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Musings & Amusings:

Third Grader Jokes from Garrison Keillor:

Why does a melon have to get married in church? **Because it cantaloupe.**

What did the zero say to the eight? **Nice belt.**

Why isn't your nose 12 inches long? **Because then it would be a foot.**

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The Deflation Threat: The economy began 2009 on a very weak note. Jobs have been falling for more than a year. Housing continues to weaken. And in recent months, the Consumer Price Index (CPI) has been dropping dramatically.

According to the most recent surveys of economists, Gross Domestic Product (GDP) won't stop falling until around mid-year. Jobs should stabilize somewhat later, closer to the end of 2009, followed by house prices a couple of quarters after that. One bit of good news: if past patterns prevail, the stock market should start rallying a few months before the GDP turns around.

The combination of deep recession and financial fragility at home and abroad makes us vulnerable to a deflationary morass. Deflation is a sustained decline in the nation's overall price level – the exact opposite of inflation. It is premature to characterize the recent sharp CPI declines as deflation. They've been caused mainly by the remarkable plunge in oil prices. However, *core inflation*, which excludes the volatile food and energy components, is also moderating.

What's so bad about deflation? After all, *less* inflation is almost always viewed as better than *more* inflation. Well, historically, deflation has usually been associated with hard economic times characterized by falling demand and serious credit problems. During the last U.S. deflation episode in the 1930s, the CPI fell a total of 25 percent from 1929-1932. Over the past decade, consumer prices in Japan fell in about half the years as the nation struggled to get out of a series of recessions.

Deflation becomes part of a vicious cycle. It is caused by falling demand and spreading credit stringency where financial institutions are unable and/or unwilling to lend. But deflation causes the demand and credit difficulties to intensify. Why buy now, when prices will be cheaper in the future? This incentive to postpone undermines demand, thereby increasing layoffs and downward adjustments to prices.

Furthermore, outstanding loan amounts are calculated in nominal (current dollar) terms. But in a period of deflation, the value of the collateral falls, as does the ability to repay on the part of borrowers. This leads to further increases in foreclosures and losses for lending institutions. It also puts additional downward pressure on the prices of assets (including collateral) as well as goods and services.

One really pesky problem is that the lower bound for interest rates is right around zero. (Occasionally, Treasury bill yields can go slightly negative as investors are willing to pay the government a small "price" for the safety and security of holding government securities). When nominal short-term rates are stuck at zero, falling prices mean that "real" (inflation adjusted) interest rates can get quite high! For example, if the fed funds nominal rate is zero and inflation is a positive 3 percent, then the *real* fed funds rate is *minus* 3 percent. But if the nominal fed funds rate is zero and inflation is *negative* 5 percent, then the *real* fed funds rate is a hefty *positive* 5 percent. This further dampens demand for borrowing.

The Japanese experience is an interesting case study. Real estate and stock market speculation had gone wild in the late 1980s so that by 1990 the Bank of Japan had to raise interest rates. Land and equity prices plunged and recession followed. Many large banks were at the edge of collapse. The nation was in and out of recession and deflation for more than a decade. This episode has been labeled "The Lost Decade" and the "Slow- Motion Depression" by Paul Krugman, the most recent recipient of the Nobel Prize in economics.

What went wrong? The plunge in asset values was much worse than we've experienced in the U.S. Stocks fell more than 60 percent – considerably more than the 40 percent U.S. drop (so far?). With hindsight, the subsequent easing by the Bank of Japan during the early years of the crisis was far too little. As were the fiscal stimulus packages, which were heavily loaded with construction projects such as highways to almost nowhere. Also, many Japanese banks were in bad financial shape and the authorities were slow in getting them to recognize their losses.

In the U.S., the Federal Reserve has acted swiftly by lowering interest rates 500 basis points in little more than a year. In dealing with losses at financial institutions, we have also acted promptly, but the various measures to inject funds are having trouble getting traction in the form of increased lending. On the plus side, a large fiscal stimulus package is likely to be enacted quickly with the inauguration of President-elect Obama.

All in all, deflation is still a long-shot for the United States. However, the odds have been rising. If actions taken to date plus the forthcoming fiscal stimulus package don't do the trick, then the Fed has little choice but to pour even more money into the economy.

But won't this cause inflation? I hope so! In order for us to break out of a deflationary debacle, the public has to believe that prices will start stop falling and start rising! Sure, at some point the Fed has to start taking funds back, but not until the deflation threat subsides.

The Region: It could be worse! Falling jobs and rising unemployment give clear evidence that the region is fully engulfed in the national recession. The most recent forecast from the New England Economic Partnership expects serious declines, but not as bad as the *Great Recession* of the early 1990s. The table below shows the actual job losses during the past two recessions and those predicted for the current downturn.

The recession of the early 1990s hit the region extremely hard, with each of the New England states losing 10 percent or more of their jobs. By the way, New York and New Jersey each lost about 7 percent of their employment. This regional recession was much worse than the nation as a whole, which experienced a mild downturn. For the northeast, this was the most severe downturn of the post World War II period, hence the label, the *Great Recession*. In the early 1990s, the region was experiencing what the nation as a whole is undergoing now: widespread financial failures, shrinking availability of credit and falling home prices.

The recession at the beginning of the present decade hit Massachusetts particularly hard, largely because of its exposure to dot.coms and high technology. Rhode Island, on the other hand, got off very lightly.

In contrast, the current recession has been very tough for Rhode Island, which is suffering from a bigger housing collapse than the neighboring states because it had a bigger real estate boom. It has also suffered from a major shrinkage in jewelry manufacturing – long a staple of the Rhode Island economy. Measured by the percentage decline in jobs, both Connecticut and Massachusetts are much more in line with the overall national economy than during the previous two cycles.

Looking ahead, jobs are not expected to rise again until mid or late 2010 for all three states. However, economic activity, as measured by Gross State Product (GSP), will start growing in the second half of this year – about in line with the national economy. Both regionally and nationally, jobs will lag gross product as businesses hire cautiously to meet the turnaround in demand. New home construction starts picking up in late 2009 and early 2010 even before home prices fully stabilize as confidence and credit conditions improve. The long slide in home prices finally ends during 2010 in Connecticut and Massachusetts, but not until 2012 for Rhode Island.

The recession has been particularly hard on state and local finances. All three states face large deficits in the current fiscal year and much bigger gaps in the fiscal year starting this July. Declining stock prices and home values have reduced income tax and capital gains receipts. Cutbacks in the financial services sector, where compensation tends to be quite high, has also curtailed receipts. Sales tax collections are down with the drop in auto sales and home construction and remodeling.

Even Connecticut's share of casino gambling receipts has fallen. It will be a major challenge to see whether the deficits can be reduced without layoffs of public sector workers and givebacks by those who remain on the payroll.

Recession Job Losses

	1989-92		2000-03		2008-10	
	%	#Thou	%	#Thou	%	#Thou
Connecticut	9.5	160	3.6	61	3.6	61
Massachusetts	11.3	356	6.1	205	4.1	134
Rhode Island	10.7	50	1.2	6	6.0	30
United States	1.5	1621	2.0	2708	2.9	4020

Source: U.S. Bureau of Labor Statistics and the New England Economic Partnership

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