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U.S. Macro Outlook: Less Than Graceful

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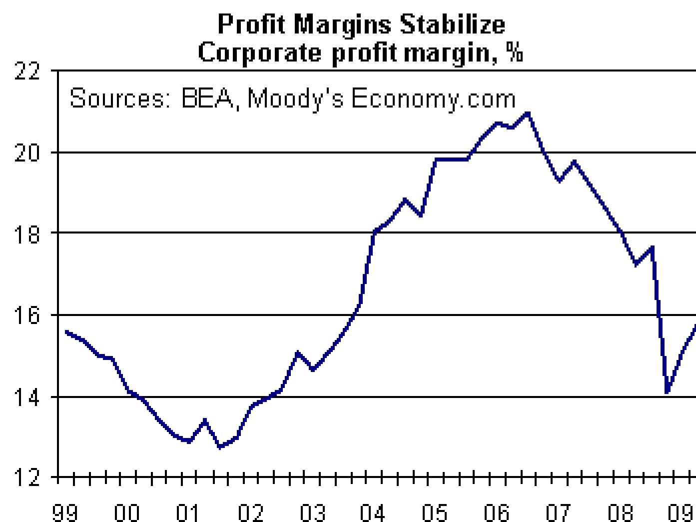
- A recovery has begun, but the transition to a self-sustaining expansion will be less than graceful.
- Without more hiring, household income will not support spending growth.
- After the trauma of last year's financial panic, businesses need time to grow confident about expanding.
- Policymakers must remain aggressive to keep the economy from falling back into recession.

The sturdy 3.5% annualized gain in real GDP during the third quarter proves that the recession ended this summer and recovery has begun. Advances were broad across consumer spending, homebuilding, business investment in equipment and software, exports, and federal government spending.

The GDP growth was mostly, if not entirely, fueled by monetary and fiscal support from the federal government. While the financial system is still not operating normally—hundreds of small banks are failing, and the structured finance market is dysfunctional—rock-bottom interest rates have stabilized the system. Cash for clunkers, tax cuts, and aid to unemployed workers drove consumer spending, and the tax credit for first-time homebuyers supported gains in homebuilding. Bonus depreciation probably boosted business investment. State and local government spending declined but clearly would have fallen much further if not for the massive federal aid provided with the fiscal stimulus.

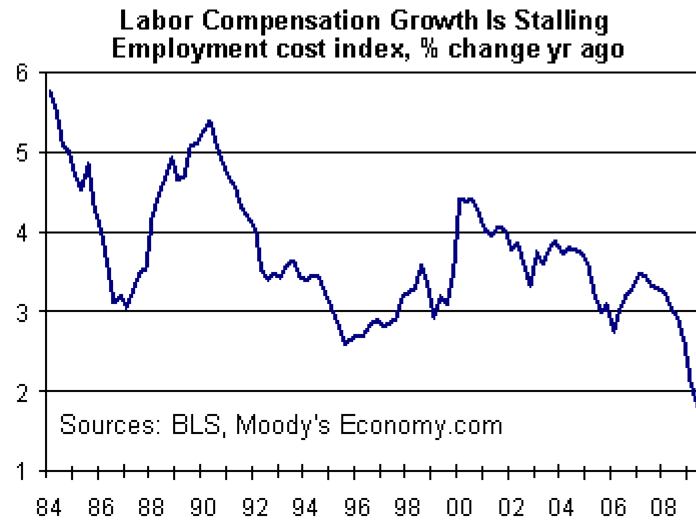
Recovery to expansion

GDP appears to be on track to rise nearly 3% again in the current quarter. Government support continues to be the principal impetus for growth, but businesses are doing the things that in past cycles have set the stage for private-sector growth. Companies have dramatically slashed expenses—as shown by plunging unit labor costs—and stabilized their profit margins. Big companies in particular are seeing meaningful profit growth, a benefit of the softer dollar and stronger global economy. Stock prices have risen appreciably in response.

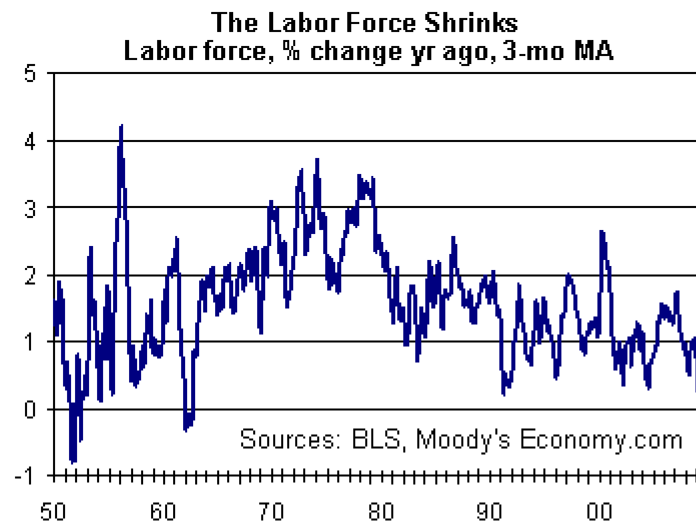


For the recovery to become self-sustaining, firms must respond to improved profitability by expanding, but there is no sign of this yet. Hiring remains dormant, and while layoffs have slowed, they remain stubbornly high. Without a pickup in hiring, the job market will not improve enough to generate the income households need to support spending growth, and the recovery will flag.

Adding urgency to the need for more hiring is the impact of underutilized labor on compensation growth. The unemployment rate reached double digits even as the overall labor force shrank, a rare, though not unprecedented, development. Workers are so discouraged by the poor job market that they have stopped looking for work, and thus are not counted as unemployed. Some may be waiting for the market to turn up, living in the meantime on severance income from previous jobs or on unemployment insurance. But this cannot go on forever, and once these workers re-enter the job market the unemployment rate will rise further.



With so many unemployed and underemployed workers, growth in labor compensation is weak and growing weaker. The broadest measure of wages and benefits—the employment cost index—rose only 1.5% annualized in the third quarter. The historical relationship between these two factors suggests that at a jobless rate of 11%, compensation growth will stall; if unemployment rises to 12%, compensation could fall. Real, after-inflation compensation growth has fallen in other recessions, but nominal compensation growth has always managed to stay positive. A drop in nominal compensation would set off a virulent deflationary cycle and renew the recession.

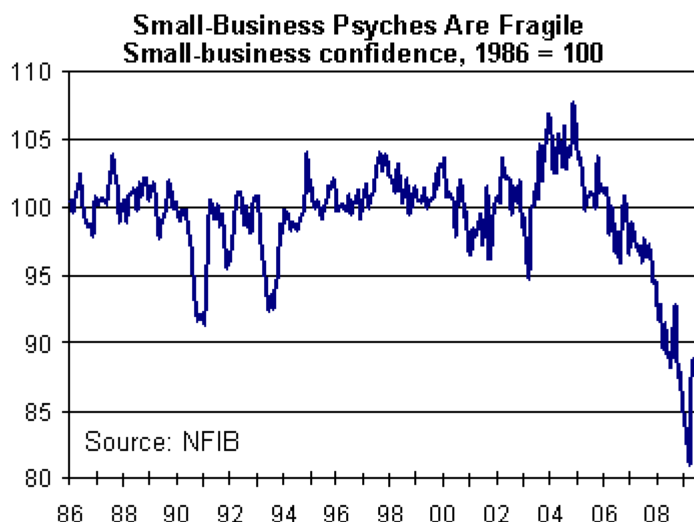


It is possible that firms will resume hiring soon. Employment growth historically lags a pickup in GDP by several quarters coming out of recessions. An increase in temporary jobs in October was a positive sign that more full-time hiring may be coming. Yet other leading job market indicators are less encouraging. For example, the number of hours worked per week remains stuck at a record low, and the number of people working part time because they cannot find full-time jobs is rising. Businesses are sure to increase hours for existing workers before hiring more.

A longer lag this time

Given what businesses have been through, the lag between GDP growth and job creation could take longer in this cycle. Many firms suffered near-death experiences during the financial panic last year, when credit dried up until the

Federal Reserve came to the rescue. Such an episode is not easily forgotten. It could thus take more time before businesses feel confident to resume hiring and investing again.



Credit remains a problem, particularly for the smaller businesses that are vital to job creation. Establishments with fewer than 20 employees account for 25 percent of all jobs, but they generated 40% of the growth in the last economic expansion. Small banks, which are the principal lenders to small business, face intense pressure as hundreds are set to be taken over by the FDIC. Credit card lenders, another key source of small-business capital, have aggressively raised their underwriting standards.

If it is a matter of confidence and credit, continued aggressive monetary and fiscal stimulus will help. Through continued low interest rates, more temporary tax cuts and spending increases, policymakers should be able to support conditions long enough to shore up business confidence and break the credit logjam. Businesses will eventually get their groove back; policymakers just need to buy time.

Expansion in 2011

While the recession is over and a recovery has begun, the recovery will remain fragile and tentative through this time next year. Not until 2011 will a self-sustaining expansion kick in.

Real GDP is projected to grow just under 3% annualized during the second half of this year, but no more than 2% during all of 2010. The economy's potential long-run growth rate is currently estimated at 2.75%; this implies unemployment will rise through at least next summer. The unemployment rate is expected to peak at 10.7% in the third quarter of 2010.

While the outlook for GDP growth has not changed appreciably for some time—the current forecast is not much different than the one produced for January 2009—the outlook for unemployment has deteriorated steadily. The expected peak in joblessness is now more than a percentage point higher than anticipated in January. The reason is that a long-standing historical relationship between GDP and unemployment known as Okun's Law is not working well. GDP fell sharply during the recession, and the recent increase has been modest, but unemployment has risen measurably more than would be expected given the GDP weakness. There are a number of plausible explanations for this, most related to measurement issues or temporary factors. Regardless of the reason, the task of accurately projecting how high and when unemployment will peak has grown especially difficult.

More federal help coming

Policymakers are expected to provide just enough additional support in the coming year to ensure the economy does not slide back into recession. The federal funds rate target will remain effectively zero throughout 2010. Fiscal policymakers are also expected to provide $100 billion more in tax cuts and additional spending (on top of the $787 billion stimulus package passed last February). This includes the $45 billion cost to extend unemployment insurance benefits and expand the homebuyer tax credit, recently signed into law.

The outlook brightens for 2011 and 2012, when GDP growth is expected to accelerate to an annual average around 4%. By then the economy is likely to have worked through most of the current impediments to growth, from the foreclosure crisis and commercial mortgage defaults to budget problems at state and local governments and a dysfunctional structured finance market. By then as well, exports will fill the void left by cautious U.S. consumers in

powering economic growth. Job growth will accelerate enough to lower the unemployment rate, although it will be 2013 at the earliest before the economy returns to full employment.

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