Uncertain Economic Outlook

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Remarks Today

✓ Gene Nelson told me I had 50 minutes to summarize today’s uncertain economic outlook.

✓ I am sure there have been periods of greater uncertainty in the economy. 9/11 may have been one. Black Monday in October 1987 and Black Tuesday in October in 1929 also come to mind.

✓ Uncertainty today is much different. What are the effects of ObamaCare rules being formulated? Will effective tax rates rise in 2011? Is more or less deficit spending needed? Is current high unemployment cyclical or structural? Will QE2 help or hurt over the longer run? These are just some of the issues leading to uncertainty facing consumers, businesses and lenders.
Signs of the Times...
If the NBER is correct that the recession started in December 2007 and ended in June 2009, the recession lasted **18 months**.

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If we ignore the Great Depression which lasted 43 months, you have to go back to **1913-1914** to find a recession that lasted longer than the 2007-2009 recession.

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It is over one year since the recession ended and the economy has yet attained the level of real GDP prior to the recession. This makes this recession unique compared previous recessions over the last 60 years.
Industrial production bounced back...

The Industrial production index also reflects the beginning and end of the recent recession. More than a year has passed and we have yet to return to pre-recession production levels.
Capacity utilization is expanding...

The capacity utilization rate has increased since the end of the recession but well below pre-recession levels. This helps explain in part the lack of interest in capital expansion despite low interest rates.
The Recession is Over?

✓ The “great recession” is over. The National Bureau of Economic Research said so, right?

✓ Tell that to small businesses.

✓ Tell that to unemployed workers.

✓ Tell that to consumers who are saving and paying down debt rather than buying.

✓ Maybe a better question: “Is another recession eminent like we saw in 1981-82 after coming out of the 1980 recession?”
How Did We Come Out of Recent Recessions?

1. Aggregate measures of economic activity
Real GDP growth rate this time is anemic...

The rate of growth slowed in the second quarter as consumers and businesses have retrenched in an uncertain environment. The “advance” number for the 3rd quarter is 2% but likely will be lowered.
Real net exports have fallen in recent months...

Real net exports have fallen thus far this year despite a weak dollar. The global economy has slowed this year. Early growth in Japan and Germany has waned. China and other big developing nations are still growing, but at single rather than double digit rates.
Unemployment rate stuck at 9+ percent level...

Last year at this time, we were at 10.2 percent; today we are at 9.6 percent. The tremendous economic stimulus has thus far not made a significant dent in unemployment, causing many to refer to the current recovery as “jobless”.
Rate of inflation remains low for now...

The rate of inflation is also much lower than the previous two recessions. While some worry about inflation in the longer run given the amount of stimulus, others express concern about deflation.
Aggregate observations

1. The longest recession is seven decades has been declared over.

2. The recovery is fragile. The economy grew 1.7% in the 2nd quarter after a relatively strong first quarter. The advance number for the 3rd quarter of 2% will likely be adjusted down given weaker September data.

3. Real disposable income is stagnant. Real employee per hour compensation fell in the 3rd quarter.

4. Unemployment remains fixed at 9.6% compared to 5% at the start of the recession, implying a cyclical unemployment rate of 4.6%. The effective unemployment rate is thought to be in the range of 17-18%.
Aggregate observations

5. The core rate of inflation is approximately 1%. Food prices and energy prices are up (commodity prices like corn are up and West Texas Crude topped $85 earlier this week).

6. Businesses are lean. Paring costs has helped boost profits in 2010. Profits also reflect gains in productivity posted in the 3rd quarter. This weakens the need, however, to expand employment numbers.

7. Home sales are near record lows which has dramatically affected the construction sector.

8. The Labor Department announced with much fanfare that payroll numbers increased by 151,000 jobs in October, but that the unemployment remained at 9.6%. 
9. While this is the first increase in 5 months, this hardly makes a debt in the 14.6 million unemployed, which includes the 8 million who lost jobs in the last recession. A significant portion of the new hires were added by retailers who are gearing up for the holiday season.

10. Another factor not captures is underemployment – a college graduate flipping hamburgers. This is said to represent 8.6 million people currently on payrolls.

11. Finally, 2.6 million workers are discouraged from looking further and thus not counted as unemployed.

12. The bottom line is that unemployment is a serious problem that is not going to be fixed overnight.
How Did We Come Out of Recent Recessions?

1. Aggregate measures of economic activity
2. Consumer activity
Real disposable income growth stagnant...

Real disposable personal income rebounded much more sharply coming out of the last two significant recessions than the 2007-09 recession.
Real personal consumer expenditures growth?

The annual rate of change in consumer spending is back in the positive range but this improvement is relatively weak compared to recent significant recessions.
Consumer sentiment remains weak...

Consumers are more uncertain about the current recovery of the economy and their economic well-being than they were coming out of the 1981-82 recession.
The personal savings rate typically jumps during recessions as consumer concerns over job security and financial stability lead them to save more and pay down debt.
Consumer debt is high but declining...

Consumer credit has grown sharply since the 1981-82 recession. The 2007-09 recession however saw the savings rate increase and consumer credit use decline – a combination of consumers paying down debt and lenders being more conservative.
Home mortgage debt fell sharply...

The percentage change in home mortgage debt outstanding reflects the sharp decline in residential investment. Unlike the last two significant recessions, we see no growth in mortgage debt after the 2007-09 recession.
Household debt coverage thus is improving...

Household debt service coverage has improved markedly, a good sign. But consumer debt in particular still remains high relative to the last significant recession.
Consumer perspective

1. Bloomberg October national poll results:
   - 45% have cut household expenses, using coupons more and changing where they shop.
   - 54% have put off major purchases (e.g., car)
   - 85% have taken steps to cut costs
   - More than 50% are worried about the longer run, are pessimistic about retirement years and are worried about the next generation’s economic outlook.

2. At the end of June, 23% of mortgage borrowers were underwater. Homeowners in general have experienced a disappearance of wealth on their balance sheets. Additional foreclosed properties coming on the market will further affect existing home values.
Consumer perspective

3. Unemployment benefits are due to expire for 2 million people and the Bush tax cuts for upper income taxpayers are expected to expire in 2011.

4. Credit card balances dropped $8.3 billion in September. Card delinquencies are down as well. The amount of bad credit card loans written off as uncollectible also fell according to Moody’s data.

5. Though consumers are de-leveraging, consumer debt remains 6 times higher than it was in the last major recession and overhangs a rebound in consumer spending, which is roughly 70 percent of GDP.
6. The bottom line is consumers are doing with less; last year saw the steepest drop in spending on record. They are conserving cash and postponing major expenditures. A lack of confidence is tied to the weak job market, expected weak economic recovery, large budget deficits and concerns about the cost and availability of health care.
How Did We Come Out of Recent Recessions?

1. Aggregate measures of economic activity
2. Consumer activity
3. Business activity
Recovering?

An index below 50 represents contraction in business activity. This index showed expansion in early 2010 for the first time since June 2007 but has fallen to 55-56 in recent months. Does not reflect bounce seen in 1981-82.
Real final sales growth rebounding slowly...

The rebound in final sales - found by subtracting increases in inventories from GDP - coming out of the most recent recession is considerably weaker than the previous two significant recessions.
Much growth in GDP related to replenishing inventories

The real change in business inventories bounced back sharply coming out of the recent recession as firms replenished their inventories. This contributed to the high GDP growth in the 1st quarter.
New orders have slumped in recent months

New orders for consumer and capital goods has declined after a strong showing in the 1st quarter. Orders for capital goods fell further in September, signaling a slowdown in business investment.
After-tax profit growth tapering off...

After-tax profit bounced back strongly in the 1st quarter of this year. While the growth rate over one year earlier tapered off in the 2nd quarter, after-tax corporate profits were still up 39% over last year.
1. Signals of non-farm business sectors backing down from gains earlier this year can be seen in several key areas:
   - Capital goods orders for equipment meant to last at least 3 years decreased in September, signaling investment cooling off despite low interest rates.
   - Sales of new houses hovering at a pace that is the lowest since records began in 1963 has implications for construction sector.
   - The BEA reports businesses are holding almost $1.6 trillion in cash reserves rather than expanding. Capacity utilization is low, productivity is up, costs are down, but sales outlook is uncertain.

2. The Index of Small Business Optimism is in the recession territory; NBER says the recession is over, but small business owners see little evidence of it.
Small business survey results on outlook for next 6 months...

✓ Plans are to further reduce their workforce.
✓ Plans to make capital expenditures is one point above the 35 year low. More owners expect the recovery to weaken rather than strengthen.
✓ Say their sales are up from the recession trough, but future sales outlook is too low to suggest a meaningful recovery by small businesses.
✓ Hiring and capital spending depend on expectations for growth in future sales, so the perceived outlook for improved spending and hiring by small businesses is not good.
How Did We Come Out of Recent Recessions?

1. Aggregate measures of economic activity
2. Consumer activity
3. Business activity
4. Lending activity
Prime interest rates much lower vs. previous recessions...

The resulting low prime rate has not led to increased consumer or business borrowing. This is a function of tighter credit conditions, existing consumer indebtedness, and a weak jobless recovery - all a byproduct of uncertainty.
Mortgage interest rates also much lower...

Loan mortgage interest rates alone have not led to a rebound in the housing market.
Excess reserves have increased sharply...

The level of excess reserves in depository institutions jumped during the recession as the Fed bought private securities from such firms as AIG, which added to bank reserves. Continued high level of excess reserves suggest banks desire to forego lending until conditions improve or the demand for credit is weak.
Bank lending to businesses has fallen off sharply...

Commercial bank lending to businesses continues to shrink. Recent months have been 10-20 percent below one year earlier.
Bank loans and leases outstanding fell sharply... 

Bank loans and leases outstanding fell percentage wise more in the 2007-2009 recession than seen in previous recessions over the post WW-II period. Recent months show near zero growth over the previous year.
Bank Perspective

✓ 279 banks have collapsed since Washington Mutual failed in 2008.
✓ Some banks may not be able to exit the bailout.
✓ Banks in general, however, are flush with cash.
✓ Banks are toning down risk taking after the experience of the recent financial crisis.
✓ Fannie Mae and others are pressing banks to buy back mortgages found to be based on inaccurate data.
✓ Banks have been increasing profits by lowering loan loss reserves, which can be released when no longer needed. Shows how banks have pulled back on loans to riskier borrowers. Banks reported their best profit in 3 years in the 2nd quarter.
How Did We Come Out of Recent Recessions?

1. Aggregate measures of economic activity
2. Consumer activity
3. Business activity
4. Lending activity
5. **Policy related activity**
Federal funds rates effectively zero...

Unlike the last two recessions, the Fed’s short term target interest rate is about as low as it can go. Thus, a major Fed policy tool used effectively coming out of the last two significant recessions is off the table.
Other Federal Reserve Options

US Treasury unveils the latest currency redesign

Monoopoly banknotes with different values (1, 5, 10, 50, 100, 200) overlapping each other.
Monetary base in recent recessions...

The monetary base or base money represents the floor upon which the money supply is created. This base has grown markedly as the result of the Federal Reserve buying securities under its quantitative easing activities during the recession (QE1).
Quantitative Easing 2

✓ The Fed announced its intentions this week to restart its quantitative easing (QE2) by buying up to $600 billion in government securities through June 2011. Purchases will focus on medium term securities with most less than 10 year maturities.

✓ Why? The unstated goal is to lower rates and thus:
  ✓ (1) encourage banks to lend the near-trillion dollars held in excess reserves,
  ✓ (2) encourage consumers to borrow and spend, and
  ✓ (3) encourage businesses to invest more and hire additional workers.

✓ In other words, avoid the liquidity trap where banks don’t lend, consumers don’t spend and firms don’t invest.
Quantitative Easing 2

This plan it not without its critics.

Some feel the Fed is holding back the recovery by giving Congress an excuse to avoid critical tax and spending decisions.

Some point to the fact that the economy is recovering and the lagged effect of QE2 will be inflationary (i.e., Friedman’s overshooting analogy of the fool in the shower not recognizing the lagged adjustment effect).

Some say QE2 will not lower the unemployment rate significantly (maybe a point) since fiscal policy remains uncertain and some unemployment is structural.

Given expected gridlock on fiscal policy, however, the Fed probably sees itself as the only game in town.
Quantitative Easing 2

✓ Risk to the Federal Reserve’s portfolio if interest rates rise – and prices on existing bonds fall.

✓ Other developed economies are addressing problems differently. The UK and EU are slashing government spending while emerging nations are raising rates to combat inflation. The hope in the UK and EU is that they will reduce uncertainty about future taxes. Our approach – QE2 - will cheapen the dollar, which helps US exports and lowers imports, but comes with some risks.

✓ QE2 is a full “U turn” from earlier this year when the Fed raised the discount rate. This underscores the problems associated with the pretense of knowledge on future economic events.
Turning to fiscal policy...

✓ A billion seconds ago, it was 1959.
✓ A billion minutes ago, Jesus was alive.
✓ A billion hours ago, your ancestors were living in the Stone Age.
✓ A billion dollars ago was only 8 hours and 20 minutes at the rate Washington spends money.
Federal deficits relied on more heavily this time...

The federal government assisted in the recovery from the 2007-09 recession by increasing government spending over and above tax revenues. While successful early, deficit spending has become a political lightening rod as evidenced by the national elections this week.
There are three groups of buyers in the US economy; consumers buying goods and services, businesses buying capital goods and governments (federal, state and local). Aggregate demand also includes exports, but that is offset by imports.

If consumers and businesses are not spending and state and local government cannot deficit finance, that leaves only spending by the federal government.

This suggests to some that the federal government should continue to deficit finance the purchase of goods and services and put more people to work until such time that consumers and businesses return to the table.
Fiscal Policy Debate

✓ Rather direct spending on entitlements, however, some argue that government’s focus should be on purchases of goods and services that improve infrastructure and productivity in the longer run while getting consumers and businesses to spend now.

✓ Greenspan last week said using government spending to make up for a lack of consumer and business spending is a risky strategy and that financial markets may not allow it in the longer run.

✓ The upcoming restructuring of Congress may not allow it either. Fiscal policy gridlock may lead to little or nothing being done to address our economic problems.
Fiscal Policy Debate

✓ The bottom line is that aggregate demand must expand in order to enhance the current weak recovery.

✓ Cutting government spending and lowering the tax burden on consumers and businesses can aid in the economic recovery process.

✓ The Deficit Commission headed by Paul Volker is scheduled to release its report on December 1st. This may contain a number of areas in which tax policy and spending programs can enhance the recovery.

✓ I expect however that very little will be accomplished in the next two years other than getting politicians more “face time” on television.
Global Economic Conditions
Times have been tight elsewhere...

✓ We have experienced the most **broad based global recession** since 1948.

✓ IMF projects the global economy will experience a gradual recovery **in 2011**.

✓ China’s and India’s economies remain relatively robust, but they have slowed to **single digit growth rates** as client nations have experienced negative or slow growth.
Global GDP Growth

The IMF forecasts a weak economic recovery globally in 2011 in the global economy, with the emerging economies expanding faster than the developed economies of the US, EU and Japan.

Source: World Economic Outlook, International Monetary Fund, October 2010.
The IMF foresees single digit growth in the Chinese and Indian economies (left hand graph) as well as slower growth rates in Brazil and Latin America (right hand graph).
Household Financials

Source: World Economic Outlook, International Monetary Fund, October 2010.

The IMF furthermore forecasts some reduction in the savings in the US and EU in 2011-12 (right hand graph), presumably reflecting an increase in consumer spending.
Uncertainties Going Forward
Light at the end of the tunnel?
Summary of Uncertainties

✓ Will QE2 lead to increased lending by banks and greater spending by consumers and businesses? The stock market has responded favorably. Will they?

✓ Will anything meaningful likely develop on the fiscal policy front in the next two years?

✓ How will other nations respond to our monetary and fiscal policy actions?

✓ Can we avoid calls for protectionism?

✓ When will the housing market turn around and the losses in household wealth taper off?

✓ Is there a chance for another recession in 2011-12?
Summary of Uncertainties

✓ Will slow growth, high deficits and high unemployment become the norm for the foreseeable future?

✓ Can new technology breakthroughs such as the information technology revolution which spurred economic activity the last several decades lead to nirvana again?

✓ My guess at the moment is that monetary policy in the form of QE2 will have a relatively minor effect and comes with some risks. A compromise on an extension of the Bush tax cuts and other incentives in the new Congress would be viewed favorably by consumers and business. Clearly something is needed on the fiscal policy front to get final sales up and lower cyclical unemployment.
A major problem today is uncertainty. The lack of transparency in monetary and fiscal policy contributes to this. Uncertainty leads to liquidity hoarding of the likes we see being practiced today by consumers, corporations and banks.

What is needed are rules, transparent rules that are adhered to, which allow the private sector to know where Washington is going. The Taylor rule (interest rates should be 1.5 times inflation rate) and Gramm-Rudman (increases in spending are offset by cuts elsewhere) are examples of such rules.

The problem today is not liquidity, but rather a lack of confidence and transparency in policy applications.
Uncertain where we are headed?
You are not alone...

“A very powerful and durable rally is in the works. But it may need another couple of days to lift off. Hold the fort and keep the faith!”
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“A very powerful and durable rally is in the works. But it may need another couple of days to lift off. Hold the fort and keep the faith!”


At the time of his prediction, the Dow Jones Industrial average was at 12,300. By late that December it had fallen to 8,500.
You are not alone...

“I think this is a case where Freddie Mac and Fannie Mae are fundamentally sound. They are not in danger of going under. They are in good shape going forward”.

You are not alone...

“I think this is a case where Freddie Mac and Fannie Mae are fundamentally sound. They are not in danger of going under. They are in good shape going forward”.

Barney Frank, House Financial Services Committee Chairman, July 14, 2008.
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Barney Frank, House Financial Services Committee Chairman, July 14, 2008.

Two months later, the government forced the mortgage giants into conservatorship and pledged to invest up to $100 billion in each.
I constantly remind myself of the 50-50-90 rule when speaking about the economy....
I constantly remind myself of the 50-50-90 rule when speaking about the economy.... **whenever there is a 50-50 chance I am right, there is a 90 percent chance I am wrong.**
Thank you for your attention