Recession may be over, but recovery will be gradual

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(PhysOrg.com) -- With the severe national recession of the past two years finally behind us, the pace of economic recovery will be slow and unemployment will remain high for quite some time, say economists at the University of Michigan.

"Based on the data currently available, the recession that began at the close of 2007 appears to have ended sometime this summer—the longest and steepest drop in output since the Great Depression," said U-M economist Joan Crary. "The federal government's series of unprecedented policy actions—both fiscal and monetary—deserve much of the credit for this dramatic shift from an economy that nearly went into free fall to one that is at least clawing its way back up. We have now shifted out of reverse and into first gear."

Historically, sharp downturns are followed by rapid growth, but Crary says that a number of factors are producing economic headwinds that will slow this recovery.

"While greatly improved from a year ago, the financial system is not yet fully healthy and credit remains constrained," she said. "Consumer spending is restrained as plummeting home prices and pension values have left household balance sheets in need of repair. The housing market still needs repair and the synchronicity of the global downturn makes it less likely that exports will be a significant driver in our recovery."

In their annual forecast of the U.S. economy, Crary and colleagues

Daniil Manaenkov and Stanley Sedo predict moderate economic output growth (as measured by real Gross Domestic Product) of 2.3 percent next year and 2.6 percent in 2011. This comes on the heels of a projected 2.5 percent loss in GDP for 2009, despite positive growth in the second half this year.

However, the labor market will continue to weaken through the early months of next year before posting a consistent, but tepid, recovery throughout the rest of 2010 and 2011, the economists say. Unemployment will top out at about 10.4 percent early next year—a quarterly average surpassed in only one quarter (4th quarter 1982) since World War II. Overall, unemployment is expected to dip under 10 percent by the end of next year, but still remain high at 9.5 percent by the end of 2011.

According to the forecast, job gains will finally be seen in the second quarter of next year after nine consecutive quarters of job losses. After losing 5 million jobs during 2009, the U.S. economy will add 600,000 jobs during 2010 and another 2.5 million jobs the year after.

Besides modest growth in GDP and, eventually, in the labor market, another positive sign of economic recovery lies in the U.S. housing market, Crary and colleagues say. Housing starts, which declined 75 percent from early 2006 to early 2009, are forecast to recover to an annual rate of about 1.3 million units by late 2011, up from 568,000 this year. Existing home sales are projected to increase from 4.5 million this year to 4.9 million in 2010 and 5.2 million the year after—still well short of the 2005 peak of 6.2 million, however.

Low interest rates will help spur home sales as the 30-year conventional mortgage rate will remain around 5 percent over the next two years, the economists say.

Like home sales, the sales of light vehicles also will continue to edge upward, they say. Sales of cars and light trucks will increase from 10.2 million this year—the poorest showing since 1970 and down 3 million from last year—to 11.2 million in 2010 and 12.1 million in 2011.

"Credit market problems, continuing uncertainty over the fate of the domestic automobile companies and the Cash for Clunkers program have made the 2009 vehicle market one of the most tumultuous in recent memory," Crary said. "However, as the market stabilizes, light vehicle sales are forecast to rebound."

As the market for cars and trucks increases, so will the cost of oil, thanks to a rebound in current and expected demand from the recovering world economy, Crary and colleagues say. Oil prices are expected to uptick slightly to $80 a barrel by the end of 2010 and $86 by the end of 2011.

Higher oil prices will be reflected in a rise in consumer prices of 2.6 percent next year and 2.3 percent the year after. In 2009, consumer price inflation registered its first yearly decline in more than a half century.

Finally, the U-M economists predict that the Federal Reserve will hold its policy rate steady at 0.25 percent during 2010, before slowly increasing it to reach 2 percent in early 2012.

"We expect that the Fed will begin to back away from its extreme accommodation in monetary policy even while the unemployment rate is still high to make sure that inflationary expectations remain well anchored," Crary said. "Once the Fed starts hiking the key rate, it will do so only gradually, consistent with the slow recovery we are forecasting."

The U-M forecast is based on the Michigan Quarterly Econometric Model of the U.S. Economy and compiled by the U-M Research Seminar in Quantitative Economics. For more information, visit www.umich.edu/~rsqe .

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