"Uneven, Uncertain and Unusual Recovery"

Lawrence Goodman and Yubo Wang

July 29, 2010

The future course of the US economy warrants much attention.

Fear regarding the state of the economy is high especially as the steepest slide since the Great Depression is fresh in the minds of many.

Much uncertainty deservedly remains, as the present recovery is highly unusual. The recent economic cycle in contrast to history demonstrates odd interactions among the components of US GDP and forceful government stimulus is rapidly losing steam.

The risk of a future of lower growth marked by more violent fluctuations is high.

Facts regarding the Recent Economic Cycle

Three facts regarding the recent recession are vital for evaluating future growth prospects.

- First, the slide in the economy was not even close to a Depression.
- Second, a forceful public policy response resulted in a recession interrupted, as evidenced by a rapid reversal in a plunge in world trade.
- Third, the recovery was by necessity engineered by the visible hand of the public sector.

As these actions are widely known, they are described more thoroughly in Appendix 1. However, clear and unintended consequences from these measures are beginning to surface with implications for its future sustainability.

Figure 1. Major Economic Contractions and Expansions since 1950

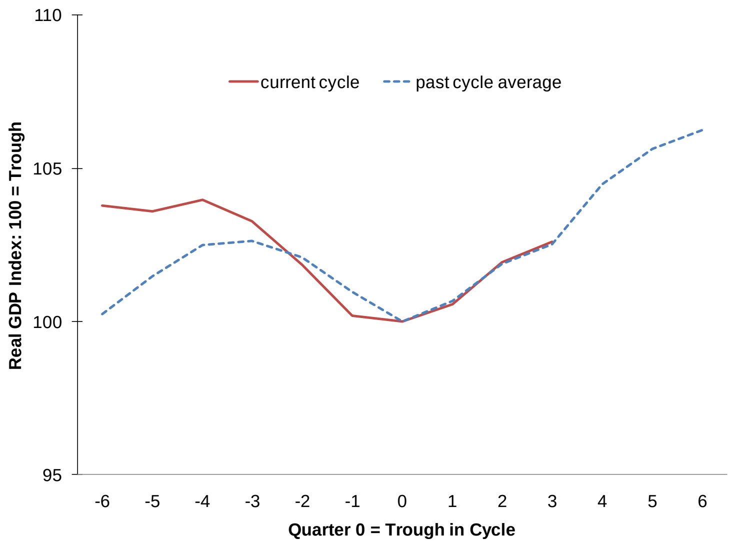
	Peak	Trough	Major Contraction	Magnitude of Contraction	Subsequent Expansion
	Start of Major Contraction	End of Major Contraction	# of Qtrs	%,peak to trough (not annualized)	# of Qtrs
1	Q3/53	Q1/54	3	-2.6%	14
2	Q4/57	Q1/58	2	-3.7%	46
3	Q4/69	Q1/70	2	-0.6%	17
4	Q3/74	Q1/75	3	-2.6%	20
5	Q2/80	Q3/80	2	-2.2%	4
6	Q4/81	Q1/82	2	-2.9%	33
7	Q3/90	Q1/91	3	-1.4%	69
8	Q3/08	Q2/09	4	-3.8%	3 as of Q1 2010

Source: Datastream and Center for Financial Stability, Inc.

Uncertainty: Consequence from the Visible Hand Led Recovery

Although the path of the overall recovery is normal by historical standards, all is not well. An index of real GDP in the current cycle vis-a-vis the past cycle average back to 1950 highlights a mundane recovery of the overall economy almost in perfect synch with prior cycles. However, the components of GDP are uniformly demonstrating extremely uneven growth across sectors - which likely signal uncertainty, a fragile recovery, and potential for mini booms and busts.

Figure 2. Present Recovery Tracks History

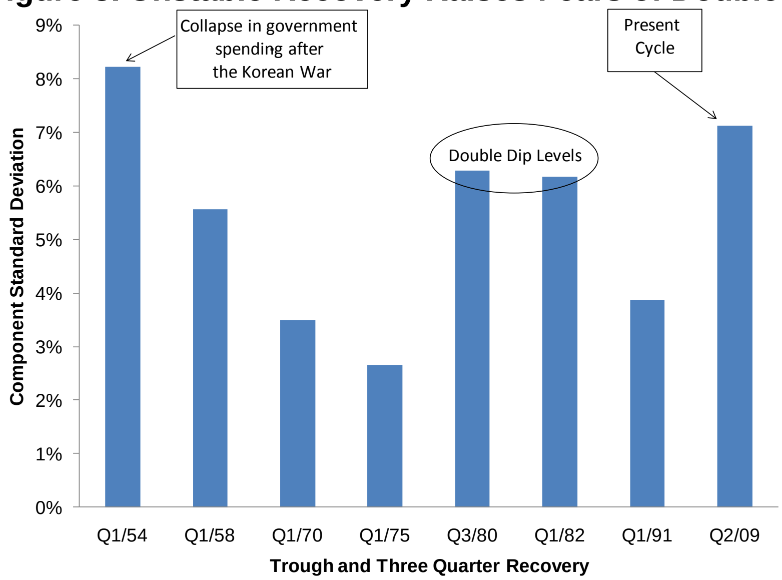


Source: Bureau of Economic Analysis and Center for Financial Stability, Inc.

Uneven Recovery - The drivers of GDP or components in the national income accounts are demonstrating unusual patterns or a profound degree of unevenness (see Figure 3). In the first three quarters of the present recovery, the components of GDP are more jumpy and agitated than usual based on cross-sectional standard deviation of the component growth of the national income accounts during recoveries.

By this measure, the recent expansion represents the second most uneven or uncertain recovery since 1950. The standard deviation coincident with the first three quarters of positive growth in this cycle is a whopping 7.1% relative to 6.1-6.3% coincident with the last double dip in the early 1980s. In fact, adjustment for the impact of the termination of the Korean War in 1953 would readily place the recent recovery as the most uneven and uncertain or least stable. The most uneven recovery occurred in the aftermath of the Korean War, when government spending contracted a cumulative 6.4% in the first three quarters of the recovery. In contrast, the government spending continued after the post Vietnam War recession in 1975 with a cumulative advance of 1.8% in the first three quarters of expansion.

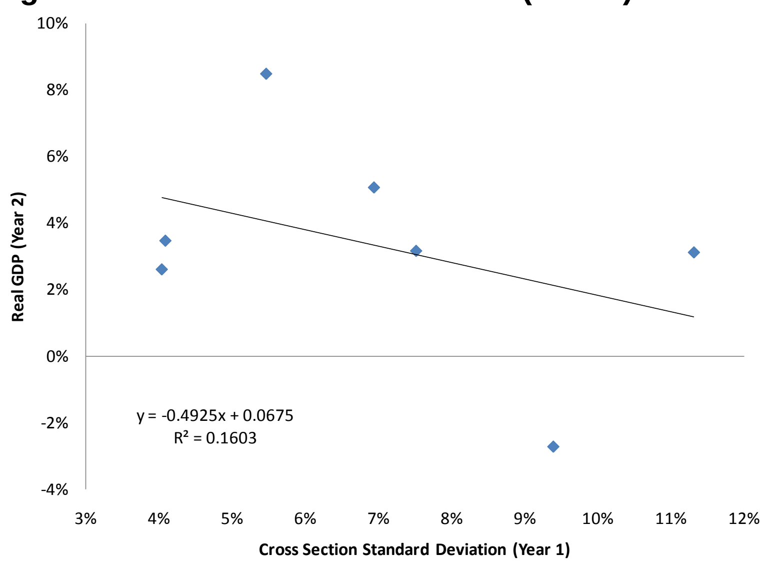
Figure 3. Unstable Recovery Raises Fears of Double Dip



Source: Bureau of Economic Analysis and Center for Financial Stability, Inc.

Risk to Lower Future Growth - The uneven and uncertain recovery likely reflects large and lumpy policy responses as well as uncertainty in the private sector regarding the longevity of the expansion. For example, a sharp expansion in public spending or provision of temporary incentives will likely be perceived as unsustainable and limit the response of the private sector to new investments and expand payrolls.

Figure 4. Uneven Growth in Year 1 (x-axis) leads to Low Growth in Year 2 (y-axis)

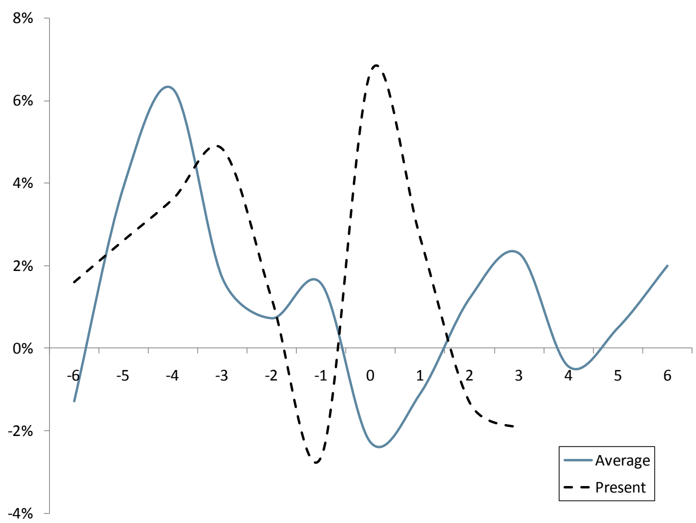


Source: Bureau of Economic Analysis and Center for Financial Stability, Inc.

The expectation that an uneven initial recovery or uncertainty (as represented by volatility on the x-axis below) reduces future growth seems highly plausible as represented by Figure 4. High degrees of uncertainty during the first three quarters of expansion after recessions underscore the potential for lower overall GDP growth in subsequent quarters (y-axis) based on analysis dating back to 1950. The statistical properties improve with the exclusion of the recession after the Korean War.

Gyrating Government Spending - Lastly, government stimulus in the present cycle is extremely volatile. The government response to the crisis was early and aggressive. Public spending surged as the economy was entering recession or well before pump priming usually begins, as represented in Figure 5. Likewise, the pattern of government behavior was very different. Typically, government spending increases gradually coincident with the recession via automatic stabilizers. In the present episode, the government acted forcefully and early with the impact beginning to fade.

Figure 5. Government: Present versus Average Fluctuations



Source: Bureau of Economic Analysis and Center for Financial Stability, Inc.

The public response is also highly unusual in this crisis with the reduction in state spending beginning to restrain the overall fiscal impact of Federal stimulus. For example, the overall contribution of the public sector to growth has been negative beginning in Q4 2009 and persisting for two consecutive quarters. Despite the overall negative contribution to growth by the public sector, the Federal government continues to contribute to overall growth via stimulus. State and local governments forced to restrain spending are actually creating a drag on the economy with the overall impact negating expansion of Federal spending.

Conclusion

The nature of the present recovery is highly unusual. Volatile and uneven interactions among the drivers of GDP threaten a future of weak growth characterized by wide fluctuations and risk of a double dip.

Officials should act to remove uncertainty, deepen confidence in the private sector, and develop a self-sustaining recovery.

Figure 6. Real GDP with Drain from State and Local Governments

	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10
Gross Domestic Product	-5.4%	-6.4%	-0.7%	2.2%	5.6%	2.7%
Personal consumption	-3.1%	0.6%	-0.9%	2.8%	1.6%	3.0%
Durable goods	-20.3%	3.9%	-5.6%	20.4%	0.4%	12.0%
Nondurable goods	-4.9%	1.9%	-1.9%	1.5%	4.0%	3.9%
Services	0.5%	-0.3%	0.2%	0.8%	1.0%	1.4%
Private investment	-24.2%	-50.5%	-23.7%	4.9%	46.1%	16.3%
Fixed investment	-20.2%	-39.0%	-12.5%	-1.3%	5.0%	-0.5%
Non-residential	-19.4%	-39.2%	-9.6%	-5.9%	5.3%	2.2%
Structures	-7.2%	-43.6%	-17.3%	-18.4%	-18.1%	-15.5%
Equipment and software	-25.9%	-36.4%	-4.9%	1.5%	19.0%	11.4%
Residential	-23.2%	-38.2%	-23.2%	18.9%	3.7%	-10.3%
Inventories	-37.4	-113.9	-160.2	-139.2	-19.7	41.2
Net exports (G&S)						
Exports	-19.5%	-29.9%	-4.1%	17.8%	22.8%	11.3%
Goods	-25.5%	-36.9%	-6.3%	24.6%	34.1%	14.3%
Services	-4.3%	-13.6%	0.2%	5.6%	2.7%	5.0%
Imports	-16.7%	-36.4%	-14.7%	21.3%	15.8%	14.8%
Goods	-19.6%	-41.0%	-16.5%	25.1%	20.3%	16.6%
Services	-0.9%	-11.5%	-7.5%	7.0%	-1.8%	7.3%
Government consumption & invest	**1.2%**	**-2.6%**	**6.7%**	**2.7%**	**-1.3%**	**-1.9%**
Federal	**6.5%**	**-4.3%**	**11.4%**	**8.0%**	**0.0%**	**1.2%**
National defense	3.8%	-5.1%	14.0%	8.4%	-3.6%	1.0%
Nondefense	12.6%	-2.4%	6.1%	7.0%	8.3%	1.5%
State & local	**-2.0%**	**-1.6%**	**3.9%**	**-0.6%**	**-2.2%**	**-3.8%**

Source: Bureau of Economic Analysis and Center for Financial Stability, Inc.

Appendix 1: Facts regarding the Recent Economic Cycle

Three facts regarding the recent recession are vital for evaluating future growth prospects.

- First, the slide in the economy was not even close to a Depression.
- Second, a forceful public policy response resulted in a recession interrupted, as evidenced by a rapid reversal in a recent plunge in world trade.
- Third, the recovery was by necessity engineered by the visible hand of the public sector with implications for its future sustainability.

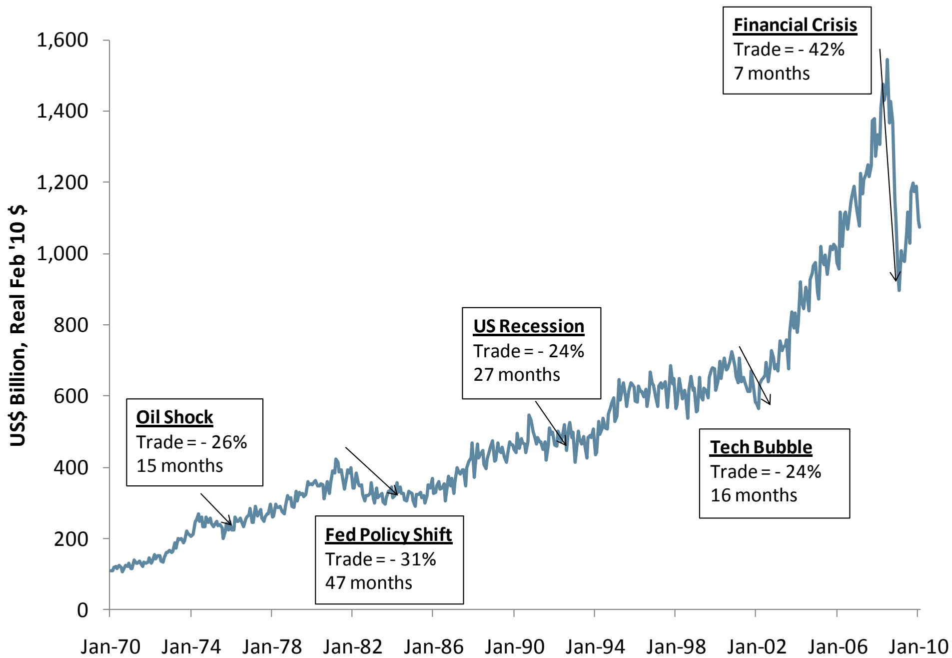
Not Even Close to a Depression - Although the recent recession was the deepest slide in output since the Great Depression, the peak-to-trough contraction was mild in comparison to the crisis witnessed in the 1930s. For example, the peak-to-trough contraction in real GDP between Q3 2008 and Q2 2009 was a scant 3.83% relative to a stunning slide of nearly 28% in real terms between 1929 and 1933. More directly, real GDP fell by 8.6% in the first calendar year of the Depression or more than double the four quarter slide witnessed coincident with the recent financial crisis.

Although the latest contraction in GDP is small in comparison with the Depression, the last recession was the longest lasting since 1950 - extending four full quarters relative to other recessions of only two or three quarters. There was only one double dip recession, which occurred in the early 1980s (see Figure 1).

Recession Interrupted - Public policy quickly halted the recession.

Patterns in world trade vividly illustrate this reality. World trade plunged from its peak in the summer of 2008 and bottomed in February 2009 - just as stimulus began to re-liquefy markets and economies. The slide in world trade lasted for a mere seven months relative to historic slowdown of 15 to 47 months. The deterioration in trade is unusually short. In other words, the recession may have persisted for far longer in the absence of such aggressive policy moves.

Figure 7. Substantial Plunge and Quick Recovery in World Trade



Source: IMF International Financial Statistics and Center for Financial Stability, Inc.

Visible Hand Led Recovery - Expansion in the size of the government and an unprecedented ease in monetary policy unleashed a man-made recovery. The size of the government - as measured by Federal spending - increased from 19.6% of GDP in 2007 to 24.5% of GDP by 2010. Similarly, Federal revenues fell from 18.5% of GDP to 14.5% of GDP over the same period. In other words, a fiscal deficit of 9.91% of GDP (and rising) was the largest since the end of WWII.

Monetary stimulus was equally impressive. The Federal Reserve pushed the funds rate down from 5.25% in 2007 to near 0 beginning in December 2008, as well as expanding the size of the Fed's balance sheet from 164% ($877 billion to $2.314 trillion from mid-2008 to mid-2010.

With thanks to Bruce Tuckman and Jeff van den Noort for comments.
