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U.S. Macro Outlook: Slow and Steady Isn't Enough

BY MARK ZANDI — OCTOBER 9, 2012

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- Economic growth remains near a lackluster 2%.
- September's drop in the jobless rate overstates the improvement in the job market, but it is slowly improving.
- The pace of job creation has remained fairly steady at around 150,000 per month since job growth resumed in 2010.
- Hiring remains slow in part because real estate is still depressed but mostly because businesses are uncertain about the future of fiscal policy.
- Growth will pick up late in 2013, assuming policymakers address fiscal issues in a reasonable way.

Notwithstanding the kerfuffle over the unemployment rate’s surprising drop in September, the jobs numbers tell a consistent story: The U.S. economy is growing but not fast enough. Real GDP is increasing at a pace near 2% per year, the economy is creating 150,000 jobs per month, and the jobless rate remains close to 8%.

Conspiracy theories

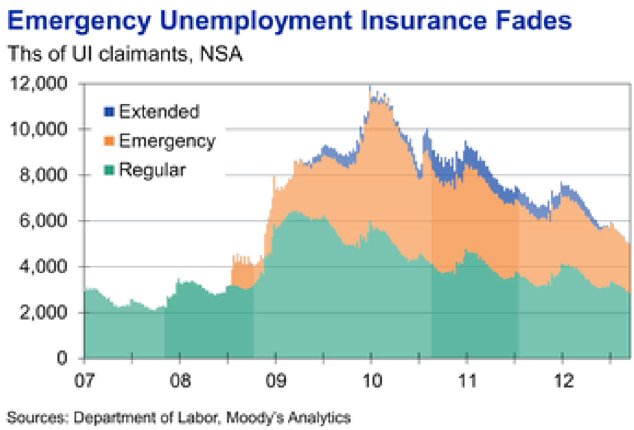
Suggestions that the jobs numbers were doctored for political purposes are silly and counterproductive. The data are constructed by professional economists and statisticians, not by politicians. For prominent people to suggest otherwise undermines the trust in our institutions, which is a key to the nation’s long-term economic growth.

Nevertheless, the measured decline in September unemployment from 8.1% to 7.8% overstates the actual improvement in the job market. The decline was driven by an outsize gain in the household employment survey, which reported more than 800,000 people found jobs during the month. Yet more than 500,000 of these were part-timers who wanted but couldn’t find full-time work.

Similar increases in part-time employment were reported in September 2011 and September 2010, but those didn’t make headlines because they were partially washed out by employment declines elsewhere. In those earlier years, moreover, the count of part-timers fell significantly in October. If the same thing occurs next month, the unemployment rate will rise.

UI benefits wind down

Having said this, it could also be that part-time employment has indeed increased somewhat, lowering the jobless rate as the emergency unemployment insurance program winds down. Extended benefits for the long-term unemployed have already been phased out, and the bar for qualifying for emergency benefits has been raised. The number of long-term jobless workers in these programs has thus fallen by almost 900,000 during the past four months. It is reasonable to think that many would take part-time jobs because they couldn’t find full-time positions. Indeed, the preponderance of studies indicate that emergency UI lifted the unemployment rate by 0.5 percentage point. As the program ends, unemployment is set to fall by this amount.



Looking past the monthly data fluctuations, the job market has produced a surprisingly steady 150,000 jobs per month since early 2010. While in more normal times this would be considered healthy—enough to reduce unemployment slowly—it is not good enough when unemployment is high and millions are suffering.

The key impediment to faster job creation is not layoffs, which are at record lows, but slow hiring. Employers appear happy with their existing workforces but for various reasons aren't willing to hire more, keeping job growth depressed. The hiring shortfall is evident across nearly every industry—only energy and healthcare are adding jobs near their prerecession pace.

Hiring is slow among both large and small firms, but the largest—those with more than 1,000 employees—are hiring somewhat more normally, while small businesses with between 20 and 50 workers are lagging. This could hint at the types of worries that are having the greatest impact: Europe's problems and the fallout on global trade may not be as much of a headwind for the U.S. job market as uncertainty about healthcare policy. Under Obamacare, firms with more than 50 employees face greater costs; thus, some firms may be holding back on hiring to not cross that threshold.

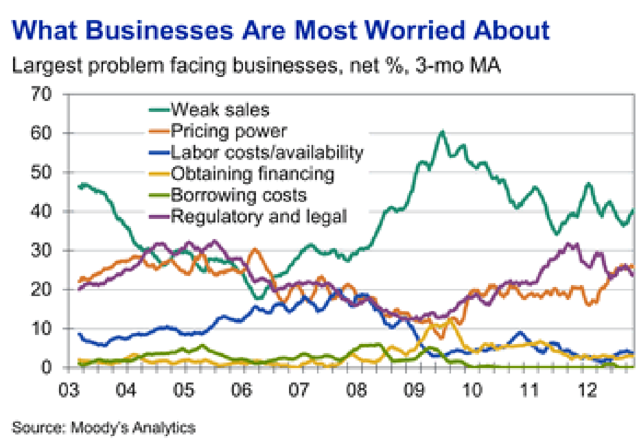
More important in the hiring shortfall is the slow recovery of real estate. Historically, housing and commercial building have powered recoveries. These are very interest rate-sensitive sectors; when rates fall during a downturn, it spurs real estate demand and thus construction and property prices. This has not been the case in the current business cycle because housing was ground zero for the financial collapse and commercial real estate construction also sank to record lows as a share of GDP. Hiring has been especially weak in construction and construction-related manufacturing, transportation and distribution, financial services, retailing, and personal services. A recent pickup in housing and commercial real estate activity augurs well for future hiring.

Policy uncertainty

Businesses’ hiring decisions have clearly been affected by uncertainty about government policy, which covers a mélange of worries. The Federal Reserve’s extraordinary monetary actions, including its recent decision to engage in open-ended asset purchases to lower long-term interest rates, have some concerned about future inflation. More disturbing to business managers is the inability to guess how the next president and Congress will address the nation’s looming fiscal issues. Besides the much-discussed fiscal cliff of scheduled tax hikes and spending cuts at the beginning of 2013, the government will also need to raise the Treasury debt ceiling again early next year. And if policymakers can’t agree to adjust taxes and spending in ways that eventually bring down the nation’s debt-to-GDP ratio, the nation faces the prospect of more credit rating downgrades.

Policy uncertainty, as measured by the Moody’s Analytics uncertainty index, remains uncomfortably high. Monetary policy uncertainty is captured in the index by professional forecasters’ expectations of long-term inflation and unemployment, as measured by the Philadelphia Fed. The nation’s central bank explicitly targets inflation and implicitly targets unemployment. The variability in forecasters’ expectations is a good proxy for uncertainty about the efficacy of monetary policy.

Fiscal policy uncertainty is captured by the index via the Moody’s Analytics’ business confidence survey in the proportion of respondents who say regulatory and legal issues are their leading concern. Currently, sales worries lead regulatory issues but not by much. Worries that the Treasury will default on the nation’s debt rose significantly during the debt-ceiling brinkmanship in the summer of 2011; this is measured by the expected probability of default implied by credit default swaps on 5-year Treasury bonds.



But the top source of business anxiety, according to the index, is the wave of tax increases set to take effect at the end of the year as part of the fiscal cliff, when the Bush-era tax cuts, the payroll tax holiday, and temporary fixes to the alternative minimum tax are due to expire.

Policy uncertainty, as measured by the Moody’s Analytics’ index, isn’t as high as it has been in recent years, but it remains high. As long as businesses are nervous about government, hiring will remain depressed and the broader economy will grow slowly.

Brighter baseline

The economy is expected to remain on its current slow growth path until the next president and Congress negotiate around the fiscal cliff, increase the Treasury debt ceiling, and lay out a credible path to fiscal sustainability. If President Obama wins reelection, negotiations will begin during Congress' lame-duck 2012 session. If Governor Romney wins, current policy will be extended for a few more months while the new administration gets organized. Either way, the fiscal issues likely won't be resolved until early next year and only after significant political brinkmanship. Confidence is sure to slump, and the economy will weaken until policymakers come to terms.

Under the baseline outlook, it is assumed that the political stars will align for a broad fiscal deal. Regardless of who wins the election, both parties will have leverage in the coming negotiations. The January 1 deadline for taxes to rise favors the Democrats' position, while automatic spending cuts agreed to last year give both sides a reason to compromise. Republicans can fight to preserve defense spending while Democrats argue against cuts to nondefense programs. Whichever party does not win the White House can also threaten to block an increase in the debt ceiling, as House Republicans did last time. Political deals generally get done when both sides have plenty to lose.

In full swing by 2014

If this narrative is roughly right, political uncertainty will abate and hiring and economic growth will revive by this time next year. By 2014, growth will be in full swing as the construction cycle definitively turns up. Real GDP growth is expected to approach a 4% annual pace, with job growth above 250,000 per month and unemployment steadily declining. The economy should return to full employment—defined as a 5.8% unemployment rate—by early 2016.

Of course, events could unfold in much darker ways, tilting the balance of risks to this outlook sharply to the downside. It is relatively unlikely that lawmakers would allow the economy to fall over the fiscal cliff into a new recession next year, but it is somewhat more likely that they will delay meaningful action and simply extend current policy. That would dodge an immediate threat but would signal that Washington is incapable of addressing our long-term fiscal problems without a fiscal crisis. Such a crisis would occur—not in 2013 or even the year after, but eventually, and inevitably.

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