Economic Review

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Musings & Amusings: *Back to the '80s*

How do you double the value of a Yugo? *Fill the gas tank.*

What does every Yugo come with? *A bus schedule.*

The original Rubik's cube has 43 quintillion combinations.

Back to the '80s: This was a decade of some pretty interesting fads – the Rubik's Cube; the mullet hairstyle (yuck!); the infamous Yugo imported car; "Where's the beef;" and Trivial Pursuit. I ask – could the dreadful Yugo have hastened the breakup of Yugoslavia?

Let's take a closer look at why, as I mentioned in my last newsletter, a recession did not occur until almost three years after the big stock market correction decline of 1987.

This was a period of economic extremes. The decade started with back-to-back recessions in 1980-82 that drove unemployment to 11 percent. The cause was the Federal Reserve's tough monetary policy response to the double digits inflation of the late 1970s. Under Chairman Paul Volcker, the prime rate hit 21.5 percent and home mortgage borrowers had to pay 18 percent. There was also the S&L bailout necessitated by the insolvency of a large part of the thrift industry. No wonder a movie with the title *Risky Business* was such a hit.

Inflation dropped dramatically, averaging only 4 percent after 1981. The economy roared back following those famous 1981 Reagan tax cuts. Real gross domestic product (GDP) grew better than 5 percent annually during 1983-85 and 3.5 percent for the rest of the decade. Growth scarcely skipped a beat after Black Monday 1987. By 1989, unemployment was cut in half. And while we're talking numbers, the '80s, and trying to put things in perspective, let's not forget that in 1985, Pete Rose broke Ty Cobb's record for most career hits only to be banned from the sport in 1989 for betting on baseball.

I won't get into the debate over baseball or whether the economic rebound resulted from the supply side incentives of lower tax rates or the big boost in aggregate demand a la Keynes. It was both – and knowing the relative importance of each is probably not essential to understanding what follows. Hey, it might even have been the surge in good feelings that followed the U.S. Olympic hockey team winning the gold medal in 1980 at Lake Placid!

Throughout the 1980s, significant imbalances were building. The federal budget deficit hit 6 percent of GDP in 1982, the highest since WWII; and was still a lofty 5 percent by mid-decade. Meanwhile, the dollar exchange rate appreciated more than 50 percent as foreign capital poured into the United States to take advantage of the booming economy. While the tax cuts had stimulated the economy and increased Treasury revenues, they fell far short of paying for themselves. At the same time, federal spending grew rapidly.

The strong dollar quickly widened the trade deficit as imports became cheaper and exports weakened. Eventually, these huge deficits caused the dollar to *plunge* almost 40 percent by September 1987.

Not surprisingly, interest rates climbed as the 10-Treasury yield note soared from 7 percent to 9.5 percent. Domestic bond buyers were worried about the fiscal deficit and the threat of inflation. Foreigners fretted that the falling dollar was shrinking the value of their Treasury holdings when translated back to their local currencies. Maybe it was a twist on that 1989 movie, "Honey, I Shrunk the Kids" making it more like "Honey, I Shrunk the Savings."

So what caused the Dow Jones stock average to plunge 22 percent on October 19, 1987 for a total of 34 percent over the next couple weeks? To start with, the market was way overvalued, having risen 40 percent in the previous year. I think the most important cause of the decline was the huge spike in long-term interest rates in the months before Black Monday. Even a simple dividend discount model would say that stocks have to fall precipitously when interest rates climb this much.

BTW: the number one song on October 19th was "Lost in Emotion" and the next week it was "Bad."

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As noted above, bond yields rose because the dollar fell. And the dollar fell because the preceding dollar rise really hurt exports and stimulated imports. But the initial dollar rise can ultimately be traced back to those large tax cuts and big budget deficits.

OK, so what kept the economy from tipping into recession after Black Monday? Some say it was newly appointed Fed Chairman, Alan Greenspan, who calmed financial markets with a few soothing words. Maybe this had some impact on keeping the market from falling further. Quantitatively, the Fed really didn't do a lot since it lowered the fed funds rate only half a point.

More important were the forces set in motion by the dollar exchange rate *decline* over the previous two years. This caused the trade deficit portion of GDP to shrink more than 50 percent from October 1987 to mid-1990, providing a significant stimulus to GDP.

Lessons learned? We live in an increasingly global economy where both interest rates and exchange rates can amplify bad effects and mute the good effects of policy actions. Policies that are successful in raising the U.S. growth rates significantly could cause the dollar exchange rate to climb as foreigners stepped up their investments in the U.S.

If tax cuts do not fully pay for themselves, then it is necessary to reduce spending in order to keep the federal budget deficit from causing problems. Deficits do matter.

This late summer equity price drop has mostly reversed itself. However, if the stock market takes another hit, where would the offsetting stimulation come from? Net exports are currently worsening. Would Congress be able to come up with a stimulus program? How about a financial rescue package if things got really bad? Finally, with short-term interest rates near zero, the Fed is almost out of ammunition.

Keep your fingers and toes crossed.

The Region: House Prices: The northeast ended the 1980s with a regional boom that turned into the biggest bust since the Great Depression. The region eventually recovered and then went on to participate in the epic nationwide housing bubble that began early in the next decade. After peaking in 2006-7, prices then plunged – as in most other parts of the country.

There are several available house price indexes. I chose the Federal Housing Finance Authority (FHFA) index that measures the prices of homes that have been sold. Others include appraisals made for mortgage refinancing, for example.

The news recently reported that the rapper, 50 Cent, reduced the asking price of his 50,000 square foot mansion near Hartford to $8.5 million. It's not clear what this will do to the FHFA index when it finally sells. He bought it from boxer Mike Tyson (Yes... can you believe it?) for $4.1 million and reportedly put another $6 million into it.

FHFA has lots of geographic and historic detail that made the price trends table possible. The metropolitan areas are broader than the names suggest. For example, New York includes parts of New Jersey while Bridgeport covers Stamford.

Prices are rising in all the metro areas of the northeast chosen for the table, but at considerably different rates. The second column compares the most recent prices with the peak for that area, generally 2006. The last one gives the percentage rise since the start of the FHFA series. Home prices have doubled in Bridgeport and more than tripled in Miami over the past quarter century.

During the past year, Boston has done well because the local economy has performed well. The magnitude of the price rise in the Philadelphia metro area (which includes parts of New Jersey, Maryland and Delaware) is surprising because economic growth has been moderate there.

HOUSE PRICE TRENDS: 2015 SECOND QUARTER

Metro Areas	percent change from		
	Year Ago	Peak	Q1 1991
Boston, MA	3.8	-2.3	165.9
Bridgeport, CT	2.1	-17.3	101.1
Hartford, CT	0.5	-12.1	52.8
New Haven, CT	2.1	-20.4	61.5
New York, NY	2.0	-12.0	140.9
Providence, RI	3.7	-17.3	102.1
Philadelphia, PA	6.7	1.8	144.3
Miami, FL	9.5	-25.3	213.2
San Francisco, CA	18.3	28.9	258.2

Source: FHFA.gov Purchase-Only Index

I'd have thought that New York would show up better. Realtors do report double digit price increases in Brooklyn and Manhattan for the past year.

Miami tells what happens when you have one of the biggest housing bubbles in the nation! Even with impressive recent gains of 9.5 percent, prices are still way below the peak.

Finally, I include San Francisco because it never ceases to amaze me. Furthermore, my son and his family live in the area so it is nice to see his property is appreciating. I went to Zillow.com and calculated that per square foot his house is worth four times as much as my home in Fairfield County. Holy cow!

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