

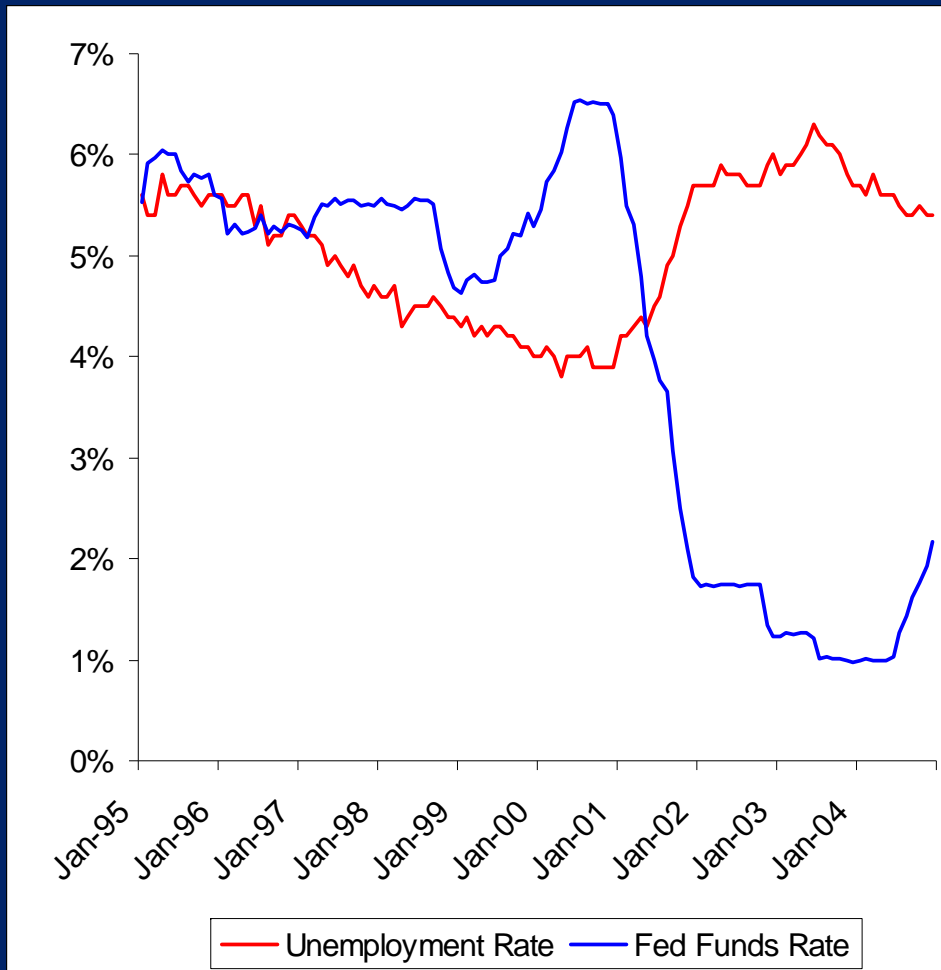
What's Happening in the State and the Nation

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The Greenspan Doctrine

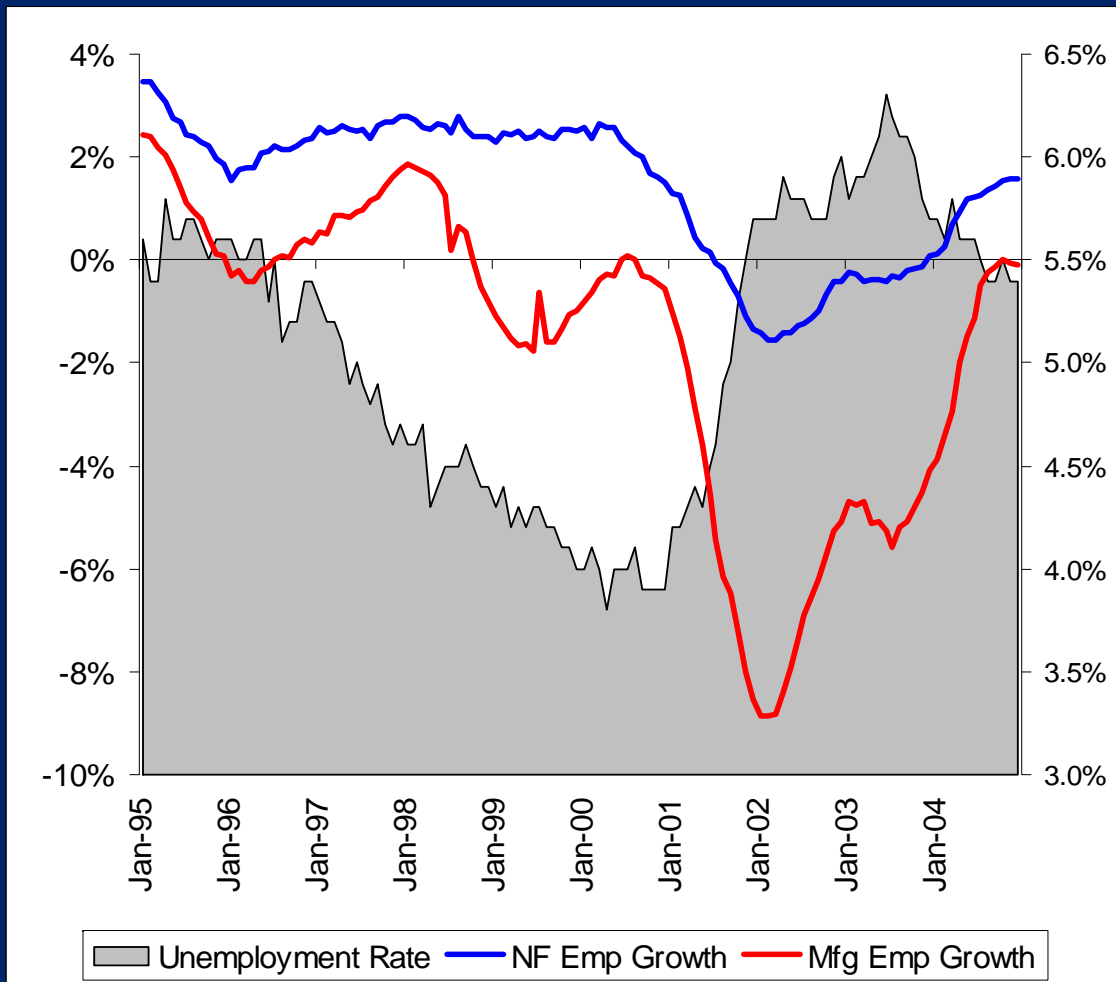
US Unemployment Rate and Federal Funds Rate



- In the late 1990s, the Fed was worried that “irrational exuberance” in the stock market was fueling an unsustainable boom in the economy.
- Greenspan’s stated policy was not to try to manage stock prices, but to intervene aggressively if a stock market crash affects the economy.
- Thus, in 2001-2, the Fed lowered interest rate more aggressively than their “usual” response to a 2.5% rise in unemployment.
- The jobless recovery made it look like the cuts weren’t helping, so the Fed again cut FF rate in ‘03, keeping it near 1% through summer 2004.

The "Jobless Recovery"

US Unemployment Rate (right) and Year-over-Year Employment Growth (left)

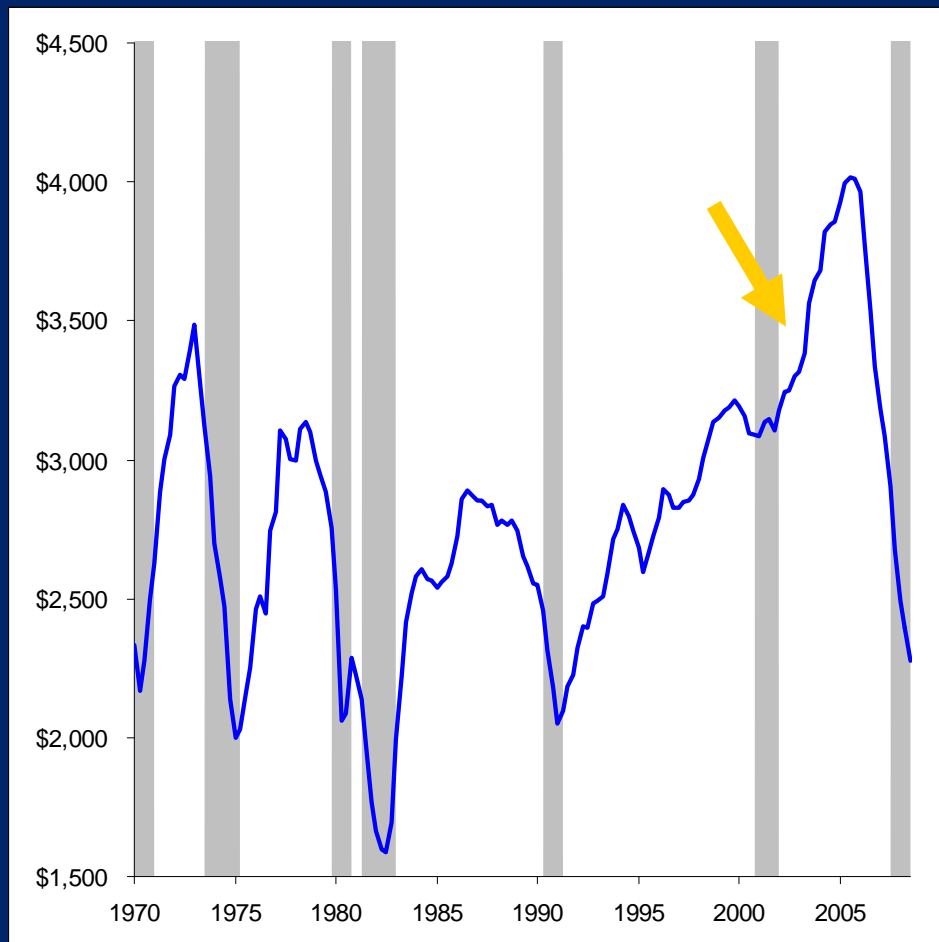


- Even though GDP growth had recovered by late 2002, employment growth was still negative through 2003, keeping unemployment rate high.
- Why? Usually, job losses in a recession are temporary layoffs (cyclical unemp).
- In the 2001 recession, the US lost over 3 million manufacturing jobs that never came back – this dose of structural unemployment kept the labor market weak longer than usual.

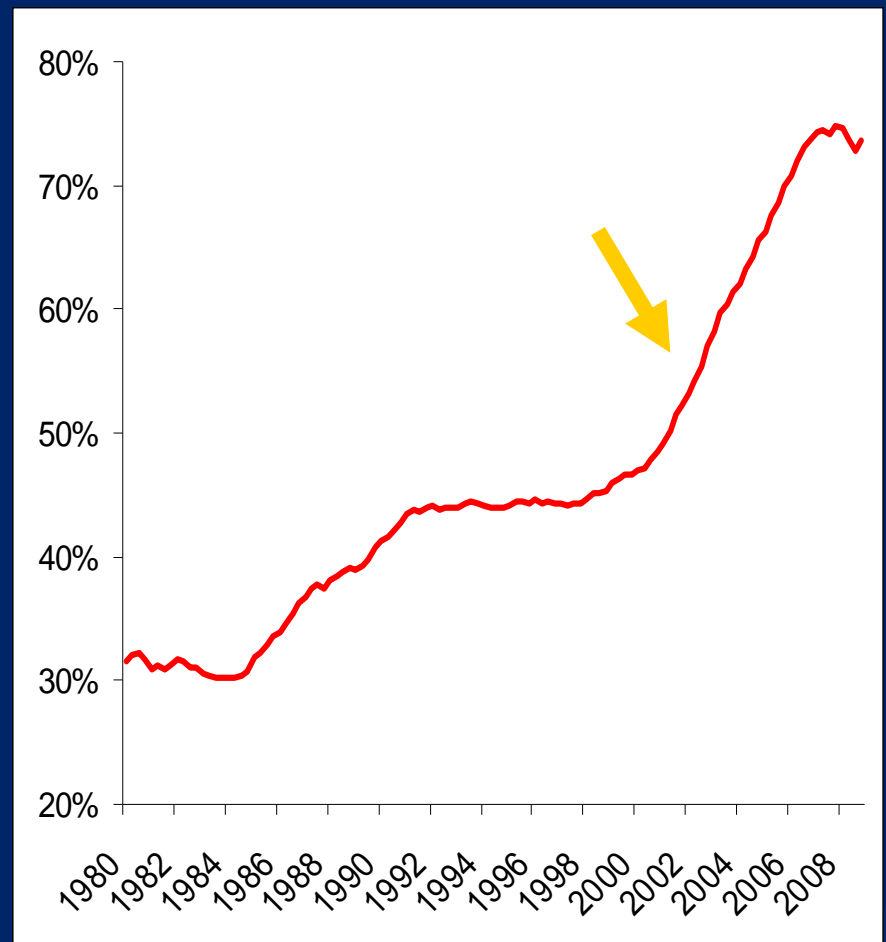
Where Did The Monetary Stimulus Go?

**Equipment and Software were still overinvested from the internet boom.
Instead, low interest rates kicked off an unprecedented housing boom.**

Real Residential Inv./ Wkr. (2000\$)

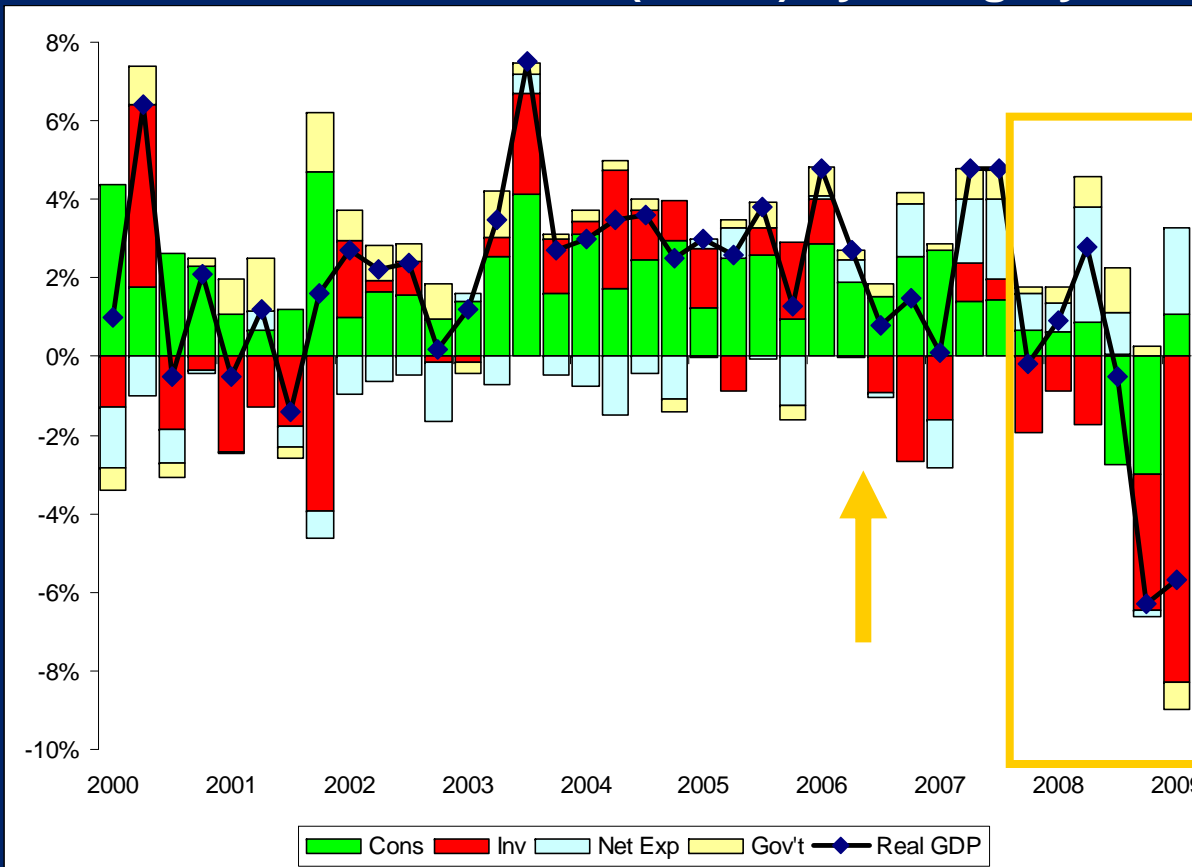


US Mort. Debt Outstanding / GDP



An Overdue Housing Recession

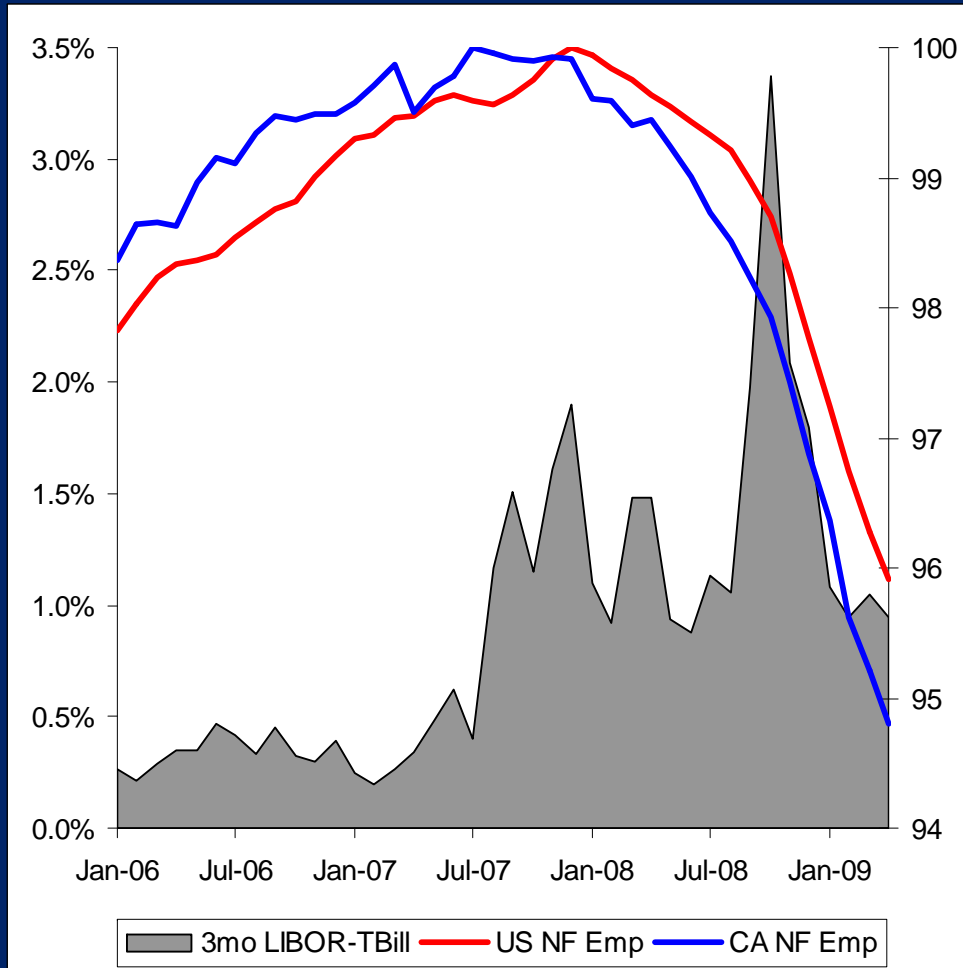
US Real GDP Growth (SAAR) by Category



- Housing Construction has been a -1% drag on GDP growth since 2006.
- Usually, recessions start ~2 qtrs after housing peak – late 2006.
- Weak dollar and resilient consumer offset housing weakness in 2006-7.
- The official recession began as both of these factors weakened in 07Q4.
- Sharp declines in Comm. RE building pull down '09Q1 Investment.

Financial Crisis was the Lethal Blow

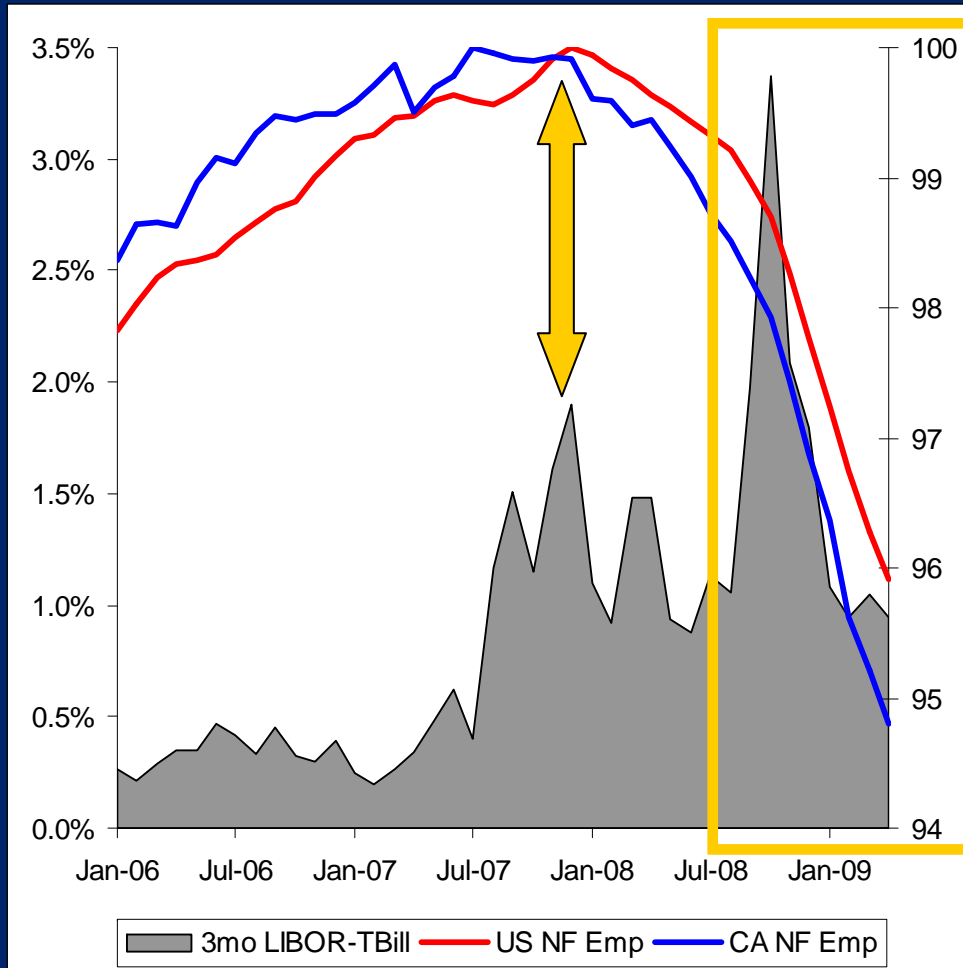
Short Term Credit Spreads and Non-Farm Payroll Employment (Peak=100)



- Foreclosure rates saw an unprecedented spike in mid-2007, leading to unexpectedly high losses on mortgage-backed securities (MBS).
- Many financial companies held lots of MBS as assets, but owed money to depositors, bondholders, etc. High losses made the MBS worth less, so many firms now owed more money than their assets were worth.
- These insolvent firms try to borrow more money to make up the difference, causing a spike in interbank interest rates (LIBOR) in late 2007.

Financial Crisis was the Lethal Blow

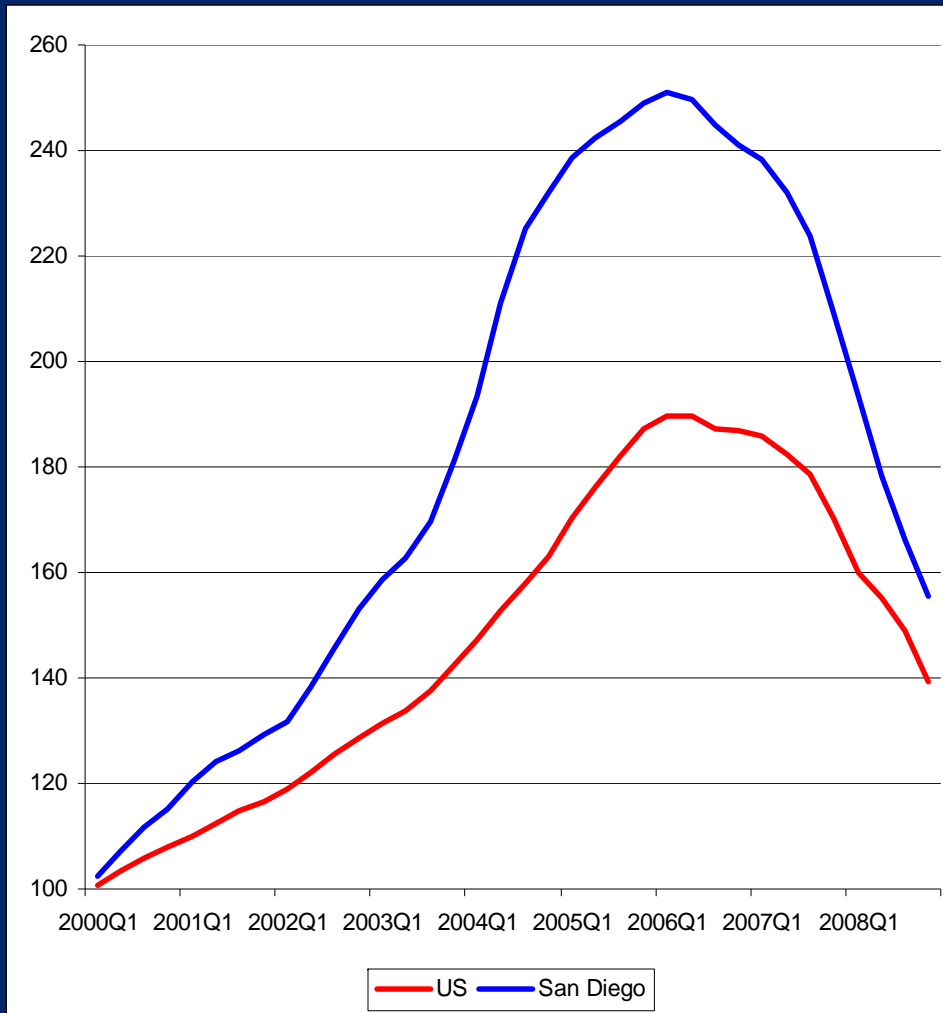
Short Term Credit Spreads and Non-Farm Payroll Employment (Peak=100)



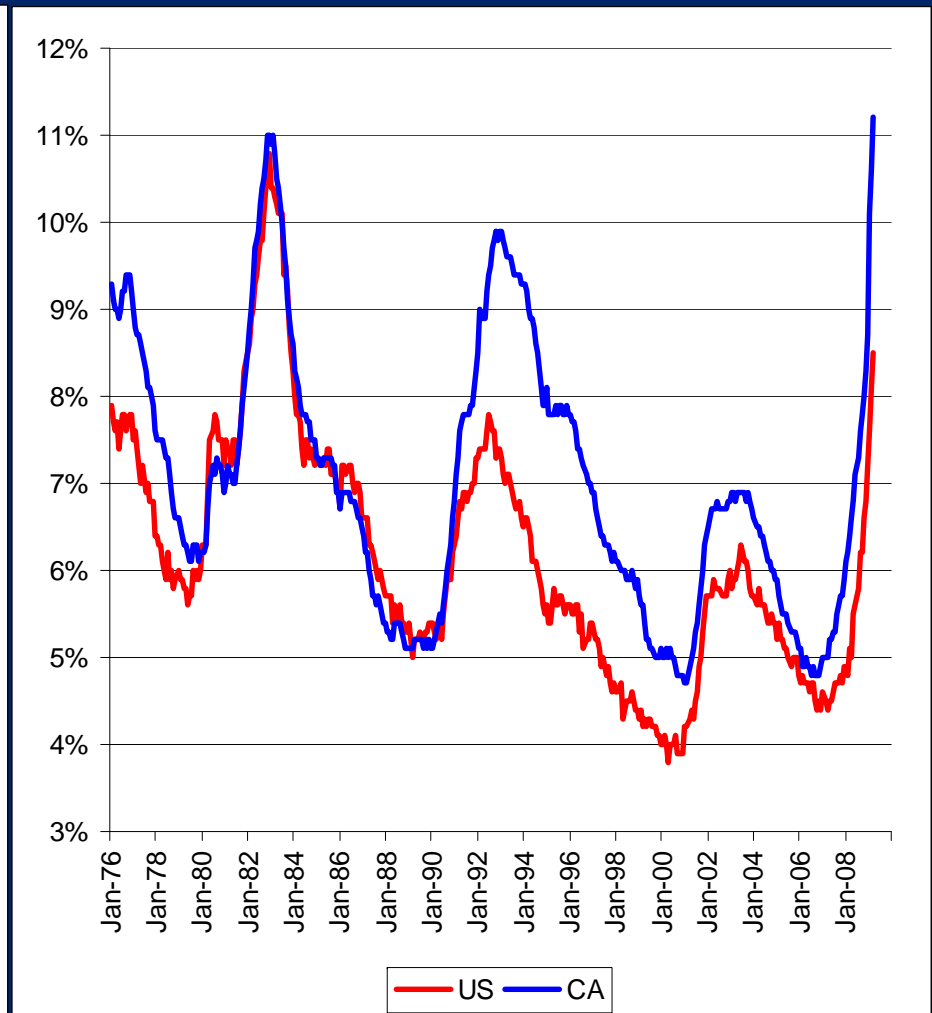
- Fed lending calms insolvency fears for a little while, but a wave of banks failures in 2008 sets up the financial crisis in October 2008: even healthy non-financial companies have trouble borrowing money.
- Note how closely the financial crisis coincides with the weakening job market: US employment started falling at the end of the first wave of the crisis, with job losses accelerating when the crisis hit its peak in Oct. '08.
- Housing weakness set up the recession, but the deterioration of the economy is more closely linked to the financial crisis.

CA: A Bigger Boom, A Bigger Bust

Case-Shiller Home Price Index

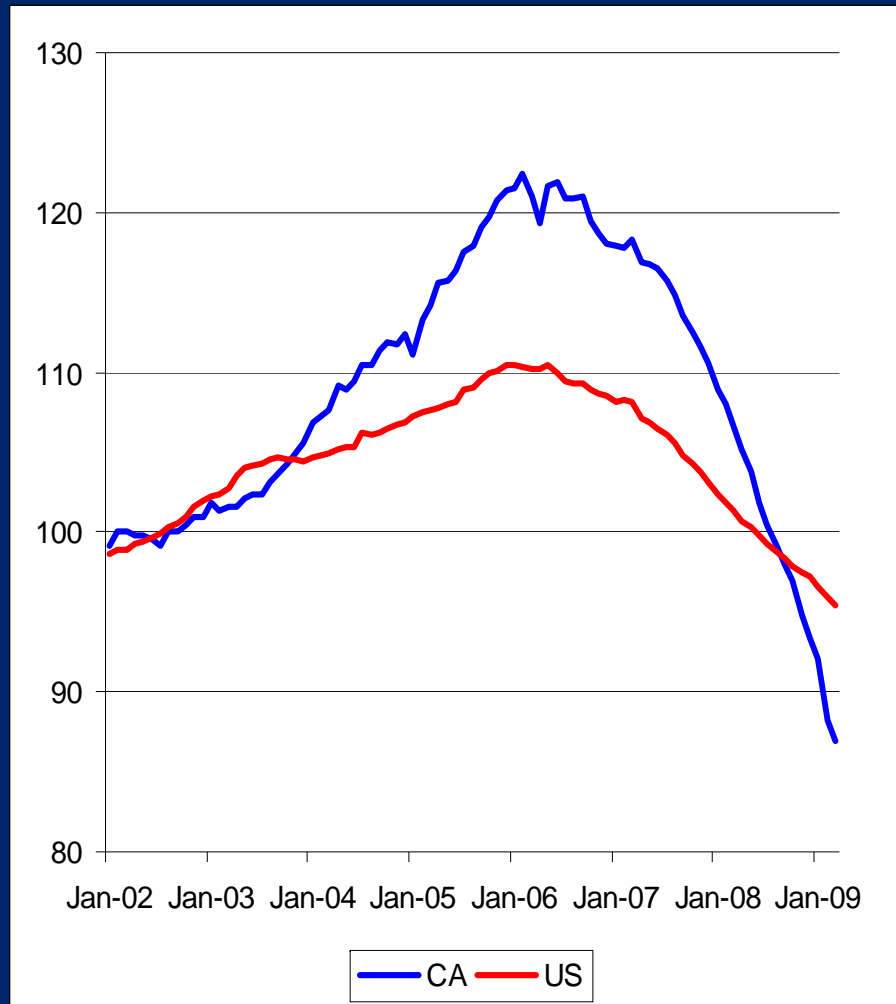


Unemployment Rate

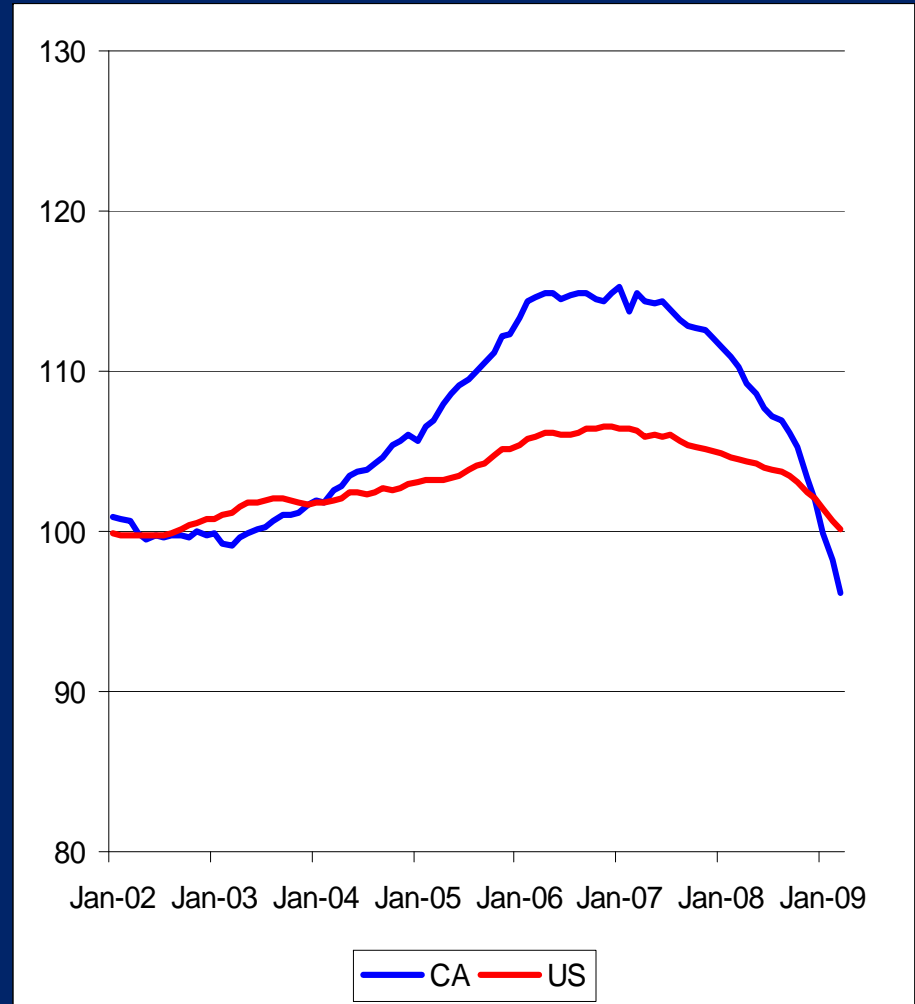


CA: A Bigger Boom, A Bigger Bust

Construction Employment



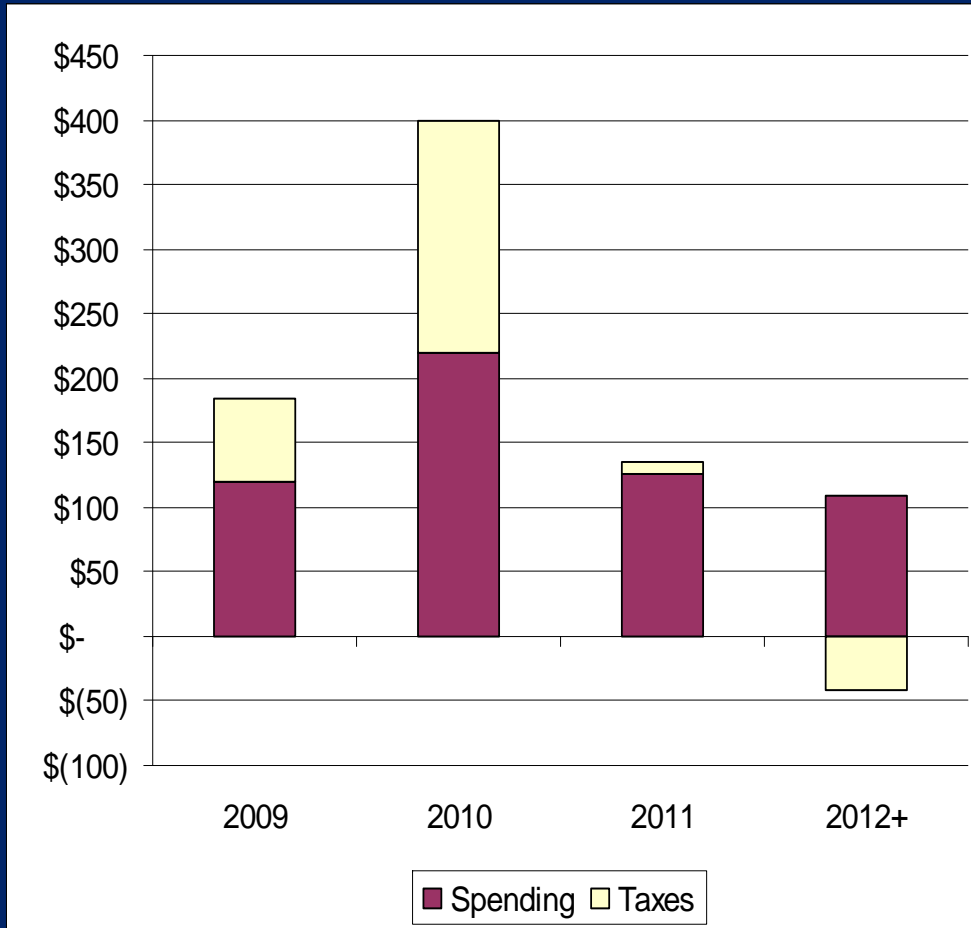
Financial Activities Employment Index



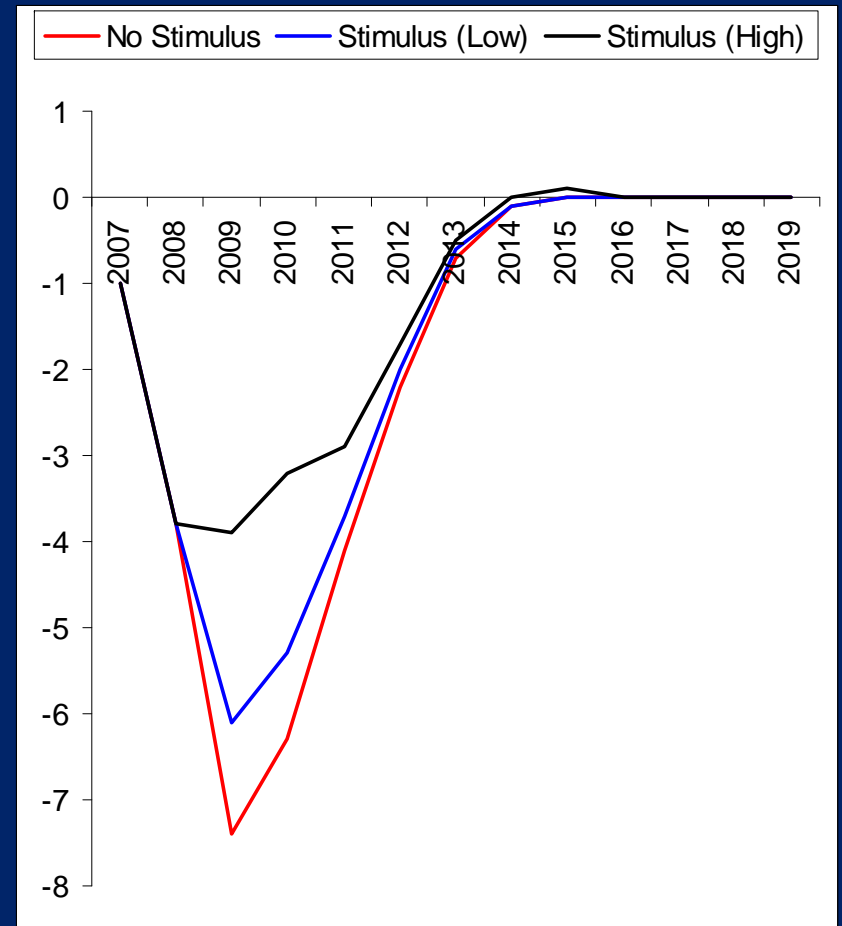
ARRA: Not Timely, Targeted, or Temporary

Stimulus Plan doesn't kick in until late '09. Most forecasts say GDP growth should pick up in 2010, but we're not back to normal until 2013.

ARRA '09 Spending by Type (CBO, bill \$)



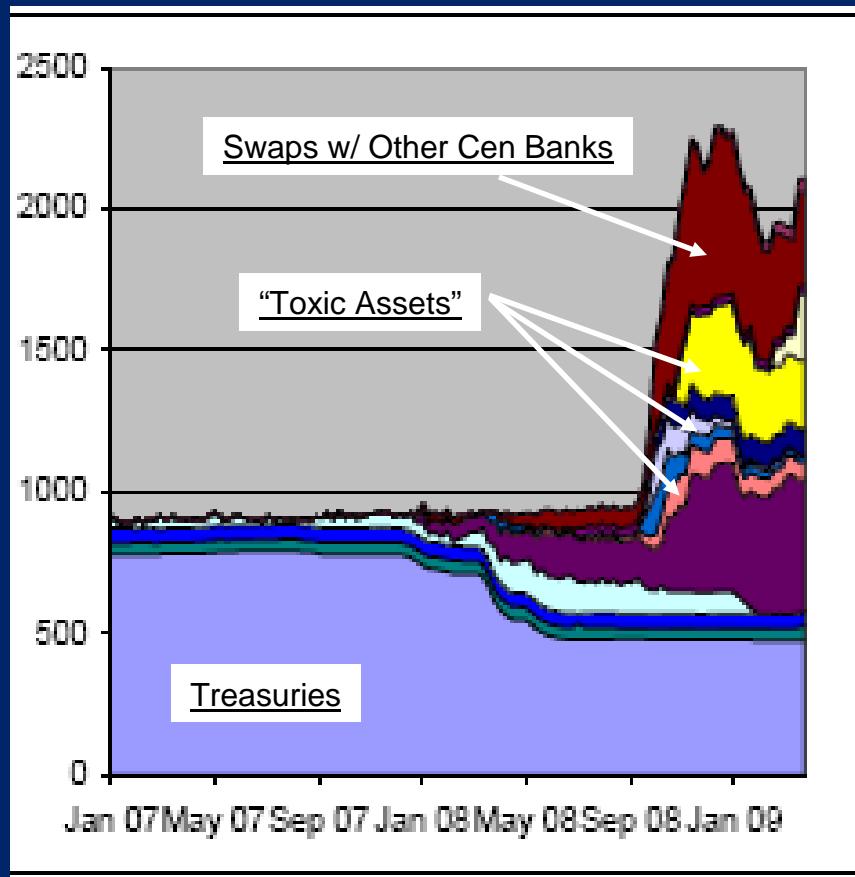
CBO: % Deviation fr. LR Trend GDP



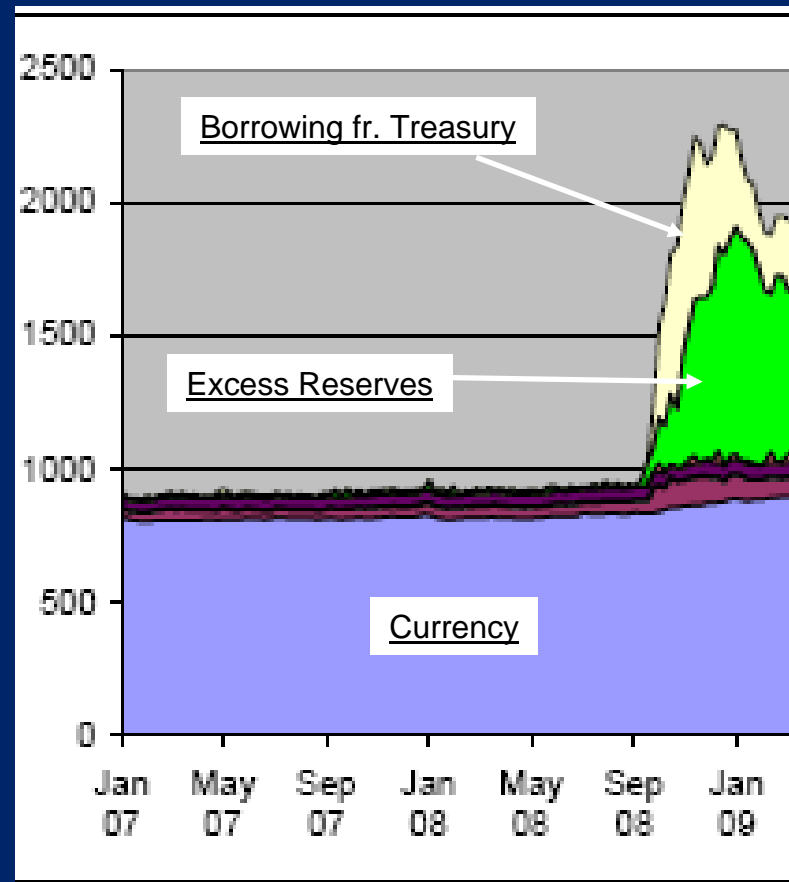
The Fed: Zero Interest Rates Only the Start

The Fed has doubled the monetary base by extending reserves to banks in return for questionable collateral. But the banks aren't lending this money... yet.

Fed Assets, billions \$

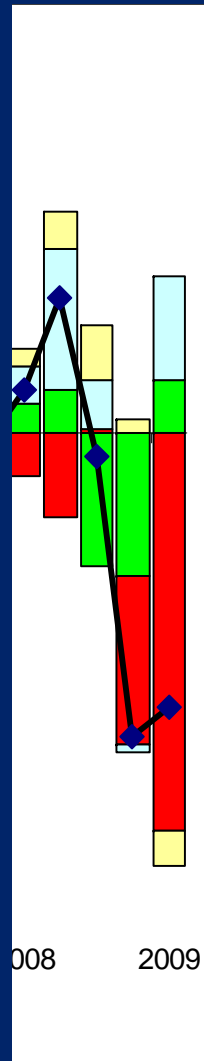


Fed Liabilities, billions \$



Source: J. Hamilton "Concerns about the Fed's New Balance Sheet"

A Closer Look at 2009Q1 GDP



NX: +2.2%

C: +1.1%

I: -8.3%

G: -0.7%

Good News: The improvement in Consumption in '09Q1 came mostly from Auto purchases. Auto purchases?!

Bad News: Continuing weakness in Res. Construction now surpassed by decline in Commercial Construction.

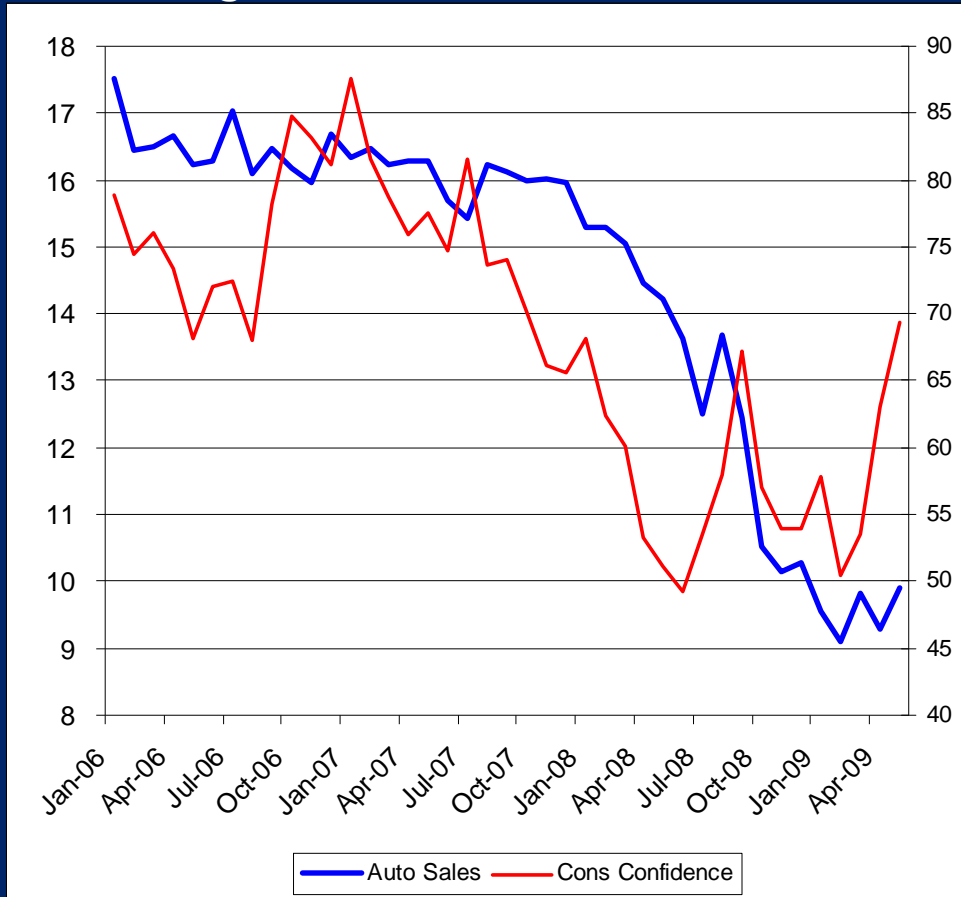
Bad News: Collapse of State and Local Gov't Spending makes Gov't a negative contribution to GDP growth!



Green Shoots? Consumption

Confidence is improving, and Auto sales look like they're bottoming out. But with income growth at its weakest in over 40 years, don't expect much anytime soon.

US Auto Sales (Left, Millions SAAR) and Leading Index of Cons. Confidence (Rt.)



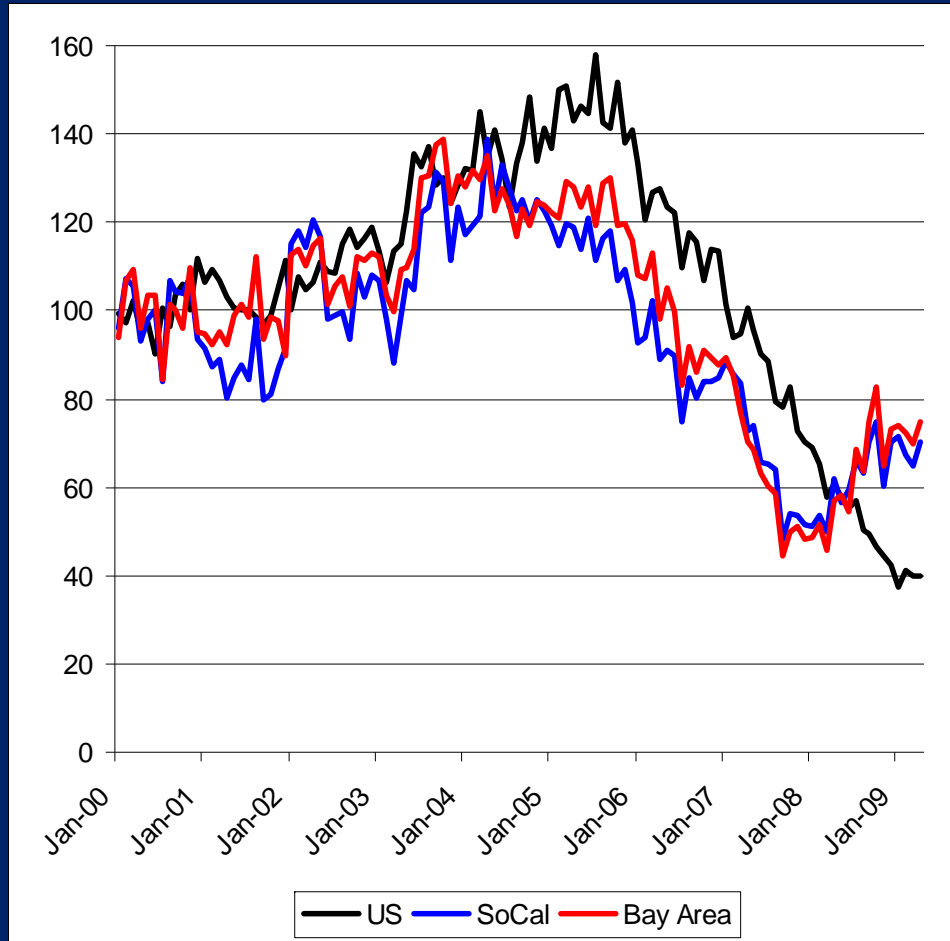
Year-over-Year Growth in US Personal Income



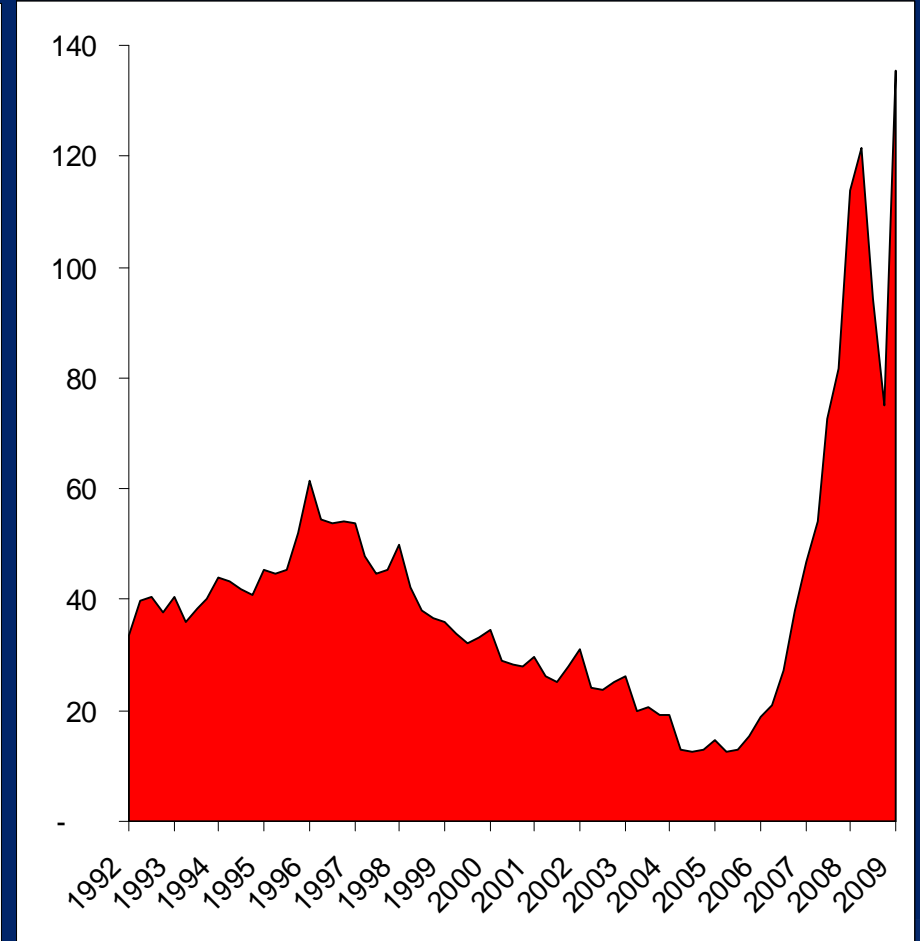
Green Shoots? Housing

Sales volumes are picking up, but with foreclosures accounting for over 50% of resales in CA, don't expect appreciation any time soon...

Index of Homes Sales (2000=100)



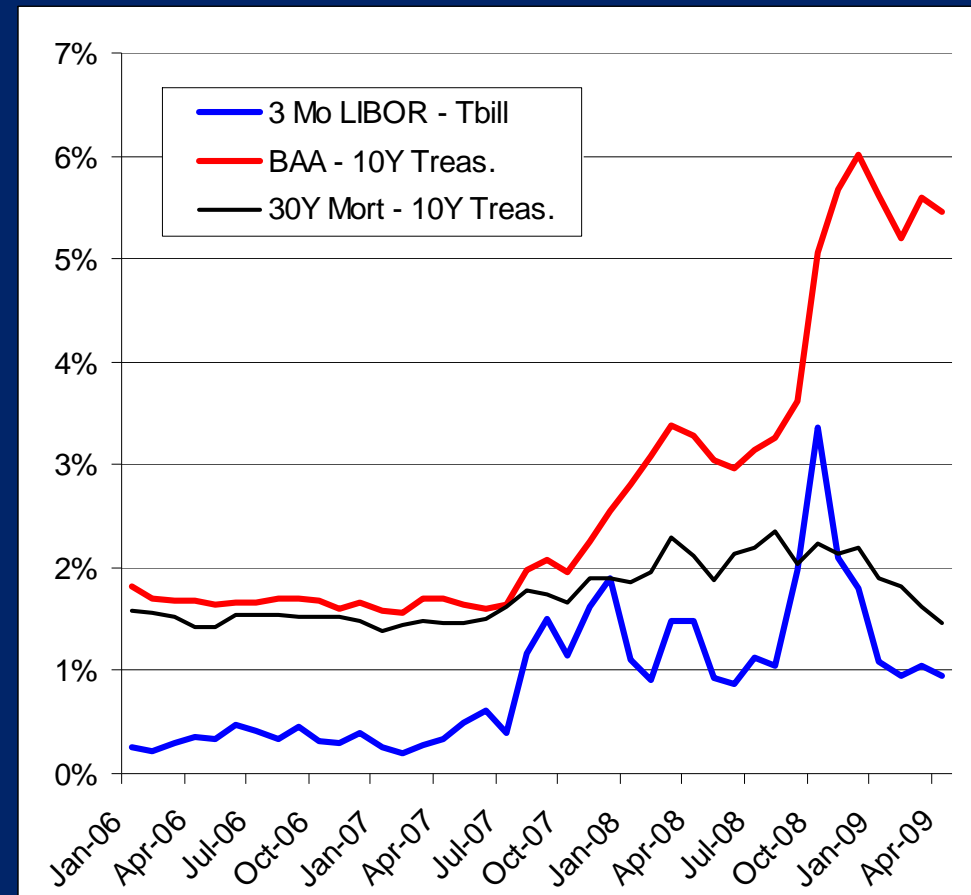
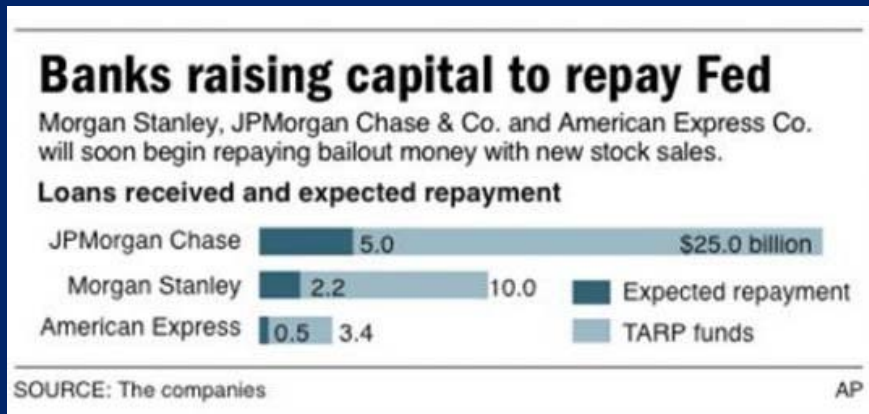
CA Notices of Default (1000s)



Green Shoots? Financial Markets

Big banks are looking healthier, while liquidity and mortgage spreads are falling. However, most risk premia are still elevated.

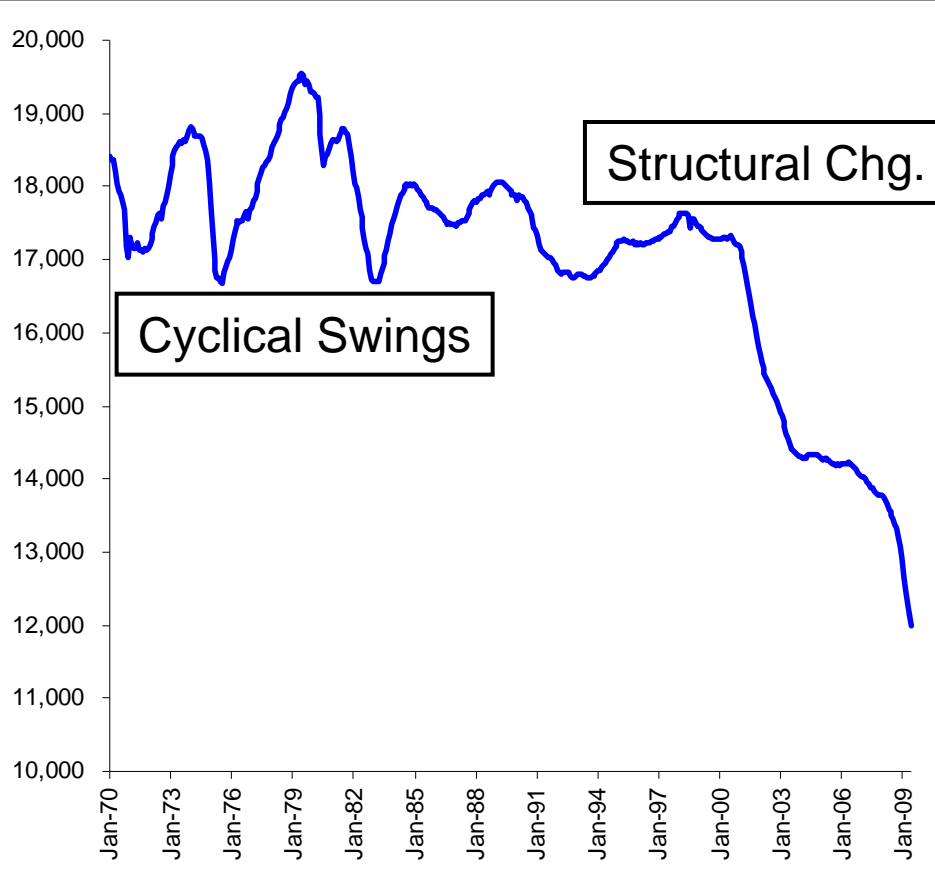
Risk Spreads



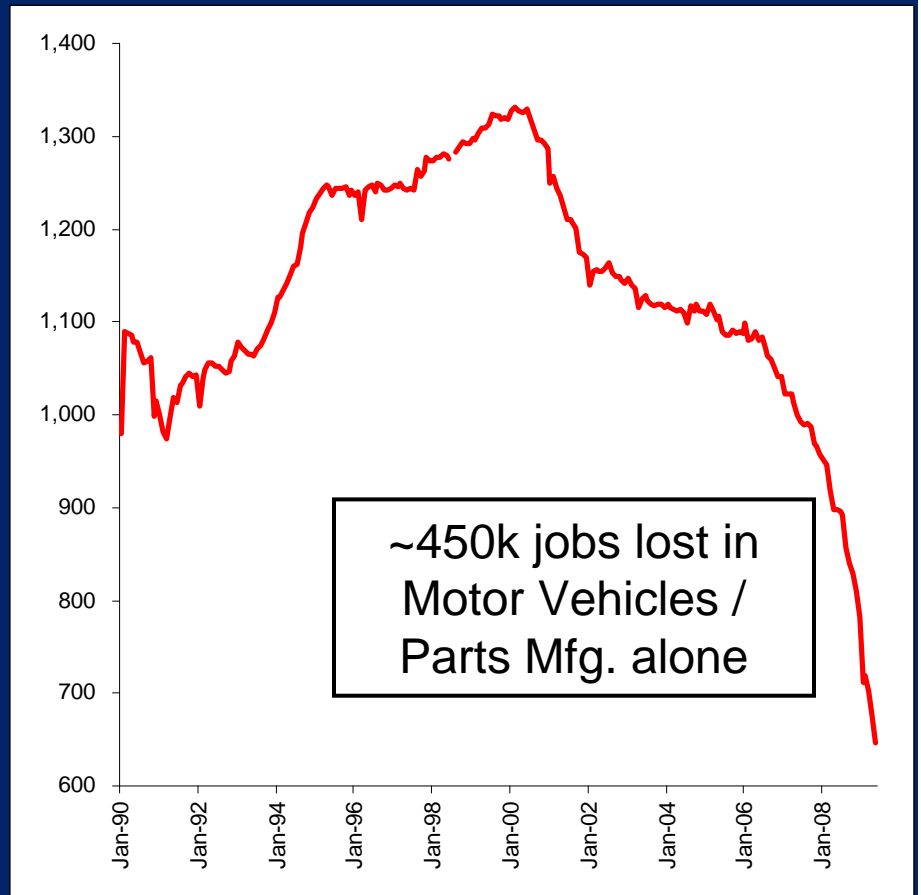
US: Structural Unemployment... Again

While GDP may improve in 2010, a large part of today's unemployment looks like structural unemployment, suggesting another "jobless recovery"

US Manufacturing Employment, (1000s SA)

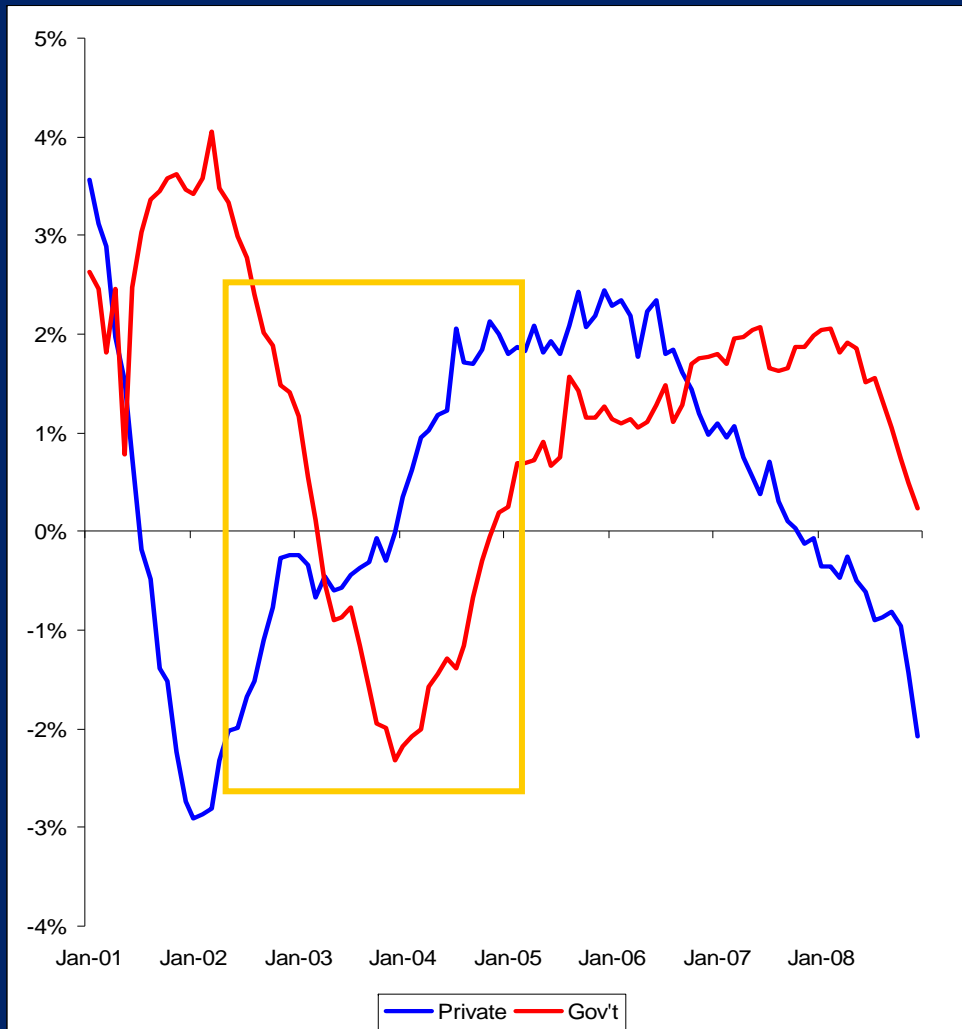


US Motor Vehicle/Parts Mfg, (1000s SA)



CA: Budget Debacle Will Slow the Recovery

YoY Chg in CA NFP Employment,
Private Sector vs. Gov't



- The 2001 recession precipitated a fiscal crisis in CA, but the employment impact didn't hit until 2003 – offsetting private sector job gains and delaying the recovery.
- Our \$40b fiscal crisis has now surpassed the \$38b projected deficit that triggered Gov. Davis' recall, with no solution in sight...
- Contraction in state spending may offset much of the federal stimulus.
- If we follow the 2001 pattern, state government will be a drag on CA job growth until late 2011!

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Final Thoughts

- There are some encouraging signs in both CA and the US that the freefall in housing may be slowing – typically the first sign of recovery.
- That said, we probably won't see a significant improvement in either the US or CA until early 2010, when the bulk of the fiscal stimulus hits the economy.
- Structural unemployment will keep labor markets weak well into 2010, and budget crisis will drag at CA's recovery.
- The Fed's balance sheet is a ticking time bomb: if not handled perfectly, there's the potential for inflation that makes the 1970s look tame.
- A dim flicker of light at the end of the tunnel, but a long way to go...

