Preface

The U.S. Outlook was prepared by Kip Beckman, Principal Research Associate, under the general direction of Paul Darby, Deputy Chief Economist.

This report focuses on the latest developments in the U.S. economy—tracking trends in labour, consumer, energy, and housing markets. It also contains an in-depth analysis of issues that are relevant to the understanding of economic trends and developments in the U.S. economy.

The U.S. Outlook is updated each quarter, based on the latest projections available to The Conference Board of Canada.

The publication can be accessed online at www.conferenceboard.ca. For more information, please contact our information specialist at 613-526-3280 or 1-866-711-2262, or e-mail contactcboe@conferenceboard.ca.
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Highlights

• Despite the severity of the current recession, we do not believe that it will turn into another 1930s-style depression.
• Real GDP will contract by 1.7 per cent in 2009 before rebounding and expanding by 2.2 per cent in 2010.
• Relief at the gas pump has been offset by a massive destruction in household wealth due to tumbling home and equity prices.
Waiting for Obama

The U.S. economy is currently experiencing its greatest contraction since the Great Depression of the 1930s. The economy officially entered recession in December 2007, according to the National Bureau of Economic Research, the organization that determines these matters. That means this recession has already exceeded the average length (10 months) of the recessions the country has experienced since the Second World War.

Almost every industry, occupation, and demographic group, as well as every region of the country, is being impacted by the current downturn. Employment recorded a mind-numbing loss of more than half a million jobs in both November and December, bringing the number of job losses since the start of 2008 to more than 2.5 million. Vehicle sales have declined to levels not recorded since the early 1980s, and consumer confidence has never been as bleak. To top it off, housing starts are as low as they have been in more than 60 years.

The recession has had an impact on every industry in the country, with the exception of health care and government. While the job market is toughest for workers lacking a high school education, unemployment is also on the increase for college graduates as well. Thirty-three states and more than 300 metropolitan areas are currently in recession, according to Moody’s Economy.com. Also troubling is the fact that the entire global economy is contracting—including much of Europe and Japan, the two other pillars of the world economy. Even the Chinese economy is struggling as export growth plunges due to weaker demand.

Behind the deteriorating outlook is the ongoing crisis in financial markets. While markets have improved markedly since mid-October (as evidenced by the declining spread between the three-month LIBOR and U.S. three-month Treasury bills), conditions are still far from normal. Private bond issuance has ground to a halt, and interest rate spreads in money and credit markets are wide. Banks continue to tighten underwriting standards.

Despite the severity of the current recession, we do not believe that it will turn into another 1930s-style depression. The Great Depression was primarily attributable to poor policy decisions, something that is not being repeated in the current environment. The Federal Reserve (Fed) has cut interest rates to close to zero and has implemented a number of new initiatives to stem the crisis. These include purchasing commercial paper and buying mortgage-backed securities from Fannie Mae and Freddie Mac. In a bid to keep the economy afloat, the federal government has committed a shocking $8.6 trillion, of which $2 trillion has already been spent. The new administration of Barack Obama is set to ramp up that commitment even more by introducing new spending initiatives on infrastructure, education, and green energy alternatives.

These initiatives will not halt the decline in economic growth currently under way. In fact, we expect that real gross domestic product (GDP), which fell in the third quarter of 2008, will continue to decline through the second quarter of 2009. However, the numerous injections into the economy by the Fed and the government will gradually start to turn things around in the second half of next year. (See box “Assessing the Obama Stimulus.”) Overall, we expect real GDP to contract by 1.7 per cent in 2009 before rebounding and expanding by 2.2 per cent in 2010. (See Chart 1.)
Assessing the Obama Stimulus

In the days and weeks leading up to the January 20th inauguration of Barack Obama, the President-elect promised to implement a massive stimulus package designed to kick-start the economy and hopefully bring an end to the recession. While the exact details of the package remained sketchy, estimates ranging from $500 billion to $1 trillion were reported. Expenditures on roads, bridges, schools, and clean-energy programs are projected to create 2.5 million jobs and thereby offset the close to 2 million job losses that occurred in the first 11 months of 2008. Also, it is possible that promises to immediately eliminate the Bush administration’s tax cut for individuals earning more than $250,000 per year will be shelved. Given the current economic situation, Obama’s advisors believe that now is not the time to increase taxes. Instead, tax rates for wealthier Americans may be permitted to rise on their own after the tax policies introduced under President George W. Bush expire at the end of 2010.

To assess the potential impact of the Obama stimulus package, we first constructed a baseline scenario of the U.S. economy, using our econometric forecasting model of the U.S. economy. The baseline forecast contains no new stimulus package. Under this assumption, the U.S. economy contracts for five straight quarters starting in the third quarter of 2008. Overall real GDP declines by 2.2 per cent in 2009 before recovering and expanding by 1.6 per cent in 2010 (driven by record-low interest rates and falling prices). The anemic recovery in 2010 reflects the view that consumer spending will continue to be constrained over the near term as households attempt to ease their debt burdens and increase savings. In fact, in the baseline scenario, real consumer spending declines by a staggering 4 per cent in 2009, and growth in spending of less than 1 per cent is anticipated in 2010.

The model was then simulated with the inclusion of an Obama stimulus package. With no details yet available, we assumed that the package would contain a conservative mix of tax cuts and government spending initiatives worth $600 billion over the 2009–10 period. The package is assumed to be equally divided between tax cuts and spending initiatives. Specifically, personal tax cuts worth $150 billion are implemented in 2009 and again in 2010. The $300 billion spending initiatives on infrastructure and green energy projects are not divided equally over the two-year period because it takes time for infrastructure spending to be put in place and to start to have a positive impact on the economy. Also, it will take longer than two years to spend the $300 billion because many of the infrastructure projects will take longer than two years to complete. As a result, the spending initiatives are assumed to take place over four years (2009 to 2012) with spending peaking in 2010 and 2011.

Although the initiatives do not stop the recession in its tracks, the economic stimulus does mitigate the damage to the economy. Real GDP is $50 billion higher in 2009 and $110 billion higher in 2010 compared with the base case. Instead of declining by 2.2 per cent in 2009, real GDP declines by 1.7 per cent. The economy expands by 2.2 per cent in 2010, compared with 1.6 per cent in the base case forecast. Overall, the economy contracts for four straight quarters beginning in the third quarter of 2008 and ending in the second quarter of 2009. In the third quarter of 2009, real GDP growth is flat with the inclusion of our Obama stimulus package, up from a decline of 0.6 per cent in the base case.

The improved economic outlook mainly reflects higher government spending. (That is because the impact of the tax cuts on consumer spending is relatively minor. Some of the tax cuts are saved—the savings rate [see chart] increases by nearly 5 percentage points between the fourth quarter of 2008 and the fourth quarter of 2009—and some of the extra money is spent on imported goods and services. These leakages dampen the impact of the tax cuts on the economy.) Real government spending increases by 6.3 in 2009 and 5.3 per cent in 2010. In the base case, the comparable increases are 3.7 per cent and 1.7 per cent.

The stimulus package and subsequent higher economic growth manage to increase employment by 76,000 in 2009 and 292,000 in 2010. The greater impact in 2010 is due to the assumption that more of the infrastructure spending occurs in 2010 than in 2009. However, the estimated job creation is much weaker than the Obama plan’s stated goal of 2.5 million new jobs. This reflects the fact that there are leakages involved with tax cuts, and these leakages take away from the positive impact on consumer spending. Also, infrastructure spending takes time to get up and running, and projects can drag on for a number of years. This also dampens the impact of spending on the economy over the near term.

The Obama plan could, however, end up being much greater than the $600 billion assumed in this analysis. Consequently, potential job creation could be much larger. There may be other initiatives that could create new jobs that are not captured in this analysis. Also, the model simulations do not capture the potential positive impact of the stimulus package on both consumer and business confidence. Nevertheless, the results reveal that it will be extremely difficult to generate the type of job creation that President Obama would like to achieve over the near term. The stimulus package will dampen the effect of the recession—but it will certainly not suddenly end the downward spiral in economic activity.

The analysis also highlights the tough decisions that the new administration will have to make once the economy begins to recover. The model simulations reveal that the federal budget deficit is already high ($733 billion in 2009, $773 billion in 2010) before the extra spending takes place. The deficit increases to $922 billion in 2009 and $1.06 trillion in 2010 as a result of the new spending initiatives.
AGGREGATE DEMAND

CONSUMPTION

Gasoline prices have tumbled in recent months, but worried consumers are saving this windfall. Through November, real spending had dropped for five consecutive months, and this trend is expected to continue in 2009 as well. Relief at the gas pump has been offset by a massive destruction in household wealth due to tumbling home and equity prices. The savings rate has steadily increased over the last few months—a clear indication that households are in no mood to spend. In the final quarter of 2008, real spending was on track to decline by around 4 per cent—the largest decline since 1980.

Retail gasoline prices are about $2.30 below their peak of last summer. For every one-cent decrease in the price of a gallon of gas, the cost to households drops by around $1 billion in the following year. Assuming that prices remain close to current levels, this implies that consumers will spend roughly $230 billion less on gasoline in 2009. While this added income will help, it will not come close to offsetting the other drags on household finances, including soaring job losses and depreciating assets.

The impact of declining home and equity prices on wealth is staggering. The Dow Jones Industrial Average finished 2008 at just under 8,800 (down from its 2007 record high of more than 14,000). Assuming that the final figures will show that home prices declined by as much in the fourth quarter as they did in the third quarter of 2008, wealth will have declined by an additional $4 trillion in the final quarter of 2008. That means households will have lost around $11 trillion in wealth since the housing boom peaked in 2006—the largest percentage drop in wealth since the Great Depression. According to Moody’s Economy.com, each dollar drop in net worth lowers consumer spending by 5 cents over the following two years. If sustained, the wealth loss in 2008 could cut $275 billion from spending in 2009 and again in 2010.

The current outlook assumes that the tumble in real consumer spending, which began in the third quarter of 2008, will continue for six straight quarters. Overall, real spending will drop by 4 per cent in 2009. (See Chart 2.) Spending will recover somewhat in 2010 with growth of 1.1 per cent but will remain sluggish as U.S. households continue to reduce debt levels and increase savings. In fact, we expect the savings rate to average 5.2 per cent in 2009 and 5.7 per cent in 2010. As a point of comparison, the savings rate averaged only 1.3 per cent in 2008.

INVESTMENT

The current economic environment is not conducive to investment spending, and we expect spending to decline by close to 8 per cent in 2009 on the heels of an estimated 1.3 per cent drop in 2008. (See Chart 3.) Businesses are not only reluctant to expand operations at a time when households are pulling back on spending, but they are also having difficulty obtaining financing from financial institutions. While the federal government has injected capital into the nation’s largest banks, the banks are still reluctant to lend because there are no guarantees in

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**Chart 2**

U.S. Real Consumer Spending
(percentage change, annualized)

**Chart 3**

Real Spending on Equipment
(percentage change)
a recession that the loan will be paid back. Also, some banks are still in the process of repairing their balance sheets and improving their asset-to-liability ratios. With corporate profits set to tumble by 11 per cent in 2009, the current outlook calls for real spending on equipment to decline by close to 8 per cent in 2009. In 2010, anemic growth of 0.6 per cent is anticipated.

Spending on non-residential structures held up well in the first three quarters of 2008, expanding at a double-digit pace. However, the depth of the recession has reduced building expansion, and real spending on structures is estimated to have dropped by close to 6 per cent in the final quarter of 2008. In 2009, a drop in real spending of 5.5 per cent is anticipated.

HOUSING

At the beginning of 2008, we expected that the declines in home prices would start to slow toward the end of the year. This has not transpired. In fact, recent data on home prices suggest that the trend is actually accelerating. The problem is that banks are dumping foreclosed properties back onto the market at deeply discounted prices. The price trends in the West, where the concentration of foreclosed properties is the highest, reflect the impact that foreclosed sales are having on overall sales. The median existing home price is down by 34 per cent from its 2005 peak.

With the malaise in housing spreading to other parts of the economy, the outlook for the drivers of housing remains very pessimistic. With the economy in recession and overseas markets also in trouble, income and job prospects for potential homebuyers remain uncertain. Also, tight consumer credit will constrain those individuals who decide to plunge back into the market. As a result, the housing market will remain in decline until the second half of 2009. Real residential construction is expected to decline by 14.5 per cent in 2009 with the bulk of the drop transpiring in the first half of the year. By the mid-point of 2009, home prices will have declined sufficiently to clear the market of excess inventories. (See Chart 4.) At this point, home prices will stop falling and the market will start the slow process to recovery.

INTERNATIONAL TRADE

The combination of low oil prices and weak import growth will lead to a sharp improvement in the current account deficit in 2009. The deficit, which is estimated at $714 billion for 2008, will drop to $346 billion in 2009. The decline in consumer spending over the near term implies that households will be spending less on imported goods and services. Real imports are forecast to decline by 2.2 per cent in 2008 and 2.1 per cent in 2010. Export growth will also weaken from the 8.1 per cent growth anticipated in 2008 (see Chart 5) due to the slump in the global economy and the strengthening of the U.S. dollar. However, export growth will remain in positive territory (2.8 per cent in 2009). This factor, combined with the slump in imports and lower oil prices, accounts for the improvement in the current account deficit. Beyond 2009, the deficit will start to deteriorate somewhat as oil prices increase and households resume spending on imports in line with an economic recovery.
The Federal Reserve is using all of its vast resources in an attempt to stabilize the financial system and ward off the threat posed by deflation. Monetary authorities recently dropped interest rates to close to zero and stated that rates would remain low for the foreseeable future. This commitment to keep short-term interest rates at or near zero should eventually help to lower longer-term rates. The Fed is also implementing aggressive forms of quantitative easing—which essentially means that it is printing money in order to purchase securities. Authorities have already bought commercial paper and mortgage securities guaranteed by Fannie Mae and Freddie Mac. They may also start to purchase long-term securities in order to lower the yields at the longer end of the market.

In addition to increasing the purchase of securities, the Fed is expanding its lending facilities. The most recent facility is the Term Asset-Backed Securities Loan facility, which will provide loans collateralized by newly issued securities backed by credit card, student, car, and small business loans. This facility will start up operations early in 2009. It is possible that this lending program could eventually include residential and commercial mortgage-backed securities.

The quantitative easing undertaken by the Fed will eventually stop the deflationary cycle that the economy is currently experiencing. Consumer prices declined in both October and November. In fact, the initiatives of the Fed are already having a positive impact on financial markets given that commercial paper rates have declined and issuance has increased over the past month. The drop in long-term treasury yields and fixed mortgages is also evidence of the impact of quantitative easing. The yield on 10-year Treasury bonds has declined to almost 2 per cent, while 5-year mortgage rates will likely drop below 5 per cent over the near term.

Just how far the Fed will go in its attempts to revive financial markets will depend on how quickly the financial system responds to the ongoing stimulus. It is possible that the Fed could eventually extend its reach to municipal bond and corporate debt markets. These actions by the Fed have led to mounting concern that it will be extremely difficult to unwind the massive monetary stimulus currently in the financial system. Once the crisis comes to a close, the concern is that inflation (which is a monetary phenomenon) will take off since the central bank is printing trillions of dollars.

These concerns are likely unwarranted and certainly do not provide valid reasons for the Fed to reverse its present action plan. Excess money creation ignites inflation only when labour markets start to tighten and capacity utilization rates come up against capacity constraints. It could take years before financial markets begin to function in a normal manner. The Fed will, therefore, have plenty of time to unwind the current stimulus in the economy. The current outlook calls for the unemployment rate to remain close to 7 per cent through most of 2010. Also, the gap between actual and potential output is not expected to close until sometime in 2012. We expect that short-term interest rates will start to increase gradually at the end of 2009 but will remain below 3 per cent well into 2010. (See Chart 6.)

The recent movements of the U.S. dollar have surprised many observers of the currency markets. The dollar began to appreciate against most of the world’s major currencies at the beginning of September and continued to rise in value until the middle of December. (See Chart 7.) Why would the currency of a country in the midst of a severe recession increase in value? After all, if the current economic conditions existed in any other country, its currency would be on the verge of collapse and interest rates would have to soar to defend its value. (This is certainly the situation in Iceland where the collapse of its banking sector sent the krona
plummeting in value.) However, the U.S. dollar remains the world’s top reserve currency, and most commodities continue to be priced in U.S. dollars. In October, at the height of the financial crisis, investors fled to the security of U.S. bonds because they are considered to be risk free. This put upward pressure on the currency.

Also, U.S. multinational corporations have engaged in a massive amount of deleveraging, another factor that has increased the value of the currency.

We do not expect that the U.S. dollar will continue to appreciate in value over the near term. In fact, the dollar began to level off and even decline in value against currencies such as the euro and pound after the Fed reduced interest rates to close to zero in mid-December. Also, as the financial crisis eases there will be less demand for U.S. Treasuries as a safe haven. Once investors come to grips with the massive budget deficits that will become a fact of life over the near term, the U.S. dollar will lose some of its lustre and start to depreciate.

The depreciation of the currency will be mild, however, because some factors will continue to put upward pressure on the currency. The U.S. economy was the first country to enter into recession and should be the first to emerge and begin the slow process of recovery. As a result, interest rates should start to increase in the United States prior to increases in Europe, Japan, and elsewhere. This development will tend to mitigate the downward movement in the currency. Also, some Asian currencies have started to depreciate against the U.S. dollar as their trade balances dwindle due to weaker export demand. This trend should continue throughout 2009. Consequently, the trade-weighted value of the dollar will receive a boost.

FISCAL POLICY

The federal deficit is set to balloon to close to $1 trillion in 2009 and is expected to exceed this mark in 2010. (See box “Huge Deficits Raise Many Questions.”) The deficit in 2008 is expected to come in at $541 billion, almost triple the deficit that occurred in 2007. (See Chart 8.) There are a number of factors in addition to the expenditures currently being undertaken to mitigate the impact of the severe recession that will propel the deficit to record highs over the near term. First, federal spending—even excluding spending on the bailout—has continued to increase at a pace well above inflation mainly because of defence expenditures required in Iraq and Afghanistan. Also, during recessions, government spending automatically accelerates as more households turn to income support programs such as unemployment insurance, Medicaid, and food stamps. At the same time, revenue growth slows due to deteriorating labour markets, lower capital gains, and reduced corporate profits.

Last fall’s decision by the government to inject equity directly into banks will be costly from a budget perspective because equity purchases are considered to be outlays, with the entire cost recorded at the time of purchase. As a result, if Treasury injects $250 billion into banks, the cost from a budget perspective would be exactly $250 billion. On the other hand, federal revenues (in the form of interest or dividends) received as a result of these injections are counted as revenues only when they are received. Then there are the huge costs of Treasury programs—including TARP (Troubled Asset Relief Program) and theTroubled Asset Relief Program. Then there are the huge costs of Treasury programs—including TARP (Troubled Asset Relief Program) and the

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**Chart 7**

**Volatile U.S. Dollar (FRB Broad Index)**

- **f = forecast**
- Sources: The Conference Board of Canada; BEA.

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**Chart 8**

**Federal Balance (NIPA basis, $ billions)**

- **f = forecast**
- Sources: The Conference Board of Canada; BEA.
Huge Deficits Raise Many Questions

With deficits projected to soar to, or even above, $1 trillion over the near term, a number of troubling questions have emerged that the new administration will have to deal with. Who will buy the bonds to finance these gigantic deficits, and what does this imply for long-term interest rates? Will inflation soar once the recession ends? And what about the U.S. dollar?

With regard to the financing of the deficit and the future course of interest rates, it is important to put the numbers in perspective. The total debt-to-GDP ratio in Japan is 91 per cent. In Italy, it is 101 per cent. Even if the U.S. Treasury issued a net $1.5 trillion of government bonds in 2009, the ratio of debt-to-GDP would be less than 60 per cent of GDP by the end of 2009. This is high but definitely manageable. It is also important to note that governments will be increasing their borrowing and spending in order to fill the gap generated by the pullback in borrowing on the part of the private sector. This should dampen the upward pressure on interest rates created by heavy government borrowing since private sector demand will be weak. Also, given investors’ reluctance to take on risk in the current economic environment, the Treasury should not have a problem selling its bonds over the near term.

This rosy scenario of benign interest rate increases even with huge government financing requirements could quickly change once the economy starts to expand again and the private sectors’ borrowing needs increase. As the economy recovers, presumably the Fed will no longer be monetizing deficits. This implies that the Treasury bonds will have to be purchased by the private sector. Huge government borrowing, combined with renewed private sector borrowing, could put upward pressure on interest rates. It will, therefore, be important for the government to have a plan in place to reduce the deficit in order to lower its borrowing requirements.

There is also growing concern that inflation could become a serious problem given the projected size of deficits and the amount of money currently being injected into the financial system by the central bank. Over the near term, inflation will not be a problem. The collapse in the price of oil and other commodities and the severe recession will serve to dampen price gains. (See chart.) In fact, as we head into 2009, deflation is more of a concern. However, there is no doubt that inflation could become a serious problem over the medium to long term, a development that could be especially difficult for those countries experiencing depreciating currencies.

There are some factors to bear in mind when assessing how the inflation story will unfold after the current crisis comes to a close. First, the current recession is generating a huge amount of excess capacity in the U.S. economy. As a result, it could take a few years before a positive output gap develops and puts upward pressure on prices—especially considering the fact that most forecasters expect the recovery to be extremely sluggish. In this environment, firms may find it difficult to increase prices even when economic growth returns.

Second, it is difficult to predict whether the inflationary implications of the huge stimulus will affect consumer prices or asset prices. The stimulus injected by the Fed after the high-tech bubble collapsed made its presence felt in soaring prices for assets such as houses. Consumer prices remained under control due to positive supply-side developments that depressed the ability of corporations to increase their prices. Specifically, China’s increasing importance in traded goods placed downward pressure on export and import prices in almost every part of the world. Productivity improvements due to technological change and deregulation in many countries also added to the competitive pricing environment.

It is difficult to speculate as to whether these supply-side forces will continue to contain inflationary pressures once the world economy begins to recover. China is increasing its presence in more sectors, and the country’s manufacturing sector is coping with a huge buildup in inventories due to weaker global demand. This suggests that Chinese export prices could decline over the near term. Alternatively, capital spending is declining in most developing countries and technological innovation has slowed in recent years. This implies that long-run productivity growth will be weaker. Consequently, upward pressure on prices cannot be ruled out.

As to the future direction of the U.S. dollar, there are real concerns that countries may balk at financing the U.S. current account deficit due to the highly stimulative monetary and fiscal policy environment that currently exists. If foreign investors and central banks decided to pull back from financing the deficit, the results would be disastrous for the global economy. There would be a collapse in the U.S. dollar. U.S. import demand would plummet, and we would see additional declines in U.S. asset prices. These developments could well plunge the world into another global depression. However, this gloomy scenario is unlikely to transpire. It is in the interest of countries with close trade linkages to the United States—such as China—to ensure that the U.S. economy does not collapse. This implies that foreign central banks will continue to purchase U.S. bonds even if private foreign investors move to the sidelines.

It is also worth noting that other countries are lowering interest rates to close to zero and implementing huge fiscal stimulus packages similar to what we’ve seen in the United States. The fact that the United States is not the only country printing money and running up huge deficits should provide some protection for the currency going forward.
Asset Relief Program), the backstop of Fannie and Freddie guarantees of U.S. bank debt. Both the Federal Reserve and the federal government have committed over $8 trillion to fight the financial crisis, of which $2 trillion has already been pledged. The new Obama administration will add to the spending. Early indications point to expenditures of at least $600 billion on infrastructure, education, and green energy initiatives. It is also likely that the tax cut for wealthy Americans will be kept in place until scheduled to expire at the end of 2010. This will put another hole in revenues, thereby adding to the size of the deficit.

These record deficits will tie the hands of the new President. Barack Obama would like to cut taxes for the middle class and make health care more accessible for poorer Americans. However, once the financial crisis comes to a close, there will be tremendous pressure from financial markets to reduce the deficit. If the administration balks at making the necessary adjustments, taxes will likely have to increase in a few years time, and ambitious spending initiatives will have to be put on hold. Failure to address the deficit issue once the economy recovers could make investors and central banks reluctant to buy the securities issued by the Treasury that will be required to finance the deficit.

The situation faced by Obama is somewhat similar to the one that President Bill Clinton encountered when he took office. The 1990–91 recession and the savings and loan crisis resulted in budget deficits soaring to 5 per cent of GDP. Similar to Obama, Clinton campaigned on a program of stimulating the economy. But concern over the budget deficit led instead to deficit reduction as taxes were increased and defence spending lowered. The result was smaller budget deficits that eventually led to budget surpluses between 1998 and 2001. Unfortunately, this rosy scenario will likely not occur this time around. The economy is in far worse shape today than was the case in the early 1990s.

**LABOUR MARKETS**

Businesses are slashing payrolls rapidly in response to a sustained contraction in housing, construction, and more recently, capital expenditures. Between September and December, the economy lost 1.9 million jobs, one of the greatest losses over a four-month period since the Second World War. The unemployment rate is now above 7 per cent, the highest it has been since 1993; and it would be even higher if not for the large number of so-called “discouraged” workers—those who have given up trying to find a job. The number of individuals employed at more than one job or working part-time has also soared, indicating that people are taking dramatic steps to make ends meet.

At the beginning of this year, job losses were primarily confined to the construction sector of the economy. However, with the exception of health care and the federal government, losses have now spread to almost every sector of the economy. Retail trade has been especially hard hit because owners have had to let staff go due to weak sales. High-end retailers are bearing the brunt of the losses while discount outlets, such as Wal-Mart, are faring slightly better. The financial services industry is experiencing massive layoffs as consolidation takes place. Even some of the banks that didn’t have much exposure to mortgage-backed securities have had to reduce staff due to the economic downturn. The manufacturing sector—especially the auto segment—continues to struggle, and job losses of between 50,000 and 85,000 each month have become routine. In the first half of 2008, manufacturers dependent on international markets were doing well due to strong global demand. However, this situation has changed quickly as the global slump and an appreciating U.S. dollar has left exporters in a more vulnerable position.

The travel and leisure sector of the economy is in trouble and layoffs have been mounting. Business travel is already declining and will continue to do so since an easy way to lower business costs is to cut back on travel to conferences and other such activities. Leisure travel will also weaken due to the global recession and a stronger dollar. Consequently, airline travel will drop and demand for hotel and leisure services will decline.

In December, the average private sector workweek fell to 33.3 hours, a record low for this indicator, as firms made additional staff cuts. The combination of a shorter workweek and smaller payrolls pushed the index of aggregate hours worked by private sector production workers down by 1.1 per cent, the ninth consecutive decline and more than twice as deep as the three-month average.
The current outlook calls for labour markets to continue to deteriorate through at least the first three quarters of 2009. The economy will begin to generate new jobs in the fourth quarter but at a very anemic pace. (See Chart 9.) The unemployment rate will peak at 8.4 per cent in the fourth quarter of 2009 and will not fall below 7 per cent until the second half of 2010.

**REGIONAL OUTLOOK**

There has been virtually no job growth in any of the four broad regions of the U.S. economy since last May. Losses have been particularly troubling in the West and Midwest. Even Texas and some of the energy-rich Mountain states have seen their fortunes decline recently. The recession has become broad-based because the effects from the earlier housing bust and now the financial crisis are widespread and are affecting most industries in every region of the country.

The financial crisis is flowing through to regional economies via a number of different conduits. With regard to exports, every region of the country benefited from solid export growth in the first half of 2008, with the Midwest manufacturers of industrial machinery showing the most notable gains. However, with the euro declining in value and most of Europe in recession, orders will decline in 2009, and the Midwest will be unable to count on export growth to revive economic activity. This will add to the other problems in this region created by the numerous layoffs in the auto industry.

The ongoing decline in consumer confidence (see Chart 10) implies that the demand for consumer durables, including cars, household appliances, and electronics, will continue to decline—a development that will impact many Midwest and Southeast metropolitan areas that manufacture these products. Retailers in every part of the country will be maintaining lower inventories, hiring fewer workers, and closing locations or lowering expansion plans.

The downturn in labour markets and tighter lending conditions will delay the much-anticipated recovery in housing markets in every part of the country. However, two factors should result in some stability by the middle of 2009. First, prices have declined to the point where home sales have levelled off nationally. Sales are actually increasing in regions like Southern California, which previously had the worst affordability and, consequently, some of the steepest price declines. Second, the aid to Fannie Mae and Freddie Mac has provided additional credit to housing markets that were the most affected by a lack of affordability. California and the Northeast should benefit from this development in 2009.

Cuts in financial services employment and income have resulted in a recession in the Greater New York City area, and this downturn will persist throughout most of 2009. At least 100,000 banking-related jobs will be lost in the New York City area, and the impact will be severe for the entire economy given that 25 per cent of the area’s income depends on this sector. Other financial centres that are in trouble include Charlotte, Boston, and San Francisco.
Weaker global investment will affect regions of the country that have a high concentration of high technology or produce industrial equipment and machinery. This implies that even those regions that have solid potential as places of innovation, at least over the long term, must contend with near-term weakness as orders decline and new ventures face difficulty in securing investors. Silicon Valley, San Diego, Boston, Austin, and Dallas are especially susceptible to the investment slump.

Migration is another factor that will affect different parts of the country. Many of the metropolitan areas of the South and the Mountain states depend on in-migration from the Northeast, the Midwest, and California to sustain underlying long-term growth trends. However, the slump in the housing market has made it difficult for people to sell their properties and move to states in the Mountain region. As a result, there will be very weak population growth in states depending on in-migration in 2009 and 2010.

Will the U.S. Remain Number One?

Imagine a country still reeling from a war gone badly wrong. Its financial sector is draining resources from its industrial sector. Its schools are viewed as being inadequate, and analysts and experts have started writing books and articles claiming that the nation is in decline and about to lose its status as the number one country in the world. If you guessed that the country in question is the United States of today, you would be wrong. Instead, this is Great Britain in 1906. The war in question was the Second Boer War, and the crisis in confidence that gripped the country at the time led to a dramatic election in 1906 that saw the Liberals dethrone the Conservatives in a landslide. While the new government implemented a bold set of reforms, Britain’s decline continued, and within four decades a new country across the Atlantic Ocean—one with greater industrial and military strength—would supplant Britain as the most powerful country in the world.

Is the United States of today heading for the same fate that befell Great Britain at the turn of the 20th century? Many observers say that it is. They point to huge debt levels as the main culprit behind what they see as the rot slowly engulfing this once great superpower. Debt helped engineer the housing crisis that has left around 16 per cent of homeowners under water with mortgages larger than the value of their homes. Debt also created and then destroyed numerous financial firms that typically borrowed $30 for every $1 in assets. The need to deal with future debt levels will constrain governments as they attempt to deal with a looming Medicare and Social Security crisis resulting from the aging of the population. The once mighty U.S. military will be unable to obtain the necessary funding to remain on top of the heap. Historian Niall Ferguson contends that the British Empire was undone by imperial overreach while the U.S. empire is unravelling because of financial market overreach.

Not so fast. Before writing the U.S. obituary it is important to note that this is certainly not the first time in recent memory that pundits have predicted the downfall of the United States. At various times between the mid-1970s and the early 1990s, Europe and Japan were supposed to supplant the United States as the number one power in the world. This never happened. Japan experienced its own housing collapse and then failed to make the necessary adjustments to its banking sector to prevent a decade-long battle with deflation. Europe has never been able to match the dynamic nature of the U.S. economy, mainly due to the inflexible nature of the economy should enable it to eventually emerge largely intact. It is important to remember that the U.S. economy is incredibly resilient, as evidenced by its ability to emerge relatively unscathed from terrorist attacks, accounting scandals, wars, and a contested presidential election in the first half of this decade alone.

The other point to consider is that the United States could remain the number one power in the world simply by default. Is there another country in the world ready to take over? Some point to Russia with its vast supply of natural resources. However, if natural resources equaled wealth, then the Democratic Republic of Congo and Nigeria would be rich countries today. The rapid decline in oil prices is exposing numerous problems in Russia’s economy. Oil production is set to decline due to a lack of investment in some of its major oil reserves and the depletion of those reserves that are being exploited. Over the long term, Russia must cope with a declining population that will require a huge influx of immigrants in order to generate strong economic growth—an influx that could easily inflame existing ethnic and religious tensions.

China is the most likely country to unseat the United States, but attaining this position would take many more decades. China remains a developing country with widespread poverty and a financial system that is clearly under stress. The double-digit growth of the past decade will not last, and China must find a way of attaining more balanced growth going forward. Also, it is not clear a system that combines a measure of free market economics with an authoritarian central government that doesn’t allow dissent can remain viable.

Will the U.S. remain number one? The answer, unequivocally, is “yes.”

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