

RESEARCH BUZZ

FEBRUARY 2006
VOL. 2, ISSUE 2

Risks to the U.S. economic outlook

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The Bush administration's forecast for 2006 is very close to private sector forecasts and to those of the Congressional Budget Office or the Federal Reserve.

The administration's forecast is shared by a broad consensus calling for little change in 2006, which is forecast to be a year of steady growth, low inflation and an unchanged unemployment rate.

The forecast actually belies considerable change.

Only recently has the slowdown in U.S. output growth in 2005 been accepted as a new norm. Real GDP had been slowing since early 2004 when real GDP grew at a 4.7 percent pace over the preceding year.

For most of 2005, growth had been pegged at a 3.6 percent rate but at the end of 2005, due to a poor fourth quarter, the annual growth rate slipped to 3.1 percent. The administration's forecast, while appearing to indicate acceleration, is actually just a return to the pace

ECONOMIC OUTLOOK FOR 2006			
NFI's forecast of the three measures of U.S. economic outlook differs from that of the Bush administration.			
	REAL GDP GROWTH *	INFLATION*	UNEMPLOYMENT RATE **
2005-ACTUAL	3.1%	3.7%	4.9%
NFI	2.4%	3.6%	5.3%
BUSH ADMINISTRATION	3.4%	2.4%	5%

* fourth quarter to fourth quarter ** fourth quarter

that had been apparent in most of 2005. The inflation forecast is also a sort of "business-as-usual" forecast. While the forecast is for consumer prices to slow, they are expected to slow to a pace that differs from 2005 only because of the temporary effects in 2005 of higher oil prices.

So the inflation forecast is simply a return to an unchanged underlying pace that is widely to be acceptable.

Finally the unemployment rate is nearly unchanged from the end of this year to the end of next. This is

consistent with an the economy growing at roughly its potential or capacity growth rate but actually the unemployment rate has been falling at about half a percent each year for the past two years despite the slowing economy.

NFI forecasts a sharp slowing in real GDP growth, especially in the second and third quarter of this year. This slowing will largely be due to the delayed effects of the rise in oil and energy prices in 2005. Certainly the Bush administration and other forecasters are aware of

these past increases but they apparently rely on a "dodged-a-bullet" scenario in which oil price shocks affect the economy much more quickly than in the past or, due to a change in the structure of the economy, not at all.

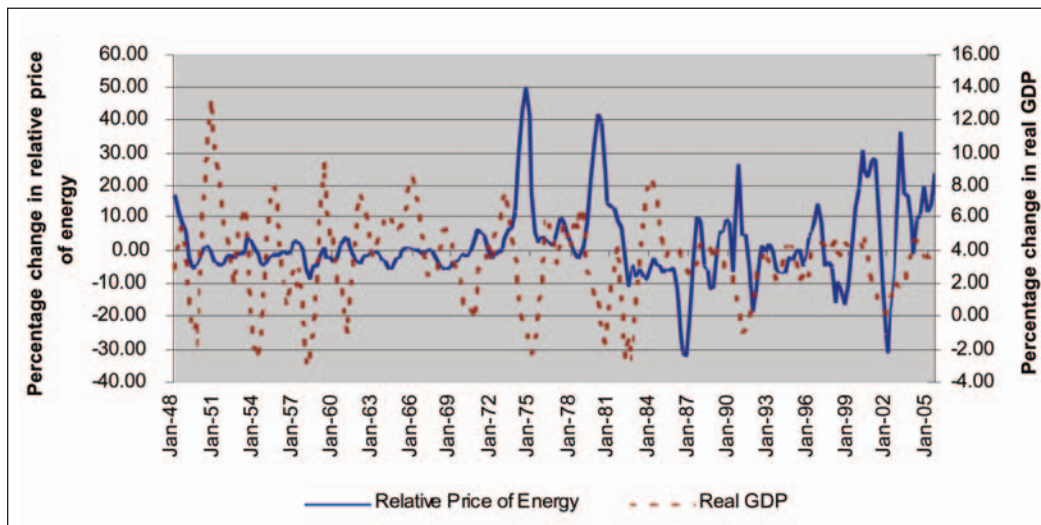
Past experience with rising energy prices shows that real GDP growth slows later and by more than has occurred so far, given the size of the increase in the relative price of energy, measured in the chart by the producer price index for fuel, power and related products relative to the output price deflator for business sector output. The effects of higher energy prices on the general level of prices also take time to work their way through the economy. Thus the maximum effects of last years' higher energy prices are still coming.

Oil prices raise energy prices and affect the economy by altering the use of energy in production. As producers and consumers attempt to avoid higher oil prices, they switch to other sources of energy and put upward price pressure on all competing forms of energy. They also attempt to change the use of resources to avoid higher cost of energy, including shutting down equipment and structures that cannot be operated profitably at higher energy prices and substituting more labor-intensive methods of production. Energy employment tends to fall, as does that of obsolete capital, so that labor productivity, the output from given labor resources, declines.

With a decline in output relative to employment, the same money chases fewer goods and puts upward pressure on the general level of prices. It takes time for higher energy prices to work their way through the economy, however.

One of the modest silver linings in an energy price shock is that a decline in productivity actually requires more employment to pro-

















When energy prices rise sharply, real GDP growth slows





ResearchBuzz is published monthly by Networks Financial Institute at Indiana State University.

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McKinsey Global Institute study points to fast growth in financial assets

Farrell, Diana, Key, Aneta Marcheva, Shavers, Tim:
 "Mapping the Global Capital Markets,"
 The McKinsey Quarterly, 2005 Special Edition:
 Value and performance, online edition:
www.mckinsey.com/mgi/publications/gcmAnnualReport.asp

McKinsey Global Institute published its study of financial assets in more than 100 countries in January 2005. The study points to the rapid increase in global financial assets. Main points of the report can be summarized as follows:

Compared to 2004, the world's financial stock increased by 15.3 percent to \$136 trillion in 2005 (derivatives are not included).

Growth in financial assets outpaced the world's GDP growth rate, which has led to further financial deepening in the markets.

There was a higher growth rate of private and government debt compared to banking deposits and equity securities.

There was continuous change of the roles of countries and different regions.

McKinsey defines the global financial stock as the sum of global bank deposits, the market value of publicly traded equities and the outstanding face value of debt securities. In the study's calculation, mutual funds, pension funds, derivative securities and other securities with similar characteristics are excluded to avoid double counting.

According to the study, world GDP grew at a 4.0 percent annual rate between 1993 and 2003. Meanwhile, global financial stock increased at an average 8.4 percent rate for the same period. In 2005, it rose 15.3 percent. Growth of capital markets in the

developing world and creation of new instruments and institutions were several of the factors accounting for the higher growth rate in financial markets. Faster growth in the global financial stock compared with world GDP has led to further financial deepening (ratio of financial stock to underlying GDP). The study emphasizes that while financial deepening has benefits, it does not by itself indicate the strength of a given financial system or underlying economy.

In particular, financial deepening is not tightly linked to economic strength. For example, the Netherlands has higher financial depth compared to the U.K. but both of them have similar GDP per capita. Although both the U.S. and Malaysia have similar financial depth, their GDP's differ substantially.

Different regions and different countries have different asset compositions. Key findings of the report include:

In 2003, the U.S. accounted for 37 percent of total global financial stock. The U.S., with the Eurozone, U.K. and Japan, made up 80 percent of total global financial stock.

Bank deposits account for the largest share in Europe, Asia and especially China. In the U.S., private debt securities make up the largest part (mainly due to securitization and Government Sponsored Enterprises).

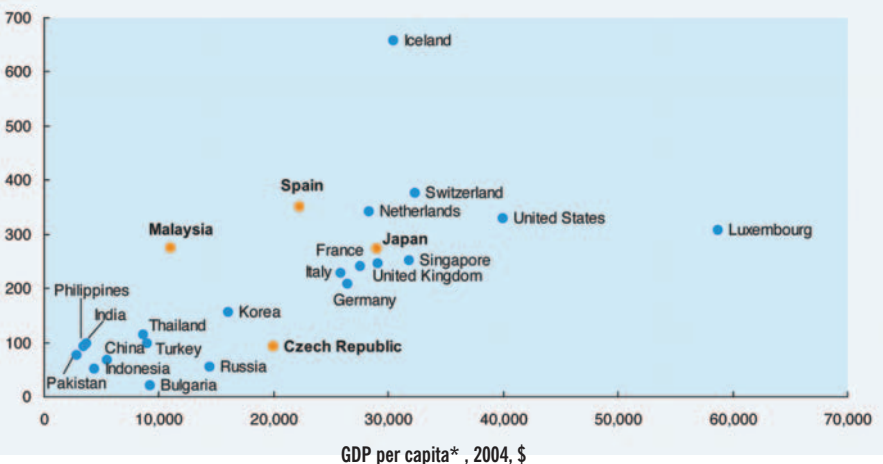
Equity securities along with private debt securities gained importance in Europe.

In Asia, the role of private debt securities is very small compared to banking deposits.

— Summary by Ozer Erdem

The link between financial depth and income

Global financial stock, 2004, percent of GDP



SOURCE: MCKINSEY GLOBAL INSTITUTE GLOBAL FINANCIAL STOCK DATABASE, WORLD BANK * At purchasing power parity

Is negative personal saving a serious problem?

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Is negative personal saving a serious problem? In most of 2005, personal saving was negative, attracting widespread attention and concern. Many analysts suggest that negative personal saving means that the typical U.S. consumer is living well beyond his or her means. Since this would be unsustainable, the fear is that an end of a consumer-spending binge could lead to a recession.

Such fears have taken on many incarnations over the past five years, focusing first on wealth declines due to the stock price crash in 2001, concern over foreigners' appetite for U.S. assets and fear of its disappearance and, lately, a feared bursting of a suspected housing bubble that would lead to a surge in saving and decline in consumer spending.

Personal saving is the difference between disposable personal income and consumer outlays. From the second quarter of 2005 to the end of the year, personal saving was negative \$21.5 billion, negative \$151.9 billion and negative \$33.3 billion, respectively. Personal saving can be pushed down by a rise in consumer spending or by a fall in disposable personal income. To see what has been happening recently, one can compare the third quarter of 2005, the latest quarter for which there is comprehensive saving data, to two years earlier, in the third quarter of 2003, when personal saving was \$205.1 billion, its last peak.

OUTLOOK

duce relatively unchanged output. The slow adjustment of prices to the energy price shock means that demand for output is not much affected initially. With depressed productivity growth, production slows with more pressure on inventory and prices as well as temporarily stepped up employment to try to offset downward pressure on sales and inventory. Eventually higher energy costs are fully reflected in prices of goods and services and employment returns to its natural level, where lower output reflects the productivity decline. There are more effects on the economy in the medium term because of the depressed return to capital and con-

FACTORS BOOSTING SAVING ELSEWHERE				
Personal saving and disposable income in the U.S. have been held down by factors boosting saving elsewhere.				
	III/2003 (billions)	Percent of GDP	III/2005 (billions)	Percent of GDP
Personal saving	\$205.1	1.9%	-\$158.9	-1.3%
Disposable personal income	\$8274.6	74.6%	\$9015.1	71.5%
Personal tax	\$940.8	8.5%	\$1215.9	9.7%
Corporate tax	\$246.9	2.3%	\$346.2	2.8%
Undistributed corporate profits	\$289.2	2.6%	\$512.2	4.1%

SOURCE: BUREAU OF ECONOMIC ANALYSIS

NFI

The decline in personal saving was associated with a fall in disposable personal income relative to GDP, not with an increase in consumer spending. Personal consumption expenditures actually declined slightly, falling from 70.2 percent of GDP to 70.1 percent of GDP over the period, so the personal saving decline did not occur because consumption spending or outlays outstripped the growth of the nation's income or GDP. Consumer spending matched the 6.6 percent annual rate of increase of growth of GDP, a broad measure of the nation's income. Instead, disposable personal income grew at only a 4.4 percent rate over the same two years, so that the share of disposable personal income in GDP fell 3.1 percent of GDP. This decline shaved about \$391 billion from disposable income and personal saving during the third quarter of 2005.

The shortfall in disposable income and personal saving is largely due to increases in "saving" elsewhere in the economy. Corpo-

rate profits boomed over the period and were, in part, paid out as higher corporate taxes or held by companies as undistributed corporate profits. Also, increased individual incomes pushed up personal current taxes. As percents of GDP, undistributed profits rose by 1.5 percent, corporate taxes rose 0.5 percent and personal taxes rose 1.2 percent. These three items account for slightly more than all the shortfall of disposable income relative to GDP and the decline in personal saving to negative territory.

The significance of this result is that undistributed corporate profits are part of business and private saving, so that part of shortfall of personal saving was offset by a rise in business saving. Similarly, higher tax payments reduce the government deficit, or raise "government saving," so that, again, part of the shortfall in personal saving is offset by a rise in another component of overall saving. Thus the decline in personal saving is not reflected in a decline in overall U.S. saving.

A measure of overall saving — gross saving, which includes funding for government capital spending — rose from 13.3 percent of GDP in the third quarter of 2003 to 13.5 percent of GDP in the third quarter of 2006, despite the large fall in the personal saving. Removing the component of government capital spending does not alter the result that overall saving rose in the U.S. between the two periods.

Note that personal saving was not a large share of private sector or of total saving even in the third quarter of 2003. This component of U.S. saving has always been a small share of the total. There are other reasons for discounting the importance of personal saving, including the likelihood of revisions that will eliminate negative saving, at least if the past is a guide, and other imperfections with its measurement. Even taken at face value, however, the appearance of negative personal saving should not be a new source of concern for the U.S. economy.

sequent effects on investment, capacity output and prices. Those effects have relatively small effects on growth, inflation or unemployment rates, however. Thus the risk to the forecasts of the Bush administration and other similar forecasts is that the past effects of energy price increases will continue to work their way through the economy. These effects are reflected in the NFI forecast and explain the slowing output growth, persistence of relatively high but temporary inflation and the moderate rise in the unemployment rate.

There are other serious risks to the outlook that are not reflected in either forecast. For some analysts,

the greatest threat is the risk of a bursting housing price bubble. This could slow consumer spending and lead to a recession. Others fear that higher interest rates could also contribute to the housing price collapse or slow business capital spending.

There are other risks to the outlook that have been discussed in the financial press but two of the greatest risks that have received less attention are major shifts in economic policy. The appointment of new Federal Reserve Chairman Ben Bernanke in the midst of program to move toward monetary neutrality or even to monetary restraint raises the risk that the Fed might be very likely to follow its

history and overdo any required tightening. If inflation continues to be higher than expected in the first half of 2006, this will be a serious risk. Also congressional concern for the budget deficit risks raising taxes on capital income beginning in three years or so, which would worsen the long-term climate for U.S. saving and investment and threaten higher interest rates and a sharp slowing in output and employment growth in the near term. Neither of these policy risks at this time has been factored in to the NFI forecast.

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