

US Economic and Political Outlook

“... and now for the bad news...”

Ian McCafferty, the CBI’s Chief Economic Adviser, and Rhian Chilcott, the head of the CBI Washington office, recently spent a week talking to economists, companies, regulators and legislators in New York and D.C. Here are their conclusions about the outlook for the US economy.

- The good news: there’s light at the end of the tunnel. Recent upticks in numbers relating to the housing market, consumer spending and employment have given hope that the worst of the recession may be over.
- The recovery will not be rapid, however. Mindsets about appropriate levels of risk and consumption may have been changed fundamentally.
- In the longer term, there is real cause for concern about the state of public finances in particular. It could be that the policy prescriptions necessary to ensure a short-term recovery imperil the long-term outlook for the US economy.

The good news

When CBI Director General Richard Lambert visited the US at the beginning of April, he commented on the lack of consensus about the economic outlook. A few weeks of data can make all the difference: by the time of Ian McCafferty’s visit (27 April – 1 May), nearly all commentators were starting to agree on the broad direction for the US economy, at least over the next year or so. They all felt that the period of steepest decline in the economy was now past, and foresaw a return to GDP growth at some point between Q3 2009 and Q2 2010. The recovery is not expected to be strong, though, with a

return to trend growth unlikely until Q2 2010 at the earliest, and possibly not until 2011. (The CBI’s own forecast is for 1.5-2% growth in 2010.) Unemployment will peak at around 10%. The Fed funds rate will stay close to zero, with inflation pressures contained by the large degree of slack evident in the economy.

US economists are basing their new-found optimism on several indicators, which together suggest that the cycle is starting to work itself out:

- Although inventory data for Q1 were dreadful - the real change in private inventories accounted for 2.79% of the 6.1% fall in real GDP in Q1 – there is a general feeling that destocking will soon come to an end, as inventories can't fall too much further. Shelves – literally, in some cases – are almost bare. Alone, the end of destocking (even if stocks are not rebuilt but only held flat) will have a marked impact on GDP, halving the rate of fall of the past two quarters.
- New unemployment claims seem to be peaking out. The initial claims number – a weekly measure of increases in unemployment – fell to 631,000 from 645,000 in the week of 25 April.
- Underlying conditions in the housing market are beginning to improve. The backlog of unsold new housing on the market is reducing somewhat, as starts and completions are now running at rates below that of sales. Pending home sales for March rose by 3.2%. US construction spending rose 0.3% in March.
- Consumers started spending again in the first quarter of 2009, with an increase of 2.2% after two quarters of negative growth. The Conference Board's index of consumer confidence rose slightly in March, and considerably in April, from 26.9 to 39.2. The US consumer's savings ratio has already jumped from close to zero to a more healthy 4-5%, giving hopes that, going forward, consumption can grow more in line with incomes, which have been boosted by the sharp fall in gasoline prices.

American politicians do not have their British equivalents' folk memory when it comes to the phrase 'green shoots of recovery' – and so it is being used liberally (including by Fed Chairman Bernanke). On both Wall Street and Capitol Hill, there was growing optimism that the worst of this recession is over. It also helped that the markets were up and the weather was nice, so perhaps we need to be a little bit chary about some of the mood music.

Such reservations are also justified as most of our interlocutors are also cautious about how quickly the upturn will take hold. An end to destocking will help, but it is hard to identify any sources of a rapid 'bounce' in final demand. Globally, this recession has hit simultaneously everywhere, so the US cannot export its way out of it. Domestically, the key sources of demand also look subdued.

First, while it may soon stop contracting, there is nothing to indicate that the housing market will rebound. That, in turn, will tend to keep durable goods sales from improving quickly. Second, the combination of a large degree of slack, elevated cost of credit and a risk-averse corporate sector suggest that fixed investment is unlikely to recover any time soon.

Finally, there are some fundamental questions about the outlook for the US consumer, and whether a substantive shift in consumer behaviour is underway. Employment creation (the payrolls data) is likely to recover only gradually – in fact, we could yet see a situation in which the level of employment in the economy actually drops below the low point of the previous downturn – the first time this would have happened since WWII. In addition, quite how consumers will react to the destruction of their housing and retirement fund wealth is so far unclear. For some time now, US consumers have essentially spent all that they have earned, allowing increases in house prices and stock market values to do their savings for them. But we have already seen a dramatic rise in the savings ratio since last autumn (from around zero to over 4%). Will this be temporary, or are consumers finally adjusting to more modest consumption patterns as they recognise the need to save more for their retirement?

So this is unlikely to be a V-shaped recession. More likely is a combination of U-shaped, W-shaped and L-shaped. In fact, there is probably no single symbol for it on your keyboard, so let's think of it as a Uuuuuuu-shaped recovery.

The bad news

The Cassandras amidst this emerging chirpiness were our business interlocutors, and those in the think tanks and government who address the longer term outlook rather than the current state of the markets. They agree that the worst of the recession is over, and they give credit to government and the Federal Reserve for putting in place policy steps to ensure that happens. But they worry that in the longer term, it will be hard to reverse these policies – and that this could be disastrous for the future of the US economy.

The fiscal exit strategy?

First, there is the bill for what's been done – perhaps decades of higher taxes, to pay off the debts incurred in the

last year. It is hard to overstate the parlous state of the US public finances (although, as we sardonically noted to several audiences, it's unfortunately quite easy to compare them to those in the UK). The Congressional Budget Office (CBO) estimates that the US government deficit "will total almost \$1.7 trillion (12 percent of GDP) this year and \$1.1 trillion (8 percent of GDP) next year—the largest deficits as a share of GDP since 1945." In their assessment of President Obama's FY2010 Budget, they estimate that the proposals in it would add \$4.8 trillion to the US national debt, taking the cumulative deficit from 2010-2019 to \$9.3 trillion. This is broadly similar to the picture in the UK: debt will essentially double from around 40% of GDP to 80% of GDP.

Some early outlines of Obama's fiscal exit strategy can already be seen. His FY2010 Budget proposed almost \$1 trillion in new taxes over the next decade, focusing the hit on higher-earning individuals and corporates. The Budget included:

- \$5 billion raised by codifying the doctrine of economic substance
- \$17 billion raised by reinstating Superfund taxes to pay for environmental clean-up
- \$24 billion raised by taxing carried interest as income
- \$61 billion raised by repealing last-in-first-out accounting
- Around \$31 billion raised from the oil and gas industry, e.g. by scrapping expensing of tangible drilling costs and imposing an excise tax on Gulf of Mexico oil and gas
- \$210 billion from reforms to international taxation, including the recently-announced measures to curb US companies' ability to defer tax on foreign profits

However, it is clear that this is just the beginning of what is expected to be a higher-tax environment for corporates. President Obama has recently announced the creation of a panel to look at a more radical overhaul of the tax code, chaired by former Fed chairman Paul Volker. Although it will not be given a revenue target to hit, its remit is explicit about the need to close the 'tax gap' (the perceived difference between taxes paid and what the government believes it should be paid) and reducing 'corporate welfare'. The panel will report by 4 December 2009.

The asset ownership exit strategy?

In addition to the fiscal exit strategy, there is also the question of how the government extricates itself from the direct ownership positions it has now taken in US corporates. President Obama has been explicit in stating he saw this as a temporary phenomenon, saying "I don't think that we should micromanage". Nevertheless, there are few signs that a divestment strategy is yet in place. There is no consensus on whether it is politically necessary for the government to at least break even when it sells its assets – or whether if they act sooner rather than later, they can take the hit and blame it on the previous Administration, who bought the assets in the first place.

There are two groups of people who are particularly concerned by this. The first are executives in almost any company that is now in receipt of government support, no matter in what form it comes. TARP-recipients only discovered after the event the full range of strings that came with the bailout money. The second is companies who are competing against government-supported entities, who point to the competitive distortions that result from an implicit federal guarantee.

The money exit strategy?

Finally, there is the question of the Federal Reserve's exit strategy. How does the Fed mop up the money that has been pumped in to support and stimulate the banking system, and return to a regime in which movements in interest rates are used to determine monetary conditions? This is a challenging situation, not least given the size of recent unconventional policy actions: the Fed now has some fifteen different programmes operating, including liquidity programmes for financial institutions; direct lending to borrowers and investors; purchases of high-quality assets and institution-specific programmes. The Fed balance sheet has tripled in size in recent months, as it has purchased assets in order to inject cash into the economy.

At present much of that cash is sitting on bank balance sheets, so that the velocity of circulation has dwindled close to zero. The worry is that if velocity picks up rapidly (as confidence returns, for example), there is a risk that the Fed will not be able to withdraw the money quickly enough, with inflationary pressure the result. But equally, given the lags in the effects of monetary tightening, they will need to start reversing the stimulus before the

recovery really gets going – and the risk is that in doing so, they will spook confidence.

So for the Fed, there are risks on both sides, and they are not negligible. But they are technical risks of timing and degree, so that the risk of a serious error resulting in persistently much higher inflation is limited. This holds true as long as the Fed maintains its independent mandate to deliver low inflation and sustained growth. But there are, at present, two vacant seats on the FOMC, the role of the reserve bank presidents in determining monetary policy is under discussion and the chairman, Ben Bernanke, is up for renomination next January. Were a combination of these factors to leave the Fed under greater political influence (as last happened under the Carter administration), the risks of longer term inflation, and a loss of confidence in the dollar, would increase.

The politics of the crisis

In addition to the purely economic considerations discussed above, the American corporate community is worried that this crisis will result in policy shifts that could be damaging to their long-term competitiveness. The quote “a crisis is a terrible thing to waste” – variously attributed to economist Paul Romer, White House Chief of Staff Rahm Emmanuel, or an ancient Chinese pictogram – is heard everywhere in DC these days.

With his FY2010 Budget, President Obama made it clear that he does indeed intend to use the current economic situation as an opportunity to introduce radical policy reform across the board. In particular, it laid the groundwork for action on climate change and healthcare reform. Although the detail of proposals in either area has yet to be worked out, there is clear concern that across the board, companies could be forced to sustain a higher cost base:

- The introduction of carbon pricing, via either a cap & trade mechanism or a carbon tax, will increase energy costs.
- Obama’s determination to extend healthcare insurance to those currently without will be funded via taxes on business, either on a sector-specific basis (the recent increase in the State Childrens’ Health Insurance Program was funded via increases in tobacco taxes) or

by increasing the pressure on all companies to offer insurance to their employees.

- An increase in corporate taxation is also expected as a response to the overall state of US public finances.

Additionally, there is more generalised worry that the US government will become used to having a more interventionist role in the US economy. Recent steps to intervene in the corporate governance of financial services companies that have received public funding – caps on executive pay, threatened punitive and retroactive taxation of bonuses, and a political focus on corporate jets and offsite training in nice locations – have executives worried. The decision to fire Rick Wagoner from GM, thereby usurping the proper role of the company board and inverting the legal primacy of shareholders over bondholders, is regarded as a very bad precedent.

Conclusion: good economics makes for tough politics?

We ended the week more optimistic about the short term outlook for the US economy, but more pessimistic about long term prospects. It seems, increasingly, as if the policy prescriptions for the short term are working. The systemic risk from the banking system has diminished, the fear of a 1930’s style depression has declined, and the economic cycle is slowly running its course.

To be sure, thus far the improvement is mostly in second order derivatives – i.e. so far, the pace of decline is slowing, rather than actually reversing. But, as the White House’s Larry Summers put it, the economy is no longer falling off a cliff. The impact of the credit crunch on the corporate sector is starting to ease. Consumer confidence seems to be picking up, although this will doubtless remain fragile as unemployment, a lagging indicator, continues to worsen.

The worry is that the policies - both monetary and fiscal - that were necessary in the short term must be reversed at the right time, in a way that maintains credibility in the markets. Politicians and regulators must then switch to other, politically less palatable measures, especially in terms of fiscal discipline, without which both the climate for business and medium term economic performance will be impaired. Two years of profligacy, two decades of frugality – not an easy political sell, even for someone with the approval ratings of President Obama.