



**An excess supply of pessimism?** Rarely has the economic mood turned so dark so quickly. The media are full of references to the dreaded “double dip” return to recession. Columnist/Nobel Laureate Paul Krugman recently wrote that the U.S. could be facing a depression. One stock market guru, who sees patterns in just about everything, contends the Dow Jones is headed below 1,000. This follows one of the strongest post-recession stock market rebounds on record. Wow!

I’m sticking to my forecast of modest economic growth (50 percent odds) but now think that the probability of a return to recession is uncomfortably high (30 percent). A depression is a long shot in my view. Recession would cause serious problems in housing, financial institutions and for state and local governments. Worst of all, renewed recession could trigger a serious bout of deflation as discussed below.

**Why so morose?** It all seemed to start in late April when financial markets were surprised by the inability of the Greeks – and other governments – to service their debts. The European “bailout” program was enacted with a minimum of enthusiasm, and has gotten off to a shaky start. Now, foreign governments are instituting budget austerity programs and so are U.S. state and local entities. These fiscal tightening moves are occurring at precisely the time that the fiscal stimulus programs enacted a couple of years ago are beginning to wind down.

U.S. jobs are growing again, but at a disappointing pace that undermines consumer confidence and spending. Housing markets slumped after the expiration of the home-buyers tax credit on April 30. Not surprisingly, the Dow Jones has dropped. After hitting 11,300 in April, it closed below 10,000 in early July. Stocks rose after July 4 as this pessimism seemed a bit overdone.

Then there’s the seeming ineptness of elected and appointed officials. The environmental disaster caused by the leaking BP oil well worsens by the day. Congress went on vacation without extending unemployment benefits for those many people out of work during the worst recession in the past 70 years. With short-term interest rates already close to zero, the Federal Reserve would seem to have little ability to stimulate the economy.

**But it’s not ALL bad!** There are some notable bright spots.

Manufacturing output continues to rise and recently stood about 9 percent above the mid-2009 lows. Auto sales have a long way to go, but they have recovered from the slump that followed the “cash for clunkers” program and are well above their recession lows.

Inflation is very tame: the Consumer Price Index (CPI) has been rising about 2 percent overall and considerably less when food and energy are excluded. Measures of inflation expectations, such as the spread between the U.S. Treasury coupon bonds and the Treasury Inflation Protected Securities (TIPS), show that financial market participants are betting that modest inflation will persist for some years to come. And despite worries about the future impact of federal budget deficits on financing costs, Treasury bond yields are very low. As a result, 30-year fixed-rate mortgages are available for less than 5 percent, something not seen in almost half a century!

The hiring and subsequent firing of temporary census workers has exaggerated the jobs slowdown and obscured the turnaround. During the first half of 2010, private sector employment grew by 600,000 following a decline of nearly one million in the preceding six months.

Even with the retreat of the stock market over the last couple of months, the Dow Jones is still about 50 percent above the recession lows of March 2009. I think equities had gotten overly exuberant so that a portion of the recent decline reflects a return to the realities of modest growth.

These positives are probably enough for Gross Domestic Product (GDP) to grow close to 3 percent during the coming four quarters – about the same as in the past year. The recovery thus far has been about half as fast as the typical rebound following post WWII recessions.

## Musings & Amusings: *Pessimism*

**George Will:** The nice part about being a pessimist is that you are constantly being either proven right or pleasantly surprised.

**Anonymous:** The light at the end of the tunnel is the headlamp of an oncoming train.

**Ralph Waldo Emerson:** When it’s dark enough, you can see the stars.

We need at least 2.5 percent GDP growth to keep the unemployment rate from rising as a result of productivity gains and labor force growth. Three percent barely makes a dent in the unemployment rate.

**The deflation downside:** For quite some time, I've been rather sanguine about the inflation outlook. And so far, I'm right. If the global GDP outlook deteriorates further and recession unfolds, I believe that deflation becomes a serious threat.

We last experienced a serious decline in the overall U.S. price level during the Great Depression, when the CPI fell 30 percent between 1929 and 1932. Japan has had intermittent bouts of deflation during the past two decades.

If inflation is bad then why isn't deflation a good thing? Deflation is usually a pathological condition resulting from inadequate aggregate demand due to monetary and/or fiscal contraction. Thus, deflation starts from weakness and it further aggravates economic weakness. When prices are falling, consumers postpone purchases because items will be cheaper later. This causes further cutbacks in production and payrolls... and further deflation.

Deflation also wreaks havoc with the financial system. Loans are fixed in dollar value terms while incomes and prices are falling, impairing the ability to repay. Also, the incentive to repay drops as house values fall and more homes go "under water" where the outstanding mortgage exceeds the value of the property. Even if the borrower continues to make all the payments on the loan, the bank has a problem as the value of the collateral diminishes or disappears. The bank may then be required to hold larger reserves against these loans, thereby reducing the amount of capital available for lending to other borrowers. Weakness begets more weakness.

Combating recession – with or without deflation – would require major monetary and fiscal stimulus! There's no evidence that the U.S. and other economies could pull out of a slump without such intervention. On the contrary, if sufficient action isn't taken, economies will sink deeper into malaise. And government budget deficits will get even larger as revenues shrink.

It is not possible for the Federal Reserve to cut short-term interest rates since they are already close to zero. Instead, the Fed would once again have to implement massive "quantitative easing." The Fed would flood the economy with money by purchasing bonds and mortgages in the hope that this would encourage people to build some expectations of inflation – rather than deflation – into their planning. You may recall hearing Fed Chairman Bernanke

referred to as "Helicopter Ben." He was given this moniker when he proposed in an academic paper that the Fed might have to drop money from helicopters under just these circumstances. Chairman Bernanke wasn't serious about the helicopter, but he was about having to pump massive reserves into the system.

As for fiscal stimulation, the situation is extraordinarily complex. After years of living far beyond their means, governments throughout the world have suddenly "gotten religion." The problem is that the timing of this conversion almost couldn't be worse! Their collective actions are adding up to a major fiscal restraint that will at least slow the nascent recoveries and possibly undermine them.

Fears that chronic budget deficits will eventually cause inflation and higher interest rates are probably well founded, but the emphasis is on eventually. In order to avert recession, governments may need to increase fiscal stimulation through tax cuts and/or spending programs in the very near term while – at the same time – passing credible legislation that reduce deficits significantly starting a few years out.

All states except for Vermont have some sort of balanced budget requirement which vary in degree of restrictiveness. Even if their state constitutions allow it most can't borrow much more to cover operating deficits because their credit ratings are at risk. Most have already used their proverbial "rainy day" funds. They have no choice but to tighten – unless the Federal government comes to the rescue by, e.g., picking up more of the tab for Medicaid (medical welfare).

However, Washington is in no such mood. As noted above, Congress went on summer break without extending unemployment benefits for those who have exhausted theirs. My guess is they'll probably extend the benefits after getting feedback from the millions of unemployed folks at home, but do little else until after the November elections. If the economy continues to soften, they'll have little choice but to enact anti-recession programs that will enlarge the deficit. Whether they'll do the right things in a timely fashion – including convincing people that deficits will eventually get smaller – is anybody's guess.

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