

The Coming Recovery in Real GDP and Jobs

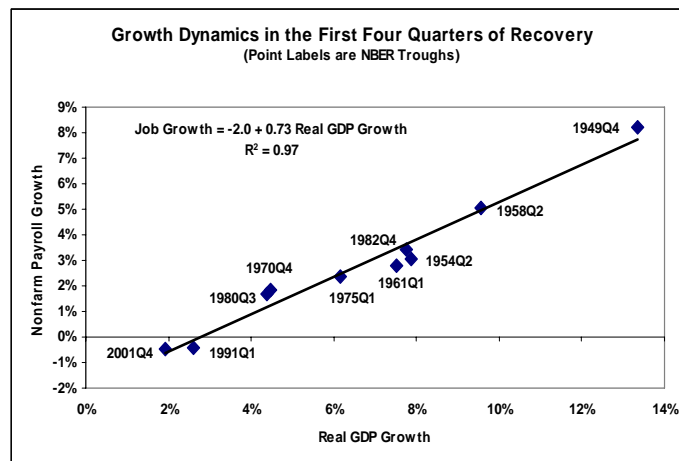
At long last, the recession is over. Economic activity is no longer contracting in a broad-based manner. Production, hours worked, and consumer spending all appear to be stabilizing, though to be sure at depressed levels. Real GDP probably will show a modest increase in the third quarter, rising at perhaps a 2 percent annual rate.

While the economy is leveling off, many people still face daunting hardships. The unemployment rate has yet to peak. With consumer spending still constrained by rising joblessness and depressed household net worth, business revenues and profits will remain weak. Government tax revenues will continue to falter, requiring ongoing cuts in spending. That is to say, the economy needs to mount a successful recovery to return to health.

The hallmark of a robust upturn is an improving labor market, characterized by solid job growth and a clear downward trend in the unemployment rate. On this score, pessimism remains widespread. The typical view is shaped by the recollection that in the early stages of the past two recoveries, jobs did not increase. The conclusion many observers draw from those jobless recoveries is that the relationship between real GDP and employment growth unexpectedly changed and that it now takes faster real GDP growth to generate an increase in jobs. Therefore, with the consensus expecting sluggish real GDP growth over the next six quarters, most forecasters are anticipating yet another jobless recovery.

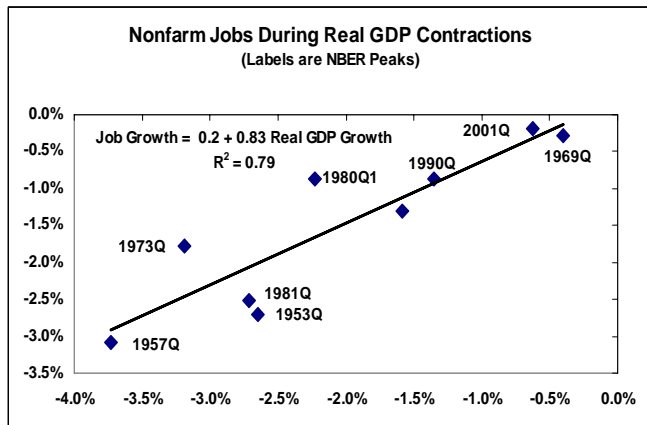
The flaw in that line of reasoning is that the relationship between real GDP growth and jobs did not change. The scatter diagram nearby plots the cumulative change in real GDP and the associated change in nonfarm payrolls over the first four quarters of the 10 post-war recoveries. As the chart shows, a remarkably tight relationship between GDP growth and jobs has persisted for more than 50 years. As is confirmed by the R^2 statistic of 0.97 (the closer that the R^2 statistic is to 1.0, the tighter is the relationship expressed in the

equation), the mapping between real GDP and nonfarm payrolls has been amazingly consistent.



The small declines in jobs that occurred in the recoveries following the 1991Q2 and 2001Q4 troughs were almost exactly what should have been expected based on the relationship between GDP growth and job increases in the previous eight post-war recoveries. Quite simply, the reason that the early parts of the last two recoveries were jobless was because real GDP growth was uncommonly sluggish initially. So looking ahead, the key question is whether the upcoming recovery will again be sluggish and, therefore, jobless.

Before tackling that crucial issue, however, I wanted to present some evidence that job losses during the current recession have been unexpectedly large given the size of the drop in real GDP. The scatter diagram on the page following plots the peak-to-trough declines in real GDP against the corresponding declines in nonfarm payrolls during the previous nine post-war contractions. In comparison to the fit during the first four quarters of recovery, the relationship between real GDP and payroll growth during downturns is somewhat more variable, as reflected in the R^2 statistic of 0.79. But still, deeper recessions clearly have a strong tendency to be associated with bigger declines in nonfarm payrolls.



The newly revised national income data indicate that the peak-to-trough decline in real GDP in the current recession was 3.9 percent. Plugging that drop into the equation estimated from prior recessions suggests that nonfarm payrolls should have declined about 3 percent from mid-2008 to mid-2009. In fact, nonfarm payrolls declined a bit more than 4 percent over the past four quarters, roughly 1 percentage point more than is consistent with historical experience.

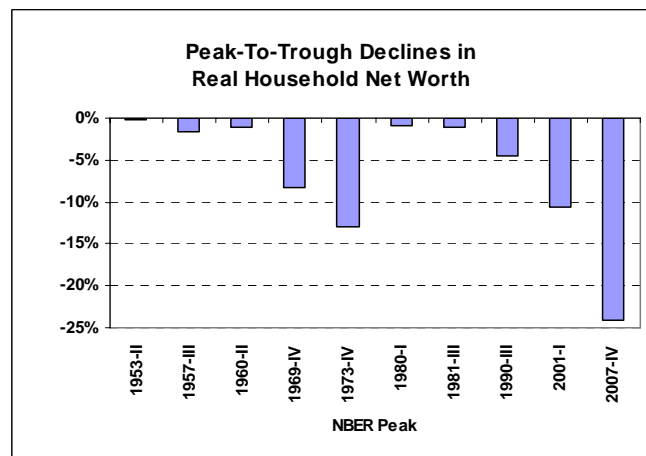
That gap suggests that the typical employer was more aggressive than usual in laying off workers. During downturns, employers tend to reduce employment by less than they reduce output. In past recessions, they often have chosen to operate with excess staffing levels for awhile in order to limit their hiring and training costs when they subsequently ramp-up production. However, faced with the free fall in the economy this past winter and the fears that a 1930s-style depression was all too possible, many companies appear to have concluded that deep cuts in payrolls were advisable.

If that is what is behind the unusually large declines in jobs relative to GDP, many employers are now so leanly staffed that they don't have much ability to increase their output without adding new workers. The important implication is that companies will need to hire more aggressively than usual once they start ramping-up production. To the extent that precautionary firing has been more prevalent than usual, hiring in the upcoming recovery will be stronger than normal relative to the real growth that emerges.

Even so, it will still be the strength of the rebound that largely dictates labor market trends. I continue to believe that the upcoming recovery will be substandard

but faster than what the consensus is forecasting. As the attached forecast worksheet indicates, I expect real GDP growth to average about 4 percent between mid-2009 and mid-2010. That would be about twice what the Blue Chip consensus is expecting. But my forecast also is about half as strong as the rebound that might have been expected following a peak-to-trough decline in real GDP of 3.9 percent. The pattern following the last nine recessions is that cumulative real GDP growth in the first four quarters of recovery was at least twice as big as the preceding peak-to-trough decline.

The two main factors that I expect to constrain the recovery are the lasting damage done to the financial system and the huge losses of household net worth. The financial markets are performing better now than was the case several months ago. Credit spreads have narrowed and the issuance of new securities has surged. But many firms are short of capital and still need to deleverage. Credit availability for many households and businesses will remain limited, thereby curtailing spending.



The huge plunge in household net worth is probably the bigger problem. As the chart above shows, the decline in this cycle dwarfs any previous loss of wealth seen in the post-war era. Net worth sank by 24 percent, or \$13 trillion, from its peak in 2007Q2 to its low at the end of the first quarter. Since then, net worth has rebounded by roughly \$3 trillion but still remains about 17 percent below its previous peak. Those terrible losses have sparked a sharp rise in the household savings rate that will continue to constrain consumer spending in the period ahead.

But the economy is resilient. The homebuilding sector is stabilizing. Inventories are falling relative to sales. Pent-up demands will underpin consumer spending. Both the monetary and budget policy responses have been unusually aggressive. That is why I continue to forecast something like a 4 percent rate of growth over the next four quarters. And if as I expect history continues to be a good guide, that sort of rebound in real GDP should translate into a 1 percent, or 1.3 million, gain in jobs over the coming 12 months. That would leave nonfarm payrolls 5 million below its previous peak but would be far better than the previous two jobless recoveries.

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Comerica Forecast Worksheet

(July 31, 2009)

	Real GDP SAAR	Nonfarm Payrolls 1,000s	Unemploy. Rate %	PCE Deflator SAAR	Core PCE Deflator SAAR
Actual					
2009Q1	-6.4	-691	8.1	1.9	1.1
2009Q2	-1.0	-436	9.2	0.2	2.0
Forecast					
2009Q3	2.0	-150	9.8	2.0	0.9
2009Q4	3.0	50	10.1	1.0	0.8
2010Q1	4.5	150	10.0	1.0	0.9
2010Q2	6.0	225	9.6	1.1	0.9
2010Q3	4.0	233	9.1	1.2	1.0
2010Q4	4.0	200	8.5	1.3	1.1
	Light Veh. Sales Millions	Housing Starts Millions	Fed Funds Rate* %	Bank Prime %	3-Month Libor %
Actual					
2009Q1	9.5	0.53	0.18	3.25	1.24
2009Q2	9.6	0.54	0.18	3.25	0.85
Forecast					
2009Q3	11.0	0.70	0.18	3.25	0.49
2009Q4	11.5	0.83	0.18	3.25	0.48
2010Q1	12.5	0.90	0.22	3.25	0.67
2010Q2	13.0	0.95	0.45	3.45	1.04
2010Q3	13.5	1.00	1.09	4.09	1.59
2010Q4	14.0	1.05	1.96	4.96	2.46
	3-Month Treas. Bill** %	2-Year Treasury %	10-Year Treasury %	Conventional Mortgage %	Fed Major Currency Index Mar73=100
Actual					
2009Q1	0.21	0.91	2.74	5.06	82.7
2009Q2	0.17	1.01	3.31	5.03	77.0
Forecast					
2009Q3	0.18	1.07	3.65	5.22	78.3
2009Q4	0.23	1.18	3.83	5.35	81.0
2010Q1	0.32	1.40	4.00	5.55	82.0
2010Q2	0.52	1.70	4.20	5.83	84.0
2010Q3	1.11	2.30	4.48	6.17	85.0
2010Q4	1.93	3.00	4.85	6.58	86.0

*Our working assumption is that the FOMC will start tightening in April 2010. Our forecast assumes that the Fed will push the funds rate to 2.25 % by the end of 2010 using a combination of 25 and 50 basis point rate hikes.

**Coupon Equivalent Yield.