Is the US heading for a depression?

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News

The sharp contraction of the US economy accelerated in the last three months of 2008, with official figures showing GDP shrinking at an annualised rate of 3.8%.

With forecasters already predicting the worst US recession since World War II, how big a danger is there that the US economy will slip into a depression similar to the 1930s?

The latest figures paint a gloomy picture of the US economy.

Consumer spending, which makes up two-thirds of the economy, fell for the second quarter in a row, by 3.5%.

This drop was led by a 22% drop in spending on durable goods like automobiles and washing machines.

The decline in motor vehicle production was so great that it alone contributed 2% to the fall in GDP.

Businesses hit

Businesses as well as consumers have been hit hard by the slowdown.

Exports, which had helped boost GDP earlier in the year, fell sharply, by 19.7%, as foreign markets for US products were hit by their own recessions.

Investment fared even worse.

Residential investment fell 23.6% as the glut of foreclosed properties reduced new home sales. Business investment was down 19.1%, led by a 27.8% drop in purchases of equipment and software.

Business inventories of unsold goods mounted. If the inventory build up - which is likely to be temporary - is excluded, GDP fell at an annualised rate of 5.1%.

"For all the talk of this being a consumer-led downturn, the credit crunch is hitting businesses even harder," said Paul Ashworth of Capital Economics.

Consumers save

The economic uncertainty does seem to be changing consumer behaviour. People are saving more in preparation for the coming downturn.

The personal savings rate rose to 2.9%, more than double the 1.2% rate in the previous quarter. Mr Ashworth predicts the savings rate will double again, to 5%.

Consumers are being hit by a triple whammy: risingunemployment, which could rise from 7% to 10% of the workforce by the end of the year; restricted access to credit; and falling asset values.

The fall in stock markets and house prices has reduced household wealth by 20%, from the middle of 2007. This alone has reduced consumption by around 1%, some economists estimate.

It may make sense for consumers to save instead of spend, but in an economy as reliant on consumer spending as the US, this does add to recessionary pressures.

How long?

The key question in whether this will turn from a recession to a depression is how long the slowdown will last.

In the 1930s, output declined for four years, with GDP cut by half while unemployment soared to one-quarter of the workforce.

Despite the New Deal, output did not recover to its 1929 level until World War II when there was a massive boost in government spending.

At the moment, most economic forecasters are predicting that the US slowdown will last around two years, with the economy returning to weak growth by 2010.

The National Bureau of Economic Research says the current economic slowdown actually began at the end of 2007 and is likely to be the longest post-war recession.

The non-partisan Congressional Budget Office (CBO) estimates a drop in real GDP for 2009 of 2.2%, followed by a rise of 1.5% in 2010, while the IMF predicts a fall of 1.6% this year, following by a recovery of 1.6% in 2010.

But economic forecasts have changed frequently in the past year. It is unclear what will happen after 2010, said the IMF's chief economist Oliver Blanchard.

Government rescue?

The only thing currently boosting the US economy is Federal government spending, which rose 5.8% in the quarter.

But even if Mr Obama gets rapid approval for his $800bn stimulus plan - which has passed the House of Representatives and is currently being considered by the Senate - it will take some time for the money to be felt in the economy.

Only $170bn will be spent before 1 October 2009, representing just over 1% of US GDP, according to the Congressional Budget Office.

The bulk of spending (including tax cuts) would occur in 2010 ($354bn) and 2011 ($174bn).

Individual states may not be able to rapidly increase spending on infrastructure projects which make up a large part of the stimulus package.

It is also unclear how many jobs will be created: President Obama aims to create 3.5 million new jobs, but others say the stimulus package could create between 1.2 and 3.6 million more jobs.

Financial squeeze

The other big uncertainty is whether the financial sector can be restored to health and at what cost.

There is now $2.2 trillion of toxic bank debt worldwide, the IMF says, $500bn more than it estimated a few months ago.

The collapse of financial markets in the autumn had a dramatic effect on consumer and business confidence.

There are plenty of reasons why growth might be even less than forecast, the IMF's Olivier Blanchard said, not least if banks have so many bad debts, they will further drag down the real economy.

The Obama administration still has $350bn left of the $700bn bailout for banks approved in October last year. It may need to ask for more.

If it gets the money it needs and if the money is spent promptly and wisely, the US might just escape with a relatively mild recession.

But given the extraordinary events of the past six months, most economists are still hedging their bets.