

NC STATE ECONOMIST

COLLEGE OF AGRICULTURE & LIFE SCIENCES

2012 ECONOMIC OUTLOOK: A Recovery, but with Weak Legs

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The National Economy: Rebuilding from the “Wealth Recession”

As always, there is both good news and bad news in the economy. The good news is that the broadest measure of the economy – the production of all goods and services – has steadily grown since mid-2009 (Figure 1). Correspondingly, there have been almost 2.5 million jobs created in the nation since early 2010. As a result, the recession, which began in late 2007, has been officially designated as ending in mid-2009.

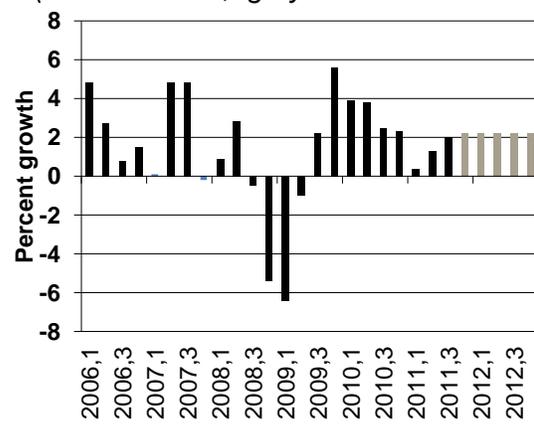
So why aren't we celebrating? It's because the rebound from the recession has been exceedingly slow. At the end of 2011, there were still 5 million fewer jobs in the nation than before the recession. The national unemployment rate was still above 8.5%, far higher than the pre-recessionary level of 5%. The annual growth rate in national production (real gross domestic product) has struggled to surpass 2%. In a “normal” economic recovery, growth would be twice this rate.

There's one major reason for these disappointing results. The 2007-2009 recession was a fundamentally different downturn than previous post-World War II recessions. Like its 1930s counterpart, it was a wealth driven, or more precisely – a “loss of wealth driven” – recession, resulting from the implosion of the residential housing market beginning in 2006. From 1997 to 2006, an asset boom occurred in the housing market,

taking average annual appreciation rates of homes from 3% to over 10%. The build-up of equity for homeowners sparked both a borrowing and spending spree.

The tightening of interest rates by the Federal Reserve brought the home-buying frenzy to an end and reduced appreciation rates – which was exactly the intent of the Federal Reserve. But as often happens when an asset bubble bursts – the retreat turned into a rout. Over the past four years, the unprecedented has happened – home values have *depreciated*. Collectively, homeowners have lost over \$7 trillion of wealth due to home price declines.

Figure 1. U.S. Real GDP Growth Rates
(black = actual; gray = author's forecasts)



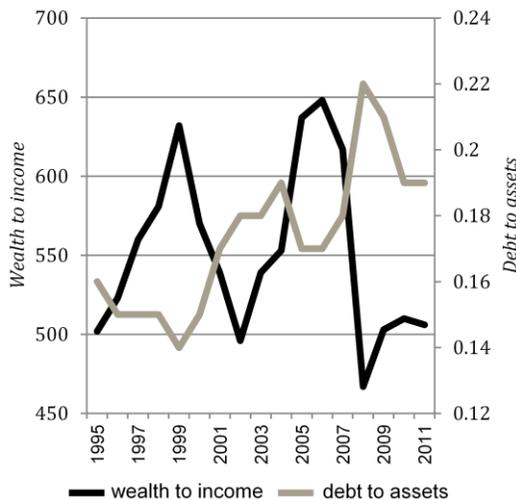
Source: U.S. Department of Commerce

The loss of real estate wealth was supplemented by a loss of financial wealth. As

a result, households have found their key financial ratios unbalanced. Wealth levels are too low and relative debt levels are too high (Figure 2). This situation has forced households to “deleverage” by curtailing spending, increasing saving, and reducing debt levels. Consumer spending (adjusted for inflation) has yet to return to pre-recessionary levels and is 12% under levels that would have been predicted by pre-recessionary trends.

It is thought by many economists that household deleveraging is the main force driving today’s economy. Until household financial ratios return to acceptable levels, the economy will be characterized by slow consumer spending, modest growth, and a relatively weak job market. At current rates, national employment won’t return to pre-recessionary levels until the end of 2013. While progress has been made in lowering the national unemployment rate, approximately half of the decline has been due to unemployed workers not actively looking for work and therefore not being counted as officially unemployed. Broader measures of the unemployment rate put it at near 15%.

Figure 2. Trends in Key Household Financial Ratios



Source: Board of Governors of the Federal Reserve

Along with the slow recovery have come two benefits – modest price inflation and low interest rates. Total, or “headline” inflation was volatile in 2011, rising when fuel prices rose or falling when those prices plunged. A more stable measure of price changes – the “core inflation rate” – shows it moving in the 1.5% to 2% range.

Both short and long-term interest rates were at multi-decadal low levels in 2011. Short-term interest rates, as measured by the 3-month Treasury bill rate, have been close to zero for three years. Long-term interest rates (10-year Treasury note rates) flirted with the 2% rate for much of the year. Forecasters see very little upward pressure on these rates as long as economic growth remains modest.

Do Old Policies Work with the New Recession?

Since 2008, traditional national macroeconomic policies have been used to address the recession. The Federal Reserve has lowered their key interest to near zero and has tripled the nation’s credit supply. Spanning the past two presidential administrations, the President and Congress working through the federal budget have added \$2 trillion of stimulus to the economy.

It is an open debate as to the degree to which these policies have worked. Critics say the economic numbers are not dramatically better, and the costs have been the threat of higher inflation (resulting from the credit expansion) and a significantly higher national debt (resulting from the additional borrowing needed to fund the additional spending). Supporters reply the economic condition – although not great now – would have been much worse without the monetary and fiscal actions.

There is a third view which says traditional policies haven’t worked as expected because such policies are only appropriate for “traditional” recessions. This viewpoint says

the 2007-2009 recession, like its 1929-1933 counterpart, was a “non-traditional” recession caused by a plunge in wealth and an accompanying drop in household and business confidence. In this situation, normal “demand side” income support programs and “supply side” credit availability tactics don’t work.

Following the writings of the early 20th century economist Irving Fisher, the third view says new policies are needed to restore wealth and confidence. This can be addressed by targeting the two components of wealth, assets and liabilities. Asset growth can be promoted by direct government purchase of assets or improving the ability of households to buy assets. Liabilities can be reduced either through legal debt forgiveness or increases in inflation. Inflation, by reducing the purchasing power of dollars, reduces the “real” value of debts.

Most of the new proposals for addressing the wealth recession have focused on the housing market. Proposals have been made for easing home-lending standards, forgiving mortgage debt, and government or Federal Reserve purchasing of home equity.

National Outlook

The year ahead looks to be a continuation of 2011 conditions. Household deleveraging will continue, meaning consumers will still be frugal in their spending and economic production will expand at modest rates. The national unemployment rate will fall by between one-half and three-quarters of a percent. Inflation will remain modest, interest rates will stay low, and businesses will be cautious in their expansion plans.

Home prices will likely decline more in 2012, although at a slower rate than in 2011. Inventories are simply too high to support price appreciation. Inventories of homes-for-sale will have to drop from their current level of 9-months supply to 6-months supply before

sufficient “tightness” in the market will support price increases.

As the U.S. economy becomes more intertwined with the international economy, economic events in foreign countries have important impacts on domestic trends. Two issues were prominent at the end of 2011. One was the direction of the Chinese economy. Chinese policy-makers have been balancing efforts to maintain strong growth against desires to curtail inflation. Higher levels of inflation have already reduced China’s cost advantage in some industries. Yet efforts to slow Chinese inflation may – in the short-run – exacerbate internal income inequality and political instability as well as contribute to slower worldwide economic growth.

The other international economic issue is Europe and problem of euro-zone stability in the wake of public financing problems in countries such as Greece, Italy, and Spain. This is important to the U.S. economy for two reasons. First, the euro-zone is the U.S.’s second largest trading partner, and sales of U.S. exports to foreign countries have been a strong contributor to domestic economic growth. Second, U.S. banks have some exposure to euro-zone debt, and therefore these banks would be harmed by any euro-zone default or investment value reduction.

A solution to the euro-zone debt and a credible path for future monetary and fiscal affairs in the euro-zone nations is important to the U.S. economy. If such a solution and path were found, then it will be a “plus” for U.S. economic growth in 2012. If not, then continued disarray and uncertainty in Europe will be a drag on U.S. economic growth.

The Paradox of North Carolina’s Recovery

Available data for 2009 and 2010 show economic production in North Carolina outperformed production in the nation. Gross domestic

product (GDP) – the broadest measure of economic output – fell in 2009, but it dropped 20% less in North Carolina than in the nation. GDP rose in 2010, and it jumped one-third more in North Carolina than in the U.S.

Yet the North Carolina job market has *underperformed* the national job market. From the bottom of the job market in February 2010 to the latest data for October 2011, employment in the U.S. increased 1.8%, but job growth in North Carolina was only 0.6%.

There are several potential explanations for this seeming paradox. One is that the job market always lags production performance, so North Carolina’s job growth has simply been delayed. However, this explanation would require the lag time between output and employment to be different in North Carolina than in the rest of the nation. Another answer might be that continuing downsizing in North Carolina’s traditional industries – tobacco, textiles, and furniture – have slowed the state’s job growth. However, while it is true that jobs in tobacco and textiles declined in 2011, these losses have been relatively modest.

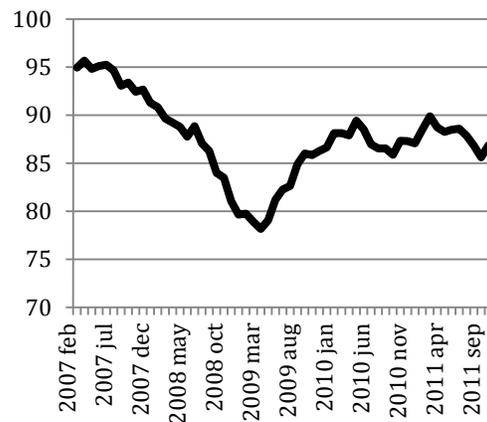
Perhaps one of the most compelling explanations is related to the flexibility in hiring by the state’s employers. North Carolina is a “right-to-work” state, and additionally has the lowest unionization rate in the nation. Both of these characteristics allow employers to more easily change employment. During recessions – and often in the initial years of the recovery – employers are motivated to reduce labor costs by increasing the use of labor saving techniques and technologies. In states where employers have greater ability to make these changes, we might expect a greater rise in unemployment during challenging economic times. Indeed, of the nine states with unemployment rates above 10% at the end of 2011, five were right-to-work states. The other four were Michigan and Illinois, where unemployment has been significantly impacted by downsizing in the auto industry, and California and Nevada, which have been

two states most adversely affected by the decline in the residential real estate market.

Other broad measures of the state economy follow the pattern of “improvement, but not yet back to pre-recessionary levels”. Inflation-adjusted retail sales in 2011 exceeded sales in 2010 but were still below 2007 levels. The same was the case for existing home sales. Also important was the fact that – as in the nation – prices of single-family dwellings dropped 5% in the state in 2011. But on an upbeat note, by the end of 2011 state tax revenues were running ahead of expectations and had returned to 2007 levels.

The NCSU Index of North Carolina Leading Economic Indicators suggests continued modest growth in the state for 2012 (Figure 3). Among the state’s metropolitan areas, job growth has been strongest in the Triangle and Triad regions in since early 2010. Areas in the east have either lost employment (Wilmington, Jacksonville, Goldsboro) or had very modest gains (Rocky Mount). This pattern is expected to be repeated in 2012, but with the addition of Charlotte as a faster-growing area. The economic divides between urban and rural and large and small will continue in North Carolina well after the recession.

Figure 3. NCSU Index of North Carolina Leading Economic Indicators



Source: Calculations by Dr. Michael Walden

Reference

Walden, Michael. 2011. "NCSU Index of North Carolina Leading Economic Indicators," Vol. 2, no. 12. www.ag-econ.ncsu.edu/faculty/walden/index/december2011.pdf