

# The Bipolar Economy

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The economy seems to be suffering from a bipolar disorder. For example, since 1985, there have been 15 quarters where real GDP expanded by 5% or more including the 5.9% gain in the fourth quarter of 2009. In every one of them, except for the fourth quarter of 2009, payroll employment typically expanded on the order of a 2-3% annual rate. In contrast, employment actually contracted at an annual rate of 1.3%. In economic terms, "Okun's Law," which defines a relationship between GDP growth and unemployment, appears to have broken down as gains in productivity swamped the employment effects of a growing GDP<sup>1</sup>.

Ironically, Washington's economic stimulus packages may have unintentionally caused the economic schizophrenia. Tax cuts and spending programs, coupled with a non-sustainable zero interest policy spur growth, but businesses do not make long-term hiring decisions based on temporary government policies. Nevertheless, the economy is now on a growth path and employment will soon be increasing, albeit modestly.

The Forecast's case for recovery is based on strength in business equipment and software, exports and a revival in home construction from postwar lows. With the exception of housing, these factors are already making positive contributions to the economy. Growth will be held back by declines in non-residential construction and stagnation and retraction in the state and local government sectors. The Forecast expects the economy to grow at a 3.2% rate for the first quarter of this year, and then level off to about 2%, leaving 2010's overall growth around 2.3%. In 2011 and 2012, GDP is forecasted to be 2.3% and 3.2% % respectively. However, payroll employment is still forecasted to be two million jobs below the 2007 peak at the end of 2012.

Now that the financial emergency of 2007-09 is over, we anticipate the Federal Reserve will start moving away from its zero interest rate policy this fall. To be sure, interest rates will remain historically low throughout 2011, but the way will be open to more normal interest rates. Indeed, the deficits arising from the financial crisis and its hangover will exert upward pressure on interest rates for a long time to come. In a cautionary note, the real risk to the economy is inflation, as the Federal Reserve's monetary policy has created circumstance ripe for inflation. We believe the Fed understands this risk, will tighten monetary policy and that inflation will remain under control.

## **Conclusion**

Modest GDP growth will soon translate into job growth, but the unemployment rate will stay above 9% through 2011. After a huge inventory rebound, economic recovery will be led by equipment and software, exports and housing. Offsetting these strong sectors will be weakness in state and local government, nonresidential structures and tepid consumption growth. Although

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<sup>1</sup> See, *Daly Mary and Bart Hobijn, "Okun's Law and the Unemployment Surprise of 2009," FRBSF Economic Letter, March 8, 2010.*

the threat is real, inflation will remain modest throughout the forecast period as the Fed ends its zero interest rate policy and gradually returns interest rates to more normal levels.