THE ECONOMIC SITUATION

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- **Lost trust: How do we move from panic to uncertainty to trust?**
- **The bludgeoned economy is seeking a bottom.**
- **What about employment?**
- **Housing markets: Is the worst behind us?**
- **South Carolina journal.**

Lost trust and financial collapse.

The current world financial collapse now has more to do with lost trust than sub-prime mortgages or newly minted monetary and fiscal policy. Indeed, once trust is lost, even the brightest and most articulate political leaders cannot repair the economic engine. It will take real action, not rhetoric to get the engine running smoothly again. In fact, the more rhetoric we get, the less trust we seem to have.

What do I mean by lost trust? How did it happen? And what can be done about it?

As background, I am referring to the tightly linked world financial market that made it possible for U.S. mortgage backed securities and collateralized debt obligations to be sold to investors worldwide. Bankers and investors in Helsinki, Tokyo, Singapore, and Dubai seemed glad to invest in mortgages that were originated in Florida, Georgia, California, and Nevada without even checking to see where the underlying property or borrowers were located. They had no reason to worry. The paper was rated AAA by the world premier credit rating agencies---Standard & Poor's, Moody's, and Fitch. And besides, some of the paper was backed by two gargantuan government sponsored enterprises, Freddie and Fannie, organizations that really couldn't fail.

Everything was Little Red Riding Hood perfect until the wolf entered the scene. Along came the sub-prime problem. Sub-prime mortgages and other fancy no-equity mortgages were in the packages investors had purchased, in some cases buried in a bundle of better AAA-rated stuff. When the U.S. Federal Reserve Board decided to tighten credit in the hope of avoiding inflation (Strange now that this was all we had to worry about!), the sub-prime and adjustable rate mortgages ratcheted up; monthly

payments soared; and many homeowners and real estate investors alike mailed their keys to their lenders. Cash flow turned negative.

World investors could no longer trust AAA. Banks with AAA securities on their books could no longer trust each other; and insurers that had hocked their balance sheets to write coverage on such securities suddenly turned pale from lack of cash.

As the sub-prime collapse spiraled down, other trust-supporting financial instruments bit the dust. When insurers of municipal bonds, long in mortgage related securities, withdrew from the market, the prices of municipal bonds collapsed. Larger insurance companies, like AIG, which had sold credit default swaps, another form of insurance, saw their net worth evaporate.

Another bit of trust was wiped out.

And then, donning sack cloth and ashes, the nation's leading financial authorities and politicians promised the people that we faced a crisis of unknown proportions unless we bailed out Wall Street, the banks, and even the auto companies. The message of fear was amplified by a president who in unusual form held short press conferences to warn of the pending financial crisis.

We people got the message, and we began checking on our banks and the level of FDIC insurance. The authorities in Washington responded by saying yes, we had great reason to worry. They doubled the level of deposit insurance.

Panic prevailed. Uncertainty loomed large. We consumers and investors pulled in our horns and hunkered down for the duration…, whatever that might mean. Victory gardens and half-soled shoes have come back into style.

Trust in impersonal markets is fundamental to the production of economic security and wealth in a highly developed economy. Once lost, trust must be regenerated largely by market processes that delivered trust in the first place. When panic has prevailed and uncertainty looms large, government institutions can be called on to buttress trust, with the risk that comes with ambitious politicians who want to serve the home folks instead of the public weal.

Panic has now passed. Uncertainty is the current station in the journey to trust. But uncertainty grows when treasury secretaries speak grimly about how serious things really are and about remedies that must be implemented, only to revise the prescription the next week, or when they speak about stress tests for banks without describing what this means. We observed a bit more market stability on February 25, when Secretary Geithner unveiled the details on the bank bailout package, this is sharp contrast to the earlier collapse when he said big things were on the way, without giving the details.

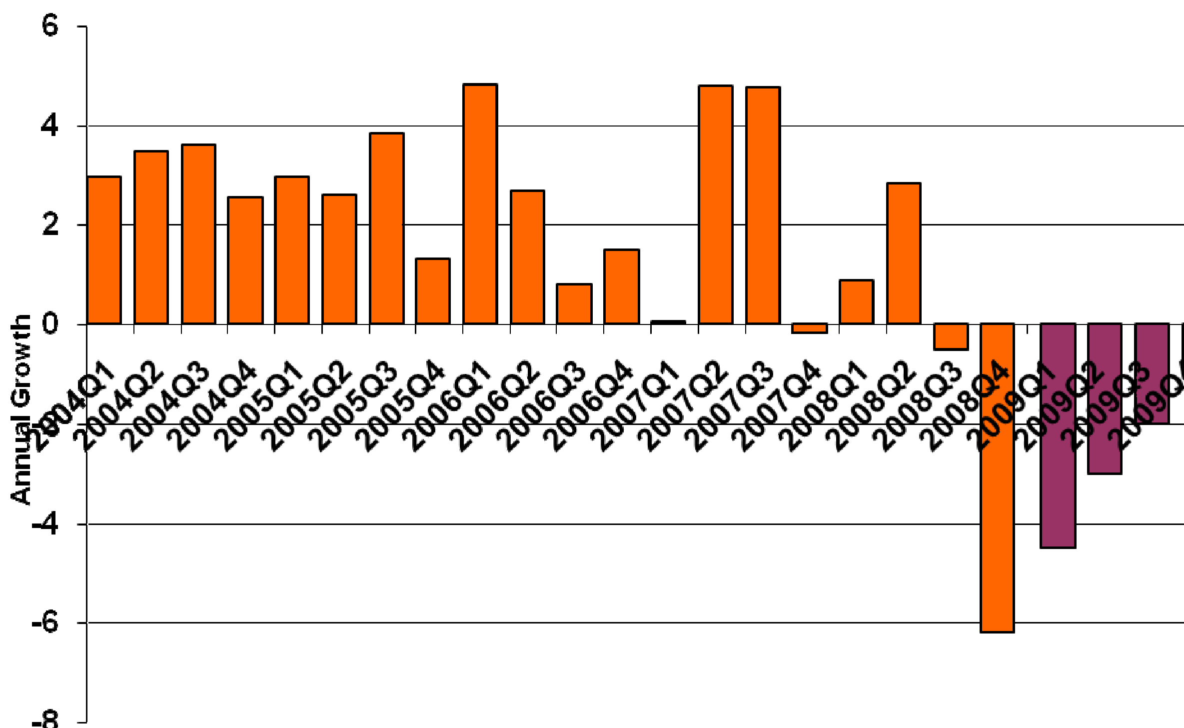
Movement to trust requires quiet measurable action, not grim warnings or soaring rhetoric.

We are in a time where silence would be golden. This is a time to clear the path and leave it alone. This novel idea was popularized in the 1750s by Vincent de Gournay, according to Wikipedia. It was Gournay who said “laissez faire et laissez passer,” or let it alone and let it pass.

Laissez faire seems like a good idea. Pass the word.

Seeking a bottom: GDP data.

With the economy in deep recession, the question now is when will we see a bottom? And then, when that question is answered, how long will it be before the economy reaches a yellow brick road leading to recovery. To approach answers, first consider the latest GDP growth estimates and some 2009 projections. I show these in the next chart. The preliminary Commerce GDP growth estimate of negative 3.8% for 4Q2008 was revised down to a very weak minus 6.2% on February 27. And the picture for 1Q2009 is not pretty. I show the 2009 in purple. Of course, the actual numbers will never be as smoothly shaped as those in the chart. By the way, the chart’s underlying 2009 numbers yield roughly -3.6% GDP growth for the current year.



This strongly negative outlook is worse than that provided by some major forecasters. But I believe more downward data revisions lie in store. The chart is silent on 2010, so let me offer some thoughts on the coming year.

As suggested by the upward trend formed by the purple bars, I think 2010 will see positive GDP growth, at least by 3Q2010. Before the year is out, the economy should be moving again but at a subnormal but pace.

No, I don't think we will be seeing yellow brick road action. Recovering long-run average growth of 3.5% will take longer, but I do think we will see 1.5% growth before the year ends.

What are other folks saying?

I report next a summary of forecasts ordered from September 2008 to February 2009. As can be seen, the more recent the forecast, the worse it gets. For example, the Congressional Budget Office's February 27 forecast shows 2009 growth at minus 2.2%. (They set 2010 at 1.5%.) So far, there is nothing in actual GDP data to suggest the discovery of a bottom. For that, we must look closer at some individual indicators.

GDP Forecasts: 2008-2009
February 27, 2009

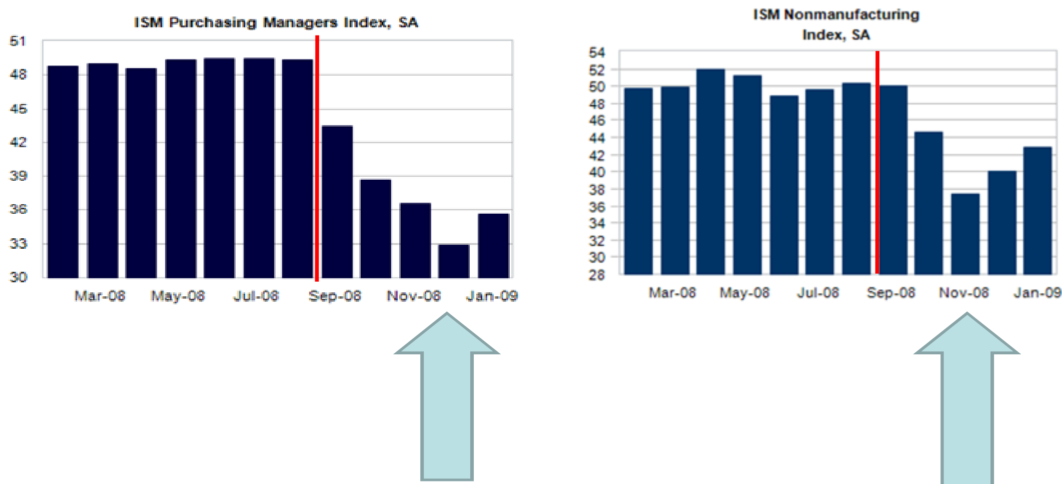
Forecast	*2008*	*2009*
Blue Chip (Sept.)	1.8%	1.5%
CBO (Sept.)	0.9%	1.8%
World Bank (Sept.)	1.1%	1.9%
IMF (Oct.)	1.6%	0.1%
Economist.com (Nov.)	1.4%	-0.2%
Economy.com (Nov.)	1.4%	0.0%
Wachovia (Nov.)	1.3%	-1.0%
Economist.com (Dec.)	1.2%	-1.7%
Wachovia (Jan.)	1.2%	-2.3%
Economy.com (Feb.)	1.2%	-1.7%
Economist.com (Feb.)	1.2%	-2.0
CBO (Feb)	1.2%	-2.2

Taking a look at some indicators.

Reflections of a bottom forming are found in the Institute for Supply Management's (ISM's) production indicators as well as with data for some other sectors. The next panel shows the ISM manufacturing and nonmanufacturing (service economy) indexes. I have marked September with a red bar in both charts. This was the month when the economy was driven over the edge by actions that fostered a climate of panic in financial markets. Notice the sharp drop off in the manufacturing chart, which is the leftmost chart in the panel. Also, recall that 50 is the magic number for these indicators. That is the value when the economy is performing at an average rate, not strong or weak.

Positive signs are seen in both charts. The manufacturing index nudged up in January. Not a trend, but at least one positive observation. But the nonmanufacturing indicators have formed a positive trend. In both cases, the positive movement is from a very low level of activity. But, let's not look a gift horse in the mouth. At least the indicators are pointing north.

Two Key U.S. Economic Indicators

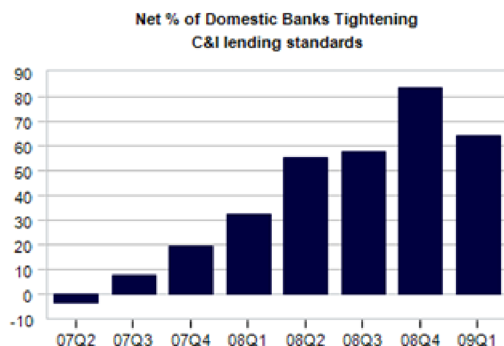


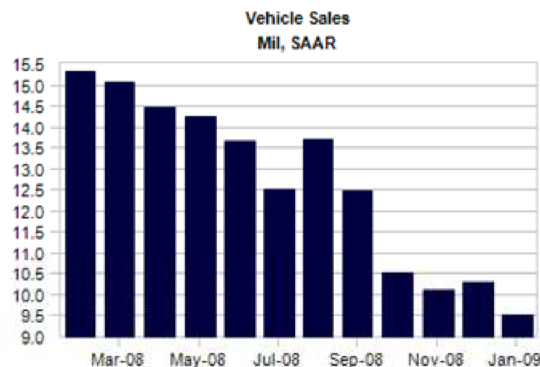
Two other positive signs are seen in the next panel of charts. Notice first the positive nudge in January retail sales, again from a low level of activity. Note also the positive bounce in January existing home sales, followed by a reversal in February. Apparently, the sharp decline in home prices in some major markets is having the expected effect.

Then, notice the response of bank lending officers in the left-most chart. Banks are relaxing their lending standards a bit.

On the negative side, we see auto sales continuing to skid downward. Why should we expect otherwise? Until the very last days when the votes were being counted, the stimulus package contained a special tax credit for people who bought a new car. This fostered a wait and see attitude. Then, there are at least two major auto companies standing in line for taxpayer assistance. Their plans already indicate certain models that will fall by the wayside. This means more cut prices.

Auto buyers logically are waiting to find out what the final deals will be. No amount of politically preaching about borrowing and buying will offset politically generated uncertainty.

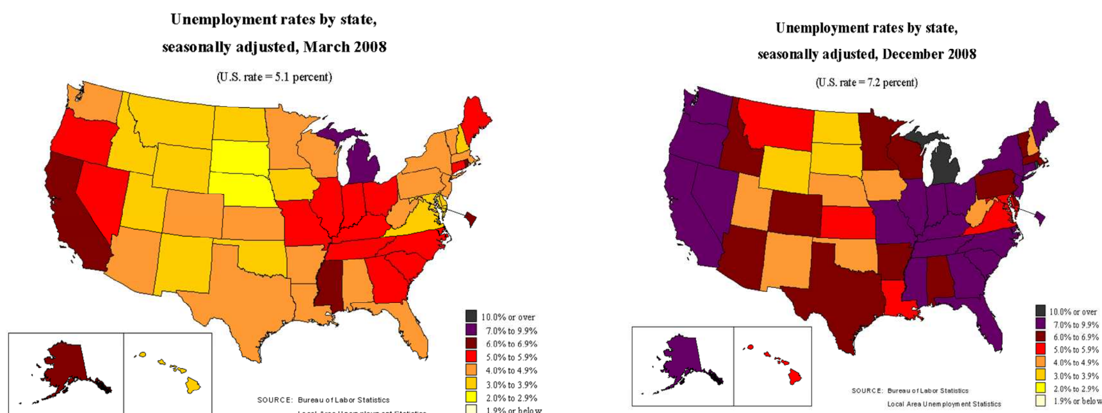




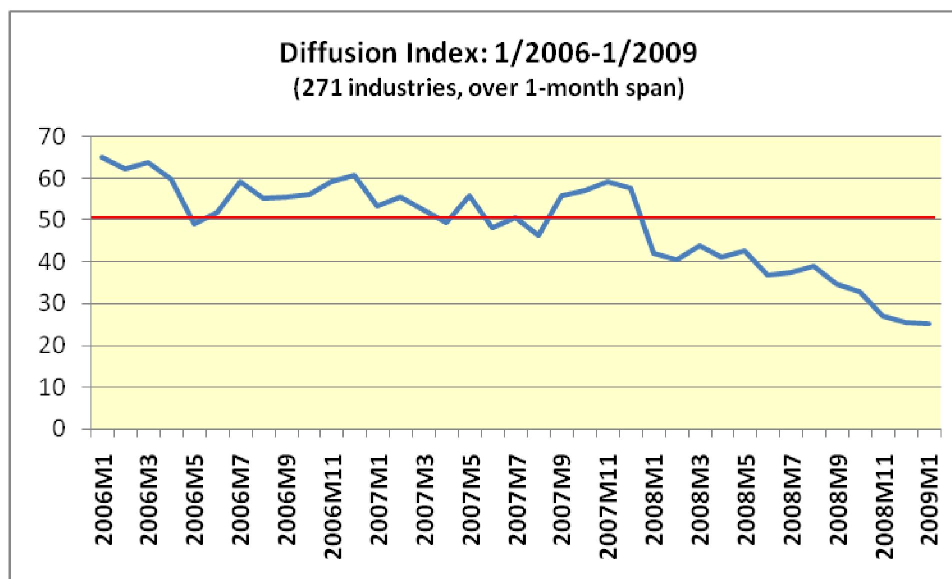
What about labor markets.

The rolling recession is taking its toll as unemployment increases across the 50 states. The picture is seen in no uncertain terms in the next chart, which shows unemployment rates by state for March 2008 and December 2008. What a difference six months can make!

U.S. Recession Contagion



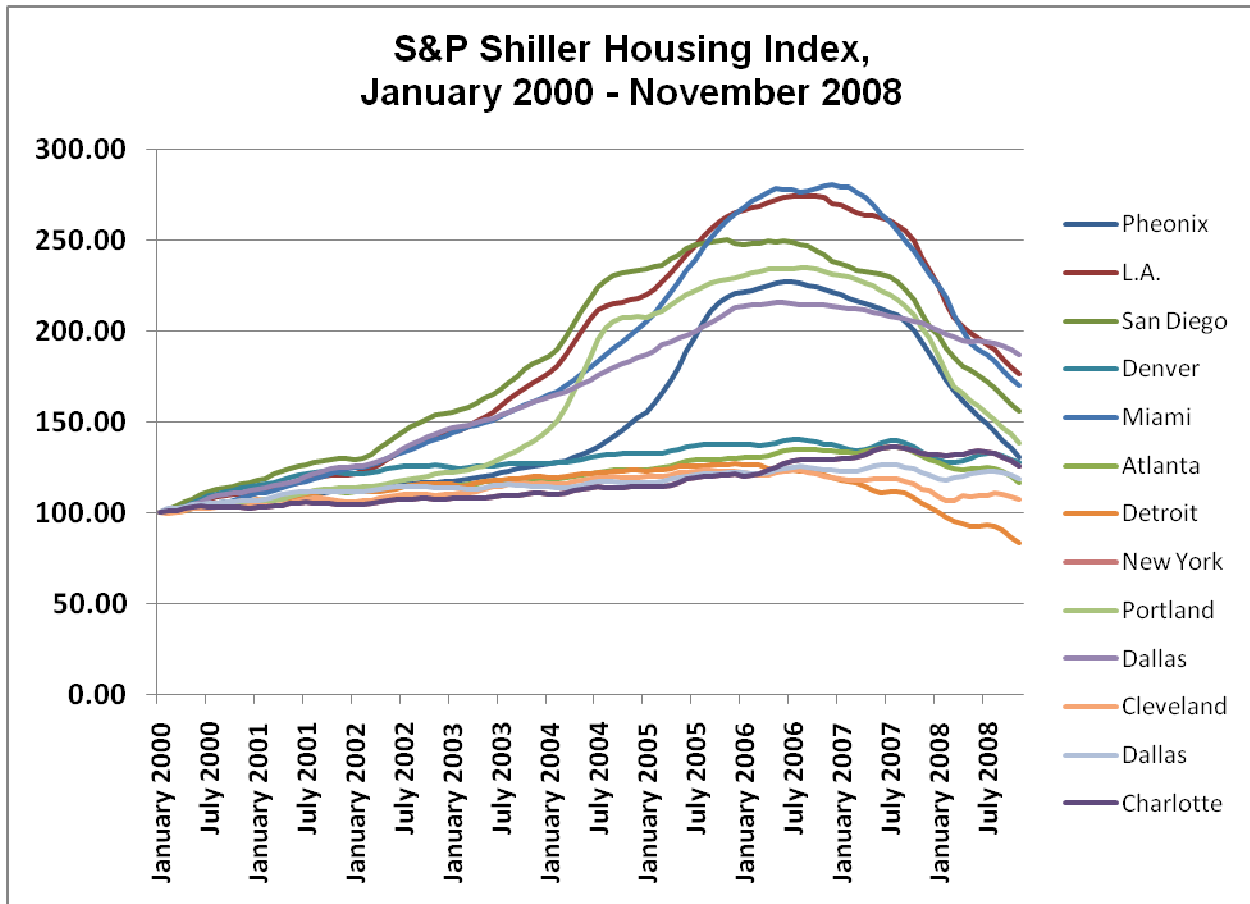
Even though U.S. employment is losing ground, there is one labor market indicator that offers a bit of hope. The diffusion index for unemployment measures the extent to which unemployment is expanding across 271 U.S. industries. As indicated in the next chart, the diffusion index seems to be bottoming. Here is yet one more sign that the economy may be near the end of the sliding board. Remember, 50 is the magic number that identifies a kind of neutral point where the number of expanding industries just equals the number contracting.



Focusing on housing, the origin of the problem.

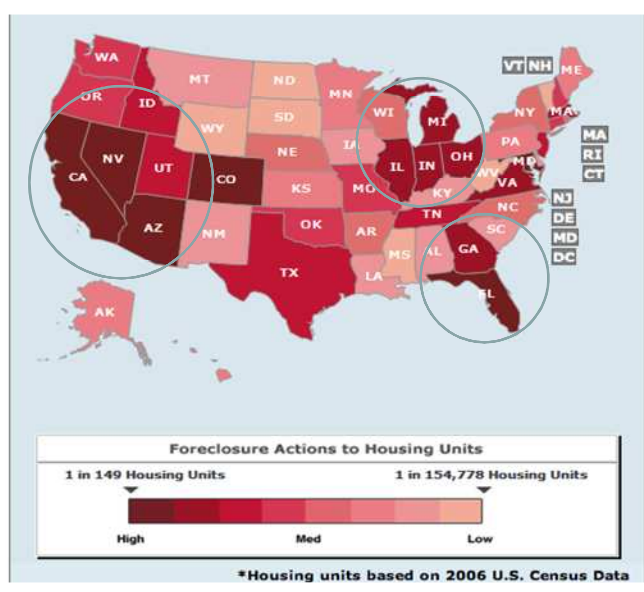
Even though there was a blip up in the sale of existing homes in January, that is not enough to say a bottom has formed. But increased sales is key to the solution. Housing sales pick up when prices fall and demand increases. What is the price picture?

The next chart reports data on the S&P-Shiller housing price index, which is the gold standard in housing circles. I show data for a sample of metro areas starting in January 2000 and ending in November 2008. The bubble is obvious. And it is obvious where the bubble is most pronounced. But the data also tell us something about a return to normalcy. We should not expect the indexes to return to the 2000 level in every market. Surely some price appreciation is to be expected. The evidence suggests a bottom is on the way.

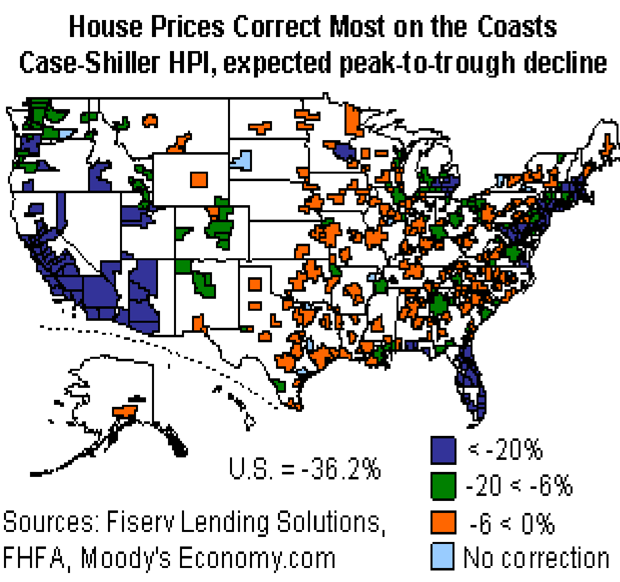


As might be expected, the mortgage default rate shown in the next chart is the mirror image of the housing price bubble. Where prices soared and too much housing was built, contracts collapsed. I have marked three hard-hit regions in the chart. The California, Nevada, Arizona, Florida locations are clearly sub-prime collapse territory. But the third region containing Michigan, Indiana, and Ohio reflects another problem. This is a region that has been in a state of decline for years. There is a default problem for sure, but it does not relate to the collapse of a housing bubble.

Mortgage Default Rate, April 2008



Finally, I provide a chart that shows the expected peak to trough decline in housing prices as measured by the Shiller index. It is clear where price adjustments are heaviest…, and default rates are highest.



Policy choices.

Since early 2008, policy makers in Washington and elsewhere have grappled with decisions to do something about what was first called the sub-prime crisis. Since then, of course, political leaders worldwide have come to fore to deal with what I now call the Great Recession of 2008-2010. We have moved beyond the sub-prime crisis. The problem faced has two distinct elements. The first element relates to failing firms and weakened industries that result from the sharp decline in world demand for goods and services. These include autos, steel, commdities and manufacturered goods generally, as well as financial and transportation services. This part of the problem has to do with the real effects of the recession. The second part relates to the monetary effects. Banks form the transmission system for the world's monetary system. While the appearances are the same, repairing the transmission so that it functions effectively is a very different matter from shoring up auto and insurance companies in the hope of avoiding severe employment effects.

Unfortunately, both problem categories get painted with the same brush in Washington when congressional hearings are conducted, and both problems seem to share the same political remedies.

There are three packages of tools available for dealing with the real and monetary problems: Monetary policy, fiscal policy, and industrial policy. We are observing all three policy packages in action. The Fed and Treasury have pulled all stops in applying monetary tools. The fuel is sitting by the fire, but it has not fully ignited. The Obama administration has now seen the passage of a large bundle of fiscal policy, but most of its effects will not be registered until 2010-2011. Put another way, the cookies are in the oven but it will be a while before they are done.

Industrial policy involves taking public ownership in insurance companies, banks, and auto companies. These actions may reduce panic and generate certainty, but it is certainty of a costly kind. Governing politicians simply do not and should not have the right incentives to run major firms and industries. Indeed, the incentives run against resource conservation and wealth creation.

In all this, we are still witnessing a search for trust. Trust will come in time, but the path to trust recovery is a difficult one.

Final Thoughts.

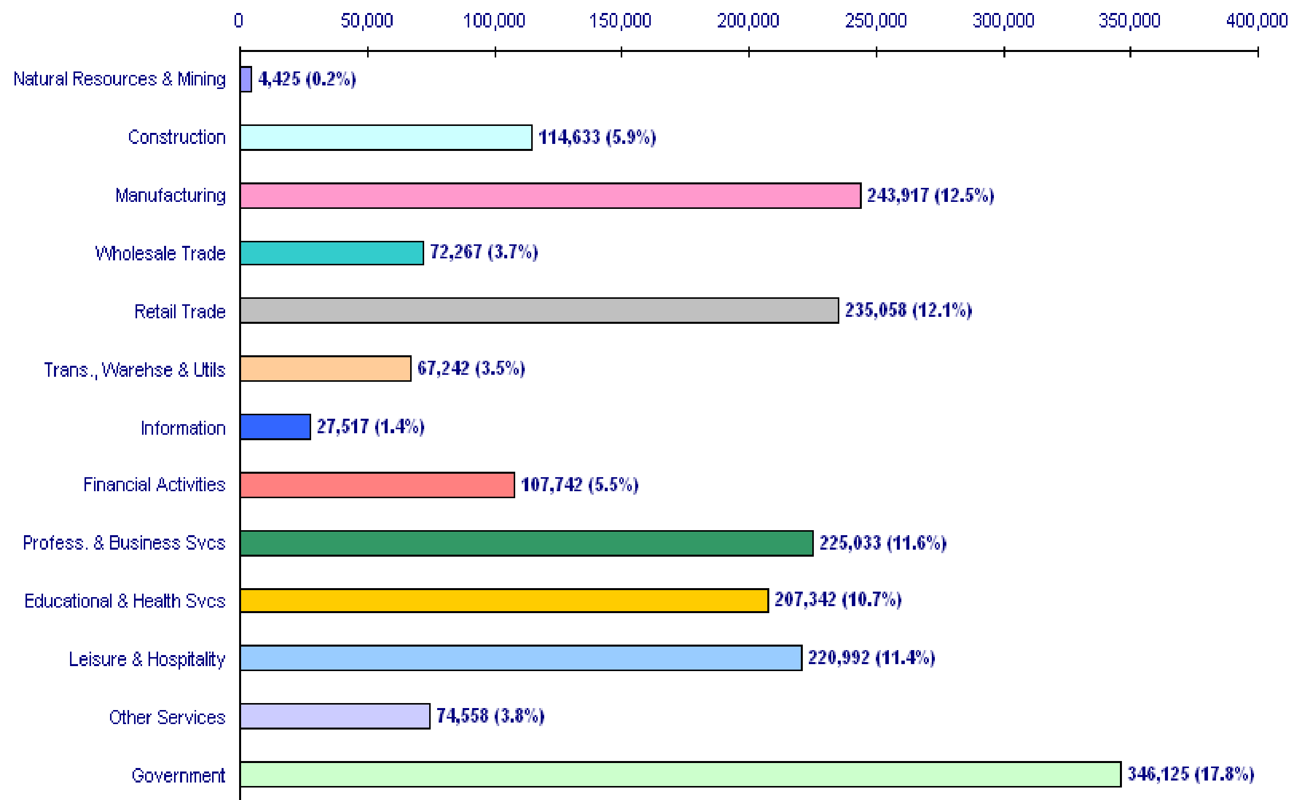
With the passing of 2009's first quarter, the recession is now 15 months old, getting a bit gray by historic standards. The average length of the 10 recessions since World War II is 10 months. The 1981-82 recession, the longest one since 1945, went on for 16 months. We are obviously tracking an unusual recession. I now offer some summary comments:

- Recessions end when a low point is reached and recovery begins. Current data suggest we will not see this point until 2010 when GDP growth becomes positive. The recession could run 24 months. Along the way, national unemployment rates will likely hit 9.0% to 9.5%, with the worst readings coming in 2009's last quarter.
- While the recession end is not in sight, there are signs that a trough is forming. The signals include positive movement in the services economy indicator, some relaxation in bank lending standards, eratic movement in home sales data, and what looks like a bottoming in the decline of home prices. There are no signs of recovery in the manufacturing economy, but the unemployment diffusion index, while still sinking, appears to be bottoming out.
- Massive monetary, fiscal, and industrial policy actions taken in Washington will eventually bring real resources to bear on the recession. For the most part, these effects will not be seen until 2010-2011, which is when the recession should be ending. This suggests that our best hope lies in the ability of markets to knit themselves together again. For now, the greatest gift politicians can impart is the gift of silence.

Laissez faire et laissez passer.

CAROLINA JOURNAL

I provide here a set of charts on the South Carolina's economy. Most of these are generated from FDIC data. The first charts show 2008 employment by industry and employment growth. Notice that government is South Carolina's largest employer and that two sectors, government and health care, show positive growth in the most recent period. The Obama stimulus package will strengthen these two sectors directly. Government will become a larger part of the economy. Growth in S.C. government employment relative to the nation is shown in the third chart.



Year End Employment by Industry
South Carolina - 2008 (NSA)
0
50,000
100,000
150,000
200,000
250,000
300,000
350,000
400,000
Natural Resources & Mining
4,425 (0.2%)
Construction
114,633 (5.9%)
Manufacturing
243,917 (12.5%)
Wholesale Trade
72,267 (3.7%)
Retail Trade
235,058 (12.1%)
Trans., Warehse & Utils
67,242 (3.5%)
Information
27,517 (1.4%)
Financial Activities
107,742 (5.5%)
Profess. & Business Svcs
225,033 (11.6%)
Educational & Health Svcs
207,342 (10.7%)
Leisure & Hospitality
220,992 (11.4%)
Other Services
74,558 (3.8%)
Government
346,125 (17.8%)
Number Employed and Percent of Total Employment
NSA = Not Seasonally Adjusted
Source: Bureau of Labor Statistics (Haver Analytics)
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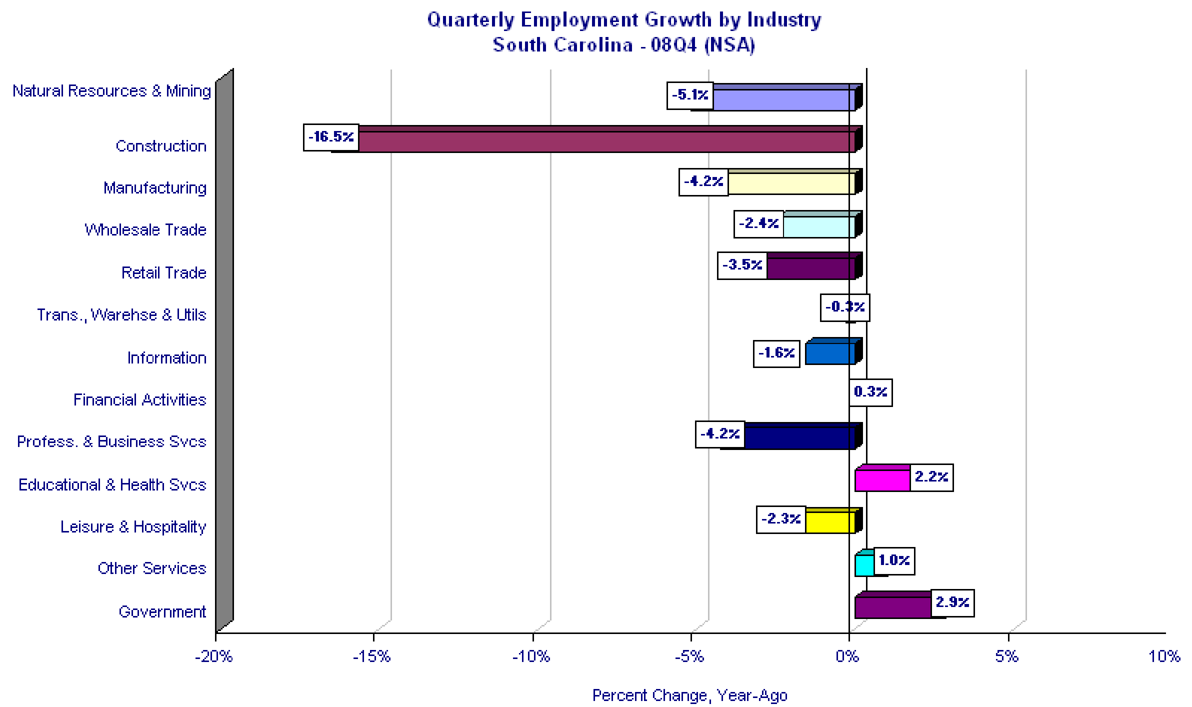
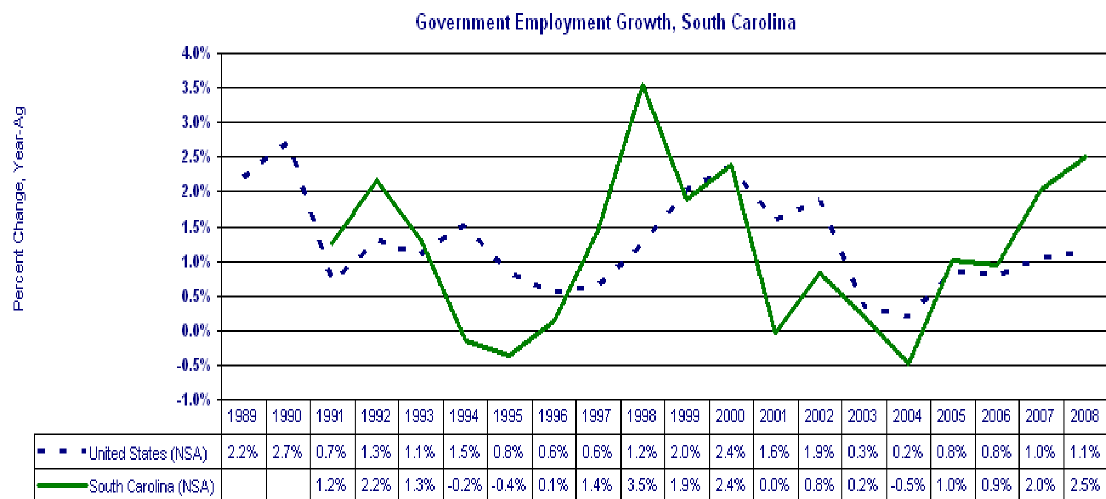
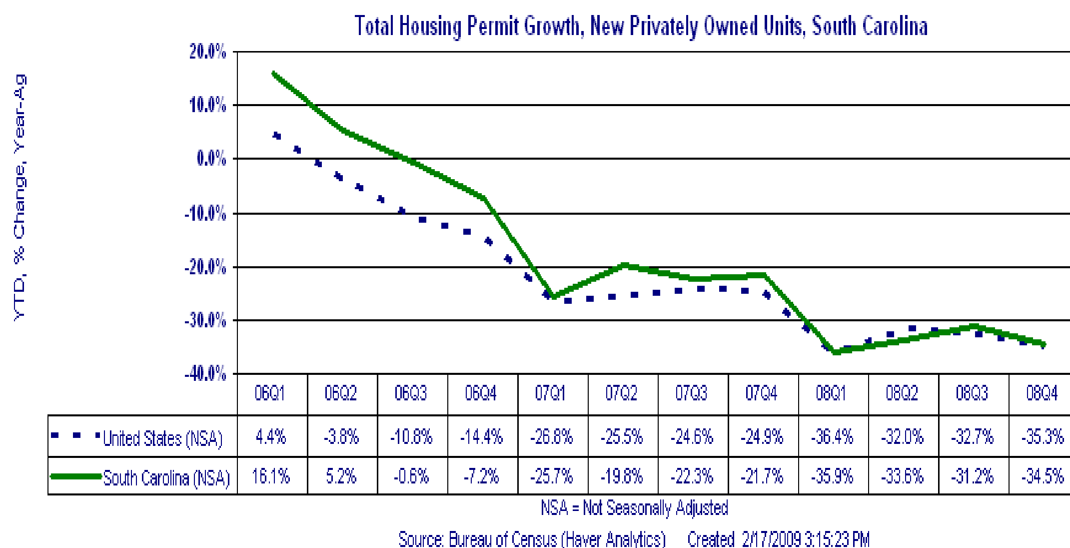




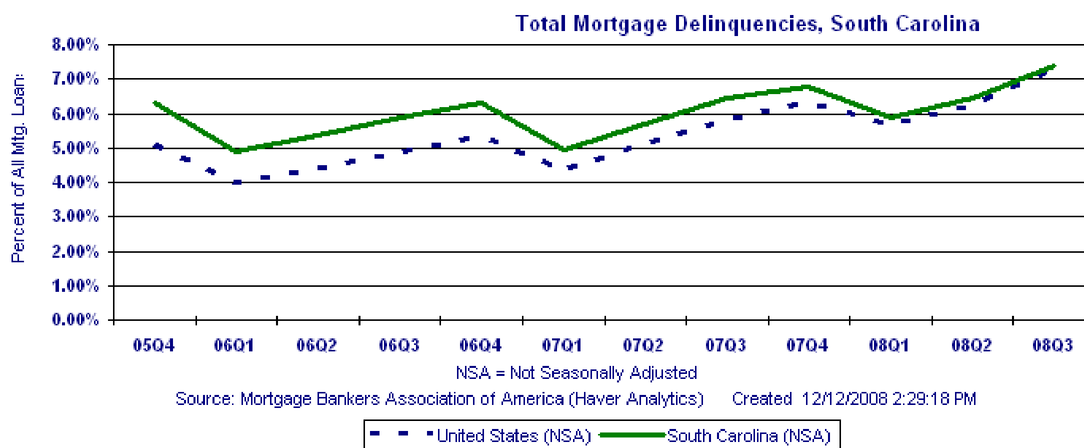
	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
United States (NSA)	2.2%	2.7%	0.7%	1.3%	1.1%	1.5%	0.8%	0.6%	0.6%	1.2%	2.0%	2.4%	1.6%	1.9%	0.3%	0.2%	0.8%	0.8%	1.0%	1.1%
South Carolina (NSA)			1.2%	2.2%	1.3%	-0.2%	-0.4%	0.1%	1.4%	3.5%	1.9%	2.4%	0.0%	0.8%	0.2%	-0.5%	1.0%	0.9%	2.0%	2.5%

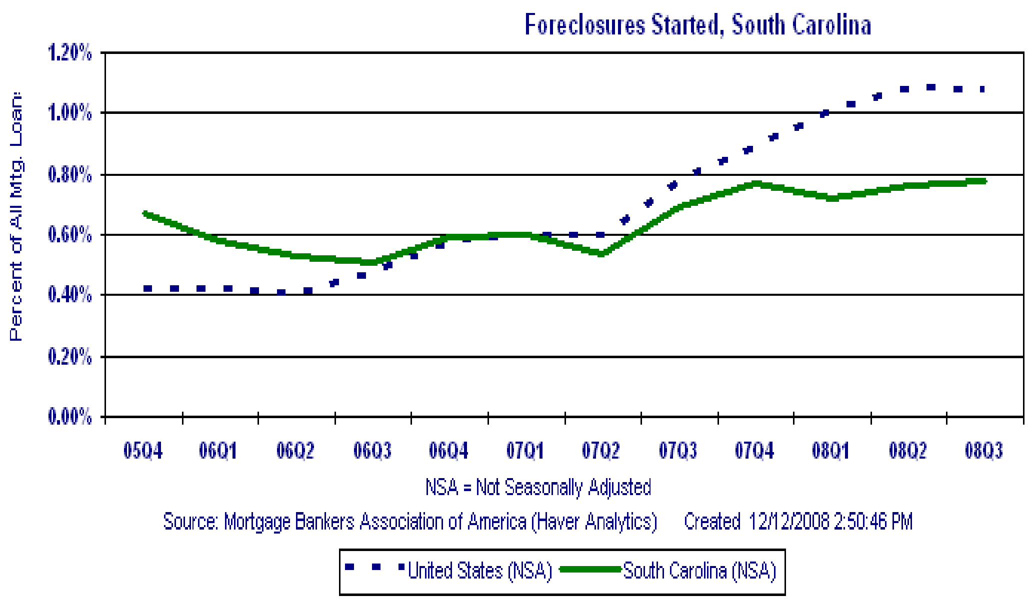
NSA = Not Seasonally Adjusted. Recessions: 4/01 - 11/01 and 8/90 - 3/91.
Source: Bureau of Labor Statistics (Haver Analytics) Created 2/3/2009 10:06:59 AM

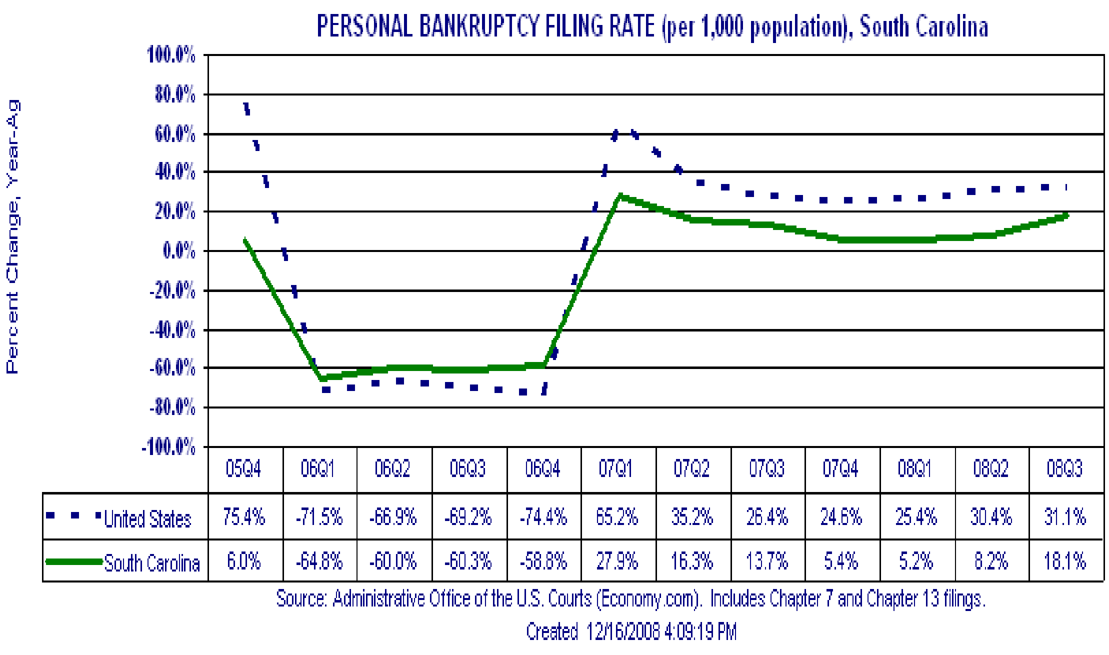
The next South Carolina charts focus on housing, defaults and bankruptcies, starting with new housing permits. Notice that South Carolina's housing starts and mortgage delinquencies follow the national pattern. However, foreclosure and personal bankruptcy rates are below the national level.



	06Q1	06Q2	06Q3	06Q4	07Q1	07Q2	07Q3	07Q4	08Q1	08Q2	08Q3	08Q4
United States (NSA)	4.4%	-3.8%	-10.8%	-14.4%	-26.8%	-25.5%	-24.6%	-24.9%	-36.4%	-32.0%	-32.7%	-35.3%
South Carolina (NSA)	16.1%	5.2%	-0.6%	-7.2%	-25.7%	-19.8%	-22.3%	-21.7%	-35.9%	-33.6%	-31.2%	-34.5%







	05Q4	06Q1	06Q2	06Q3	06Q4	07Q1	07Q2	07Q3	07Q4	08Q1	08Q2	08Q3
United States	75.4%	-71.5%	-66.9%	-69.2%	-74.4%	65.2%	35.2%	26.4%	24.6%	25.4%	30.4%	31.1%
South Carolina	6.0%	-64.8%	-60.0%	-60.3%	-58.8%	27.9%	16.3%	13.7%	5.4%	5.2%	8.2%	18.1%

Source: Administrative Office of the U.S. Courts (Economy.com). Includes Chapter 7 and Chapter 13 filings.
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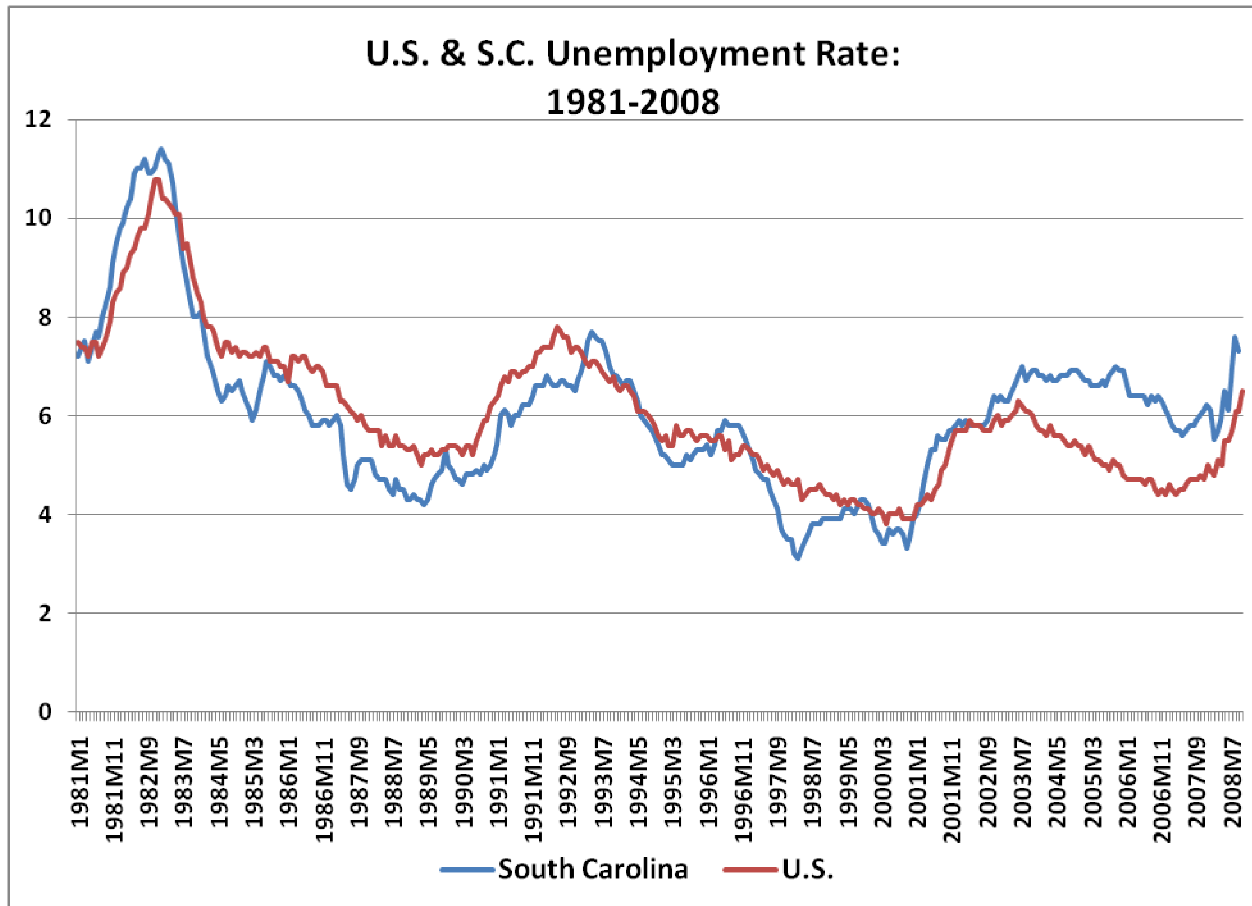
Finally, I provide data that compare unemployment rates for South Carolina and the United States. It is here that we see the difficult challenge. South Carolina's evolving economy is producing wealth at a much lower pace than the nation's, at least as measured by employment. The problem has been around for eight years; it is not a result of the current recession or the sudden attractiveness of the state to folks looking

for greener pastures. The problem is apparently related to market demands for knowledge workers and the supply of those workers.



Stay tuned for the next report, which will be produced in June 2009.