ECONOMICS
WEEK

The US economy is now past the worst and is recovering at a steady pace, but it is still far from booming, says Gerard Lyons

US economy clambers out of the doldrums

How strong is the US economy? This is one of the key questions for financial markets. Economic weakness in the US and fears of a continued downturn prompted the US Federal Reserve to cut the funds rate by 0.25% to 5.25% at the end of January. Since that easing, there have been signs of economic life, with a number of indicators stronger than the market expected.

During recent weeks, US bonds and equities have suffered. The worries in US financial markets are similar to those that have surfaced recently in the UK. The key concern is that recovery will trigger inflation, justifying higher interest rates.

In my view, the US is recovering, but at a steady pace, with continued low inflation. It is certainly not booming. The US Labour Secretary, Robert Reich, calls it a 'Goldilocks recovery': not too hot to trigger inflation, not too cold to point to recession.

Fears of recession at the start of the year were triggered by continued weakness in the manufacturing sector. Data on this sector has been weak for some time, and although manufacturing appears to be past the worst, the data is still weak.

Industrial production rose 1.3% in February but is only 1.6% higher than a year ago. The important index of leading economic indicators also rose 1.3% in February but in three of four months it fell, which normally suggests recession. One of the best gauges of the manufacturing sector is the National Association of Purchasing Managers index. If it is below the so-called boom/bust 50 level this suggests the manufacturing sector is contracting. This index bottomed at 44.2 in January, but even though it has risen in the two months since, it is still only at 46.9.

What is happening in the manufacturing sector is a classic example of inventory adjustment. Last summer, US companies were unable to sell their goods, so inventories of unsold stock built up quickly. Output was cut, workers laid off and excess stocks run down. Thus, on some indicators, the manufacturing sector appeared to be in recession. At the start of this year the big three US motor companies cut prices aggressively to reduce their excess stocks and this contributed to the increase in car sales.

Despite its recent disappointing performance, the outlook for manufacturing should be good. The sector is efficient and competitive. The dollar's depreciation against the yen and deutschmark has contributed to the US capital goods and auto sectors becoming increasingly competitive in international markets. US productivity has increased. Two weeks ago, the chairman of the Federal Reserve, Alan Greenspan, drew attention to the strong productivity of both the manufacturing and service sectors, which he felt was not being fully reflected in released economic data.

The key in the next few months will be what happens to consumer spending. Consumption is the most important area of the US economy. Companies are unlikely to make the same mistakes they made last year of increasing output in the hope of healthy demand. That led to the inventory build up. Instead they will wait and see. If demand picks up, production will rise in response.

One should not underestimate the rebound that is possible after an inventory correction; if firms have reduced their unsold stocks then any genuine improvement in demand can soon trigger a strong burst of industrial activity.

The question then is, how strong is the US consumer? In recent years the answer has been, not that strong. Wages have been sluggish and job insecurity high. This has prompted talk about the end of the "American dream" as this generation of workers has failed to do better than its parents.

Last year, there was a surge in credit as people borrowed to finance their spending. US savings are low, and people are under pressure to increase their savings, particularly as the government appears committed to reducing future entitlement in order to cut the budget deficit.

The key to any sustained pick-up in demand is an improvement in the labour market, with employment and wage prospects improving. Hence the importance of the latest jobs data, which worried the financial markets.

Employment, as measured by non-farm payrolls, rose 140,000 in March and 624,000 in February. Although this indicates recovery, it does not suggest higher interest rates, as the markets seem to fear. Payrolls fell 146,000 in January, so in the first quarter of this year employment rose by 618,000. Although this seems high, it is lower than the 717,000 jobs created in the same period last year. That was not a time of buoyant growth, so the latest rise in jobs is not exceptional.

Now there are fears of a rebound in wages, something even Greenspan is concerned about. US firms are in a better position because they have high profits with which to pay increased wages if they wish. It is not clear they will. In recent years, skilled wages have risen – a trend that will continue although unskilled wages will remain low – because of global competition. Modest wage growth will reinforce the favourable inflation outlook. US inflation is likely to be 2.5% this year.

The overall picture is that the US economy is recovering from its recent weakness and could rebound further in coming months. This points to interest rates remaining on hold for now, although I expect them to fall further eventually. The key area the US Federal Reserve will focus on will be wage and employment prospects. Developments there should confirm the US economy is past the worst but is still some way from a boom.

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