



Liftoff or Cold Shower? The Economy in 2011

By John H. Makin

The extra fiscal stimulus from the tax cuts late in 2010 could produce a 4 percent growth rate for the first half of 2011—a sharp turnaround from December’s gloomy news on US employment. However, China’s overheating and Europe’s sovereign-debt crisis continue to threaten the global recovery. In addition, four risks could make liftoff difficult for the US economy: hostility in the new Congress to additional fiscal stimulus; higher energy costs, which could offset the boost from the payroll tax cut; a housing sector under heavy stress; and fiscal drag from state and local governments as the federal stimulus wears off. We have already fired the economic and monetary stimulus guns for the second time. If these measures fail to provide liftoff, we could face a cold shower in 2012.

A year ago, the biggest risk to the global recovery lay inside the United States—with debt-burdened consumers not spending as much and with producers aiming at cutting costs instead of expanding capacity. Those concerns remain, but at the end of 2010 there was tentative evidence that spending by US households and businesses was picking up. Moreover, extra monetary and fiscal stimulus is now coming into effect. With a more favorable US spending environment emerging, more substantial risks to the global recovery for the first half of 2011 appear to lie outside the United States, specifically in China and Europe.

That said, we all hang together in a global economy tightly bound by intertwined bank balance sheets and trade ties among multinational firms. A hard landing in China or a more intense sovereign-debt crisis in Europe would jeopardize US growth nearly as much as the failure of Lehman Brothers in 2008 did. Given these circumstances, the criticism being heaped by European and Chinese policymakers on the United States’ latest round of stimulus seems oddly misplaced. Stronger US growth would help mitigate some of the problems in Europe and China.

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US Stimulus Counters Foreign Risk

As we enter 2011, the stakes being wagered on a sustainable, post-financial-crisis recovery of the global economy are higher than ever. The United States, dismaying its newly resurgent macroeconomic noninterventionists (what I call the neo-Austrian school), has doubled down on its stimulus bet with both monetary and fiscal guns blazing. The Federal Reserve is buying an extra \$600 billion worth of Treasury securities, and the federal government is adding over \$800 billion in

Key points in this *Outlook*:

- US economic growth looks promising in the first half of 2011, following the tax cuts in late 2010.
- With inflation accelerating in China and the sovereign-debt crisis continuing in Europe, the best hope for sustainable global growth is more US consumption.
- Stimulus measures may boost the economy enough to provide liftoff, but if they fail to produce lasting growth, 2012 could be painful.

tax relief to the US economy that would not have been granted had the Bush tax cuts been allowed to expire on schedule. To enable that tax relief, Vice President Joe Biden and Republican Senate leader Mitch McConnell agreed on—and Congress passed—\$400 billion worth of additional stimulus, including unprecedented payroll tax cuts, extended unemployment benefits, and capital spending measures.

The tax relief has substantially improved the US outlook for 2011—especially for the first half—at a time when risks to global growth are growing elsewhere. China is overheating; its annualized inflation rate for the three months ending in November jumped above 10 percent, up sharply from just 3 percent several months ago. On December 25, China provided a modest boost of about a quarter percent to interest rates, taking one-year deposit rates to about 2.75 percent and one-year lending rates to 5.81 percent. Even when compared with the more stable year-over-year inflation rate, now 5.1 percent, deposit rates in China are still negative when adjusted for inflation, and lending rates are barely positive. In short, China has more work to do to slow its accelerating inflation rate, with the attendant rising risk of a hard landing for its economy, which has supplied about a third of global growth over the past two years.

In Europe, the other major economic zone, the sovereign-debt crisis in southern Europe has re-intensified over the past several months. Ireland's solvency problems have been added to those of Greece. Simultaneously, the cost of insuring against default on Portuguese government debt rose to a year-end high of nearly four hundred basis points over the virtually zero cost of insuring against default on German government debt. Portugal's problems have bled into Spain since Spanish banks are heavy lenders to Portuguese borrowers in the public and private sectors. The European Central Bank and European Union have prescribed fiscal consolidation, higher taxes, and lower spending—in sum, the reverse of America's path—on behalf of the German government as the remedy for southern Europe's beleaguered sovereign bonds. The German government has refused to provide adjustment aid in the form of temporary finance to southern European governments without a "firm" commitment to fiscal stringency on their part. Of course, too much stringency, like too much dieting, is counterproductive. It means that painful efforts—in this case, spending cuts and tax increases—to cut budget deficits may actually increase them because such

measures can sharply reduce growth, leading to a revenue collapse. (Ireland and Latvia are cases in point.) Europe's sovereign-debt problems will not go away in 2011, and uncertainties about how they will be resolved will continue to burden the global economy. As the extent of Europe's economic cohesion remains in question, the likely depreciation of the euro against the dollar will

constrain the growth in net exports that the United States requires to sustain overall growth in 2011 and thereafter.

In contrast to Europe's fiscal stringency and China's monetary tightening aimed at constraining inflation, the United States is aiming for liftoff. The lame-duck Congress and President Barack Obama have attempted to spur a jump in tax-cut-financed spending big enough to boost

hiring and investment—a boost sufficient to catalyze privately financed spending growth. The tax cuts paired with monetary stimulus are—ominously to the neo-Austrian noninterventionists—the second try at using a combination of fiscal and monetary stimulus to induce liftoff. The first round of stimulus, initiated early in 2009, was wearing off by mid-2010, when the Fed stepped in with its promise of a second round of quantitative easing (QE2) followed by the surprise tax-relief package in December.

The second round of fiscal stimulus, largely tax cuts and the avoidance of tax increases (which is what expiration of the Bush tax cuts would have amounted to), is better designed than the first round, which consisted largely of transfers to state and local governments, enabling them to delay most spending cuts for about eighteen months. The first round of stimulus was not a resounding success judging from the fact that only about 1 percentage point of the 2.9 percent growth rate between early 2009 and mid-2010 was attributable to nontemporary cyclical factors. The rest was tied to a temporary surge in inventory investment that will fade in 2011. Further, that weak expansion occurred while the Fed added over \$1 trillion to its balance sheet under the precursor to QE2 announced in November 2009.

Sharply increased US stimulus, the tax-relief package, and QE2 have boosted consensus growth forecasts for 2011 to well over 3 percent. Simultaneously, stronger net exports, defense spending, and consumption have pushed fourth-quarter 2010 growth forecasts up close to 4 percent. This represents a sharp turnaround from the gloom that accompanied the December 3 payroll report, which showed a rise in the unemployment rate from

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9.6 percent to 9.8 percent, while meager payroll growth of 39,000 jobs—mostly temporary ones—was far below consensus forecasts.

The divergence between overall growth and the state of the labor market at the end of 2010 is perhaps best captured by looking at the latest available report on personal income and consumption. During the months ending in November, real disposable income, a reflection of activity in the labor market, rose by a meager 1.1 percent annual rate, while real consumer spending rose at a 4.3 percent annual rate. In other words, US consumers celebrated during the fall by boosting spending at a rate substantially in excess of income growth. They cut saving. Part of the spending increase was probably tied to a rise in the stock market that helped enhance consumer confidence. Another boost of confidence was probably tied to the modest drop in initial claims for unemployment insurance that appeared in the last six to eight weeks of the year. It is important to bear in mind, however, that lower claims for unemployment represent a moderation in the rate of layoffs. The overall payroll increase depends on an increase in hiring that has yet to occur.

The tax relief is important because it reduced what was about to become fiscal drag of between 1 and 1.5 percentage points of gross domestic product (GDP) starting during the fourth quarter of 2010 and continuing into 2011. While some fiscal drag persists, the tax-relief legislation has reduced it to about 0.85 percentage points of GDP for 2011.

The biggest surprise in the legislative deal was the payroll tax cut, which will boost disposable income by about \$88 billion in calendar year 2011 and \$24 billion in calendar year 2012, based on the Joint Tax Committee estimates prepared in December. Probably about 70 percent of the addition to disposable income will be spent. The largest marginal impact will come in the first quarter of 2011, when disposable income will probably jump by about 4.5 percent, but some spending is also likely to spill over into the second quarter. Of course, the first quarter of 2012 will see a sharp reversal back to fiscal drag of about 2 percentage points as the payroll tax cuts and extended unemployment benefits expire. While some analysts are suggesting that another reprieve—further extension of income supports by Congress at the end of 2011—will be enacted at the first sign of a late 2011 slowdown in US growth, I strongly doubt it. The “young guns” in the House

are bent on aggressive deficit reduction, and some even opposed last month’s reprieve of fiscal austerity. While they were unable to block the stimulus passed in December, they can surely block further fiscal largesse in 2011 and 2012 given their strong majority in the House.

Will 2011 Growth Last?

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The stimulus package will probably produce about a 3.4 percent growth rate in 2011, with a 4 percent annual growth rate possible in the first half and a 2.8 percent rate in the second half. These are estimates, of course, but the front-loading of the tax relief, especially the reduced payroll taxes, will give a nice boost to growth early in 2011. The tricky part will come at the end of the year. If the

monetary-fiscal stimulus combination does not work—that is, if US growth is fading again in the second half of 2011—the US economy will face a very unpleasant 2012. The Fed is under far too much unfavorable scrutiny to attempt another expansion of quantitative easing. Even the full implementation of its QE2 stimulus measures by the middle of 2011 is in question. Beyond that, the new Congress—especially House Republicans, as well as twenty-one Democratic and two Independent senators facing 2012 reelection campaigns and currently sensing a strong national desire for fiscal retrenchment—has already signaled that last month’s tax-relief package was the end of the road for US fiscal stimulus in the near future. Indeed, spending cuts are highly probable for the 2012 fiscal year that starts on October 1, 2011. So if 2011 does not see sustainable US liftoff, then 2012 could be a painful year in which the US economy is left to adjust on its own without the aid of macrostimulus. The neo-Austrians may get their wish alongside the likely-to-be-chagrined European and Asian critics of the United States’ current extra stimulus.

Given the “last chance” nature of the stimulus policy being implemented as we enter 2011, it is important to ask what the chances are for the US economy to start growing steadily in 2011. Will the US economy continue to expand at a 3 percent sustainable rate without the aid of additional stimulus? The risks from outside the United States in China and Europe have already been mentioned, but four internal risks will make liftoff difficult for the US economy. First, as already mentioned, the new Congress will be far less friendly to additional stimulus plans and may even implement fiscal consolidation. Simultaneously, the Fed will be

on hold in view of increased scrutiny from a hostile House Financial Services Committee. Second, higher energy costs tied to a sharp rise in the price of oil could be a drag on disposable income. If current energy prices persist, they will constitute an estimated tax of about \$60 billion on US households and firms during 2011, enough to erase a little more than half of the boost from the payroll tax cut. Third, the housing sector remains under heavy stress with substantial excess capacity from inventory overhang that will continue to depress home prices and household wealth. Higher mortgage interest rates tied to the rise in Treasury yields that has occurred simultaneously with higher growth prospects are also reducing housing affordability and increasing the chance of another downturn in the housing market. Another drop in real estate values would further impede credit flows from the banking sector while reducing the wealth in US households. Fourth, state and local governments will be intensifying the fiscal drag already underway as support from the initial federal stimulus package wanes.

These four risks, coupled with the persistence of substantial excess capacity in US industry, make it unlikely that the ominous downward drift in US inflation will be interrupted. Further disinflation and outright deflation will undoubtedly occur in 2012 if the US economy fails to obtain self-sustaining liftoff. In short, part of a cold shower would be Japanese-style deflation that characterizes an economy in which standard macroeconomic policy measures have failed to produce sustainable growth. During the three months ending in November, the annualized PCE Core Inflation Index dropped to a 0.3 percent annual rate, perilously close to zero given the upward bias in all price indices. The falling US inflation rate—even at current levels—substantially adds to the real interest burden on US households and firms. Benchmark ten-year Treasury yields, from which lending rates for both US households and firms are gauged, have risen by nearly 100 basis points from their October lows to about 3.4 percent. During the same time interval, year-over-year inflation has dropped by another 50 basis points. The resulting 150-basis-point increase in benchmark real yields in the United States sharply curtails any extra borrowing by US households and firms. The reluctance of banks to lend also presents a formidable barrier.

The rise in US yields also results in a tendency for a stronger dollar. Since its November lows, which occurred in the aftermath of sharp global criticism of the Fed's QE2 stance, the dollar has strengthened by about 4 percent on a trade-weighted basis against a basket of foreign currencies. A combination of strong US growth during the first half of

2011 coupled with doubts about the future of the European Monetary Union will probably further strengthen the dollar. This is good news from the standpoint of US purchasing power over global goods, but it presents a challenge to US traded-goods companies attempting to increase net exports in a competitive global economy. Many analysts are counting on a rise in US net exports to replace higher inventory investment as a source of US growth in 2011. However, combined growth of inventory investment and net exports is unlikely to produce more than a zero contribution to growth on a sustained basis.

US Consumers: Still the Key

It is ironic that in a world where complaints of excessive US consumption abound, the best hope for sustainable global growth as we move into 2011 is more US consumption, financed this time by a combination of temporary tax cuts. Further irony lies with the fact that the only relief for Europe given its path toward fiscal stringency is a substantially weaker euro that will primarily benefit German exporters, who are the least in need of further support for continued growth in 2011. The European hope appears to be that German exporters will prosper enough to encourage the German government to write a large check, worth hundreds of billions of euros, to continue transfers to southern Europe and Ireland. The alternative—breakup of the European monetary system—would, needless to say, be highly disruptive to the global financial markets, not to mention the global economy.

Also problematic will be the likely fact that the symbols of US outperformance—assuming that tax relief and QE2 support impressive growth in the first half of 2011—will be a stronger dollar, which challenges US producers, and higher real interest rates, which challenge the all-important US consumer. The legislative deal and QE2 have bought us some time, but it remains to be seen whether they have bought us liftoff in the form of sustainable growth past the second half of this year.

The critics of QE2 and the tax-relief package have a point. Such measures provide only temporary relief, and if they do not trigger sustainable growth, they only postpone the day of reckoning to a time when more public debt has been accumulated, some of it by the public and some by the central bank. Against this background, a third try at liftoff—were it needed a year from now—looks like a long shot. Should QE2 and the tax-relief deal fail to produce liftoff, we will be testing the tolerance of the Fed, the White House, and Congress for a cold shower in 2012.