The Economy Continues To Strengthen, but Risks Remain

By Kevin L. Kliesen

During the first year and a half of the business expansion, the U.S. recovery was characterized by below-average growth of real GDP, anemic job creation and a high unemployment rate. It was fairly weak by historical standards. Early this year, however, the U.S. economy seemed poised to grow by more than the roughly 2.75 percent growth of real GDP registered last year. This strengthening, which is consistent with the projections of the Federal Open Market Committee and the consensus of private-sector professional forecasters, likely reflects a few key factors. These include the economy's natural built-in corrective forces and the expansionary monetary and fiscal policies put in place to jump-start the economy. In addition, financial markets have healed, and the worst of the housing crisis appears to be behind us.

Key Trends Remain Positive

Last year, real GDP increased by about 2.75 percent. This increase was significantly larger than in the previous year (0.2 percent), but still only about equal to the economy's estimated growth of potential real GDP. When actual real GDP and potential real GDP are growing at about the same rate, there is not much scope for improving labor market conditions—particularly after a deep recession. Indeed, job gains were decidedly lackluster last year, as nonfarm payroll employment rose by an average of 76,000 per month. Likewise, the unemployment rate averaged 9.6 percent in the fourth quarter of last year, down only modestly from a year earlier (10 percent).

Growth of real GDP was strengthening over the second half of last year after a springtime lull that saw the nation's output growth slip to about 1.75 percent in the second quarter. Broadly speaking, the economy's momentum at the end of 2010 appears to have carried over into 2011, as many of the nation's key indicators are pointing to a quickening in the pace of economic activity this year. First, the Conference Board's Index of Leading Economic Indicators increased by nearly 8 percent in 2010, which was the largest annual increase since 1983. Second, productivity growth remains quite strong. One immediate manifestation of this is reflected in strong growth of corporate profits, which then helps to increase stock prices. Rising stock prices against the backdrop of an improving outlook provide firms with an incentive to expand their capital stock. Rising stock prices also increase household wealth, which may provide a boost to consumption spending.

At some point, strong productivity growth should lead to faster growth of real income and, thus, rising employment. Indeed, according to the February 2011 Survey of Professional Forecasters, nonfarm payrolls are projected to increase by an average of 200,000 per month over the final nine months of this year.

Despite this robust job growth, forecasters expect that the nation's unemployment rate will remain quite high this year (9.1 percent) and next year (8.5 percent). Larger declines in the unemployment rate are possible, but probably only if real GDP increases by more than the roughly 3.25 percent growth that forecasters expect for this year and next.

Risks to the Outlook

Financial crises tend to have long-lasting effects. One notable legacy of a financial crisis is a large increase in government debt to GDP. The Congressional Budget Office (CBO) now projects that the federal budget deficit will average about 8.5 percent of GDP for fiscal years 2010 to 2012. This compares unfavorably with an average of 2.1 percent from 1960 to 2007. Typically, as the economy strengthens, the deficit naturally lessens as tax revenues increase because of rising real incomes, and government outlays decline as fewer individuals require unemployment benefits or other forms of assistance. However, the CBO estimates that the lion's share of the deficit in 2010 was not due to these cyclical factors. Thus, something more than a strengthening of the economy is required to reduce the budget deficit to its longer-term levels.

Unless addressed promptly, these outsized budget deficits present several risks to the economy. First, large deficits tend to put upward pressure on interest rates, as the government absorbs more of the funds available for private-sector investment. Second, the threat of rising interest rates may cause investors to either sell their existing holdings of government securities or refrain from purchasing newly issued securities. Finally, the prospect of large future budget deficits may cause households to save more in the present in anticipation of higher future taxes. The prospect of higher future corporate tax rates might also cause businesses to cancel or delay capital investment projects.

The sooner that governments at all levels return their finances to sustainable levels, the better off the economy will be for the long haul. Ω

Kevin L. Kliesen is an economist at the Federal Reserve Bank of St. Louis. See http://research.stlouisfed.org/econ/kliesen/ for more on his work.

© GETTY IMAGES/DAVE CUTLER