Dead slow. And stop.

Economic perspective

15th June 2011

This is the fourth note in a series looking at the outlook for the global economy in the next eighteen months. The first notes have dealt with the political environment and the probability of a collapse in the euro-zone. This note examines the outlook for the US.

- What's moving in the US, can't move in a full recovery with rising interest rates and a stronger dollar
- The parts of the economy outside the stimulus are only going backwards
- Gas and petrol prices and import prices tell the non-housing story of rising Australian household wealth and declining US household wealth

When I was growing up, I had a hockey coach who didn't think much of my running. "White", he said, "you have two speeds. Dead slow. And stop." I feel this is as good a description of the US economy, today, as any.

There are areas of the US economy that can provide some growth momentum in the coming months and years. Good examples include the housing industry (how much lower can it go); luxury shopping (the rich are getting richer with higher equity prices) and corporate balance sheets are awash with cash to be spent. But these represent cyclical opportunities in an economy that is hamstrung with a structurally failed policy; low interest rates and a weak dollar.

This policy has created two groups – those that are furiously active, but going nowhere when policy shifts, and those that are on the outside looking in while the cost of living does nothing but rise.

Dead slow.

The dead slow part of the US economy is the 'bail-out economy'. This is the part of the economy that has been able to expand in the past two years since the end of the recession. Manufacturing has benefited from a weak dollar and the enormous and erroneous de-stocking of inventories that occurred in late 2008 and early 2009. Financial services were saved by the actions of the TARP plan to re-capitalise the banks and, subsequently, the positive impact of quantitative easing on asset prices.

This part of the economy has begun to slow. But why's it dead? It's dead because no meaningful recovery in the US will be based on manufacturing or low interest rates.

Let's start with manufacturing. It's not just that the sector's not big enough to employ the people currently sitting on the sidelines of the US labour market. Indeed, a sustainable manufacturing recovery could act as a catalyst for a broader structural recovery through the multiplier. The problem is manufacturing's structural decline. It is on its way to becoming just a marginal part of the US economy and so the current level of activity is broadly unsustainable.

The so-called renaissance in US manufacturing seems solely based on greater price competitiveness due to the weakness of the US$. There are a number of problems with this:

- When/if the US economy improves, the US$ will rise and, once again, much of the industry becomes uncompetitive
- Much of the valuable US manufacturing operates in relatively price insensitive areas, high technology for instance, and receives no benefit from a weak US$. Indeed, a weak dollar leaves value on the table.
- Forcing a re-valued currency on China only pushes China up the value chain; it starts importing more capital equipment and so becomes competitive with even more valuable parts of the US industry

There is little evidence that firms are raising their productivity through investment in plant and equipment, with only software investment returning to pre-crisis levels. Non-residential, non-structural capital spending remains 12.5% below its mid-2008 peak. We also know that they're not hiring overly aggressively, suggesting the industry knows this is transitory.

An historical comparison is Winston Churchill's return of Britain to the gold standard in the 1920's. This required British industry to deal with a stronger exchange rate. While the immediate effect was to make British coal uncompetitive and put many miners out of work, it's long run effect was to create a more competitive manufacturing industry, capable of the technological advances.

A sustainable manufacturing industry in the US will be smaller but add more value than is currently the case.

The story is the same with financial services. Product based on zero interest rates must also be unsustainable. Indeed, the lower growth outlook for Australian banks is one that will need to be adopted by all banks around the world once money stops being free and the Basel III criteria start sticking. Yes, growth has already slowed in the global banking industry since the start of the sub-prime crisis, but it has a long way to go once interest rates start rising as has been the case in Australia.

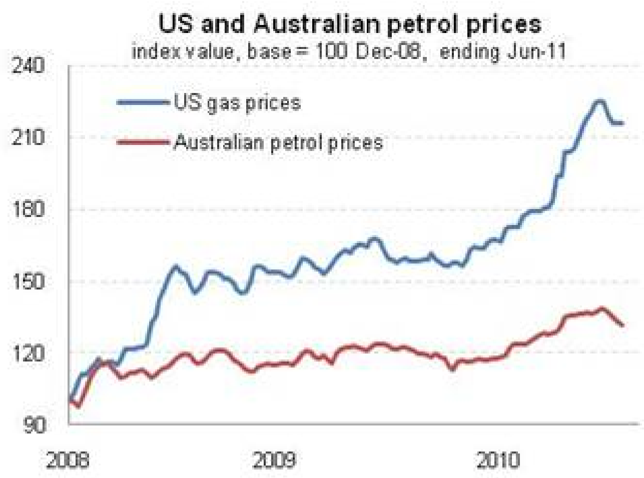
And stop.

The bail-out recovery comes at the expense of economic activity elsewhere, particularly in domestic services where the majority of Americans are employed. The weak US$ has eroded the purchasing power of US households. As a result they are spending more money on imported essentials, particularly commodities, and less on domestically supplied, inessential services. In the last three to four months this argument has come to the fore in the shape of the higher oil price.

The chart below highlights this perfectly. Since petrol / gasoline prices bottomed in December 2008, prices have risen 35% in Australia and 116% in the US. The rise is broadly attributable to the weakness of the US$. In Australian dollar terms the shocks from a moratorium on Gulf of Mexico drilling, trouble in the Middle East and the earthquake in Japan seem to have had only a relatively weak impact. There has been just a 16% rise in Australian petrol prices since the low in September 2010 compared to a 38% rise in US gas prices. The US$ weakness is exacerbating moves. It is driving the US economy to a standstill.

What goes for oil, US$ weakness, goes across all imported goods. The second chart shows the remarkable divergence between the prices Australian consumers are paying and US consumers are paying. Can it really be a surprise that employment, particularly in services, in Australia is booming?

Source: Bloomberg



Source: Bloomberg

Conclusion

The outlook for the US depends in many ways on what happens in Europe. A eurozone crisis presents an opportunity for the US; it would lead to US$ strength and so provide households with some respite in the form of lower living costs. Alternatively, the likely extension of monetary policy, Goldman Sachs says into 2013, will only worsen the situation. The sugar hit from cheap money, weak currency and manufacturing growth is weakening. The hangover has the potential to be more prolonged than just a 'soft patch' and, all the while, households will continue to be weighed under by the rising price of imports.

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