



BY DR. MIKE BRADLEY

# Why Haven't We Had A Recession Yet?



Considering the persistent flow of negative economic news over the last six months the question has turned from, "When are we going to have a recession?" to "Why haven't we had a recession yet?" While this latter question is both a bit too negative and a bit too premature, it does raise the issue of just what is keeping the economy going. In other words, what positive momentum is offsetting the various negative pressures: the productivity slowdown, the oil price increases, the housing sector collapse and the ever widening credit crunch?



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Looking across the economy for pockets of strength, we come across two unlikely sources, both emanating from what had long been considered areas of weakness. First, in quite a turnaround, the international trade sector has gone from a large drag on the U.S. economy to a source of economic growth. The large and persistent U.S. trade deficits over the last decade put persistent downward pressure on the value of the dollar as U.S. consumers annually used their dollars to buy hundreds of billions more goods from abroad than U.S. producers were able to sell. Consequently, a large overhang of dollars was created in world financial markets and adjustment was inevitable. The U.S. dollar has fallen as a result, but that decline has been gradual but steady over the last five and a half years. In the last year or so, the decline has gotten large enough to make a significant difference in pricing of U.S. goods being sold abroad. The dollar has fallen by 20 percent against all of our trading partners' currencies and 30 percent against the major currencies. (The overall decline is less than the decline against currencies like the yen and euro because a material amount of U.S. trade is with developing countries. A number of these countries peg their currency to the dollar.)

The decline in the dollar and the pick-up in growth in several economies around the world have significantly helped U.S.

## U.S. Net Exports

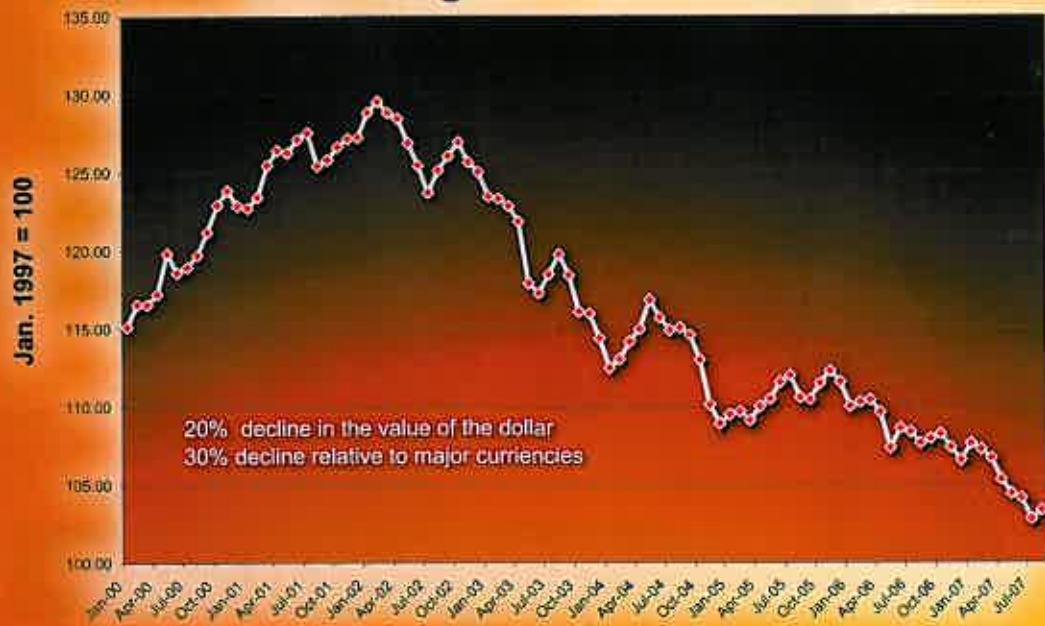


exports. Exports have grown steadily over the past 18 months, and now stand 10 percent higher, adjusted for inflation, than they were a year ago. Of particular interest to manufacturers is the fact that most of these gains have been focused on exports of goods (where the U.S. has run large deficits) not on exports of services (where the U.S. has run modest surplus-

es). For example, in the last six months, inflation-adjusted exports of goods have risen by \$67.2 billion while exports of services have increased on \$10.9 billion. This increase in foreign demand for U.S. goods comes at a good time, as domestic purchases of consumer durables and equipment have softened.

At the same time, the decline in the

## Trade-Weighted Value of the Dollar



value of the dollar has made imports more expensive, in dollar terms, and has helped U.S. import-competing firms. Foreign producers have attempted to "eat" as much as the decline in the dollar as they can in order to keep market share, but when the decline reaches 30 percent, even healthy profit margins begin to evaporate. Ultimately, the dollar price of imports will rise. As a result, U.S. imports have been relatively flat; meaning that the increase in exports has created an improvement the trade balance. For the first time in over 15 years, the economy has experienced a sustained increase in its trade balance and the trade deficit is \$100 billion smaller than at the beginning of 2006. Every dollar reduction in the trade balance is an additional dollar of demand for domestically-produced goods, so this turn around in trade has helped to offset weakness in other sectors of the economy. In fact, international trade follows only consumers as the sector of the economy contributing the most to growth. During the last 20 years, GDP growth was typically smaller because of international trade so this source of positive momentum it is a welcome turnaround.

The other area of strength in the economy has been the labor market. This too comes as a bit of surprise, because job growth has been relatively weak in the last two expansions. It wasn't that many years ago that the buzzword was "the jobless recovery" to encapsulate the fact that GDP was growing steadily but employment was not. That has changed and firms are hiring in a number of sectors. For example, firms added a net 166,000 jobs in October, after adding 96,000 in September. This gain is all the more impressive given the weakness in both construction and automobile manufacturing. The construction sector shed 21,500 jobs in October and manufacturing lost another 21,000, with the losses concentrated in autos and sectors (like furniture) which are related to the housing collapse.

Because of this relatively strong job growth, the unemployment rate has not increased, and remains around its lowest level since the last recession. This is very important for the economy for three reasons. First, a strong labor market is essential for continued consumer confidence. Consumers buy about 70 percent of the output of the economy, so even modest declines in consumer spending can have large ripple effects across the economy. Consumer confidence is an important driver of consumption purchases. People are more

likely to buy new goods when they are confident about the future. Consumer confidence has suffered lately, in part due to higher gas prices and in part due to concerns about financial markets. But a strong labor market puts a floor under consumer confidence, as nothing concerns households more than the possibility of a pending job loss. The decline in consumer confidence would be far sharper if the unemployment rate was moving up.

The second reason that a strong labor market is important relates the recent declines in housing prices and stock prices. When housing prices were rising rapidly (and the stock market was also rising) households felt richer and spent a rising proportion of their income. With those price increases turning into declines, this source of momentum for consumer spending has been removed. If the labor market turns soft and households start to lose jobs, a second source of momentum will be removed. So far, a strong labor market has helped offset weakness in asset prices and it is important that this continues.

Historically, the primary reason for an increase in mortgage defaults has been job loss. Defaults typically rise when the unemployment rate goes up. Most American households do not save, and the household cash flow loss created by unemployment often makes it impossible for a household to meet its monthly mortgage payments. This brings us to our third reason

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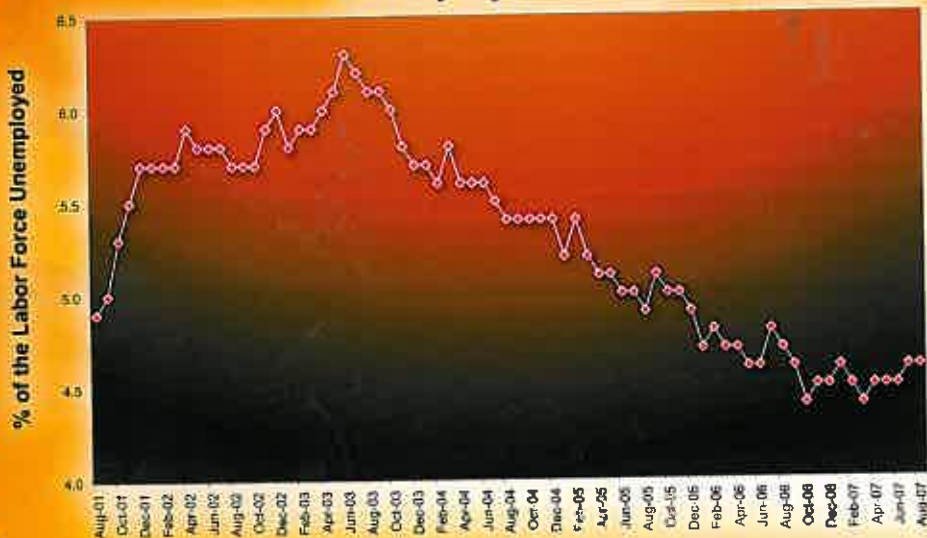


# Eye on the Economy

Why a strong labor market is important. This year, we have been experiencing an increase in mortgage defaults without an increase in the unemployment rate. The housing sector and large portions of the financial markets are already under stress. Given the weakness that already exists in both the housing and the mortgage sectors, and up tick in defaults could turn a serious problem into an outright debacle. Given the size of household debt, strength in the labor market is essential in continuing to avoid a recession.

Like a boxer that won't go down after taking repeated blows, the U.S. economy is recording its third consecutive long expansion. And the early indications of a relatively strong performance in the third quarter are good news, suggesting that the resilient U.S. economy is fighting off its latest challenges. But stay tuned, because the fight is not over and there are some important rounds coming up. □

## Unemployment Rate



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