

No Recession Any Time Soon, But Troubles Ahead, Nonetheless

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Problems in housing will cause inevitable weakness in the US economy. The hard forecasting problem is to decide when the problems will begin and how much trouble this will cause outside of housing. We expect housing to start slowing the economy in this quarter or the next, but we do not see a national recession being caused by this trouble in housing because of the current downtrodden status of the manufacturing sector.

A recession is first and foremost a period of job loss and elevated unemployment. Most of the job losses have occurred in the two highly-cyclical sectors of the economy: manufacturing and construction. Otherwise, there may be some softening of job growth, but not actual job losses.

Historically, the cycles of jobs in manufacturing and construction have been closely coordinated - peaks and troughs have occurred at roughly the same points in time. Currently we have construction job levels reaching toward the ceiling but manufacturing jobs are virtually at the floor. With hardly any room

to fall further, it doesn't seem likely that problems in housing and in construction will spread to manufacturing this time.

To explore this idea carefully, we examine the employment in durables and nondurables. The recent job loss in manufacturing has been partly from cyclical demand fluctuations, partly from a surge in productivity and partly from a rising trade deficit. Weaker productivity growth, and improvements in the trade deficit may offset the loss of demand that could come from a sluggish housing sector.

Without significant job loss in manufacturing, we are not likely to have a recession-level elevation of joblessness. Also, absent a sharp decline in jobs, the correction in the housing sector is likely to be spread over a larger number of years, since it takes job losses that force home sales to make the market respond quickly to a new level.

It's a good thing that the construction cycle and the manufacturing cycle have become disconnected.

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Housing is in a Perilous Position

Our concern about the role of housing in the future growth of the economy has been influenced by several facts that are captured in Figures 1 and 2.

Figure 1 illustrates real per capita (16 and over) spending on residential investment. This figure reveals that:

- Eight of the last ten recessions got started in the housing sector.
- There have been two “false positives” – significant problems in housing that did not precede a recession. One was in 1967 (think Vietnam) and the other in 1951 (think Korea).
- There have been two “false negatives” – recessions that were not preceded by a sharp fall in housing. The 2001 event was one of these and 1953 was the other. The 2001 down turn came from the collapse of business spending on equipment and software in the aftermath of the Internet Rush. The 1953 recession was a response to a huge reduction in spending by the Department of Defense following the Korean Armistice in June 1953.
- Each quarter lately we have been setting another new record in real spending per capita. If real spending on homes per worker returns from the stratospheric levels of almost \$3,400 per American to the previous peak level of \$2,700, that is a reduction of \$700 per person. Multiply that by 220 million people (over the age of 16) to get a reduction of \$150 billion, about 1% of GDP. If spending were to move back to previous normal levels, say \$2,000 per capita, the spending reduction would be about 2% of GDP.

Figure 2 illustrates the fraction of GDP that has gone to residential investment. The potential for losing as much as 2% of spending is further confirmed in this figure based on the possibility that the

fraction spent on residences declines from the recent stratospheric level of 6% back to the less-than-normal level of 5%.

Figure 1 Real Per Capita Residential Investment

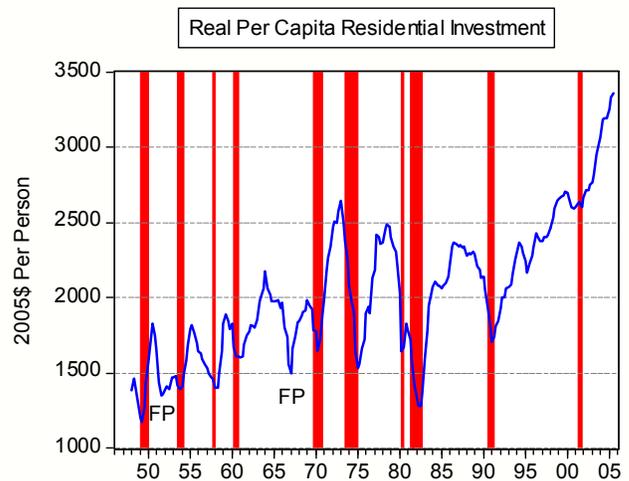
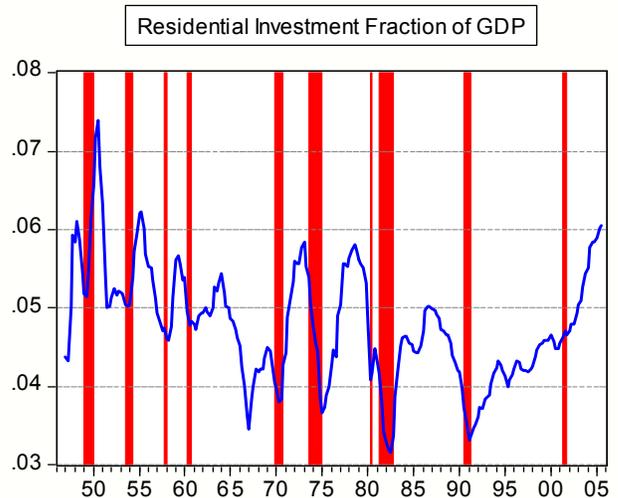


Figure 2 Residential Investment Share of GDP



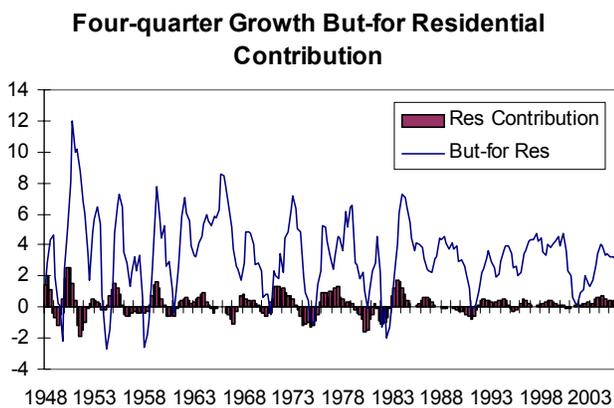
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But Housing Alone Cannot Constitute a Recession

Figure 1 and Figure 2 strongly suggest that another recession is in our immediate future unless we can replace spending on homes with something the equivalent of Department of Defense spending during the Vietnam or Korean Wars.

But loss of spending on housing by itself is not enough to get us into a formal recession. Figure 3 depicts the four-quarter average contribution to growth that comes from residential investment and the GDP growth with residences removed. While residential spending has been the straw that broke the camel's back, dragging GDP growth numbers into the negative territory, the negativity from residential spending alone is nowhere near enough to turn the growth rate negative. The largest four-quarter negative from housing is only -1 percent, compared with normal GDP growth exceeding 3 percent. Thus in order to get to negative growth while housing is pulling growth down, the rest of the economy needs to suffer very sluggish growth. Before we make a recession call, we therefore need to confirm that the rest of the economy will contribute to the recession, as housing inevitably will.

Figure 3



Most Forecasters Don't Seem Very Worried

A small fraction of forecasters think that housing will precipitate a recession. One of them is Dean Baker of CEPR:

“The collapse of the housing bubble will throw the economy into a recession,” and quite likely a severe recession, according to economist Dean Baker, co-author of the report.

But there is not much concern about housing evident in the 56 forecasts that form the *Wall Street Journal* poll. Table 1 reports some summary statistics for these 56 forecasts of the GDP growth in the second quarter of next year, a time when housing might be slowing the economy. The table includes forecasts made at five different months this year, first in June of this year and most recently in November. You have to look hard to see any evidence of concern about cooling. The June average was 3.3%, which is a normal figure for US growth. This hardly changed from June to November. It is true that the percent of forecasts in the abnormal range, below 3% did edge

Table 1

As the Future Gets Closer, The Vision Doesn't Change
 The WSJ Forecasts for GDP Growth, 2006 Q2
 56 Forecasters

Forecasts for 2006 Q2

	<u>Month of 2005 When Forecasts Were Made</u>				
	<u>June</u>	<u>Aug</u>	<u>Sept</u>	<u>Oct</u>	<u>Nov</u>
Average	3.3	3.2	3.3	3.3	3.3
Std Dev	0.54	0.52	0.59	0.57	0.51
Below 3%	16%	21%	23%	25%	27%
<u>Cumulative</u>					
Minimum	0.5	1.8	2.0	2.0	2.2
25% percentile	3.0	3.0	3.0	3.0	2.9
Median	3.4	3.3	3.3	3.3	3.2
75% percentile	3.5	3.5	3.7	3.7	3.7
Maximum	4.1	4.3	4.8	4.5	4.4

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up a bit from 16% to 27% but without changing the mean or the standard deviation.

It is not just 2006 Q2 where there is very little concern about problems in the economy. Table 2 has the November forecasts for all of 2006. The consensus seems to be for slightly stronger growth in 2006 Q1 but otherwise about normal in the low 3% range. Compared to the "4s" we have been racking up, this is some significant degree of slowing but quite far from recession.

We think that these forecasters are missing the importance of housing.

The Payroll Data Reveal No Dead Wood In Need of Pruning

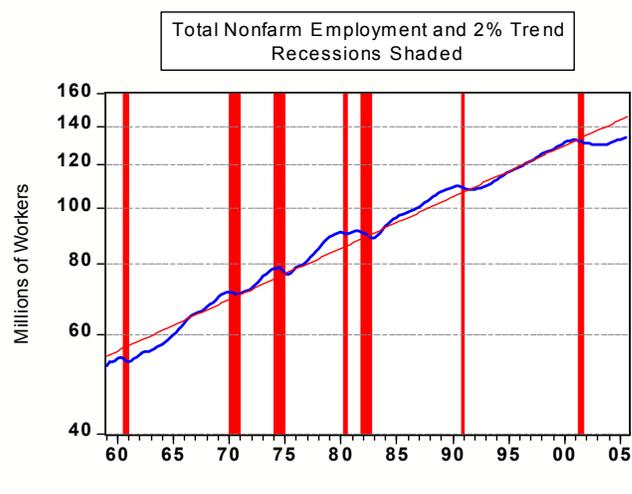
Just because the *Wall Street Journal* forecasters don't see a recession doesn't mean we won't have one. They have missed all the recessions. Should we be expecting a recession soon? A recession is first and foremost a period of elevated idleness of labor – a substantial and sustained increase in unemployment. One good place to look for signs of recession is in the

Table 2

As the Future Gets Farther, The Vision Doesn't Change
 The WSJ Forecasts for GDP Growth Made in November 2005
 56 Forecasters

	2005 Q4	2006 Q1	2006 Q2	2006 Q3	2006 Q4
average	3.0	3.5	3.3	3.1	3.0
Std Dev	0.66	0.57	0.52	0.54	0.68
Below 3%	44%	16%	28%	35%	35%
Minimum	1.5	2.2	2.2	1.8	0.0
25% percentile	2.6	3.0	2.9	2.7	2.7
Median	3.0	3.5	3.2	3.1	3.1
75% percentile	3.4	3.9	3.7	3.5	3.5
Maximum	5.4	4.7	4.4	4.2	4.2

Figure 4 The Cycle in Nonfarm Payroll Jobs



employment data. Figure 4 illustrates the growth of nonfarm payroll jobs compared with a 2% trend. In the expansions, jobs get above that trend line, and in the recessions jobs dip down to or below that 2% trend. But in the aftermath of the 2001 recession there has been no recovery of payroll jobs and we find ourselves distinctly below that 2% trend: not positioned for a recession but instead for a recovery with robust payroll job growth.

Figure 4 is therefore incompatible with the hypothesis that there will be a national recession any time soon. The normal pattern of job formation is expansion followed by recession followed by expansion and so on. As an expansion precedes, inevitably less productive workers are hired and some productive workers lose their energy and motivation. It is during the recession that this dead wood is pruned. But as far as payroll jobs are concerned, we are still in the depths of a recession and have not even begun the process of excess job formation that precipitates the pruning of a recession. There is no dead wood on those branches!

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But, you should object, that is a rather simple-minded analysis. Maybe there are some good reasons for the weakness of payroll jobs and maybe we are actually above some new trend line. For example, much has recently been made of the gap between the payroll jobs counted with employer surveys and the household jobs counted by household surveys. Maybe the labor market is behaving differently these days with fewer payroll jobs and more self-employment and more off-the-books work. These other jobs might be picked up by the household survey. But Figure 5 which illustrates the payroll employment and the household employment reveals a household employment data that also is well below trend. No apparent dead wood there either.

Manufacturing, Construction and the Other Sectors

Before we jump to conclusions, a look at some more detailed data is in order. Figure 6, Figure 7 and Figure 8 illustrate the cyclical behavior of jobs in manufacturing, construction and the rest of the economy. Each graph includes a trend line estimated

from 1970 to 1995, thus excluding the high-growth 1960s and the high-growth Internet Rush. This period from 1970 to 1995 is taken to be “normal.” The number of jobs and the trend are graphed using the right-hand scale, which is logarithmic, thus making the constant rate of growth trend line straight in each figure. The deviation from trend is also included in these figures, using the left scale.

Figure 5 Payroll and Household Surveys Aren't That Different Any More

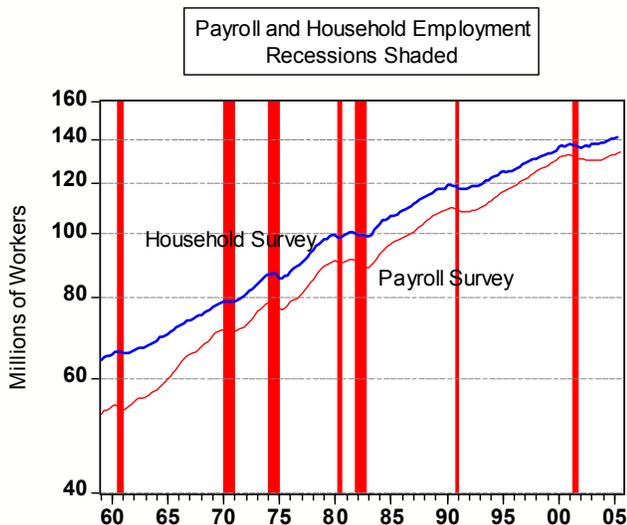


Figure 6 Payroll Jobs, Manufacturing

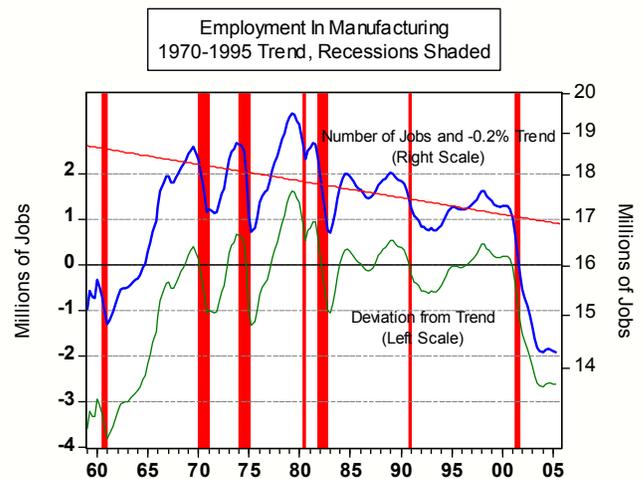
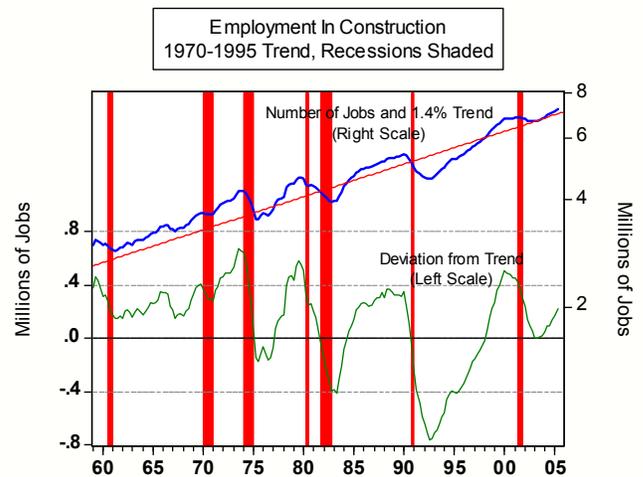
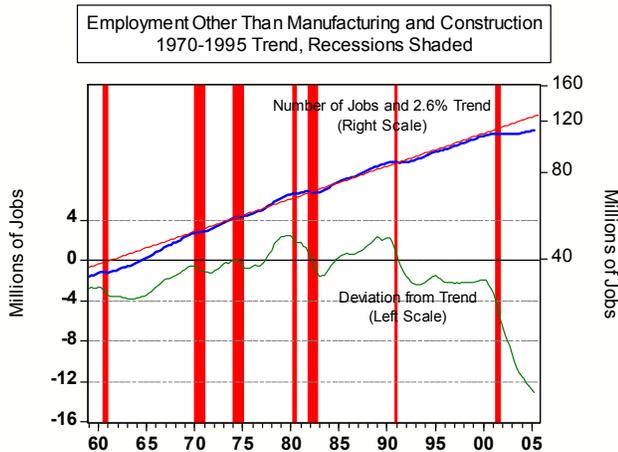


Figure 7 Payroll Jobs, Construction



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Figure 8 Payroll Jobs, Other Than Manufacturing and Construction



The manufacturing jobs illustrated in Figure 6 from 1970 to 1995 declined at the rate of -0.2% per year. This sector is highly cyclical, with substantial outright job losses during the recessions. With that very modest negative trend, the deviation from trend and the actual number of jobs look very similar. At the troughs the payroll jobs in manufacturing are about a million below trend. At the peaks the payroll jobs in manufacturing are 0.5 to 1.0 million above trend. The recessions thus involved a swing in jobs on the order of 2 million on a base of 18 million.

But the decline in jobs after the 2001 recession has been extremely great, knocking down jobs by almost 3 million, from 17 million to 14 million. Recently, we are only bouncing along the bottom with no further losses. There is no dead wood in manufacturing. There are hardly any trees left.

The other sector with substantial job loss during recessions is construction, illustrated in Figure 7. If you look hard, you might see a little bit of dead wood on those branches, but even in construction, in the midst of a housing bubble, the excesses are hardly noticeable. Construction jobs from 1970 to 1995 grew at a rate of 1.4% per year. In the depths of the

recessions, construction jobs have been about 1 million off their previous peak levels. Right now, we are over that trend line by only 200,000 jobs.

Outside of manufacturing and construction, there is no noticeable decline in jobs during recessions. The data illustrated in Figure 8 hug closely to that 2.6% per year trend line. There is some noticeable variability around the trend since job formation in these stable sectors is weak during the recessions and strong during the expansions.

But look at the data after the 2001 recession. We went from about 2 million under the trend line to 13 million under. No dead wood here either.

A bursting of the housing bubble could well come with a sharp decline in jobs in construction, likely $\frac{1}{2}$ million jobs and maybe as many as 1 million, but phased in over two or three years. But with no likely job loss in manufacturing and with the rest of jobs growing at $2.6\% = 2$ million per year, there cannot be enough job loss for the NBER to call it a recession.

And There is Hardly Any Dead Wood in the Sectoral Detail

Nonsense, you reply, Figure 8 is too broad a group and it is hiding the problems that lurk beneath. Well, we can look at the subcategories to see if we can find any apparent dead wood. For each of the subcategories we can make a figure like Figure 8, looking for evidence that the current level of employment is significantly above trend, and in need of pruning.

- Education and Healthcare: No dead wood there. (Figure 9)
- Finance: 300,000 jobs are at risk. (Figure 10)
- Information: No dead wood there. (Figure 11)
- Leisure and Hospitality: No dead wood there. (Figure 12)

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Figure 9 Payroll Jobs, Education and Health

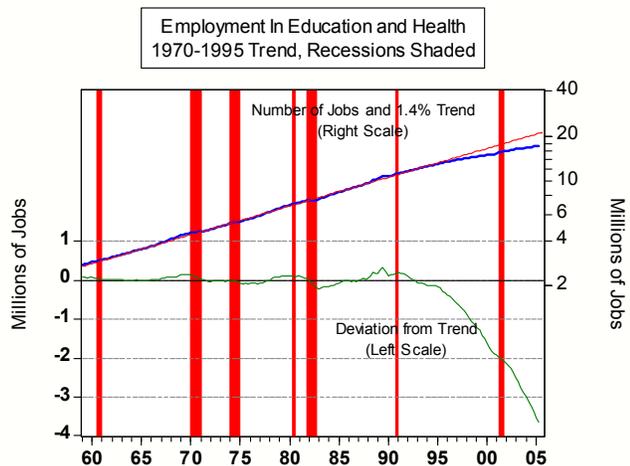


Figure 10 Payroll Jobs, Finance

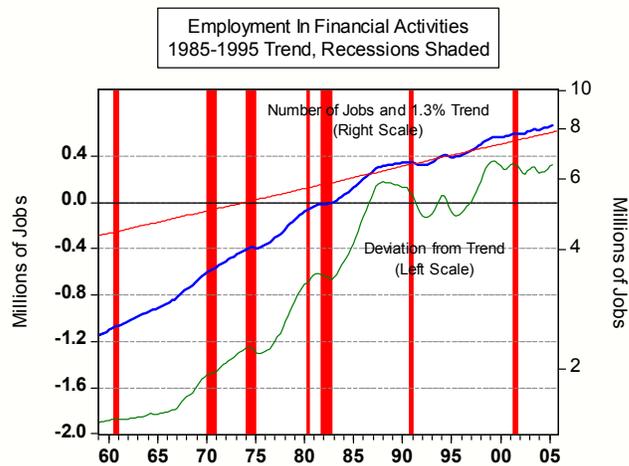


Figure 11 Payroll Jobs, Information

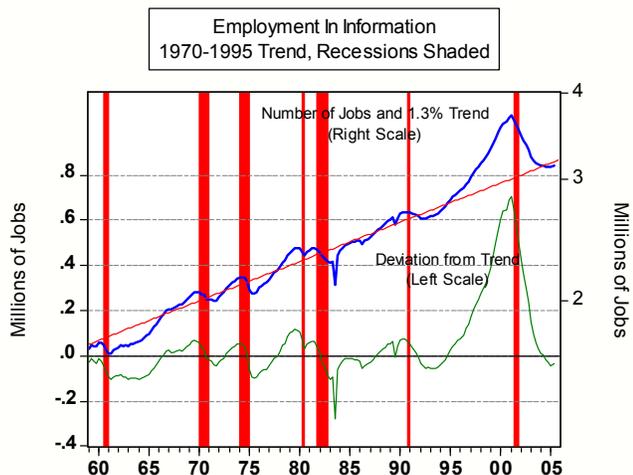
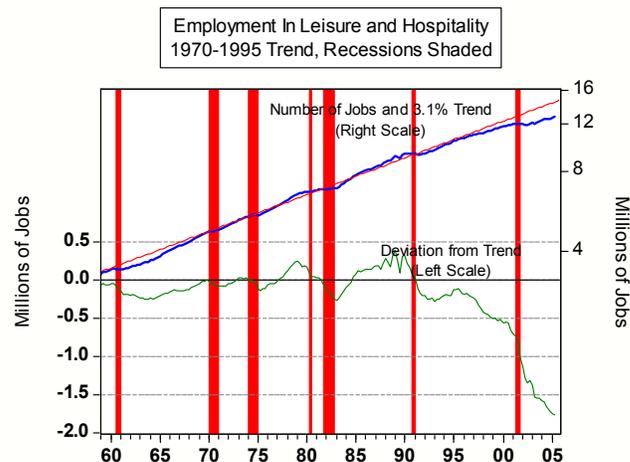


Figure 12 Payroll Jobs, Leisure and Hospitality



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Figure 13 Payroll Jobs, Professional and Business Services

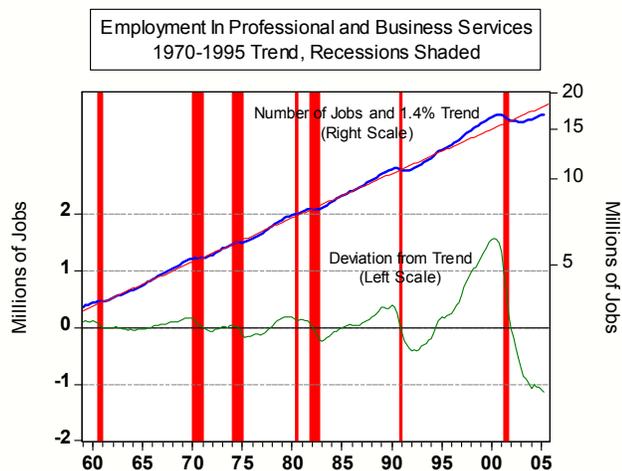


Figure 14 Payroll Jobs, Retail

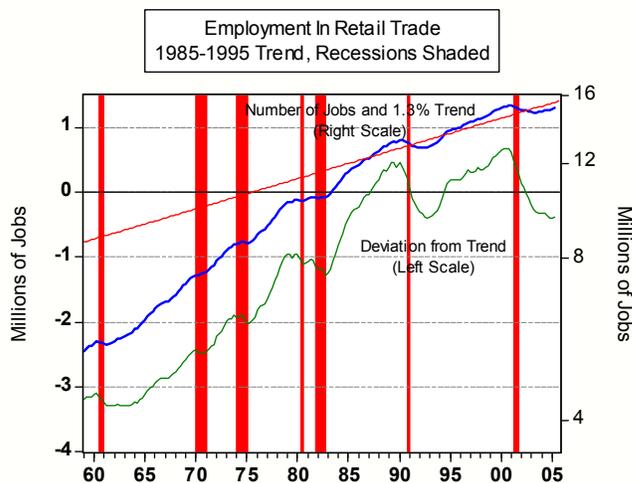


Figure 15 Payroll Jobs, Transportation and Warehousing

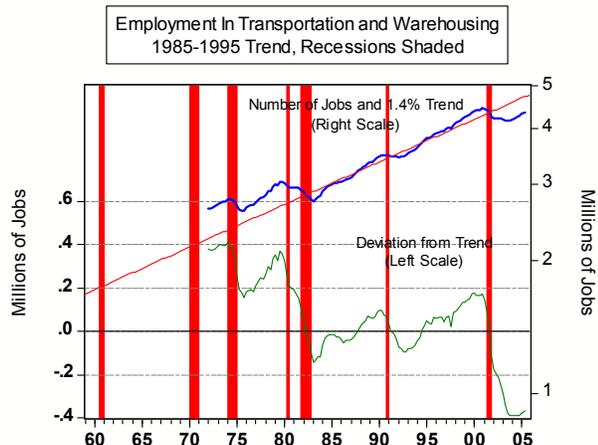
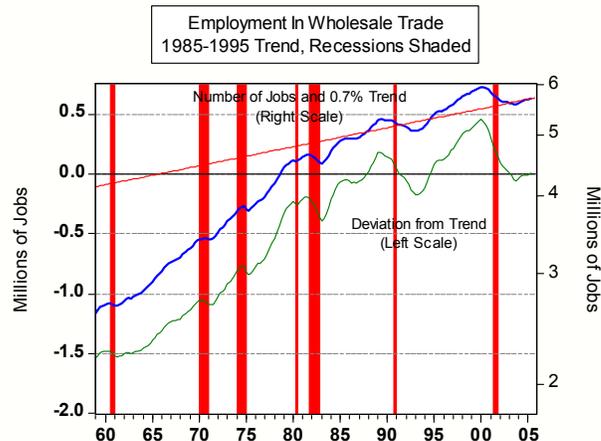


Figure 16 Payroll Jobs, Wholesale Trade



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- Professional and Business Services: No dead wood there. (Figure 13)
- Retail Trade: No dead wood there. (Figure 14)
- Transportation and Warehousing: No dead wood there. (Figure 15)
- Wholesale Trade: No dead wood there. (Figure 16)

Forgive me, if I don't force you to look at the pictures for government, and natural resources. You and I know there won't be a lot of job losses there.

Bottom line: a jobless recovery is going to be followed by a jobful non-recession. Expect losses of ½ million construction jobs and 300,000 financial jobs but that's about it.

What's the Matter with Manufacturing Jobs? Are We Shipping Jobs to China?

Historical recessions have come with a coordinated decline in jobs in construction and in manufacturing. It looks as though the cycles in construction and manufacturing have become disconnected, with a current peak in construction coinciding with a current trough in manufacturing. Absent job loss in manufacturing, it seems unlikely that there can be enough job loss to have a formal recession. But to get comfortable with this notion, we need to figure out why manufacturing jobs have been suffering so greatly in the aftermath of 2001 and determine whether that trend will continue or reverse.

It could be international trade. International trade has allowed Americans to consume well beyond their means, and that necessitates a massive deficit with imports greatly exceeding exports. Figure 17 illustrates the employment in nondurables manufacturing and the external deficit in nondurables equal to constant dollar exports minus constant dollar imports. Nondurables employment and the nondurable deficit closely parallel each other. The deficit falls off the

table starting in 1996 Q1 from around \$100 billion and to \$277 billion today. Paralleling this increase in the nondurable deficit is a decline in employment of roughly 1.5 million jobs. Do the math: \$177 billion / 1.5 million = \$118,000 per job. Figure 18 offers the same information about durables. The cyclical ups and downs in durables employment are not mirrored by the external deficit. The breakpoint is a little later

Figure 17 Employment in Nondurables and External Deficit in Nondurables

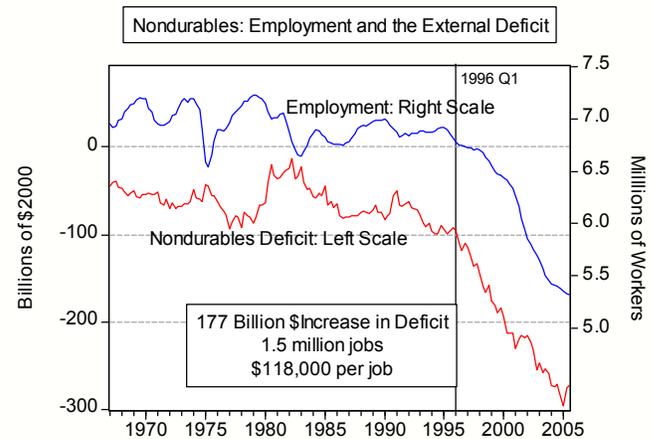
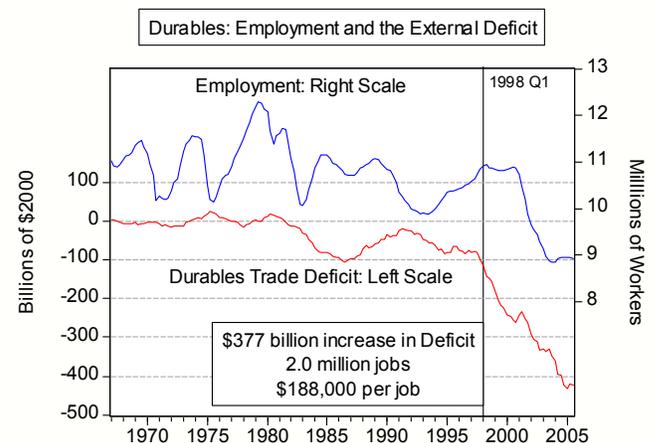


Figure 18 Employment in Durables and External Deficit in Durables



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for durables, in 1998 Q1. From then until now, the deficit has increased by \$377 billion dollars and jobs in durables have fallen by 2 million. Again the math: \$377 billion / 2 million jobs = \$188,000 per job.

What’s the Matter with Manufacturing Jobs? Demand, Productivity or International Trade?

But before we jump to trade as the driver, better lay out all the possibilities. It could be that a burst in productivity is allowing the few to do the work of the many. And it could be that domestic demand is too weak to allow normal job formation. The level of employment is necessarily equal to domestic demand times the ratio of production to domestic demand divided by productivity (output per worker):

$$Workers = DomesticDemand * \frac{GDP}{DomesticDemand} * \frac{1}{GDP/Worker}$$

where domestic demand is equal to GDP + Imports – Exports and the ratio of GDP to domestic demand measures the fraction of demand satisfied from local supply, a measure of the external deficit.

The trends since 1970 in employment and these three components of the employment identity are reported in Table 3. In durables, domestic demand has been growing smartly at the rate of 5.6% per year

but the effect of this strong demand growth on employment has been largely offset by an improvement in productivity at the rate of 5.5% per year. Thus demand growth net of productivity improvement yields a potential growth in employment in durables of 0.1% per year. But from that number we need to subtract –0.5% to account for the trend in the sourcing of supply from foreign locations, leaving a trend downward of employment in durables equal to –0.4% per year. One might be tempted from this to conclude that, but-for the trade deficit, there would have been some slight employment growth in durables but trade pulls that number into negative territory.

The story of nondurables is rather different with weaker domestic demand growth (2.6%) and with productivity growth (3.0%) that outstrips domestic demand, leaving employment growth at –0.4% per year, absent any globalization effect. But the globalization effect subtracts another –0.1% from that number, leading to employment in nondurables declining at the trend rate of –0.5% per year, about the same as durables.

A continuation of these long-term trends implies job losses in manufacturing at roughly –0.5% per year, but since the recession of 2001 we have lost fully 18% of payroll jobs. Whence comes that? Figure 19, Figure 20, Figure 21 and Figure 22 illustrate the long-term trends and the deviations from trend of the three determinants of employment: domestic demand, productivity and international trade. Look across these charts to see big deviations from trend after the 2001 recession. Try to find something that looks like the deviation from trend in employment, Figure 19.

To help do the comparison, Table 4 reports the change in the deviation from trend from 2000Q1 to 2005Q2 for employment and for the components of employment. This table indicates that since 2000 employment in durables has deteriorated by 17.2%

Table 3 Decomposition of Employment Trends

Trends: 1970 to 2005

	Durables	Nondurables
Employment Growth Rate	-0.4%	-0.5%
Consisting of		
Domestic Demand	5.6%	2.6%
Productivity	5.5%(-)	3.0%(-)
Trade (GDP/Domestic Demand)	-0.5%	-0.1%

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Figure 19 Trends in Employment in Manufacturing

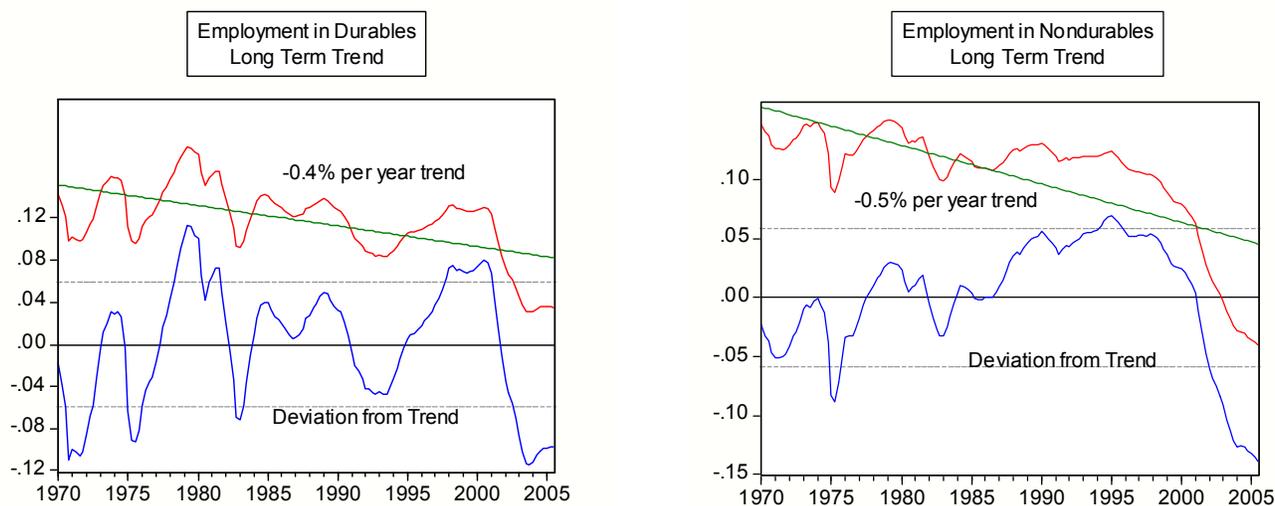
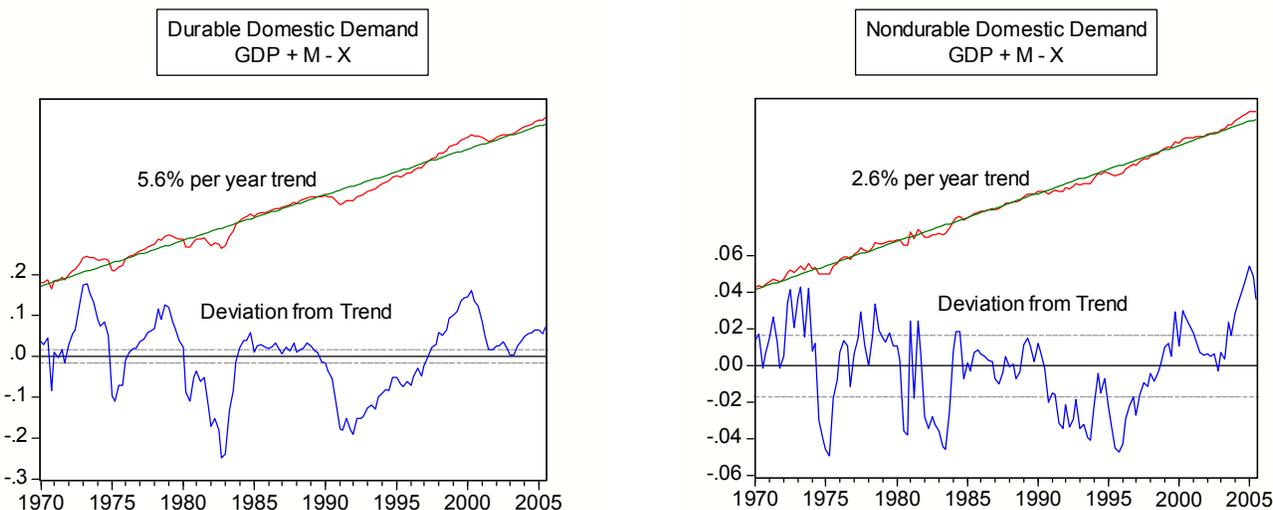


Figure 20 Trends in Domestic Demand (GDP+M-X): Durables and Nondurables



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Figure 21 Trends in Productivity (Output per Worker): Durables and Nondurables

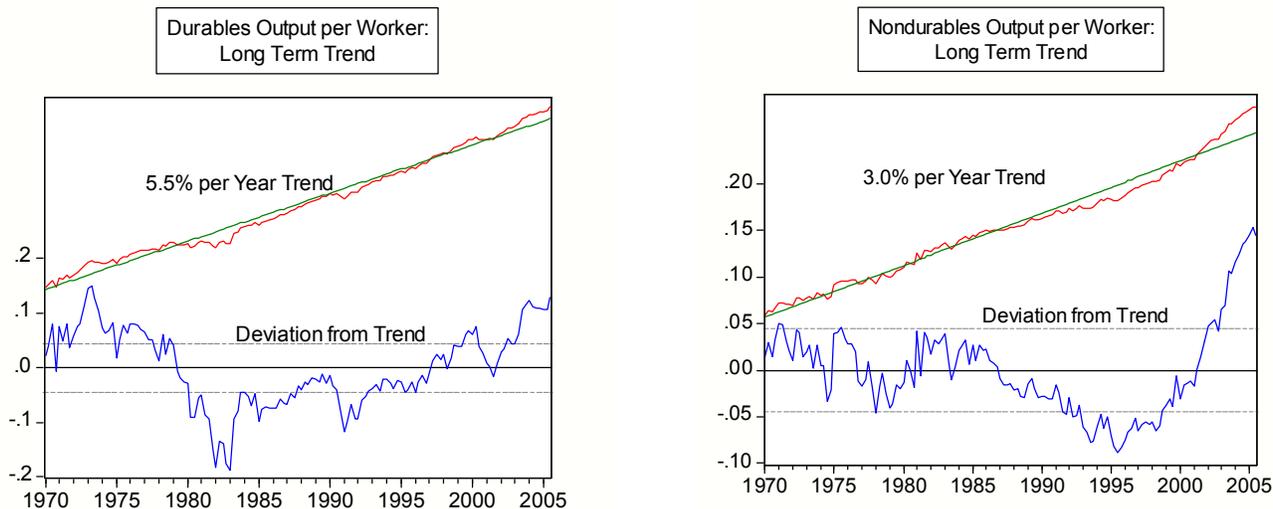
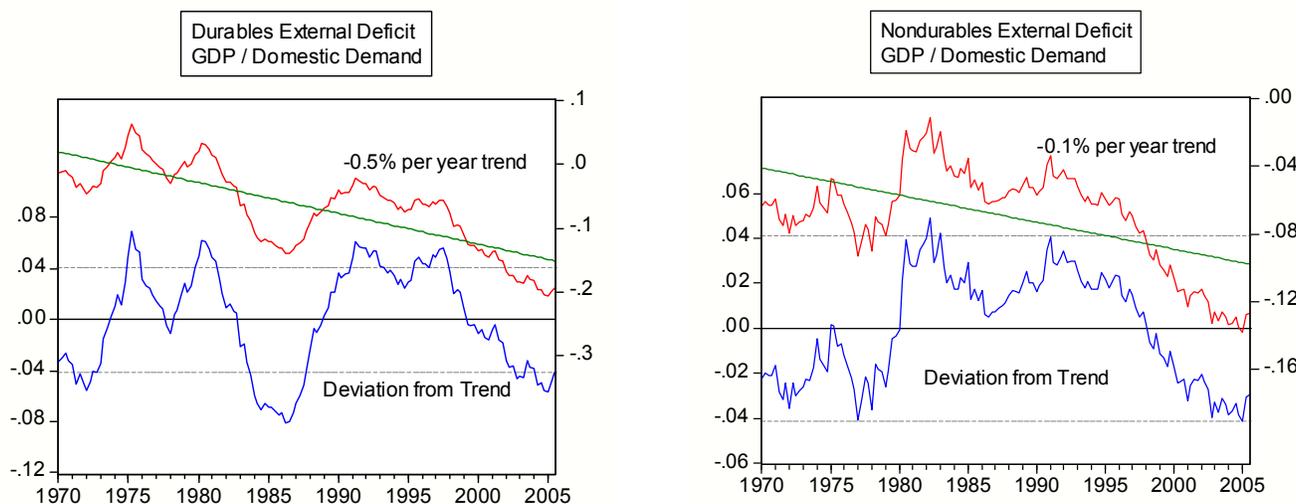


Figure 22 Trends in Ratio of GDP to Domestic Demand: Durables and Nondurables



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Table 4 Decomposition of Job Losses since 2000

2000-2005 Change in Deviation from Trend		
	Durables	Nondurables
Employment	-17.2%	-16.3%
Consisting of		
Domestic Demand	-7.3%	2.6%
Productivity	6.8%(-)	17.6%(-)
Trade (GDP/Domestic Demand)	-3.1%	-1.3%

relative to trend. That decline in employment is composed of 7.3% loss of work from weakness in demand, 6.8% from unusually strong productivity growth and 3.1% because of the rising trade deficit.

For nondurables, the big news is in the productivity number. Job loss in nondurables of 16.3% relative to trend is explainable by a surge in productivity, 17.6% relative to trend.

Table 4 understates the loss of jobs because of the external deficit because of the focus on the period from 2000 to 2005. The effect of the external deficit, measured by the ratio of production to demand illustrated in Figure 22, got started in 1995 and 1996, and since then has created an 8% loss of jobs in durables and a 6% loss of jobs in nondurables.

So what does all this mean? Is there dead wood in manufacturing or not? If the economy weakens, can we expect significant job losses in manufacturing? It depends on what happens to domestic demand, to productivity and to the external deficit. First,

demand. Cyclical dead wood is going to be most evident in the domestic demand component of employment, Figure 20. The recessions put demand below trend and the expansions above trend. The cycles in both employment and in demand are much more evident in durables than in nondurables. Durables demand experienced a sharp run-up during the Internet Rush and returned to trend in the recession of 2001. Durables demand is now slightly above trend, providing some potential for a fall in demand leading to lower employment. Nondurables, which has a less extreme cycle in jobs and demand, has demand also above trend. Thus there is some scope for a fall in demand to lead to a loss of manufacturing jobs.

Next productivity. Some of the burst in productivity is a response to greater foreign competition and some of it the ripple effect of information technology investments made in the Internet Rush. The most recent trends may continue by the effect of foreign competition and the Internet investment boom are likely to recede.

Last, on the trade side, everyone has been expecting a correction to our external deficit yesterday, or tomorrow at the latest. It seems likely that this force will return to trend, and support job growth on the order of 4%.

Bottom line: some jobs in manufacturing might well disappear as a result of weakness in housing, but this may be offset by jobs brought-home or not-lost-to-foreign-competition. The job-destroying force of productivity growth is likely also to dissipate.