

U.S. CYCLICAL OUTLOOK

CONSUMER-LED RECOVERY TO PERSIST

A One-Legged Recovery

Ever since a business-led downturn triggered a recession in 2001, the optimists have been predicting a V-shaped rebound in the second half of each year. While somewhat stronger growth is probable in the coming months, the V-shaped recovery will remain elusive.

The problem is not really the consumer, who has kept spending and is likely to keep doing so, given the amount of disposable dollars available. After all, the current volume of mortgage refinancing alone is 25 times the volume seen three years ago.

The real issue is the absence of a strong upturn in business investment, without which a V-shaped recovery will remain a mirage. As we pointed out in this publication in April ([Vol. VIII, No. 4](#)), the timing of a rebound in business spending depends on the three Cs: cash, confidence and capacity. Profits at many firms have turned up, and cash can also be borrowed at low interest rates. In the aftermath of the Iraq war, there has also been a modest revival in business confidence. Yet, overcapacity continues to plague most industries – and this is often overcapacity on a global scale. Thus, the situation is materially unchanged from what it was back in April – a strong rebound in business spending remains unlikely.

A consumer-led jobless recovery is set to persist, even as manufacturing jobs disappear.

Under the circumstances, the recovery is set to limp along on one leg – consumer spending. In the near term, therefore, the economy cannot break into a sprint.

A Real Recovery

Many people feel the U.S. economy is still in recession. Others who pay more attention to the objective data concede that some sort of recovery is in progress after six straight quarters of GDP growth at a 2.6% annual rate, but some are still waiting for a "real" recovery.

It is not just lay observers, but also some experts, who are confounded by the current recovery. To understand the reasons for the unusual nature of this upturn, it is useful to examine the key coincident indicators of the economy that tend to move in step with the business cycle.

While industrial production slipped during the slowdown that started last summer, it remains above its December 2001 low. Since their own cyclical lows in 2001, personal income has risen at a 1.0% annual rate, while manufacturing and trade sales has advanced at a 3.8% annual rate. Although the household survey shows 1.34 million jobs being added since its March 2002 low, the establishment survey suggests that nonfarm employment has not bottomed. However, the latter survey assumes the 172,000 military reservists called up this year to be job losers, which is unrealistic. If those reservists are not

assumed to have lost their jobs, the low in nonfarm employment may have been reached in December 2002.

In essence, the key coincident indicators that track recessions and recoveries show the economy to be in a recovery, although nonfarm employment is weak enough to cause some doubt. Clearly, output, income and sales are above their cyclical lows. While employment may also be above its cyclical low, it is unusually anemic for a recovery. What explains this weakness?

The Giant Sucking Sound

For two decades, the Federal Reserve and the world's other major central banks fought the demon of inflation. By the late 1990s, they had essentially succeeded in wringing inflationary psychology out of most of their economies, and the U.S. economy in particular had come close to virtual price stability.

Meanwhile, it had become an article of faith among some policy makers that the decades-long trend of falling cyclical volatility had finally culminated in the end of the business cycle. Thus, there was a feeling that the economy had entered a "new era" of endless inflation-free growth.

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Future Inflation Gauge: Was flat in May after peaking in February.

Leading Employment Index: Slid in May, along with its growth rate, as did the Coincident Employment Index.

Long Leading Index: Climbed further, along with its growth rate, affirming the drop in recession risk.

Short Leading Index: Recovered modestly, along with its growth rate, but remained consistent with subpar growth in the near term.

Leading Services Index: Growth rose to a one-year high, promising a pickup in services activity.

Leading Financial Services Index: Growth rose to a 32-month high, suggesting an improved outlook.

Leading Manufacturing Index: Growth edged up, but it is too soon to predict an upturn in manufacturing.

Leading Construction Index: Growth rose sharply, while growth in the Coincident Construction Index continued to crawl upward.

Focus:

How Jobless a Recovery?
pages 3 to 5

VANISHING MANUFACTURING JOBS KEY TO JOBLESS RECOVERY

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Recessions always cause inflation to drop. When the first synchronous global recession in a generation arrived in 2001, it brought in its wake global overcapacity, which exerted downward pressure on already low inflation rates. In effect, it resulted in falling prices for tradable goods, due to ample overcapacity.

In order to survive in this environment, manufacturers rapidly boosted productivity in order to reduce per-unit costs. Alternatively, they could also shift production to a country with very low productivity-adjusted labor costs. For many manufacturers the answer was China, which was ready for the influx. The ability of some firms to produce goods at ever-lower costs pressured their competitors to follow suit in the interest of survival. The result was a deflationary spiral in the tradable goods sector, which sharply accelerated the movement of manufacturing jobs to China in particular.

To understand the magnitude of the structural change that has hit the U.S. economy, it is helpful to break employment down by major sectors. Chart 1 shows job gains and losses in three sectors of the economy on the same scale; thus, the same size of rise or fall in each line implies the same number of jobs gained or lost. As the chart shows, services employment rose rapidly in the late 1990s, peaked in March 2001 as the recession started, and then bottomed out in December 2001 as the recession ended. Since then, service sector employment has been rising, slowly but surely. Construction employment also peaked in March 2001, when the recession began, and probably bottomed in February 2003.

The manufacturing sector is a different story altogether. After slow growth following the 1995 slowdown, employment peaked in March 1998, three full years before the recession began. What followed was a gradual loss of manufacturing jobs until the pace of job losses took off after the onset of the recession in March 2001. After the recession ended in December 2001, the pace of job losses slackened a bit, but still, nearly a million manufacturing jobs have been lost since then.

The upshot is that U.S. manufacturing employment is now at a 45-year low. In exactly 50 years, manufacturing jobs have gone from a high of 32.4% to only 11.3% of total employment, with no end to the decline in sight. In effect, the rate of loss of manufacturing jobs has all but neutralized the job gains in the service sector, which now accounts for a record 83.0% of employment. Not surprisingly, this has now become the longest postwar period of rising joblessness since a recession ended.

What this shows is that the normal cyclical pattern of employment in the current business cycle has been distorted by a rapid structural shift in manufacturing. That is why there is so much confusion (in some quarters) about the end of the recession.

The Outlook

The cyclical outlook for manufacturing employment remains gloomy, as discussed elsewhere (pages 3 to 5). But the real problem is that it is difficult to tell when the structural shift represented by the rapid loss of manufacturing jobs will come to an end.

Whether through the direct movement of manufacturing jobs abroad, or through job losses enabled by productivity-enhancing capital investment, manufacturing payrolls continue to shrink. When a new equilibrium will be reached remains highly uncertain.

Naturally, the epicenter of deflation is in the tradable goods sector, which is largely synonymous with manufacturing. In the service sector, which has slowly but surely been adding jobs since the recession ended, there is certainly no sign of deflation.

It is not clear that lower interest rates can effectively counter either the core deflationary impulse or the attendant loss of manufacturing jobs. To the extent that lower interest rates and investment incentives may eventually encourage higher business spending, such spending may well be in productivity-enhancing assets that result in job losses.

While the stimulus can help consumer spending, a significant part of the money may be spent on imported goods in any case, especially if their prices continue to fall. Nor does a cheaper U.S. Dollar help much in this situation, since, at least in the Chinese case, their currency is pegged to the Dollar.

Of course, accommodative policy measures can prop up the non-manufacturing portion of the economy, making the overall economy less likely to tip into a new recession that could trigger economy-wide deflation. In other words, while a new recession is already unlikely and monetary stimulus can help keep it that way, it is unlikely to spur a pickup in manufacturing jobs or end deflation in the tradable goods sector anytime soon.

As growth picks up a bit in the second half of the year, it may boost job growth in services, but that is less likely in manufacturing. For the time being, therefore, this is likely to remain something of a jobless recovery. Any change in this situation is likely to be heralded by improvement in ECRI's Leading Employment Index.

Chart 1: Nonfarm Employment (thousands)

