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Has the US Recovery Begun?

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CAMBRIDGE – Although the American economy is continuing to decline, it is no longer falling as fast as it was at the beginning of the year or in the weeks after the collapse of Lehman Brothers in September 2008. In that sense, it is reasonable to say that the worst of the downturn is now probably behind us.

But my reading of the evidence does not agree with that of those who claim that the economy is actually improving, and that a sustained cyclical recovery is likely to begin within the next few months. Although the stimulus package of tax cuts and increased government outlays enacted earlier this year will give a temporary boost to growth, we are unlikely to see the start of a sustained upturn until next year at the earliest.

The optimists back their claims of an earlier recovery by pointing to a variety of statistics. They note that construction activity is rising, home prices are declining more slowly, disposable personal income increased in the first quarter, consumer spending is up, and the labor market is improving.

But a careful look at these data is less reassuring. In each case, the details do not support what the headline number appears to indicate.

While total construction spending recently rose by a very small 0.3% (less than the measurement error), private construction spending actually fell and residential construction was down a much more significant 4%.

Likewise, home prices declined at a very rapid rate of 18.7% in the 12 months to March, which is not meaningfully lower than the 19% fall over the 12 months to February. And the most recent monthly decline corresponded to an annual rate of more than 25%.

Moreover, disposable personal income rose in the first quarter only because of a massive jump in tax rebates and government pension payments. In contrast, salaries, self-employment income, dividends, and interest all fell. The anomaly of rising consumption driven only by tax rebates and social-welfare payments ended in March, when consumer spending declined in response to lower employment and falling labor incomes. This was confirmed by a fall in retail sales in April.

Finally, employment continues to contract rapidly. Although the pace of decline slowed between March and April, half of that improvement was the result of an increase in government employment, owing to a one-time hiring of more than 60,000 temporary staff to conduct the 2010 census.

But, although the recent news is not as encouraging as some have claimed, I expect that the next few months will see some real improvements that will reduce the rate of overall economic decline, or even produce a temporary rise in the GDP growth rate, owing to the Obama administration's fiscal stimulus measures.

The stimulus package will add about $60 billion to overall GDP during April, May, and June, or roughly 1.5% of quarterly output. But when the GDP figures for the second quarter are reported later this summer, the government's statisticians will annualize the 1.5% increase and add 6% in calculating the annual growth rate. If economic activity apart from the stimulus package is continuing to decline at nearly the 6% annual rate that was recorded in the last two quarters, the temporary boost from the stimulus package will suffice to make the overall GDP change close to zero or even positive.

But the key thing to bear in mind is that the stimulus effect is a one-time rise in the level of activity, not an ongoing change in the rate of growth. While the one-time increase will appear in official statistics as a temporary rise in the growth rate, there is nothing to make that higher growth rate continue in the following quarters. So, by the end of the year, we will see a slightly improved level of GDP, but the rate of GDP growth is likely to return to negative territory.

The positive effect of the stimulus package is simply not large enough to offset the negative impact of dramatically lower household wealth, declines in residential construction, a dysfunctional banking system that does not increase credit creation, and the downward spiral of house prices. The Obama administration has developed policies to counter these negative effects, but, in my judgment, they are not adequate to turn the economy around and produce a sustained recovery. Having said that, these policies are still works in progress. If they are strengthened in the months ahead – to increase demand, fix the banking system, and stop the fall in house prices – we can hope to see a sustained recovery start in 2010. If not, we will just have to keep waiting and hoping.

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