



Perspectives by Ruth Lea

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America's economic "soft patch" should worry us all

Introduction

As we have discussed in previous Perspectives, the Government is partly relying on "export led growth" to drive the British economy forward over the next few years.¹ The US is our biggest trading partner, by a very considerable margin. In 2010 the UK exported £38.0bn of goods alone, the bilateral services data are not yet available, to the US compared with £27.8bn to Germany, our next biggest trading partner. But whilst Britain experienced a visible trade deficit with Germany of £17.7bn we chalked up a healthy surplus of £10.5bn with the US. In the three months to April, exports to the US increased by over 5%, whilst imports fell back by nearly 5%. The US's economic health is, therefore, of a key factor in our own recovery. And the US's economic "soft patch" should be of great concern.

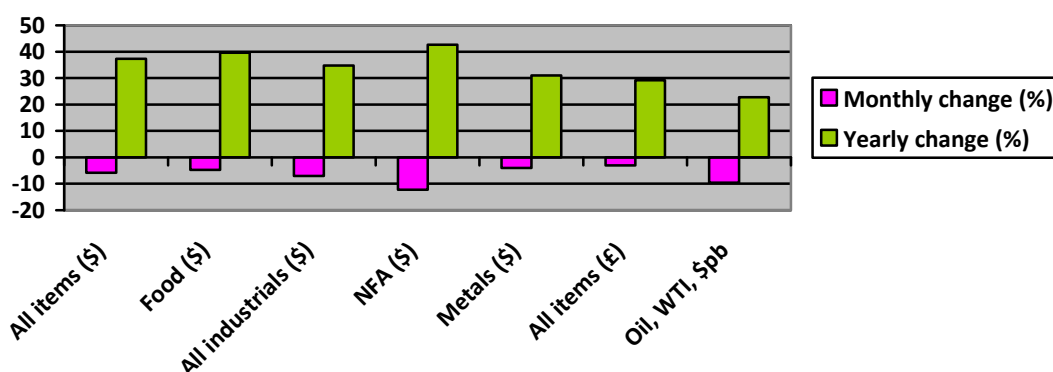
As the IMF pointed out recently in its update of the *World Economic Outlook*, even though the world economy had continued to recover after the 2008-09 recession in the second quarter of this year, there were two risks that were more worrying than they had been just two months earlier. They were the renewed financial volatility in the Eurozone and the greater-than-anticipated slowdown in the US.² Whilst the former may have been temporarily assuaged by the Greek Parliament's acceptance of the latest austerity package, the IMF remains concerned about the risk of disorderly defaults within the Eurozone triggering a Lehman-style shock to the financial markets. And the US's position continues to worry, not least of all because of the political bickering over fiscal policy.³

Disappointing growth in the US

GDP growth was a relatively weak 1.9% (annualised, 3rd revision) in 2011Q1, compared with 3.1% in 2010Q4. Moreover, indicators so far available for the second quarter suggest no upturn in fortunes. Personal consumption (in real terms) fell by 0.1% in both April and May and consumer confidence fell in June to its lowest point since November 2010.

There were undoubtedly transitory factors bearing down on growth in the first half of the year. These included higher commodity prices, which squeezed real incomes, bad weather and the impact of supply chain disruptions on manufacturing industry in the wake of March's Japanese earthquake. Commodity prices are however now stabilising, if not reversing, as monetary policy in the emerging markets (principally China and India) has been tightened. Chart 1 shows how commodity prices are easing back.

Chart 1 Economist commodity price index, 2005=100



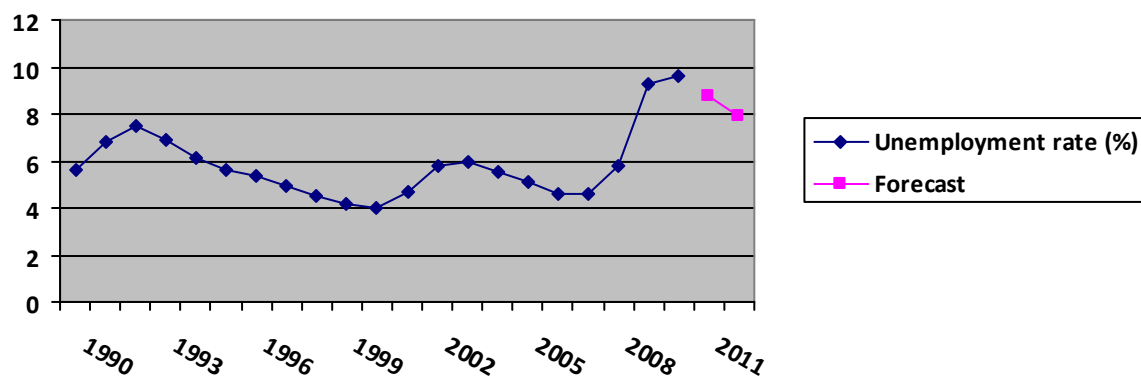
Source: *Economist*, 2 July 2011. The "all items" index comprises food and "all industrials". The "all industrials" index comprises non-food agriculturals (NFA) and metals. The oil prices are for West Texas Intermediate (WTI), \$ per barrel.

But even if the economy picks up in the second half of 2011 there are, more worryingly, factors which cannot be regarded as short-lived that are bearing down on America's ability to grow buoyantly. They include high structural unemployment, the continued slump in the housing market and tight credit supply conditions in the wake of the financial crisis, which could become more binding as credit demand recovers.

Concerning unemployment the US is experiencing almost unprecedentedly high post-war unemployment rates in the wake of the unusually deep recession and reflecting the rather weak recovery, though it should be noted that rates hit 10% in the early 1980s recession. Chart 2 shows unemployment rates since 1990. Providing GDP growth picks up as forecast, unemployment is expected to fall in 2011 and 2012, though it will still be high by recent historical standards. And it should be noted that the private sector added only 83,000 jobs in May, compared with an average of 244,000 in the previous 3 months. The unemployment rate actually rose between April (9.0%) and May (9.1%). So these forecasts are more likely to err on the optimistic side rather than the pessimistic.

Along with the higher rates is the mounting number of workers who have been out of work for an extended period, the long-term unemployed. There are disquieting signs that structural unemployment is inching closer to European levels. The US has not been here before. Moreover, the difficulties in the housing market, discussed below, are damaging the US's flexible labour market by making it harder for the unemployed to move to find work.

Chart 2 Unemployment rates (%) in the US since 1990, annual data

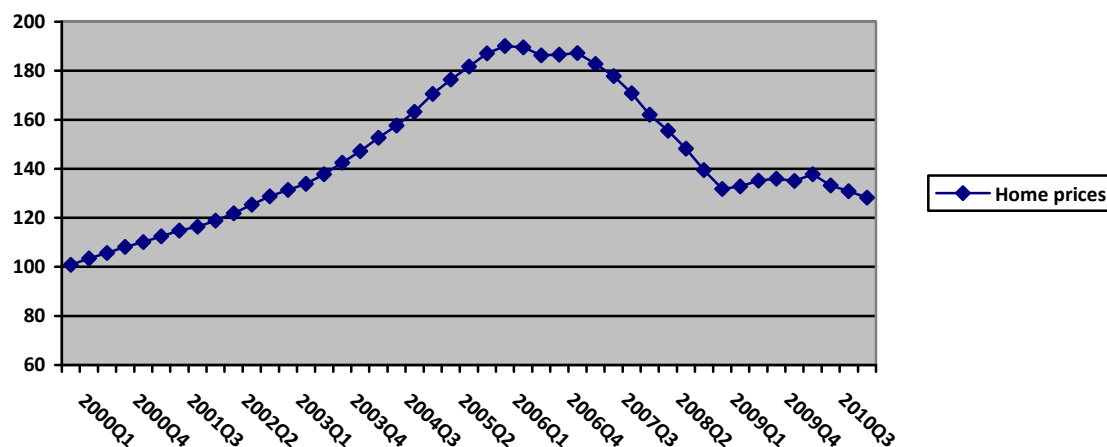


Sources: OECD, *Economic Outlook*, no 89, May 2011; the US Department of Labor, Bureau of Labor Statistics.

The housing market remains dismal with the Case-Shiller house price index hitting a new recession low in 2011Q1, having experienced a double dip, as shown in chart 3.⁴ The numbers are truly awful and are a blight on economic recovery. In 2011Q1 prices slipped back for the 3rd consecutive quarter and were 5% lower than a year earlier, even at a time when the economy was growing. Home prices are nearly one third lower than they were at the time of the peak in 2006Q1 and back to the level of 2002Q4.⁵ By comparison the decline in prices in the late 1920s and early 1930s was, at 31%, slightly more modest. But, worse, analysts are expecting further falls. Case-Shiller, one of the more optimistic, expects prices to drop by 5% in 2011, reflecting a glut of foreclosures, tighter credit standards, the high national unemployment rate and a surge in “underwater” mortgages. Many people are stuck in their homes and are unable to move, due to the fact that they owe more on their home than what is worth. There is a plague of negative equity.

As home prices continue to decline household wealth is further damaged which, along with households striving to cut debt levels, weighs down heavily on private consumption. There are, of course, parallels with the UK’s economic situation though, at least in one respect, the situation in Britain is not as bad as in the US. The housing market, though “treading water”, does not seem to be “double dipping”.

Chart 3 Case-Shiller home prices, US national index levels since 2000Q1



Source: www.standardandpoors.com, note that 2000Q1=100.8.

Downgraded GDP forecasts for the US

Reflecting the poor first half data, the US authorities and international organisations are downgrading their GDP forecasts. Table 1 includes the June forecasts of the Federal Reserve and the IMF compared with their April equivalents – made just two months earlier.^{6,7} The Fed's forecasts in particular still look over-optimistic.

Table 1 Fed and IMF GDP growth forecasts (%)

	2011	2012	2013
Fed (April), central tendency	3.1-3.3 (3.2)	3.5-4.2 (3.85)	3.5-4.3 (3.9)
Fed (June), central tendency	2.7-2.9 (2.8)	3.3-3.7% (3.5)	3.5-4.2 (3.85)
IMF (April)	2.8	2.9	Na
IMF (June)	2.5	2.7	Na

Sources: (i) Federal Reserve, www.federalreserve.gov; (ii) IMF, www.imf.org.

The Fed and monetary policy

Fed Chairman Ben Bernanke made his customary statement on the economy, in general, and monetary policy, in particular, after the last Federal Open Market Committee (FOMC) meeting of 21-22 June 2011.⁸

Concerning the economy Bernanke discussed his downgraded GDP forecast, pointing amongst other factors to the possible impact of the Eurozone events in the event of a disorderly default in Greece, the weakness of the financial sector, the continuing slump in the housing market, high unemployment, supply problems and high oil prices. But perhaps a more significant development was that he dropped the word “subdued” when talking about inflation. Total CPI inflation has picked up reflecting the high commodity prices, though this can be expected to fall back. In May it rose 0.2% to be 3.6% up on a year earlier. But perhaps of more concern was the 0.3% increase in core CPI, less food and energy, in May (1.5% up year-on-year). It should however be noted that higher prices inflation is not feeding into higher wages growth.

On monetary policy, the Fed stated that economic conditions were “likely to warrant exceptionally low levels for the federal funds rate for an extended period”. In other words the Fed Funds rate of 0-0.25% (introduced in December 2008) could be in place for another 12-18 months, possibly longer.⁹ Concerning QE, the Fed stated that it would complete its purchases of \$600bn of Treasury bonds by end-June and would maintain its existing policy of reinvesting the proceeds of maturing assets into Treasuries, thereby maintaining the size of the Fed's balance sheet and preventing a *de facto* tightening of policy. (The Fed made its final purchase of \$4.9bn of Treasury bonds on 30 June 2011.) To date, the Fed has ruled out QE3. But given that monetary policy is *de facto* the only major policy tool left to the authorities to stimulate the economy given the dire fiscal position, it cannot be ruled out altogether.

The need for fiscal consolidation

The IMF in its recent assessment of the US economy paid particular attention to the state of the US's public finances.¹⁰ They said that damaging "unfavourable fiscal outcomes" could take the form of a sudden increase in interest rates and/or a sovereign downgrade if an agreement on fiscal consolidation did not materialise or the debt ceiling was not raised soon enough. (These are both discussed below.) The IMF claimed that these events would have significant global repercussions, given the central role of US Treasury bonds in world financial markets. But they also cautioned that an "excessively large upfront fiscal adjustment could significantly weaken domestic demand".

The key fiscal priority for the US was therefore to "implement credible and well-paced consolidation programmes focused on bolstering medium-term debt sustainability". But, given the tepid recovery thus far, consolidation should "ideally be gradual and sustained so as not to undermine growth prospects." In other words, there was a need for a medium-term deficit reduction programme, coupled with short-term fiscal support.

The recent long-term budget outlook by the Congressional Budget Office (CBO) underlined the need for medium-term fiscal consolidation plans.^{11,12} The CBO reported that the national debt (held by the public) as a % of GDP was already the highest in history except for World War II. It was expected to reach nearly 70% of GDP in fiscal year 2011 (FY2011).^{13,14}

The CBO also presented the outlook under two scenarios that embodied different assumptions about future policies governing federal revenues and spending:

- The first, the Extended-Baseline Scenario, adhered closely to the current law and concluded that federal debt held by the public would grow from 69% (FY2011) to 84% by 2035.
- The second, the Alternative Fiscal Scenario, incorporated several changes to the current law (especially relating to taxes) that are widely expected to occur or that would "modify some provisions of current law that might be difficult to sustain for a long period". This scenario was, therefore, more "realistic". Under this scenario the CBO projected that the national debt held by the public would climb to 100% of GDP by 2021. By 2023, it would break the World War II historical record of 109% of GDP. It would then continue to rocket upward to 190% of GDP by 2035. This scenario graphically underlines the requirement for medium-term fiscal consolidation.

Negotiations held up by partisan bickering

The current negotiations relating to the Budget for FY 2012 (for October 2011 to September 2012) and the required increase in the debt ceiling are marked by clear disagreements between two parties, accompanied by much partisan bickering. Time is beginning to run out. The President, along with his party, has one approach, whilst the Republicans have a very different approach. To complicate matters the Democrats control the Senate, whilst the Republicans control the House of Representatives. (The current make-up of Congress is discussed in a footnote below.)

To simplify, the President broadly wishes to maintain spending commitments, provide a short-term fiscal stimulus, whilst supporting increased tax revenues either by raising taxes or closing loopholes. He seems reluctant however to engage with the construction of a radical medium-term deficit reduction package (arguably). On the other hand, the Republicans, influenced by the Tea Party movement, would like severe short-term spending cuts, which could derail the recovery, whilst objecting to any tax rises.¹⁵ Suffice to say compromises will have to be made but finding those compromises is proving a long and difficult process.¹⁶

Whilst there is more time to discuss the 2012 Budget, time really is running out vis-à-vis the need to increase the national debt ceiling, which must be agreed by Congress very soon.¹⁷ The ceiling in question relates to debt as defined by “total public debt outstanding”, which comprises:

- Debt held by the public, representing all federal securities held by institutions or individuals outside the US government, as discussed above under the CBO.
- Intragovernmental holdings, representing US securities held in accounts which are administered by the US government, such as the OASI Trust fund administered by the Social Security Administration.

The current ceiling is \$14.3tn and was technically hit in May, though the Treasury is currently working around the limit. However the Treasury has said that its measures to fend off default will be exhausted by 2 August 2011.¹⁸ Despite the conflicts between the Republicans and Democrats there will surely be a short-term deal, even if the negotiations for the Budget drag on further, and default will surely be avoided.^{19,20}

Footnote: America's balance of power

The current Congress, the 112th, runs from January 2011 to January 2013. The Congress consists of:

- The 100-member Senate, 2 per state, which has a Democrat majority. There are 51 Democrat Senators, supported by 2 independents, and 47 Republican Senators. The President of the Senate is Vice-President Joe Biden. Senators serve staggered 6-year terms.
- The House of Representatives which went Republican in the mid-term elections of November 2010. There are 435 voting Representatives and 6 non-voting Representatives. Of the voting Representatives, 240 are Republican, 192 are Democrat and there are 3 vacancies. The Speaker is John Boehner (R). Representatives serve for just 2-year terms.

References

1. Ruth Lea, “The MPC and the Budget: marking time”, Arbuthnot Banking Group, 4 April 2011.
2. IMF, “Mild slowdown of the global expansion, and increasing risks”, 17 June 2011, available on www.imf.org
3. IMF, “Concluding statement of the 2011 Article IV mission to the USA”, June 2011.
4. S&P indices, “National home prices hit new low in 2011Q1, according to the S&P/Case-Shiller home price indices”, 13 May 2011.

5. The boom in home prices was partly driven by so-called “NINJA loans”, a type of subprime loan. They were described as a “No Income, No Job, (and) no Assets” loans because the only thing an applicant had to show was his/her credit rating. NINJA loans were especially prominent during the US housing bubble of the 2000s but have gained wider notoriety due to the subprime mortgage crisis in July/August 2007 as a prime example of poor lending practices.
6. Federal Reserve, “Economic projections of the Federal Reserve Board Members and Federal Reserve Board Presidents, June 2011”, 22 June 2011, www.federalreserve.gov
7. IMF, “Mild slowdown of the global expansion, and increasing risks”, 17 June 2011, available on www.imf.org
8. The next FOMC meeting is 9 August. The FOMC has 8 scheduled meetings a year. At these meetings, the FOMC reviews economic and financial conditions, determines the appropriate stance of monetary policy, and assesses the risks to its long-run goals of price stability and sustainable economic growth.
9. Board of Governors of the Federal Reserve System, press release, 22 June 2011.
10. IMF, “Concluding statement of the 2011 Article IV mission to the USA”, June 2011.
11. Congressional Budget Office, “CBO’s 2011 long-term budget outlook”, June 2011, www.cbo.gov
12. Note that the states, with the exception of Vermont, are required to run balanced-budgets.
13. The US fiscal year begins on 1 October of the previous calendar year and ends on 30 September of the year with which it is numbered. Thus FY2011 runs from October 2010 to September 2011.
14. In FY2010, government outlays were \$3,456bn, revenues were \$2,163bn (62.5% of outlays) and the deficit was \$1,294bn (8.9% of GDP). GDP in FY2010 (October 2009 to September 2010) was \$14,540bn.
15. A large bloc of Republicans elected in last November’s midterm elections are influenced by the Tea Party movement, named after the Boston Tea Party. TEA is a “backronym” for Taxed Enough Already.
16. *FT*, “US budget impasse”, 21 June 2011, reported that a Budget deal was beginning to take place. The deal was in the form of a “down-payment” in the form of spending cuts, backed by a longer-term commitment to bring the deficit down to under 3% over 3-5 years. The Republicans are likely to compromise over increases in revenues too.
17. Congress decides the debt ceiling, which is the limit of how much debt the US can owe without risking default. Congress raises the ceiling when they feel the need to borrow more money to sustain the economy. The legislature has had these powers since 1917 and has raised the debt ceiling 74 times in the past 50 years, and about ten times since 2001.
18. The IMF said there would be a severe shock to the capital markets if the US failed to address the debt ceiling. A failure by Congress to increase US borrowing authority by 2 August would have a “significant and unpredictable impact” on capital markets.
19. *FT*, “US budget impasse”, 21 June 2011.
20. The White House probably needs to strike a deal by 22 July 2011 to avoid the risk of defaulting, so that it can get the requisite legislation through the Senate and the House of Representatives by 2 August 2011.

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