

31. THE UNITED STATES OF AMERICA

Strong headwinds will slow down recovery

The recession which started at the end of 2007 has been the deepest and longest in the United States for more than sixty years. It has taken a heavy toll in terms of employment and output loss. Current data indicate that output contraction ended last summer and that the economy is stabilising although unemployment continues to rise. The financial system has improved, but remains fragile. The headwinds facing the economy are formidable and are likely to make the recovery relatively sluggish and prone to setbacks over the forecast period.

Exit from the Great Recession

The National Bureau of Economic Research, the quasi-official arbiter of the US business cycle, has determined that the recession started in December 2007. The downturn was moderate at first, partly because the stimulus package from February 2008 supported domestic demand temporarily. When the financial crisis worsened in connection with the failure of Lehman Brothers, economic activity started to contract sharply. According to current data, real GDP declined by 3.8% from the second quarter of 2008 to the second quarter of 2009.

Currently, a wide array of data is suggesting that the recession ended in the summer months although this will not be confirmed for some time. Data on industrial production and the purchasing managers' index indicate that manufacturing is expanding again. The PMI for the non-manufacturing sector has also risen above the 50%-mark in September. Capital spending shows signs of stabilisation after the free fall of last winter. Export volumes have started to increase again. The housing sector seems to have bottomed out with home sales and housing starts rising from very low levels. House prices have stopped declining and may even be rising again, according to some national measures. Consumer spending has increased in the third quarter, helped by government incentives for car purchasing. Overall, economic activity seems to be expanding at an above-trend pace in the second half of 2009. Certainly employment, always a lagging indicator of the business cycle, has continued to fall, but at a much reduced speed compared to the worst months of the recession last winter.

Drivers of the recovery

One of the main drivers of domestic demand at the current juncture is the fiscal stimulus contained in the *American Recovery and Reinvestment Act of 2009* which was adopted in February. According to the Congressional Budget Office, the Recovery Act will increase the federal deficit by \$787 billion over the next ten years, predominantly in the first three years. The expected sequence of measures means that the fiscal stimulus amounts to 2.0% of GDP in 2009, 2.3% in 2010 and 0.7% in 2011. About one quarter of the stimulus consists of tax cuts. Most of the rest is devoted to infrastructure projects, but it also includes assistance to state and local governments, an extension of unemployment insurance benefits, and additional funding for other social programmes. Most of the \$150 billion of expenses in the first six months have been for individual tax cuts, state fiscal relief, and transfers to those most directly hurt by the recession.

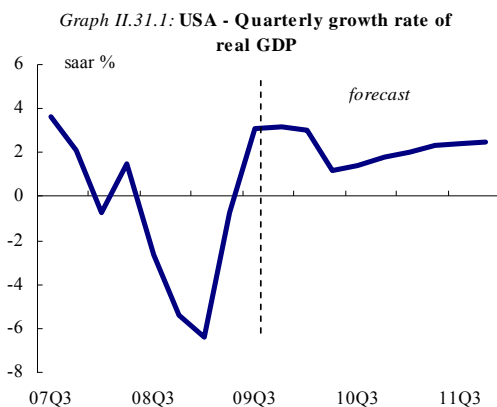
Plausible estimates of the macroeconomic impact of the Recovery Act suggest that annualised real GDP growth has been lifted by about 2 pps. in the second quarter and by 3 pps. in the third quarter. The effect on GDP growth will decline gradually in subsequent quarters and turn negative in the second half of 2010. In addition to February's stimulus package, consumer spending and GDP growth received temporary support in the third quarter from the \$3 billion spent under the government incentive programme for new car purchases ("cash for clunkers").

A second important driver of the economy in the near term is the inventory cycle. In the first half of 2009 business inventories were reduced at a very fast rate, which deepened the recession significantly. Stocks have now been brought into much better alignment with sales, particularly in the automotive industry. Although inventories overall are still declining, this now seems to happen at a slower rate which already provides a positive contribution to GDP growth. As the inventory cycle progresses and enters the restocking phase, the positive growth contribution will continue. It is expected that the effect will be very strong until next spring and then flatten out.

The dollar's recent depreciation will also strengthen the recovery over time (based on the

assumption of constant exchange rates). In real effective terms the dollar's exchange value has fallen by 8% between March and September 2009, thereby reversing the appreciation over the preceding six month period and benefitting the international competitiveness of US goods and services. Once import-intensive restocking has petered out and trade flows have normalised, net exports are expected to make a positive contribution to GDP growth.

In addition, the recovery will be supported by a continuation of an extremely accommodative monetary policy and the recent improvement in financial market conditions. The Federal Reserve already lowered the policy interest rate to close to zero at the end of last year and continues to state that "economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period". There has been an impressive rise in equity values since March and a material decline in private sector borrowing rates



Headwinds

The fiscal stimulus and the inventory cycle will only boost growth temporarily. The key question for the recovery is therefore whether it will have become self-sustained when the temporary factors subside. A cyclical upturn has an inherent dynamism which will usually ensure this. However, the US economy is currently encumbered by a number of weaknesses which will tend to mitigate the recovery.

(1) The drop in house and equity prices has reduced the net worth of US household by close to 17% between the beginning of the recession and mid-2009. This is bound to result in a large negative wealth effect. Households will cut back on consumption as they try to rebuild their wealth

by saving out of income to compensate for the fall in the value of their assets. The net saving rate (measured as personal saving as a percentage of personal disposable income) has already doubled from 2% in the pre-recession period to around 4% between May 2008 and August 2009. A further significant rise is likely since wealth effects usually operate with a time lag.

(2) Although the fiscal stimulus is going to add to GDP growth until the middle of next year, the effect has probably already peaked. Unless additional stimulus is injected into the economy or other demand-boosting factors will take over from the Recovery Act, the payback in terms of reduced growth numbers will become clear in the course of 2010. In addition, the budgets of states and local governments are facing large revenue shortfalls which need to be addressed with tax increases or spending cuts under existing constitutional requirements. Federal transfers appropriated in the Recovery Act will only finance part of the growing budget deficits. This means that the sub-federal public sector will exert a drag on the recovery over the forecast period.

(3) The labour market has continued to weaken in recent months although the rest of the economy is stabilising. Employment has declined throughout the third quarter while unemployment has approached the 10% mark. Even a more concurrent indicator like first-time claims for unemployment benefits has remained in recessionary territory and hourly earnings are close to stagnation. The implication is that income growth will continue to suffer and consumer spending with it. The experience of "jobless recoveries" after the two preceding recessions seems to be repeated. The dismal state of the labour market is also reflected in consumer confidence. Although it is up from the record-low early this year, it remains close to a level which represented the lows during previous recessions.

(4) The economy's spare capacity in the form of unemployed workers, idle manufacturing capacity and vacant homes are at or close to record-high levels. The Congressional Budget Office estimates that output will be about 7% below its potential in 2009. The existing slack in resource utilisation is likely to restrain private fixed investment throughout the forecast period.

(5) Although financial conditions have improved recently, credit availability for households is likely

to remain more restricted than before the financial crisis. Mortgage lending has clearly returned to stricter lending standards. New issues of subprime mortgages have practically disappeared and non-conforming loans are only made with large premiums. Consumer credit is contracting, partly reflecting stricter lending practices. At least as long as unemployment is rising and, thereby, default risk, credit availability is unlikely to improve. This will be an additional restraint on consumer spending going forward.

A subdued recovery with a second dip in 2010

The balance and sequence of driving forces and headwinds suggests a growth profile with an above-trend expansion of around 3% during three quarters starting in mid-2009. But when the fiscal stimulus and the inventory cycle lose most of their power next spring, the economy is likely to fall into a state of low growth in which the inherent dynamics of the recovery are largely offset by the restraints listed above. Only in 2011 the economy should be able to return gradually to growth close to its long-run potential. But this will be far from sufficient to close the output gap by the end of the forecasting period. It would result in annual average growth of 2.2% in 2010 and 2.0% in 2011. This would represent a very subdued performance

by historical standards and in view of the depth of the preceding recession.

In this scenario, the unemployment rate will rise to 10% next year and slightly higher in 2011. The large slack in resource utilisation should keep headline inflation low over the forecasting period. The household saving rate will rise by 4½ pps. from 2008 to 2011. Over the same period, the fiscal deficit of general government will more than double to 13% of GDP. The current account deficit is narrowing significantly from 4.9% of GDP last year to 2.9% in 2009. But this improvement is not expected to last. In 2010 and 2011 the current account deficit should widen again to around 3½% of GDP although export growth is projected to be higher than import growth, particularly in 2011.

The risks associated with this forecast are considerable, but appear to be balanced. Regarding GDP growth, the risks relate mainly to the uncertainties about the magnitude of the rise in the household saving rate.

Table II.31.1:

Main features of country forecast - THE UNITED STATES

	2008			Annual percentage change						
	bn USD	Curr. prices	% GDP	92-05	2006	2007	2008	2009	2010	2011
GDP	14441.2	100.0	3.3	2.7	2.1	0.4	-2.5	2.2	2.0	
Private consumption	10129.9	70.1	3.7	2.9	2.6	-0.2	-0.8	-0.2	0.4	
Public consumption	2386.8	16.5	1.5	1.2	1.5	3.4	2.5	4.1	2.9	
Gross fixed capital formation	2667.1	18.5	5.7	2.3	-1.4	-4.2	-14.5	4.6	4.5	
of which : equipment	1264.9	8.8	7.4	8.2	1.5	-4.4	-15.0	3.9	4.4	
Exports (goods and services)	1831.1	12.7	5.2	9.0	8.7	5.4	-10.9	7.7	8.4	
Imports (goods and services)	2538.9	17.6	8.2	6.1	2.0	-3.2	-14.9	7.5	5.7	
GNI (GDP deflator)	14583.1	101.0	3.5	3.5	0.9	-0.2	-2.8	2.2	2.0	
Contribution to GDP growth :										
Domestic demand			3.8	2.7	1.8	-0.4	-2.8	1.3	1.5	
Stockbuilding			0.1	0.1	-0.3	-0.4	-0.7	1.1	0.3	
Foreign balance			-0.5	-0.1	0.6	1.2	1.1	-0.2	0.2	
Employment (*)			1.3	2.1	1.1	-0.5	-3.5	-0.5	0.3	
Unemployment rate (a)			5.4	4.6	4.6	5.8	9.2	10.1	10.2	
Compensation of employees/head			3.8	4.1	3.7	2.6	-0.2	0.6	0.7	
Unit labour costs whole economy			1.7	3.5	2.7	1.7	-1.3	-2.1	-0.9	
Real unit labour costs			-0.4	0.2	-0.2	-0.5	-2.4	-2.1	-0.8	
Savings rate of households (b)			-	-	4.5	5.3	7.2	8.2	10.0	
GDP deflator			2.1	3.3	2.9	2.1	1.1	0.0	-0.1	
General index of consumer prices			-	3.2	2.8	3.8	-0.5	0.8	0.1	
Terms of trade of goods			-0.2	-0.8	-0.1	-5.7	6.4	-2.5	-0.9	
Trade balance (c)			-3.6	-6.5	-6.1	-6.0	-3.7	-4.2	-4.2	
Current account balance (c)			-3.0	-6.0	-5.2	-4.9	-2.9	-3.4	-3.3	
Net lending(+) or borrowing(-) vis-à-vis ROW (c)			-3.1	-4.3	-5.1	-5.6	-3.0	-3.4	-3.3	
General government balance (c)			-2.6	-2.0	-2.7	-6.4	-11.3	-13.0	-13.1	
Cyclically-adjusted budget balance (c)			-	-	-	-	-	-	-	
Structural budget balance (c)			-	-	-	-	-	-	-	
General government gross debt (c)			64.5	61.2	62.2	70.7	82.7	93.9	105.3	

(a) as % of total labour force. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.

(*) Employment data from the BLS household survey.