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U.S. economic recovery threatened by events in Midwest, Middle East

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Just when the economic recovery seemed to gain momentum, two new threats have emerged that could undermine it. One has flared in the Midwest, the other in the Middle East.

The standoff over benefits for public employees in Wisconsin, pitting Gov. Scott Walker (R) against unions and their Democratic allies, presages battles in many state capitals that could lead to hundreds of thousands of public jobs being cut nationwide. And in Washington, congressional Republicans are demanding steep, immediate budget cuts that economic forecasters estimate would slow the pace of economic growth in 2011.

Budget cutting is already taking a greater toll than analysts had expected, according to figures released Friday by the Commerce Department. The data showed that the U.S. economy grew at a rate of 2.8 percent during the final three months of last year, significantly slower than previously estimated. The disappointing result in large part reflected an unexpected 2.4 percent drop in spending by state and local governments during the fourth quarter.
Political turmoil in Libya and other Arab nations, meanwhile, has driven the price of oil up 14 percent this week and is already starting to mean higher prices for American consumers at the gasoline pump. The price spike could buffet global financial markets if the upheaval spreads further.

These two developments - higher energy costs and government austerity - could reinforce each other. If rising fuel prices lead to slower economic growth, that could leave states with even bigger budget gaps, partly because of falling tax revenue. That in turn could cause state governments to cut spending even more aggressively than they would otherwise.

The new risks have emerged suddenly, after several months of greater optimism about the economy. The stock market rose 28 percent from Sept. 1 through Feb. 18. An index of expected volatility in the market fell to its lowest level since 2007.

And economic forecasters and corporate chief executives alike upgraded their predictions for 2011. This week, a measure of consumer confidence rose to a three-year high.
"We had every reason to believe the U.S. economy will do extremely well this year," **said Bernard Baumohl**, chief global economist for the Economic Outlook Group. "Now we have to go back to the drawing boards."

In recent weeks, the consensus of economists had been that the economy would grow 3.5 to 4 percent in 2011. That would represent an improvement on the 3.2 percent growth rate that the Commerce Department initially estimated for the final three months of last year. Instead, the figure released Friday is much less encouraging, four-tenths of a percentage point lower than calculated earlier.

And that was before the latest spike in oil prices. According to the analysis of leading forecaster Macroeconomic Advisers, every $10 increase in the price of a barrel of oil - about the amount of the increase so far - will reduce U.S. economic growth by a quarter percentage point.

With the rise in energy costs and deep cuts in government spending, there's a distinct possibility that the economic growth will fall short of the pace needed to reduce unemployment. Economists say the economy must expand at a rate of about 2.5 to 3 percent just to keep up with population growth and greater worker productivity - much less add new jobs.

Few forecasters are predicting that the run-up in fuel prices and potentially dramatic budget cuts will tip the economy back into recession. But that could change if the Middle East turmoil disrupts oil production in more countries and energy prices rise sharply, sparking a new round of financial panic. The vulnerability of the global financial system was highlighted in spring 2010, when the debt crisis in Europe sent world stock markets falling and set back the U.S. economy.

"This is definitely a risk that we weren't thinking about too much two months ago but we're thinking a lot about now," said Joel Prakken, chairman of Macroeconomic Advisers.

The showdown in Wisconsin over benefits and bargaining rights for public employees is one particularly intense skirmish in a broader fight over the size of state workforces. State and local governments have cut 400,000 workers since 2008.

"States have already done significant cutting," said Scott Pattison, executive director of the National Association of State Budget Officers. "Federal stimulus money is drying up. They've harvested all the low-hanging fruit. Now, state leaders are pretty much running out of options."

The Center on Budget and Policy Priorities, a liberal-leaning research group, has calculated that states face a collective $125 billion budget shortfall for next year, which would translate into the loss of 850,000 jobs if that gap were to be closed simply by shedding employees. (States are more likely to close the gap with a mix of trimming workforces, cutting other expenses, and raising taxes and fees).

The private sector has been growing fast enough to offset those declines. During the past year, for example, state and local governments have shed 237,000 jobs while private employers added 1.2 million jobs. Moreover, forecasters have already taken into account substantial further cuts by those governments in their projections.

Still, analysts were caught off-guard by the results from the Commerce Department. Previously, it had estimated that spending by state and local governments was down 0.9 percent in the fourth quarter. The revised figure shows that the drop was nearly three times as large. By contrast, state and local spending from July through September had increased 0.7 percent.

If cuts this year end up steeper than currently forecast - because a poor economy leaves states with bigger budget gaps or because fiscal hawks at the state level win the upper hand - that would further weaken the recovery.

The dispute in Washington over federal government spending has perhaps even more potential to alter the course of the economy this year. Economists at Goldman Sachs estimate that the $60 billion package of spending cuts that House Republicans passed last week, if able to overcome stiff opposition from Senate Democrats and President Obama, will reduce the pace of economic growth by 1.5 percentage points in the second quarter of this year and two percentage points in the third quarter.

If the federal spending cuts are more modest - say, $25 billion - they will still reduce second-quarter growth by up to one percentage point, Goldman found.

"We see federal spending cuts as the most important near-term risk," economist Alec Phillips wrote in the report.

A potential government shutdown, which could happen as early as Friday if the two parties cannot reach agreement on keeping the government funded, would also sap economic activity. That impact is likely to be transitory, however, with any slowdown made up for later when the government is running again.

"A one-week shutdown in March could knock a couple of tenths of a percent off of GDP growth in the first quarter, but it would add about that much back in the second quarter," said Prakken, of Macroeconomic Advisers.