The U.S. Economy: Getting the Diagnosis Right

Debate in the media has been dominated for some time now by the question of whether or not the United States is actually in a recession. This question is interesting from an analytical and a policy perspective. But a diagnosis of recession won't restore much-needed confidence in U.S. financial and economic institutions. Nor will it lead to the right prescription to get the U.S. economy back onto a solid growth path.

To be sure, many economic indicators, including our own, point to worsening economic conditions in the short term. It is short-sighted, however, to focus too much on these and not enough on the peculiar nature of this sharp slowdown, how long it may last, and what will ultimately get us out of it.

The pace of decline in The Conference Board's Leading Economic Index (LEI) and its breadth of weakness meet the typical criteria of a recession signal. In normal times, this decline in the LEI would signal the beginning of a recession sometime between January and June 2008. Our Consumer Confidence Index also has declined sharply in recent months. Whether or not this period is ultimately labeled as such, consumers feel that we're in a recession. And even though GDP is likely to remain in positive territory for the first quarter, it would be abnormal if a period of slow growth such as this one did not end in a recession.

But, these are far from normal times.

There is no question that the United States is in a very late stage of this economic cycle. The Coincident Economic Index (CEI), the LEI's companion in gauging the direction of U.S. economic activity on a monthly basis, has drifted more or less sideways since its high in October 2007. Its breadth of strength is narrowing, but the powerful cyclical processes that have marked past recessions still are not evident.

The LEI reached a peak in January 2006, remained essentially flat until July 2007, and has been trending downward since. U.S. economic performance during these two years was shaped by the depressing effects of a rapidly weakening housing sector and high gas prices on consumer spending, and the growth benefits of a strong business sector buoyed by strong profitability and a booming global marketplace. The economy slowed to about 2.5 percent annual growth during this period. And when growth slows, the economy becomes more vulnerable to shocks and the probability of recession rises.

However, while prescribing for a "recession," with doses of tax- and interest-rate cuts, may target the short-term weaknesses, it won't go far enough in addressing longer-term issues. Regardless of whether this slowdown is, becomes, or doesn't become a recession, the economy is unlikely to show a traditional, V-shaped recovery on the other side. Indeed, the declining Consumer Confidence Index suggests that American households do not take much comfort in the counter-cyclical actions taken to date – though these have been unprecedented in magnitude, could be considered institutionally innovative, and were applied with remarkable swiftness.

There are important drivers behind today's economic picture that are not primarily cyclical in nature. And these structural changes currently underway will shape the pace of growth and the mix of economic activity in the United States for years to come.

The U.S. and global economies are undergoing a long and painful deleveraging process. It is unlikely in any scenario that credit will be as available to households in the future as it was in the past. Household equity as a percentage of real estate value has declined as mortgage credit became more readily available. Since the 1970s, homeowners' equity has dropped from almost 70 percent of the value of total real estate assets to less than 50 percent today. That trend is about to reverse.

One consequence will be a rise in U.S. consumer savings and a slowdown in consumer spending. The fact that consumer spending has already slowed to about half its growth earlier this decade is one reason there is not more cyclical downdraft in the current environment.

The deleveraging also impacts the U.S. trade balance: U.S. imports are slowing due to the economic downturn and the weak dollar, and the export balance is improving. In other words, the rest of the world is bearing some of the brunt of the rebalancing of the U.S. economy and helping to support its growth.

These are all trends that will shape the U.S. economy for years to come and which aren't impacted by cyclical stimuli. Indeed, one might argue that such stimuli will just postpone required adjustments and may be dissipated in higher inflation rates.

The U.S. economy is actually in good structural – and internationally competitive – shape. Productivity growth was 1.9 percent for 2007. It was 1 percent in the fourth quarter alone, while GDP growth was a mere 0.6 percent. The U.S. business sector is remarkably resilient. It restructures almost continuously to address market and cost concerns, and has enjoyed good profit performance as a result.

In fact, the U.S. economy's real growth opportunities lie precisely in the context of raising its long-term productivity performance. The Conference Board projects that productivity growth could hit 2- to 2.5 percent per year for about the next 15 years. Productivity responds to innovation and to improving the quality of the workforce. Yet these are the kind of structural factors that risk losing crucial attention if we focus too much on the short term.

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