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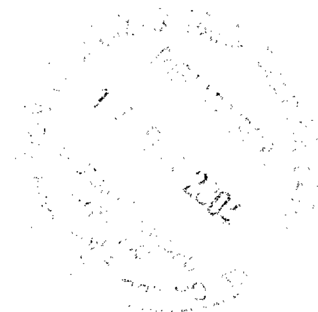


UNITED STATES ECONOMIC OUTLOOK

Quarterly Developments

U.S. ECONOMIC OUTLOOK

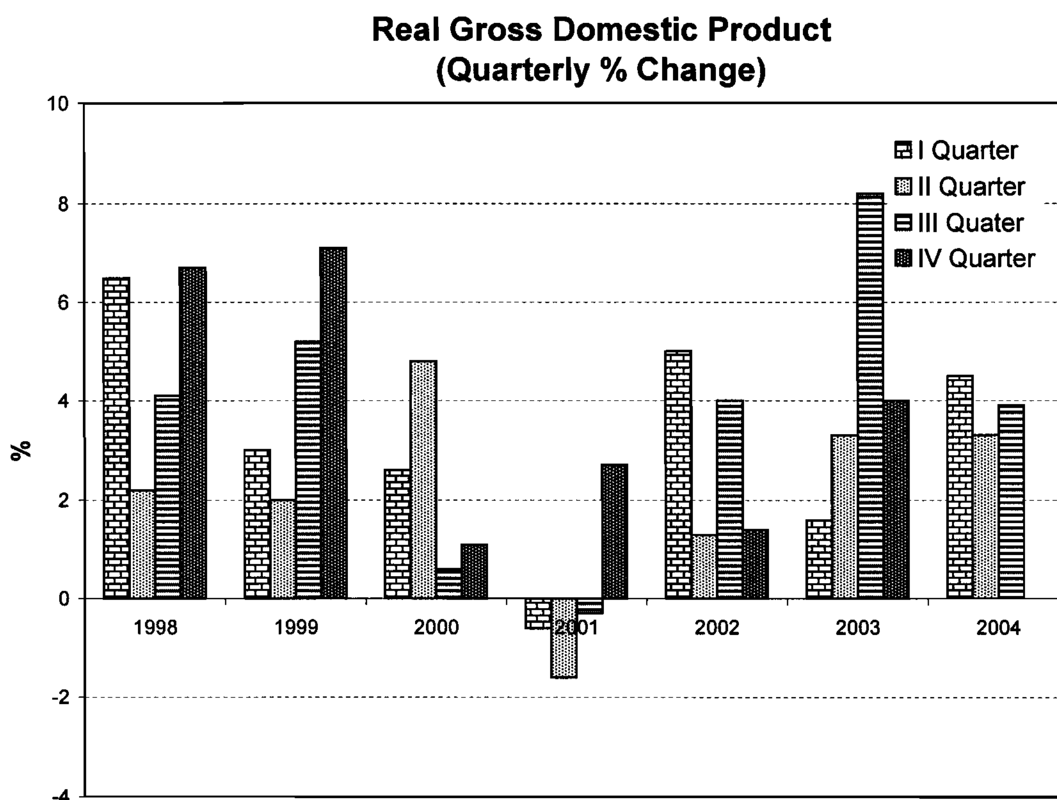
The U.S. economy continued to show solid economic growth in the third quarter of 2004. During the same time, the labor market, that had remained weak during most of the year, started to show signs of recovery.

As expected, the Federal Open Market Committee (FOMC) raised the federal funds rate to 2.0% in its latest meeting on November 10th. The inflation outlook, though still tame, could start to change on account of higher oil prices and the decline of the dollar thus making the case for an uninterrupted move towards neutrality. Uncertainties over the 2005 economic path are fuelled by high and volatile oil prices and significant fiscal and external deficits.

I. CURRENT ASSESSMENT

- **GDP growth**

Gross domestic product grew by 3.9% during the third quarter of 2004, compared to a 3.3% growth in the second quarter. The key driver of third quarter growth was the strong rebound in consumer spending, probably due to strong job, particularly in October, and income growth. Noticeable, consumer spending grew even in the middle of the fading effect of the tax cuts and elevated energy prices.



Real equipment spending increased 17.2%, up from the previous quarter's growth of 14.2% increase. Favorable financial conditions, high returns to investment and the expiration of depreciation benefits supported equipment spending during the third quarter.

The trade deficit rose to $588 billion from $580 billion in the second quarter.

- **Sectoral Developments**

Industrial production rose 0.7% in October, a much larger increase than anticipated. This is the second consecutive increase this year, which has been characterized by ups and downs in industry production. Production growth was strong across market and industry groups. Manufacturing production rose 0.7% more than offsetting the 0.3% decline experienced by this sector in September.

Industrial Outlook

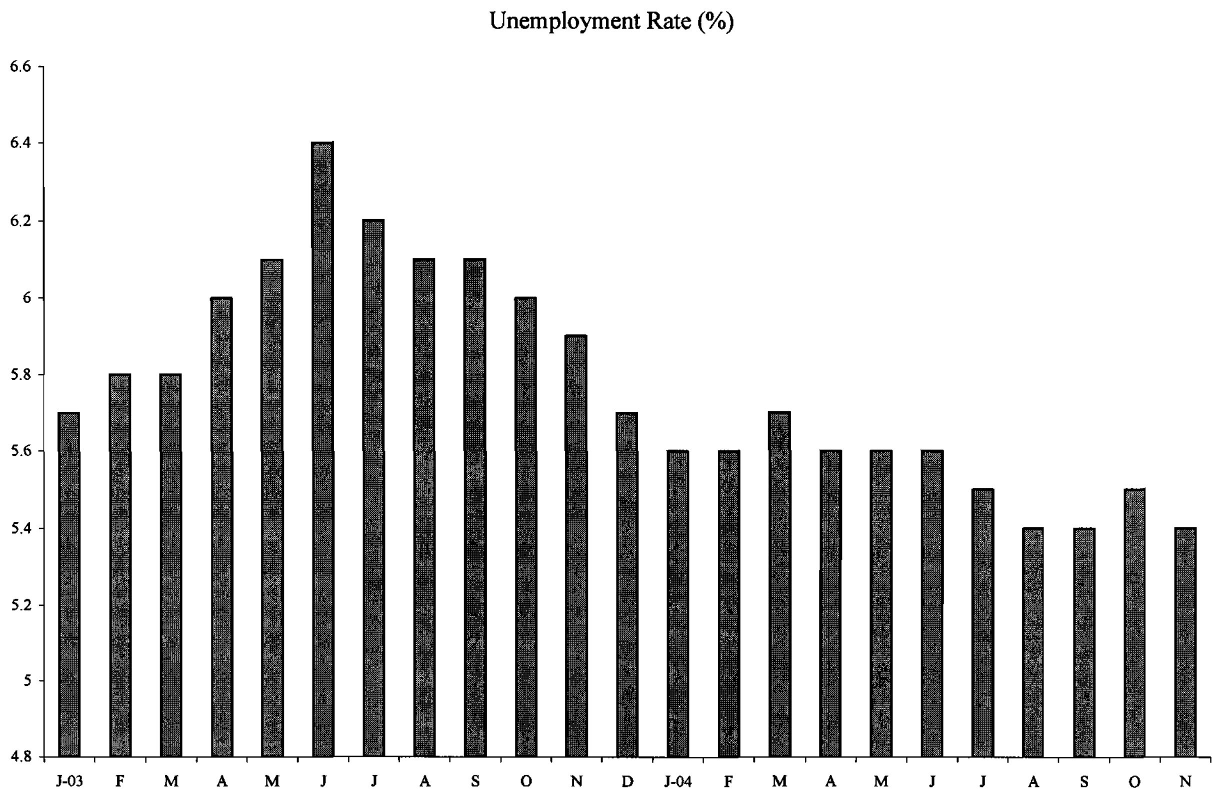
2003/2004	Total Industrial Production		Capacity Utilization Rate (%)
	Index 1997=100	Percentage Change From Previous Month	Total Industry
2003 Q1	110.5		75.2
January	110.8	0.8	75.4
February	110.7	-0.1	75.3
March	110.1	-0.5	74.8
2003 Q2	109.4		74.2
April	109.5	-0.5	74.3
May	109.5	0.0	74.3
June	109.3	-0.1	74.1
2003 Q3			
July	110.8	0.8	74.5
August	110.9	0.0	74.5
September	111.5	0.6	74.9
2003 Q4			
October	111.8	0.3	75.0
November	112.9	1.0	75.7
December	113.1	0.2	75.8
2004 Q1			
January	113.8	0.6	76.2
February	114.6	0.7	76.6
March	114.5	-0.1	76.5
2004 Q2			
April	115.3	.5	76.8
May	116.3	.9	77.4
June	115.8	-.5	76.9
2004 Q3			
July	116.7	0.7	77.4
August	116.5	-0.1	77.2
September	116.7	0.1	77.2

An important driver of industrial production was mining production that rose 0.7% after having fallen 2.4% in September, due mostly to the low oil production in the Gulf of Mexico during the harsh hurricane season.

The increase in production pushed capacity utilization higher by 0.4% to 77.7

- **Labor markets**

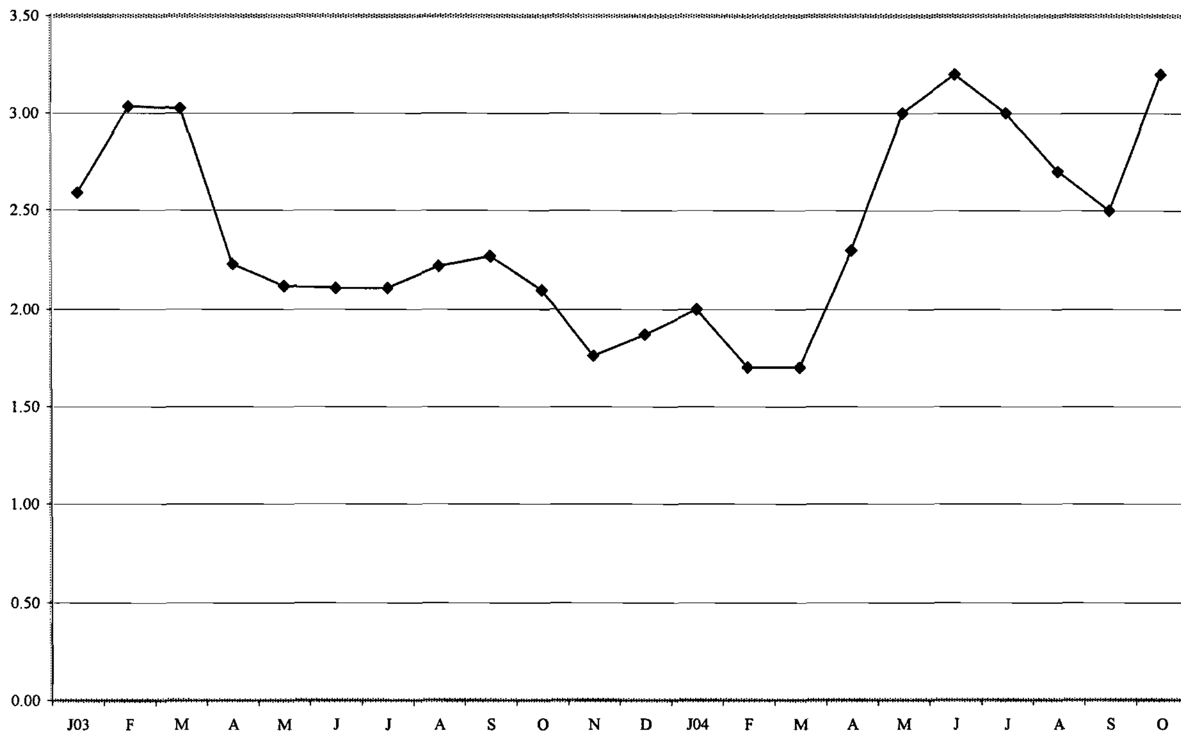
After very solid job gains in October –about 300,000-, the November employment creation number -at 112,000- was somewhat disappointing. However, the average job creation rate for the last three months was 178,000 comfortably above the 150,000 a month estimated to be needed to sustain the growing population.



The unemployment rate decreased by one tenth of a percentage point from 5.5% in October to 5.4% in November.

- **Prices and Monetary Policy**

The Federal Reserve raised the federal funds rate by a quarter-point to 2 % on November 10th. This was the fourth time this year that the Fed has raised the interest rate suggesting that it would continue to do so at a "measured pace" probably most of next year.



In the statement that accompanied their decision, the Fed showed a more upbeat tone than in their previous September meeting, pointing out that output was growing at a moderate rate and that inflation, as well as long-term inflation expectations, seemed under control. The message was ambiguous enough to accommodate expectations of either another rate hike or a pause in the tightening trend for their December 14th meeting.

Chairman Greenspan publicly acknowledged at a banking conference in Frankfurt that the level of the current account deficit is unsustainable in the long run as global investors will inevitably become satiated of dollar denominated assets pressuring down the dollar value. His comments were also interpreted as a signal that interest rates are headed up significantly in the coming months. The strength of the domestic demand growth together with a weakening currency fuel the idea of increased inflation and reinforce the view of increased tightening of monetary policy.

Dollar Adjustment

The value of the dollar against its trading partners has come down 6% since May, with an 8% adjustment against the Euro and a 7% against the Yen. This is hardly surprising given that the current account deficit of the United States has reached 5.5% of GDP, the fiscal deficit is also at unprecedented levels and monetary policy continues to be accommodative. In other words, the fundamentals almost certainly point towards a lower dollar. This puts Administration in a tough

situation: on one hand, they want the market to set the dollar in response to fundamentals but, on the other hand, they do not want to undermine confidence in the dollar and risk a stampede against it by saying that they approve of its drop. In fact, after Greenspan's speech in Frankfurt the Dow Jones fell 115 points and bonds fell as well.

Increasing the pace at which interest rates are raised could help improve fundamentals by constraining consumer and investment spending. This involves, however, the risk of stalling the solid economic recovery observed until now. Letting the dollar drop could also help control the current account deficit but it entails the risk of mostly fuelling inflation. Moreover, when the bond market begins to weaken due to a declining dollar value, yields rise and mortgage rate follow suit thus increasing the risk of stalling the economic recovery. Even more problematic seems to be the fact the if the dollar falls with the Chinese Yuan pegged to the dollar, most of the burden of the adjustment in the dollar value will fall in Europe and Japan potentially hurting their tame economic recovery, hurting US exports, and therefore aggravating the current account situation in the US.

LOOKING AHEAD

In its semiannual economic outlook, the OECD recognized that high and volatile oil prices have already taken a toll on the growth of the US and other OECD economies:

- Although the OECD continues to expect the US to lead the global recovery, it has cut its growth forecasts for 2005 from 3.7% to 3.3%. Behind the numbers is the rise in oil prices that has weakened consumer and business confidence and the forecast that if prices continue rising, governments will have to deal with oil-induced inflationary pressure by raising interest rates, hurting economic growth even further.

- The persistence of fiscal and balance of payment imbalances reinforce the risk of even higher interest rates hikes in the long run.