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2004: ANOTHER STRONG YEAR

The economic recovery from the 2001 recession really kicked into high gear in 2003 and 2004. The economy grew by 3% in calendar year 2003 and followed that with 4.4% growth in real GDP in 2004 – well above the 3% average of the past 25 years. Both years featured strong growth in domestic final demand, especially in 2004 when domestic demand contributed 4.6 percentage points to the overall GDP growth rate. GDP was further boosted by an 0.8 percentage point contribution from production for export and another 0.4 percentage points from inventory accumulation. However, a huge jump in imports, which contributed a negative 1.4 percentage points to GDP growth, held the final tally of domestic production to a “mere” 4.4% growth. US demand for final goods and services increased quite a lot last year, but proportionately, demand for imports increased even more.

After a “no change” in the job count in calendar 2001 and two years of job losses thereafter – even in 2003 when real GDP grew by 3% – the job count finally posted a healthy increase in 2004, which saw a gain of 1.5 million jobs for the year and even more, 2.1 million jobs, from 2003 Q4 to 2004 Q4. The latest reading on jobs, the count of 132.8 million for February, is 300,000 above the pre-recession jobs peak attained in January 2001. By 2004

the ability of employers to tease more and more output out of fewer workers had about run its course. That, plus renewed business confidence in the strength of the expansion, produced a sharp jump in jobs.

EARLY 2005

The best evidence we have is that the domestic economy has remained strong in the first half of this year, though it is clearly not accelerating. A few examples make this point. The Michigan Index of Consumer Sentiment edged down to 94.1 in February 2005 and survey director Richard Curtin noted, “The small decline recorded in February hardly changed the positive level of confidence that still prevails” among American households. Sentiment among the nation’s independent businesses remains at least as robust, according to the National Federation of Independent Business. NFIB’s February survey reports that the Small Business Optimism Index is “...unchanged from January’s solid reading of 103.7” with “no sign of weakness in the domestic economy ... [and] job creation plans strengthened again, eclipsed only by readings [from] the late 1990s and early 2000.” Finally, the Institute of Supply Management’s March 1 report on the state of manufacturing begins with the heading:

“New Orders, Production Growing, Inventories Contracting.”

It then notes, “February was another good

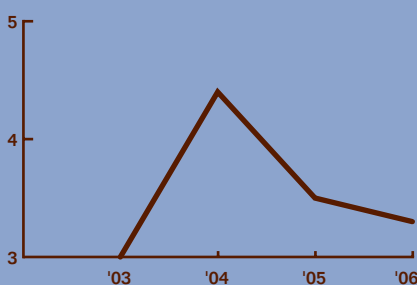
month in the manufacturing sector. While the ... rate of growth is slowing, the overall picture is improving... Customers’ inventories declined slightly, reinforcing the probability that inventories are not yet a concern.”

FISCAL AND MONETARY POLICIES ON A NEW TRACK

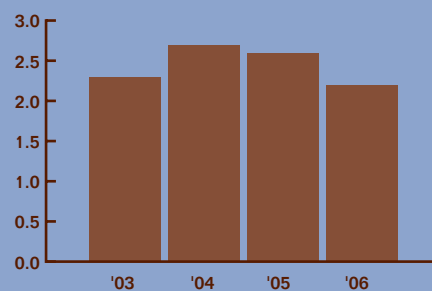
The federal budget was highly stimulative in 2003, but less so in 2004 as expenditure growth eased and the phasing in of the Bush tax cuts was virtually complete. Looking ahead, the federal budget now appears to be on an approximately neutral path vis-à-vis economic stimulus. This does not imply that the federal budget deficit – which reappeared in fiscal 2002 and hit an all-time record \$381.3 billion (NIPA basis) in fiscal 2004 – is disappearing. It is expected to improve a little in the next few years – we are anticipating a decline in the deficit to about \$305 billion for fiscal 2007 – but then it is likely to worsen again later in the decade, depending on the permanence of the Bush tax cuts, Social Security financing and other contentious budget reforms now under discussion.

While fiscal policy has already hit approximate macroeconomic neutrality, monetary policy is still heading that way. Although the Federal Reserve has raised the federal funds rate by 150 basis points since last June and is likely to

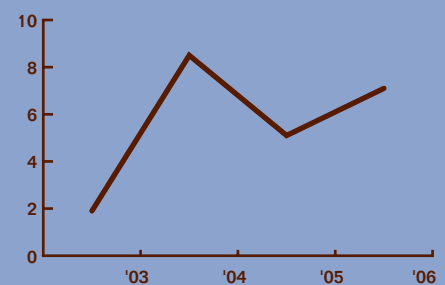
GDP GROWTH (%)



CPI INFLATION (%)



EXPORT GROWTH (%)





add another 100 basis points by the end of this year, that will take the funds rate to just 3¹/₂%. That level for short-term interest rates is consistent with an end-of-year mortgage rate of about 6¹/₂% and a 10-year T-bond rate of about 5% — long rates which are not likely to do much harm to housing activity, business investment, or the car market. After all, the mortgage rate averaged 7³/₄% and the T-bond 6.4% from 1992 through 1998.

Consistent with the current forecast of continued firm economic growth and declining unemployment through 2006 and into 2007, we anticipate further increases in the federal funds rate next year and a 2006 year-end level of 4³/₄%. (That is about the value that the fed funds rate had declined to in 1999 before the Fed started to raise rates to slow the economy). This path describes a monetary policy that continues to move interest rates up along a trajectory which the Fed has been characterizing as a *measured pace*. We judge that such a policy of moderate rate increases can continue over the next two years, absent an unanticipated and sustained step-up in the rate of the economic expansion and/or a significant inflation shock. Indeed, we are expecting that the policy of raising rates at every FOMC meeting that has been in place since last June will end soon — probably after the funds rate hits 3% — which explains the slower pace of increase in short rates during the second half of this year and 2006, compared with mid-2004 to mid-2005.

ECONOMIC GROWTH ABROAD

Economic growth among the nation's major trading partners and the path of exchange rates are the major determinants of the US export market. Nearly 60% of US exports is accounted for by five trading partners — Canada, Mexico, Japan, the U.K. and Germany — and we track their GDPs very closely. In terms of a trade-weighted average of their real GDPs, these five countries grew at an average annual rate of 3.6% per year during the five-year interval 1995 Q4–2000 Q4 — significantly above their long-term average of 2¹/₂% during 1980–2004. Real exports grew at a healthy 6.6% pace during those same five years. The next three years, 2000 Q4–2003 Q4, produced a slowdown to a growth rate of just 1¹/₂% for the five-country average GDP, and US exports fell at a rate averaging about 1% per year. Growth abroad then picked up to a currently estimated 2.8% during 2004, a bit above trend for the five-country average.

Based on the best information we can gather from the consensus of individual country analysts, we are assuming that economic growth abroad will continue at this 2.8% pace over the course of the next several years. In combination with a continuing depreciation of the US dollar over the same period, this is expected to provide a significant growth in US exports; specifically, a 6% growth of real exports during this year and an acceleration to 7.4% during 2006.

THE 2005-2006 OUTLOOK

Propelled by strong initial conditions, including still very low interest rates and pretty solid growth abroad, the economy is projected to post a 3.5% growth rate in the first half of 2005 and to ease off to 3% growth during the second half of the year. Healthy gains in consumer demand and some rebuilding of inventory stocks pace the growth of real GDP in the first half of 2005. Business investment in equipment slows during the first half as the boost from temporarily higher depreciation provisions comes to an end. The moderate slowdown during the second half of this year will result from several cross-currents. The contribution from business investment moves back up, but residential building and inventory accumulation ease back and net exports take a bigger bite out of the growth rate.

Growth edges back up again to a 3.3% rate for calendar 2006, reflecting somewhat stronger consumption growth and a strong, steady contribution from business capital investment, including commercial and industrial construction. This growth pattern goes along with continued job gains — just over 2 million this year and another 1.8 million next year — and a slow decline in the unemployment rate to a 5.1% average for calendar 2006 and to 5% or less by late '06.

Core inflation remained exceptionally low in 2004, with the core CPI increasing by just 1.8% for the year. But with oil prices up by 33% (to a calendar year average of \$41.40/barrel), the all-items CPI was up by 2.7%. Core inflation is



forecast to move up this year, with the core CPI increasing by 2.2%. Oil prices are forecast to be up again, but by less than last year (to a \$49.40/barrel average), so the all-items CPI will be up by 2.6% for 2005, little changed from 2004. With oil prices expected to be down in 2006 (to a \$41.25/barrel average), overall CPI inflation is forecast at 2.2% for 2006, while the core rate of inflation accelerates to 2.6%.

AN ECONOMIC CONCERN RECYCLED

The federal budget seems to be surfacing as the major concern *du jour*. After 28 straight years of annual deficits (NIPA basis, fiscal years 1970-97), the federal budget registered a string of four surpluses in 1998-2001. The budget returned to red ink in fiscal 2002 and has now registered three straight deficits, with the largest over \$381 billion in FY 2004. Two questions come naturally to mind: 1) Why the return to deficits? and 2) Why is it a problem?

The first question has a straightforward answer. The Bush administration, with Congressional cooperation, put a series of large tax cuts on the books in 2001, 2002 and 2003 at significant direct cost to revenues. The terrorist attack of 9/11 stimulated reactions

that raised federal spending dramatically for homeland security and related activities, along with the war against terrorism waged in Afghanistan, and the much bigger war to depose Saddam Hussein in Iraq. Although these were the major factors turning the budget around, there were others as well, including the revenue losses due to the collapse of the stock market bubble in the second half of 2000 and the mild recession of 2001.

The second question has a much more complicated answer, or set of answers. Fiscal deficits do not cause much of a problem unless they are large and persistent. A deficit is simply spending in excess of income, which is another way of saying demanding more resources than contributing. A bit of that — meaning a small amount relative to the size of the economy — is acceptable because its effect is swamped by the rest of the economy, which tends to be less profligate. But if enough of that goes on long enough, it eventually puts pressure on prices and interest rates and that causes a number of well-documented problems. So the question becomes: Are the deficits big and persistent? One common indicator of whether a federal deficit is large is how much it is driving up the federal debt. Since the government has to

borrow to finance the deficit, its outstanding debt rises whenever there is a deficit. And if that deficit manages to raise the debt relative to the size of the economy, that's a big deficit.

Data relevant to this matter are contained in the table, covering five-year intervals from 1985 through 2000, plus the four years 2001-2004. Back in fiscal 1985, the privately held federal debt outstanding amounted to \$1,338.2 billion, or 32.3% of GDP.¹ The deficits of the 1980s and 1990s drove the debt up to 44.9% of GDP by 1995. This was a period during which there was mounting concern about the deficit, but policies begun under the first President Bush and continued by President Clinton got control of the deficits and by 2001 the debt had fallen back to 27.6% of GDP. Indeed, the absolute size of the debt itself declined from \$3,286 billion at the end of fiscal 1995 to \$2,779.7 at the close of fiscal 2001.

The reappearance of budget deficits is once more generating concern. The debt outstanding is climbing again and reached \$3,607 billion at the end of fiscal 2004. Even more importantly, the deficit is big, as indicated by the fact that it is driving the debt up relative to GDP. After bottoming at 27.6% in 2001, the debt rose to 31.2% of GDP in fiscal 2004. The debt ratio is

FOREIGN OWNERSHIP OF U.S. GOVERNMENT DEBT* AND INTEREST (SELECTED FISCAL YEARS, 1985-2004)

Fiscal Year	U.S. GOVERNMENT DEBT			INTEREST PAYMENTS		FOREIGN OWNERSHIP	
	Total Privately Held	Foreign Owned	Total Debt as % of FY GDP	Total	To Foreign Owners	% of Debt	% of Interest
1985	1338.2	222.9	32.3	166.2	23.0	16.7	13.9
1990	2207.3	463.8	38.5	232.1	40.2	21.0	17.3
1995	3286.0	820.4	44.9	285.0	51.5	25.0	18.1
2000	2936.3	1057.9	30.2	284.0	80.6	36.0	28.4
2001	2779.7	1005.5	27.6	267.8	84.3	36.2	31.5
2002	2924.8	1200.8	28.2	233.5	77.5	41.1	33.2
2003	3268.0	1455.8	30.1	216.6	72.1	44.5	33.3
2004	3607.0	1886.2	31.2	216.6	79.7	52.3	36.8

* Debt measured at end of fiscal year. Debt and interest in billions of \$s.

Federal government debt outstanding rose from 32.3% of GDP in 1985 to 44.9% in 1995. From the mid 1990s to 2001, shrinking deficits and surpluses brought the debt ratio back down to 27.6% in 2001. The re-emergence of deficits has pushed the debt ratio back up to 31.2% of GDP. Meanwhile, foreign ownership of the debt has risen steadily, from 16.7% of the debt in 1985 to 36% in 2000 and to more than 52% in 2004; and foreign ownership of interest paid on the debt has gone up from 13.9% in 1985 to 36.8% in 2004.



nowhere near the 44.9% of 1995, but there is nothing on the horizon that suggests it's going anywhere but up in the foreseeable future. In the not-all-that-distant future, this could well be accompanied by enough competition for resources to begin producing upward pressure on prices and interest rates – to rekindle the inflationary process that plagued the late 1980s and early 1990s.

What's more, there is a budgetary time bomb out there. In about 2018 – a few years after the baby-boomer retirement gets under way – the Social Security Administration is going to have to start cashing in the government bonds that have been accumulating in its trust fund in order to pay retirement benefits in excess of its tax revenue from then-current workers. If the federal budget is still in deficit by then – and that appears likely – the US Treasury will have to float enough debt to finance both the operating deficit of the government and the bonds that are being cashed in by the Social Security Administration!

Lately, as shown in the table, progressively more of the federal debt has come to be foreign owned. In 1985, only 16.7% of the debt was owned abroad. Fifteen years later, in 2000, the foreign ownership share had risen to 36%, and just four years after that it had jumped to 52.3%. This is a problem for two reasons. First, with the rest of the world owning a larger share of the debt, it collects a larger share of the interest being paid on the debt. In 1985, 13.9% of the interest the federal government paid went abroad; in 2004, it was up to 36.8%.² The interest that goes abroad is a direct transfer of income from the US to the rest of the world. That has been rising, and the outlook is for it to continue to do so.

The second aspect of the problem of rising foreign ownership of US debt is perhaps the

most complicated of all. Foreign ownership of US debt is, in fact, foreign investment in the US economy. There is now nearly \$1.9 trillion in federal debt owned abroad, plus foreign investment in US stocks, corporate bonds, businesses, real estate, and the like. If foreign investors decide to diversify into other assets, a large amount of dollar-denominated assets could suddenly wind up for sale. In particular, think of the fall in bond prices and the resulting rise in interest rates if foreign owners decide to move out of US debt *en masse*. And think of how much cashing in of dollars for other currencies would suddenly flow through the foreign exchange markets, how fast the dollar might depreciate, and how that could induce a run on the dollar and a foreign exchange crisis. Not a pretty picture. It is not very likely, but it is certainly possible. And it's a risk to which the US economy becomes increasingly vulnerable as it issues more and more debt to finance a budget deficit that remains significant and persistent.

OTHER RISKS TO THE FORECAST

There are numerous uncertainties that could impact our forecast. In addition to the risks just discussed in connection with the federal budget and the foreign exchange market, we can cite the following additional risks:

Geopolitical Issues. Implicit in our forecast is a significant improvement in stability and security within Iraq in the coming year. This would allow US troop withdrawal to begin early in 2006 and would reduce the likelihood of continued disruptions to Iraqi oil production. This assumption may prove to be too optimistic.

The Price of Oil. The price of west Texas intermediate crude oil averaged \$53.09/barrel

in October 2004, retreated to \$43.26/barrel in December, moved back above \$50/barrel in late February, and flirted with new highs in March. In our forecast, the quarterly peak in the price of oil is \$52/barrel in 2005 Q2. We have the price of oil down to \$47/barrel in 2005 Q4, and the price hits bottom at \$38/barrel in 2006 Q4. A few years ago, \$20-\$25 was thought to be the underlying equilibrium price. Is that no longer possible? Has stronger world demand, especially from China, revived OPEC's pricing power and raised the equilibrium permanently? Is there a significantly higher risk premium that's bound to continue for years to come? It is not hard to come up with scenarios that make our price path either too high or too low. There is real risk in the oil market and we could be wide of the mark either way.

An Inflation Surprise. The PPI for non-food, non-energy crude materials rose nearly 48% from 2002 Q4 to 2004 Q4, led by soaring prices for iron and steel scrap. We have assumed that the current cycle in crude materials prices will mirror the historical commodity price pattern. Soaring prices typically bring forth additional supply and a retreat in prices. But, just as rest-of-world growth has played a roll in pushing up oil prices, growing demand may also hold other crude materials prices up. The risk is that we may not yet be approaching the down side of the crude materials price cycle. In addition one hears more these days about the ability of firms to pass on price increases. The combination of rising commodity prices and a renewal of pricing power by firms has the potential to translate into an inflation surprise.

¹ The gross federal debt exceeds the amount that is privately held. Most of the rest is composed of the debt held by the Federal Reserve, plus intragovernmental holdings, especially trust funds such as the \$1,500 billion in the Social Security Administration's Old Age and Survivor's Insurance trust fund at the end of fiscal year 2004.

² The foreign share of interest is less than the foreign share of debt because recent debt accumulation has taken place at interest rates that are lower than the rates applying to average (older) debt holdings.