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UNITED STATES ECONOMIC OUTLOOK

Quarterly Developments

U.S. ECONOMIC OUTLOOK

As 2002 comes to a close, the U.S. economy is “working its way through the soft spot.” Among the forces weighing on the economy are the lengthy adjustment of capital spending, the fallout from corporate malfeasance, the decline in equity values, and heightened geopolitical risks. While households have become more cautious, business spending has yet to show any substantial vigor.

Notwithstanding some pessimistic forecasts of a double-dip (“big W”) recession or economic “flat-lining,” the U.S. economy continues to exhibit remarkable resilience. Real GDP has grown 3 percent over the past four quarters and the performance of productivity continues to be impressive. However, it remains to be seen how long it will take the economy to work its way through the “soft spot,” and how strong the recovery will be.

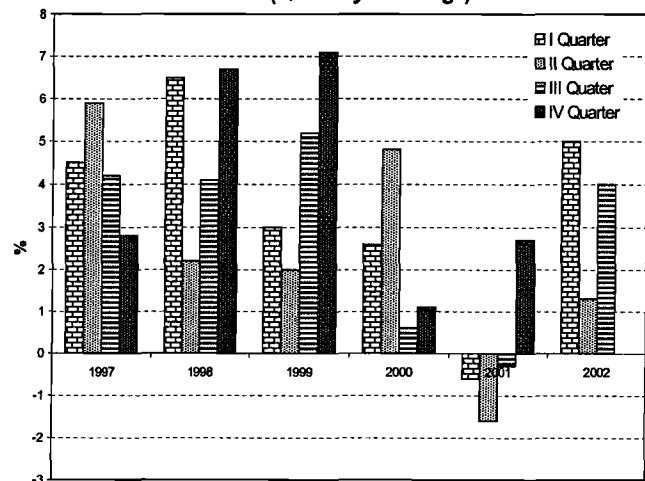
I. CURRENT ASSESSMENT

- **GDP growth**

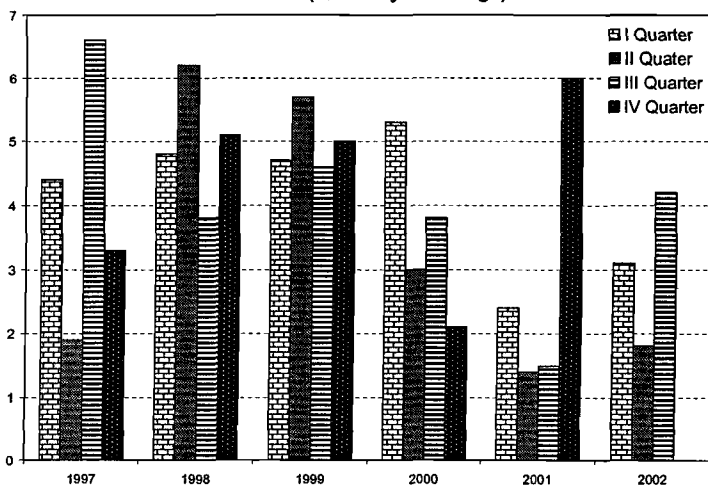
The U.S. economy expanded at an annual rate of 4.0% in the third quarter of 2002, increasing close to three percentage points from the previous quarter’s level of 1.3%.

The growth of gross domestic product (GDP) in the third quarter was primarily due to automobile sales. Excluding motor vehicles, growth was only 1.5%. In the second quarter, growth was driven primarily

**Real Gross Domestic Product
(Quarterly % Change)**



**Personal Consumption Expenditures
(Quarterly % Change)**



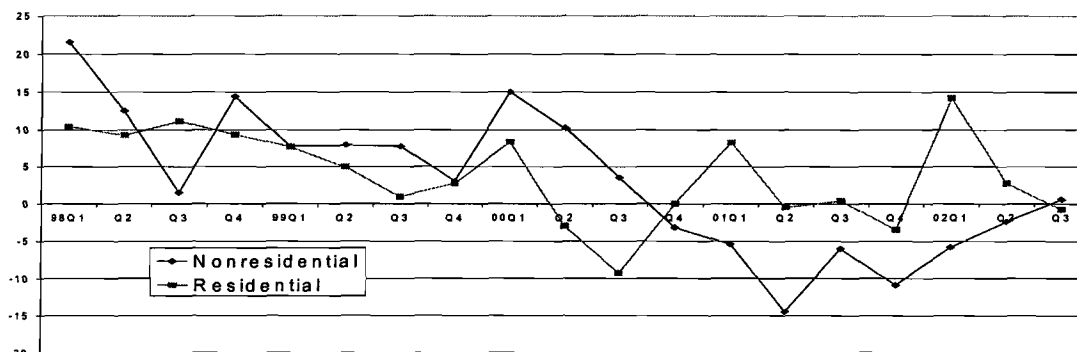
by inventories, while, in the third quarter, inventories fell to their lowest level on record relative to sales.

Consumer spending accounted for almost all the growth during the third quarter. Business investment in buildings, equipment and software increased 0.6%, reversing a downward trend that had run for seven quarters. However, spending on structures continued its fall of an estimated 20.6%.

Both imports and exports grew in the third quarter. As a result, the trade deficit continues to rise, judged now to be \$437.3 billion or 4.2 % of the economy.

While the current growth rate is respectable in normal times, higher rates are needed for an economic recovery. Uncertainties regarding corporate-governance scandals, the stability of the stock market, and a war in Iraq are all contributing to a slow recovery.

**Gross Private Domestic Investment
(Quarterly % Change)**



• **Sectoral Developments**

Industrial Outlook

2000/2001	Total Industrial Production		Capacity Utilization Rate (%)
	Index 1992=100	Percentage Change From Previous Month	Total Industry
2001			
January	143.9	-0.8	79.3
February	143.5	-0.3	78.9
March	142.9	-0.4	78.5
2001 Q1	143.4		78.9
April	142.0	-0.6	77.8
May	141.6	-0.3	77.5
June	140.3	-0.9	76.7
2001 Q2	141.3		77.3
July	140.4	0.1	76.7
August	140.0	-0.3	76.4
September	138.5	-1.1	75.5
2001 Q3	139.6		76.2
October	137.7	-0.6	75.0
November	137.2	-0.3	74.7
December	136.7	-0.4	74.4
2001 Q4	137.2		74.7
2002			
January	137.6	0.6	74.8
February	138.1	0.4	75.0
March	138.6	0.3	75.2
2002 Q1	138.1		75.0
April	138.8	0.1	75.3
May	139.5	0.5	75.6
June	140.4	0.7	76.0
2002 Q2	139.6		75.6
July	141.0	0.5	76.3
August	140.7	-0.2	76.1
September	140.4	-0.2	75.8
2002 Q3	140.7		76.1
October	139.3	-0.8	75.2

Industrial production underwent its third consecutive month of decline in October, dropping by 0.8%. This is a significant change from previous months, in which industrial output had increased for 7 consecutive months. While industrial sectors such as defense, capital goods, and semiconductors saw double-digit growth, other industries including nonresidential building construction and oil and natural-gas drilling fell over 20%.

The Institute for Supply Management's purchasing managers' index (PMI) of manufacturing activity experienced the third consecutive month of decline in November, to its current level of 49.2%. For the past three months, the PMI has been below 50%, indicating a contraction within the manufacturing sector.

Capacity utilization has continued to decline, reaching 75.2% in October.

Factory orders dropped 2.3% in September, but rose once again in October by 1.5%. Much of the fall in factory orders can be attributed to a falling demand for durable goods. The poor performance of the manufacturing sector has slowed the country's economic recovery.

Aside from the weak automobile sector, retail sales are on the rise. With automobiles excluded, retail sales rose 0.7% in October.

• **Labor markets**

November's unemployment reached 6.0%, an eight year high that was also reached in April. Predictions for 2003 anticipate unemployment rates of around 5.7%. The welfare of the manufacturing industry has contributed significantly to unemployment levels, with heavy layoffs occurring within the sector. Layoffs have occurred more quickly and on larger scales than during previous recessions.



Productivity continued to rise, marking the fifth consecutive quarterly increase in productivity. The productivity of workers in non-farm businesses rose 5.1% in the third quarter, while hours worked remained constant. Productivity growth is being credited to increased internal efficiencies instead of increased use of information technology.

Productivity and costs: Preliminary Third-quarter 2002 measures
(Seasonally adjusted annual rates)

Sector	Productivity	Output	Hourly Hours	Real hourly compensation	Unit labor costs
	Percent change from preceding quarter				
Business	4.3	4.1	-0.1	5.2	0.9
Nonfarm business	4.0	4.1	0.1	4.8	0.8
Manufacturing	5.9	3.4	-2.4	4.5	-1.3
Durable	8.8	4.5	-4.0	4.4	-4.1
Nondurable	2.0	2.1	0.1	5.0	2.9

- **Inflation**

For the twelve months ended in October, the consumer price index (CPI) rose 1.7%. This figure was up 0.2% from September.

Deflation has occurred in the goods sector in markets most sensitive to international competition.

Specifically, prices have declined for

apparel, automobiles, and appliances. Generally, prices are falling for durable goods, constant for non-durable goods, and rising for services. With the inflation rate in services remaining stable at 2.5% and services accounting for 60% of spending, overall the economy is experiencing low levels of inflation.

The Federal Reserve asserted that the level of excess capacity in the economy is not sufficient to cause deflationary pressures.

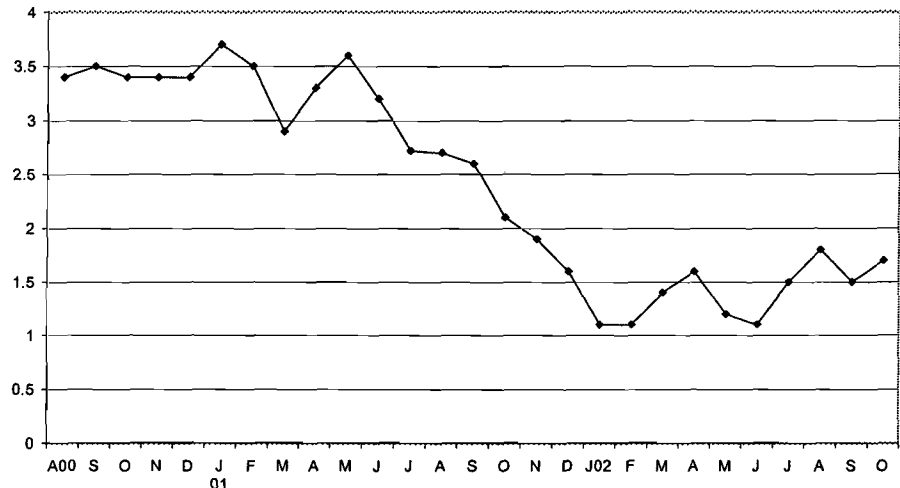
- **Monetary policy**

In December 10th's Federal Reserve meeting, the interest rate was kept unchanged. Committee members stated that the economy is currently working through a soft spot, and in order to cope with the slowdown, interest rates remain at their lowest level in 41 years. Interest rates had been cut by 0.5% to the current level of 1.25% during the November 6th meeting of the Federal Reserve. While a rate cut was expected then, the magnitude surpassed expectations. The Federal Reserve also cut its discount bank loan rate from 1.25% to only 0.75%. November rate cuts were made in order to correct a bias in the economy.

The Federal Reserve believes that an economic recovery is underway, but also acknowledges forces weighing down consumer confidence. The threat of terrorism and war in Iraq has slowed recovery. Furthermore, the cut promises to help the economy pass through a current soft spot.

There are concerns that few tools remain available to fight the recession. With interest rates at their lowest levels in decades, and the current high levels of non-economic sources of uncertainty, further cuts become less and less valuable. The inflation-adjusted interest rate is now negative, and still consumers are not consuming at the desired levels. With many car dealerships promoting car sales with zero interest rates, and mortgage rates at very low levels, the demand for these goods is no longer increasing. This indicates that interest rate policy may

Evolution of Domestic Prices
(CPI % Change over 12 months)



not be effective beyond some lower bound. If the economy continues to show slow signs of recovery, the government will probably rely on fiscal policy to provide further stimulus.

• **Financial Markets**

October readings for the three major indexes (Dow Jones, S&P 500, Nasdaq) were down from the third quarter. The stock markets have rebounded since

Stock Market

	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
January	10,682.74	1,335.63	2,656.86
February	10,774.57	1,305.75	2,449.57
March	10,081.32	1,185.85	1,986.66
April	10,234.52	1,189.84	1,933.93
May	11,004.96	1,270.37	2,181.13
June	10,767.20	1,238.71	2,112.05
July	10,444.50	1,204.45	2,033.98
August	10,314.68	1,178.51	1,929.71
September	9,042.56	1,044.64	1,573.31
October	9,220.75	1,076.59	1,656.43
November	9,721.82	1,129.68	1,870.06
December	9,979.88	1,144.93	1,977.71
2002			
January	9,923.80	1,140.21	1,976.77
February	9,891.05	1,100.67	1,799.72
March	10,500.95	1,153.79	1,863.05
April	10,165.18	1,112.03	1,758.80
May	10,080.48	1,079.27	1,660.31
June	9,492.44	1,014.05	1,505.49
July	8,616.52	903.59	1,346.09
August	8,685.48	912.55	1,327.36
September	8,160.78	867.81	1,251.07
October	8,048.12	854.63	1,241.91
Week ended:			
2002 Oct 5	7,706.38	822.13	1,175.71
12	7,518.97	799.97	1,147.31
19	8,153.31	869.26	1,259.11
26	8,448.80	893.23	1,310.51
Nov 2	8,415.81	889.96	1,326.71

October, however the overall picture for the year is quite poor. Investors are hopeful that the current rally will extend into December, however the improvements will, in all likelihood, not be significant enough to prevent the annual indexes from showing decline over the year. Analysts are quite certain that, for the third consecutive year, the three major indexes will decrease. This is

the first of such an occurrence since 1939-1941. So far this year, the Dow Jones industrial average decreased 12% this year, the S&P 500 dropped 19%, and the Nasdaq fell 24%.

Following the election results of early November as well as the Federal Reserve's announced rate cut, stock rose from the increased measure of certainty. However, poor growth forecasts for the fourth quarter continue to exert downward pressure on stock prices.

The overall picture for the future is brighter. The only record of four consecutive years of decline in the markets is the years 1929-1932, and investors are confident that the

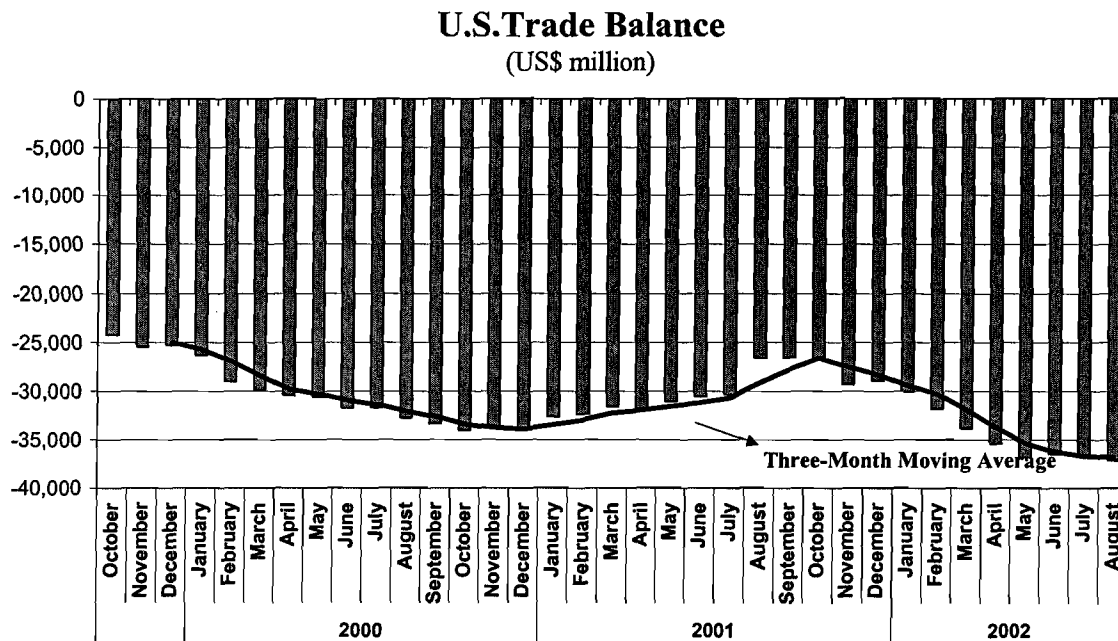
U.S. Treasury Security Yields
(Percent per annum)

	3-Month Bills (new issues)	Constant maturity 30-year
2001		
January	5.27	5.54
February	4.93	5.45
March	4.5	5.34
April	3.92	5.65
May	3.67	5.78
June	3.48	5.67
July	3.54	5.61
August	3.39	5.48
September	2.87	5.48
October	2.22	5.32
November	1.93	5.12
December	1.72	5.48
2002		
January	1.66	5.45
February	1.73	*
March	1.81	*
April	1.72	*
May	1.74	*
June	1.71	*
July	1.68	*
August	1.63	*
September	1.63	*
Week ended:		
2002 Sept 7	1.61	*
14	1.65	*
21	1.66	*
28	1.61	*
Oct 5	1.54	*

worst of the problems in the stock market are over. There is agreement that stock prices have readjusted to more realistic levels, and corporate earnings are improving.

- **External sector**

After August's record trade deficit, the trade deficit fell by close to \$300 million in September. Goods exports increased by \$100 million while imports fell \$500 million. Automobile exports fell by \$100 million, though foreign sales of capital goods increased by \$200 million. The fall in imports reflects lower purchases of consumer goods. The global economy is slowing down, expected to bottom out during the first half of 2003. Current trade data is reflecting this slowdown.



On the trade policy front, the US has presented a proposal to the WTO on November 26 with the objective of drastically lowering tariffs by 2010 and eliminating them five years later for all products. The proposal raised concerns on the part of developing and developed countries. On the one hand, it is said to overlook the importance of tariffs for government revenues and for protecting infant industries. On the other hand, some developed countries have found it unrealistic, as it would be almost impossible to attract the necessary consensus for tariffs elimination.

After two years of negotiations, on December 11, the US finalized a free trade agreement with Chile.

The official round of negotiations with the countries of Central America is expected to be launched on January 8th, 2003.

II. LOOKING AHEAD

- The unemployment rate jumped back to an eight-year high in November, as signs of economic revival have not sufficed to stimulate business confidence and generate employment at a healthy rate.
- Treasury Secretary Paul O'Neill's resignation appears to make a broad fiscal stimulus—about \$300 billion more likely. The package would consist of a variety of tax cuts and it is intended to strengthen the shaky recovery.