

As a New Decade Is Ushered In: Why Only Some Economists Are Celebrating

Sondra Albert

Chief Economist, AFL-CIO Housing Investment Trust

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Economic growth resumed in the second half of 2009 on the heels of a large government stimulus and accommodative monetary policy by the Federal Reserve that were meant to achieve this result. While economists' views on the 2010 economy appear to run the spectrum from upbeat to extremely pessimistic, there is some agreement that if positive growth continues, it will be significantly slower than the "V" shaped recovery normally experienced after a severe contraction like one we have just seen. Peter Goodman, writing in *The New York Times*, asserts that "The Great Ambiguity" has replaced the Great Recession. He defines the "Great Ambiguity" as a time of considerable debate over the clarity of economic indicators and the staying power of apparent improvements.¹ How can we sort out the contradictory signs and assess the true state of the economy?

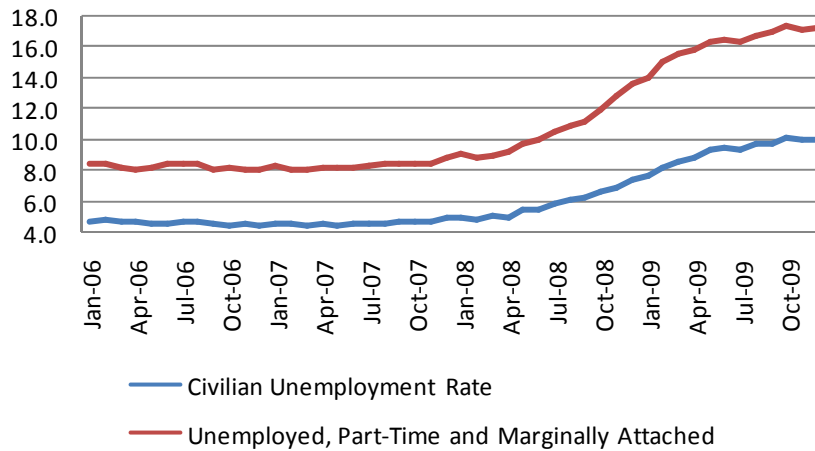
Growth Resumed but Labor Market Remains Weak

The economy showed some signs of improvement in 2009, with economic growth expanding in the second half of the year. While that improvement did lead to a slowing of monthly job losses, it did not translate into job growth. Household employment has declined by 8.38 million jobs since the recession began in December 2007, according to the Bureau of Labor Statistics. The national unemployment rate ended 2009 at 10%, while the broader measure of unemployment, which includes marginally attached workers, ended the year at 17.3%.² While the unemployment rates appear to be leveling off, further weakness in the labor market is evident in the lowest labor market participation rate since 1985. With so many U.S. workers remaining idle, the economy is suffering from a huge loss of productive capacity.

¹ "Divergent Views on Signs of Life in the Economy," by Peter Goodman, *The New York Times* (1/5/2009).

² Bureau of Labor Statistics.

Unemployment Rates (Percent)



Source: Bureau of Labor Statistics

Weakness in the labor force has added to the weakness in the single family housing market, because so many unemployed individuals have been unable to pay their mortgages. This led to a rise in delinquencies and foreclosures for prime fixed rate loans during 2009, according to the Mortgage Bankers Association. The housing market was strengthened in 2009 by the Federal Reserve’s purchase of mortgage-backed securities, which led to a decline in mortgage rates, as well as by the federal government’s tax credit for first-time home buyers. These programs led to a stabilization of home prices in many areas. But unless new jobs are created to replace the jobs lost in the economy, foreclosures will continue to place downward pressure on home prices.

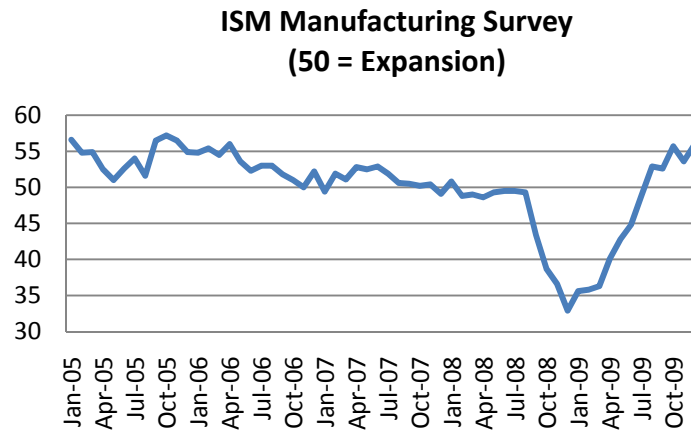
Some of the U.S. economic growth in 2009 was due to the replenishment of inventories and a narrowing of the trade deficit. Credit remained tight throughout the year, making it difficult for small and medium sized firms to obtain credit essential to their survival. Many large financial institutions returned to profitability in 2009, but this did not translate into an overall increase in the availability of credit. While some economic indicators turned positive in the second half of 2009, the recovery still has not translated into labor market improvements that are essential to put the economy on a path to sustainable recovery.

Some Optimistic Economists See the Expansion Gaining Steam in 2010

Economists who say the recovery is gaining strength cite recent positive economic data in some sectors and increases in stock prices as evidence of growth. Allen Sinai, the chief global economist at the research firm Decision Economics, was recently quoted as saying, “We’re really coming back. . . The expansion is picking up the pace.”³ As an example of strength, some economists have cited the Institute

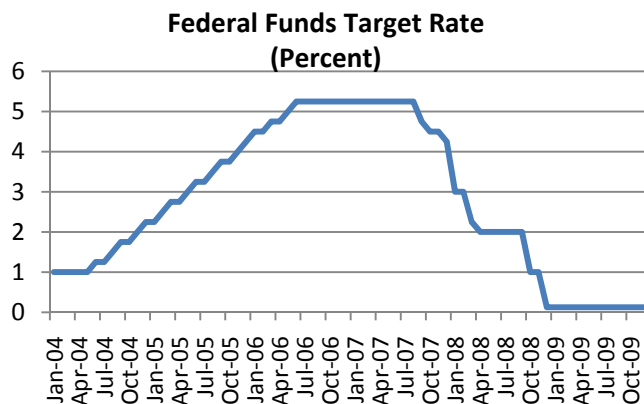
³ Ibid.

for Supply Management ISM Manufacturing Survey, which rose to 55.9 in December, its highest level since April 2006, before the subprime crisis gripped the U.S. economy.⁴



Source: Institute for Supply Management

Some other well regarded economists changed their views on the economy toward the end of 2009. This group includes Alan Blinder, Princeton economist and former vice chairman of the Federal Reserve Board, who stated his case for optimism in a *Wall Street Journal* article in December 2009. Blinder lists four reasons to be bullish: The slingshot effect (the more severe the downturn, the faster the recovery), improving employment, government stimulus, and the easy monetary policy of the Federal Reserve. Blinder is not entirely optimistic regarding the economy. He does not expect rapid growth this year and admits that the investment slingshot and fiscal stimulus will both peter out in 2010. Consumer finances and confidence remain shaky in his view, while banks are still failing and commercial real estate has not begun to recover. Nevertheless, Blinder forecasts a 3%-4% real growth rate in 2010.⁵

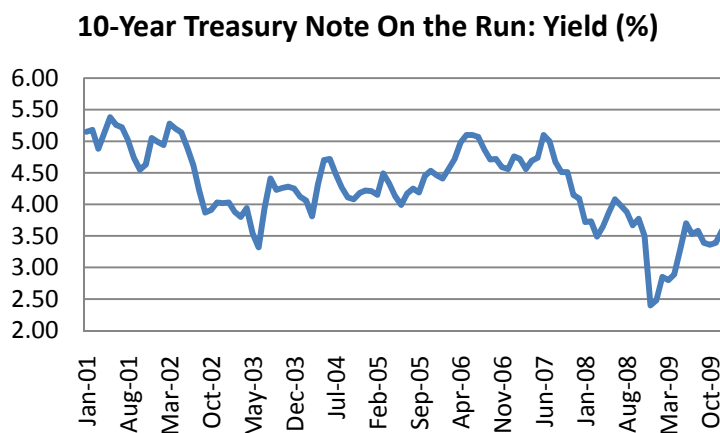


Source: Federal Reserve

⁴ Institute of Supply Management.

⁵ "The Case for Optimism on the Economy," by Alan Blinder, *The Wall Street Journal* (12/15/2009).

Byron R. Wien, Vice Chairman, Blackstone Advisory Services, recently issued his list of the Ten Surprises for 2010 with his predictions about this year, many of which pertain to the economy. Wien forecasts that the U.S. economy will grow at a 5% real rate during the year and the unemployment level will fall below 9%. He predicts that the sectors leading the recovery will be exports, inventory building, and technology spending. His forecast for interest rates predicts a Federal Reserve decision to increase rates in a series of successive hikes beginning in the second quarter, and he foresees the Federal Funds rate reaching 2% by year-end. Wien's forecast for government debt includes rising U.S. Treasury yields due to heavy borrowing by the U.S. Treasury and some reluctance by foreign central banks to keep buying notes and bonds. In his opinion, this will boost the yield on the 10-year Treasury above 5.5% by the end of 2010. Also leading to higher yields will be a predicted increase in bank loans to corporations and individuals and a pulling away from the carry trade, thereby reducing demand for Treasuries. Even though the economy will be strong and earnings will exceed expectations, rising interest rates and full valuations will dampen growth, in his view.⁶



Source: New York Times, Monthly Average of Daily Figures

While Wien is extremely optimistic about 2010, he does acknowledge that investors may be unsettled by concerns about longer-term growth and obligations to reduce leverage at both the public and private level. However, he does anticipate that financial service legislation will be enacted this year and that it will be softer on the industry than Wall Street originally expected. He expects the legislation to provide greater consumer protection, more transparency, tighter restrictions on leverage, and increased scrutiny of derivatives, but the regulatory changes for investment bankers and hedge funds will not be onerous, he predicts. Wien expects trading volume and merger activity to increase and financial service stocks to become exceptional performers in the U.S. market. After 25 years of forecasting trends in the U.S. economy, Wien was extremely accurate with most of his predictions for 2009, but his forecasts for 2010 appear overly optimistic.⁷

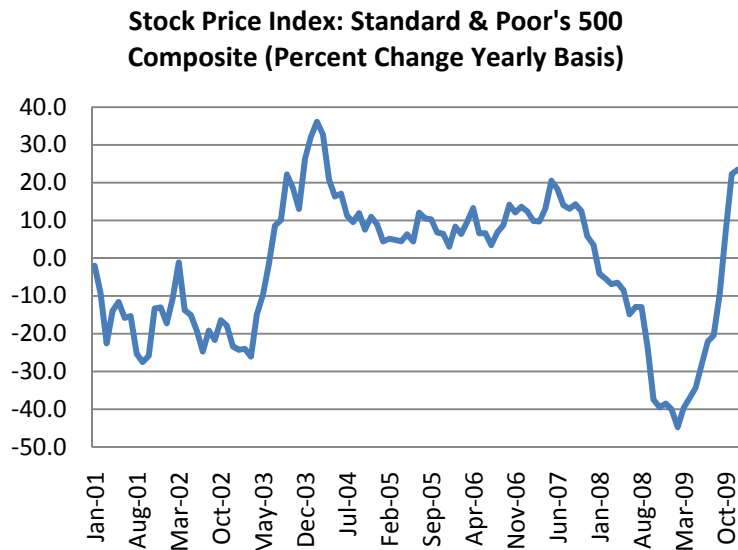
⁶ "Blackstone Group's Byron Wien Announces Top Ten Surprises for 2010," by Byron Wien, Buisnesswire.com (1/4/2010).

⁷ Ibid.

The Optimism of a Few Economists Is Balanced by Pessimism of Others

Paul Krugman and Martin Feldstein have recently said there is a 30-40% chance that another recession will unfold in the second half of this year as inventory restocking and fiscal/monetary stimulus both begin to fade. Joseph Stiglitz and Nouriel Roubini also see a significant amount of weakness in the economy this year.⁸

Krugman, a Princeton University professor and Nobel Prize winner in economics, expects growth will slow as the Federal Reserve ends purchases of securities, the Obama administration's \$787 billion stimulus program winds down, and companies stop rebuilding depleted stockpiles. The Federal Reserve's plan to end purchases of \$1.25 trillion of mortgage-backed securities and about \$175 billion of federal agency debt in March could spur an increase in mortgage rates and lead to declines in home sales and prices, according to Krugman. Krugman disagrees with former Federal Reserve Chairman Alan Greenspan's view that the surge in stock prices last year reduces the need for additional government stimulus. Krugman recently wrote that while the Standard & Poor's 500 Index rallied 23% in 2009, its best performance since 2003, "People are a lot poorer than they were four years ago." He noted, "Consumption is not that dependent on stock values, much more so on housing values."⁹ Krugman had previously criticized the Obama administration's 2009 stimulus package as too small to jump start sustainable growth in the economy. He may be proven correct.¹⁰



Source: Wall Street Journal

⁸ "Krugman Sees 30-40% Chance of U.S. Recession in 2010," by Steve Matthews, Bloomberg.com (1/4/2010).

⁹ Ibid.

¹⁰ Ibid.

Paul Krugman's outlook on the economy is shared by Martin Feldstein, Harvard University economics professor and a member of the Business Cycle Dating Committee of the National Bureau of Economic Research, the panel charged with determining when U.S. recessions begin and end. Feldstein recently said U.S. economic growth may falter this year because of a waning stimulus from federal spending and from tax incentives for home and auto purchases. "These forms of stimulus will be missing in 2010, creating a serious cloud over the near-term economic outlook," Feldstein said on January 7 during a panel discussion at the American Economic Association's annual conference. "Enormous fiscal deficits," he said, could weigh on the expansion, as may the weakness in residential and commercial real estate markets, which remain depressed. Local banks around country have not loosened credit because of the default risk in a weak economy.

Joseph Stiglitz, a professor at Columbia University and a former White House economic adviser under President Bill Clinton, agreed with Feldstein at the American Economic Association meeting and was quoted as saying, "it is not likely we will have robust growth anytime soon." He does not see any industry in the U.S. that can provide as many jobs for unemployed individuals as the real estate and finance industry sectors did during the housing boom.¹¹

Eric S. Rosengren, President and Chief Executive Officer of the Federal Reserve Bank of Boston, recently cited three headwinds facing the U.S. economy in 2010 that will restrain growth. First, he feels that although the U.S. banking crisis has passed, banking problems remain. Historically, most economies that experience significant banking problems have been slow to recover. Second, consumers and businesses will likely remain cautious. Therefore, consumption will continue to be subdued, as consumers are fully aware that housing prices are well off their peak, unemployment rates are high, and home foreclosures are continuing. Third, recessions this severe have broader ramifications for labor markets. Workers become discouraged and leave the labor force, the skills of workers who are unemployed for long periods may atrophy, and new entrants to the labor market often have to settle for lower pay than what they would be offered in a more robust economy.¹²

There are divergent views on whether growth will continue this year or fizzle out as the stimulus impact subsides. One thing that is clear, though, is that the weak labor market will continue to be a drag on the recovery. Although economic growth resumed in the second half of 2009, the economy is not beginning 2010 on solid ground because of high unemployment and the prospect of rising foreclosures that threaten to derail growth this year. Weak demand by consumers and businesses will likely keep inflation well contained through the year, giving the Federal Reserve room to hold off raising rates until there are signs of improvement in the labor market.

¹¹ "Feldstein Says Lack of 2010 Stimulus 'Serious Cloud on Growth,'" by Steve Matthews & Timothy Homan, Bloomberg.com (1/3/2010).

¹² "Prospects for Employment, Evidence From Prior Recoveries," by Eric S. Rosengren, at the Connecticut Business & Industry Association and the MetroHartford Alliance Economic Summit & Outlook 2010 (1/8/2010).

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