

UNITED STATES

Output has slowed to below its potential growth rate, reflecting a dramatic contraction in house building. As this flattens out, GDP growth should progressively return to trend. Core inflation has been high, partly due to rising housing costs and the flow-on of higher energy prices to other goods and services. But, as long as expectations of inflation remain relatively low, these effects should fade and inflation should edge down.

Monetary policy is mildly restrictive. This stance should be maintained as long as core inflation remains high and the unemployment rate stays low. The federal government budget deficit has fallen, reflecting a largely unexplained surge in tax collections. But the fiscal improvement looks likely to be reversed due to rising military spending and the effects of slower GDP growth on tax collections. This raises the urgency of addressing the long-run challenges of funding entitlements.

Output has slowed

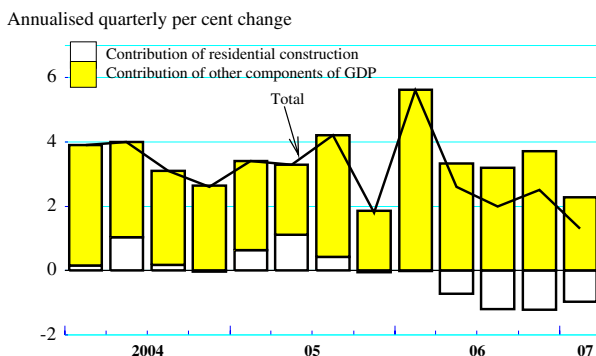
Real GDP grew by 2.1 per cent over the year to 2007Q1, a markedly slower rate of growth than before. The deceleration reflects a sharp drop in residential construction, which subtracted 1% from GDP in this period. Rising interest rates and a correction of previous building excesses have contributed to this contraction, though its magnitude is surprisingly large. Outside the housing sector, activity in the rest of the economy has been strong, with spending on non-residential structures and exports growing particularly quickly. In more fundamental terms, the slowdown in activity was necessary, as the expansion appeared to be outstripping available resources.

But the labour market remains strong

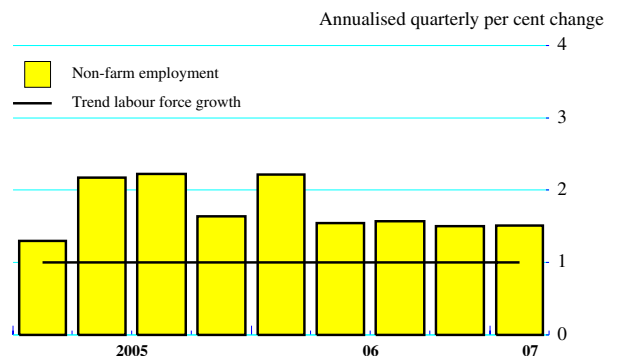
Although the growth in GDP has been below that of its potential (now estimated to be about 2.7%), the labour market has been strong. Non-farm payrolls grew at an annual rate of 1.5% in 2007Q1, the same pace as in previous quarters and well in excess of the trend growth of the labour force. Consequently, the unemployment rate has trended down, reaching a six-year low of 4.4% in March. Most of the strength of the labour market – and its corollary, weak productivity – probably reflects cyclical lags. Indeed, the most recent April data showed weaker employment growth.

United States

GDP has slowed



But the labour market remains strong



Source : US Bureau of Labor Statistics, Bureau of Economic Analysis, OECD Analytical Database.

StatLink <http://dx.doi.org/10.1787/032782680558>

United States: Employment, income and inflation

Percentage changes from previous period

| | 2004 | 2005 | 2006 | 2007 | 2008 |
|--|------|------|------|------|------|
| Employment ¹ | 1.1 | 1.6 | 1.8 | 1.0 | 0.4 |
| Unemployment rate ² | 5.5 | 5.1 | 4.6 | 4.6 | 4.8 |
| Employment cost index | 3.8 | 3.1 | 2.9 | 3.3 | 4.0 |
| Compensation per employee ³ | 4.4 | 3.6 | 4.6 | 4.5 | 4.5 |
| Labour productivity ³ | 3.1 | 1.7 | 1.6 | 1.1 | 2.1 |
| Unit labour cost ³ | 1.7 | 2.2 | 2.9 | 3.5 | 2.4 |
| GDP deflator | 2.8 | 3.0 | 2.9 | 2.6 | 2.2 |
| Consumer price index | 2.7 | 3.4 | 3.2 | 2.6 | 2.6 |
| Core PCE deflator ⁴ | 2.0 | 2.1 | 2.2 | 2.2 | 2.1 |
| Private consumption deflator | 2.6 | 2.9 | 2.7 | 2.4 | 2.2 |
| Real household disposable income | 3.6 | 1.2 | 2.6 | 3.1 | 2.9 |


1. Whole economy, for further details see *OECD Economic Outlook Sources and Methods*, (<http://www.oecd.org/eco/sources-and-methods>).

2. As a percentage of labour force.

3. In the private sector.

4. Price index for personal consumption expenditure excluding food and energy.

Source: OECD Economic Outlook 81 database.

StatLink  <http://dx.doi.org/10.1787/033785723873>

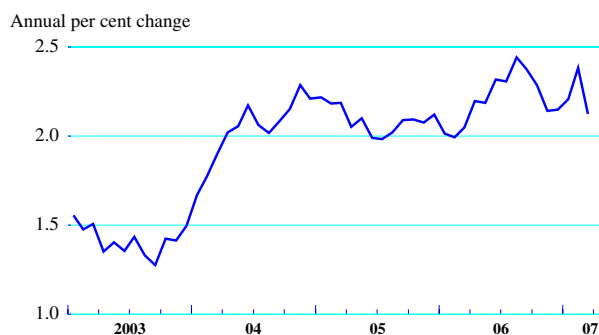
Nevertheless, the persistence of the divergence between weak output and strong employment raises questions about whether estimates of trend productivity should be further revised downward.

Although core inflation is too high...

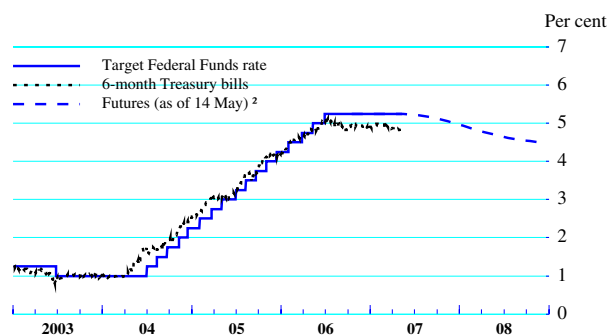
Since early 2004, core inflation, as measured by the price index for personal consumption expenditures (PCE) excluding food and energy, has remained above 2% – the upper limit of the range some policy-makers have said they are comfortable with. A substantial part of this excess inflation may reflect indirect effects of higher energy prices, though estimates of this contribution are uncertain. More recently, housing costs, largely comprising rent and the price owner-occupiers are assumed to pay themselves, have risen sharply. The rise in rents is difficult to attribute to

United States

Core inflation remains high ¹




But markets expect a monetary policy easing



1. Price index for personal consumption expenditure, excluding food and energy.

2. Eurodollar futures, adjusted for term and risk premia.

Source: Federal Reserve, Chicago Mercantile Exchange, OECD Main Economic Indicators.

StatLink  <http://dx.doi.org/10.1787/032831018583>

United States: Financial indicators

| | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|------|------|------|------|------|
| Household saving ratio ¹ | 2.0 | -0.4 | -1.1 | -1.2 | -0.8 |
| General government financial balance ² | -4.6 | -3.7 | -2.3 | -2.7 | -2.9 |
| Current account balance ² | -5.7 | -6.4 | -6.5 | -6.1 | -6.2 |
| Short-term interest rate ³ | 1.6 | 3.5 | 5.2 | 5.3 | 5.0 |
| Long-term interest rate ⁴ | 4.3 | 4.3 | 4.8 | 4.7 | 4.8 |

1. As a percentage of disposable income.
 2. As a percentage of GDP.
 3. 3-month euro-dollar.
 4. 10-year government bonds.
- Source: OECD Economic Outlook 81 database.

StatLink  <http://dx.doi.org/10.1787/033817867311>

excess demand, as vacancy rates are high. It may reflect a catch-up to previous large increases in house prices. In any case, this contribution seems likely to continue but at a diminishing pace.

... inflation expectations remain moderate


Despite some strong upward pressures on inflation, expectations of long-term inflation remain moderate. For example, bond yields appear to include a premium compensating for expected increases in the consumer price index of about 2½ per cent, much as they have for the past several years. Given historical term premia and differences between the price series, that seems consistent with core PCE prices rising at about a 2% rate. Although wage measures are mixed, the employment cost index for private-sector workers has remained remarkably subdued, rising 3.2% in the year to March 2007 – showing little, if any, sign that wage setters are building higher inflation into their negotiations.

United States: Demand and output

| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|-------------------------------|------------------------------|--|------|------|-------|------|
| | Current prices \$ billion | Percentage changes, volume (2000 prices) | | | | |
| Private consumption | 7 703.6 | 3.9 | 3.5 | 3.2 | 3.1 | 2.4 |
| Government consumption | 1 736.5 | 2.1 | 0.9 | 1.6 | 2.5 | 2.5 |
| Gross fixed investment | 2 005.7 | 6.1 | 6.4 | 3.1 | -2.9 | 1.8 |
| Public | 356.0 | 0.5 | 1.1 | 4.1 | 2.4 | 2.5 |
| Residential | 572.4 | 9.9 | 8.6 | -4.2 | -16.0 | -3.4 |
| Non-residential | 1 077.4 | 5.9 | 6.8 | 7.2 | 2.6 | 4.0 |
| Final domestic demand | 11 445.8 | 4.0 | 3.6 | 2.9 | 1.9 | 2.3 |
| Stockbuilding ¹ | 14.3 | 0.4 | -0.3 | 0.2 | -0.2 | 0.0 |
| Total domestic demand | 11 460.2 | 4.4 | 3.3 | 3.2 | 1.7 | 2.4 |
| Exports of goods and services | 1 040.8 | 9.2 | 6.8 | 8.9 | 5.6 | 7.1 |
| Imports of goods and services | 1 540.2 | 10.8 | 6.1 | 5.8 | 2.0 | 4.7 |
| Net exports ¹ | - 499.4 | -0.6 | -0.2 | 0.0 | 0.3 | 0.0 |
| GDP at market prices | 10 960.8 | 3.9 | 3.2 | 3.3 | 2.1 | 2.5 |

Note: National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. For further details see *OECD Economic Outlook Sources and Methods*, (<http://www.oecd.org/eco/sources-and-methods>).

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
- Source: OECD Economic Outlook 81 database.


StatLink  <http://dx.doi.org/10.1787/033826503575>

United States: External indicators

| | 2004 | 2005 | 2006 | 2007 | 2008 |
|-----------------------------------|--------------------|---------|---------|-------|-------|
| | \$ billion | | | | |
| Goods and services exports | 1 178.1 | 1 303.2 | 1 466.2 | 1 594 | 1 734 |
| Goods and services imports | 1 791.4 | 2 019.9 | 2 228.7 | 2 319 | 2 487 |
| Foreign balance | - 613.2 | - 716.7 | - 762.5 | - 726 | - 753 |
| Invisibles, net | - 52.1 | - 74.8 | - 94.2 | - 116 | - 152 |
| Current account balance | - 665.3 | - 791.5 | - 856.7 | - 842 | - 905 |
| | Percentage changes | | | | |
| Goods and services export volumes | 9.2 | 6.8 | 8.9 | 5.6 | 7.1 |
| Goods and services import volumes | 10.8 | 6.1 | 5.8 | 2.0 | 4.7 |
| Export performance ¹ | - 1.6 | - 1.4 | - 0.1 | - 1.2 | - 0.6 |
| Terms of trade | - 1.3 | - 2.5 | - 0.9 | 0.9 | - 0.8 |

1. Ratio between export volume and export market of total goods and services.

Source: OECD Economic Outlook 81 database.

StatLink  <http://dx.doi.org/10.1787/033875521410>

Monetary policy is mildly restrictive

The federal funds rate has remained at 5¼ per cent since July 2006. This mildly restrictive stance reflects a core inflation rate that is higher than desired and an unemployment rate that is below most estimates of its sustainable level. Ordinarily, tighter policy might be expected in these circumstances. However, the expectation that the increase in inflation is temporary, coupled with the downturn in the housing market, suggest that only light restraint is needed – an assessment that will be revised in the light of incoming data. Should core inflation remain high and unemployment stay low, then a further tightening would be appropriate.

Bond yields seem low

Long-term interest rates have fluctuated without trend about a low level over recent months. Financial markets seem to expect the federal funds rate to fall to 4½ per cent by late-2008. This suggests the markets are discounting Federal Reserve statements that it is worried about the inflation outlook. If the federal funds rate does remain at its current level through 2007, as assumed in this projection, then bond yields are likely to rise slightly.

The near-term fiscal position has improved

The consolidated federal budget deficit (including the social security surplus) narrowed further in calendar year 2006, to 1.5% of GDP on a national accounts basis. The decline reflected a further unexpected boom in tax receipts while outlays rose in line with GDP. Looking forward, the deficit is expected to widen again. Expenditures are seen to rise in real terms, mainly due to military spending. Revenue growth seems likely to ease with the slowdown in the economy – though the share of taxes in GDP will remain high.

Housing will eventually level out

Residential investment should continue declining for several more quarters, largely reflecting further reductions in activity flowing from the decline in starts that has already occurred. But with the fundamentals underpinning housing demand (rising incomes, population, low

unemployment, moderate mortgage rates) still solid, a collapse like those seen during past recessions is unlikely and the market should flatten out. With the rest of the economy continuing to grow strongly, GDP growth should return to near its potential rate by 2008. The unemployment rate is projected to rise to 4¾ per cent and then flatten out. Strong demand abroad coupled with slower growth at home should help to stabilise the current account deficit at a little over 6% of GDP.

Core inflation should decline slightly

Core inflation is expected to edge down slightly. The impetus from higher energy prices and housing costs should fade. If inflationary expectations remain moderate, the increase in core inflation should not persist. With unemployment remaining near the non-accelerating inflation rate of unemployment (NAIRU), demand pressures on inflation are likely to be small.

Sub-prime mortgages pose a downside risk...

One uncertainty about this projection concerns the recent turmoil in the sub-prime mortgage market. Though important for financial markets, the macroeconomic implications of these developments may be small. At the time of writing, there appears to have been little flow-on effect, so far, to fixed-rate sub-prime lending, prime mortgages, or other credit markets, such as for automobiles. There will probably be some further reduction in home lending, though that should also be small relative to the sharp decline already seen to date. But these conjectures may prove too optimistic, so there is a risk of larger effects.

... as does equipment spending

Another uncertainty relates to business spending on equipment. In the first quarter of 2007, orders and shipments of core capital goods (that is, those excluding aircraft and defence) fell noticeably. Although the sources of this decline are not fully understood, many factors could have contributed: changes in overall demand typically have larger effects on business investment via accelerator mechanisms; new emissions regulations brought truck sales forward; and demand for construction equipment has weakened markedly. The special nature of these factors suggest that the slump in equipment spending may be short-lived. Indeed, recent monthly data show a pick-up. But if that assessment is incorrect, economic growth will be weaker going forward.

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Conventional signs

| | | | |
|------|-------------------------|----------|-------------------------------------|
| \$ | US dollar | . | Decimal point |
| ¥ | Japanese yen | I, II | Calendar half-years |
| £ | Pound sterling | Q1, Q4 | Calendar quarters |
| € | Euro | Billion | Thousand million |
| mb/d | Million barrels per day | Trillion | Thousand billion |
| .. | Data not available | s.a.a.r. | Seasonally adjusted at annual rates |
| 0 | Nil or negligible | n.s.a. | Not seasonally adjusted |
| – | Irrelevant | | |

Summary of projections

| | 2006 | 2007 | 2008 | 2007 | | | 2008 | | | | Fourth quarter | | |
|---|----------|------|------|------|-----|-----|------|-----|-----|-----|----------------|------|------|
| | | | | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | 2006 | 2007 | 2008 |
| | Per cent | | | | | | | | | | | | |
| Real GDP growth | | | | | | | | | | | | | |
| United States | 3.3 | 2.1 | 2.5 | 2.5 | 2.3 | 2.5 | 2.5 | 2.6 | 2.7 | 2.7 | 3.1 | 2.1 | 2.6 |
| Japan | 2.2 | 2.4 | 2.1 | 1.8 | 1.9 | 2.0 | 2.1 | 2.2 | 2.1 | 2.2 | 2.5 | 2.0 | 2.2 |
| Euro area | 2.8 | 2.7 | 2.3 | 2.6 | 2.5 | 2.4 | 2.3 | 2.2 | 2.1 | 2.1 | 3.3 | 2.5 | 2.2 |
| Total OECD | 3.2 | 2.7 | 2.7 | 2.7 | 2.6 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 3.2 | 2.6 | 2.7 |
| Inflation | | | | | | | | | | | | | |
| United States | 2.9 | 2.6 | 2.2 | 2.3 | 2.0 | 2.2 | 2.4 | 2.2 | 2.1 | 2.1 | 2.5 | 2.6 | 2.2 |
| Japan | -0.9 | -0.4 | 0.2 | -0.4 | 0.0 | 0.1 | 0.2 | 0.3 | 0.4 | 0.6 | -0.5 | -0.3 | 0.4 |
| Euro area | 1.7 | 2.0 | 2.0 | 1.0 | 2.0 | 2.0 | 2.0 | 2.1 | 2.2 | 2.2 | 1.6 | 2.0 | 2.1 |
| Total OECD | 2.2 | 2.1 | 2.0 | 1.9 | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 | 1.8 | 2.3 | 2.0 |
| Unemployment rate | | | | | | | | | | | | | |
| United States | 4.6 | 4.6 | 4.8 | 4.5 | 4.6 | 4.7 | 4.8 | 4.8 | 4.8 | 4.9 | 4.5 | 4.7 | 4.9 |
| Japan | 4.1 | 3.8 | 3.6 | 3.8 | 3.7 | 3.7 | 3.6 | 3.6 | 3.6 | 3.6 | 4.1 | 3.7 | 3.6 |
| Euro area | 7.8 | 7.1 | 6.7 | 7.1 | 7.0 | 6.9 | 6.9 | 6.8 | 6.7 | 6.6 | 7.5 | 6.9 | 6.6 |
| Total OECD | 5.9 | 5.6 | 5.5 | 5.6 | 5.6 | 5.6 | 5.5 | 5.5 | 5.5 | 5.4 | 5.7 | 5.6 | 5.4 |
| World trade growth | 9.6 | 7.5 | 8.3 | 7.7 | 8.2 | 8.4 | 8.3 | 8.3 | 8.2 | 8.2 | 8.6 | 7.7 | 8.3 |
| Current account balance | | | | | | | | | | | | | |
| United States | -6.5 | -6.1 | -6.2 | | | | | | | | | | |
| Japan | 3.9 | 4.8 | 5.4 | | | | | | | | | | |
| Euro area | 0.1 | 0.4 | 0.4 | | | | | | | | | | |
| Total OECD | -1.9 | -1.5 | -1.5 | | | | | | | | | | |
| Cyclically-adjusted fiscal balance | | | | | | | | | | | | | |
| United States | -2.5 | -2.8 | -2.8 | | | | | | | | | | |
| Japan | -2.2 | -2.7 | -3.2 | | | | | | | | | | |
| Euro area | -1.0 | -0.8 | -0.7 | | | | | | | | | | |
| Total OECD | -1.7 | -1.8 | -1.9 | | | | | | | | | | |
| Short-term interest rate | | | | | | | | | | | | | |
| United States | 5.2 | 5.3 | 5.0 | 5.3 | 5.3 | 5.2 | 5.1 | 5.1 | 5.0 | 4.9 | 5.3 | 5.2 | 4.9 |
| Japan | 0.2 | 0.5 | 0.6 | 0.6 | 0.6 | 0.6 | 0.6 | 0.6 | 0.6 | 0.7 | 0.4 | 0.6 | 0.7 |
| Euro area | 3.1 | 4.1 | 4.3 | 4.0 | 4.2 | 4.3 | 4.3 | 4.3 | 4.3 | 4.3 | 3.6 | 4.3 | 4.3 |

Note: Real GDP growth, inflation (measured by the increase in the GDP deflator) and world trade growth (the arithmetic average of world merchandise import and export volumes) are seasonally and working-day-adjusted annual rates. The "fourth quarter" columns are expressed in year-on-year growth rates where appropriate and in levels otherwise. The unemployment rate is in per cent of the labour force while the current account balance is in per cent of GDP. The cyclically-adjusted fiscal balance is in per cent of potential GDP. Interest rates are for the United States: 3-month eurodollar deposit; Japan: 3-month certificate of deposits; euro area: 3-month interbank rate.

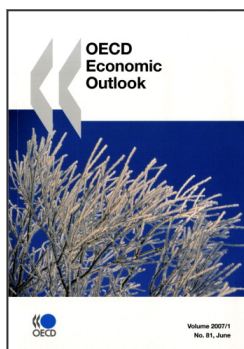
Assumptions underlying the projections include:

- no change in actual and announced fiscal policies;

- unchanged exchange rates as from 9 May 2007; in particular 1\$ = 119.72 yen and 0.74 euros;

The cut-off date for other information used in the compilation of the projections is 15 May 2007.

Source: OECD Economic Outlook 81 database.



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