

## THE OPERA AIN'T OVER 'TIL BRÜNNHILDA SINGS

**A** May 26 Quinnipiac poll found that 74 percent of all Americans thought that the economy was still in the grips of the “Great Recession.”<sup>1</sup> Yet data through May suggest that total output of goods and services—Gross Domestic Product (GDP)—exceeds its pre-recession peak and the economy has recovered.

What explains the discrepancy?

While GDP is estimated quarterly, there are reliable monthly data on its components. An index of these data, the National Activity Index prepared by the Chicago Federal Reserve Bank<sup>2</sup>, has reached its highest level since February 2007, nine months before the recession began and suggests that economic activity is near its long term trend.

So, at the time of the Quinnipiac poll, the economy was not just retracing lost ground, it was making new highs. The U.S. economy was producing more goods and providing more services than when the contraction began at the end of 2007.

Why, then, did three-quarters of American households think the economy was still in recession? Primarily because what is obvious on the stat sheet is not yet apparent on Main Street.

GDP may have fully recovered its 3.7 percent peak-to-trough decline, but employment was 5.3 percent below its pre-recession high. On Main Street, where GDP is just another number, jobs count.

Employment has increased at an accelerating rate since the beginning of the year. Employers report adding 982,000 jobs

in the first five months of 2010. Those gains were widespread, with 38 states reporting increases in the most recent month.

But on Main Street America, the jobs picture appears less fulsome for three reasons.

First, some three-quarters of 2010's new jobs are temporary. Since the beginning of the year, the Census Bureau filled 550,000 temporary jobs, the bulk in May. Concurrently, temporary help firms added 175,000 jobs.

Second, under-employment remains at historically high levels. Among all workers, 6.3 percent hold part-time jobs for economic reasons, almost double the pre-recession under-employment rate of 3.2 percent. Third, largely as a consequence of the first two, average weekly earnings are lower than a year ago.

Temporary and part-time jobs are better than unemployment, but they do not instill the same confidence nor yield the same income as permanent, full-time positions. And that may well explain why 75 percent of the respondents told the Quinnipiac pollsters that the Great Recession had yet to end.

Yet even though households say the recession continues, their outlook has brightened. For example, consumer confidence is higher than at any time since the credit crisis began in mid-2007. It is a tenuous improvement, however. May's retail sales, which slipped 1.4 percent after seven consecutive monthly increases, demonstrated that households remain cautious. Despite the pull back, however, retail sales are up 8.6 percent since bottoming at the end of 2008.

Over that period, even as households increased spending, they reduced their short term debts—including their credit card balances. In other words, consumers are both spending more and spending differently.

Coincidentally, the savings rate—which jumped as households increased their precautionary savings during the Panic of '08—moved lower. While this suggests that households may feel somewhat more optimistic about the future, it is also to be noted that the savings rate has not fallen to pre-panic levels.

Looking forward, the household sector's more confident, but still cautious, outlook should sustain consumer spending into next year. If jobs and incomes grow more robustly, consumer spending will accelerate the rate of expansion. A cautious optimism prevails.

Similarly, the business sector—where the signs of the turnaround first appeared—is fueling growth as it invests in equipment, updates software, and restocks shelves. This is expected to continue in both the manufacturing and service sectors according to the Institute for Supply Management's surveys.

With the exception of the anemic construction sector—particularly nonresidential construction—private investment looks to expand through mid-2011.

Based on conditions in the household and business sectors (and assuming no seismic shocks), the economy's low-trajectory, self-sustaining expansion should carry well into 2011, perhaps beyond.

During that time employment, incomes and profits should increase steadily—although only gradually.

<sup>1</sup> <http://www.quinnipiac.edu/x271.xml>

<sup>2</sup> The Chicago Fed National Activity Index is a composite of 85 indicators of output, employment, income, consumption, and housing. It compares current conditions to historic trend and indicates whether the economy is expanding or contracting.

This outlook has a relatively short shelf-life. And Brünnhilda ain't singing.

The turbulence that began in 2007 has been contained, but its underlying causes have yet to be resolved. Indeed, the monetary and fiscal policies that successfully stabilized the financial system and restored economic growth—both globally and domestically—were hair-of-the-dog remedies (looser money, larger deficits) that unavoidably fed the mongrel to calm it.

Now, *Orthrhus* needs de-fanging or, at the very least, muzzling. Only when that is accomplished will Brünnhilda start singing.

Doing so (i.e., adopting financial and fiscal restraints) will inevitably impinge on economic growth. But not doing so risks a reprise of the Panic of '08 and, therefore, policymakers will eventually act. Although as happened during the Panic of '08, they may well stall until markets compel action, as occurred prior to the adoption of the Troubled Asset Relief Program (TARP).

The inevitable implications for Main Street are: credit will contract (i.e., less available, tighter standards, higher rates) and costs will rise (viz., higher taxes and fees).

The changes may not occur abruptly, but some are already moving forward (e.g., financial reform, state and local budget cuts). Others (e.g., the impending hikes in taxes on various types of investment income) will occur if action is not taken.

The precise magnitude, distribution, and timing of their economic impacts will depend on details that remain to be settled. While projecting how those details will be resolved is entirely speculative, one thing is certain: they will have a substantial, pervasive and disruptive effect on every element of the economy, including your business and household.

Rather than speculating about the details of impending policies, it would be more beneficial to plan for how you will adapt to their inevitable consequence: a credit-constrained, higher-taxed economy.

That's Brünnhilda's aria...and she's about to start singing. ■

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