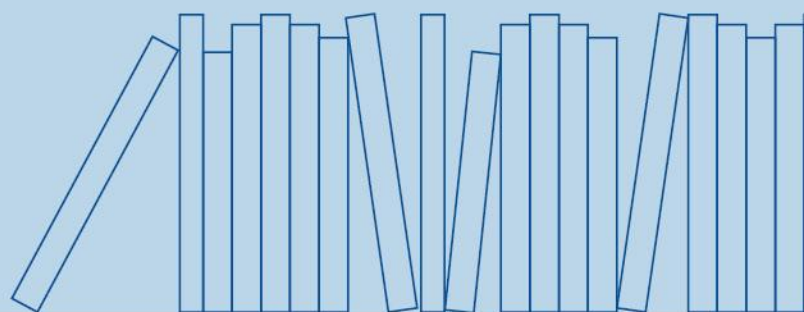


Economic Commission for Latin America and the Caribbean
ECLAC OFFICE IN WASHINGTON, D.C.



U.S. Economic Outlook

Quarterly developments



UNITED NATIONS



Washington, D.C., 7 July 2017

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Highlights

- In the first quarter of 2017, the U.S. economy grew at an annualized rate of 1.4%. Fixed investment was the main driver of growth, while inventories were a large drag. Consumer spending slowed significantly from its pace in previous quarters, but still accounted for about half of GDP growth in the first quarter.
- U.S. employers added a seasonally adjusted 1,079,000 jobs during the first six months of 2017, the weakest first-half performance since 2010, according to data the Labor Department, although this was only 2,000 fewer jobs than in the first half of last year.
- Productivity was flat in the first three months of the year. Slumping productivity gains have led to disappointing real GDP growth this expansion.
- Unit labor costs rose 2.2%. Hourly compensation, encompassing everything from salaries to retirement benefits and health care costs, also rose at a 2.2% annual rate in the first quarter.
- Over the last 12 months, the all items Consumer Price Index rose 1.9% before seasonal adjustment. The core CPI was up 1.7% on the year. Core inflation appears to have moderated, as year-over-year growth was weaker than the 2.2% gain in May 2016.
- Regarding the external sector, the current account deficit, the broadest measure of U.S. trade with the rest of the world, widened to US\$ 116.8 billion in the first quarter of 2017, an increase of US\$ 2.8 billion. In May, the U.S. trade deficit narrowed 2.3% to a seasonally adjusted US\$ 46.51 billion, as exports rose to their highest level in more than two years.
- The Federal Open Market Committee (FOMC) raised interest rates by a quarter point two times in the first half of 2017: in March and in June. Minutes of the June meeting suggest that the Fed's plans for the second half of the year are less clear.

Overview

The U.S. economic expansion remains on track as it prepares to enter its ninth year. June marked the 96th month of growth for the U.S. economy, which completed 8 years of expansion so far. In two years the current economic expansion will be the longest on record.¹ Forecasters surveyed by the Wall Street Journal in early June saw just a 16% probability, on average, of a new recession beginning within the next year. The unemployment rate sits at 4.3%, the lowest level in 16 years, suggesting the economy has reached, or nearly reached, full capacity.

Gross domestic product expanded at a seasonally and inflation-adjusted annual rate of 1.4% in the first quarter of 2017, according to the Commerce Department's third and final estimate released at the end of June. First-quarter GDP was initially reported at an anemic 0.7%, but was revised up in subsequent months. Fixed investment was the main driver of growth (contributing 1.71% to growth in the first quarter), while inventories were a large drag (chart 1).

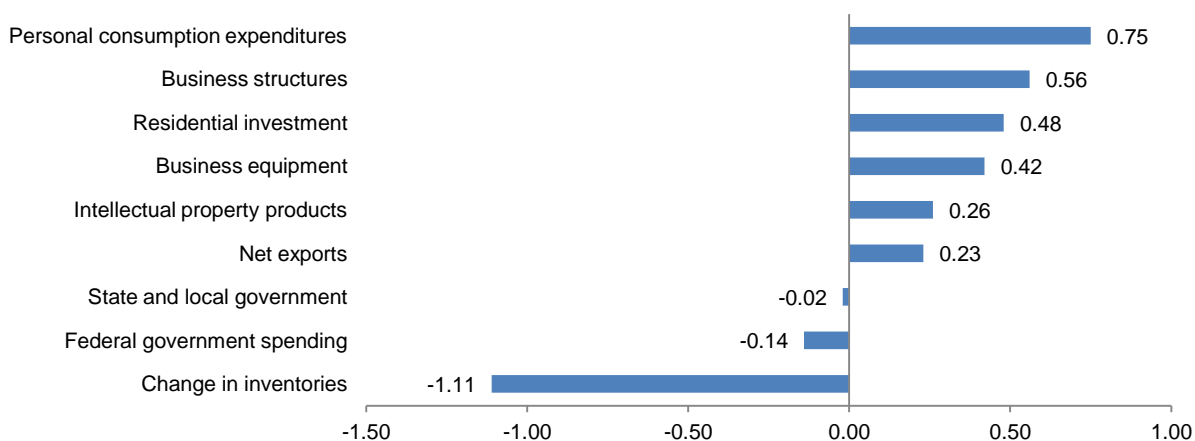
First-quarter growth figures have repeatedly disappointed in recent years, prompting economists to warn that seasonal-adjustment problems may be causing distortions. The Commerce Department has said it is working to address the issue. Quarterly forecasts for the rest of the year show slightly higher growth. The U.S. government will release its first official estimate for second-quarter GDP on July 28.

In Mid-June, Federal Reserve Chair Janet Yellen said that “following a slowdown in the first quarter, economic growth appears to have rebounded, resulting in a moderate pace of growth so far this year.” On average, markets project that the U.S. economy will grow at a 3% rate in the second quarter, and 2.4% and 2.2% in the third and fourth quarters, respectively, with most forecasts made in June (table 1).

Although forecasters do not envision a recession beginning within the next year, there are reasons for caution. The labor market is at full strength, asset prices are frothy, monetary policy is tightening, and implied volatility has been low, suggesting a pervasive sense of calm in financial markets. Those are conditions that have anticipated most previous recessions.

¹ The economic expansion that began in July 2009 is already the third-longest growth run in U.S. history; only the expansions of the 1960s and 1990s were longer.

CHART 1:
CONTRIBUTIONS TO U.S. GROWTH: Q1 2017
(Percentage Points)



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

TABLE 1:
QUARTERLY FORECASTS FOR U.S. ECONOMIC GROWTH

	Q2 2017 (qoq)	Q3 2017 (qoq)	Q4 2017 (qoq)	Date of Forecast
What Markets Say				
Bank of America/Merrill Lynch	2.5%	2.3%	2.3%	Jun-17
Credit Suisse	2.6%	2.3%	2.4%	Apr-17
J.P. Morgan	3.0%	1.8%	1.8%	Jun-17
Moody's Economy.com	3.1%	2.7%	2.5%	Jun-17
Mortgage Bankers Association	2.9%	2.3%	2.1%	Jun-17
National Association of Realtors	3.6%	2.7%	2.4%	Jun-17
National Bank of Canada	3.4%	2.1%	2.0%	Jun-17
TD Bank Financial Group	3.1%	2.5%	2.0%	Jun-17
Wells Fargo/Wachovia	2.5%	2.9%	2.6%	Jun-17
Forecasts average	3.0%	2.4%	2.2%	

Source: ECLAC, on the basis of several market sources.

A tightening in monetary policy has preceded every recession. The Fed has raised rates three times since December and central banks in Britain, the Euro zone and Canada all hinted that years of easy money are coming to an end. Implied volatility in bonds, stocks, currencies and gold sits near its lowest level since mid-2007, the eve of the financial crisis, according to a composite measure maintained by Variant Perception, a London-based investment advisory. Similarly, when unemployment got nearly this low in 1989 and again in 2006, a recession was about a year away.²

Although today's conditions do not suggest a recession or a market slowdown, they expose vulnerabilities that make either more likely in the face of some catalyzing event. When growth is steady and interest rates are low for a long period of time, there is always a risk that investors and businesses become complacent. Even with muted economic growth, stocks are trading at 22 times the past year's earnings, a historically high. Home prices also have returned to their pre-crisis peaks in major U.S. cities. Companies meanwhile have increased borrowing, often to buy back stock or pay dividends. Corporate debt as a share of economic output is at levels last seen just before the past two recessions.

² See Greg Ip, "Why Soaring Assets and Low Unemployment Mean It's Time to Start Worrying," *Wall Street Journal*, 5 July 2017.

On the other hand, some things are different this time. Banks are healthier, as the recent stress tests done by the Federal Reserve attested. All 34 institutions that are checked annually for financial soundness by the Fed got a passing grade at the end of June, the first all-clear since the tests began in 2011. “Elevated asset valuation pressures today may be indicative of rising vulnerabilities tomorrow,” Fed Vice Chairman Stanley Fischer warned recently. But if asset prices fall, they probably won’t take banks down with them.

Another difference is inflation, which remains low, rather than too high as in previous cycles. It is less likely that central banks will have to raise interest rates sharply or rapidly. However, this backdrop of lower inflation and lower growth makes it harder for businesses to climb out of debt, and interest rates may have an effect at lower levels than before. This confronts the Federal Reserve with a dilemma. It will be tricky to hike interest rates up to 3% as planned if bond yields continue to rover around 2% to 2.5%. On the other hand, if the Fed does not raise interest rates as planned, it could perpetuate excesses that make the economy more vulnerable to a growth reversal.

The U.S. economy grew 1.6% in 2016, and growth is now expected to accelerate to more than 2% this year (table 2). U.S. consumer price inflation was 1.3% last year, but according to market projections, the CPI is expected to increase at a 2.2% rate on average in 2017. However, forecasts cannot capture the uncertainty surrounding the economic policy and legislative landscape. What the U.S. economic policy-mix will be is still not clear, as well as what its domestic and global repercussions may be.

**TABLE 2:
ANNUAL FORECASTS FOR U.S. ECONOMIC GROWTH**

		Real GDP (% change, y/y)		CPI (% change, y/y)		Unemployment Rate (%)		FED Funds Rate (%)		Date of Forecast
		2017	2018	2017	2018	2017	2018	2017	2018	
A. What Government Agencies Say										
	FED*	2.2%	2.1%	1.7%	2.0%	4.3%	4.2%	1.4%	2.1%	Jun-17
	CBO	2.3%	2.0%	2.4%	2.3%	4.6%	4.4%	<i>na</i>	<i>na</i>	Jan-17
	OMB	2.3%	2.4%	2.6%	2.3%	4.6%	4.4%	<i>na</i>	<i>na</i>	May-17
B. What Markets Say										
	Bank of America/Merrill Lynch	2.1%	2.1%	1.9%	1.7%	4.4%	4.2%	1.38%	2.13%	Jun-17
	Credit Suisse	2.3%	2.2%	2.3%	2.1%	4.6%	4.4%	<i>na</i>	<i>na</i>	Apr-17
	JPMorgan	2.1%	1.8%	2.1%	2.1%	4.4%	4.1%	<i>na</i>	<i>na</i>	Jun-17
	Moody's Economy.com	2.3%	2.7%	2.2%	2.4%	4.4%	4.1%	1.0%	1.9%	Jun-17
	Mortgage Bankers Association	2.1%	1.9%	2.4%	2.3%	4.3%	4.1%	1.38%	2.38%	Jun-17
	National Association of Realtors	2.4%	2.4%	2.3%	2.2%	4.6%	4.4%	1.0%	1.8%	Jun-17
	National Bank of Canada	2.2%	2.4%	2.3%	2.2%	4.5%	4.4%	1.50%	2.25%	Jun-17
	TD Bank Financial Group	2.2%	2.1%	2.1%	2.2%	4.4%	4.2%	1.25%	1.88%	Jun-17
	The Economist Intelligence Unit	2.0%	2.1%	2.3%	1.9%	4.4%	4.2%	<i>na</i>	<i>na</i>	Jun-17
	Wells Fargo/Wachovia	2.2%	2.7%	2.2%	2.1%	4.4%	4.1%	1.31%	1.88%	Jun-17
	Market Average	2.2%	2.2%	2.2%	2.1%	4.4%	4.2%	1.3%	2.0%	
C. What International Organizations Say										
	United Nations DESA (Baseline)	2.1%	2.1%	2.3%	2.4%	4.8%	4.8%	<i>na</i>	<i>na</i>	May-17
	World Bank	2.1%	2.2%	<i>na</i>	<i>na</i>	<i>na</i>	<i>na</i>	<i>na</i>	<i>na</i>	Jun-17
	OECD	2.1%	2.4%	2.5%	2.2%	4.6%	4.3%	<i>na</i>	<i>na</i>	Jun-17
	IMF*	2.1%	2.1%	1.8%	2.0%	4.3%	4.3%	<i>na</i>	<i>na</i>	Jun-17

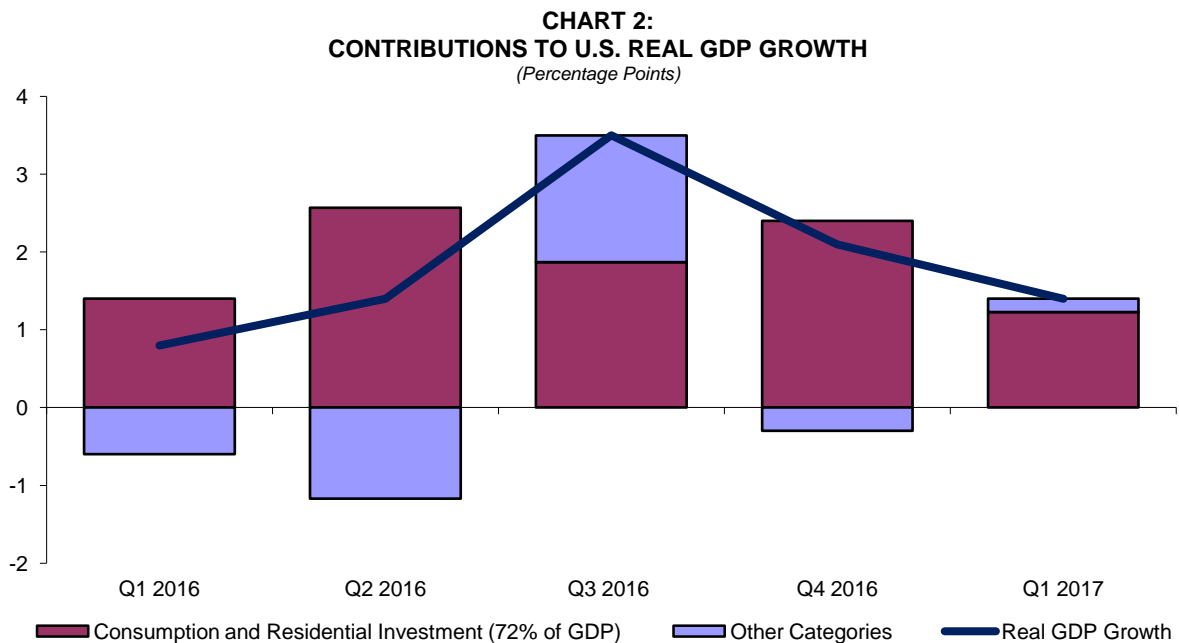
Source: ECLAC on the basis of official and market sources.

Note: FED: Federal Reserve; CBO: Congressional Budget Office; OMB: Office of Management and Budget (U.S. Administration's forecasts).

*Forecast for PCE inflation.

I. Quarterly Developments

U.S. growth slowed in the first quarter of 2017, but first-quarter growth figures have repeatedly disappointed in recent years, prompting warnings that seasonal-adjustment problems may be causing distortions. The core of the U.S. economy – consumption and residential investment – remained resilient (chart 2), but consumer spending slowed relative to the pace in previous quarters. On the positive side, however, business investment was a driver of economic growth, contributing 1.24%, while in the first quarter of 2016 it subtracted from growth.



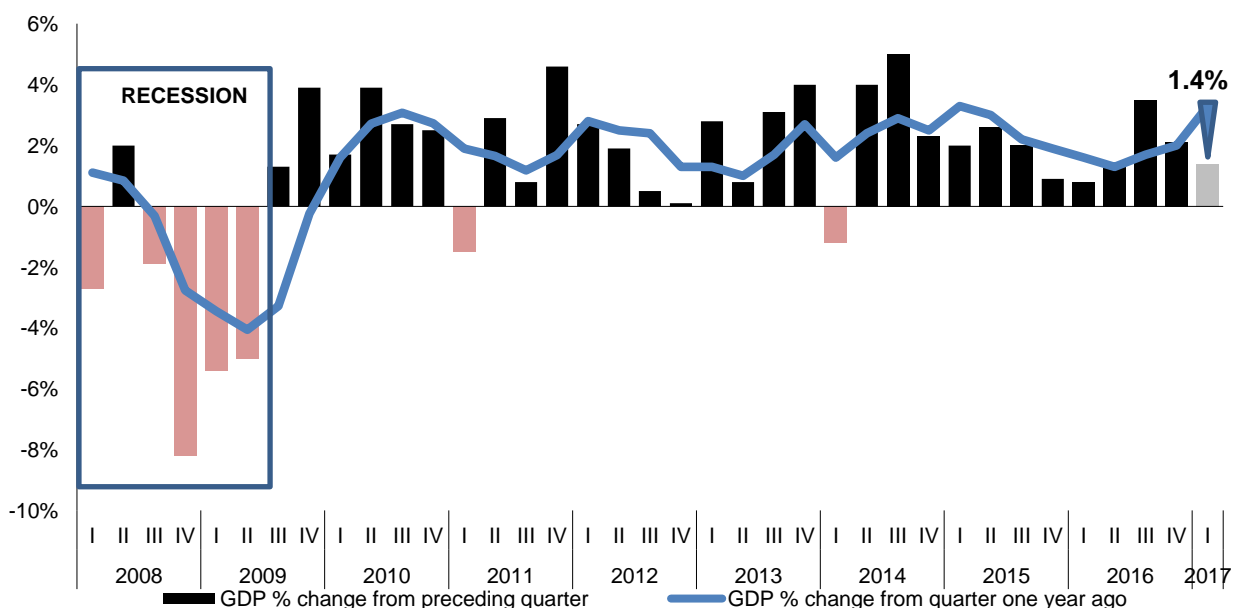
Source: ECLAC, on the basis of data from the Bureau of Economic Analysis, U.S. Department of Commerce.

Note: Contributions to growth are measured at seasonally adjusted annual rates.

A. GDP Growth

According to the third estimate released by the U.S. Department of Commerce on 29 June 2017, the U.S. economy grew at an annual rate of 1.4% in the first quarter, following an increase of 2.1% in the previous quarter. It has followed a similar pattern to recent years, with a sharp slowdown early in the year (chart 3). As first quarter growth has been soft for several years, some analysts believe the weakness may be coming from problems in seasonal adjustment. Growth seems to be already surging in the second quarter. Nonresidential fixed investment, exports, consumer spending, and residential fixed investment made positive contributions to growth in the first quarter that were partly offset by negative contributions from private inventory investment, federal government spending, and state and local government spending. Imports, which are a subtraction in the calculation of GDP, increased.

CHART 3:
U.S. REAL GDP: QUARTERLY GROWTH
(Percentage Points)



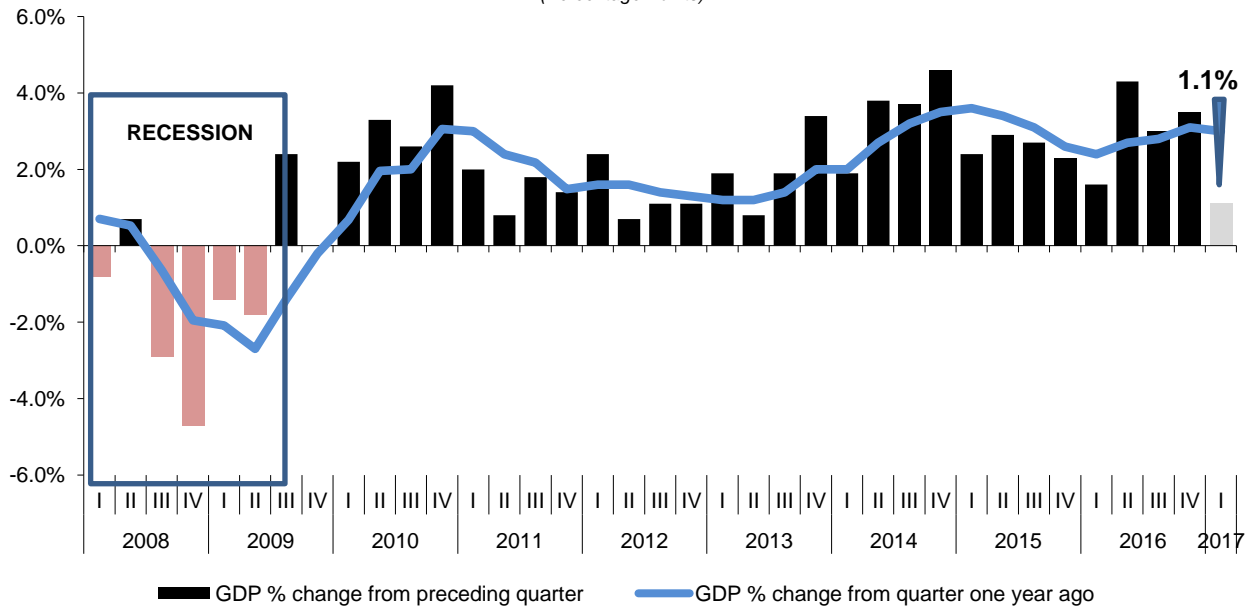
Source: ECLAC, on the basis of data from the Bureau of Economic Analysis, U.S. Department of Commerce.

The largest component of GDP, real personal consumption expenditures, grew 1.1% in the first quarter, following an increase of 3.5% in the fourth quarter of 2016 (chart 4). Consumer spending was a modest driver of growth, contributing 0.75% to growth. This was down from the 2.4% contribution in the fourth quarter. Stronger and higher-quality job growth in recent years, low borrowing costs and record low debt service burdens, rebounding housing prices, and lower oil prices have supported consumer spending.

Fixed investment contributed 1.7% to growth in the first quarter, led by structures, residential and equipment investment. Real residential investment rose at a 13% pace (contributing 0.48% to first-quarter growth), following an increase of 9.6% in the previous quarter (chart 5). The invigorated housing market has provided a boost to the economy. Real nonresidential fixed investment, which represents overall business spending, increased at a 10.4% annual rate in the first quarter, following a small increase of less than 1% in the previous quarter (it added 1.23% to first-quarter growth). Investment in nonresidential structures increased 22.6% (contributing 0.56% to first-quarter growth), following a decline of 1.6% in the fourth quarter of 2016. Investment in equipment increased 7.8%, after increasing 1.9% in the fourth

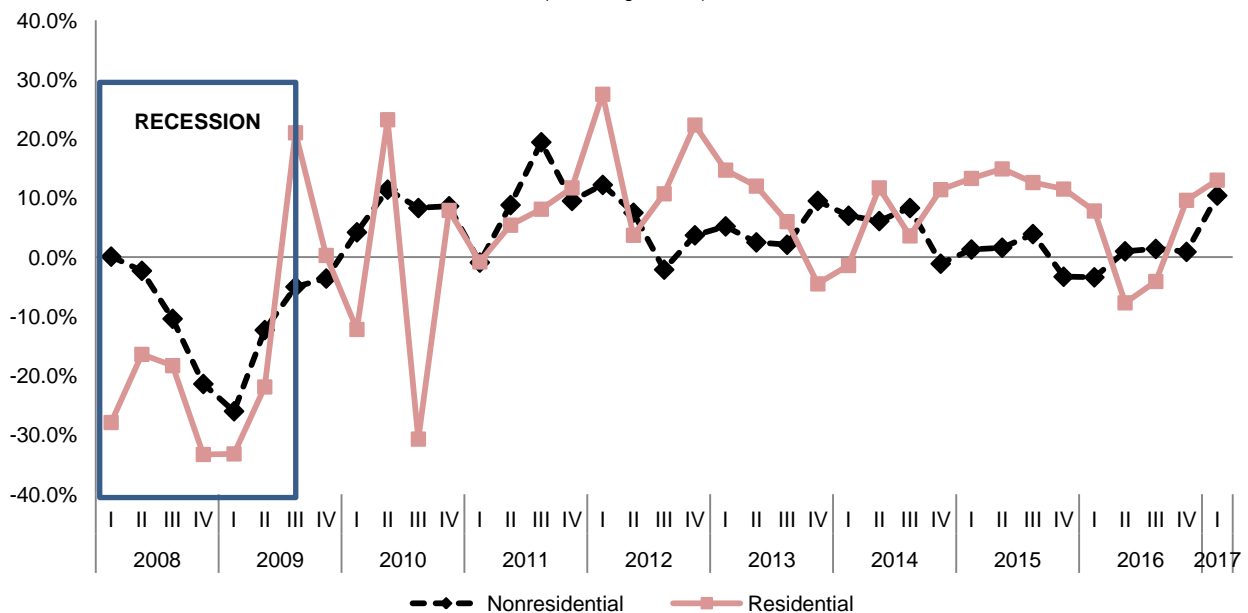
quarter (contributing 0.42% to first-quarter growth). Investment in intellectual property products – including software, R&D, entertainment, literary and artistic originals – increased 6.4%, following a smaller increase of 1.3% in the fourth quarter (contributing 0.26% to first-quarter growth). Fixed investment was the main driver of growth in the first quarter.

CHART 4:
PERSONAL CONSUMPTION EXPENDITURE: QUARTERLY GROWTH
(Percentage Points)



Source: ECLAC, on the basis of data from the Bureau of Economic Analysis, U.S. Department of Commerce.

CHART 5:
GROSS PRIVATE DOMESTIC INVESTMENT: QUARTERLY GROWTH
(Percentage Points)

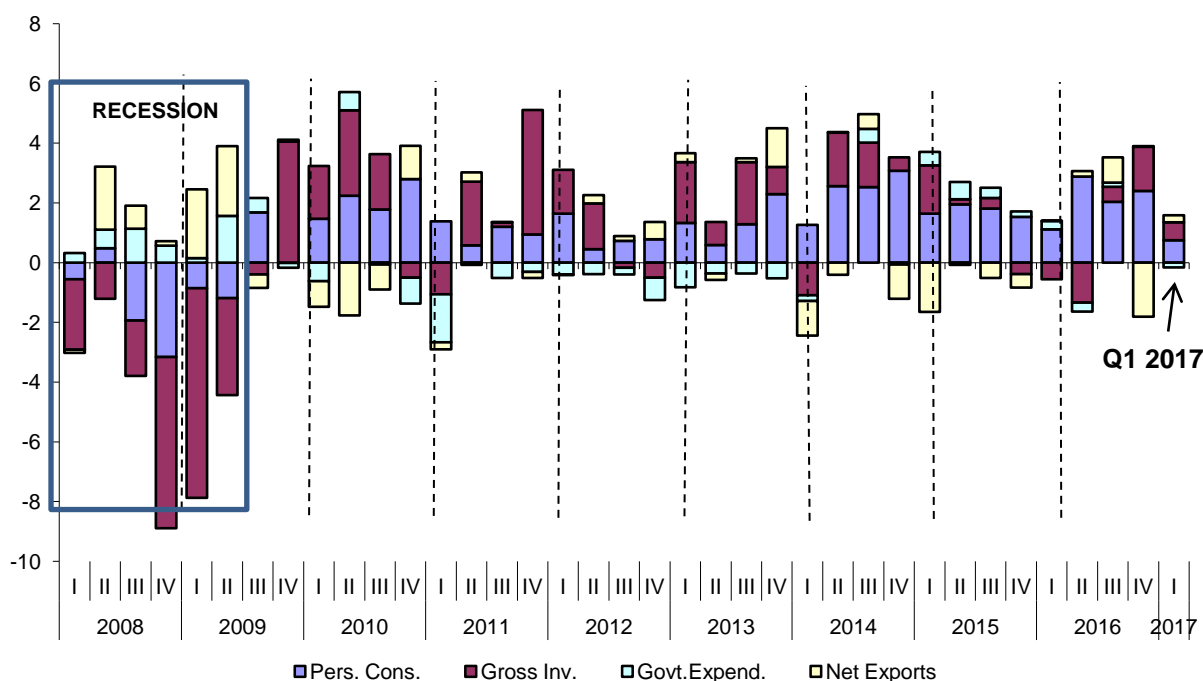


Source: ECLAC, on the basis of data from the Bureau of Economic Analysis, U.S. Department of Commerce.

The change in private inventories subtracted 1.11% from the first quarter change in real GDP, after adding 1.01% to growth in the previous quarter. Overall, gross private domestic investment increased at a 3.7% annual rate in the first quarter, adding 0.60% to first-quarter GDP growth (with 1.71% due to business fixed investment – 1.23% from nonresidential and 0.48% from residential – and -1.11% due to inventories). Real final sales – GDP excluding the change in inventories – expanded at a 2.6% pace, up from the 1.1% pace in the previous quarter.

Total government consumption was a negative to growth in the first quarter. Overall, government spending declined 0.9% and subtracted 0.16% from growth in the first quarter. State and local government spending declined 0.2% and federal outlays declined 2% in the first quarter (national defense spending fell 3.9%, while nondefense spending increased 0.7%). Finally, net exports added 0.23% to growth in the first quarter. Exports increased 7% and imports 4.4% (chart 6).

CHART 6:
CONTRIBUTIONS TO REAL GDP GROWTH
(Percentage Points)



Source: ECLAC, on the basis of data from the Bureau of Economic Analysis, U.S. Department of Commerce.

Note: Contributions to growth are measured at seasonally adjusted annual rates.

In summary, the third estimate of GDP growth in the first quarter was revised up, but it still looks disappointing, although other indicators, employment in particular, point to economic strength. When allowance is made for residual seasonality, unseasonable weather, and late tax refunds, much of the slowing in growth can be explained by temporary factors. Despite the moderation in quarterly growth, the U.S. expansion enjoyed its eighth birthday in June. Final sales grew at an above-average pace, thus trend growth remains at the pace it has kept throughout this eight-year expansion. The U.S. expansion has been remarkably stable in the recent years. With the economy seemingly at full employment and monetary policy expected to tighten further, the expansion is likely entering its later stages.

B. Industrial production

The latest report on industrial production did not show overall gains but provided more evidence that the U.S. economy is now on healthier ground than this time last year, with both manufacturing and mining in a better place than a year earlier. Industrial production remained flat in May, falling short of the consensus, but the change for April was revised slightly higher. This marks the fourth consecutive month in which production has not declined. Manufacturing production lost 0.4% and kept overall production from advancing higher. Mining output advanced 1.6%, whereas utilities output rose 0.4%. Capacity utilization edged 0.1 percentage point lower (table 3).

**TABLE 3:
U.S INDUSTRIAL PRODUCTION**

	Total Industrial Production		Capacity Utilization Rate
	Index 2012=100	Percentage Change From Previous Period	Total Industry (%)
2016 Q4	103.3	0.7	75.8
October	103.2	0.2	75.7
November	102.9	-0.2	75.5
December	103.8	0.8	76.0
Annual	103.1	-1.2	75.7
2017 Q1	103.7	1.5	75.8
January	103.5	-0.3	75.7
February	103.7	0.3	75.9
March	103.9	0.1	75.9
2017 Q2			
April	105.0	1.1	76.7
May	105.0	0.0	76.6

Source: U.S. Federal Reserve, Industrial Production and Capacity Utilization

Note: Quarterly changes are at annual rates. Annual changes are calculated from annual averages.

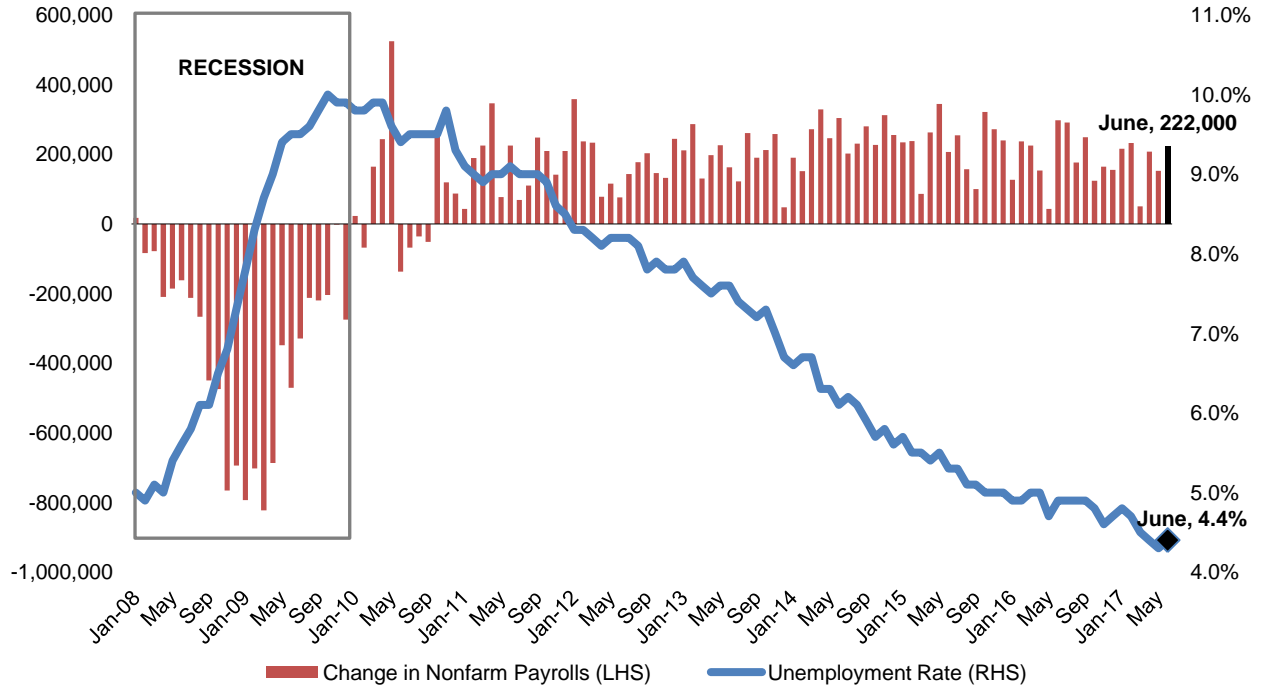
C. Labor market

The U.S. economy added 222,000 jobs in June, exceeding expectations, while the figures for the prior two months were revised higher by a total of 47,000. Employers added on average 194,000 each month from April to June, about twice what is needed to keep pace with the growth in the working age population. The average jobs growth for the first quarter of 2017 was 166,000 a month, while the average gains for the first half of 2017 are 180,000 a month. In 2016, the economy added 187,000 jobs per month on average.

The 222,000 headline number was boosted by an unusual source: the public sector, which added 35,000 jobs. That's the highest number in a year, and a number that has pushed public payrolls to their highest level since 2010, according to BMO Capital Markets.

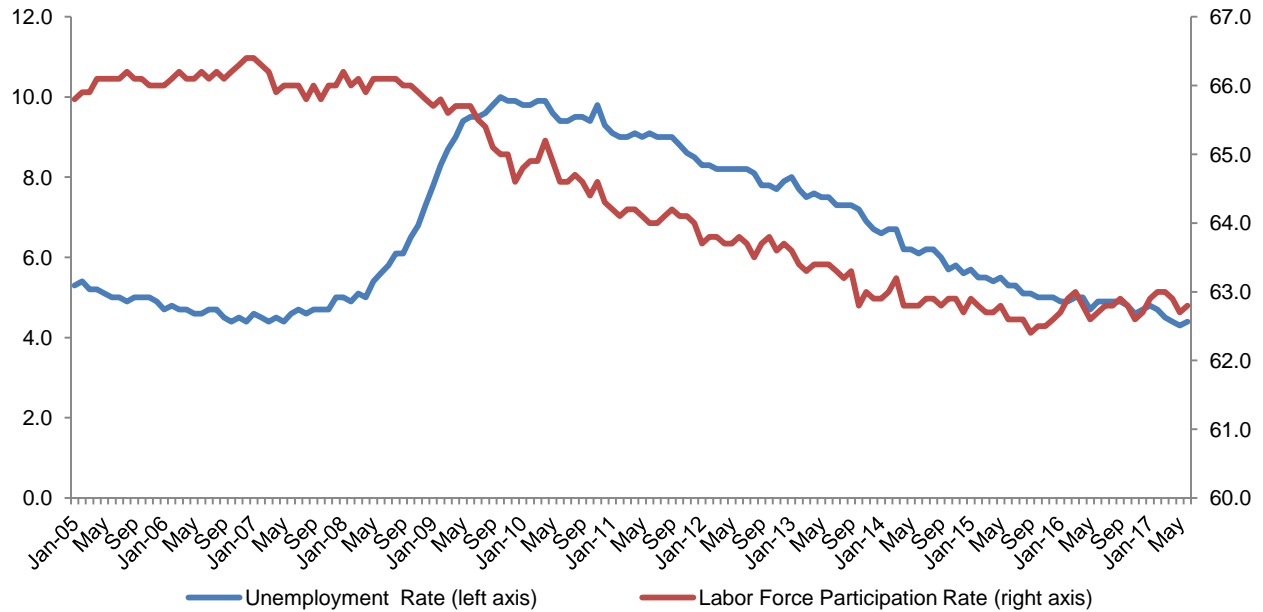
The unemployment rate edged higher to 4.4% as more workers entered the labor force (chart 7). Wage growth still remains modest, rising by only 0.2% during the month for an annual gain of 2.5%, same as in May. In May, the unemployment rate had fallen to 4.3% from 4.4% in April. That was the lowest level since 2001, but the decline was driven by people leaving the labor force, rather than buoyant hiring. The labor force participation rate increased to 62.8% in June from 62.7% in May. The labor force participation rate has shown no clear trend over the past year (chart 8). The employment-population ratio (60.1%) was also little changed in June and has held fairly steady thus far this year.

**CHART 7:
THE U.S. LABOR MARKET**
(Average Monthly Job Growth (left axis); Percentage Points (right axis))



Source: ECLAC, on the basis of data from the U.S. Bureau of Labor Statistics.

**CHART 8:
U.S. UNEMPLOYMENT RATE AND LABOR FORCE PARTICIPATION**
(Percentage Points)



Source: ECLAC, on the basis of data from the U.S. Bureau of Labor Statistics.

With not enough credit growth and sluggish business formation, the U.S. economy is suffering from stalled productivity. Nonfarm productivity was unchanged in the first quarter of 2017. Nonfarm business output increased 1.7% and employee hours were up 1.7% from the preceding quarter. Hourly compensation increased 2.2% in the first quarter of 2017, and unit labor costs also increased 2.2% (table 4, chart 9). On a year-ago basis, unit labor costs were up 1.1% in the first quarter while productivity increased 1.2%.

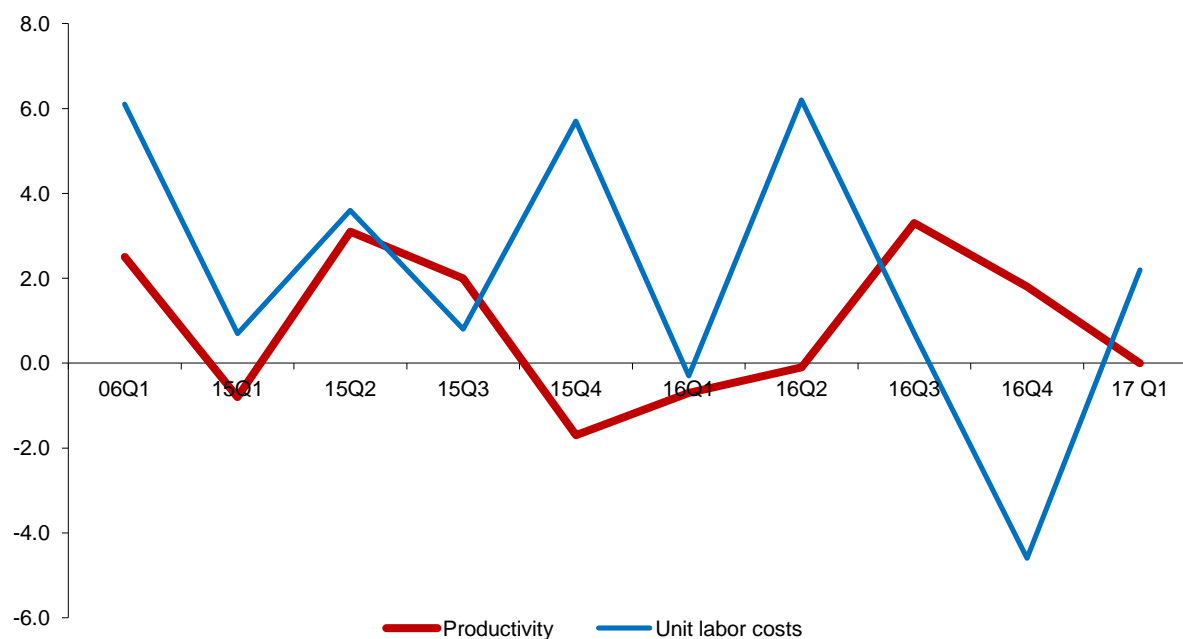
Because of the volatility, the longer trend is important, but it isn't encouraging. Productivity increased at an average annual rate of 0.6% from 2011 to 2016, well below the long-term rate of 2.1% from 1947 to 2016. The weak trend in productivity will take time to improve significantly. Among the possible reasons for depressed productivity growth are measurement issues, labor mismatching, weak business formation, regulation, low labor costs, an aging population, and the availability of credit.

**TABLE 4:
U.S. PRODUCTIVITY AND COSTS**

Revised first quarter 2016 annual averages (Seasonally adjusted annual rates)						
Sector	Productivity	Output	Hours	Hourly compensation	Real hourly compensation	Unit labor costs
Percent change from preceding quarter						
Nonfarm business	0	1.7	1.7	2.2	-0.9	2.2
Business	-1	1.1	2.2	1.6	-1.5	2.7
Manufacturing	0.5	2.6	2.1	2.9	-0.3	2.4
Durable	-0.7	2.9	3.6	1.7	-1.4	2.4
Nondurable	2.7	2.3	-0.4	4.9	1.7	2.1

Source: ECLAC, on the basis of data from the U.S. Bureau of Labor Statistics.

**CHART 9:
U.S. NONFARM BUSINESS SECTOR: PRODUCTIVITY VS UNIT LABOR COSTS**
(Percentage Change from Previous Quarter at Annual Rates)

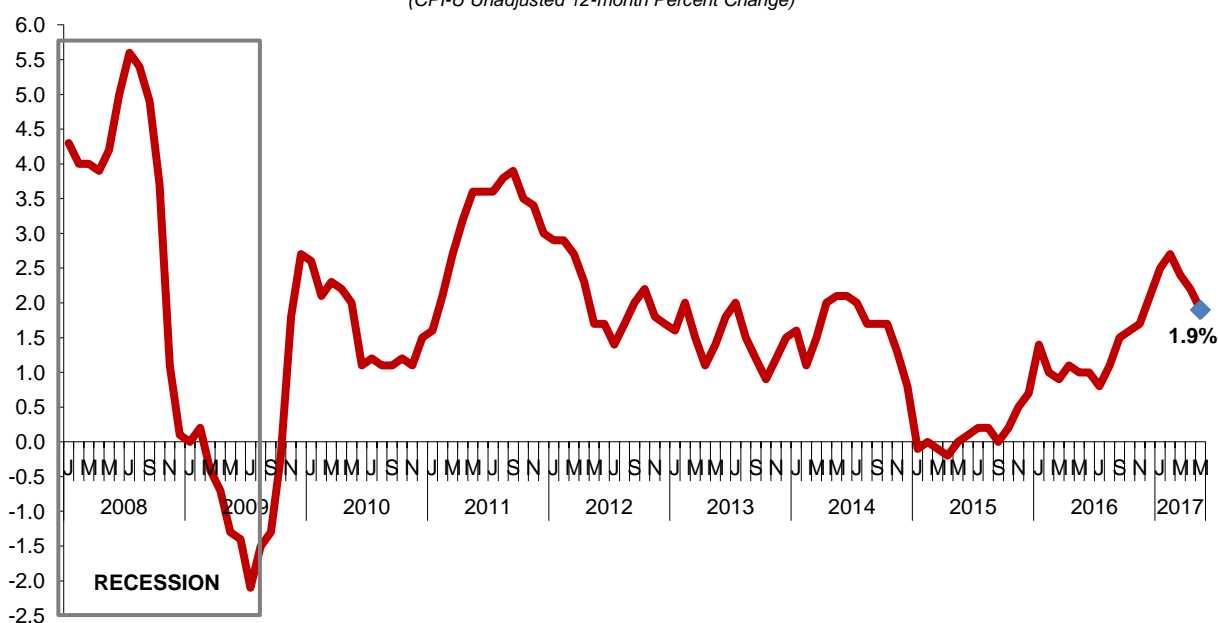


Source: ECLAC, on the basis of data from the U.S. Bureau of Labor Statistics.

D. Inflation

In May, the Consumer Price Index for All Urban Consumers (CPI-U) decreased 0.1% on a seasonally adjusted basis, after posting a 0.2% gain in April and a fall of 0.3% in March. May's decline was weaker than consensus expectations. Some of the weakness appears to be transitory, as the CPI for energy dropped 2.7% in May following a 1.4% gain in April. Gasoline prices were down in excess of 6% in May. Food prices increased 0.2% for the second consecutive month. Over the last 12 months, the all items index rose 1.9% before seasonal adjustment (chart 10), a smaller increase than the 2.2% rise for the 12 months ending April. According to the Bureau of Labor Statistics, this month's increase is still a larger rise than the 1.6% average annual increase over the past ten years.

CHART 10:
U.S. DOMESTIC PRICES: MONTHLY EVOLUTION
(CPI-U Unadjusted 12-month Percent Change)



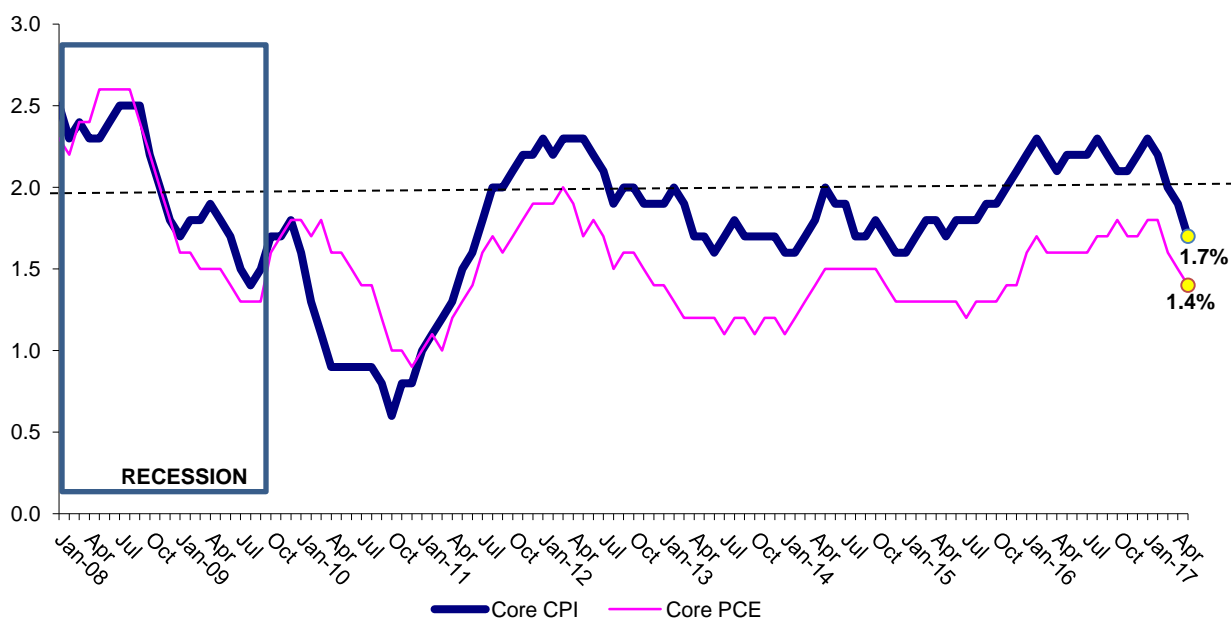
Source: ECLAC, on the basis of data from the U.S. Bureau of Labor Statistics.

Excluding food and energy, the CPI increased 0.1%, weaker than the consensus had anticipated. The core CPI was up 1.7% on the year. Core inflation appears to have moderated, as year-over-year growth was weaker than the 2.2% gain in May 2016.

The most closely watched measure by the Federal Reserve – the Personal Consumption Expenditure (PCE) core price index– increased at an annualized 2.1% in the first quarter. In May, the core PCE advanced at 1.4%, lower than the Federal Reserve's threshold of 2%. May marked the 61st consecutive month in which prices have fallen short of the Fed's 2% annual target (chart 11).

PCE, which is published by the U.S. Commerce Department's Bureau of Economic Analysis, is derived from retail-sales data collected in business surveys, and in this data, medical care tends to carry the greatest weight. The CPI, on the other hand, is derived from consumer purchases reported in household surveys. Typically, consumers report spending more on shelter than anything else, giving that category more weight in the CPI. Since shelter costs have been rising, the core CPI has been increasing faster than the core PCE.

CHART 11:
U.S. CORE CONSUMER PRICE INDICES
(Year-over-year Percentage Change)



Source: ECLAC, on the basis of data from the U.S. Bureau of Labor Statistics (BLS), Department of Labor and the Bureau of Economic Analysis (BEA), U.S. Department of Commerce.

Although the May readings on inflation came below expectations, the Fed still raised rates in its June meeting, but the weakness in inflation over the past several months reduces the odds of a September rate hike. Although the labor market is strong, the Fed cannot ignore the deceleration in inflation, which is not consistent with a full-employment economy.

E. Monetary policy

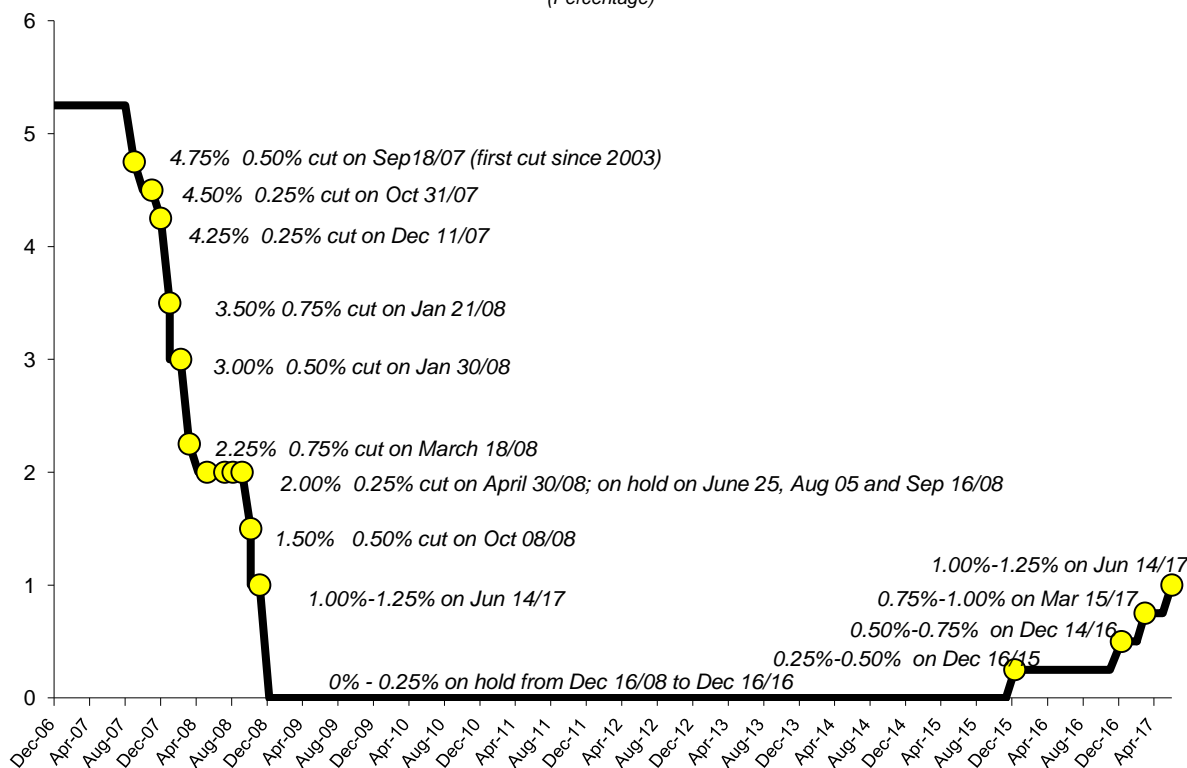
The Federal Open Market Committee (FOMC) raised interest rates on schedule during the first half of 2017. There were two interest rate increases: in March, to a range of 0.75%-1.00%, and in June, to a range of 1.00%-1.25%. The June meeting marked the third consecutive quarter that the Fed's benchmark interest rate was raised (chart 12).

Minutes of the June meeting suggest that the plans for the second half of the year are less clear. The Federal Reserve policymakers seem ready to press ahead with the unwinding of its crisis-era economic stimulus program within months, a historic step that it will pursue in spite of a spate of weak inflation readings. The minutes of the June meeting said several officials wanted to start "within a couple of months," while others favored waiting, suggesting that officials are debating whether to begin in September or wait until December.³

³ The Fed revealed plans for winding down its holdings of Treasury and mortgage securities in May. This should have an effect on long-term interest rates, which would be expected to rise as a result. The central bank stopped adding to its holdings, also known as its balance sheet, more than three years ago, but it has been reinvesting the proceeds of maturing assets to keep those holdings steady. The Fed's plan would start reducing the holdings by allowing a small amount of net maturities per month. This amount would rise each quarter, ultimately rising to a maximum of US\$ 30 billion a month for Treasury notes and US\$ 20 billion a month for mortgage securities.

Officials also debated why price growth has been sluggish. Most participants decided that the softness reflected “idiosyncratic factors,” including falling drugs prices. They expect inflation to head back to target, although several officials expressed concern that the progress to the inflation target of 2% of GDP had slowed, underscoring divisions in the Fed over how to interpret persistently below-target inflation. Some Fed officials also worry that investors are not responding to the recent rate increases. Contrary to the Fed’s intentions, financial conditions remain loose.

CHART 12:
U.S. FEDERAL FUNDS TARGET RATE
(Percentage)



Source: ECLAC, on the basis of data from the U.S. Federal Reserve.

F. Financial conditions

U.S. government-bond yields surprised many investors in the first half of the year by falling, disappointing expectations that a recovery in inflation would drain cash from the credit market. The yield on the benchmark 10-year Treasury note settled at 2.298% on June 30, down from 2.446% at the end of 2016 and well below its recent peak of 2.609% set in March. Yields fall when bond prices rise.

Weaker measures on inflation are one of the main reasons for the yields’ decline. Inflation is a threat to long-term government bonds because it erodes the purchasing power of their fixed returns. Softening inflation bolsters demand for Treasury debt, driving down yields. Yields have declined even as the Fed has raised interest rates twice this year and signaled the possibility of another increase in the second half of the year.

Some investors say yields cannot fall much further, and recent hints that some major central banks could be moving close to unwinding their monetary stimulus has already contributed to lift yields from their 2017 lows.

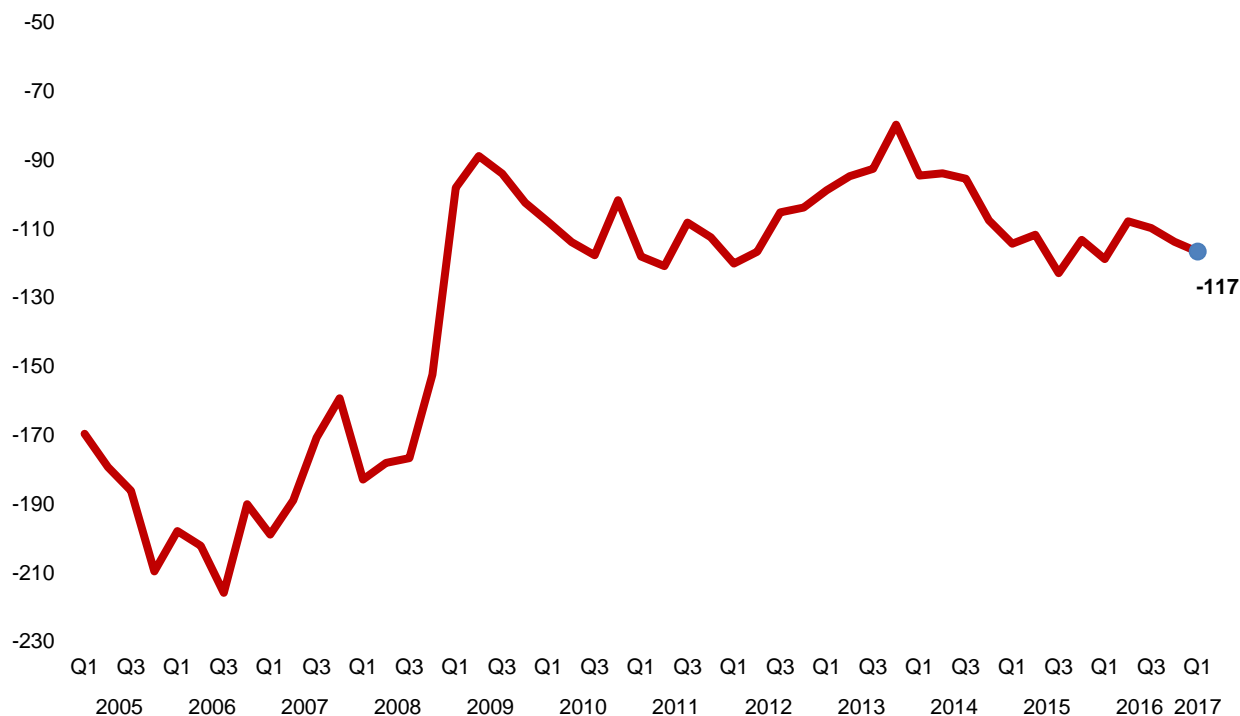
Stock markets performed well in the first quarter of 2017, with the Dow Jones Industrial Average, the S&P 500, and NASDAQ gaining 5.63%, 5.35%, and 8.35%, respectively.

Regarding the banking sector, on June 28 the Federal Reserve Board on Wednesday announced it had completed its review of the capital planning practices of the nation's largest banks and did not object to the capital plans of all 34 bank holding companies participating in the Comprehensive Capital Analysis and Review (CCAR). This was the first all-clear since the Fed tests began in 2011. Looking forward, many of these institutions might have more flexibility to lend, a major factor in promoting the long-term growth of businesses.

G. External sector

The U.S. current account deficit, the broadest measure of net exports to the rest of the world because it includes income payments and government transfers in addition to foreign trade, widened to US\$ 116.8 billion in the first quarter of 2017, an increase of US\$ 2.8 billion. The goods deficit, the largest component of the current account, increased by US\$ 5.3 billion to hit an eight-year high.

CHART 13:
U.S. BALANCE ON CURRENT ACCOUNT
(Quarters, Seasonally Adjusted, US\$ Billion)



Source: ECLAC, on the basis of data from the Bureau of Economic Analysis, U.S. Commerce Department.

The current account deficit widened in the first quarter, but the movement was not so large as to cause concern. Despite the quarter's increase in the current account, it is lower than the US\$ 119.3 billion deficit in the first quarter of 2016. The current account deficit has also fallen as a share of nominal GDP, decreasing from 2.9% a year earlier to 2.4% in the first quarter of 2017.

The continued increase in the goods deficit is more significant, as merchandise trade makes up the largest component of the current account. The goods balance widened to its largest deficit in eight years, with both exports and imports gaining ground. According to Moody's, higher oil prices are partially responsible, and lower prices in the second quarter may take some pressure off imports. The rising deficit is also a result of the strong U.S. expansion. The U.S. is on a firmer footing than many of its trade partners. This puts upward pressure on the trade deficit, as it increases demand for imports while restraining export demand.⁴

However, both imports and exports have risen this year, reflecting a stronger world economy driving an upswing in global trade flows. The dollar has strengthened against other currencies since 2014 but weakened since late last year; a strong dollar makes U.S. products more expensive for foreign customers.

In May, the latest data available, the U.S. trade deficit narrowed 2.3% from the prior month to a seasonally adjusted US\$ 46.5 billion. The decline was smaller than expected, but the details were largely positive. Total exports rose by US\$ 900 million, their highest level in more than two years, while imports fell slightly (US\$ 223 million). The goods deficit fell by US\$ 900 million, while the services surplus increased by US\$ 200 million. Exports of autos and consumer goods both increased substantially from the previous month. Domestic demand was less robust, with total nominal imports dropping by 0.1%, after climbing in the previous two months. Imports of capital goods rose to an all-time high, however, an encouraging sign for business investment.

⁴ Moody's, United States Current Account https://www.economy.com/dismal/indicators/releases/usa_bop/United-States-Current-Account

II. Recent U.S. trends and Latin American and Caribbean

Debt sales by issuers from Latin America and the Caribbean boomed in the first quarter of 2017, reflecting strong investor appetite for higher-yielding bonds and an improvement in the region's economic fundamentals, with Brazil beginning to emerge from a deep recession and Argentina's economic conditions improving. Bonds from the region offer more yield than government bonds in advanced economies, in which rates continue to be historically low. Most of the LAC issuance during the quarter was denominated in U.S. dollar and that could pose challenges for some issuers if U.S. interest rates rise faster than expected or the dollar resumes its ascent.

The Federal Reserve raised interest rates two times in the first half of this year, and has signaled that it can raise interest rates again in the second half of the year. When the Federal Reserve increases the federal funds rate, it normally reduces inflationary pressure and works towards an appreciation of the dollar. When the dollar rises, so does the cost of servicing dollar debts. Further monetary tightening from the Fed may unsettle emerging markets used to abundant dollars.

The implications of fewer dollars, particularly for emerging markets, are starting to be pondered as Fed officials begin discussing shrinking the central bank's US\$ 4.5 trillion balance sheet, possibly starting later this year. Once the Fed slows its purchases of Treasuries and other securities, the dollars effectively given out around the world through those deals will start to disappear, and this could be very hard on emerging markets.

III. Looking ahead

The U.S. economy slowed down at the beginning of the year, but since then incoming data has been more positive. Economic growth is expected to pick up in the second quarter. Market projections for real GDP growth in 2017 (made mostly in June), now range from 2.1% to 2.4% (see table 2). On average, growth in 2017 is expected to expand at an annual pace of 2.2%. Market projections for real GDP growth in 2018 currently range from 1.8% to 2.7%. On average, growth in 2018 is expected to expand at an annual pace of 2.2%.

The Fed has increased its benchmark interest rate twice so far this year, and is planning to start reducing the size of its balance sheet within months. Officials consider moving as soon as September on the portfolio when they said in their June policy statement the reduction plan could begin “this year.” Allowing some of the holdings to mature without reinvestment could push up long-term rates, but markets haven’t shown a significant reaction so far.

One potential complication for these plans and for Fed policymakers is the debt ceiling. If the U.S. Congress has not acted to raise the U.S. government’s borrowing limit by the Fed’s September meeting, the central bank and the U.S. economy may face increased market volatility. Analysts expect the Treasury Department will deplete its cash reserves by early October.



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