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Recession RX

By James P. Gaines

The current economic downturn is in its 23rd month and, so far, no one can say for sure when it will end. Some experts predict the recession will end sometime during this quarter; others say it will last into 2010.

Two points of general consensus have emerged: this downturn is the deepest and hardest hitting the country has experienced since the Great Depression, and recovery will be slow and uneven.

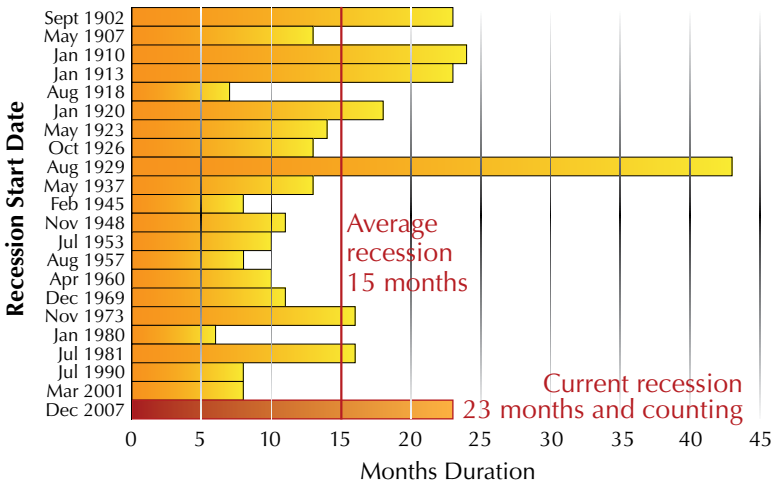
The average duration of the 21 identified recessions since 1900 is 15 months (13 months if the Great Depression is not included). The current recession already exceeds the average and has lasted longer than any downturn since the Great Depression. It may become the second longest-lasting down cycle since 1900 (Figure 1).

What makes this cyclical downturn noteworthy is the severity with which it hit the financial and housing markets. The nation has gone through previous bouts of substantial job losses and economic retrenchment, but the effects of this "Modern-Day Depression," as some have termed it, have been exceptional.

Six major economic themes underscore the seriousness of this environment: credit contraction, price/asset deflation, household wealth devastation, business profit elimination, employment reduction, and, perhaps most important of all, federal government intrusion.

The U.S. economy functions through the use of borrowed capital (credit). In fall 2008, the banking/financial system came to a virtual halt and threatened to crumble altogether. Banks and other lenders stopped making loans as their reserves disappeared from losses on previous loans and investments. Even with the federal funds rate effectively at zero, banks were

Figure 1. Length of U.S. Recessions 1900 to Present

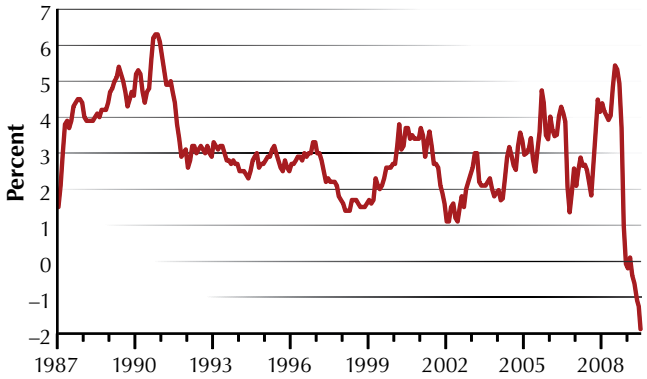


Source: National Bureau of Economic Research

not lending to each other, much less for short-term corporate needs, commercial paper, capital project financing, home loans, commercial real estate loans or business acquisitions.

Consumer credit fell. People stopped buying and started saving to pay off debt to keep debt service payments in line with their incomes — a process known as deleveraging. Consequently, demand shrank for all manner of goods and services, resulting in price declines not only for consumer products but also for housing and investment assets. The overall Consumer Price Index (CPI) most recent value was a *negative* 2 percent, year-over-year (Figure 2). Falling energy prices and home values were the two major contributors to the negative CPI.

Figure 2. Overall Inflation Rate



Source: Bureau of Labor Statistics
Yr/Yr Rate of Change in the SA Monthly Index, U.S. Urban, All Items

The loss in value of homes and financial assets (retirement and savings accounts, 401k accounts and bonds, for example) caused U.S. households' net worth to plunge approximately 17 percent in 2008 from 2007. The most recent data from the Federal Reserve indicate that through first quarter 2009, U.S. households have lost a total of $12.2 trillion (19.5 percent) in net worth since 2007 through a combination of lost real estate value (–$2.57 trillion) and lost value in financial assets (–$9.5 trillion) (Figure 3).

Excesses in home financing led the nation into recession, so it is not surprising that the housing market has been severely impacted. Total U.S. household equity value in real estate (primarily homes) fell $2.1 trillion or nearly 21 percent from 2007 to 2008, and by first quarter 2009 had dropped more than $5 trillion or 41 percent since its 2005 peak (Figure 4).

The effects of the current cycle on the housing industry are well documented. The sales volume of existing and new homes fell 33 percent and 75 percent, respectively. New home construction declined almost 75 percent from its recent peak.

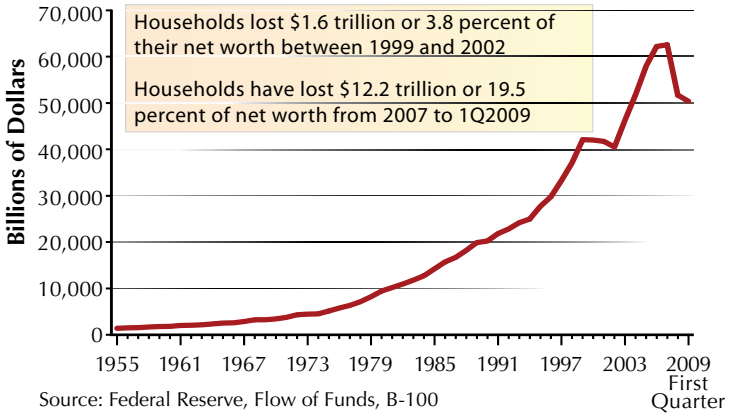
As equity in American homes fell, so did profits of American companies. Since peaking in third quarter 2006, corporate earnings dropped 17.5 percent through first quarter 2009 (Figure 5). Substantial corporate profit declines forced businesses to reduce costs through job layoffs, retrenchment and reduced capital spending.

If capital and credit are the lifeblood of economic activity, employment provides the backbone. One of the most notorious outcomes of this recession has been the precipitous loss of jobs.

Since January 2008, job losses total nearly 5.9 million, or 4.3 percent of total jobs. This is the highest total number of jobs lost since the Great Depression. The percentage of total lost jobs is the highest since the 1948 recession (5.2 percent lost) but still a far cry from the 10.1 percent loss in the November 1943 recession. The effective "underemployment" of an estimated 10 percent or more of those employed exacerbates the unemployment issue (Figure 6).

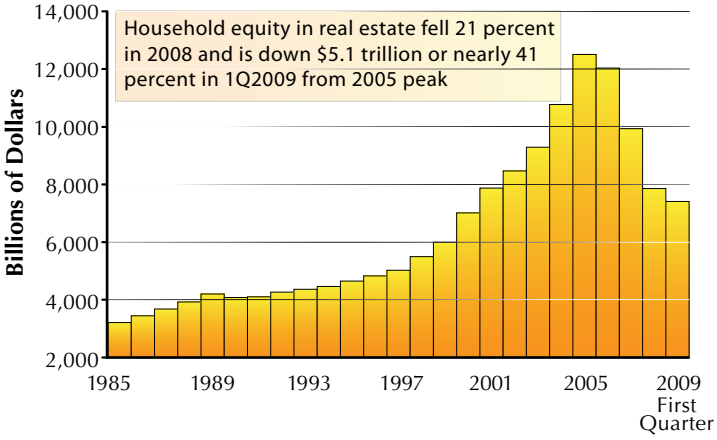
The most obvious, and perhaps most far-reaching, result of this economic decline is the increased involvement of the federal government in traditionally private economic affairs. The federal government now has substantial ownership positions in several of the nation's largest banks; it has completely taken over Fannie Mae and Freddie Mac; and it will hold majority ownership of General Motors when it emerges from bankruptcy. In addition, the government is poised to severely regulate or oversee private investment companies and Wall Street brokerage operations and to initiate a universal health-care insurance program.

Figure 3. Households' Net Worth



Source: Federal Reserve, Flow of Funds, B-100

Figure 4. Household Equity in Real Estate



Source: Federal Reserve, Flow of Funds, B-100 (Billions of Dollars)

How Will the Recession Turn Around?

What needs to happen to end this slump? It will take a reversal of most, if not all, of several interrelated economic forces to engineer a substantive recovery.

Businesses Must Make Profits

The U.S. economy relies primarily on two groups for sustained growth and prosperity: consumers, who spend money, and businesses, which employ people. If businesses do not make profits, they do not produce as much, do not build or occupy space, and do not hire people.

Indeed, without profits they do just the opposite: they let workers go and shrink their operations, which is what has been going on for the past 19 months. The effects on small and medium-sized companies are just as pronounced and equally important to the economy as they are for major corporations. Smaller businesses may not have the financial resources to withstand a prolonged slump, and the vast majority of people work for small- or medium-sized companies.

Figure 5. Corporate Profits

(Quarterly With Inventory Valuation and Capital Consumption Adjustment)

Source: Bureau of Economic Analysis

Consumers Have to Spend

Seventy percent of the U.S. gross domestic product consists of personal consumption expenditures. During the last "up" cycle, consumers spent more than their incomes, leading to a negative savings rate and a run-up in total debt. Household monthly debt service payments reached unsustainable levels. Now, consumers are spending less and saving more to try to get back into financial balance. Loss of confidence and significant job losses have caused consumer spending to drop dramatically.

People buying goods and services provide the impetus for companies to sell products and make profits. For people to spend freely, they need jobs (income), credit and confidence in economic conditions.

Financial, Credit Systems Must Operate Normally

Availability and cost of credit is key to business and personal spending as well as real estate. The shocks to the financial market from losses derived from bad lending practices during the boom created a credit freeze at almost every level. Banks stopped lending to other banks as well as to businesses, consumers and homebuyers as they attempted to absorb losses from bad lending decisions, to recapitalize and remain solvent.

For things to improve, consumers will need access to credit cards and other consumer debt (car loans, for example). Businesses (and especially the housing sector) will need access to substantial amounts of capital at attractive terms.

While the major financial institutions claim willingness to lend, recent survey results by the Federal Reserve reveal a significant falloff in demand for loans. Home sales, commercial real estate transactions, car sales, computer sales and sales of other similar products have fallen. Consequently, fewer new loans are being made.

Household Debt Service Must Revert to Norm

U.S. households borrowed too much money during the "easy credit" period from 2002 to 2007 and ended up with total monthly payments for mortgages, credit cards, auto loans and other debt that required an unsupportable amount of their disposable income to repay.

Historically, the economy runs smoothly if households' total debt service payments are approximately 10 to 11 percent of disposable personal income. During 2008, the household debt service ratio reached almost 15 percent, causing significant financial problems throughout the system. A large number of households fell so far behind that they lost possessions. Lenders foreclosed on their homes. Those who avoided the more catastrophic effects have cut back on spending and are trying to pay off loans.

Employment Must Stabilize, Then Grow

Turning job losses into job gains is fundamental to any economic recovery. Recent monthly data suggest the rate of job losses may be slowing, but the losses have not stopped altogether. It may be some time before any significant number of new jobs are created.

Some leading economists project the unemployment rate will continue to grow through the rest of 2009 and perhaps into early next year and could exceed 10 percent of the labor force. New job formations will be tied largely to corporate profitability. No substantial improvement will occur until new jobs are created at a rate faster than the growth in the labor force.

Home Prices Must Stabilize, Then Grow

For nearly two years, all of the reported measures and indexes indicated a fairly substantial decline of home values. The National Association of Realtors' median home price declined 1.8 percent in 2007, the first annual price decline ever recorded, and then fell nearly 15 percent in 2008. The U.S. median price is down almost another 15 percent so far in 2009. The fall in home values contributed greatly to the loss of total net worth among U.S. households.

The housing sector should be a major force in reversing the current downturn. The multiplier effect of new home construction as well as home purchases generally provides significant stimulation to the overall economy through improvements in employment, incomes and business profits in various affected industries.

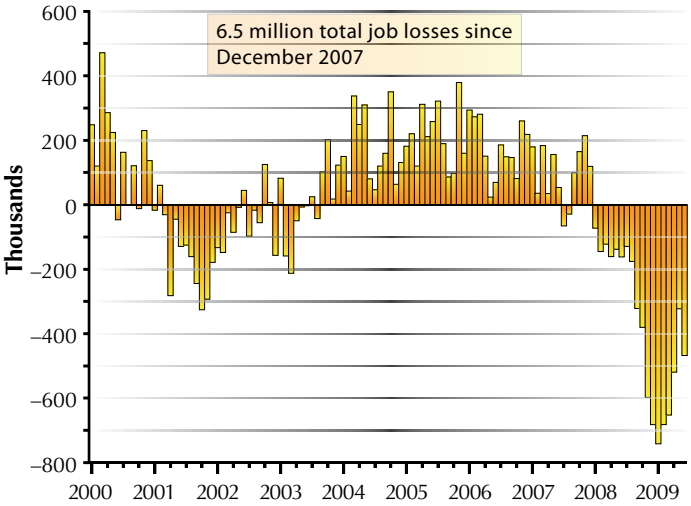
One positive effect of lower home prices has been the increase in housing affordability as prices become more aligned with household incomes. This increase in affordability, however, has been offset by the conservative lending and underwriting practices lenders have reverted to, which limit many households' ability to qualify to purchase a home.

Return of Investor Confidence

During the past cycle, many in the investment community and capital markets transformed from conservative, analytical, risk-based decision makers into bookies. They laid off their bets on risky investments (loans) by issuing collateralized debt obligations and then hedged their positions through credit default swaps or other financial derivatives. Unfortunately, the market failed to recognize and price the risks correctly and suffered significant losses, declines in earnings and net worth as a consequence.

Today, investors with capital have been reduced to speculators on government activity and the various stimulus programs. They must wait to see what the government does next, which companies or industries are backed and which are not, and how stimulus money is spent.

Figure 6. Change in Monthly Employment



Source: BLS, SAAR

Long and Short of It

The U.S. economy is basically a three-legged stool. The three legs are personal consumption (people buying things), corporate spending and government spending (all levels). Right now, two of the legs are broken.

For the first time in a long time, total personal consumption spending is down. The savings rate is at its highest level in more than 15 years. Similarly, corporate spending on everything from computers to new buildings and especially on new jobs is down and contributing little to nothing to the overall economy.

Only government, for the moment, is left to try and support the economy and get the other two legs stabilized. Hence, the various bailouts, financial-sector recovery plans, stimulus programs, tax breaks and unprecedented government spending at the federal level.

Some of the federal effort is being inhibited by severe cutbacks in state and local revenues and expenditures. Indeed, a significant portion of the federal stimulus package was directed to the states to help shore up local budgetary shortfalls. In the short run, government action is essential to regain balance and avoid a complete economic collapse. In the long run, if the government leg becomes disproportionate to the other two, the economy will be in perpetual imbalance.

This discussion has been long on what needs to occur and short on how to make it happen. The government's stimulus programs as well as the activities of the Treasury and the Federal Reserve are all aimed at one or more of these general outcomes.

Businesses, financial institutions, developers, builders, government at all levels and everyone else in the United States have a stake in the final outcome. For the time being, the economy is the ultimate "reality show." Stay tuned for further developments.

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THE TAKEAWAY

Interrelated economic forces will have to reverse directions for the U.S. economy to get past this slump. Consumers must begin to buy again but keep household debt service payments within their budgets. The financial and credit systems must return to sound lending practices that give businesses the capital they need to grow and be profitable.

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