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The Upturn: More tortoise than Hare

by Patrick O'Keefe, Director of Economic Research

In mid-September, Federal Reserve Chairman Ben Bernanke remarked that "from a technical perspective the recession is very likely over."

Since a recession ends when the economy stops shrinking, he was more stating a fact than forecasting the future.

Of five key indicators of the economy's general health, four had either stopped declining or were improving. During the quarter that ended with September, there were gains in gross domestic product (GDP), the broadest gauge of economic activity, and industrial production, as a year-long inventory depletion ended. Meanwhile, after-tax incomes were flat and merchant sales were little changed. Of the five key indicators, only employment continued to decline.

The end of a downturn, while welcome, provides little insight into the timing, pace, or durability of the eventual rebound. This is particularly the case in the aftermath of a global downturn that ends with household balance sheets in disrepair and key sectors (e.g., financial and automotive) depending on fiscally challenged governments for life support.

Since the contraction began at the end of 2007, more than eight million jobs have been eliminated, the number of unemployed has more than doubled, and the nation's net worth has shriveled (down almost 17%).

This Time is Different (Really)

The most pronounced and protracted downturn since the Great Depression was not just a cyclic recession, but a ***retrocession***—a downward shift in long-term growth potential.

That is not to say that the economy will not recover. It will. But the pace will be slower and the growth lower than in rebounds over the past several decades. The economy will be more tortoise than hare.

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In the near term, through the first half of 2010, several factors will give the economy some additional lift. Monetary policy will remain accommodating (i.e., low rates, ample liquidity). And Federal stimulus efforts—which are gaining traction after a slow start—will increase total public sector spending, although the net impact will be diminished by reductions in state and local appropriations.

Increased public outlays will be augmented by increased spending by manufacturers and merchants who need to replenish depleted inventories. Concurrently, the economies of several of the nation's trading partners are recovering—some quite robustly—adding to the demand for exports.

Consumer spending, flat through much of 2009, will increase somewhat in the first half of 2010 as compensation rises due to employment gains (including hours worked by part-time employees) and wages.

Beyond Mid-2010?

In past cycles, the virtuous circle of fiscal and monetary stimulus, increased investment, and rising employment and incomes would lead to a self-sustaining recovery, with the rate of growth accelerating as idle resources returned to productive use.

While there is a general consensus regarding the outlook through the middle of 2010, there is considerable difference of opinion as to the path that will unfold in the second half of next year and beyond.

The predominant view is that the economy will continue to grow into 2011, but at a relatively slow pace. Others see the pace of growth accelerating sharply next year and gaining strength through 2011. A third perspective is that the economy will stall (i.e., flat line) or stumble (i.e., double-dip recession) as 2010 progresses.

Of the three, the second view seems least probable. It projects a robust recovery without addressing the implications of (1) deleveraging by financial entities, households, and nonfinancial businesses; (2) dissipation of fiscal stimulus; and (3) the unwinding of accommodative monetary policies.

In addition to the historic resilience of the U.S. economy, proponents of a robust rebound anticipate an acceleration in growth due to a rising tide of consumer spending, business investment, and exports. The equity markets, given their performance

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over the past six months, also anticipate a vibrant rebound even though there is little data to support that outlook.

Those who forecast a slow-growth recovery, on the other hand, agree that the combination of countercyclic policies and rising private investment is sufficient to spur an expansion that will be sustained by rising employment and incomes.

But in their view the recovery will be tepid because the potential rate at which the economy can expand is limited by the legacies of the past decade's borrowing binge, including elevated debt levels, an over-leveraged financial system (still choking on "impaired assets") and a fluctuant real estate sector. Further, they anticipate that over the course of 2010 the economy will experience the drag of dissipating fiscal stimulus, diminishing financial sector backstops, and a gradual tightening in monetary policy.

Deficits, Devaluation, and Rates

The perspective of the proponents of a stall/stumble outlook does not differ analytically from the slow-growth view. For the most part, they accept the underlying diagnosis but differ on matters of degree (e.g., changes in the household savings/spending mix and the residual impacts of countercyclic policies).

There is one significant difference, however. The stall/stumble perspective anticipates an earlier rise in interest rates due to the U.S. fiscal outlook and the recent bout of dollar devaluation. The latter also has implications for commodities prices, most notably oil, which could alter the inflationary equation and further pressure rates.

To date, policymakers have offered lip service as an alternative to a credible strategy for collaring the nation's structural deficits and bolstering declining currency.

Despite much hand-wringing, there is scant evidence that either of these factors has yet to have an impact on interest rates. And while commodity prices have risen of late, that appears to reflect an improving global economy.

To date, policymakers have offered lip service as an alternative to a credible strategy for collaring the nation's structural deficits and bolstering declining currency. And, to date, the world's financial markets have financed the deficits and accumulated dollars.

Nevertheless, perpetual deficits and a declining dollar will inevitably trigger higher rates. The question is not whether, but when and by how much? Without a credible strategy, the options grow fewer and the potential costs higher.

Therein lies the key difference between the slow-growth and stall/stumble perspectives. The slow-growth outlook expects that the Fed can keep rates low throughout 2010; the stall/stumble view is that the Fed cannot. Neither is explicit as to whether it assumes a credible strategy or mesmerizing lip service, but only one will prove right.

In the interim, we have an economy which looks to grow, at least for a while—and, then, at the pace of a tortoise instead of a hare. ■

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