

Economic Research – Scott J. Brown, Ph.D.

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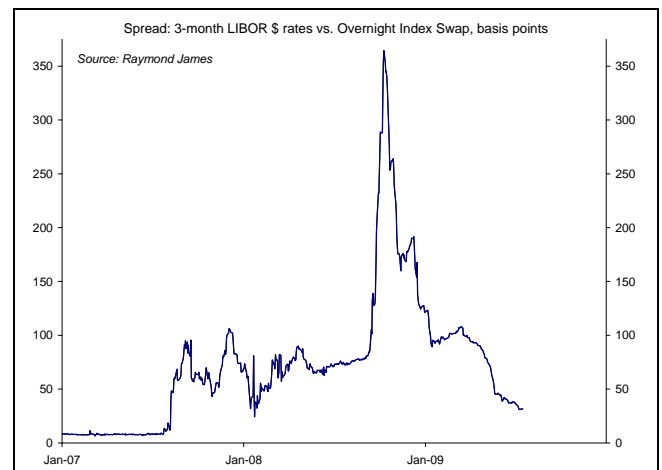
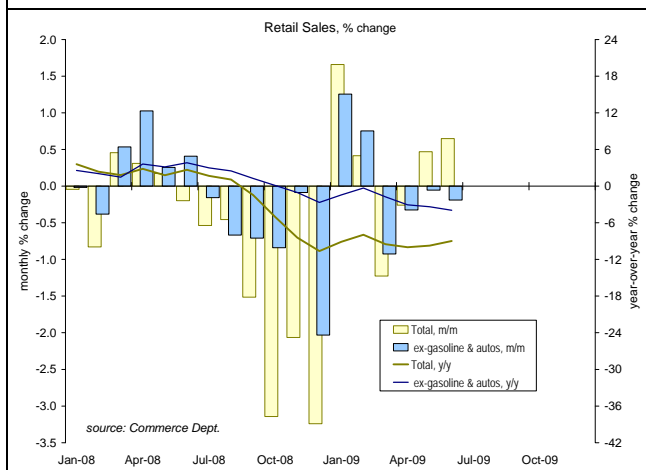
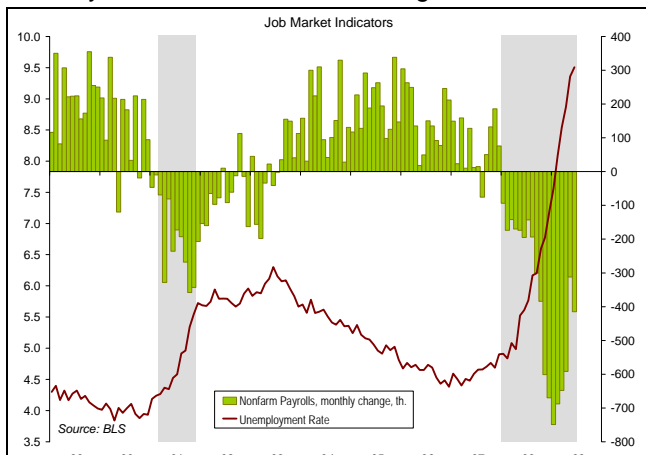
Bouncing Toward A Bottom

- Recent data have continued to suggest that the pace of economic decline has slowed and that the recession is nearing an end.
- However, the recovery is expected to be gradual, with continued weakness in the labor market.
- The Fed sees the risks to growth and inflation as more balanced, but is unlikely to begin removing monetary policy accommodation until next year.

The government will report its advance estimate of 2Q09 GDP growth on July 31. The early consensus is that GDP growth remained negative in the second quarter, but the pace of decline was a lot lower than in the previous two quarters. In addition to the usual uncertainty in the advance estimate (the government must make assumptions about June inventories, foreign trade, and other components), this release will include annual benchmark revisions. One shouldn't get too hung up on the numbers, and should focus instead on the story. Consumer spending was soft, but not horrible. Business fixed investment likely contracted further. The inventory correction in manufacturing is far from over.

Nonfarm payrolls fell at a slower pace in May (down 322,000), but posted a large decline in June (down 467,000). The unemployment rate rose to 9.5% and measures of underutilization (those working part time, but preferring full-time employment) signaled further deterioration. The job market will be a lagging indicator in the recovery, but we must see a moderation in the pace of job destruction to have much confidence that the overall economy will begin to improve.

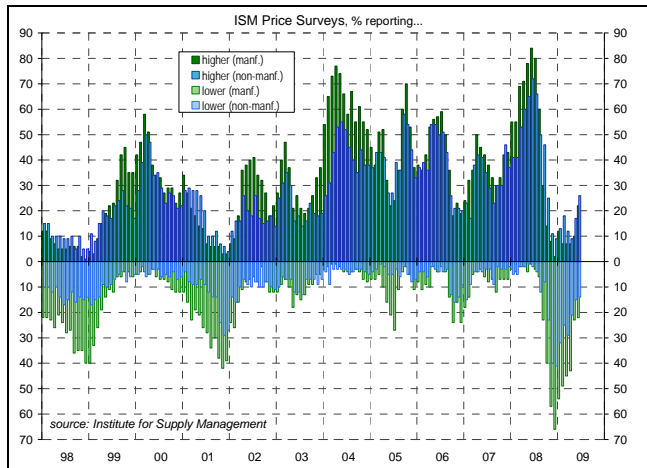
While private-sector wage income continued to weaken in recent months, disposable income advanced, boosted by extended unemployment insurance benefits, lower tax payments, and tax stimulus checks mailed to the elderly. The savings rate jumped in April and May, but the increase may reflect temporary factors (such as those stimulus checks). Consumer spending was mixed in May and June, with retail sales supported partly by higher gasoline prices. However, the rise in gasoline prices left consumers with less to spend on other things.



Financial conditions continued to improve in recent months. Major financial institutions have been able to raise private capital – a good sign. The Fed has seen reduced demand for a number of its special liquidity facilities. However, terms and standards for bank lending remain tight and the demand for loans has decreased. Residential mortgage delinquencies and foreclosures will remain elevated for the foreseeable future. Commercial real estate tends to lag in the economic cycle, turning down in the late stages of a recession and well into the early part of the recovery. Commercial real estate loans are likely to be a significant problem for small and medium-sized banks.

Federal Reserve officials see reduced downside risks to growth, but those risks are still viewed as significant. In late June, Fed policymakers kept their commitment to keep short-term interest rates low for “an extended period” and did not alter asset purchase plans.

With reduced downside risks to the growth outlook, the Fed also sees a smaller chance of deflation. The Consumer Price Index fell 1.4% in the 12 months ending in June. Technically, that is deflation (a general fall in the price level), but it's not the type of deflation that we worry about (where weak demand leads to falling prices, which in turn lead to weaker growth, and so on – a downward spiral). Prices of non-fuel imports, which fell sharply in the second half of last year, have stabilized. The ISM surveys show more balanced input price pressures. The labor market has remained weak, putting downward pressure on wage inflation (average hourly earnings rose 2.7% y/y in June).



Many still fear that the Fed is sowing the seeds for higher inflation in the future. The monetary base has jumped, but the velocity (or turnover) of money has plunged. The high level of excess capacity in the labor and product market should keep inflation in check. The Fed has spent a large amount of time planning its exit strategy. The Fed now pays interest on reserves. This will be an important tool if and when inflation pressure start to heat up (by raising the rate it pays on reserves, the Fed would cool off bank lending, helping to slow the economy – but we're a long way from such action).

The public is still generally confused about efforts to revive the economy. The Fed is not part of the government (it is answerable to Congress, but not run by Congress). Through its policies, the Fed can create money out of thin air, but that is not necessarily inflationary. In contrast, to spend more, the federal government has to borrow (or raise taxes). Increased government borrowing is not necessarily inflationary. Japan has had huge budget deficits and battled deflation over the last two decades. Large budget deficits could crowd out private borrowing, but that's certainly not the case right now. Still, the increase in government borrowing has largely offset the decline in private borrowing, leaving national borrowing little changed.

It's important to divide the budget deficit into cyclical and structural components. The sharp rise in the deficit is largely cyclical. The recession has cut tax revenues and boosted outlays (unemployment insurance benefits, etc.). The financial sector rescue and the fiscal stimulus package are transitional. The cyclical deficit will shrink as the economy improves. However, there is still a large structural deficit to deal with. The retirement of the baby-boomers will boost spending on Social Security and Medicare. The Administration is counting on healthcare reform to help keep entitlement costs contained, but such reform will have to be paid for with higher taxes. However, in a recession and weak recovery, taxes are unlikely to be raised anytime soon.

There are some calls for a second fiscal stimulus. Relatively little of the \$790 billion American Recovery and Reinvestment Act has gone out – so it hasn't had time to have an impact. Half (\$400 billion) will show up in FY11. A significant near-term concern is the strains in state budgets. States are running contractionary policy, cutting spending and raising taxes. The ARRA included some aid to the states, but more is needed. Another issues is that the stimulus will drop in 2011. Accounting for multiplier effects, this will be about a 2.5%-of-GDP drag on the overall economy. Hence, some added spending may be needed to lessen that impact.

	3Q08	4Q08	1Q09	2Q09	3Q09	4Q09	1Q10	2Q10	3Q10	4Q10	2008	2009	2010
GDP (↓ contributions)	-0.5	-6.3	-5.5	-0.8	0.5	1.0	2.2	2.8	3.0	3.0	1.1	-2.5	1.8
consumer durables	-1.2	-1.7	0.6	-0.4	0.1	0.1	0.2	0.2	0.3	0.3	-0.3	-0.4	0.2
nondurables & services	-1.6	-1.3	0.3	0.1	0.6	0.8	1.4	1.6	1.7	1.7	0.5	-0.2	1.2
bus. fixed investment	-0.2	-2.6	-4.6	-2.6	-1.5	-0.8	-0.4	0.0	0.2	0.2	0.2	-2.4	-0.6
residential investment	-0.6	-0.8	-1.4	-0.6	-0.2	-0.1	0.0	0.1	0.2	0.3	-0.9	-0.7	0.0
government	1.1	0.3	-0.6	0.4	0.6	0.7	0.8	0.8	0.5	0.4	0.6	0.3	0.7
Domestic Final Sales	-2.3	-5.8	-5.4	-3.1	-0.3	0.8	2.0	2.7	2.9	3.0	0.0	-3.4	1.5
exports	0.4	-3.4	-4.2	-1.5	-1.0	-0.5	-0.1	0.1	0.2	0.3	0.8	-2.0	-0.3
imports	0.7	3.3	6.6	3.0	1.2	0.1	-0.3	-0.4	-0.5	-0.6	0.6	3.1	0.1
Final Sales	-1.3	-6.2	-3.3	-1.6	-0.1	0.4	1.7	2.4	2.6	2.7	1.4	-2.2	2.3
ch. in bus. inventories	0.8	-0.1	-2.2	0.8	0.6	0.6	0.5	0.4	0.4	0.3	-0.3	-0.3	0.5
Unemployment, %	6.0	6.9	8.1	9.2	9.8	10.1	10.2	10.2	10.2	10.1	5.8	9.3	10.2
NF Payrolls, monthly, th.	-208	-553	-691	-436	-210	-95	70	120	20	90	-257	-358	75
Cons. Price Index (3 mo)	3.1	-12.4	2.2	3.3	2.1	2.0	2.0	2.1	2.1	2.2	0.2	2.4	2.1
excl. food & energy	2.3	0.2	2.2	2.4	1.8	1.8	1.9	1.9	2.0	2.0	1.7	2.0	1.9
PCE Price Index (q/q)	5.0	-4.9	-0.9	1.7	2.9	1.7	1.9	1.9	1.9	2.0	3.3	0.5	2.0
excl. food & energy	2.4	0.9	1.6	2.4	1.6	1.7	1.7	1.8	1.8	1.9	2.2	1.8	1.8
Fed Funds Rate, %	1.96	0.53	0.19	0.18	0.20	0.23	0.25	0.45	0.92	1.50	1.94	0.20	0.78
3-month T-Bill, (bond-eq.)	1.5	0.3	0.2	0.2	0.2	0.2	0.3	0.6	1.1	1.6	1.4	0.2	1.2
2-year Treasury Note	2.4	1.2	0.9	1.0	1.0	1.3	1.8	2.3	2.8	2.9	2.0	1.1	2.5
10-year Treasury Note	3.9	3.2	2.7	3.3	3.6	3.8	4.0	4.2	4.3	4.4	3.7	3.4	4.2