



### U.S. Recovery Progresses

February 10, 2010

Recent data suggest economic growth may be nearing a pace at which job losses might give way to modest gains. However, debt deleveraging and tight credit conditions will continue to restrain the economic recovery. Growth has been aided by conventional monetary and fiscal policy stimulus efforts and by increased financial flows as once-frozen credit markets continue to thaw.

#### GDP Strengthens in Fourth Quarter

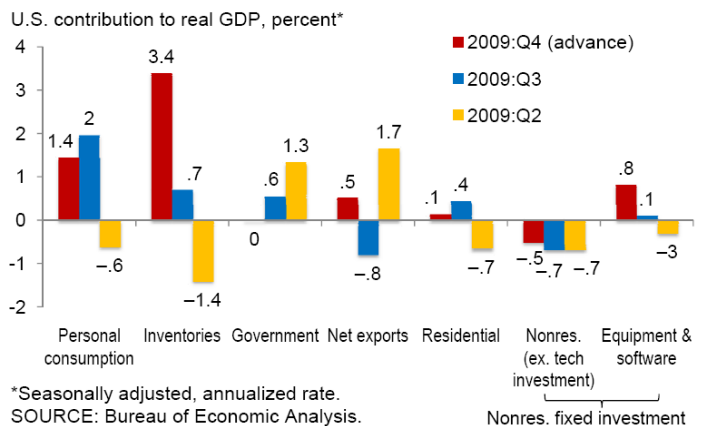
Real gross domestic product (GDP) grew at a better-than-expected 5.7 percent seasonally adjusted annualized rate in the fourth quarter—the fastest since third quarter 2003 and the second consecutive quarter of growth. Much of last quarter's strength came from a pickup in production to offset the pace of inventory liquidation, which was \$105.7 billion slower than in third quarter 2009. The result was the addition of 3.4 percentage points to overall GDP growth (*Chart 1*). Real final sales, which exclude inventories, grew 2.2 percent—1.7 percentage points from rising domestic demand and 0.5 percentage points from higher net exports.

The Conference Board's Leading Economic Index points to a growth pace above those of the prior two "jobless" recoveries but below the robust recoveries that followed the deep recessions of the mid-1970s and early 1980s (*Chart 2*). This index jumped 1.1 percent in December, the ninth consecutive monthly rise. December's increase was broad-based across the index's components. Over the prior six months, the index rose at a sharp 10.8 percent annualized rate. This suggests first-half 2010 GDP growth above the 2.9 percent Blue Chip average forecast. It should be noted that the leading index did not closely track the unusual financial factors that adversely impacted GDP during late 2008. As reviewed below, the negative effects of those omitted factors are unwinding. The index's recent surge implies that the conventional indicators it tracks are pointing to continued economic recovery.

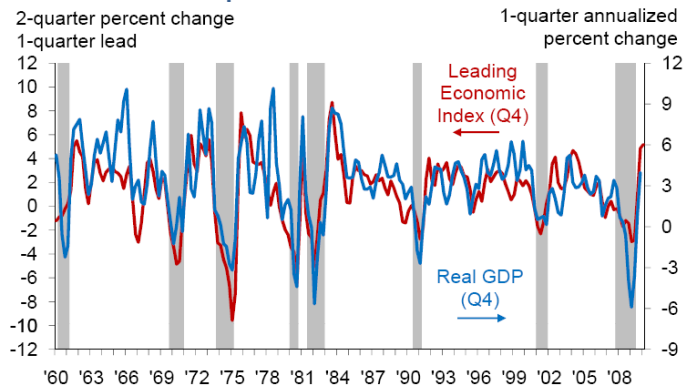
#### Growth Good in Manufacturing, Slow in Services

The Institute for Supply Management (ISM) composite manufacturing index rose to 58.4 percent in January, the highest level since August 2004 and the sixth consecutive month of readings pointing to manufacturing growth. Led by a 5.9 percent rise in utility output, industrial production rose at a 0.6 percent rate in December, the same pace as in November. But following a 0.9 percent increase in November, total manufacturing output dipped 0.1 percent in December, pulled down by big drops in output of construction-related supplies. The level of manufacturing activity is still very low due to huge declines between September 2008 and July 2009. Moreover, with capacity utilization at 68.6 percent, much manufacturing capacity remains unused.

**Chart 1**  
Slower Inventory Liquidation Spurs Strong Q4 Growth



**Chart 2**  
Leading Indicators Suggest Pace of Recovery Falls Between Earlier Episodes



In contrast to the sector's improvement, January's ISM non-manufacturing index showed that business activity outside the goods sector has improved little, with readings pointing to a very modest recovery so far. However, recent Beige Book reports indicate that "while economic activity remains at a low level, conditions have improved modestly further" and those "improvements are broader geographically" than in December's report.

#### Consumer Spending Firms; Housing Outlook Less Clear

Cutting through monthly changes, the underlying pace of consumer spending has firmed to a moderate level. Retail

sales rose 5.4 percent from a year earlier—5.2 percent excluding autos.

After falling below 1981–82 recession levels, the Conference Board’s overall consumer confidence index has recovered only about one-quarter of its drop since mid-2007. The comeback has been stronger in the index’s future jobs component, which reflects the percent of households expecting more jobs six months from now, minus the percent expecting fewer jobs. This component plunged at the height of the financial crisis but has recovered to slightly negative levels since mid-2009. These readings are consistent with the recent improvement in real consumer spending (*Chart 3*).

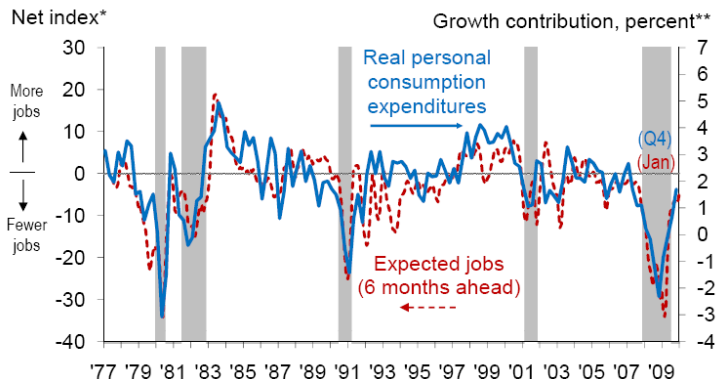
Hurt by bad weather, housing starts fell in December, while the less-weather-sensitive housing permit series jumped for the second straight month, with total permits rising 10.3 percent in December and 15.8 percent from a year earlier. This jump was likely spurred by the extension of the homebuyer tax credit, which now expires in June. Nevertheless, the housing rebound appears somewhat vulnerable to future negative payback effects after the tax credit expires. For example, home sales moved up ahead of the old deadline of Nov. 30, which was followed in December by a record 16.7 percent plunge in existing-home sales and a larger-than-expected 7.6 percent drop in new-home sales.

**Labor Pains: Approaching Job Growth?**

The January labor market report was mixed. The Bureau of Labor Statistics revised nonfarm payrolls downward to reflect that 8.4 million jobs have been lost since the recession began in December 2007. The survey of employers showed a 20,000 decline in nonfarm payrolls (*Chart 4*). However, the more volatile household survey registered an employment jump of 441,000 that followed a 489,000 drop in December. Last month, the overall unemployment rate fell from 10 percent to 9.7 percent as the underutilization rate (measuring marginally attached, discouraged and part-time workers) declined from 17.3 percent to 16.5 percent. This sharp improvement is encouraging; however, it remains to be seen how quickly the labor market rebounds as the labor force participation rate returns from 25-year lows.

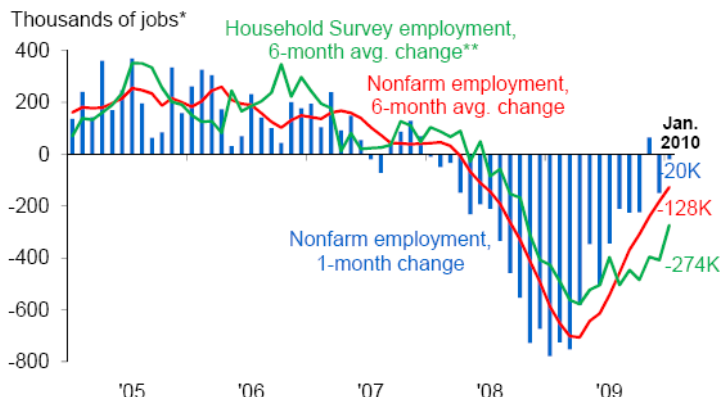
Despite the mixed readings in the January report, the job and productivity patterns of recent months suggest that net job losses are nearing an end. Real productivity growth, a harbinger of job growth, surged an annualized 6.2 percent last quarter. It is typical for productivity to climb in the early stages of recovery when firms increase production and existing workers’ hours before they add more staff. January’s 0.3 percent increase in overall hours worked and 0.5 percent jump in average hourly earnings are consistent with this pattern. Also of note, within the industry breakdown of the nonfarm payroll survey, temporary hiring rose for the fifth straight month. Like productivity, this component usually leads a pickup in overall payrolls early in economic recoveries because firms hire tentatively before they add to regular staffing. Thus, recent indicators suggest that job losses will give way to net gains as the year unfolds; however,

**Chart 3  
Consumption Contribution to GDP Growth  
Tied to Labor Market Prospects**



\*3-month moving average.  
\*\*2-quarter moving average; seasonally adjusted, annualized rate.  
SOURCES: Bureau of Economic Analysis; Conference Board.

**Chart 4  
Payroll Job Losses Nearing Zero?**



\*Seasonally adjusted.  
\*\* Adjusted to be equivalent with the nonfarm payroll survey.  
SOURCE: Bureau of Labor Statistics.

**Chart 5  
Bond Spreads Still Elevated; Commercial Paper  
Spreads Fall to Normal**



NOTE: Shaded areas indicate recession.  
SOURCES: Federal Reserve Board; authors’ calculations.

substantial labor market slack remains from the deepest economic contraction since the 1930s.

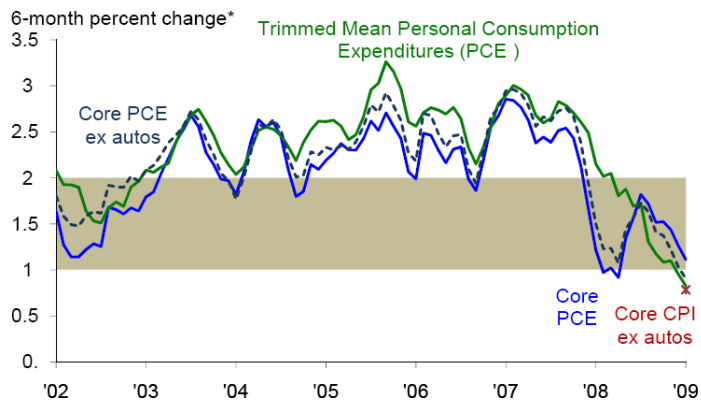
### Financial Markets Normalizing

Investment-grade corporate bond yield spreads have continued falling, with the Baa–Aaa spread dropping to levels seen in the recovery from the deep 1981–82 recession. Because the liquidity premium between Treasury securities and top-grade bonds remains a little elevated, the Baa–Treasury spread is down but still near the high levels seen in the recessions of the early 2000s, mid-1970s and early 1980s. Similarly, junk spreads have recovered more slowly from their crisis highs than money market spreads, such as the commercial paper–Treasury spread (*Chart 5*). Money market conditions have been well maintained even after the Federal Open Market Committee reiterated at its last meeting that several liquidity and asset programs would end in early 2010. These developments reflect a fallback in risk aversion associated with the unwinding of the financial crisis, an improvement in the economic outlook and the stabilization of the financial system.

### Price Pressures Remain Subdued

Recent data indicate continued downward pressure on consumer price inflation but some stabilization of commodity prices. Reflecting a partial rebound in energy prices, overall Producer Price Index (PPI) inflation appears to be returning to a 2 percent year-over-year pace. Although the financial crisis has abated, the high degree of slack that accumulated during the recession is imparting considerable disinflationary pressure. This is reflected in core PPI inflation, which decelerated to 0.9 percent for all of 2009 after rising 4.5 percent in 2008. Further reflecting domestic slack, core consumer prices edged up only 0.1 percent in December after they were unchanged in November. Annualized core Consumer Price Index inflation is falling rapidly on a six-month basis. Indeed, excluding recent outliers from new and used auto prices that were distorted by the cash-for-clunkers program, the trimmed mean consumer inflation

**Chart 6**  
Excluding Cash for Clunkers, Core Consumer Inflation Measures Fall Below 1 Percent



\*Seasonally adjusted, annualized rate.

NOTE: The shaded area represents the unofficial range of acceptable inflation measures by several members of the Federal Open Market Committee.

SOURCES: Bureau of Labor Statistics; Bureau of Economic Analysis; Federal Reserve Bank of Dallas.

measure reveals a more continuous disinflationary trend (*Chart 6*).

### Modest Recovery Seen Despite Frictions

With two quarters of real GDP growth to build on, the economic recovery will likely broaden even though several headwinds have not fully died down. GDP growth will probably ebb from last quarter's 5.7 percent surge as support from the fiscal stimulus and inventory cycle begins to fade. Going forward, structural drags from tight credit and household deleveraging will restrain the economy, while traditional stimulus from monetary policy and pent-up demand from the recession will help growth. Much will depend on how quickly financial headwinds abate, as well as how long it takes domestic demand to soak up labor market slack and unused resource capacity.

—David Luttrell and John Duca

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The Dallas Fed's National Economic Update is available online at [www.dallasfed.org/research/update-us/](http://www.dallasfed.org/research/update-us/).