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Are We Having An “H” Shaped Recovery?

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Economists talk about “V” shaped recoveries, “W” shaped recoveries and “L” shaped recoveries. As a child I used to love alphabet soup, but I cannot say it is as enjoyable today. Just as my brother and I used to make up stories for the letters in our soup, I think we are in the midst of an “H” shaped recovery!

We have talked in the past about “V,” “W,” and “L” shaped recoveries. ***What is an “H” shaped recovery and how does it differ from all those other “funny” letters?*** A “V” shaped recovery is how we describe an economic cycle with a rapid decent followed by a strong rapid recovery ascent. Once the elements that caused the economy to decline have been purged, the pent-up demand coupled with the underlying strength of the economy aided historically with tax cut stimulus (See the ***Managing For Success*** Article, “Why Stimulus Is A Key Component To A Dynamic Recovery”) propel a rapid return of broad based growth across the economy, generating accelerating job growth.

A “W” shaped recovery is what we call a double dip. In essence, a second dip occurs after an initial recovery period. Because the government failed to take the right combination of steps to facilitate the private sector, the first stage recovery is cut short and a second dip occurs.

A “W” shaped recovery, normally ends with a strong second recovery, because the government changes course and the economy experiences a strong second recovery phase similar to what we experienced coming out of the recession in 1982.

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The end result of a "W" shaped recovery can be a long period of prosperity lead by the private sector with strong job growth. The mid-1980 recovery extended essentially until 2006!

An "L" shaped recovery is where the economy bottoms out, but does not experience real growth. Because the economy only reaches equilibrium, stabilizing at a substantially reduced level of economic activity, hard times follow, and creating a real recovery becomes very difficult. The Great Depression of the 1930s had many of these characteristics. A deep depression followed by a bottoming out, a slight flat recovery and then a second period of prolonged depression that lasted until World War II.

For America, World War II took approximately 14 million Americans out of the work force and put them into uniform. It also brought many new people into the work force, including women, who filled industry's needs as it expanded to raise war production and created prosperity at home.

One of President Truman's truly great accomplishments after World War II was engineering the integration of our people in uniform back into a peace time economy, while maintaining economic growth and prosperity. No simple matter.

So why do I think we are having an "H" shaped recovery now? Certainly not because I like alphabet soup! The reference to an "H" shaped recovery is because it appears we are experiencing something we have not experienced before in modern times. It is a recovery that does not have all the characteristics of a "V" "W" or "L."

It is a "haves and have not's" recovery. In some respects, the economic data indicates that we are having a segmented but broad based recovery across many sectors of the economy. We are seeing pent-up demand fueling growth. But we are also seeing a different pattern emerge.

For one thing, we are not seeing a sharp upturn in many important segments of the economy. This makes the recovery "mild" rather than "strong." Some times economist today comment on how "fragile" the recovery is. The data is often contradictory. Under these circumstances we do not see unemployment responding as it would in a normal "V" shaped recovery.

Many of the changes are fueled by government driven activities which change how many and which segments of the economy respond. Much of the recovery may depend on the government continuing spending programs which should have been temporary. Those who have lost their jobs are not being substantially drawn back into the workforce yet. We are not creating enough private sector jobs to absorb both the unemployed and new entrants into the work force. Nor are we creating higher paying private sector jobs.

This means that those who kept their jobs are experiencing a return to prosperity, while those who have lost their jobs are sliding toward real depression levels. State governments that were propped up with federal funds are experiencing greater difficulties as those programs are being gradually withdrawn.

Thus, the choice of the term "H" shaped recovery. The left half of the "H", the first post of the "H" or"⊢," is the "haves" who are experiencing a return to prosperity. The second post of the H, the right post "⊣" is the "have nots" who are experiencing increasing depression as the length of time they remain unable to find work increases.

It is true that whenever we have a structural disconnect, such as "the tech bubble" there are parts of the economy that may not return to the pre-recession level for many years. Fiber optics production was an example, where we had years of over capacity left after the bubble burst. If we had a strong "V" shaped broad recovery, it would create other opportunities and absorbs most of the unemployed, albeit in other sectors, rapidly back into the economy before their resources are exhausted.

Here we are not seeing that type of recovery with the private sector able to move rapidly forward and create the necessary jobs. For example, those that have been out of work the longest are increasingly finding it hard to reintegrate. Nor are we seeing the type of government focus and actions that would change this.

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Secondly, government actions appear to be creating new and different disconnects in the economy that will in time create new structural issues. Prolonged low short term interest rate and high long term deficits coupled with tight credit are creating future bubbles in a slow growing economic environment.

Since we are coming off extreme lows, the statistics in this recovery appear large when reported as percentage increases. In absolute terms these statistics tell a different story.

To illustrate, if you drop from selling 100 units to selling 75 units you have a 25% drop. For a mature modern economy, drops of over 10% represent a major drop in the level of economic activity. Take for example, retail sales, where reduced sales are hurting the commercial real estate sector.

If you have a 5% recovery, which sounds like a lot, (following a 25% drop) you only add 3.75 units for aggregate sales of 78.5 units total. You are still down 22 units or 22% below where you were before the down turn occurred.

Translated into what we are seeing today, if you slimmed your business down to where you could make money at the low point of the recession, last fall, then adding a few units gives you a real profit pick up. Thus, today we are seeing good earnings reports compared to last fall. It does not, however, create the conditions for hiring back all of the terminated employees. Nor does it lift commercial real estate out of its slump.

The most recent unemployment figures show layoffs slowing and employment stabilizing, but not the needed job creation levels. It is a an “H” shaped recovery. “H” shaped recoveries are inherently unstable. There are many factors that can destabilize them and cause new economic problems.

What are some of the risks inherent in an “H” shaped recovery? Rising interest rates, inflation, chronic unemployment, unduly weak sectors of the economy, increasing taxes, prolonged deficits, to name a few. When an economy that has not fully recovered from a severe recession experiences these types of further dislocations it becomes increasingly hard to recover real economic stability.

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These are the types of problems that lead to the issues faced by countries like Spain and Greece. These types of problems inevitably lead to decreasing standards of living. What is needed is substantial growth of GDP as measured in constant dollars. To achieve this requires entrepreneurial small business growth of the type that fosters the famous America creativity and innovative spirit.

Free market economies inherently allocate resources to repair economic dislocations. Governments, it is believed according to modern economists, can through prudent application of collective resources assist the free market in allocating resources and repairing dislocations. By the same token, if governments interfere with the operation of the laws of economics, rather than assist the free market, it can cause even bigger problems.

Government, in these types of times, can be faced with chronically inadequate revenues and respond by raising taxes. As Winston Churchill once said "We contend that for a nation to tax itself into prosperity is like a man standing in a bucket and trying to lift himself up by the handle." Government activities that take liquidity out of the economy and reduce private sector capital, impede the resource allocation necessary for a strong recovery and job growth. Higher taxes inhibit private sector job creation.

Private sector job creation has a different impact than government job creation. Private sector jobs contribute to the multiplier effect while government jobs don't. Private sector jobs are inherently sustainable by a functioning economy because it is private sector demand that created them, while government jobs can only be maintained by taxes. Policy can have a definite and substantial impact on how the economy performs in the long run.

Winston Churchill noted that "Some see private enterprise as a predatory target to be shot, others as a cow to be milked, but few are those who see it as a sturdy horse pulling the wagon." Without a healthy "sturdy horse," a nation's standard of living is reduced. That is why in comparing capitalism to socialism Churchill said "The inherent vice of capitalism is the unequal sharing of blessings; the inherent virtue of socialism is the equal sharing of miseries."

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With an “H” shaped recovery we are in a period of time when how the government assists or hinders the recovery can lead to dramatically different results. 2010 can be the beginning of a real recovery. But as an “H” shaped recovery, its inherently fragile nature means that any one of a number of dark clouds on the horizon could derail it going into 2011.

China, as we have noted has long term plans to alter the international monetary system, Iran and North Korea are altering world security, the Gulf oil well explosion threatens the economic stability of our Gulf states, Europe’s recovery is faltering, the recovery in international trade remains fragile, among other economic problems. How all of these will play out is still uncertain. More than ever it is important for the United States to have a thoughtful coordinated approach to all of these issues. An uncoordinated approach, as we are now experiencing, will be counterproductive in the long run.

One of the leading economic forecasting firms, The Institute For Trend Research, and our strategic partner, in commenting on the April Purchasing Managers Index said that “the falling rate-of-change suggests that growth *may* slow early next year” indicating caution for early 2011. Clearly there are too many variables to know what next year will bring.

For business, scenario planning is the micro equivalent of being prepared as those changes which are out of your control, effect the economic environment in which we do our business. If your business is in one of the sectors that is not yet in recovery, planning and implementing strategic action steps that will build new revenue sources and increasing brand penetration can make all the difference.

If your sector is moving into recovery, planning and implementing strategic action steps that prepare for the stresses the economy will face as we enter 2011 will make a major difference in whether you can take advantage of what is coming. Today we can see many bumps in the road ahead. Knowing how to identify them and what is the right response is critical. Like our successful clients, you may want to put our experience to work for you. We can help.

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