

# The Economy Looks for Its Second Wind

By Kevin L. Kliesen

Following a burst of activity late last year and early this year, the recovery hit the summer doldrums. The second-quarter slowdown was weaker than most forecasters were expecting, and many have since downgraded their assessment of growth over the second half of 2010. Still, forecasters generally do not expect a “double dip” recession, and few have significantly downgraded their assessment of the economy’s growth prospects for next year. Still, many businesses remain hesitant to expand their productive capacity and hire additional workers.

To an important degree, this hesitancy stems from weak growth in consumer spending—despite solid growth of real after-tax income and labor productivity. On the one hand, lackluster consumer spending reflects weak job growth and a stubbornly high unemployment rate. On the other hand, it also reflects an upsurge in the personal saving rate and a downshift in the demand for credit (probably stemming from a desire by households to reduce their debt-to-income ratio).

At the same time, business expenditures on equipment and software have risen sharply since the third quarter of 2009. This upsurge reflects solid gains in manufacturing activity, which was bolstered by the inventory cycle and a rebound in exports. With the inventory restocking largely complete, the economy’s dependence on exports and capital spending will increase in importance unless the pace of consumer spending picks up.

Traditionally, housing construction is a key driver of real GDP growth during the initial stages of the recovery. But that’s not happening this time, as housing activity remains weak and appears unlikely to contribute much to near-term growth.

Businesses also remain reticent to expand because some stiff headwinds have produced higher-than-usual levels of uncertainty about

the economy’s near-term strength. This uncertainty stems from several sources.

The first is reversing—in a timely manner—the extraordinarily stimulative policies undertaken by U.S. fiscal and monetary policymakers. Trillion-dollar budget deficits and near-zero short-term interest rates are not consistent with maximum sustainable growth and price stability over time.

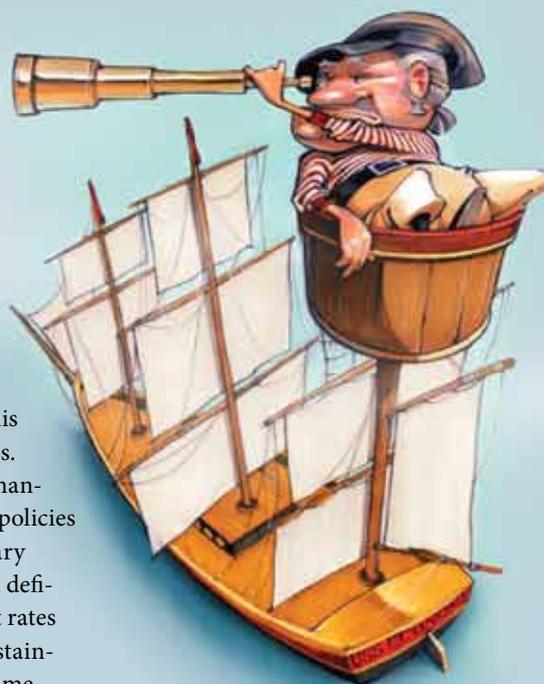
Second, the automotive, construction and finance industries are undergoing significant reorganization. These structural adjustments have lengthened the duration of unemployment for many individuals.

Third, many firms are uncertain about the future cost of their capital and labor because of recent policy initiatives related to health-care financing and financial regulation and to the possibility of higher tax rates next year.

Concerns about the health of the global economy and its potential effect on the United States have also weighed on U.S. financial markets. The source of concern mostly stems from the tumult in European banking and financial markets earlier this year. Facing unsustainably large budget deficits, several European countries, including the United Kingdom, undertook actions to reduce spending or raise taxes. Since the European sovereign debt crisis erupted in late April, equity prices and interest rates have fallen noticeably, and the St. Louis Fed’s Financial Stress Index remains above its long-run average. In short, quelling these myriad uncertainties will help bolster the growth of U.S. output and employment.

## Another Deflation Scare

In the minutes of the June meeting of the Federal Open Market Committee (FOMC), some members expressed concern about the possibility of deflation developing in the United States. Counting this episode, there have been three deflation “scares” in the United States over the past decade or so;



the other two occurred in 1997 and in 2003. Although core and headline inflation (12-month percent change in the price indexes) is near zero if one accounts for the measurement biases that are still inherent in the Consumer Price Index, most forecasters believe that the probability of deflation this year and next remains extremely small.

At the same time, financial markets appear less certain about deflation. Over the next three years, Treasury market participants have lowered their expected inflation rate by 1 percentage point to about 0.75 percent. Assuming no change in food or energy prices, this would be the smallest three-year core inflation rate since the 1930s.

But as events over the past few years have shown, the unexpected can happen. With inflation at low levels, an adverse economic shock could cause actual and expected inflation to turn negative. If this were to occur on a sustained basis, nominal incomes would fall relative to debt, thereby increasing the real cost of servicing the debt and, thus, imparting a further drag on real activity and, thus, prices. Likewise, with an abundance of monetary stimulus in the pipeline, an unexpected surge in demand may cause the opposite to occur: an unacceptable rise in actual and expected inflation. The FOMC is committed to avoiding either outcome. 

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