Growth Prospects in the Wake of Economic Crisis

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10 September 2009
As of early September 2009, the global economy appears to have weathered the most severe financial crisis and, for many countries, the deepest contraction since the Great Depression. Recent indicators suggest that real GDP is reaching bottom in the U.S. and many other advanced economies, and that rapid growth is set to resume in some emerging market economies. Despite these hopeful signs, several worrisome factors presage an extended period of sluggish growth relative to the pre-crisis years. Many of these factors arise from circumstances in the U.S., but the effects will be felt worldwide. I will describe these factors, offer a prognosis for near-term and longer-term growth in the United States and draw out some of the likely implications for East Asian economies.
U.S. Unemployment Rate Projections by the Obama Administration in January 2009 Compared to Actual Path

Unemployment Rate With and Without the Recovery Plan

- June '09
- May '09
- April '09
- July '09
- August '09

Maroon dots are actual unemployment data. Everything in blue was created by Obama’s economic team.
http://innocentbystanders.net
They pretend to know.

Yes.

Yet they don't know.

Correct.

And they get paid for this?

Paid well, too.

Man, I wanna be an economist!!!!
A Roadmap for the Talk

1. U.S. Economy: Where is it now, and what are the near-term prospects?
2. Some implications for Asian economies
3. 10 reasons for concern about medium-term and longer-term U.S. growth prospects
4. More on implications for Asian economies
Okun’s Law: Slow Growth Leads to Rising Unemployment

8-Quarter Changes in Real GDP and the Unemployment Rate, U.S. Data, 1948 to 2009-Q2

Change in Real GDP from t-8 to t

Change in Unemployment from t-8 to t

y = -0.7309x + 2.5137

2009-Q2
2008-Q4
2009-Q1
Signs of Reaching Bottom in the U.S. Economy

Real GDP Growth

Quarterly percent change, seasonally adjusted annual rate

<table>
<thead>
<tr>
<th>Quarter</th>
<th>GDP Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007:Q1</td>
<td>1.2</td>
</tr>
<tr>
<td>2007:Q2</td>
<td>3.2</td>
</tr>
<tr>
<td>2007:Q3</td>
<td>3.6</td>
</tr>
<tr>
<td>2007:Q4</td>
<td>2.1</td>
</tr>
<tr>
<td>2008:Q1</td>
<td>1.5</td>
</tr>
<tr>
<td>2008:Q2</td>
<td>-0.7</td>
</tr>
<tr>
<td>2008:Q3</td>
<td>-2.7</td>
</tr>
<tr>
<td>2008:Q4</td>
<td>-5.4</td>
</tr>
<tr>
<td>2009:Q1</td>
<td>-6.4</td>
</tr>
<tr>
<td>2009:Q2</td>
<td>-1.0</td>
</tr>
</tbody>
</table>
U.S. Nonfarm Payroll Employment, Seasonally Adjusted, Monthly Changes from August 2007 to August 2009

Homeowner Vacancy Rate

(Percent)

Sources: Congressional Budget Office; Department of Commerce, Bureau of the Census.

Notes: The homeowner vacancy rate is the number of vacant year-round housing units that are for sale, as a percentage of all housing units intended for owner occupancy.
Monthly New Home Sales in the United States
Seasonally adjusted data, January 1963-July 2009

Spread measured as difference between 3-month LIBOR and expected average Fed Funds rate over same 3-month interval. Weekly data through August 13, 2009.

Sources: Congressional Budget Office; Bloomberg.


Notes: The data is a daily version of the data used monthly in Bloom (2009), “The impact of uncertainty shocks”, which contains full details.
Upward Revisions: U.S. Real GDP Growth Forecasts for 2009 Q3

Third-Quarter Growth Forecast

Source: Macroeconomic Advisers
Summary: Where Is the U.S. Economy Now?

- At or near the bottom
- Barring major new negative shocks, a resumption of output growth is imminent
- Other major advanced economies show a similar picture

*So what are the prospects for near-term growth, say over the next two years?*
A Rapid Near-Term Bounce Back in US Growth?

• A Case for “Yes”
  – Strength of likely inventory correction
  – Pent-up demand for consumer durables
  – Historical relationship between severity of downturn and strength of near-term recovery
  – Continuing effects of the highly aggressive central bank response to the financial crisis
  – Ongoing large fiscal stimulus
Change in Inventories and the Growth of Output

(Percent)

Output Growth

Inventory Change

Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.
Does a deeper contraction portend a stronger recovery?

The Unemployment Rate and Real GDP Growth
Over the Following 2 Years

Unemployment Rate in Quarter t

Real GDP Growth from Quarter t to t+8

Percent

y = 0.83x + 2.2544
• History suggests a strong chance of a vigorous recovery over the next one to two years.
• But the historical link between current unemployment and future growth is not tight.
• And the current recession differs from most other recessions in several major respects:
  1. Severity of financial crisis as a causal factor
  2. Nature and aggressiveness of monetary policy response
  3. Large fiscal stimulus
  4. High policy uncertainty looking forward
A Rapid Near-Term Bounce Back in US Growth?

• A Case for “No”
  – Historical experience of delayed and weak recoveries in the wake of severe financial crises
  – Consumer demand will not soon return to pre-crisis levels
  – Many financial institutions remain under strain
  – Policy uncertainty and concerns about looming fiscal problems
  – Appetite for risk taking will remain below pre-crisis levels
Percent Decline in Real GDP (left panel) and Years Duration of Downturn (right panel)

- Spain, 1977
- Japan, 1992
- Norway, 1987
- Philippines, 1997
- Sweden, 1991
- Hong Kong, 1997
- Colombia, 1998
- Korea, 1997
- Historical Average
- Malaysia, 1997
- Finland, 1991
- Thailand, 1997
- Indonesia, 1997
- Argentina, 2001
- US, 1929

Percent decrease

-9.3 percent

Duration in years

1.9 years
Sluggish Demand Growth in the U.S. Private Sector?

Household Consumption Demand

- Desire and need to rebuild HH balance sheets
- Tighter credit and less collateral
- Fears about job loss and lower earnings
- Strong likelihood of sizable tax hikes

All of these factors push in the direction of a household savings rate several percentage points above pre-crisis levels.
Martin Feldstein estimates that 1/3 of American homeowners with mortgages are already “underwater” – i.e., the outstanding balance on the mortgage loan exceeds the market value of the home.

Reproduced from The Economist, 3 September 2009
## Worried Workers

### Percent of US Workers Who Worry that They Will Experience the Following in the Near Future

<table>
<thead>
<tr>
<th></th>
<th>Hours Cut</th>
<th>Wage Cut</th>
<th>Benefit Cut</th>
</tr>
</thead>
<tbody>
<tr>
<td>August 1997</td>
<td>15</td>
<td>17</td>
<td>34</td>
</tr>
<tr>
<td>August 2003</td>
<td>15</td>
<td>17</td>
<td>31</td>
</tr>
<tr>
<td>August 2004</td>
<td>14</td>
<td>17</td>
<td>28</td>
</tr>
<tr>
<td>August 2005</td>
<td>13</td>
<td>14</td>
<td>28</td>
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<tr>
<td>August 2006</td>
<td>16</td>
<td>19</td>
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<tr>
<td>August 2007</td>
<td>12</td>
<td>14</td>
<td>29</td>
</tr>
<tr>
<td>August 2008</td>
<td>14</td>
<td>16</td>
<td>27</td>
</tr>
<tr>
<td>August 2009</td>
<td>27</td>
<td>32</td>
<td>46</td>
</tr>
</tbody>
</table>
The personal saving rate rose from 1.2% of disposable income in 2008 Q1 to 5.2% in 2009 Q2, a level last seen in the late 1990s, and 6.9% in May 2009.

Consumer credit fell at an annual rate of 6.6% in 2009 Q2. As of July 2009, it had declined for six months in a row.
Sluggish Demand Growth in the U.S. Private Sector?

Business Investment Demand

• Impaired financial institutions and reduced risk appetite $\rightarrow$ higher borrowing costs for firms $\rightarrow$ less investment

• Uncertainty about major policy initiatives encourages a cautious wait-and-see stance:
  – Health care
  – Cap and trade
  – Union card-check elections
  – Personal income taxes
Demand Growth in the U.S. Public Sector

- Large fiscal stimulus will help sustain U.S. demand for the next two years or so
- But rapidly rising US debt levels and large structural deficits make it unlikely and, in my view, unwise for the U.S. to follow up with another large fiscal stimulus
Summary of Near-Term U.S. Output Growth and Demand Picture

- My Forecast: Weak to moderate output growth in 2010 and 2011 of 2-3% per year
- Coupled with weak private sector investment demand and a decline of several percentage points in C/Y ratio relative to pre-crisis levels
- Much smaller U.S. current account deficits than pre-crisis years

*These projections imply sluggish near-term growth in U.S. imports, even with a recovery.*
East Asian Economies Are Highly Sensitive to U.S. and World Demand

The chart covers HK, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan, and Thailand.

Reproduced from April 2009 Macroeconomic Review, Monetary Authority of Singapore
Asian Intra-Regional Trade Is Also Sensitive to U.S. Demand

Figure 1.4. Emerging Asia Intraregional Exports and United States Non-Oil Imports\(^1\)
(Year-on-year percent change)

...and appears to have become more so.

Reproduced from IMF Regional Economic Outlook, Asia and Pacific, May 2009

Sources: Haver Analytics; and IMF, Direction of Trade Statistics database.
\(^1\) Includes China, Hong Kong SAR, Korea, Singapore, Indonesia, Malaysia, the Philippines, and Thailand.
Singapore’s Experience

Real GDP, A Comparison

Asian Financial Crisis
(Peak=Q3 1997)

1985 Recession
(Peak=Q1 1985)

2001 IT Downturn
(Peak=Q4 2000)

Current
(Peak=Q1 2008)

Index (Peak=100), SA

Number of quarters

88

92

96

100

104

Reproduced from the Macroeconomic Review, April 2009, MAS
Employment Growth During Recessions

- Asian Financial Crisis
- 2001 IT Downturn
- Current

QOQ % Growth

Number of quarters from GDP peak

- 1
- 2
- 3
10 Reasons for Concern about Medium- and Longer-Term U.S. Growth Prospects

1. The extent to which major financial institutions remain impaired, and the central role of credit in facilitating production, investment, transactions and ownership changes

2. Past declines in real estate values will continue to strain financial institutions, restrict collateral of would-be borrowers, slow consumer spending, and depress construction activity
10 Reasons for Concern

3. A further big drop in real estate values, while unlikely, would wreak havoc among households and financial institutions with already weak balance sheets. There would be large and harmful ripple effects on mortgage-backed securities held world wide.

4. Less appetite for risk taking in any event (i.e., even after balance sheets are rebuilt), because we have learned that the economy is more fragile and the downside risks more highly correlated than previously thought.
10 Reasons for Concern

5. A strong likelihood of major future tax hikes and uncertainty about the form they will take.

6. Uncertainty about new climate and energy-related regulations and taxes. This type of uncertainty discourages and delays investments in new capital goods and new technologies for the usual option-value reasons.

7. Institutional and political barriers to much-needed reform of public education at the primary and secondary levels.
10 Reasons for Concern

8. Government interventions that retard the reallocation of capital and labor from less efficient to more efficient producers
   – For example, U.S. government actions to prop up General Motors and Chrysler, partly at the expense of Ford, Toyota, Nissan, Honda, etc.

9. A nontrivial probability that the government will introduce harmful new regulations or become persistently entangled in micro-managing large parts of the economy.
   – E.g., compensation in the financial industry
10 Reasons for Concern

10. The possibility, once quite remote but no longer so, that fiscal burdens or political pressures on central banks will lead over the medium and longer term to high inflation, an abrupt depreciation of the dollar or sharply higher real interest rates for major government borrowers.
How Big is Uncle Sam’s Fiscal Hole?
The U.S. Fiscal Outlook

• Estimated FY 2009 deficit: 11.2% of GDP
• The Obama Administration projects deficits from 2010-2019 of about $9 trillion
  – CBO and OMB project deficits of 3-4% of GDP after recovery and return to steady growth
  – Debt-GDP ratio: from 54% in 2009 to 68% in 2019
  – Assumptions for baseline CBO projections:
    • Average output growth of 3%, inflation of 2%, a nominal interest rate of about 5% per year
    • No new government spending programs
    • Rising debt raises real interest rates by less than 1 percent
• Concord Coalition projects deficits of $14 trillion from 2010 to 2019, which implies a debt-GDP ratio in 2010 of about 90%.

• Martin Feldstein think the current U.S. fiscal path plus Democratic health care plans could lead to deficits of about 8% of GDP in 2010 and a debt-GDP ratio > 100%.

• In addition, the U.S. has about $5 trillion in loan and debt guarantees from Fannie and Freddie.
How much will it cost to service the debt?

• CBO projects net interest payments to rise from 1.4% of GDP in 2010 to 3.4% in 2019.
• Concord Coalition projections for debt-GDP ratio imply that net interest payments will be closer to 4.5% of GDP in 2019.
• CC projections + 20% losses on Fannie & Freddie guarantees imply net interest = 5% of GDP + passage of Democratic healthcare proposals imply net interest = 6% of GDP.
Paths Out of the Fiscal Hole

1. Strong Growth – and Long Time
2. The Taxman Cometh
3. Government Spending Rollback
4. Inflation
1. Growth and Time as the Solution

- The U.S. has successfully handled high debt-GDP ratios in the past. In fact, government debt exceeded annual GDP in 1945.
- But entitlement spending + interest on the debt made up only 5% of federal government spending in 1945, so one could reasonably anticipate a large decline in federal spending after the war. That's not true today.
- And there's no guarantee that the U.S. will grow at 3-4% per (or more) in the next few decades.

Bottom line: A risky, imprudent approach.
2. The Taxman Cometh

If you drive a car, I'll tax the street
If you try to sit, I'll tax your seat
If you get too cold, I'll tax the heat
If you take a walk, I'll tax your feet
… Be thankful I don't take it all.

– Lyrics from the “Taxman”

Bottom line: a likely scenario, sadly for U.S. taxpayers and the rest of the world
3. Government Spending Rollback

- Opinion polls show rising concerns about government spending and budget deficits among American citizens
- But it’s hard to imagine President Obama and the Democratic-controlled Congress as agents of a government spending rollback
- *Bottom line:* Seems like a pipe dream in the current political environment, and it is doubtful that American voters would support a major rollback even under different political leadership.
4. Inflation

• Inflation rates of 5-6 percent per year, sustained over several years, would erase much of the real value of outstanding U.S. government debt

• If fiscal pressures intensify enough, there will be strong economic and political pressures to rely on inflation as a means to relax the fiscal burden.

• More likely if Fed independence diminishes

• *Bottom line: a real possibility if U.S. growth is sluggish over the long term*
Implications for Asian Economies

1. For the foreseeable future, U.S. output growth is likely to slow by 1-2 percentage points compared to the 1983-2007 average.

2. It is unlikely that the U.S. will return to the large current account deficits of recent years.

3. Points 1 and 2 imply:
   A. Much slower growth in exports from Asia to U.S.
   B. Big declines in current account surpluses and a slowdown in foreign reserves accumulation.
   C. Major structural adjustments in China and elsewhere
Implications for Asian Economies

4. A reduced capacity of the U.S. to advance the research, technology and commercial frontiers would be a significant force for slower economic development worldwide.

A. This aspect of a U.S. slowdown is likely to have bigger effects on countries – like Japan and Singapore – that are already at or near the economic frontier.

B. “Catch-up” growth in China and other developing economies may be less sensitive in the near- and medium-term to slower advance at the frontier.