US Economic Outlook:

3 Questions about the Recovery

Ryan Ratcliff
Asst. Professor of Economics

Dec. 14, 2010

SCHOOL OF BUSINESS ADMINISTRATION

University of San Diego

3 Questions about the Recovery

Q1: Was the stimulus a failure?

Q2: Why is the recovery so weak?

Q3: Inflation or Deflation?
Zimbabwe or Japan?

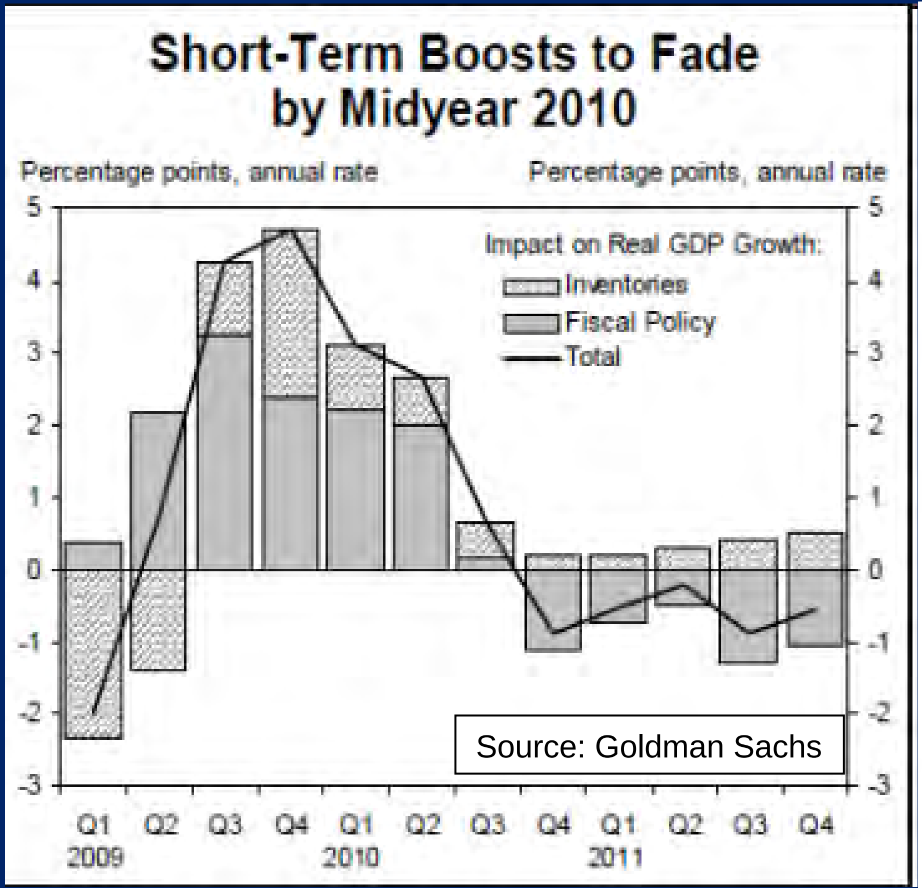
Q1: Did the Stimulus Fail?

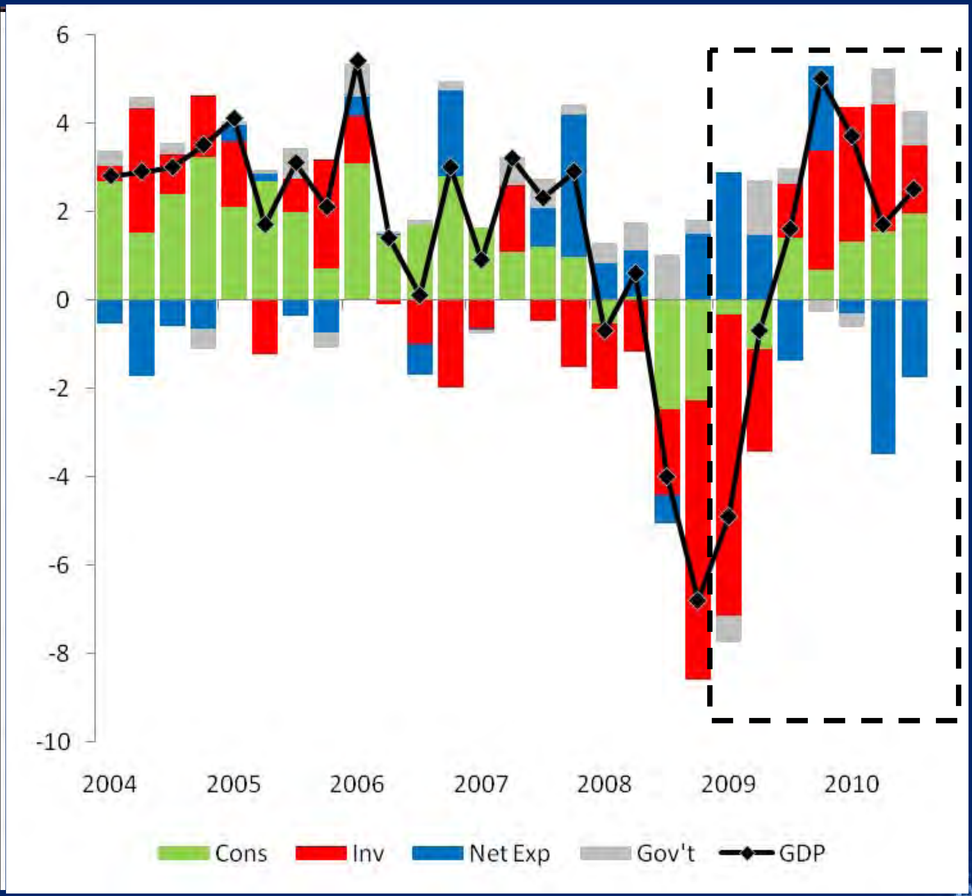
US Unemployment Rate

Identifying the Stimulus

Federal spending added 1% directly to GDP growth in 2009, with another estimated 1% of induced "multiplier" spending.

Contributions to Real GDP Growth: Estimated(Left), Actual (Right)





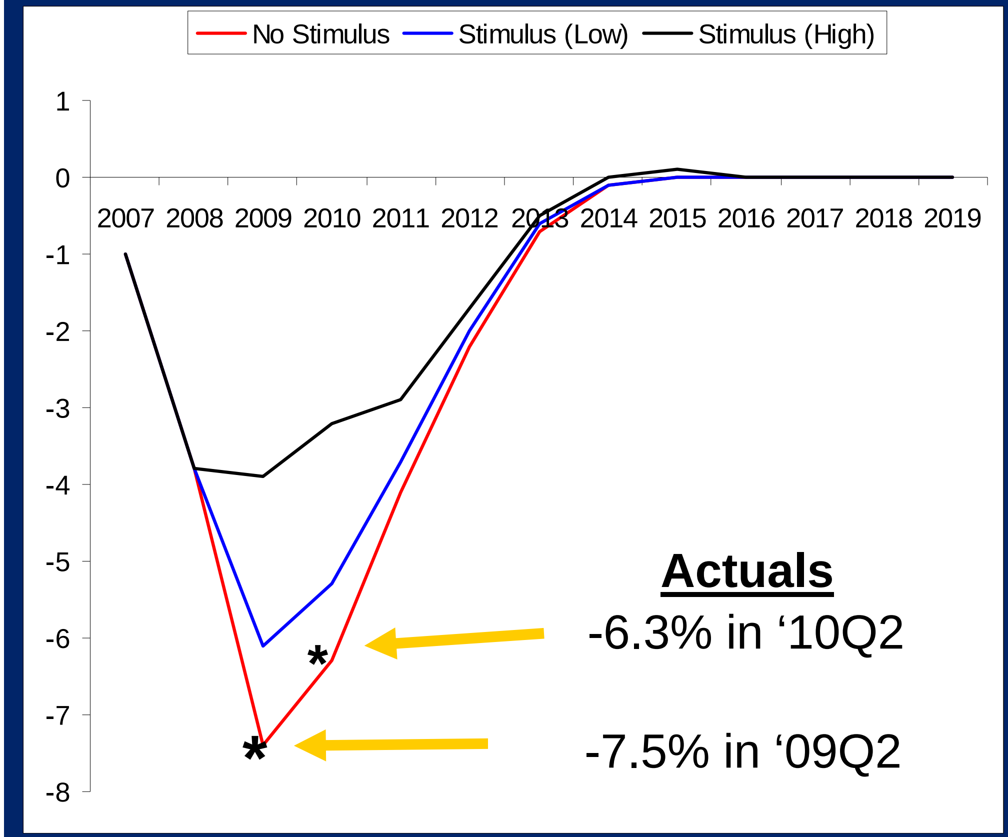
SCHOOL OF BUSINESS ADMINISTRATION

University of San Diego

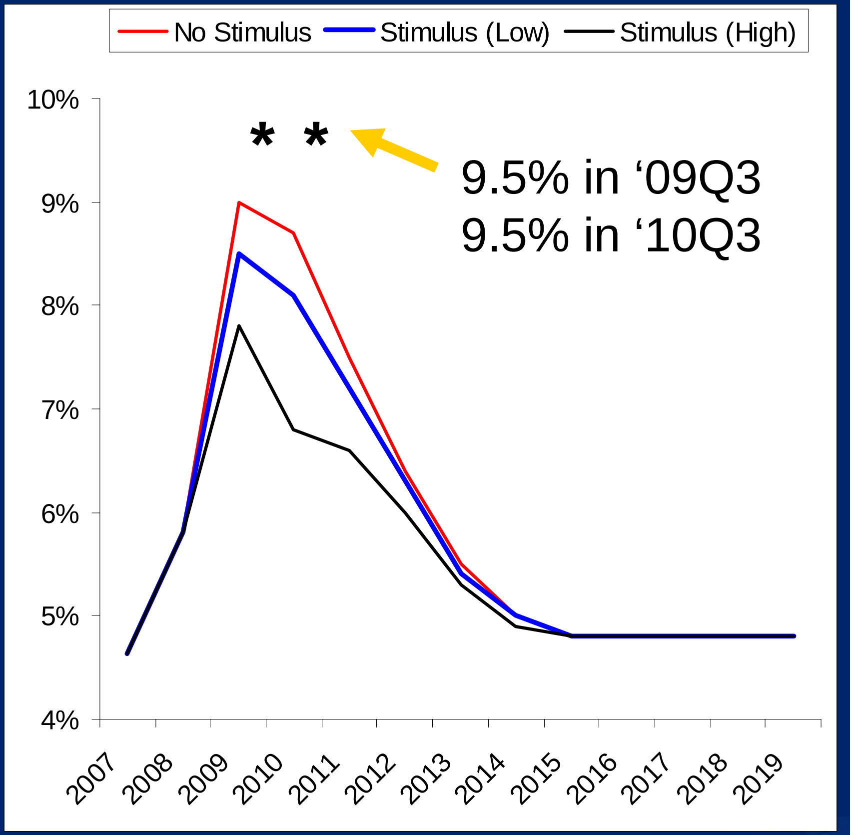
Did Fiscal Stimulus Work?

It's tough to make predictions, especially about the future.

CBO Est. Impact on GDP Gap (Y-Y*, %)



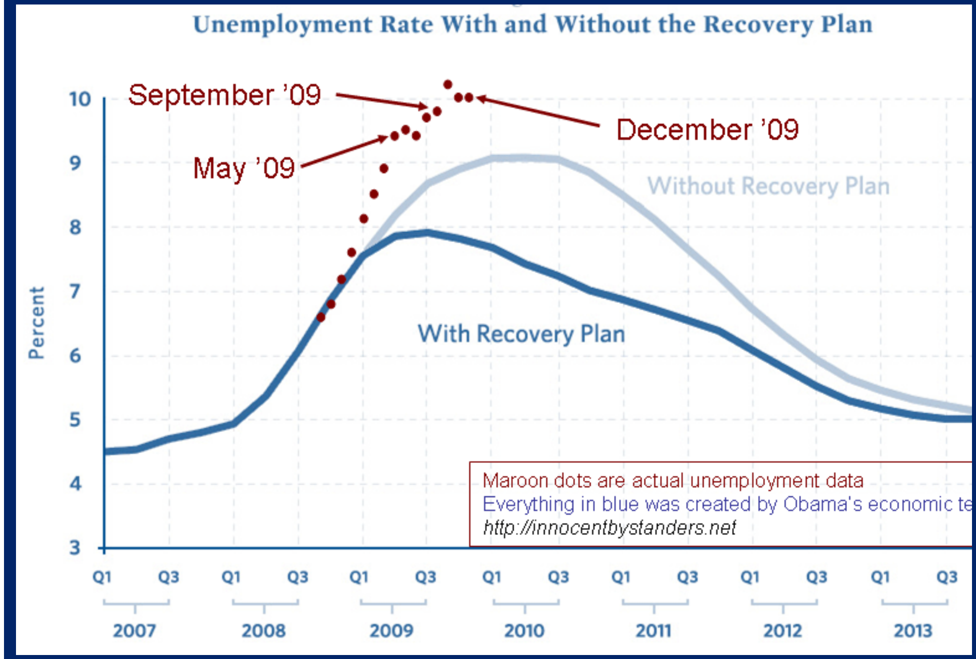
Est. Impact on Unemployment

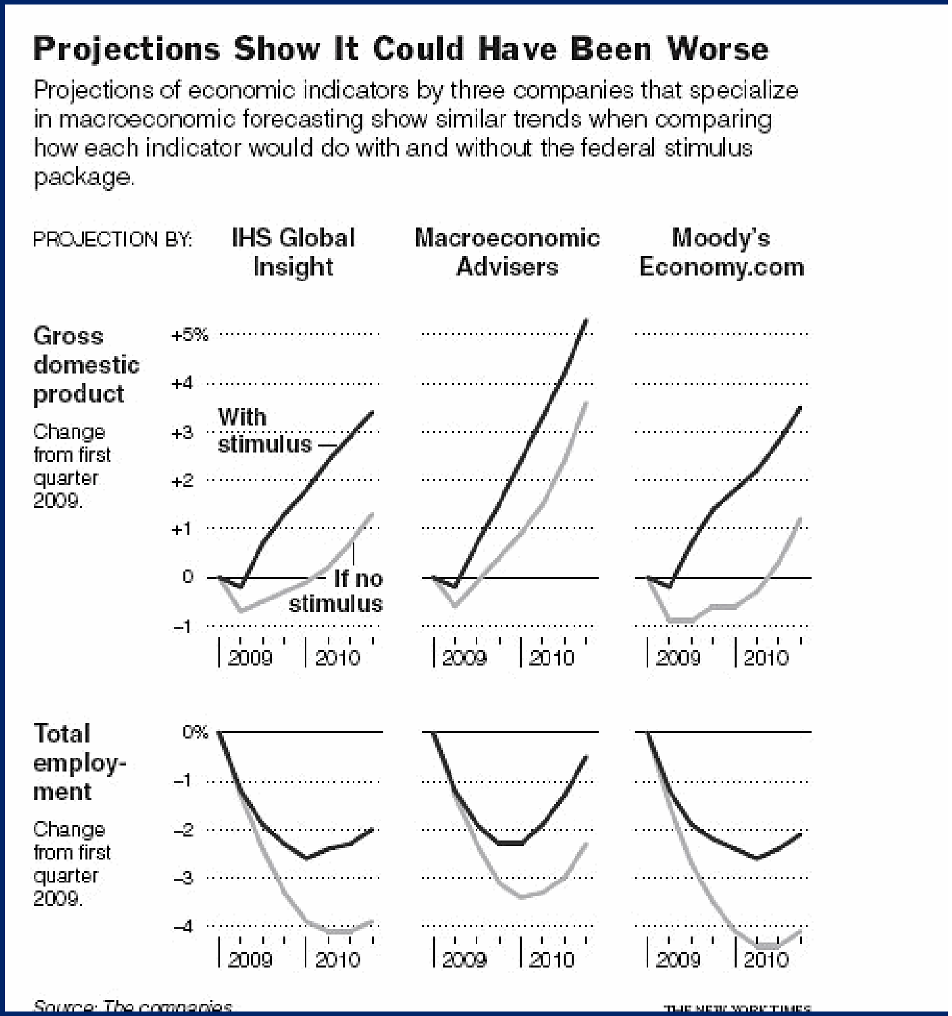


SCHOOL OF BUSINESS ADMINISTRATION

University of San Diego

The Stimulus: No Silver Bullet





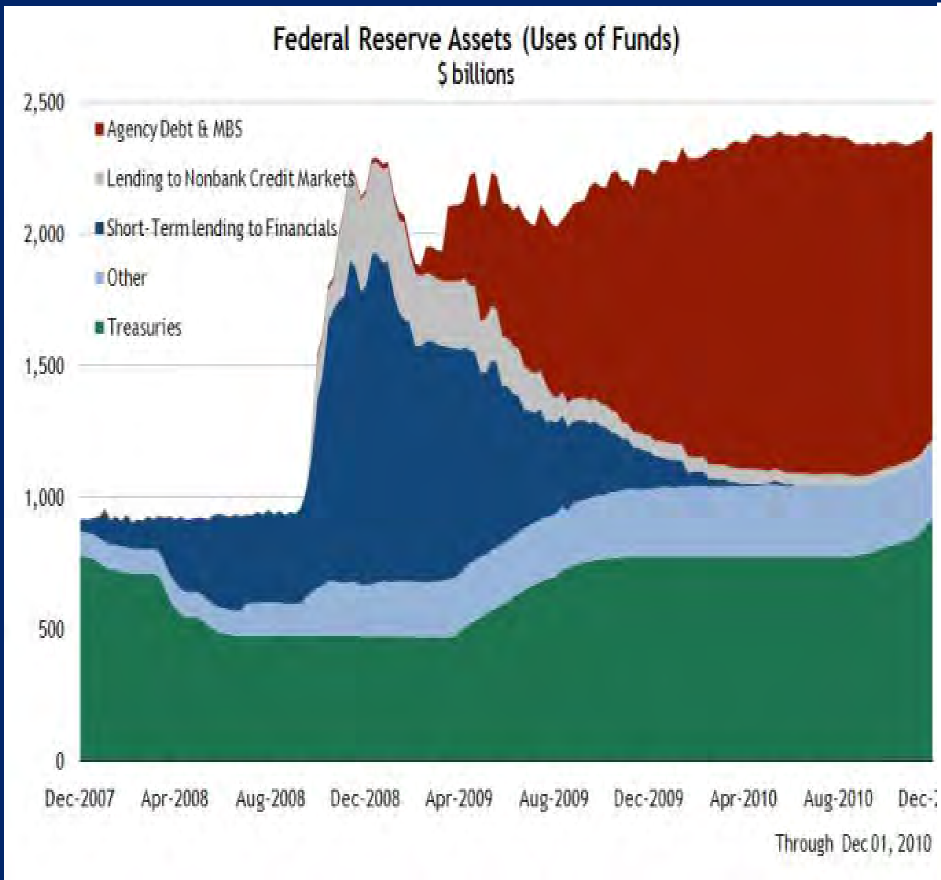
Despite an optimistic sales pitch, $757b in stimulus was never going to cure the recession. But the recession was MUCH worse than we thought in late '08, and things would have been worse without it.

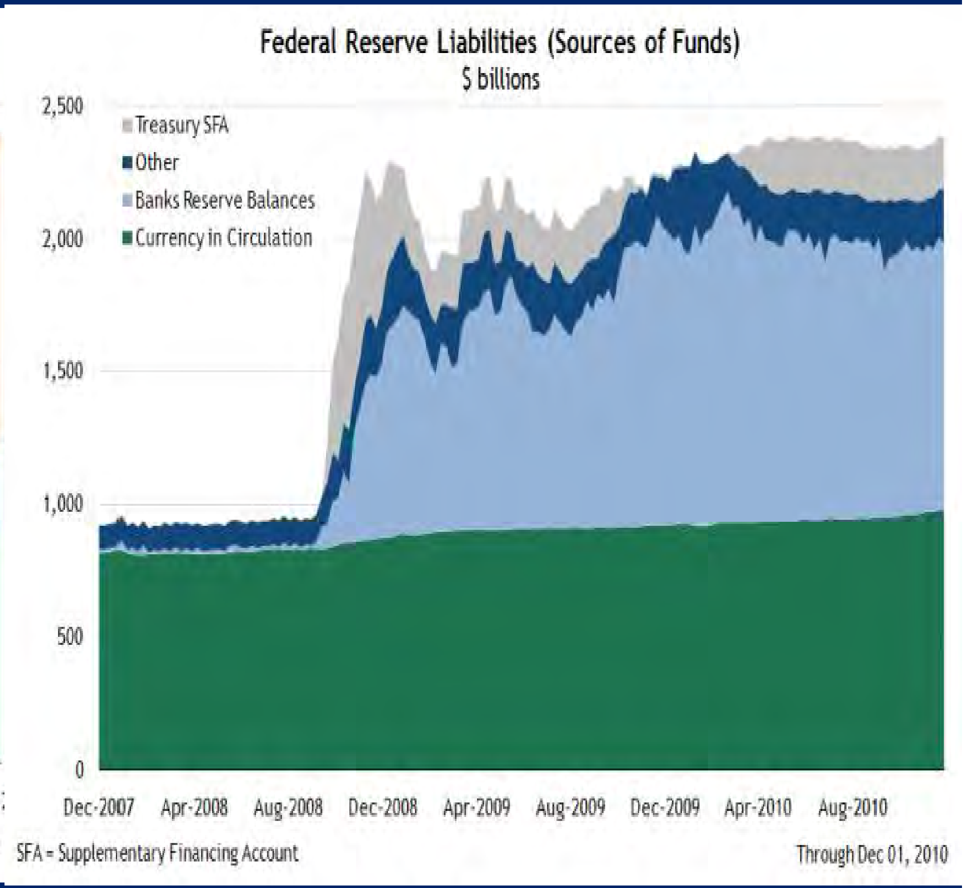
SCHOOL OF BUSINESS ADMINISTRATION

University of San Diego

The Fed: Into Uncharted Waters

On top of 0% interest rates, the Fed has <u>doubled</u> the monetary base by extending reserves to banks. But the banks are still holding these loans as capital reserves

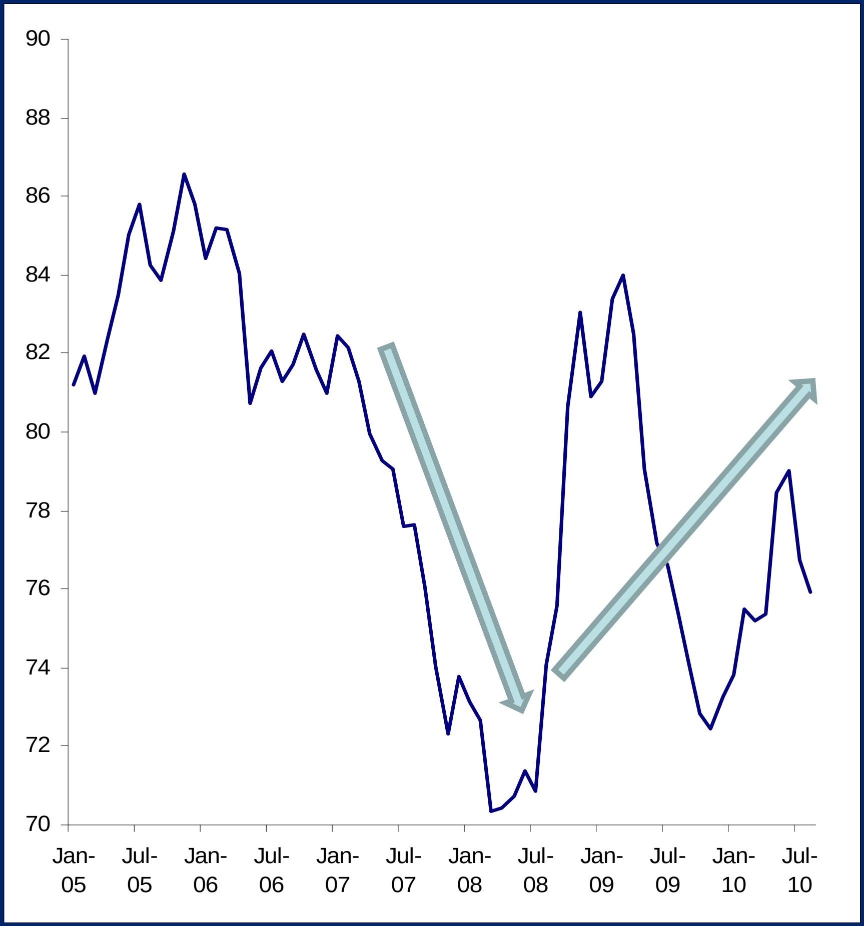




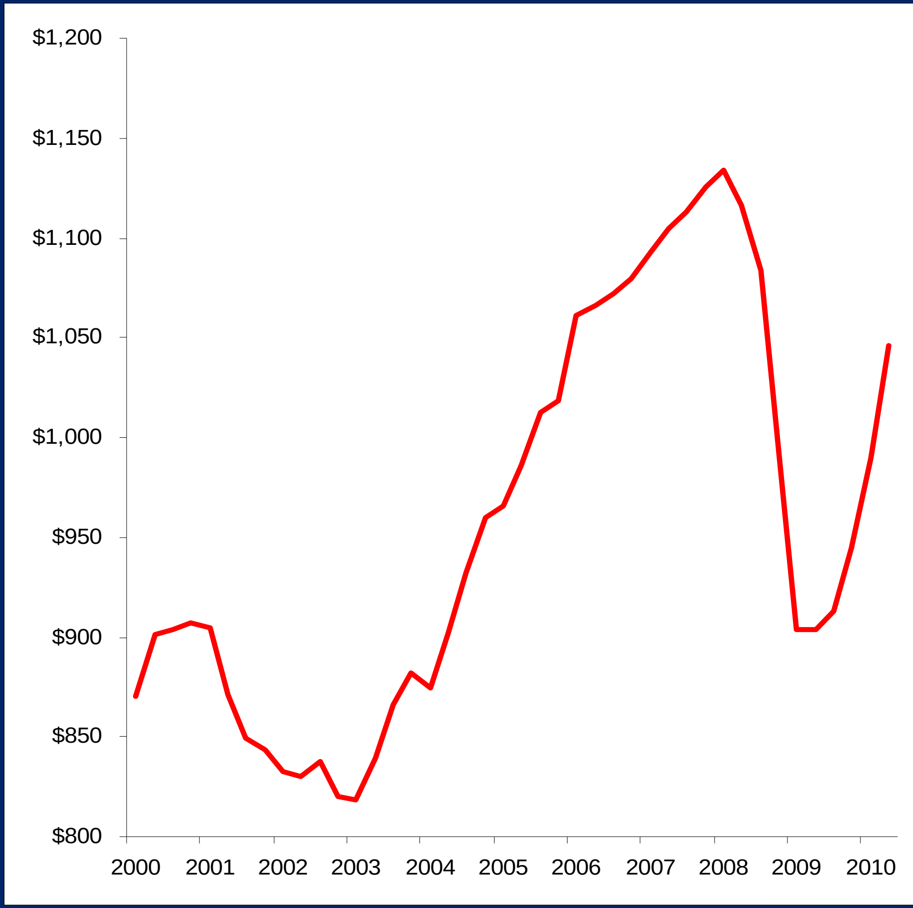
Rate Cuts Did Help, but not how you think…

Fed's rate cuts in '07 didn't help investment, but boosted Net Exports via a weaker dollar. E&S has picked up recently: low rates, or improved outlook?

US Trade Weighted Exchange Rate



Real Eq. & Soft. Investment (billions)

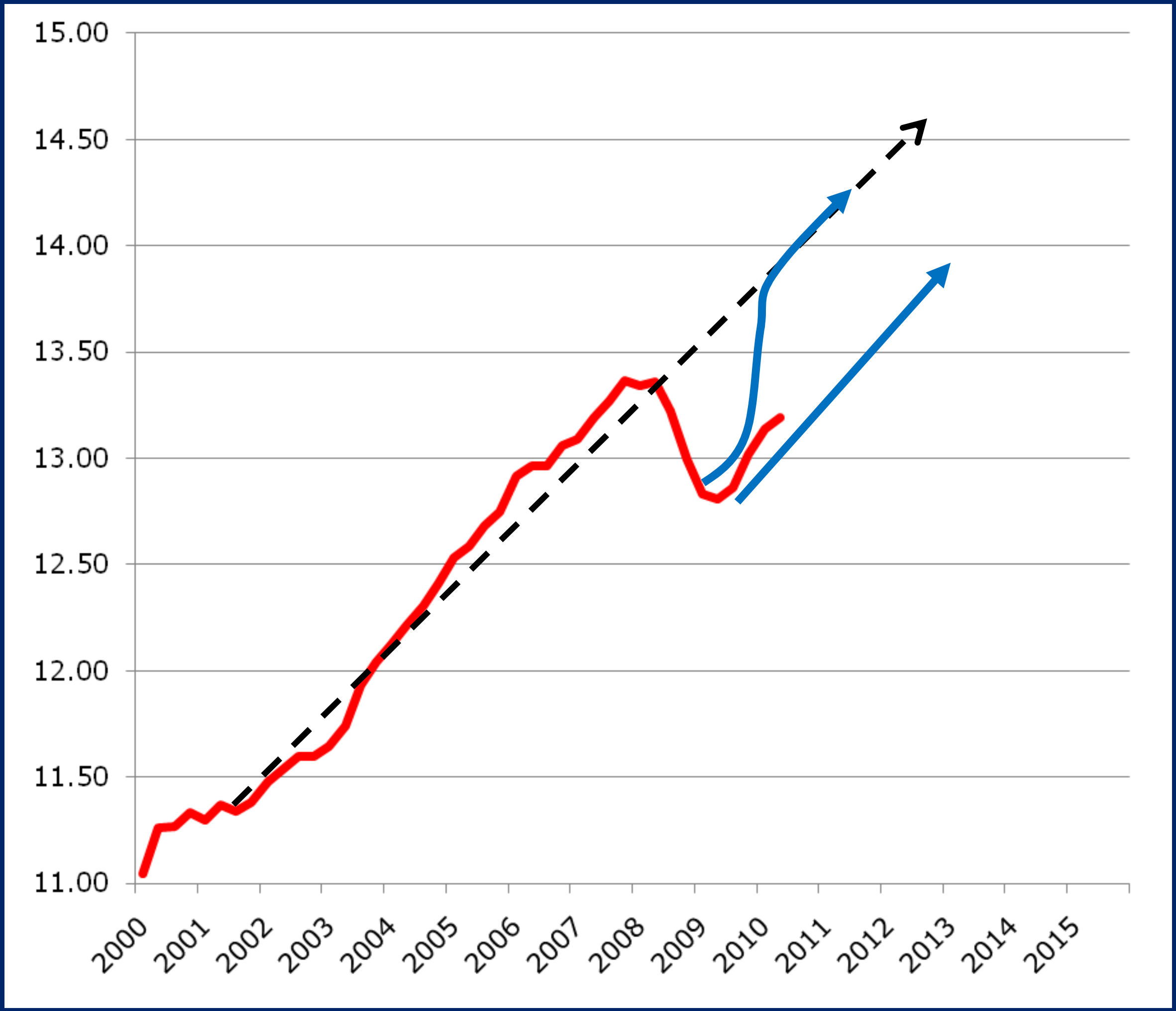


SCHOOL OF BUSINESS ADMINISTRATION

University of San Diego

Q2: Why is the Recovery So Weak?

US Real GDP (trillions)



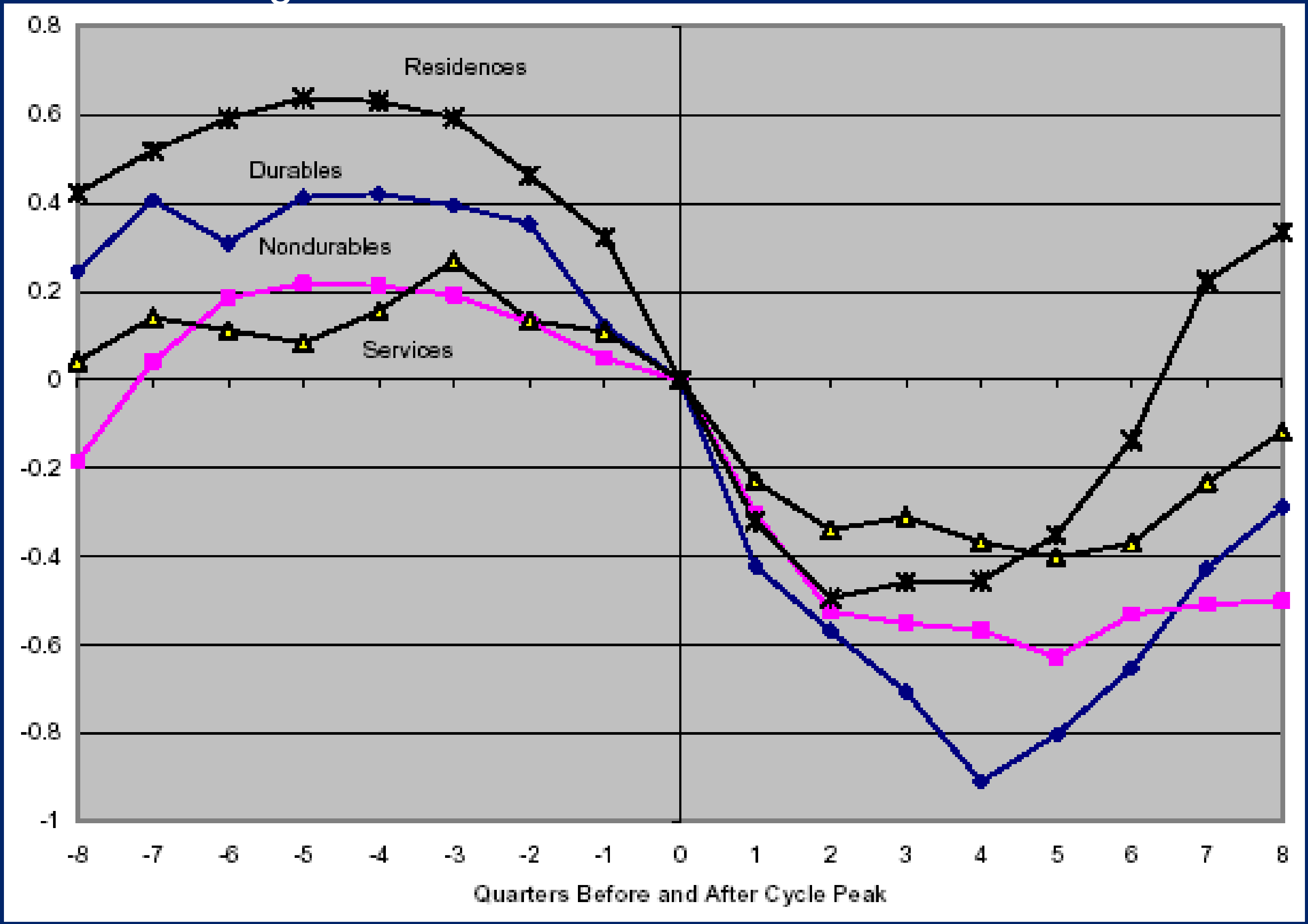
- Typically, a recession is followed by strong growth bringing us back to trend…
- The last year has been treading water: not recovering, but not sinking either.

SCHOOL OF BUSINESS ADMINISTRATION

University of San Diego

Houses and Cars Typically Lead Recovery

Average Cum. Ab. Contributions to GDP Growth



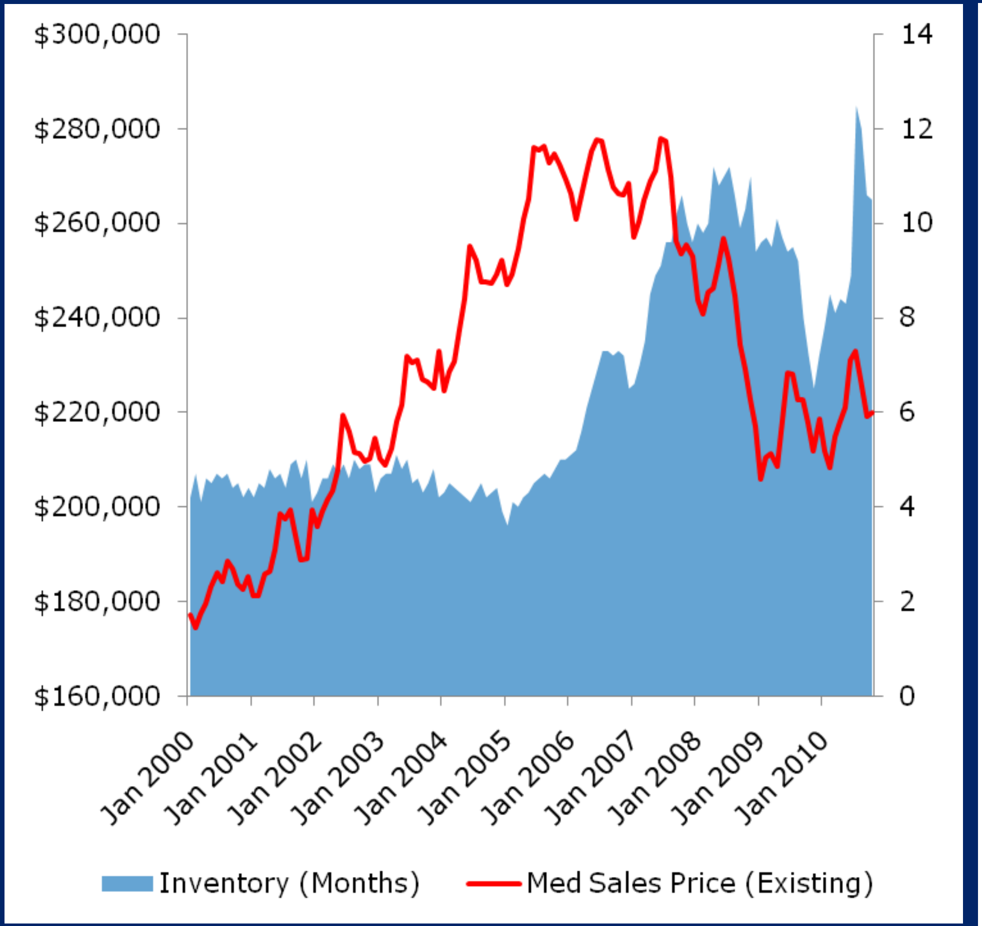
SCHOOL OF BUSINESS ADMINISTRATION

University of San Diego

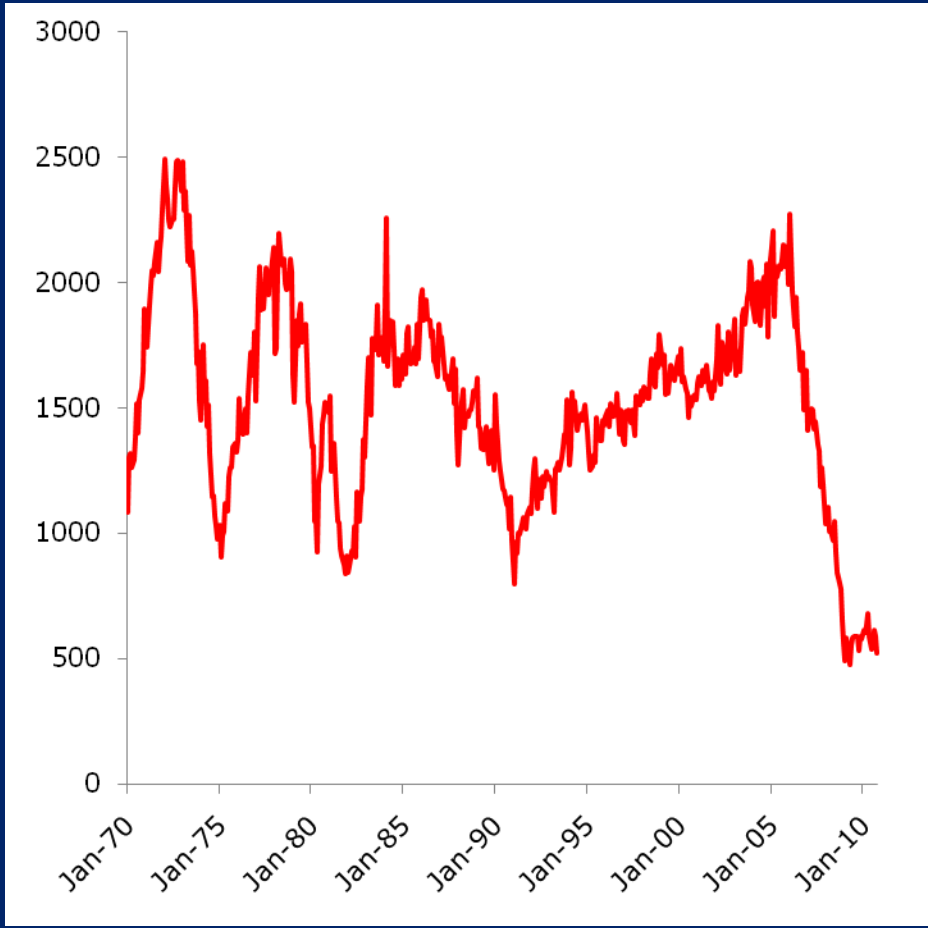
Housing Hangover

Sales volumes are picking up, but glut of existing homes keeps construction weak. With foreclosures ~40% of sales in CA, don't expect appreciation soon…

US Existing Homes: Inv. and Med. Price



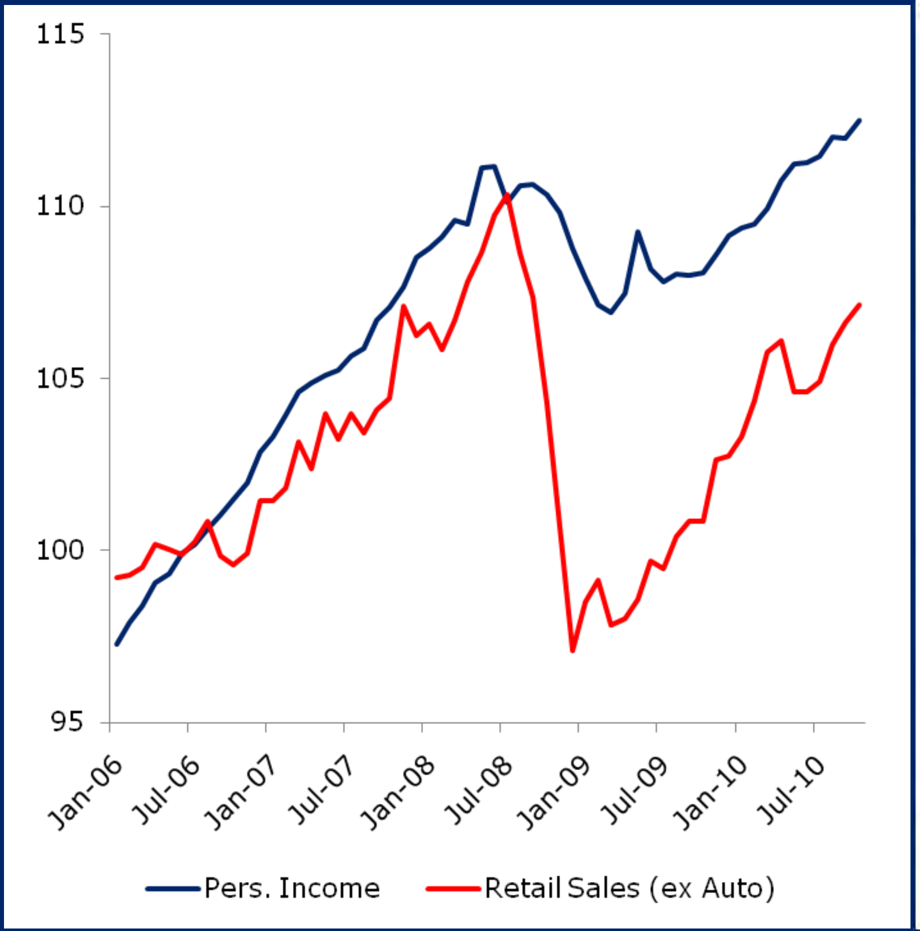
US Housing Starts (1000s SA)



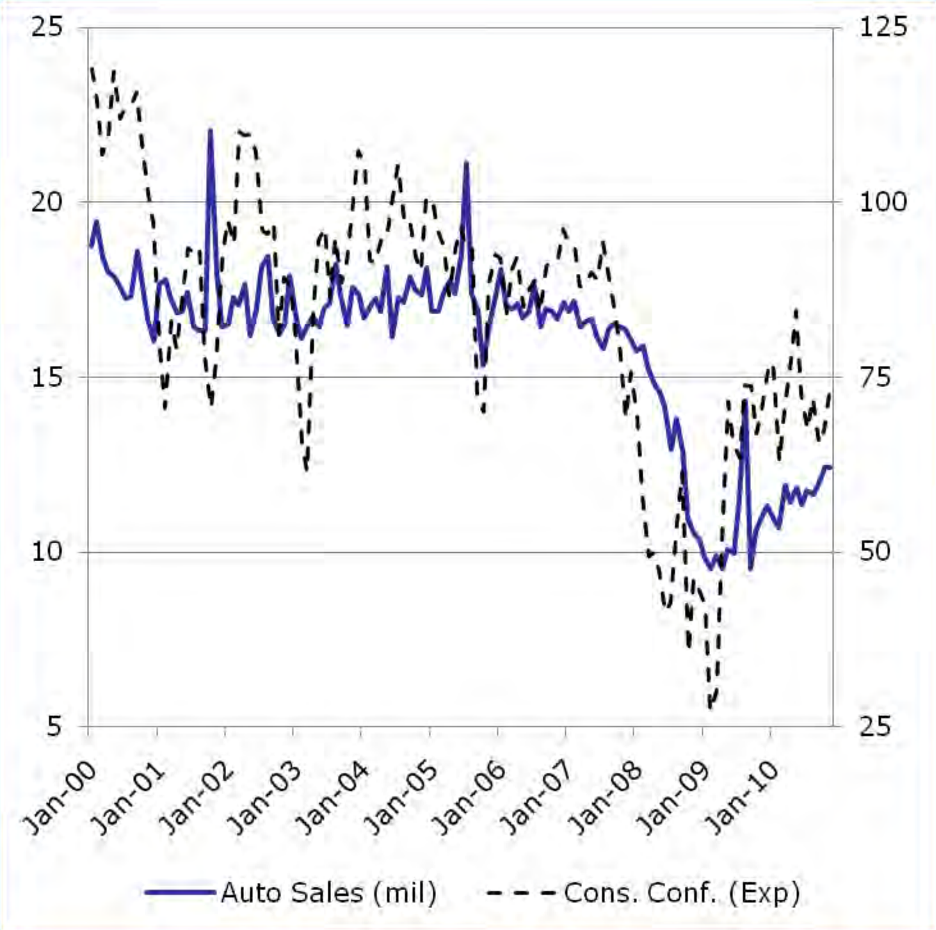
Consumption: A Debt Hangover

The worst growth in incomes in recent memory, and thrifty consumers have cut deep. Some signs of life in confidence, but autos also slow to recover.

Income & Retail Sales (2006=100)



Auto Sales (Mil) & Cons. Confidence



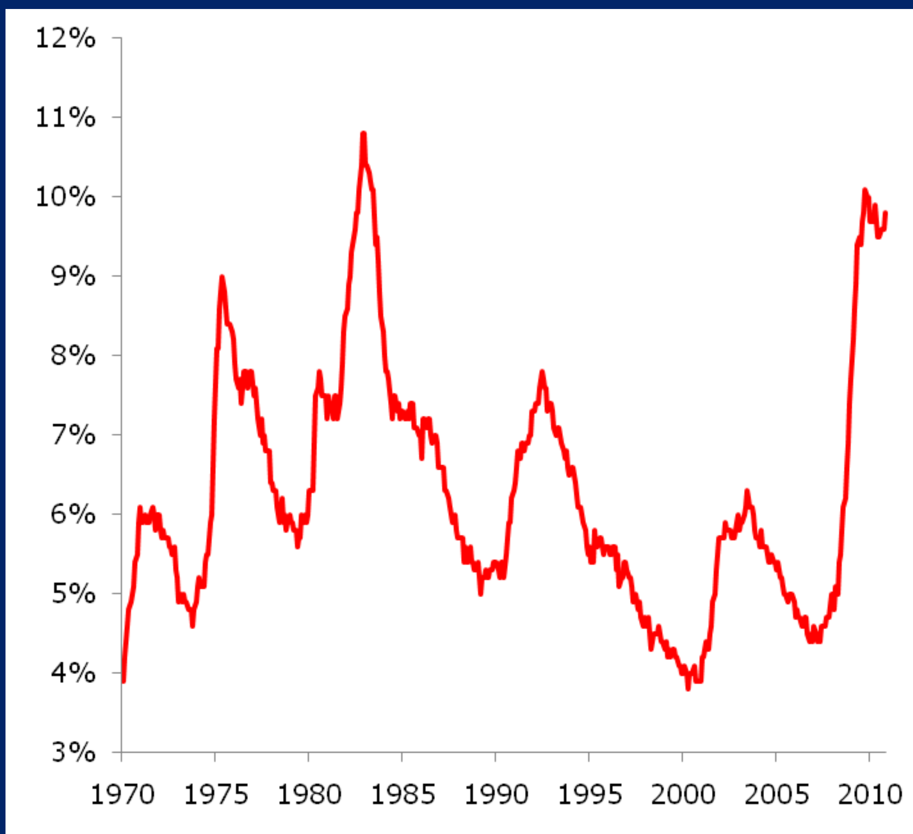
SCHOOL OF BUSINESS ADMINISTRATION

University of San Diego

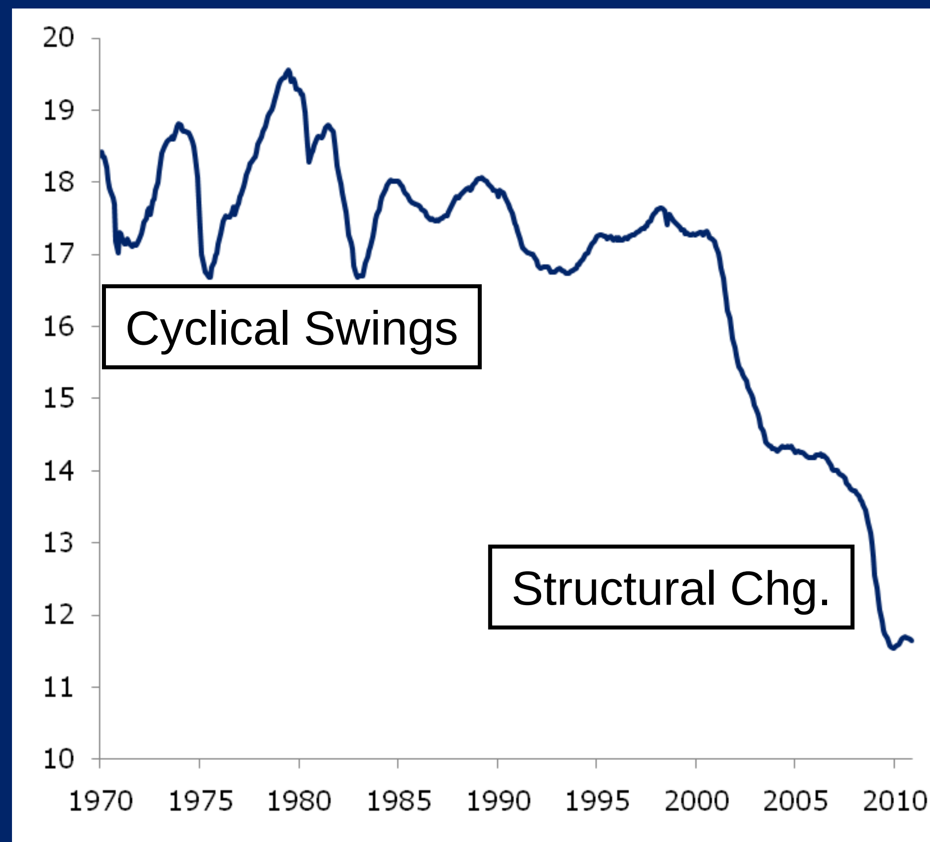
Structural Unemployment… Again

Another structural shift in Mfg. leads to another "jobless recovery." Combined with reduced mobility from negative home equity, the labor market is stuck.

US Unemployment Rate (SA)



Manufacturing Employment, (mil SA)



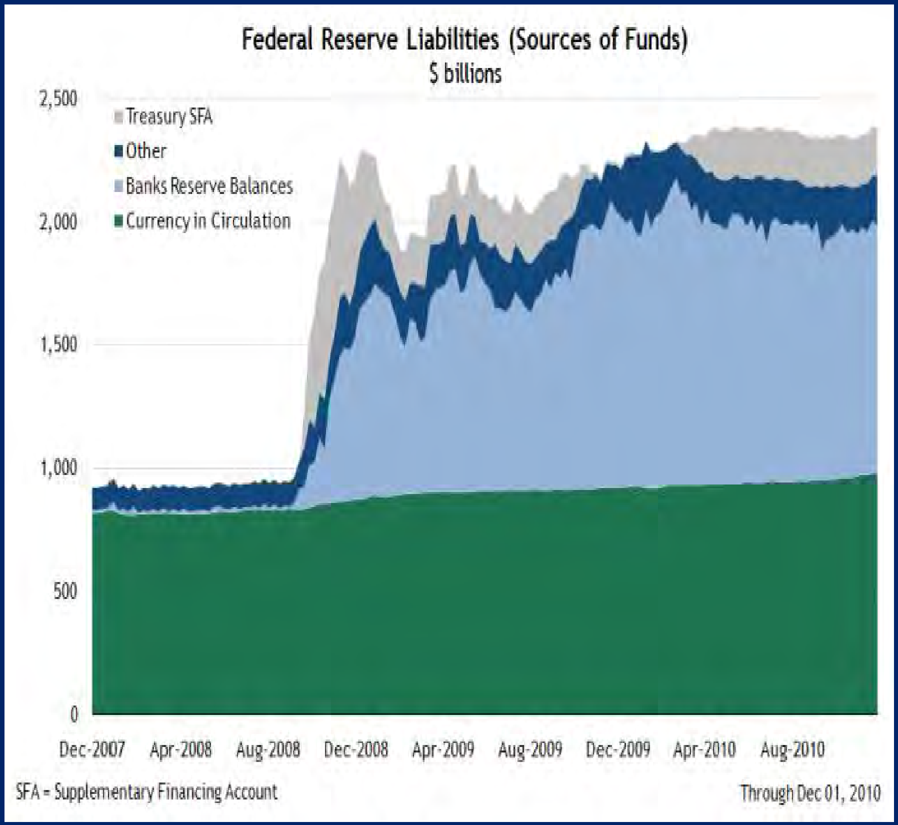
SCHOOL OF BUSINESS ADMINISTRATION

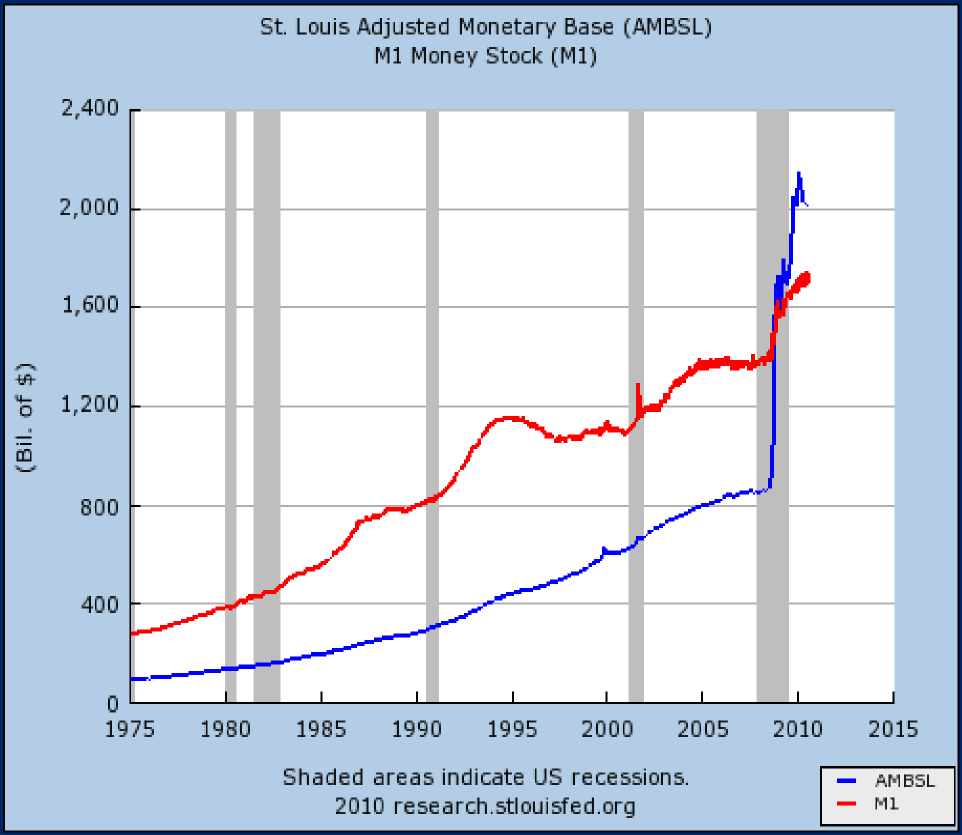
University of San Diego

Q3: Inflation or Deflation? Zimbabwe or Japan?

Huge Monetary Expansion = Inflation?

Econom 102



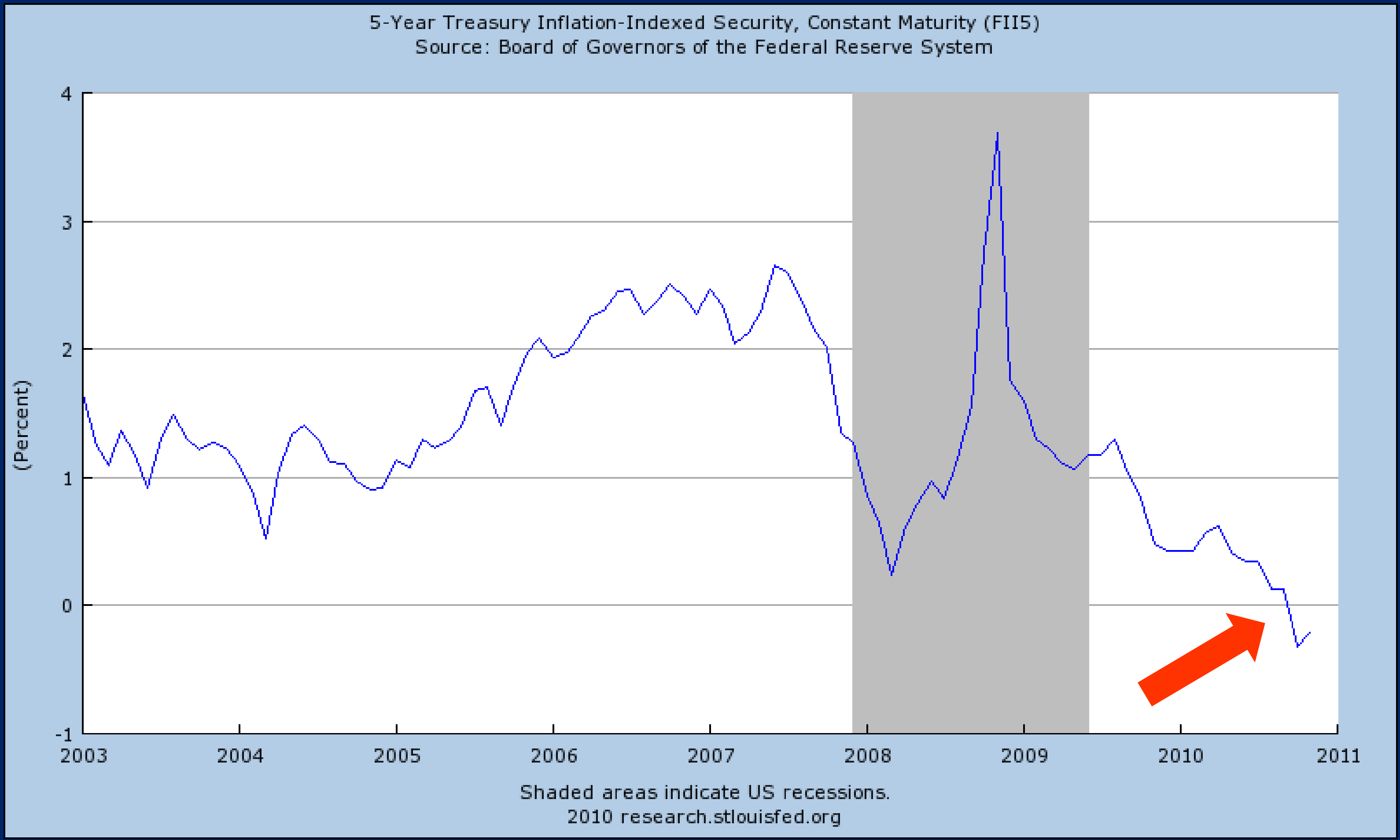


SCHOOL OF BUSINESS ADMINISTRATION

University of San Diego

Some markets fear inflation…

Recently, "inflation protected" 5yr TIPS sold for negative interest rates. Purchasers lose money unless inflation comes in higher than ~2%



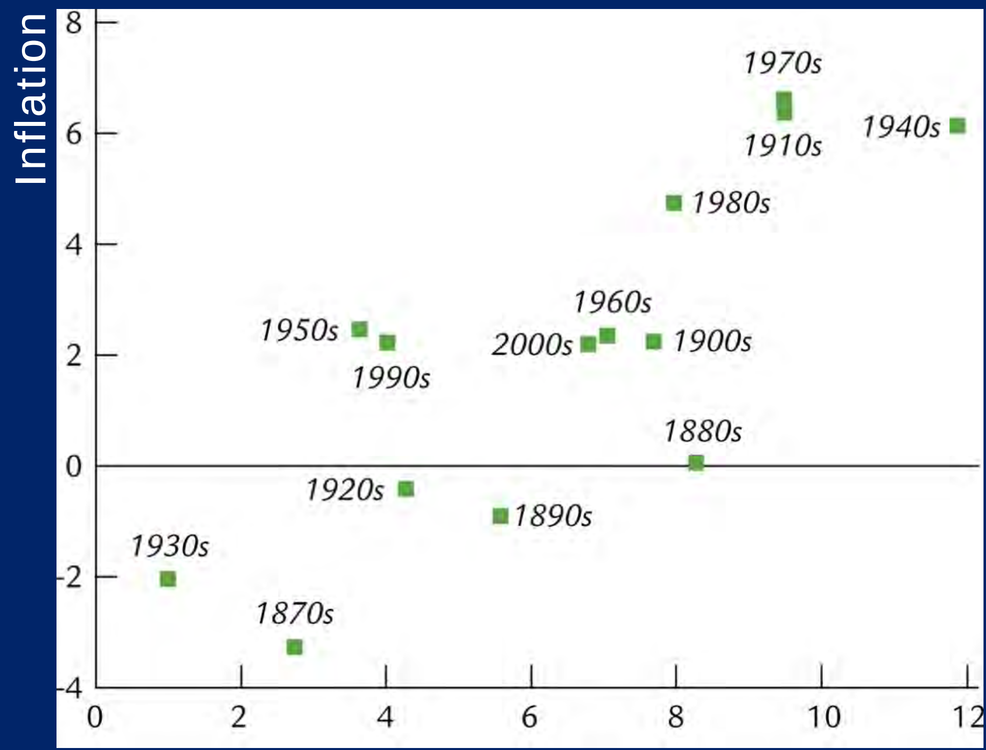
SCHOOL OF BUSINESS ADMINISTRATION

University of San Diego

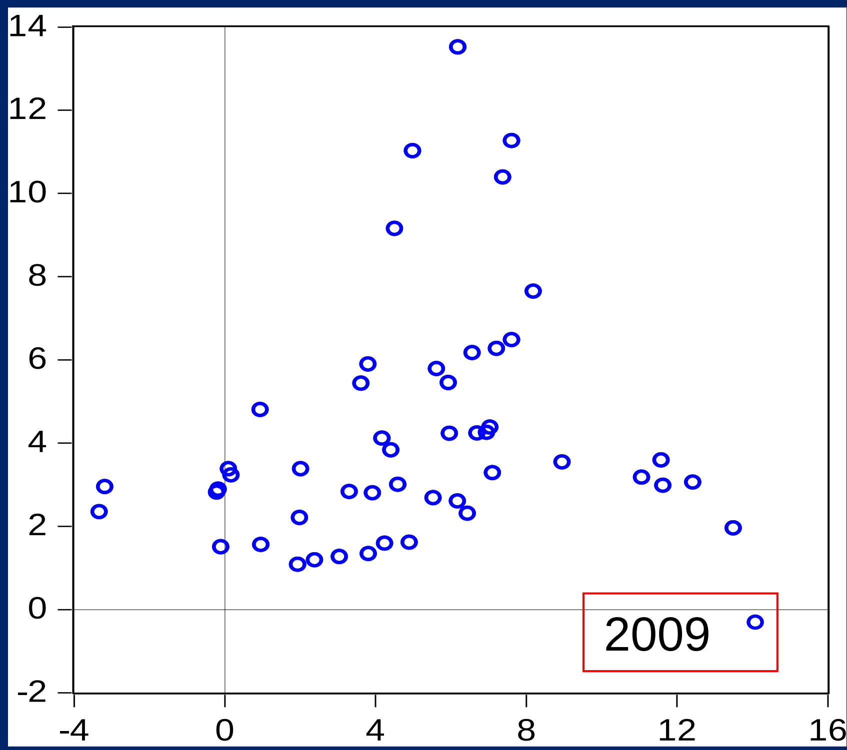
… but the history is complicated…

In the US, the link between money growth and inflation holds up pretty well over decades. However, it's much less convincing on an annual basis.

US Inflation v. Money Growth (Decades)



US Inflation v. Money Growth (59-09)



% Chg in Money Supply

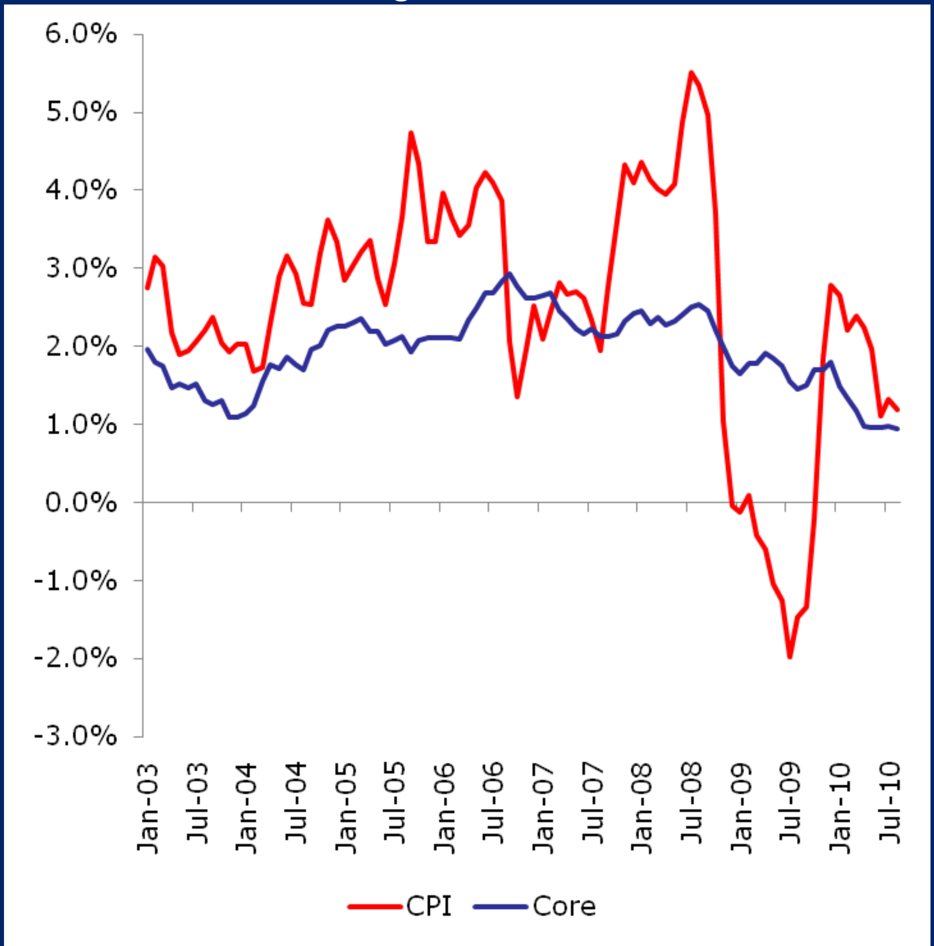
SCHOOL OF BUSINESS ADMINISTRATION

University of San Diego

… and deflation is a bigger worry right now

Core CPI declined several times in 2010. Deflation comes from weak demand, and causes consumers to wait for even lower prices – stalling the economy even more

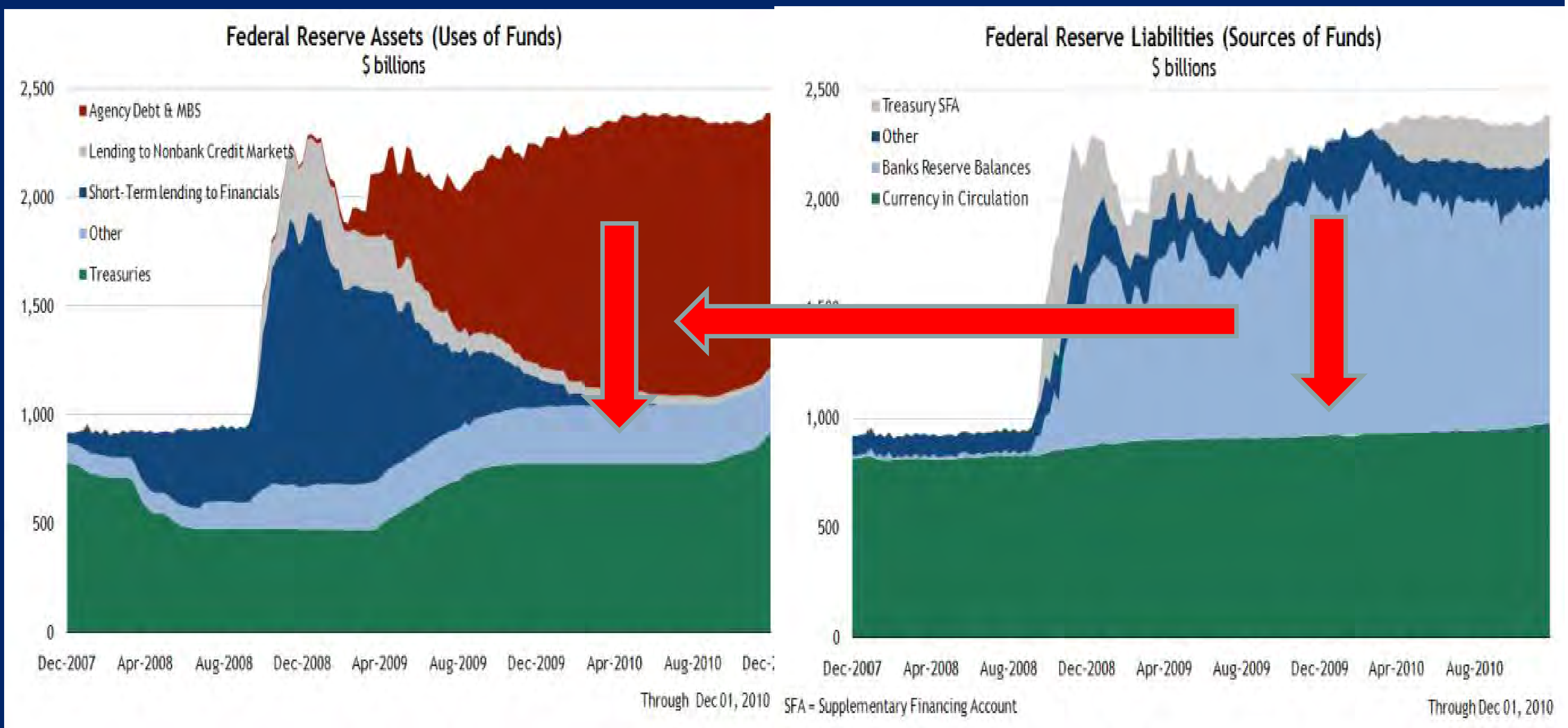
YoY % Change in Price Index



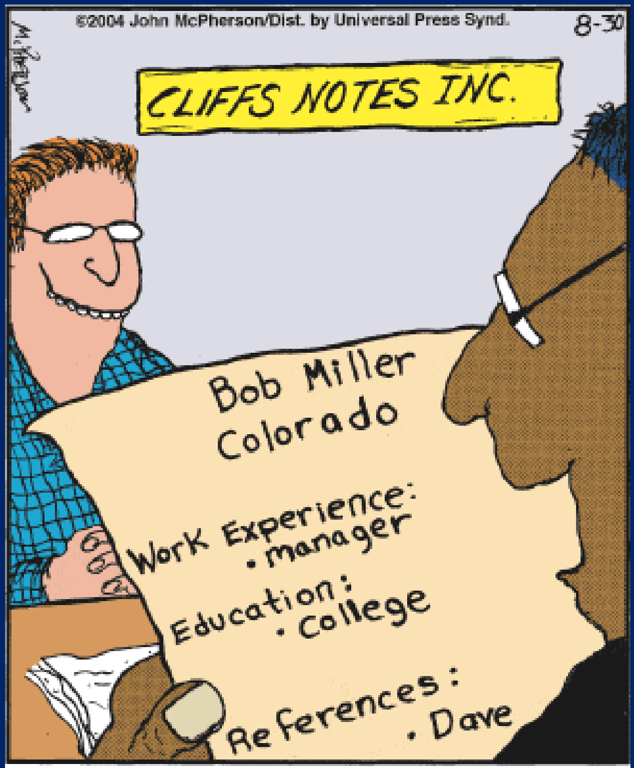
Inflation Expectations from Bond Markets

Fed's Exit Strategy

Fed hopes that as the economy recovers, banks will use excess reserves to buy back formerly junky assets, shrinking the balance sheet back to normal size.



In Summary



"VERY impressive resume, Mr. Miller!"

Q1: Was the stimulus a failure?

- Recession was far worse than forecast.
- Politics leads to a smaller "low multiplier" stimulus.
- No silver bullet, but things would've been worse without it.

Q2: Why is the recovery so weak?

- Housing and Cars typically fuel early recoveries. Housing bust and consumer deleveraging keep these sectors weak.
- Weak economy, job mismatch and negative home equity slow labor market healing.

Q3: Inflation or Deflation? Zimbabwe or Japan?

- d) None of the above…
- Most of the recent money growth is stuck on bank balance sheets: a lurking but uncertain inflation threat.
- With so much excess capacity right now, deflation looks like the bigger worry… for now.

Looking Ahead

- Absent other shocks, the recovery has enough momentum to avoid a double dip.
- Spending /GDP should improve, but structural unemployment will keep labor markets weak into 2011, and budget crisis will drag at CA's recovery.
- Housing markets are starting to get off the mat – barely. But distress sales still cast a long shadow over any serious recovery.
- Worries about deficit and inflation are warranted – but not now. The Fed has a tough problem 2012 and on: how to avoid inflation without killing the recovery.
- A dim flicker of light at the end of the tunnel, but a long way to go…