

# THE US ECONOMIC OUTLOOK

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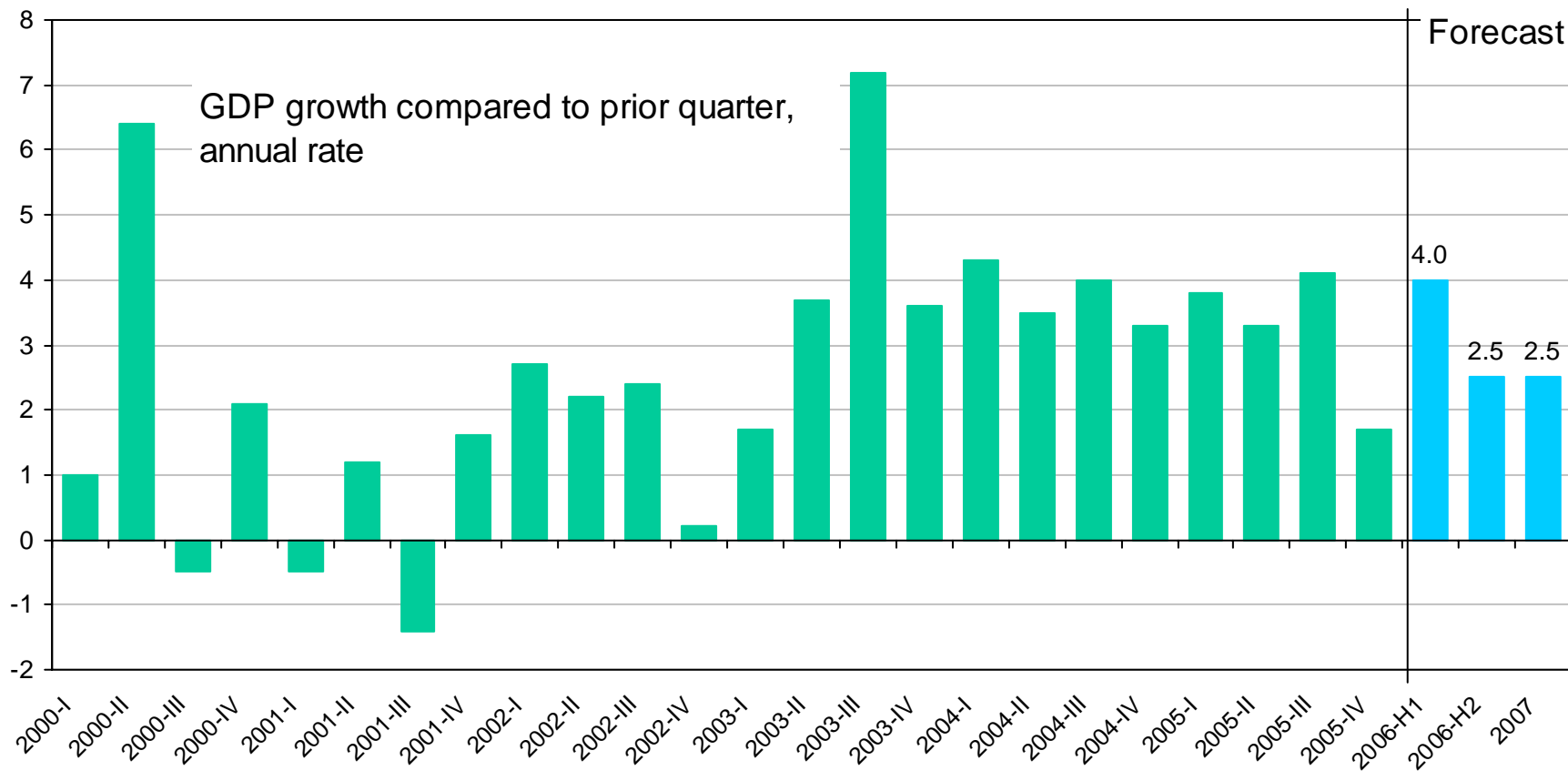
April 11, 2006

Revised.

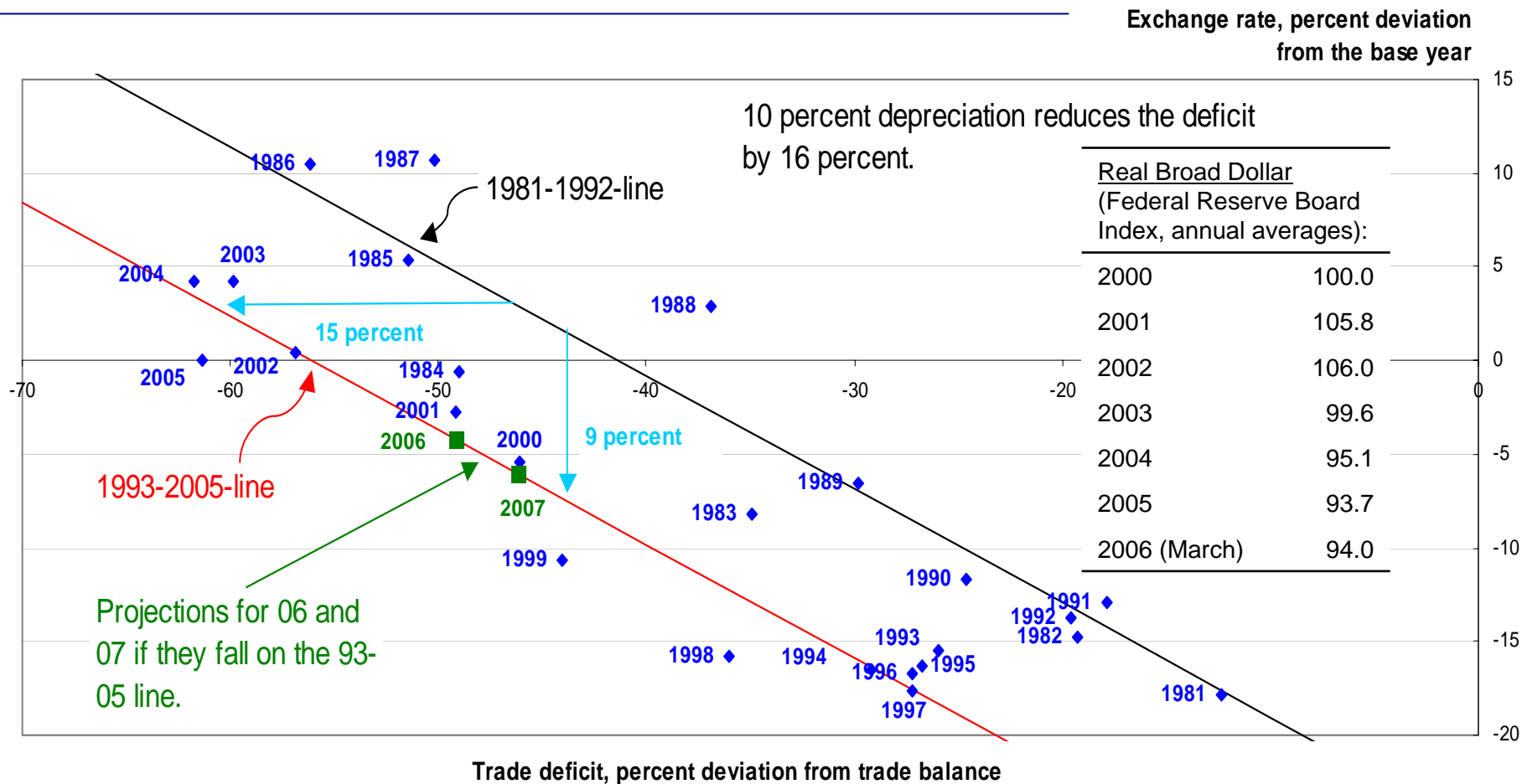
# Topics for this Presentation

- The Forecast
- Trade should provide less of a drag on growth
- The Fed will adjust policy based on how fast the economy can grow without triggering inflationary pressure.
  - How fast is potential growth?
  - Inflationary pressure already?
- Risks
  - Oil prices
  - Consumption and housing

# GDP Growth is Likely to Slow in the Second Half of 2006 and in 2007



# Based on the Past Response of Trade to the Dollar, Net Exports Should Provide a Modest Boost to Growth by 2007.



Source: Baily and Lawrence forthcoming. Data from BEA. Exchange rate is lagged one, two and three years (weighted). Exports and imports in 2000 dollars. Fed real broad exchange rate index. Estimate for 2007 assumes the exchange rate for March of 2006 prevails throughout the year.

# How Fast is US Potential Output Growing? Productivity and Labor Force

**Administration**  
through 2011

Economic Report of the President Feb. 2006, p. 44

| Hours Worked<br>NF Bus. |   | Labor Productivity<br>NF Bus. |   | NF Bus. To GDP |   | Potential<br>GDP |
|-------------------------|---|-------------------------------|---|----------------|---|------------------|
| 1.0                     | + | 2.6                           | - | 0.4            | = | 3.2              |

**Macro Advisers**

Quarterly Outlook Meeting March 2006

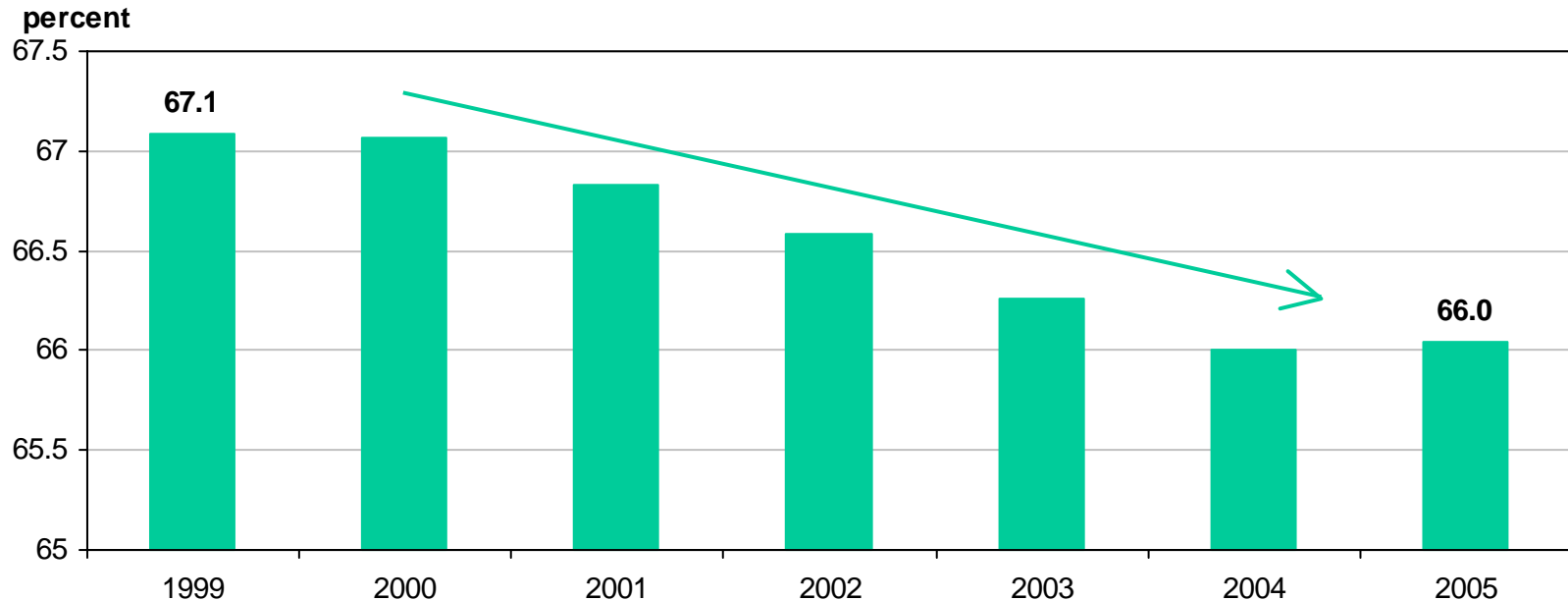
| Hours Worked<br>NF Bus. |   | Labor Productivity<br>NF Bus. |   | NF Bus. To GDP |   | Potential<br>GDP |
|-------------------------|---|-------------------------------|---|----------------|---|------------------|
| 1.0                     | + | 3.0                           | - | 0.5            | = | 3.5              |

**CBO**

Analysis of Budget Proposals March 2006

Around **3.5 percent now**, falling to about **2.5 percent by 2016**.

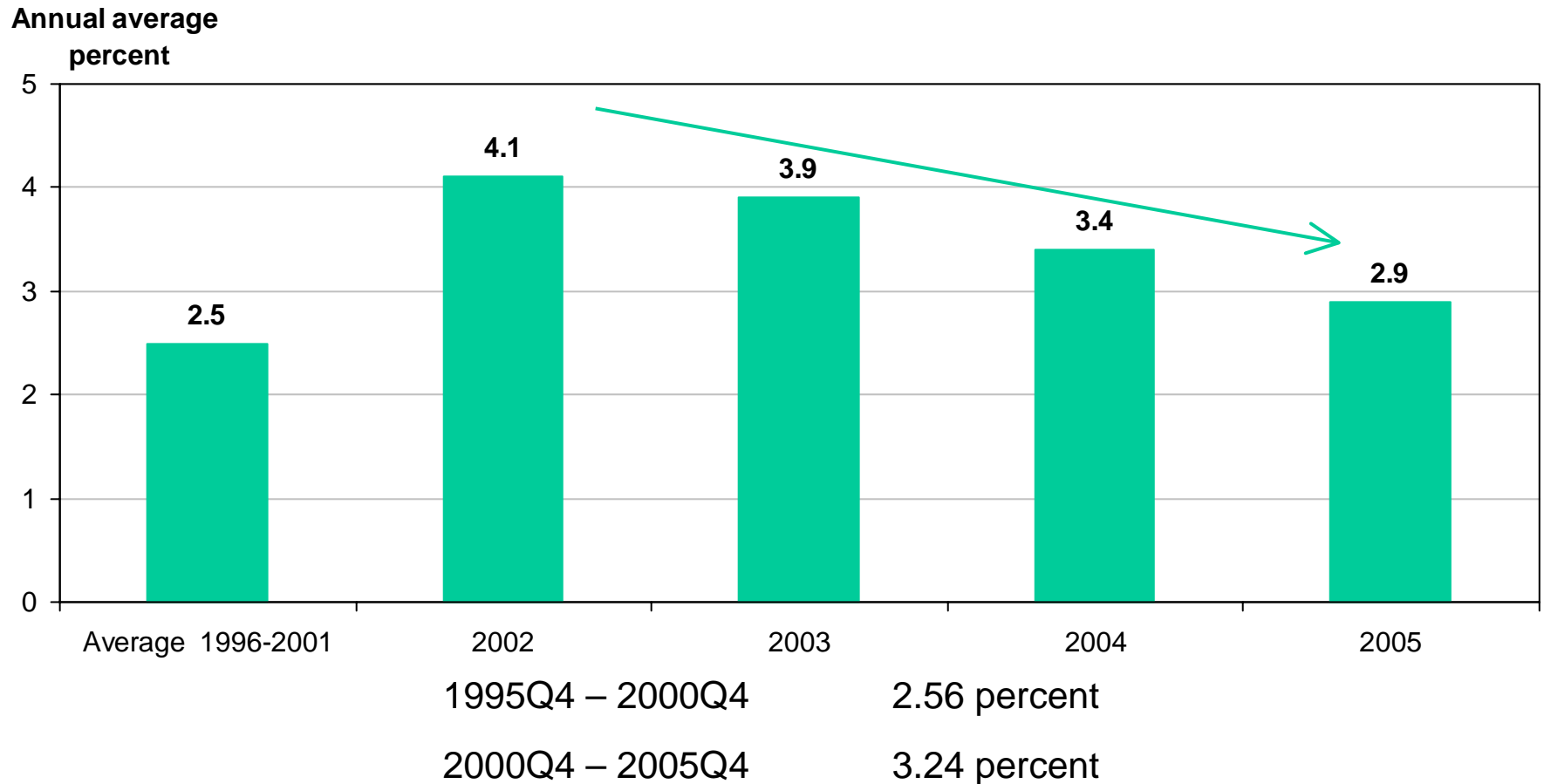
# Labor Force Participation Has Declined



- Smaller cohort in prime working years
  - Young people are staying in school
  - Female participation is flat or declining
  - More people are on disability
  - However, older people are working more
- About half of the reduction is temporary, half is permanent.

# Labor Productivity Growth is Slowing – But Still Strong

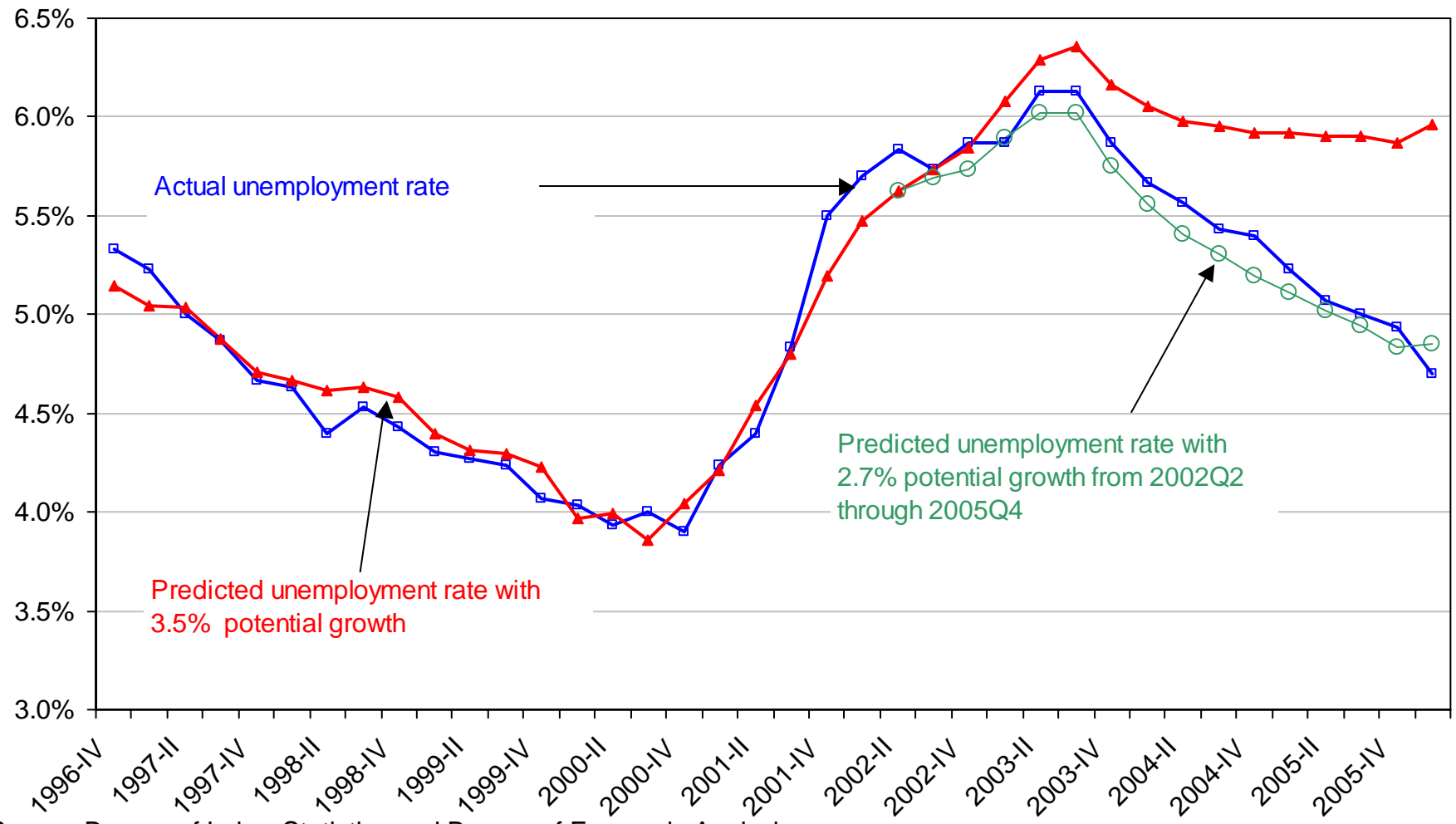
Output per hour, nonfarm business



Source: Bureau of Labor Statistics

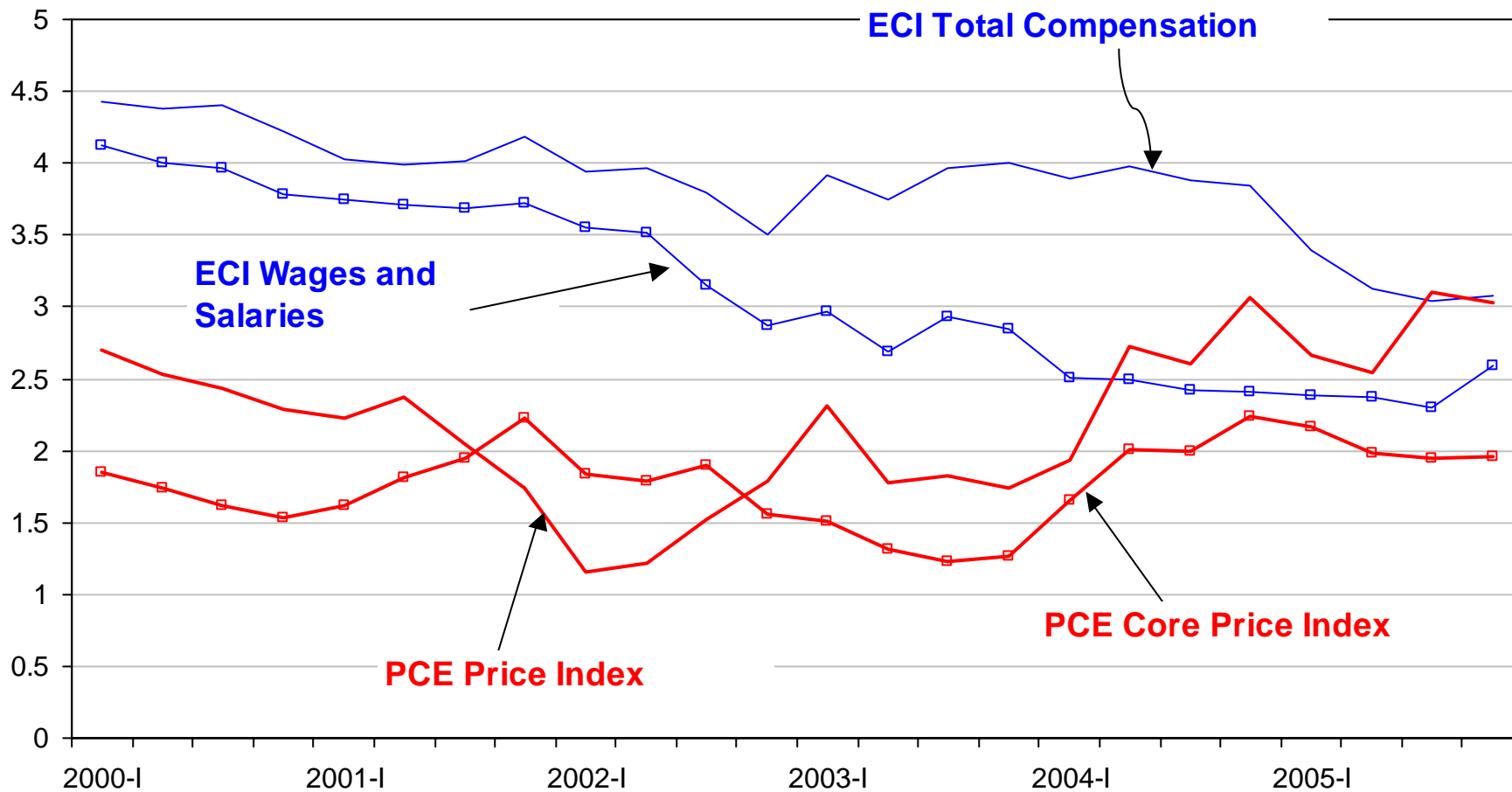
# How Fast is US Potential Output Growing? Using Okun's Law

Actual and Predicted Unemployment Rates for the United States, 1996-2005, with 3.5 percent potential growth declining to 2.7 percent



Source: Bureau of Labor Statistics and Bureau of Economic Analysis.

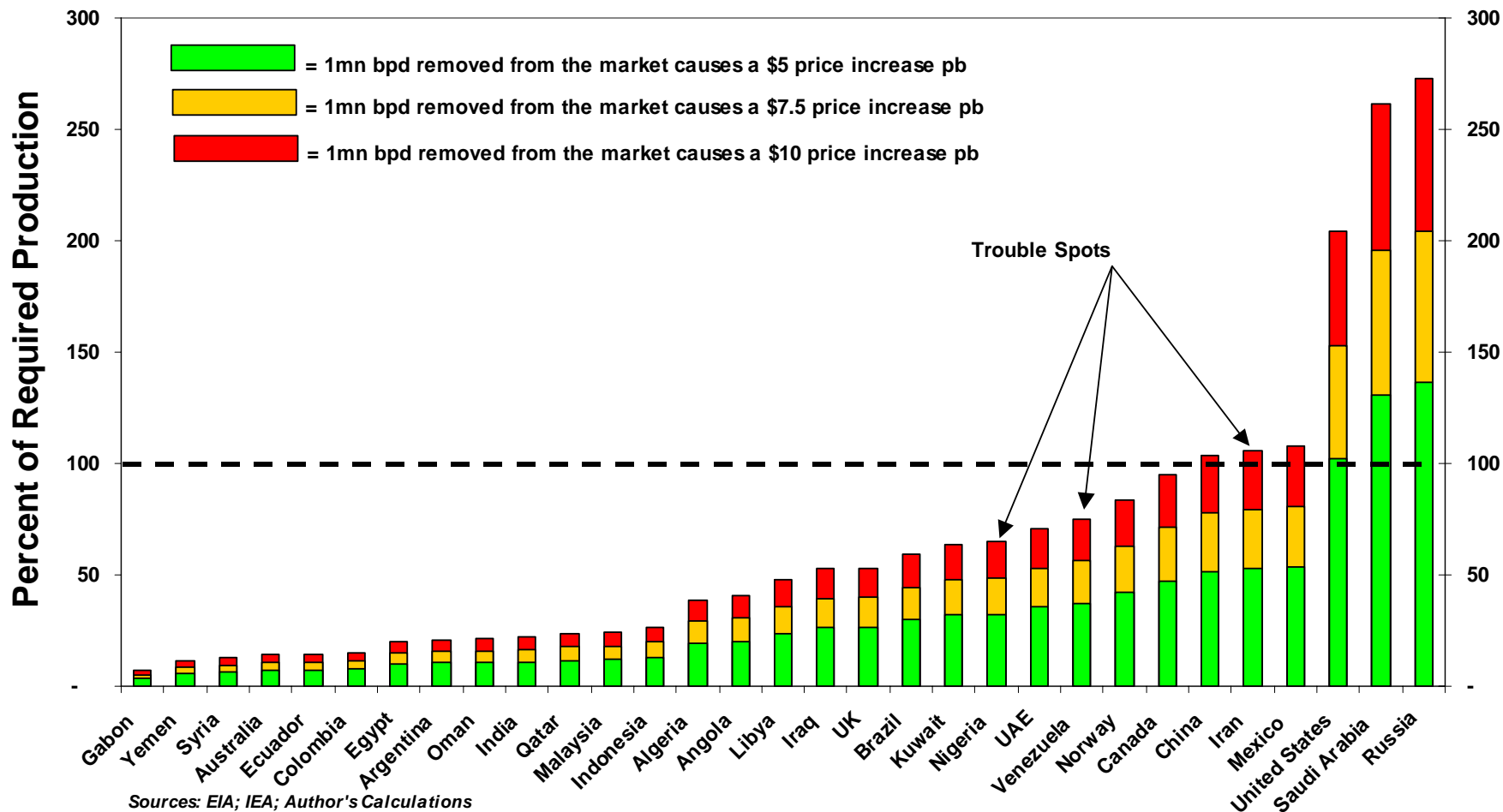
# As Yet, Little Sign of Excess Demand Inflation. A Small Spillover of Energy into Core Inflation



With continued strong productivity growth and some recovery of participation, potential GDP growth should be in the 3 to 3¼ percent range.

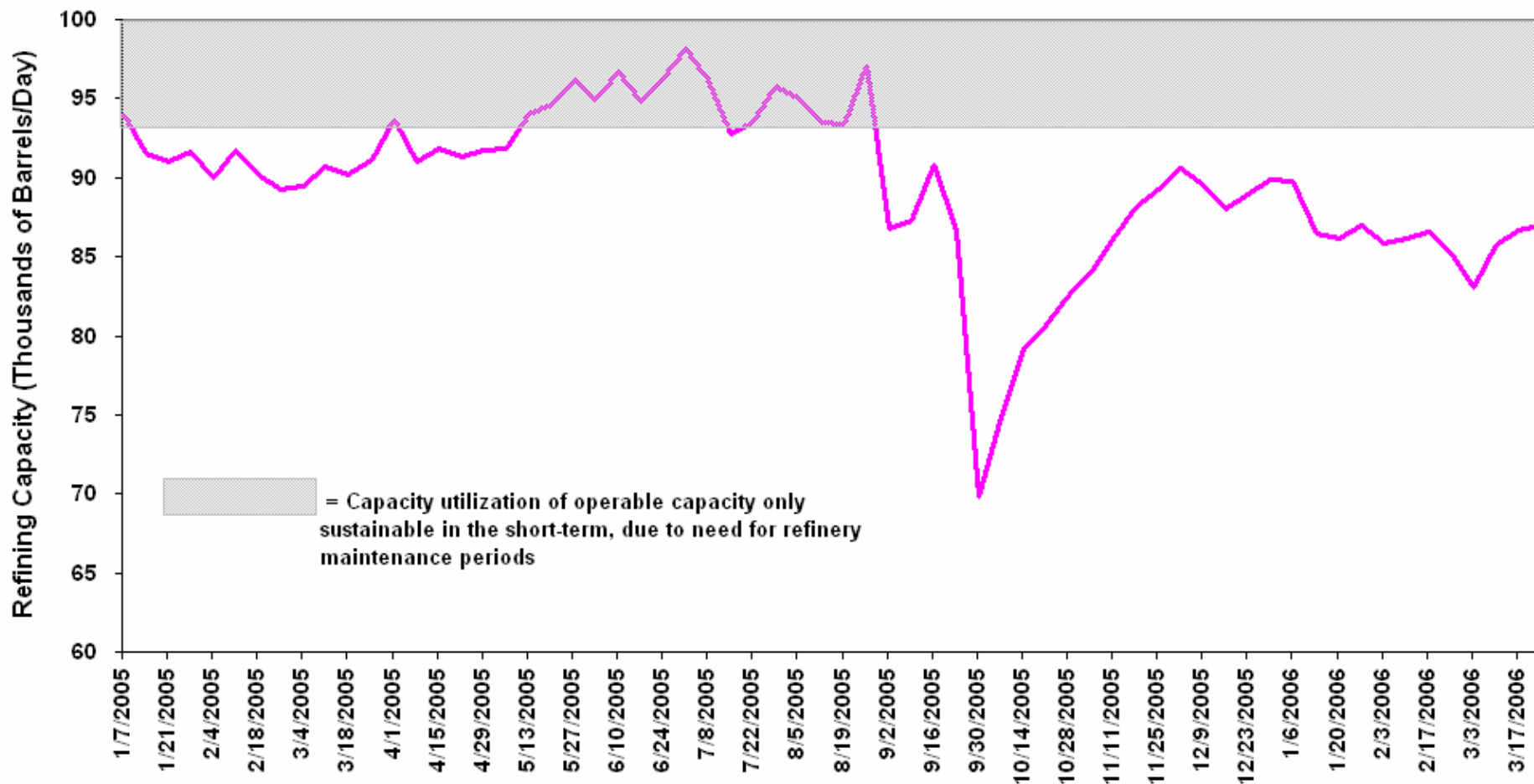
# Could a Supply Disruption Send the Oil Price to \$100?

## Production (Feb 2006) As A Share Of the Decline Sufficient To Send World Oil Prices to \$100/Barrel



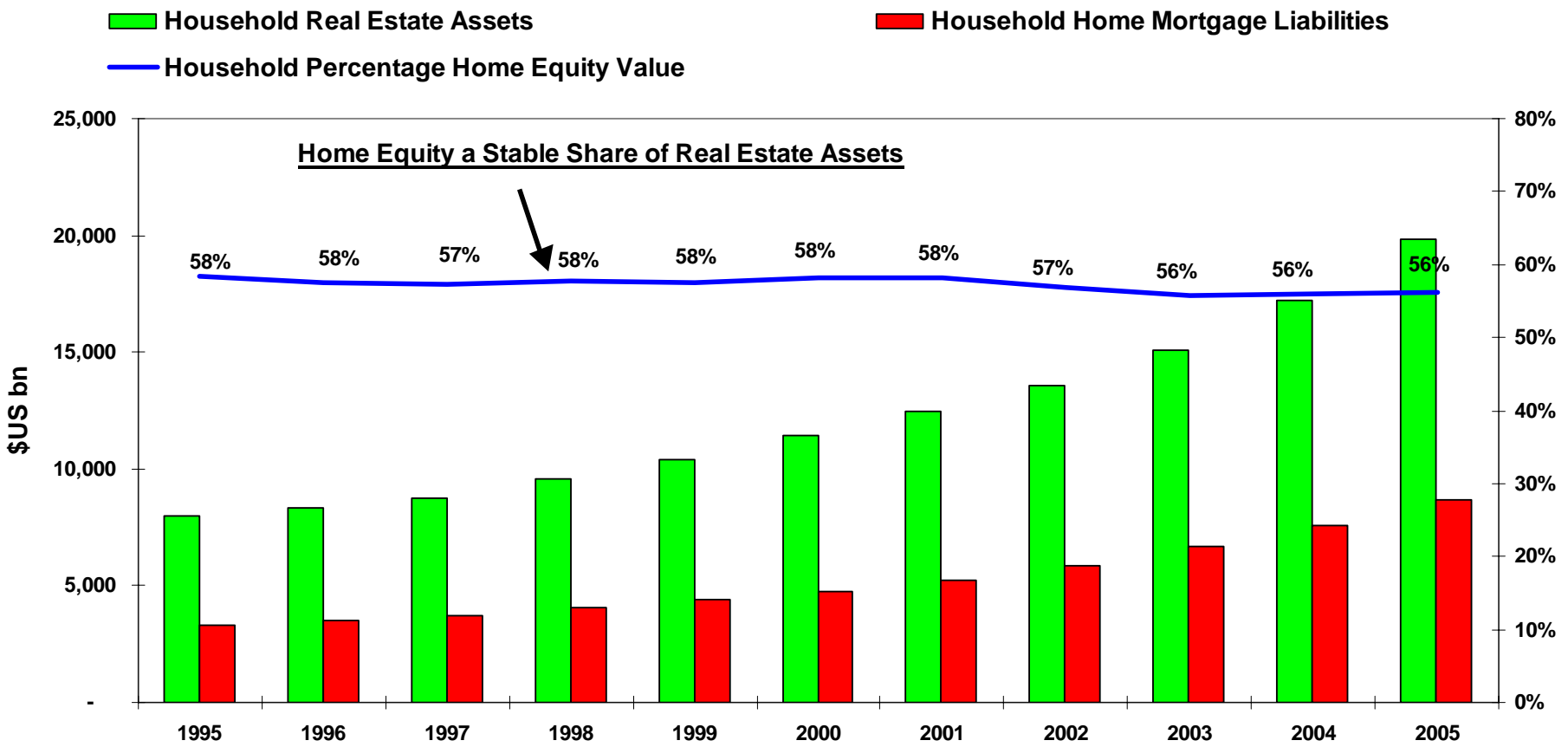
# There is Now Some Refining Cushion

## Utilization of US Operable Refining Capacity



# US Home Equity Tracks Asset Valuations Closely, Indicating "No Borrowing Binge", But No Further Economic Boost From Housing Either As Interest Rate Rises Cool The Market

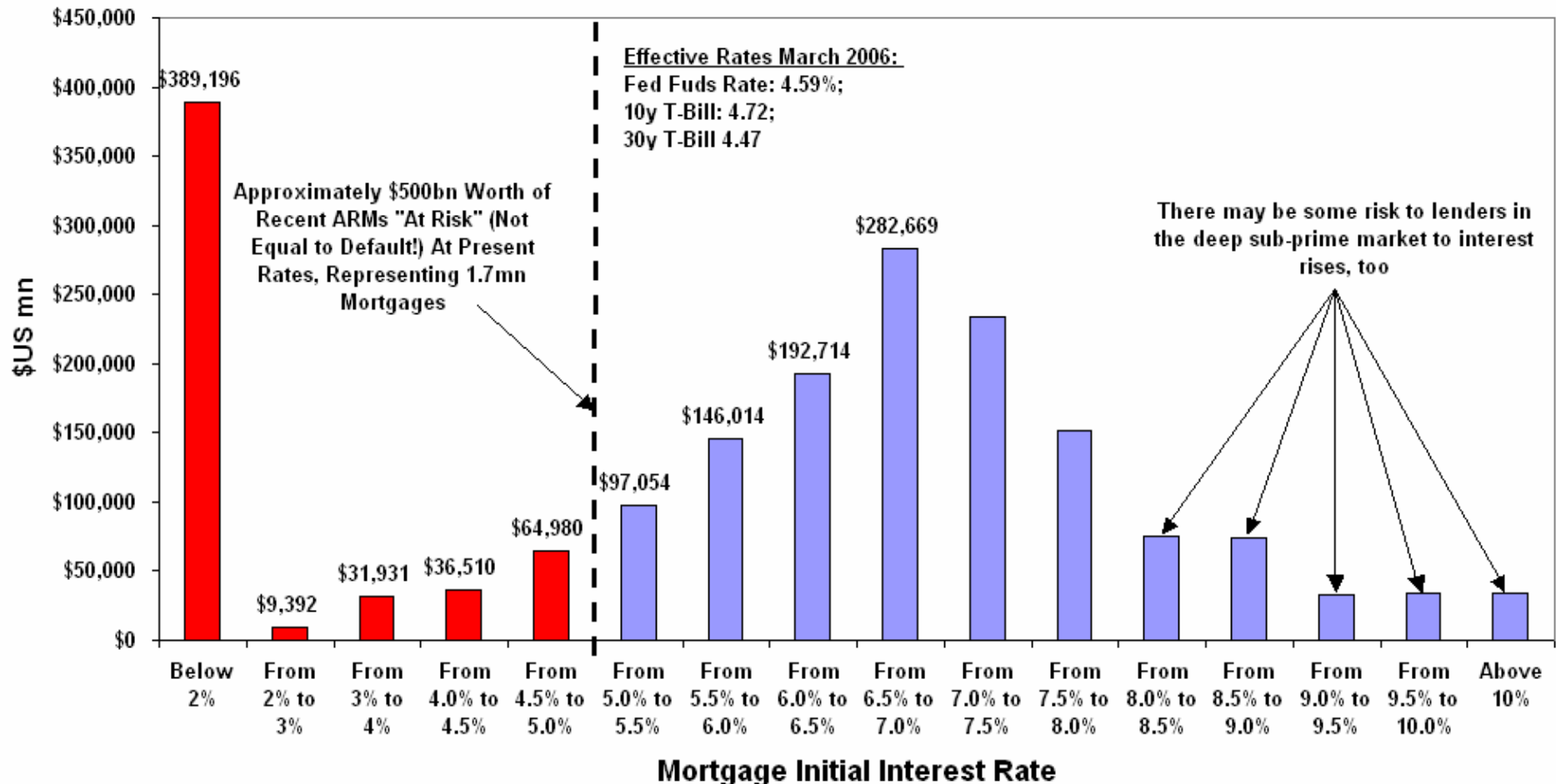
## US Household Sector Real Estate Assets and Home Mortgage Liabilities, 1985-2005



Source: Federal Reserve Flow of Funds Accounts

**Most of the Vulnerable ARMs Originated in 2004-05 and will be Reset in 2007-08. About \$500 billion are on Properties with Less than 5% Equity.**

**Adjustable-Rate Active Recent 2004-2005Q3 First Mortgages, By Initial Interest Rate (Original Amount of Mortgages)**



Source: First American Real Estate Solutions; "Mortgage Payment Reset" February 2006; Federal Reserve Board

# Conclusions

- **Upside:**
  - oil price decline
  - pick-up of labor force growth
  - strong productivity growth and easing of core inflation
  - investment boom
  - resulting in a modest improvement in the budget deficit picture
- **Downside:**
  - oil price rise
  - worsening inflation, rising interest rates
  - sharp housing market decline
  - weaker consumption
  - continued drag from net exports

- Scenarios for a severe downturn
  - major oil supply disruption
  - or a sharp drop in the dollar and rise in US interest rates
  - rising inflation limits the Fed response
  - rising budget deficit limits the fiscal response
  - global economy weakens
- Mitigating Factors
  - if the US and global economies weaken, this lowers interest rates and the oil price
  - a sharp drop in the dollar would increase US net exports (with a lag)