

UNITED NATIONS
ECONOMIC COMMISSION FOR
LATIN AMERICA AND THE CARIBBEAN
ECLAC Washington Office



Distr.
RESTRICTED
LC/WAS/R.37
February 28, 2005
ORIGINAL: ENGLISH



UNITED STATES ECONOMIC OUTLOOK

Quarterly Developments

U.S. ECONOMIC OUTLOOK

The U.S. economy performed well in 2004, growing at the highest rate of the past five years. The U.S. real gross domestic product (GDP) grew at an inflation adjusted rate of 4.4% in 2004, the highest rate since 1999, compared with 3.0% in 2003. With favorable financial conditions, combined with stimulative fiscal and accommodative monetary policies, consumer spending was buoyant and businesses increased investment in capital equipment and inventories, despite sizeable increases in oil prices. Although consumer price inflation moved higher with the increase in energy prices, core consumer price inflation (excluding food and energy) remained well-contained. The recovery of the labor market was slow and uneven, but was almost complete by the end of the year. The troubling aspect of the economy's performance was the eroding trade and current account balances.

Concern over the wide U.S. budget and trade deficits has been the driving force behind three years of dollar declines. Over the past three years, the dollar has fallen 16% against a basket of its trading partners' currencies. The weaker dollar was expected to help trim the current account deficit, but the fall of the dollar alone has not been enough to reduce the trade gap. A cut in the budget deficit and higher interest rates are widely perceived as necessary to curb consumer spending, which has been contributing to higher imports.

The Federal Reserve increased interest rates six times in the last six meetings. However, although short-term interest rates have been raised six times, the cost of home mortgages and long-term corporate financing has actually declined, thus monetary policy remains accommodative. Federal Reserve Chairman Alan Greenspan, in his semiannual testimony before the Senate Banking Committee on February 16, 2005, spoke about the unusual decline of long-term bond yields since the Fed began raising short-term rates, which, in his own words, is a development that "contrasts with most experience". He played down technical explanations, such as growing purchases of Treasury bonds by Asian central banks, or mortgage hedging, noting that long-term rates had also declined in Europe and other parts of the world; he also played down the notion that market participants have reduced their expectations of economic growth going forward, perhaps because of the rise in oil prices, saying that this interpretation does not fit with the rise in stock prices and the narrowing of credit spreads observed over the same interval. He acknowledged his own puzzlement and concluded that the drop is "a conundrum", which may prove to be a "short-term aberration".

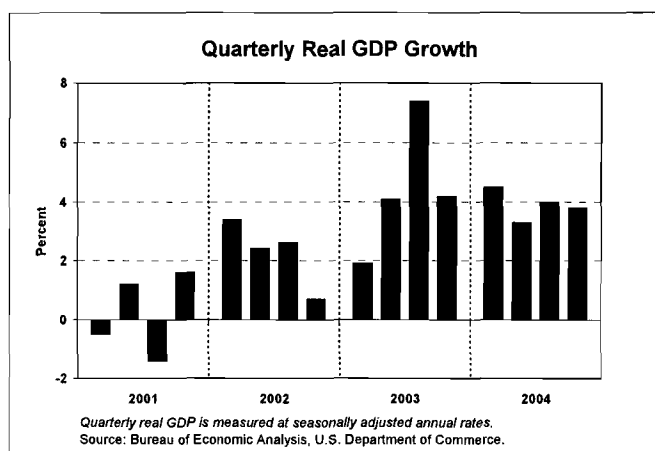
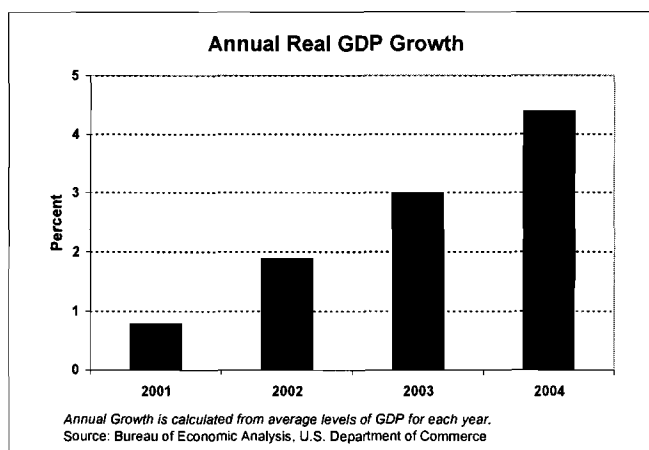
In response to increasing concerns with respect to the growing U.S. debt and budget deficit, the Administration proposed broad spending cuts in the fiscal 2006 budget, which according to budget officials were the most significant proposed cuts in domestic spending since the Reagan administration. However, the proposed budget seems to do little to increase the government's revenue, as it aims to turn the temporary administration tax cuts into permanent. In addition, the proposal did not account for the costs of the Iraq war or the costs associated with the administration's proposed Social Security reform. Nevertheless, the message that fiscal restraint is on the way is seen as a positive step in Washington.

The main source of risk to the U.S. economy continues to be increasing consumer spending with a low (and falling) savings rate, leading to higher imports and to an increase in the U.S. current account deficit. A growing portion of the current account deficit has been financed by private fixed income inflows, short-term borrowing from foreigners. Timothy Geithner, current head of the New York Fed, highlighted the risks: "We are significantly more dependent today on the confidence of the rest of the world in U.S. economic policy."

I. CURRENT ASSESSMENT

- **GDP growth**

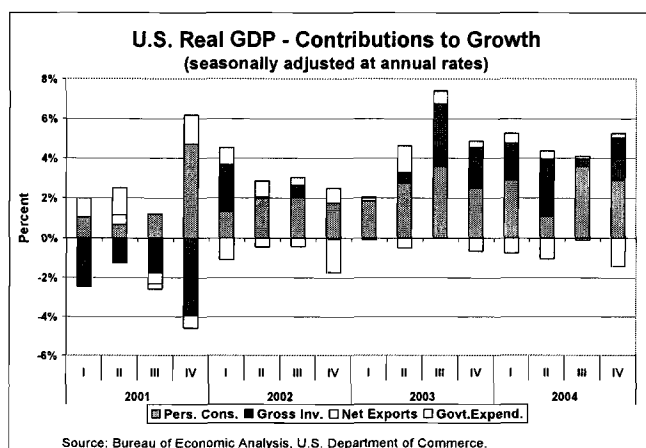
According to the latest estimates released by the U.S. Department of Commerce on February 25, the U.S. economy grew at an annual rate of 3.8% in the fourth quarter of 2004, slightly down from the previous quarter's rate of 4.0%. This small reduction in real GDP growth reflected an increase in the trade deficit, and a deceleration in consumer spending. The fourth quarter growth rate was stronger than previously estimated and showed that the U.S. economy moved at a healthy pace in 2004 and headed into 2005 with impetus.



The slightly slower growth rate in the fourth quarter was due mainly to declining exports and climbing imports. Real exports of goods and services increased 2.4% in the fourth quarter, in contrast to an increase of 6.0% in the third quarter. Real imports of goods and services increased 11.4%, compared to 4.6% in the previous quarter. In the government's calculations, the declining exports and rising imports trimmed 1.43% off growth in the fourth quarter.

Consumer spending slowed, increasing 4.2% after rising 5.1% in the third quarter. Purchases of durable goods, motor vehicles in particular, decelerated. In contrast, inventory investment, which pulled down growth in the third quarter, boosted GDP growth in the fourth quarter. Businesses expanded their stocks by US\$51 billion, compared to only US\$34.5 billion in the third quarter. Overall business spending rose 14%, with spending on equipment and software up by 18%. Personal expenditure contributed 2.89% to growth in the fourth quarter, and gross private domestic investment 2.13%.

Low interest rates and higher household wealth (given the rising house and equity prices) were important factors



propelling consumer spending in 2004. According to the Federal Reserve's flow of fund accounts, the ratio of household net worth to disposable income rose sharply in 2003 and continued to rise in 2004, and given that the effects of increasing wealth on household spending take a period of several quarters to be felt, the wealth increase in both 2003 and 2004 were important in supporting consumer spending in 2004.

Consumers' attitudes about the economy seemed to be upbeat at the end of the year. The Conference Board, a private research group, said its consumer-confidence index, a measure of consumers' assessment of current economic activity, jumped 9.7 points to 102.3 in December, reflecting falling oil prices and improved job prospects. It rose again in January to 103.4, despite lingering concerns about whether the economy would lose steam in the months ahead. The index is at its highest level since May 2002. Consumers are slightly cautious about the next six months, however. The January expectation index, an assessment of the state of the economy in the next six months, dropped to 98.4 from 100.7, as consumers believe the outlook for jobs, business activity and income growth has deteriorated.

- **Sectoral Developments**

Industrial production expanded at an annual rate of 4.1% in the fourth quarter of 2004, following a 2.7% increase in the third quarter. On a year-over-year basis, total industrial production increased 4.4%, the strongest December to December gain since 1999, with manufacturing up by 5%.

The December gain was broad-based in manufacturing, with production increasing by 0.7% in December. The growth was led by the durable goods, whose production expanded by 0.9%. Consumer goods production also strengthened in December, gaining 0.7%. Recovery in durable manufacturing has been greater than in the nondurable sector. Durable goods have been led by machinery, computers and aerospace sectors. The Commerce Department reported that orders for durable goods increased 10.9% last year, to US\$2.3 trillion. That was the largest gain since 1994.

Utilities production also rose sharply in December (by 2.7%), following two months of decline. For the year, output is up by 2.2%. Mining production is the one major sector that weakened in December, decelerating to 0.4%, from 2.2%. For the year, output is down 0.4%.

Industrial Outlook			
2003/2004	Total Industrial Production		Capacity Utilization Rate (%)
	Index 1997=100	Percentage Change From Previous Period	Total Industry
2003 Q1	110.8	-0.7	74.7
January	110.9	0.2	75.4
February	111.0	0.1	75.5
March	110.6	-0.4	75.2
2003 Q2	109.7	-4.0	75.5
April	109.5	-0.9	74.6
May	109.6	0.1	74.7
June	109.9	0.3	74.9
2003 Q3	110.8	4.1	76.5
July	110.6	0.6	75.4
August	110.5	-0.1	75.3
September	111.3	0.7	75.8
2003 Q4	112.4	5.7	75.5
October	111.6	0.2	76.0
November	112.7	1.0	76.7
December	112.9	0.2	76.8
2003	110.9	0.0	75.5
2004 Q1	113.9	5.6	77.3
January	113.2	0.3	76.9
February	114.4	1.1	77.7
March	114.1	-0.3	77.4
2004 Q2	115.1	4.3	77.9
April	114.7	0.5	77.7
May	115.5	0.7	78.2
June	115.1	-0.4	77.8
2004 Q3	115.9	2.7	78.2
July	115.9	0.7	78.3
August	116	0.1	78.3
September	115.7	-0.3	78.0
2004 Q4	117.1	4.1	78.8
October	116.6	0.8	78.5
November	116.8	0.2	78.6
December	117.8	0.8	79.2
2004	115.5	4.1	78.0

Source: Federal Reserve.

Total industrial capacity expanded only 1.2% in 2004. The rate of capacity utilization in December was 79.2%, 2.4% above the year-earlier level, but still 1.9% below its 1972-2003 average. However, capacity utilization is quickly approaching 80%, a level that may increase inflationary pressures.

- **Labor markets**

By the end of 2004 the recovery of the labor market was almost complete, with employment level on its way to reach pre-recession levels. Sixteen consecutive months of job gains added over 2.2 million new payroll jobs in 2004, the largest annual gain since 1999 and a number that nearly compensates for the 2.4 million jobs lost from 2001 and 2003. Manufacturing employment rebounded in December and added 76,000 payroll jobs in 2004, the first year of net job gains in manufacturing since 1997. The unemployment rate dropped to 5.2% in January 2005, from 5.4% in December, reaching its lowest level since September 2001.

There were large swings in job creation and employment levels in 2004. With an average of 185,920 jobs a month, job gains swung from around 80,000 to almost 350,000 in different moments of the year. In the last quarter, after gaining 282,000 jobs in October, job creation fell below 200,000 again in November and December. The disappointing results in November and December were due to weak gains in the construction industry, and losses in retail trade. While the pace of job



Source: Bureau of Labor Statistics.

creation in 2004 was sufficient to absorb new entrants into the labor market, it was insufficient to bring back many previously displaced workers. The unemployment rate fell by 30 basis points over the past 12 months, but remained unchanged during the last six months.

Productivity gains for U.S. workers in the nonfarm business sector slowed down in the fourth quarter. The Labor Department reported that productivity for the final three months of the year was up at a seasonally adjusted annual rate of just 0.8%, which was the slowest quarterly increase in almost three years. For the year, however, productivity of workers in the nonfarm business sector increased 4.1%, after increases of 4.4% in both 2002 and 2003. The 4.3% average productivity gain for those three years was the best performance since the 1949-1951 period.

Productivity and costs: Preliminary fourth-quarter 2004 measures
(Seasonally adjusted annual rates)

Sector	Productivity	Output	Hourly		Unit labor costs
			Hours	Real hourly compensation	
Percent change from preceding quarter					
Business	2.5	3.3	0.8	4.2	0.8
Nonfarm business	0.8	2.8	1.9	3.1	-0.3
Manufacturing	5.6	4.5	-1.0	6.0	2.5
Durable	7.3	6.6	-0.6	6.1	2.6
Nondurable	3.7	2.0	-1.7	5.7	2.2

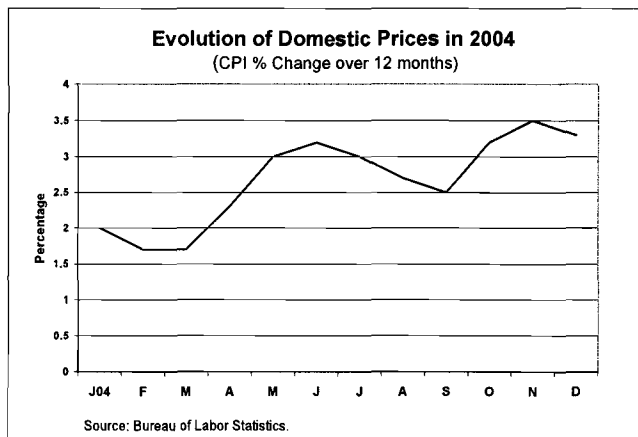
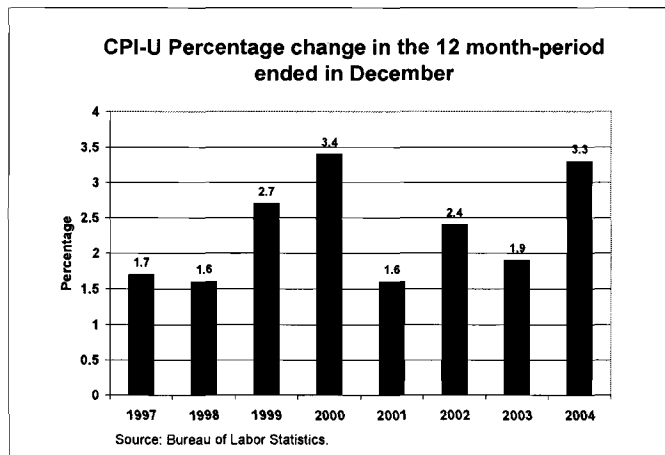
Source: Bureau of Labor Statistics.

As a consequence of the slowdown in productivity, unit labor costs rose for three consecutive quarters in 2004. In the fourth quarter they rose to 2.3%, the fastest pace in 2 ½ years, compared with a 1.6% increase in the third quarter. Productivity growth has served as a cushion against inflation by driving down labor costs. Two-thirds of the final cost of goods and services come from rising labor costs. If productivity growth continues to slow down, wage pressures may start to put upward pressure on inflation.

Wages and salary trends in the currently most dynamic sectors of the economy (construction, financial services and transportation) remain very well contained, however. In addition, although total productivity has slowed down, manufacturing productivity growth accelerated to a 5.6% annual rate in the fourth quarter from 4.2%, taking the year-on-year trend to 4.8% from 4.3%.

• **Inflation**

The Consumer Price Index for All Urban Consumers (CPI-U) rose at a seasonally adjusted annual rate of 3% in the fourth quarter of 2004, following increases in the first three quarters at annual rates of 5.1, 4.8, and 0.6%, respectively. For the twelve-month period ended in December the CPI rose 3.3%. This compares with an increase of 1.9% in all of 2003, and was the highest rate since the 3.4% rate in 2000. The energy index rose 16.6% in 2004, its largest annual increase since an 18.1% rise in 1990, and accounted for about 36% of the overall advance in consumer prices, according to the Bureau of Labor Statistics. On a monthly basis, the CPI oscillated up and down in 2004, as energy prices fluctuated. It decreased 0.1% in December, as energy prices dropped 1.8%.



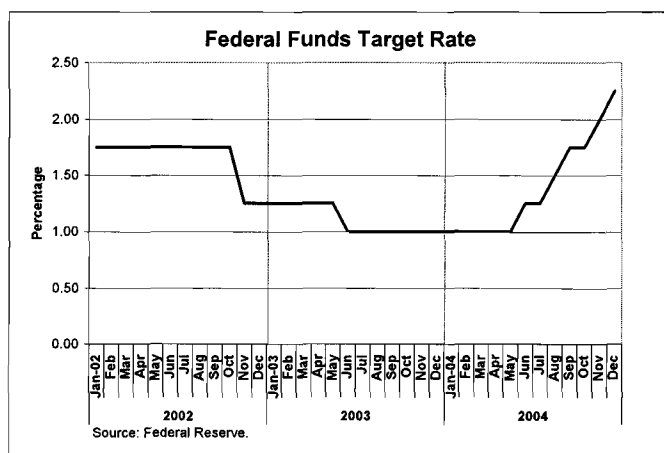
Excluding food and energy the CPI-U advanced at a 2% seasonally adjusted annual rate in the fourth quarter of 2004, following increases of 2.9, 2.3, and 1.8% in the first three quarters. For the twelve-month period ended in 2004, it advanced 2.2%, compared with a rise of 1.1% in 2003. This is considered a comfortable level from the Federal Reserve's point of view, given that the 2003 level was considered uncomfortably low for several Fed officials, who worried about the possibility of deflation that year. Core inflation is expected to remain stable in 2005, although pressure is building up, with

capacity utilization quickly approaching 80%, and productivity slowing down. With respect to oil prices, the U.S. and global economies are expected to expand more slowly in 2005, which will, in turn, mean a slower growth in the demand for oil. If prices are not disturbed by unforeseen events, most analysts believe that oil prices should settle in the low US\$40 per barrel in 2005. Lower oil prices should cool inflation considerably.

However, crude oil prices rose 5.8% to their highest level in nearly four months on February 22, jumping above US\$51 a barrel, on concerns that OPEC might curb supplies in its next meeting in March. The jump in crude oil prices follows a higher-than-expected gain in the core index of the producer-price report the week before. Cold weather in North America and Europe contributed to the increase by pushing up heating oil prices. In addition, Saudi Arabia, the world’s largest oil producer, signaled a shift in oil markets toward higher prices, as the Saudi oil minister Ali Naimi, on February 24, predicted prices would be between US\$40 and US\$50 a barrel for the rest of 2005.

- **Monetary policy**

The U.S. Federal Reserve raised the federal funds target rates five times in 2004, from 1% in May to 2.25% in December, and ended the year signaling that it intends to keep raising rates in the months to come. The Federal Open Market Committee (FOMC) raised short-term interest rates once more on February 2, 2005, its sixth increase since June 2004, repeating previous declarations that it could afford to raise rates at a “pace that is likely to be measured”. The Fed indicated then that it would keep its steady approach to raising rates in small increments at each meeting. Federal Reserve officials also maintained their positive outlook on the economy, saying that growth appeared to be solid and inflation expectations were “well-contained”.



However, even with this latest increase, short-term borrowing costs are still well below historical averages. At 2.5%, the funds rate is above the core inflation of 2.2%, although below the 3.3% rate recorded by the broader consumer-price index. More important, long-term interest rates for corporate bonds and home mortgages have declined in recent months. According to analysts, liquidity is so high that the only way lending institutions can compete is by lowering rates. Fed officials believe that the funds rate remains below “neutral” (a level that neither stimulates nor restrains economic activity), and that

monetary policy remains “accommodative”, thus the FMOC is expected to continue to tighten monetary policy in the months to come. Which level is considered “neutral” is object of speculation, and is placed anywhere between 3 to 5%.

The conditions for gradual tightening –steady job growth and well-contained but rising core inflation– are expected to remain in place in 2005. Federal Reserve Chairman Alan Greenspan, testifying before Congress on February 16, indicated that U.S. interest rates would keep rising in the

months ahead to keep inflation under control, but this time he didn't mention whether interest rates would keep rising at a "measured pace", as the Fed has been saying since June. The absence of such wording may mean that the Federal Reserve is less sure of the pace of future increases in interest rates, since with the economy stronger and productivity growing slower, the Fed no longer has the sizable cushion against inflation that made raising rates gradually possible.

• **Financial markets**

U.S. Treasury Security Yields

	Constant Maturities	
	3-year	10-year
1998	5.14	5.26
1999	5.49	5.65
2000	6.22	6.03
2001	4.09	5.02
2002	3.10	4.61
2003	2.10	4.01
2004	2.78	4.27
2004		
January	2.27	4.15
February	2.25	4.08
March	2.00	3.83
April	2.57	4.35
May	3.10	4.72
June	3.26	4.73
July	3.05	4.50
August	2.88	4.28
September	2.83	4.13
October	2.85	4.10
November	3.09	4.19
December	3.21	4.23

Source: Economic Indicators, U.S. Printing Office

The Federal Reserve steadily lowered its funds rate in 2001 and 2002, and left it at 1% throughout 2003, creating large amounts of liquidity in financial markets, as the cost of borrowing declined. In the second half of 2004, the Fed steadily raised its funds rate up to 2.25% in December, attempting to slow the pace of lending in financial and housing markets. However, the higher funds rate has not generated an increase in market interest rates, which have fallen sharply since the Fed first started raising rates on June 30. The yield on the 10-year Treasury note was trading at 4.23% in December, compared to 4.73% in June. Mortgage rates, which follow the 10-year note, have also fallen, with the 30-year fixed mortgage rate averaging 5.77%, down from 6.42% in June, according to HSH Associates.

Fund managers attribute the fall in market rates to continued strong demand for U.S. debt securities from Asian investors, which has pushed prices higher and yields lower, lowering borrowing costs for home buyers and companies. The ongoing low level of market rates keeps asset prices high. Both average U.S. home prices and stock prices increased in 2004. With respect to 2003, the Dow Jones Industrial Average, the S&P 500 and the NASDAQ composite were up 15%, 17% and 21%, respectively.

The December figures on U.S. capital inflows released by the Treasury Department show that appetite for U.S. government bonds rose in 2004, with private net purchases of U.S. domestic securities reaching US\$679.6 billion, compared to US\$602.8 in 2003. The Treasury data also show that foreign central banks accounted for almost 26% of all net purchases of U.S. domestic securities in 2004, up from 7% in 2002. They also accounted for 57% of net purchases of Treasury bonds and notes, up from 41% in 2003 and only 6% two years ago. While foreign official demand was up in 2004, net private demand for U.S. Treasury bonds and notes slipped, especially in the second half of the year. It was down to US\$153.6 billion in 2004, from US\$160.5 in 2003. If the Federal Reserve maintains its strategy to tighten monetary policy gradually in 2005 as expected, private demand for Treasuries may remain subdued. Asian central banks, on the other hand, are expected to keep purchasing Treasuries in the short-term, as part of their overall policy of stimulating exports.

Stock Prices

	Dow Jones Industrial Average	S&P 500	Nasdaq
1998	8,625.52	1,085.50	1,794.91
1999	10,464.88	1,327.33	2,728.15
2000	10,734.90	1,427.22	3,783.67
2001	10,189.13	1,194.18	2,035.00
2002	9,226.43	993.94	1,539.73
2003	8,993.59	965.23	1,647.17
2004	10,317.39	1,130.65	1,986.53
Growth Rates %			
2003	-2.52	-2.89	6.98
2004	14.72	17.14	20.60
Monthly Stock prices			
2004			
January	10,540.05	1,132.52	2,098.00
February	10,601.50	1,143.36	2,048.36
March	10,323.73	1,123.98	1,979.48
April	10,418.40	1,133.08	2,021.32
May	10,083.81	1,102.78	1,930.09
June	10,364.90	1,132.76	2,000.98
July	10,152.09	1,105.85	1,912.42
August	10,032.80	1,088.94	1,821.54
September	10,204.67	1,117.66	1,884.73
October	10,001.60	1,118.07	1,938.25
November	10,411.76	1,168.94	2,062.87
December	10,673.38	1,199.21	2,149.53

Source: Economic Indicators, U.S. Government Printing Office

- **External sector**

The U.S. annual goods and services deficit widened from US\$496.5 billion in 2003 to US\$617.7 billion in 2004, as imports increased nearly twice as much as exports. As a percentage of GDP, the trade deficit increased from 4.5% in 2003 to 5.3% in 2004, a level that adds more downward pressure on the value of the dollar and increases the amount of debt held overseas.

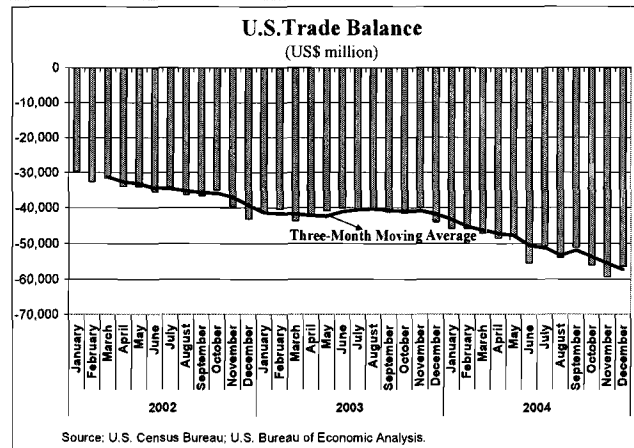
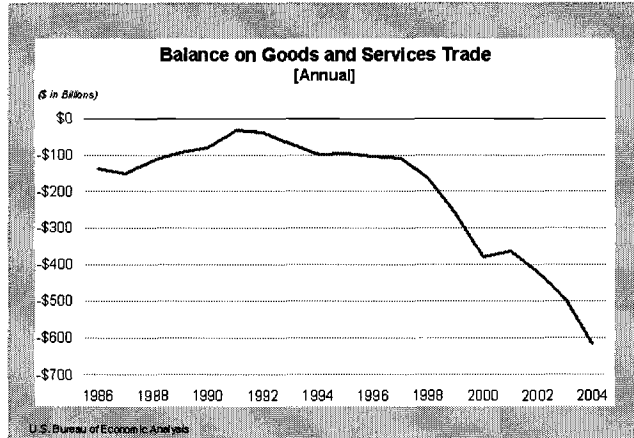
Still, the year-end spurt in exports, with exports of US\$100.2 billion in December, a solid 3% gain over November that ended a five-month stretch of export stagnation, made 2004 the best exporting year for U.S. companies since the peak of the technology boom and global financial bubble in 2000. The exports helped narrow the trade deficit in December by US\$2.9 billion, to US\$56.4 billion, from the record US\$59.3 billion level in November.

For 2004, exports of goods and services increased US\$125.6 billion in 2004 to US\$1,146.1 billion. Goods exports were up US\$94.5 billion from 2003, with the largest increases in capital goods (US\$37.5 billion), industrial supplies and materials (US\$30.5 billion), and consumer goods (US\$12.9 billion). Services exports increased US\$31.2 billion, with the largest increases in travel (US\$10.2 billion), other private services (US\$8.5 billion), and other transportation (US\$5.5 billion).

Imports of goods and services increased US\$256.9 billion in 2004, to US\$1,763.9 billion, 54% more than exports. Goods imports were up US\$213.1 billion and services imports were up US\$33.8 billion. The largest increases in goods imports were in industrial supplies and materials (US\$98.6 billion), capital goods (US\$48.0) and consumer goods (US\$39.3 billion). The largest increases in services imports were in other transportation (US\$8.9 billion), other private services (US\$8.5 billion) and travel (US\$8.0 billion).

The U.S. trade deficit widened with every major region of the world in 2004. The deficit is widest with China, having increased from US\$124.1 billion in 2003 to US\$162.0 in 2004. The U.S. shortfall with China accounts for about one-fourth of the total U.S. trade deficit. The 2004 trade deficit with China was the largest ever recorded by the U.S. with any single country.

The trade deficit is expected to stabilize and maybe improve modestly in 2005. The dollar has depreciated enough over the past three years for this process to finally get started. However, a measurable improvement in the trade deficit faces several obstacles: import volumes are 1.5 times as



large as export volumes, thus exports will need to grow faster than imports to avoid further deterioration in the trade balance; the U.S. domestic demand needs to contract relatively to output (and national savings need to increase), while domestic demand in the U.S. trading partners needs to accelerate; finally, further dollar depreciation is required to improve the deficit significantly, but there is a considerable degree of market intervention by foreign governments in currency markets –as in the case of many Asian currencies– thus the dollar has held steady against these currencies and has not been a tool to help improve trade imbalances with these countries.

II. LOOKING AHEAD

- After six rate rises at six successive meetings, interest rates in the United States still remain low by most measures. Interest rates are expected to continue to increase gradually to curb consumer spending, although the omission of the word “measured” by the Chairman during his testimony may indicate that Fed policymakers are less willing to signal what actions they might take in the future. The conditions for gradual tightening –steady job growth and well-contained but rising core inflation– are expected to remain in place in 2005. However, with the economy stronger and productivity growing slower, the Fed no longer has the sizable cushion against inflation that made raising rates gradually possible. In addition, import price pressures from a lower dollar and rising industrial capacity utilization may increase inflationary pressures.
- Although there are risks to the U.S. economy’s performance, the economic projections for 2005 and 2006 by the Federal Reserve policymakers are positive. They expect the economy to expand moderately and inflation to remain low. According to their forecast, real GDP will grow between 3.75 to 4% in 2005, and between 3.25 and 3.75% in 2006. The civilian unemployment rate is expected to average about 5.25% in the fourth quarter of 2005. With regard to inflation, FOMC participants project that the chain-type price index for personal consumption expenditures excluding food and energy (core PCE) will increase between 1.5% and 1.75% both in 2005 and 2006, about the same as the 1.6% increase posted over 2004.