

US recovery looks like a long, hard slog

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The US economy is slowing, but how close is it sailing to the much feared double-dip recession?

The US Federal Reserve announced a new round of quantitative easing by re-investing in longer-term Treasury securities and indicated that “exceptionally low levels of the federal funds rate” were likely for an extended period.

Most voting members of the Fed's open market committee were not convinced by Thomas Hoenig, whose judgment is that the US economy probably is recovering modestly. Or at least they were taking no chances.

As the former Federal Reserve governor, Frederic Mishkin, famously argued, monetary policy in the presence of a financial crisis must be flexible and conducted with an eye to the “tail risks” – the high-impact, low-probability events buried in the tail of the forecaster's probability distribution.

In the present, still-fragile state of the US financial system, a second dip into recession could have an exaggerated effect on bank lending, which could make the recession worse. That, in turn, could make the banking system even more risk-averse, which would feed back on the economy.

The Fed's decision will strengthen the ability of banks to lend and keep downward pressure on long-term interest rates.

Economists are debating whether it will be enough. But in an interesting review of the chances of a double-dip recession, Michael Blythe's team of economists at the Commonwealth Bank of Australia argue that the strength of US business investment has already sharply reduced the risk of a double-dip recession. Business investment rose almost 7 per cent in the June quarter and is now running almost 30 per cent above its mid-2009 level.

The US corporate sector, the bank's team argues, is benefiting from both a big drop in the US dollar and a massive increase in productivity as a result of labour shedding. The real exchange rate is close to its lowest level in 40 years. This has brought the labour shedding to a halt and triggered a turnaround in business investment.

The trends in capital goods orders, they say, suggest that the upturn in investment spending has further to run. They also bode well for employment, capital spending providing a pretty good marker for turning points in US employment growth. The nominal value of non-defence capital goods orders is running about 19 per cent up on a year ago.

Nevertheless, it seems the US recovery is shaping up to be the long, hard slog that the International Monetary Fund and almost everyone else thought it would be – at least until the recent burst of growth raised hopes that this might be an exception to the rule of financial crisis recoveries.

The lesson of history is that recoveries from financial crises and internationally synchronised recessions are slow.

Why? Because, the IMF explains, households and businesses are trying to rebuild their balance sheets and face a shortage of credit. Spending with long planning horizons and industries that rely heavily on credit are slow to recover. Synchronised recessions also are, on average, longer and deeper, and the recoveries from them are slower, because there is less opportunity to use exports as an engine for growth.

The IMF says it takes 50 per cent longer for economic output to recover after a synchronised recession. The 2008-09 recession was both a financial crisis and synchronised.

A key reason for financial crisis recessions being worse than ordinary recessions is that consumer spending takes a bigger hit. And the IMF's profile of financial crisis recoveries shows consumption grows more slowly than in ordinary recoveries.

The accompanying graphs show the average level of activity measured in index points for 12 quarters following the start of the recovery. Private investment continues to decline after the trough in gross domestic product, residential construction declining for two years after the beginning of the recovery. Credit growth is faltering. House prices are weak.

Most of these weaknesses are evident in the US. The Fed notes that household spending remains constrained by high unemployment, modest income growth, lower housing wealth and tight credit. Non-dwelling construction continues to be

weak. Employers remain reluctant to hire. Housing starts remain depressed, and bank lending is still contracting.

Unfortunately, both the demand and supply sides of the economy have been damaged by the financial crisis.

IMF economists estimate that the US economy's potential growth rate will be reduced for several years. Potential output growth is driven by the labour supply and productivity growth which, in turn, is driven heavily by capital investment and innovation. It is the level of growth that can be sustained without putting strain on resources and creating inflation pressures.

This will become an issue in the later stages of the recovery and in the post-recovery expansion.

The economists predict that the potential growth rate will fall below 2 per cent in the coming years and rise only slowly to about 2 per cent by 2014.

The Australian Financial Review

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