Joint Economic Committee
Republicans

Representative Kevin Brady
Vice Chairman

RECENT ECONOMIC DEVELOPMENTS — AUGUST 11, 2011

Turmoil in Financial Markets

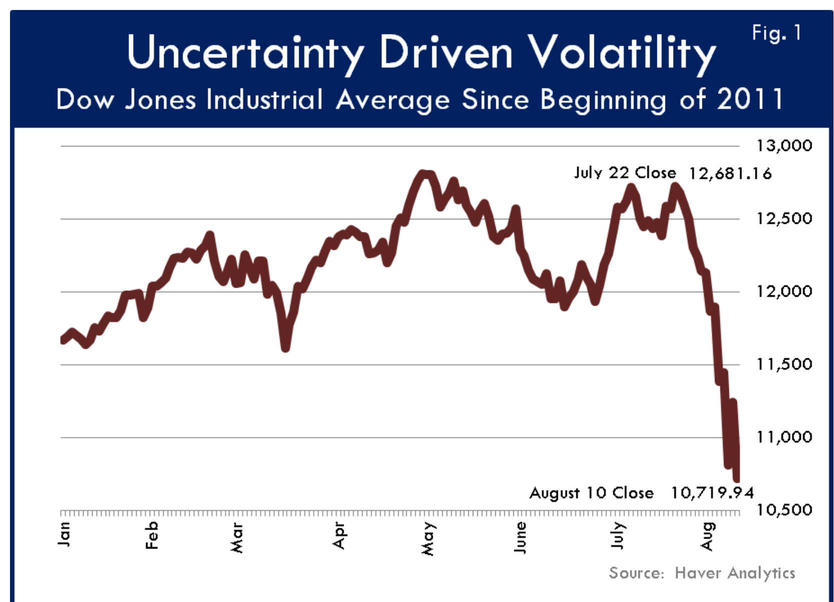
Crisis in Europe and Deteriorating U.S. Economic Outlook to Blame

Many commentators attributed the large decline in U.S. stock prices on Monday August 8, 2011 to the decision of Standard and Poor's (S&P) to downgrade the credit rating of the U.S. government from AAA to AA+ with a negative outlook on Friday August 5, 2011, two other factors probably played a much larger role than the credit downgrade: (1) increasing pessimism about the outlook for the U.S. and European economies, and (2) growing doubt that the European Union (EU) can contain the euro-crisis.

On Tuesday, August 9, 2011, U.S. stock prices rallied following the Federal Open Market Committee's (FOMC) announcement that conditions warranted keeping a near zero interest rate policy in place through mid-2013, but remain extremely volatile as evidenced by subsequent trading.

Budget Control Act of 2011, S&P Downgrade, and U.S. Stock Prices

For weeks before President Obama signed the *Budget Control Act of 2011* into law on August 2, 2011, S&P publicly and repeatedly warned that it would downgrade the credit rating of the U.S. government unless the legislation raising the federal debt ceiling contained at least $4 trillion in federal budget deficit reduction over ten fiscal years.[1]



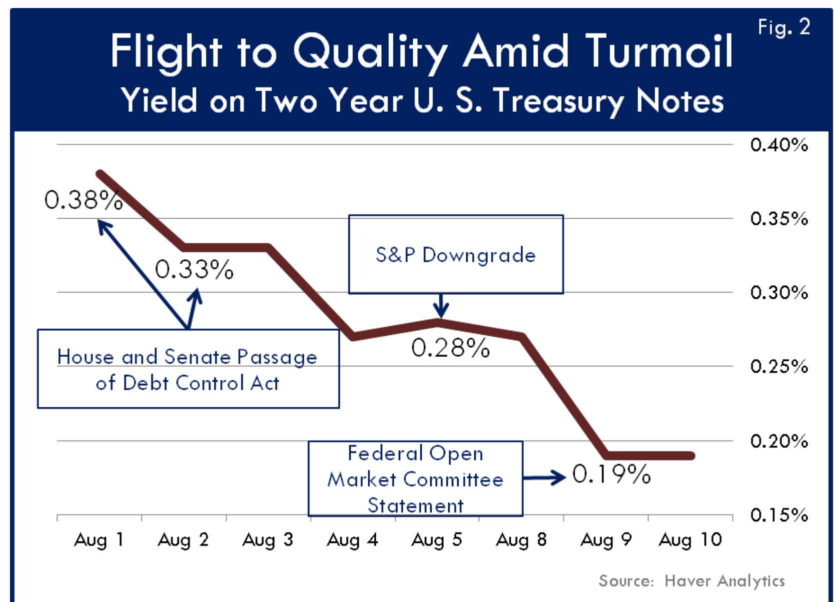
In private discussions over several weeks, Speaker John Boehner struggled valiantly with President Obama to reach an agreement to achieve $4 trillion of deficit reduction. By the evening of Friday July 22, 2011, the talks broke down when the President publicly drew a line in the sand insisting on tax increases during a fragile economy. Obama demanded a $400 billion tax increase and refused to specify entitlement savings. At this point, the credit downgrade became likely, and its effects were rapidly reflected in U.S. stock prices.

U.S. stock prices peaked immediately before the termination of the Obama-Boehner talks and fell thereafter. The Dow Jones Industrial Average peaked at 12,724.41 on Thursday July 21, 2011, while the S&P 500 Index and the NASDAQ Composite Index peaked at 1,345.02 and 2,858.83, respectively, on Friday July 22, 2011 (see Fig. 1).

Following the termination of the Obama-Boehner talks through Friday, August 5, 2011, the DJIA, S&P 500, and NASDAQ fell by 10.1%, 10.2%, and 11.4%, respectively (see Fig. 1). Before S&P's announcement after the stock

[1] The *Budget Control Act of 2011* enacted $917 billion in discretionary savings and created a Joint Select Committee on Deficit Reduction to recommend at least $1.2 trillion in entitlement savings that Congress must consider on an expedited basis in a straight "up-or-down" vote.

market closed on Friday, August 5, 2011, the negative effects of its downgrade were fully incorporated into stock prices. The announcement when it came should not have had a significant effect on U.S. stock prices.



If the downgrade caused the panic, then the price of U.S. government debt securities (Treasuries) should have fallen, while the yields on Treasuries rose to reflect the higher risk. Instead, demand drove Treasury prices up and yields down at all maturities. Despite the downgrade, financial market participants apparently still regard Treasuries as the world's safest financial asset (see Fig. 2).

Europe Takes Center Stage

The euro-crisis that began in Greece in May 2010, spread to Ireland in November 2010 and then Portugal in April 2011, and began to engulf Italy and Spain last week.

On Sunday evening August 7, 2011, the European Central Bank (ECB) announced that it would buy Italian and Spanish government debt securities in secondary markets from private banks, other financial institutions, and individuals to lower the yields on these bonds and ensure that Italy and Spain can continue to borrow at affordable rates. On Monday August 8, 2011, the ECB's intervention had some success. Yields on 10-year Italian government bonds fell from 5.93% to 5.14%, while yields on 10-year Spanish government bonds dropped from 6.05% to 5.15%.

The ECB's bond purchases are a temporary measure until euro-zone member-states can arrange for bailouts of Italy and Spain through the European Financial Stability Facility (EFSF). The EFSF is a mechanism set up in May 2010 through which solvent euro-zone member-states could collectively assist insolvent member-states.

Recently, euro-zone heads of government agreed to allow the EFSF to buy government bonds on secondary markets. However, euro-zone member-state parliaments must ratify this change, and the ratification process will not be completed until October. Currently, the EFSF has a capacity of €440 billion ($626 billion). The European Commission asked for a massive increase in the EFSF's capacity, and many financial market participants believe the EFSF's capacity must be increased to at least €1.5 trillion ($2.1 trillion) to deal with Italy and Spain.

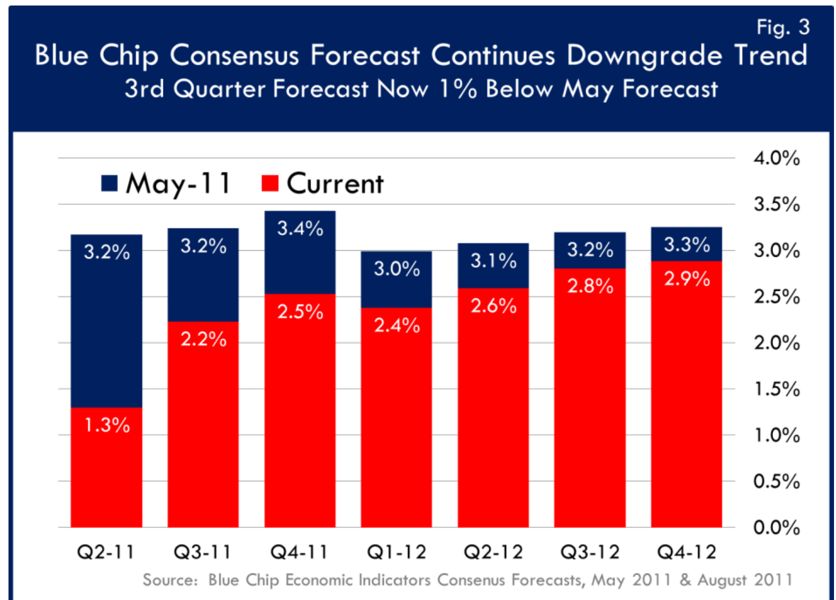
Just 12 hours later at press conference on Monday, August 8, 2011, however, a spokesperson for German Chancellor Angela Merkel, Christoph Steegmans, dashed market hopes for a larger EFSF. "The EFSF will remain what it is, and keep the volume it had." The government of the Netherlands also expressed its opposition to an increase in the EFSF.

European stock prices dropped sharply after the German announcement, and the U.S. stock prices followed suit after they opened. For the first time, many financial market participants are beginning to question whether the euro can survive as the currency for all of the euro-zone. The growing uncertainty over the future of euro and what it portends for economic growth in the euro-zone member-states and the solvency of a number of European banks eroded investor confidence around the world.

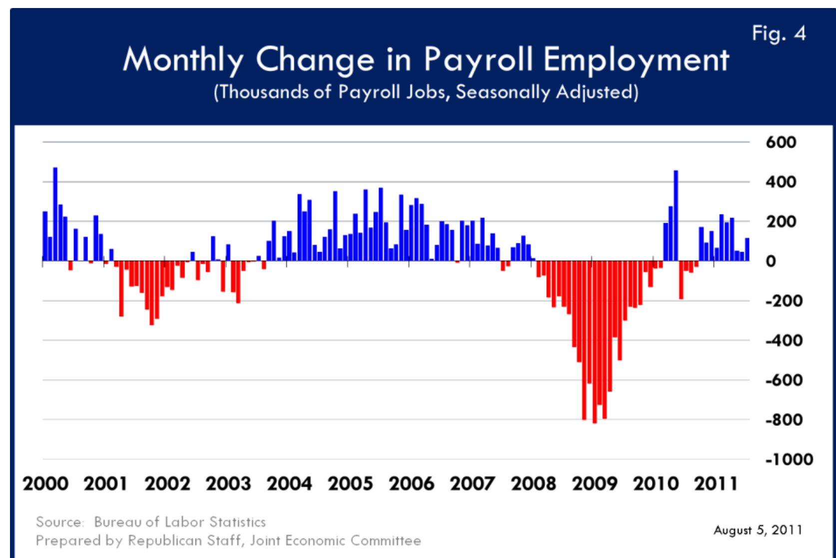
U.S. Economic Outlook

On Friday, July 29, 2011, the Bureau of Economic Analysis announced that the first estimate for seasonally adjusted annual rate of real GDP growth in the United States during the second quarter of 2011 was 1.3% and the real GDP growth rate for the first quarter was revised down to 0.4%.

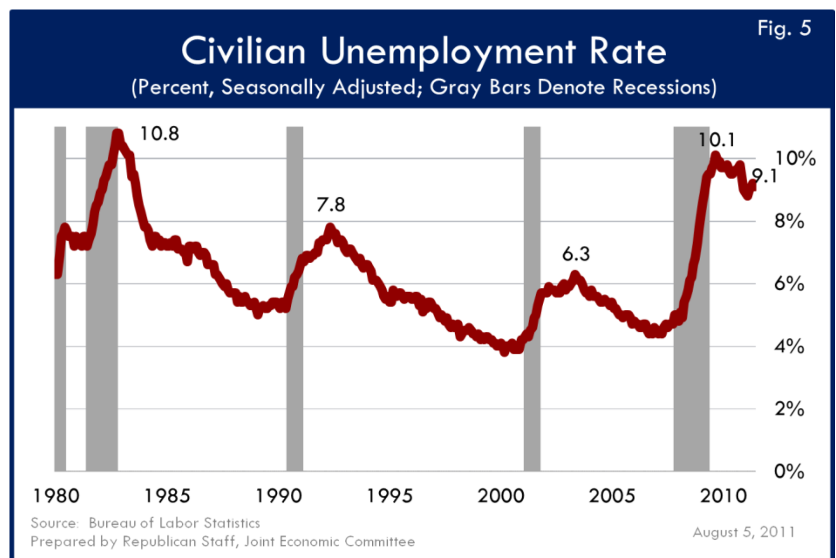
The FOMC statement, issued on Tuesday, August 9, 2011, noted that since the committee last met in June, "economic growth so far this year has been considerably slower than the Committee had expected." The statement also noted that data "suggest a deterioration in overall labor market conditions in recent months …." The statement continued that the FOMC "expects a somewhat slower pace of recovery over coming quarters than it did at the time of the previous meeting and anticipates that the unemployment rate will decline only gradually …." And that "downside risks to the economic outlook have increased."



Private economic forecasters have been trimming their forecasts for real GDP growth in both the United States and the EU over recent weeks. On Wednesday, August 10, 2011, it was revealed that private economic forecasters surveyed by Blue Chip Economic Indicators think that there is a three in ten chance that a U.S. recession will occur before the end of 2012. As Fig. 3 shows, since May 2011, the Blue Chip Economic Indicators consensus estimate for growth over the next several quarters has declined as much as one percentage point.



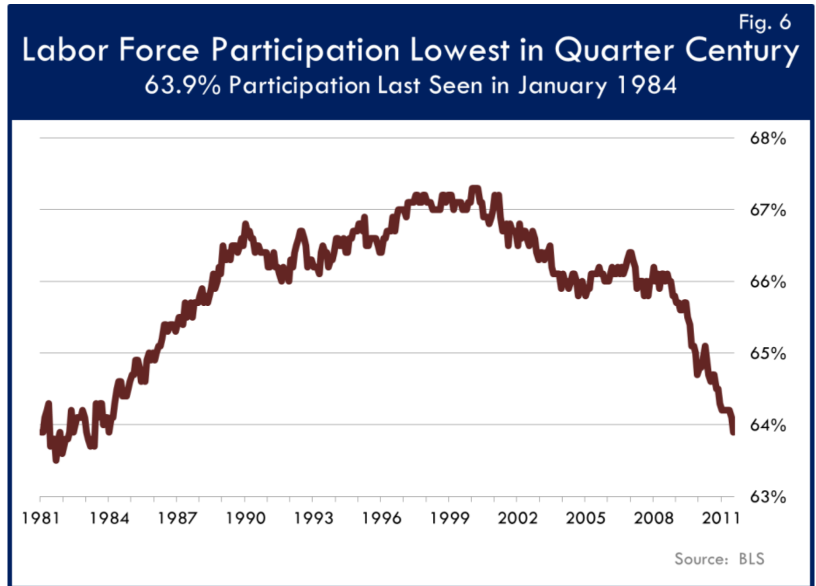
While the Employment Situation Report for July 2011, released on Friday, August 5, 2001, showed a gain in non-farm payroll employment of 117,000 (see Fig. 4) that surprised to the upside and showed the unemployment rate declining by 0.1 percentage point to 9.1% (see Fig. 5), the report fell short of numbers needed to generate a meaningful improvement in the labor market outlook.



In response to a question from Vice Chairman Kevin Brady, on how long it would take to reduce the unemployment rate to its pre-recession level (4.7% in November 2007) at present rate of payroll job growth during a Joint Economic Committee hearing on the Employment Situation on Friday August 5, 2011, Commissioner of the Bureau of Labor Statistics Dr. Keith Hall responded:

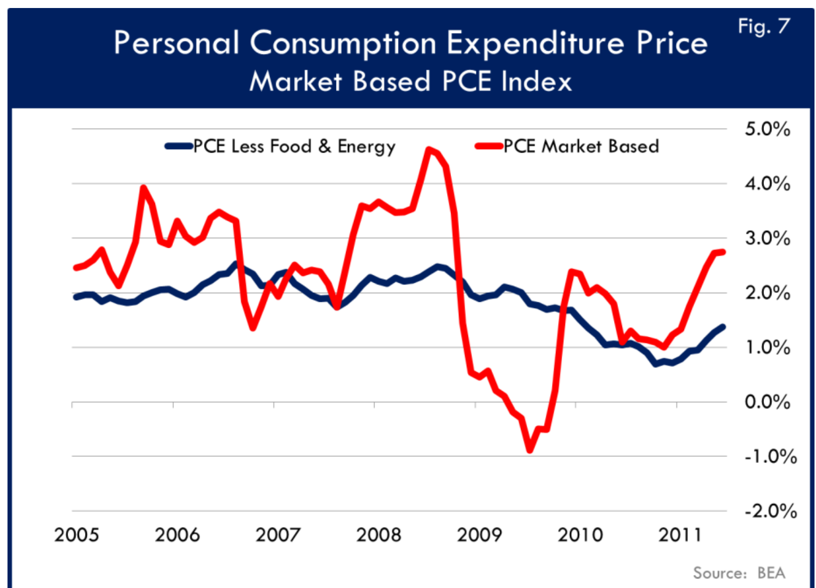
> ***I don't want to be flip, but at 117,000 we would never regain (the pre-recession unemployment rate). You need about 130,000 at least by my rough calculation just to absorb the population growth. So really, if you are looking in terms of recovery, I think the way you should look at these numbers if how far above 130,000 we can get. … 117,000 still is treading water.***

Although the Establishment Survey registered an increase of 117,000 in payroll jobs, the Household Survey showed a decline in the number of employed individuals of 38,000. Consequently, the July 2011 drop in the unemployment rate was driven primarily by 193,000 person decline in the labor force. This pushed the labor force participation rate to 63.9%, the lowest level since January1984 (see Fig. 6). This is a sign of a weakening labor market.



On the inflation front, the FOMC noted that while "[i]nflation picked up earlier in the year, mainly reflecting higher prices for some commodities and imported goods, as well as the supply chain disruptions. More recently, inflation has moderated as prices of energy and some commodities have declined from their earlier peaks. Longer-term inflation expectations have remained stable."

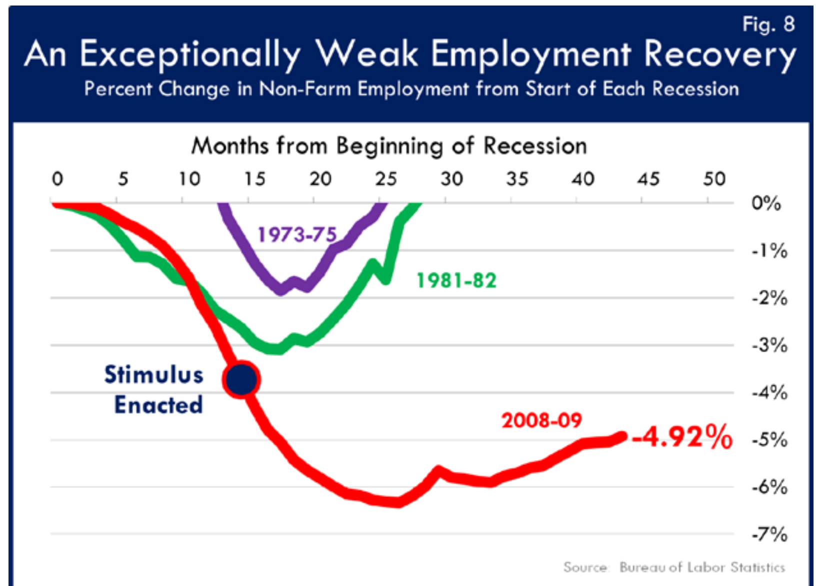
While it is true that energy prices have started to moderate in recent weeks, year over year changes in the Personal Consumption Expenditures (PCE) index are higher than at the beginning of this year (see Fig. 7).



Conclusion

It is unclear whether the U.S. economy is on the verge of entering the second part of a double-dip recession. This uncertainty added to government driven uncertainty over fiscal and regulatory policy only increases the risk of recession or continued very tepid growth.

Clearly, this recovery remains subpar when compared to other severe recessions of the last 30 years. Growth is barely noticeable, and payroll employment remains mired 4.92% below prerecession levels (see Fig. 8).



Jump starting the economy requires that policy makers focus on removing the overhang of uncertainty surrounding future fiscal and regulatory policy at the federal level. Maintaining a course of fiscal consolidation based on reducing the size of government relative to the economy is critical to job creation and economic growth.