Time for a double dip?

A lousy debt deal, rising fears of a recession, the danger of longer-term stagnation: America's outlook is grim

THIS ought to have been a good week for the American economy. The country's leaders at last ended a ludicrously irresponsible bout of fiscal brinkmanship, removing the threat of global financial Armageddon by agreeing to raise the federal debt ceiling. Yet far from heaving a sigh of relief, investors are nervous. Stockmarkets around the world have tumbled (see page 61). On August 2nd, the day the debt deal was signed, the **S&P** 500 index saw its biggest one-day fali in over a year, and yields on ten-year Tteasury bonds dropped to 2.6%, their lowest levei in nine months, as investors sought safety.

It is not all to do with America: the euro zone is a mess (see next leader) and manufacturing everywhere seems to be slowing. But America's prospects have suddenly darkened. Statistical revisions and some grim new figures have revealed a weaker-than-assumed recovery that has all but ground to a halt. Once stalled, an economy can easily tip back into recession, particularly if it is hit by a new shock-as America's is about to be, thanks to a hefty dose of fiscal tightening made worse by the debt deal. The odds of a double dip over the coming year are uncomfortably high, perhaps as high as 50%.

America's recovery from a balance-sheet recession was always bound to be sluggish and fragile. And its woes need not fell the world economy, thanks to the strength of emerging markets (see Economics focus, page 66). But the thoughtlessness of the debt deal—notably its failure to tackle any of the real sources of America's fiscal problems, such as entitlement spending—raises a bigger worry. Can the country's politicians, so starkly polarised and so willing to gamble with the economy, be trusted not to turn what was always an inevitable period of hardship into longer-term stagnation?

The fin rising to the surface

Begin with the state of the recovery. On July 29th America's government statisticians published revisions to the past few years of **GDP** statistics. They showed that the 2008 recession was deeper than first thought, and the subsequent recovery flatter. Output has not yet regained its pre-recession peak. And the feeble recovery is petering out. Over the past year output has grown by a mere 1.6%, well below what most economists consider to be the economy's underlying growth rate, and a pace that has in the past almost always been followed by recession. Over the past six months the United States has eked out annualised growth of merely 0.8%. Even observers who, like us, had expected America to bounce along near the bottom for a while had not expected growth to be this low.

Temporary factors have played some role in this. Soaring oil prices crimped consumer spending. The Japanese earthquake disturbed supply chains. In some industries, notably car production, a rebound is plainly under way. But the overall economy is now so weak that it would take a lot to get growth up to a reasonable rate. And there are some signs that the temporary shocks may have left a more lasting dent on the psyche of firms and shoppers. That is why the newest figures are so disconcerting. Consumer spending fell in June; consumer confidence slumped in July, as did manufacturers' orders. Of course, these are early, incomplete, snapshots, but the chances of a double dip over the coming year, which seemed relatively small only a month ago, have risen alarmingly.

If that happens, then America's politicians will bear much of the blame (see page 25). Their prescription for a weak economy is a large slug of austerity. Thanks to the expiry of a payroll-tax credit and extended jobless benefits in December, the United States is on course for a fiscal contraction of some 2% of **GDP** next year, the biggest of any large economy-and enough to drag a weak economy into recession.

The debt deal, which implies only modest new spending cuts in the short term, is not directly responsible for this. But Congress could, and should, have stopped this potentially ruinous trajectory. There was a deal to be had: keep up spending in the short term, with a stress on much-needed infrastructure investment, as well as extending the temporary tax cuts, in exchange for a big medium-term reduction in the déficit, centred on entitlements and tax reform. Congress did precisely the opposite, failing to support the economy now and failing to find enough cuts over the next decade to stabilise America's debt. Any hard decisions have been given to a commission-a cop-out that condemns workers and firms to more crippling uncertainty about how the country's fiscal mess will be tackled. Would you build a factory today if you knew that taxes had to rise eventually, but had no idea which ones?

Worse, the poisonous politics of the past few weeks have created new sorts of uncertainty. Now that the tea-partiers have used default successfully as a political weapon, it will surely be used again. The refusal to compromise, rapidly becoming a point of honour for both parties, is wreaking damage elsewhere, partially shutting down the Federal Aviation Administration (see page 27) and postponing trade bills. At best, the politicians will have slowed a sputtering expansion; at worst they will have killed off the recovery and inflicted lasting harm on the world's most impressive prosperity machine.

In the land of the blind the one-eyed Fed is king

Does it have to be this way? Not necessarily. Barack Obama or one of his Republican challengers may yet discover the courage to tell the truth about the American economy in next year's presidential election. But given the politicians' current uselessness, the only institution with the power to avert danger is the Federal Reserve. With interest rates so low, that means more quantitative easing. Printing more money is justifiable in the circumstances, but still a tool offering diminishing returns. Fiscal help would have been much better.

If America does manage to avoid recession and slowly begins to pull out of this mire, it will be testimony to its underlying strengths. It still has huge advantages over other rich countries: a younger, less-taxed population, a more innovative economy and, for now at least, the dollar as the global reserve currency. If only it had the political leaders to match, its chance of avoiding recession would be far better than one in two. •

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