

The Economy: How Bad is it Really?

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How bad is it really? Well, the future is not what it used to be, is the way I would say it. The National Bureau of Economic Research has a committee of PhD economists and they've taken upon themselves the task of deciding whether we're in a recession or not. The answer is yes; it's official. The recession began in January 2008. Now that's a little bit like going to your doctor with chills and a fever and a terrible headache. The doctor says, "You have the flu. It started two weeks ago at 11:00 o'clock." In other words, there's not a whole lot of news in the fact that this economy has been doing very poorly, but what we want to know is: what comes next?

We've got a big change in the way the economy has behaved over the last couple of months. I want to talk about what we think is going to come next. It's very hard to predict it. So, the statistician – which is part of my function – predicts what comes next by looking at episodes that are similar to the episodes that we're in today. There's a heck of a lot of information totally unlike anything that we've seen before which means that, in a way, we don't do forecasting. We do hunches and guesses and hopes more than ever before. So, I'm hoping for good things and I'll try to tell you why some good things might actually occur.

In terms of a slowdown there are three possible hypotheses here. One is that we're going to have a typical V-shape recession. You should put "V" into your head. At the first stroke of the V, you will lose a couple of million jobs, maybe more. That takes about three quarters. The second stroke of the V you get them all back. The same is true for equity dollars. So, your strategy, if you knew a recession was coming, was to sell out a couple of quarters before the recession begins and lose about 20 or 30 percent of value but on the second stroke of the V, you're going to get it right back. So, if history is any guide at all, that terrible decline that you all experienced in equities is going to find its way back rather rapidly as soon as we get clear evidence that the recession is over. So "V" for victory; "V" for the shape of this kind of episode as it has occurred historically.

Now, we thought this time it would be different. That instead of having the V-shaped downturn we would have what I call "serial adjustment" rather than parallel adjustment. The ordering of these recessions – these consumer recessions – is first you have problems with houses. Then a couple of quarters later, maybe less, you've got problems in durables, particularly automobiles. Then when the official recession is there, that's when businesses start cutting back big time on their spending on equipment and software.

The last things are long-life assets and structures; the long-life business assets. So, the ordering is: homes, cars, equipment and then structures. Coming out of the recession is the same kind of ordering. In a recession, all four of those items are getting socked; they're declining in terms of sales. But we thought this time, instead of having a parallel recession in which all four of those things were declining at the same time; we'd have a serial recession.

We'd first deal with housing. So housing peaked in December of 2005 and we went through a full two to two-and-a-half years of housing adjustment. Then along comes the auto sector. This was a very extended serial kind of adjustment rather than parallel. And, therefore, we were hopeful that instead of falling down we'd stumble forward throughout this year and not have the kind of typical V-shape recession. That didn't turn out to be the case but that was our prediction for a long period of time.

The Wall Street prediction is that this will be the deepest and longest downturn since the Great Depression as the banking sector, desperate to repair their troubled balance sheets, terminates business and consumer lending just as it terminated mortgage originations in 2007.

There are really two metaphors here for the relationship between the real economy and the financial economy – the relationship between Wall Street and Main Street. The real economy – Main Street – that's people getting up in the morning, going to work, building things, going to school, playing, real living – that's the real economy. One possibility is that the financial economy is only a shadow of that real economy. Sometimes a shadow is long and sometimes it's short. If you're a business owner selling the shadow, like Wall Street is, and that shadow starts to shrink you think, "Oh, my God, the real economy must be collapsing as well."

To give you an example: after the 2001 [recession] I read in the *L.A. Times* that \$7 trillion of wealth had been destroyed. So, I got in my car and drove to San Francisco, Denver, St. Louis and New Orleans because I wanted to find where fire and floods and earthquakes had occurred that destroyed all that wealth, and I couldn't find any of them. Then it occurred to me what they were really talking about was just numbers on hard drives. Just the numbers on hard drives changed, that's all.

So, unless those numbers that are on the hard drives materialize and affect your spending, the real economy is completely isolated from that "wealth effect." That's what we thought would happen this time as it happened in 2001, that we would all slowly realize that we were not as wealthy as we thought we were and slowly cut down spending, but not do it all at once. So, that's the recipe for a sluggish economy for at least a couple of years, maybe more, but not for a real downturn. Unfortunately, we had a huge coordinating mechanism that got consumers to cut back spending dramatically in September and October and November and now we're in the midst of a consumer-led recession.

And, by the way, the focus by both Washington D.C. and Wall Street on the financial side is in my mind misplaced. The real problem is on the consumer side. You have to maintain consumer spending in order to maintain opportunities for businesses to sell their products and therefore hire workers. If consumer spending collapses, we're going to have big problems. That was always our greatest concern and that's exactly what's materializing. Our leaders focused on the wrong thing. They focused on lending; they should have been focusing on the U.S. consumer.

The first crack in this troubled economy occurred in July. For Initial claims for unemployment insurance, the typical number – the weekly number – is 300,000 jobs; 300,000 Americans each week file for unemployment insurance. So if you read that Bank of America laid off 1,000 workers, that's got to be put in perspective because every week 300,000 Americans lose their jobs. That's kind of normal, and this statistic was elevated throughout the first half of 2008 to more like 350,000. So, it's a troubled economy but not the catastrophic trouble that's characteristic of real recessions. But then in July this figure elevates to 450,000 and in September it's up to 500,000 and in November it's up to 550,000.

So it just broke loose starting in July. Employers said, “We can’t have you working at this work place any longer. We have to lay you off.” And that decision to lay somebody off, that’s a forecast of substantial weakness ahead. It’s the material and evident clear statement that businesses are not expecting sales to continue to be very strong because they start to lay off those workers. That happened in July.

Now the story of payroll jobs is that the first half of the year was weak just like we expected. We were losing jobs at the annualized rate of about one percent month after month after month. But in September, October and November we just collapsed. The job market totally collapsed in those three months. So we need to begin to look around and try to figure out what it is that caused that incredible change in the economy. An economy that was stumbling forward all of a sudden just fell down and we produced some really weird data in the second half of 2008.

Before I go through the data that’s so weird I wanted to read you a little bit about what FDR said. FDR was elected in 1933 and became president on March 4, 1933. Within a week of his inauguration there were bank runs around the country. He had to close the banks; announced a bank holiday and he did one of his fireside addresses. This is the rhetoric that he used in that fireside address. It’s such a powerful statement.

“I do not promise you that every bank will be reopened or that individual losses will not be suffered, but there will be no losses that possibly could be avoided; and there would have been more and greater losses had we continued to drift....After all there is an element in the readjustment of our financial system more important than currency; more important than gold, and that is the confidence of the people. Confidence and courage are the essentials of success in carrying out our plan. You people must have faith; you must not be stampeded by rumors or guesses. Let us unite in banishing fear. We have provided the machinery to restore our financial system. It is up to you to support and make it work. It is your problem no less than it is mine. Together we cannot fail.”

Contrast that with the message that we got on September 24 from President Bush. “The government’s top economic experts warn that, without immediate action by Congress, America could slip into a financial panic and a distressing scenario would unfold.” He didn’t quite say it but he was thinking the Great Depression is right around the corner.

What was this year’s scariest Halloween outfit? It was Secretary Paulson. He got a \$700 billion treat by threatening us with the Great Depression trick. Bush, Paulson and Bernanke also said the same thing: “Unless you pass this cockamamie bill by Friday, we’re going to have this great depression.”

The original bill was, I thought, a joke, an Internet hoax. It was only three pages and – seriously, it was three pages – and what it said was that the secretary was going to buy mortgage-backed securities in any way he wants to. His decisions are not reviewable by any agency or any court of law. So, he was like suspending the Constitution. That’s why I thought it must have been a joke. But he put that in front of Congress, and you knew that it wasn’t going to fly.

From the very beginning the idea of buying mortgage backed securities never made any sense to me. The problem was insolvency. There were banks that were insolvent by virtue of their losses of mortgage-backed securities. The solution to an insolvency problem is transparency. Let the insolvent banks die, or the insolvent financial institutions die, and let the other ones have a capital

infusion to keep them healthy. So from the very beginning there should have been a capital infusion, which he turned around and did soon enough.

But in the meantime, he scared us all to death. So if you're thinking a great depression is going to be next year, you're going to sell your equities at any price just so you have some cash to put into your mattress. When everybody else is in the soup line, you'll be able to go into your mattress and pull out a couple of bucks so that you can still go to Starbucks for that latte.

The same thing is true for consumers. It's not just Wall Street that matters, it's also Main Street. It's the consumers that drive the economy and if consumers are told that the Great Depression is coming, they take defensive action, too. So rather than spending every dime that they earn, they take ten percent or more and put that in the mattress as well. That's what's killing the economy: it's fear. Fear and just total panic sets in around August and September. So now I've got a picture of the next one here. This shows you the decline in industrial production that the United States has experienced from its previous peak.

What it says is that this is nothing like the Great Depression, folks. In the Great Depression, industrial production fell by more than 55 percent, and as of August 08 we hardly saw a decline in industrial production. Moreover, those big swings in industrial production which were so important and so extreme in the first half century – those are a thing of the past. We're a totally different kind of economy than we were during that Great Depression, and we have a totally different kind of government and a completely different relationship between the financial system and Washington, D.C. So, there's no reason to frighten us about the Great Depression. I think it may be appropriate to say we have solvency problems because of losses on mortgage-backed securities and we need to do something that improves the health of the financial system, but we don't need to be frightened about the Great Depression.

So, here are some things that have happened: We have 44 percent year-over-year decline in the Dow. To get to a number like that you have to go back to 1937 and we're going to surpass that 1937 number pretty soon. We can easily get the biggest drop in equity values that we have ever experienced, except in the Great Depression when GDP was down by 25 percent; unemployment rate was up to 25 percent, industrial production was 55 percent. We're in a total panic mode because we're pricing in, through our equity decisions, something that is highly implausible.

We're not going to have that kind of outcome. It's not just the panic on Wall Street but more importantly the panic on Main Street. Housing starts – typically, you had about 80 workers for every new home that is built. But in August that fell to 173 – a catastrophic decline in September and October. It looked as though the L.A. market was repairing itself, starting with the sales volumes increasing again, particularly in the eastern part of the county. But that just came to a crashing halt because of this Paulsen panic.

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The same thing was true with autos where normally it takes about eight jobs per auto sale. That fell to 13 jobs in October. And, trust me, the auto sector has capacity to make 16; 17 million units per year, including potential imports – maybe more. And they're always selling at the rate of ten million. Every company in that business is going to have a troubled year and it doesn't matter whether you bail them out or not. There's a heck of a lot of hurt coming next year for the auto sector, particularly if we maintain such low levels of sales.

It wasn't just Main Street, it was Wall Street and the bond market. We had a rate on a three-month treasury of .01 percent – basically you were paying the government to hold your cash. You sold everything you had at whatever price, it didn't matter, and you put your money into the equivalent of a mattress which was three-month treasuries. And you were being charged for that. You know what the biggest consumer sales item was during this period of time? It was safes. People were actually taking cash and putting it in their homes – a huge increase in the demand for cash and demand for these very short-term treasuries.

There's a tremendous amount of liquidity out there waiting for something to do and Mr. Bernanke is going to keep interest rates low until you pull that money out of your mattress. If you're the last one to pull your money out of your mattress you are not going to get good prices on those equities. So now is the time to start thinking about investment opportunities rather than wait because logic suggests you're going to have very sharp returns as soon as the economy starts to improve.

In terms of ten-year treasuries, we've actually seen below three percent now; about 2.95. To get three percent, remember, you have to go way back to 1952-53 – really, an incredible sequence of things. Consumer prices fell off the radar – by 10.9 percent in October of 2008. You have to go back to the Great Depression to get a decline in consumer price index that is comparable to that. The crude oil price that fell by 60 percent year-over-year in November, we haven't experienced that, ever. What is that about when the crude oil price goes up to \$147 and then back down? That is so inconsistent with the historical record and it's a heck or a hard thing for economists to understand in terms of simple supply and demand models.

The other thing is that the return for risk taking just sky rocketed. The spread between the AAA and the three-month treasury – AAA is the best securities offered by corporate America – and that went up to 550 basis points in October, a number we have never seen before. The spread between the junk bond rate and the AAA rate – that went up to numbers that we have seen before in 1980 but once before that, and that was during the Great Depression.

Wall Street buyers of bonds and equities are pricing in the kind of economy that we haven't seen since the Great Depression and if you look around to see where the problem is – we have a weakness in the auto sector, that's for sure – but the trouble sectors, if you hire me to be president I'm going to worry about these two trouble sectors: retail and restaurants, in addition to temporary workers. That's where we need to help; that's where the big layoffs are occurring. These are poor people. These are entry-level jobs; relatively low-paying jobs; temporary type jobs. These are the people who get really hurt during these downturns. That's where the focus ought to be rather than maintaining the salaries of General Motors management. We should be focused on where the hurt really is.

So, let's understand that the problem has been with falling home prices. All these firms that went under – Countrywide, Fannie Mae, Freddie Mac, it's all because of home prices. If you hire Secretary Paulsen to buy mortgage-backed securities for you, he'd better have a forecast of future home prices, and delinquencies and defaults on those homes, because that's what's going to determine the values of those mortgage-backed securities. Home prices are fundamental. A year ago if you'd ask me to design a package that would make the economy healthier I would have said to focus on homes. That's where the problem is. Now, it's leaked over into the rest of the economy particularly, as I said before, retail. This looks like a heck of a bad holiday retail season, and restaurants are laying off workers like crazy. We need to get people back shopping again and back in restaurants.

We've really seen a lot of movement in home prices. There's been a dramatic drop in prices in Los Angeles, and in Detroit, prices are well below their historical trend. There's still some movement being made in Miami – Miami Beach. But prices are starting to get to the point where buyers are becoming willing to get back into the marketplace, particularly here in Los Angeles. One other thing you need to know is that the U.S. economy experiences recessions but it also experiences structural adjustments. One structural adjustment is the transition from a war time to a peace time economy.

We had one of those in 1953 when the Korean Armistice was signed in July of 1953. DOD spending, which had gone up to 14 percent of GDP fell virtually overnight to 8 percent. There was no way the economy could absorb that tremendous reduction in spending by the DOD so we had a recession, not only in unemployment but in weak economic growth. The other structural adjustment was this 2001 Internet comeuppance. Structural adjustment just means you don't get to be – you don't return to – where you were. After the downturn you're in a different kind of economy. So, in 1998-99 businesses thought the Internet was a profit-maker and invested heavily in information technology, equipment and personnel, and they were totally disappointed in terms of profitability in that sector. The result is they dropped spending on equipment and software dramatically and we had a structural adjustment at that time. That spending didn't come back when the recession was over.

We're probably in the midst of a structural adjustment today. The Bush administration, whose economic policies I liked to a large extent, tried to create an ownership society. They thought they were creating an ownership society, but what they created was a consumption society; a consumption-loving, debt-depending, foreign-depending society. So, we talk about consumption being two-thirds of the economy but it really went up to 72 percent. So when that happened it went up to 6 percent, where did that money come from? The answer is we borrowed from foreigners. So we have to make a structural adjustment in which we start to pay for our imports from China and other places of exports. We have to do that by drawing down the amount of spending that consumers do.

This is a little bit like driving a car – when you have to make an adjustment you make a lane change smoothly and everything is great. But you make an adjustment all-of-a-sudden and try to yank that steering wheel you're going to roll the car over. That's where we are now. Consumers suddenly said, "Oh, my God. I have this future I have to worry about and I'm going to have to do some saving." That happened on September 2, 2008 and we're still in that same mode. That's good for the long run but it's really bad for the short run. So what we need now are subtle policy changes that encourage people to spend now but keep their eye on the long-term goal which is more savings and more concern about retirement issues going forward.

So, here are some of our long-term forecasts: We're still in an extended serial adjustment and a very severe one. The housing adjustment is the largest but we're in the situation where we're in a world of hurt for a couple more quarters with very substantial negative GDP numbers. The unemployment rates are going to elevate. But after the slowdown it's not going to be V-shaped phenomena. It's going to be, "the future isn't what it used to be," because we have to adjust to the fact that we were a debt-driven, consumer-spending driven economy and that's going to be behind us for the foreseeable future. So, what should investors do now? You've got to think "V." You have to walk out of here with a V printed clear across your head because that's what typically happens.

Now, there are offsetting forces on equity valuations. One is weaker profits and more distressed debt particularly over the next year. By the middle of next year we're not going to continue to lay off workers or have negative GDP growth. We won't have a strong economy at that time; we won't have a difficult second stroke of the V, but you won't have the terrible catastrophic numbers that we've had starting in September. That means weaker profits, more distress debts throughout all of 2009, probably lingering into 2010. So that's the reason for low valuations and high corporate debt. In addition, you can expect more volatility; the economy is acting in this very peculiar and volatile way.

So those are the reasons for low valuations but the fundament reasons for these very high valuations is still with us which is a crumbling low rates of interest. That's again my reference to your mattress where you have all that money trying to decide what to do with it? When do you get back to the market? You get a negative real rate of return on that because your zero return will be eaten by inflation. Mr. Bernanke is going to continue to punish you and your mattress until you get that money out of there. We are stuck with low rates in the short run. In the long run, investors faced with that reality will bid up assets again including equities. So that makes us more optimistic going forward.

Thank you.

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