

The Recovery Might Be a 98-Pound Weakling

By Kevin L. Kliesen

During the third quarter of 2009, real GDP rose at a healthy 2.8 percent annual rate. This increase, the first in a year, and the likelihood of continued moderate growth in the fourth quarter signaled the end of the Great Recession, which started in December 2007. However, a majority of the public probably has a different opinion because most people often view the state of the economy through the lens of labor market conditions, which remain quite weak. Regardless, the discussion among economists and forecasters is turning to the contours of the recovery in 2010 and to whether inflation will remain quiescent. Many economists and key policymakers expect real GDP to continue to grow this year, by about 3 percent, with CPI inflation to be about 1.75 percent. Still, there is some concern that the recovery may weaken as the temporary measures that were designed to boost growth come to an end.

An Unusual Recession and Recovery

Typically, deep recessions are followed by strong economic recoveries. Following the 1973-75 and 1981-82 recessions, real GDP growth averaged 7 percent during the first four quarters of the recovery. By comparison, the recoveries that followed the relatively shallow 1990-91 and 2001 recessions produced only modest real GDP growth, and the unemployment rate continued to rise well after the recession ended. Thus, if the past is any guide for the future, forecasters should have projected rapid real GDP growth and a sharp decline in the unemployment rate for 2010. Yet, that is not the case: The consensus of forecasters surveyed in November 2009 for the Philadelphia Fed's Survey of Professional Forecasters was that real GDP growth would average about 2.5 percent in 2010 and that the unemployment rate would remain above 10 percent for most of the year.

This forecast is even more unusually low in light of the exceptionally robust

countercyclical policies put in place to jump-start the economy. On the fiscal side, these temporary measures included fiscal stimulus packages in 2008 and 2009, a tax credit for first-time home buyers and the so-called Cash for Clunkers program. On the monetary side, Federal Reserve policymakers initiated several innovative lending programs designed to improve conditions in financial and mortgage markets. Fed policymakers also stated their intention to maintain their federal funds interest rate target at an exceptionally low level for "an extended period."

The Recovery's Potholes

When attempting to project the pace of economic activity over the next several quarters, forecasters often look closely at factors that influence spending by households (consumption and housing investment) and businesses (fixed investment). Together, these components comprised a little less than 85 percent of GDP in 2009. The following are likely to be key developments influencing the pace of household and business expenditures, and thus the shape of the recovery, in 2010.

First, job gains are expected to average about 11,000 per month over the first half of 2010 and then average about 150,000 per month over the second half. With weak job growth likely moderating the pace of consumer spending, businesses are going to be reluctant to boost outlays for structures, equipment and software.

Second, households continue to boost their saving rates and pay down the sizable levels of debt that were taken on over the past 20 years or so.

Finally, the U.S. economy appears to be undergoing some significant structural changes in the aftermath of the financial crisis and Great Recession. As labor and capital leave these industries (for example, autos



and housing), time is needed for these economic resources to become fully employed again. For all of these reasons and more, the recovery is expected to be relatively tepid compared with the snap-back that typically follows deep recessions.

Disagreement about the Inflation Threat

Much disagreement seems to exist about the outlook for inflation over the next two to three years. Some economists believe that a high unemployment rate, subdued inflation trends and well-anchored inflation expectations will keep inflation low and stable over this period—and maybe beyond. Other economists, while perhaps not sensing an imminent threat this year, point to the potentially inflationary consequences of doubling the monetary base, large protracted fiscal budget deficits and further declines in the dollar.

Despite these concerns, financial market indicators and surveys of households and businesses generally suggest little fear of deterioration in the inflation outlook over the next few years. As long as inflation expectations remain low and stable, long-term interest rates should also remain relatively low and stable. Long-term price stability will help the economy as it evolves in the face of structural change and in the labor market dislocation that this change produces. 

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