A Closer Look

US outlook for 2012: Crosscurrents

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Overview

There are a lot of crosscurrents buffeting the US outlook for 2012, with plenty of risks, but also some hopeful signs. On the plus side, progress has been made in working off some of the excesses of the housing/credit bubble, and we expect that progress to continue, gradually reducing the headwinds that have been restraining this recovery and eventually enabling growth to shift into a higher, more self-sustaining gear. Pinning down the timing of this shift is difficult, though, because the shocks the economy is struggling to recover from are near the outer bounds of historical experience. It’s hard to know just how much longer the legacy of the bubble years will continue to weigh on activity, and whether some scars will be permanent. Recent data are encouraging, but this recovery has seen false dawns before. And events abroad, especially in Europe, pose fresh risks. If the European situation were to metastasize into a full-blown financial crisis—not our base-case, but a palpable risk—it would severely damage, and possibly even derail, the US recovery. If Europe manages to “muddle through,” as we expect, avoiding the disaster scenario but still suffering a recession and credit tightening as it gropes to a fundamental resolution, the US will feel some ill winds, particularly in the first half of 2012, but these effects should be manageable. Another wild card is US fiscal policy; it is set to turn less supportive in 2012 (albeit nothing like the tightening in the cards for Europe), but how much so depends crucially on whether the payroll tax cut and prolonged unemployment insurance benefits are extended. If they are, as we still expect, the fiscal drag will be mitigated. And monetary policy is likely to remain accommodative for years, with Federal Reserve policymakers even standing ready to do more, principally through enhanced communication strategies but potentially even through additional asset purchases should the outlook deteriorate.

On balance, if the worst-case risk scenarios in Europe can be avoided, we see 2012 as a year of further modest recovery for the US from the trauma of 2008–’09, with real GDP advancing at a 2½% to 3% rate (assuming at least some fiscal stimulus is extended). The pace will likely be weaker in the first half of the year, when the worst effects of Europe’s travails are apt to hit, and then gradually firm, but still remain shy of the kind of robust expansion needed to make more rapid progress in repairing the damage from the downturn. That will likely have to wait a while longer.

A look back

Hard to believe, but it will soon be six years since the US housing market peaked. Six years since the whole housing/credit bubble first began to deflate, setting in motion the worst economic and financial crisis since WWII, whose aftereffects the US economy is still trying to shake. The decline began gradually enough, with home prices and housing activity starting to edge down in 2006, then picked up speed and ominously spread in 2007, when strains began to appear in the financial system and the broader economy started to weaken. But that was a mere prelude to the carnage that ensued in 2008 and early 2009, when the financial system nearly collapsed, and the economy plunged into severe recession. Aggressive policy actions helped prevent even worse outcomes, and together with the economy’s natural recuperative powers and a purging of some of the worst excesses of the boom, have gotten activity back on a recovery path. But that recovery—now 2½ years old—has been modest, wholly inadequate to repair the damage done during by the financial crisis and recession.
Just a few broad metrics can give a sense of the losses. Real GDP has just recently gotten back above its pre-recession level, which is nearly three times longer than it typically takes following a recession. And just getting output back to where it was doesn’t mean the losses from the recession have been recouped. Far from it. Output (and the income generated in its production) is a flow per unit of time; although that flow has now been restored to what it was, the sum total of output produced (income earned) over the past four years is well below what it would have been absent the recession. Even if output had stayed flat at its pre-recession level, it would have summed to about 2% more than was actually produced during the recession and subsequent recovery. And if real GDP had continued to grow at its pre-recession trend of about 2½% per annum, its cumulative sum since the peak of the last business cycle would have been about 6½% more than was actually produced. In 2011 dollars, that translates into roughly $4 trillion of “missing output” as a result of the Great Recession and its aftermath.

The hit to wealth has been similarly huge. Households lost almost 25% of their net worth between mid-2007 and early 2009, reflecting declines in the prices of both houses and equities. And they’ve recouped only some of those losses since then; indeed, household net worth remains about 14% below its mid-2007 peak. Adjusted for inflation and population growth, net worth is still about 25% below its peak, and has not increased, on balance, for about a decade.

The toll on the labor market has also been enormous. About 8.8 million jobs were lost in the recession and its immediate aftermath, and only 2.5 million have been restored, leaving the level of payrolls about 6.3 million, or 4½% below its pre-recession peak. And even that understates the damage. To keep up with growth in the working-age population, about 4½ million jobs needed to have been created since the end of the last recession. So the level of payrolls is really closer to 11 million shy of what would be necessary to restore employment to the same share of the working-age population as it was before the downturn.

Clearly, the recession wrought havoc, and the recovery has repaired little of the damage. On even the most optimistic outlooks, it’s going to be a long climb back. Even if real GDP were suddenly to start growing at a persistent 4% annual rate—highly unlikely any time soon—it would take more than five years to get back up to a level consistent with the pre-recession growth trend. Similarly, even if payrolls were to begin increasing at a 2% annual rate, or roughly 220k per month—also not terribly likely—it would take 2½ years just to get back to the pre-recession level, and about seven years to restore the employment-population ratio to where it was. Worse, these gaps may never fully close. A number of studies suggest that deep, prolonged recessions, especially those related to financial crises and housing collapses, can dent the level of trend output (though usually not the permanent growth rate) and raise the structural rate of unemployment, not least because the longer the economy remains mired in a slump the more likely it is for the capital stock and especially labor resources to deteriorate, as prolonged bouts of unemployment erode skills and weaken attachments to the labor force.1 Those risks may have increased in the US in recent years given the large rise in the long-term unemployed, the decline in labor force participation, and even some hints of deterioration in the matching of the unemployed to available jobs. How much of this type of

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long-term damage the US is apt to sustain is hard to say, and may not be clear for years. Right now, the economy still seems to be operating far below most estimates of the level of potential output or full employment; if it weren’t, labor costs and underlying inflation would not likely be so dormant, nor would there be so few reports of labor shortages and production backlogs. So even if the level of output is never able to get all the way back onto its pre-recession path, and employment is not able to be restored fully to its former share of the working-age population, there’s likely still plenty of “non-inflationary running room,” or scope to re-employ idle resources and sustain a period of rapid growth once aggregate demand recovers more fully.

So far, though, that type of vigorous recovery has been slow to materialize, largely because of persistent headwinds from the bursting of the housing/credit bubble. An overhang in housing, for example, has constrained the rebound in a sector that normally leads the way out of recessions. Similarly, efforts by households to repair balance sheets and reduce debt after the hit to their wealth, coupled with a more cautious attitude by lenders who are still licking their own wounds, have kept the snap-back in consumer spending well below historical norms. Indeed, real per capita consumption is still below its pre-recession peak, marking the weakest sustained performance in the post-WWII era. State and local governments have been retrenching as well, further depressing aggregate demand. Against this backdrop, firms have been reluctant to expand, despite their generally strong financial positions, keeping the rebound in capital spending and hiring—which normally amplify and propagate an economic recovery—subdued. All in all, the fallout from the bubble era has weakened the economy’s usual recovery mechanisms, delaying and diluting the venting of pent-up demands that typically fuels recoveries, while also rendering monetary stimulus, which normally works in part by supporting housing and other interest-sensitive sectors, less effective.

A look ahead

The outlook hinges crucially on when these lingering headwinds will die down sufficiently to allow more normal recovery mechanisms to kick in. The good news is that progress has been made in curbing some of the most egregious imbalances of the bubble era, suggesting that the restraints are easing, and should diminish further in 2012. But they’re probably not all gone, and new risks, stemming primarily from the European crisis, pose additional challenges.

One area where progress has been made is housing. House prices have been bought back into much better alignment with fundamentals. Ratios of home prices to rents are no longer above their long-term averages, and we estimate ratios of home-ownership costs to rents to be below their long-term averages because real mortgage rates are so low. Of course, that doesn’t mean home prices are ripe for a rapid recovery. A lingering pipeline of foreclosures and other shadow inventory of potential homes for sale, coupled with still-tepid demand for home buying given the sluggish recovery of the labor market, a slow rate of new household formation (itself a function of weak labor markets), and residual scars from the housing-market devastation of recent years, is likely to keep a lid on home prices for some time. Still, the steep declines are likely behind us, and the conditions for at least a broad-based bottoming in home prices seem at hand. A similar, if even slightly more upbeat argument can be made for housing activity. New home building has been running below the pace consistent with underlying demographics (even allowing for a temporarily slower rate of household

Chart 3: Nonfarm Payrolls—A Big Hole to Fill

![Chart 3: Nonfarm Payrolls—A Big Hole to Fill](image)

Source: BLS

Chart 4: Real Consumption Per Capita—A Damaged Trend?

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Source: BEA, Census
for nearly four years, whittling down the excess of homes built during the boom. That excess is probably not all gone, but substantial headway has been made, enough perhaps even to allow a modest pick-up in new home construction, likely concentrated in the multi-family sector, to capture the ongoing shift away from home ownership and toward renting. Again, a meaningful recovery in housing still seems far off; but the steep, pernicious drag that this sector has imparted on the broader economy in recent years—through declines in both prices and activity—appears to be near an end.

Households have also made strides in improving their financial positions. Household debt has declined for an unprecedented 13 straight quarters, as both borrowers and lenders have taken a more cautious attitude towards new credit and some households have paid down or defaulted on existing obligations. The cumulative decline in household debt has only been about 5%, though, and together with modest income gains has chipped just a little more than 10% off the peak debt-to-income ratio reached in 2007, bringing it back to 2004 levels. But the changes households have already made to their spending/borrowing patterns imply that further declines in debt ratios are in train, and do not require additional restraint on consumption. Moreover, even more progress has been made in bringing down debt servicing burdens; aided by lower interest rates, the ratio of household debt payments to income has reversed all of its increase from the boom years and fallen back to levels not since the mid-1990s. All told, consumption should at least be able to grow in line with disposable income, which is likely to firm as job growth continues to improve. Another boost to household purchasing power is on the way from declines in energy prices brought about by weaker global demand, reversing at least part of what had been a significant drag on disposable income earlier in the year.

Credit conditions have improved markedly since the financial crisis, with banks gradually becoming more willing to lend again, and credit spreads generally narrowing. One exception is the recent tightening of credit conditions by European banks in the US; this is a direct result of pressures on their liquidity and capital positions owing to the financial crisis engulfing the region, and there’s probably more of this to come. Even US banks may become a bit more cautious in credit allocation given their exposures to Europe. This is one of the key channels through which the European crisis is apt to damp US activity. And even before Europe’s recent woes, it was clear that US credit conditions were not going to return to the free-wheeling days of the bubble era, especially not in areas like sub-prime mortgage financing. But barring a complete meltdown in Europe, they’re not headed back to 2008–2009 stresses either. Reasonable credits can get financing on reasonable terms and, in general, conditions have been becoming gradually more accommodative. Further, real interest rates are at historic lows, encouraged in part by the Fed’s aggressive monetary stimulus, so the real cost of borrowing for many is extremely favorable.

And it’s likely to stay that way for a long time. The Fed is apt to maintain an accommodative policy stance, holding the funds rate at zero and keeping its balance sheet elevated for years, until the recovery becomes much stronger and more self-sustaining. Although policymakers are encouraged by the firmer tone of recent data, they’re concerned about downside risks, especially from Europe. With inflation in check and even likely to move lower in 2012, restrained by ample spare capacity, tame labor costs, benign inflation expectations, and declining commodity prices owing to weaker global demand, the Fed
has latitude to keep policy accommodative and, if need be, to ease further. Obviously, the Fed is out of conventional ammunition, but there are still tools in the policy quiver. Policymakers can refine their communications—perhaps first by adopting explicit forecasts for the Fed funds rate to go alongside their forecasts for inflation and growth—to increase transparency and strengthen expectations that policy will remain accommodative for a long time, thereby holding down the expectations of future short-term rates embedded in longer-term rates and supporting risk assets. Other moves, less likely right away, include tying policy to some medium-term objectives for unemployment, inflation, or nominal GDP. Finally, there is always the option of more asset purchases, though that would likely require a significant deterioration of the economic outlook and/or a boiling over of the European crisis. Of course, nothing the Fed has done or is likely to do is a panacea; but monetary policy has clearly helped, and we expect it to remain supportive.

The outlook for fiscal policy is murkier. We still anticipate that at least some stimulus will be retained in 2012, but this is far from guaranteed. There is a non-negligible risk, for example, that the payroll tax cut and extended unemployment benefits don’t get renewed. This is really part of a broader concern that fiscal policy gets tightened prematurely. Although major fiscal adjustments will eventually be needed, they can and ought to be phased in gradually over many years, and structured so as to minimize their adverse effects on economic activity (e.g., tax reform that lowers marginal rates and reduces deductions so as to bring in more revenue but in ways that are less disruptive to economic activity, plus entitlement reform that encourages people to work longer, save more, and be more economical in their health choices). Whatever fiscal adjustments are made, it is crucial they not be implemented until the private sector is on sound footing.

And it’s not quite there yet. Yes, much of the corporate sector is in solid financial health; yes, there seem to be pent-up demands, both for consumer spending and business investment given how little they’ve recovered following their deep declines during the recession, and how old the average ages of the stocks of consumer durables and business capital are by historical standards; yes, recent economic data have been perkiest; and yes, as we’ve already stressed, some of the headwinds that have been holding back this recovery have diminished. But they’re not all gone. Housing is not ready to play even a shadow of its usual role in supporting economic recovery, nor is consumer spending. Though it’s hard to say just when the healing will have proceeded sufficiently to allow more normal recovery dynamics to take hold, it’s unlikely to be completed in 2012, especially given the rising risks emanating from outside the US.

The crisis in Europe poses the greatest threat to the near-term US outlook. If it spirals out of control, resulting in disorderly debt defaults, a break-up of the EMU, bank runs, a deep credit crunch, financial crisis, and severe European recession, the US would be hard hit. The impacts would be felt partly through the trade channel (fortunately, US exports to the EMU make up only about 2% of US GDP), but more through financial linkages, which are harder to pin down but would surely include tighter credit, weaker equity prices, and lower confidence. Even if European policymakers succeed in averting this disaster scenario, as we expect, Europe still faces at least a mild recession and credit tightening, while global financial markets are apt to remain on edge for some time as a fundamental resolution of Europe’s problems proves elusive. Some of this is sure to blow across the Atlantic, especially in H1 2012. And Europe is not the only source of worry on the global front. Emerging economies face challenges too, albeit different ones. Many are slowing down, and will likely slow further in the near term, partly as the lagged effects of policies aimed at reducing overheating risks and curbing incipient asset/credit bubbles kick in, but also because of the potential knock-on effects of Europe’s crisis, especially to emerging economies’ exports. We still think most will be able to skirt a “hard landing,” though, aided by healthy lashings of policy stimulus (many emerging economies have already begun to shift policy gears, and more easing is on the way), and predicated on Europe containing its crisis. But less benign outcomes abroad are certainly possible, with commensurately greater adverse effects on the US.

**Conclusion**

All told, if the world (especially Europe) can avert disaster, the US recovery should persist at a moderate pace in 2012—a bit weaker perhaps early on, then gradually improving as the post-bubble headwinds continue to wane. But recovering from the kind of massive shocks that hit the US in recent years is not easy. And some scars may persist. The healing is well under way, though, and barring new shocks, should eventually enable a more normal recovery.

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2For more on our view on Europe, see “Europe in Crisis,” A Closer Look, November 2011, DB Advisors. https://www.dbadvisors.com/globalResearch/economic_viewpoint_4586.jsp
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