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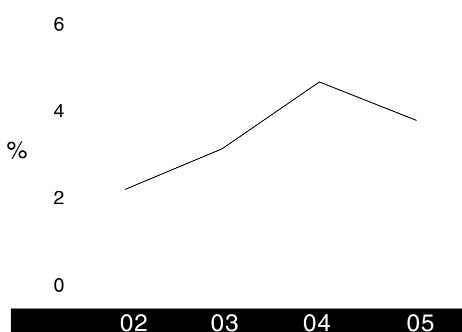
THE US ECONOMY IN RECOVERY: 2002–2003

The recession that began during the first quarter of 2001 (2001q1) ended in the closing quarter of that same year. The 2001 recession lasted only eight months—two months short of the ten-month average for post-World War II recessions. In the first full year of recovery, calendar year 2002, the United States' real GDP grew by just 2.2% while the unemployment rate continued to rise and moved up from a 4.7% average in 2001 to a 5.8% average for 2002. The economy strengthened in 2003, especially in the second half of the year, and, for the year as a whole, real GDP posted a far more satisfactory 3.1% increase. Although the unemployment rate ticked up to an average of 6% for the year, the monthly rates peaked at 6.3% in June and then moved down during the second half of the year, reaching 5.7% in December.

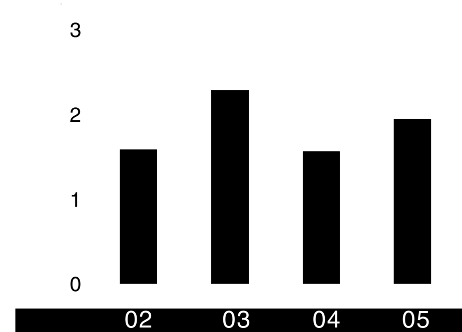
Officially, we have now experienced eight quarters of economic expansion since the 2001q4 trough. And there's little doubt that 2004q1 will register as the ninth straight quarter of growth when data are released at the end of April. But, there has been a great deal of concern about weakness in the job market, despite continued growth of GDP, and the presidential election season (which heated up a few months back) has served to focus the national spotlight squarely on the issue of whether there might not be a serious inconsistency between the signals coming from the market for goods and services and the market for jobs. Let us ask directly, then, 'To date, has the current economic recovery been relatively strong, just average, or relatively weak?'

The fact of the matter is that the economic expansion of the past two years has been relatively weak, and that's true according to a number of metrics of measurement. The most obvious measure by which to judge is total economic output, or real GDP. The chart 'Real GDP in recoveries' compares the current expansion with that following the cyclical trough in 1991q1, and with the average of the six prior expansions that followed the troughs of 1982q4, 1975q1, 1970q4, 1961q1, 1958q2 and 1954q2. The line labelled *GDP2001* represents real GDP during the period from 2001q4 through 2003q4, with the real GDP values scaled to an index of 100 in the trough quarter, 2001q4. The line labelled *GDP1991* represents real GDP during the period from the trough in 1991q1 through 1993q1, with the real GDP values scaled to an index of 100 in 1991q1 and shifted ahead 43 quarters so that the 1991q1 trough lines up with the 2001q4 trough. The line labelled *GDP5482* is the result of scaling and shifting the real GDP in each of the other six expansions beginning during 1954–82 in the same way, and then averaging the resulting scaled real GDP, quarter by quarter, to come up with a composite that represents the average behaviour of real GDP during the first two years of those six pre 1990s expansions.

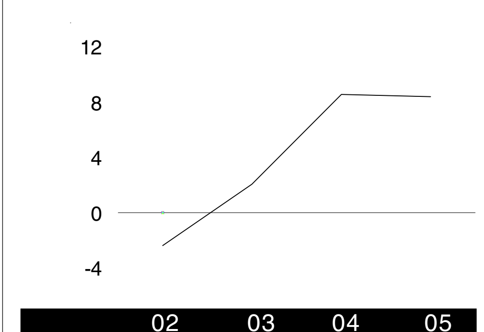
GDP growth



CPI inflation



Export growth



The message is immediately obvious: the post 1991 expansion and the current expansion are much alike but considerably weaker than the average pre 1990s expansion. Indeed, at age two years, the average pre 1990s expansion had already generated an 11.4% recovery in real GDP, compared with only 6% and 7.2% in the two most recent expansions. To draw relatively small distinctions between *GDP2001* and *GDP1991*, the current expansion started out a bit stronger, hit a slight snag during 2002q3–2003q2, but then accelerated nicely during the second half of 2003 to end its second year at an output level more than a percentage point higher, relative to the trough, than was the case in the previous expansion. But if the three-and-a-half-decade period from the mid 1950s through the 1980s is taken as the standard of comparison, the current expansion, like that of the early 1990s, has been notably weak.

The chart 'Payroll Employment in Recoveries' changes the metric of comparison from output to employment, with the latter measured by the count of payroll jobs as reported by nonfarm business establishments (including all units of government). The data were handled in exactly the same fashion as real GDP, permitting a direct comparison of the behaviour of payroll employment in the two years since the trough in 2001q4 (*Jobs2001*) with that following the trough in 1991q1 (*Jobs1991*) and with the average for the six pre 1990s expansions (*Jobs5482*). Again, the big message is immediately obvious: the post 1991 expansion and the current expansion are much alike but considerably weaker than the average pre 1990s expansion. Indeed, a 6.4% gain in payroll employment two years into the average pre 1990s expansion contrasts with very small net changes of –0.7% and 1% in the two most recent expansions.

The two most recent recoveries are commonly referred to as 'jobless' and, compared with the pre 1990s experience, they certainly merit that epithet. A careful comparison of the 'Output and Employment' charts reveals, however, that the weakness in jobs in the current recovery goes even beyond what can be explained by the corresponding weakness in output. The average pre 1990s recovery showed an 11.4% gain in output after two years, compared with just 7.2% for the current recovery—an output deficit of 4.2 percentage points. The jobs deficit in the current expansion, on the other hand, comes to 7.1 percentage points—6.4% minus a negative 0.7%. This implies that only about 60% of the joblessness of the current expansion (4.2 out of 7.1 percentage points) is accounted for by the slower output growth. The remaining 40% (2.9 out of 7.1 percentage points) represents the extent to which employers have lately managed to generate more output per job—in other words, more productivity improvement—than was the case in pre 1990s experience. Productivity improvement is a two-sided coin. It makes for greater efficiency and therefore a higher standard of living in the long term, but it costs jobs in the near term.

The current expansion, therefore, has been 'jobless' for two reasons. Output growth is not matching its pre 1990s performance, and that accounts for a 4.2 percentage point deficit in the job count that shows up relative to pre 1990s experience. In addition, significantly better productivity improvement, by itself, is accounting for a further 2.9 percentage point deficit in the job count. If measured by the number of jobs that just weren't there in 2003q4, these deficits amount to and 5.5 million jobs lost to slower output growth and another 3.8 million jobs lost to better productivity performance.

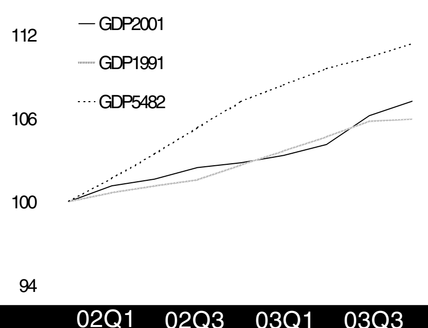
THE RECENT ACCELERATION OF REAL GDP

Although the pace of the economic recovery since late 2001 has been disappointing in historical terms, it is apparent that economic growth accelerated smartly in the second half of 2003. An anaemic 2.5% growth rate during the first half of 2003 was followed by annualised growth rates of 8.2% and 4.1%, respectively, in the third and fourth quarters. The huge burst in 2003q3 was led by

- a jump in overall consumer demand, but especially light vehicles and other durable goods
- a sharp step-up in business investment in equipment and software
- a surge in residential building activity
- a jump in exports, while imports were uncharacteristically weak.

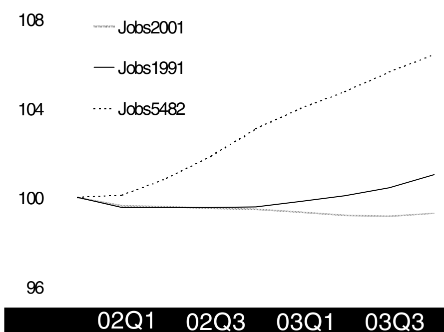
The fourth quarter slipped back to a less frenetic, but still solid, pace as vehicle sales and residential building backed off from their third quarter

Real GDP in recoveries



The chart on the left shows that the current economic recovery, *GDP2001*, is much like its immediate predecessor, *GDP1991*, but that both are much weaker than the average of the six recoveries that began during the period from 1954 to 1982. The chart on the right shows that the weakness of the recent recoveries is confirmed whether the recoveries are measured in terms of output or employment.

Payroll employment in recoveries



contributions, while imports surged. Exports, however, continued to accelerate and production for inventories turned from decumulation to significant accumulation.

At the close of 2003, most forward-looking indicators were strongly positive and this includes the policy outlook.

MACROECONOMIC POLICIES

The Federal Reserve has been on an expansionary policy track for more than three years and has only lately begun to deliver even small hints that it cannot stay that way permanently. Currently, the federal funds rate, the central bank's short-term policy rate, stands at a four-and-a-half-decade low of just 1%. This forecast assumes that the Fed's policymaking body, the Federal Open Market Committee (FOMC), will not begin to increase the federal funds rate until its mid August policy meeting, and will then move the rate up by no more than 75 basis points before year's end. That implies a federal funds rate ending the year no higher than 1.75%, which leaves monetary policy quite expansionary for at least the rest of 2004.

Firm economic growth and declining unemployment are expected to induce the FOMC to keep interest rates rising during 2005 and into 2006. It is assumed that a series of increases will push the federal funds rate up by 175 basis points over the course of next year, bringing it to 3.5% by year's end. That keeps rates well under the 6–6.5% range that the Fed took the funds rate to back in the late 1990s when it intended policy to become seriously restrictive. The next year and a half, in other words, should be thought of as the period during which the Federal Reserve gets short-term rates back to sustainable levels. Although monetary policy will necessarily become relatively more restrictive during this period, it will not likely move beyond neutral in any absolute sense.

Bush-era fiscal policy has also been highly stimulative—the result of two major tax cuts (in 2001 and 2003) and the aftermath of the terrorist attacks on September 11, 2001, which were followed by sharp increases in federal spending for homeland security and the military forays into Afghanistan and Iraq.

With provisions of the 2001–03 tax acts cutting taxes again in 2004 and federal spending slated to rise sharply yet again, the 2004 economy remains under the influence of an expansionary fiscal policy. The degree of fiscal stimulus may well begin to weaken by 2005, but there's little likelihood of any near term shift to a restrictive federal budget.

STRONGER ECONOMIC EXPANSION ABROAD

Most of the United States' major trading partners are either experiencing strong rates of economic expansion, including Japan, the United Kingdom, and China, or, like Canada and Mexico, are expected to see their rates of growth pick up during 2004. Improving economic strength abroad, in conjunction with a dollar that has weakened considerably against the currencies of most major economies—with the clear exception of China whose currency remains pegged to the dollar—implies a growing export market for US goods and services over the 2004–05 forecast horizon.

THE NEAR-TERM OUTLOOK

Propelled by a preponderance of positive initial conditions and highly expansionary monetary and fiscal policies, the US economy is projected to post a strong 4.6% growth rate in the first half of 2004. Healthy gains have been made in

- consumer demand, which contributes 2.9 percentage points to GDP growth
- business capital investment, adding 1.1 percentage points to the growth rate
- government purchases, accounting for 0.5 percentage points
- a much-needed rebuilding of inventory stocks, which contributes another 0.7 percentage points.

These gains pace the growth of real GDP in the first half of this year, while net exports make a negative contribution as import growth surges.

In response to this vigourous economic growth, the jobs' outlook strengthens substantially. The job count has to increase by about 130,000 per month merely to offset the natural growth of the working age population. This forecast of near-term growth averaging 4.6% implies that monthly gains in payroll employment will move into the range of 100,000–150,000 during the spring and even higher by the summer months. Such an improvement in the jobs outlook will be sufficient to start cutting into the jobs deficit to a meaningful degree.

On 2 April the Labor Department announced an increase of 308,000 jobs in the month of March, a huge increase compared with the 60,000 per month average since the job count turned up in September 2003, and well beyond what this forecast would imply for these early months of 2004. At least 70,000 of the March increase is generally considered to reflect one-off special circumstances, and there is virtually no expectation among US forecasters that so strong a pace of job growth will continue in the coming months.

THE ECONOMY AFTER MID 2004

The pace of economic growth backs off to a solid 3.6% rate during the second half of this year and then sustains essentially that same rate to 3.7%, during 2005. Consumer demand contributes a steady 2.4 percentage points to the economic growth rate from mid 2004 through the end of 2005, and business fixed investment adds another point. Inventory building continues to pump up economic growth in the second half of this year, but weakens next year, while net exports begin to make small positive contributions to GDP growth in 2005. On a calendar year basis, real GDP posts a 4.7% growth rate for 2004—the highest in 20 years—and 3.8% in 2005.

Employment responds to the sustained and strong economic growth, leading to a slide in the unemployment rate from a 6% average for calendar 2003 to 5.4% for 2004, 5.1% for 2005, and a level at or below 5% by the end of 2005. The rate of industrial capacity utilisation moves up to average 78.7% in 2004 and 81.8% in 2005, compared with an average of just 74.8% in 2003.

Inflation remains exceptionally low in 2004, with the private non-farm GDP deflator rising by just 1.1% for the year, the CPI increasing by only 1.6%, and the core CPI (excluding the volatile food and energy prices) gaining just 1.4%. Inflation picks up in 2005, with the deflator rising 1.8%, the CPI rising by 1.9%, and the core CPI posting a 2.2% gain for the year. By the close of 2005, the CPI inflation rate is expected to be at, or above, 2.7% and rising. The inflation/unemployment scenario of late 2005/early 2006 fairly guarantees the continued rise of interest rates into 2006.

RISKS AND CONCERNS IN THE OUTLOOK

Consumer sentiment is currently very strong and business optimism, especially among small and medium-sized enterprises, is high and rising. (These statements refer specifically to the consumer sentiment surveys conducted by the University of Michigan's Survey Research Center and the business attitude surveys conducted by the National Federation of Independent Business.) But, by all indications, continuation of strong consumer sentiment depends heavily on an improving job market, while further gains in business optimism and the improved hiring rates that will follow from those gains, require healthy growth of final demand. It is easy to see how the economy could travel in either direction on this two-way street; and how movement in either direction reinforces itself. Which direction will dominate in the near term represents the single most significant purely economic risk element in the outlook.

There is also a highly significant set of risks that are geopolitical in nature but could have serious economic consequences, negative or positive, for the United States and other countries. These are well known; many are centred in the Middle East; they are issues of war and peace, of terrorism, of energy prices, and they hardly require discussion here. They cannot, however, be forgotten.

Finally, and returning to a more directly economic issue, there is the risk that accompanies the high and worsening US current account deficit. In 2003, that deficit came to more than US$525 billion (NIPA basis), or 4.8% of nominal GDP. The current account deficit is forecast to reach US$600 billion in 2004 and US$640 billion in 2005—or 5.2% of GDP each year. Over the same two years, the US dollar is projected to decline by nearly 14% against the seven other currencies in the Federal Reserve's major currencies index. That is a relatively orderly process of adjustment: the dollar weakens, the current account deficit tops out as a percentage of GDP, and, eventually, it leads to an equilibration of the current account. But there is no assurance that such an orderly path will eventuate. Could there be a dollar-crash instead? If other currencies gain favour as reserve currencies, and if economies other than the United States gain greater favour among international investors, the risk of a disorderly decline in the dollar will increase. This may very well be a low probability risk, but it certainly is not negligible.