COUNTRY REPORT

United States of America

United States of America at a glance: 2002-03

OVERVIEW

The president, George W Bush, has widened the war on terrorism to include countries that threaten the US or its allies with weapons of mass destruction, but how this will be implemented remains open to debate. There will be unanimous backing from Congress on this issue, but gridlock on most other issues is likely in the run-up to the mid-term congressional election in November. The party of the president normally suffers losses in the mid-term election, but the Republicans could benefit from Mr Bush's extremely high approval rating if it sustained. There are increasing signs that the economy has bottomed out, and economic recovery is likely to gather pace in the second half of 2002 and to reach 3.6% growth in 2003. Inflation will not pose a serious problem, but the current-account deficit will remain substantial.

Key changes from last month

Political outlook

- Mr Bush's readiness to confront "an axis of evil" will strain relations between the US and its European allies, although a fully fledged military attack on Iraq, Iran or North Korea is highly unlikely.
- The Bush administration has so far managed to contain the political impact of the Enron scandal, but this still has the potential to damage the Republican Party in the run-up to the mid-term election.

Economic policy outlook

- The economic stimulus package has failed, but the federal budget is still expected to move into deficit in fiscal year 2001/02 (October-September) as war and recession take their toll on government finances.

Economic forecast

- The worst of the recession is over, and the Economist Intelligence Unit's GDP forecast for 2002 has been revised up from 1.1% to 1.4%.

February 2002

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United Kingdom

The Economist Intelligence Unit

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Electronic delivery

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ISSN 0269-6185

Symbols for tables

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Printed and distributed by Patersons Dartford, Questor Trade Park, 151 Avery Way, Dartford, Kent DA1 1JS, UK.

Outlook for 2002-03

Political outlook

Domestic politics

The president, George W Bush, is enjoying an extremely high approval rating, which soared in the immediate aftermath of the September 11th terrorist attacks and is now stabilising at around 85%. His main domestic political challenge will be to ensure that his high standing rubs off on his Republican Party in the mid-November congressional election. However, his popularity could be threatened by the persistence of the recession, the potential fall-out from the Enron bankruptcy scandal or a significant setback in the war on terrorism. Both the Democrats and Republicans are still united behind the president in the fight against terrorism, but the spirit of patriotic bipartisanship stops there.

War and recession have taken their toll on government finances, with the Bush administration's budget projections showing deficits for this and the next two fiscal years. While Mr Bush should be able to gain congressional approval for substantial increases in the military and homeland security budgets, his plans for spending cuts and further tax cuts will be fiercely resisted in Congress. Chances of further tax cuts were already slight after the non-partisan Congressional Budget Office announced that its ten-year budget surplus forecast had dropped from US$5.6trn to US$1.6trn. In fact, Mr Bush recently felt compelled to head off a potential attempt to scale back his US$1.35trn tax cut passed last year.

The Enron scandal has not turned into a fully fledged political scandal, although the Bush administration has particularly close ties to the Texas-based energy trader. Enron was a major Bush campaign contributor and a number of administration officials have direct ties to the company. The administration was able to demonstrate that it did nothing to help the company avoid financial ruin, despite several requests for aid. But the prospect of lengthy congressional investigations into the debacle, plus numerous private lawsuits against the company and its officials, ensures that this will remain an important electoral issue.

The Enron scandal will also have a definite impact on legislation this year. It has already brought campaign finance reform back to life and it will hurt the administration's proposed energy programme. There will also undoubtedly be new business accounting and regulatory oversight legislation. These could be unwelcome diversions for Mr Bush, as he also focuses on the war on terrorism by confronting countries that threaten the US with weapons of mass destruction. The end result could be that little of his domestic agenda is enacted before the November mid-term election.

Election watch

Mr Bush could worry less about Democrats if his own party recaptures control of the Senate in November and strengthens its weak grip in the House of Representatives. Historically, the party of the president has done poorly in mid-term elections; voters tend to punish the party in power for failing to live up to expectations. But the national sense of crisis has changed voters' perceptions. Many opinion polls now put the Republicans ahead of the Democrats.

Whether the present overwhelming popular support for the president carries through to the November mid-term election is likely to depend, above all, on the economy. Although GDP should pick up momentum before the election, the unemployment rate may still be high, since it tends to be a lagging economic indicator, and this could hurt the Republicans. They could also be damaged by either the fall-out from the Enron scandal or a significant setback in the war on terrorism, but both of these risks can be minimised through a policy of careful preparation, communication and transparency. These have, for the most part, been Mr Bush's strengths. Although the economy will remain key, its importance may be overridden if most Americans believe they are still at war. This could pave the way for Republican gains in November.

The Senate now comprises 50 Democrats, 49 Republicans and one independent. Thirty-four seats will be up for re-election this November. However, only about 12 of these are considered competitive contests, with six seats completely open, three seats slightly leaning to the Democrats, and three slightly leaning to the Republicans. All 435 seats in the House of Representatives, currently comprising 222 Republicans, 211 Democrats and two independents, are up for re-election. The Democrats will need a net gain of six seats to regain a majority in the House.

International relations

Emboldened by his military success in Afghanistan, Mr Bush redefined the war on terrorism—and with it US foreign policy—in his state of the union address on January 29th. The US, from now on, will target not just terrorists but countries that threaten the US or its allies with weapons of mass destruction, and will do so pre-emptively. Mr Bush warned that the US must confront "an axis of evil" formed by Iraq, Iran and North Korea. This could strain relations between the US and its European allies. Even if Mr Bush has clarified US policy, he has come no closer to explaining how he will implement it, or when he will resort to military force.

Mr Bush has never specifically threatened a fully fledged military attack on Iraq, Iran or North Korea, perhaps because he understands the cost of such an undertaking. Instead, he is likely to adopt a strategy of verbal intimidation backed up by the selective application of military force. It is clear that the US government sees September 11th as a transformational event, not as an aberration that will soon pass into history. This will colour US relations with its allies. While the US is anxious to retain strategic alliances, with western Europe, for example, and will try to build new ones, as it is doing with Russia and India, the pursuit of domestic security after September 11th will take precedence. This will lead to frosty spells in foreign relations for the US. On the one hand, the Bush administration will insist on, and for the most part receive, good co-operation from other countries on matters of intelligence gathering, law enforcement and financial interdiction. On the other, it will be less than accommodating to allies' concerns when it believes that these limit its room to manoeuvre.

Economic policy outlook

Policy trends

The recession and the September 11th terrorist attacks have, between them, totally altered US political thinking on fiscal policy. Fiscal stability may still be the long-term aim, but it is no longer central to the current policy debate. The federal budget will move into deficit this fiscal year (October 2001-September 2002) and remain in deficit in 2002/03. The Federal Reserve (the central bank) held interest rates steady at its most recent policy meetings, and, with the economy over the worst of the recession, further rate cuts in the coming months seem unlikely.

Fiscal policy

After a flurry of emergency spending following the terrorist attacks, Congress has failed to agree on a supplementary economic stimulus package. This partly reflects irreconcilable differences between Republicans and Democrats on the composition of the package, as well as the growing realisation that the rationale for such a package has begun to slip away. Mr Bush has published his proposed budget for 2002/03 and beyond, although the final shape of tax and spending legislation will be decided in Congress, not by the administration. His proposals include yet more tax cuts and spending increases, and the Economist Intelligence Unit expect that the eventual legislation will result in small deficits over the next few years.

Monetary policy

The Federal Reserve cut interest rates by 475 basis points during 2001, leaving the official federal funds target rate at 1.75%. But at its January policy meeting it decided to hold rates steady, as there are increasing signs that the economy has bottomed out. Nonetheless, a bias towards easing remains in place—this is the Federal Reserve's way of telling financial markets that it is prepared to cut rates again should the economy resume its deterioration. With headline consumer price inflation (CPI) running at 1.5%, real interest rates are close to zero, and thus highly stimulatory.

The economy is probably over the worst already, and we believe that the monetary and fiscal stimulus currently under way will lead to a substantive recovery in the second half of this year. We therefore expect the Federal Reserve to start raising interest rates from the third quarter of 2002. When growth accelerates in 2003, we expect the federal funds rate to rise sharply to 6% by year-end. Although high compared with its current rate of 1.75%, this equates to a real interest rate of just over 3%, which is a broadly neutral policy-setting.

Economic forecast

International assumptions

The global economy remains very weak. But we also estimate that the trough of the global recession has arrived—after falling in the final months of 2001, we believe that global activity has bottomed out and will start to pick up in the months ahead, albeit gradually. Annual GDP figures do not tell the full story—we expect global GDP growth in 2002 to average 2.4% (on a purchasing power parity basis), not much better than in 2001. But in 2001 the global economy started the year in growth and ended it in contraction, while in 2002 it will be the other way round.

This picture of economic activity increasing during the year is true even in the EU and Japan, where average growth for 2002 will actually be slower than in 2001—in both cases a recovery (albeit a weak one) is expected in the second half of 2002. Many emerging markets will also be growing more robustly later this year. The improvement in global economic conditions towards the end of 2002 will be maintained into 2003, when global growth will average a far better 4.2%, close to our estimate of trend growth for the global economy. The OECD economies are expected to perform strongly, which will boost performance in many emerging markets.

International assumptions summary
(% unless otherwise indicated)

	2000	2001	2002	2003
Real GDP growth				
World	4.7	2.2	2.4	4.2
OECD	3.8	0.9	0.9	3.0
EU	3.3	1.5	1.3	2.5
Exchange rates (av)				
¥:US$	107.8	121.5	128.8	123.5
US$:€	0.924	0.896	0.960	1.015
SDR:US$	0.758	0.785	0.771	0.751
Financial indicators				
¥ 2-month private bill rate	0.24	0.18	0.10	0.10
€ 3-month interbank rate	4.48	4.28	3.13	4.60
Commodity prices				
Oil (Brent; US$/b)	28.5	24.3	18.3	20.2
Gold (US$/troy oz)	279.3	268.8	255.0	250.0
Food, feedstuffs & beverages				
(% change in US$ terms)	–6.1	–1.0	11.9	13.4
Industrial raw materials				
(% change in US$ terms)	13.4	–9.7	1.3	14.8

Note. Regional GDP growth rates weighted using purchasing power parity exchange rates.

Economic growth

The US economy officially entered recession in March 2001 (according to the National Bureau of Economic Research, which is responsible for dating recessions). The assessment is based on a broad range of indicators—on the more normal definition of two consecutive quarters of declining GDP, the economy appears to have avoided a recession, as preliminary estimates show that (after contracting in the third quarter of 2001) GDP expanded marginally in the final months of the year. We now expect GDP to rise slightly in the first quarter of 2002, with the recovery gathering pace in the second half of the year. GDP growth for 2002 as a whole is forecast to average just 1.4%, after an anaemic 1.1% rise in 2001. By 2003 GDP growth is forecast to average 3.6% in response to the aggressive easing of fiscal and monetary policies.

The economy grew in the fourth quarter largely because private consumption surged in October after collapsing in September in the wake of the terrorist attacks. But now that this one-off disruption has passed, the underlying economic reality for consumers—lay-offs, low confidence and stagnant incomes—is returning to the fore and private consumption is expected to fall for the first few months of 2002. Business investment remains in freefall and the pace of decline is expected to remain high in early 2002. In addition, as large swathes of the global economy contract, real exports are also likely to continue to fall. All this, of course, paints a very weak picture for real imports, which will act as a significant drag on growth elsewhere in the world.

Yet, despite all this bad news, we expect the economy to grow slightly in the first quarter of 2002. The incredible pace of destocking by companies over the past year has returned inventories to a more normal level, and stockbuilding should begin contributing to growth from the first quarter. In addition, with excess inventories worked off, a recovery in industrial production is in prospect—orders figures and the latest business surveys suggest an improvement in industrial activity in the second quarter of 2002. But a more durable recovery, based on stronger final demand (consumption, investment and trade) is not expected until later in the year.

Forecast summary

(% unless otherwise indicated)

	2000[a]	2001[a]	2002[b]	2003[b]
Real GDP growth	4.1	1.1	1.4	3.6
Gross fixed investment growth	7.6	–1.9	–5.1	5.8
Industrial production growth	4.5	–3.7	–1.5	4.5
Unemployment rate (av)	4.0	4.8	6.1	6.2
Consumer price inflation				
Average	3.4	2.8	0.9	2.6
Year-end	3.4	1.5	2.1	2.8
3-month commercial paper rate	6.3	3.6[c]	2.0	4.9
Federal government budget balance				
(% of GDP)[d]	2.4	1.3	–0.2	–0.2
Exports of goods fob (US$ bn)	774.9	726.4[c]	665.8	745.0
Imports of goods fob (US$ bn)	1,224.4	1,152.3[c]	1,058.8	1,185.4
Current-account balance (US$ bn)	–444.7	–410.9[c]	–377.8	–432.8
% of GDP	–4.5	–4.0[c]	–3.6	–3.9
Exchange rates				
¥:US$ (av)	107.8	121.5	128.8	123.5
US$:€ (av)	0.924	0.896	0.960	1.015

[a] Actual. [b] EIU forecasts. [c] EIU estimates. [d] Federal government, fiscal year (October-September).

Aggressive policy action will play a large part in delivering this expected economic rebound and the further acceleration of growth in 2003. The monetary easing that has already occurred (most of which has yet to feed through into the economy) will help to support the consumer in the year ahead through boosting mortgage refinancing activity and interest rate-sensitive purchases. Emergency government expenditure on the military and internal security, combined with tax cuts contained in Mr Bush's US$1.35trn ten-year tax cut package, will also help to lift the economy in the second half of the year. By 2003 we expect GDP growth to reach 3.6%, well above our estimate of the trend rate of growth.

A high degree of uncertainty surrounding the prospects for the US economy in the short term remains, particularly for business investment and consumption. We are factoring in further cuts in investment spending in the coming months before a gradual recovery later in the year, but we are not ruling out an even sharper retrenchment, given the weak financial position of the corporate sector. In addition, consumer spending could fall by even more than we expect if companies feel the need to cut headcount more sharply in response to financial weakness. We attach a 30% probability to this more pessimistic scenario, in which GDP could fall by 5% peak to trough. But, given the extent of policy easing implemented over the past year, there is also an upside to the forecast, and we attach a 20% probability to a stronger rebound scenario, with growth reaching an annualised rate of over 4% in the coming months.

Gross domestic product by expenditure

(US$ bn at constant 1996 prices; % change year on year in brackets except stockbuilding and foreign balance, where figures are contribution to GDP growth)

	2000[a]	2001[a]	2002[b]	2003[b]
Private consumption	6,257.8	6,447.3	6,534.5	6,727.9
	(4.8)	(3.0)	(1.4)	(3.0)
Public consumption[c]	1,572.6	1,627.7	1,708.8	1,758.4
	(2.7)	(3.5)	(5.0)	(2.9)
Gross fixed investment	1,716.2	1,682.8	1,596.4	1,689.6
	(7.6)	(–1.9)	(–5.1)	(5.8)
Final domestic demand	9,551.9	9,759.5	9,841.2	10,177.6
	(5.0)	(2.2)	(0.8)	(3.4)
Stockbuilding	50.6	–62.0	–7.5	35.0
	(–0.1)	(–1.2)	(0.6)	(0.4)
Total domestic demand	9,602.5	9,697.5	9,833.7	10,212.6
	(4.8)	(1.0)	(1.4)	(3.9)
Exports of goods & services	1,133.2	1,080.7	1,021.2	1,087.6
	(9.5)	(–4.6)	(–5.5)	(6.5)
Imports of goods & services	–1,532.3	–1,494.4	–1,458.5	–1,567.9
	(13.4)	(–2.5)	(–2.4)	(7.5)
Foreign balance	–399.1	–413.7	–437.3	–480.3
	(–0.9)	(–0.2)	(–0.3)	(–0.5)
GDP[d]	9,224.0	9,325.6	9,458.9	9,803.3
	(4.1)	(1.1)	(1.4)	(3.6)

[a] Actual. [b] EIU forecasts. [c] Includes government's capital expenditure. [d] Includes residual.

Inflation

Consumer price inflation will slow further in 2002. Oil prices are expected to be about 25% lower than their 2001 level, and the price of many non-oil industrial raw materials will remain depressed until global demand starts to recover in the second half of 2002. Unit labour cost growth will slow dramatically as wage growth (in both real and nominal terms) weakens and employment declines. This will allow CPI to average just 0.9% in 2002, and producer prices will fall by some 2.5%. But inflation will accelerate in 2003. Both oil and non-oil commodity prices will pick up, a resumption of employment growth will allow wages to rise a little more strongly, and firms will regain some limited pricing power as domestic demand growth accelerates.

Exchange rates

The euro is still expected to remain weak against the US dollar over the next 12 months. Policy has not been eased as aggressively in Europe as in the US, and the pace of economic recovery is therefore likely to be slower. But the new currency is also undervalued, and should start to rise in 2003 as economic performance in the euro zone improves. However, the appreciation will only be gradual—US growth will still outstrip that of Europe by a considerable margin and investors are unlikely to make a sharp portfolio reallocation in favour of euro-denominated assets. The euro is expected to average US$0.89:€1 in 2002, rising to US$0.97:€1 in 2003. Expectations of Japanese economic growth continue to be downgraded, and we expect the yen to remain weak over the next 12 months, sliding from an average of ¥122:US$1 in 2001 to ¥135:US$1 in 2002 before appreciating slightly to ¥130:US$1 in 2003.

External sector

Visible trade flows are likely to shrink further during 2002. Global demand will remain weak, particularly in the first half of the year. US domestic demand will be similarly depressed. In 2003 visible trade flows will start to expand again. External demand will accelerate as most regions of the world see an economic recovery, while stronger domestic demand will help to boost import growth.

The trade deficit is expected to shrink from an estimated US$426bn in 2001 to US$393bn in 2002 before expanding again in 2003. The service surplus will rise only marginally in 2002, although the 2001 surplus was artificially enlarged by insurance pay-outs related to the September 11th terrorist attacks. The deficit on income will remain broadly stable as worsening returns on foreigners' investments in the US are offset by a weakening of returns on US assets abroad (as the rest of the global economy remains sluggish). Overall, the current-account deficit will shrink slightly in 2002, largely owing to the movement in the merchandise trade deficit, but will deteriorate again in 2003. This means that the US will enter its next economic expansion with a current-account deficit averaging about 4% of GDP. One of the major imbalances that marked the expansion in the 1990s will not have been corrected by the current recession.

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