Bloomberg Businessweek

VIEWPOINT July 27, 2010, 4:40PM EST

Double Dip? New Normal? No Fun Either Way: Frank Aquila

The Businessweek.com columnist examines the struggles ahead for the U.S. economy

By Frank Aquila

As Federal Reserve Chairman Ben Bernanke told Congress on July 21, "the economic outlook remains unusually uncertain." The shallow U.S. recovery has left investors, consumers, and business executives all asking whether we are headed for yet another recession. Not since George Costanza was caught placing his chip in the salsa bowl a second time in a classic *Seinfeld* episode—sparking a brawl with his girlfriend's brother in the process—have Americans been so focused on a "double dip."

Whether or not the second leg of a so-called double-dip recession is imminent, it is clear that the U.S. economy will struggle for some time to come.

A recession is a period of negative growth, or contraction, of the economy. Although there is no official definition for a double-dip recession, the term is used to describe two recessions with a short recovery in between. Double-dip recessions are rare, and the U.S. has not experienced one since 1981.

Given the weak economy and lack of meaningful job creation—the private sector added only 83,000 jobs in June, below economists' estimates—it is not surprising that many wonder whether we have ever actually come out of the recession in the first place. True, we have had modest economic growth so far this year, but much of that has been fueled by historically low interest rates, the massive U.S. stimulus program, and the hiring of temporary Census workers. Despite a long and deep recession, the worst since the Great Depression, the recovery has been rather tepid.

CONFIDENCE WANES

The sputtering economy and talk of a possible second recession have certainly rattled an already fragile American consumer. Consumer confidence is now at its lowest level in a year, and consumer spending tumbled in May and June. Since consumer spending accounts for more than two-thirds of U.S. economic growth, a nervous consumer is not a good omen for a robust recovery.

Job creation is a key factor in increasing consumer confidence. While economists estimate that we need economic growth of 4 percent or more to stimulate significant job creation, the economy has grown at only about 2 percent to 3 percent, with a slowdown expected in the second half.

Whether or not another recession is likely, a difficult economic environment will essentially be our "new normal" for some time. (The phrase "new normal" was coined by Pimco in May 2009 to describe a world characterized by high unemployment rates, more regulation, and a shrinking role for the U.S. in the global economy.) Despite a rather steep drop in home prices since the bursting of the housing bubble in 2007, and a temporary uptick in home sales induced by the first-time home buyer's tax credit, the residential real estate market now appears to be headed for a further downturn.

Home sales plunged to a record low in May, the month following the expiration of the home buyers' tax credit, despite record low mortgage rates. The foreclosure rate has continued to rise, and the mortgage delinquency rate has risen from 9.5 percent to 10.1 percent. It is estimated that up to 7.8 million homes have either been foreclosed or have delinquent mortgages, in addition to the 3.9 million homes already on the market. Given these levels, home prices are unlikely to increase for some time in most parts of the country.

SPECTER OF PRICE DECLINES

Anemic home values could be a marker for a broader economic malady: deflation. Not since the Great Depression has the U.S. experienced deflation, a sustained dropping of prices and asset values. Since the Federal Reserve has cut interest rates to near zero and the government has boosted spending significantly to address the current weakness, one would expect a resultant resurgence in inflation. Instead, inflation has remained extremely low, with the headline consumer price index up 1.1 percent from a year earlier (a 0.9 percent rise if you exclude food and energy prices).

Economists and central bankers are now worried about deflation. The notes from the June meeting of the Federal Reserve's Open Market Committee indicate that policymakers are clearly concerned about deflation. Boston Federal Reserve Bank President Eric Rosengren, an FOMC member, has acknowledged that deflation is "more of a risk than I would like to see at this point." Former Federal Reserve Board member Larry Lindsey went even further, proclaiming that the U.S. has entered a "deflationary trap."

While falling prices might seem to be a good thing for consumers, the reality is much more complex and in fact rather painful. Deflation makes money more valuable and everything else less valuable. Why buy a car or a new home or a flat-panel television today if they are going to be cheaper next month and possibly even cheaper next year. If consumers are not buying and the value of inventory is dropping, where is the incentive for business investment? There is none, which is why deflation leads to economic contraction rather than expansion.

STATES IN A BIND

While U.S. public companies have accumulated nearly $2 trillion in cash reserves, state and local governments have not been as lucky in the wake of the economic downturn. Tax revenues have been down while spending continues to grow. Almost all U.S. states are struggling to close massive budget deficits. Most local governments are in similar dire straits. Unlike the federal government, state and local governments have few options when faced with significant budget shortfalls. Whether they cut services, raise taxes, or both, the effect on the broader economy will surely be negative.

New and smaller businesses, the primary engine of job creation in the U.S., are not likely to lead the way this time around. Small business owners, already struggling after the past two years, are finding it difficult to access the credit needed to grow and expand.

Even if entrepreneurs can obtain credit, most are not in the mood to expand at the moment. Uncertainty dampens business confidence, and business is facing plenty of uncertainty at the moment. With health-care reform, financial regulatory reform, and the scheduled expiration of the tax cuts enacted by President George W. Bush all about to take effect, business owners are more inclined to take a "wait and see" attitude when it comes to expansion.

With governments struggling under the weight of ballooning budget deficits and businesses waiting for the return of sustained growth, it is the American consumer who will have to lift the global economy out of the mire. Given the recent news and current consumer sentiment, that appears to be an unlikely prospect in the near term.

As George Costanza learned, getting caught in a double dip is no fun.

Aquila is a partner in the Mergers & Acquisitions Group of Sullivan & Cromwell LLP.