Economic Update
Federal Reserve Bank of Dallas
NATIONAL

Oh, the Places We'll Go: Three Scenarios for Economic Trajectory

September 24, 2010

The recent recession[1] proved to be one of the largest setbacks to U.S. output and the largest contraction in employment in the post–World War II era. After starting strong, the subsequent recovery has begun to show signs of slowing down, with second quarter 2010 real gross domestic product (GDP) growing at a revised 1.6 percent annualized rate. While the recovery has exhibited an overall growth rate that would be acceptable during normal periods of growth in the business cycle, one would expect more robust growth at the current phase of recovery given the magnitude of the recession. In fact, stronger growth is required if the U.S. economy is to return to its prerecession path of output growth (*Chart 1*).

While the economic outlook is unusually uncertain, there are three general scenarios that the economy could follow.

Scenario One:
The current slowdown in economic growth proves to be transient, and real GDP growth accelerates and eventually reaches its former path.

The recent business cycle has been remarkable in that productivity, or how efficiently the economy creates goods and services, showed more resistance during the downturn than is typical and has been a primary driver of growth in the recovery (*Chart 2*). Employment, on the other hand, was hard-hit during the recession and has yet to rebound significantly (*Chart 3*).

The most recent recession saw businesses laying off workers and squeezing their employees and capital to increase efficiency rather than hiring new employees. This had the effect of ending the contraction in economic output before the labor market began to heal. However, this surge in productivity should taper off as workers return to normal hours, tempering productivity.

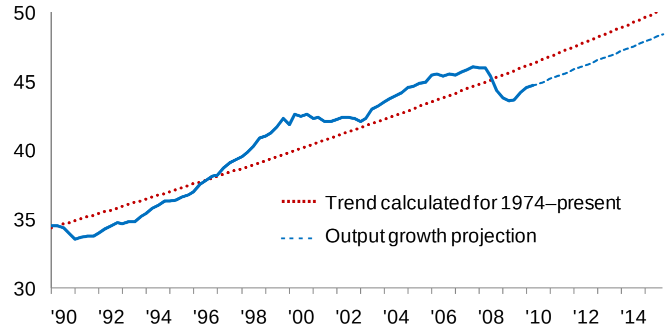
If the economy follows the path of scenario one, this drop in productivity could be accompanied by job gains, as businesses hire new employees to keep output steady. As employment and incomes grow, consumers would be less constrained and increase consumption. Rising consumption might motivate businesses to release excess cash, prompting investment and further hiring. Momentum builds accordingly. For scenario one to be confirmed, increasingly strong employment reports would feed improved consumption and investment flows.

Scenario Two:
The current slowdown is longer-lasting with subdued growth for an extended period of time.

This could be thought of as a shift down in the medium-term path of recovery, characterized by weak or falling investment rates and subdued or modestly rising consumer inflation.

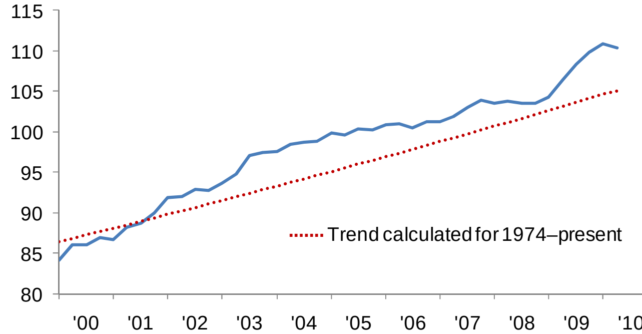
Residential investment was a significant drag on growth starting in 2006 as the housing bubble burst (Chart 4). Since the recovery began, most housing sector indicators have been signaling

Chart 1
Output Growth Below Trend
GDP per capita (thousands of real dollars)



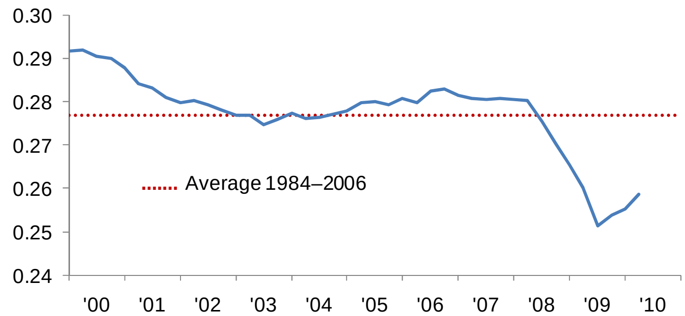
SOURCES: Bureau of Economic Analysis; Federal Reserve Bank of Dallas calculations.

Chart 2
Productivity Growth Proves Resilient
Index, 2005 = 100*



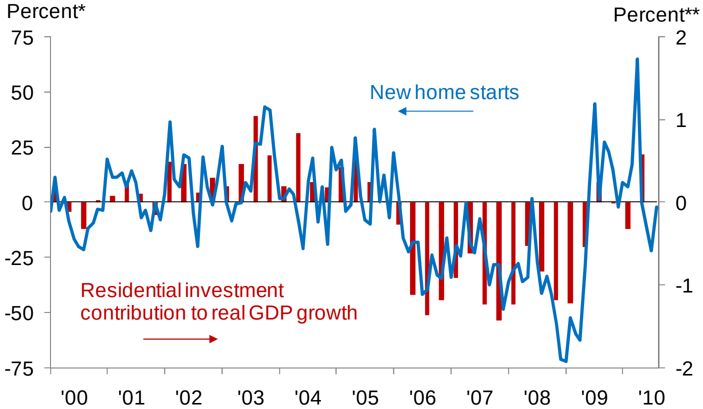
*Output per hour per person, seasonally adjusted.
SOURCE: Bureau of Labor Statistics.

Chart 3
Labor Market Hit Hard During the Recession
Hours worked index*



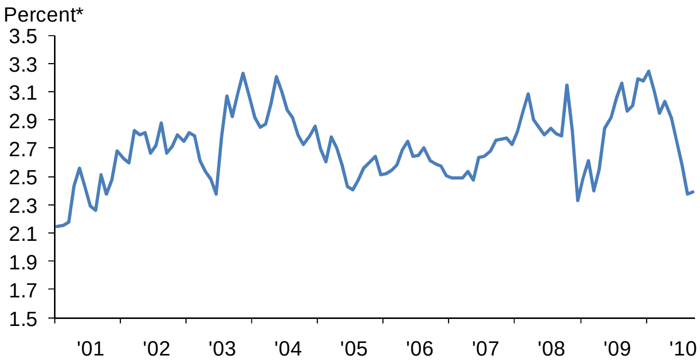
*Average weekly hours worked per 100 weekly available hours for civilian population 16 years and over.
SOURCES: Bureau of Labor Statistics; Federal Reserve Bank of Dallas calculations.

Chart 4
Residential Investment Less of a Drag on Growth



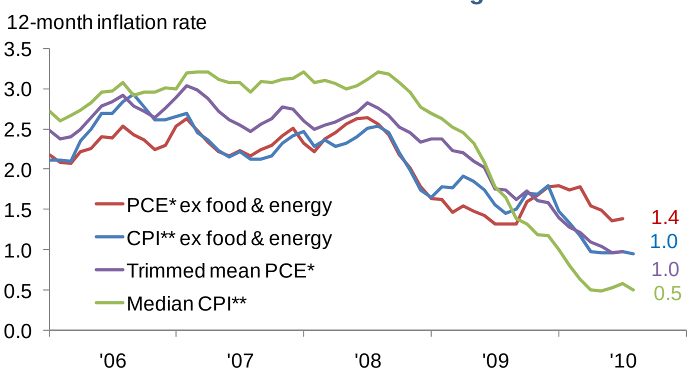
*6-month, seasonally adjusted, annualized percent change.
** Seasonally adjusted, annualized rate.
SOURCES: Census Bureau; Bureau of Economic Analysis.

Chart 5
Long-Term Inflation Expectations Remain Anchored



*Implied 5-year forward inflation rate is the average inflation rate that the 5- and 10-year Treasury Inflation-Protected Security (TIPS) yields indicate the market expects in years 6 through 10.
SOURCE: Federal Reserve Board.

Chart 6
Consumer Inflation Remains in Holding Pattern



*Personal consumption expenditures.
**Consumer Price Index.
SOURCES: Bureau of Labor Statistics; Bureau of Economic Analysis; Federal Reserve Bank of Dallas; Federal Reserve Bank of Cleveland.

that the free fall is over, but a significant rebound in housing activity accretive to the economic recovery has yet to occur. A substantial number of vacant or foreclosed homes remain on the market, creating disincentive for new residential construction. Until this supply overhang is worked off, residential investment will continue to face headwinds.

Housing sector indicators that begin to accelerate and show surprising strength would likely point to scenario one, while stabilization at today's very low levels would suggest the extended subdued growth of scenario two.

Scenario Three:
The anemic recovery degenerates into a period of little or no growth, continued high unemployment and disinflation.

This worst-case scenario is likened to the experience of the Great Depression or "the lost decade" of Japan. While this scenario does not appear likely given current data, it is worthwhile to anticipate the trajectory of economic variables that would distinguish this scenario from the previous two.

Unlike the first two scenarios, in scenario three the unemployment rate would increase above already elevated levels. Higher unemployment would put further downward pressure on prices. At the extreme, deflation would cause an adverse feedback loop: falling prices would create a positive real rate of return on holding cash, which in turn would reduce consumption and investment, creating more deflation. This severe situation requires a slip in long-run inflation expectations, which currently remain within historical ranges (*Chart 5*).

Unusually Uncertain Times
It is still too early to give up on scenario one. Considering the pent-up demand of the past two years, the underlying strength of the recovery could gain momentum. However, history suggests that economic contractions associated with financial crises have a lasting negative impact on long-run trends. Scenarios two and three are differentiated by the dynamics of inflation and unemployment. In scenario two, there is less slack present, engendering much less downward price pressure than seen in scenario three. As long as prices remain in their current holding pattern, the economy will tilt toward scenario two (*Chart 6*).

Although outright deflation seems unlikely, the U.S. recovery remains vulnerable to financial market stress—demonstrated when prospects of peripheral euro-zone sovereign debt problems dampened the pace of the U.S. recovery in the second quarter of this year. Further, concerns about U.S. fiscal deficits provoking higher future taxes (or regulations with the same effect) have introduced uncertainty and unknown costs into household and business decisionmaking. Thus, policymakers face increased pressure to pursue an optimal combination of fiscal and monetary maneuvers to achieve the nation's full economic potential. The recovery should remain on track through the second half of the year, but the trajectory of growth is still unknown given the unusually uncertain times.

—Tyler Atkinson and David Luttrell

About the Authors
Atkinson is a research assistant and Luttrell is a research analyst in the Research Department at the Federal Reserve Bank of Dallas.

Note
1. The National Bureau of Economic Research (NBER) has officially dated December 2007 to June 2009 as the most recent business-cycle contraction.