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Article

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THE U.S. ECONOMY: RECESSION AHEAD?



PRO: WEAKNESS WILL PERSIST

WILLIAM C. DUDLEY*

Is this the beginning of the end or the end of the beginning of this bout of economic weakness in the United States? There are some signs that the worst of the slump is over. The factory sector appears to be contracting more slowly; factory inventories are being brought under control. Moreover, consumer confidence, after falling sharply, may be stabilizing. This has caused some observers to argue that we are at the beginning of the end. The economy will rebound sharply in the second half of the year.

I, however, am much more pessimistic. That is because, from my vantage point, all that we are close to is the end of the beginning, the first stage of what will be a continuing slump in U.S. economic performance. It is the end of the beginning because it is now widely recognized that an investment bust is fully underway. The factory sector is contracting sharply. But we are nowhere near the end because we have just begun to see the impact of the investment bust on the consumer sector.

Although consumer spending has held up reasonably well to date, there is little reason to expect that this is sustainable. First, layoff announcements will soon translate into job losses that will push the unemployment rate higher and create more anxieties about job insecurity. Second, the wealth effect is now powerfully negative. More than \$5 trillion of stock market wealth has been destroyed in about one year's time. This is far larger than at any other time in U.S. history. Scaled by the size of the economy, the wealth destruction is about 2½ times as big as in the 1987 stock market crash.

Moreover, this is all happening at a time that consumers are stretched. The household saving rate is currently in negative territory, the lowest rate since the Great Depression. In contrast, in 1987, the household saving rate was around 7% of disposable income.

This suggests that the economy will remain weak for some time to come. As households try to save more, consumption will have to grow more slowly than income. This, in turn, will erode income gains, reinforcing the softness in consumer spending. It will take time for consumers to retrench, especially when there is no other global economic locomotive.

But what about monetary policy? Won't that turn the economy around? After all, the Fed has aggressively been cutting interest rates.

The answer is no. The problem is that the Fed has not accomplished much yet. Financial conditions have not eased. The decline in interest rates has been fully offset by a weaker stock market and a strengthening dollar. Our Goldman Sachs Financial Conditions index is tighter now than it was at the beginning of the year before the Fed starting cutting its federal funds rate target.

This does not mean that monetary policy does not work, just that the easing lever will have to be pushed much more aggressively to have the desired effect. The Fed needs to get the dollar down and the stock market back up. To do this, they are going to have to ease monetary policy much more aggressively over the next six months. Put simply, the virtuous circle has turned vicious. It is going to take time and monetary and fiscal accommodation to engineer a reversal of the current trend.

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