



# Economic Review



Issue XXXII  
May 2008

Nicholas S. Perna **Economic Advisor**

## Musings & Amusings

Donald Rumsfeld

As we know,  
There are known knowns.  
There are things we know  
we know.  
We also know  
There are known  
unknowns.  
That is to say  
We know there are some  
things  
We do not know.  
But there are also  
unknown unknowns,  
The ones we don't know  
We don't know.

For an online version  
of *Economic Review*  
or to listen to  
*Economic Review*  
Podcasts, visit us at  
[WebsterOnline.com/  
EconomicReview](http://WebsterOnline.com/EconomicReview).

### Ask the Money Doctor.

When my son was in kindergarten, the teacher asked the little students what kind of work their fathers did. My son answered "My daddy is a doctor for money and not for checkups." That was his way of explaining that I was a Ph.D. economist and not a medical doctor. Ever since then, my family has referred to me as "The Money Doctor." I thought I might try my hand at answering some of the questions on people's minds these days about the health of the economy.

### Q. Are we really in a recession?

**A.** I realize that real Gross Domestic Product actually rose a little during the first quarter, but other indicators say that we most likely are in recession. Although the April decline was quite small, jobs have fallen for four straight months. Home building and sales have plunged and so have new car sales. If you're wondering how jobs can fall and GDP can rise at the same time, the answer is productivity growth. Quite simply, the nation can produce a little more output with fewer workers. I'm forecasting that jobs and GDP will both decline during the second and third quarters of this year.

There are other signs that the economy has at least slowed very dramatically, even if it is not in recession. Many states are starting to have budget problems as tax receipts come in well below expectations. A number of major retailers have recently filed for bankruptcy. Except for the newspaper headlines, there really isn't much difference between a sharp slowdown, where the economy grows a little, and a relatively mild recession, where it declines moderately.

### Q. When will it end?

**A.** My belief is that financial markets have been stabilizing thanks to aggressive efforts by the Fed to inject funds where needed, but we haven't felt the full fallout from declining house prices and rising oil prices, which surpassed \$125 per barrel as I wrote this. That's why I'm forecasting that

GDP will contract in the middle two quarters of 2008 and then start to rise.

### Q. Will the tax rebates work?

**A.** They'll help keep the recession from being longer and deeper and so will the Federal Reserve's interest rate cuts. Even if people use their rebates to pay down their credit card balances, those checks will still stimulate the economy because people will again be able to go out and spend using their charge cards. Don't expect miracles, however. Rising fuel and food costs will more than eat up those rebates. Moreover, falling house prices mean many people have lost the ability to tap the equity in their homes to sustain their lifestyles.

### Q. Why is inflation accelerating?

**A.** Outside of food and energy, inflation has not accelerated. The "core" consumer price index (CPI), which excludes both these, has risen 2.5 percent during the past 12 months – about the same as in recent years. Food costs, which account for about 15 percent of the typical household's spending, have increased 5 percent, and energy, which takes 10 percent of your dollar, is up almost 20 percent during the past 12 months.

There are lots of reasons for the troubling behavior of these two necessities. World demand is stronger for both – especially from the rapidly developing countries such as India and China. Supplies are also a problem. A severe drought in Australia has helped push up the world price of rice. (Until recently, I never knew the Aussies even grew rice!). OPEC is unable (more likely, unwilling) to increase oil production. Sure, the "speculators" have piled on but they don't account for most of the recent rise.

I don't believe we're headed into an era of significantly higher inflation. I'm betting that oil prices will fall in coming months, thanks to the U.S. recession. Looking a bit

farther ahead, we'll face the same 3 percent annual rise in the CPI that we've had for the past 20 years.

**Q. Are the banks in trouble?**

**A.** Although the sub-prime mortgage mess has reduced the profits of many banks, hardly any are in danger of failing. Bear Stearns, which was saved from bankruptcy by the Federal Reserve, wasn't a bank. It didn't take deposits or make loans to the public. Rather, it was a so-called "investment bank" whose business was arranging corporate mergers, underwriting those complex financial arrangements involving sub-prime mortgages, and owning some hedge funds, two of which imploded.

**Q. Was bailing out Bear Stearns a good idea?**

**A.** That depends on what you think would have happened if the Fed "let the chips fall where they may." If you believe, like most economists, that letting Bear Stearns go under would have caused serious problems for many other companies, then the risk of taking a hands-off approach would have been too great. The result could have been a very severe financial meltdown and a major global recession.

To me, the nagging question is how do we keep one financial institution from threatening the entire economy. This time it was Bear Stearns, and a decade ago it was the Long-Term Capital Management hedge fund, both of which were outside the regulated banking system. The answer probably lies in regulations that require these financial institutions to reduce their leverage and reduce the use of fancy financial derivatives and complicated financial products such as those that led to the sub-prime debacle. The problem with leverage, which is the use of borrowed money to make financial bets, is that when things go bad the losses multiply and can quickly wipe out a company. This then spreads to other companies, particularly those that were owed funds by the troubled entity. Economists call this "counterparty risk". Some of those new financial instruments designed to "spread the risk" have the ability to spread the problems.

**Q. Speaking of mortgages, how far will house prices fall?**

**A.** Prof. Robert Shiller of Yale, who is an authority on market bubbles, says that the decline could be worse than the 1930s Depression and as deep as 30-45 percent. This is a very extreme view. Most economists, as evidenced by a recent *Wall Street Journal* survey, are predicting that the total decline

will average less than 10 percent nationally. Of course, prices will drop more in some places and less in others. They also think that the price decline will continue into 2009. After that, my bet is that prices will rise slowly for a number of years as buyers remain on the cautious side and lenders try not to repeat the mistakes of the past.

**Q. Does this mean I should rent rather than buy a house right now?**

**A.** The answer depends on a lot of things that vary by individuals. However, it makes sense to at least consider renting. You may, however, be trading one risk for another. While renting gets you out from under the risk that house prices may fall further, by the time you are ready to buy, mortgage interest rates might be considerably higher. Nonetheless, renting might make a lot of sense for a household that only expects to be in a given area for a year or two and then to move elsewhere. A few years back, buying under these circumstances might have paid off nicely when the home was resold for a profit. However, large short-term gains are unlikely – at least for the next few years.

**Q. What's happening in southern New England?**

**A.** The picture is really mixed and unusually difficult to interpret. Massachusetts, which is having one of the larger house price declines in the Northeast, has seen jobs grow so far in 2008. Connecticut is having the opposite experience. House prices have been more stable, but jobs are falling. Rhode Island is somewhere in between. Jobs have been slipping for a while now, and the house price correction is about the same as Massachusetts. Incidentally, the house price declines in both these states have been only about half as large as Florida and one-third the magnitude of California.

Month to month changes in jobs at the state level can be rather volatile – especially for rather small states such as Connecticut and Rhode Island. We need at least several more months of jobs data before we can draw any firm conclusions. Comprehensive house price data by state and city for the first quarter won't be available until late May. We'll assess these in the July-August issue.



*Economic Review* is published by Webster Financial Corporation. The opinions and views in this publication are those of Dr. Nicholas Perna, Webster's economic advisor, and are not intended to provide specific advice or recommendations for any individual. Consult professional advisors with regard to your individual situation. For more information or to submit a story idea to *Economic Review*, contact Edward Steadham by telephone at 203-578-2287 or by email at [esteadham@websterbank.com](mailto:esteadham@websterbank.com). © 2008 Webster Financial Corporation.



The Webster Symbol and Webster We Find a Way are registered in the U.S. Patent and Trademark Office. Webster Bank, N.A., Member FDIC, Equal Housing Lender