United Nations
Economic
Commission for
Latin America and
the Caribbean

ECLAC WASHINGTON
Office

LC/WAS/R.41

UNITED STATES ECONOMIC OUTLOOK

Quarterly Developments

Washington, D.C. April 11, 2006

U.S. ECONOMIC OUTLOOK

Estimates released on March 30 by the U.S. Department of Commerce confirmed that the U.S economy grew 3.5% in 2005, its fourth full year of growth since the 2001 recession. Growth remained steady in face of soaring energy prices, damage from powerful hurricanes, and in spite of a series of interest rate hikes by the Federal Reserve. The economy slowed down in the fourth quarter, however, growing at an annual rate of 1.7%, the lowest quarterly rate since early 2003.

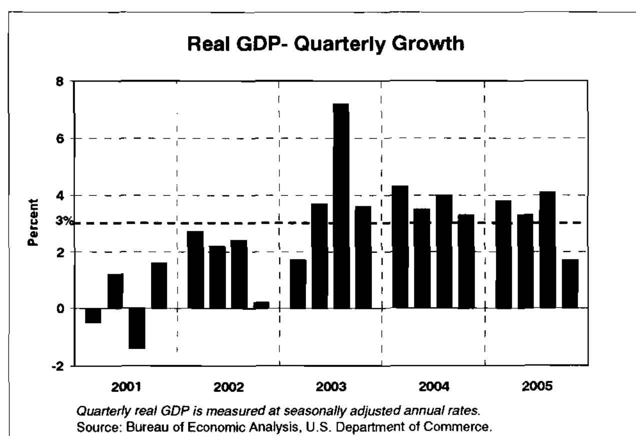
Productivity growth remained well above its historical average, although it fell at an annual rate of 0.5% in the fourth quarter. Labor markets continued to strengthen. The unemployment rate continued to decline and employers created 2 million jobs. Inflation rose substantially at mid-year, but came down by year-end, following the movements in energy prices.

The Federal Reserve remained focused on inflation and kept an optimistic view on economic growth. The Federal Open Market Committee (FOMC) continued the process of gradually removing monetary accommodation in the fourth quarter of 2005, raising short-term interest rates in November 1, to 4% and December 13, to 4.25%, the thirteenth increase since June 2004. The FOMC raised its target fed funds rate by another 25 basis points to 4.5% on January 31, 2006, softening its stance toward future monetary tightening. References to "measured" future increases were dropped, leaving room for more flexibility to avoid committing the new chairman Ben Bernanke, who took office on February 1, to a specific policy path. Ben Bernanke, at his first Fed policy meeting as chairman on March 28, inaugurated his tenure with another increase in interest rates by 25 basis points, and a hint of more to come. It was the Fed's 15th consecutive quarter-point rate increase since it began to raise rates from a 46-year low of 1% in June, 2004.

I. CURRENT ASSESSMENT

- **GDP growth**

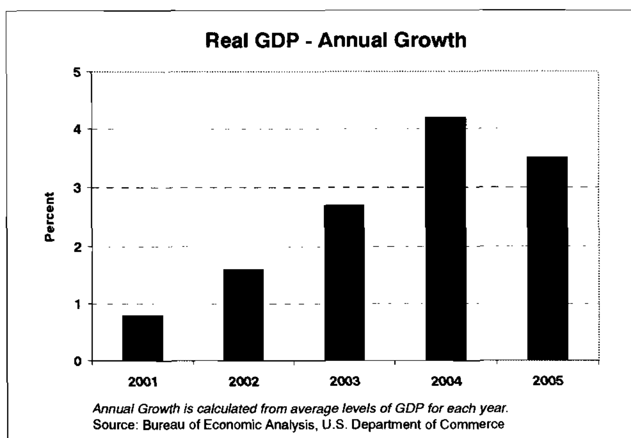
According to the final estimates released by the U.S. Department of Commerce on March 30, the U.S. economy grew at an annual rate of 1.7% in the fourth quarter of 2005, the lowest rate since early 2003, following an increase of 4.1% in the third quarter, and 10 consecutive quarters with growth above 3%.[1] The slowdown in real GDP growth reflected a deceleration in consumer spending, acceleration in imports, a downturn in federal government spending, and weaker growth in equipment-and-software and residential investment. These losses were partially offset by an increase in



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

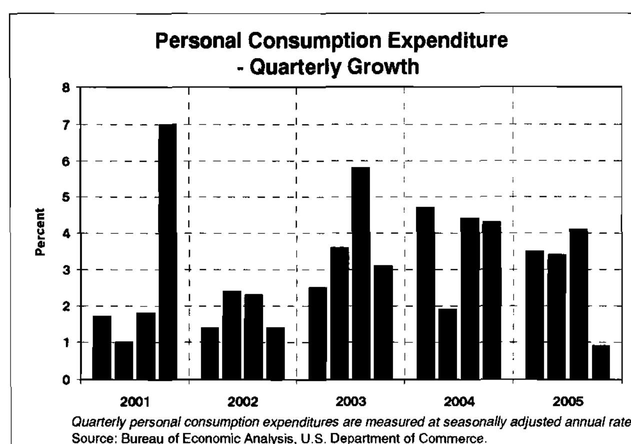
[1] The government revised economic growth for the fourth quarter of 2005 up to 1.7% from earlier estimates of 1.1% on January 27, and 1.6% on February 28, 2006. The revision was driven by stronger exports, government spending, and investment in equipment and software, while an increase in imports offset some of these gains.

inventory investment and acceleration in exports. For the year as a whole, real GDP grew 3.5% compared with 4.2% in 2004. The slowdown in GDP growth in 2005 reflected for the most part a downturn in inventory investment, and a slowdown in consumer spending and in federal government spending.



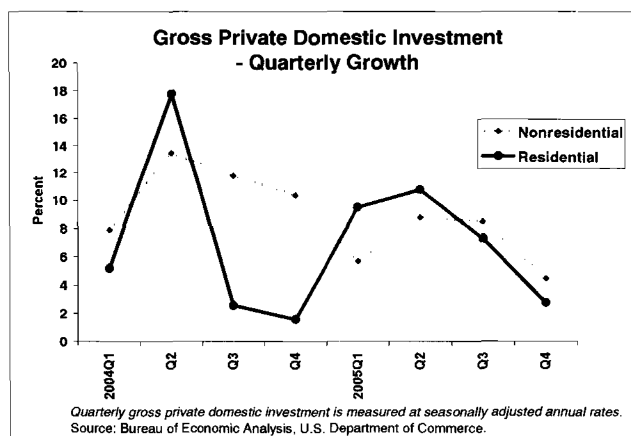
Annual Growth is calculated from average levels of GDP for each year.
Source: Bureau of Economic Analysis, U.S. Department of Commerce

Real consumer spending slowed in the fourth quarter, increasing only 0.9% – the lowest rate since the second quarter of 2001 (when real consumer spending actually increased 1%) – compared with an increase of 4.1% in the third quarter. Consumers turned away from the auto sector in the fourth quarter following the end of the summer's sales inducement and price-cutting, but while auto purchases declined, consumption expenditure excluding auto spending grew at its quickest pace since late 2003. Real personal consumption expenditures (PCE) contributed 0.62% to overall GDP growth in the fourth quarter, with motor vehicles and parts subtracting 1.92% from overall growth.



Quarterly personal consumption expenditures are measured at seasonally adjusted annual rates.
Source: Bureau of Economic Analysis, U.S. Department of Commerce.

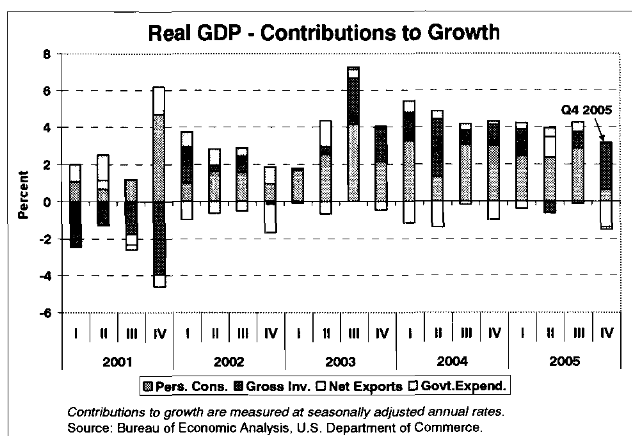
Real nonresidential fixed investment, which represents overall business spending, increased 4.5% in the fourth quarter, compared with an increase of 8.5% in the third. Real residential fixed investment increased 2.8%, compared with an increase of 7.3% in the third quarter. Total fixed investment contributed 0.65% to overall GDP growth, and the inventory building contributed 1.89%, thus gross private domestic investment contributed 2.54% to overall GDP growth.



Quarterly gross private domestic investment is measured at seasonally adjusted annual rates.
Source: Bureau of Economic Analysis, U.S. Department of Commerce.

Trade was a negative factor in the fourth quarter, with net exports of goods and services subtracting 1.36% from overall GDP growth. Real federal spending decreased 2.6% in the fourth quarter, compared to an increase of 7.4% in the third. National defense decreased 8.9% in the fourth quarter, in contrast to an increase of 10% in the third. Defense spending is often volatile, and analysts do not expect the fourth quarter drop to persist. Real government spending subtracted 0.15% from overall GDP growth.

The major reasons for the weaker GDP growth in the fourth quarter – a large decline in vehicle sales after the end of the summer's employee pricing programs and a big decline in federal defense spending – are one-time factors, and analysts predict that growth will pick up again in the first half of 2006.



Contributions to growth are measured at seasonally adjusted annual rates.
Source: Bureau of Economic Analysis, U.S. Department of Commerce.

- **Sectoral Developments**

Industrial Outlook			
2005	Total Industrial Production		Capacity Utilization Rate (%)
	Index 2002=100	Percentage Change From Previous Period	Total Industry
2005 Q1	**107.2**	**3.8**	**79.9**
January	106.9	0.2	79.8
February	107.4	0.4	80.0
March	107.3	0.0	79.9
2005 Q2	**107.6**	**1.6**	**79.9**
April	107.2	-0.1	79.7
May	107.4	0.2	79.8
June	108.3	0.8	80.3
2005 Q3	**108.0**	**1.4**	**79.8**
July	108.3	0.0	80.2
August	108.6	0.3	80.3
September	107.2	-1.3	79.1
2005 Q4	**109.5**	**5.6**	**80.6**
October	108.4	1.1	79.9
November	109.5	1.1	80.6
December	110.5	0.9	81.2
Annual	**108.2**	**3.3**	**80.1**

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

Industrial production increased 5.6% at an annual rate in the fourth quarter. On a year-over-year basis (fourth quarter 2004 to fourth quarter 2005), total industrial production increased 3.1%. Capacity utilization increased to 81.2% in December, from 79.1% in September. For the quarter as a whole, the capacity utilization rate was 80.6%, higher than in the previous three quarters.

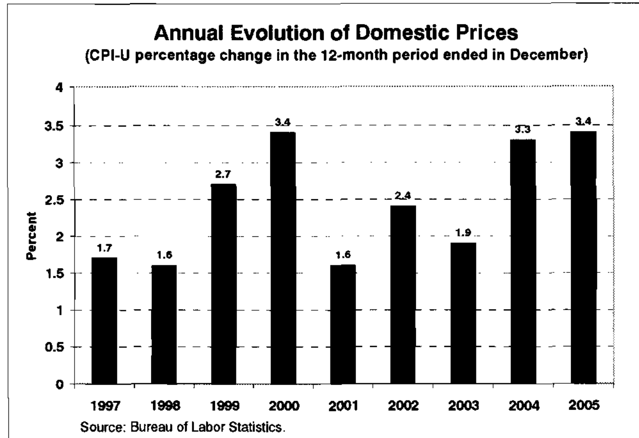
Manufacturing production increased 0.5% in December. Nondurable manufacturing production posted a 0.5% gain, and durable goods production posted a 0.4% gain. On October and November, manufacturing output increased 1.8% and 0.7%, respectively. Analysts believe output growth slowed in December because the reconstruction in the Gulf Coast had driven manufacturing surveys readings above trend early in the quarter, and in December these readings reverted to trend as the boost from reconstruction waned. For the quarter, manufacturing production increased 9%, with the production of nondurables increasing 2.1%, and of durables 15.3% at an annual rate.

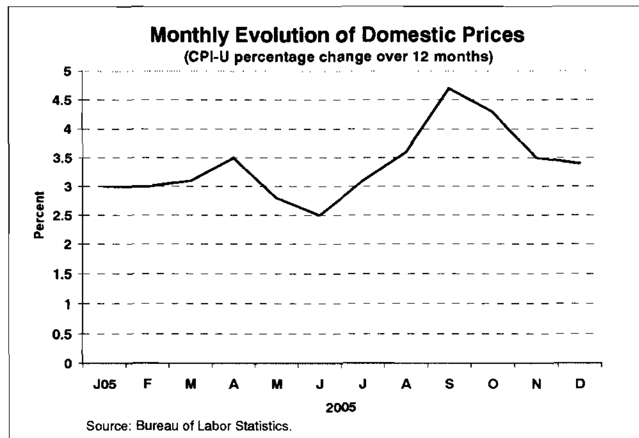
Mining production edged down at an annual rate of 12.9% in the fourth quarter, following a decrease of 14.9% in the third quarter. Mining output increased 2.8% in December, however. Utility production was up by 2.8% in December as well, as oil refineries and utilities in the Gulf Coast continue to recover from the summer's hurricanes. Utility production was down by 4.1% for the quarter, following a 13.8% gain in the third quarter.

Total industrial capacity expanded 1.8% in the fourth quarter of 2005. The rate of capacity utilization in December was a strong 81.2%, 0.2% above the 1972-2004 average.

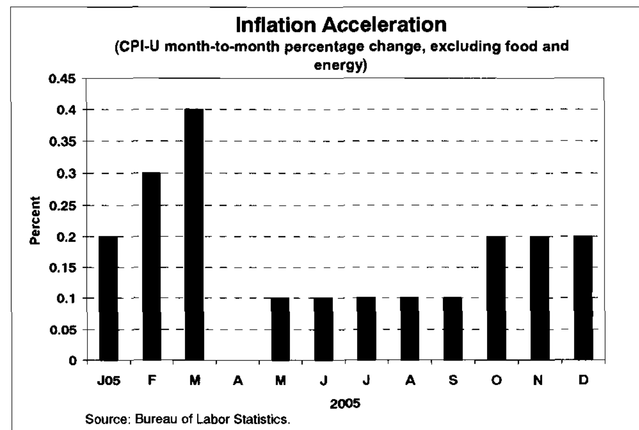
- **Inflation**

The Consumer Price Index for All Urban Consumers (CPI-U) rose at a seasonally adjusted annual rate (SAAR) of 1.6% in the fourth quarter of 2005, following increases in the first, second and third quarters at annual rates of 4.3%, 1.9%, and 9.4%, respectively. This brings the 2005 annual rate to 3.4% and compares with an increase of 3.3% in all 2004. In 2005, the energy price index rose 17.1%, following a 16.6% increase in 2004, and accounted for about 40% of the overall advance in the CPI-U. While the increases in the overall energy indexes for 2004 and 2005 were similar, the composition was different. Petroleum based energy accounted for nearly 80% of the 2004 increase in the energy component, but just over half of the 2005 increase.



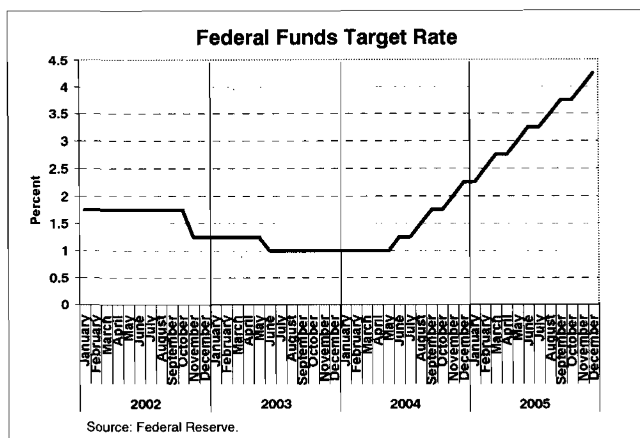


Excluding food and energy, the CPI-U advanced at a 2.8% seasonally adjusted annual rate in the fourth quarter, following increases at rates of 3.3%, 1.2% and 1.4% in the first three quarters of 2005. Core inflation remained contained at just 2.2% in 2005 (the same rate as in 2004), compared to a rate more than twice as high back in 1991. However, core inflation accelerated slightly in the fourth quarter, increasing 0.2% in each of the last three months of 2005, after growing 0.1% for five straight months. The Personal Consumption Expenditure (PCE) price index excluding food and energy, the Federal Reserve's preferred inflation measure, was up 2.4% in the fourth quarter on an annualized basis, an increase from 1.4% in the third quarter. Consistent gains above 2% would be a concern for policymakers and investors.



- **Monetary policy**

The U.S. Federal Reserve raised the federal funds target rates eight times in 2005, from 2.25% in the beginning of the year to 4.25% in December. The Federal Open Market Committee (FOMC) raised short-term interest rates on February 2, March 22, May 3, June 30, August 9,



Source: Federal Reserve.

September 20, November 1, and December 13, which was its thirteenth increase since June 2004. The committee slightly changed its view on near-term monetary policy in the December 13 release, saying that "some further measured policy firming is likely to be needed." The Fed focused on keeping inflation from reviving in 2005, 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.

The FOMC raised its target fed funds rate by another 25 basis points to 4.5% on January 31, 2006. The committee softened its stance toward future monetary tightening, saying that "some further policy firming *may* be needed," and it also dropped any references to "measured" future increases. Alan Greenspan stepped down as Fed chairman at the end of January, being succeeded by Ben Bernanke. By changing the language in its statement, Fed policymakers left room for more flexibility, avoiding committing the new chairman to further increases, but signaling that further increases remained likely, depending on the economic data. Mr. Bernanke testified to Congress for the first time since he succeeded Mr. Greenspan on February 15. He said the U.S. economy was off to a strong start in 2006 and was likely to perform well in the months ahead, despite the risks of a cooling housing market and high energy prices, reinforcing the expectations of a rate increase in March.

The Fed raised interest rates by another 25 basis points at its March 27 meeting, to 4.75%. It was its 15th consecutive quarter-point rate increase since June 2004, when it began to raise rates from a 46-year low of 1%, and it was widely expected. It was the first meeting of the FOMC chaired by Ben Bernanke. The statement noted that the slowdown in the fourth quarter was only temporary, and that the economy has "rebounded strongly in the current quarter but appears likely to moderate to a more sustainable pace." On inflation, the FOMC indicated that high energy prices had still not led to a rise in core inflation. According to the Committee, "ongoing productivity gains have helped to hold the growth of unit labor costs in check, and inflation expectations remain contained." However, they added that if the economy continued to use up spare capacity, inflationary pressures could intensify. The statement left open the possibility of a rate rise at the FOMC's next meeting. Future markets are now pricing in one more interest rate increase, up to 5%.

- **Financial markets**

Total net inflow of capital in the U.S. economy in 2005 was US$910.7 billion according to the Treasury International Capital (TIC) report, far more than the trade gap of US$725.8 billion. The Treasury Department's monthly data is increasingly popular as a sign of the ability of the U.S. to meet its external financing needs. The U.S. trade deficit hit a record in 2005, but foreigners invested more than enough in U.S. stocks and bonds to cover the gap.

However, foreign purchases of U.S. securities declined in December relative to the fast pace of recent months, falling to US$74.2 billion from US$105.7 billion in November. Subtracting the

US$17.6 billion of foreign securities that U.S. investors bought during the month brings the net inflow of portfolio capital to US$56.6 billion, the smallest amount since May, and less than the overall trade deficit, which amounted to US$ 65.1 billion in December. The decline was concentrated in Treasury bonds, with purchases slipping from US$50.81 billion to US$12.7 billion. The drop in foreign purchases of U.S. Treasury securities may have been accounted for by the smaller amount of Treasury debt that was auctioned in December. The U.S. Treasury auction calendar declined from a US$62 billion refunding in November to US$32 billion in December.

The net foreign purchases of U.S. securities were less than the overall trade deficit for the second month in a row in January of 2006, according to the latest figures on U.S. capital inflows, prompting investors to wonder about the U.S. ability to attract adequate external financing to cover its large current account deficit during the rest of the year. There has been a shift in the mix of U.S. assets being acquired by foreigners, however. While net foreign purchases of U.S. debt slowed substantially in December 2005 and January 2006, foreign appetite for U.S. stocks has strengthened, suggesting continued confidence in U.S. assets. Net foreign purchases of U.S. equities stood at US$21.2 billion in January 2006, the second highest monthly figure in the last five years.

According to analysts, given that supply pressures have not been particularly strong, demand should be a more important driver of government bond markets in 2006. Pension funds seeking assets to match long-dated liabilities are among the investor groups likely to have a significant influence. The return of the 30-year long bonds in February, after a break of more than four years (see Box 1), was an important event for investors, meaning that the supply will have record "duration". The current flatness of the yield curve could lead to even more longer-dated issuance.

After yields on 10-year U.S Treasuries fell below those on two-year notes for the first time on December 27, the possibility of a slowdown in the U.S. economy weighed on stock investors, as an inverted yield curve has often led to a recession. Fed's chairman Ben Bernanke, in a recent speech delivered in New York, said he did not interpret the narrowing gap between short and long-term rates as "indicating a significant economic slowdown," saying it might instead reflect investors' confidence in the economy. However, despite the growth implications of the inversion of the yield curve, a period with 10-year yields below two-year returns could affect financial markets because many lenders fund their longer-term lending by borrowing short-term, and this strategy becomes unprofitable with an inverted yield curve.

Box 1: The Comeback of the 30-Year Bond

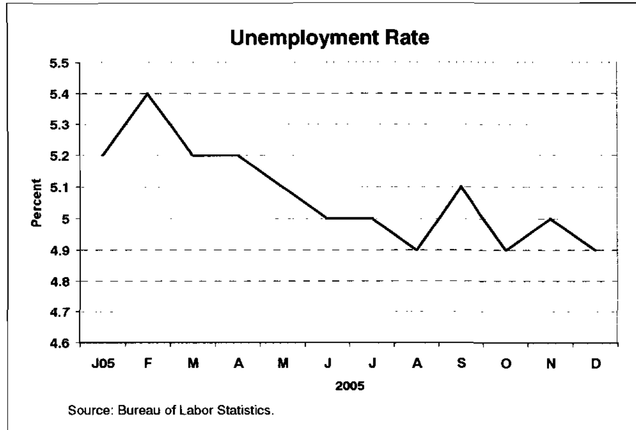
The first auction of the U.S. Treasury's 30-year bond since 2001 was met with strong demand. The sale, which took place on February 9, allowed the United States government to borrow US$14 billion at a yield of up to 4.53%. The strong demand for the 30-year bond helped pushed yields below those on two-year bonds (after the auction the yield on the 30-year bond fell to 4.50), extending the yield curve inversion that some economists have warned could be an indication of a recession. The last six recessions have all been preceded by a yield curve inversion, but not all inversions have been followed by a recession.

The demand was stronger than expected, with 65% of the bids coming from bidders other than the brokerage firms required to bid at auctions, indicating that investors like pension funds were probable buyers.

- **Labor markets**

The U.S economy created 2.019 million jobs in 2005, fewer than the 2.194 million recorded for 2004. However, considering the adverse effect of the hurricanes to the economy in late summer,

the labor market performed rather well, recovering form the hurricane dislocation much more quickly than had been expected. Among the industries that contributed most to payroll gains during the year were business/professional services (486,000), education/healthcare (36,000), and construction (246,000). During the fourth quarter 438,000 jobs were created. Fourth quarter gains were about equal to those in the third quarter, which generated 442,000, although the number of net new jobs created in December was far lower than expected.



The labor force participation ended 2005 at 66%, compared to 67% prior to the 2001 recession. In a similar fashion, the employment to population rate remained largely unchanged in the second half of the year at 62.8%, after peaking at 64.7% in the beginning of 2000. Despite some mitigating factors, the low participation and employment to population rates suggest some weakness in the labor market.

The unemployment rate fell to 4.9% in December, from 5% in November. 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.

The decline in unemployment has not led to higher wages so far. Hourly compensation rose 2.8% in the fourth quarter, after increasing 5.5% in the third quarter. When the increase in consumer prices was taken into account, real hourly compensation fell 0.4% in the fourth quarter and rose 0.3% in the third. Unit labor costs, one of the key pieces of the inflation puzzle going forward, rose 3.3% in the fourth quarter after increasing 1.2% one quarter earlier.

Productivity and costs: Revised fourth-quarter 2005 measures

(Seasonally adjusted annual rates)

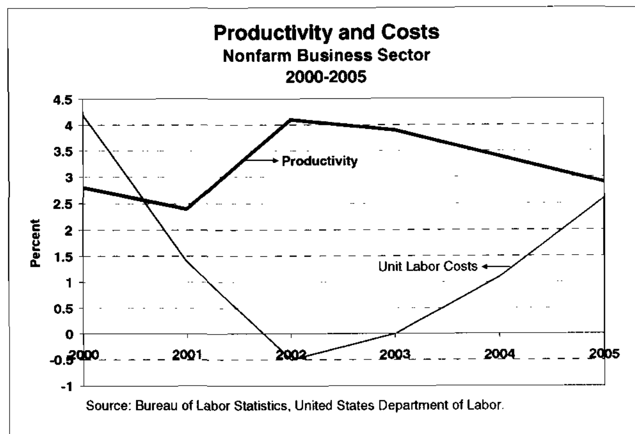
Sector	Productivity	Output	Hours	Hourly compensation	Real hourly compensation	Unit labor costs
	Percent change from preceding quarter					
Business	0.0	1.8	1.7	3.1	-0.1	3.1
Nonfarm business	-0.5	1.5	2.0	2.8	-0.4	3.3
Manufacturing	4.7	9.3	4.4	1.8	-1.4	-2.8
Durable	10.2	15.3	4.6	1.8	-1.4	-7.7
Nondurable	-2.0	2.0	4.0	1.8	-1.4	3.9

Source: Bureau of Labor Statistics.

Productivity growth for the nonfarm business sector fell at an annual rate of 0.5% in the fourth quarter, as output rose 1.5% and hours of all persons grew 2% (seasonally adjusted annual rates). This was the first quarter of negative productivity growth since the beginning of 2001. Most analysts believe the negative fourth quarter productivity growth number is transitory, and a result of various one-time factors, such as the hurricanes, high energy cost, a decline in federal government defense spending, and a big drop in durable goods consumption. Productivity growth is expected to turn positive again in the first half of 2006.

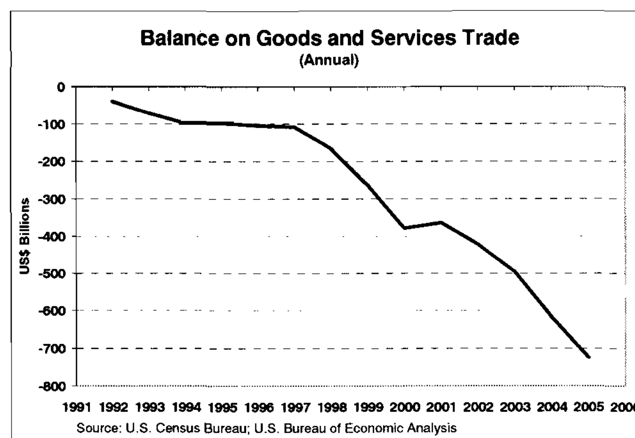
Despite the quarterly drop, productivity rose a healthy 2.9% in 2005. The 2005 growth rate brought productivity gains back to the levels of mid-to-late 1990s, when the effects of the technology boom started to kick in. Since the 2001 recession, the economy has enjoyed strong productivity growth and modest labor costs, a combination that has helped keep inflation under control. In 2002

productivity growth reached a peak, and unit labor costs a low. Since then productivity growth has been declining and unit labor costs have been rising. Unit labor costs increased 2.6% in 2005, the highest annual growth since a 4.2% jump in 2000.

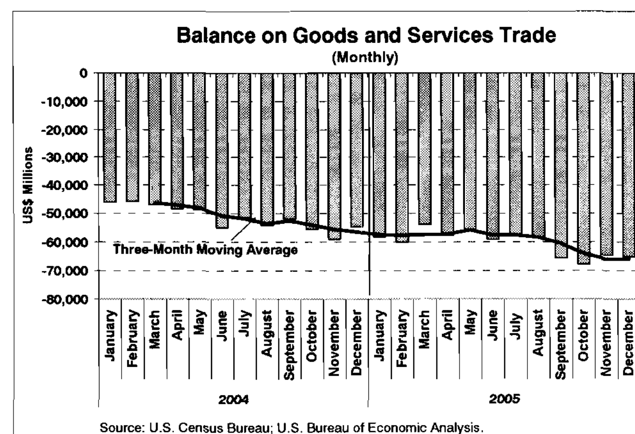


- **External sector**

According to the Bureau of Economic Analysis and the Census Bureau, the U.S. goods and services deficit widened in 2005, increasing US$106 billion from US$617.6 billion in 2004 to US$723.6 billion in 2005. Imports increased nearly twice as much as exports. As a percentage of GDP, the goods and services deficit increased from 5.3% in 2004 to 5.8% in 2005. This was the fourth consecutive annual record, with the gap between export and imports reaching almost twice the level of 2001. The deficit was driven by strong consumer demand for foreign goods and soaring energy prices that sharply increased the bill for imported oil. The current account deficit, the amount of net American borrowing from foreigners, grew by 20% in 2005 to US$804.8 billion.



The U.S. monthly goods and services deficit grew to US$65.1 billion in December, following a decrease in November, as imports increased more than exports. Fueling the December trade gap was a US$3.3 billion rise in imports, to US$177.2 billion, compared to an increase of US$2.3 billion in exports above the November level, to US$ 111.5 billion.



The goods deficit with China and the European Union decreased for November and December of 2005. The goods deficit with the European Union decreased from US$14.5 billion in October to US$10.1 billion in December. The goods deficit with China decreased from US$20.5 billion in October, to US$16.3 billion in December. Despite the declines in November and December, the deficit with China in 2005 broke the 2004 record of US$161.97 billion, reaching US$201.6 billion.

II. LOOKING AHEAD

- The Fed's new chairman Ben Bernanke, in a speech delivered in New York on March 20, addressed a key concern among investors eager to anticipate how much higher the Fed will raise the key short-term interest rate. However, according to Mr. Bernanke, "The bottom line for [Fed] policy appears ambiguous." At the current stage of the interest rate cycle it is hard to give clear guidance, particularly in the light of what his predecessor Alan Greenspan called the "conundrum" of low long-term interest rates.

- According to chairman Bernanke, "the implications for monetary policy of the recent behavior of long-term yields are not at all clear-cut." The subsequent path of short-term interest rates remains uncertain, in part because the significance of low long-term rates remains so unclear.

- On one hand, investors at the global level seem to be requiring less compensation for the risk of lending money in the long-run, because they expect low inflation and healthy economic growth to continue. In this case, the Fed would need to raise the federal funds rate to keep inflation in check, Mr. Bernanke said, because "the effect is financially stimulative and argues for greater monetary policy restraint".

- On the other hand, the existence of a "global saving glut," reflecting low levels of intended investment in the global economy relative to savings, has pushed down long-term interest rates around the world. Low long-term rates seem to reflect an increase in the demand for long-term securities by foreign central banks, oil producers, pension funds and other savers worldwide. Sluggish domestic demand growth outside the U.S., and in turn weak demand for U.S. exports, has held down global interest rates, leading to a lower federal funds rate than would otherwise be needed. According to the chairman, so long as the saving glut persists, "global interest rates (and, consequently, the neutral policy rate) will be lower than they otherwise would be." If this is the case, the Fed would end its tightening cycle sooner.

- The Fed now, according to Ben Bernanke, will await data from "multiple sources" and will use "multiple methods of analysis" to determine which policy direction to take.

- However, after 15 consecutive rate increases, the cycle of monetary tightening seems to be reaching its peak, with interest rates approaching what markets see as the "neutral" policy rate. Markets now forecast that the Fed will raise interest rates by a quarter point one more (and last) time at its next FOMC meeting on May 10, stopping the current tightening cycle at 5%.

- Finally, U.S. external imbalances remain large. The U.S. trade deficit jumped to US$68.5 billion in January 2006, far surpassing expectations and reaching another record. The deterioration was spread across a range of sectors, from capital goods to consumer goods and industrial supplies. The 2005 and January 2006 figures raise the prospect that the trade deficit will be a large drag on economic growth in the first months of 2006.