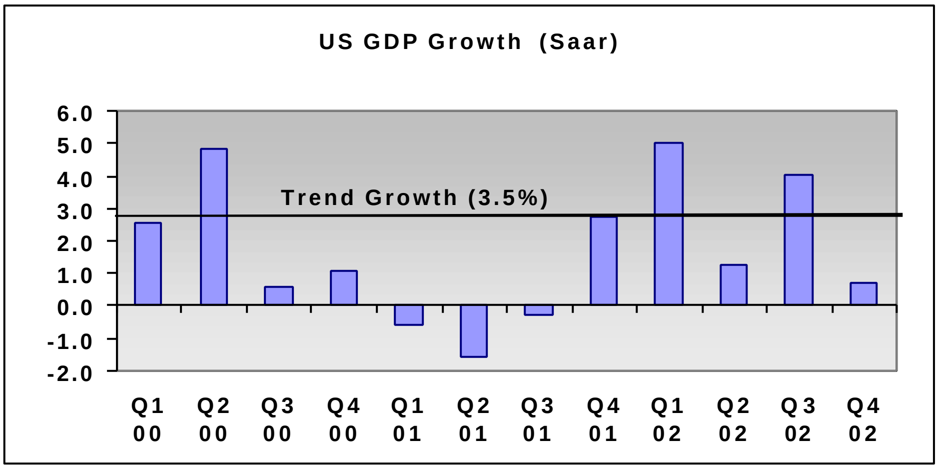
US Growth Stays Subdued and Uneven



Continuing 2002's uneven pattern, US Q4 GDP growth came in at a disappointing 0.7% (saar). In the third quarter the economy had grown by 4.0% (saar). This brings the growth rate for the year as a whole to 2.4%, well below the economy's potential growth rate of 3.5%. As expected, there was a sharp deceleration in consumer spending. This slowdown was driven by a significant drop off in car sales from the previous quarter. A fall inventories and net exports also hit growth. Government spending continued to provide significant stimulus to the economy, led by an 11.2% gain in federal defence spending, which has been propping up the industrial sector. Price pressures rose a bit, but remain low and should not be of major concern to policy makers.

The weak headline number, following a solid 4% gain in the third quarter, is not as bad a it looks. Consumer spending is generally holding up. Auto sales have been extremely volatile as consumers react to the timing of various marketing deals. Therefore, the overall drop in personal consumption in Q4 does not suggest a collapse in consumer spending. There was good news on the investment front with business spending rising for the first time in nine quarters. Non-residential fixed investment was up 1.5%. Spending on computers continues to rise, and structures investment, at least, is falling at a slower pace. However, balanced against the pick-up in investment is a slowdown in inventory accumulation, suggesting that businesses are still nervous about the pace of future demand and are willing to forgo sales rather than be left with excess stock.

Growth in the US then continues to be subdued and uneven. Three factors, in particular, are contributing to the subdued nature of the upswing. First, the recession of 2001 was relatively mild. Thus, there is little of the pent up demand that usually boosts activity in the early stages of an upswing. Second, the imbalances created by the bubble economy of the late 1990s are still in the process of being corrected. In particular, the low personal savings ratio is being rebuilt, while overcapacity resulted in another sharp fall in business investment in 2002. Furthermore, the correction in stock market valuations proved particularly painful during the past year. Finally, the very weak state of the international economy, most notably, the eurozone and Japan is dampening US activity.

The stance of macro-economic policy will remain very stimulatory in 2003. Interest rates are set to remain at very low levels, the dollar is in decline, while another large increase in Federal government spending plus further tax cuts are on the cards. Meantime, inventories are at very low levels while the correction to business investment seems to have been completed at this stage. This should result in some pick up in manufacturing activity in the year ahead.

Nevertheless, the economy is exposed to considerable risk. The main risk stems from a retrenchment in consumer spending. Household spending has proved to be remarkably resilient over the past couple of years. However, the sluggishness of the economy also means that it is quite vulnerable to shocks. In other words, it wouldn't take much of a downturn in activity as a result of a shock to trigger a recession. Shocks by their nature are difficult to predict and thus do not form part of our benchmark forecast. What we can say, though, is that while a recession is unlikely, there are many factors that seem set to impede activity in the US economy this year, resulting in a continuation of sub-par growth.

These factors include (i) the personal savings ratio should continue to edge higher in 2003 against a backdrop of weak stock markets, rising unemployment and fragile consumer confidence (ii) oil prices are likely to remain high in the early part of the year, reflecting geopolitical tensions (iii) an end to mortgage refinancing is likely as the decline in long term rates bottoms out - refinancing gave a considerable boost to spending power in 2001/2002 (iv) a fall in auto sales from their bloated levels of 2001/2002 when special financing deals accelerated purchases (v) a further rise in unemployment is expected with obvious consequences for income growth.

The above factors will dampen growth in consumer spending, in particular, during 2003. Other factors which seem likely to dampen economic activity this year are (vi) a war with Iraq is quite possible in the coming months which will add to economic uncertainty and damage confidence (vii) low capacity utilisation rates which will hinder a recovery in business investment (viii) fragile stock markets as companies struggle to increase profits (ix) a tightening in the state and local government fiscal stance to meet their balanced budget rules following a big fall-off in revenue in 2002 and, finally, (x) a continuing weak global economy which will dampen export growth.

Hence, despite the very stimulatory stance of policy and low inventories, we look for a continuation of below trend economic growth. We expect US GDP to grow by around 2.5% again in 2003. We would expect the economy to register annualised growth of around 2% in the opening half of the year, rising to 3-4% in H2 2003 as some of the negative influences identified above begin to abate. Such an economic outlook points to a further rise in unemployment and continuing low inflation.

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