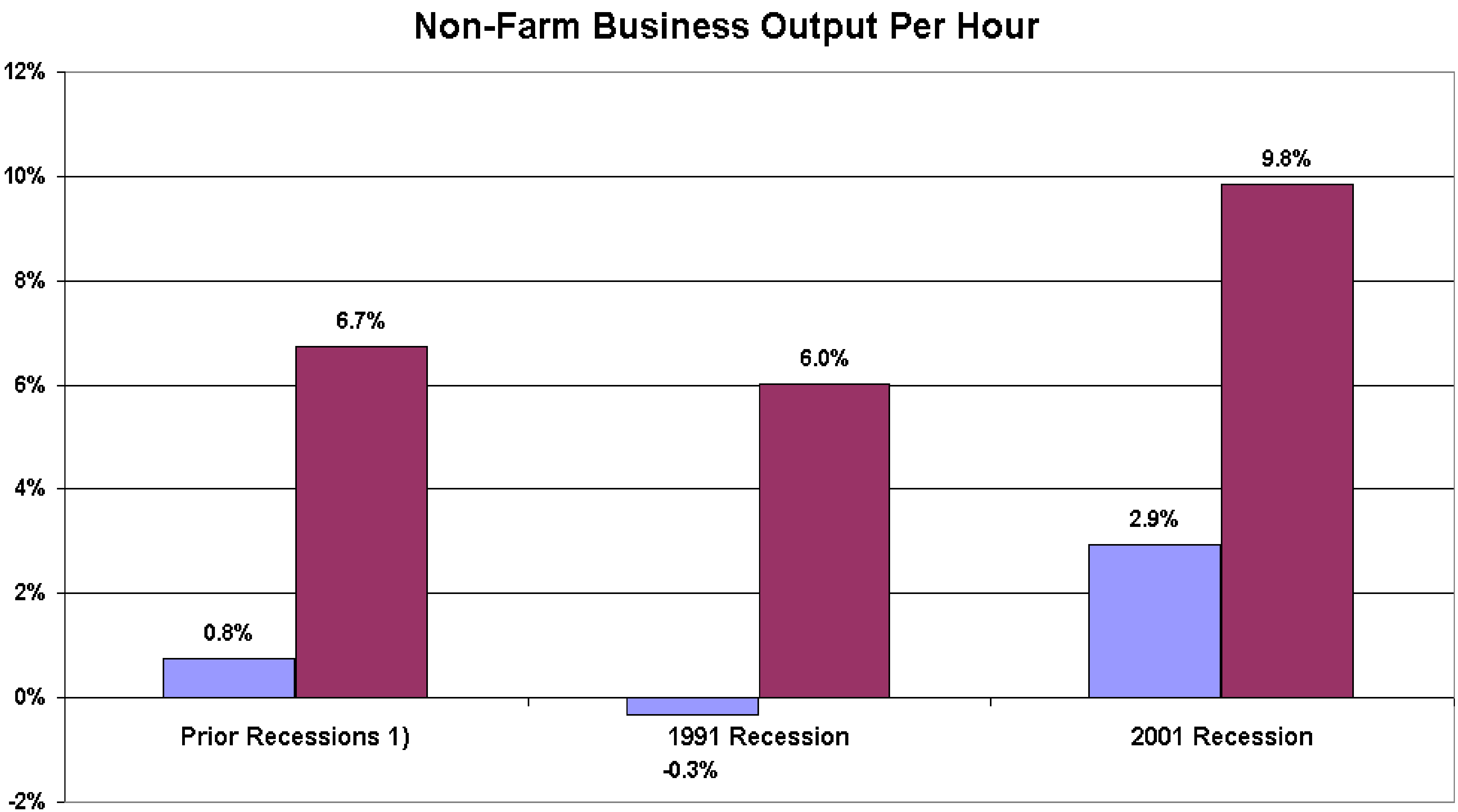

1) Excludes 1980 Recession

Source: BEA, Bureau of Labor Statistics

The Increased Trade Deficit 2000-03 Caused at Most 14 Percent of the Payroll Job Decline

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In the 1990s the trade deficit did not cause net job loss because domestic demand was more than strong enough. With weak demand since 2000, trade has contributed modestly to employment weakness.

- **The <u>increase</u> in the manufactured goods trade <u>deficit</u> implies a decline of 350,000 manufacturing jobs (annual data).**
- **This represents 13 percent of the 2.74 million decline in the manufacturing sector from 2000-03.**
- **The <u>slow</u> increase in the services trade <u>surplus</u> implies a decline of 14,000 service sector jobs (assuming, conservatively, sectoral productivity growth at historical rates).**
- **Total job loss 2000-03 from trade, 364,000.**
- **This represents about 14 percent of the 2.64 million decline in nonfarm employment 2000-03.**
- **As evidenced by US postwar experience, the expansion of international trade does not cause job loss.**

Source: Bureau of Labor Statistics, Author's calculations

Is Weak Job Growth the Result of Rising Health Care Costs?

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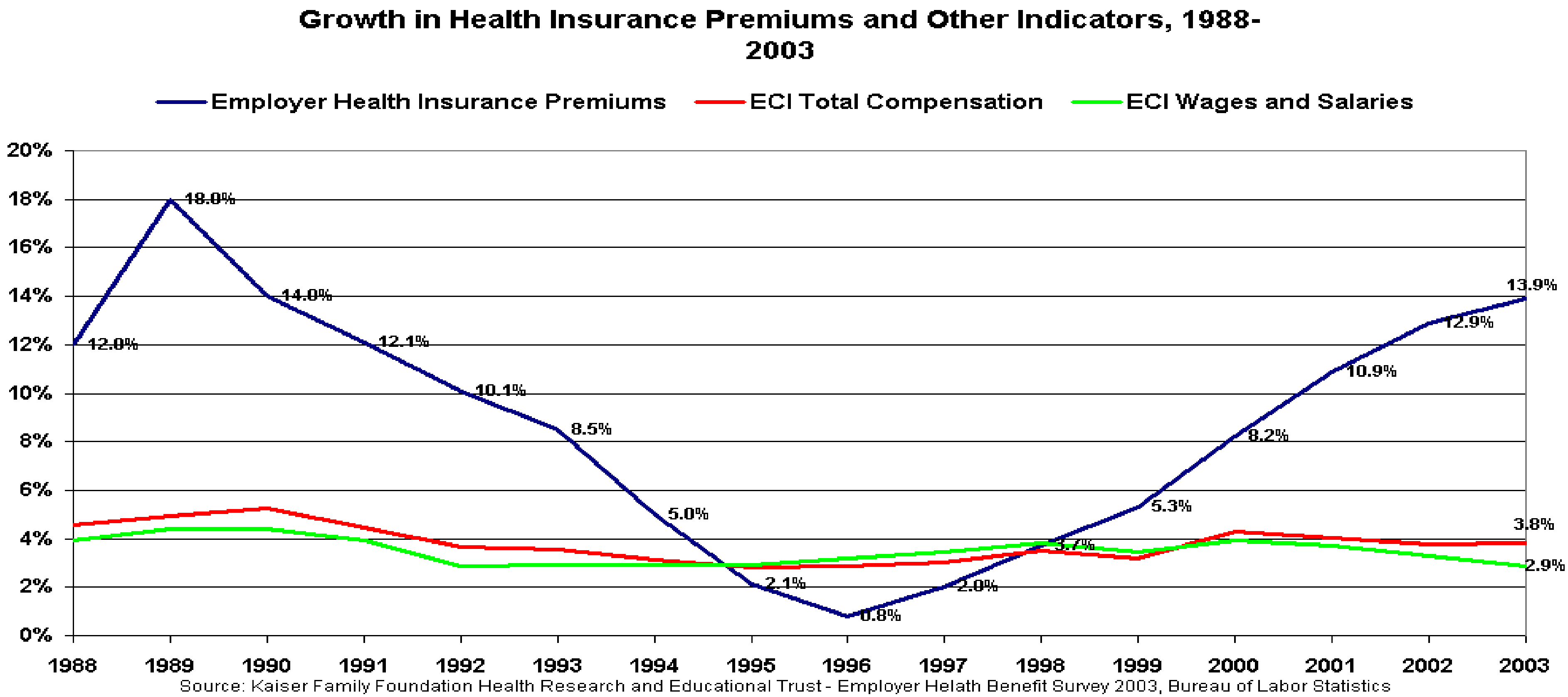
- **These are growing rapidly, but total compensation per hour is not accelerating.**
- **Since benefits are a fixed cost, they encourage companies to increase hours rather than the number of employees as demand picks up.**



Dealing With the Structural Imbalances to Sustain Growth

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- Chronically low private savings together with large federal (and local) deficits mean that the US is not financing its domestic investment.
- So far the consequences have not been that severe, because the rest of the world has been willing to lend to the US on very favorable terms.
- But the deal has not been cost free for the US – a chronic trade deficit, fewer jobs in manufacturing, and protectionist pressures.
- Balancing the federal budget will not guarantee trade balance (e.g., 2000). But rebalancing the world economy will be hard (impossible) unless fiscal discipline is restored in the US.
- The rest of the world must play a part, allowing exchange rates to adjust and stimulating domestic demand.

US Federal Budget Scenarios, 2004-14

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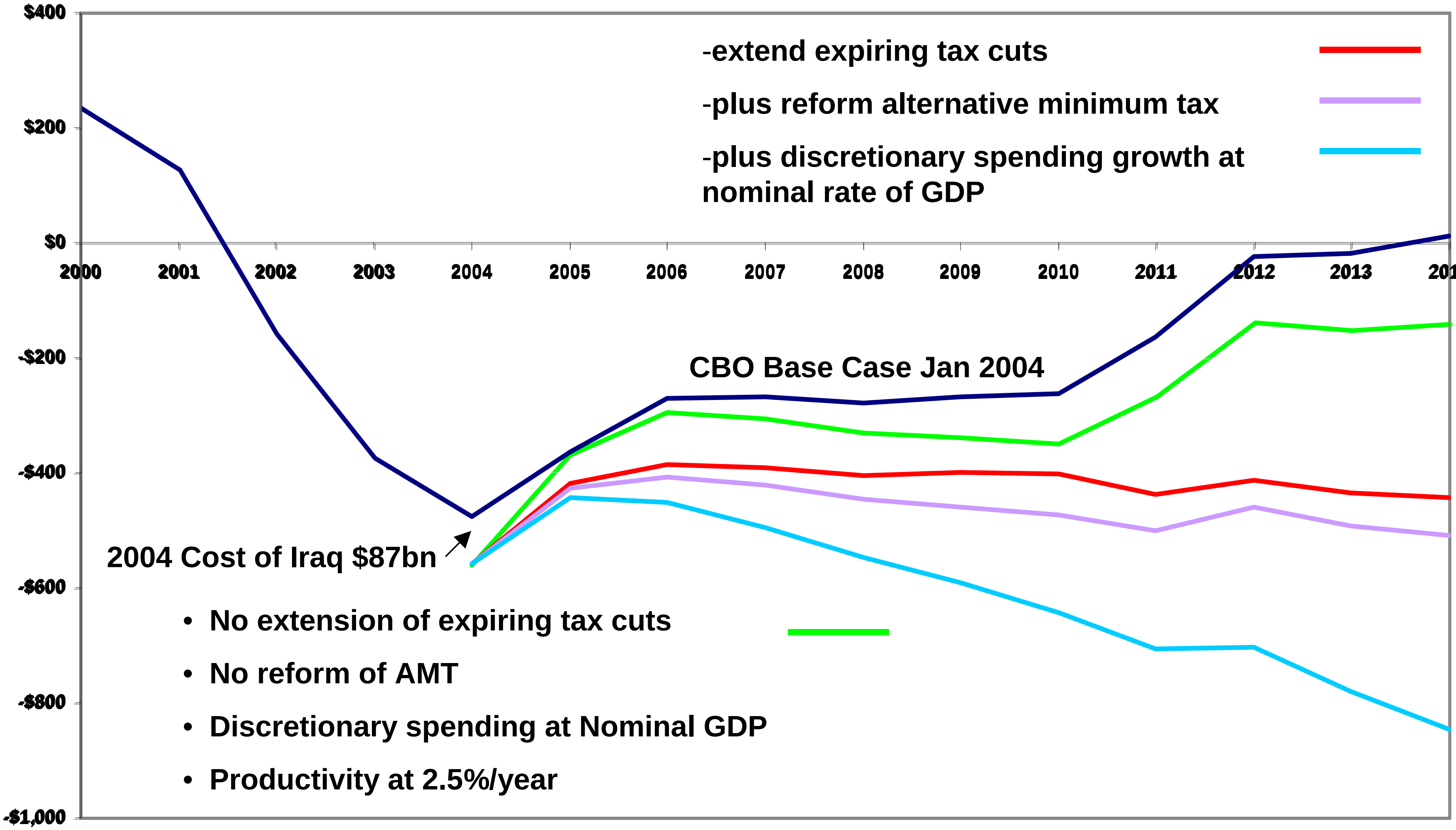

Source: CBO January 2004, author's calculations

It Will Be Very Hard to Keep Spending Growth at the Same Rate as Nominal GDP

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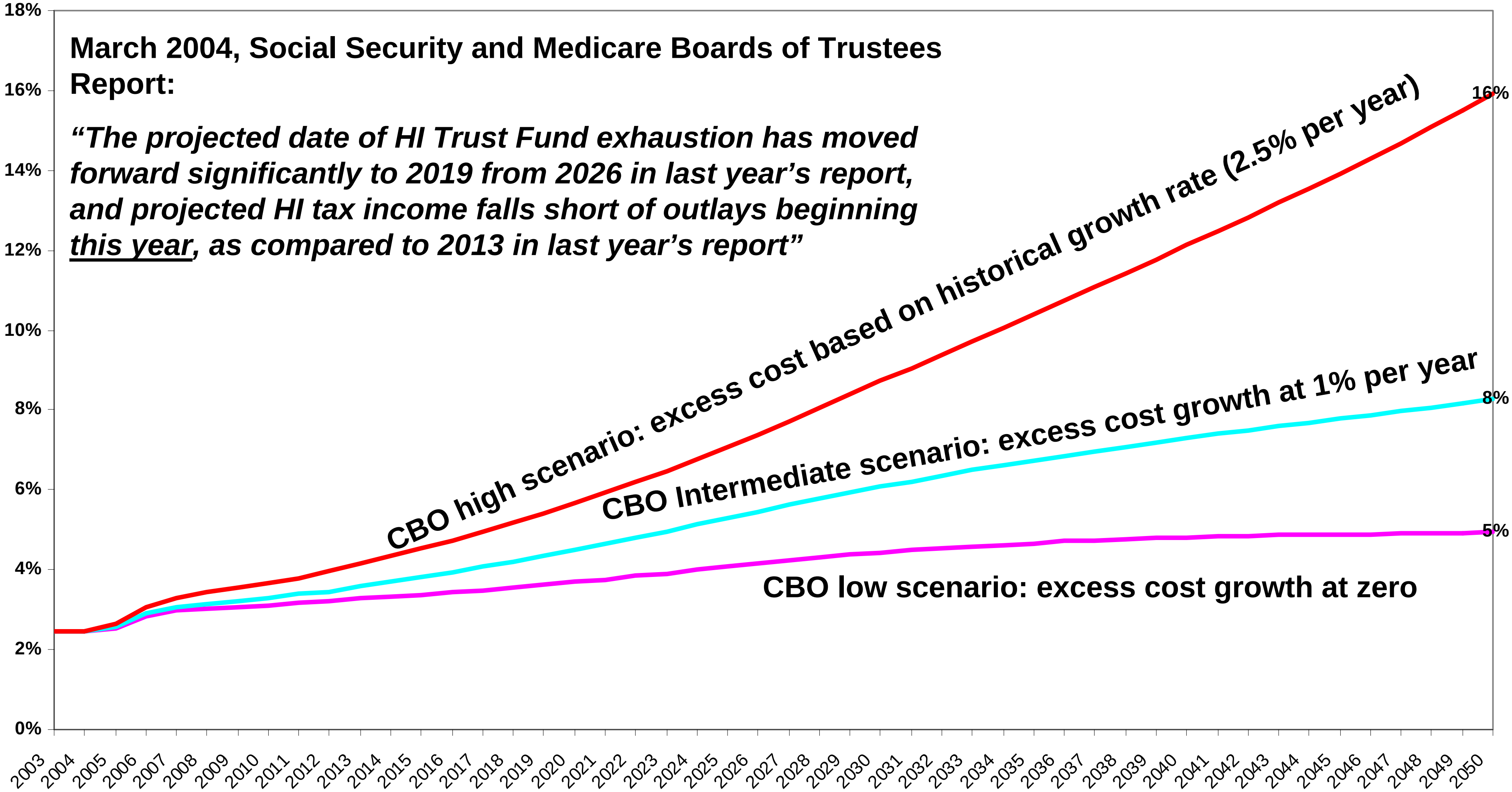

Source: CBO December 2003 Long-Term Budget Outlook

Conclusions

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- As growth in residential housing, auto sales, and government spending cool down, business investment must fill the gap to sustain strong GDP growth.
- Rapid productivity growth, not matched by sufficient demand growth, has resulted in continued hiring weakness. Trade/offshoring and rising health costs have contributed, but are much less important.
- If the tax cuts are allowed to expire, if spending growth is kept to the growth of GDP and productivity growth is at 2½ percent, the deficit is gradually eliminated.
- To deal with Social Security and Medicare, additional tax revenues will almost certainly be needed.