ECONOMIC BEAT

Barron's

Reasons for Thanks as Recession Risk Recedes

By GENE EPSTEIN 11/24/2011

On this Thanksgiving 2011, start by giving thanks that the U.S. economy is "no turkey," according to a Wednesday missive from the economists at Credit Suisse.

The Credit Suisse recession-probability model now puts the risk of recession in the U.S. at one in 10 (specifically, 11%), based on preliminary estimates for November that admittedly include projections. But that's way down from the high end of more than one chance in three (36%) as recently as September.

Key elements in the model that helped bring improvement since September are lower initial jobless claims and energy prices, higher readings on consumer expectations, and a firmer equity market, despite the recent selloff.

Also be thankful that real growth of domestic final sales in the U.S. accelerated to 3.1% in the third quarter. DFS consists of consumer spending, plus business investment in plant and equipment, plus business and consumer investment in residences and government outlays—vital elements of gross domestic product. (The only parts of GDP excluded are the change in inventories, and exports and imports.)

In fact, be especially thankful that growth in domestic final sales accelerated. Had DFS growth continued at the same anemic rate as in the first two quarters of this year—1.4% in the second quarter and 0.4% in the first quarter—the forecasters at Benderly Economics might have expected a recession. As they point out, three consecutive quarters of such below-trend growth "has almost always been accompanied by at least a mild recession."

Give thanks, too, that despite last week's downward revision to third-quarter GDP growth—from 2.5% to an even 2%—most of it came from a change in inventories, which augurs well for future growth. The revised data now show that inventories actually declined in the third quarter. So if we project even modest growth of demand in the current quarter, it's likely that more of this demand will be satisfied by actual production, the stuff of which GDP growth is made, rather than a further drawdown of inventories.

In the thanks-for-small-favors category, be grateful that, despite the downward revision in gross domestic product, real third-quarter GDP is still higher than real GDP in fourth-quarter '07, the last peak in the business cycle before the 2008-09 recession. So the data still show that recovery from that recession was achieved in the third quarter, and that the expansion phase has resumed.

The recovery still took nine calendar quarters since the recession ended in the second quarter '09. Real GDP growth over these nine quarters has run at an annual rate of just 2.4%, less

than half the rate of growth during recoveries from comparable recessions. I have begun to suspect that this sustained subpar performance has much to do with the decline in the Economic Freedom Index for the U.S., as compiled by the Vancouver, Canada-based Fraser Institute.

Research has shown that movement up or down in a country's Economic Freedom Index, which tracks five key factors, correlates with its economic performance. The EFI for the U.S. suffered a huge decline for a single year in 2009, an acceleration of a downtrend that actually began in 2000, based on the Fraser Institute's most recently available data. Be thankful nonetheless that even by '09, the U.S. still ranked 10th among more than 140 countries rated, down from third in 2000, which still made the U.S. one of the freest in the world. (The Fraser Institute has agreed to provide updates for the U.S. through 2010 and '11, which might help confirm my hypothesis about the causes of the sick recovery.)

Also give thanks that, if High Frequency Economics Chief U.S. Economist Ian Shepherdson is right, the recession risk due to fallout from Europe "has been hugely overplayed." Shepherdson asserts, "The banking system in the U.S. is now strong enough to withstand all but an overwhelming shock from Europe."

CHRIS EDWARDS, the Cato Institute's editor of DownsizingGoverment.org, is thankful that the congressional supercommittee failed last week to agree on a deficit-reduction plan. "If the supercommittee had agreed to a deal," Edwards wrote in his blog last week, "it might have paired phony spending cuts with real tax increases."

As matters stand, Edwards added in an e-mail, "We still have a modest $1.2 trillion in spending reductions scheduled. And while defense hawks like Senator McCain want to undo the defense cuts, at least he'll be on the defensive in his defense-spending advocacy next year and in later years. Our huge budget problems won't be solved by one giant bill. Instead, give thanks this year for the modest incremental reforms that are starting to wrestle the spending beast to the ground."

In a similar spirit, New York University finance professor Baruch Lev admits to being thankful for "our divided government and do-nothing Congress." Lev adds, "With a unified Congress, we would have stringent climate-change laws, higher taxes on millionaires and billionaires, and public-employee pension-fund bailouts. We would be closing on Greece, without Germany to bail us out."