



US Economic Outlook:

3 Questions about the Recovery

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3 Questions about the Recovery



Q1: Was the stimulus a failure?

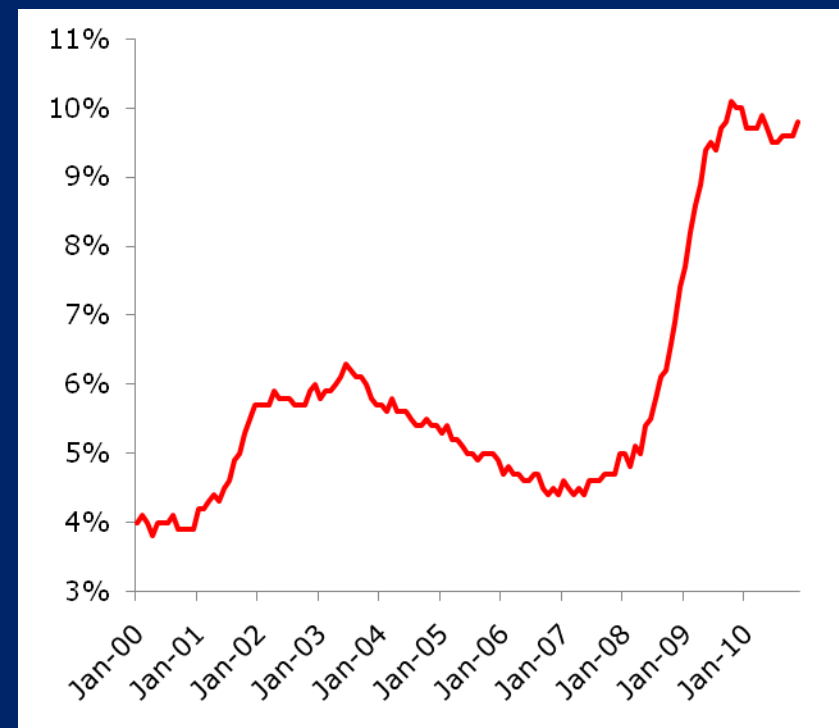
Q2: Why is the recovery so weak?

Q3: Inflation or Deflation?
Zimbabwe or Japan?

Q1: Did the Stimulus Fail?



US Unemployment Rate

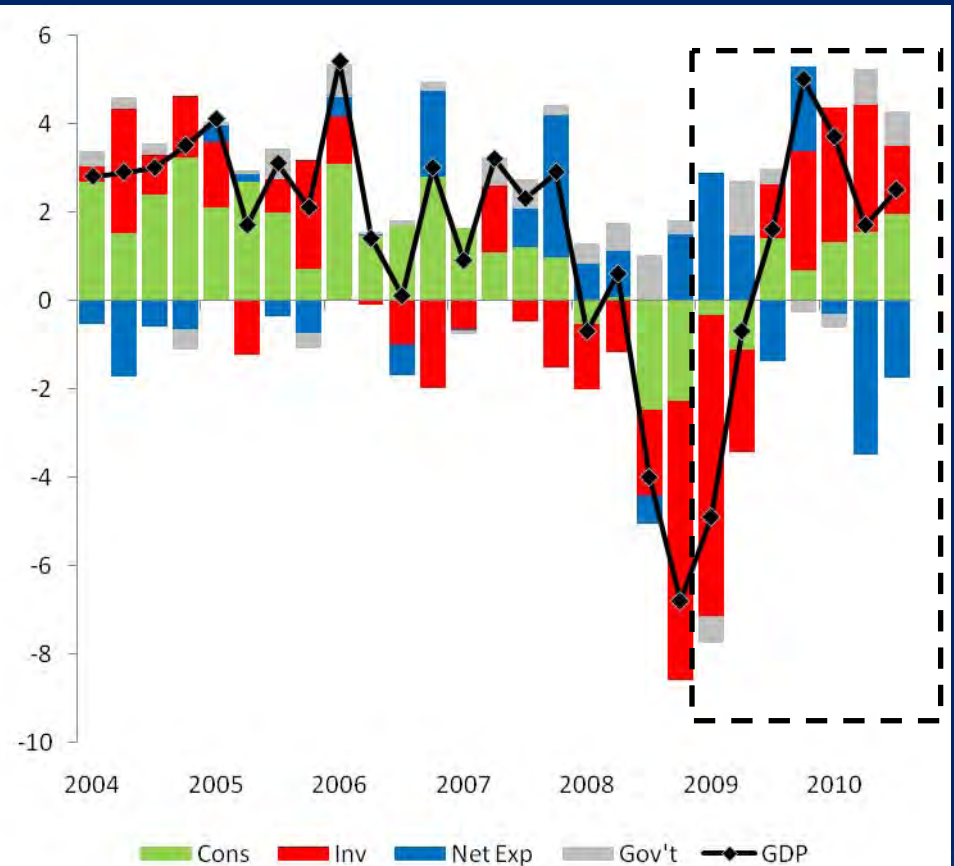
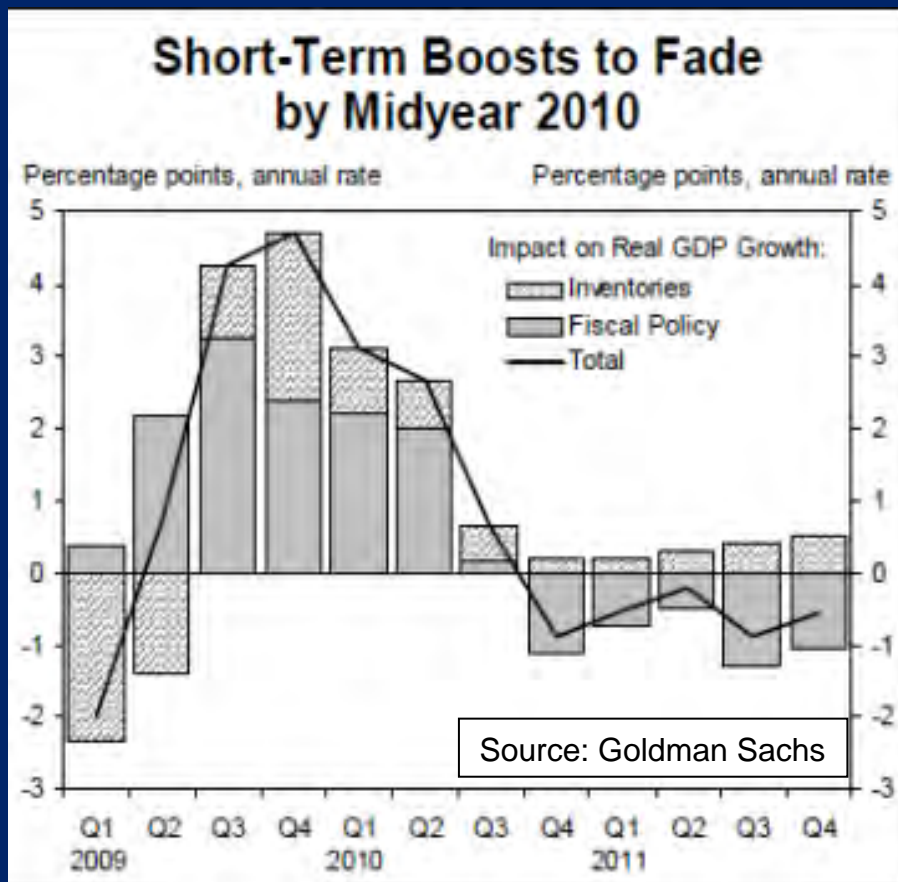


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Identifying the Stimulus

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)

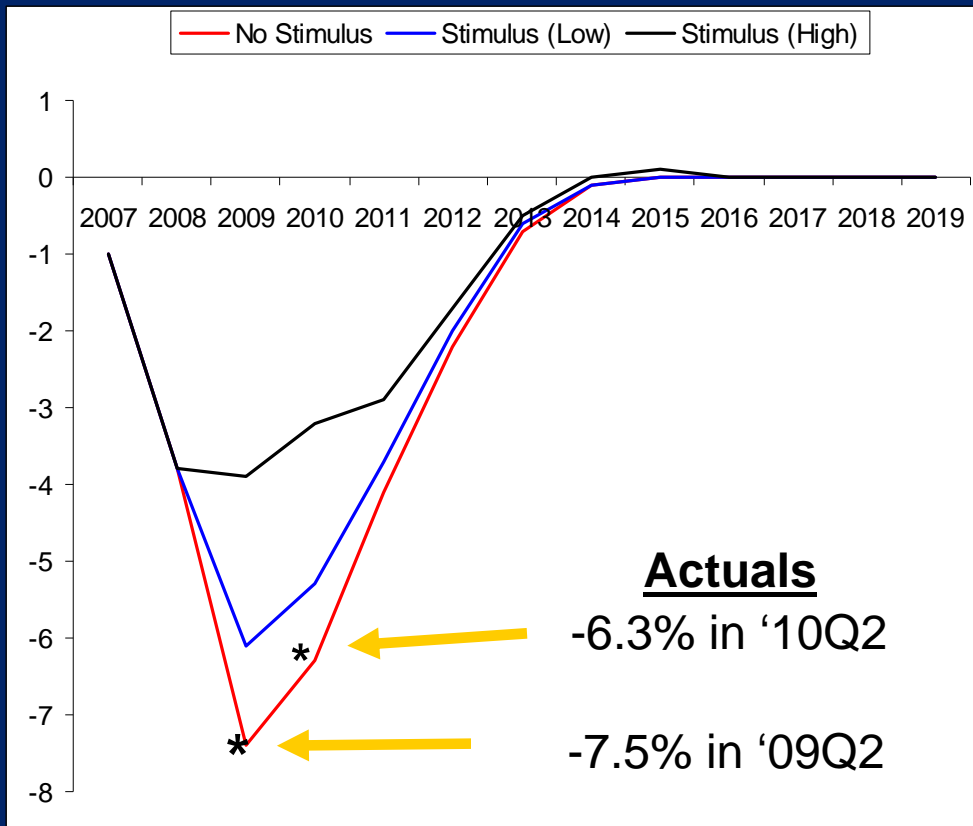


Did Fiscal Stimulus Work?

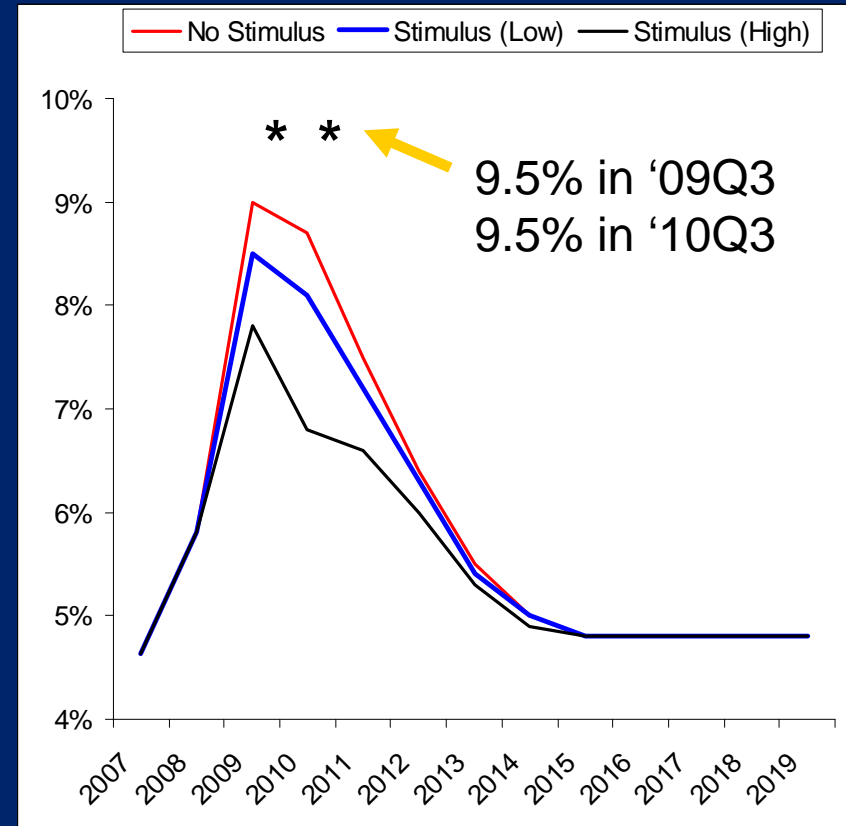
It's tough to make predictions, especially about the future.



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



Est. Impact on Unemployment



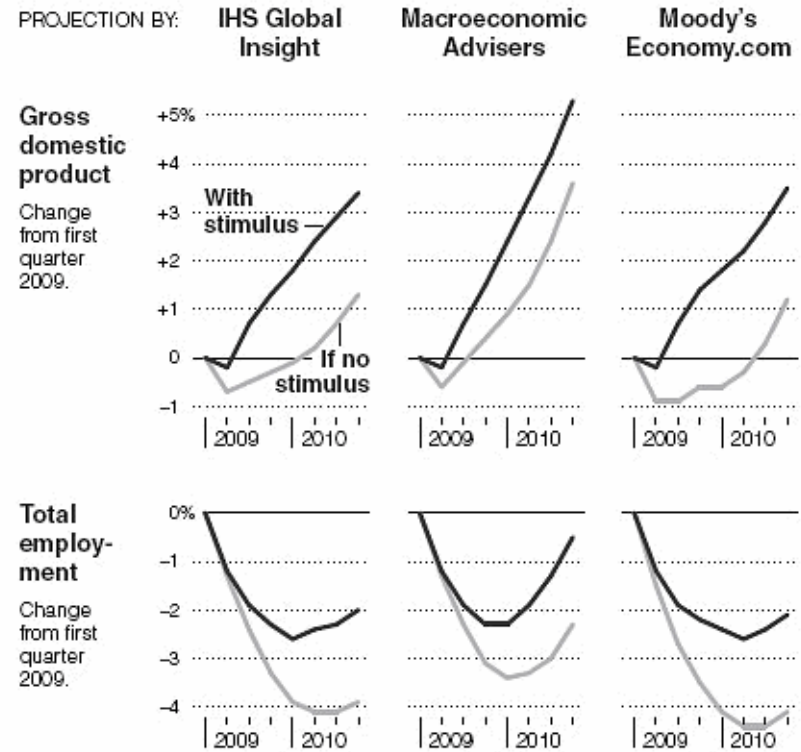
The Stimulus: No Silver Bullet

Unemployment Rate With and Without the Recovery Plan



Projections Show It Could Have Been Worse

Projections of economic indicators by three companies that specialize in macroeconomic forecasting show similar trends when comparing how each indicator would do with and without the federal stimulus package.



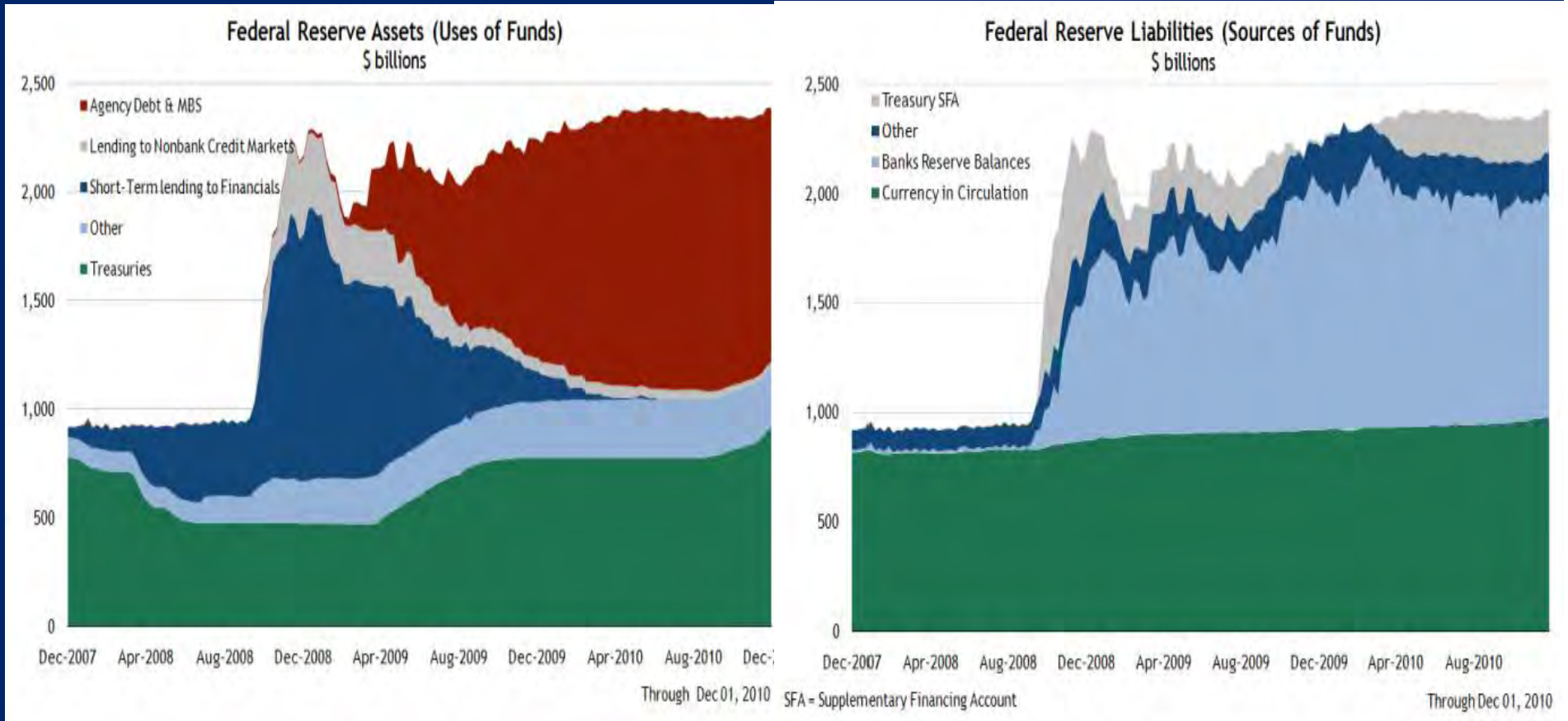
Source: The companies

THE NEW YORK TIMES

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.

The Fed: Into Uncharted Waters

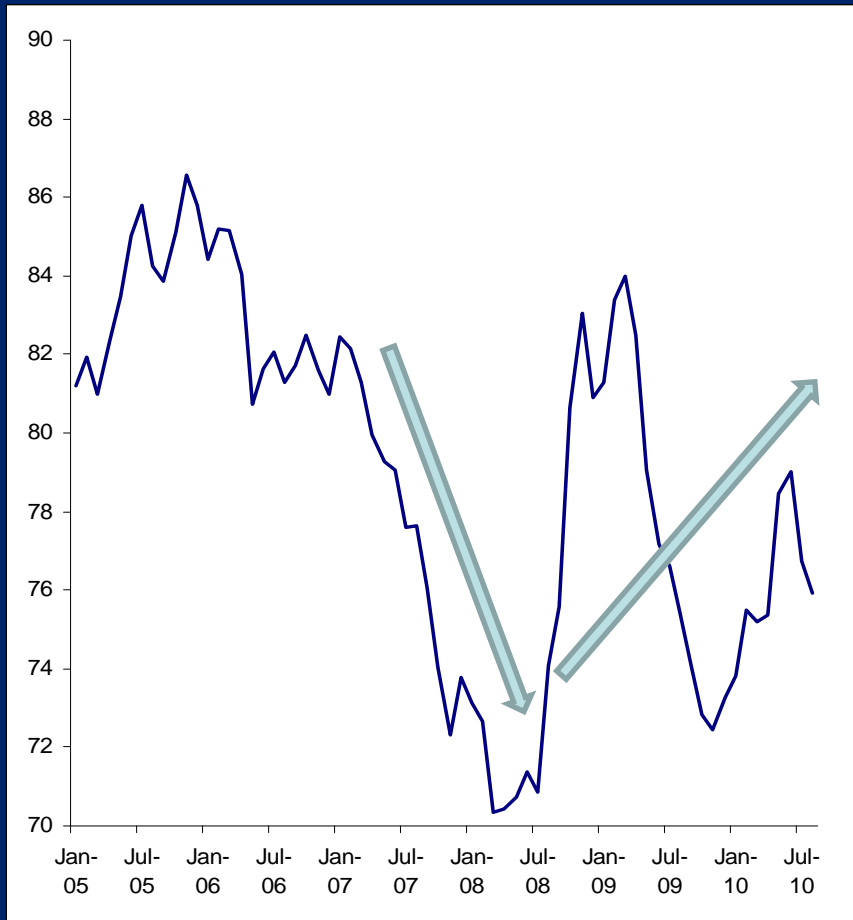
On top of 0% interest rates, the Fed has doubled the monetary base by extending reserves to banks. But the banks are still holding these loans as capital reserves



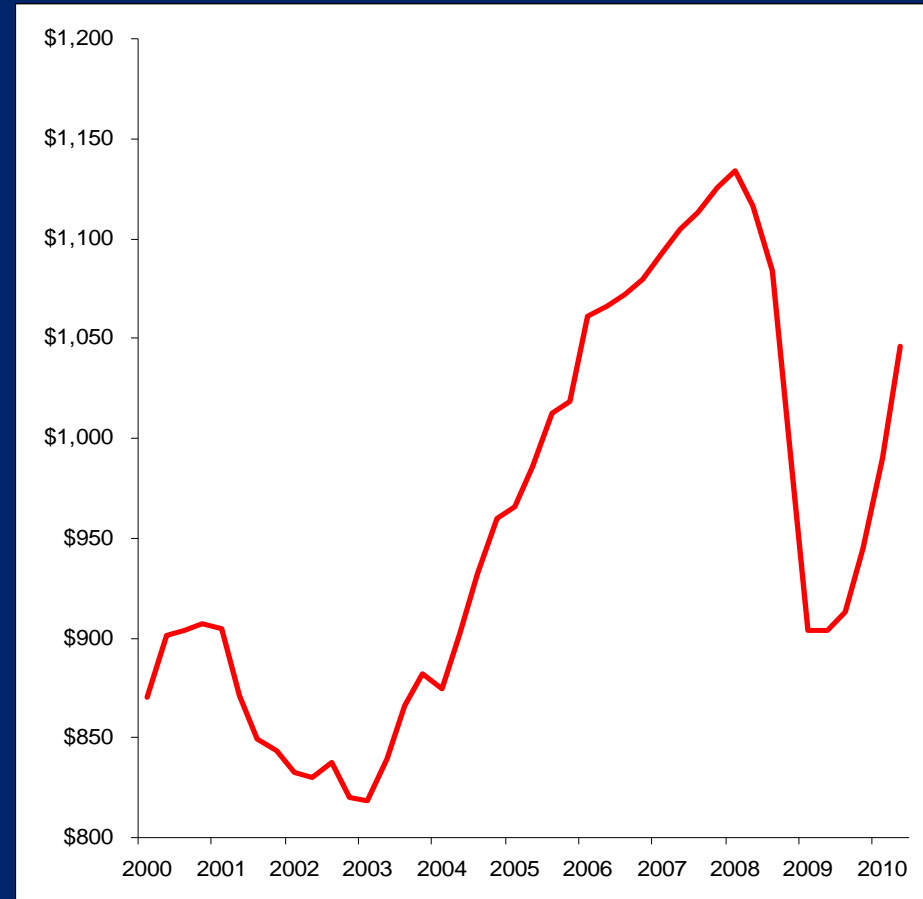
Rate Cuts Did Help, but not how you think...

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

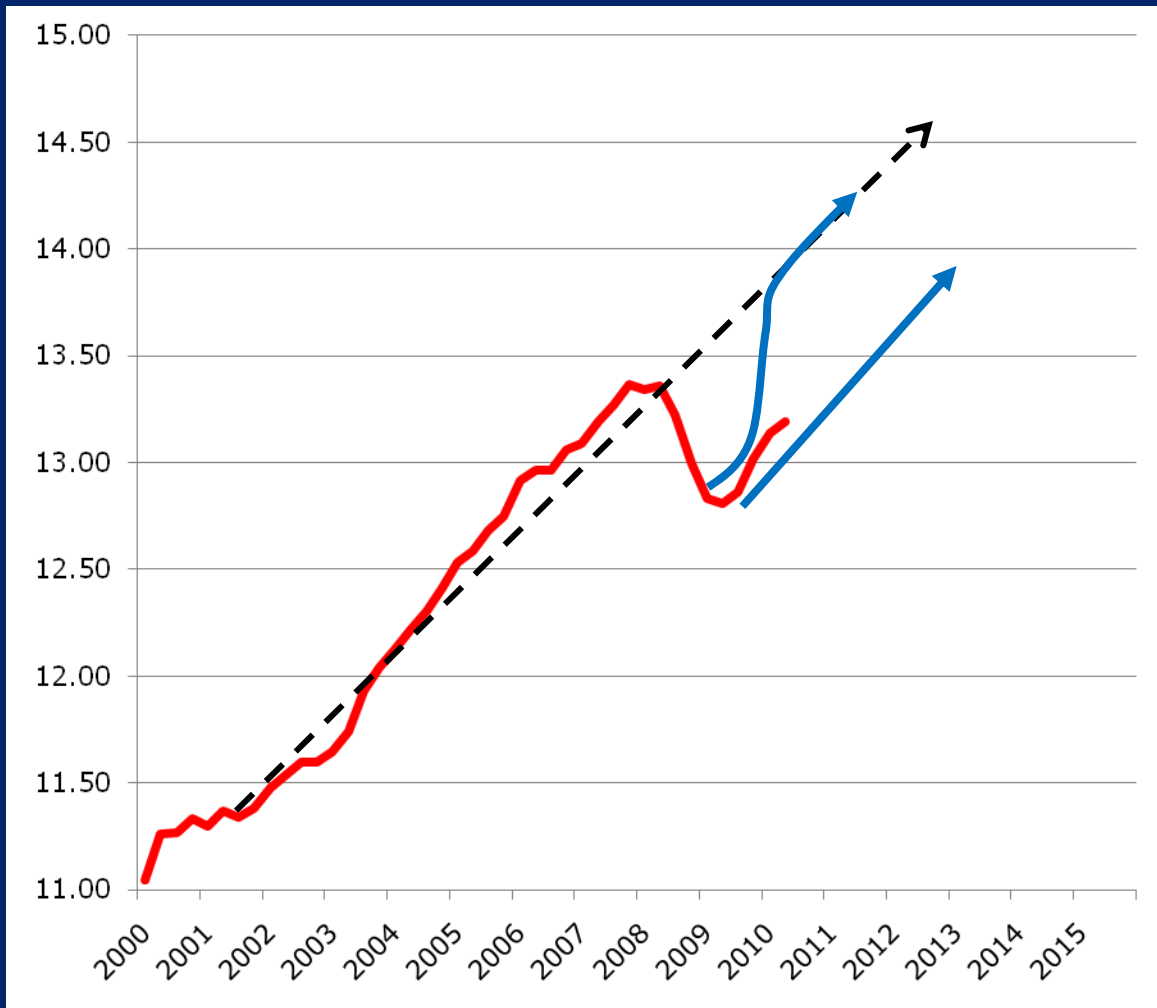


Real Eq. & Soft. Investment (billions)



Q2: Why is the Recovery So Weak?

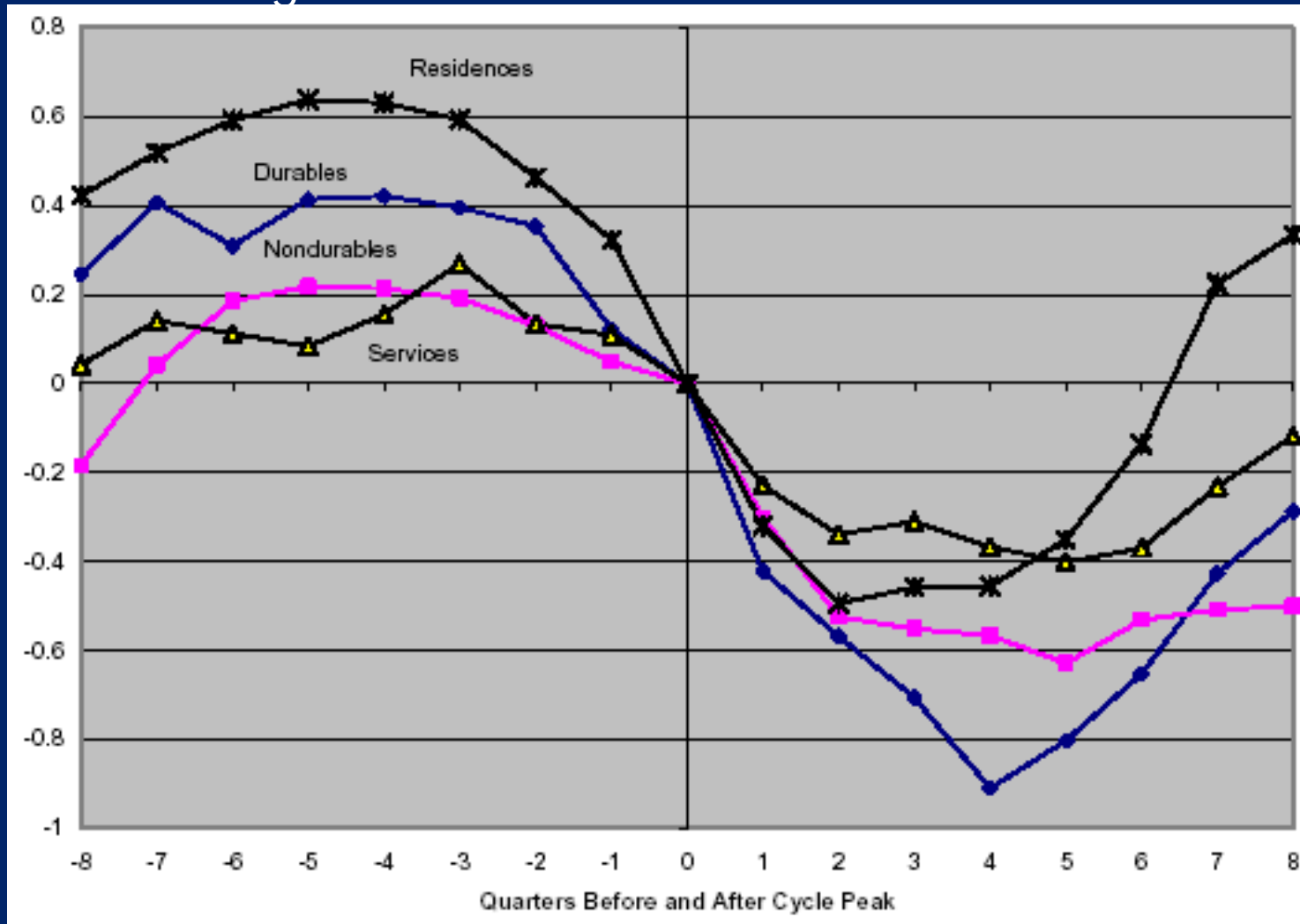
US Real GDP (trillions)



- 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.

Houses and Cars Typically Lead Recovery

Average Cum. Ab. Contributions to GDP Growth

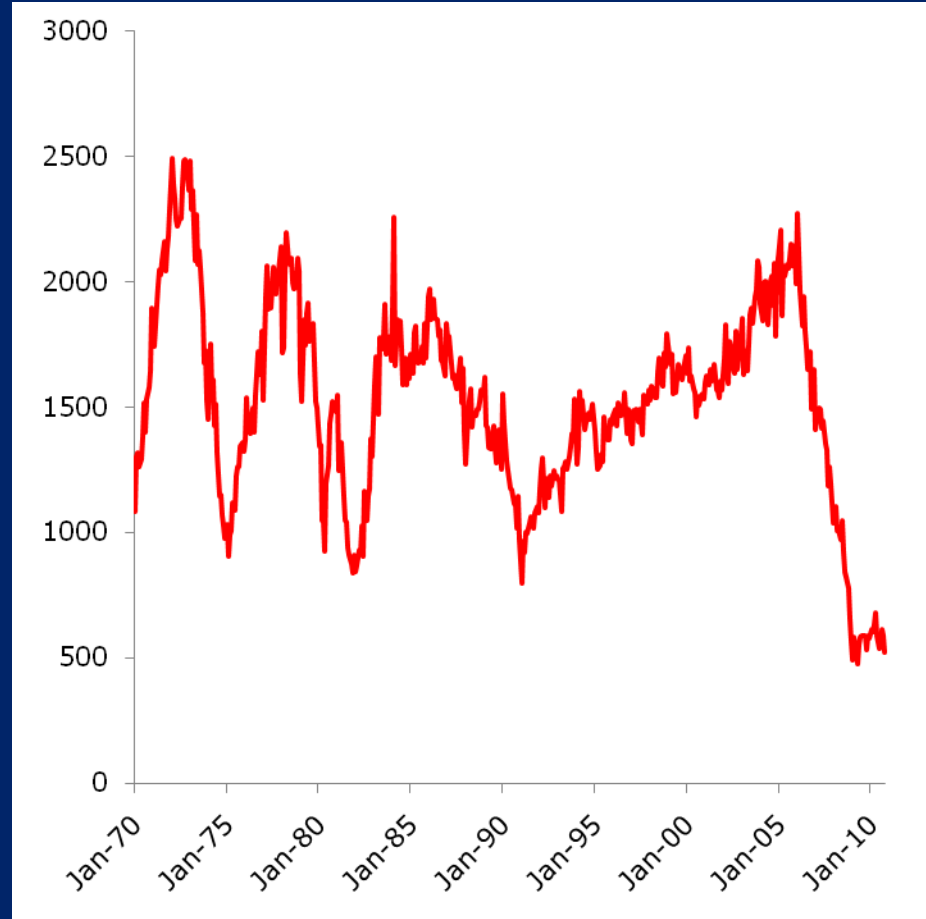
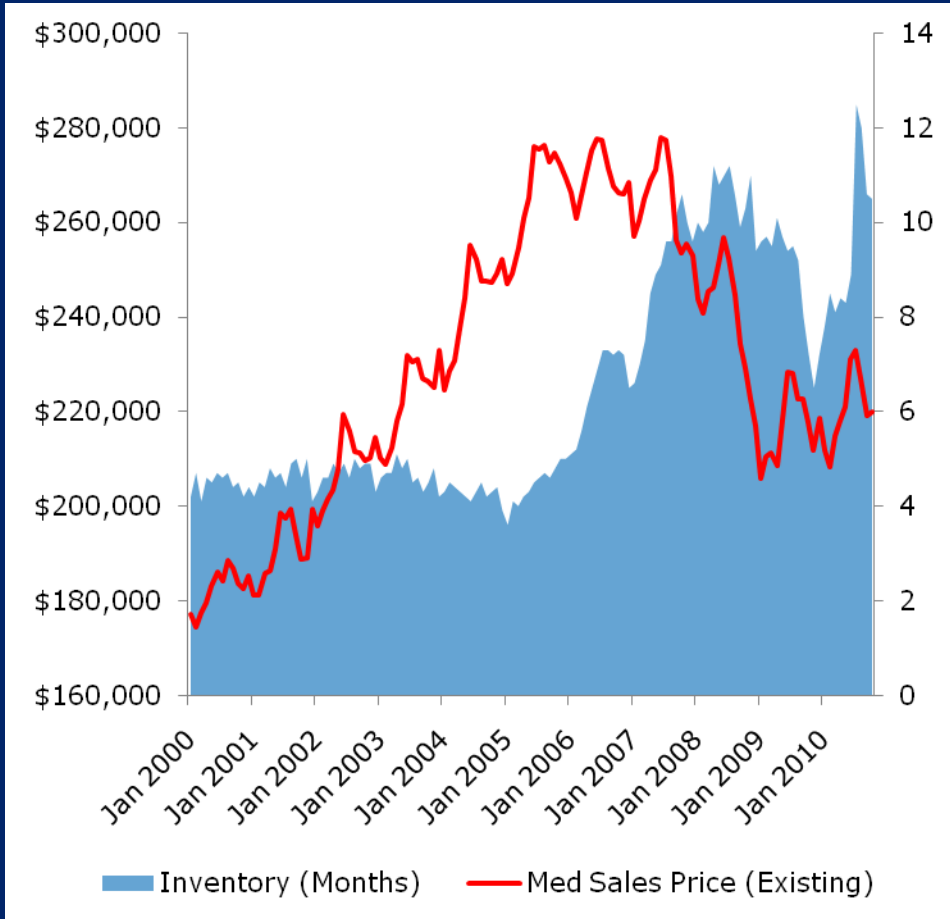


Housing Hangover

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

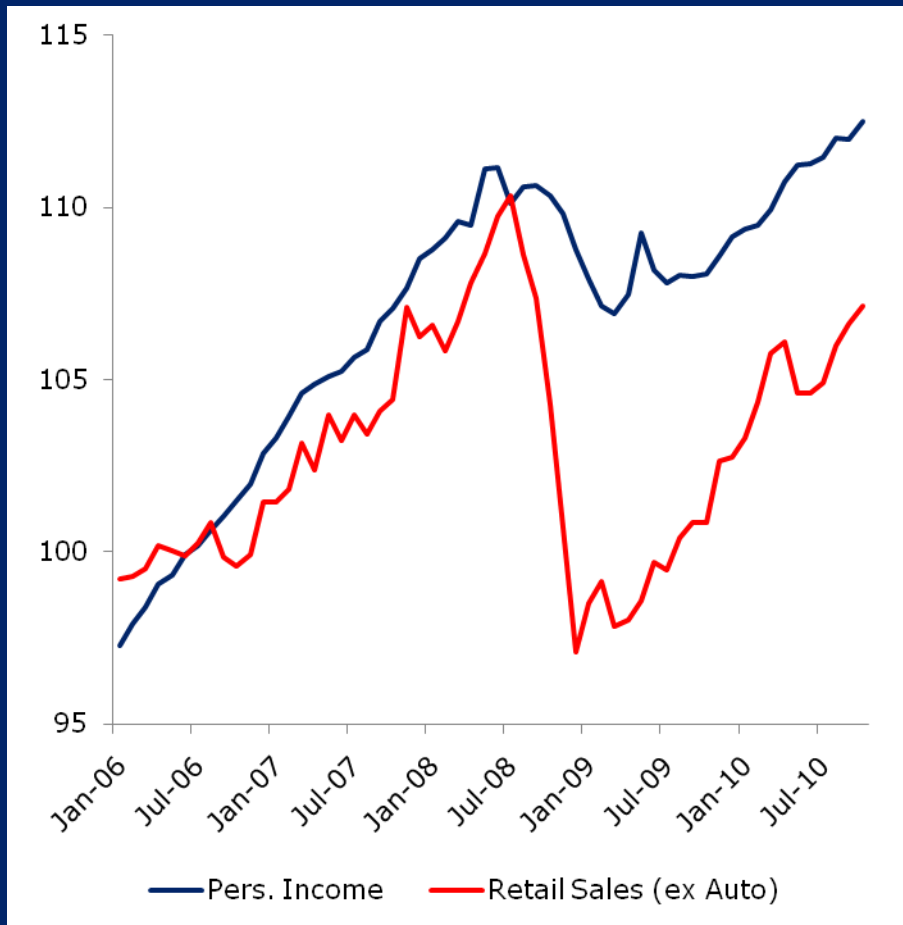
US Housing Starts (1000s SA)



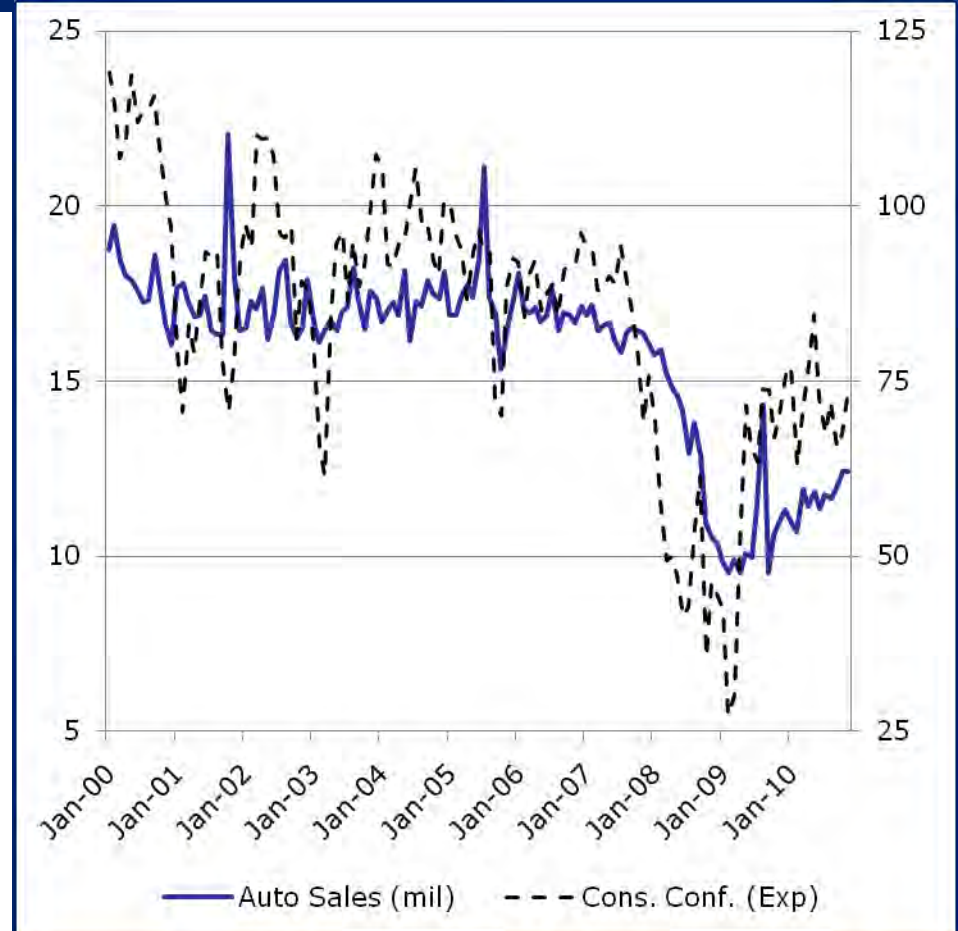
Consumption: A Debt Hangover

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)



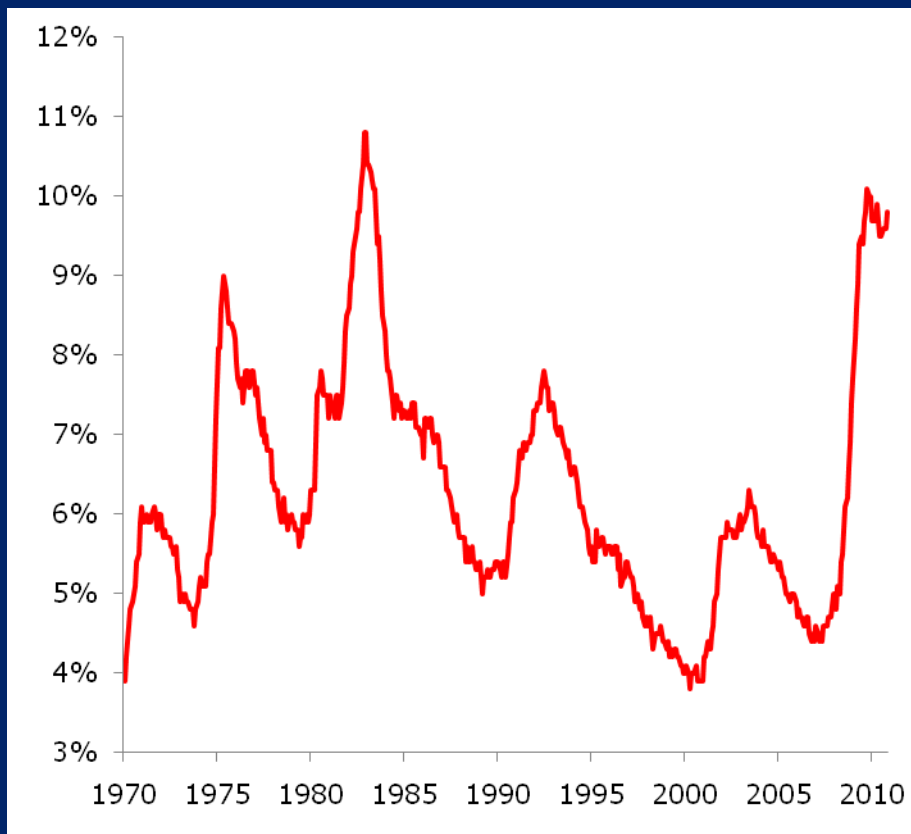
Auto Sales (Mil) & Cons. Confidence



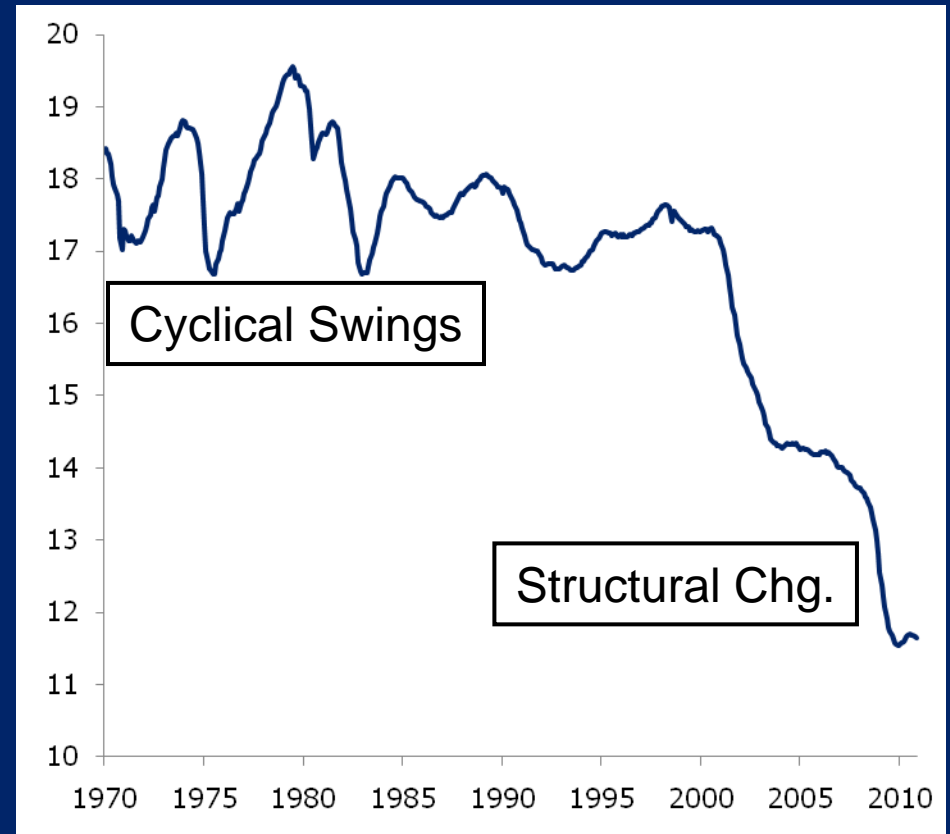
Structural Unemployment... Again

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)

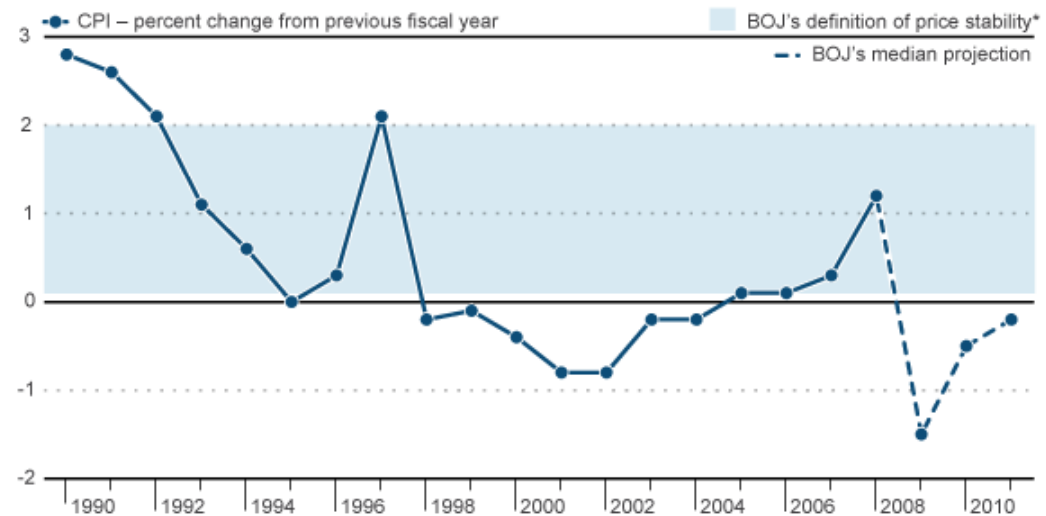


Q3: Inflation or Deflation? Zimbabwe or Japan?



Japan deflation expected to continue

Fall in core core consumer prices is expected to ease but not end in next two years



Note: *The BOJ has said board members define price stability as inflation of two percent or below
Sources: Interior Ministry, BOJ

REUTERS

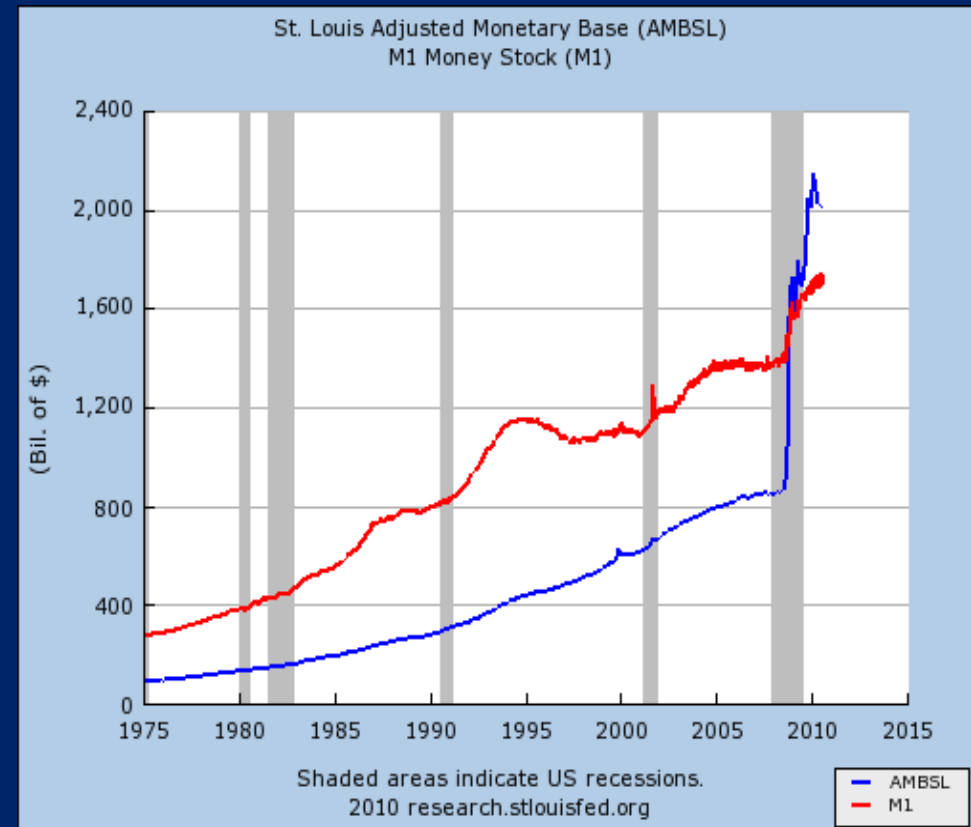
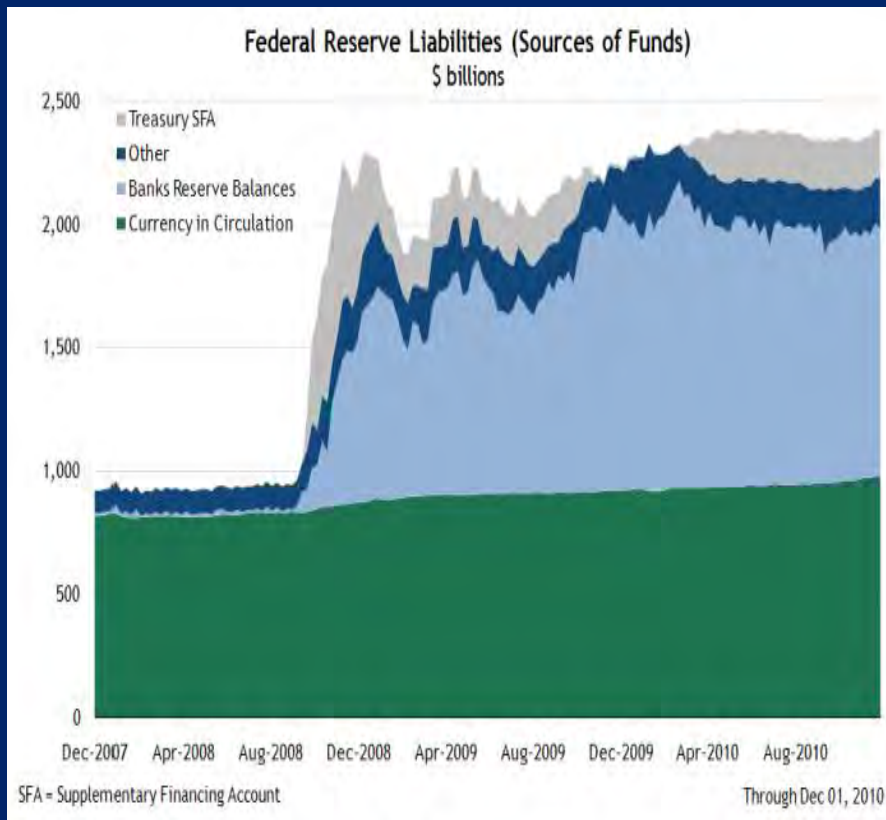
Reuters graphics/Christine Mical

17/02/10

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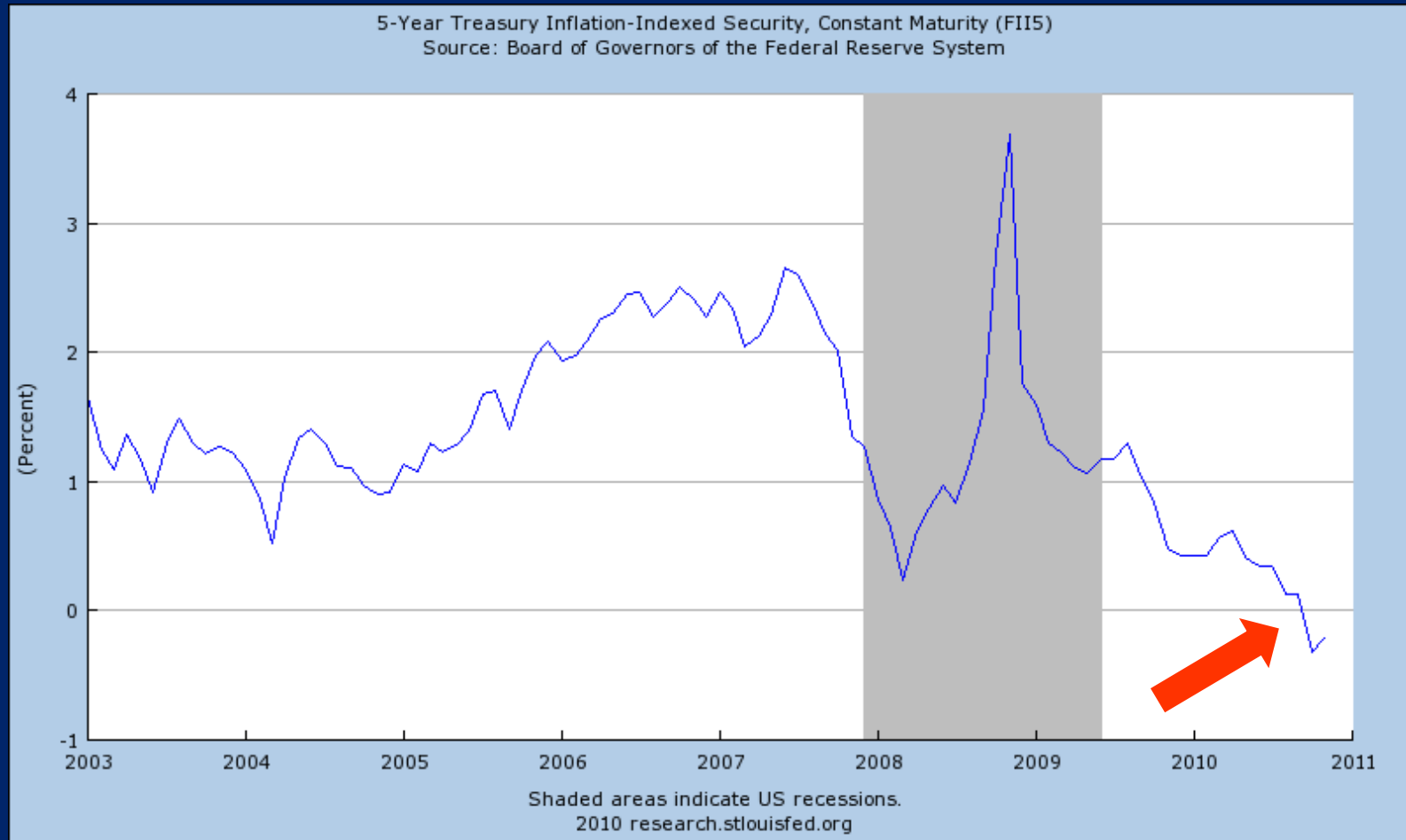
Huge Monetary Expansion = Inflation?

Econ 102: Doubling the money supply will eventually just double prices.
Econ 503: Most of the new money is stuck in interest –paying bank reserves.
Inflation is possible, but far from certain.



Some markets fear inflation...

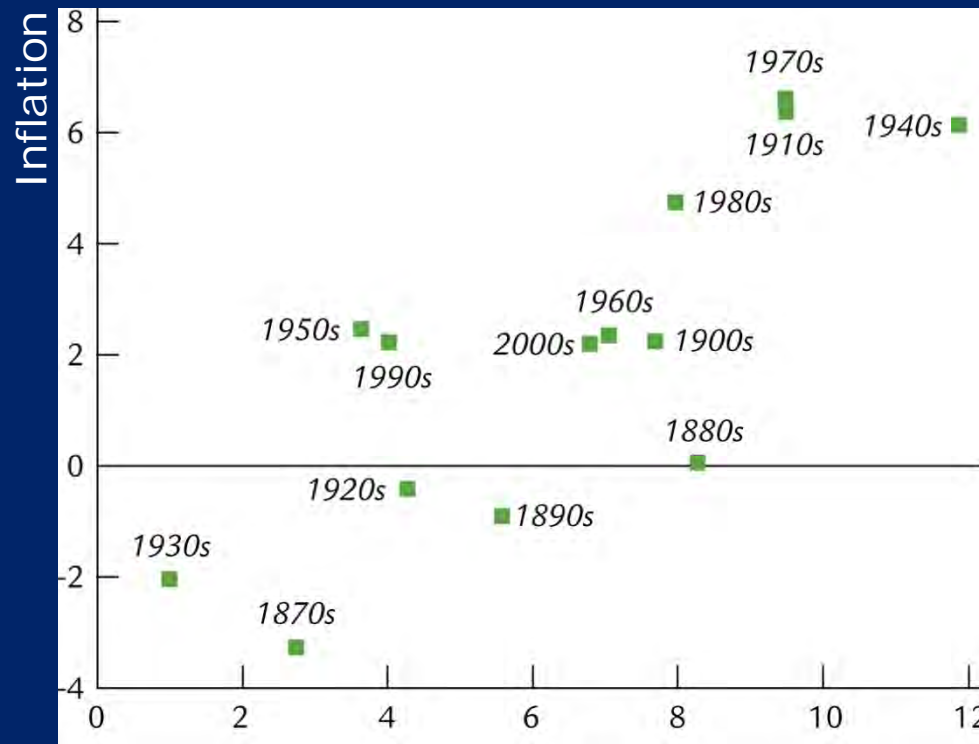
Recently, “inflation protected” 5yr TIPS sold for negative interest rates. Purchasers lose money unless inflation comes in higher than ~2%



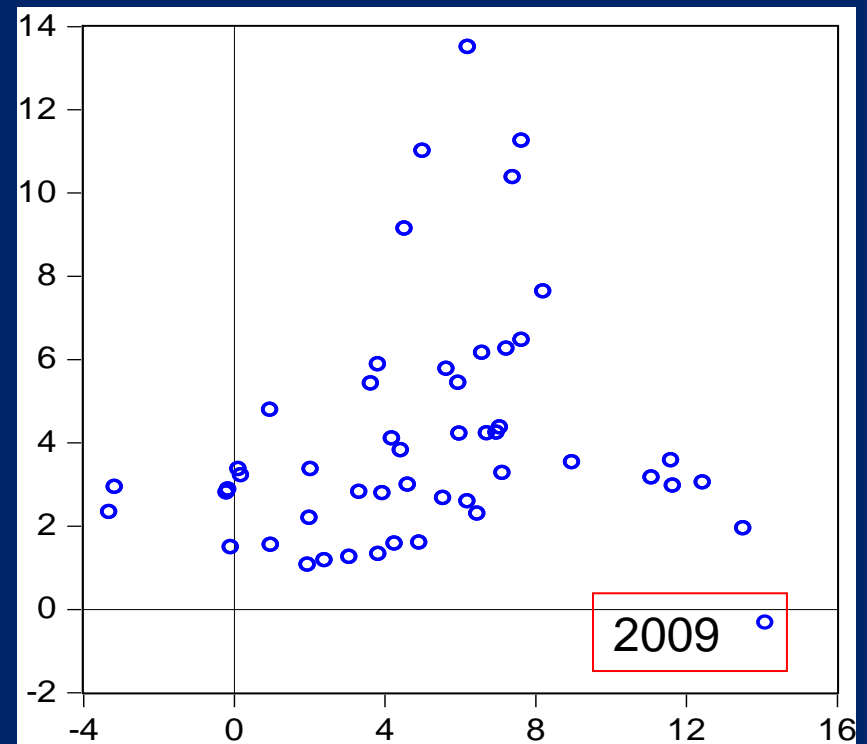
... but the history is complicated...

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)

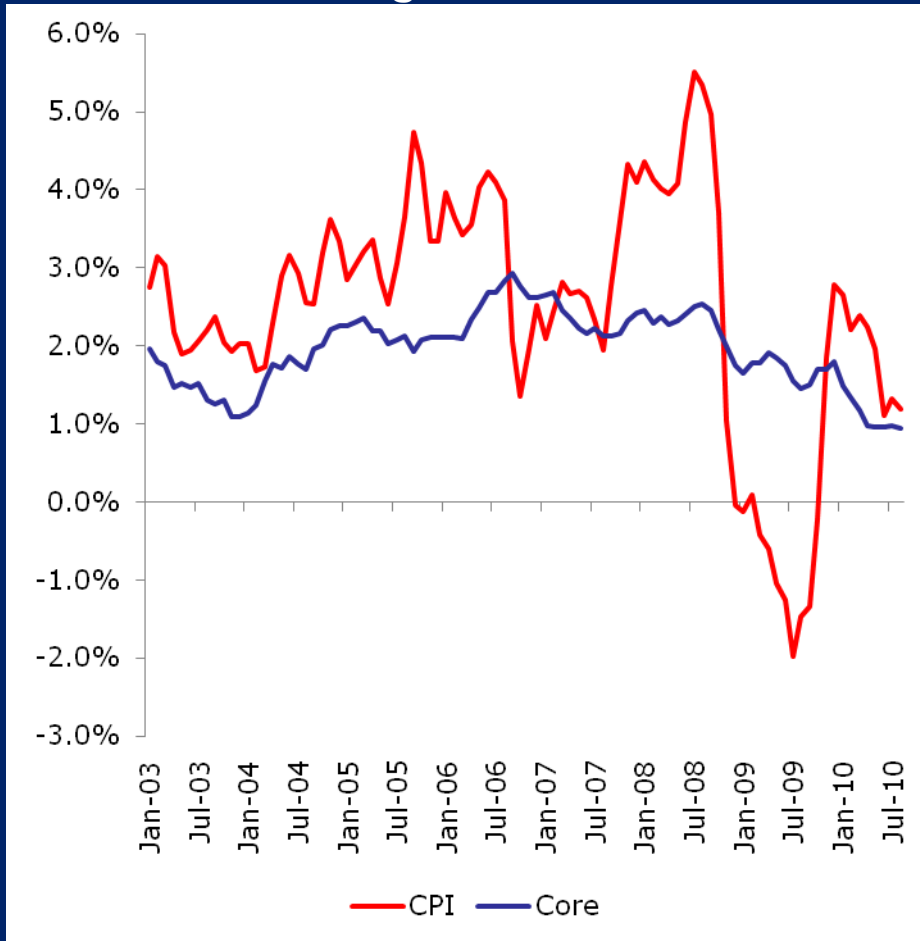


% Chg in Money Supply

... 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

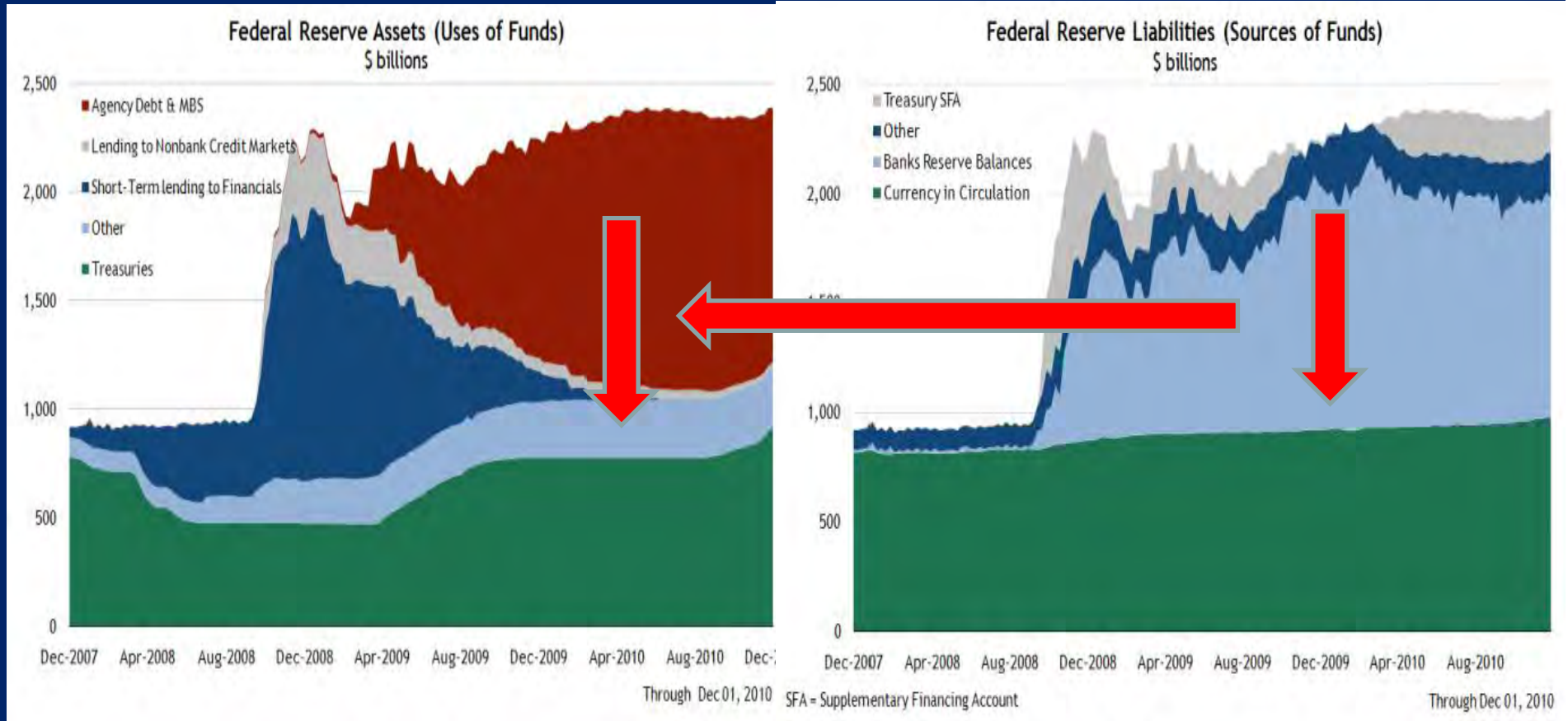


Inflation Expectations from Bond Markets



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

Q1: Was the stimulus a failure?

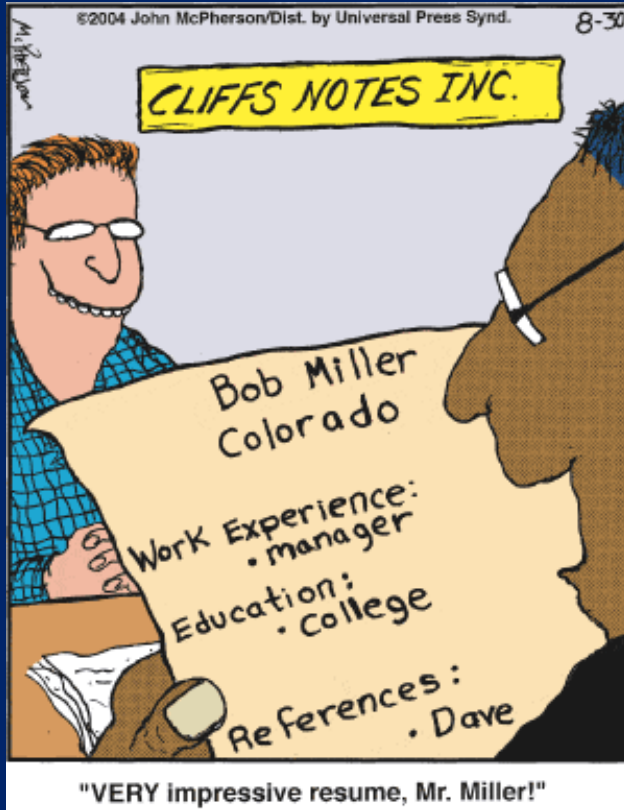
- Recession was far worse than forecast.
- Politics leads to a smaller “low multiplier” stimulus.
- No silver bullet, but things would’ve been worse without it.

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...

