

A Homeless Recovery

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Historically, U.S. recoveries with exceptional growth and very favorable job markets have been driven by an expansive consumer buying homes and cars after sitting on the sidelines for a year or more. That is unlikely this time. Our forecast is for a frugal consumer powering tepid growth, especially symbolized by steady but slow improvement in the housing market. Thus it is only somewhat inaccurate to use the rhetoric: A homeless recovery.

Though GDP began growing in the third quarter of 2009, the labor market produced relentlessly bad news until January 2010 when a paltry increase of 16,000 private sector jobs was a great relief. The 16,000 was followed by four months of ever better news, culminating with a 218,000 private sector job gain in April 2010. But in May, we are back to disappointment: only 41,000 private sector jobs.

What's going on? Where are the jobs? Will the recovery be strong enough to put Americans back to work and drive down that unemployment rate which is now at 9.7, compared with 4.5 before all of our troubles began? Or will we have normal growth of 3%, strong enough to maintain the unemployment rate about where it is, but not strong enough to drive it down substantially. To answer the question, we first need to study carefully the past. The following section discusses our attempt to do just that with the resulting data shown in Table 1 and highlights of some of the key details following.

A Frugal Consumer, not an Expansive Consumer

Although we call it a business cycle, it usually has been a consumer cycle with sharp declines in consumer spending on homes and cars driving us into our recessions, followed by delayed and reluctant declines in business spending first on equipment and software and last the long-lived business assets: offices and factories. If the next year is going to bring exceptional growth, consumers will need to express their optimism in the way that really counts – buying homes and cars. And that is not going to happen if businesses continue to express their pessimism in the way that really counts – by not hiring workers.

What now makes the future hard to see is that we are experiencing a structural adjustment¹ layered on top of a long-delayed consumer downturn. If it were just a consumer downturn, the growth prospects would be exceptional. The structural adjustment will hold us back in ways hard to predict.

One might think that since consumer durables spending and residential investment, two very volatile components of GDP have fallen from their normal shares of GDP to all-time² lows that a return to normal would mean we are poised for some exceptional growth. Not likely. Consumption overall, which is often said to be 2/3 of GDP, was 2/3 in the early 1990s but has elevated relentlessly to its all-time high of 71% of GDP in the third quarter of 2009, more than offsetting the recent decline in consumer durables. As we move that consumption share down to a level appropriate to an aging America, the consumer will not be the driver of a recovery like she has been.

Expect the recovery to march relentlessly forward, at a good pace, but not a really great one.

Summary Table

Table 1 summarizes the prospects for growth ahead and the experience so far in the recovery since the third quarter of 2009. This table decomposes total GDP growth into contributions from each of the GDP components.

¹ The structural adjustment is a correction of highly-leveraged consumer balance sheets, with the phantom assets created in the dot-com and the housing booms eviscerated and with more savings needed to repair the damage.

² Since 1947 when the quarterly data begin.

Table 1. Gap Between Current and Trend, Difference Between Recovery So Far and Normal Recoveries

	Normal (1)	Gap (2)	Gap Order	Recovery (3)	Comment
GDP	3.08	-9.42		-2.25	
Imports	-0.94	5.26	13	-1.07	
Residential Investment	0.14	-3.01	2	-0.92	Likely to remain troubled
Consumer Services	1.27	-2.46	4	-0.67	
State and Local	0.31	-1.73	5	-0.52	Likely to remain troubled
Business Structures	0.09	-0.60	8	-0.46	Likely to remain troubled
Consumer Durables	0.61	-2.69	3	-0.26	
Consumer Nondurables	0.47	-1.36	7	-0.18	
Federal Nondefense	0.05	0.10	10	-0.12	
Net Exports	-0.29	3.57	12	0.15	
Federal Defense	0.11	0.33	11	0.17	
Equipment and Software	0.61	-3.49	1	0.17	
Inventories	0.03	-0.45	9	0.39	Likely to get weaker
Exports	0.65	-1.69	6	1.22	

(1) Normal Contribution to GDP Growth, SAAR (2) Gap is the 2010Q1 cumulate minus the normal cumulative
(3) Recovery is the 2010q1 three-quarter cumulative contribution minus the recovery normal

The first column of Table 1 reports the normal contribution to GDP growth over the period from 1947Q2 to 2007Q4. The biggest contributor to normal growth is consumer services which has a normal contribution of 1.27. Residential investment makes a tiny normal contribution of only 0.14.

The second column of Table 1 records the gap between the cumulative actual contribution and the cumulative normal, thus indicating how much above or below the normal trend is each of the components. The third column records the order of these gaps. GDP is now 9.42 percent below normal trend. We need 9.42 excess growth to get us back to the GDP trend in addition to the 3% per year normal. If we were to get it all back in 5 years, that would require GDP growth of almost 5%, 2% above the normal 3% for five years.

The data indicate that GDP overall has been growing in this recovery 2.25 percent points less than a normal recovery of 5%. The biggest contributor to that negative is imports, which properly interpreted is a symptom of strength of consumer spending. The real weakness is in residential investment, and consumer services, and state and local government and business structures. The strength is in inventories, and equipment and software. The inventory gap which was large has shrunk considerably, which means there is little more that this component can do. Setting that back to normal we lose 0.39 of exceptional growth. That is enough to offset some of the likely improvement in consumer services, but the rest is likely to remain pretty much the same, with continued weakness in residential investment, state and local government, and business structures. That adds up to GDP growth that is about 2% slower than a normal recovery, thus 3%, not 5%.

Bottom line here: We see the year ahead producing continuing economic growth approximately 3% which is the long-run growth rate but substantially smaller than the historical recoveries averaging 5%. Our forecast is similar to the sluggish recoveries from the 1990 and 2001 recessions. With this weak economic growth comes a weak labor market and unemployment slowly declines to 8.6% by 2012. Tepid growth leaves plenty of excess capacity, subdued pricing power and very little inflation. This will allow the Federal Reserve to postpone interest rate increases that the forecast expects to come late this year or early next, as the sustainability of a modest recovery becomes clear and as the need for preemptive action against future inflation begins to dominate monetary policy decisions.