

Current Business Developments

Robert C. Fry, Jr., Ph.D.
DuPont Economist's Office

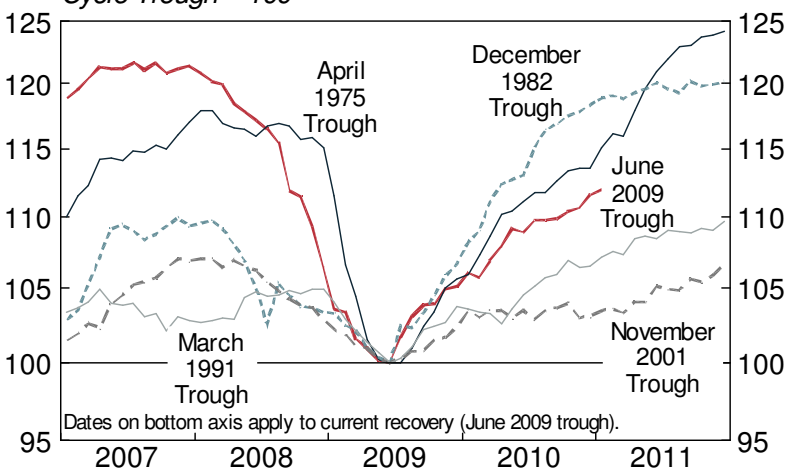
February 17, 2011

HOW FAST COULD THE U.S. ECONOMY GROW?

In the September 18, 2008 issue of this newsletter, entitled *How Bad Could Things Get?*, I discussed how most people in the work force had never been through a severe recession and did not know how bad a severe recession could be. As it turned out, that was the very week that the collapse of Lehman Brothers helped turn a garden-variety recession into the longest and deepest U.S. recession since the Great Depression. By the time it ended, the recession had lasted 18 months and reduced real GDP by 4.1%.

The recession officially ended in June 2009, but so far the recovery has been weak by historical standards. Based on the historical relationship between the depth of recessions and the strength of the ensuing recoveries, real GDP should have grown about 9% in the first four quarters of the recovery. It grew 3.2%. Housing and employment have been the two missing links in the recovery. Housing market activity, which had led every previous economic recovery since World War II, has recovered very little. Housing starts, which fell from a seasonally adjusted annual rate of 2.273 million in January 2006 to a cyclical low of 0.477 million in April 2009, fell in December to a 0.520 million annual rate, the lowest level since the trough. Starts rose in January, but the National Association of Home Builders' housing market index does not point to a strong near-term rebound. Downwardly revised data show that payroll employment has grown by only 1.019 million since hitting bottom in February 2010, reversing little of 8.737 million decline from December 2007 to February 2010. This had held back consumer spending, which accounts for about 70% of GDP.

US Industrial Production: Manufacturing
Cycle Trough = 100



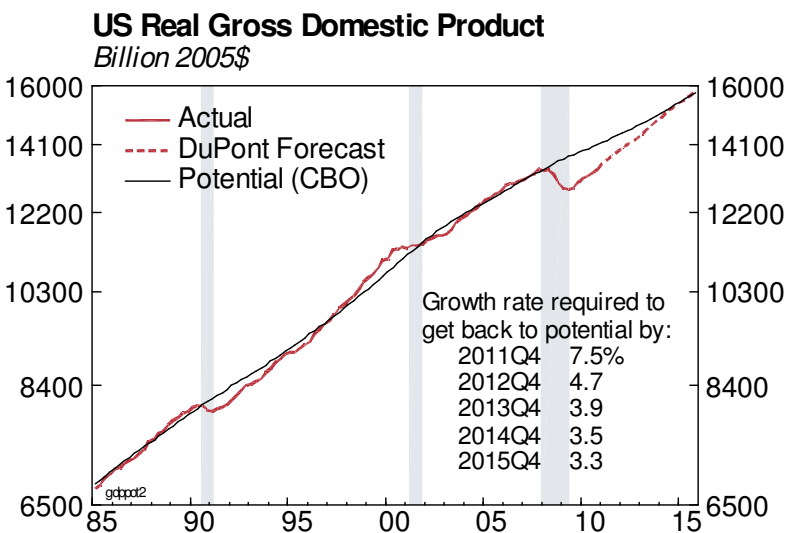
Some parts of the economy have done better. The recovery in manufacturing has been only slightly weaker than the recoveries from the two previous severe recessions, and much stronger than the recoveries from the last two (mild) recessions. Real exports rose 18.4% (11.9% annual rate) from the second quarter of 2009 to the fourth quarter of 2010. Investment in equipment and software has also rebounded strongly, powered by the replacement of obsolete high-tech equipment.

As weak as the recovery has been by historical standards, it has actually been better than many expected. This is especially true in

manufacturing, but true of GDP as well. The Blue Chip Consensus Forecast for 2010 GDP growth fell as low as 1.8% in April 2009. Actual growth came in at 2.9%. The consensus forecast for 2010 growth in U.S. industrial production fell to 1.7% in June 2009. Actual growth was 5.7%. (Our June 2009 forecast, the fourth highest and second most accurate among the 50 Blue Chip panelists, was for 5% growth.)

Just as people had not been through a severe recession, they had not been through the recovery from such a recession and had little idea about how strong a normal recovery from a severe recession was.

There are reasons why the recovery from the recent recession should be weaker than the historical norm. Research by Carmen Reinhart of the University of Maryland and Kenneth Rogoff of Harvard University has shown that financial crises have long-lasting effects on the economy and that high levels of government debt slow economic growth. The first of these factors has certainly held back the recovery so far, but I believe that both are more important to the medium-term (5-10 years) growth trend of the economy than to the short-term cyclical recovery, and I think growth could exceed the expectations of most forecasters over the next few years. The Congressional Budget Office provides estimates and forecasts for “potential GDP”, the highest level of real GDP that can be sustained without causing inflation to accelerate. Over the three decades ending in 2000, potential GDP grew at a 3.1% annual rate. Growth slowed to a 2.7% rate from the fourth quarter of 2000 to the fourth quarter of 2007, when the economy peaked. From the fourth quarter of 2007 through the end of the potential GDP series



in 2021, CBO expects potential GDP to grow at just a 2.2% annual rate. The slowdown reflects a slowdown in population growth, but also the adverse effects of government and personal debt and the need to deleverage. If CBO's estimates of potential GDP are valid, GDP needs to grow at an above-trend rate for an extended period of time to get back to even this diminished potential. Of course, it is possible that potential GDP growth is even less than CBO's estimate, but 2.2% is a relatively conservative estimate. Pro-growth policies, particularly a tax system that broadened the base, lowered marginal rates, and eliminated the double (and triple) taxation of corporate income, could result in faster potential growth.

Given an estimate of potential GDP, the question becomes “how fast does GDP return to potential?” Since World War II, real GDP has never remained below CBO's estimate of potential GDP for more than 31 quarters (most of the 1980s). (Data do not go back to the Great Depression.) Real GDP has now been below potential for 12 quarters. Spending 31 quarters below potential again would imply getting back to potential in the fourth quarter of 2015, which requires five years of growth at a 3.3% annual rate. Given all the monetary stimulus that has not had much impact yet, a housing sector that has nowhere to go but up, and motor vehicle sales that are still below the normal vehicle scrappage rate, such growth seems attainable and is consistent with our current forecast. Estimating potential growth in industrial production is more difficult, but industrial production in U.S. manufacturing would have to grow at a 4.2% annual rate over five years to get back to its 2000-2007 growth trend – at 1.8%, a much slower trend than in previous decades -- by the end of 2015. If better tax policies, tort reform, and the decline in the real trade-weighted value of the U.S. dollar (currently nearing an all-time low) make it more attractive to manufacture in the United States, trend and actual growth could both be stronger.

Nearer term, things look good, especially for U.S. manufacturing. Industrial production in manufacturing rose just 0.3% in January, but December data were revised up sharply. The Institute of Supply Management's New Orders Index rose to a seven-year high in January and other leading indicators continue to point to expansion. Government debt and lingering fallout from the financial crisis have likely lowered the potential growth rate of the U.S. economy, but getting back to even this diminished trend will require stronger growth than many expect.



The miracles of science™