The U.S. Economic Outlook: The Economy Has Weakened

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Summary

Current conditions show weakening economic growth and labor market. After the slowest initial recovery in postwar history, the economy took off briefly in mid-2003; since then, however, the expansion has generally decelerated. **Growth is slowing, because the job market remains weak, real wages and incomes continue to fall, and energy prices have risen sharply**. The worst trade and current account deficits in U.S. history also threaten a potential dollar crisis that would drive up interest rates and further slow the economy. With the United States and China weakening, another sustained jump in oil prices could trigger a global downturn in 2005.

- The U.S. expansion slowed to a 2.8 percent annual rate in the second quarter, a sharp downshift from the 4.5 percent pace in the first quarter and a 6.2 growth rate for the second half of last year.
- Last year's spurt of strong growth was based not on the economy's own strengths, but mainly on the short term effects of the July 2003 cuts in income taxes and interest rates.
- The poor performance of the job market since 2001 largely precludes the strong, self-sustaining growth of the 1990s: Job losses in the 2001 recession, relative to the decline in GDP, were three times greater than in previous downturns; and the job gains in this recovery have been the slowest on record.
- The slow job market has driven down real wages for three consecutive years, despite the stimulus of record-high deficits and record-low interest rates.
- With real incomes still falling, this year's 35 percent jump in energy prices will continue to weaken consumer spending, the main driver of U.S. growth.

- **Looking ahead, growth is likely to slow further in the second half of this year and into 2005:**
  - Energy prices will likely remain high: Demand will increase with colder weather, and the supply problems in Russia, Iraq, Venezuela and Nigeria are expected to persist;
  - U.S. businesses, facing intense global competition and fast-rising costs for energy and health care, will continue to create jobs at less than half the rate of previous recoveries;
  - Until strong job creation is restored, pressures on real wages will persist;
  - With wages falling, household debt at record levels, and family bills for energy, health care and debt service all rising, Americans are cutting back on other spending, weakening the expansion.

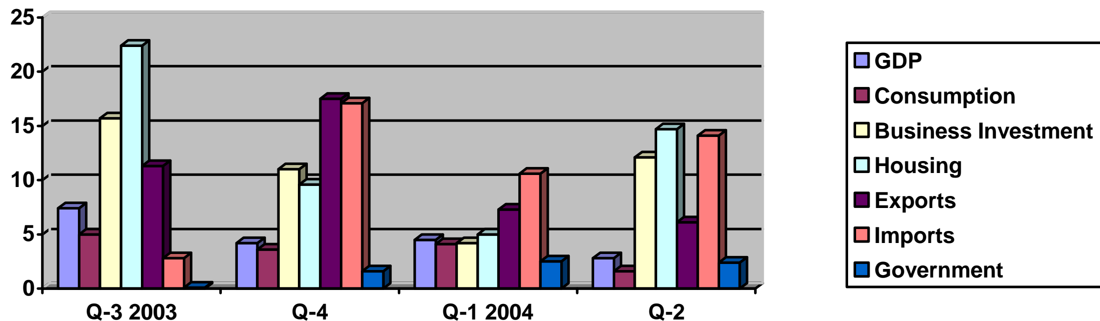
The United States is *not* in danger of slipping into a recession. Even as consumers cut back, business investment will sustain a modest expansion in the second half of this year: Record profits will provide the means for this capital spending, historically low inventory-to-sales ratios provide the demand, and investment tax benefits set to expire on Dec. 31 will spur the timing. Housing investment also should remain healthy in the second half as the economy's overall softness helps keep mortgage rates low.

Foreign factors could produce more serious problems next year. **Our trade and current account deficits already top the levels which in 1987 triggered a dollar crisis and sharp drops in U.S. and global stock markets, and our imbalances are unlikely to improve.** The United States absorbs more than 80 percent of worldwide saving to fund the current account, mostly from Asia; if an economic slowdown in Asia cuts into those savings, it will weaken the dollar and force up U.S. interest rates. Should this occur while China's slowdown deepens, and oil prices remain high, it could mean a global downturn in 2005.

U.S. ECONOMIC PERFORMANCE OVER THE PAST YEAR

Following an initial two years of slow recovery, the U.S. economy achieved substantial momentum in mid-2003 (Figure 1). As the economic strength of that period depended not on the economy's own forces but on tax and interest-rate cuts, the recent quarter's modest results more truly reflect the economic dynamics of this expansion.

Figure 1. Growth of GDP and its Major Components Over the Past Year (Percent Change from Preceding Period, at Annual Rate)

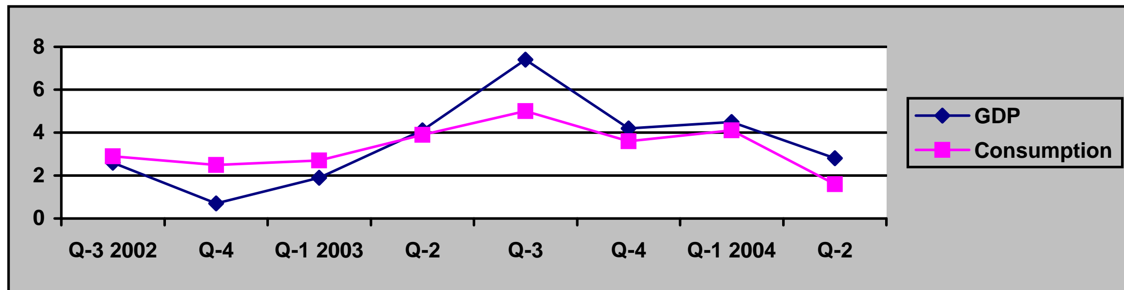


	Q-3 2003	Q-4	*2003*	Q-1 2004	Q-2
GDP	7.4	4.2	*3.1*	4.5	2.8
Consumption	5.0	3.6	*3.1*	4.1	1.6
Business Investment	15.7	11.0	*3.0*	4.2	12.1
Housing	22.4	9.6	*7.5*	5.0	14.7
Exports	11.3	17.5	*2.0*	7.3	6.1
Imports	2.8	17.1	*4.0*	10.6	14.1
Government	0.1	1.6	*3.3*	2.5	2.4

The Pattern of Growth Since 2002: Real Growth of the Major Components of GDP

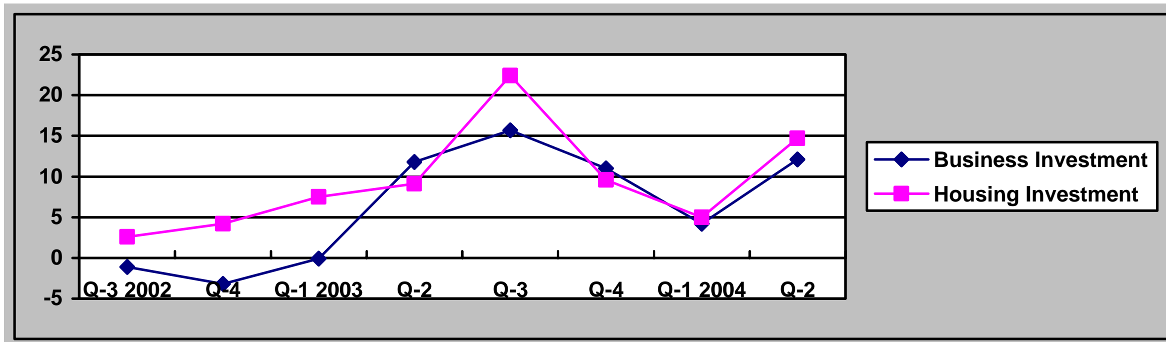
The economic shape of the expansion becomes more apparent when we chart the specific patterns of growth in GDP and consumer spending, and investment.

Figure 2. Consumption and GDP (Percent Change from Preceding Period)



The recovery began in the fourth quarter of 2001, but consumer spending and GDP growth remained weak until 2003 (Figure 2a, above). Throughout the recovery, growth has accelerated when consumption has strengthened, and growth has faltered when consumers have retrenched. Moreover, the large gains in consumption have followed large shots of fiscal, monetary and exchange-rate stimulus. There are no prospects of additional fiscal or monetary stimulus in coming months.

Figure 3. Business Fixed Investment and Housing Investment (Percent Change from Preceding Period)



Following the over-investment of the late-1990s, capital spending remained depressed through the 2001 recession and until the second quarter of 2003. Since then, business investment has been strong (with the exception of the first quarter of 2004) and is likely to remain so, based on high corporate profits, tax incentives and low inventories. Low interest rates also have supported strong housing investment since the first quarter of 2003. The housing spurt in the third quarter of 2003 followed the Federal Reserve's last interest-rate cut, and the dip in the first quarter of 2004 followed the Fed's first interest-rate hike. Early data for the third quarter suggest the housing market may be slowing down; when interest rates rise again, housing investment is likely to slow further.

The principal, underlying problem with the current expansion is sub-par rates of job creation and income growth. It began with the 2001 recession, which cost Americans three to four times as many jobs, relative to the decline in GDP, as previous recessions. And since the recovery began, U.S. firms have created 200,000 or more jobs per month in only three out of 32 months, compared to an average of 14 times in the

same period of previous recoveries. If businesses had been creating jobs since 2002 at the rate they did in the last expansion, we would have 3 million more jobs today. **Instead, in the first eight months of this year, U.S. firms created an average of just 140,000 jobs per month, or about half the job-creation rate of the latter-1990s – and two-thirds of those new jobs were in low-wage industries.** Those job gains have barely kept pace with population: The employment-population ratio in August was unchanged from January.

With such slow job creation, average real wages and real family incomes have declined for three years, and personal and household debt have reached record levels. Over the last 12 months, average hourly earnings have continued to lag inflation by more than 1 percentage point; and while average family incomes stabilized in the last six months, the top one-fifth of Americans captured virtually all of any gains.

As we discussed in previous reports, the underlying changes in job creation and wages largely reflect a substantial, underlying increase in global competition arising mainly from the success of the WTO process in the 1990s. More intense competition forces businesses to raise their productivity while also limiting their ability to raise their prices, even when costs increase. As energy and health care costs have soared in the last three years, U.S. firms have responded by cutting their wages and labor forces.

Facing these forces, the administration used large doses of fiscal and monetary stimulus to support consumption, but failed to address the underlying problems with job creation and wages. Now, with no leeway for more fiscal or monetary stimulus, consumption and growth are very vulnerable to higher energy prices and interest rates.

Over the last five months, prices for gasoline and heating oil have increased, on average, by 35 percent, compared to the same months of 2003; and this difference widened to 40 percent for the last two months. With incomes flat and household debt at record levels, the higher prices for gasoline and utilities quickly dampened family consumption in the second quarter of this year: Consumer spending grew at a rate of just 1.6 percent. The higher energy prices also have intensified pressures on firms to cut other costs, further holding down job creation and wages in recent months. Moreover, the futures market sees more increases in oil prices later this year, when demand jumps with colder weather while supply problems in Iraq, Russia, Venezuela and Nigeria remain unresolved.

Most price measures show that overall inflation, while still modest, has accelerated. Producer prices, including "core" prices (excluding energy and food) are rising this year at twice the rate of last year. Moreover, unit labor costs, which fell in 2002 and 2003, started rising again in the first half of 2004 as productivity gains slowed and pension and health-care costs rose sharply. **With prices rising again, the Fed has begun a new cycle of interest-rate hikes. These rate increases translate directly into higher debt-service costs for average families holding record household debt, forcing cutbacks in other goods and services.** Higher interest rates also are likely to dampen mortgage refinancing,

which millions of American families used in 2002 and 2003 to support and maintain their purchasing power as their real wages were falling.

These forces are evident in the latest data. June and July saw the smallest gains in personal income since late 2002, and consumer confidence fell sharply in August. Most important, over the last three months, the private sector has created just 100,000 jobs per month – compared to 10 years ago, at a comparable point in the last expansion, when firms were creating 310,000 jobs per month, in a labor force that was 15 percent smaller.

THE THREAT TO THE U.S. ECONOMY FROM THE TRADE AND CURRENT ACCOUNT DEFICITS

The other factors likely to restrain U.S. growth in the near term are our record trade and current account deficits. These imbalances deteriorated sharply through 2002, stabilized in 2003, and then worsened badly again this year (Table A). Reducing these deficits and supporting U.S. growth will require more national saving and more dollar depreciation. The administration has rejected the first course with its budget deficits, and our major trading partners in Asia have resisted the second. Yet, if these imbalances are not addressed, they could trigger a currency crisis that could cripple the expansion.

Table A. U.S. Trade and Current Account Deficits, 2002-2004 Q2

	Trade Deficit	**Current Account Deficit**	**Share of GDP**
Q-1 2002	$93.8 billion	$110.2 billion	4.27%
Q-2	$103.4 billion	$117.9 billion	4.52%
Q-3	$106.9 billion	$119.0 billion	4.52%
Q-4	$117.8 billion	$126.9 billion	4.78%
2002	*$421.7 billion*	*$474.0 billion*	*4.52%*
Q-1 2003	$125.4 billion	$138.2 billion	5.15%
Q-2	$123.4 billion	$133.9 billion	4.94%
Q-3	$122.3 billion	$131.6 billion	4.74%
Q-4	$125.5 billion	$127.0 billion	4.51%
2003	*$496.5 billion*	*$530.7 billion*	*4.83%*
Q-1 2004	$136.9 billion	$147.2 billion	5.13%
Q-2	$150.8 billion	$166.2 billion	5.71%

These record trade and current account deficits are essentially caused by inadequate saving. When we don't save enough to finance our business investment needs and budget deficits – and instead consume more than we produce – we have to borrow the funds from abroad. **With real incomes down and budget deficits up, U.S. saving rates have fallen sharply:** U.S. net private savings has averaged just 3 percent since 2000, compared to 4.8 percent in the 1990s; and the net national saving rate is now barely 2 percent, compared to 5.3 percent in the 1990s. In the face of these sharp drops in private and national saving, America has to borrow hundreds of billions of dollars from abroad:

In 2003, the United States claimed 79 percent of the world's surplus saving, to pay for our excess imports and to fund private investment; and we are certain to absorb an even larger share of global savings this year.

Borrowing on this scale cannot go on forever, because foreign lenders eventually become wary of holding so many dollar assets. There are signs that this may be occurring already. From 2000 to 2002, private foreign investors eager to earn the higher returns of U.S. markets dominated the funding of our current account deficits, with foreign governments' share of U.S. net inflows averaging just 8 percent. From September 2003 to June 2004, however, foreign government purchases jumped to 35 percent of those net inflows, as private foreign investors stepped back and Asian governments supported the dollar to keep their own exports competitive.

The last time the world saw a massive buildup in official foreign holdings of dollar assets was in 1987, and it was followed by a run on the dollar and stock market crashes in the United States and abroad. The likelihood is rising that the current and unprecedented imbalances will again produce, at a minimum, a sharp drop in the dollar and sharp increases in U.S. interest rates. The most likely trigger would be declining support for the dollar in Asia – for instance, if an accelerated slowdown in China narrows its trade surplus, reducing China's ability to purchase U.S. assets.

With economic growth moderating in both the United States and China, the world economy is more acutely sensitive to external shocks, whether they come from rising oil prices or a falling dollar. Even if those shocks do not materialize, our continuing problems with the job market and incomes will produce slower U.S. and global growth in late 2004 and into 2005.

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