THE ECONOMIC SITUATION

Bruce Yandle
Dean Emeritus,
College of Business & Behavioral Science, Clemson University
Distinguished Adjunct Professor of Economics, Mercatus Center, George Mason University
yandle@bellsouth.edu

Note: Cartoonist Robert Arial has generously allowed his cartoons to be used in the Economic Situation report. To add your name to the report email list, please send an email: economic_situation-l-subscribe@strom.clemson.edu

September 2011

- **A long way from May to December.**
- **Two different worlds we live in.**
- **Becoming more like Greece.**
- **Housing is the problem but not part of the solution.**
- **Why stimulus doesn't seem to work.**
- **Final thoughts: tax payers and tax spenders.**

Another September Song

In 1938, songwriters Maxwell Anderson and Kurt Weill wrote the hauntingly beautiful *September Song* for the Broadway musical *Knickerbocker Holiday.* Do you remember the words?

"Oh, it's a long, long while from May to December, but the days grow short when you reach September."

What a lovely tune it was, and what precious romantic words. Maybe the words describe a part of our current situation, even if the mood of the song does not.

After a tumultuous summer filled with epoch-making bad economic news and other misfortunes, many investors, business people and ordinary folks are looking forward to the close of 2011. When the year comes to close, the trip from May to December will seem long indeed.

Since May we have seen the spectacle of a Keystone Cops version of political negotiations for avoiding default; it was a public ordeal that never seemed to end. Yes, political arm wrestling and sausage making should always be done behind closed doors. The Facebook generation has something to learn from the old folks.

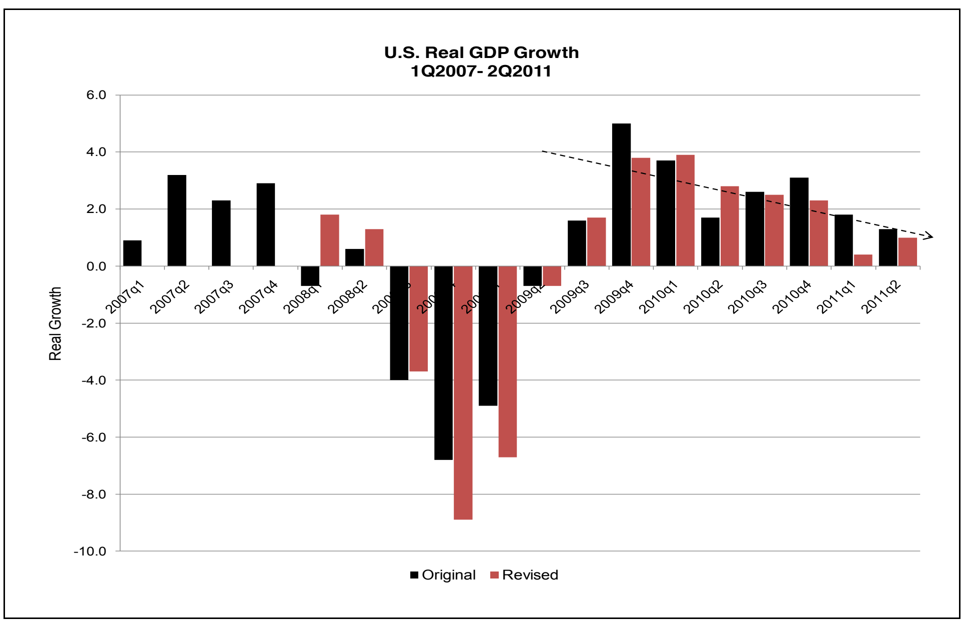
The world next witnessed Standard & Poor's reference the ordeal and the timid result that followed as a basis for downgrading their rating of U.S. debt, even after admitting a small three trillion dollar accounting error in favor of the good old USA. With commentators preparing to don sackcloth and ashes, we saw the Secretary of Treasury, Congress, and the Securities & Exchange Commission attempt to shoot the benighted S&P messenger, as if financial markets for years had not been assigning higher risk to U.S. bonds by way of prices paid for credit default swaps.

We then received the unwanted news that the government deficit was going to be larger than previously anticipated, and that government spending, aside from defense and stimulus, was growing apace. (Some wondered if anyone was minding the store.) On top of all this, a horrible Pacific earthquake crippled Japanese supply of critical auto and computer parts to world markets, and floods and tornadoes took a heavy human and economic toll in Alabama, Tennessee, Kansas, North Dakota, and elsewhere. (All this was before hurricane Irene added another dose of disaster.)

Then, in the economic background music, we continued to hear repeating themes of Greek bankruptcy, Spain not making it, and France and Germany becoming Europe's salvation. With all this going on, the U.S. economy seemed destined to stumble into a deranged default-avoiding, tsunami-driven, S&P downgrade-hammered, unending world financial crisis, double-dip recession, or something like that.

But as if this weren't enough to break the spirit of recession- and war-weary Americans, along came GDP revisions that told us that when we thought things were darkest during the deeps of the recession, we were wrong. The situation was even darker than we thought. Downward GDP revisions then became the order of the day as the numbers for 2011's first and second quarter were cut. These were followed logically by cuts in GDP growth forecasts for 2011 and 2012. Instead of calling for GDP growth in the 2.5% range, major forecasters, including the Obama White House, are now telling us to expect 1.7% or 2.6% growth this year and next. And to top this off, the Obama soothsayers are promising that the unemployment rate will stay stuck at 9.0% on into 2012.

Of all the sad events that have transpired since June, I believe the GDP revisions are the most noteworthy. The depth of the GDP adjustments are shown in the accompanying chart. The unhappily descending dashed line outlines the post 2008 trend.



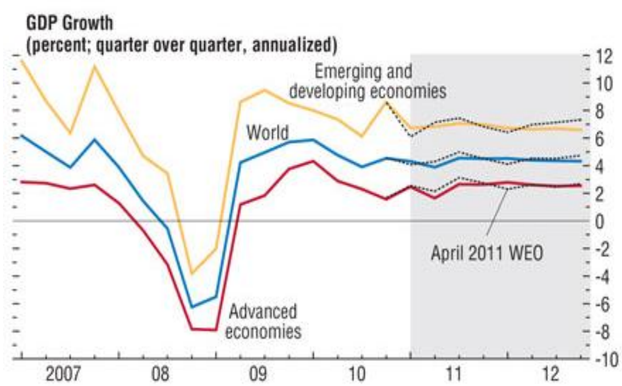
With GDP growth getting close to negative territory, continued weak growth in employment, rising food and energy prices, and Keystone Cops playing in Washington, it is little wonder that American consumers turned pessimistic about the present and future situations. While poll-based indicators of consumer sentiment matter a lot and deserve our attention consumer behavior matters more. Consumer savings is rising just a bit, but retail spending still shows a positive pulse. The consumer may be down, but not out.

But will we get a double-dip, another two consecutive quarters of negative GDP growth? Close perhaps, but not the real thing. This said, there is little difference between vanishingly small and negative GDP growth as far as consumers and businesses are concerned. Still, the prospects overall say the U.S. economy, led by manufacturing, is doggedly moving to higher ground.

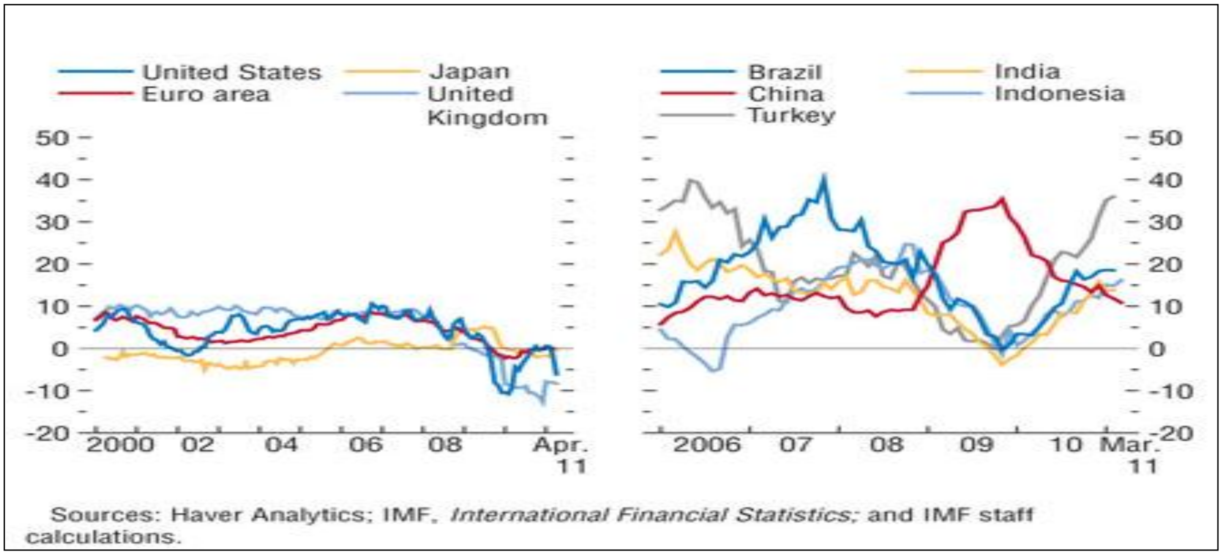
Yes, it is a long, long way from May to December, but the world economy is still kicking.

Two different worlds we live in

The rather bleak prospects for U.S. GDP growth parallel those seen for the rest of the "old" developed world. But there is another world that is healthy and prosperous, a world where wealth is being created at a fast clip. Of course, the world's investors know this, as do young people who will seek their fortunes where prospects are brighter. Consider the next two charts, which were produced by the International Monetary Fund for their April *World Economic Outlook* (WEO) report. The chart to the right shows GDP growth for the advanced economics, the fast growth developing countries, and the composite growth. You can see the WEO GDP estimate dashed in the chart. The chart below shows expansion of credit. Think of it as bank lending, for the same country groupings.



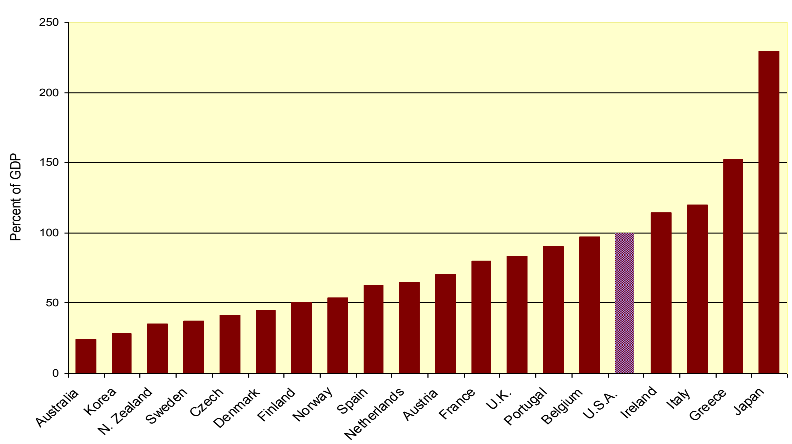
Year-over-Year Real Credit Growth



Becoming more like Greece

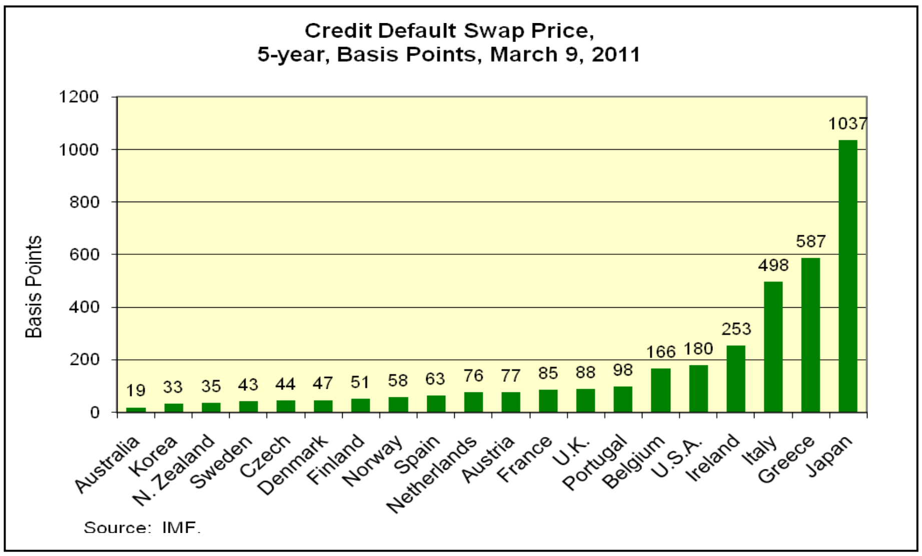
Unable to pull off a large deficit reduction package that might have included major changes in the tax code, Mr. Obama and Congress settled on meaningful, but small cuts with no tax increases. The timid but still difficult action and drawn out negotiations added color to S&P's downgrade decision referred to earlier. But more than likely, the unpleasant S&P decision was driven by data. As indicated in the accompanying chart showing public debt as a share of GDP, the U.S. has joined the neighborhood of the down and out.

Gross Public Debt, % of GDP, 2011

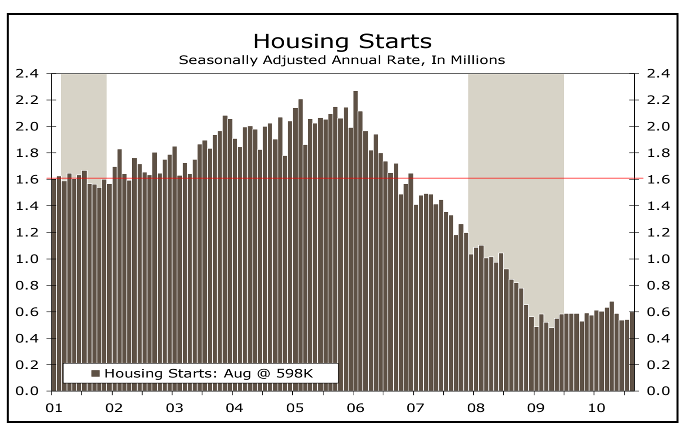


Source: IMF, Global Financial Stability Report, 2011, p. 20.

World financial markets reveal the relative riskiness of sovereign debt by way of the prices paid for credit default swaps. The next chart shows the price in basis points for CDS on 5-year debt, as of March 9, 2011, which is the date when the gross debt data were compiled. World investors have clearly assigned more risk to U.S. debt than to the bulk of the other industrialized nations. It's interesting that we never hear much about Japan's huge problem.



Housing: The great contraction that doesn't go away



To appreciate the difficulties faced in the current economic recovery, we must return to the scene of the collapse and remind ourselves of the housing sector's role in bringing the financial collapse to fore. As shown in the accompanying chart, the U.S. simply built too many houses from 2002 through 2006. Too many? The long-run average for housing starts is shown by the red line at 1.6 million units. The mountains formed above the red line turn out to be too many houses.   Too bad we can't just clip off the excess housing and dump it intact into the post-2007 cavern. In a sense, though, that it what markets are attempting to do. After all, the excess housing is left standing. More on this later.

Why did it happen? Too many false signals. Consumers and investors relied on price and interest rate signals when making decisions, as they always do. But the price signals were woefully distorted by government policies, faulty credit ratings and other mischief. There were too many subsidies, too many special deals, and too much Fed-delivered abundant credit. All this came tumbling down when the Fed reversed its loose credit policy and interests rose, cutting off the flow of cheap money and blunting the edge of economic activity.

There is obviously more to the story, but when we blow away the dust of technical explanations, we are left with the fact of more than three million too many housing units added in the U.S., the equivalent of some $4 trillion in misguided investment.

When bad investment are made on borrowed money, no matter the reason, there are just a couple of roads to recovery. One route is taken when underwater borrowers default, go bankrupt and sometime take their lenders with them. We saw something like this happen in Iceland and a bit of it in Ireland. A less painful route is taken when those deep in debt get their loans restructured, or heaven help us, forgiven. This means the lender shoulders some if not all of the borrower's burden. While working down the loan, those who made bad decisions have to cut expenses, work harder, save more, and find ways to create new wealth. Part of Europe's turmoil is about coming to terms on just how to spread the pain and gain in large debt work outs while avoiding default and bankruptcies of major financial institutions.

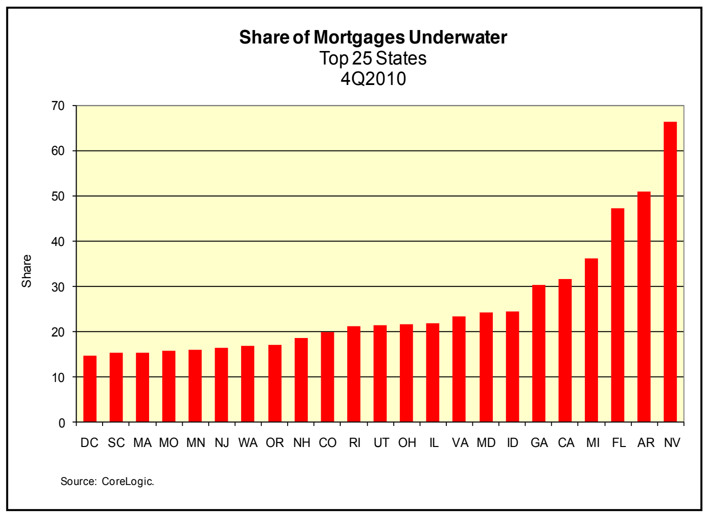
Then there are private citizens who are caught in the housing trap. So far, some of the private U.S. debt associated with the great housing expansion has been paid off. But a lot of houses are still for sale. And a lot of the inferior debt has been moved from one balance sheet to another. In the U.S., banks moved some "toxic assets" to the Fed's balance sheet. European banks moved their bad housing debt to the European central bank. But much of the bad debt is still there smoldering on the books of private sector financial institutions, as well as on public sector balance sheets.

Since much of the debt is housing related, falling housing prices place additional pressure on the financial system. Each month falling housing prices bring another downward revision of debt held by banks. And each downward revision places some banks closer to bankruptcy or further way from being able to expand loans.

No matter what the federal government may do to stimulate the economy, short of flying over the 50 states and dumping gold coins in America's backyards, there is just no quick way to erase the housing sector problem. Stimulus programs that target health care, education, school construction, and the unemployed just don't do much for the housing overhang. Unlike these actions, the special tax treatment for first-time home buyers did address the problem. But it's crazy season in America. Election fever is in the air. Stimulus programs that affect organized voting groups are more valuable politically than those that simply spur the economy.

Taking a closer look at the housing finance picture

There are several ways to illustrate the difficulties posed by too much housing and too few jobs. First off, according to Corelogic, in 4Q2011, some 23% of mortgage-financed homes in America were worth less than the mortgage balance due to the lender. The mortgages were upside down. As shown in the chart, of the top 25 upside-down states, Nevada led the pack with 65%. Arizona counted 50% in the upside-down category, and Florida, 47%.



Upside-down mortgages lead to foreclosures when homeowners decide they will walk away from property that is worth less than they owe on it. In 2Q2011, there were some 1.6 million foreclosed homes in America with the bulk held as real estate owned by banks. Unfortunately, there is little movement in that number. Why? State attorneys general are negotiating settlements with mortgage lenders in an attempt to ease the pain being felt by affected homeowners. Until the negotiations are concluded, the homeownership pipeline will be clogged with dead capital.

Slowing the foreclosure process postpones clearing the market of excess housing. Meanwhile, according to RealtyTrac, the share of all real estate sales accounted for by foreclosed property stands at 65% in Nevada, 56%in Arizona, 51% in California, 40% in Michigan, 38% in Georgia, and 35% in Florida. The average discount from the mortgage value on sales of bank-owned real estate runs as high as 49% in Illinois to a low of 22% in Idaho. The discount central tendency is 40%. While the process of clearing the market of three million too many housing units is slow and painful, it is working.

Interestingly enough, the sale of heavily discounted homes is attracting global buyers. Real estate markets are no longer local, regional, or national. They are global. According to the National Association of Realtors, foreign residential investment grew from $66 to $82 billion between March 2010 and 2011. The purchases include vacation homes, rental property and partially developed land. According to NAR, some 31% of the global buyers came from North America, 26% were from Asia, and another 24% from Central America, with the rest coming from South America, Africa, and the Middle East.

But consider a back of envelope analysis of the overall effect of this much real estate being caught up in foreclosures and fire sales. There are some 56 million mortgaged homes in the U.S. They are occupied or owned by about half of the households; the others are renters. About 23% of the owned homes have negative equity. That is roughly 11 million households or about 10% of all households that face negative equity, significant losses in wealth, and potential foreclosures. It's no wonder that consumers and investors have cut back, that the economy has a bad case of the slows, and that American's nationwide wonder when the much discussed government stimulus program will finally kick in.

The stimulus challenge: a little history

In January 2009, Chairman of the President Council of Economic Advisors Christina Romer and White House economic advisor Jared Bernstein produced a much celebrated study in support of the White House $800 billion stimulus proposal. Because of the large size of the stimulus request in light of government deficits and the wherewithal to pay for it, the Romer-Bernstein study received unusual attention. The 7.8% unemployment rate that prevailed when the study was released seemed high at the time, but looks mighty good now.

Romer and Bernstein famously predicted that with the stimulus in place 3.675 million jobs would be added to payrolls and/or that many job losses avoided by 4Q2010. They also stated that with the stimulus the unemployment rate would never rise above 8%, but would hit 9% if the stimulus was not approved. They have been defending that nettlesome prediction ever since.

The stimulus was immediately approved by congress. Almost as if acting to show spite, in February 2009, the very next month, the unemployment rate rose to 8.2% and then climbed above 9.0% and levitated at 9.0% or above for all but two months till now. In August the rate was 9.1% and holding. Now the Obama White House says 9.0% unemployment is here to stay through 2012.

When faced with stinging criticism regarding their early optimistic stimulus promise, Romer and Bernstein countered that the economy was in far worse shape in January 2009 than they or anyone else realized. Recent Commerce Department GDP revisions surely give credence to that response. But as former Bush CEA chairman Larry Lindsay recently explained, even if the Obama economics team was plowing bad data, the promise of 3.675 million jobs in exchange for $800 billion in deficit financed stimulus would not be a very good deal. The price per job would hit $211,000. On average, each job produced through stimulus would generate a loss for the economy.

But the forecast difficulty was more profound than suggested by Larry Lindsay's comment. Romer and Bernstein relied on statistically derived multipliers when estimating employment gains. Increases in government spending would generate a positive overall gain, almost like magic. To some extent, the multiplier model assumes the economy can almost costlessly convert spending into jobs, no matter how specialized the unemployment may be or how targeted the spending. But the more fatal assumption buried in the multiplier is the idea that purchasing power taken from one part of the economy and spent in another part does not leave an empty economic hole when it is transferred. By some estimates, the hole that is left is larger than the gain that comes from the spending.

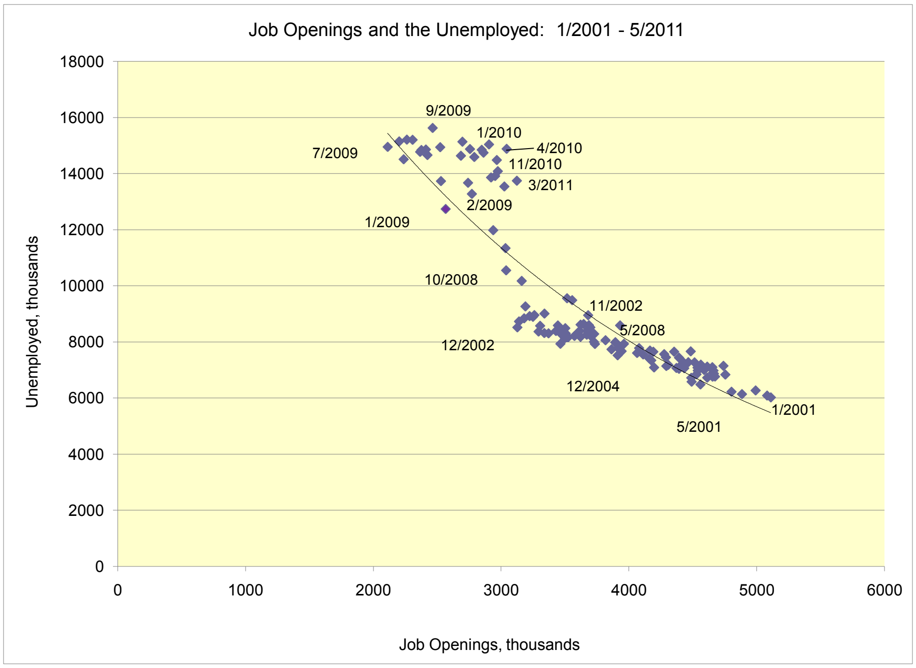
Did the $800 billion generate jobs when it was spent? Of course it did. There's no way to spend that much money without generating some employment. Jared Bernstein explained recently in a National Public Radio interview, that he visited cities and counties that received stimulus money and saw with his own eyes the resulting increases in employed police, firemen, and teachers. But does seeing new hires in crisp blue uniforms mean that the rookie policemen are net positive hires for the economy? The more precise question is did the stimulus generate a net increase in jobs? The unseen jobs that may have been generated by spending that could not and did not take place when funds were diverted to stimulus projects cannot be observed.

The first stimulus spending is coming to an end. According to the White House, 90% of the $288 billion in tax benefits has been paid out. Some 81% of the $275 billion in contracts, grants, and loans has been spent, and 84% of the $224 billion tagged for unemployment benefits, Medicaid entitlements and family services has been spent. The first stimulus attempt failed to achieve its architects' high hopes. With sustained high unemployment, sagging GDP growth and zero job growth in August 2011, chances are good that another dose is on the way.

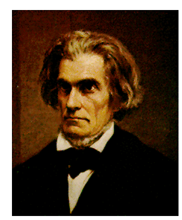
The structural mismatch

Most of the first stimulus money was targeted toward healthcare, education, unemployment compensation, and tax reduction. But housing was the sick sector, and construction workers the heaviest hit among the unemployment. Since April 2006, when construction employment was at its most recent peak, some 2.2 million construction workers have become unemployed. The 28.8% decline, the largest percentage loss for any employment sector, is the steepest employment drop in the sector since the labor market disturbances caused when men marched off to war during World War II. In July 2011, the total unemployed for all sectors stood at 14.4 million. Of these, 1.1 million were unemployed construction workers. The construction unemployment rate stood at 13.6 percent. With 1.5 million out of the work in the leisure and hospitality sector, another hard hit sector, the unemployment rate was 10.9 percent. Combine these two and we have 2.6 million, which is not quite 20 percent of the total unemployed. Roughly one out of five of those seeking work come from relatively low educational attainment sectors. As a result, we continue to see unusually high unemployment rates among those with less than a high school education and relatively low unemployment rates among the experienced college educated.

We have a structural unemployment problem that is linked to the great housing contraction, and only time and slow growth will deal with it. The result is seen in a growing number of job openings that are not being filled, even though the count of unemployed stands at a high level. The accompanying chart shows a monthly mapping of the number unemployed and the number of job openings. I call attention to the data points in the upper center of the chart that are off the fitted curve. These monthly data points are for 2009, 2010, and 2011. They show a high level of openings in the face of high unemployment. The emerging economy is generating job opportunities that may not fit the location, skill level, or educational attainment of the unemployed.



Final thoughts: why it is so hard to break our deficit habit



Writing in 1810, in his *A Disquisition on Government*, politician and political theorist, John C. Calhoun (1782-1850) warned of a problem that could develop when a community became divided on the basis of those who pay taxes and others who spend taxes. He had this to say on the matter when one citizen group or region gained at the expense of another group:

"… it must necessarily follow, that some one portion of the community must pay in taxes more than it receives back in disbursements; while another receives in disbursements more than it pays in taxes… The necessary result, then, of the unequal fiscal action of the government is, to divide the community into two great classes; one consisting of those who, in reality, pay the taxes, and, of course, bear exclusively the burthen of supporting the government; and the other, of those who are the recipients of their proceeds, through disbursements, and who are, in fact, supported by the government; or, in fewer words, to divide it into tax-payers and tax-consumers."

Mr. Calhoun's deeper concern was how to construct a constitution that would constrain political behavior and preclude the persecution of the minority, those who pay taxes, by a majority, those who receive benefits. It was in this context that he wrote:

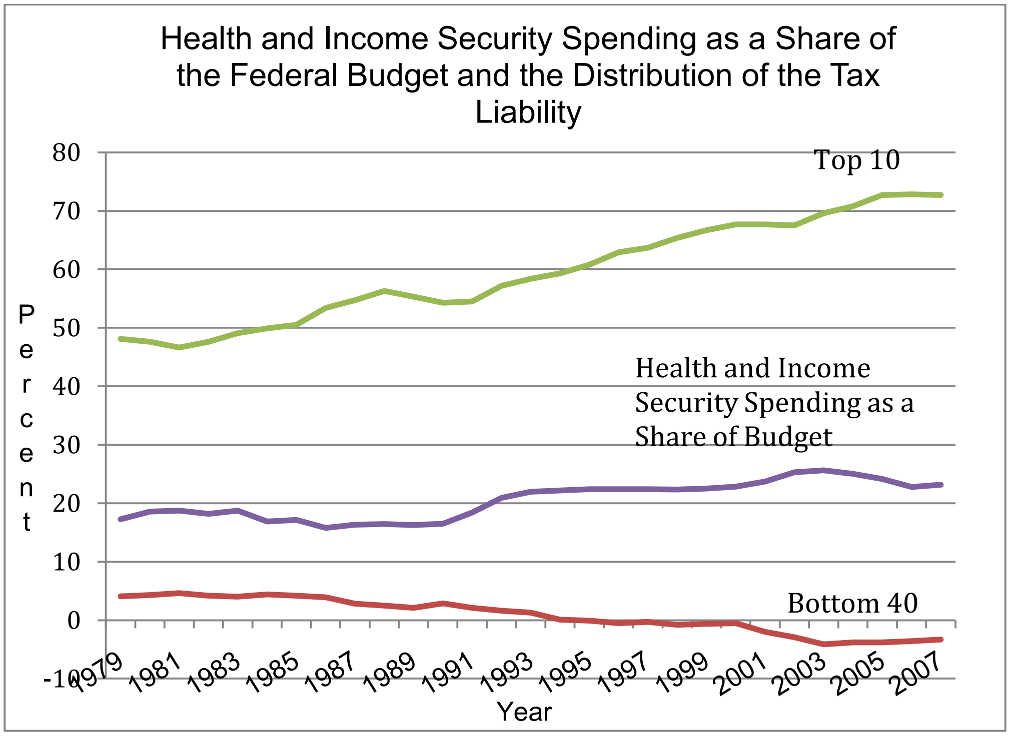
“There is no difficulty in forming government. It is not even a matter of choice, whether there shall be one or not. Like breathing, it is not permitted to depend on our volition. Necessity will force it on all communities in some one form or another. Very different is the case as to constitution. Instead of a matter of necessity, it is one of the most difficult tasks imposed on man to form a constitution worthy of the name; while, to form a *perfect* one—one that would completely counteract the tendency of government to oppression and abuse, and hold it strictly to the great ends for which it is ordained—has thus far exceeded human wisdom, and possibly ever will.”

Presbyterian College economist Jody Lipford and I recently completed a report for George Mason University’s Mercatus Center that examined what has happened as between U.S. tax payers and receivers of federal entitlement funds across the years 1979-2007. During that time, the share of all federal taxes, income and payroll taxes, paid by taxpayers in the lowest 40% income group has fallen from 9.3% to 5.2% of all revenues received. The share paid by those in the highest 10% income group has risen from 47% to 55%.

When we took out payroll taxes and focused only on income taxes, we saw a different picture. Across 1979-2007, the share of income taxes paid by those in the lowest 40% fell from 4.1% to minus 3.3%. On average, those in the lower group received a check from the government. The share of income taxes paid by those in the highest 10% rose from 48.1% to 72.7%.

Of course, there are a lot more people in the lower 40% group than in the upper 10% group. The federal income transfer system has a large number of people receiving funds from a much smaller number. The political dynamics that go with this suggest it will be very difficult to convince the tax spenders to carry more of their load. It seems easier to demand higher taxes from those that make up the smaller share of taxpayers.

The accompanying chart, developed from Congressional Budget Office data, shows what has happened to tax shares paid by the lower 40% and top 10% along with the record for transfers as a share of the federal budget.



We will likely hear more about this in the presidential debates that lie ahead.