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*, %)

<table>
<thead>
<tr>
<th>Year</th>
<th>No Stimulus</th>
<th>Stimulus (Low)</th>
<th>Stimulus (High)</th>
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<tbody>
<tr>
<td>2007</td>
<td>-8</td>
<td>-7</td>
<td>-6</td>
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<tr>
<td>2008</td>
<td>-5</td>
<td>-4</td>
<td>-3</td>
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<tr>
<td>2009</td>
<td>0</td>
<td>1</td>
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<td>2010</td>
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<td>2011</td>
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<td>2012</td>
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<td>2015</td>
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Est. Impact on Unemployment

-7.5% in ‘09Q2

-6.3% in ‘10Q2

9.5% in ‘09Q3

9.5% in ‘10Q3

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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.

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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?

- 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

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

US Housing Starts (1000s SA)

- The chart shows the trend of US housing starts from 1970 to 2010, with a notable downturn post-2000.

Inventory (Months) vs. Med Sales Price (Existing)
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.
Another structural shift in Mfg. leads to another “jobless recovery.” Combined with reduced mobility from negative home equity, the labor market is stuck.
Q3: Inflation or Deflation? Zimbabwe or Japan?

Japan deflation expected to continue

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

**Graph:**
- CPI: percent change from previous fiscal year
- BOJ’s definition of price stability
- BOJ’s median projection

**Note:** The BOJ has said board members define price stability as inflation of two percent or below.

**Sources:** Interior Ministry, BOJ

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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.*

![Graphs showing Federal Reserve Liabilities and St. Louis Adjusted Monetary Base (AMBSL) vs. M1 Money Stock (M1) from 1975 to 2015.](image-url)
Some markets fear inflation...

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