# Economic Review

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***Musings & Amusings:*** *from our Presidents*

Abraham Lincoln: "If I were two-faced, would I be wearing this one?"

Herbert Hoover: "Blessed are the young, for they will inherit the national debt."

Teddy Roosevelt: "When they call the roll in the Senate, the Senators do not know whether to answer 'present' or 'not guilty.'"

**The new *abnormal*:** Things are really getting weird. The presidential campaign is just plain bizarre. We began with close to two dozen potential candidates. Some were strange and none seem to have a sense of humor. While Jimmy Carter could be a bit loopy, at least he could also be funny, e.g., "I have often wanted to drown my troubles, but I can't get my wife to go swimming."

The global economy is even weirder. Slow growth and recession, low inflation and deflation, miniscule and negative interest rates seem to go on and on. The Federal Reserve has once again reduced its already anemic forecast of the U.S., Gross Domestic Product (GDP) growth. And the IMF (International Monetary Fund) has lowered its global forecast for the fourth time in a year.

Why? Some blame the global financial crisis that started in 2008 and continues in some parts of the world. Deleveraging (reducing debt) and reassessment of risk have constrained economic activity. However, this can hardly be a complete explanation for the recent disappointing performance of the U.S. and Germany in 2016.

Others point to central bank policies, particularly QE (quantitative easing) in Japan, the U.S., and the Eurozone. They have purchased large amounts of government securities in order to lower long-term interest rates and stimulate borrowing.

However, I find it difficult to see how QE is at fault. It did not create inflation as was feared. And while it may have produced some current financial asset bubbles, I don't understand how un-punctured bubbles could cause growth to slow and prices to decline.

For the past several years, Larry Summers has been saying that we are suffering from secular stagnation – a concept first promulgated by Alvin Hansen in the 1930s. Summers, who was Treasury Secretary under Bill Clinton and then President of Harvard University for a while, first discussed this at the IMF in 2013 and more recently at the Federal Reserve Bank of St. Louis.

He says the world is suffering from insufficient aggregate demand. Among the main reasons are relatively tight fiscal policies in the U.S. and, especially, Europe, where austerity has been imposed on those nations with difficulties servicing their debts.

In addition, China has been trying to slow an economy that had been growing too fast and shift emphasis from exports towards domestic consumption. The hoped for "soft landing" has been a bit bumpy.

There's also the possibility that households are attempting to rebuild their wealth by saving more. And low interest rates may mean they have to save more for their retirement and to put their kids through college.

All this has undermined natural resource prices. The oil price drop, plus the consequences of Putin's invasion of Ukraine, have plunged Russia into recession. Sagging demand for its exports and political chaos have helped push Brazil into recession.

OK, so what can we do? Several presidential candidates propose very large, one might say HUGE, tax cuts. Another aspirant advocates very large spending increases. These would certainly increase aggregate demand.

However, impartial assessments warn that they would also add trillions to the federal debt even after allowing for plausible revenue feedbacks from faster growth. Even deficit doves start to worry about soaring borrowing costs and a collapsing dollar exchange rate with changes this massive. I won't go into this now, but the two candidates whose proposals have the smallest impact on federal deficits are Republican John Kasich and Democrat Hillary Clinton. As President Ronald Reagan said, "I am not worried about the deficit. It is big enough to take care of itself."

**Can you believe: negative interest rates?** Stagnation, secular or otherwise, is responsible for interest rates dropping below what economists call the "zero lower bound." Japan, the Eurozone, Denmark, Sweden, and Switzerland have all turned to negative interest rates (NIR) by imposing a fee on excess reserves held by member institutions. This is the opposite of paying positive interest on reserves which the Federal Reserve still does.

The main hope is that NIR will make banks more willing to lend and customers more willing to borrow. Hopefully, this will stimulate aggregate demand and transform deflation into moderate inflation.

So far the results have been mixed and, in a few cases, unintended. In some countries, people have switched from holding bank deposits to buying real estate as a way of increasing their returns. The resulting leverage is worrisome as is the run up in housing prices.

In Japan, savers have turned to long-term Japanese government bonds, driving their yields down. Problem is that any subsequent increase in bond yields will cause the market value of these bonds to plunge. (Remember: the value of a bond and interest rates move in opposite directions; and the longer the maturity, the bigger the change).

There are also some concerns about the long-term effects of NIR. They increase the present value of future liabilities while decreasing the future stream of investment returns. This has obvious ramifications for pension funding. They also make it harder for insurers to pay the minimum investment return guarantees that some of them have offered. And NIR tend to squeeze bank profit margins.

Will NIR happen here? On the one hand, the Fed has announced that it still plans to raise short term rates about half a point this year and more in the next couple of years. On the other hand, negative rates might be necessary if the weakness affecting much of the rest of the world spreads to the U.S. By the way, it was Harry Truman who said that all he needed was a one armed economist who would not be able to equivocate.

**Regional cost of living.** I recently came across estimates of how much it costs to live in different parts of the country. The data from the Bureau of Economic Analysis is quite similar to the approach used for Consumer Price Index (CPI). The numbers come out with a lag of several years, so that the data for 2013 may not be completely representative of current differences. Remember, these are relative measures: they tell you that it cost 15.3 percent more to live in New York than the average of the 50 states.

The metro indexes are very similar except that they are calculated relative to the average of all metro areas which is expressed as 100. Hence, it costs 23.2 percent more to live in metro New York than Providence (122.3/99.3).

**REGIONAL PRICE PARITIES IN 2013**

*United States = 100*

| States | | Metro Areas | |
|---|---|---|---|
| New York | 115.3 | Boston | 110.9 |
| Connecticut | 108.5 | Hartford | 100.4 |
| Massachusetts | 107.5 | New York | 122.3 |
| Rhode Island | 98.1 | Providence | 99.3 |
| | | Philadelphia | 107.9 |

Just like the CPI, Regional Price Parities (RPPs) include sales, excise and property taxes, but not income and inheritance taxes. Hence, the cost of living RPP of 93.6 in Lakeland, FL (an area between Tampa and Orlando popular with retirees) is even lower relative to, say, Boston or Hartford than suggested by my table because Florida has neither income nor estate taxes.

The RPP also follows the CPI approach for owner occupied housing costs. It uses the costs of equivalent rents and not home selling prices.

Honolulu is the most expensive place to live (122.5) followed by metro New York City (122.3), San Jose, CA (121.3), and Stamford, CT (120.5). Surprisingly, Boston shows up as a relative bargain at 110.9. My guess is that rents have really taken off in the last couple of years and this won't show up for a while in the RPP.

Want to save money? The cheapest metro area in the U.S. is Beckley, WV. At 78.0, it is 35 percent less expensive than Stamford! (78.0 vs. 120.8) and you can visit the coal mine museum! Of course, there's much more to choosing a place to live than the cost of living, but these RPPs do provide some interesting insights.

Former Speaker of the House (and fellow Boston College grad) Tip O'Neill once said, "All politics is local." He could also have said that in a very real sense all economics is local...

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