U.S. Economic Overview
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Marin Economic Forum

and

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Contents

KEY OBSERVATIONS

- Economic recovery continues, with the pace of recovery appearing to quicken, as forecasts suggest annual growth rates in excess of 3.0% for the next several years. This is a pace of growth not seen on an annual basis since 2005.
- There are concerns abroad: growth in China and other parts of Asia remains slow, there is the prospect of deflation in Europe, and other mounting geopolitical issues such as ISIS and Ebola can affect the mood of consumers.
- Forecast gains in US GDP through 2017 are based on rising income domestically and abroad, which may prove to be optimistic.
- GDP per capita in the United States has recovered to its prerecession levels. In this sense, the economy has recovered, but current levels of GDP remain far below the economy's potential.
- Employment has also recovered to prerecession levels, but unemployment is still high. Declines in labor force participation suggest that joblessness is a bigger problem than is evidenced by the unemployment rate.
- Equity markets, along with corporate profits, are booming. The rapid increase in stock values may well be a source of concern. There have been wobbles, with significant one-day losses, but these do not necessarily portent a significant correction in the near future.
- Housing markets have largely recovered, with the help of low interest rates. Federal Reserve policy is supporting this recovery, while at the same time keeping a keen eye on inflation, which is hovering at about 2% at the national level.
- Income inequality is growing rapidly in the United States. Research increasingly shows that extreme levels of inequality are deleterious to economic growth. The US is among the countries with the highest levels of inequality, a fact that may deleteriously affect growth in the future.

U.S. ECONOMIC OVERVIEW: Mostly Sunny with a Chance of Showers

Economic growth in the United States continues at a moderate pace, with fits and starts. Overall, growth is taking hold. Three of the most recent four quarters have experienced growth at rates in excess of the long-term trend (Figure 1). Were it not for the first quarter of 2014, the last four quarters would have shown the best economic performance in the wake of the recession.

Figure 1: US GDP Growth and Other Measures of Recovery

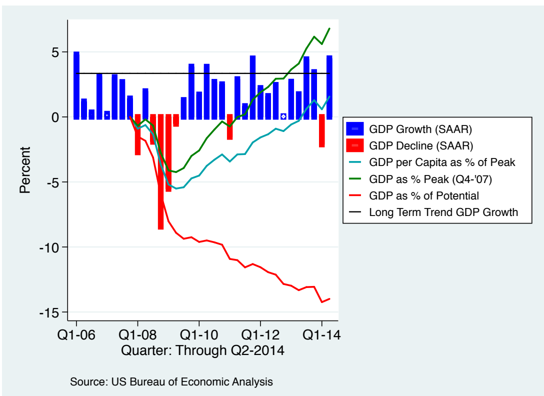
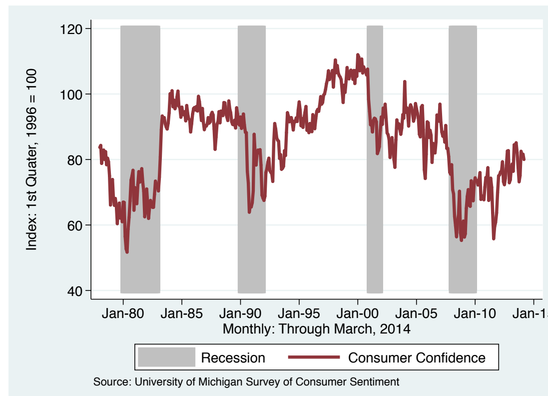


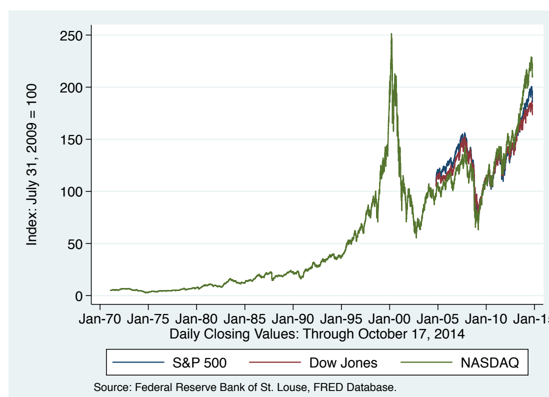
Figure 2: University of Michigan Consumer Confidence Index



Despite recent growth, per capita GDP is just 1.5% above its prerecession level, and economic performance remains well below its long-run trend. Were it not for the recession and the relatively poor performance in its wake, GDP could have been as much as 14% above its current level.

Although growth may have found its footing, it is still too soon to declare victory and full recovery. The Federal Reserve continues to pursue loose, expansionary monetary policy, maintaining low interest rates. And rightly so. Although unemployment rates are down and employment growth has been accelerating, there remains a lot of room for improvement. One telling aspect of the nature of the recovery is the slow return of consumer confidence. By some measures, confidence remains below the levels that were experienced through most of the 15 years prior to the Great Recession of 2007–2009 (Figure 2).

Figure 3: Equity Markets Have Gone Beyond Recovery



Where recovery has clearly found its footing is in equity markets. Since just over five years ago, equity markets have experienced increases in value ranging between 80% (DOW) and 125% (NAS-

DAQ, Figure 3). These are remarkable gains in a five-year period, only before seen during the late 1990s. This does beg the question of the recent run-up's sustainability, but only time will tell. There have been wobbles, with significant one-day losses, but these do not necessarily portend a significant correction in the near future.

At the same time, markets in Europe are experiencing steep losses, with the FTSE hitting a 13-month low. Worries around global economic growth, deflation in Europe, and continued debt problems in specific European countries are all spawning concern over future growth. A growth target of just 7% in China and weak business confidence in Japan signal weakness in Asia. Coupling these observations on economic activity outside of the United States with geopolitical concerns, and although US economic growth is currently solid, dark clouds loom on the horizon.

EMPLOYMENT GROWTH

Although it has been five years since the official end of the recession (July 2009), employment has only recently recovered. In May of this year, payroll employment in the United States was 138.5 million, just above the prerecession peak of 138.4 million in January 2008. The slow first quarter of this year hampered the economy's projected performance significantly. Outside of that period, the 12-month moving average rate of monthly employment growth began increasing steadily in early 2013 (Figure 4). Despite the slow growth at the end of 2013 and in early 2014, the 12 months ending in September 2014 matched the fastest rate of employment growth in any 12-month period since early 2006.

Figure 4: National Payroll Employment Change

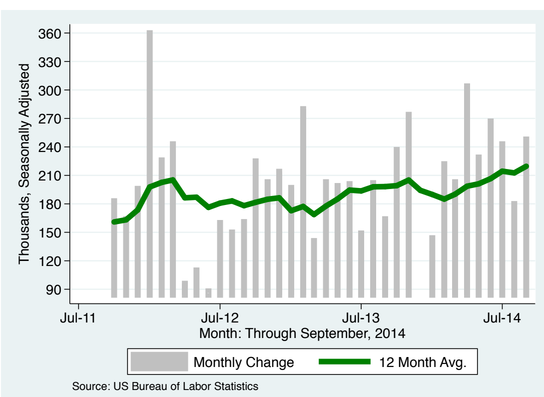
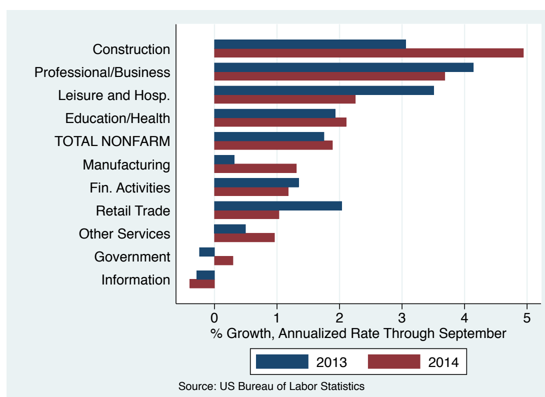


Figure 5: US Employment Growth by Industry, 2013 and 2014



Through August, employment growth in 2014 has outpaced employment growth during the same period in 2013 (Figure 5). As housing markets have recovered, employment in the hard-hit construction sector has recovered rapidly. Other sectors that have experienced significant growth include professional/business services and leisure and hospitality. Despite being the second and third fastest growing sectors in 2014, they are growing more slowly than they did in 2013. Education/health is the remaining major sector growing faster than the overall average, and its growth in 2014 is higher than in 2013.

Growth in other sectors appears to be accelerating. In particular, the manufacturing, other services, and government sectors grew significantly faster through August 2014 than in 2013. Faster growth in manufacturing is certainly important, but it may not indicate the renaissance in this sector that many popular accounts project. More likely, it indicates continued recovery from dramatic declines that were experienced during the recession. Manufacturing employment peaked in June 1979 and has been in decline for nearly all of 35 years. The decline started in earnest in 1998, with year over year employment losses experienced through early 2010. Since that time, manufacturing employment growth has been largely positive, as the sector recovers from year over year declines in excess of 15% during the Great Recession.

As employment recovers, so too does the unemployment rate. Having peaked at 10%, the overall unemployment rate declined to just 5.9% by September 2014 (Figure 6). While still higher than it has been for 14 of the last 20 years, it is no longer the lightning rod socioeconomic issue that it has been since the end of the recession. The unemployment rate is also creeping closer to a level that may trigger Federal Reserve interest rate policy increases.

Figure 6: Unemployment in the United States

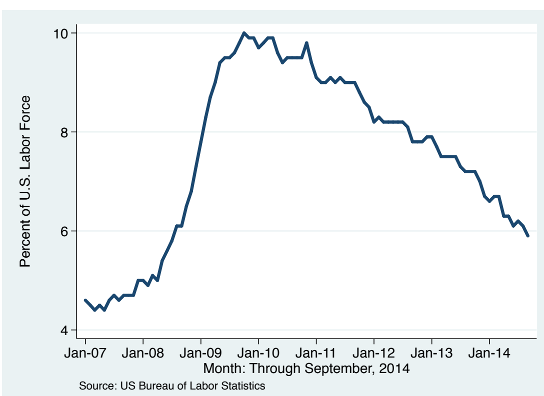
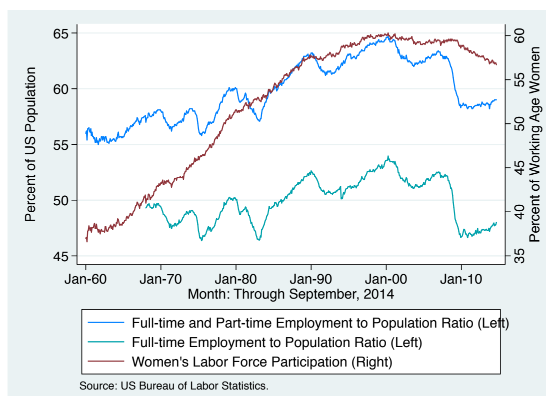


Figure 7: Employment to Population Ratios



At the same time that employment has recovered to its prerecession levels and the unemployment rate has become more politically palatable, other aspects of the labor market remain troubling. In particular, labor force participation among women has been in rapid decline since the onset of the recession. Although in general decline since 2001, the decline accelerated through the Great Recession (Figure 7).

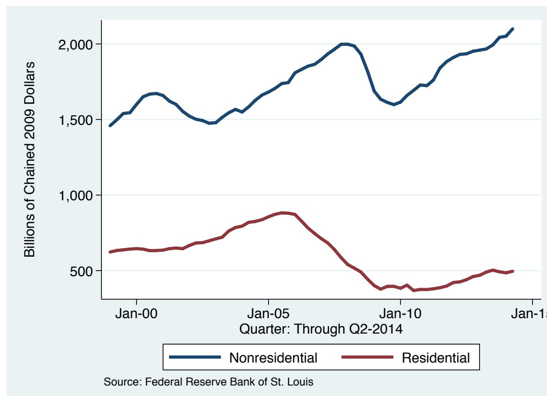
The recession also took a heavy toll on full-time employment. The ratio of full-time employment relative to the population is at a level not seen since the recession of the early 1980s and is recovering very slowly. Overall employment, full-time or part-time, is similarly at levels not seen since the early 1980s.

It is important to note, first, that the unemployment rate is elevated even with recent growth. Second, the rate of participation in the labor force is well below what we estimate would be achieved if the demand for workers was stronger. And third, the share of part-time workers who would prefer full-time work is significantly higher than it was before the recession. Although demographic changes help to explain the declines in labor force participation, all three of these observations highlight lingering effects of the Great Recession that are deserving of policy attention.

FIXED INVESTMENT

Fixed investment includes capital expenditures on new factories, machinery, tools, buildings, homes, and inventories. This investment is broken out into residential and nonresidential, with nonresidential accounting for roughly 70% of fixed investment in the United States. These two types of investment, particularly nonresidential, reflect additions to the productive stock of capital in the economy and are important for future growth. Since the end of the recession, both types have increased, with nonresidential growing substantially faster than residential (Figure 8).

Figure 8: Real Private Fixed Investment in the United States



That residential investment is growing relatively slowly is not surprising given the building that occurred nationwide during the housing bubble and the low rates of return for continued building during the recession. The slow pace of residential investment is likely to be a transitory phenomenon reflecting the built-up inventory and the remaining difficulties in borrowing to purchase a home. The nonresidential growth, however, reflects a continued significant and rising investment in the future of the US economy.

INCOME GROWTH AND INEQUALITY

Another indicator of the success of an economy is growth in personal income. According to this measure, the United States has long surpassed its prerecession levels. Aggregate, or total, personal income in the United States is now two trillion dollars (roughly 15%) higher than it was at its peak in 2008 (Figure 9), and the gap appears to be narrowing between the prerecession (2000−2007) and postrecession (2010−2014) trend lines for personal income growth.

Figure 9: Personal Income in the United States

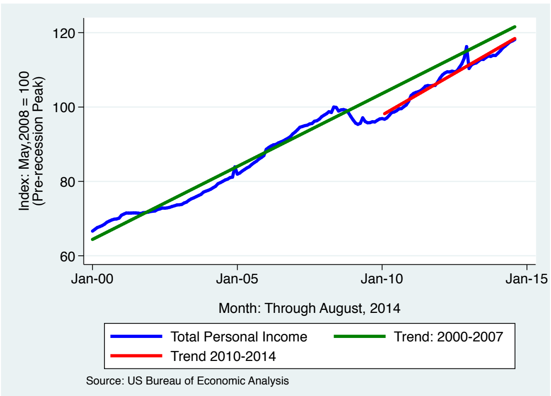
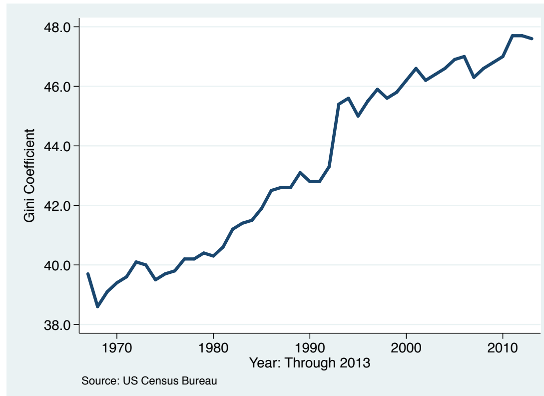


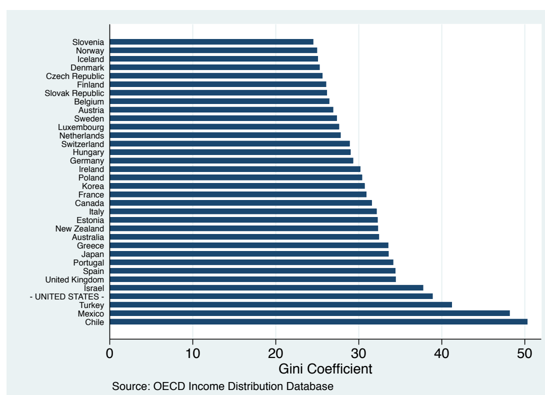
Figure 10: Income Inequality in the United States



As promising as this growth looks, it is complicated by the fact that the majority of it has been accruing to the richest members of society. Since the end of the recession, the richest 1% have accumulated 90% of all income gains. This pattern of rapidly rising income inequality in the United States is not new. The Gini coefficient (a common measure of relative income inequality) for the United States has been on a significant upward trajectory since the late 1970s (Figure 10).[1]

This rapid growth in income inequality leaves only three member countries of the OECD with inequality higher than that in the United States (Figure 11). Those countries are Turkey, Mexico, and Chile. Most countries with which the United States might be considered a peer have levels of inequality that are much lower. These countries include Japan, Canada, Germany, and France. Indeed, all of the European nations have levels of after tax and transfer income inequality that are significantly below that of the United States. The United States fares only slightly better when considering labor market income only, though even then there are only 5 countries with higher levels of inequality than the US.

Figure 11: After Tax and Transfer Income Inequality in 2011



This finding conforms to conventional thinking about taxation in Europe versus the United States — that overall tax rates are higher in Europe than in the United States. Accordingly, taxation serves

[1] The Gini Coefficient is sometimes expressed as a decimal number, for example, .42 instead of 42.

as a greater equalizing force in Europe. This is particularly true when you consider the additional services that are provided by most European governments, such as free access to medical care. The European systems therefore ameliorate inequality through direct transfers, through differential rates of taxation between the rich and the poor, and through services that the public sector provides. Research is increasingly suggesting that this approach is in fact more conducive to faster overall economic growth than is an approach that ignores rising inequality.

Inequality is generally heralded as a constructive force in a capitalist economic society. Higher incomes go to those who perform at a higher level than others, thus creating incentives for investing more time and money into succeeding economically. Increasingly, however, research is showing that high levels of income inequality are associated with lower levels of overall economic growth. As resources are increasingly concentrated in the hands of a few, those with lower levels of income are increasingly denied access to the tools with which to succeed.

Education is one of those tools. Whether through active neglect or a failure to innovate in this important economic sector, it is reasonably clear that the public education system in the United States is slowly falling behind its peers in other countries. This is particularly true in lower income and inner city schools. The failure to adequately invest in education is but one factor that leads to a gross underutilization of the nation's potential labor resources and to slower economic growth.

Figure 12: Real Median Household Income in the United States

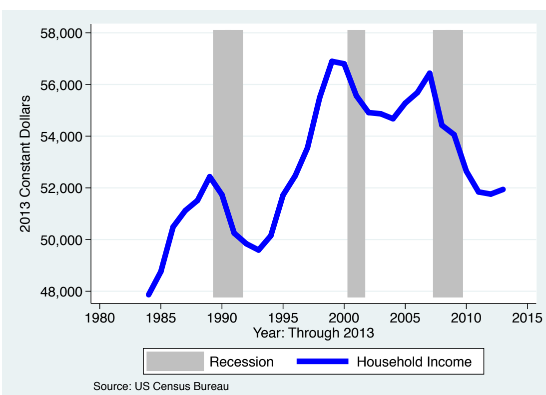
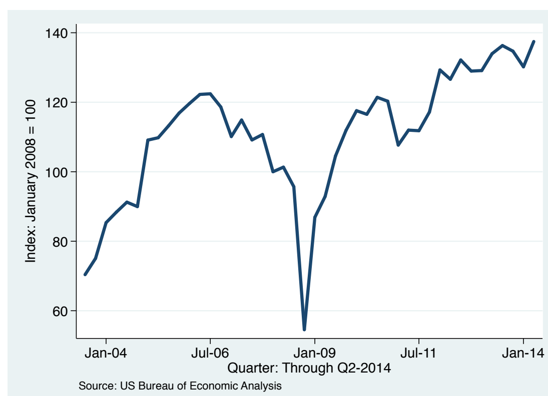


Figure 13: Corporate Profits

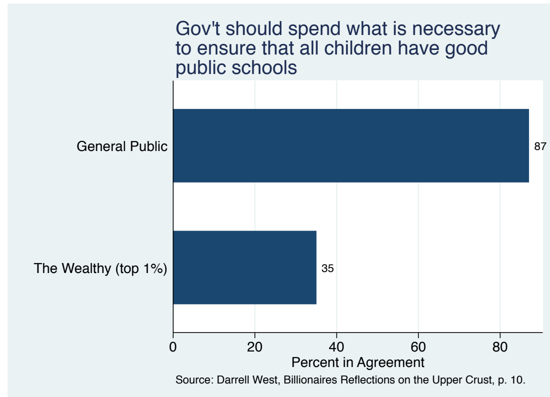


Accordingly, the growth in personal income in the US is not merely a matter of all groups experiencing income growth, but rather of higher income growth being experienced among the better off. In fact, the pattern of rapidly rising income inequality in the US comes from a diminishing of opportunities and/or outcomes for those in lower income categories. In 2013, real median incomes had fallen by more than $4,000 since 2007 (Figure 12). Between 2010 and 2013, in particular, median incomes fell for all income categories other than the wealthiest 10% of households.

At the same time, corporate profits have resumed their upward trajectory and are well ahead of their prerecession levels (Figure 13). Although of course a good thing for the overall economy, corporate profits tend to accrue to the most fortunate among us and add to increasing inequality when incomes more generally are not rising.

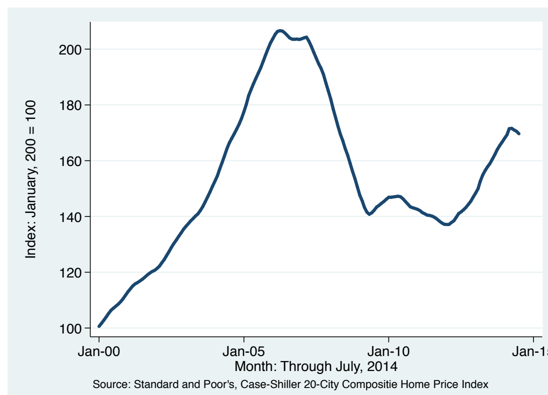
Recent evidence suggests that the wealthy are pulling up the ladder behind them. For instance, although a large majority of the general public advocates for public school spending, only one-third of the wealthy do (Figure 14).

Figure 14: Opinion on Government Spending for Public Education



It is also true that concentrating income and wealth in the hands of the few constrains domestic consumption, a major driving force behind economic growth in the United States. The claim is generally made that this concentration of income will provide more resources to the "job creators" in the economy, but that argument ignores the fact that most job creation is a result of growing demand in the economy. This growing demand comes from consumption. Investments are not made in the face of weak demand for the end products. Increasing income inequality has the significant potential to weaken demand. The wealthy simply spend a smaller proportion of their income than do the poor.

Figure 15: Case-Shiller US National Home Value Index



HOUSING

Between 2006 and 2011, homes in the United States lost an average of 28% of their value. Nonetheless, home values are rebounding and have been since 2012. This rebound is partly a reflection of low interest rates available to home buyers. Job growth and income recovery have also fueled home sales and a rebound in both national home values and housing wealth for homeowners (Figure 15).

INTEREST RATES, INFLATION, AND CONSUMER SPENDING

Interest rates remain extremely low, with long-term, US government debt securities ("treasuries") offering approximately 2.5% interest. Due to their connection to treasuries in financial markets, 30-year conventional mortgages are hovering near 4.25% (Figure 16). These low interest rates reflect several aspects of the current economy and investment climate globally. In particular, they reflect loose monetary policies (rounds I, II and III of so-called "Quantitative Easing") that have been followed by the Federal Reserve. These policies and holding to approximately zero the Federal Funds Rate (the rate at which banks lend to each other overnight to cover their reserve accounts) have translated into low interest rates for most eligible borrowers, including the US government.

Figure 16: Headline US Interest Rates

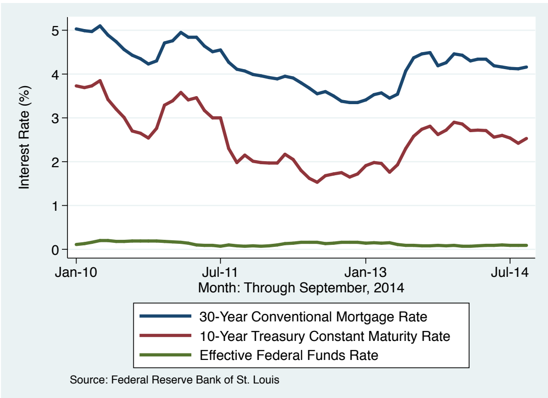
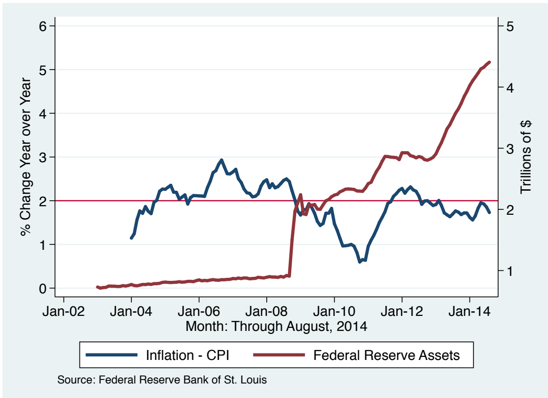


Figure 17: Inflation and Federal Reserve Holdings

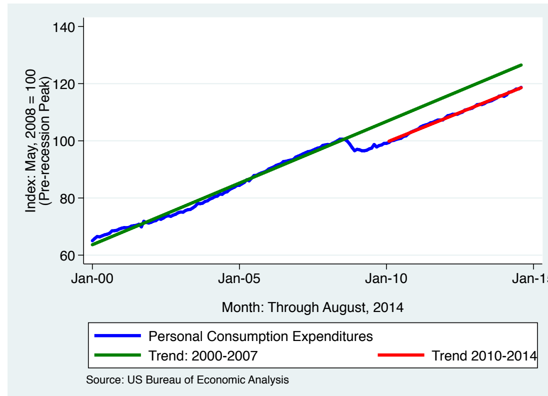


The low rates also reflect the interest in foreign buyers in holding US treasuries. Given conditions in Europe and elsewhere, the safety of these instruments is holding down rates even as US government borrowing has grown significantly. This pattern seems unlikely to change in the near future.

Despite the loose monetary policy and low interest rates, the national inflation rate remains low, hovering at about 2% (Figure 17). Although consumer demand has rebounded well from the recession (Figure 18), it has not had the effect on inflation that it might have had if the Federal Reserve were "printing money" (i.e., effectively financing the deficit of the federal government on a permanent basis by issuing large amounts of currency). For most of the postrecession period, inflation has been at or below 2%, the oft-cited target inflation rate of the Federal Reserve.

Partly using profits from assets purchased in 2008 and 2009, the Federal Reserve has been buying treasuries, and the increase in the Federal Reserve's holdings of treasuries has been matched by an increase in reserve balances held by the banking system. In 2008, the Federal Reserve started paying interest on excess reserves held by banks at the Fed. The excess reserves have correspondingly increased from just under $2 billion to nearly $2.7 trillion – yes, from billion to trillion. So, instead of lending the money out to consumers, banks have been holding the increased supply of money as excess reserves, thereby avoiding the inflation problem. This is a new mixed regulatory approach concerning how banks hold cash and risk aversion, specifically in business lending.

Figure 18: Spending in the United States

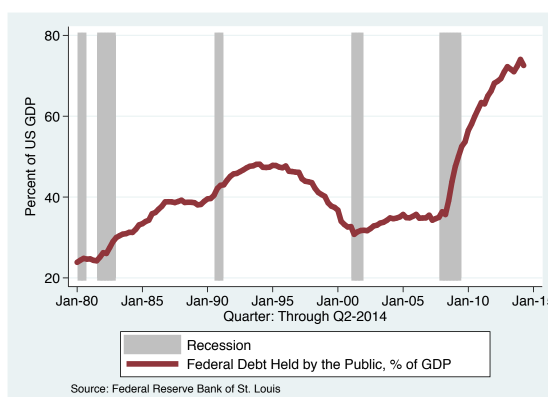


With the recovery of the economy has come a significant recovery in personal consumption expenditures (PCE). This is a measure of goods and services purchased by individuals. Spending recovered relatively quickly, and the postrecession PCE growth path appears roughly similar to the trend before the recession, but at a perhaps permanently lower level. This corresponds closely to the pattern discussed earlier (see Figure 9) regarding the growth in personal income (the genesis of PCE). However, unlike the gap between the prerecession and postrecession trends in income growth, the gap between the previous spending trend line and the postrecession spending line does not appear to be closing.

GOVERNMENT POLICY

Through the recession and recovery, federal government debt held by the public as a percent of GDP has more than doubled from 35% at the end of 2007 to 73% in the second quarter of 2014 (Figure 19). In 2009, the federal deficit reached a peak of $1.4 trillion. It fell to less than half of that in 2013 and projections suggest that it will fall by another $150 billion in 2014.

Figure 19: US Federal Government Debt



The ratio of federal debt to GDP is likely to remain unchanged in the next couple of years as growth in the debt and GDP are both forecast to grow at just over 3% in the coming years. The bottom line is that we continue to have a debt problem. It is not the primary concern facing policymakers, but we have yet to implement a long-term solution.

With interest rates as low as they are now, borrowing today to fund infrastructure and to make other investments in our economic future makes good sense. However, over the long term, there are concerns about government borrowing crowding out private-sector borrowing and concerns about the long-term sustainability of current fiscal policies.

Neither of these concerns is overwhelming today, but once the economy is back on sound footing, the crowding-out aspect could be important. In time, though the United States is never likely to default on its debt, markets may come to fear such an outcome, making continued borrowing very expensive.

The national fiscal picture does look rosier than it did several years ago. This is partly because the recovery has taken hold and mandatory government spending has fallen, but also because projected increases in Medicare expenses have not materialized.

INTO 2015

Going into 2015, there are neither glaring headwinds nor prospects for significant tailwinds. The status quo is likely to persist. The most obvious impediments to growth are a slow-growing Europe (for reasons of export demand) and a lack of federal government stimulus. The need for the latter is much debated and perhaps its time has passed. Other geopolitical factors, Ebola and ISIS, in particular, may be dampening consumer sentiment, posing a further drag on growth. At the same time, prospects for US GDP growth are moderate, with most forecasts in the 2.5–3% range for the second half of 2014 and into 2015. Looking further out, forecasts are expecting growth rates in excess of 3.0% through 2017 (Table A.1).

Expectations for labor markets include some acceleration in employment growth, with very little in the way of wage pressures. The fact that the unemployment rate remains too high and the possibility of a pool of workers sitting on the sidelines out of the labor market both portend sluggish growth or continued declines in the wages of most workers.

While income inequality is not an explicit driver of the slow growth that we are experiencing today, too little emphasis on providing broad access to education and the concentration of income in the hands of a few have been placing drags on the economy for some time. As inequality grows, so too will its drag on economic growth.

APPENDIX: Forecast for 2014-2017

Table A.1: United States Forecast: 2014-2017

Selected US Economic Indicators	Annual Percent Change 2011	2012	2013	2014	2015	2016	2017
REAL GDP	1.8	2.8	1.9	2.4	3.0	3.4	3.2
PERSONAL INCOME	6.1	4.2	2.8	3.6	5.1	5.4	5.6
Unemployment Rate (Percent)	8.9	8.1	7.4	6.5	6.1	5.6	5.3
Non-Farm W&S Employment	1.2	1.7	1.7	1.6	1.9	2.1	1.8
CPI All Items	3.2	2.1	1.5	1.7	2.1	1.9	1.9
Industrial Production	3.3	3.8	2.9	3.1	3.4	3.3	2.9
Housing Starts	4.5	28.0	18.6	12.5	32.9	13.9	1.4
Light Vehicle Sales	10.2	13.4	7.3	3.4	2.4	1.8	0.1
Total Corporate Profits	0.7	18.5	3.4	17.0	−0.2	−0.1	−1.5
Corporate Profits Taxes	−0.4	16.7	−4.5	40.7	11.4	3.5	−4.6
Corporate Profits After Tax	0.6	19.2	5.1	12.6	−3.4	−1.2	−0.6
S&P Index of 500 Stocks (year end)	0.0	13.4	29.6	3.1	4.4	3.8	3.1
GOVERNMENT PURCHASES	−3.2	−1.0	−2.2	−0.6	0.4	0.2	0.6
Federal	−2.6	−1.4	−5.2	−1.7	−0.1	−1.0	−0.6
State and Local	−3.6	−0.7	−0.2	0.1	0.7	1.0	1.3
United States Personal Income	Annual Percent Change 2011	2012	2013	2014	2015	2016	2017
Personal Income	6.1	4.2	2.8	3.6	5.1	5.4	5.6
Equals Disposable Personal Income	4.8	3.9	1.9	3.5	5.0	5.4	5.6
Real Disposable Income w/ Adjustments	2.4	1.9	1.2	1.8	3.4	3.6	3.6
Saving Rate (Percent)	5.7	5.6	4.5	4.2	4.7	5.1	5.6
Effective Personal Tax Rate (Percent)	10.6	10.9	11.7	11.9	11.9	12.0	11.9

Source: California Department of Finance