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2009 Economic Outlook: Containing the Damage

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The National Economy: The Recession Arrives

Review of 2008

On December 1, 2008, it became official – the U.S. economy was in a recession and had been in a recession for a year. The pronouncement was made by the National Bureau of Economic Research (NBER), a private research organization that is charged with dating the ups and downs in the economy. To many the announcement was not startling, because certainly what had been happening in the economy during 2008 "looked and felt" like a recession, if not worse.

The main indicators of a recession are found in the first three rows of Table 1. Real (inflation-adjusted) gross domestic product (GDP) is the broadest measure of economic activity and tracks the collective production of all firms. Although final 2008 numbers are not yet in, growth in real GDP is expected to be at best only slightly positive (as shown here) or actually negative for the year, and well below 2007's value. Employment growth will be unambiguously negative, which is also reflected in the jump in the unemployment rate. The conclusion: the economy experienced a broad-based decline in 2008 which, in the judgment of the NBER, qualified as a recession.

Other measures in Table 1 reflect 2008's recessionary conditions. Production from the nation's factories (industrial production) dropped; consumer income (real disposable personal income per capita) and real consumer spending also posted declines; and consumers significantly reduced their debt loads (household debt service ratio) – something that's rarely been seen in recent years – in response to the deteriorating economic conditions and uncertainty about the future.

As is now well known, the driving force behind the recession has been the contraction in the national residential housing market. Low interest rates, easily available loans, and the chance to earn tax-free capital gains made residential housing the premier investment in the early 2000s. Home construction boomed, homeownership rates soared, and perhaps most importantly, price appreciation for homes reached unprecedented double-digit annual rates. Fearing a speculative bubble, the Federal Reserve began increasing interest rates in 2004 and continued this policy through 2007. The goal was to gradually "deflate" the housing bubble and bring appreciation rates back to normal levels between 2% and 4% per year.

Unfortunately, the policy didn't work. High-risk buyers with adjustable rate mortgages began defaulting, and the retreat from the housing market turned into a rout. By 2008, average housing prices were actually *falling* – in some markets by double-digit rates. Lenders and investors who had bet on continuing rising home prices now found that those investments had turned toxic, and the ensuing plunge in the housing market began to pull down the entire financial system.

This situation set the stage for the government "bailout" of the financial system. Beginning in the spring of 2008, the U.S. Treasury Department and the Federal Reserve initiated a series of actions to stabilize banks and other financial institutions. These included low cost loans, purchase of non-performing loans, and outright purchase of equity in financial firms. The Federal Reserve also dramatically lowered its key short-term interest rates and at the end of 2008 began to substantially increase the nation's supply of money and credit. These actions were based on the belief that the financial system is crucial to the economic system – that without a functioning financial system, commerce and production would stall and unemployment would rise to unacceptable levels.

However, the size of the housing market collapse and the resultant losses in financial firms were large enough that a recession became inevitable. Therefore, the federal government's actions in 2008 were intended to contain the recession, not prevent it.

The imbalances in the residential housing market can be seen by two indicators in Table 1. "Housing prices" is the national average rate of appreciation for homes based on an analysis of repeat sales by the federal government. The measure posted a modest gain in 2007, but slid by 4% in 2008. Other indicators of changes in home prices, such as the so-called Case-Shiller index, show a reduction in home prices in both 2007 and 2008 and by larger amounts. The second indicator "housing excess supply" is the months of housing inventory available for sale. A normal level is six months. The levels for both 2007 and 2008 were well above this level.

Inflation and interest rates both took wild rides in 2008. Led by surging energy prices, the annualized inflation rate reached over 6% during some months early in the year. By year's end, however, collapsing energy prices pulled average price changes down to deflationary levels. Thus, the "total inflation rate" for the entire year is somewhat deceptive because it combines two entirely different performances during the year. Perhaps a more accurate view of price changes is provided by the "core inflation rate", which excludes changes in volatile energy and food prices. This measure showed a modest 2.2% gain over the year, similar to 2007's performance.

Interest rates on the benchmark Treasury securities edged lower in 2008. The reduction was much greater for short-term rates (T-bill) than for long-term rates (T-note), suggesting a market view that the reduction in loan demand, and the drop in inflation is temporary. Interestingly, interest rates on many private loans, such as mortgages, did not follow this path. Those rates rose in early 2008 as investor concerns about risks in the housing market mounted. But once the Federal Reserve announced the purchase of a large quantity of mortgages held by the secondary lenders Fannie Mae and Freddie Mac at the end of 2008, mortgage

Table 1. Key U.S. Economic Measures

	2007	2008	2009 (forecast)
Real U.S. Gross Domestic Product (% chg.)	+2.3%	+0.7%	-2.5%
Payroll Employment (% chg.)	+0.8%	-1.5%	-1.3%
Unemployment Rate (end of year)	5.0%	6.8%	8.0%
Industrial Production (% chg.)	+2.0%	-1.2%	-3.5%
Real Disposable Personal Income (% chg.)	+0.9%	-0.8%	-1.10%
Household Debt Service (chg in % pts)	-0.20	-3.50	-3.00
Real Consumer Spending (% chg.)	+2.2%	-0.2%	-1.5%
Housing Prices (% chg)	+0.8%	-4.0%	-4.0%
Housing Excess Supply (no.of months)	9.8	11.2	10.3
Consumer Price Index (% chg.)	+3.2%	+3.5%	+1.5%
Core Consumer Price Index (% chg.)	+2.3%	+2.2%	+1.8%
3-Month Treasury Bill Rate (chg in % pts)	-1.90	-3.10	no chg
10-Year Treasury Bill Rate (chg in % pts)	-0.50	-0.60	+0.10
30-year Fixed Rate (chg in % pts)	-0.12	-0.24	no chg
1-yearAdjustable Rate Mortgage (chg in % pts)	no chg	-0.25	no chg
S&P 500 Stock Index (% chg.)	+2.0%	-38.0%	+5.0%
Deficit to GDP Ratio (% chg.)	-1.7%	-3.5%	-6.0%

Sources: U.S. Dept. of Commerce, Federal Reserve System, Office of Federal Housing Enterprise Oversight, U.S. Census Bureau, author's forecasts. Values for 2008 are annualized rates based on the latest available data.

interest rates tumbled and will end the year slightly lower.

The final two indicators in Table 1 illustrate the problems evident in both the private and public sectors in 2008. Clearly the stock market had a horrendous year in 2008 – indeed, one of the worst in the post-World War II period. The market decline began in the fall of 2007, thereby preceding the beginning of the official recession, and continued throughout 2008 as the recession deepened. The rise in the federal (national) debt to GDP ratio in 2008 reflected the increase in borrowing by the federal government to fund the additional spending used to combat the recession.

Issues and 2009 Forecasts

The forecasts for 2009 in Table 1 are grim. The leading broad-based measures of economic growth – real U.S. GDP, payroll employment, and industrial production – all show expected declines over the year and the projected unemployment rate indicates a major jump in joblessness. Real disposable personal income per capita and real consumer spending also will retreat. On the positive side, households will continue to reduce their debt service ratios, inflation should be tame, and interest rates won't rise. The housing market should also hit bottom and begin the road to improvement, although the path will be long and uneven and recovery will certainly not be full. The brunt of the drop in the economy will occur in the first half of the year, with more moderate losses in the second half, or – if we're lucky – some modest growth.

Clearly the key issue for policymakers, including those at the Federal Reserve and in the new Obama administration, will be to contain the immediate economic damage from the recession. To this end, a new fiscal "stimulus" plan focused on infrastructure spending (roads, bridges, public buildings) will likely be passed early in 2009. An income tax cut for low and moderate income households could also be forthcoming. The total public cost of the package could be $500 to $750 billion.

At the same time, the Federal Reserve, in coordination with the Treasury Department, will continue to support the financial system through a combination of loan guarantees, equity purchases, and credit creation. The continued functioning of the financial system is considered essential to the performance of the wider economy. Without an operating financial system, the "lifeblood" of the economy– money and credit – would stop flowing.

It is important to realize these government actions are not without cost. The new stimulus package and potential tax cuts will be financed through borrowing, as are the funds used by the Treasury Department to invest in financial firms. This additional public borrowing will add to future interest payments on the national debt, which will have to be financed either by reductions in other federal spending or future tax increases. The enhanced money and credit creation by the Federal Reserve can lead to higher inflation rates in later years.

However, the public policy tradeoff is this: if the additional federal government stimulus is not taken, the very real risk is that the recession will be deeper, unemployment will be higher, and income losses will be greater. So the calculation is to reduce economic losses now in exchange for higher public and private costs later.

The North Carolina Economy: In Recession, but Improvement from the Past

The recession also came to North Carolina in 2008. Although payroll employment increased slightly for the year, the unemployment rate rose over two percentage points from 2007 (Table 2). Real (inflation-adjusted) retail sales, real wages per employee, and existing home sales also declined by significant rates. As a result, state revenue growth slowed dramatically in 2008 compared to 2007. This development has put pressure on public budgets all over the state.

However, the recession to date in North Carolina has been milder than in past downturns. Unlike the nation, total payroll jobs were not lost in 2008, and the rate of manufacturing job losses has

Table 2. Key North Carolina Economic Measures

	2007	2008	2009 (forecast)
Payroll Employment (% chg.)	+2.6%	+0.10%	-1.1%
Manufacturing Employment (% chg.)	-2.7%	-4.7%	-3.5%
Unemployment Rate (end of year)	4.7%	7.2%	8.6%
Real Wages Per Employee (% chg.)	+1.1%	-3.1%	-2.5%
Real Retail Sales (% chg.)	+4.7%	-8.2%	-2.5%
General Fund Revenue (% chg)	+11.1%	+2.2%	-3.0%
Housing Prices (% chg)	+5.1%	+2.0%	no chg
Existing Homes Sales (% chg)	-11.1%	-26.0%	+7.5%

Sources: U.S. Dept. of Commerce, N.C. Dept. of Revenue, Federal Reserve System, N.C. Controllers' Office, Fiscal Research Division of the N.C. General Assembly, Office of Federal Housing Enterprise Oversite, North Carolina Association of Realtors,author's forecasts. Values for 2008 are annualized rates based on latest available data.

been one-half less than in the 2001 recession. The recent transformation of North Carolina from traditional manufacturing (tobacco, textiles, and furniture) to a technology and service driven economy – which accelerated this decade – is the reason for these relatively better results.

One positive trend in North Carolina has been the continued rise in housing prices. Still, there are some areas – mainly on the coast – where housing prices have fallen. Also, despite the better condition of housing prices in North Carolina, the state still has not escaped the increased foreclosures plaguing other regions of the country.

Looking ahead to 2009, North Carolina's economy will essentially follow national movements. For the year, this will mean job losses, higher unemployment, and weak retail sales and wage growth. Home sales will rise off their bottom, but the housing market will still remain weak. With general revenue growth negative, legislators will face their biggest challenge in two decades in balancing the state budget.

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