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"Status of the U. S. Economy"

Economic Outlook

Chairman Conrad, Senator Gregg, members of the Senate Budget Committee. Thank you for the opportunity to discuss my views on the current status of the economy, where we may be going over the next year and also provide some thoughts about the role fiscal policy might play in the recovery.

The good news is that we have had one full year of economic growth. Over that time, the economy has expanded by 3.2%, a very impressive performance given the problems the economy faced. Consumers have started spending again, though they are not "shopping 'till they drop". Maybe it is better described as "shopping 'till they're tired". Business investment, which had collapsed during the recession, has made a strong comeback. Exports are also solid as the generally weaker dollar has helped our competitiveness overseas. All of these factors tell me that the recession is over.

Unfortunately, my outlook for the next year is very cautious. Indeed, that has been my view this entire year. Early last fall, I warned that we should watch for what I called "the head fake". Growth would probably accelerate, but the sharp upturn would likely be the result of temporary factors and as a consequence, it might not be sustainable. Already we are seeing signs of fraying around the edges, if not the core, of the recovery.

Indeed, it was unrealistic to expect a strong, "V-shaped" recovery. The economy was, still is, and will continue to face a number of significant headwinds that will restrain growth. First and foremost, the enormous damage done to the economy by the bursting of the housing bubble and the near collapse of the international financial system continues to weight on the economy because it is not something that could be cured in a short period of time.

While the banking industry is better, it is far from being in good condition. Bank failures this year are running at twice the pace they were last year. Larger institutions are concentrating on rebuilding capital not adding to their loan books. As a result, credit, while more available today than one year ago, is still limited.

In part, tight credit is the result of having gone through the worst recession since the Great Depression. Bankers like to say that they are not turning down good loans. Technically, that is correct. But the devil is in the details of what constitutes a "good loan". Credit reviews require looking back at the past few years of corporate financials.

Since that encompasses most of the recession, not many firms would have had stellar results over that period of time. Not surprisingly, then, it has been hard for financial institutions to find what they are defining as really good credit risks.

In addition, there is the reality that financial institutions, as they always do, have tightened standards. As the recent Federal Reserve's Quarterly Senior Loan Officer survey shows, those requirements have not been modified. Unless growth turns out to be stronger than I expect, there may be no significant easing for at least twelve to eighteen months. Since the economy runs on credit, this major headwind, limited credit availability means the growth potential is reduced.

The second element of the economic crash was the bursting of the housing bubble. This not only took down the home construction sector but was also the key factor in the collapse of so many of our major financial institutions. I do not believe that housing will play a major role in growth for the remainder of 2010 or even most of 2011.

This is a concern because in previous upturns housing either led the recovery or within one quarter was once again growing robustly, often by double-digit rates. This is not likely to happen because of a number of factors. First, it is "back to the future" when it comes to mortgage credit standards. The days of "no docs" and little or nothing down are over, thankfully. But that also means fewer people will qualify for mortgages.

But maybe more important is the loss of equity that many homeowners have suffered. The housing market gets its vibrancy from people trading up - or down. Until equity is rebuilt, a smaller number of households will be able to meet the down payment requirements. Each time a homeowner cannot sell their home, take the equity and buy a new house, at least two sales are lost.

This diminution of demand is but one factor in the dismal forecast for new residential construction. There is also the foreclosure crisis. Foreclosures are greatest in those parts of the country where construction has typically been the strongest: California, Arizona, Nevada and Florida. As long as builders face the competition of a large number of low priced foreclosed units, new construction activity will be limited.

So, where can growth come from? Consumer spending makes up roughly seventy percent of the economy and it is the place where we always look first. Indeed, except for the recovery after the 2001 recession, consumers normally started hitting the malls pretty hard early in the upturn. That is not the pattern we should expect to see in this current recovery.

The most significant factor is the surprisingly depressed level of consumer confidence. However, there are very good reasons why consumers should be cautious about their economic situations.

When it comes to confidence, at least as it translates into consumer spending, we need to watch closely the perception of the labor market and job availability. This relationship has become increasingly more critical over the past twenty years.

Two decades ago, workers believed that if they did well, they could keep working for the same company. They defined job security as "the ability to work for one firm possibly for their entire career".

But businesses have learned that in a globalized economy, productivity and cost controls are critical to long term survival and workers are, unfortunately, largely overhead. Divisions are cut when the product line becomes less valuable, segments are outsourced or sold off and/or production is off shored. The employment compact between businesses and workers was broken and both groups now recognize that clearly.

What has replaced this relationship? Several years ago I argued that we should define job security as "the ability to walk across the street and get another job". Essentially, people will feel comfortable about their economic situation when they can sell their labor easily and not feel they are stuck in their current position or at the current employer.

This new definition has critical implications. In a slow growth environment pricing power is largely non-existent. Businesses operate as efficiently as possible and at the lowest cost. Since labor is the largest expense for businesses, there must be tight controls over payrolls. You do that by limiting both hiring and wage increases. In the early part of the recovery that strategy allows profits to rise and firms to rebuild their balance sheets, a necessity given the depth of the downturn. But the solid earnings gains, created in part by limited payroll increases, are the basis for what is being described as the disconnect between Main Street and Wall Street.

Firms will continue to be hesitant to hire until they believe the economy is going to grow strongly and for an extended period. But that creates a troubling cycle. If companies limit hiring, then workers, who define job security as the ability to get a new job, are going to be troubled. We should not be surprised that consumer confidence is at recession levels. To the average person, it is job opportunities that matter and without them, they will not be very optimistic.

A depressed worker is not someone who will spend lavishly. There is a lot of debate about the value of consumer confidence surveys. Clearly, we shouldn't follow the month to month movements but only the trend. Even then, it is important to understand the reason for any changes in the outlook. I watch the confidence indices carefully when I believe they are being driven by fundamental household financial reasons, and jobs, job security and potential income gains are those key factors.

The implication is that slow job growth, which begets uncertain households, will lead to cautious spending. That is what we have right now and there is little reason to believe that will change before the end of the year, at the earliest. And the sluggish spending will limit private sector job creation. Payrolls should continue to rise, as they have all this

year, but the increases are not likely to be large enough to rapidly reduce the unemployment rate.

Speaking of the unemployment rate, don't be surprised if it ticks back up. Actually, I am looking forward to that time. If the expected upturn in the unemployment rate is due to a rise in the labor force, that would be good news. It would say that people are becoming more confident about the economy and they believe they can actually find a job. Unfortunately, it will take time for most to actually do that, so the rate will rise.

Does that mean we are having a so-called jobless recovery? The reality is that the last couple of recoveries and more than likely most future recoveries will be defined by slow job growth. The idea that recoveries lead to an immediate surge in jobs is an anachronism. It is a myth born when we were a largely manufacturing economy.

In the first four decades after World War II, as the recession progressed and inventories surged, industrial companies dramatically slowed production and furloughed large segments of their workforce. Once they discovered the recovery was under way, their inventories had fallen too far and they were forced to rehire rapidly and robustly.

The industrial economy that created lots of jobs early in a recovery in order to provide the bulk of goods and services to the suddenly expanding economy is largely history. As we saw with the latest GDP report, when the economy recovers, we feed the growing economic needs not simply with goods from domestic companies but with products from around the world. That is the downside of offshoring our industrial capacity. It may have led to lower consumer and industrial goods costs in the United States but it also means that few people will be called back to work quickly. Those workers are being hired elsewhere.

Since it is normal that recoveries begin with anemic job growth I believe we should stop using the phrase "jobless recovery" and assume that all recoveries start with modest job growth.

With job and income growth modest and consumers uncertain, the forecast for the rest of this year and into next year is for moderate consumption. It will be enough to keep the economy going, but clearly not enough to make anyone exuberant.

If consumers are not spending lavishly, can business investment remain robust? Investment in software and equipment soared at the end of 2009 and during the first half of this year. But I again suggest we read these data with caution.

From the summer of 2008 through the spring of 2009, firms dramatically cut back their capital spending. More recently, businesses have started making up for the failure to invest in capital equipment needed to remain competitive and on assets that depreciated. But that is just infilling delayed investments. Once that process is completed, firms will invest further only when they believe their returns will warrant the costs.

Right now, it is not costs that may be restraining investment; it is perceived returns. It is hard to rationalized major new purchases of software, equipment or structures if the economy is not expected to grow solidly. Uncertainty about tax policy is not helping either. As a consequence, investment may be limited to replacement and competitive factors. All this argues for solid but not spectacular gains in capital spending.

Similarly, the inventory rebuilding that added greatly to GDP growth is likely over. In 2009, firms reduced inventories in a breathtaking but excessive manner. This year, they have been refilling those empty warehouses. Once more reasonable levels are reached, firms will need only to replace depleted stocks rather than refill emptied shelves. That transition is already under way as second quarter inventory building added less to growth and it will likely become an insignificant factor by the end of the year.

So far, my forecast of a modest recovery is based on the lack of credit, a stuck in the mud housing market, an uncertain and cautious consumer and a wary business community that has largely restocked emptied warehouses, infilled depleted workforces and replaced deteriorated critical equipment and software. That leaves only three other places to get strong growth: Exports, fiscal policy or monetary policy.

The generally weak dollar, which strengthened during the European crisis, is likely to continue to decline slowly over time. This will allow for the strong gains in exports to continue. However, the sector is not large enough to carry the economy by itself. In addition, as the recovery progresses, imports will grow faster. Thus, I expect the trade deficit to widen and that will restrain growth going forward.

Without any changes in fiscal or monetary policy, my forecast for the next year is for growth to be in the 2% to 2.5% range. This may appear to be weak but we have to judge the pace not on the basis of the past two decades, when growth closer to 3.75% rate was considered to be strong. Those were artificial periods of growth.

Over the past twenty years the economy was hyped by two huge bubbles: In the 1990s there was the dot.com/tech bubble and in the last decade there was the housing bubble. A lot of critical resources flowed to these sectors and while that helped power the strong growth pace we experienced, it did not create lasting value commensurate with the expenditures. The long term growth pathway of the economy was likely slowed, at least for a period of time, as capital was clearly misallocated. Unless we have future bubbles, that extra growth is not likely to appear. So don't evaluate this recovery on the basis of two artificial, bubble-hyped expansions.

On top of that we must add the reality that fully repairing the damage from the collapse of the housing and financial sectors will not be accomplished in a year or two. Stabilizing the economy and jump starting it has cost us dearly. That is a bill that we will have hanging over us for a long time. A strong, "V-shaped" recovery was more a hope than a realistic expectation.

It is in the context of a badly weakened, slowly recovering economy that the course of fiscal policy must be judged. I find it strange that monetary policy is always evaluated on the basis of where we are in the businesses cycle but fiscal policy seems to be viewed in a vacuum. Few would argue that the Fed should raise rates when the economy is falling into recession or lower rates when the economy is expanding rapidly and inflation is a risk. Unfortunately, fiscal policies are often proposed as if the impacts are the same regardless of the condition of businesses, households or even the federal budget deficit.

Businesses will invest when the returns to capital outweigh the costs. Too often the discussion about fiscal policy focuses on the costs to businesses. More weight should be given to the potential returns.

Consider two recent but contrasting periods. In early 2009, most executives' business plans boiled down to simply surviving until 2010. That meant cutting expenditures and taking on no additional costs. Firms had little interest in investing and nothing that Congress or the Fed could have done would have changed that.

In contrast, in the summer of 2003, the economy had been growing for seven consecutive quarters. We were moving out of the recovery stage into the expansion stage and firms were poised to invest more heavily. Fiscal policy fed that awakening beast and investment surged.

But it is also unclear the extent that tax cuts played. In the past three quarters, absent fiscal policy, investment in equipment and software has surged at rates that exceed anything we saw after the implementation of the 2003 tax cuts. In economics, the true cause and effect may not be nearly as obvious as they seem on the surface, or in theory.

That raises a second issue about evaluating the efficacy of fiscal policy: It is changes that matter, not necessarily levels. Economists often argue that a policy should be judged on the basis of what the circumstances would have been absent that policy. Is the current high unemployment rate a sign of fiscal policy failure or success? It depends upon what the rate would have been had the policy not been implemented, been implemented in a different manner or different polices were passed.

And that brings us to the third point about fiscal policy. Something that provides short term relief may not be the best policy in the long run. Alternatives that produce less initial bang but more long term bucks should be considered. As my example about investment in dot.coms and housing pointed out, there were significant short term gains when private capital flowed in those directions but those returns were overwhelmed by subsequent long term costs. Public capital must be used judiciously and should maximize long term growth potential.

The issue of balancing the current with the future heightens concerns about the deficit. If we increase the deficit, and remember, that can be done either through more spending or tax cuts (which have not shown to be self funding in the short run), we are creating costs

for future generations. It needs to be shown that the short term gain overcomes the long term pain before we impose those burdens on our children.

What this boils down to is this: At all times, policies intended to grow the economy should be evaluated on the basis of whether they makes sense in the context of current economic circumstances, in particular where we are in the business cycle, as well as the implications for future growth and the budget deficit - not on any other basis. Conditions change and that means policies should change with them.