

April 3, 2008

# *The Liscio Report*

## On the Economy

For John Liscio 1949-2000

### Tough love, Swedish style

Only one third of that states in our survey met or exceeded their withholding tax collections in March, down from 60% in February, and fully one third found themselves in negative territory year over year, up from one fifth in February. We want to reiterate what we said

last month, that the February level was probably inflated by calendar quirks and bonus payments. So, instead of the big drop in the current month, we want to emphasize the weakening trend—and bonus payments may still

be providing support, suggesting an even weaker underlying employment situation. One of our contacts saw some spikes in payments around March 15, which he suggested were businesses squaring up bonuses that can be deducted in 2007 but must be paid by March 15, 2008. Several other states showed a similar pattern, and some contacts pointed out that bonus payments appear to be heavy in non-financial firms this year. In April, bonus payments should be mostly washed out of the sur-

vey. In any case, the level of our survey is currently about 50 points below where it was last year at this time.

The best year-over-year results centered in the Midwest. This may seem counterintuitive, but it reflects

the fact that while other states were busting out in the housing boom, many of those in the Midwest were languishing in the “real economy” doldrums. Having missed the benefits they are skirting the downside as well, for

the most part reporting decent growth, especially when contrasted to the weakness, and sometimes sharply negative numbers, we’re hearing about from housing boom states. But weakness and uncertainty are spread throughout the country, whether because of the front-loaded housing boom, or the failure to thrive, and this is reflected in diminished expectations in budget forecasts. Some contacts remarked that efforts to balance budgets are going to get increasingly ugly in coming

- ***withholding slides, even with some support from bonuses***
- ***federal contracting responsible for 20% of private sector job growth!***
- ***what's up with remittances? and immigrants are shunning U.S.***
- ***coping with a banking crisis: the Swedish model***

*fidarsi é bene; non fidarsi é meglio*

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months, which, of course, is happening at a very bad time for the overall economy.

There's a factoid in Jane Zhan's March 25 *Wall Street Journal* piece, "How Government Adds to Ranks of Uninsured," that we want to highlight. Although the article focuses on the growing ranks of workers contracted out by the Federal government, mainly those in service positions, without health insurance—and using cash intended for purchase of health insurance on things like, oh, the rent—buried in the piece is a suggestion by NYU's Paul Light that the number of such jobs doubled to 5.4 million between 1995 and 2005. (Dr. Light told us that he came up with this estimate by matching individual purchasing transactions with BEA input/output models by type of job.) Contacts at the BLS confirmed that these employees would be counted in the private sector under the new NAICS classification. Following that logic, at least 2.7 million private sector jobs migrated from

the public to the private sector in those ten years, which would account for 19% of growth in private sector payrolls over

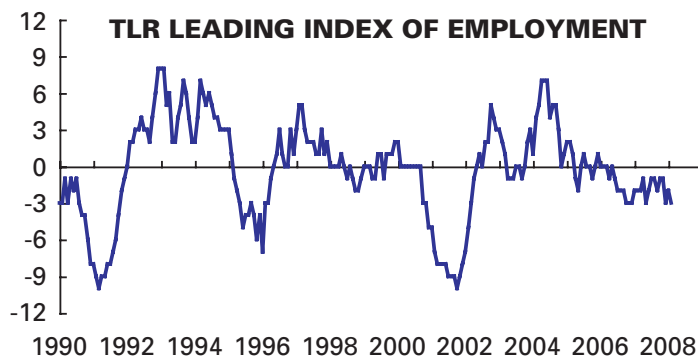
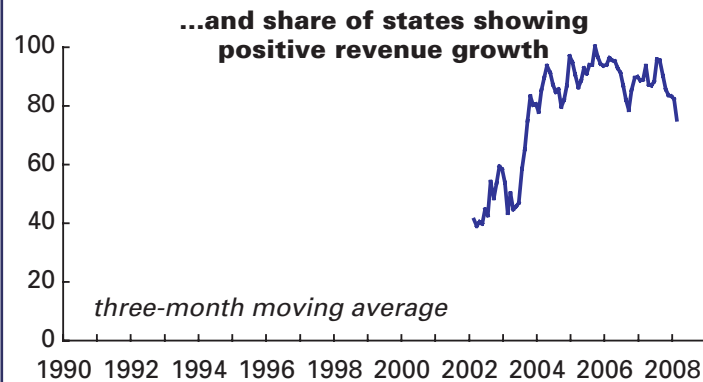
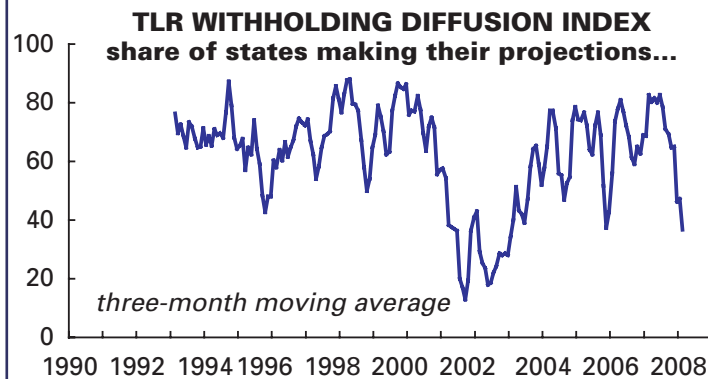
the same period (+14 million). The trend has surely continued, and the 2.7 million has surely increased, but even the 2005 level is about 2.3% of current private payrolls (115.6 million). This suggests considerably less dynamism in private, strictly defined, payrolls since the federal outsourcing trend began.

### Remittance update

Worker remittances from the U.S. to Mexico showed a mild uptick in February—up 5% from January, though not enough to reverse January's 8.5% decline. The yearly change was barely above 0. This is a sharp undoing of the 25–

30% growth rates of 2003–2005, and the weakest performance in the history of the series (which begins in 1990). There was a brief downdraft in late 1999, but it was quickly reversed. That doesn't seem to be happening this time.

### three leading indicators of employment



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Last month, we interpreted this as evidence of the loss of undocumented jobs in construction combined with the increasingly hostile attitudes towards immigrants, which has caused them either to lie low or “self-deport.” We now have some new evidence of how unusual this development is. In a new IMF working paper, two Fund economists, Shaun K. Roache and Ewa Gradzka, look at remittances from the U.S. to Mexico and other Latin American countries between 1990 and 2007 and find virtually no influence of the U.S. business cycle on homeward money flows. So unless this is a random event, which seems unlikely, something has really changed in the U.S. labor market.

That something could just be the unprecedented housing collapse, which could be too recent to appear in Roache and Gradzka’s work. But it may also be that a new hostility to immigrants is really changing the landscape. A tax contact in a border state wonders if one of the factors depressing their withholding receipts are the state’s tougher document requirements that appear currently to be forcing immigrant workers into neighboring states where laws are more lax. Contrary to common wisdom, many illegal workers do in fact pay taxes, using the social security cards that are part of standard-issue forged papers available on many street corners.

Adding to this impression is a report in Wednesday’s *Financial Times*, citing World Bank remittance expert Dilip Ratha, showing that immigrants are shunning the U.S. in favor of Europe and Canada. (Being less welcoming to immigrants than Europe would be quite a trick!) It’s not just low-end workers, either—it’s doctors,

nurses, and IT specialists. A major reason is the weakness of the U.S. dollar, which can’t get any respect in any quarter these days.

If this is the beginning of a long-term trend, it’s alarming for U.S. growth prospects. There’s little question that one of the reasons for our long-term economic success has been our openness to talented and ambitious foreigners. Let’s hope we remember that before it’s too late.

### The Swedish precedent

News that the Fed is studying how the Nordic countries handled their early-1990s banking crises got some recent attention, but all the enthusiasts who bid up stocks on Tuesday probably weren’t paying attention. Because as interesting as that precedent is, it’s nothing to get thrilled about yet.

Peter Englund’s paper, “The Swedish Banking Crisis: Roots And Consequences” (*Oxford Review of Economic Policy*, 1999), provides an excellent case study on a successful, but painful, approach to cleaning up after a burst bubble.

From the 1960s into the early 1990s, Sweden experienced negative real interest rates. But since the financial sector was tightly regulated for most of that period,

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speculative energies were largely bottled up. Starting in the early 1980s, though, Sweden joined the worldwide deregulatory trend, and credit growth exploded. Combined with an expansionary fiscal policy, this fueled a consumption boom and an asset bubble. Stock prices rose in the late 1980s, though the acceleration over earlier-1980s growth rates wasn't all that dramatic. The real action was in real estate, commercial and residential—especially single-family houses. After five years of stagnant nominal house prices in the early 1980s, prices doubled between 1985 and 1991. Nothing in the economic or demographic fundamentals could explain the boom.

Sound familiar? So does the end of the boom. One prominent finance company found it impossible to roll over maturing debt, leading to a sort of “run” on the whole industry, leading to a freeze-up of the market by which mortgages were funded. (They're called *marknadsbevis* in Swedish, and sound a lot like our commercial paper market.) Risk premia expanded markedly, and soon Treasury bills were the only thing that investors wanted. The crisis spread from specialized finance companies to the broad banking sector, leading to a stock market panic, declines in real estate prices, and eventually a severe recession (about which more in a moment).

The Swedish government stepped in fairly quickly. The policy was to save the banks but not their owners, so shareholders in the most troubled institutions were largely wiped out. But the government pumped 65 billion kronor (\$11 billion at 1991 exchange rates or 4% of that year's GDP) into the banks to keep them afloat.

Englund emphasizes two important points about the bailout. One is that it was done quickly, with almost universal political support. And the other is that the shareholders of rescued banks were wiped out. No doubt other banks were kept afloat because of the psychological assurance the government provided, thereby preserving shareholder wealth in surviving institutions. But there was no dickering, a la Bear Stearns.

A year or so after the outbreak of the banking crisis, in 1992 Sweden experienced a severe currency crisis, which led the Riksbank to raise overnight rates to 500% to defend the krona. When the central bank gave up defending the currency, it lost almost 40% of its value against the U.S. dollar. The U.S. has already experienced something similar to that depreciation; Sweden wasn't lucky enough to issue the world's reserve currency, so it really felt like a crisis. Imagine the Fed having to raise interest rates even to 10% in the current environment!

To resolve the crisis, the government created a holding company that took on non-performing loans and underlying real assets. These were mostly sold on the open market during 1995 and 1996; by 1997 the process was largely wound up. The final bill to taxpayers, after gains on the asset sales, was about 2% of GDP.

The emergency response was not enough to prevent a recession. As the top chart on p. 7 shows, GDP went deeply negative between 1991 and 1993, leading to a total contraction of over 5%; that's roughly twice as deep as the 1974–75 and 1981–82 recessions in the U.S. But although there was a credit crunch, it was short-lived, and the Swedish economy recovered. As

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the inset bar chart shows, GDP growth in the 1990s was actually slightly higher than in the 1980s, and averaged a highly respectable 3.4% in the second half of the decade. (U.S. growth over the same period averaged 3.9%. But given the differential in population growth, the per capita figures are virtually identical.)

Contrast that recovery with Japan's dismal performance. That country dithered after its asset bubble burst in the late 1980s, never really moving decisively to close failing banks and recapitalize survivors. The result was a sub-1% average growth rate for the 1990s, a performance that's hardly improved in the 2000s.

So if we want to avoid something like the Japanese scenario, the lessons are clear: move quickly to recapitalize failing banks (while not sparing the shareholders). But it must be acknowledged that Swedish politics has long been characterized by a much broader consensus than we have in the U.S. It seems very unlikely that Washington could move as decisively in spending \$300–600 billion (the equivalent of Sweden's 2–4% of GDP). But there are great risks in dithering.

### **Friday's numbers**

We should remember that while the job market is deteriorating, it's not yet contracting at the rate typical of earlier recessions, when monthly declines of 300,000 were not unknown. Similarly with initial claims; if the recession began in December, a proposition we see no reason to abandon, we'd be seeing weekly claims numbers north of 400,000 were this an "average" downturn. Things could always take a sharp turn for the worse—as we noted in our last flow of funds analy-

sis, the mortgage crisis has not yet spread into the broader credit markets, though you have to wonder how long that can continue. A bearish friend of ours points out that Countrywide tapped every penny of its available credit lines before blowing up; in the words of the poet A.R. Ammons, who wouldn't turn up the voltage when you know the lights are going out? But we're still thinking slow leak more than rampant bloodletting, at least for now. That's the other side of the generally weak job growth in the late expansion.

As we mentioned last month, there is a strong serial correlation between monthly payroll numbers (+0.61), unlike some other indicators like monthly retail sales report (-0.36). Last month's -63,000 nonfarm payroll was weaker than we expected, but we're taking that to mean that the downtrend trend is now in place, and likely to continue, not that we should expect payback. The overall seasonal adjustment factor for February and March are pretty much equal: both expect job gains of about 600,000. But the mix shifted in March. In February 66% of those jobs were to occur in the public sector, in March about 80% are expected in the private sector, where current conditions are likely to have more power. We have noticed over the years that it is more common to see significant falls in employment when the factors are expecting gains than when they are expecting layoffs, probably because employers are less likely to lay off workers than hire workers in times of uncertainty.

So, with anecdotal evidence, including that nasty food-stamp spike, gloomy confidence and polling data, the continuing droopiness of our leading employment index, withholding tax receipts pointing to

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a slowing job market, and the technicals less than accommodative, we expect another 65,000 decline in payrolls, a jump in the unemployment rate to 5.0% (or even 5.1%), earnings at a restrained +0.2%, and a stable workweek for March.

By the way, a contact at the BLS confirms that they adjust for hours and earnings for Easter but not employment, since they have no evidence of a serious effect. We have noticed a slight tendency for early Easter to lift retail payrolls, but think that will be trumped by the overall retail climate: it's unlikely stores padded payrolls two weeks before the holiday in anticipation of shoppers flooding their stores to stock up on chocolate bunnies.

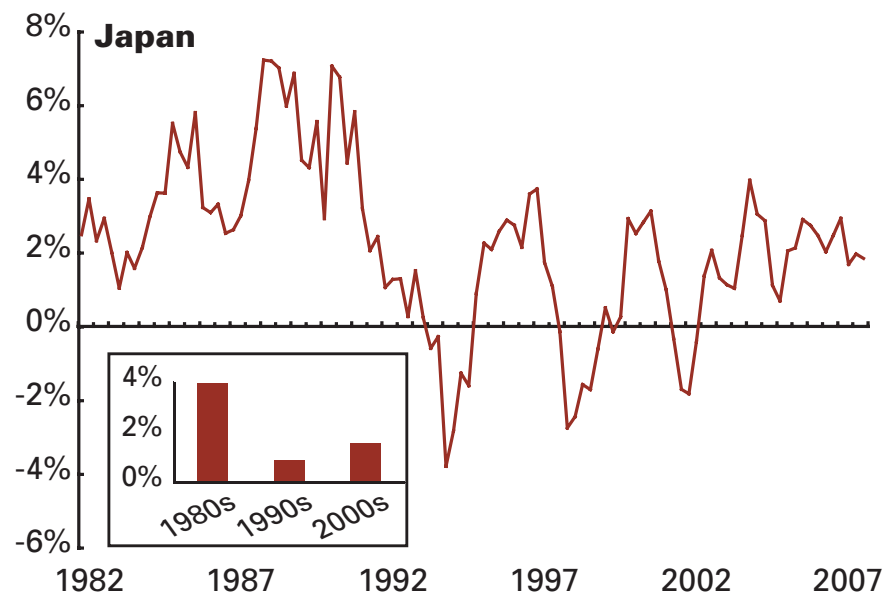
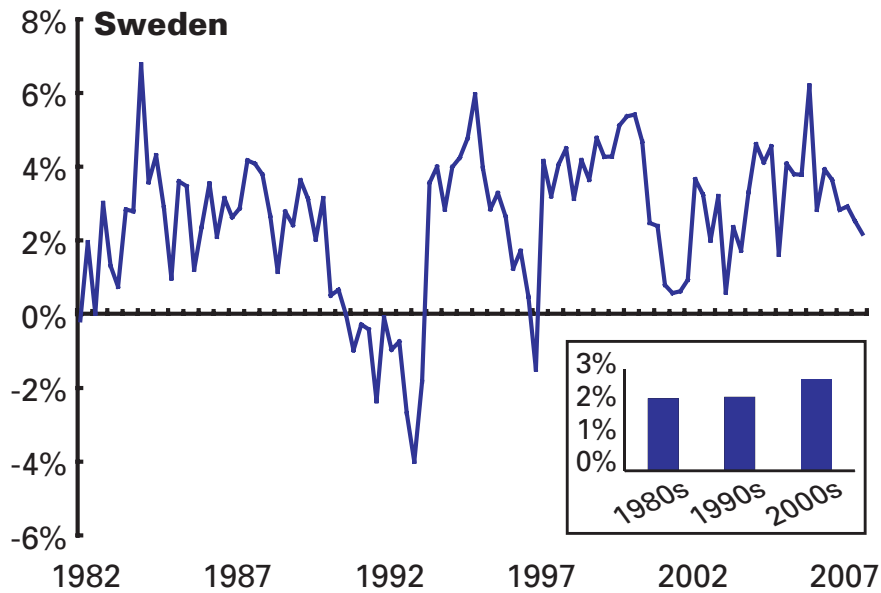
—Philippa Dunne & Doug Henwood

***Sweden vs. Japan***



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### TWO APPROACHES TO A BANKING CRISIS Sweden vs. Japan, yearly GDP growth and decade averages



Line graphs show yearly growth rates in real GDP; inset bar graphs show decade average growth rates for the 1980s, 1990s, and 2000s (though 2007).