UNITED NATIONS

ECONOMIC COMMISSION FOR
LATIN AMERICA AND THE CARIBBEAN
ECLAC Washington Office

Distr.
RESTRICTED
LC/WAS/R.40
December 7, 2005
ORIGINAL: ENGLISH

UNITED STATES ECONOMIC OUTLOOK

Quarterly Developments

U.S. ECONOMIC OUTLOOK

The U.S economy grew at a strong pace in the third quarter of 2005, despite the adverse impact of Hurricanes Katrina and Rita. According to the preliminary estimates, the economy grew 4.3%, compared to 3.3% in the second quarter. The improvement from the second quarter came from a smaller decline in inventories and stronger growth in personal consumption expenditures and federal government spending (partly due to the response to Hurricane Katrina), which were partially offset by greater imports and decelerations in exports, residential fixed investment, and state and local government spending.

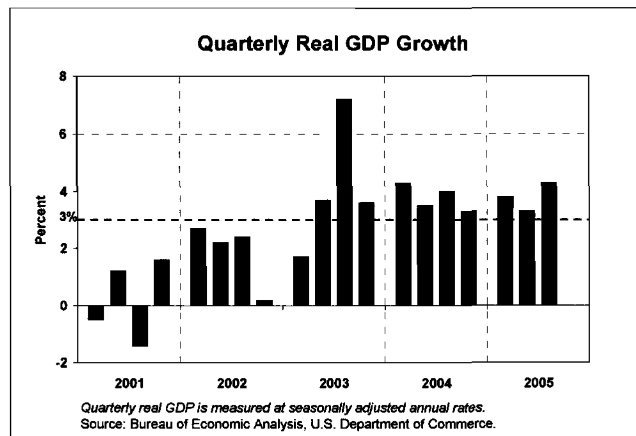
The Federal Reserve remained focused on inflation and kept an optimistic view on economic growth, despite the negative impact of the recent hurricanes. The Federal Open Market Committee continued the process of gradually removing monetary accommodation in August 9, September 20 and November 1, raising the federal funds rate to 3.5%, 3.75% and 4%, respectively. However, the release of the last meeting's minutes revealed that "some members cautioned that the risks of going too far with the tightening process could also eventually emerge". The minutes indicated that the Fed believed it was nearing a more neutral policy stance, hinting that the cycle of rising rates may be coming to an end.

The hurricanes that hit the United States in the third quarter did not reduce economic output as feared. Higher oil prices in the immediate aftermath of the hurricanes did not have a dampening effect on growth because output is less sensitive to higher oil prices, given that the economy is now less energy intensive and more energy efficient. However, while gasoline prices have returned to pre-Katrina levels, significantly higher heating oil and natural gas prices will confront consumers in the coming months.

I. CURRENT ASSESSMENT

- **GDP growth**

According to the preliminary estimates released by the U.S. Department of Commerce on November 30, the U.S. economy grew at an annual rate of 4.3% in the third quarter of 2005, up from the previous quarter's rate of 3.3%.[1] This acceleration in real GDP growth reflected a slower decline in private inventories, which subtracted only 0.44% from overall growth, compared to 2.14% (the sharpest negative contribution in more than five years) in the second quarter. It also reflected accelerations in personal consumption

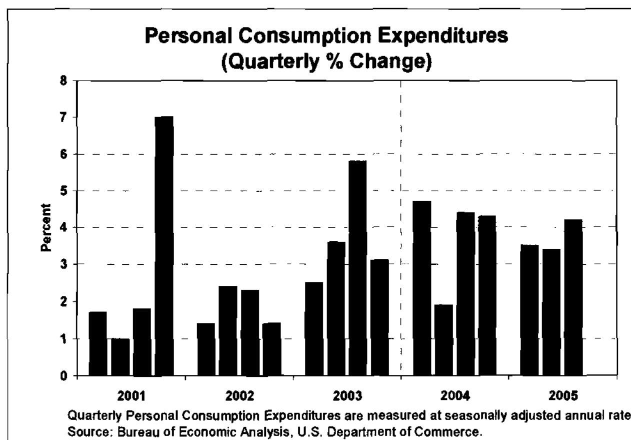


Quarterly real GDP is measured at seasonally adjusted annual rates.
Source: Bureau of Economic Analysis, U.S. Department of Commerce.

[1] The government revised economic growth for the third quarter up to 4.3% from an earlier estimate of 3.8%. The revised 4.3% estimate was far higher than the 4% most analysts had expected. The revision was driven by even stronger consumer spending than earlier thought.

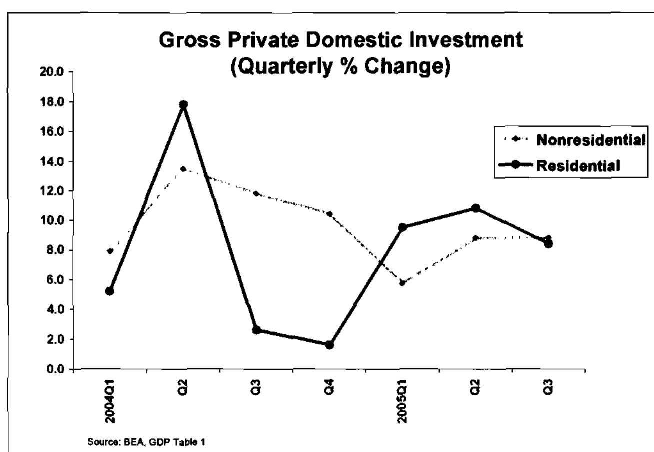
expenditure and in federal government spending, which were partially offset by greater imports and slower growth in exports, investment in housing, and state and local spending. Growth has now exceeded 3% for 10 straight quarters.

Real consumer spending continued to expand on a solid pace in the third quarter, increasing 4.2% (compared to an increase of 3.4% in the second). Purchasing patterns continued to re-align in favor of durable goods, which increased 10.5%, largely due to stronger vehicle sales, compared with an increase of 7.9% in the previous quarter. Nondurable goods purchases were unchanged at an annual rate of 3.6%, while spending on services rose 3.3%, compared with an increase of 2.3% in the second quarter. Real personal consumption expenditures (PCE) contributed 2.97% to overall GDP growth.



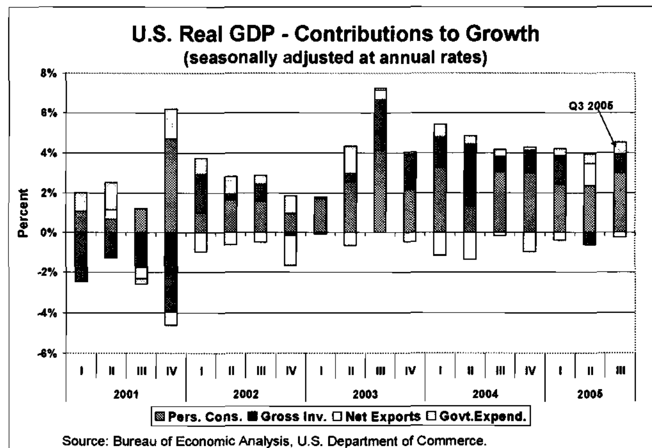
Before Katrina and Rita, inflation-adjusted oil and gas prices were well below their historic 1981 highs, but they were rising rapidly and creating concerns to consumers. Since 1986, gasoline purchases have averaged 2.5% of total PCE. In 2005, consumers have seen gasoline purchases consume a greater portion of their budgets, with gasoline purchases accounting for 3.5% of PCE in the third quarter. In 1981, in comparison, gasoline purchases represented 5% of PCE. The smaller share of gasoline purchases in PCE today may be explained by the fact that consumer spending held up well even as gasoline prices were quickly rising.

Real nonresidential fixed investment, which represents overall business spending, remained unchanged in the third quarter, at an annual rate of 8.8%. There was a 10.8% increase in private fixed investment in equipment and software (compared with 10.9% in the previous quarter) and a 2.7% increase in investment in nonresidential structures (the same rate as in the second quarter). Real residential fixed investment increased 8.4%, compared with an increase of 10.8% in the second quarter. The housing market remained a key contributor to growth. However, investment in housing, while still strong, slowed from its remarkably rapid pace of the past few years. Total fixed investment contributed 1.40% to overall GDP growth, but the decline in inventories subtracted 0.44%, thus gross private domestic investment contributed 0.96% to overall GDP growth.



Trade was a negative factor in the third quarter, with net exports of goods and services subtracting 0.25% from overall GDP growth. Real exports of goods and services increased only 0.8% in the third quarter, compared with a previous increase of 10.7%, while real imports of goods and services increased 2.1%, compared with a 0.3% decline in the previous quarter.

Real federal spending rose sharply, increasing at an 8.1% annualized rate, compared to 2.4% in the second quarter. Some of this growth was due to hurricane spending. However, real state and local government spending was up a modest 0.4% in the quarter, compared to a growth of 2.6% in the second quarter. Real government spending contributed 0.60% to overall GDP growth.



Source: Bureau of Economic Analysis, U.S. Department of Commerce.

Although the hurricanes did not reduce economic output in the third quarter as feared, they may have economic effects that will go beyond those directly associated with energy. The Congressional Budget Office reported that the destruction and dislocation of businesses in the Gulf States due to Katrina alone would significantly reduce regional production through the end of the year. The loss of output, combined with a possible slowdown in consumer spending due to higher energy costs, could slow economic growth in the last quarter of the year. However, federal spending in the Gulf Coast should help to boost growth, especially next year. Moreover, inventories, which have been a drag on economic growth in each of the last two quarters, are now low and with growth remaining strong, inventory accumulation should be a positive factor for the economy in the fourth quarter and early next year.

Finally, with growth well above the economy's potential (of about 3.5%) in the third quarter, the FOMC will probably remain concerned about inflation pressures, and should continue tightening interest rates in its next meeting in December, as well as next year.

- **Sectoral Developments**

Industrial production dropped 1.3% in September, as Hurricanes Katrina and Rita and a strike at a major aircraft producer significantly reduced output. For the third quarter as a whole, production rose 1.3% at an annual rate. On a year-over-year basis (September 2004 to September 2005), total industrial production increased 2%. Capacity utilization declined to 78.6% in September from 79.8% in August. For the quarter as a whole, the capacity utilization rate was 79.4%, the same as in the second quarter.

Industrial Outlook

2005	Total Industrial Production		Capacity Utilization Rate (%)
	Index 1997=100	Percentage Change From Previous Period	Total Industry
2005 Q1	**118.2**	**3.6**	**79.3**
January	117.8	-0.1	79.1
February	118.3	0.5	79.4
March	118.6	0.2	79.5
2005 Q2	**118.6**	**1.4**	**79.4**
April	118.1	-0.4	79.0
May	118.5	0.3	79.2
June	119.4	0.8	79.8
2005 Q3	**119.0**	**1.3**	**79.4**
July	119.4	0.0	79.7
August	119.6	0.2	79.8
September	118.0	-1.3	78.6

Source: Federal Reserve.
Note: Quarterly changes are at annual rates.

Manufacturing production decreased 0.5% in September, mostly due to lost refining output, with the production of nondurables declining by 1.2%, and of durables by 0.1%. Most of the losses in September were concentrated in nondurable goods tied to petroleum, including a 3.3% drop

in chemical production due to hurricane-related shutdowns in the Gulf Coast, and a 6.4% drop in petroleum and coal products. Among durable goods, the largest decline was a 15.1% drop in the strike-affected aerospace and miscellaneous transportation equipment category. The largest gainers were computer and electronic products (2.8%) and motor vehicles and parts (2.2%). For the quarter, manufacturing production increased 2.3%, the production of nondurables decreased 2.2%, and of durables increased 7.6% at an annual rate.

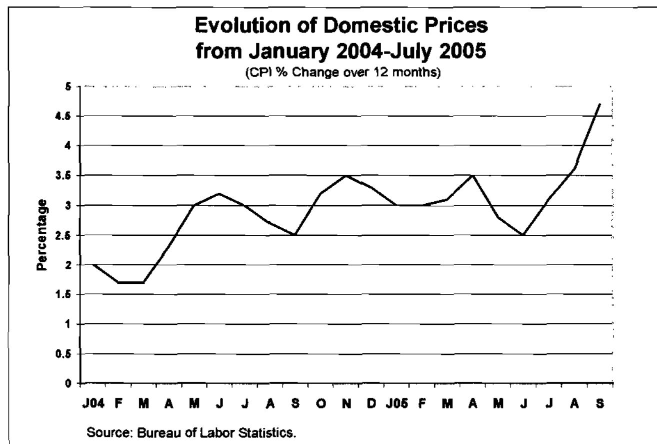
Mining production edged down at an annual rate of 16.5% in the third quarter, following an increase of 3% in the second quarter. Mining output declined 9.1% in September, a decrease driven by lost oil and natural gas production due to the hurricanes. Utility production was down by 0.9% in September, but up by 10.7% for the quarter.

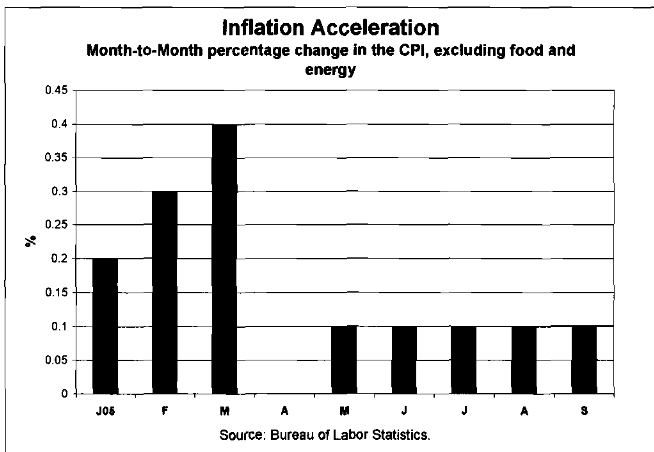
Total industrial capacity expanded 1.2% in the third quarter of 2005. The rate of capacity utilization in September was 78.6%, 2.4% below the 1972-2004 average.

The larger impact of the hurricanes Katrina and Rita was to the oil and natural gas extraction in the Gulf of Mexico, with significant adverse effects on manufacturing with a heavy presence in the region. These included petroleum refining and chemical output, much of which uses petroleum products as inputs. Much of the rest of the production infrastructure performed well. The production of consumer goods showed an increase of 0.2%, even after accounting for a 2.2% decline in consumer energy production. The fact that the production of consumer goods was for the most part unaffected by the hurricanes may explain the lack of core inflation pressure. Except for energy goods, the hurricanes did not cause shortages for most consumer goods, preventing price spikes.

- **Inflation**

The Consumer Price Index for All Urban Consumers (CPI-U) rose at a seasonally adjusted annual rate (SAAR) of 9.4% in the third quarter of 2005, following increases in the first and second quarters at annual rates of 4.3 and 1.9%, respectively. This brings the year-to-date annual rate to 5.1% and compares with an increase of 3.3% in all 2004. In September, the first full-month of post-Katrina data showed consumer prices increasing 1.2% from a month earlier, on the strength of a particularly large increase of 12% in energy prices. Over the last 12 months, the CPI has increased 4.7%, which is the fastest pace since 1991. Core inflation remained tame, however, with a fifth straight reading of 0.1%, keeping the annual rate at 2%.



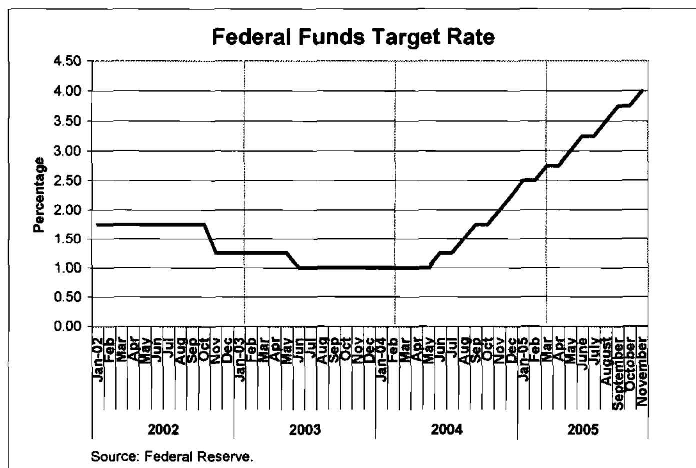


The energy index, which advanced at annual rates of 21.1% and 7.5% in the first two quarters of the year, advanced at 122.1% in the third quarter. Energy costs have risen at a 42.5% SAAR so far this year, after rising 16.6% in all 2004.

Excluding food and energy the CPI-U advanced at a 1.4% SAAR in the third quarter, following increases at rates of 3.3% and 1.2% in the first and second quarters.

Although consumer inflation is now at the highest level of the past 14 years, reflecting the recent spike in energy prices after the hurricanes, core inflation remains contained at just 2% annually, compared to a rate more than twice as high back in 1991. However, given the size of the increase in energy prices and the respective impact on both consumer spending and inflation expectations, it might be misleading to place too much emphasis on core readings. For example, consumer surveys have shown a sharp increase in inflation expectations.

- **Monetary policy**



The U.S. Federal Reserve raised the federal funds target rates seven times in 2005, from 2.25% in the beginning of the year to 4% in November, signaling that it intends to keep raising rates in the months to come. The Federal Open Market Committee (FOMC) raised short-term interest rates on February 2, March 22, May 3, June 30, August 9, September 20, and November 1, which was its twelfth 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 this year has focused on keeping inflation from reviving, reasoning that should it raise rates too slowly, it might be forced to raise them drastically later, sending the price of houses and other assets down sharply.

According to minutes from the Fed's November 1 meeting, which are an edited summary of discussions at the Federal Open Markets Committee, the members of the Committee agreed that their statement about the outlook on rates "would have to be changed before long." Since the spring of 2004, the Fed has consistently said that it would see to raise overnight federal funds rate at a "measured" pace, which investors have understood to be a quarter-point increase in each policy

meeting. That raised the possibility that policy makers would stop giving strong hints about where interest rates are headed. Economists took this to mean that rates are getting close to "neutral", although the Fed has never defined that level. However, the minutes' release did nothing to really change the outlook on interest rates, because policy makers said they were still more worried about inflationary pressures than about slowing economic growth.

There is currently great speculation about how much more the Fed will raise its benchmark short-term rate, before Mr. Greenspan's leaves. Alan Greenspan will step down as Fed chairman at the end of January. President Bush has nominated Ben Bernanke to succeed Mr. Greenspan, and the Senate Banking Committee unanimously voted for him. He is expected to win an easy approval by the full Senate in January. During his confirmation hearing before the Senate Banking Committee, Mr. Bernanke underlined his commitment to inflation targeting, saying that a well-defined inflation objective was consistent with current practices and congressional mandate. However, he also said he would proceed with caution and seek consensus within the Fed before moving toward setting an inflation target, one of the few areas of policy where Mr. Bernanke differs from Mr. Greenspan.

Investors also speculate whether Mr. Bernanke will nudge interest rates higher still to prove his resolve to fight inflation. The current debate is whether the rate considered "neutral" by the Fed will be 4.5% or 4.75%, and it has been grabbing investors' attention. In its twice-yearly Economic Outlook, the Organization for Economic Cooperation and development (OECD), said robust U.S. domestic demand and a pick-up in inflation next year meant the Fed needed to continue to raise interest rates by another 0.75 percentage point to 4.75%.

- **Financial markets**

The enthusiastic foreign appetite for U.S. securities in recent months expanded even further in September, as net foreign purchases of domestic securities surged to a record US$118.1 billion, far above the previous record set in May 2003. Net of U.S. investments in securities abroad, which are a counterbalance for some of these purchases, the net securities inflow to the U.S. came to US$101.9 billion (up from US$89 billion in August), also a monthly record.

The heavy demand for U.S. assets was surprising in the wake of concerns about the Hurricanes Katrina and Rita and their potential damage to the U.S. economy. In the first nine months of 2005, net foreign purchases of domestic securities have totaled US$762 billion, up 14% from the total in the first nine months of 2004, a pace that is more than enough to finance the large and expanding U.S. current account.

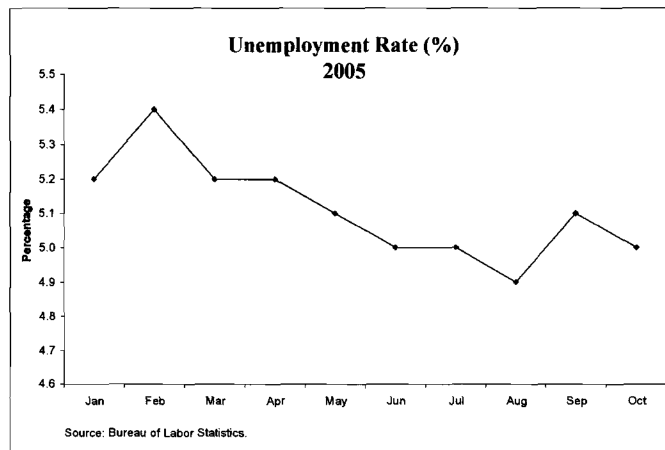
Foreign investors bought both U.S. bonds and stocks in very large amounts in September. The net purchases of U.S. corporate bonds totaled US$51.1 billion (the second-highest monthly total ever, after June's record US$54 billion), while a record US$24.6 billion of stocks were purchased by foreigners in September (the largest monthly net inflow for U.S. equities since February 2000). The purchase of both classes of assets is somewhat surprising because usually these assets behave as alternatives to each other. The flow into stocks indicates a broadening of investor interest that should support future inflows, and the voracious appetite for U.S. corporate bonds reflects not only the high yield offered by U.S. companies but the appeal of their strengthening balance sheets as corporate profits soar. The net foreign purchases of U.S. Treasuries slowed slightly in September to US$21.8 billion (from US$28.2 in August), with the Treasury reporting that foreign central banks were net

sellers of Treasuries, and that private purchases of treasuries remained high in September, at US$22.93 billion.

The risk that foreign investors will suddenly pull out of the U.S. bond market has been raised frequently as a concern facing the U.S. economy in the months ahead. According to Goldman Sachs[2], foreign investors now own about 50% of all marketable U.S. treasuries and while this includes a 32% share for foreign central banks, the share of private investors has increased from 7% in 1990 to 18% now. Foreign inflows into other fixed income assets, such as corporate bonds, have followed an even more explosive growth path. Because of these inflows the Balance of Payments, including foreign official buying of U.S. securities, has managed to stay in relatively small deficit in recent years when compared with the current account deficit. As a consequence, the risk that foreign investors will be satiated with U.S. assets and decide not to add to their holding remains an important issue for the prospects of the U.S. economy.

- **Labor markets**

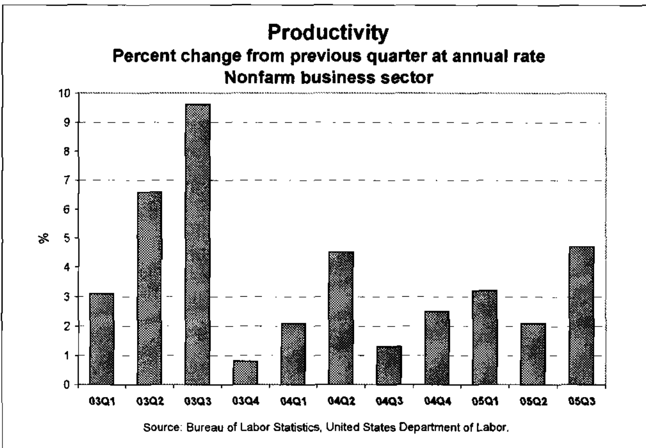
The labor market took a hit as a result of Hurricane Katrina and the subsequent surge in energy prices. Despite the loss of hundreds of thousands of jobs in the Gulf region, the labor market managed to post a gain in September, what underscores the strength in the remainder of the economy during the third quarter. With an average of 143,000 jobs a month (lower than the average of 198,000 in the second quarter), job gains swung from 277,000 in July, to 148,000 in August, and to 17,000 in September. The unemployment rate declined from 5.2% in March to 4.9% in August, but spiked to 5.1% in September (returning to 5% in October). The unemployment rate has fallen from a peak of 6.3% in 2003, and although it is not quite as low as the 4.2% unemployment rate in February 2001, when the recession began, it is fairly low by historical standards.



Average hourly earnings increased by 0.4% in July, 0.2 % in August and 0.1% in September. Growth for the last 12 months (up to September) was unchanged, at 2.6%, and given the increase in energy prices, lagged behind increases in the cost of living. However, hourly earnings increased 0.6% in October and 0.2% in November, making the gain over the past 12 months up to November increase to 3.16%, the best gain since early 2003.

There was an unexpected productivity jump in the third quarter of 2005. Productivity gains for U.S. workers in the nonfarm business sector grew at a 4.7% seasonally adjusted annualized rate (SAAR), according to the Bureau of Labor Statistics, up from 2.1% in the second quarter (which had been the slowest increase since the summer of 2004). Compensation costs remained tame. Hourly compensation increased 3.6% during the quarter, while real compensation fell 1.4%. Unit labor costs,

[2] Goldman Sachs, *Global Markets Daily: The Anatomy of past U.S. Bond Outflows,* 23 November 2005.



one of the key pieces of the inflation puzzle going forward, decreased 1% during the third quarter. In the third quarter, unit labor costs fell to the lowest level, while productivity rose to the highest level, since the second quarter of 2004. These were good news for the Fed, as the data showed that more fundamental pressures on inflation remain contained going into the fourth quarter.

With unit labor costs only 1.8% higher that they were last year, labor costs pressures were not an issue in the third quarter. However, this may be a result of the hit the labor market took as a result of the hurricanes. November posted solid job gains, and job growth – thus hours worked – should grow more quickly in the fourth quarter, likely increasing the rate of growth for compensation as well. The hurricanes may end up delaying the eventual cost pressures originating from the labor market by about one quarter.

Productivity and costs: Preliminary third-quarter 2005 measures

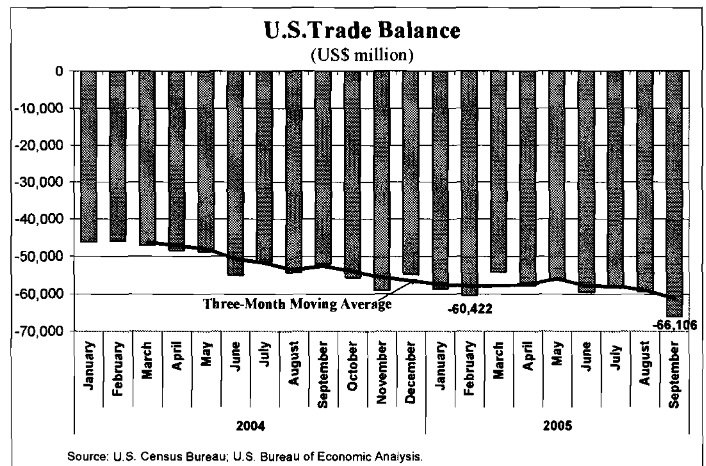
(Seasonally adjusted annual rates)

Sector	Productivity	Output	Hours	Hourly compensation	Real hourly compensation	Unit labor costs
	Percent change from preceding quarter					
Business	5.4	5.0	-0.4	4.2	-0.8	-1.1
Nonfarm business	4.7	4.8	0.1	3.7	-1.4	-1.0
Manufacturing	3.4	2.4	-1.0	3.1	-1.9	-0.3
Durable	6.5	6.9	0.3	2.6	-2.4	-3.6
Nondurable	0.2	-3.1	-3.3	3.8	-1.3	3.6

Source: Bureau of Labor Statistics.

- **External sector**

According to the Bureau of Economic Analysis and the Census Bureau, the U.S. monthly goods and services deficit swelled to a record US$66.10 billion in September as energy prices surged in the aftermath of the hurricanes that hit the Gulf of Mexico region. The trade gap widened 11.4% from August, the biggest percentage jump in more than a year, and easily surpassed the previous monthly record of US$60.42 billion posted in February.



Fueling the September trade gap was a 2.4% rise in imports, to US$171.3 billion, and a decline of 2.6% in exports (after two consecutive monthly increases), to US$105.2 billion. A strike at Boeing Co. helped depress aircraft exports. The storms also disrupted some shipments abroad of U.S.

grain and other foodstuffs. In the case of imports, price shocks produced by hurricane-induced disruptions in the country's energy markets contributed to the increase, as did consumers' strong appetite for foreign-made consumer goods, including TV sets, video recorders, toys and sporting good. For those reasons, some analysts believe that the huge increase in the deficit is probably temporary. However, the trade gap has been widening steadily over the past several years and the September's figure was substantially higher than most analysts forecast. Overall, the trade gap is on pace to easily exceed last year's record of US$617.58.

The goods deficit with China increased US$1.6 billion to US$20.1 billion in September, from US$18.5 billion in August. The deficit with China is on track to break the 2004 record of US$161.97 billion. Deficits were also recorded with the European Union (US$10.14 billion), OPEC (US$9.05 billion), Japan (US$6.41 billion), Canada (US$7.39 billion), Mexico (US$4.31 billion), Korea (US$1.21 billion), Taiwan (US$1.29 billion), and Brazil (US$0.74).

For the first nine months of the year, the trade deficit was US$528 billion, US$81 billion more than in the same period last year. The current level of high crude oil prices should hurt the trade balance in coming months.

II. LOOKING AHEAD

- The recent releases of economic data portray the U.S. economy as growing at a healthy pace, even though the housing market continues to cool, and hurricane-related job losses continue to mount.

- However, there are risks on the horizon, and the biggest is inflation. The policy risk is that inflation will keep surprising markets on the high side, and thus the Federal Reserve will have no choice but to continue increasing interest rates. Although the release of the last FOMC meeting's minutes indicated that some of the Committee's members seemed to think they were nearing a more neutral policy stance, recent economic data indicating that the U.S economy continues to show momentum will keep the Fed watching closely for price signals.

- According to minutes from the Fed's November 1 meeting, the members of the Committee agreed that their statement about the outlook on rates "would have to be changed before long." If the Committee were to remove the words about "removing monetary policy accommodation at a pace that is likely to be measured," Mr. Bernanke, who will succeed Mr. Greenspan as chairman of the Fed when he steps down in January, would have more freedom to chart the interest rate's course. The conventional wisdom, however, is that Mr. Bernanke will push through at least one more interest rate increase after he becomes chairman, if only to reassure investors of his determination to head off inflation.

- U.S. external imbalances remain large, and imagining a scenario under which the current account deficit improves substantially is difficult, as it requires U.S. domestic demand to remain significantly weaker than world demand for an extended period of time.