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The Liscio Report

On the Economy

For John Liscio 1949-2000

The news will keep getting worse

Only 18% of the states in our survey met or exceeded their forecasts for withheld tax collections in December, down from 23% in November. Several states have recently dropped their forecasts yet again; if these states were facing their retired targets, the survey would be more like 13% at forecast.

But even with the accommodative calendar, the number of states reporting positive year-over-year comparisons slipped from 43% in November to 39% in December. That's a small move for the survey but indicative of a seriously deteriorating trend, especially alarming considering the extra collection days.

- ***once again, falling short of falling targets***
- ***the aftermath of banking crises: we're really just beginning***
- ***housing, jobs, GDP probably have a lot more downside***
- ***job market: still catching up to recession averages***

With extra collection days in most states, the calendar was kind in December after a harsh November. Some states account for calendar anomalies in their initial forecasts, and none of the states that raised their forecasts because of the calendar made their numbers. Other states forecast without adjusting for such calendar factors, and then consider the results of the two months together to determine how they stack up. Although December looked better than November, our contacts have suggested that if they missed their combined two-month target we should consider them under forecast for December, and we have done so.

Once again we have to report that the majority of our contacts are in the process of dropping their forecasts and the mood is generally grim, with weakness spread around the country. Also worrisome were widely reported "chilly" non-wage installment payments. These have more to do with profits than with employment, but indicate yet another shoe is dropping.

aftermaths

In a new paper, economists Carmen Reinhart of the University of Maryland and Kenneth Rogoff of Harvard have taken the measure of several major banking crises over the last few decades to give us some hint of what lies ahead for us. Not to spoil the dramatic tension, but the road looks pretty rough.

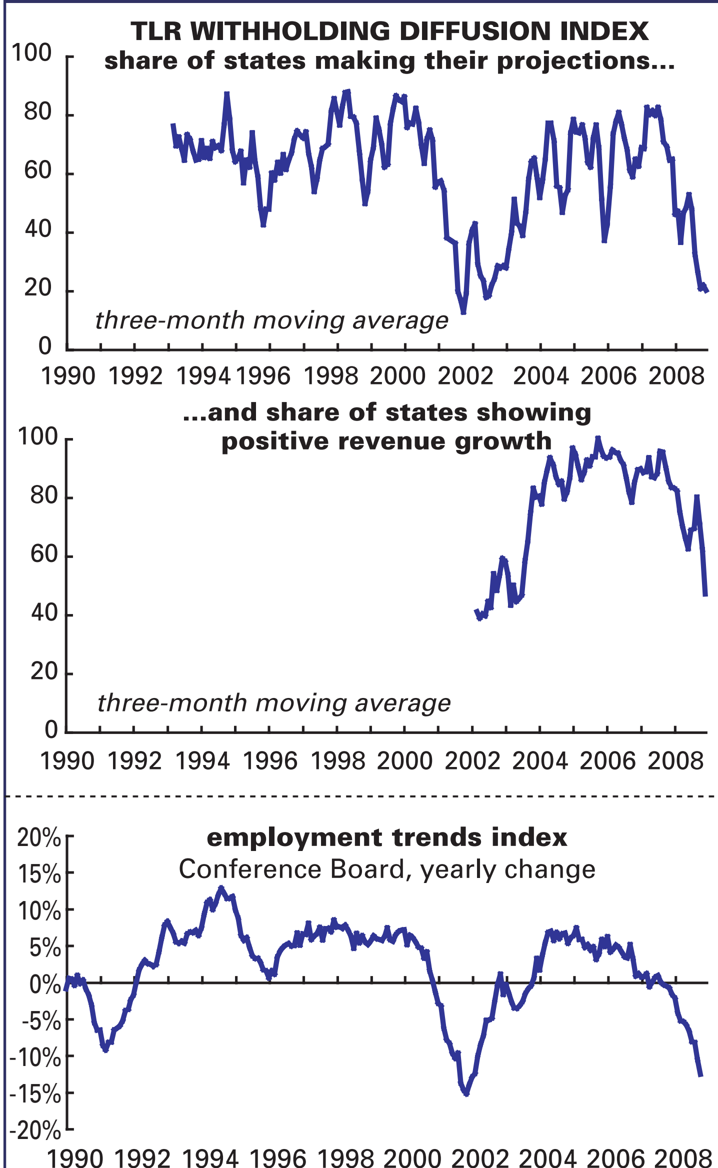
Here's the bullet-point summary of their paper (available at <www.economics.harvard.edu/faculty/rogoff/files/Aftermath.pdf>:

• Declines in asset prices are deep and prolonged: an average of 35% for house prices over six years, and 55% over three-and-a-half years for stocks.

• Declines in GDP and employment are "profound.' The unemployment rate rises an average of 7 points over four years, and per capita GDP declines by 9% over two years.

• Government debt explodes: up an average of 86%, not just because of bailout costs, but also because of recession-inspired declines in tax revenues. (Tell us about it.)

three employment indicators



The Conference Board's ETI leads payroll growth by about three months. It appears here with permission.

In an earlier paper, Reinhart and Rogoff (R&R) focused on eighteen banking crises in the developed world, singling out five major ones for special attention. They ignored crises in the developing world, because they thought they might be structurally distinct. But they turn out to be rather similar to those in richer countries, so in this paper, R&R blend them all into one sample.

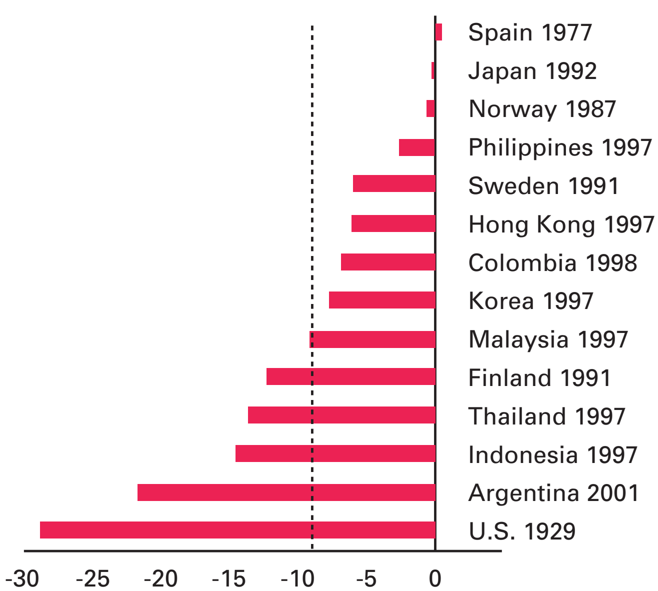
Expanding on the bullet points:

Though the average house price decline was 35%, the maximums were in Finland, the Philippines, Colombia, and Hong Kong, where the crashes were in the 50–60% range. The U.S. experience so far is approaching the average—the Case–Shiller–Weiss national index is off 30% in real terms since its mid-2006 peak. That, by the way, is far larger than the nominal decline at the onset of the Great Depression; Robert Shiller's long-term index was off almost 26% between 1928 and 1933. (Note that housing usually peaks a year or so ahead of the broader economic cycle.) Comparisons are hard, though. That decline was in nominal terms—in real terms, house prices barely changed over those five miserable years, because consumer prices fell by over 25%. Though our decline is approaching the average in price, we're still well short of the average duration of six years. In fact, there's little variation around that average—only Japan, with its 17-year streak, is a real outlier. Almost none are shorter than five years. So it's a safe bet that housing has further to fall, though the sharpest part of the price decline might be behind us.

Our stock price decline is also approaching the historical average; the S&P was down a little over 50% between its October 2007 high and its November 2008 low. But again, the duration comes in on the brief side; at just over a year, it's only about a third as long as the average crisis-induced bear market.

With only one quarter of y/y negative numbers, and that of just –0.4%, we've only scratched the surface of GDP declines. (See graph, above right.) Given population growth of about 1% a year, hitting a 9% decline over two years would imply two years of –3.5% real GDP. Since the Great Depression, only the postwar decline of 11% in 1946 comes near the magnitude of such a contraction. The recessions of the 1950s turned in declines of around 3%, as did the 1973–75 downturn, but even the deep 1981–82 recession gave us a cumulative decline of "only" 2.6%. If we experience anything like the usual banking-crisis-induced contraction, it will get a lot worse.

real per capita GDP decline in banking crises

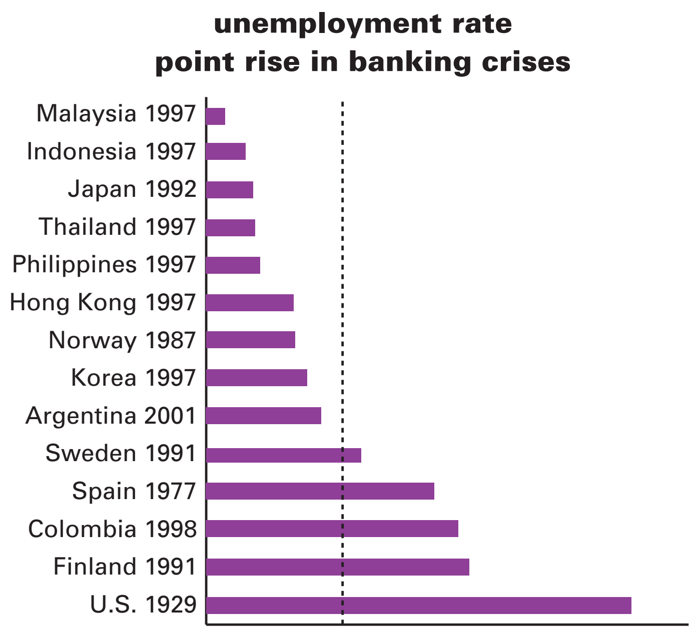


Peak-to-trough decline in real GDP per capita in major banking crises. Dotted line is average, –9.3%. Adapted from Reinhart and Rogoff.

The same with unemployment. (See graph, p. 4.) We're two years into the rise, half the R&R average, and only about a third of the way along the point increase. The authors point out that developing countries, especially those in Asia, do better on unemployment than their developed counterparts (in both time and magnitude). They speculate that this might be due to greater labor market flexibility and weaker social safety nets, which "presumably…make workers more anxious to avoid becoming unemployed." In that sense, the U.S. may be closer to developing Asia than to Scandinavia.

Finally, government debt rises sharply in the wake of banking crises, an average of 86%. Behind that average is a wide range of numbers, from a minimum of around 50% in Malaysia in their post-1997 crisis to over 275% in Colombia. Clearly there will be no shortage of Treasury bonds in the coming years; let's hope there's no shortage of buyers.

R&R ask how relevant these precedents are for divining the future. Mitigating the worst prospects are the aggressive policy responses in the U.S. and elsewhere, which were not present in many other cases (though in many of those early cases, the crises were national or regional, not global, meaning mutually reinforcing). And they warn that we should never flatter ourselves into thinking "that we are smarter than our predecessors. A few years back many people would have said that improvements in financial engineering had done much to tame the business cycle and limit the risk of financial contagion." And we know how that turned out.



Total increase in unemployment rates in banking crises. Dotted line is average, +7.0 points. Adapted from Reinhart and Rogoff.

recessions

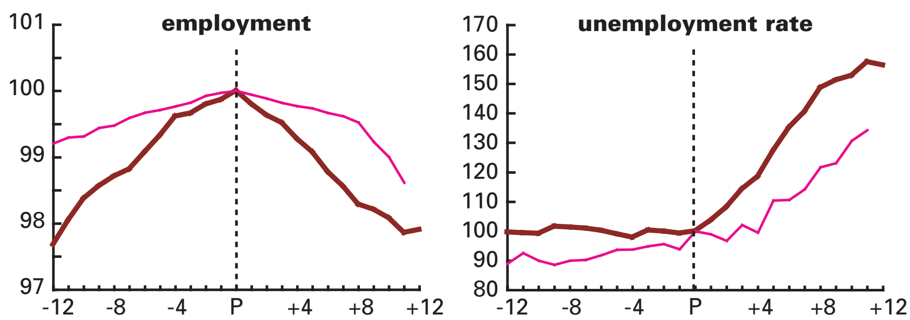
Given the acceleration in job market deterioration in recent months, you might think that what started out as a mild recession is merely turning into an ordinary one. Actually, we're not even matching the average yet, though that's almost certain to change in the coming months.

Graphed on p. 5 are comparisons of recent experience with historical averages for payroll employment and unemployment. In both cases, November's readings were less severe than the average. Were unemployment following the 'average" line, it would have been 7.8% in November rather than 6.7%, and employment would have been 1.05 million lower. Note also that while the employment dropoff has been weaker than average, the gain going into the peak was also weaker. On average, a recession roughly undoes the gains of the year going into the peak; November employment was 815,000 lower than it was in December 2006, a year before the cycle peak. Normally, it should have been 274,000 higher. And in average downturns, employment would be stabilizing and about to turn up; not this time.

And graphed on p. 6 are job losses in post-World War II recessions, both total and at an average annual rate. On both measures, we've got some catching up to do. The job loss through November was 1.4%, compared with a post-1950 average of –2.1% (and if we lost 600,000 in December, we'll still be 30 basis points short of the average). The annual rate of loss so far is 1.5%, a full point below average. Given how awful things feel now, some might take this as surprising news.

But, as the graph of the Conference Board's Employment Trend Index (ETI) on p. 2 shows, we've got at least several more months of employment losses ahead of us, and probably accelerating ones. Their ETI (and thanks to them for allowing us to reprint it) leads employment by about three months, and since November's is the latest reading, we can expect more negative numbers though February, at least. And if R&R, not to mention our tax contacts, are right, much longer than that.

employment & unemployment in recessions



Graphs show the average performance of total payroll employment and the unemployment rate during post-World War II recessions (heavier, darker lines) vs. recent experience (thinner, lighter lines), from 12 months before to 12 months after the peak. Values in peak month indexed to 100.

Friday's numbers

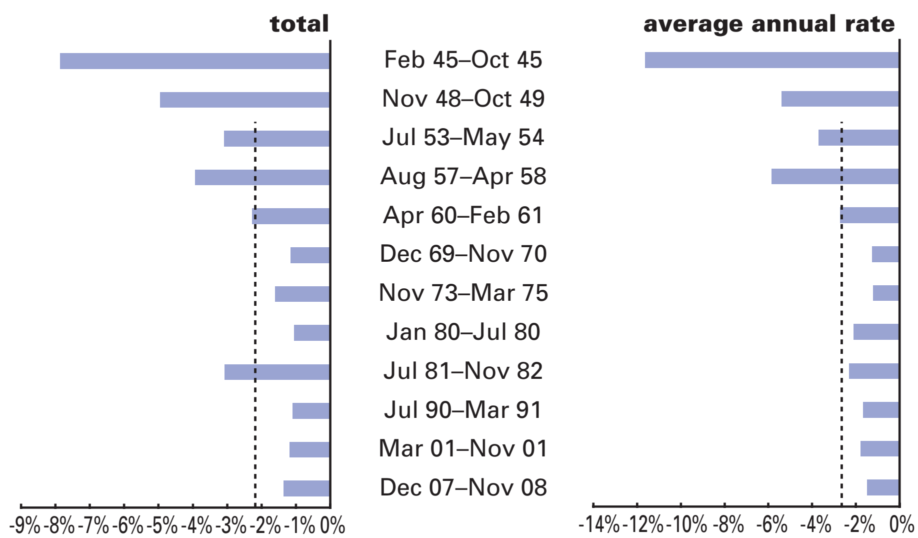
The much missed—by us anyway—Lone Star Café in NYC used to sport a garish banner over the front door that read, "Too much ain't enough." With ADP already out at close to –700,000 and the whisper number moving deeper into the red, we just don't know how bad will be bad enough on Friday morning in terms of market moves. And then there's that pesky concurrent seasonal adjustment program working overtime to smooth monthly job losses (and, sigh, gains) in order to provide a more readable, if harder to forecast, data series.

As we pointed out last month, the raw numbers for September and October were actually revised up before seasonal adjustment, meaning that November numbers were so weak as to shove the prior months down after adjustment. We saw what happened to October and September, but we don't know what happened to the prior months whose revisions are not reported. And the concurrent factor moves weakness forward as well, so, although December payrolls are likely handicapped by November's weakness, adjustment techniques will distribute job losses to surrounding months, possibly taking some of the sting out of the December headline. Even so, we believe the most honest forecast, considering our weakening survey, regional reports, and all manner of anecdotal evidence, is for a drop of 600,000 payrolls in December, brought about by accelerating layoffs, a hiring freeze, and reinforced by a wide-armed winter storm that caused flooding, electrical outages, and traffic disruptions up and down the eastern seaboard.

Our unemployment model tends to be most accurate when it is most outrageous, and outrageous it is: 7.1%, a very sharp rise of 0.4 point. We are overriding it in our forecast and looking for 7.0%, because that 7.1% would be contingent on an awful lot of workers continuing to beat the pavement despite dwindling hopes, but do want to note the risk. We expect wage growth to drop back to 0.2%, and the workweek to remain at its all-time low of 33.5 hours, although with the dramatic cuts in hours we are hearing about it could inch downward.

—Philippa Dunne & Doug Henwood

recession job losses



Job losses in post-World War II recessions. Graph on left shows total loss for the whole cycle (though employment peaks and troughs may have occurred outside the official recession boundaries); graph on right shows losses at an annualized rate. Vertical dotted lines represent averages since 1950; the 1940s downturns are excluded because they really pull up the averages.