Global Economic Prospects as of September 9, 2011: How Deep the Current Slowdown?

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Overview

After solid performance across most of the world economy early this year, global growth slowed significantly in the spring and yet shows little sign of accelerating. Even with some anticipated pick-up later this year, real GDP growth for the world economy will probably come in a little below 4 percent this year after 5 percent growth in 2010. The key question now is whether growth of around 4 percent may still reasonably be expected for 2012 or whether a more significant and sustained slowdown is more likely?

My assessment (see table 1) continues to be optimistic but not exuberant. After declining from an unsustainable pace of 7 percent growth in 2010 to just below 6 percent this year (a downward revision of 0.2 percent), I expect that emerging-market and developing countries will sustain about 6 percent growth in 2012. This assumes that the emerging-market and developing countries will not be burdened by the advanced economies again falling into recession this year or next.

Specifically, while growth in the advanced economies will probably fall somewhat below 2 percent this year (versus an April forecast of 2.7 percent growth), I expect that next year will see a modest acceleration, but to a growth rate that is somewhat below the 2.9 percent rate forecast in April. For the world economy as a whole, growth this year is now expected to be 3.8 percent and growth in 2012 is projected at 4.2 percent.

The continued relative optimism about growth prospects for emerging-market and developing countries is based on three fundamental factors. First, the growth slowdown that we are seeing this year among these countries does not generally reflect deepening domestic economic difficulties but rather a normal slowdown after the initial stages of a cyclical recovery. Second, the present slowdown partly reflects the tightening of economic policies in a number of countries to contain risks of rising inflation. With the recent abatement of inflationary pressures associated with many commodity prices, the need for policy tightening is also abating, and many countries would probably now have room to ease policies if the slowdown in growth were more severe or prolonged. Third, while emerging-market and developing countries are still vulnerable to a recession in the advanced economies, they are, individually and collectively, much better able to weather the effects of slower growth among the advanced economies than they were a decade or two ago.

For the advanced economies, the situation is more complicated. Revised GDP estimates indicate that the US economy was far weaker in the first half of this year than was expected six months ago, and concerns about an extended slowdown or possible recession have been heightened by controversies over fiscal policy that are yet to be resolved. After stronger than expected first quarter results, weakening economic activity and broadening concerns about fiscal sustainability in Europe (and its implications for the banking system) have depressed expectations for growth in the remainder of 2011 and into 2012. In Japan, the economic impact of the earthquake and its aftermath have been more negative than initially estimated, although recovery is still expected to begin in the second half and extend through next year.

Table 1 Forecasts for real GDP growth and forecast revisions (percent)

Region or country	**2011**	**Revision**	**2012**	**Revision**
World (PPP weights)	3.8	–0.5	4.2	–0.3
Advanced economies	1.9	–0.8	2.6	–0.4
United States	1.8	–1.5	2.8	–0.4
Japan	–0.5	–1.5	3.5	Nil
Canada	2.7	–0.4	2.7	–0.2
Western Europe	1.9	–0.2	1.8	–0.4
United Kingdom	1.5	–0.5	2.1	–0.4
Other non-euro area	2.8	–0.4	2.0	–0.3
Euro area	1.9	–0.1	1.7	–0.4
Germany	3.1	+0.2	2.0	–0.2
France	1.9	–0.1	1.8	–0.3
Italy	1.0	–0.3	0.9	–0.5
Other euro area	1.5	–0.1	1.8	–0.5
Other advanced non-Europe	3.9	–0.4	4.2	–0.4
Emerging-market and developing economies	5.9	–0.2	6.1	–0.2
Asia	8.2	–0.2	8.0	–0.1
China	9.2	Nil	8.7	–0.1
India	8.2	–0.6	8.1	–0.4
Other Asia	5.6	–0.2	5.4	–0.1
Latin America	4.4	–0.6	4.2	–0.3
Brazil	4.5	–1.0	4.5	–0.5
Mexico	4.0	–0.5	3.5	–0.5
Other Latin America	4.5	–0.2	4.5	–0.2
Central and Eastern Europe	4.2	Nil	4.5	Nil
Commonwealth of Independent States	4.8	Nil	4.8	Nil
Middle East and North Africa	0.5	–0.5	4.0	Nil
Sub-Saharan Africa	5.0	+ 0.2	5.2	Nil

For inflation, the recent weakening of global growth has brought general relief from the upward pressure apparent early this year, although inflation remains worrying in some countries. Specifically, on a three-month moving average basis, overall global consumer price inflation has declined from 5.5 percent early this year to under 4 percent most recently, and this downtrend applies both to the advanced economies and the emerging-market and developing economies. The recent downtrend also applies to core consumer prices for emerging-market and developing economies, but the situation is more mixed for the advanced economies, where core inflation has been on an uptrend for the United States, somewhat erratic for Europe, and significantly negative in Japan.

The easing of many key global commodity prices (especially for oil) after run-ups earlier this year is an important part of the broad inflation story. The prospect that world economic activity will continue to follow a somewhat lower path than was anticipated early this year, as well as favorable prospects for resolving some of the supply concerns that contributed to the spike in oil prices, suggest that rising inflation is not likely to be a key global concern through this year and into next.

My main concerns for global economic performance over the next year or so relate primarily to the advanced economies, and these concerns merit more extensive discussion. Before turning to that discussion, however, it is useful to explore somewhat more fully the situation in emerging-market and developing countries and why these countries will likely be somewhat immune to problems besetting the advanced economies.

Emerging-Market and Developing Countries

China accounts for more than one-quarter of the economic weight (on a purchasing power parity [PPP] basis) of all emerging-market and developing countries and one-eighth of world GDP. China's rapid economic growth in recent years has contributed more than one-fourth of world real GDP growth. Recently, China's growth rate has slowed from over 10 percent in 2010 but still appears likely to come in slightly above 9 percent for 2011.

Evidence of recent further slowing has raised some concerns that growth for 2012 might fall significantly below 9 percent and even below 8 percent. Although I continue to expect that China's growth rate will slow to a little below 9 percent next year, I regard a more pronounced slowdown as unlikely. The current slowdown reflects in substantial measure the successful efforts of the policy authorities to cool an overheating economy, as indicated by higher than desired inflation and an unsustainable boom in residential investment. It now appears that there is little need for further efforts to cool the economy and the real estate market, beyond the recent useful decision to allow somewhat more rapid appreciation of the yuan against the US dollar.

Conversely, if China's growth rate appeared to be falling to 8 percent or lower, the authorities have plenty of room to ease back on their recent policy tightening in order to give a meaningful boost to the economy. Unlike many of the advanced economies where further policy easing seems to have lost most of it normal stimulative power, this is not the case in China. Moreover, because 2012 is a year of important political transition in China, the authorities are likely to be even more sensitive than usual in responding to any growth slowdown.

Looking to the medium term, it is clear that China's economic growth cannot continue to be based on a rising share of fixed investment, which at 49 percent of GDP is already well into world record territory. The recent shift away from heavy investment in export-oriented industries toward infrastructure and residential investment is generally welcome, but this too cannot go on indefinitely. Nor too will it be possible for China to return to rising net exports as a key driver of real GDP growth, as they were between 2002 and 2007. Instead, rising real consumption will need to play an increasingly important role in driving the demand for China's GDP. The sooner this transformation happens, the better; but it does not necessarily need to get powerfully underway to keep the Chinese economy growing through 2012.

A number of other Asian economies with particularly strong economic links to China will clearly benefit from sustained rapid growth in China. This will afford some, but not unlimited, protection, should the advanced economies suffer a more pronounced slowdown than is now being forecast.

India is less strongly linked to the rest of the world economy than its larger co-titan in emerging Asia. The recent slowing of economic growth in India reflects primarily domestic forces, including the efforts of the policy authorities to rein in inflation. Growth this year now looks likely to come in somewhat below my April forecast, at 8.2 percent rather than 8.8 percent. For 2012, I have also reduced the growth forecast modestly from 8.5 to 8.1 percent. The rest of emerging Asia is also expected to do relatively well with growth of around 5.5 percent this year and next year.

For Latin America growth both this year and next appears likely to be somewhat subdued relative to my early April forecast. For Brazil growth this year will probably be about 1 percent lower than my April forecast of 5.5 percent, and growth next year will probably be about one-half percentage point below my April forecast of 5 percent. For Mexico, estimates of recent growth have remained relatively strong despite the reported slowdown in the United States. However, this may not continue, and the growth forecasts for Mexico are cut to 4 percent (from 4.5 percent) this year and to 3.5 percent (from 4 percent) for next year. For the rest of Latin America, the situation is mixed, but on balance there is a slight reduction in the growth forecasts for this year and next from 4.7 to 4.5 percent.

In Central and Eastern Europe, economic developments have come along about as expected, and there is no substantial reason to alter my April forecasts: growth of 4.2 percent this year and 4.5 percent next year for Central and Eastern Europe; and growth of 4.8 percent this year and next for the Commonwealth of Independent States (CIS).

For the Middle East and North Africa, the political turmoil has quieted down in most countries, but the negative impact on growth this year is likely to be substantial—with the region as a whole showing barely positive growth. Next year should be better and growth of 4 percent is still expected. Meanwhile, Sub-Saharan Africa has weathered recent storms in the world economy quite well, and growth of around 5 percent is still expected for this year and next.

Japan and the Other Advanced Economies of the Asia Pacific

For Japan, following a fall in GDP in 2010Q4, the negative impact of the mid-March earthquake and its aftermath are likely to push real GDP growth down to –0.5 percent for 2011, despite a rebound in the second half, which appears already to be underway. Continuation of this rebound into 2012 implies that growth next year will likely reach the 3.5 percent rate forecast in April.

In the new advanced economies of Asia (Hong Kong, Singapore, South Korea, and Taiwan), growth has slowed somewhat over the past year, as indicated by the fact that as of the second quarter, growth over the preceding four quarters was, for all of these countries, the lowest it had been since the recovery began in mid-2009. However, except for Singapore, where GDP data are highly erratic, growth for all of these countries was still substantially positive and for the group as a whole was only slightly below my April forecast. With the rebound in Japan and continued strong growth in China, I expect that the new advanced economies of Asia will achieve 4.5 percent growth this year and next.

For Australia, the flood-related decline in output early this year is already beginning to be reversed and growth for 2011 is likely to come in between 2 and 2.5 percent. Allowing for temporary factors that have pushed up some prices, the monetary tightening undertaken over the past year and the recent appreciation of the Australian dollar appear adequate to bring inflation within its target range. For 2012, year-over-year growth of about 4 percent is now forecast.

New Zealand suffered an earthquake-related output shock early this year, which will be reflected in a moderation of year-over-year growth for 2011 of about 1.5 percent. A pickup to growth of nearly 4 percent is forecast for 2012, but there remain some concerns about inflation running above target.

Western Europe

The economic, financial, and fiscal problems in Western Europe have dominated most economic commentary in recent months. The saga of Greece continues with increasing concerns about whether the Greek government will be able to meet its demanding fiscal policy objectives and about the wider consequences for Europe and its banks if it does not. Meanwhile, worries about fiscal sustainability have broadened beyond the three relatively small countries of Greece, Ireland, and Portugal to recently affect Spain and Italy. European policymakers have responded to these challenges, but often their responses have been seen, rightly or wrongly, as too little, too late.

Led by another strong quarter for Germany, the euro area turned in stronger than expected performance in 2011Q1 with 3.4 percent annualized real GDP growth. Growth fell to 0.7 percent in the second quarter as Germany's advance slowed to 0.5 percent and the French economy stagnated. Nevertheless, year-over-year growth for the euro area in 2011 appears still to be on track to achieve almost the 2 percent rate forecast in April.

The slowdown in the second quarter may have been marginally affected by renewed concerns about Greece's ability to meet the objectives of its fiscal consolidation program and about the prospective need for a restructuring of at least some of Greece's large public debt. Broader concerns about fiscal sustainability in the euro area, however, arose mainly this summer when interest rates on Spanish and Italian government bonds escalated sharply to over 6 percent. Announcements of enhanced efforts at fiscal austerity by both governments provided some relief, but the decline in yields to about 5 percent did not come until the European Central Bank (ECB) announced that it would purchase both Spanish and Italian bonds on the open market and did so in significant quantities.

Increasing worries about fiscal sustainability spilled over to concerns about the viability of European banks that hold large volumes of the debts of European sovereigns. It was generally thought that most banks were sufficiently well capitalized to absorb the costs of a not-too-aggressive restructuring of Greek government debt. But problems with Spain's much larger public debt or with Italy's enormous public debt would be quite a different matter. Indeed, if one adopted the principle of marking to market the value of government bonds held by European banks, the writedowns in value associated with the recent escalation of Spanish and Italian interest rates would imply significant impairment of the capital positions of a number of major European banks.

European bank regulators, like those elsewhere, do not generally apply mark-to-market accounting for securities held in the investment portfolios of banks (in contrast to those held in trading accounts). Accordingly, these regulators and the ECB and most European bankers maintain that, with a few exceptions, bank capitalization levels remain adequate.

This position is not absurd, but it also is not entirely reassuring. Market values reflect the fear of a possible default sometime in the future. If no default actually occurs and a bank continues to hold a government bond (rather than selling it at distress prices), it will suffer no loss. Moreover, situations where there are moderate fears of a possible default do not usually turn into actual defaults. However, sovereign defaults do sometimes occur—as developments in Greece are now demonstrating. And, even without actual defaults, declines in the market values of sovereign bonds held by banks are often reflected to some degree in the market value of the banks' own equities. Even if the book value of a bank's equity remains adequate to meet official standards, a decline in the market value of that equity to low levels can seriously impair the bank's ability to perform its fundamental function as a credit intermediary. We saw this during the financial panic of late 2008 (in the United States and elsewhere) when the market values of the equity of many banks fell to exceptionally low levels even while book values of equity were assessed at much higher levels.

At this stage, broader concerns about fiscal sustainability of some key euro area countries and associated worries about European banks have not been successfully resolved. If the crisis deepens significantly further, the implications for economic growth in Europe and more broadly and for financial stability would likely become quite grave.

Although it is a risk, I do not believe that this is the path we are likely to follow. In stark contrast to all of the loud rhetoric of "no bailouts, no lender of last resort, and never any ECB support of government bond markets," since the spring of last year euro area policymakers have been forced to deal with reality. Not surprisingly, action has come only under duress, but it has come. Substantial financial support packages (with the participation of the International Monetary Fund [IMF]) have been arranged for Greece, Ireland, and Portugal—conditional on serious efforts of fiscal consolidation. Greece's support package has been expanded, on the condition of more vigorous efforts of fiscal consolidation and a contribution from private creditors to reduce the present value of their claims. The ECB has intervened in credit markets in ways and to an extent that President Jean-Claude Trichet and his colleagues would have proclaimed "inconceivable" and probably "beyond the legal mandate of the ECB" before the recent crises.

More will be needed. The European Financial Stability Fund (EFSF) is probably big enough to deal with Greece, Ireland, and Portugal. But, more firepower is needed to beat back other threats. Specifically, Spain and Italy can, in my view, maintain fiscal sustainability but may still need some help in facing potentially self-fulfilling crises of confidence. Spain's sovereign debt to GDP ratio is below the euro area average and its primarily budget deficit is modest and probably declining. Italy has a much higher ratio of sovereign debt to GDP but is in primary budget surplus and headed toward overall budget balance. Both countries need to continue to demonstrate their commitments to sustainable fiscal policies over the medium and longer term.

Because the maturity structures of their public debts in relatively long, neither country is facing the prospect of a very large short-term funding crisis. However, such a crisis might tend to become self-fulfilling if it forced a government to borrow at high interest rates suggesting that fiscal sustainability could not be maintained in the longer term. This is where external financial support on a significant but not massive scale could prove useful. The ECB's recent purchases of sovereign Spanish and Italian bonds in the secondary market are an example of exactly such external support. Expansion of the EFSF to support such operations and allow the ECB to lever its support (with the EFSF absorbing any plausible losses) would provide a potentially valuable safeguard against a stampede in the market. A doubling of the present size of the EFSF to 880 billion euros should be adequate for this task.

An alternative approach would be to create a broad mechanism for the issuance of "eurobonds" that would be the joint and several liability of the members of the euro area (or possibly of the European Union). Under this approach, euro area governments would all issue their public debt as eurobonds, perhaps limited to some fraction (such as 60 percent of GDP). All of these governments would be subject to rigorous discipline over their fiscal policies.

There are three main objections to this approach. First, it is not going to happen. Quite rightly, the citizens of those euro area countries that regard themselves as fiscally responsible are not going to agree to underwrite in such a massive way the debt of countries that they regard as not so fiscally responsible. And the deplorable tendency of some euro area political leaders to bypass the need for popular support of their proposal to expand the authority of euro area institutions is unlikely to be tolerated in this instance.

Second, the broad eurobond proposal is almost surely unworkable. Experience in the euro area and elsewhere indicates that it is difficult to enforce rigorous fiscal discipline on national governments except when they are in dire need of external assistance. A limit on national eurobond issuance acceptable to the most creditworthy countries is likely to be well below normal borrowing levels of many countries. If there is substantial debt issuance above the limit (not in eurobonds), concerns about national defaults will not be suppressed. Moving to a truly national government for the euro area, with sovereign authority similar to that of the Federal Republic of Germany or of the United States, would resolve these difficulties. But there is no indication that the citizens of the members of the euro area are presently prepared to go anywhere near that far. The argument that this must be done in order to preserve the marvelous accomplishments of the euro is silly.

Third, introducing eurobonds that would cover the bulk of the sovereign debt of members of the euro area, say 8 trillion to 10 trillion euros, is far more than is needed to respond to present difficulties. Doubling the size of the EFSF to 880 billion euros and increasing the flexibility for its use ought to be sufficient. If it is not possible reach agreement on this, it will be impossible to agree on a far grander scheme.

Beyond this strengthening of the EFSF, it is important to raise the capital ratios of European banks to levels that more adequately account for the risks associated with fluctuations in the market value of their sovereign debt holdings. Shareholders and especially managers of banks will resist such measures, but such resistance is really part of the proof that too much reliance is being placed on expectations of public (or central bank) assistance in the event of difficulties. The time has long since passed for public officials and central banks to stop kissing and start kicking the posteriors of bankers whose self-interest diverges substantially from the public interest.

Assuming that official efforts over the next few months to contain and dampen the recent crisis are reasonably successful, the euro area economy will still feel adverse effects but will not likely fall back into recession. Declines in consumer and business confidence and losses in stock market wealth will retard consumption and investment, as will higher interest rates in several countries. More intense efforts of fiscal consolidation will also have some negative effect on demand growth. But potential financial crises that do not materialize into major crises tend to have moderate and temporary negative effects on economic activity.

My expectation is that economic growth in the euro area will be marginally depressed relative to my April forecast, down from 2 to 1.9 percent. A larger negative effect will be seen in the year-over-year growth for 2012, where my forecast is cut from 2.1 to 1.7 percent. Germany will be affected but should weather recent problems better than most, returning soon to moderate growth. France will pick up from no growth this spring to an average annualized growth rate of 1.5 to 2 percent through 2012. Italy's economy will continue to struggle with growth around 1 percent. Spain's recovery will be set back but growth of 1.5

percent or so during 2012 is still a reasonable expectation. Greece's economy will continue to suffer through this year and into 2012. Ireland and Portugal should fare somewhat better. The other smaller economies of the euro area will probably see growth on the order of 2 percent or so.

Outside of the euro area, the UK economy has performed close to my April forecast, following an output decline in 2010Q4. No doubt ambitious efforts of fiscal consolidation have weighed upon economic growth and may be expected to continue to do so. Nevertheless, modest positive growth is expected for the remainder of this year, with some acceleration likely during 2012. The Bank of England continues to maintain a highly accommodative monetary policy, despite inflation running consistently above the official target. The spillover from recent turbulence in the euro area is likely to have only a limited depressive effect in the United Kingdom. The forecast for growth this year is reduced from 2 to 1.5 percent, and the forecast for next year is cut by a similar amount to 2.1 percent.

It remains to be seen how much the Swiss economy will be affected by the recent strong appreciation of the franc against the euro and by recent developments in the euro area, but the effect will not be positive. Year-over-year growth will probably still exceed 2 percent this year but probably fall below that figure next year. Meanwhile, growth in Sweden's economy has remained reasonably robust and growth this year will likely somewhat exceed 4 percent. With the Swedish economy now operating close to potential, with monetary policy having been tightened to restrain rising inflation, and with some negative spillover from the euro area, growth for next year is likely to fall a little below 3 percent.

Uncertainties about the US Economy

Real GDP growth in the United States clearly fell substantially below my April forecast of a 3.5 to 4 percent annual rate in the first half of this year, and it is not accelerating to near that rate this summer. If the revised estimates for real GDP from 2007 through 2011Q1 (released in late July) and the estimate of 2011Q2 growth released in late August are taken at face value, the forecast for year-over-year growth needs to be cut about in half from my April forecast of 3.3 percent. And, this assumes that we get acceleration to about 4 percent growth in 2011Q4.

For 2012, the year-over-year growth forecast needs to be cut at least modestly to 2.8 percent (from 3.2 percent) simply because of the carryover effect of weaker-than-anticipated growth during 2011. How much further the forecast for next year should be adjusted, down or up, depends on several key uncertainties.

Two of these uncertainties were already highlighted in the April forecast. One is the timing and pace of the prospective recovery in residential investment. The huge drop in residential investment from 2006 through mid-2009 made an important contribution to the great recession, and the failure of residential investment to recover as it usually does during a general recovery is a key reason why the present recovery so far has been so sluggish. At some point, new household formation will push new homebuilding above the rate necessary to offset depreciation (about 500,000 units per year) and back toward about 1.5 million new housing units per year. All of the problems associated with the one-third drop in home prices since 2006 and the flood of foreclosures have stalled this recovery process for two years into the general economic recovery. Despite exceptionally low mortgage interest rates, however, there is little evidence that a meaningful recovery in residential investment has yet begun. Provided that the US economy achieves at least modest overall growth, I still expect that we will begin to see such evidence over the next year—but there are no guarantees.

A second concern raised in April was the possibility of a significant tightening of US fiscal policy during 2012. The two percentage point cut in payroll taxes, the allowance for immediate expensing of most business investment, and the funding for extended unemployment benefits are all scheduled to expire at the end of this year. In addition, other components of the stimulus package passed in early 2009 have already expired or are winding down, and the legislation to finish the FY2011 budget and the recent deficit reduction legislation linked to the rise in the debt limit provide for about another $30 billion of budget cuts in 2012 (and significantly more in the out years). All told, if this legislation stands unaltered, the federal budget would be expected to fall by nearly 2 percent of GDP next year (assuming an unchanged path for the economy). Meanwhile, despite rising tax revenues but with federal transfers waning, state and local governments are continuing to cut back spending and employment.

If the recovery were robust and expected to remain so, with rapidly declining unemployment, then substantial fiscal consolidation during 2012 would be in order. However, with the recovery presently weak and not expected to gain a great deal of momentum, the prospective scale of fiscal consolidation next year appears excessive. It risks turning an already disappointing recovery into something worse.

President Barack Obama has proposed extension of most of the expiring stimulus measures, as well as additional measures to boost employment. No doubt, Congress will not simply accept all of the president's proposals. Indeed, I believe that it would be a mistake to attempt to forestall virtually all of the fiscal consolidation scheduled to take effect next year in an effort to boost job growth before the November 2012 election. The evidence suggests that fiscal stimulus measures of the type recently undertaken are not very powerful in stimulating economic activity, and they ultimately need to be paid for.

That said, extending the payroll tax cut for another year and winding it down over the next two years and allowing extended unemployment benefits to recede as unemployment rates fall is sensible. Passing a normal land transportation bill, funded by the existing gasoline tax, and passing the trade agreements negotiated with South Korea, Colombia, and Panama would also be useful. Grand new programs for infrastructure investment and other programs for increased federal spending do not make much sense in an era of necessary fiscal consolidation.

A new cause for concern has arisen from the stock market sell-off and financial turbulence associated with efforts at deficit reduction in the United States and with the fiscal and financial sector troubles in Europe. The political process that led to the deal in early August to raise the debt limit and cut government spending was not edifying and probably helped to erode consumer confidence. The subsequent downgrading of US Treasury debt by Standard and Poor's was also not helpful. In my view, however, neither of these developments has done significant or lasting damage to the US economy. This concern would return if the efforts of the congressional supercommittee to find significant new measures for deficit reduction over the medium term break down in partisan bickering. I expect a more favorable outcome, even if the political process of arriving at it again looks messy.

Worries about developments in Europe have been a more persistent cause of turbulence in US equity prices since last spring, although they have also recently put significant downward pressure on interest rates for US Treasury bonds. If Europeans fail to resolve their present difficulties satisfactorily and Europe descends into a full blown financial crisis, then the negative spillover effects to the US economy and financial system will be substantial. As explained earlier, this is not my present expectation.

Yet another worry arises from questions about the accuracy and meaning of recent US economic data. The revised estimates for real GDP released in late July paint a quite different picture of the US economy than earlier estimates. The recession caused real GDP to fall by a full percentage point more between 2007Q4 and 2009Q1 than was earlier thought, and the recovery of real GDP from 2009Q2 through 2011Q1 was reduced modestly by 0.3 percent. More relevant to present concerns, as indicated in table 2, the estimated pattern of the recovery since mid-2009 has changed. The acceleration of growth in 2009Q4 is more modest in the revised data, and the sharp slowdown of growth in the spring of 2010, which was an important part of the motivation for the Federal Reserve to launch QE2, disappears in the revised data. The modest acceleration of real GDP growth previously estimated for 2010Q4 now disappears, and the revised 2011Q1 results show virtually no output growth.

The revised real GDP growth rates for 2010Q4 and 2011Q1 are strikingly inconsistent with key data on the labor market (as also reported in table 2). The unemployment rate (measured by the household survey) fell from 9.6 percent in 2010Q3 to 8.9 percent in 2011Q1. After declining by 137,000 during 2010Q3, employment (measured by the establishment survey) rose by a solid 414,000 in 2010Q4 and another 497,000 during 2011Q1. The average workweek also rose slightly from 2010Q3 to 2011Q1, indicating solid gains in total hours worked. Weekly data on unemployment claims confirm that labor market conditions improved significantly in late 2010 and early 2011, before worsening in 2011Q2.

Table 2 Recent data on US GDP growth, employment, productivity, and inflation
(in percent, except for employment)

Quarter	**Real GDP growth, old estimate**	**Real GDP growth, revised estimate**	**Unemployment rate**	**Employment increase** (thousands)	**Labor productivity growth rate**	**Unit labor cost rise**	**Core PCE inflation rate**
2009Q3	1.6	1.7	9.7	–766	6.5	–3.9	1.5
2009Q4	5.0	3.8	10.0	–185	5.5	–4.1	2.2
2010Q1	3.8	3.9	9.7	118	4.6	–3.1	1.1
2010Q2	1.7	3.8	9.6	540	1.2	1.4	1.3
2010Q3	2.6	2.5	9.6	–137	2.1	–0.2	0.7
2010Q4	3.1	2.3	9.6	414	2.2	–1.6	0.7
2011Q1	1.9	0.4	8.9	490	–0.6	6.2	1.6
2011Q2	—	1.0	9.1	316	–0.7	3.3	1.9

PCE = personal consumption expenditure price index

These inconsistencies between the revised GDP data and the employment data are reflected in the revised estimates for labor productivity (output per hour worked) and, taking account of what has been happening to wages, in the estimates of labor costs per unit of output. These estimates are usually reported for nonfarm business (which accounts for over 60 percent of GDP). As again reported in table 2, the estimates now show that labor productivity growth was very strong in the initial three quarters of the recovery, then moderated during the next three quarters, and turned negative in 2011Q1 and Q2. Weak wage growth late last year led to a decline in unit labor costs in 2010Q4, but negative productivity growth and rising wages implied substantial increases in unit labor costs during the first half of 2011. This rise in unit labor costs is seemingly consistent with the recent rise in core inflation (which is reported in terms of annualized percentage increases in quarterly measures of the personal consumption expenditure [PCE] price index, excluding food and energy)—a rise of core inflation that is otherwise difficult to rationalize with continuing high unemployment.

So what? If one takes all of the current data at face value, the US economy and US economic policy are in a pickle. The weak output growth estimated for recent quarters suggest that fiscal and monetary policy should become more stimulative to boost the pace of recovery. But weak productivity growth (which is implied arithmetically by sluggish output growth and moderate employment growth) raises serious concerns about the longer-run potential growth rate of the US economy. These concerns, in turn, add to worries about the medium and longer term path of the government deficit and stock of public debt—increasing the urgency for serious efforts at deficit reduction. Moreover, if productivity growth is really as sluggish and unit labor costs are really rising as rapidly as recent estimates suggest, then inflation is a more pressing problem than most policymakers appear to believe. Specifically, the implication would be that the Federal Reserve made a serious mistake in its recently announced intention to keep short-term interest rates near zero for at least another two years. Certainly any notion of further quantitative easing should be off the table until the situation with inflation becomes clearer.

I discount these concerns because I believe that the revised estimates of real GDP growth late last year and early this year are significantly too low. Most of the economic data, aside from the revised real GDP estimates, support the view that after six months of fairly satisfactory growth in the autumn of last year and the winter of this year, the US economy did slow significantly this spring, and the summer is not seeing much improvement. But, it would be premature to conclude either that the underlying potential growth rate of the US economy is well below the 2.5 percent rate or that underlying inflationary pressures are already a serious problem.

However, I have been wrong about such matters before, and making such errors is not my unique talent.