A Recovery At Risk

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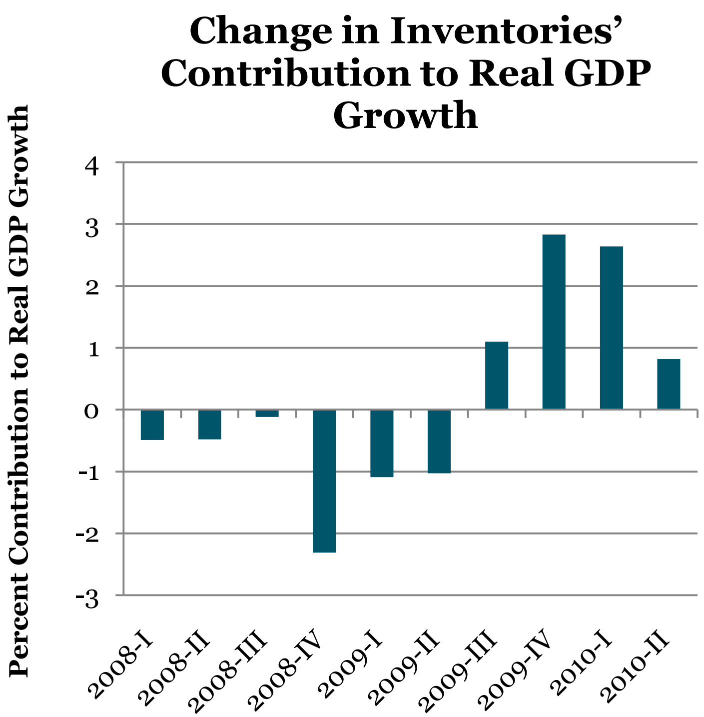
Contents

Drivers of the Recovery: Inventory Rebuild

Inventory restocking contributed significantly to growth in the second half of 2009 and first quarter of 2010.

The inventory rebuild added 1.1%, 2.8%, and 2.6% to GDP growth in Q3 2009, Q4 2009, and Q1 2010, respectively.

The inventory cycle slowed somewhat in the second quarter of 2010, adding 0.8% to growth.



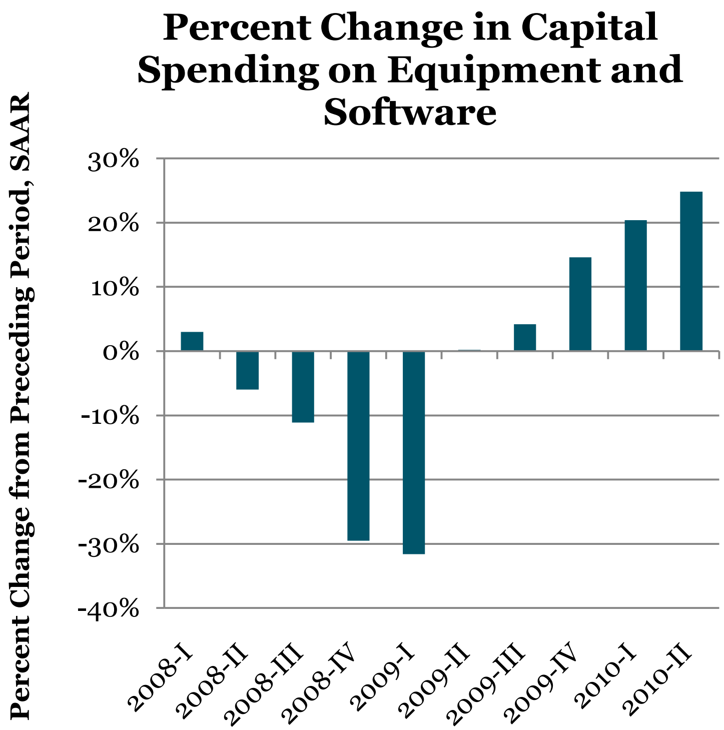
Source: Bureau of Economic Analysis

Drivers of the Recovery: Business Investment

Capital expenditure and industrial production have shown signs of strength over the last three quarters through Q2 2010.

Capital spending on equipment and software expanded 24.8% in Q2 2010.

Industrial production increased 6.2% year-over-year in August, the fastest pace since mid-1997.



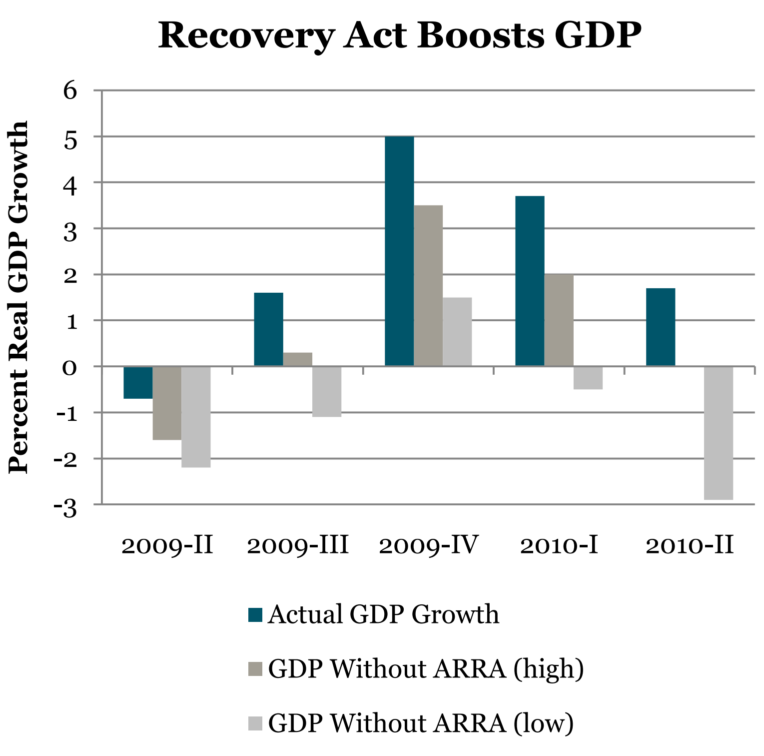
Source: Bureau of Economic Analysis

Drivers of the Recovery: Government Stimulus

Without the Recovery Act, the economy would have contracted nearly every quarter since the beginning of 2009, according to some estimates from the Congressional Budget Office.

The Recovery Act saved or created 2.5 to 3.6 million jobs as of the second quarter of 2010, according to estimates from the Council of Economic Advisors.

As of September 2010, the Recovery Act provided $160 billion for states and localities struggling with budget shortfalls.

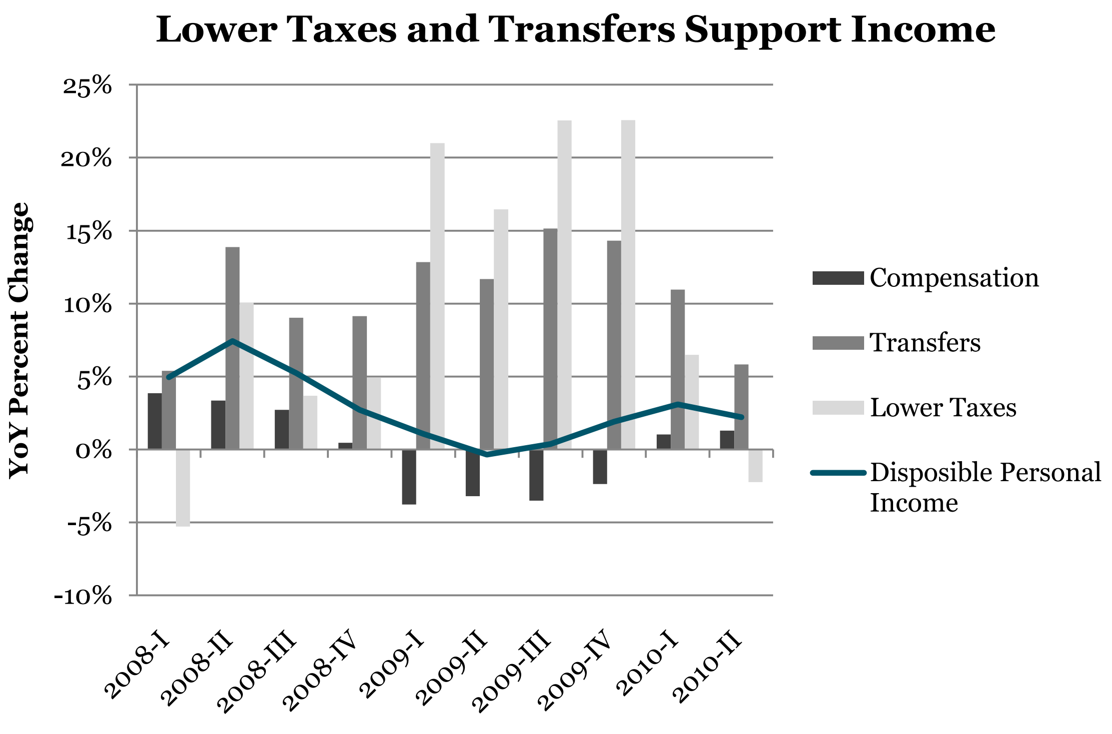


Source: CBO, Council of Economic Advisors

Drivers of the Recovery:
Government Support for Consumers

Government transfers and lower taxes have supported household income, helping to offset weaker compensation.

60% of Recovery Act funds and 65% of all fiscal stimulus has gone to support individuals' incomes through government transfers and tax cuts.



Source: Bureau of Economic Analysis

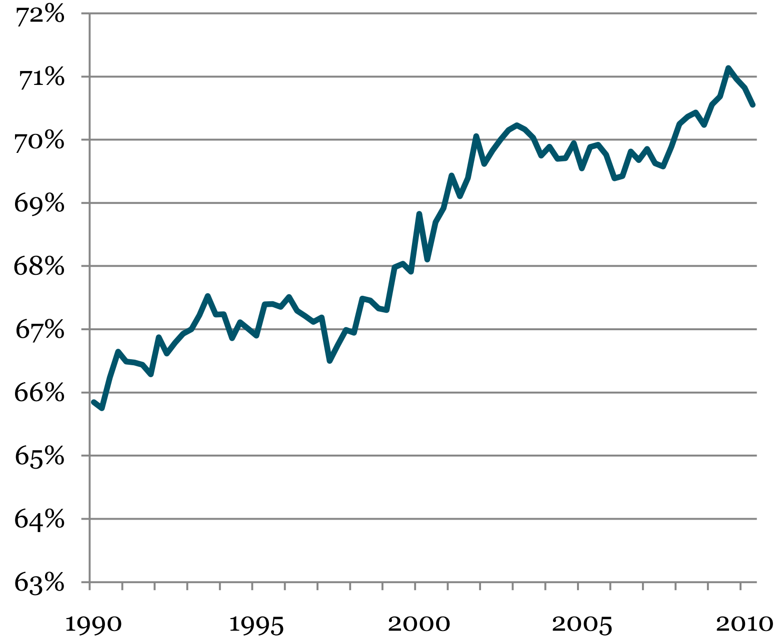
Drivers of the Recovery: Consumption Gains

Tax breaks, rebates, and government transfers supported gains in consumer spending.

In the second quarter of 2010, consumer spending contributed 1.5% to the 1.7% increase in GDP.

Consumption as a percentage of GDP recently increased to an all-time high of 71%.

Consumption as a Percent of GDP



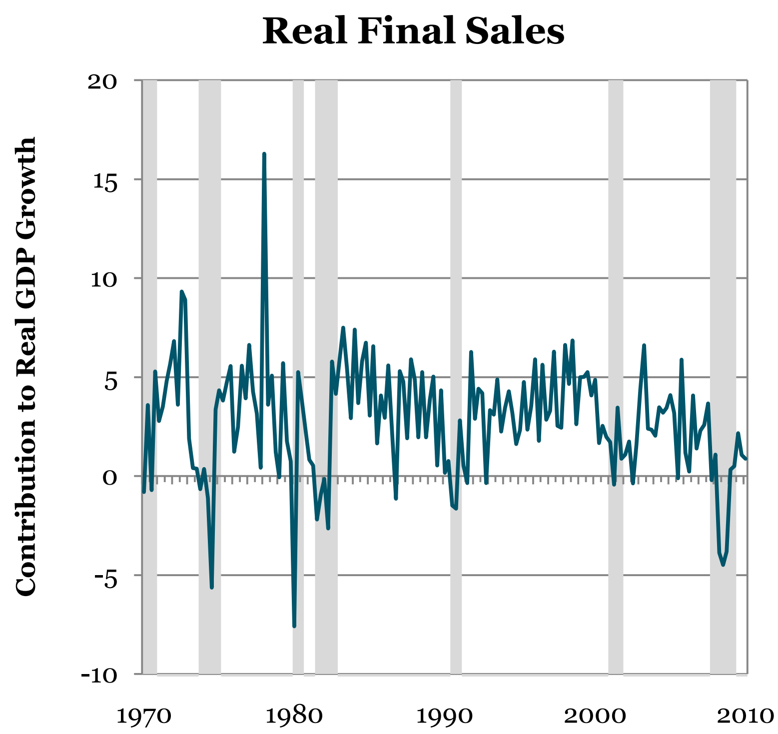
Source: Bureau of Economic Analysis

Growth is Fading:
End of the Inventory Rebuild

Growth from rebuilding inventories are one-off gains if final demand does not materialize.

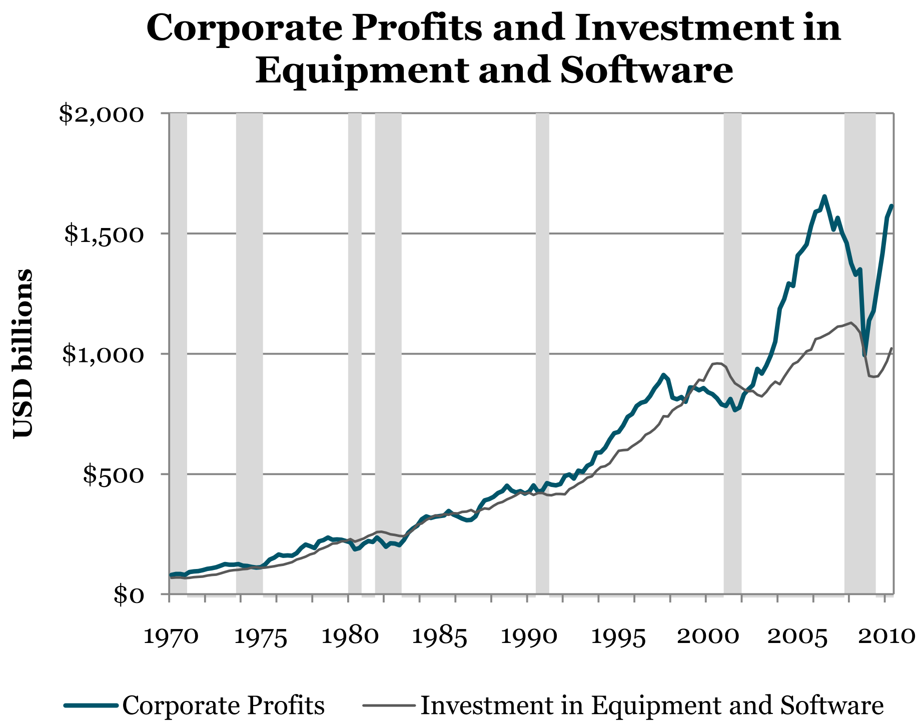
During the past five recessions, real final sales by this point in the recovery averaged 3.5%, but since the end of the Great Recession real final sales have averaged only 1.2%.

Inventories will be a drag on growth in the future if final sales do not pick up.



Source: Bureau of Economic Analysis

Growth is Fading:
Slowing Business Investment



Source: Bureau of Economic Analysis

Business investment has been one of the drivers of the recovery, but it has lagged behind surging corporate profits.

The Purchasing Managers Index (PMI) slowed to 54.4 in September from 56.3 in August, as new orders slipped.

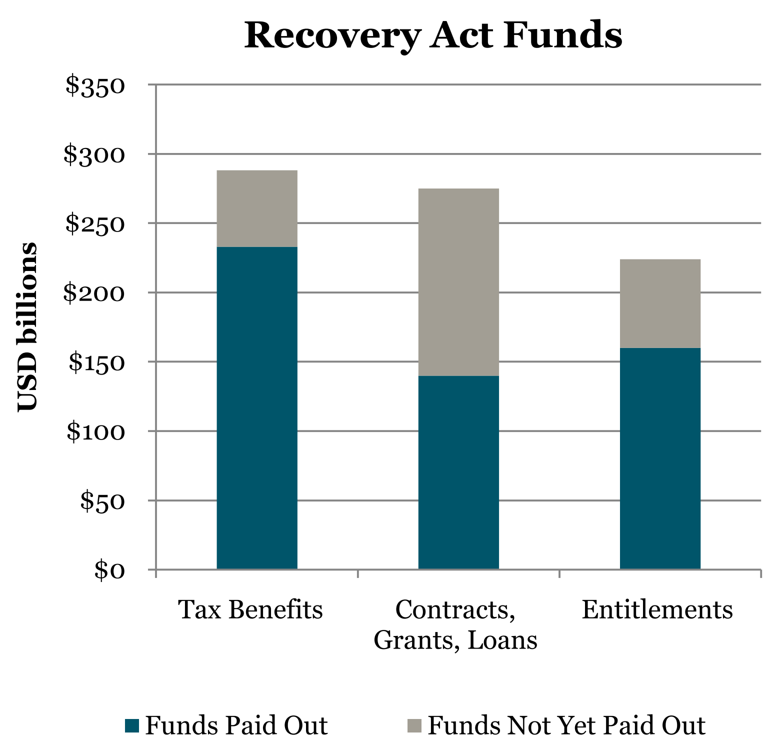
This suggests companies are cautious about the future and may slow investment.

Growth is Fading:
Government Stimulus Declines

The wind-down of the fiscal support from the Recovery Act will soon act as a drag on growth.

Federal stimulus from the Recovery Act is still supporting the economy, but it is declining. This means that it will have a negative impact on GDP growth beginning in late 2010.

Over $545 billion of Recovery Act funds have been paid out, leaving $242 billion of federal fiscal stimulus left for the remainder of 2010 and beyond.



Source: Recovery.gov

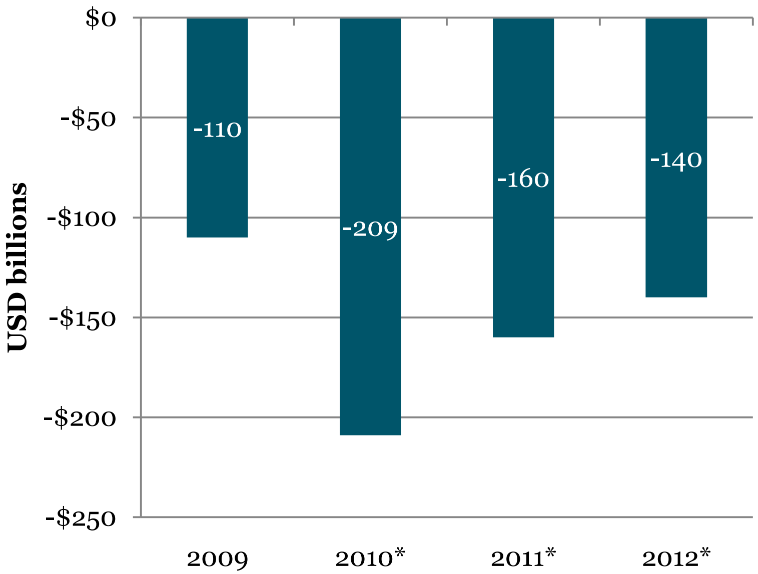
Growth is Fading:
A State Fiscal Crisis Bites

States face budget shortfalls of more than $100 billion for fiscal years 2010, 2011, and 2012.

If these budget gaps lead to further state cuts, they could subtract 0.7% from GDP growth.

Government payrolls declined by 159,000 in September: 77,000 due to departing Census workers and 76,000 due to declining local government payrolls.

Projected State Budget Shortfalls



* Estimates
Source: Center for Budget and Policy Priorities

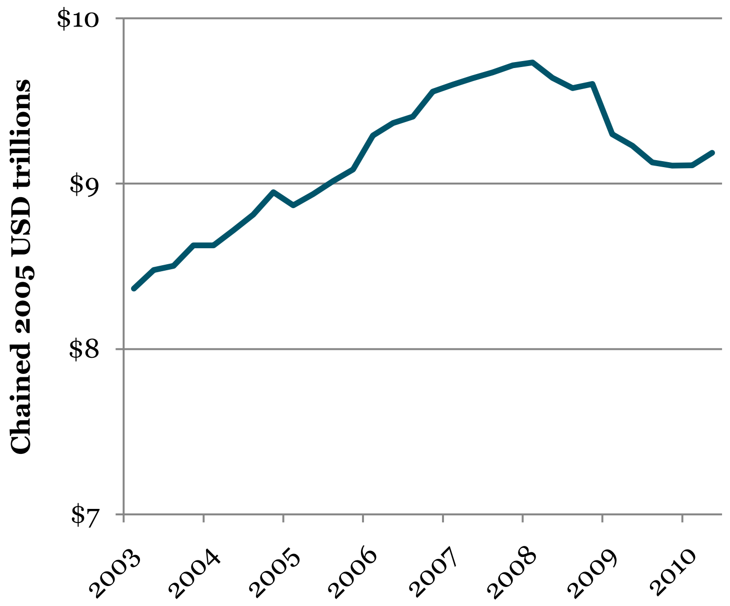
Growth is Fading:
Eroding Government Income Support

Consumer spending has been supported not by rising wages, but primarily by government transfer payments and tax cuts.

Transfer payments now make up nearly a fifth (18.3%) of personal income.

Excluding transfer payments, real personal income is at the same level as during the first quarter of 2006.

Personal Income Excluding Income Transfers



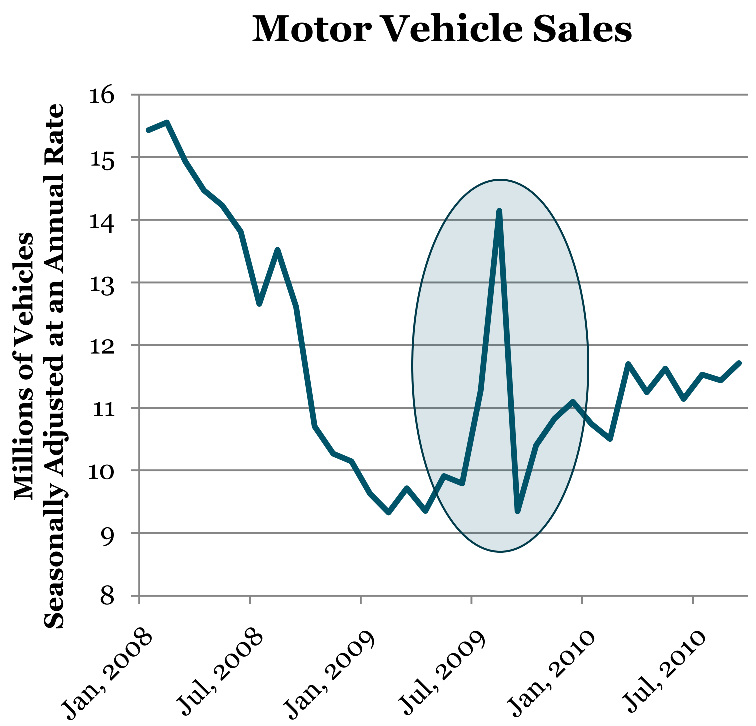
Source: Bureau of Economic Analysis

Growth is Fading:
Consumer Rebates Borrow Demand

Government rebates merely borrowed demand from the future.

With the end of "cash for clunkers," auto sales fell and with the end of the homebuyer tax credit, housing prices softened.

After "cash for clunkers," auto sales plummeted from an annual rate of 14.15 million vehicles in August 2009 to 9.35 million vehicles one month later.



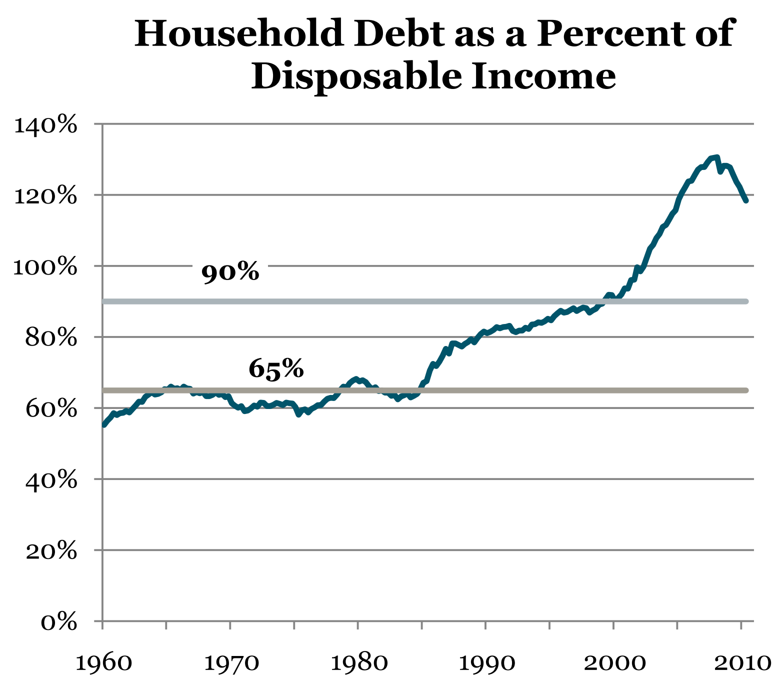
Source: Bureau of Economic Analysis

Continuing Headwinds: Household Deleveraging

Households have just begun the long process of deleveraging, or paying down debt.

In order to return to the debt-to-income level in 2000 (90%), households would have to cut $3.2 trillion of debt.

To reach the debt-to-income from 1960-1985 (65%), households would have to cut $6.1 trillion of debt.



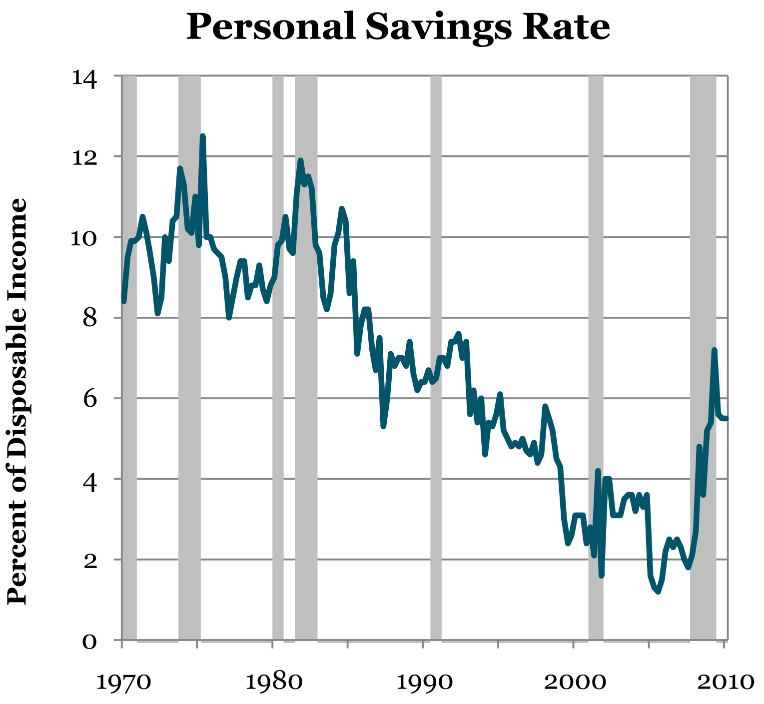
Source: Federal Reserve, Bureau of Economic Analysis

Continuing Headwinds:
Deleveraging Means More Savings

Saving more is necessary to repair household balance sheets, but higher savings will constrain growth and will make companies hesitant to invest.

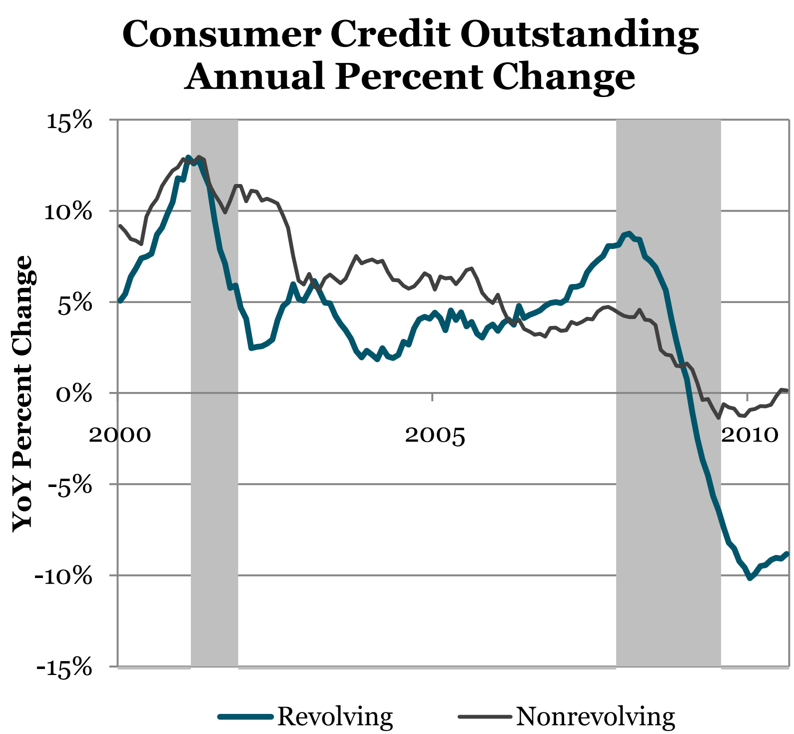
If the savings rate in 2011 increased to the 1929-2009 average (7.4%), it would subtract $180 billion from consumer spending, or 1.3% of projected 2011 GDP.

With a 10% savings rate, consumer spending would be $470 billion lower.



Source: Bureau of Economic Analysis

Continuing Headwinds:
Credit Continues to Contract



Source: Federal Reserve

Consumer credit has fallen steadily since 2008.

Consumer credit fell $3.3 billion in August, and is down $168 billion from its peak in July 2008.

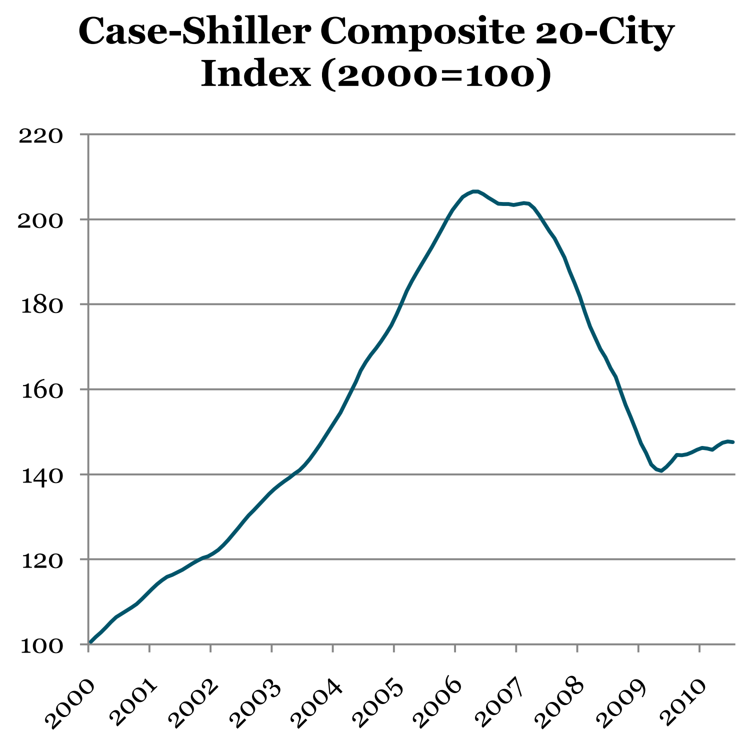
Many small businesses rely on consumer credit, such as credit cards, to finance their daily operations.

Continuing Headwinds:
A Housing Collapse

The housing market, after considerable support from the homebuyer tax credit and the Fed's purchase of mortgage-backed securities (MBS), is showing weakness.

The shadow inventory of unsold homes continues to grow as banks are finally forced to put houses back onto the market at lower prices.

Indices of home prices are declining again, suggesting that the inventory overhang is beginning to depress prices.



Source: Standard and Poor's

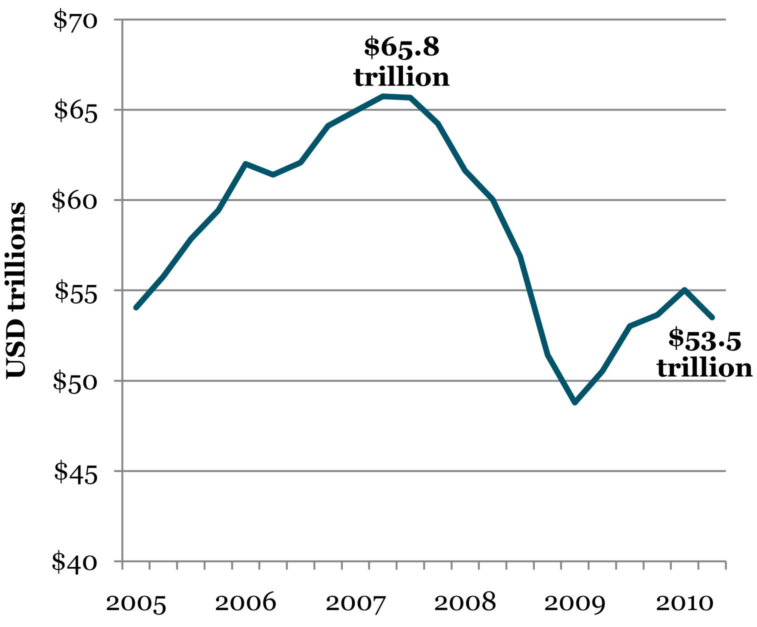
Continuing Headwinds:
Declining Household Wealth

From the second quarter of 2007 to the second quarter of 2010, household net worth fell by $12.3 trillion.

Since the first quarter of 2006, household equity in real estate declined from $13.5 trillion to $7.0 trillion, a 48% decline.

From the first to the second quarter of 2010, household assets held in corporate equities and pension fund reserves declined by $910 billion and $650 billion, respectively.

Net Worth of Households and Nonprofit Organizations



Source: Federal Reserve

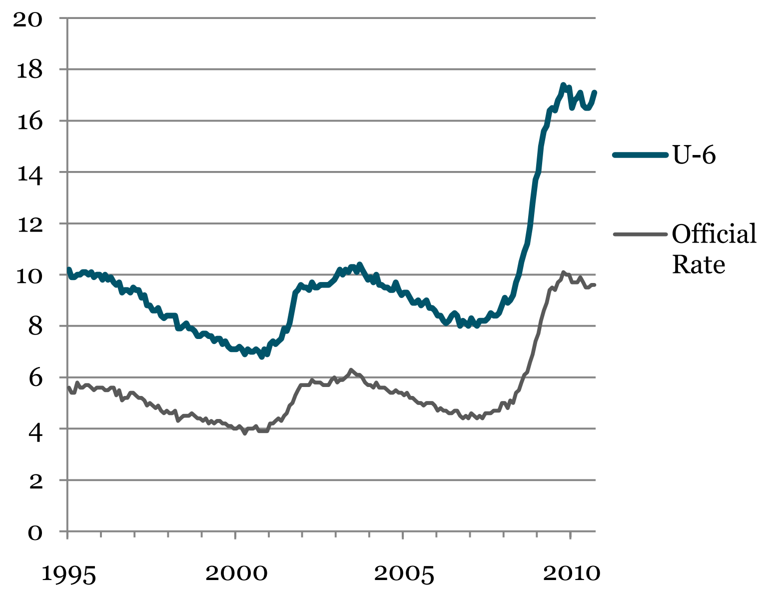
Continuing Headwinds:
High Unemployment

The economy lost 95,000 jobs in September because of large cuts in the government sector and weak private sector job creation.

The official unemployment rate remains excessively high at 9.6%, while the unofficial rate, which includes discouraged workers and "involuntary part-time workers," climbed in September to 17.1%.

More than 25 million Americans are still underemployed or unemployed.

Official Unemployment Rate and Broader Measure of Unemployment (U-6)



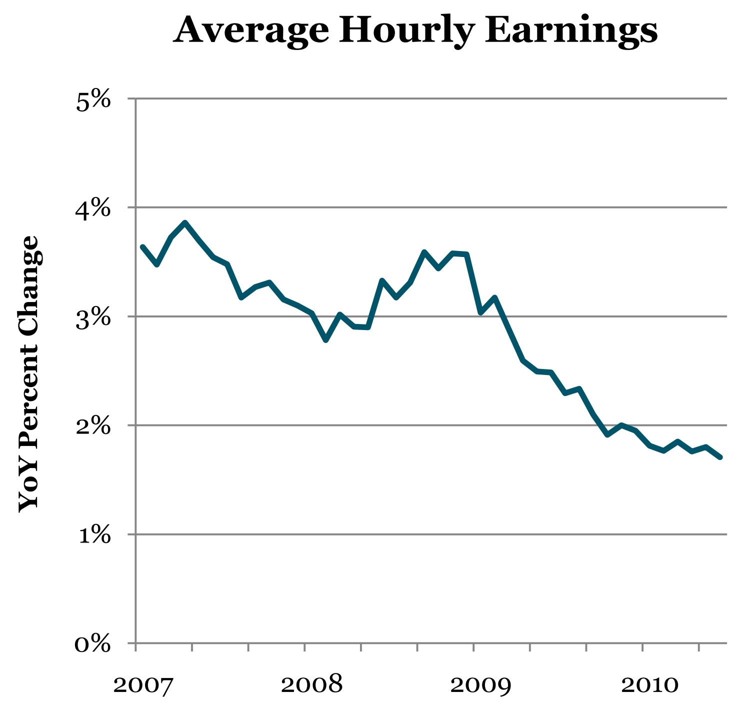
Source: Bureau of Labor Statistics

Continuing Headwinds: Wage Stagnation

Corporate profits have rebounded but job growth and wage gains remain anemic, in part because of continued productivity growth and the ability of companies to outsource production.

Nominal wage growth has grown only 1.7% from September 2009 to September 2010.

Weak wage growth means a slower pace of deleveraging and less-than-healthy consumer demand.



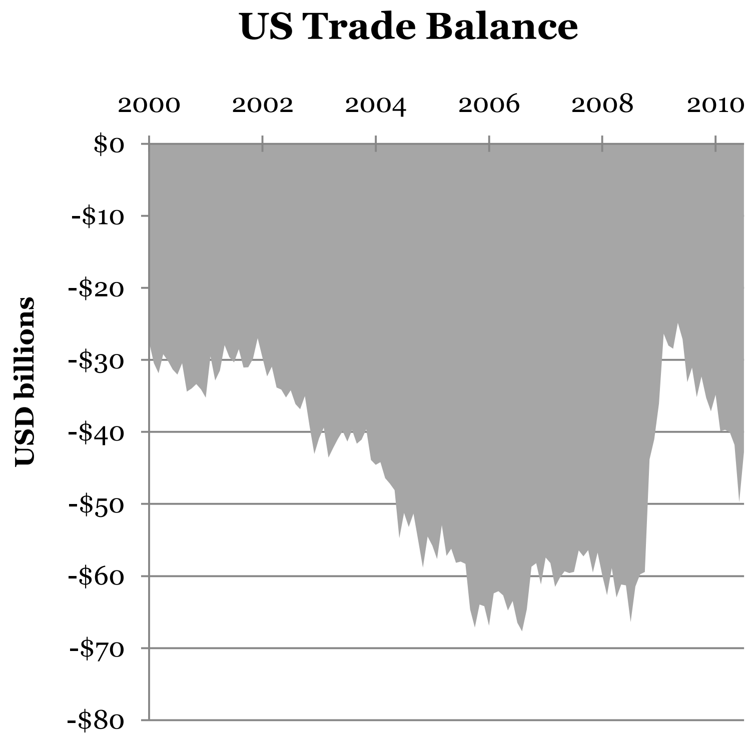
Source: Bureau of Labor Statistics

Continuing Headwinds:
Widening Trade Deficit

A healthy economic recovery would benefit from rising net exports.

But, net exports subtracted 3.4% from GDP growth in the second quarter of 2010.

The trade deficit was $42.8 billion in July and has risen dramatically since 2009, due to relative dollar strength and weakness among America's largest trading partners.



Source: US Census Bureau

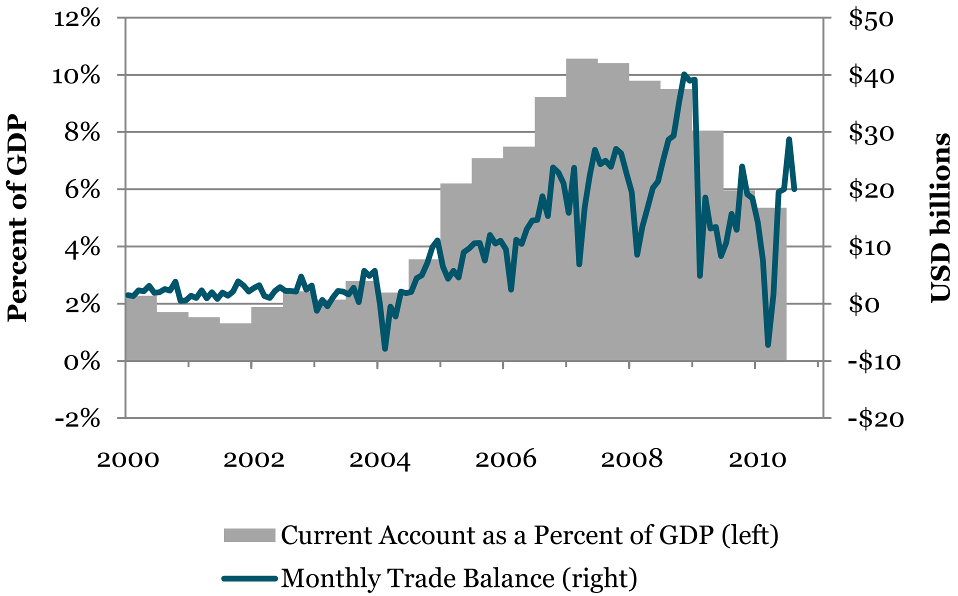
Continuing Headwinds:
Overcapacity and Devaluations

Because of global overcapacity and a large western debt overhang, deflationary pressures continue.

To compensate for weak global demand, economies are engaging in competitive devaluations and resorting to export-oriented growth.

In this environment, it will be impossible for the United States to export its way to a sustainable recovery.

China: Current Account Balance and Monthly Trade Balance



Source: State Administration of Foreign Exchange, The People's Bank of China, National Bureau of Statistics, New America Foundation

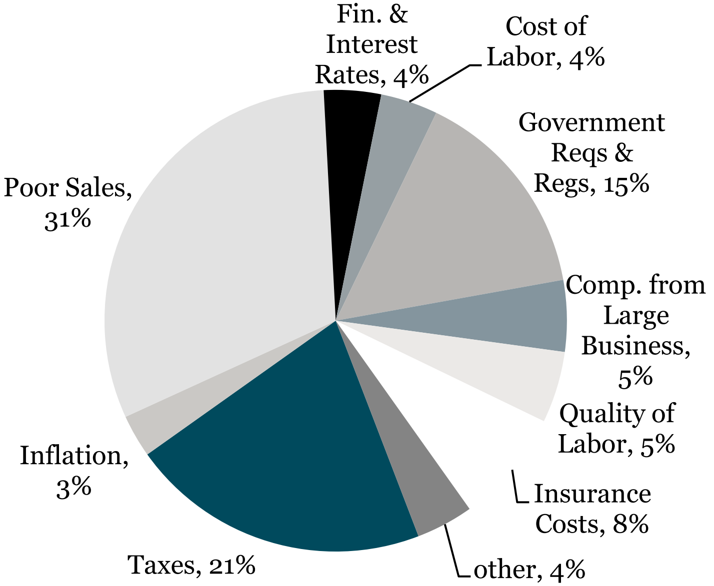
Continuing Headwinds:
Policy and Business Uncertainty

Uncertainty over taxes and government regulation is deterring business investment and job creation.

Fading government support and questions about the effectiveness of monetary policy are leading to new doubts about the adequacy of demand.

Corporate profits have been boosted primarily by cost-cutting measures, but may suffer if growth slows and taxes and other costs of doing business increase.

Single Most Important Problem for Small Businesses



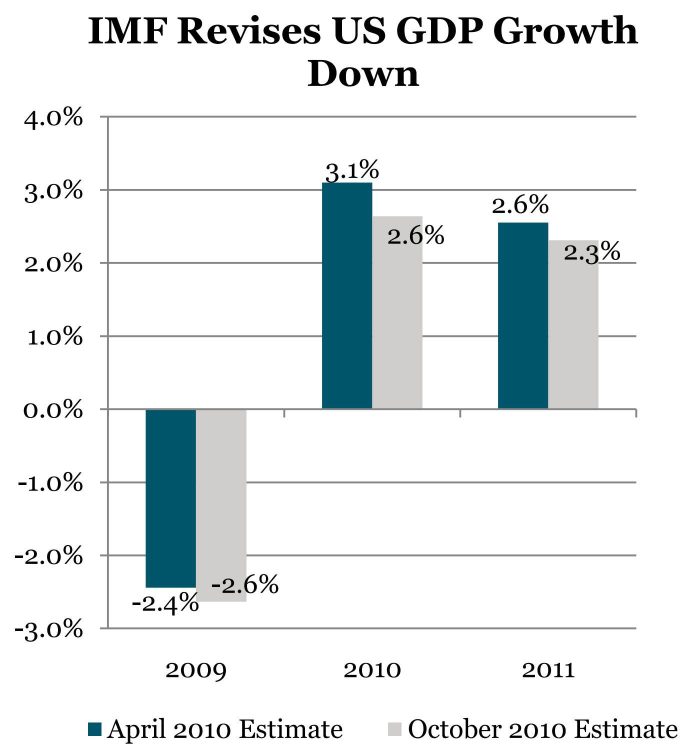
Source: National Federation of Independent Businesses

Policy Implications:
A Bleaker Outlook

The International Monetary Fund recently estimated that the United States contracted more in 2009 and will grow more slowly in 2010 and 2011 than previously forecast.

The National Association of Business Economists revised down their 2010 GDP forecast from 3.2% in May 2010 to 2.6% currently.

Given the continuing headwinds, forecasts may need to be revised down more in the future.



Source: International Monetary Fund

Policy Implications: Policy Produced an Unsustainable Recovery

Monetary reflation	→	Asset reflation, financial sector profits, and the return of global trade imbalances
Tax cuts, "cash for clunkers," and unemployment insurance	→	(Temporary) support of consumer spending
Modest infrastructure and public works spending	→	Weak job creation and stagnant wages

Policy Implications: Conclusions

1. Policy has not put the economy on a sustainable path of private-sector led growth. More government support will be needed for an indefinite period as households continue to delever.

2. Monetary policy—i.e. quantitative easing—alone will not work and may only add to hard asset inflation. To work, quantitative easing must be accompanied by a robust fiscal policy.

3. Fiscal policy over the past two years relied too heavily on tax cuts and other measures to shore up consumption and general demand. It was relatively ineffective in creating jobs because much of the demand leaked out of the economy.

4. Fiscal policy must now target public investment and job creation. Long-term investments in infrastructure and human capital have a healthy multiplier and job-creation effect in the short term and high returns to the economy in the long term.

5. The United States must re-establish its global economic leadership by offering ideas to expand global demand—e.g., a new issuance of SDRs to support public investment—so as to reverse the trend toward competitive devaluations and other beggar-thy-neighbor export policies.