United States Economy

Beacon Economics is optimistic about the U.S. economy in the short term, but acknowledges there are substantial problems the nation will eventually have to address. The economy is still far behind where it should be at this stage in the business cycle, explaining much of the weakness in the labor markets.

- In recent years the U.S. economy has grown by slightly less than 3% (in real terms) per year. Apply this basic growth trend starting in 2008, and it is clear the nation is "behind" by nearly 9% of GDP–roughly $1.3 trillion of output in current values.
- The output gap is not driven by consumer spending (the American consumer continues to overspend, which has maintained the still worrisomely large U.S. trade deficit), but by the ongoing trade deficit, and less construction and business investment in equipment and software. Construction is being hampered by excess inventories of residential and commercial property. The precise reason behind lower business spending is less clear, but economic and financial uncertainty and a lack of substantial domestic demand might explain the gap.
- The Federal deficit eventually needs to be closed, whether driven by tax increases or spending cuts

Overview: Things Are Looking Up—But Challenges Remain

On September 30th the Economic Cycle Research Institute (ECRI) announced that the U.S. economy had "officially" entered a new recession.[5] This call had two interesting features to it. First, the ECRI does not date recessions. Rather the National Bureau of Economic Research took that task upon itself decades ago. So for the ECRI to call it "official" seems presumptuous. Secondly, they are wrong, as the data simply does not support such a call.

Despite ECRI's declaration, other negative reports, the grim prognoses of the TV pundits, and the stock market volatility, the U.S. economy is not, we repeat, not, falling back into another recession. Yes–the U.S. economy slowed sharply in the first half of the year, but slowing growth is not the same thing as a recessionary contraction. For the economy to shrink there needs to be a significant and sustained negative shock to the system. While there have been a number of mild ones–some of which have contributed significantly to the slowing of the economy in

[5] "U.S. Cyclical Outlook: September 21, 2011," Economic Cycle Research Institute. Note: this report was posted on the ECRI website. www.businesscycle.com, on September 30, 2011.

the first half of the year–these have all been reversed, and as such we expect growth to pick up in the second half of the year and into 2012. Indeed, we currently estimate that third quarter growth could come in at 2.5% to 3.5%–more than tripling the growth seen in the first half of the year.

There is plenty of data to support this view. Consumer spending was back in positive territory in July and August. Auto sales and overall levels of retail spending were very solid in September. Industrial production and durable goods orders have also showed signs of growth over the past few weeks. And private sector employment continues to expand as the nation adds jobs, albeit at a very weak pace (the U.S. added nearly 150,000 jobs in September, and the previous two months also saw upward revisions). Incomes are growing, despite all the turmoil in recent months, and the number of job openings continues its slow climb.

Exports are growing as well, fueled by strong fundamentals in Asia, Canada, and Mexico. In October, we saw an acceleration in bank lending for commercial and industrial loans, which bodes well for business investments in equipment and inventory. State and local government revenues have seen modest growth, and later in the year, the improvements in revenues will finally start to offset some of the drain that this sector of the economy is having on overall growth. Housing prices have stabilized, and population growth will surely help to chip away at the problem of excess supply. Indeed recent numbers have shown a decline in vacant units for the first time since 2006. We expect home construction to pick up a modest amount of speed by the end of 2012. And while the number of homes in foreclosure remains at near record-high levels, the number of seriously delinquent mortgages has been falling for over a year. Similarly, vacancy rates for most commercial property types have peaked and are starting to fall–implying that nonresidential construction will continue to be a mildly positive force for growth.

This is not to say that the markets will quickly regain lost ground. Much of the decline in equity values reflects the simple fact that the recovery of the financial market was far too aggressive given the slow pace of economic recovery. P/E ratios had climbed back to high levels from a historical context, risk spreads had shrunk to pre-recession levels, and the frenzy started to spill into the real estate markets as cap rate spreads on trophy properties started to fall even though rents had not yet stabilized and vacancies remain at high levels. A correction was clearly needed in order to realign equity prices with where the U.S. economy is at this moment in time.

Indeed the correction has had some beneficial side effects–namely, causing the price of oil to fall by over $30 per barrel and causing interest rates to drop yet again to record low levels, both of which are stimulative for the economy.

While we are optimistic in the short term, we also acknowledge that there are substantial problems the nation will eventually have to address. As noted in the "Key Findings" section above, the U.S. economy is still far behind where it should be at this stage in the business cycle, explaining much of the weakness in the labor markets. Yet even as the economy starts to close the gap, there are issues that give us pause regarding how fast the recovery can occur.

Some of these issues are still left over from the massive imbalances that pushed the U.S. economy into the recession in the first place. But most stem directly from the massive government intervention in the economy that pulled us out of the downturn. In some cases, these policies prevented the U.S. economy from getting back on a normal footing–that is, they were good for supporting the economy in the short run, but they ultimately left some of the painful but necessary readjustments to be dealt with in the future. In other cases, the problems are the direct results of these programs–namely, the Federal budget deficit and loose money policies by the Federal Reserve.

- While housing has turned the corner, the recovery will be slow. It isn't a lack of credit or the number of foreclosures that is the problem, but a lack of equity left over from the over-borrowing of the last decade. Americans use equity in their current homes to put down payments on bigger houses and pay the moving costs. This lack of equity will hamper the move-up market for years, in turn reducing the demand for new homes, particularly at the higher end.
- The American consumer continues to overspend, spurred on by low interest rates that discourage savings and by tax cuts from the federal government. This in turn has maintained the still worrisomely large U.S. trade deficit. While closing the deficit and shrinking consumer spending will ultimately help the U.S. economy resume a strong path of growth, the transition will be painful for some industries, particularly retail and logistics.
- The federal government will need to fix its deficit problems as well. And while the parties battle over whether tax increases or spending cuts will constitute the majority of the fix, either way it's going to cause transitory pain for the U.S. economy. Moreover, future generations will need to grapple with the trillions of dollars in debt racked up over the last decade.

- Some voices in the financial world have called for another round of monetary easing on the part of the Federal Reserve. But over the last few months, the basic measures of the money supply have shown an accelerating pace of growth. This is a good sign for the economy in the short run, as it means that monetary velocity is picking up, which is in turn an indication that the recovery is beginning. But at the same time, it means that inflationary pressures may start to become a problem within two years. The Fed has plenty of time to remove the excess liquidity, but it has to be cognizant of the impact that this action might have on the markets, regardless of whether such a move would have any real impact on the economy. Bernanke is surely starting to lay exit plans and will not pursue any further easing. In the meantime watch out if the bond markets begin to fear the potential of inflation more than the potential of a second downturn, as bond rates could quickly reverse themselves.
- The labor markets are weak in part because of the weak recovery, but also because there is a large skill mismatch between those out of work and the needs of the current economy. With sectors that employ low-skilled workers likely to be those experiencing a sluggish recovery, expect the unemployment rate to fall painfully slowly regardless of the growth rate for overall GDP. But also remember that this is a social crisis–not an economic one. It needs to be dealt with through social policies, not tax cuts and monetary easing. Sadly the best social tools seem to be the first to be axed during tough fiscal times.
- While we do not think that there will be a major default in Europe, the problems in Portugal and Greece may cause some minor ones. This will not spill over to the U.S. banking system–Europeans learned the lesson of Lehman Brothers as much as U.S. regulators did, and will surely use a TARP-type program to recapitalize European banks. But such a development would cause the U.S. dollar to appreciate and would hurt the recovery just as the current appreciation of the Japanese yen and Swiss franc have had a detrimental impact on those economies.

We think that the U.S. economy will ultimately overcome these challenges and will make up some of the lost ground of the last few years. But clearly the road is going to be bumpy.

Double Dip? We Don't Think So...

The Great Recession came to an end over two years ago, but the economy remains the central focus of many current policy discussions. It isn't that the U.S. economy isn't growing–we have had eight straight quarters of increases in economic output. Yet it is clear that the United

States has yet to fully recover from this downturn that was fueled by credit and spending. Consider the last two serious downturns in the mid-1970s and early 1980s, when the economy contracted by 3.2% and 3.6% from peak to trough, respectively. After these downturns ended, the economy grew at a much greater than average speed in the following two years, giving the economy a chance to catch up with its long-run growth path.

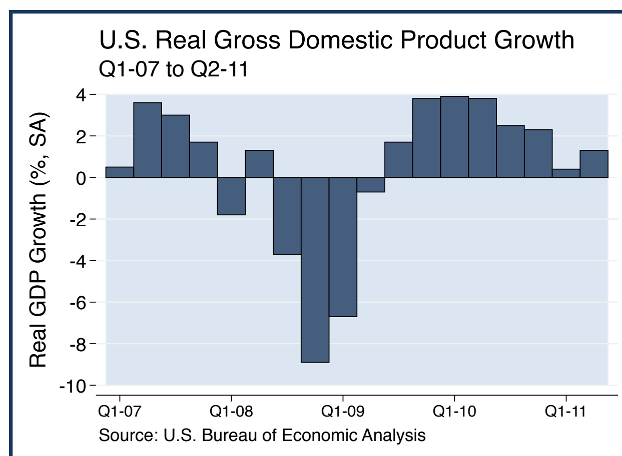
U.S. Real GDP Growth
During and After Recessions

Recession	Peak to Trough Decline Percent (%)	Average SAAR Growth 2-Years After Percent (%)
1973-74	−3.2	4.7
1981-82	−3.6	6.6
2008-09	−5.1	2.4

Source: U.S. Bureau of Economic Analysis

Contrast this to today. With the recent revisions to the GDP figures, the 2008–09 recession is now estimated to have cost the U.S. economy over 5% of output. Even worse, growth in the following two years has been slower than average, not faster. The gap between the current path of growth and the long-run path is growing wider rather than shrinking, and the U.S. economy is still producing less in the way of goods and services than it did prior to the recession. It's little wonder that the unemployment rate remains stubbornly high.

On top of this looming challenge, 2011 has started out with a fizzle. The growth of over 3% seen in 2010 slowed to a crawl in the first half of the year, averaging just 0.7%. This, combined with the problems in Europe, caused a sudden reversal in the bull market that started in late 2009. The markets are down nearly 15% from the peak seen in May, risk spreads have yet again widened, and 10-year bond rates have fallen to below inflation levels as investors seek safety.



With the decline in confidence, that old specter the “Double Dip” is yet again being splashed across the headlines. And along with the headlines have come the oddsmakers–the folks in my profession who like to attach probabilities to economic events. Claims that the chance of another recession will occur have ranged from 30% to near certainty depending on which analyst you listen to. These claims are mainly based on the slowing of growth. In response the president has rolled out his latest stimulus plan–a nearly half trillion program of tax cuts, direct aid, infrastructure investments, and tax incentives for hiring and investment.

But a slowing economy is not a contracting economy. Before we get spooked by these bearish claims, yank all of our money out of the markets, and start stashing it in gold bars buried in the backyard, I would suggest there are a couple of more “D’s” we need to look at–namely, Drivers and Data. Both would point not to an economy about to tip into another recession, but rather one that has simply hit a soft spot. This isn’t to say that the United States doesn’t have serious challenges–it clearly does. But worrying about a double dip would, in our opinion, divert attention from focusing on more pressing issues. But before we examine these, let’s take a closer look at why we don’t see a downturn in the economy in the near future.

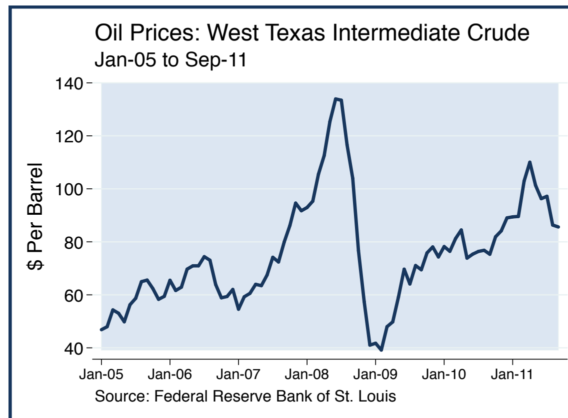
Economies don’t randomly fall into recessions. Rather they are pushed there by a negative shock. A shock has to have three characteristics: it must be large, rapid, and sustained. All recessions can be traced back to such a shock–oil prices in the mid-1970s, the fight against inflation in the early 1980s, the real estate bust and S&L mess in the early 1990s, and the pullback in tech spending in 2001 after years of bubble-driven over-investment.

The cause of the last downturn was twofold, with both problems stemming from the unsustainable increase in asset prices in the U.S. that occurred from 2003 to 2007. First, consumer spending on goods and housing returned to normal levels after asset prices sagged to historical norms, removing the wealth effects that had driven up spending in the first place. The second shock came out of the financial system itself, which had leveraged up during the boom years to a record level. When asset prices collapsed back to earth, the collapse set off a credit crisis that the nation is still working its way through.

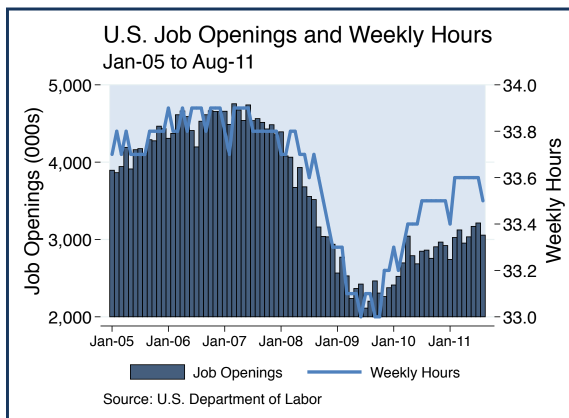
So for all of the bears out there calling for another downturn we ask–what is the driver? Because no driver, no downturn.

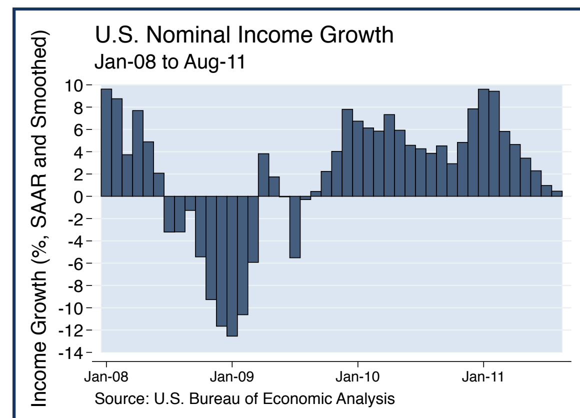
- Some might say oil prices. But the United States is more resilient to oil prices than ever before. Energy spending is a smaller share of consumption that it has ever been, and, if necessary, Americans can learn to park the pickup truck and start driving a Prius (admittedly it doesn’t have the same degree of machismo, but we all have to make sacrifices somewhere). Furthermore, with the market turbulence, prices are down $30 per barrel

from the peak reached earlier in the year. Now that Libya is falling under rebel control, prices could come down even further.



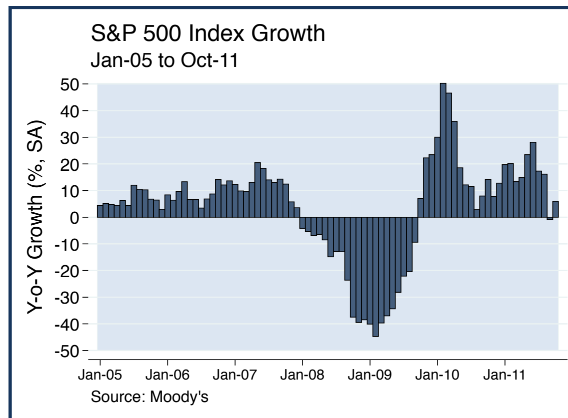
- How about the weak labor markets? Well, labor markets are a lagging indicator, not a leading indicator. They sag *after* the economy does, not the other way around. They don't cause recessions–they are caused by them. Even though growth in employment has slowed, this is simply reflecting the weakness in the first half of the year. Job openings are increasing slowly and weekly hours worked remain high–all indicative of a market that is stable, not weakening. Employment growth will pick up in the fourth quarter. In any case, as relevant as the labor numbers are, so too are the income numbers–and real incomes will start to grow again as prices for energy products fall.



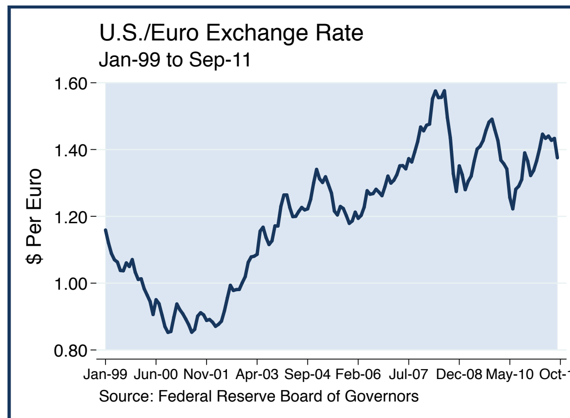


- And the stock markets? It is true that financial turbulence doesn't help the economy, but there has never been a stock market crash that caused a recession by itself. Rather, stock market crashes occur along with the driver of a recession–such as the massive number of bank failures during the Great Depression, the large pullback in business spending at the

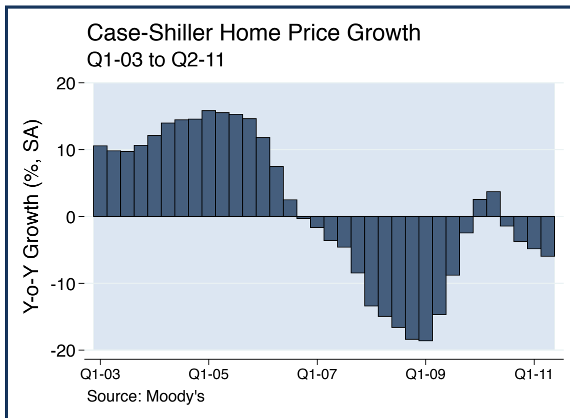
end of the tech bubble, or the drop in consumer spending and the credit crisis in 2008. There are other cases, such as in 1988 when the market dropped precipitously without a secondary driver–and no recession occurred. In any case, the declines to date have been simply a retraction of the bull market from the start of the year. Keep in mind that even with the recent declines, year over year the market is still up by double digits.

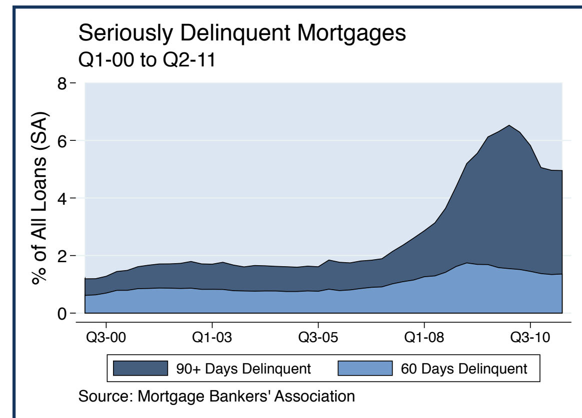


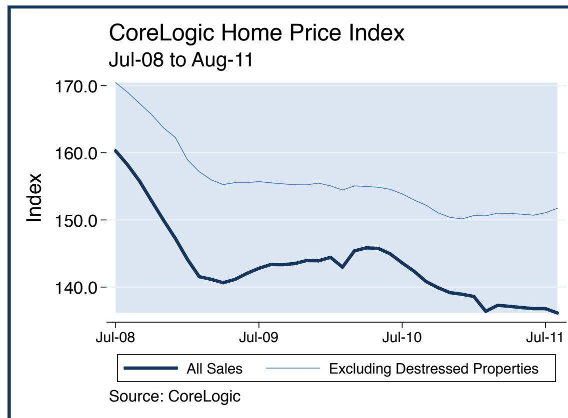
- Then there is Europe. With numerous European countries struggling with excessive public debt and slow-growth economies, there are financial jitters aplenty. But the shock–a default–has yet to occur. It would seem logical to wait for that to happen before we call for a European credit-crisis-led-double-dip recession on this side of the pond. And in any case, it seems highly improbable that Europe would allow any major bank in the euro zone to fail. European leaders are typically more liable to intervene in their economies at any time, and particularly while the lesson of Lehman Brothers is still fresh on the minds of regulators. In any case, it seems a small probability that any of the major European economies will be in trouble in the next year or so. Only lowly Greece is truly on the brink. Don’t believe me? Take a look at the euro-dollar exchange rate. If the markets were truly betting on a major default, the euro would have dropped sharply.



- Housing? The double dip here was more hype than reality. Home prices fell a whopping 4% from the mini-peak in 2010 according to the S&P/Case-Shiller index. And those declines have stabilized since the spring. Now all of the major price indexes, including Case-Shiller, CoreLogic, and the data from Fannie Mae and Freddie Mac all show home prices starting to rise slowly. And while sales of homes are softening a bit, the number of seriously delinquent mortgages is falling. The worst is clearly behind us.

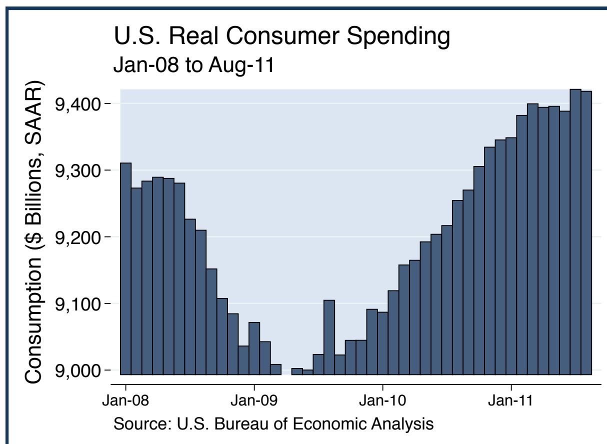


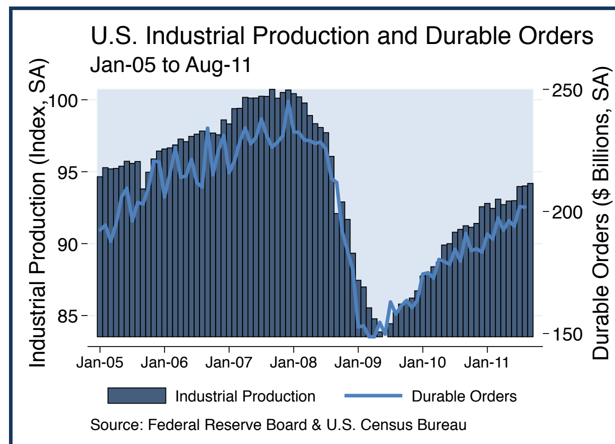




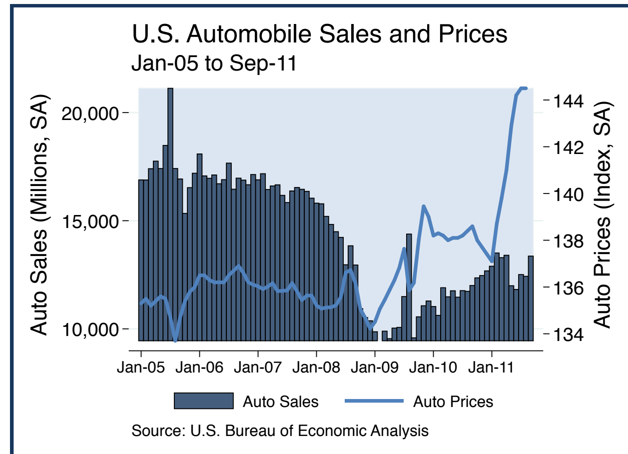
The most likely source of a new recession would have come from the federal government if it had failed to raise the debt ceiling. Although the nation would not have defaulted on its debt, it would have been forced into a severe austerity spending plan. This rapid cut in spending would surely have caused a downturn by the end of the year. But the ceiling was raised and the crisis averted. Nothing to see here folks, move along.

Then there is the data. The biggest source of weakness in the first half of 2011 was consumer spending–particularly in the second quarter. But this is largely due to the brief spurt in inflation that was driven by food and energy costs, combined with a lack of cars on dealer lots. In the former case, the pressure is now off for the aforementioned reasons. As for the latter, we know it was a supply issue because the price of cars has risen sharply in recent months–the exact opposite of the reaction we would expect if the decline in auto sales had been driven by demand. The supply chain is starting to move again, pushing sales and U.S. industrial production up in July. Oh, and retail sales grew as well. You may not have seen these numbers under the litany of negative press, but they are out there.

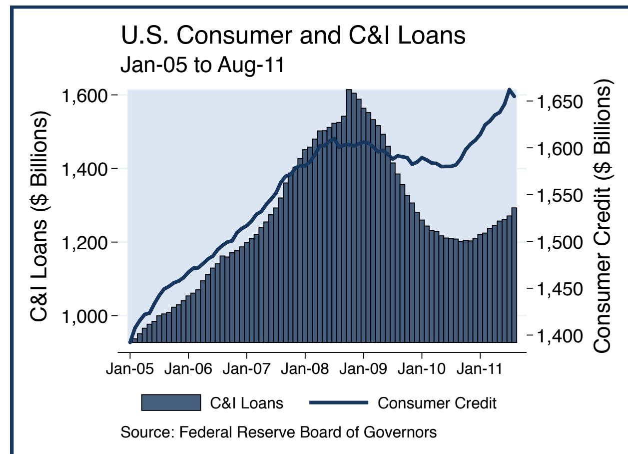




Moreover, the data regarding the leading indicators of consumer demand–namely, delinquency rates on consumer loans and growth in consumer credit–point to better times ahead, not worse. The labor market also picked up a bit of speed in July, and income growth remains decent. Another leading indicator of a downturn is falling home starts. They aren't falling–they have just been sitting on the bottom for a number of years. And nonresidential construction is picking up some speed. There is also good news on interest rates. Rates have come down so much in recent years that the financial obligations ratio–an estimate of the share of income households use to support their debt servicing and rent–is down to levels not seen since 1993. Americans are not credit constrained.



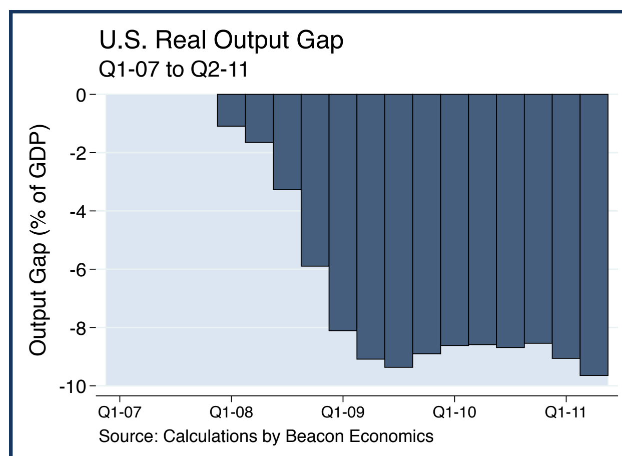
As for business spending–it never really came back much after the long downturn. Indeed, net business investment remains low from a long-run perspective. It seems unlikely that it could drop far enough to cause a big hit to the economy. And, after all, corporate America is sitting on tons of cash. It would seem that they would be able to weather most storms at the moment. Here is yet more good news: according to bank data from the Federal Reserve, the outstanding quantity of commercial and industrial loans grew sharply in the first half of August. Firms are borrowing for some reason.



Add these up, and we have our own probability: the chance of a double-dip recession is pretty close to 0% for the second half of 2011, short of a major development not highlighted above. Now that is a number worth throwing out there.

The Output Gap

In recent years the U.S. economy has grown by slightly less than 3% (in real terms) per year. If we apply this basic growth trend to the U.S. economy starting in 2008, and compare that to what has actually happened, we can see that the U.S. is "behind" by nearly 9% of GDP–roughly $1.3 trillion of output in current values. This lack of production is the largest reason for the ongoing weakness in the labor markets. If the U.S. can catch up, many of these folks will go back to work.



In thinking about this issue, it is helpful to do a small thought experiment. Imagine that the United States was at something closer to full output–say at a level of production 8% more than the current levels. Then imagine that not only is the economy at full output, but equivalently the shares of spending in the economy are closer to historical norms. (In this example, we use the 1996 economy as our base.) If we then compare what is being spent by the various sources of demand in the economy to what is actually being spent, we can see where the "demand gap" is.

U.S. Real Output Gap

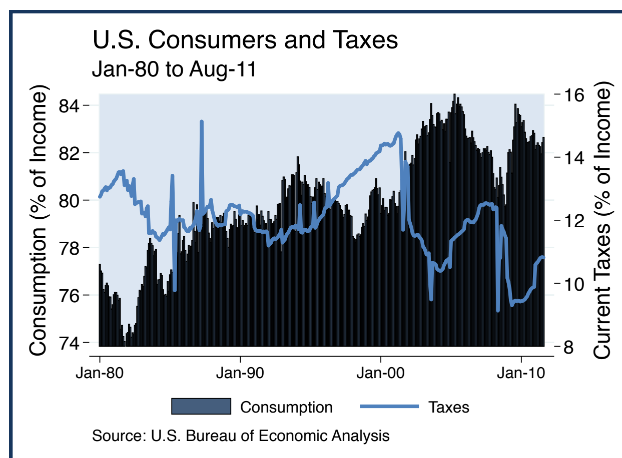
GDP Component	Gap $ Billions	Share Percent (%)
Gross Domestic Product	-1,195	
Personal Consumption	-231	19.3
Durables	-242	20.3
Nondurables	-95	
Services	107	
Gross Private Investment	-677	
Nonresidential Structures	-72	6.0
Equipment/Software	-246	20.6
Residential	-354	29.7
Change in Inventories	-5	
Net Exports	-390	32.6
Exports	268	
Imports	658	
Government Consumption	103	
Federal	144	
State/Local	-41	

Source: Calculations by Beacon Economics

The following table highlights the results of this exercise, and the findings are quite enlightening. Housing and nonresidential construction account for one-third of the output gap. This is due to the tyranny of the inventory–the rapid pace of building occurred right up until the recession, leaving a large supply of excess homes and commercial space in the U.S. economy. The good news, as noted, is that the supply is slowly being consumed, and these parts of the economy will begin to grow back to normal levels in 2012.

Encouraging consumer spending has continued to be one of the central focuses of stimulative policies by the federal government–with the common assumption being that since the U.S. consumer is such a large portion of the economy, it's logical to start there. But while consumer spending is responsible for a portion of the gap, it's less than one-fifth of the problem. And the weakness here is almost exclusively in durable goods, which is in part a function of the current supply-driven slump in auto sales and in part a function of the slow pace of homebuilding and resales. These weaknesses further limit the demand for other durables, such as furniture and appliances.

Indeed, when we look at consumer spending as a share of income, the percentage is still near an all-time high level. Consumer spending is not the problem–quite the opposite, consumers are still overspending relative to the current economy, largely as a result of the tax cuts they have received as part of the various stimulus efforts.



At the same time that consumer spending is still too high, the U.S. economy is running a trade deficit that is still too large. The ongoing trade gap is responsible for one-third of the output gap. If the United States could close this gap by shrinking imports and exporting more, it would go a long way toward helping the U.S. catch up. Why has this trade gap stayed so stubbornly wide? In part, the ongoing financial turmoil in Europe has kept the dollar stronger than it should be at this point in time. It's also due to the intransigence of some nations in the developing world that look to trade surpluses as an important part of their economic development, using a variety of trade barriers and active interventions in the currency markets to achieve such goals.

But the primary reason for the problem is that the U.S. consumer continues to overspend. The degree of spending (as a share of income) and the trade deficit show a strong correlation. The marginal U.S. dollar goes to goods produced overseas. A large portion of the money spent to boost consumer spending in this economy goes not to U.S. production, but to overseas production. These efforts continue to keep consumer spending too high, putting off a portion of the necessary healing of the U.S. economy off into the future. As far as policy tools go, this has

a low return. Sadly, tax cuts and consumer spending continue to dominate policy debates in Washington, D.C.

Our feeling is that if such cuts were removed, and if the funding were instead used for infrastructure investments, it would have a much greater bang for the buck, since infrastructure spending will have less spillage into the world economy. Policymakers are calling for infrastructure spending, but the numbers are too small, and the complicated permitting and review process means that the money takes far too long to have a quick impact on the economy. More money and new policies to speed up the implementation process are needed.

The last part of the gap is business investment in equipment and software, accounting for the same gap as consumers, although overall it is a much smaller portion of aggregate demand. The proportionate shortage is thus much higher. The issues here are less clear. The weak economy is surely one reason–with an economy so far below full employment there is little need for new investment. The good news is that the basic force of capital depreciation will eventually imply investment will need to pick up. Additionally, the decline in the dollar will help close the trade gap, which will in turn stimulate demand for business investments to deal with exports. A boost in government infrastructure spending would also help. Some have postulated that the sheer uncertainty in both the recovery and the regulatory environment has made businesses shy about making any long-term investments. This may be the case, but measuring such confidence issues is at best tricky.

It is worth noting that the president is proposing to extend the program by which businesses can use an accelerated depreciation for new investments. The true stimulative value of such programs is weak, since taxes avoided today will need to be paid tomorrow. A program with more direct values–tax credits for investments for example–would seem to have more of an impact.