Outlook for the U.S. Economy:
How Long Will the Party Last?

Presentation to
The Economic Society of Calgary

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The Plan of the Presentation

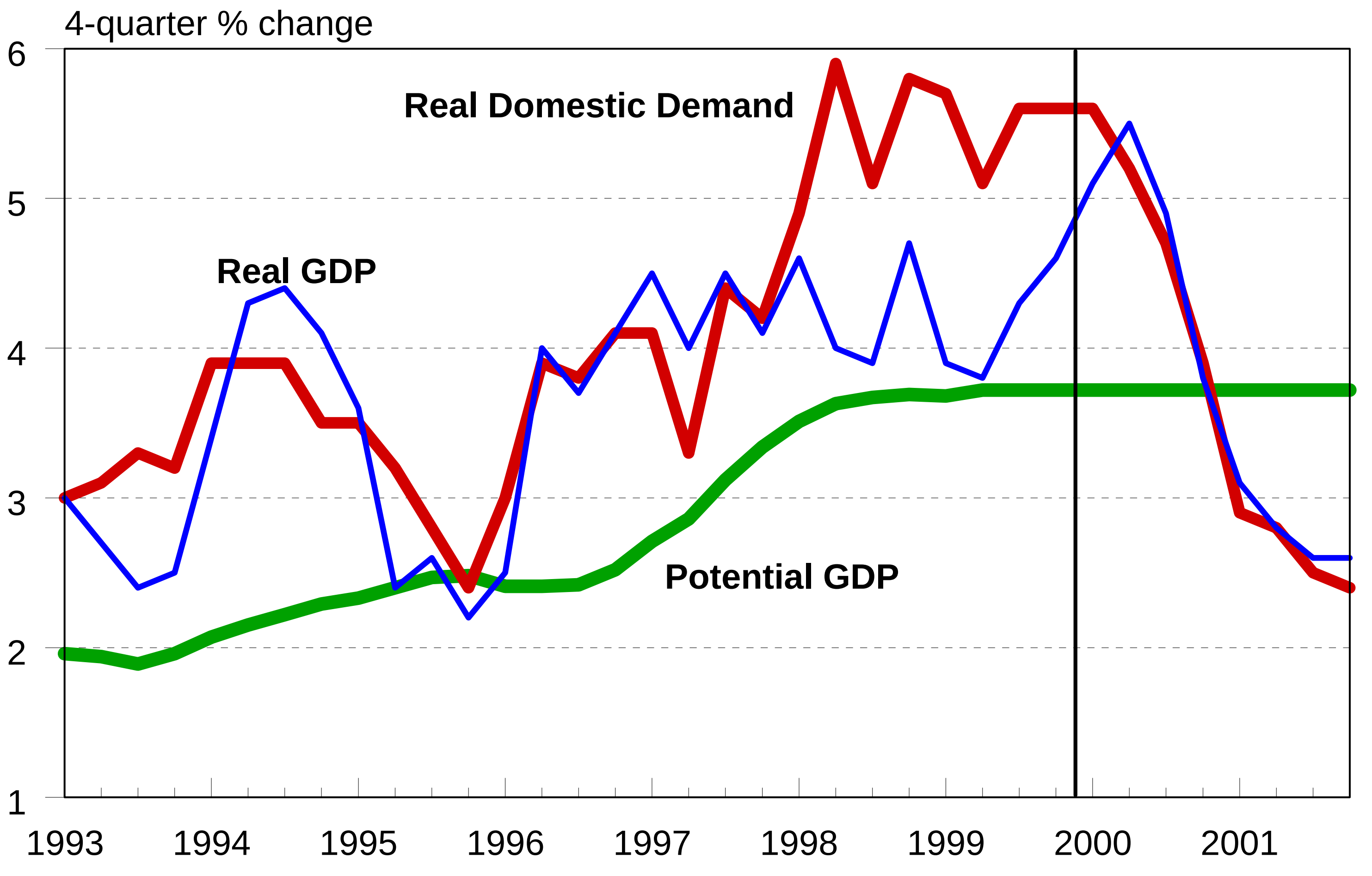
- The Big Picture ➡ Achieving the Soft Landing
- The Short-term Forecast
- What if There's No Correction?
- What if Oil Prices Jump?

The Big Picture

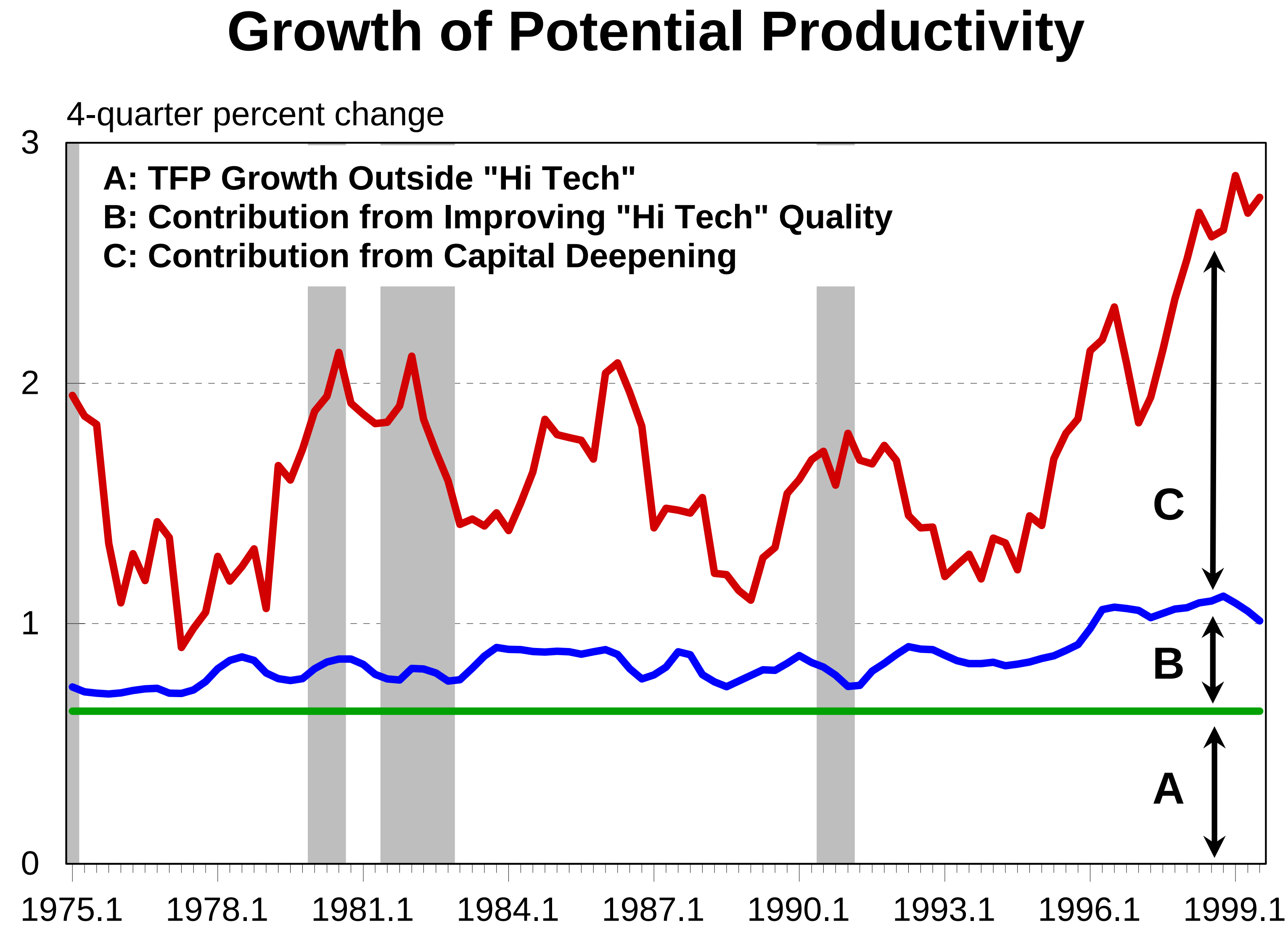
- Challenge: Transition from Above-Trend to Below-Trend
- Economic growth will slow from 4%-5% pace of the last 3 years to less than 4% this year; stocks “correct” 10%-15%
- Labor markets will continue to be very tight; the un-employment rate dips further then begins a gradual rise
- Core inflation creeps higher; oil prices peak in Q1 then head lower
- Expect four more 1/4 point rate hikes; fed funds to 7%
- Risks: equities don’t drop, oil prices jump, dollar plunges

Transition to Below Trend

Domestic Demand Versus Domestic Output



Decomposing Growth in Potential Productivity

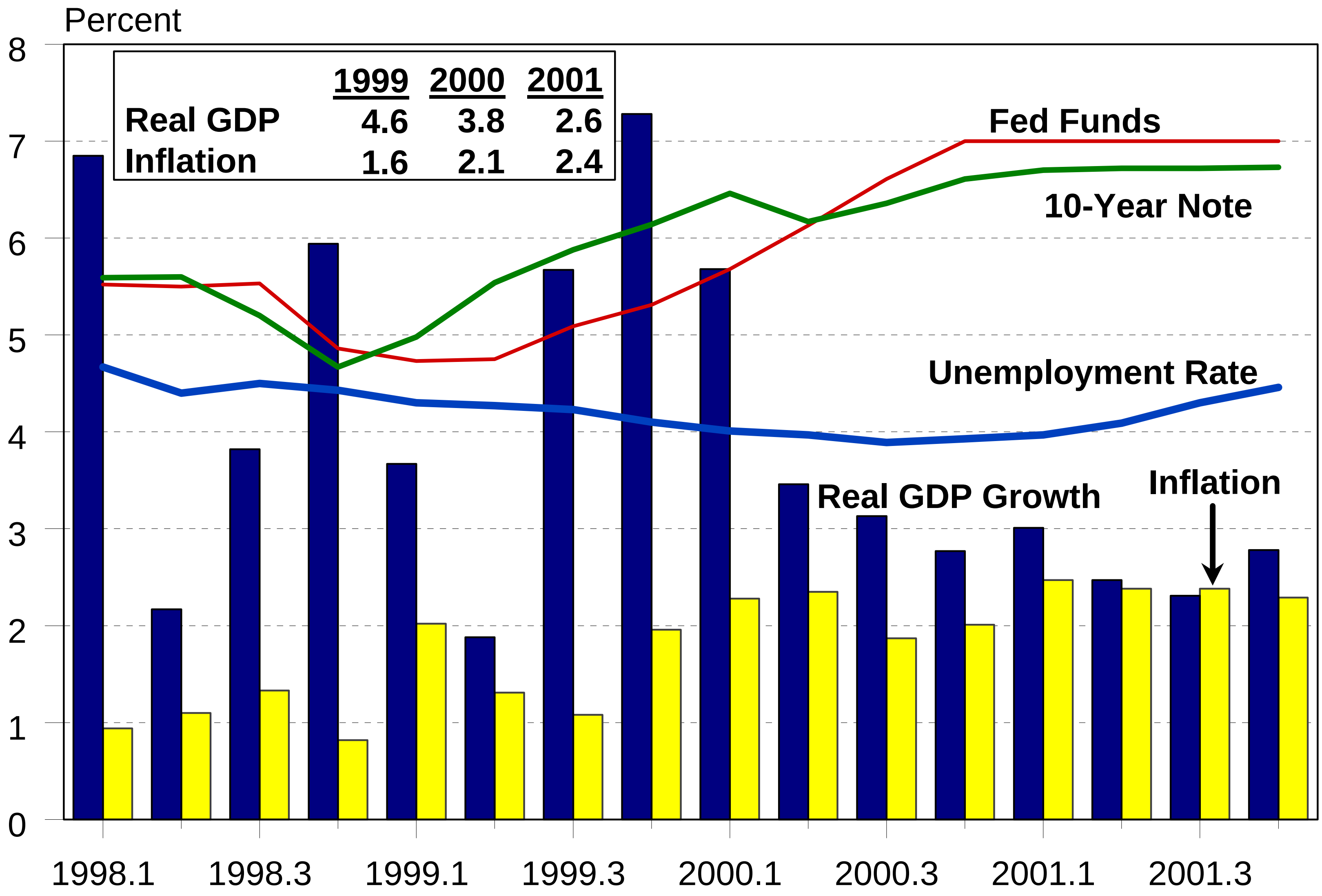


Decomposing Growth in Potential Productivity

GROWTH OF POTENTIAL PRODUCTIVITY, 1998.2-1999.2

	Unrevised NIPA's	Revised NIPA's	Change
Total Growth of Potential Productivity	2.5	2.7	0.2
From Capital Deepening	1.2	1.7	0.5
Hardware/Software	0.6	1.1	0.5
All Other Capital	0.6	0.6	0.0
From Improving "Hi-Tech" Quality	0.5	0.4	-0.1
TFP Growth Outside "Hi-Tech"	0.5	0.6	0.1
New Price Methodologies	0.3	NA	-0.3

The Outlook at a Glance



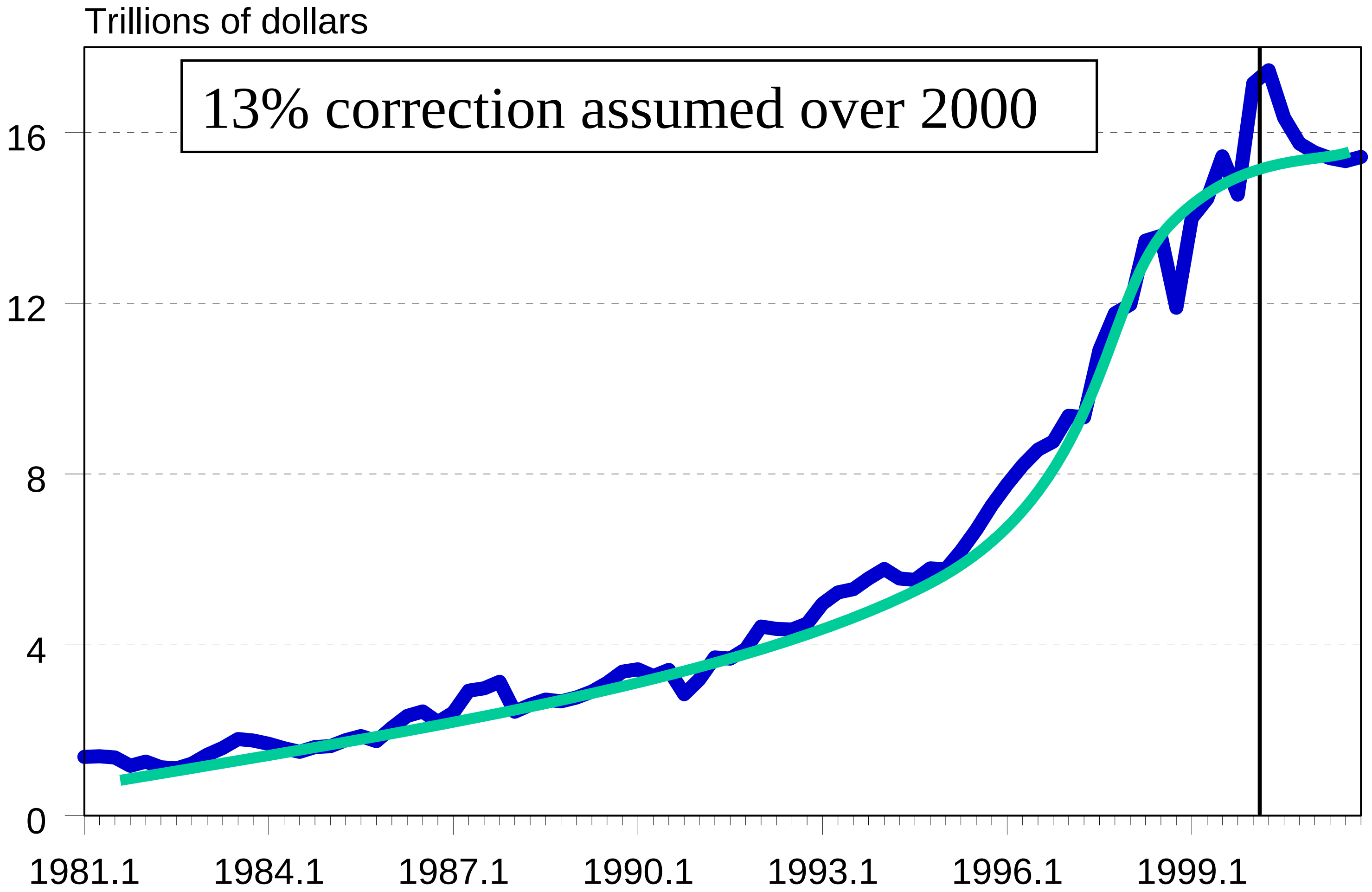
Composition of Demand in ‘00

- **Consumer spending “boom” moderates (5.6%–3.4%)**
  - **13% Stock-market correction *trims* wealth effect**
  - **Real personal disposable income growth slows**
  - **Backside of consumer durables “cycle”**
- **Business fixed investment accelerates (7.0% – 9.8%)**
  - **Capital goods prices are weak, especially hi-tech**
  - **“Accelerator” provides momentum**
  - **Higher rates impede capital spending**
- **Housing starts decline; (1.67m – 1.59m)**
- **Net export decline slows to a crawl (-1.2pp – -0.1pp)**

Real GDP Growth: 4.5% in ‘99, 3.8% in ‘00

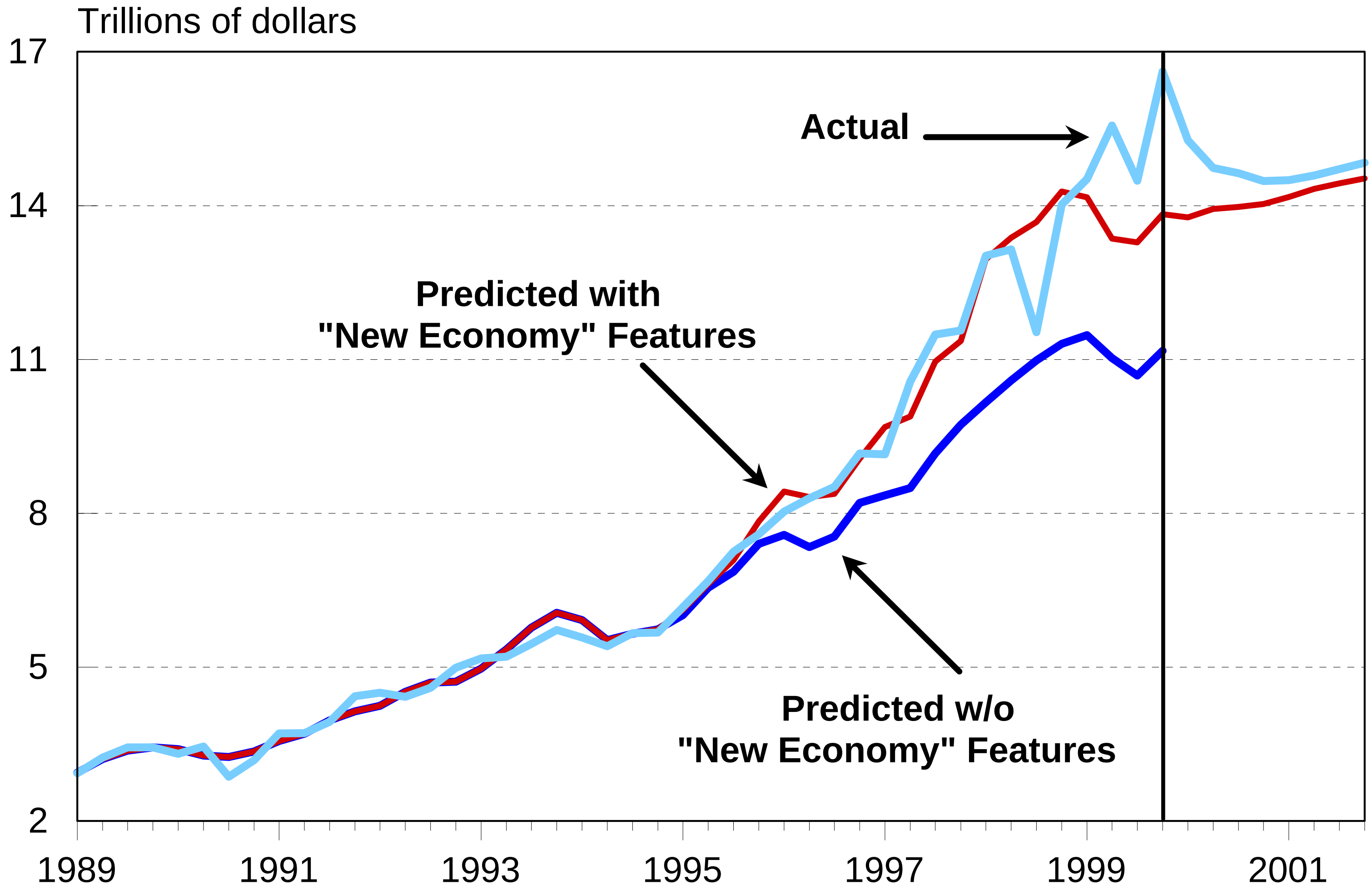
PCE: Equity Wealth Flattens

Household Holdings of Corporate Equities



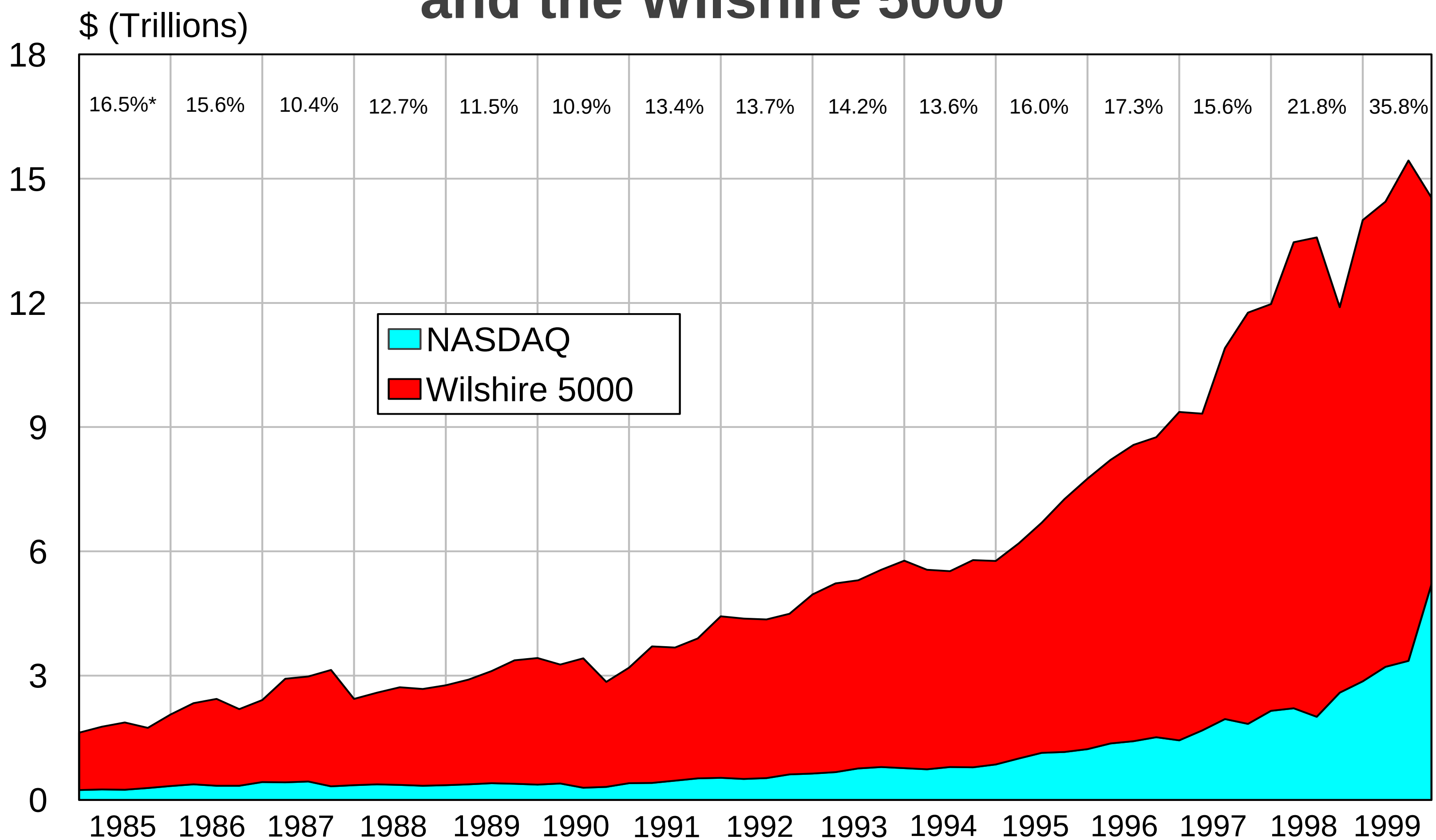
Why Assume a Correction?

Actual & Predicted Equity Wealth



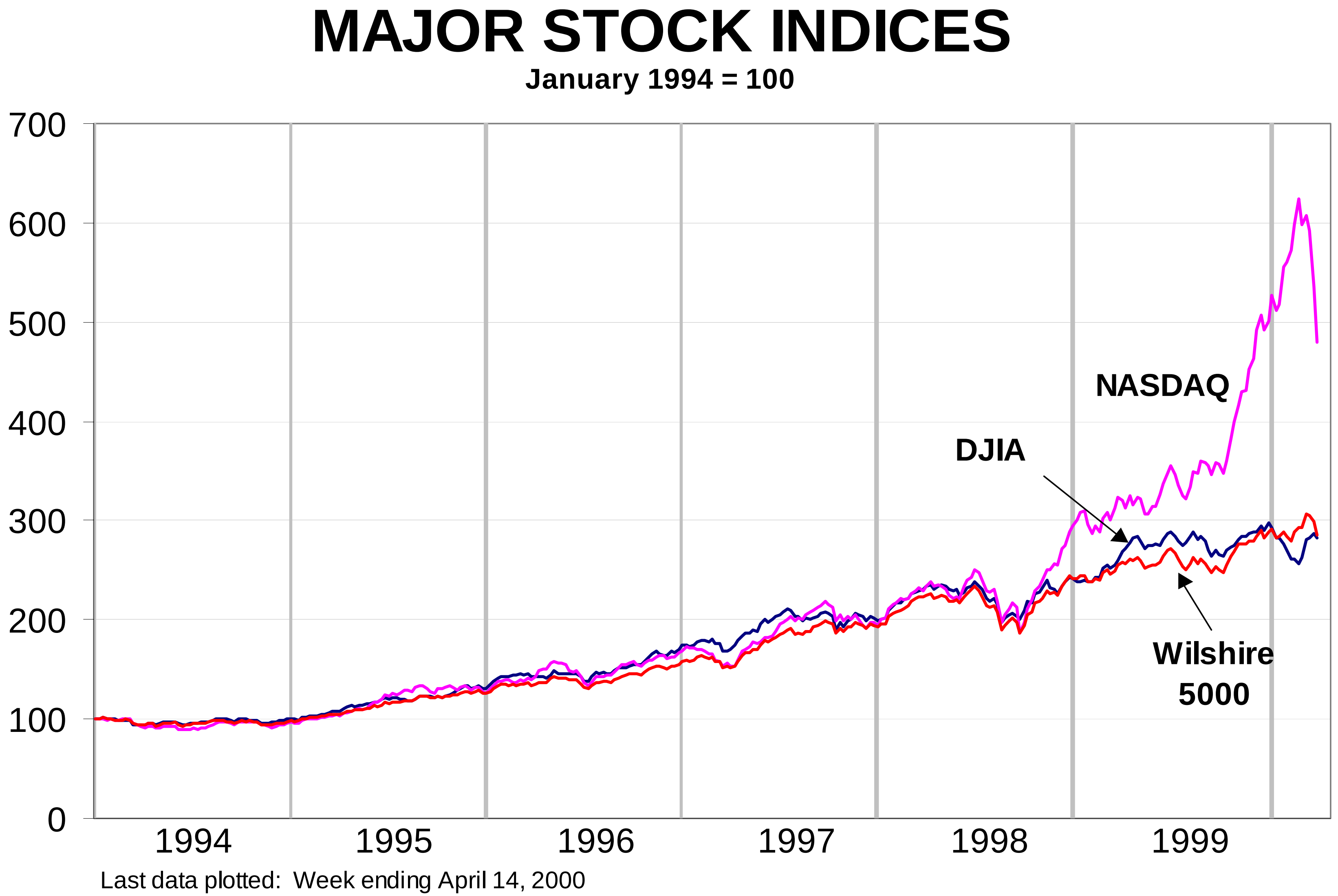
High-Tech = High-Flying

Market Capitalization of the NASDAQ and the Wilshire 5000



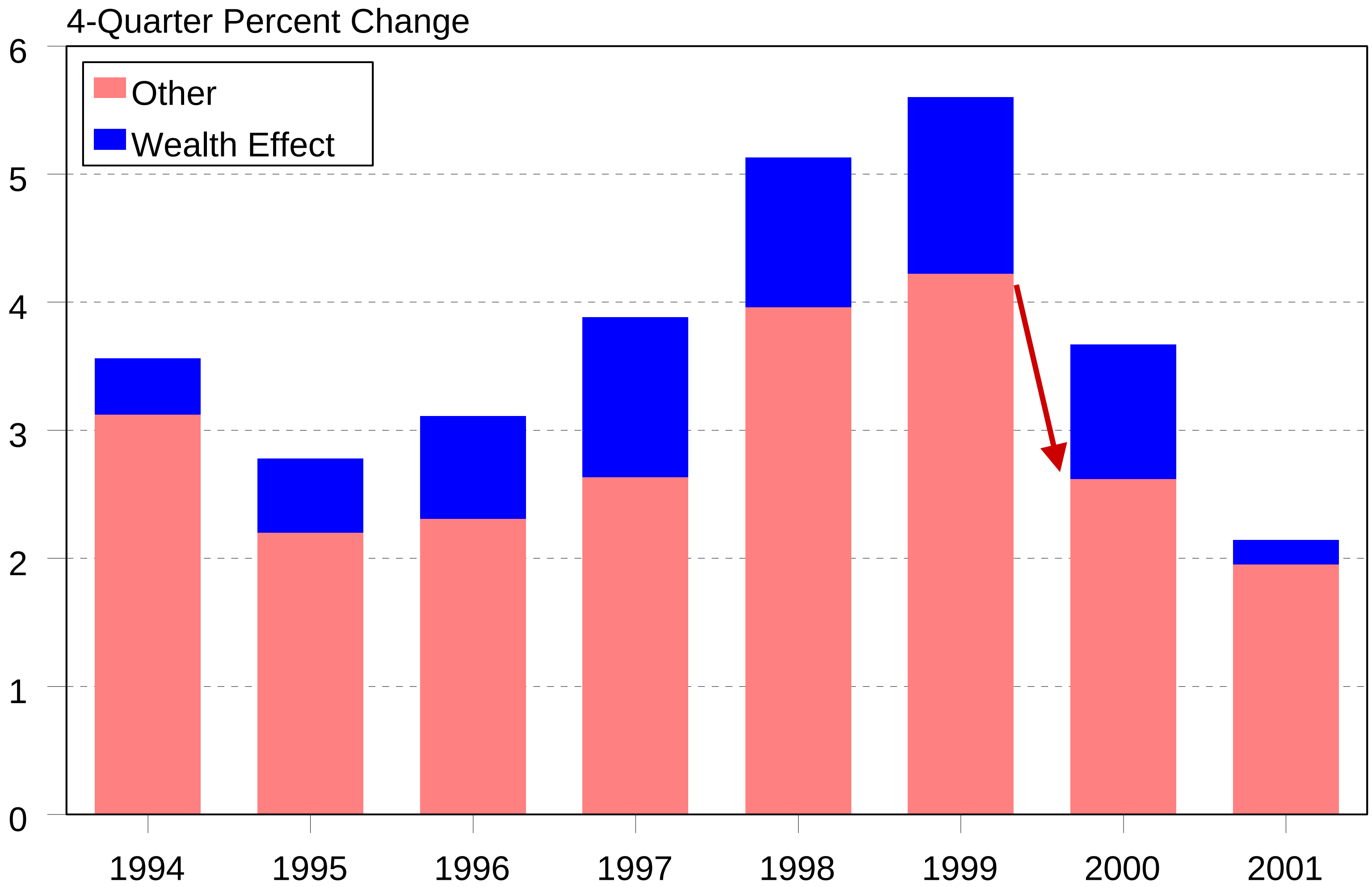
*NASDAQ percent of Wilshire 5000 at fourth quarter

Uneven Gains



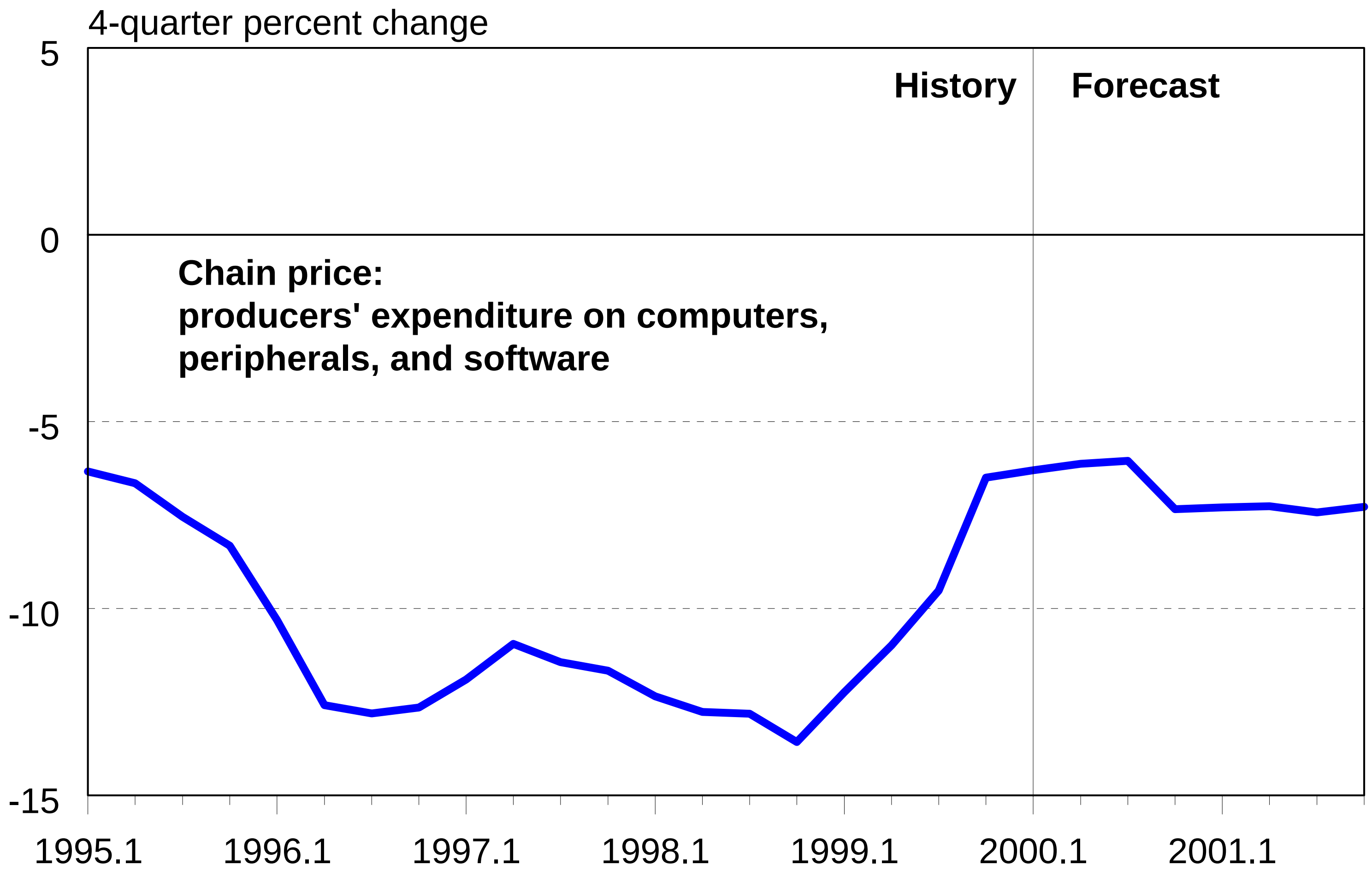
What Do Equity Gains Contribute?

Real Personal Consumption Expenditures



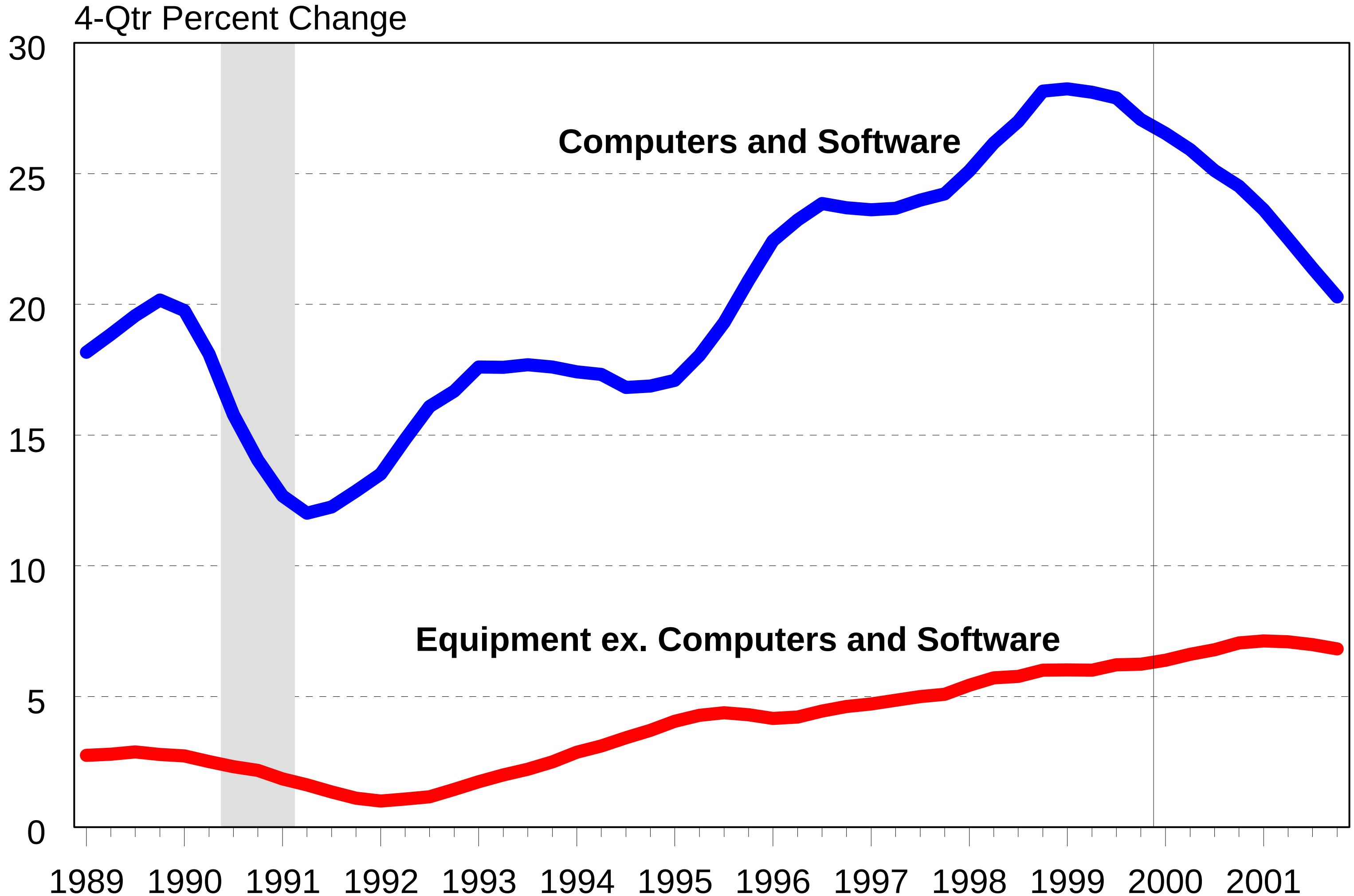
Computer & Software Investment

Computer Prices Falling Less Rapidly



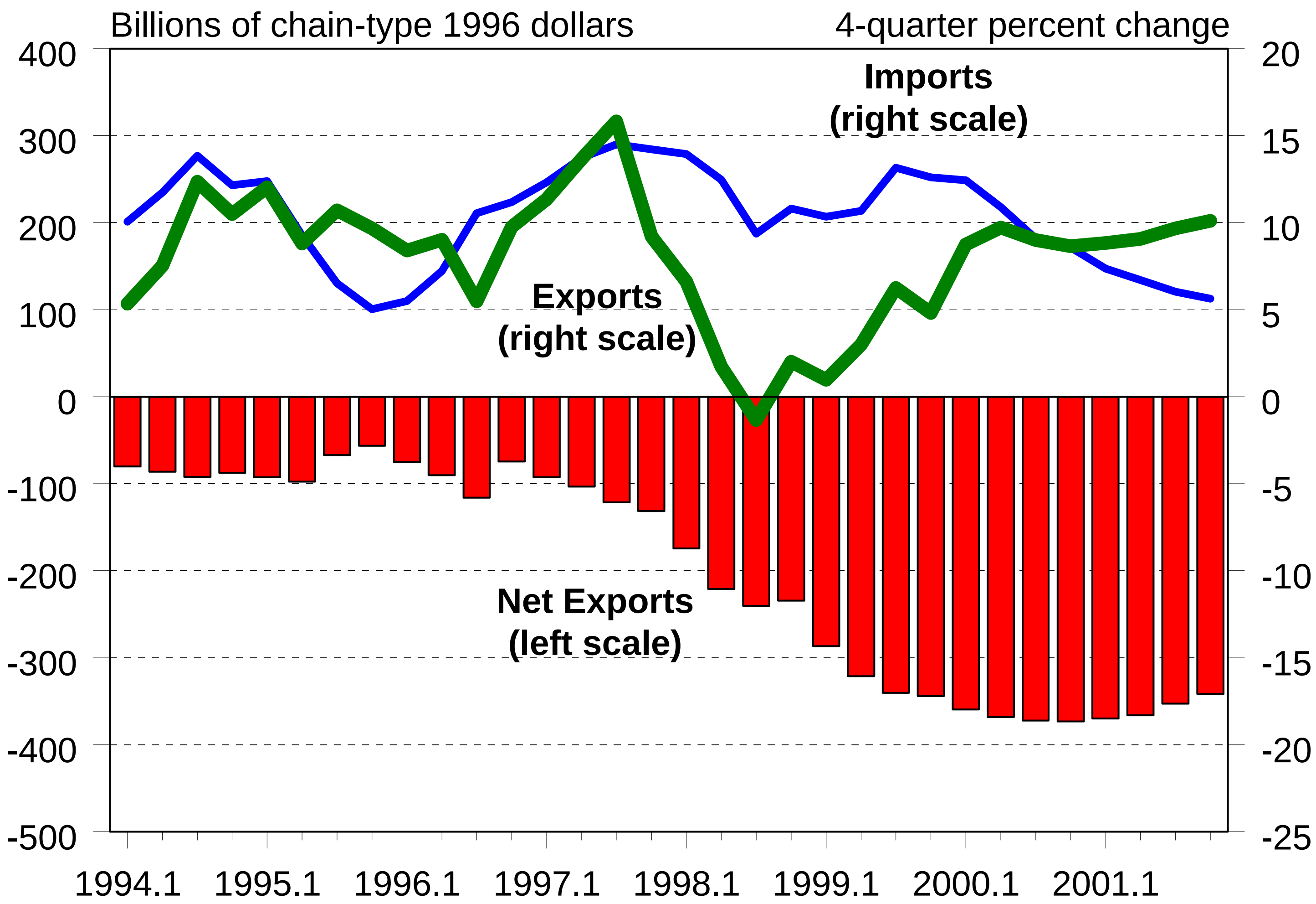
High Investment, Growing Stocks

Growth of Business Capital Stocks



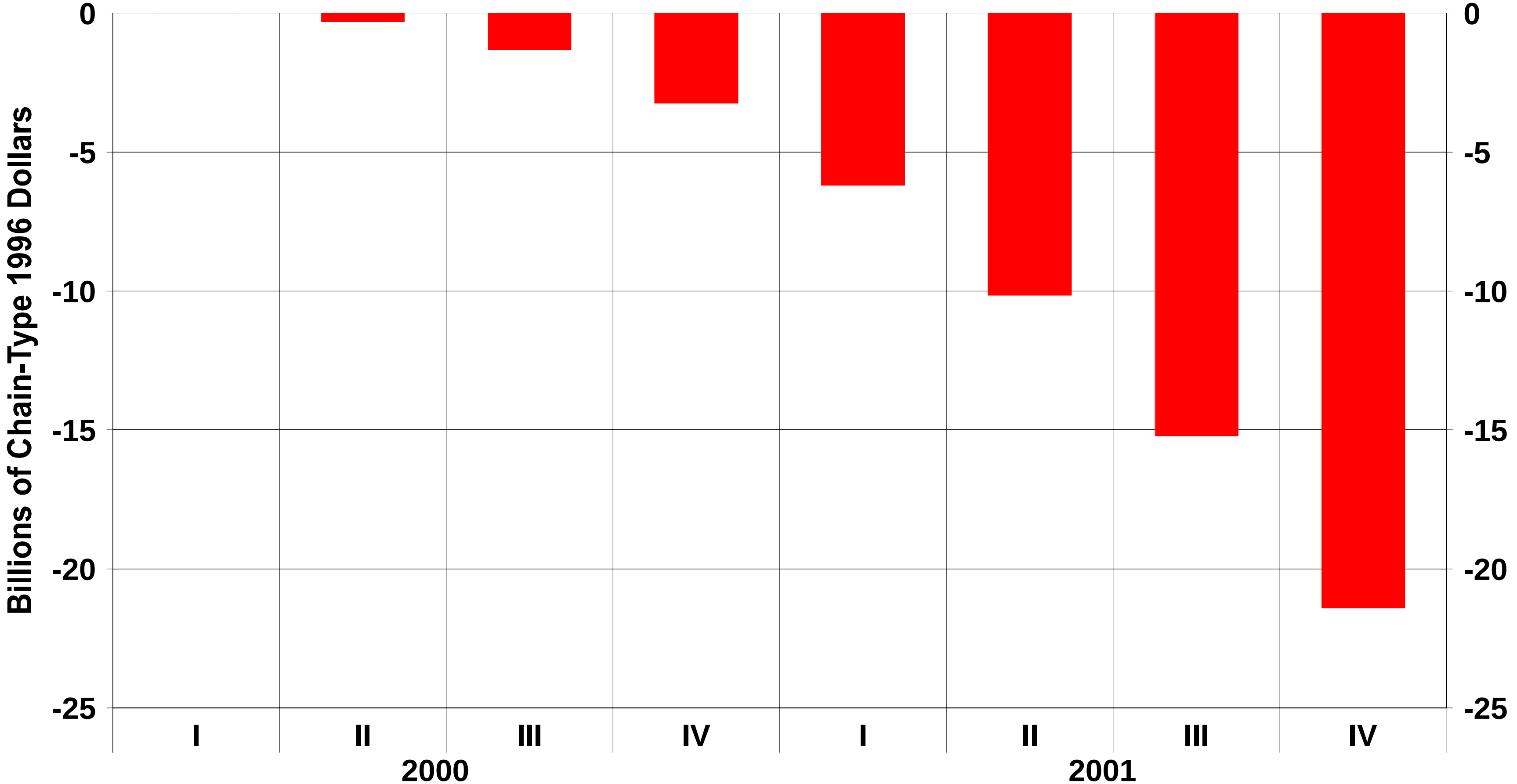
Trade Sector: Less of a Drag

Trade in the Forecast



Impact of Gradual 5% Decline in $

How Much Lower Would Merchandise Net Exports Be if the Dollar Did Not Decline 5%?



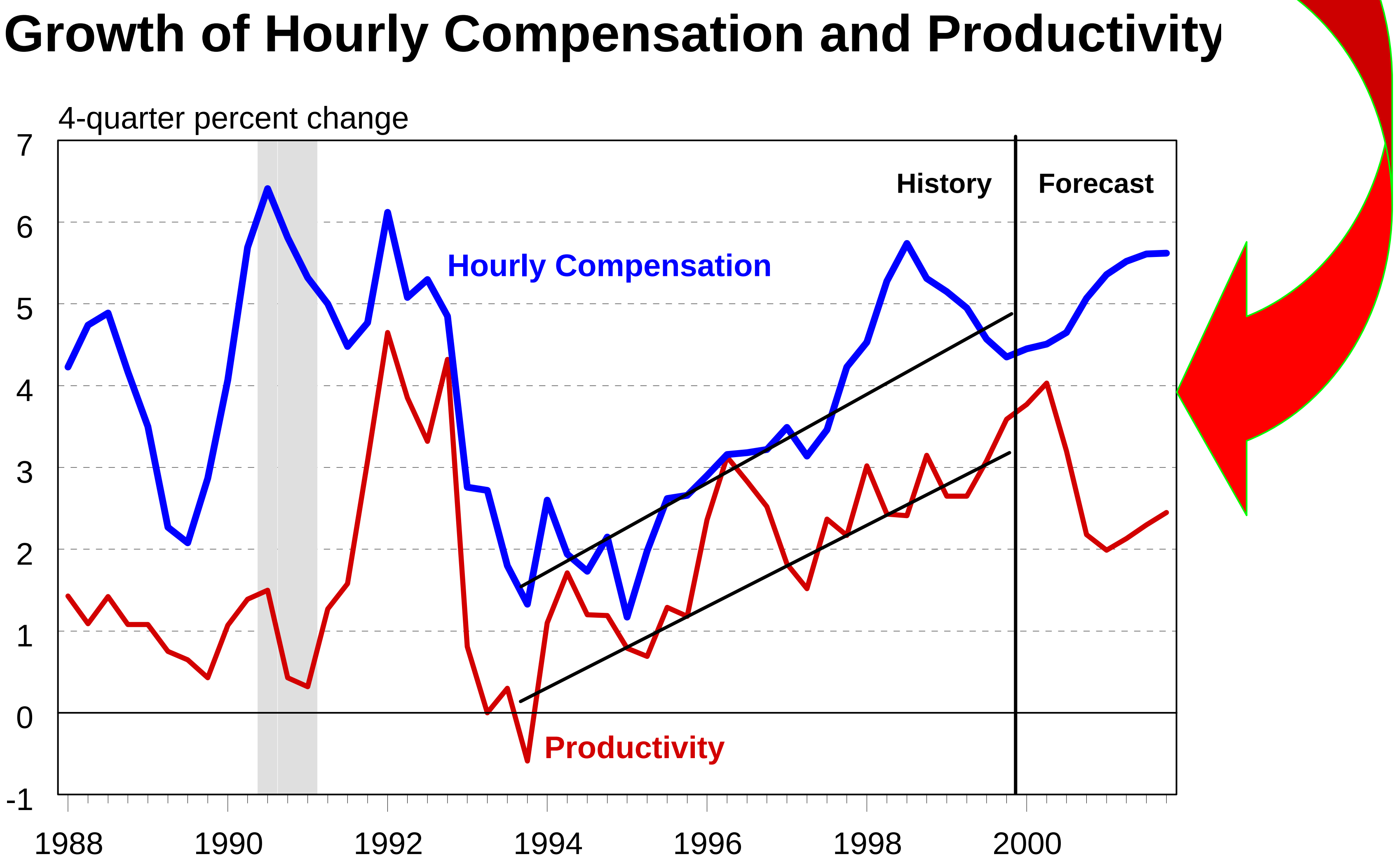
Note: Partial effects only on non-petro imports and non-ag exports

Summary of Expenditure Growth

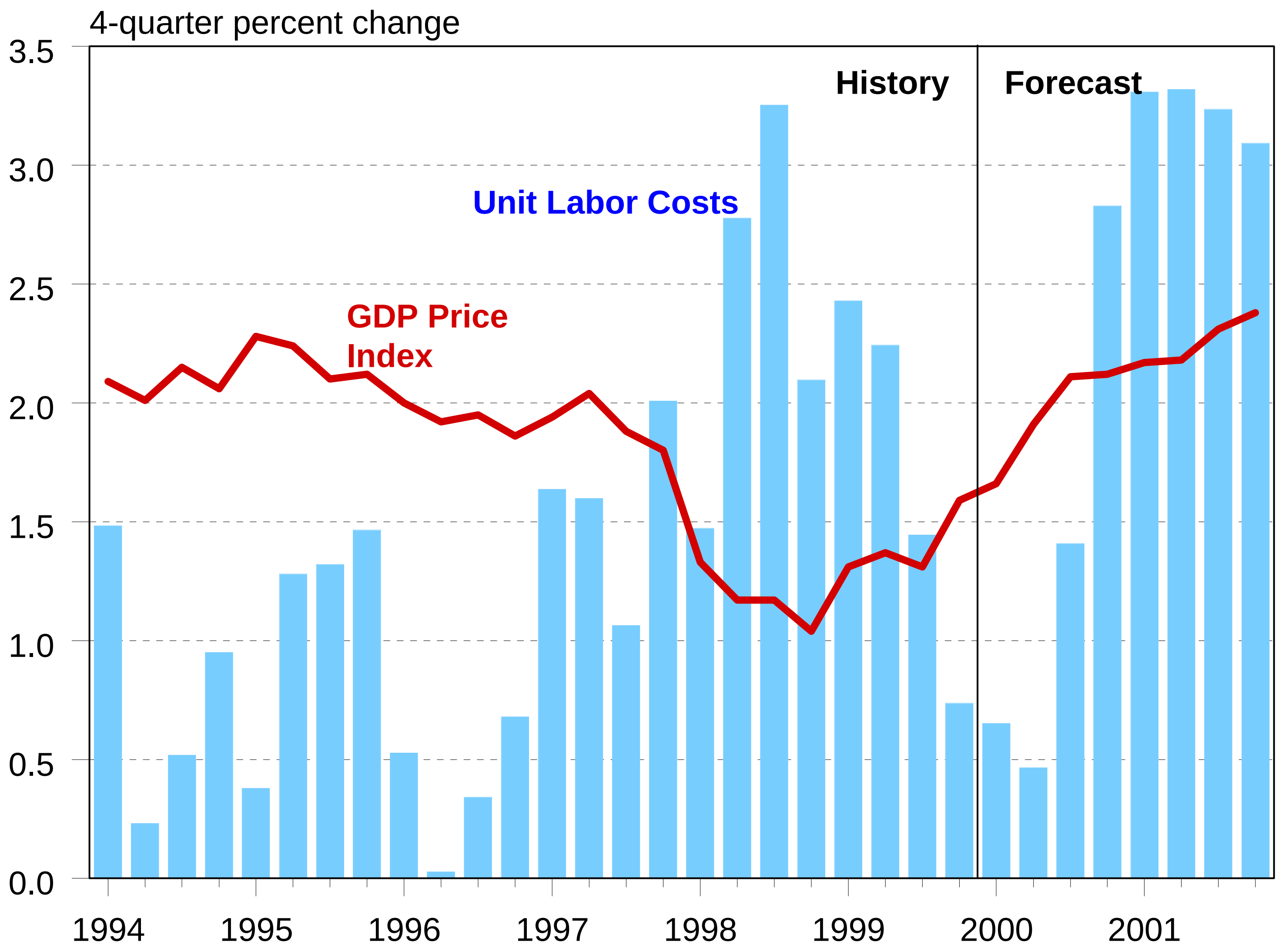
	1999	2000			2001
	4/4	1st half	2nd half	4/4	4/4
Real Gross Domestic Product	4.6	4.6	3.0	3.8	2.6
Consumption	5.6	4.7	2.8	3.7	2.1
Business Fixed Investment	6.3	14.5	8.7	11.5	5.3
Residential Investment	3.9	1.7	-6.9	-2.8	0.4
Inventory Investment*	0.0	0.0	0.1	0.0	-0.2
Net Exports*	-1.1	-0.5	-0.1	-0.3	0.3
Exports	4.8	8.7	8.6	8.6	10.1
Imports	12.6	10.0	7.2	8.6	5.6
Government C&GI	5.0	0.3	2.1	1.2	1.8

* contribution to GDP growth

Utilization Risk

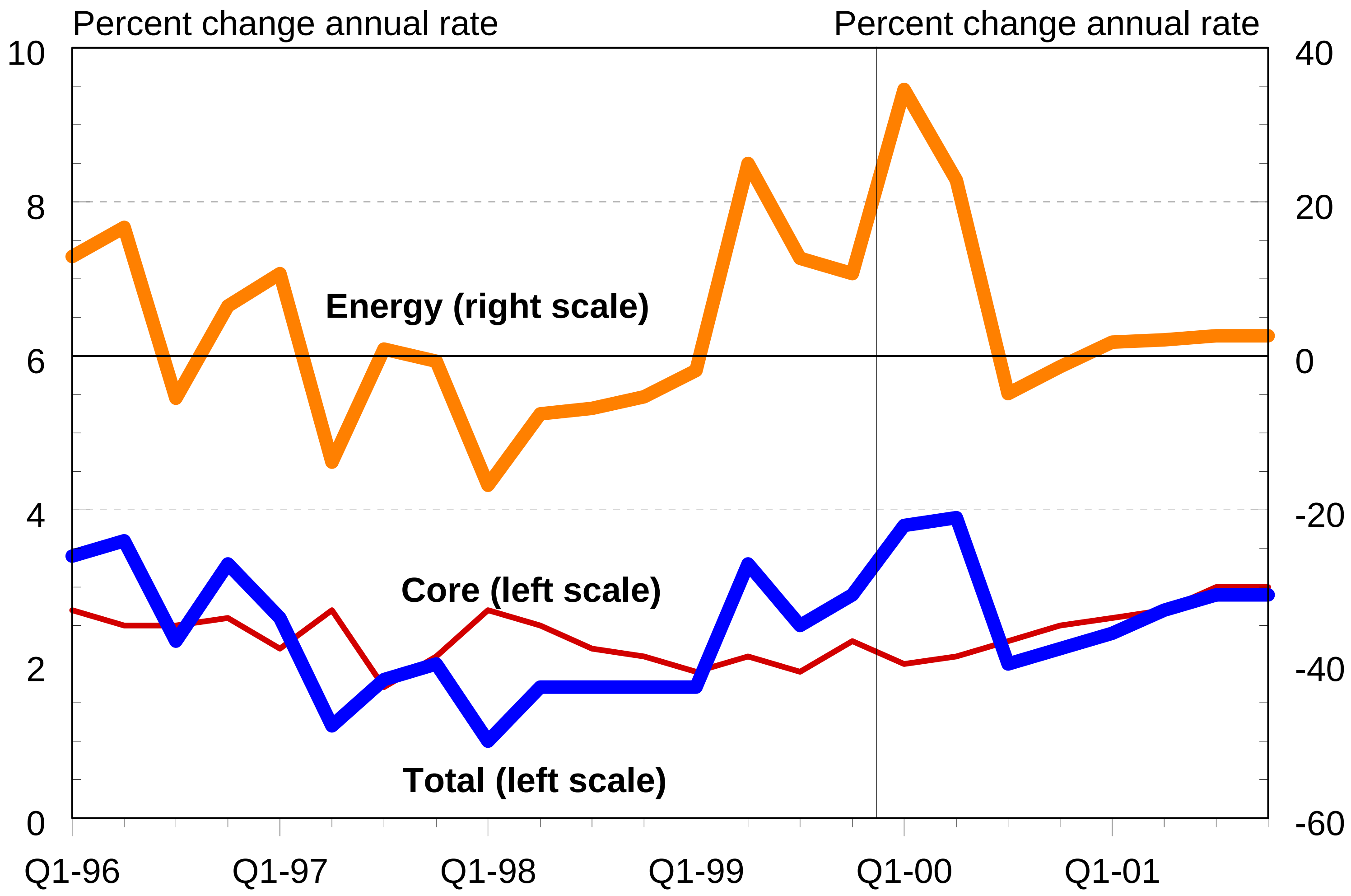


Inflation is Headed Up

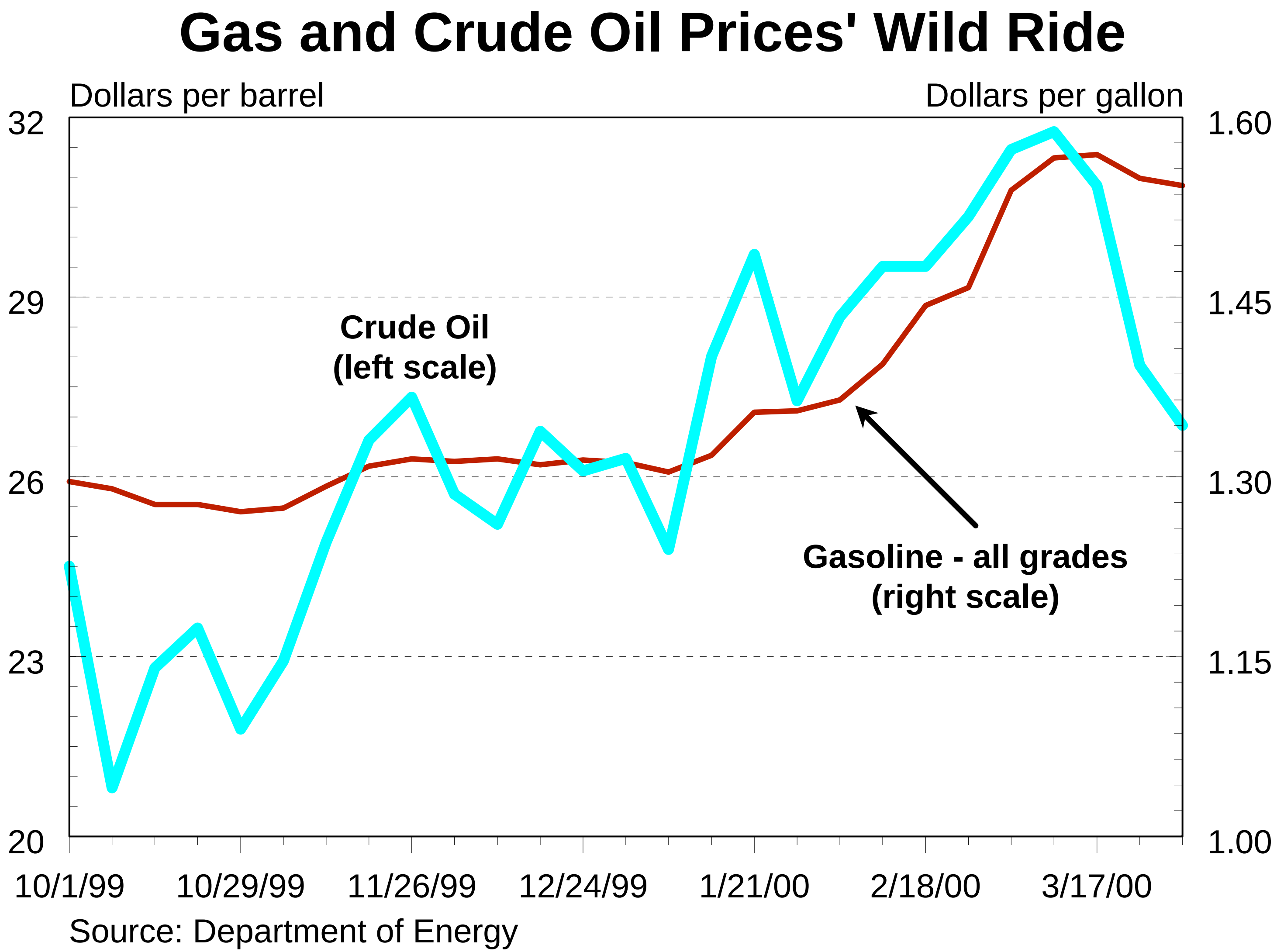


Impact of Oil Price Forecast

Energy Prices and CPI Inflation



Gasoline Prices: Stubborn Down



Federal Reserve Policy

- Comforted by continued low inflation, but...
- Aware of temporary nature of much of the recent good news
- Knows that there are “growth limits”, but unsure what they are
- Watching for hints in the data that aggregate demand is slowing
- Wary of upside risks to aggregate demand in 2000; forecast errors
- Even if *growth* slows, *utilization* risk remains
- MFCI suggests less accommodation w/ or w/o stock mkt correction
- Rate Risk 1: The stock market fails to correct
- Rate Risk 2: The dollar cracks

Best Guess: Two more tightenings, but risks are to the upside

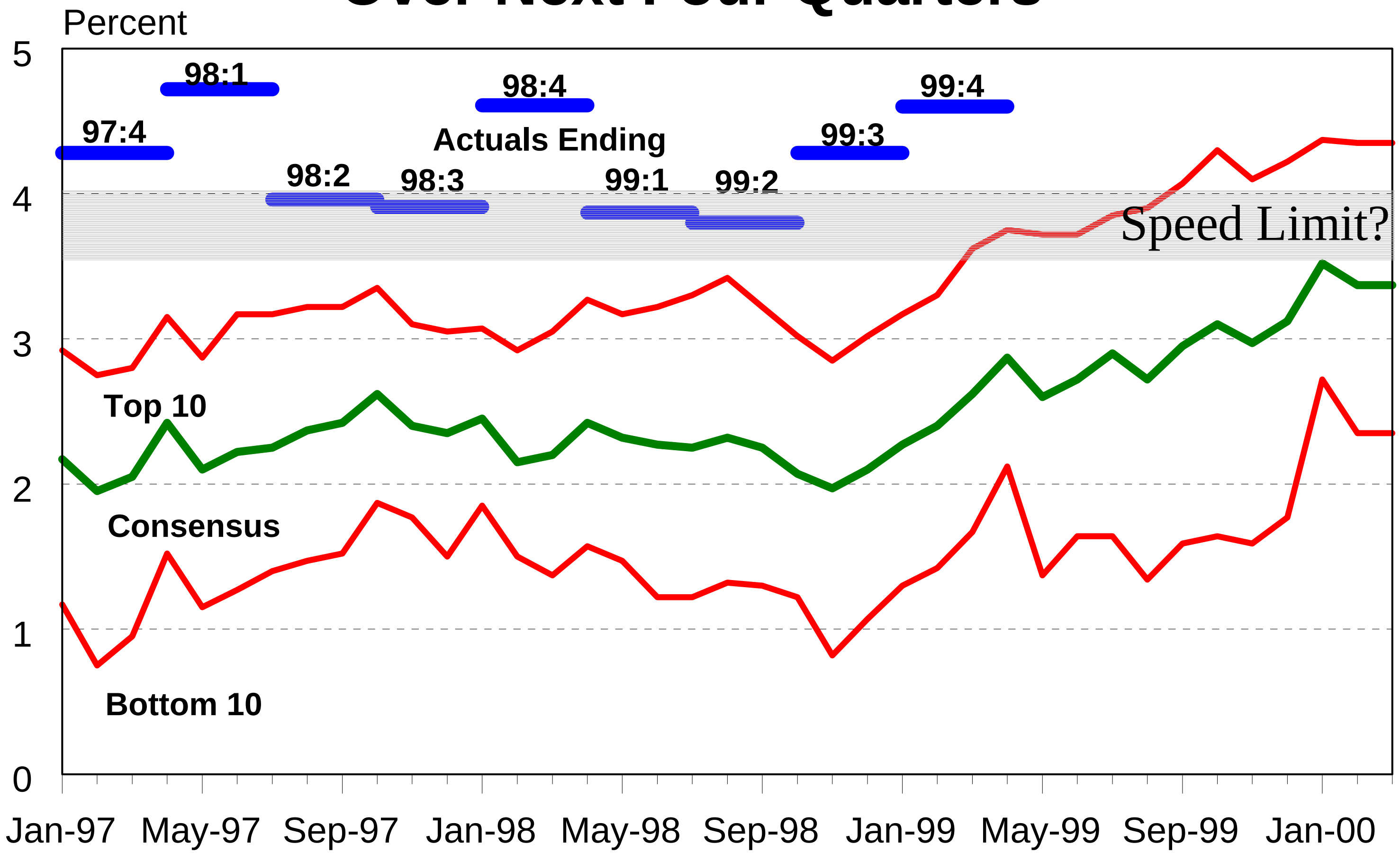
What does MA Expect?

- 1/4 point tightening at May meeting
- 1/4 point tightening at June meeting
- 1/4 point tightening at August meeting
- 1/4 point tightening at October meeting

⇒ Fed funds rate reaches 7%

Growth Risk: Part I

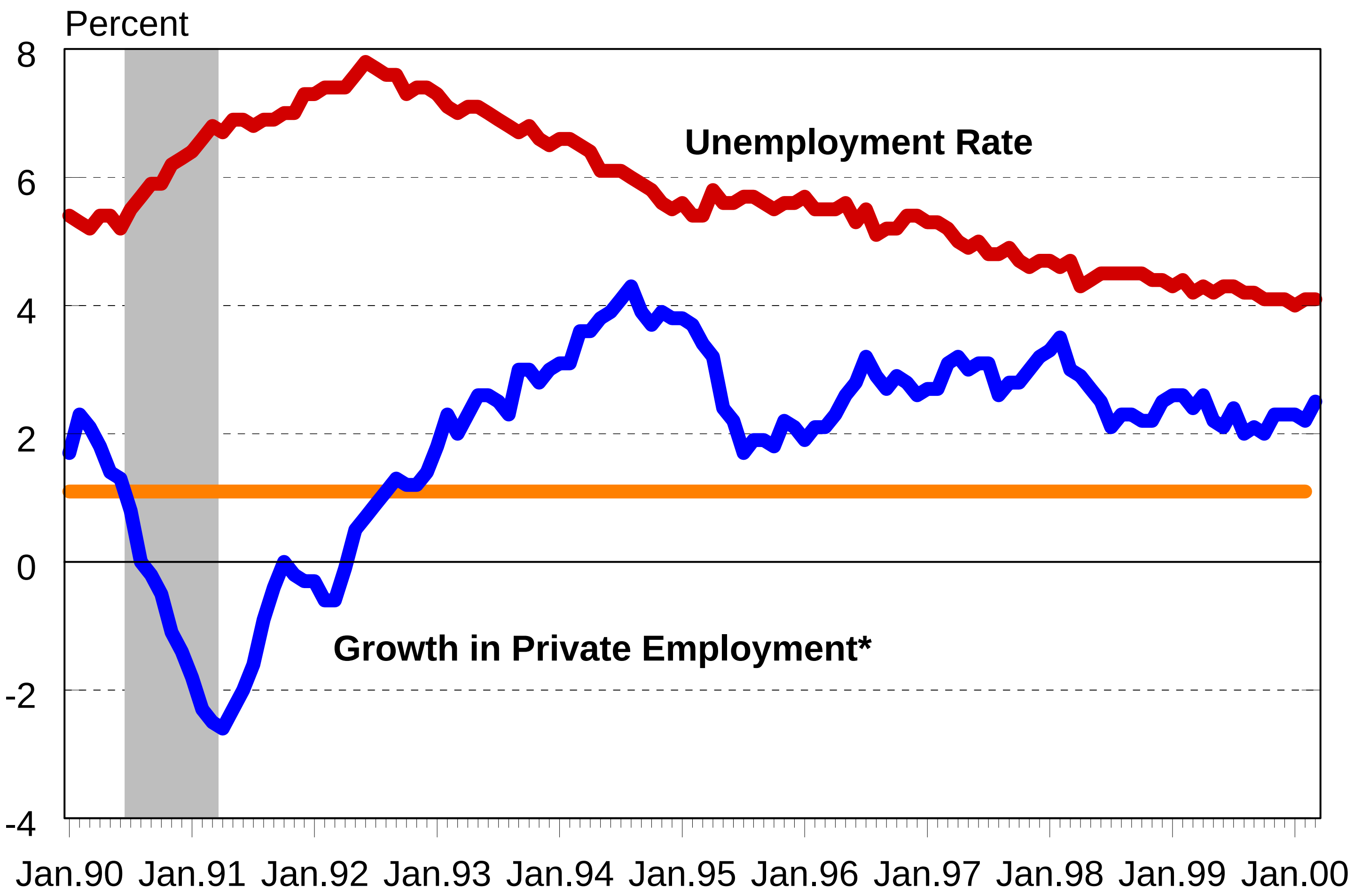
Blue Chip Consensus Forecasts of GDP Growth Over Next Four Quarters



Source: Blue Chip Economic Indicators, Macroeconomic Advisers

Growth Risk: Part II

Unsustainable Growth in Employment ?



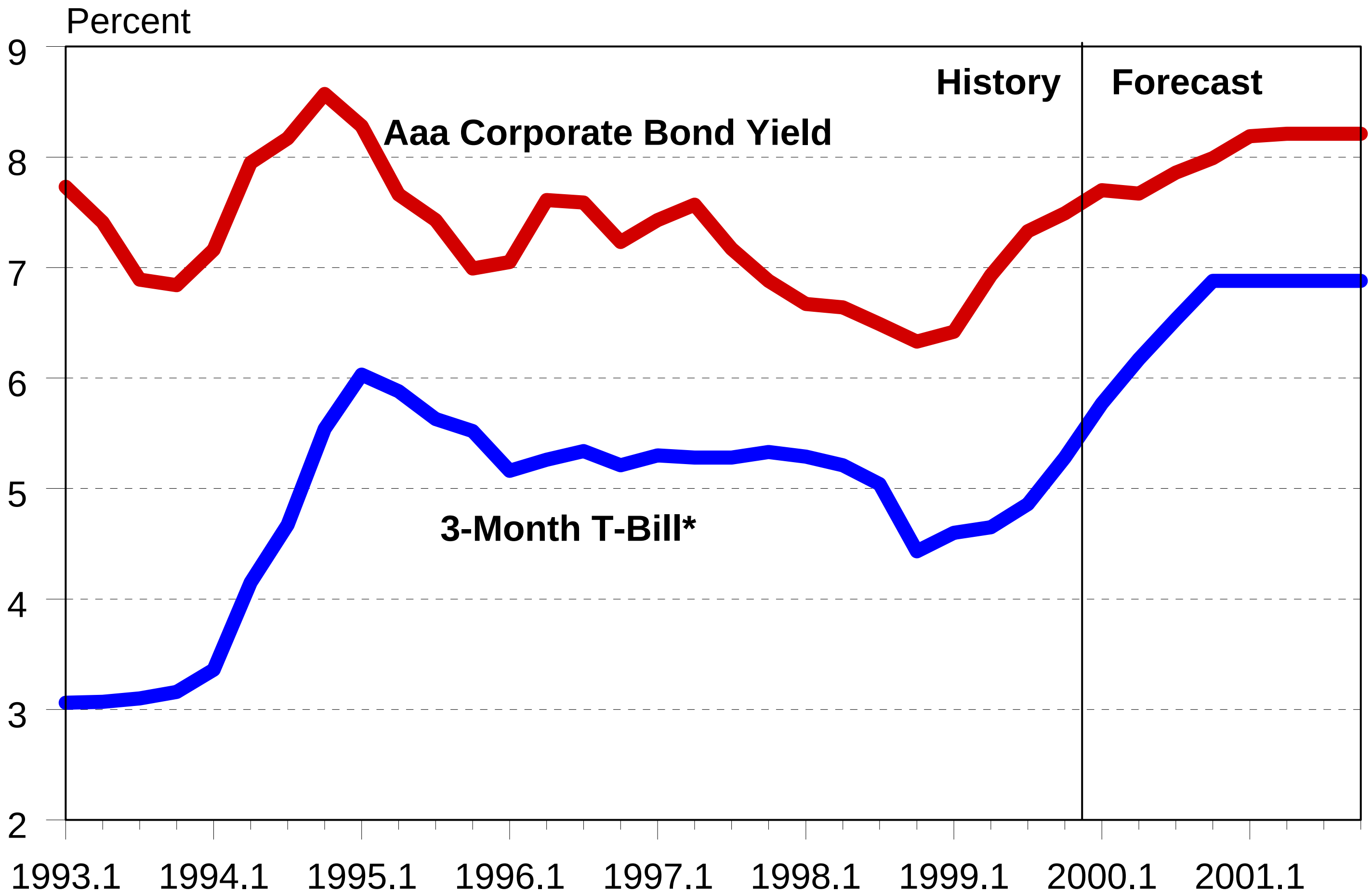
*6-month % change, annual rate

Determinants of Long-term Yields

- **Federal Reserve: Anchors the short end after 1 or 2 more move**
  - **Strength of the real economy: Will growth continue above trend?**
  - **Core inflation #'s may look unfriendly for a while**
- **Inflation and inflation expectations: Past bottom for the cycle**
- **Reverse of previous flight-to-quality: Fund flows return to Asia**
- **Expected path of the dollar: Is a strong $ consistent with huge and persistent current account deficits? Probably not.**
- **Federal Deficit/Surplus: CBO predicts surplus measured in hundreds of billions of dollars through FY 2009**
- **1/2 as many 30-yr Treasuries to be issued in FY '00 versus FY '99**

Rising Shorts, Steady Longs

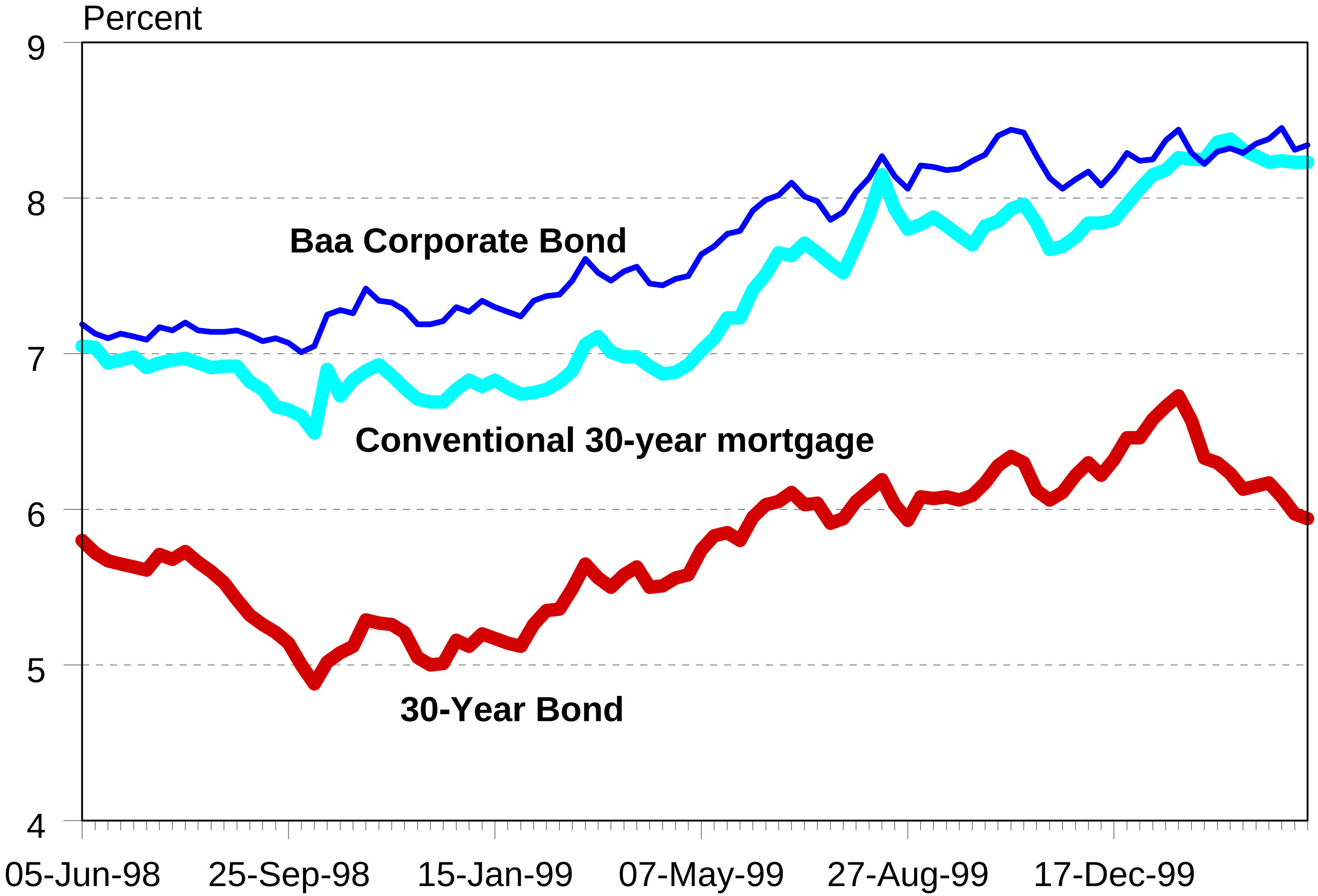
Short & Long-Term Interest Rates



*Bond-equivalent yield

Treasury Yields Sag for Lack of Supply

Long-Term Interest Rates



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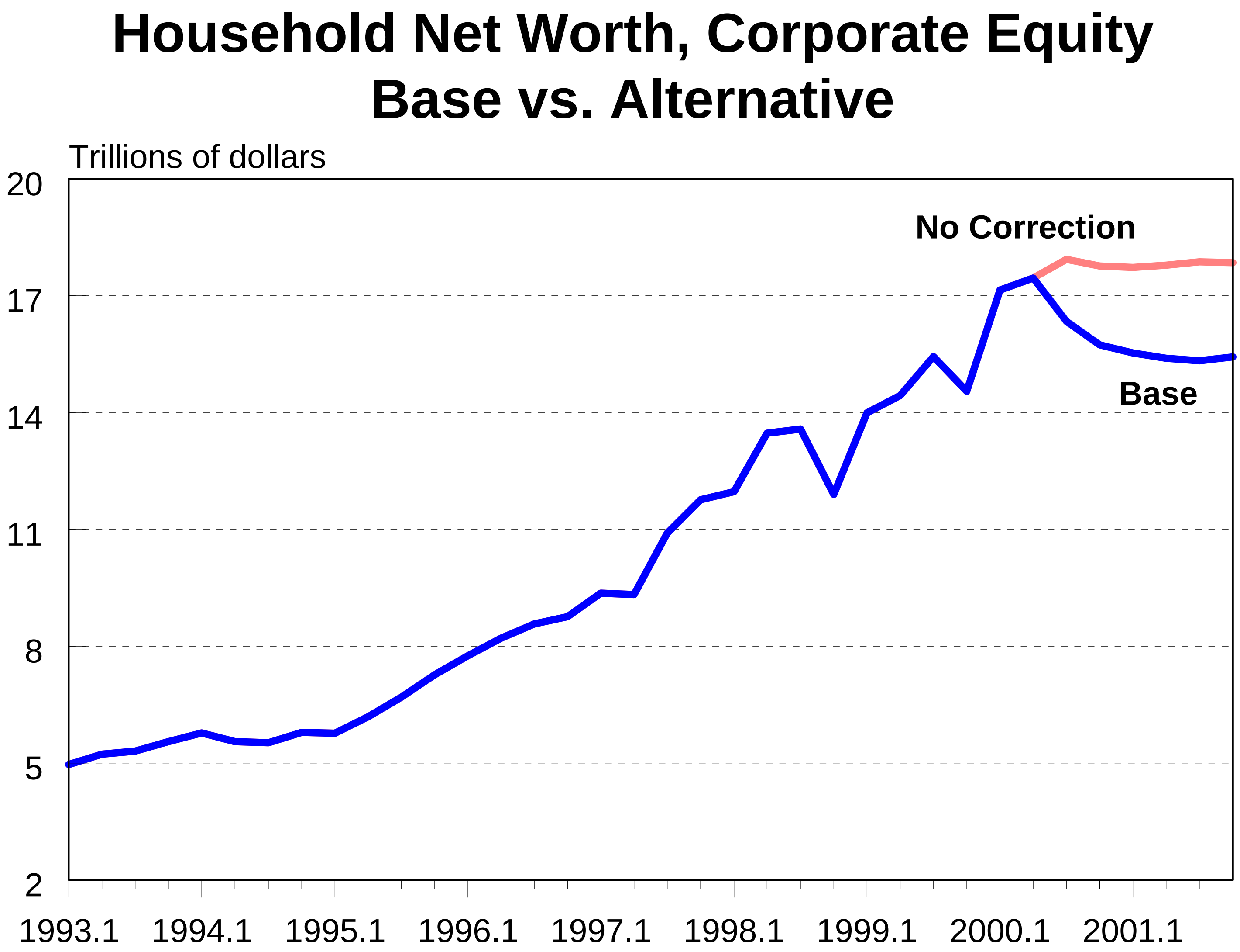

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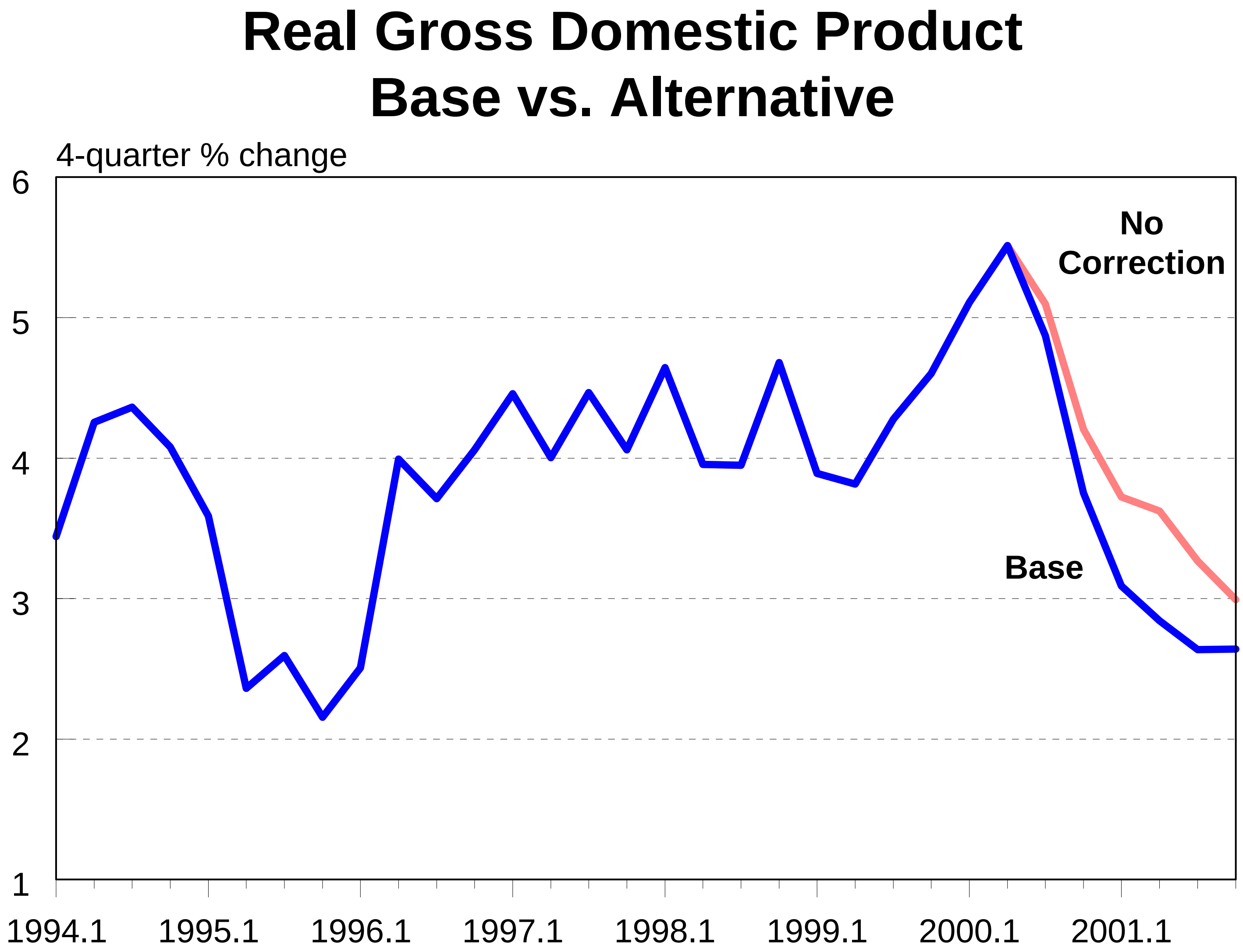

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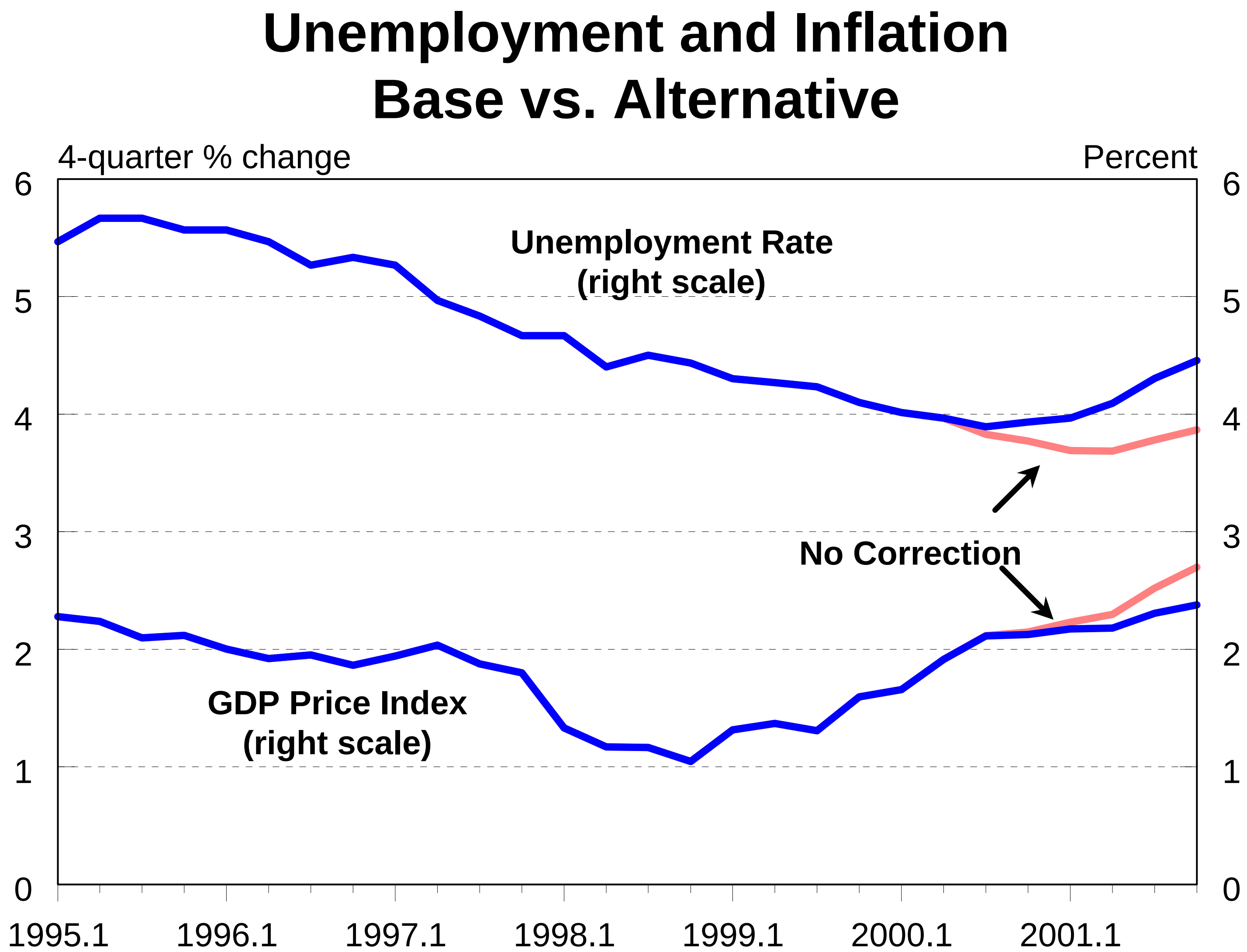

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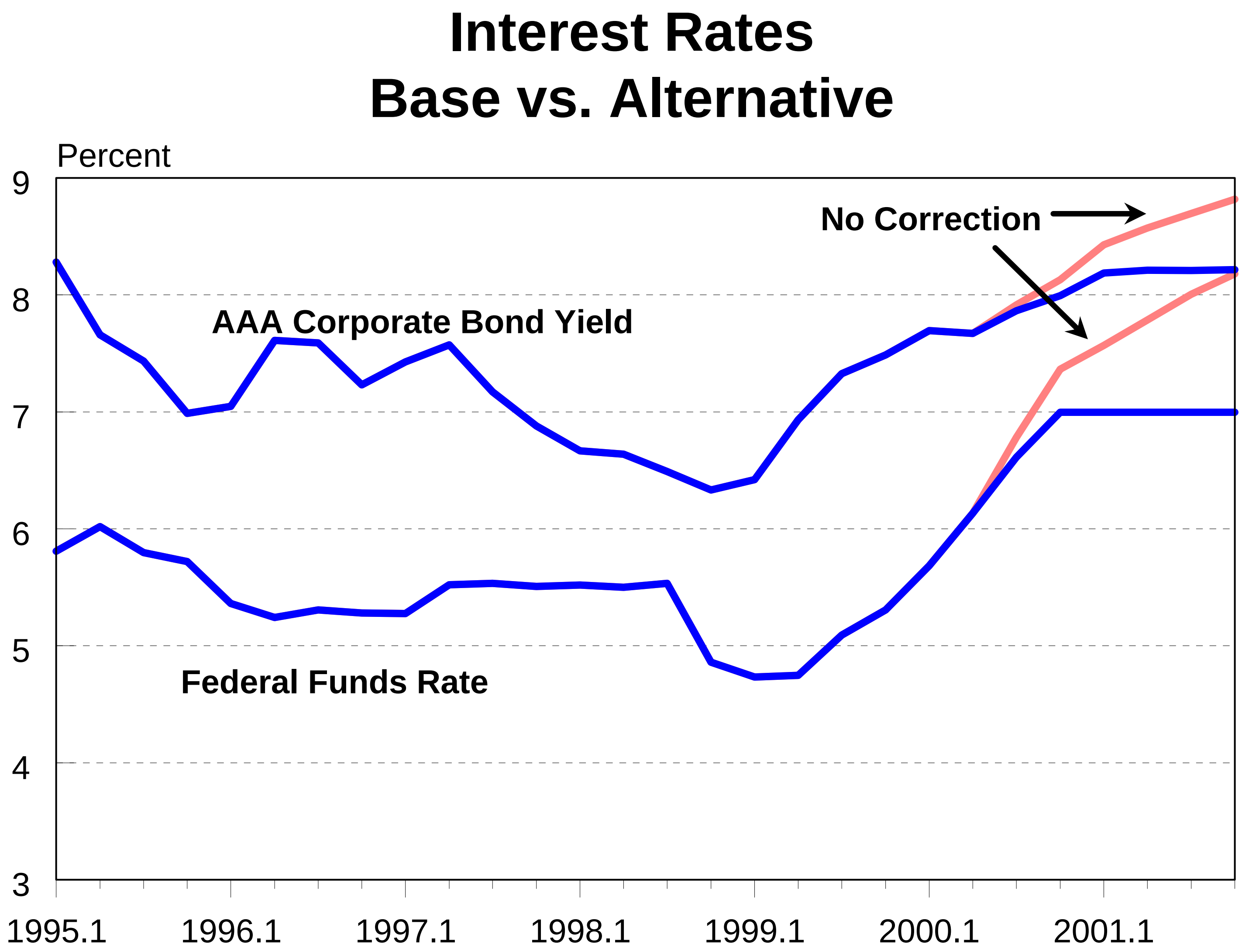
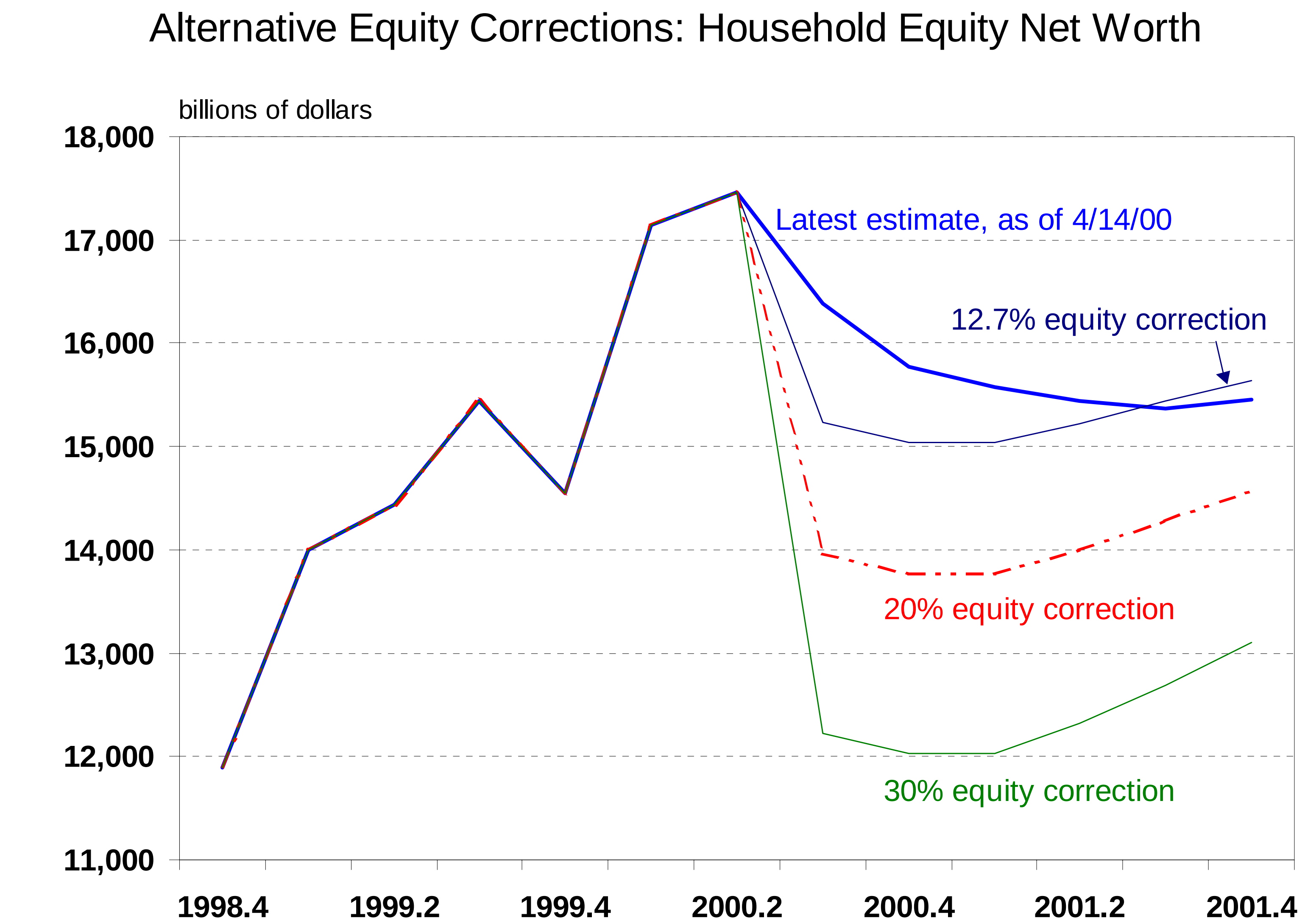
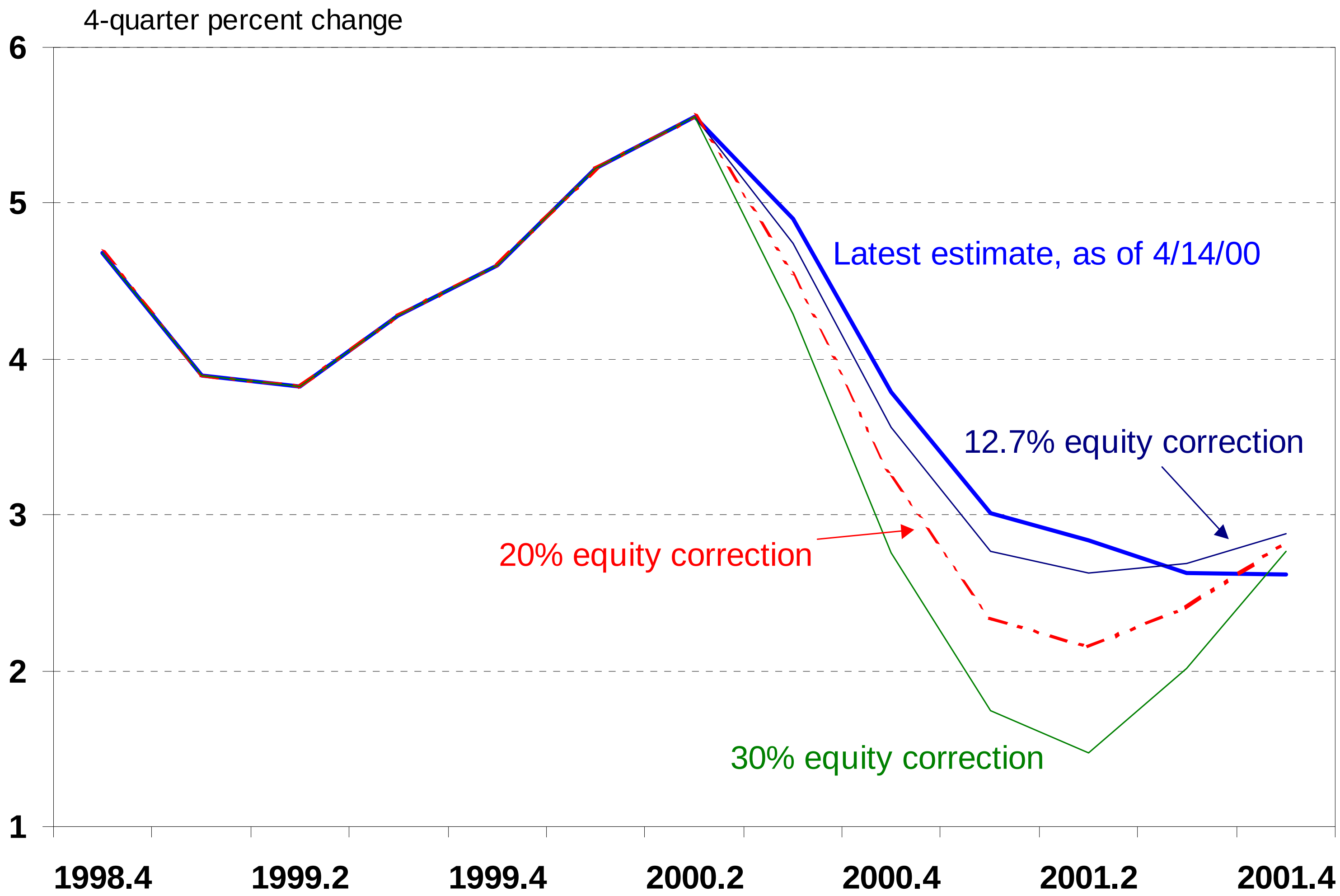


What if There's a Big Correction?



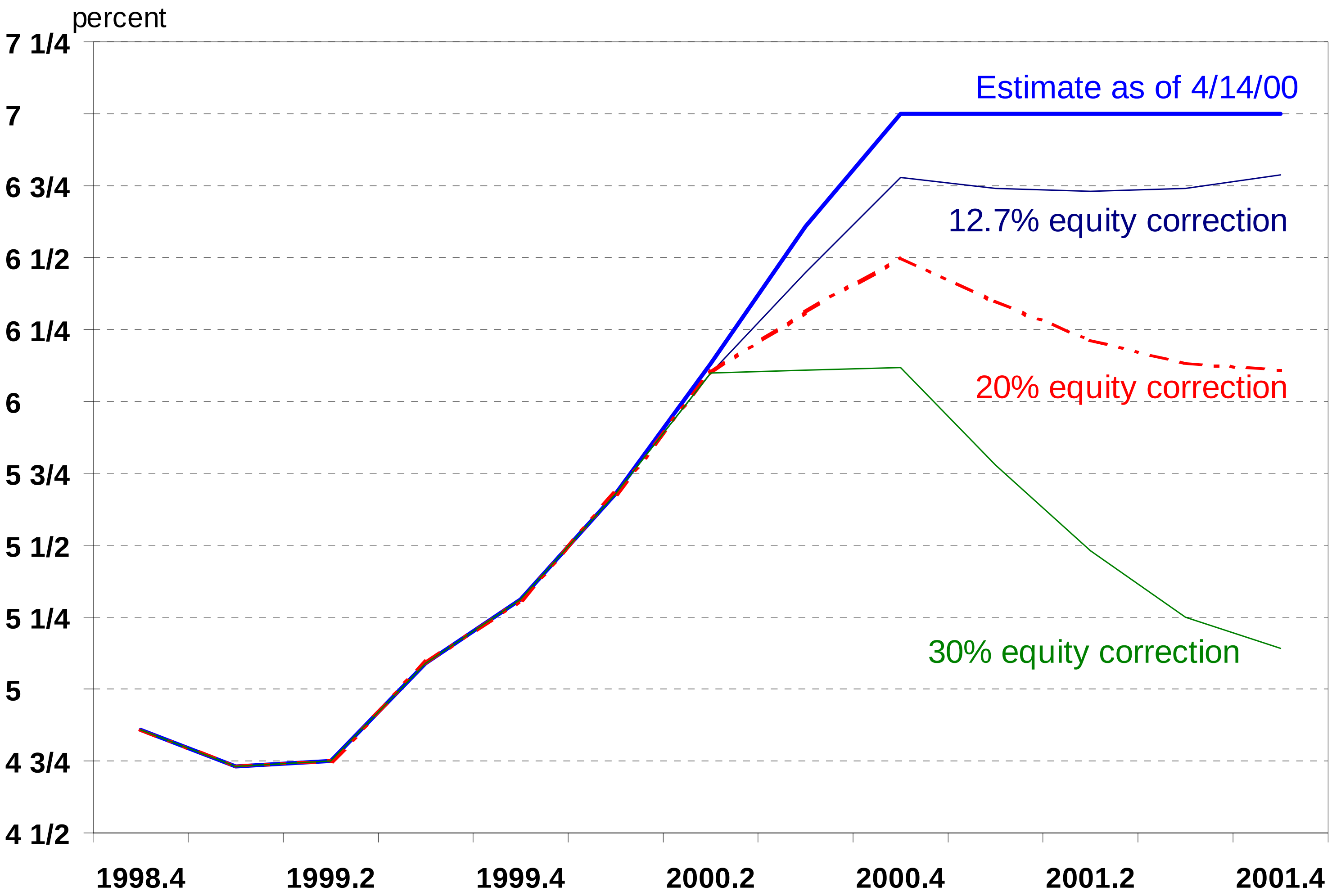
What if There's a Big Correction?

Alternative Equity Corrections: GDP Growth

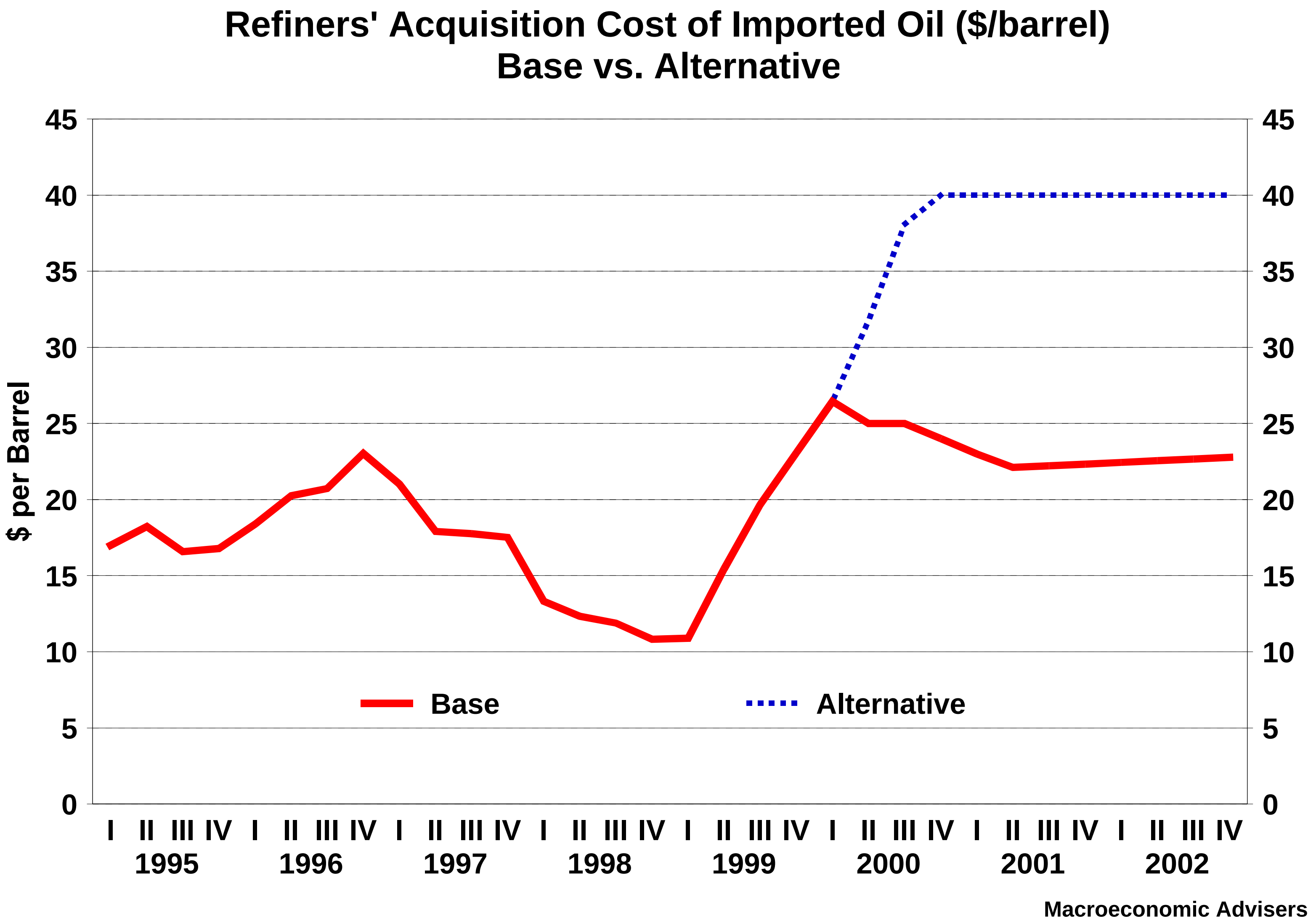


What if There's a Big Correction?

Alternative Equity Corrections: Fed Funds Rate



What if Oil Prices Jumped?



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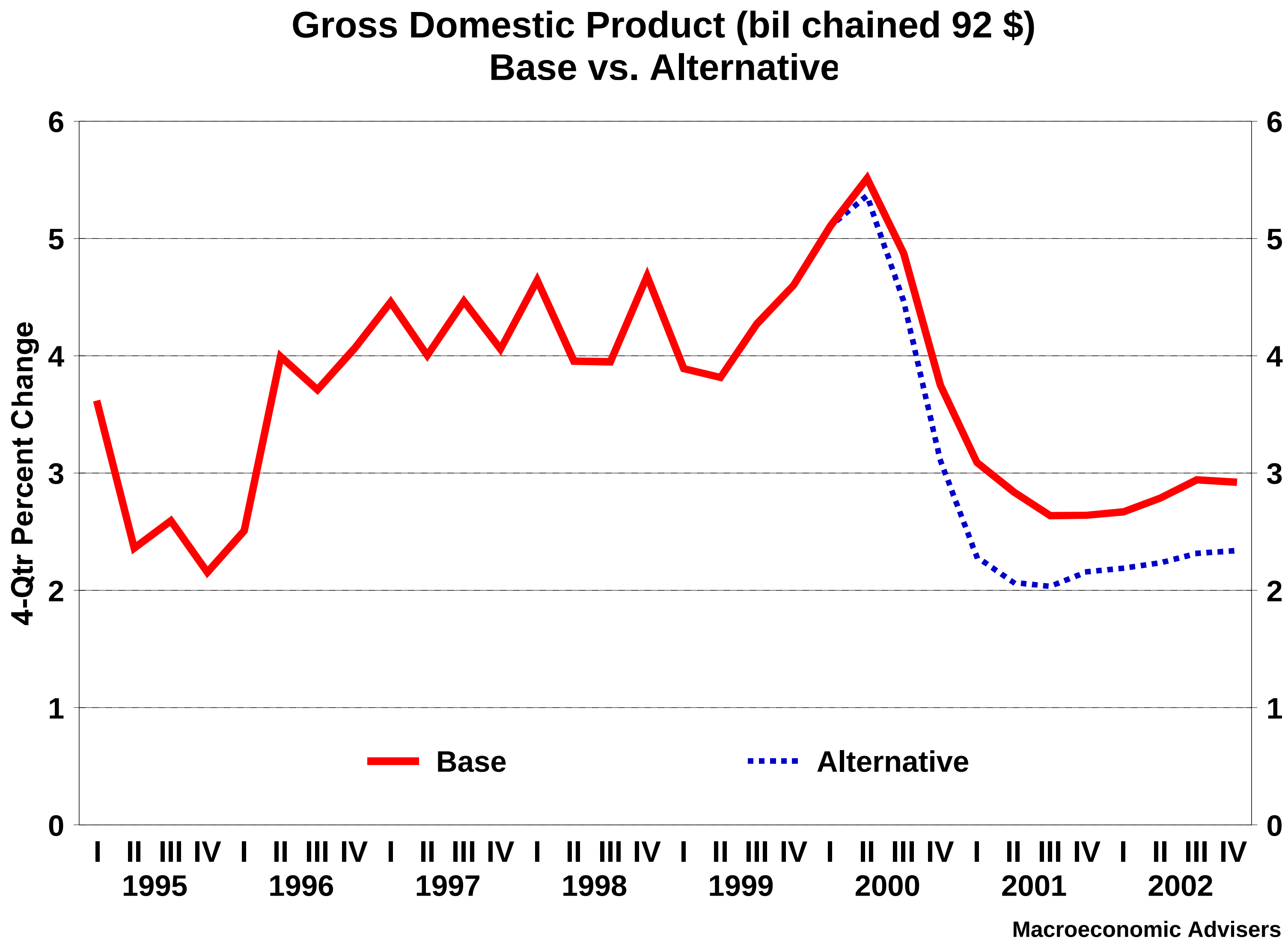

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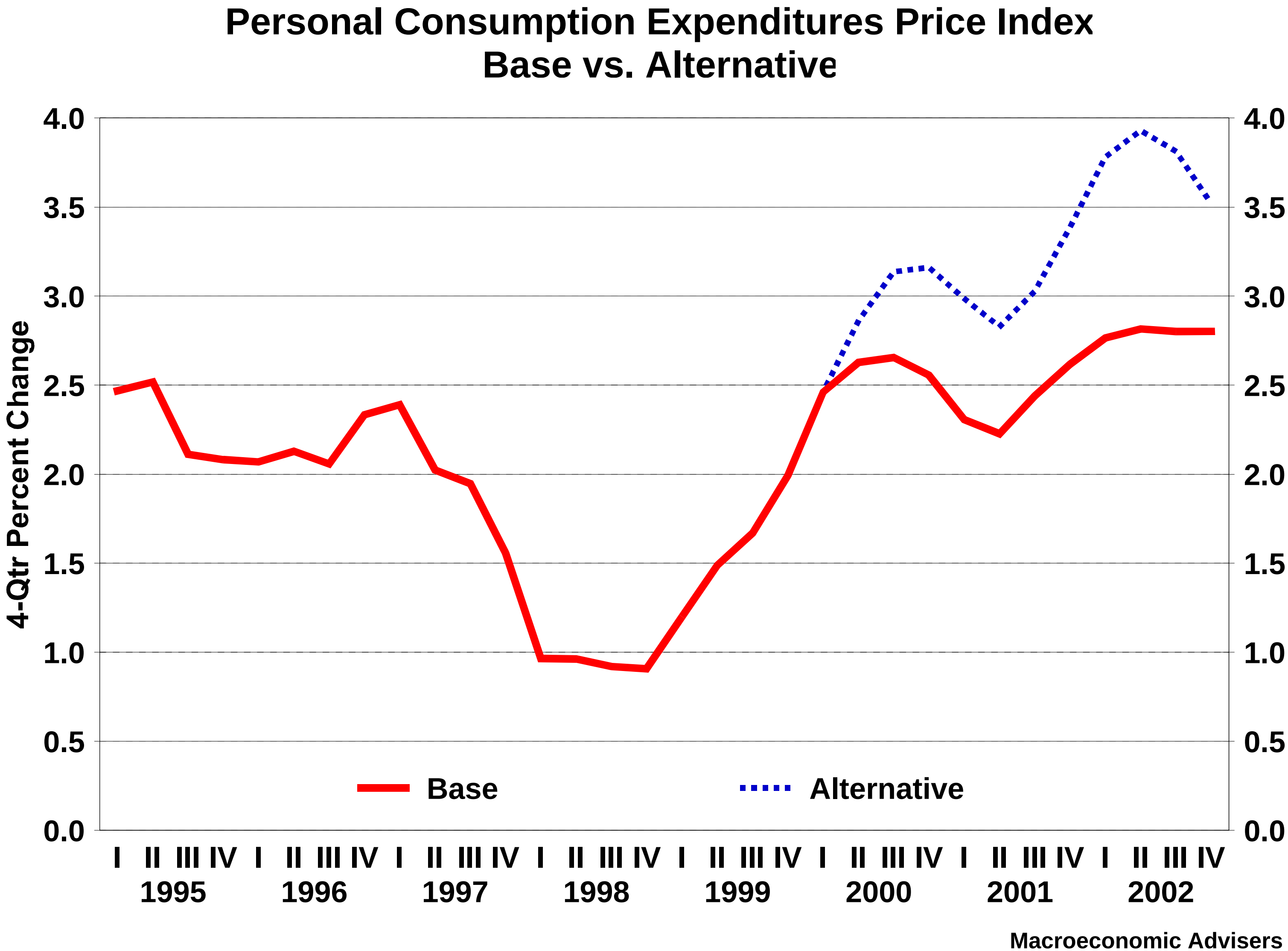
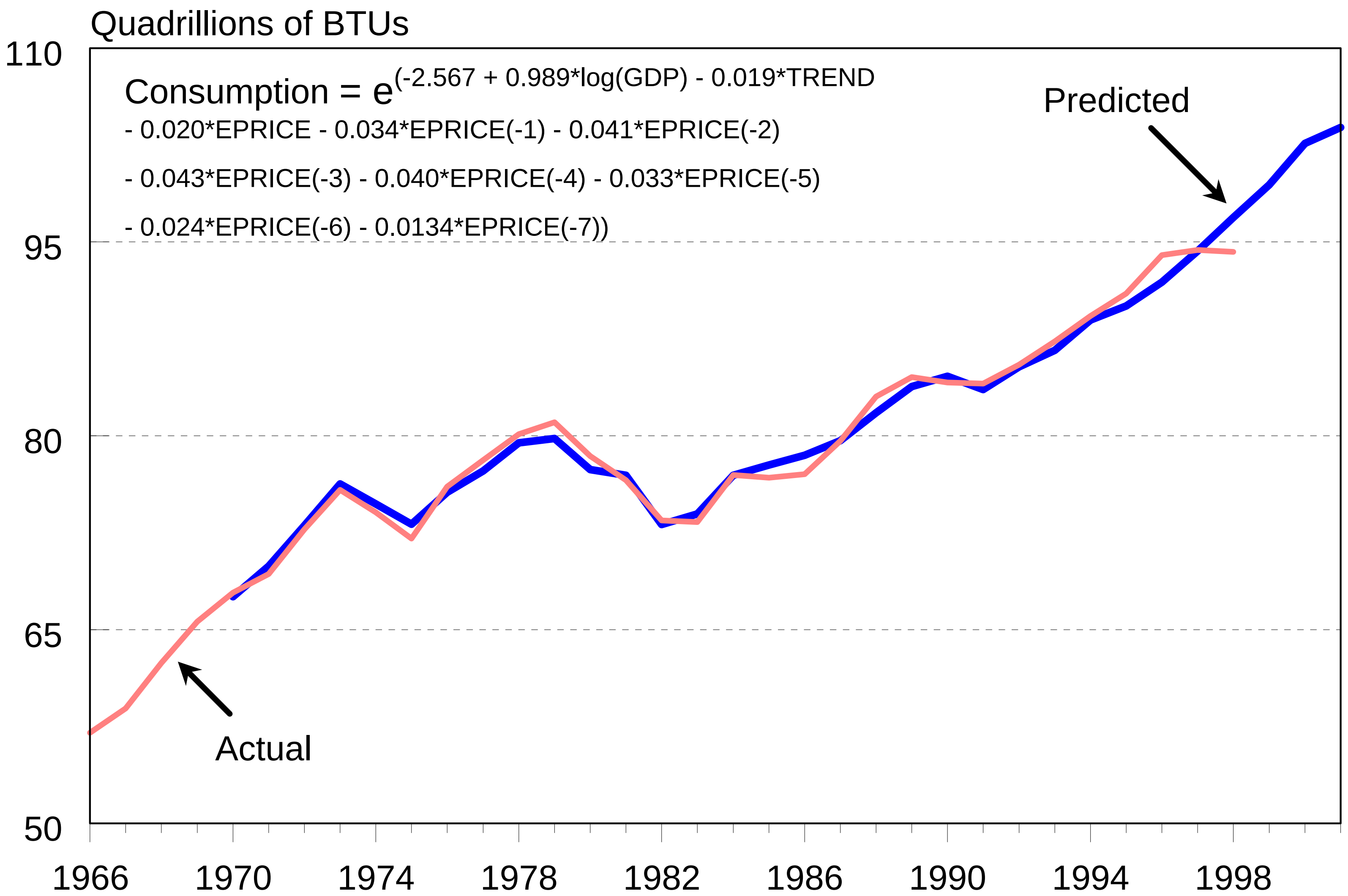


US Energy Consumption



Source: US Department of Energy