A peculiar economic recovery in the US

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Everything seems to be on the up and up so far as the recovery in the US economy is concerned. Last week the Commerce Department made a second revision of its estimate of the annual growth rate in the fourth quarter of last year, lifting it to 1.7 percent, compared with its initial estimate of only 0.2 percent.

This was followed by the news this week that manufacturing activity in March rose to its highest level since February 2000 as factories boosted production to meet the biggest increase in demand for eight years. One of the key indicators of future activity, the Institute for Supply Management's monthly Purchasing Managers' Index, rose in March to 55.6 from 54.7 in February. (Any figure above 50 indicates growth, below 50 contraction.)

Now Wall Street investment bank Merrill Lynch is predicting a major increase in the rate of the growth of the gross domestic product. According to the firm's latest forecast, GDP growth will rise to 4.8 percent by the fourth quarter of this year, while the economy will grow by 3.2 percent overall in 2002—about half a percentage point above its previous forecast.

But even as the economic revival numbers continue to flow in, there are fears in some quarters that all is not as it seems and that the upturn may be simply the outcome of another financial bubble. These concerns centre on the fact that the recession of 2001 is unlike any other in the post-war period. Generally in a recession, there is a fall in debt, a decline in the balance of payments deficit and a fall in consumption spending. None of these things has happened this time around.

One of the main reasons for this peculiar outcome has been the maintenance of high levels of consumption spending, fuelled by increases in house prices. At least that is the view of the *Economist* magazine. In an article entitled "The houses that saved the world", published on March 28, it noted that increased house prices may have helped "shelter the world economy from deep recession."

The downturn in the US economy in 2001 was the outcome of a rapid decline in corporate profits—estimated to be the steepest since the 1930s depression—the collapse of the share market bubble and a sharp drop in business investment.

While the interest rate cuts ordered by the Federal Reserve Board made little impact on investment decisions, or even the share market, they have had a significant effect on housing. With official interest rates at a 40-year low, and mortgages consequently cheaper, house prices have risen sharply. According to the *Economist*, the average rise in US house prices of nine percent in real terms over the past year is the biggest increase ever. With two-thirds of Americans owning their own homes, the rising value of this asset has tended to encourage increased spending.

The boom has not been confined to the US. In countries such as Britain, Spain, Australia and France, the article notes, "house prices have been rising at their fastest pace in real terms since the late 1980s boom."

"The boom in house prices stands in sharp contrast to previous economic downturns, when house prices typically stagnated or fell. Unlike in previous post-war cycles, this downturn was not caused by a spurt in inflation which forced central banks to raise interest rates sharply, thereby killing off a housing boom."

Instead the US entered recession with low and even falling inflation rates, enabling the Fed to cut interest rates in order to provide a cushion for consumption spending to counter the rapid decline in business investment. While these measures may have prevented a deep recession they have not resolved the underlying economic problems and could well be deepening them.

As the *Economist* put it: "Massive monetary easing by central banks has succeeded in propping up consumer spending around the world, partly by boosting housing prices. To put it crudely: as one bubble burst another started to inflate.”

The peculiar dynamics of the US and world economy are also being discussed in some US financial circles. Morgan Stanley chief economist Stephen Roach points out that in the five years ending mid-2000 the US accounting for 40 percent of the increase in global GDP, roughly double its 20 percent share in the world economy. But the US will not be able to deliver a similar boost to the world economy in the coming period.

This is because of the widening US current account deficit. In the past, recessions have led to a reduction in the payments deficit to near balance. This is not the case on this occasion. The balance of payments deficit is currently running at 4.1 percent of GDP and could widen to as much as 6 percent in 2003. At this level America would have to suck in capital from the rest of the world at the rate of $2 billion a day to finance its external imbalance.

Another to voice concerns over peculiar features of the current recovery is Rob Parenteau, global strategist for the firm Dresdner RCM. In an article published on March 8 entitled “The unanticipated consequences of an incomplete recession”, he claims that “because the recession was odd, any recovery will be even odder still.”

“In many ways, the recession process is incomplete. For example, consumer cyclical spending growth never fell negative, housing prices never corrected, equity market multiples never fell below long term averages, the trade deficit never returned to balance, and perhaps most important of all, private sector balance sheets never got cleaned up. All these departures from normal business cycle recessions are in fact intimately related—they are expressions of continued financial imbalances in the US economy ...”

The fundamental “imbalance” is the gap between private income and expenditure which has seen a rapid increase in debt. The problem, according to Parenteau, is that in the absence of a fiscal stimulus and improving trade deficit, “the only way the economy can grow is if the private sector returns to and deepens its deficit spending ways again.”

According to conventional analysis, economic recovery means higher income flows to the corporate and household sectors, leading in turn to debt reduction.

Not so this time around, he insists, because “given the current policy configuration, any improvement in private incomes can only come from an acceleration in private deficit spending and hence private debt loads. ... There is a bubble left to pop, and that is the bubble of credit left on private balance sheets. We have seen the equity bubble pop, and we have seen the tech capital spending bubble pop. The corporate and household debt bubble will also pop, but curiously and paradoxically, it may be most likely to pop during the upcoming recovery...”

In other words, while statistics on production, investment and consumption may point to an upturn in the economy, these figures could themselves be the result of processes that are weakening its foundations.