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I. Sustaining strong growth and social cohesion: key challenges

The economic situation

After a very weak start, the recovery from the 2001 recession finally gained momentum in the spring of 2003. Until then, the recovery had proceeded very unevenly, with GDP increasing by only 2.1 per cent over the four quarters to the first quarter of 2003, despite enormous amounts of monetary and fiscal stimulus. Growth during this period remained entirely driven by household and government spending (Table 1.1). Real business fixed investment contracted in each quarter between the first quarter of 2001 and the first quarter of 2003, despite very low interest rates

Table 1.1. **Contributions to GDP growth**

Percentage points, volume terms, chain 2000 prices

	1999	2000	2001	2002	2003
Private consumption	3.4	3.2	1.7	2.4	2.2
Private residential investment	0.3	0.0	0.0	0.2	0.4
Private non-residential investment	1.1	1.1	–0.6	–0.8	0.3
Government consumption and investment	0.7	0.4	0.5	0.7	0.6
Final domestic demand	**5.5**	**4.6**	**1.6**	**2.5**	**3.5**
Stockbuilding	0.0	–0.1	–0.9	0.4	0.0
Total domestic demand	**5.4**	**4.5**	**0.7**	**2.9**	**3.4**
Net exports	–1.0	–0.9	–0.2	–0.7	–0.4
GDP	**4.5**	**3.7**	**0.5**	**2.2**	**3.1**
Memorandum items:					
Growth rate of:					
Private consumption	5.1	4.7	2.5	3.4	3.1
Private non-residential investment	9.2	8.7	–4.5	–7.2	3.0
Core PCE inflation	1.5	1.7	1.9	1.7	1.2
Output gap	2.5	2.2	–1.1	–1.8	–2.0

Source: Bureau of Economic Analysis.

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and the special depreciation allowances legislated in March 2002. The weakness in capital spending owed to the remaining capital overhang following the investment boom of the late 1990s and a pervasive sense of uncertainty ahead of the conflict in Iraq, as well as renewed efforts at cost cutting and balance sheet improvements in the wake of corporate governance scandals (further discussed in Chapter IV).

During the final three quarters of 2003, however, GDP grew at an annual rate of around 5 per cent, and business fixed investment has finally joined the expansion (Figure 1.1). The combination of the swift resolution to the conflict in Iraq, a strong rebound in corporate profits driven by a substantial decline in unit labour costs since the beginning of 2002, and further easing of financial conditions (see below) has led to a clear improvement in the fundamentals for corporate capital formation. Household consumption, which had been well maintained throughout 2002 and early 2003, surged in the third quarter, as disposable income was lifted by the 2003 income tax reductions, and household net wealth was boosted by a continued strong housing market and a rebounding stock market (Table 1.2). Mortgage refinancing activity has picked up again recently, and equity extraction from residential real estate through turnover or home equity loans has remained strong. Moreover, residential investment has been boosted by some of the most favourable financing conditions since the early 1960s. In several respects, this recovery resembles the previous one, notably in the delay with which GDP and employment picked up and with the persistent disinflation. There are, of course, also differences, such as the larger and more protracted decline in business fixed investment following the investment boom of the late 1990s, and the greater contribution to growth from government purchases, reflecting the enormous expansion of federal discretionary spending after the terrorist attacks of September 2001 and military operations in Afghanistan and Iraq. Furthermore, the contribution from net exports during the current expansion has been smaller, as the current business cycle has been more synchronised across the major regions than was the case in the early 1990s.

In terms of productivity gains, however, this recovery differs sharply from its predecessor. In the late 1990s labour productivity, as measured by output per hour in the non-farm business sector, began to accelerate compared to the previous 20 years, from an annual growth rate of 1.5 per cent during 1975-95 to a rate of 2.5 per cent during 1996-2000. Since the beginning of 2002, however, productivity has increased at an annual rate of 4.8 per cent (Figure 1.2), compared to a rate of 2.6 per cent over the first two years of the previous recovery. Although productivity tends to grow rapidly during the early stages of recovery, this typically follows a period of weak productivity growth or even declines, neither of which happened before or during the 2001 recession. Since investment was particularly weak for much of this period, the recent acceleration has not been driven by capital deepening. Instead, the gains may reflect firms' efforts to better utilise the capacity put

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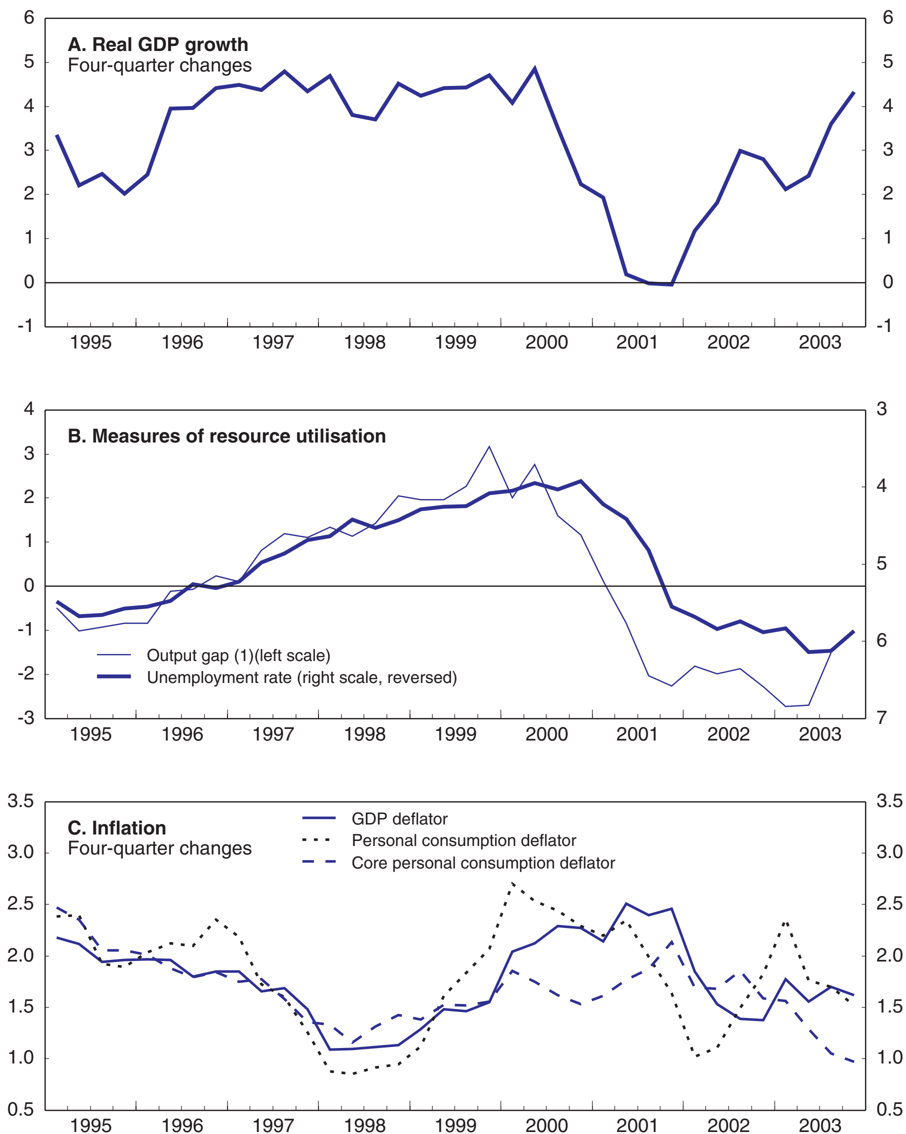
Figure 1.1. **Aggregate economic indicators**
Per cent



1. Per cent difference between actual and estimated potential output.
Source: OECD.

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Table 1.2. **Labour market and household indicators**
Per cent

	1999	2000	2001	2002	2003
Unemployment rate (level)	4.2	4.0	4.7	5.8	6.0
Labour force participation rate (level)	67.1	67.1	66.8	66.6	66.2
Private non-farm employment growth[1]	2.5	2.1	–0.3	–1.7	–0.4
Personal income	5.1	8.0	3.4	2.3	3.1
Disposable personal income	4.7	7.5	3.8	5.2	4.4
Personal saving rate (per cent of disposable personal income)	2.4	2.3	1.7	2.3	2.0
Household net worth	13.3	–0.8	–1.6	–3.7	11.7

1. Establishment survey.
Source: Bureau of Labor Statistics; Bureau of Economic Analysis; and Board of Governors of the Federal Reserve System.

in place during the investment boom of the late 1990s (Kohn, 2003), thereby raising multifactor productivity. Most likely productivity will decelerate as the expansion matures. Much uncertainty therefore attaches to current estimates of its trend growth rate, but for now nothing suggests that the increase in the growth rate seen during the late 1990s will be fully reversed.

The enormous productivity gains combined with modest average GDP growth during the recovery has meant that economic slack did not bottom out at the end of the recession but continued to expand until the beginning of 2003, with the output gap reaching about 2½ per cent. This view of only recently diminishing excess capacity in the product market is consistent with the fact that industrial capacity utilisation continued to decline through June, and that the labour market has only recently shown signs of improving, even if only modestly. Although there has been some debate recently about the accuracy of different labour-market statistics (see Box 1.1), according to the most widely used measure total non-farm employment has declined by 323 000 between the end of the recession in November 2001 and March 2004. This impression of labour market weakness is confirmed by the fact that the unemployment rate peaked in June 2003, 18 months after the business cycle trough, at 6.3 per cent, and its decline since then reflects not only moderate employment gains (according to the household survey), but also a decline in the labour force participation rate, particularly pronounced among those aged 16 to 19. The various measures of compensation show either little acceleration or deceleration. With spare capacity at firms only gradually dissipating, and absent labour cost pressures, core inflation measures have declined considerably over the past two years, but have stabilised more recently, so that the risk of outright deflation in the near future seems now small (see Chapter III).

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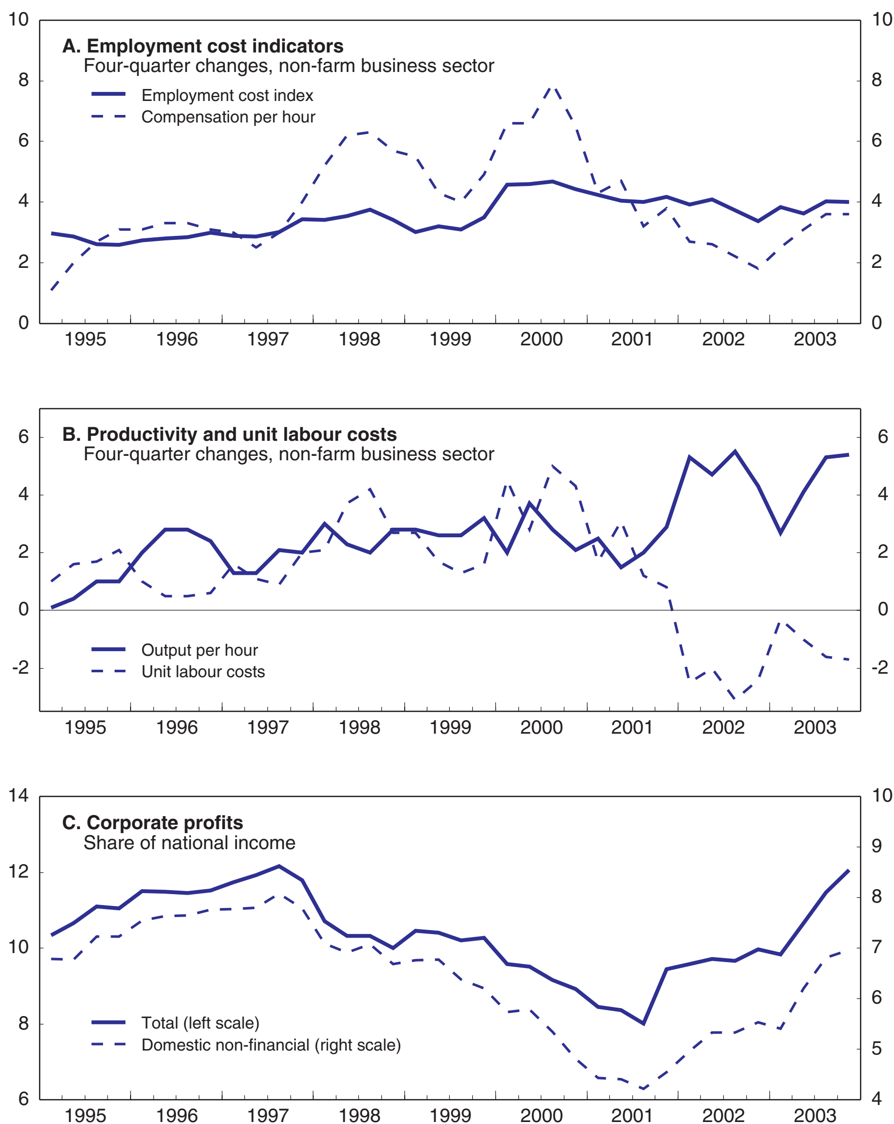
Figure 1.2. **Labour costs, productivity and profits**
Per cent



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

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Box 1.1. Jobless recoveries

The two most important sources on aggregate US employment data are the Current Population Survey (informally known as household survey) and the Current Employment Statistics Survey (commonly referred to as the establishment survey). The household survey, which is conducted monthly by the Bureau of Labor Statistics (BLS) and the Bureau of the Census, is based on a random sample of about 60 000 households. Each household contacted is asked for the employment status of each person aged 16 or older, *i.e.* how many persons are currently employed, are searching for but unable to find employment, or are neither working nor looking for work. Although the household survey provides information on the level and change of employment, the most widely known statistic based on this survey is the unemployment rate. The establishment survey conducted monthly by the BLS, by contrast, is based on payroll records of about 400 000 business establishments, covering about one-third of total non-farm payroll employment. Moreover, with a lag of about one year the employment estimates from the establishment survey are benchmarked to an almost complete count of payroll employment based on state unemployment insurance tax records. The statistic of the establishment survey that receives the most attention is the monthly change in non-farm payroll employment.

The discrepancies between the changes in aggregate employment reported by the two surveys have received considerable attention of late because they have provided somewhat different views on the extent to which the current recovery is "jobless". While according to the household survey employment rose by more than 1.5 million over the two years following the business cycle trough in November 2001, according to the establishment survey it fell by 844 000.[1] In part these differences are explained by differences in coverage between the two surveys. Employment in the household survey includes unincorporated self-employed workers, unpaid family workers, private household workers and farm workers, none of which is included in payroll employment in the establishment survey. On the other hand, the household

Table 1.3. **Reconciliation of household and payroll employment**
Seasonally adjusted, in thousands

	November 2001	November 2003	Change
Household employment[1]	136 602	138 158	1 556
Less:			
Agriculture[1]	2 234	2 411	177
Self-employed[1]	8 878	9 515	637
Unpaid family and private household[1]	901	855	–46
Multiple job holders[1]	7 171	7 282	111
Adjusted household employment	131 760	132 659	899
Non-farm payroll employment (establishment survey)	130 871	130 027	–844

1. Adjusted for updates to population estimates.
Source: Bureau of Labor Statistics; OECD calculations.

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Box 1.1. Jobless recoveries (*cont.*)

survey counts the number of employed persons whereas the establishment survey counts the number of jobs, so that a person holding two jobs counts once in the household survey, but twice in the establishment survey. Table 1.3 provides a rough estimate of the effects of these differences in coverage.[2] The gap between the two surveys' changes narrows somewhat, in part because growth in agricultural employment and the number of self-employed has been unusually strong during the current recovery. Even after accounting for these differences, however, employment in the household survey rose by about 900 000 over the two years since the recession ended.

The question therefore arises to which survey one should pay more attention. Some have argued that the establishment survey initially underreports employment in the early part of expansions because much employment is created by newly formed businesses that are systematically underrepresented in the establishment survey.[3] However, the BLS has expended much effort on improving the adjustments made to the raw data to account for births and deaths of establishments. Moreover, the benchmark revisions to the level of employment as of March 2002 and March 2003 have both been negative. As mentioned above, after the benchmark the establishment survey's employment data are based on an almost complete count of payroll employment. By contrast, the household survey employment estimates are obtained by scaling the responses of the 60 000 households to the overall population size. They are therefore sensitive to population estimates, and there is

Table 1.4. **Labour market indicators during and after recessions**

	Recession		
	1957-82 average	1991	2001
Decline in employment from its peak to its trough, per cent			
Household survey	1.8	1.5	1.5
Establishment survey	2.5	1.5	2.0
Rise in unemployment rate from its trough to its peak, percentage points	3.2	2.8	2.4
Change over first 24 months of expansion[2]			
Employment (per cent)			
Household survey[1]	5.2	1.6	1.1
Establishment survey	6.6	1.3	–0.6
Unemployment rate (percentage points)	–1.7	0.2	0.3
Change over first 8 quarters of expansion[2]			
Productivity (per cent, annual rate)	3.8	3.0	4.7

1. Adjusted for updates to population estimates.
2. 1980 recession omitted from 1957-82 averages.
Source: US Bureau of Labor Statistics; OECD calculations.

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Box 1.1. **Jobless recoveries** (*cont.*)

some evidence suggesting that in recent years population may have grown more slowly than assumed by the population estimates used in the household survey (Juhn and Potter, 1999; Nardone *et al.*, 2003). If so, the household employment estimates would be biased upward. In summary, while neither survey provides a completely accurate picture of employment, the bleaker picture presented by the establishment survey cannot be discounted.

Table 1.4 provides some historical perspective on the jobless nature of the current recovery. The first three rows give some impression of the severity of the last two recessions in terms of the labour market indicators discussed above and compare them to the average of the previous six recessions, using the recession dates of the National Bureau of Economic Research (NBER). Specifically, the percentage decline in employment from its peak, typically right before the onset of the recession, to its trough, usually shortly after the end of the recession, are reported, as well as the increase in the unemployment rate from its trough to its peak. By all three measures, the past two recessions were slightly milder than the average of the previous six, but not by much. Thus, the sluggish recoveries of the labour market after the past two recessions are not simply a reflection of small job losses during those recessions. The next three rows report the percentage changes in employment and the change in the unemployment rate over the 24 months following the end of the recession. By these measures, the past two recessions are indeed strikingly different from the previous five (the recession of 1980 is omitted because the 24-month horizon extends into the following recession). This impression is confirmed by the timing of the peak in the unemployment rate: 15 months after the end of the 1991 recession, and 19 months after the end of the 2001 recession compared to an average of 5 months following the previous six recessions.

The reasons for the different labour market experiences during the past two recoveries compared to earlier norms are not yet well understood. One recent study (Groshen and Potter, 2003) has focused on structural change, as measured by the trend rise or decline of employment in different industries, as a potential source for the protracted labour market weakness. These authors noted that, contrary to earlier recessions, during the past two recessions those industries in which employment fell during the recession continued to contract afterwards, whereas many of those industries that had been gaining employment during the recession continued doing so afterwards. This decline in the cyclicality of employment within industries is consistent with the fact that the great majority of layoffs during recent recessions have been permanent, not temporary. Besides structural change, another contributing factor in the most recent recovery has undoubtedly been the high rate of productivity growth. As shown in the last line of Table 1.4, output per hour in the non-farm business sector rose much faster during the first eight quarters of the current recovery than during the comparable previous periods, in fact faster than during the two years following any of the previous seven recessions. Without a proportional pickup in demand, businesses were able to expand output sufficiently without expanding employment. Finally, the deterioration in the US trade balance over the past decade has probably

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Box 1.1. **Jobless recoveries** (*cont.*)

gone hand in hand with the acceleration in the long-run trend decline in manufacturing employment, in particular since a large part of the change in trade expand output sufficiently without expanding employment. Finally, the deterioration in the US trade balance over the past decade has probably gone hand in hand with the acceleration in the long-run trend decline in manufacturing employment, in particular since a large part of the change in trade flows has taken place in manufactured goods (Bernanke, 2003). In fact, manufacturing employment declined by almost 1.5 million over the 24 months following the end of the recession, far above the decline in overall payroll employment during that period.

1. The household employment numbers have been adjusted for updates to population that the BLS does not carry backward.
2. The reconciliation is only approximate because the figure for multiple job holders includes for example self-employed and farm workers, but at the same time simply adding this number does not correct for persons holding more than two jobs. Moreover, no correction is made for unpaid absences, which count as employment in the household but not the establishment survey. For a more detailed reconciliation of the 1994 and 2000 employment estimates involving data not regularly published by the BLS see Nardone *et al.* (2003).
3. Kitchen (2003) presents some evidence that in the past the establishment survey initially underestimated employment growth early in expansions. However, it is unclear to what extent these results still apply given the methodological changes that the BLS has introduced over recent years.

Financial conditions have eased since the beginning of 2003. While long-term Treasury yields and mortgage rates currently stand at roughly the same level as then, spreads of corporate yields over Treasuries have decreased compared to their previously elevated levels (Figure 1.3). Moreover, the stock market has rebounded, and broad market indices have reversed roughly half of the losses between its peak in 2000 and the trough in late 2002. The rise in the stock market and the continued strong housing market have pushed household net worth in the fourth quarter of 2003 above its previous record level in early 2000. Despite rapid growth in home mortgage debt, homeowners' debt burden, as measured by the ratio of financial obligations to disposable income, has fallen slightly since the end of 2002 as they have locked in low mortgage rates. The financial obligations ratio for other households has also declined over the same period. The fact that households' net acquisitions of financial assets rose rapidly over the past two years suggests that the proceeds from home-equity withdrawal have largely been used for balance-sheet improvements. The aggregate balance-sheet of the non-financial corporate sector too has improved since the recession, as profits have rebounded sharply while capital spending has picked up only recently. Corporations have also sought to take advantage of the low interest rates by

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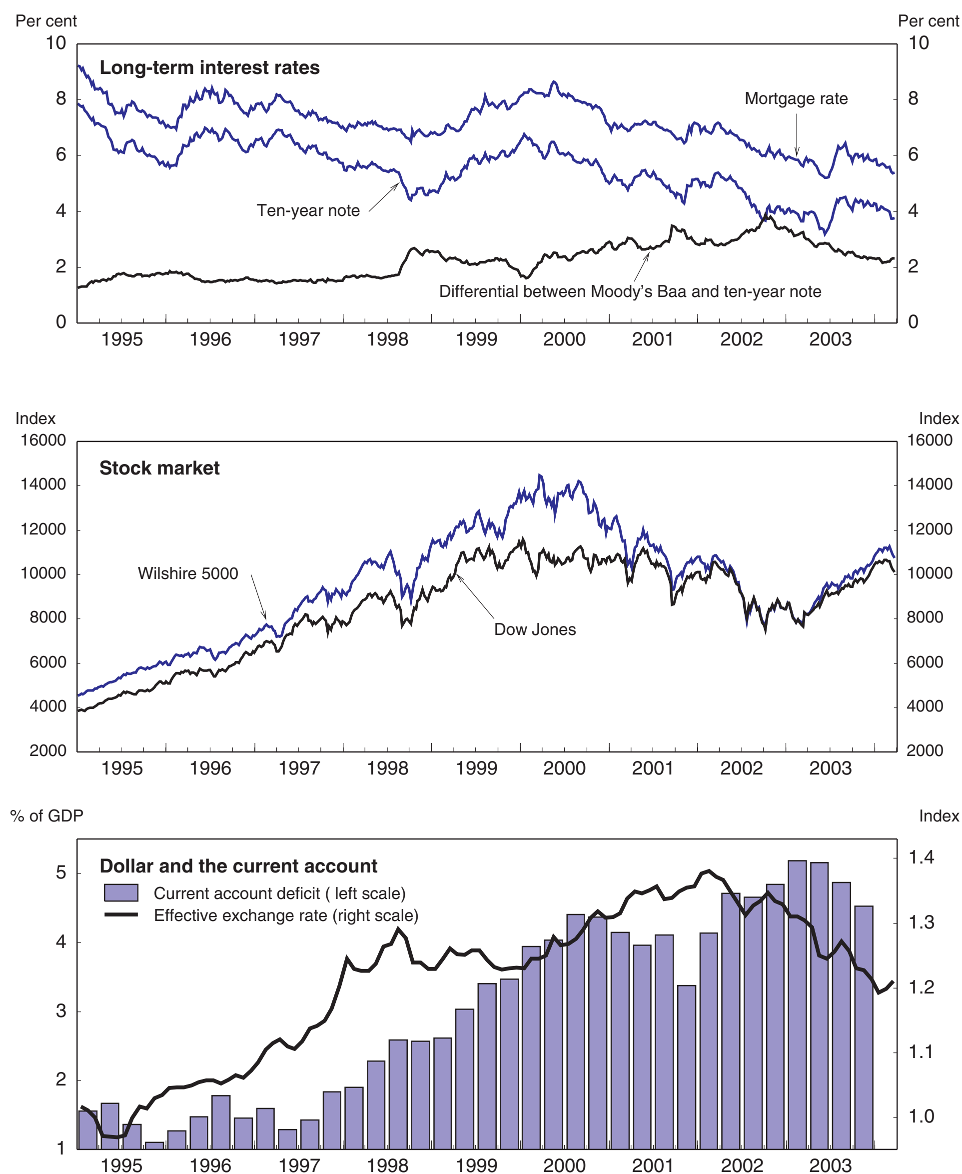
Figure 1.3. **Financial indicators and current account**



Source: Board of Governors of the Federal Reserve System, Bureau of Economic Analysis, Thomson Financial.

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Table 1.5. **Balance of payments**
$ billion, seasonally adjusted, annual rate

	2001	2002	2003	2002	2003			
				Q4	Q1	Q2	Q3	Q4
Current account balance	–394	–481	–542	–514	–557	–559	–541	–510
of which:								
Exports of goods, services and income	1 285	1 230	1 294	1 244	1 239	1 246	1 294	1 398
Imports of goods, services and income	1 632	1 652	1 768	1 697	1 727	1 737	1 768	1 839
Net unilateral transfers abroad	–47	–59	–68	–62	–70	–68	–67	–69
Balances:								
Goods	–427	–483	–549	–529	–544	–552	–545	–557
Non-factor services	69	65	59	65	58	56	58	65
Investment income	11	–4	17	12	–1	5	12	50
Private transfers	–29	–37	–41	–39	–41	–40	–39	–44
Official transfers	–17	–22	–27	–23	–29	–28	–28	–25
Memorandum:								
As per cent of GDP								
Current account	–3.9	–4.6	–4.9	–4.8	–5.2	–5.2	–4.9	–4.5
Foreign assets in the United States (flows)	7.6	6.7	7.8	7.4	9.0	9.7	4.3	8.2
US assets abroad (flows)	–3.5	–1.7	–2.5	–1.7	–3.8	–4.1	–0.5	–1.8
Net position	4.1	5.0	5.2	5.7	5.3	5.5	3.8	6.4
Statistical discrepancy	–0.2	–0.4	–0.3	–0.9	–0.1	–0.3	1.1	–1.9

Source: Bureau of Economic Analysis.

restructuring their debt, and net interest payments as a share of this sector's GDP have continued to decline. The dollar continued its fall that started in early 2002, having depreciated by about 12 per cent in trade-weighted terms as of March 2004 and reversing about half of the rise from the beginning of 1997. With the substantial depreciation over the past two years, the balance on goods and services may have stopped its rapid decline from a deficit of about 1 per cent of GDP in early 1997 to 4.6 per cent of GDP in the second quarter of 2003, narrowing slightly in the second half of the year (Table 1.5). Exports have been slow to pick up, as export market growth has remained subdued, while imports have been growing apace following a brief pause during the recession. As will be discussed further below, at this stage the United States is not yet experiencing any difficulties in financing its current account deficit, partly because the favourable outlook compared to other major economic regions means that it remains an attractive destination for foreign investment. Moreover, it seems unlikely that the depreciation of the dollar alone will substantially reverse the trend in the foreign trade position.

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The policy stance

Monetary policy has remained highly accommodative since the end of the recession in late 2001. By most measures, the real federal funds rate has fluctuated around zero or has been negative for the past two years. This stimulus has been transmitted to the economy through very low yields on long-term private and government securities, resulting in exceptionally low mortgage rates and, especially since the stock-market trough in late 2002, in a low cost of capital for businesses. After the aggressive easing of 2001, the Federal Reserve kept its federal funds target at 1.75 per cent for most of 2002. At its November 2002 meeting the Federal Open Market Committee (FOMC) reduced the funds rate target by another 50 basis points in response to signs of renewed output deceleration and ongoing labour market weakness. It attributed the weakness in both product and labour markets to greater uncertainty, in part due to heightened geopolitical risks. As productivity growth remained robust, the weak GDP growth in late 2002 and early 2003 implied a substantial further widening of the output gap and hence intensified disinflationary pressure. In the statement following its May 2003 meeting was understood by markets as signalling that it was concerned about the risk of substantial further disinflation, and declines in various measures of inflation expectations during the spring of 2003 suggested that this concern was shared by the private sector. At its June 2003 meeting the FOMC reduced its funds rate target by another 25 basis points to 1 per cent. Around that time, the first signs emerged that the recovery was finally gaining momentum, and over the next few weeks long-term interest rates reversed earlier declines. Since then, the risk that the recovery could stall again has faded, and monetary policy turned towards fostering the recovery by indicating that, in the presence of extremely low inflation, an accommodative stance could be maintained for "a considerable period", and that the FOMC can be "patient in removing its policy accommodation".

Fiscal policy has also continued to support aggregate demand through strong growth in government purchases of goods and services as well as further reductions in personal and corporate taxes. Real purchases of goods and services at the federal, state and local levels combined have expanded at an annual rate of 3½ per cent since the beginning of 2001, about three times as fast as during the previous decade. Spending on defence and homeland security has of course grown vigorously since September 2001, but discretionary spending outside of these areas has also expanded rapidly. Following the two major rounds of tax cuts and investment incentives of June 2001 and March 2002, the revenue legislation passed in May 2003 brought forward many of the personal income tax reductions originally legislated in 2001, expanded the previously implemented investment incentives and reduced the taxation of corporate dividends and longer-term capital gains. The reductions in marginal tax rates on personal income in particular not only provided timely support for household incomes but should also have beneficial effects on labour supply in the long run. However, the combination of sharp increases in

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government spending, income tax cuts and plunging tax revenues due to sharply reduced capital gains realisations have led to ballooning deficits at the federal level as well as to severe budget shortfalls at the state level. The deficit in the unified budget of the federal government rose from 1.5 per cent of GDP in fiscal year (FY) 2002 to 3.5 per cent in FY 2003.

Near-term prospects and risks

The near-term outlook for the US economy is favourable (Table 1.6). The recent rapid pace of the expansion is expected to moderate over the coming quarters, but GDP growth should exceed its potential rate of about 3¼ per cent for the foreseeable future.[1] The sizeable depreciation of the dollar – about 12 per cent in trade-weighted terms from its peak in early 2002 – and a gradual acceleration in worldwide demand are expected to reduce the drag from net exports on growth. The improvement in foreign trade, however, may not be strong enough to reduce the current account deficit much below 5 per cent of GDP. Consumption expenditures will receive another boost in early 2004 from large income tax refunds reflecting tax cuts retroactive to the beginning of 2003, and are expected to remain well maintained thereafter as employment gains begin to support household incomes. Business fixed investment is expected to advance rapidly, although the expiration of the partial expensing provisions at the end of 2004 is likely to reduce the growth of spending on equipment in early 2005. Residential investment, on the other hand, will tend to weaken after its recent torrid expansion, especially as monetary policy is assumed to tighten beginning in mid-2004 and long-term interest rates could well rise substantially when this occurs. Nonetheless, the momentum from consumption and investment should keep real GDP expanding at a rate of 3¾ per cent even as federal spending decelerates in 2005 after the current round of spending increases has run its course. The result is that the output gap is expected to close in the middle of 2005. With spare capacity only gradually diminishing, core inflation is likely to remain near its current low level for the next two years.

There are substantial risks to this outlook, but they appear more evenly balanced now than during the earlier stages of the recovery. On the upside, the recent strong productivity performance may spark another cycle of optimism concerning business profits and household incomes and may fuel business investment and household spending. Continued strong productivity growth would also likely prevent inflation from rising anytime soon and allow monetary policy to remain on hold for longer than projected. On the downside, it is unclear how fast the factors that have held back hiring by companies are subsiding. If firms continue to exercise great caution in hiring, consumption may decelerate more than currently projected once the stimulus from tax cuts has faded. Moreover, given the enormous run-up in residential construction, housing investment may contract sharply once long-term interest rates begin to rise. The high federal budget and current-account deficits increase the risk of

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disorderly exchange-rate movements and a larger rise in long-term interest rates than projected, which might stifle the recovery in business investment. Finally, if productivity were to decelerate more sharply than anticipated and the decline in the labour force participation rate turned out to be more lasting, excess capacity would be reduced more rapidly and inflation expectations might rise, calling for an earlier tightening of monetary policy.

Table 1.6. **Near-term outlook**[1]

Percentage change over previous period, volume terms (chain 2000 dollars, s.a.a.r.)

	2003	2004		2003	2004	2005
	Q4	Q1	Q2			
Private consumption	3.2	3.4	3.3	3.1	3.7	3.1
Government consumption	0.7	3.3	3.4	3.9	2.5	1.9
Gross fixed investment						
Private residential	7.9	3.0	3.0	7.5	6.1	1.9
Private non-residential	10.9	5.8	8.9	3.0	9.1	8.9
Government	–3.6	4.2	4.2	1.5	3.7	3.5
Final domestic demand	**3.6**	**3.6**	**3.8**	**3.4**	**4.1**	**3.5**
Stockbuilding[2]	0.7	0.3	0.2	–0.1	0.3	0.2
Total domestic demand	**4.3**	**4.0**	**4.1**	**3.3**	**4.4**	**3.7**
Exports of goods and services	20.5	2.0	12.0	2.0	9.7	10.6
Imports of goods and services	16.4	1.5	9.0	4.0	7.3	8.1
Foreign balance[2]	**–0.4**	**0.0**	**–0.1**	**–0.4**	**–0.1**	**–0.1**
GDP at market prices	**4.1**	**4.1**	**4.1**	**3.1**	**4.5**	**3.7**
GDP price deflator	1.5	1.6	1.0	1.7	1.3	1.3
Private consumption deflator	1.0	2.2	0.9	1.8	1.3	1.1
Output gap	–1.3	–0.8	–0.5	–2.0	–0.5	0.0
Potential output	3.2	2.3[3]	3.3	3.2	2.9[3]	3.2
Unemployment rate	5.9	5.6	5.6	6.0	5.5	5.2
Federal funds rate	1.0	1.0	1.0	1.1	1.2	2.8
Ten-year Treasury note rate	4.3	4.0	4.2	4.0	4.4	5.3
Net lending of general government						
$ billion	–485.3	–573.7	–578.2	–522.4	–574.7	–495.4
Per cent of GDP	–4.3	–5.0	–5.0	–4.8	–4.9	–4.1
Current account balance						
$ billion	–510.5	–540.7	–554.0	–541.9	–561.6	–604.2
Per cent of GDP	–4.5	–4.7	–4.8	–4.9	–4.8	–4.9
Household saving rate[4]	1.7	2.1	2.3	2.1	2.5	2.8

1. Preliminary projections prepared for *Economic Outlook* 75.
2. Contribution to GDP volume growth.
3. Values for 2004 Q1 and 2004 are below trend growth rank of 3.2 per cent due to BLS population controls.
4. OECD definition.

Source: OECD.

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Key challenges

Although the US economy has proved remarkably resilient in the face of serious adverse shocks and the near-term outlook is for continued robust growth, a number of challenges remain that will need to be addressed in order to sustain robust expansion over the medium and longer term. It is important that the external deficit, which is unusually large for this stage of the cycle and would seem to be difficult to sustain at current and projected levels, unwind in an orderly fashion. This will require, above all, that the unusually large budget deficit be corrected and put on a sustainable footing, the issue addressed in the next chapter. The following chapters pick up three further challenges: the maintenance of price stability both through appropriate monetary management and adjustments to the current framework; the restoration of financial-market confidence that has been tainted with corporate scandals; and the further strengthening of product-market competition with a view to sustaining higher productivity growth. Assuring robust expansion is the objective focused on in this *Survey*. But there are other important challenges, such as those in the human capital development, environment and social areas, which are briefly addressed at the end of this chapter, having been covered extensively in previous *Surveys*. A comprehensive overview of progress in structural reform can be found in Annex 1.1.

Coping with the external deficit

The current external account, which had basically been in a slight surplus position since the late nineteenth century, has displayed substantial deficits over most of the past 20 years. At around 5 per cent of GDP in 2003, the current account deficit reached the highest level ever recorded, although it declined somewhat over the course of the year. As a result, the US net international investment position, which was still in broad balance in the late 1980s, has moved to a net negative position equivalent to around 25 per cent of GDP of late (Figure 1.4). To some extent, the rising external deficit reflects a higher import propensity and a stronger economic expansion than abroad, with the growth gap widening since the mid-1990s (reaching more than ½ and nearly 1 percentage point per annum against the OECD and European Union, respectively). It could be argued that the deterioration in the current account should not be of great concern to the extent that it was related to the favourable productivity shock, which not only attracted foreign capital but also prompted lower saving as households discounted the steeper future path of real income increases ("consumption smoothing"). Moreover, special factors have played a role: while the rise in the dollar contributed, part of the lack of the usual cyclical improvement during the recent recession can be related to the downturn in international demand for ICT goods, which hit US exporters particularly hard. More fundamentally, however, the external imbalance reflects a rising gap between domestic investment and saving (Figure 1.5, Panel A). During the second half of the 1990s, this gap was partly held in check by higher government saving, but that effect

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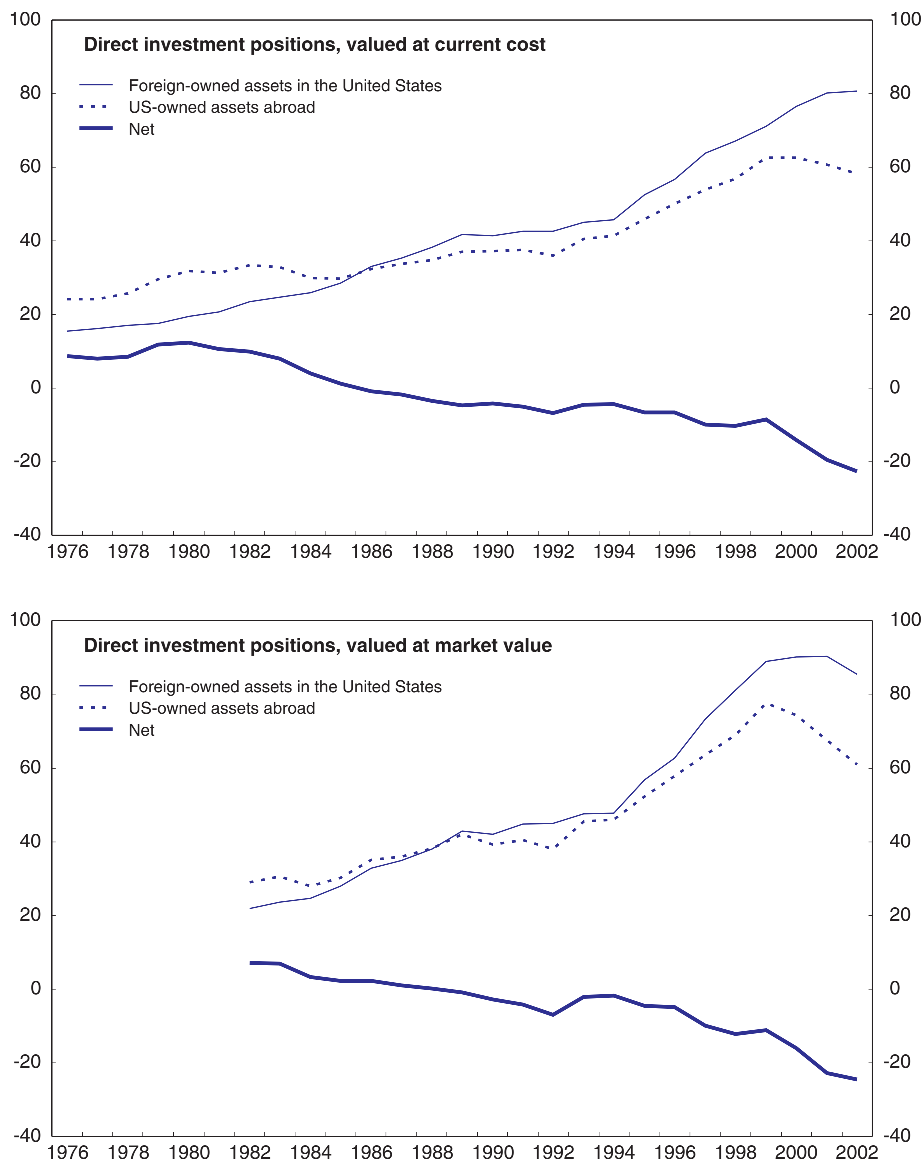
Figure 1.4. **Net international investment position of the United States**
Year end, percentage of GDP



Source: Bureau of Economic Analysis.

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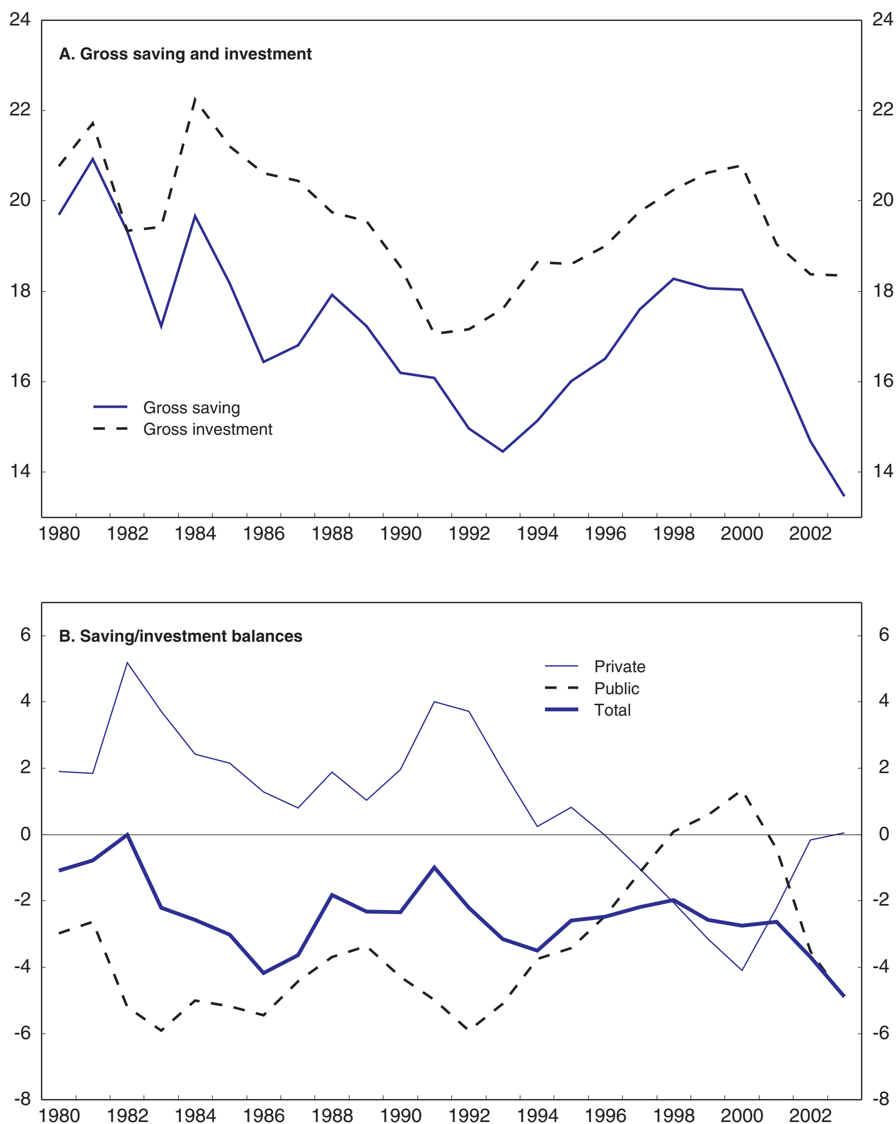
Figure 1.5. **Gross saving and investment**
Per cent of GDP



Source: Bureau of Economic Analysis.

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reversed subsequently as the budget slipped back into deficit (Panel B). At the same time, although the private sector eliminated its financial deficit as firms reduced investment outlays, its saving/investment balance has remained lower than at this stage of most previous recoveries, given the persistently low household saving rate.

A large and persistent current account deficit portends rising financial payments arising from the increasingly negative international investment position, which could become more and more difficult to finance. However, the build-up in net external claims on US residents is relatively recent, and hence the net servicing cost of the debt still very small. And to the extent that foreign capital inflows have helped quicken productivity gains, the resulting increase in GDP growth enhances the country's capacity to service the debt. Yet, even though the US economic expansion is again more vigorous than most others', foreign investors may in the future become less willing to finance the gap between US spending and output. Indeed, while remaining high, the flow of private capital into the United States has slowed somewhat in the last two years. Although governments – especially those of Japan and China – have stepped up their purchases of US assets (Table 1.7), this slowdown may have contributed to the fall of the dollar on foreign-exchange markets since early 2002 (see Chapter IV). Still, the capability of the United States to incur foreign debt has been

Table 1.7. **Capital flows into the United States**
$ billion

	1999	2000	2001	2002	2003
Foreign official purchases of US Treasury securities	12.2	–10.2	10.7	43.1	128.5
Foreign official purchases of other government securities	20.4	40.9	20.9	30.4	24.8
Other foreign official purchases of US assets	11.0	7.0	–26.6	21.3	54.4
Foreign direct investment	289.4	321.3	151.6	39.6	82.0
Other foreign purchases of US Treasury securities	–44.5	–76.9	–7.4	96.2	139.9
Other foreign purchases of other US securities	298.8	455.3	406.6	291.5	238.7
Other foreign purchases not included elsewhere	152.9	288.8	209.7	184.8	188.5
Total inflows	740.2	1 026.1	765.5	707.0	856.7
Memorandum items:					
US purchases of financial assets abroad	–503.6	–569.8	–349.9	–179.0	–277.7
Current account deficit	290.8	411.5	393.7	480.7	541.8
Stock of foreign official assets in the United States	–	–	–	–	1 343.1
Held as Treasury securities	–	–	–	–	827.3
Held in Asia	–	–	–	–	928.1

Source: Bureau of Economic Analysis.

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greater than in other deficit countries, given its ability to finance its external deficit in a reserve currency (Greenspan, 2003). Indeed, less than 10 per cent of aggregate US foreign liabilities are currently denominated in non-dollar currencies.

Looking forward, the weight of US investments in global portfolios will impose an increasing restraint on current account deficits. The marginal allocation of US assets in the global portfolio has risen sharply over the 1990s, absorbing most of the increase in net financial wealth earlier in this decade outside the United States. The foreign accumulation of US assets is likely to slow if they come to occupy too large a share of the world's portfolio. What constitutes "too large" will depend on confidence in the ability of the borrower to meet its obligations and on relative expected rates of return, although governments have other motivations than the private sector. After rising to over two-thirds during the course of the 1990s, the US dollar share of global central bank foreign exchange reserves has declined somewhat while the euro's share is approaching one-fifth. But strong central bank purchases of dollar assets over the past year – aimed at limiting exchange-rate movements – may have reversed or halted this trend (abstracting from exchange-rate effects). Approximately half of private cross-border holdings are denominated in dollars, with one-third in euros. If global investors seek greater diversification in non-dollar assets, then US spending will need to match production more closely, and more production will need to be exported abroad (Kohn, 2004). In this regard, the declining exchange value of the dollar will be helpful, despite repercussion effects on foreign growth and hence US exports. A crucial issue is what kind of domestic spending will bear the brunt of restraint. With a reduced availability of foreign saving, domestic saving will need to increase or investment – which is not especially high in cross-country comparison, albeit apparently highly efficient – has to be cut back. Increased saving can be achieved by decreasing household consumption relative to income or by decreasing public spending relative to taxes. If the fiscal outlook does not change, then unless there is a considerable rise in private saving, it is investment that could be expected to adjust. The mechanism would be higher real interest rates than otherwise, ultimately implying slower growth in the capital stock, productivity and economic potential, which would itself reduce the relative interest in US assets. Hence, in one way or another, the situation of a high current account deficit and strong capital inflows will need to unwind, with the timing and nature of the adjustment remaining uncertain.

Ensuring fiscal sustainability and budgetary discipline

Reining in the fiscal deficit will be essential in order to avoid passing a heavy burden onto future generations, and will also facilitate the necessary external adjustment. The federal budget has moved from a surplus of nearly 1½ per cent of GDP in fiscal year 2001 to a deficit of 3½ per cent in 2003 and a projected 4¼ to 4½ per cent this year. The income tax cuts of 2001 and 2003 and the investment incentives of 2002

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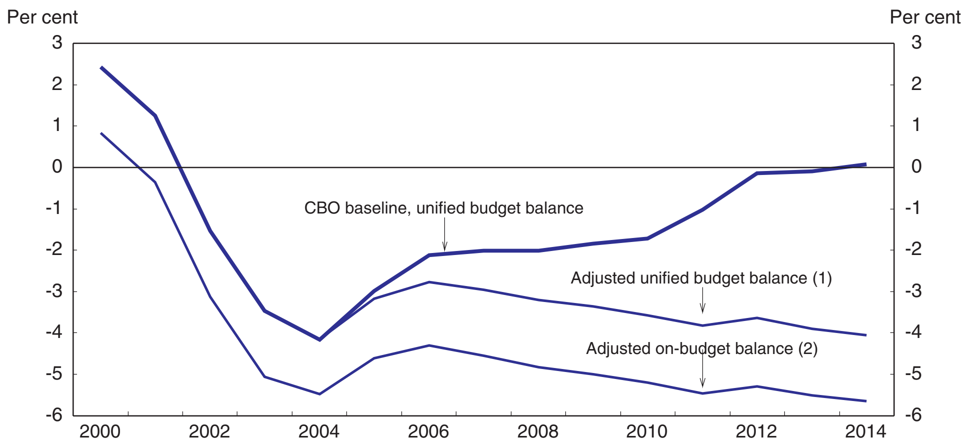
Figure 1.6. **Baseline and adjusted federal budget surplus**
Fiscal years, per cent of GDP



1. Adjusted for alternative policies; see Chapter II.
2. Adjusted surplus excluding Social Security trust fund surplus.
Source: Congressional Budget Office.

helped keep the recent recession short and shallow. They also provided timely support to the economy during the subsequent period when the recovery was held back by the effects of stock-market declines and corporate scandals and by a pervasive sense of caution toward hiring and capital spending. In principle, the reductions in marginal income-tax rates should also have beneficial supply-side effects over the medium term. However, while a return to budget deficits in the wake of the recession was appropriate, the revenue measures combined with the recent strong expansion in outlays mean that, without corrective action, large budget deficits will persist. Indeed, Secretariat calculations suggest that, if some plausible adjustments are made to the official baseline projections, the federal unified budget deficit including the surpluses accruing to the Social Security trust funds is unlikely to fall much below 4 per cent of GDP over the next ten years (see Figure 1.6 and Chapter II). By reducing national saving and therefore the domestically owned capital stock, deficits of this magnitude threaten to more than offset the beneficial effect on national income from the marginal tax rate reductions. The reduction in national saving could also be expected to put upward pressure on interest rates.

The projected large budget deficits are especially problematic because of the impending demographic stresses on public finances associated with the retirement of the baby boom generation beginning towards the end of the decade. Not much has been done in recent years to put Social Security on a sounder financial footing. Without any changes to current payroll taxes and sched-

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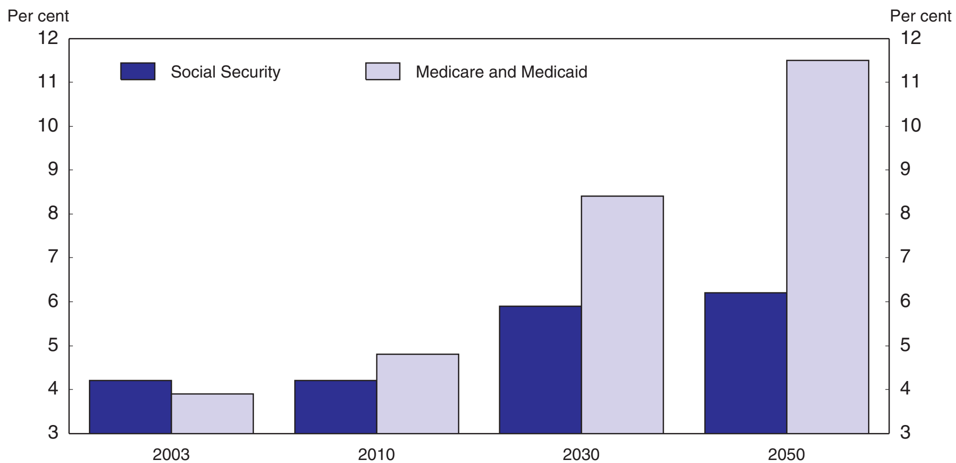
Figure 1.7. **Long-term projected entitlement spending**
Per cent of GDP[1]



1. Intermediate spending path.
Source: Congressional Budget Office, *The Long-Term Budget Outlook*.

uled benefits, the trust funds will begin running deficits in 2018 and be exhausted by 2042. The financial outlook of the Medicare programme is much more uncertain because of the unknown growth of future medical costs, but in all likelihood this programme is in substantially poorer condition. On the one hand, the effects of demographic changes on public health spending are particularly sensitive to the rise in the retired population since it is at this point that the primary burden shifts from private to public insurance; on the other hand, it would seem politically difficult to pass rapid increases in medical costs largely driven by technological advance on to Medicare enrolees through premium or other cost-sharing increases. The recent addition of a prescription drug benefit to the programme has made matters considerably more difficult from this point of view, despite the use of deductibles and co-payments. Prescription drug expenses among the elderly are highly concentrated, and the structure of the co-payments makes it likely that the benefit will be disproportionately used by those with extremely high expenses. The Medicaid programme too is facing sustained projected cost increases, resulting from prescription drug expenses as well as growth in demand for long-term care. Based on conservative assumptions regarding cost increases per enrolee, spending on Medicare and Medicaid together is projected to increase from the current 4 per cent of GDP to 8½ per cent in 2030 and to 11½ per cent in 2050 (Figure 1.7). As time progresses, the

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cost of restoring the entitlement programmes to financial balance will rise rapidly. Hence, reform of all of them must remain a policy priority.

Maintaining price stability

The recent acceleration in demand makes it increasingly likely that within the next year the Federal Reserve will have to begin withdrawing some of the monetary stimulus that is currently being imparted to the economy. With core measures of inflation near the lower end of their desirable ranges, tightening as pre-emptively as a decade ago to head off incipient inflationary pressures seems unnecessary. Although policymakers can probably be more patient now than in earlier recoveries, the focus of policy has to be shifted from forestalling further economic weakness to managing the risks associated with the prospective closing of the output gap – the "exit strategy" from the recent overriding goal of achieving economic recovery through stimulatory policy.

As discussed in Chapter III, both the efforts to deal with the increasing deflation fears and risks in the spring of 2003 and the subsequent task of fostering the upswing by keeping real long-term interest rates low in the face of strong growth have highlighted the value of clear communication between the central bank and the private sector. Because the transmission of monetary policy through long-term interest rates relies importantly on private-sector expectations of future short-term interest rates, the Federal Open Market Committee's own view of the likely future course of the economy and its policy responses would be a useful element of its discourse with the public. Communicating this information effectively and in a manner that clarifies the contingent nature of their commitments regarding future interest rates is a major challenge for monetary policymakers. Moreover, in an environment of effective price stability, firmly anchored long-term inflation expectations are especially important, not only to maintain public confidence in the durability of low inflation achieved over the past two decades, but also to limit the risk of a potentially self-reinforcing deflationary spiral in the face of a hypothetical negative shock. Improvements to the monetary framework that anchor long-term inflation expectations without limiting the ability of policymakers to respond flexibly to shocks would probably be valuable.

Improving confidence and reducing distortions in financial markets

Corporate governance and accounting scandals undermined investor confidence and exacerbated the stock-market decline in the early part of the decade (Chapter IV). In this way they contributed to the uneven pace of the recovery from the 2001 recession and continue to pose a latent threat to financial stability in the sense that further scandals could easily re-ignite negative market behaviour. Underlying the corporate scandals have been weak governance structures, compounded by questionable accounting practices and executive compensation

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schemes that provided undue incentives to boost short-term share prices, even at the expense of longer-term value. The 2002 Sarbanes-Oxley Act responded to these and other concerns by calling for measures, among other things, to increase penalties for fraud, to enhance both auditor independence and regulation of the accounting profession, and to increase both disclosure requirements for public companies and the responsibility of their executives for financial reporting. Considerable progress has been made in implementing this agenda, but challenges remain, such as pressing ahead with improvements in the accounting for stock options, ensuring the independence of corporate boards, enhancing shareholder rights and achieving greater harmony between US and other international accounting standards. Moreover, renewed scandals in recent months, involving the New York Stock Exchange and the mutual funds industry, have demonstrated that there is still unfinished business in the area of corporate reform.

The substantial under-funding of defined-benefit corporate pension plans also poses significant financial, regulatory and accounting issues. Although they have become less widespread, such plans remain an important source of retirement security for 44 million American workers. Under-funded pension obligations have acted as a drag on corporate profits and credit ratings for a number of major US corporations. The failure of several large companies with significantly under-funded plans has also weakened the finances of the agency that insures such private pensions. Given the adverse impact on corporate finance and potential risks to financial-market stability, weaknesses in the regulatory framework and accounting practices that have allowed these problems to arise need to be addressed. In view of the rapid growth and systemic importance of some government-sponsored enterprises, their regulation and supervision will have to be tightened, too. Indeed, the two leading housing-finance enterprises, Fannie Mae and Freddie Mac, which have become major players in financial markets, have both admitted substantial accounting irregularities. An ongoing issue is these enterprises' special status, which has led to the market perception of a government guaranty, significant rents to their shareholders and a marginally lower cost of funds to home purchasers, a distortion that is incremental to the tax preferences already provided.

Enhancing competition to sustain higher productivity growth

Regulatory reform efforts in a broad range of industries, which began in the 1970s and accelerated in the 1980s, have resulted in increased importance of competitive forces as a means to allocate resources and improve economic efficiency. A number of indicators suggest that such forces have been stronger in the United States than in most other Member countries for some time. This has contributed to sizeable productivity gains and good economic performance by international comparison over the past decade or so. Nonetheless, despite the generally pro-competitive thrust of policies, a number of challenges remain (see Chapter V).

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Although there are few sectors of the economy from which competition policy and law are completely excluded, given the high risks of sanctions and damages for violation, many anomalous exemptions and special regimes have found their way into US legislation. Contrary to other Member countries, government-related firms are exempted from competition enforcement. Intellectual property rights (IPRs) create special challenges for competition policy, as their purpose is to limit competition temporarily to capture the long-run benefits of innovation. The strengthening of IPRs over the past 20 years has been accompanied by a surge in patents. But the evidence linking this to increased innovation is slight, and some problems have followed the shift to stronger IPRs, such as the soaring cost of patent litigation.

The generally favourable experience with deregulation created pressure for liberalisation in network industries, where the United States has rather been a laggard, at least in the electricity sector. Reforms in the 1990s have entailed some positive results but also some setbacks, reflecting both the difficulties in ensuring competition in such industries and policy mistakes. As to telecommunications, the advent of competition for voice services in local markets following the reforms in the mid-1990s has started to bear fruit, but policies are still needed that make sure that entry in local voice services and broadband are not thwarted by dominant carriers. Introducing competition in the electricity market has proved particularly difficult, and restructuring has stalled in the wake of the California meltdown in 2000-01, which reflected flaws in the regulatory framework rather than the impact of competition. The urgency of further regulatory reform was highlighted by the August 2003 blackout, which has been traced in part to weaknesses in supervision and co-ordination.

The trade policy challenge

The United States continues to place great importance on free trade and competition in its commercial relations with the rest of the world. Controversially, it believes that it is appropriate to advance on all fronts – "competitive liberalisation" *via* "complementary courses" – despite the implications for the most-favoured nation (MFN) principle and the inability to deal properly with agricultural subsidies. It is therefore busily negotiating bilaterally and regionally, in addition to assuming its key role in the Doha Round. In 2003, new free trade agreements were concluded with Chile and Singapore, both including commitments to dispute settlement and compensation mechanisms in case capital controls were ever implemented. More recently, agreements, still to be approved by Congress, have been reached with five Central American nations and with Australia. They both avoid full liberalisation in sugar and the former in clothing as well. Negotiations are still underway with Morocco, Panama and the Dominican Republic, and are imminent with the Southern African Customs Union and four Andean nations. Despite these

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bilateral developments, US officials have not given up their hopes to have a Free Trade Area of the Americas (involving 34 countries) in place before mid-2005 when fast-track authority expires, arguing that narrower agreements will buttress and not undermine such plans.

On the multilateral front, negotiations in the Doha Round stalled with the Cancun ministerial meeting in September 2003. The United States had proposed to abolish tariffs on all manufactures by 2015 and have faster elimination for some other products. However, unlike the EU, it did not wish to include the so-called Singapore issues (customs procedures, transparency in government tendering, competition rules and investment). Efforts are now underway to restart the talks in order to have some chance of reaching the 2005 deadline. If that is not met, the risk is that the pace of protectionist tendencies will increase further, as seems to be happening in the matter of foreign outsourcing ("offshoring").

Foreign outsourcing has become controversial

While comprehensive data are not available, it appears that there has been an increase in outsourcing, at least in the services sector. It can tentatively be asserted that while globalisation in the manufacturing sector has been a feature throughout the half-century following World War II, this trend seems to have accelerated in recent years as an international value chain has been formed in many industries. In the IT-hardware sector alone this may have boosted real GDP growth by 0.3 percentage points per annum since 1995 (Mann, 2003b). Moreover, with the continued digitisation of economic activity and the ability to transmit increasingly large amounts of information at ever lower cost, it has become possible and profitable to shift the production of a rising number of services abroad,[2] just as earlier occurred with manufactures, even though such job transfers are unlikely to be responsible for the meagre overall job gains during this expansion. In any case, in accordance with comparative advantage, the life cycle of these goods and services often calls for their production to move to low-wage environments, once they have been standardised to some extent,[3] especially if the destination country has an abundance of skilled labour. Both source and host countries gain real income from the resulting specialisation. A recent study suggests that offshore outsourcing generates an average of about $1.46 of value to the world for each dollar of activity shifted offshore from the United States to India, of which 78 per cent (about $1.13 – that is, a net gain of 13 per cent) is retained in the US economy (McKinsey Global Institute, 2003).

For the United States the gains depend importantly on the degree to which workers whose positions are outsourced can find new employment. Concern over the lack of net job creation during the current recovery (see Box 1.1 above) has provided fuel for those opposed to employers' ability to outsource abroad, although job creation is projected to pick up from now on. The difficulty in finding

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employment for those whose positions have been eliminated is not a new phenomenon, even though in the 20 years to 1999 a clear majority of those displaced from their jobs in import-sensitive industries both in- and outside of manufacturing found new employment within a fairly short time at wage rates that were broadly equal to their previous levels (Kletzer, 2001). However, this still leaves a sizeable minority who lost out, especially concentrated among females and the low-skilled: indeed, about a quarter took longer than six months to find another job, and even among those successfully re-employed, more than a fifth had to take pay cuts of 30 per cent or more.[4]

The United States has long had legislation on its books that provides trade adjustment assistance to workers in manufacturing who are displaced by the side-effects of liberalisation. But that may be inadequate in the current context. As a result, Congress has a whole series of draft bills before it intended to deal, at least in part, with the problem. One would extend the existing training, health care and other benefits to displaced service-sector workers. Another would require firms to provide three months' advance notice of outsourcing moves. Other legislators have gone further in a restrictive direction by advocating that: the federal government should bar loans, grants and guarantees to any firm laying off more workers domestically than abroad; federal contracts should not be awarded to firms that intend to use offshore labour;[5] and tax deductions should be denied for corporate expenses to move workers abroad or hire foreign contractors. Earlier, some observers had proposed the implementation of a wage insurance scheme.[6] For its part, the Administration has recommended a system of "personal re-employment accounts", which would provide as much as $3 000 for displaced workers to spend on education, re-training or counselling at an estimated cost of $3.6 billion per year, but Congress has not yet voted on this proposal. As many as 30 states have recently been considering (and four have passed) legislation that would restrict international outsourcing by, for example, limiting the use of offshore contractors in state and local government procurement and requiring call centre employees to disclose their locations. The challenge for policy-makers will be to avoid protectionist responses to these developments, possibly by pre-empting such measures in the Doha Round (Mattoo and Wunsch, 2004) and focus instead on growth-promoting policies and improved adjustment assistance and social protection, so as to maintain the economy's ability to adjust flexibly to future developments.

Several important trade disputes

In that regard, there have been a rising number of commercial disputes, many of which have involved the WTO. Anti-dumping investigations still dominate, but safeguard cases are growing more strongly, both in number and importance. While the United States is a major user of these measures, it was

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supplanted by India as the heaviest anti-dumping user in 2002. Easily the most attention has been devoted to the safeguard tariffs of up to 30 per cent imposed by the United States on steel imports in March 2002 for three years (with subsequent exemptions for about one-third of total imports). In 2003, the WTO ruled that such duties were illegal, and the EU and Japan prepared to impose sanctions. A September 2003 study by the US International Trade Commission on the impact of the steel tariffs noted steep price increases and considerable associated earnings losses in steel-consuming industries, along with a modest ($42 million) fall in US welfare, despite estimated tariff revenue of $650 million.[7] With international steel prices firming, the dollar at a much lower level and progress in restructuring the steel industry, the United States agreed to eliminate the measures in December 2003. However, it simultaneously announced the continuation of the licensing and monitoring programme that had been in effect during the safeguard period and a possible change to the way anti-dumping duties are calculated, and pressures have surfaced to ban exports of scrap steel in view of prospective shortages. Still, the early elimination of the tariffs has given a lift to the prospects of reaching a steel-subsidies agreement at the OECD-led talks this year.

Another dispute, which may be near resolution, is that concerning Canadian softwood lumber. A provisional accord reached in December 2003 would give Canada duty-free access to 31.5 per cent of the US market, somewhat below its present market share and the pre-dispute quota level. Yet, complications have arisen with subsequent rulings by NAFTA and the WTO, the first of which objected to the countervailing part, while the second validated the anti-dumping part of the combined 27 per cent current duty on Canadian softwood lumber. In any case, import quotas are at best only a second-best solution, and it would be preferable to agree on the amount and eventual removal of alleged Canadian subsidies to the industry.

There are also several ongoing important disputes with the EU. One is over the so-called Foreign Sales Corporation (FSC) provisions in the US tax code, which the WTO ruled are not consistent with international agreements. In 2003, the WTO considered that US actions to abide with this ruling were not sufficient and entitled the EU to levy tariffs on US exports, which the EU started implementing in March. At the time of writing, there was no agreement in Congress on legislation addressing this issue, but proposals being considered would cut the corporate income tax rate for manufacturers progressively over the next five years by amounts in line with the foreign sales of the firm. Other disputes concern anti-dumping legislation. First, under the so-called Byrd amendment (the Continued Dumping and Subsidy Offset Act of 2000), the US authorities have been giving several hundred million dollars per year in revenues collected under anti-dumping and countervailing duties to the plaintiff companies, a procedure the WTO recently ruled to be in contravention with its rules. The WTO has also ruled that the Anti-Dumping Act of 1916 is not consistent with its rules and authorised the EU to

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suspend trade obligations on a corresponding amount of US exports. Judicial proceedings, especially in the latter case, have been especially burdensome for foreign exporting firms.

Finally, two sectors that have traditionally been subject to frequent disagreement continue to be sensitive. One is textiles and clothing, where the United States recently imposed safeguard quotas on certain imports from China (which has recently become a WTO Member), a move that has to be seen in the context of the impending expiration of the Multi-Fibre Agreement. The other is agriculture, where an explicit "peace clause" agreed at the foundation of the WTO has just expired. That clause prevented Member countries from resorting to its dispute settlement procedures with respect to farm subsidies, except if such subsidies rose beyond their 1992 levels. The current level of support relative to revenue in the US agricultural sector is relatively low by international comparison. In 2000-02, producer support estimates were 21 per cent in the United States, 35 per cent in the EU and 59 per cent in Japan. However, the 2002 farm bill demonstrates a marked shift away from the goal of greater market orientation embodied in the 1996 farm legislation. It increases and extends support, tightens the link between payments and production parameters and imposes higher costs not only on US taxpayers but also on other countries. It thus risks accentuating both production distortions and trade tensions, despite ambitious US proposals for agricultural liberalisation in the context of the Doha round, and is not at all in line with long-term OECD policy reform objectives.

The energy/environment challenge

With official estimates of dependence on foreign oil and natural gas being revised upwards and the reliability and cost of electricity supplies called into question by the August 2003 blackout and the California electricity crisis of 2000-01, the attention of the authorities has been focused for some time now on improving supply conditions in the industry and hence longer-term energy security. Legislation under consideration in Congress would provide tax incentives to most energy-producing sectors, including nuclear power and coal. It would encourage the production of ethanol to mix with gasoline, despite the fact that ethanol is widely considered to be far more expensive than other possible sources of transportation fuel (International Energy Agency, 2004), even when account is taken of its environmental advantages. But it would not tighten the "CAFE" standards on fuel efficiency by motor vehicles, even new vechicles' fuel efficiency has stagnated for the past decade at a level some 6 per cent below the 1987 peak level, as light truck sales have gone from one in ten to one in two and both weight and horsepower have continued to increase within each market segment. Criticisms levelled at the draft energy legislation include that it puts excessive emphasis on traditional petroleum over other kinds of energy and

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conservation, which means that greenhouse gas (GHG) emissions will rise inexorably. However, the Administration has separately succeeded in raising the "CAFE" standard for light trucks for the model years 2005 to 2007 by a cumulative 6 per cent. It would be useful to tighten up the definition of what constitutes a light truck so that the comparatively lax standards they face are not an artificial advantage in the market place.

The authorities continue to oppose efforts to reduce GHG emissions through the Kyoto protocol, claiming that existing technologies for their reduction would not be cost effective, harming economic growth excessively and allowing no role for new technology. They thus prefer to support climate science and related research focusing on "breakthrough technologies" such as carbon sequestration, hydrogen use, clean coal and nuclear fusion (specifically the ITER project). A July 2003 research plan calls for 21 separate reports on varying aspects of climate change to be produced over the next four years. US policies nevertheless aim at cutting the emissions intensity of output by 18 per cent relative to past trends by 2012, which would still allow a rise in actual emissions by 14 per cent relative to recent levels and 31 per cent over the 1990 (Kyoto baseline) outcome. In late 2003, the authorities announced that they intend to toughen the rules of the voluntary GHG registry, established in 1994 in order to make it more credible, and to launch a system of tradable credits. Firms exceeding a certain CO2 threshold would have to report emissions from all their plants and get credit only for the reductions achieved since 2002. The federal position is to some extent undercut by the states, with some of them having adopted policies to reduce or register GHG emissions, and others co-operating to decrease power plant emissions. Many private firms have announced their intention to cut emissions voluntarily, and a number of them have joined the city of Chicago to form the Chicago Climate Exchange to trade emission credits. In a related matter, the United States has asked for exemptions from the agreed January 2005 ban on methyl bromide (used in agriculture) in the context of the Montreal protocol on ozone protection.

In other energy policies with clear environmental impacts, in August 2003 the Administration weakened the New Source Review rules – requiring the installation of pollution-reducing technology when facilities are expanded or modernised – by allowing an escape clause if firms say that they are "upgrading" rather than modernising their plant and equipment. Neither will routine maintenance, repair and replacement bring about an enhanced pollution abatement requirement. In its view this requirement had been a barrier to carrying out such investments. A Congressionally mandated study had found that the existing system had failed to curb pollution by the nation's oldest plants and recommended that the latter should be given 10 years to clean up or shut down. In its Clear Skies initiative, the Administration set a target of reducing SO_2/NO_X/mercury pollution by 29 per cent by 2007 and 70 per cent by 2018, but it opposes recommendations to include GHG emission targets. In December 2003, it proposed to meet the mercury

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target by a cap-and-trade system rather than the previous administration's policy of requiring individual plants to respect specific mercury targets, which would have led to a reduction of at least 90 per cent by 2007. More recently, the Environmental Protection Agency has been studying the proposal rule to ensure that it would indeed achieve the target over the promised horizon and not as much as a decade later.

The social/equity challenge

Apart from the fiscal aspect mentioned above, the strong rise in health care costs also has a social dimension. Many Americans from all socio-economic groups lack health insurance, although it is among the poor, those with low educational attainment minorities and youth that the lack is most severe (Table 1.8). The overall proportion without health insurance picked up to over 15 per cent in 2002, after temporarily receding from its previous peak of over 16½ per cent in 1998. Public programmes, especially Medicaid, covered more people, but not enough to offset the decline in private coverage. The trend increase in the share of the uninsured is likely to continue as soaring costs discourage both employer-sponsored coverage and the purchase of individual insurance. This also has a significant economic impact. One study (Institute of Medicine of the National Academies, 2003) put the cost of poorer health outcomes and earlier death because of the lack of health insurance at 1¼ per cent of GDP. This is far greater than the estimated cost of providing the extra services that the uninsured would receive if they were covered, probably implying an efficiency loss of around ½ per cent of GDP. The public policy challenge of health care is the problem of maintaining some degree of equity in the face of technological change that persistently increases the cost of meeting that goal (Glied, 2003).

In contrast to health coverage, latest figures show that the fears that the cyclical downturn would reverse some, or all, of the sharp drop in welfare caseloads following the 1996 reforms have proved unfounded. While the downtrend has been slowing, it continued through mid-2003. The cumulative reduction in welfare caseloads since the 1993-94 peak is now some 60 per cent, and related to individuals (rather than families) it is now down to levels witnessed at the beginning of the 1960s. Probably half of the decline is attributable to a fall in *entry* to programmes, rather than beneficiaries being removed from the roles (Grogger, 2003). On the other hand, poverty rates have risen again. Although, at 12 per cent of the population, the overall poverty rate in 2002 was still 3 percentage points below the previous peak in 1993, poverty is likely to have kept growing in 2003. Moreover, it remains at around one-fifth for ethnic minorities and female householder families with no husband present. At the same time, there is notable hardship among the poor, with 40 per cent of poor single-parent working mothers' spending at least half of their income on childcare and a significant and rising proportion of poor households paying more than half of their income for housing.

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Table 1.8. **The non-elderly without health insurance**

1998

	Current Population Survey	Per cent	Survey of Income and Program Participation	Per cent	Medical Expenditure Panel Survey	Per cent	National Health Interview Survey	Per cent
A. Absolute numbers (in millions)								
Uninsured for the entire year	–	–	21.1	9.1	31.1	13.3	n.a.	–
Uninsured at a specific point in time	–	–	40.5	16.6	42.6	18.3	39.0	16.5
Uninsured at any time during the year	–	–	56.8	24.8	59.0	25.3	n.a.	
Other[1]	43.9	18.4	–	–	–	–	–	–
	Spells beginning from July 1996-June 1977				Spells in progress in March 1998			
B. Duration of uninsured spells (%)								
Four months or less		44.5					87.9	
Five to 12 months		26.2					14.4	
13 to 24 months		13.4					} 77.8	
More than 24 months		15.9						
	Uninsured at any time during the year				Uninsured for the entire year		Distribution of the population uninsured for the entire year	
C. Selected characteristics (%)								
i) Race/ethnicity:								
White, non-Hispanic		18.4			6.3		48.4	
Black, non-Hispanic		33.4			10.7		15.3	
Hispanic		47.4			22.5		30.8	
Other		31.1			10.9		5.5	
ii) Family income (% of poverty level)								
Less than 200		47.9			19.5		74.9	
200 to 399		17.4			5.3		19.8	
400 or more		6.0			1.6		5.3	

Table 1.8. **The non-elderly without health insurance** (*cont.*)

1998

	Uninsured at any time during the year	Uninsured for the entire year	Distribution of the population uninsured for the entire year
C. Selected characteristics (%)			
iii) Highest education level among adults			
No high school diploma	50.4	24.6	28.4
High school graduate	33.1	12.7	36.4
Some college	22.1	7.3	26.6
Bachelor's degree or higher	9.9	2.6	8.7
iv) Family employment status			
At least one full-time worker all year	15.0	5.9	42.9
Part-time or part-year work only	46.1	16.1	46.6
No work	32.8	13.1	10.6
v) Age			
Less than 19	26.8	7.3	24.9
19 to 24	41.9	14.4	13.7
25 to 34	31.1	12.3	21.9
35 to 44	20.2	9.3	19.7
45 to 54	15.1	7.6	12.6
55 to 64	14.0	6.7	7.2
vi) Health status			
Excellent	23.7	8.9	28.8
Very good	25.1	9.3	32.8
Good	24.6	9.1	24.5
Fair	25.1	8.7	8.9
Poor	25.3	10.3	5.1

1. The CPS figure is intended to measure the number uninsured for the entire year but is believed to be up-biased and closer to a measure of those uninsured at a specific point in time.

Source: CBO (2003).

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Finally, overall income inequality has stopped rising after its continuous run-up since 1979.

The education challenge

The current Administration has made reform of the compulsory education system one of its priorities. Already a decade ago the Committee termed its effectiveness "mediocre at best", pointing to low scores on international tests and high minority dropout rates as evidence and a lack of standards and incentives as culprits (OECD, 1994, p. 136). The costs of poor-quality compulsory schooling are multiple:

- greater numbers of dropouts;
- more remedial courses required among college students;
- more training needed by employers;
- an inability to handle new, productivity-enhancing technologies; and
- a reduced capacity to adjust to both temporary and permanent shocks, especially those related to "offshoring", that is shifting business functions to low-cost, foreign sites.

The Administration of the time tried a strategy of voluntary national standards for the public school system and for vocational studies, with little tangible success. Test scores later in the 1990s continued for the most part to show modest results in view of the comparatively high spending levels in the United States.[8] According to the most recent figures (1998), spending remains well above other countries' outlays, suggesting that value for money is still lacking. And upper secondary graduation rates are still on the low side by OECD standards.

A new and more ambitious approach is embodied in the 2002 No Child Left Behind (NCLB) Act, whose goal is not only to boost academic achievement overall but to bring all students up to a challenging standard labelled "proficiency". While the controversial idea of vouchers was dropped during Congressional debate, the legislation imposes mandatory standards – albeit ones that states are left to define completely for themselves[9] – and increased accountability on teachers, schools and administrators. Last year the states had to define a level of proficiency in reading and mathematics which they pledged to achieve for all pupils by 2013-14. In order to monitor progress annual tests for all those between 8 and 14 have to be set by 2005. Other deadlines include the fixing of standards in science and the guarantee that all teachers be "highly qualified" in their subject areas, each by 2005-06.

A key requirement in coming years will be for schools to achieve "adequate yearly progress" (AYP). AYP is being determined by test outcomes[10] and any school found wanting (either across the board or by race, income or disability group) will be sanctioned with increasing severity. In the first year the school is to receive "technical assistance". After two consecutive years students are supposed to be allowed to transfer. However, few have been able to do so thus far because of a lack of available

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space at better schools (though this is not supposed to be a legitimate excuse). Extra tutoring is called for under the law if a third straight year of underperformance is registered, but again the reality is that only a minority of those eligible so far have benefited from such help because of financial constraints.[11]

This may be symptomatic of a more general problem:[12] many state and local officials have claimed that the NCLB mandates have not been adequately funded by the federal government.[13] For example, it initially provided $360 million per year ($410 million is proposed in 2005) to pay for testing, but the National Association of State Boards of Education charged that it would cost many times more than that. Yet the federal government *has* been ramping up its aggregate discretionary education spending in recent years: since 2001 the average increase has been 8 to 9 per cent per year through to the Administration's proposed 2005 figures (depending on whether the calculation is made using outlays or budget authority), including double-digit average annual growth in funding the NCLB Act. But these are merely marginal increases in total government spending on schooling in kindergarten through twelfth grade, for which federal dollars are only about 7 per cent of the total. On the other hand, states have been in a severe although improving financial position, and education has been one area where dramatic cutbacks[14] have been made in some cases – even, ironically, in the very teacher training that is needed to achieve the NCLB Act objective of having only "highly qualified" teachers. It is clear that the situation will bear close monitoring in the coming years.

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Notes

1. This growth rate of potential output is predicated on conservative assumptions for trend multifactor productivity growth (just below 2 per cent), growth of the capital stock (rising from 2 per cent in 2004 to 2½ per cent in 2005) and trend labour force growth (1¼ per cent). The implied growth rate of trend labour productivity in the business sector is about 2¼ per cent.
2. There are no official data on the magnitude of the phenomenon of outsourcing. One aggregate private-sector estimate, by the IT research firm Forrester, points to 400 000 US jobs that had been moved abroad cumulatively by July 2003, with a prediction of 3.3 million by 2015. These are of course small proportions of total job creation and destruction in the US economy, which average more than 30 million per year. Bardhan and Kroll (2003) judge that US employment in occupations at risk to outsourcing was around 14 million in 2001 (11 per cent of total employment), the majority of which were in office and administrative support categories with mean annual salaries some 25 per cent below average. However, about 5 million were comprised of business and financial support occupations and computer and mathematics professionals with salaries at least a third above average. The industries in which these occupations are prevalent all experienced worse employment outcomes in the nine quarters to the second quarter of 2003.
3. Furthermore, many jobs are simultaneously being "insourced", that is, being moved to the United States by foreign firms. Indeed, the United States habitually runs a surplus on its external trade in private services.
4. Those displaced from industries that were deemed relatively insensitive to import competition experienced similar re-employment and earnings change outcomes.
5. The Senate passed such legislation in March 2004. It would not apply to countries that have liberalised their public procurement rules.
6. Kletzer and Litan (2001) suggest that employers subscribe to such insurance with annual payments of up to $10 000 per worker for as long as two years at a yearly premium cost of some $5 billion. Agrawal and Farrell (2003) extend the idea and suggest that full-time workers could be covered for 70 per cent of all the wages lost until re-employment as well as healthcare subsidies for up to two years.
7. Similar negative assessments can also be found in a series of papers by Hufbauer and Goodrich (most recently, 2003).
8. Recent tests have included another eighth grade test in mathematics and science in 1999 (the so-called TIMSS-R), where US results were both quite low; and below-average outcomes in reading, mathematics and science literacy in the OECD's 2000 PISA programme for 15 year-olds. (The dispersion of reading outcomes was also especially marked.) However, in the 2001 PIRLS reading literacy test for fourth graders

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US results were better than average, confirming that the real problem lies in later grades. Another piece of evidence suggesting sub-standard outcomes comes from the prevalence of incoming college students enrolling in remedial courses: according to the National Center for Educational Statistics, almost half of all freshmen at two-year colleges and nearly one in five at four-year schools enrolled in at least one remedial course in 2000 and they spent a longer time in remediation than in 1995 (OMB, 2004, p. 109). Eventually, 53 per cent of all college students take at least one remedial class in English or Mathematics (The American Diploma Project, 2004). Finally, by one count more than 60 per cent of employers rate high school graduates' basic language and mathematical skills as only "fair" or "poor" (The American Diploma Project, 2004).

9. Indeed, states also create their own tests and set their own thresholds for a student to be determined "proficient". Obviously, there is a risk of "dumbing down" both teaching and the tests so that the "standards" are met.

10. This is viewed as dangerous by teachers' unions, which fear the conflation of effects of teacher competency and school efficiency on the one hand and other exogenous factors such as innate ability, background and class size in the assessment of "proficiency". Critics have also charged that teaching will be increasingly tied to the tests. In any case many states have set their AYP targets such that the need for significant improvement is postponed until late in the 12-year adjustment period. Nonetheless, initial results and predictions are that a very high share of schools will fail to meet their targets right from the outset, even though some have even adjusted their scoring systems to downgrade what defines "proficiency" for the purposes of the NCLB Act. The American Diploma Project (2004) has established a set of English and Mathematics benchmark skills for college and workplace readiness. It urges all states to adopt them and the federal government to align its 12th grade testing on them and ensure that all students in the nation take that standardised test, as the NCLB Act requires at 4th and 8th grades.

11. After four years of failure to achieve AYP, schools must replace their staff, and after five the state must either run the school itself, transform it into a charter school or turn it over to a private manager.

12. More fundamental concerns that have been voiced (Ryan, 2003) are that NCLB creates perverse incentives:

    – for states to lower academic standards, thereby creating a race to the bottom;

    – for administrators to increase segregation by class and race and to push out low-performing pupils; and

    – for the best teachers to avoid problem schools.

13. The Democrats contend that the FY 2004 appropriations bill passed in January underfunds the NCLB programme by around $ 7 billion or 13 per cent.

14. Compulsory education is not the only component to bear the brunt of state cutbacks: higher education has suffered trend declines since the late-1980s because of spending pressures emanating in part from Medicaid demands. This has led to upward pressure on tuition increases at public colleges and universities and a widening quality gap with their private counterparts (Kane and Orszag, 2003).

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Annex 1.1

Progress in structural reform

Labour markets

Previous recommendations

- Avoid increasing the federal minimum wage.
- Identify strategies to increase employment of the disabled.
- Tighten work requirement for welfare recipients.

Action taken

- A tightening of work requirements for welfare recipients, which currently have little bite, is under consideration in Congress.

Education

Previous recommendations

- Bring more schools up to the standards now in place.
- Expand competition in primary and secondary schooling.
- Reduce funding disparities across school districts and reconsider the design of state programmes.

Action taken

- The 2002 No Child Left Behind Act provides for testing, greater accountability, increased choice in public schooling and additional federal funding for schools in lower-income areas; it remains to be seen if the Act is sufficiently adapted or financed to achieve these objectives.

Product markets

Previous recommendations

- Improve competition in local telephone industry.
- Improve energy infrastructure, particular in electricity transmission and generation.
- Roll back the extra support given to farmers in recent years.

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Action taken

- Unbundling of network elements has boosted competition for local voice services and provided incentives for investment and new services.
- The energy bill still considered in Congress focuses on increasing energy supply. Some of its provisions might help foster regional electricity transmission integration and related investment.
- The 2002 farm bill further increases support and distortions in the agricultural sector.

Financial markets

Previous recommendations

- Reassess bankruptcy and patent laws with aim of curbing abuses.
- Break links of government-sponsored enterprises with the federal government.
- Create independent regulatory board for, and limit consulting services by, auditors.
- Consider move toward principles-based accounting rules.
- Examine expensing of stock options.

Action taken

- Bankruptcy reform legislation has been stalled in Congress.
- The 2002 Sarbanes-Oxley Act created a regulatory board for auditors, the Public Company Accounting Oversight Board, and limited their non-auditing activities.
- As mandated by the Sarbanes-Oxley Act, the Securities and Exchange Commission carried out a study that recommended a prudent move toward principles-based accounting.
- The Financial Accounting Standards Board has recommended the mandatory expensing of stock options but there is still opposition in Congress.

Taxation

Previous recommendations

- Increase the limits for contributions to tax-free savings accounts.
- Eliminate deductions for mortgage interest and state and local income tax.
- Reform indirect taxation.
- Extend Earned Income Tax Credit.

Action taken

- Recent legislation has expanded tax-free Health Savings Accounts (HSAs) and the Administration has proposed the creation of tax-exempt Lifetime Savings Accounts (LSAs) and Retirement Savings Accounts (RSAs).

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Environment

Previous recommendations

- Consider introducing a domestic cap-and-trade system for CO_2 emissions.
- Make evaluation of environmental costs and benefits of agriculture when providing support to this sector.
- Increase fuel taxes in lieu of tightening "CAFE" standards.
- Consider a carbon tax on all carbon-based energy products, including coal and natural gas.

Action taken

- While opposing efforts to reduce GHG emissions through the Kyoto protocol, the Administration has implemented a suite of policies to slow the growth of GHG emissions including aggressive technology investments in carbon sequestration, hydrogen, and fusion energy..
- The 2002 farm bill increases the size and scope of environmental programmes in this sector.
- The Administration has implemented a significant increase in fuel economy ("CAFE") standards for light trucks and SUVs over the coming three model years.
- The Administration has sent legislation to Congress and proposed regulations to cap emissions of SO_2, NO_x, and mercury from power plants by 70 per cent and has also proposed regulations to reduce emissions from diesel engines and diesel fuels. Taken together, these regulations are intended to satisfy the new National Ambient Air Quality Standards (NAAQS) for ozone and fine particulate matter by 2020.

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BASIC STATISTICS OF THE UNITED STATES

THE LAND

Area (1000 sq. km)	9 629
Population of major cities, including their metropolitan areas, April 2000 (thousands):	
New York	21 200
Los Angeles-Anaheim-Riverside	16 374
Chicago-Gary-Kenosha	9 158

THE PEOPLE

Resident population, July 1st 2002	288 369 000
Number of inhabitants per sq km	29.9
Annual net natural increase (average 1998-2002)	1 592 400
Natural increase rate per 1 000 inhabitants (average 1998-2002)	5.7
Civilian labour force, 2003	146 515 667
of which :	
Health services	11 812 800
Unemployed	8 776 583
Net immigration (annual average 1998-2002)	1 116 000

PRODUCTION

Gross domestic product in 2003 (billions of US $)	10 988
GDP per head in 2003	38 073
Gross fixed capital formation	
Per cent of GDP in 2003	18.4
Per head in 2003 (US$)	6 997
Origin of national income in 2002 (per cent of national income[1]):	
Manufacturing	13.7
Finance, Insurance and real estate	20.0
Services	24.7
Government and government enterprises	13.7
Other	27.9

THE GOVERNMENT

Government consumption 2003 (per cent of GDP)	15.5
Government current receipts, 2003 (per cent of GDP)	30.7
Federal government debt held by the public (per cent of GDP), FY 2003	36.1

Composition of the 108th Congress as of November 5th 2002:

	House of Representatives	Senate
Republicans	228	51
Democrats	205	48
Independents	1	1
Vacancies	1	–
Total	435	100

FOREIGN TRADE

Exports:	
Exports of goods and services as per cent of GDP in 2003	9.5
Main exports, 2003 (per cent of merchandise exports):	
Foods, feeds, beverages	7.5
Industrial supplies	23.2
Capital goods	40.5
Automotive vehicles, parts	11.0
Consumer goods	12.4

Imports:	
Imports of goods and services as per cent of GDP in 2003	14.1
Main imports, 2003 (per cent of merchandise imports):	
Foods, feeds, beverages	4.8
Industrial supplies	15.2
Capital goods	25.3
Automotive vehicles, parts	18.0
Consumer goods	28.5

1. Without capital consumption adjustment.

Note: An international comparison of certain basic statistics is given in an annex table.

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•

The economic situation and policies of the United States were reviewed by the Committee on 10 March 2004. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 30 March 2004.

•

The Secretariat's draft report was prepared for the Committee by Hannes Suppanz, Thomas Laubach, Michael Kiley and Michael Wise under the supervision of Peter Jarrett.

•

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