

THE ECONOMIC OUTLOOK GROUP



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ECONOMIC TALKING POINTS

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GDP Shocker

The initial reaction to the revised GDP numbers will have many asking whether this is the end of days. The 6.2% drop in economic activity in the final quarter of 2008 was the worst in more than a quarter century as consumers, businesses and foreign buyers are nowhere to be found. As a result, the economy is now completely starved of demand.

Consumer spending dropped by a 4.3% pace, the steepest fall in 28 years. It also marks the first time in history we have seen two consecutive quarters where household spending has fallen by more than 3% for two consecutive quarters.

Businesses certainly have no incentive to invest in this climate. The steel industry is operating at only 40% of capacity and most other factories are functioning at between 50% and 65% of their operating potential. Nor are companies even adding to inventories. Why should they given the bleak outlook for the economy?

Then there's the dramatic shrinkage in foreign trade. US exports have been falling for five consecutive months and now stand at their lowest level since June 2007.

Equally alarming is that even the veteran forecasters seem to lack a full understanding of how weak the economy is. When the advance report on IV quarter GDP came out last month, government economists had to estimate some of the macro numbers because the formal data was still incomplete. Typically, these experts have a good enough grasp of economic conditions to be off on average about 0.5 percentage points between the

advance and preliminary numbers. Not this time! Fourth quarter GDP was revised from a 3.8% decline to a 6.2% drop. That 2.4 percentage point revision was nearly *five* times the average correction! Private economists were also off the mark, with the consensus view expecting a 5.4% deterioration. In fact, we're not aware of anyone saying GDP would fall in excess 6%. (By the way, we were also way off since our projection called for a minus 4.2%.)

We bring this up because it is always unnerving when analysts miss by such a magnitude. Is there something out there that we are missing? What assumptions led forecasters astray? Where did everyone go wrong?

One area was in miscalculating the change in inventories. In the initial report, the government believed the change in business inventories *increased* by a \$6.2 billion annual rate. That turned out to be wrong. As new data arrived, we see that inventories instead *plummeted* by a \$19.9 billion rate. A second miscalculation was consumer spending. The advance report noted a 3.5% decline, while today's release revised that to minus 4.3%. Net exports were also problematic for forecasters. Last month, foreign trade was viewed as *adding* to GDP growth (by 0.9 percentage points). That proved wrong too. The revised report said that trade had so deteriorated, foreign trade ended up *subtracting* from growth (by 0.46 percentage point.)

Keep in mind that there are only four legs of support the economy counts on at all times: consumer spending, business outlays, government expenditures and net exports. Right now, three of those legs have collapsed. Presently, the one and only source of rising demand in the economy is --- you guess it --- the government. And by that I mean exclusively the federal government. State and local municipalities have been forced to slash expenditures given the growing the red ink in their budgets. The problem is that the federal spending accounts for only about 7% of total GDP. Thus the only way Washington can pump up demand sufficiently to end the recession is to launch a shock and awe spending program --- and that is what we have underway right now.

So... is this the end of days? Is the US economy now condemned to experience its own lost decade? Do the dynamics in the economy now more closely resemble depression than recession?

Our answers to these questions are no. This is not the end of capitalism. We are not doomed to a lost decade of the sort experienced by Japan in the 1990s. Nor are we in a depression. We view the drop in GDP in the last quarter, which, by the way, we may see repeated in magnitude this quarter, as symptomatic of a recession in its final convulsive stages, to be followed a recovery in the second half of the year.

Now, some may wonder whether this is a forecast --- or a prayer. It's both, of course. But in our model, the economy is in the final, painful throes of a correction that should end by fall or winter. Reason? The \$787 billion economic stimulus program, the Administration's housing recovery plan, the Federal Reserve's ultra accommodative monetary policy, low energy prices, a rebuild in inventories, and the unprecedented

coordination among global finance ministers and central banks to get the world economy back on its feet --- should work to pull the economy out of recession and back into positive growth before the end of this a year.

This is not to say the US economy will rebound sharply afterwards. We're going to be locked into a period of slow growth from late 2009 through 2010, with GDP increasing about 2% per quarter. One factor responsible for this sluggish pace is the extended recuperation of the banking sector, which could last two to three years. The second is the penance now done by households for their excessive consumption and debt over the last ten years. Consumers are now deleveraging and building up their savings, all of which translates into less spending for years to come. The final factor that will restrain the US recovery is that foreign economies will take longer to emerge from recession.

So, yes, like just about everyone else, we were taken aback by today's sharply revised GDP numbers. But the seeds are in place for a recovery, if anemic, in the second half.

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