

America: Optimism on hold

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Shopped out: downtime at the Mall of America, one of the biggest in the US. Job growth remains too slow to support the rise in consumption required for a self-sustaining recovery

A month ago, it all seemed to be going so well. Growth in the US economy was picking up. The financial system was, mainly, functioning. The risk of contagion from Europe had diminished after an unprecedented **€110bn (\$139bn, £91bn) bail-out** from the European Union and the International Monetary Fund. Things were creeping back towards normality.

Then in early June, as Alan Greenspan, former Federal Reserve chairman, put it, the economy hit "an invisible wall". The US had a run of bad news – disappointing job growth; unexpectedly low employment; indices suggesting manufacturing and services losing momentum; renewed jitters from Europe's sovereign debt markets and its banks. While most economists think it unlikely this heralds the famous double-dip recession feared by policymakers, it does come at a time when America's monetary and fiscal authorities are struggling for room to manoeuvre.

In truth, there was always a risk that growth would hiccup at this point. Fiscal stimulus and companies rebuilding inventories have given the recovery a strong push start. But those are one-off effects; the recovery must now switch to power from its internal engine. "We haven't entered into that self-sustaining stage yet," says Gus Faucher of Moody's Analytics, who estimates the chance of a dip back into recession at 25 per cent.

A self-sustaining recovery needs a steady rise in jobs, wages and profits that will allow a steady rise in consumption and investment, feeding back into jobs, wages and profits. So it is worrying that private **payrolls** rose by only 33,000 in May and 83,000 in June – not fast enough to support a rapid rise in consumption – and both average wages and hours worked have dipped a little.

Business investment has boosted the recovery in the past few quarters but some surveys suggest it is slowing. June's purchasing managers index for manufacturing fell from 59.7 to 56.2 – implying still rapid but slowing expansion. Nor is the housing market a roaring source of growth. Home sales and housing starts fell in May after the expiry of a tax credit. Prices appear to have stabilised but the **IMF recently noted** that "the backlog of foreclosures and high levels of negative equity, combined with elevated unemployment, pose risks of a double dip in housing".

All this sounds bad. But as Neal Soss of Credit Suisse in New York points out, there is a big difference between a slowdown in growth and actual falls in economic activity. "The economy is still growing and there's every reason to think it will keep growing," he says.

Like many economists, Mr Soss has always thought the recovery would be slow as households have heavy debts and banks need to repair their balance sheets. One consequence, however, may be recurring alarm about a double dip. "You'll have some speed-up scares and some slowdown scares," he says. "But if you're starting from a high level of unemployment, then slowdown scares are more likely to get attached to words like 'recession' instead of 'deceleration'."

The US could really do with a helping hand. Sadly, that seems elusive. If Europe thought the Greek crisis had been solved by the EU-IMF rescue package, it had succumbed to an early bout of World Cup euphoria. It may have eliminated Athens' immediate financing needs but it did not end speculation that Portugal or Spain would follow. Nor did it quiet fears about the amount of Greek and Spanish debt held by eurozone banks.

In the past month, a familiar pattern of risk aversion has re-emerged. Credit spreads of indebted countries widened as investors fretted about the solvency of governments; equities dropped; the dollar and US Treasury bond prices rose as investors sought safe havens. This is not all bad news: higher bond prices equal lower long-term interest rates.

But more than America needs cheaper money, it needs businesses and consumers to be optimistic. "The net effect of the past month on the US has been slightly negative. The purely economic factors cancel each other out but the uncertainty, on top of a poor jobs picture, has not done any good," says Professor Eswar Prasad of New York's Cornell University.

Seeking to rebalance its lopsided economy, the US is embarking on a **drive to double exports** and thereby create 2m jobs. But plans announced this week by President Barack Obama – a ragbag of bureaucratic shake-ups and trade missions – are regarded by many economists as inadequate. Far more importantly, the global environment for demand looks unpropitious.

With a strong dollar, even higher demand growth in emerging markets is unlikely to give US net trade much of a boost. The **flexibility in the Chinese exchange rate** announced in June was symbolically important. But the small rises allowed so far will not suck in many US exports.

Net trade boosted US gross domestic product by 1.2 percentage points in 2009 but largely because weak consumer spending caused a huge drop in imports. The Organisation for Economic Co-operation and Development, the Paris-based think tank, predicts that imports will grow faster than exports, subtracting from economic growth by 0.3 percentage points this year and 0.4 percentage points in 2011.

Worryingly, a combination of economic and political factors constrains US authorities. Thus any hit to confidence from events such as the **Greek crisis** are likely to be magnified.

On the monetary policy front, Federal Reserve officials are, as yet, not particularly concerned about the health of the recovery. They still think that the most likely outcome is steady growth over the next couple of years. But they do think the downside risks to growth and inflation have risen in recent months, and

probably outweigh upside risks such as a surge in bottled-up consumer demand.

So one measure Fed officials will watch is inflation expectations, especially if inflation is very low later this year, which could become a self-fulfilling process. The risk of a slide into outright deflation could prompt easier monetary policy from the Fed.

The central bank thinks it has tools available for the unlikely eventuality that it is forced to act. One is buying more long-term assets such as Treasury bonds and mortgage-backed securities. Another is cutting the interest rate paid to banks that deposit money with it. That would increase their incentive to lend money out instead.

But no amount of monetary easing will help if banks do not extend credit because consumers do not want to spend nor companies to invest. And the weapons governments tend to use in such circumstances – spending rises and tax cuts – pose problems more political than economic.

On the economic side, bond market investors do not seem worried about the effect of current deficits on US solvency or expecting Washington to inflate its way out of debt. Yields on 10-year Treasury bonds have **sunk to very low levels**, about 3 per cent, and expected inflation derived from the prices of index-linked bonds remains about 2 per cent.

Less happily for those in the administration who believe in continued stimulus, political support for public spending is eroding. Although recent primary elections ahead of November's midterms have produced mixed results, some seemed to punish candidates for favouring Big Government.

Administration officials insist that the damage is mainly to candidates who supported the troubled asset relief programme, the federal financial bail-out, rather than government spending in general. But even continuing current stimulus is a struggle. Proposals to **extend unemployment benefits** and prolong aid to states are snarled in Congress. One senior administration official reports an interlocutor saying: "There are only three Keynesians left in America, and they all work in the administration."

Alec Phillips of Goldman Sachs says: "The potential expiration of stimulus measures appears to be an increasingly important risk to growth." As Treasury secretary Tim Geithner is fond of pointing out, for all the accusations that the US is a fiscal profligate, its deficit is due to fall more sharply in the near future than that of almost any other leading economy, from 10.6 per cent of GDP in 2010 to 5.1 per cent in 2013, compared with a fall from 5.5 per cent to just under 3 per cent in supposedly self-flagellating Germany.

Mr Phillips calculates that if the stimulus bill enacted last year is allowed to expire, including unemployment benefits, aid to states and a special personal tax credit, the effect could be to subtract 2 percentage points of GDP growth – more than half the US trend growth rate – at about the middle of next year. Even a more plausible scenario, in which the unemployment payments and tax credits are extended, would take at least a percentage point off growth throughout next year.

The US economy is not yet in severe trouble. **Rises in equity prices** over the past few days have comforted optimists that confidence is returning. But the economy's sputter over the past month indicates just how fragile the recovery is and how dependent America is on generating its own demand. And if it starts to turn down rather than simply to decelerate, policymakers turning to their arsenal will find it dangerously depleted.

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