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Morning in America Means a 'Long Slog' as Phelps Eyes Recovery

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By Scott Lanman and Steve Matthews

Aug. 3 (Bloomberg) -- Just as banks from **JPMorgan Chase & Co.** to Deutsche Bank Securities Inc. rushed to raise their forecasts for U.S. growth in coming quarters, Nobel laureate **Edmund Phelps** warned the economy is in for a "long slog."

The divergence emerged after the Commerce Department said July 31 the economy has now contracted the most since the 1940s. Benchmark revisions to the department's National Income and Product Accounts also showed consumer spending has tumbled 2 percent since the end of 2007, a magnitude unseen since the 1980 slump that ushered President **Jimmy Carter** out of office.

The deeper decline sets the stage for a faster recovery in the second half of the year, said **Bruce Kasman** at JPMorgan and **Joseph LaVorgna** at Deutsche Bank. It's what comes later that worries Phelps and others, including **Mark Gertler**, the New York University economist who was a research partner of **Ben S. Bernanke** before he became Federal Reserve chairman.

"I'm not convinced that there's going to be another wave of innovation in the offing" to propel growth, leaving the economy facing a "long slog," said Phelps, a professor at Columbia University in New York. Gertler said "financial headwinds" will restrain growth by limiting credit to households and companies.

Phelps foresees real, or inflation-adjusted, gains in gross domestic product of 2.5 percent in the years following the current slump. That's weaker than the average expansion rate during any postwar decade except the current one, in which growth has been pulled down by two recessions. Growth averaged better than 3 percent in the 1990s, 1980s and 1970s, and exceeded 4 percent in the 1960s.

Jobs Outlook

"Employment is going to be on the weak side" for several years, added Phelps, who won the 2006 Nobel economics prize for his theories on the interplay between inflation expectations and joblessness.

Bill Gross, who runs the world's biggest bond fund at Pacific Investment Management Co., said last week that corporate profits will be depressed because GDP, unadjusted for inflation, will grow at a 3 percent pace in coming years, compared with a 5 percent to 7 percent average the past 15 years. He cited "massive overcapacity" -- from retail shopping outlets to automobile production volume -- as a legacy of the downturn.

Some analysts countered that the recession, caused by a bust in homebuilding and a credit crunch that has seen financial institutions lose or write down $1.5 trillion so far, hasn't hurt the economy's underlying potential.

'Robust' Recovery

"Nothing here changes our view that the economy is set to recover in a pretty robust way," said **Dean Maki**, chief U.S. economist at Barclays Capital Inc. in New York, who previously researched consumer spending at the Fed in Washington. Maki's colleague **Tim Bond**, head of global asset allocation in London, said in a report last week the "prevailing consensus forecast of a very weak recovery is at odds with history."

Maki said U.S. GDP will increase 3.4 percent in the fourth quarter of 2010 from 2009. Deutsche Bank, on the

same basis, predicts 3.2 percent growth next year.

Gary Becker, another Nobel laureate in economics, counted himself among those "a little more optimistic" about the outlook. Demand from China, Brazil and other emerging markets will help aid U.S. growth, and credit flows are poised to recover because of the Fed's actions, he said. Hundreds of billions of dollars in so-called excess reserves that banks have on deposit at the Fed give lenders fuel to extend lending.

Becker's Worry

"If the economy picks up as I expect it will" there will be "a big inflationary potential," said Becker, who won the Nobel economics prize in 1992 for applying economic principles beyond markets. "We will see considerable inflation," he warned, and said he's skeptical whether the central bank will be able to address the threat adequately, given likely "political pressure" to hold off.

Kasman, chief economist at JPMorgan in New York, raised his estimate for the expansion in the current quarter to 3 percent -- the best performance in two years, and up from a prior estimate of 2.5 percent. LaVorgna, chief U.S. economist at Deutsche Bank in New York, lifted his average growth forecast for the second half of 2009 to 2.25 percent from 0.5 percent.

Some economy-watchers warned that weaker growth is poised to undermine the nation's long-term fiscal health.

"It is worrisome how we can finance the deficit without having inflation," said **Allan Meltzer**, a Fed historian and economics professor at Carnegie Mellon University in Pittsburgh.

Budget Deficit

Bernanke, in congressional testimony last month, urged Congress and the Obama administration to lay out a plan that would bring the budget deficit down to a "sustainable" level of 2 percent to 3 percent of GDP.

The International Monetary Fund predicted last week that the U.S. will fall short of that goal for at least five years, forecasting a ratio of 4.7 percent of GDP in 2014.

Another threat to the U.S. outlook is that the slump is in danger of returning next year, according to some economy- watchers.

Former Fed Chairman **Alan Greenspan**, speaking on ABC's "This Week" program yesterday, warned that a "double dip" -- or return to contraction -- is a risk because house prices have yet to stabilize. A further decline of 10 percent in home values may trigger another wave of mortgage foreclosures, he said.

Treasury Secretary **Timothy Geithner**, also speaking on ABC, said the threat of a double dip is "something we're very focused on." The Obama administration is committed to maintain its stimulus and credit-providing programs "until we're very confident we have a strong, private sector-led recovery in place."

To contact the reporter on this story: **Scott Lanman** in Washington at **slanman@bloomberg.net**; **Steve Matthews** in Atlanta at **smatthews@bloomberg.net**.

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