

**For Release on Delivery
2:00 p.m. EST
Tuesday, September 9, 2008**

U.S. Economic Prospect and Policy Possibilities

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Testimony before the House Budget Committee, Hearings on “A Weakened Economy: How to Respond,” Cannon House Office Building, Room 207, Washington, D.C., Tuesday, September 9, 2008.

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by Allen Sinai*

After approximately six years of economic expansion in the U.S. characterized by booms in housing and mortgage finance, credit and debt, financial services and financial markets generally; strong economic growth or booms in a number of non-U.S. countries; relatively low inflation globally until six-to-nine months ago; and improving jobs and falling unemployment rates, the U.S. and Global economies now are in the midst of very difficult economic and financial stresses that pose great challenges to economic policy.

What are they? *For the U.S.*, there is a witch's brew of problems and issues, ranging from recession and inflation to disarray and turmoil in the financial system and financial markets; to high and rising energy costs and the increasingly unacceptable long-time U.S. dependence on fossil fuels; rising federal government deficits and increasing U.S. Government debt relative to GDP; although improving, continuing imbalances in foreign trade and on current account; the inefficient provision of health care and reining in of its high inflation and rising costs; the financing of Social Security and retirement saving; a need to rebuild savings to rebalance imbalances in the financial positions of financial institutions, households and government; and the rebuilding of U.S. infrastructure to help increase productivity and public welfare.

In addition, *the unwinding of what was an incredible housing, mortgage finance, debt, derivatives, structured investment product, credit and debt boom has led to financial turmoil and financial instability in the U.S. financial system and financial markets*—characterized by a housing boom that has bust, a bursting housing asset price bubble, credit crunch, and unprecedented contractions in the balance sheets of numerous bank and nonbank financial intermediaries—*posing yet another difficult policy challenge.*

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Financial instability, a portion of what might be called the financial business cycle, always has been integral to real economy downturns; indeed, especially the most severe and long-lasting ones. Crunches and financial instability typically present at the upper turning point of the U.S. business cycle, integrated in the structure and processes of the U.S. macroeconomic system.

In the global economy, U.S. economic weakness and financial instability are impacting other countries through diminished export growth. Higher oil, energy, food and derivative prices, many set in world commodities markets but exogenous to individual countries, are providing a negative economic and inflation shock, much as in the 1970s and early 1980s. While endogenously determined by aggregate global demands and supplies, crude oil and food prices present themselves as exogenous to oil-consuming countries, essentially much of the global economy.

Currently, an increasing number of countries are experiencing incipient recession, recession-like conditions, or appear headed for them. Financial turmoil in the U.S. and elsewhere is preventing the normal economic responses to the lower interest rates and increased liquidity provided by the Federal Reserve and other central banks, and is being overshadowed by risk-averse financial institutions who are absorbing liquidity but not lending nor investing much. Previously, strong-growing economies are slowing. Boom economy countries are settling-down to lower growth. As measured by DE, some 55% to 60% of the global economy probably is in, or about to enter, some sort of recession. A global recession-of-sorts perhaps is becoming a reality!

Presently, as shown in Table 1, 11 countries are forecasted to be in or very near recession, 8 countries headed for recession, 14 that were solidly-growing now weakening and 7 countries previously booming, now slowing. 7 countries still seem strong or stable.

Table 1
Policy Challenges: U.S. and Global “Recession?”

| Countries In-or-Close to “Recession” | | Countries Headed for “Recession” | | Solid Growth Weakening | | Boom Countries Slowing | | Countries Still Strong or Stable | | Total |
|--------------------------------------|-------------------|----------------------------------|-------------------|------------------------|-------------------|------------------------|-------------------|----------------------------------|-------------------|-----------------|
| Country | Pct. of Total (1) | Country | Pct. of Total (1) | Country | Pct. of Total (1) | Country | Pct. of Total (1) | Country | Pct. of Total (1) | |
| 1. U.S. | 25.6 | Spain | 2.6 | Brazil | 2.2 | China | 5.8 | Russia | 2.2 | |
| 2. Japan | 8.6 | Australia | 2.5 | South Korea | 1.8 | India | 2.0 | Indonesia | 0.8 | |
| 3. Germany | 6.1 | Mexico | 1.7 | Switzerland | 1.7 | Argentina | 0.5 | Austria | 0.7 | |
| 4. U.K. | 5.0 | Netherlands | 1.4 | Belgium | 0.8 | Hong Kong | 0.4 | Poland | 0.7 | |
| 5. France | 4.6 | Sweden | 0.8 | Turkey | 0.8 | Venezuela | 0.4 | Israel | 0.3 | |
| 6. Italy | 3.8 | Taiwan | 0.7 | Greece | 0.7 | Columbia | 0.1 | Egypt | 0.2 | |
| 7. Canada | 2.5 | Portugal | 0.4 | Norway | 0.6 | Peru | 0.1 | Jordan | 0.03 | |
| 8. Denmark | 0.5 | Hungary | 0.2 | South Africa | 0.5 | | | | | |
| 9. Ireland | 0.5 | | | Finland | 0.4 | | | | | |
| 10. New Zealand | 0.5 | | | Thailand | 0.4 | | | | | |
| 11. Singapore | 0.3 | | | Chile | 0.3 | | | | | |
| 12. | | | | Czech Republic | 0.3 | | | | | |
| 13. | | | | Malaysia | 0.3 | | | | | |
| 14. | | | | Philippines | 0.3 | | | | | |
| 15. | | | | | | | | | | |
| Total(s) | 58.0 | | 10.3 | | 11.1 | | 9.3 | | 4.93 | 92.93(2) |

(1) 2007 end-of-year data, with conversion to nominal GDP in dollars; percent of global total.

(2) Rounding and omitted countries approximately 7% of the global total.

Source: Decision Economics, Inc. (DE).

Less jobs growth and rising unemployment are already occurring in a significant number of countries; where not, probably to-come. In the U.S., the bulk of the reductions in the workforce and biggest part of rising unemployment probably are still on the horizon for well into 2009.

The countries in or near recession account for about 58% of the global economy, as measured by Decision Economics, Inc. (DE). The seven countries counted as headed toward recession represent 10.3% of total world output. The 21 countries where economic growth is slowing from the previous pace represent about 20.4% of the global economy. And, of the remaining countries forecasted and analyzed, seven of them are still growing nicely or not slowing, representing 4.93% of global output.¹

Why this slippage globally?

The U.S. is at the epicenter of the downmove in economic activity that is rippling-through much of the world, with now a “hunkering-down” by the American consumer to far below historical trend growth spreading-out to reduce the export growth of numerous countries, although less exposed to a U.S. downturn than previously, still exposed, particularly to the demands for their exports from U.S. consumers and businesses. With intra-global regional trade more pronounced than ever before within Asia, the Eurozone and Emerging Europe, the Americas and the Middle East, those countries whose exports to the United States are weakening are also seeing trade flows and trade-related businesses with each other weaken.

¹ Decision Economics, Inc. (DE) forecasts and analyzes some 47 countries in the global economy, which account for approximately 93% of total global output. The rankings of these countries in the global economy are obtained by converting local currencies to nominal dollars using country exchange rates. Thus, the calculations relating to expansion and recession and for the rankings of the economies involved may differ from others, such as the IMF. For example, a U.S. recession is defined by standard NBER criteria, which includes growth in real GDP but more importantly relies on a wide range of readings, relative to previous peaks, for a number of monthly economic indicators. A *global* recession on the DE figures is less than 2% real GDP growth and is based on a diffusion index approach to growth versus historical potential rates of growth. Monthly economic indicators also are used for individual countries, although in many nowhere near as reliable as is the U.S. monthly indicator information.

The financial turmoil and financial instability in the U.S. also are significant, operating to impact other countries indirectly through depressed housing activity, declining housing prices, and the negatives surrounding aggregate consumption and business spending. But the U.S. financial turmoil also is directly a factor, negatively impacting on global equity markets and taking away support for global economic activity by U.S.-based companies who are cutting-back and some damaged globally-based financial institutions whose balance sheets are contracting.

A future risk to the U.S. lies in a current area of strength, exports, and to the companies whose businesses have become increasingly tied to revenues and earnings generation from outside the U.S.. Currently, U.S. exports are over 13% of real GDP, more than four times the now depressed real residential construction, so that as the global economy weakens, with lags U.S. exports will themselves weaken and then through export multipliers negatively affect the economy.

At the same time and over the past six-to-nine months, inflation almost everywhere has surged higher, in part a consequence of large rises in crude oil prices, in energy prices, and in food inflation. The high and rising inflation that has occurred is squeezing domestic purchasing power in many countries, particularly for consumption, so that along with worsening trade is creating recession or recession-like conditions.

Over 40 countries are showing high, or rising, inflation rates—some double-digit, some mid- to high single-digits, or high low single-digit—that have exceeded, or some exceeding, the limits set by central banks. In many countries, wage inflation is on the rise as well, threatening to pass into higher prices through rising unit labor costs then back perhaps into wages again, then prices, etc., although at the current time not the United States.

Table 2 indicates the ranges of inflation and countries assessed to be in each range; also whether price inflation has been Accelerating (A), is Stable (S), or Decelerating (D).²

Inflation has moved up quite sharply in a large number of countries, particularly over the past six-to-nine months. Of the 47 economies analyzed and forecasted by Decision Economics, Inc. (DE), the inflation indicated has been high or rising in 41 of the countries, in part from the same forces that have been driving U.S. inflation higher—rising oil, energy and food prices—but also from the demand-pull of strongly-growing economies and increased costs of production. Inflation targets or the desired ranges of central banks are being exceeded in more than half the countries where applied.

Central banks can be hamstrung when there is both recession and too high inflation, or “stagflation,” not sure which to deal with, the “stag” or the “flation.” The combination of a weak or weakening economy, high or rising inflation, and rising unemployment presents an extremely negative backdrop for the U.S. economy. The circumstances being seen now have few parallels—perhaps the downturns of 1973-75, 1979-80, and the early 1980s.

But none of these downturns had some of the other challenges now confronting the U.S.—1) contraction and crisis in the financial system with a degree of risk-averse behavior and deleveraging not seen since the 1930s or in

² The overall CPI was used for these assessments. “Core” inflation, generally CPI inflation Ex-Food and Energy, also was examined and is on the rise in numerous countries, including the United States. But, for most, readings on core CPI, originally meant mainly as a classificatory measure, present the lowest possible readings on inflation when energy and food prices are rising and even when they are not. If the increases are exogenous or transitory, then taking-out food and energy prices can make policy sense. If not, then policymakers that use it run the risk of thinking that inflation might be low, arguably the situation that has existed before in the United States. Crude oil and energy prices have been rising, on average, for years, hardly a transitory phenomenon; volatile yes, transitory no. The very low interest rate regime chosen by the Federal Reserve in the early and middle part of this decade reflected a core inflation focus, undoubtedly contributing to the boom in housing, credit and debt, and indirectly the excesses that grew up around these areas of activity.

Table 2
Policy Challenges: U.S. and Global—“Inflation”

| Countries with Double-Digit Inflation (10% to 35%) (1) | | | Countries with Inflation (6% to 9.9%) (1) | | Countries with Inflation (3% to 5.9%) (1) | | Countries with Still Low (Below 3%) Inflation | |
|---------------------------------------------------------------|----------------------------------------------------------|---|--------------------------------------------------|----------------------------------------------------------|--------------------------------------------------|----------------------------------------------------------|------------------------------------------------------|----------------------------------------------------------|
| Country | Accelerating (A), Stable (S), or Decelerating (D) | | Country | Accelerating (A), Stable (S), or Decelerating (D) | Country | Accelerating (A), Stable (S), or Decelerating (D) | Country | Accelerating (A), Stable (S), or Decelerating (D) |
| 1. | Venezuela | A | Chile | A | Taiwan | A | Japan | A |
| 2. | Egypt | A | Thailand | A | South Korea | A | | |
| 3. | Jordan | A | Malaysia | A | Peru | A | | |
| 4. | Russia | S | Columbia | A | U.S. | A | | |
| 5. | South Africa | A | Czech Republic | S | Mexico | A | | |
| 6. | Turkey | A | Hungary | S | Belgium | D | | |
| 7. | India | A | Singapore | D | Spain | A | | |
| 8. | Philippines | A | China | D | Greece | S | | |
| 9. | Indonesia | A | Hong Kong | S | Israel | D | | |
| 10. | Argentina | A | Brazil | A | Poland | A | | |
| 11. | | | | | New Zealand | A | | |
| 12. | | | | | U.K. | A | | |
| 13. | | | | | Ireland | D | | |
| 14. | | | | | Sweden | A | | |
| 15. | | | | | Finland | S | | |
| 16. | | | | | Norway | A | | |
| 17. | | | | | Australia | A | | |
| 18. | | | | | Italy | S | | |
| 19. | | | | | Denmark | A | | |
| 20. | | | | | Austria | S | | |
| 21. | | | | | France | A | | |
| 22. | | | | | Canada | A | | |
| 23. | | | | | Germany | S | | |
| 24. | | | | | Netherlands | A | | |
| 25. | | | | | Switzerland | A | | |
| 26. | | | | | Portugal | D | | |

(1) Latest, Year-over-Year; CPI Overall.
Source: Decision Economics, Inc. (DE).

Japan during the 1990s; 2) increasingly fragile U.S. government finance, with increasing burdens thrust on the Federal Reserve and U.S. Treasury of weak asset collateral and risks to the full faith and credit of U.S. sovereign debt from failing financial institutions; 3) the unknown effects of a huge deleveraging, contractions in asset-based lending, investments, and financial intermediary balance sheets a large number of financial intermediaries responsible for the greatest amounts of funding to the U.S. economy ever; and 4) a global inflation reflecting increased costs-of-production in non-U.S. economies, especially developing, that for a long time provided considerable deflation and disinflation. Cost-push sources of rising inflation from this source are numerous.

The collapse of the U.S. commercial banking system and in credit during the 1930s now is widely, and correctly, seen as a major reason for the Great Depression. But the large number of nonbank financial institutions that have been involved in asset and balance sheet-leveraged financing now dwarfs the commercial banking system in size and amounts, having operated through capital markets to fund much of the economic expansion, now contracting and presenting unknown potential downside consequences.³

U.S. Economy Prospect: Recession and Impediments to Recovery

The state of the U.S. economy is a recession or recession-like conditions; if recession so far “shallow,” but spreading and intensifying, complicated by the high

³ See Tobias Adrian and Hyun Song Shin, “Financial Intermediaries, Financial Stability and Monetary Policy,” presented at the Federal Reserve of Kansas City Symposium, *Maintaining Stability in a Changing Financial System*, August 22, 2008, Jackson, Wyoming. The authors present evidence on the growth in asset-backed lending and capital markets-centric nature of lending and investing by financial intermediaries rather than the deposit-based lending and investments of commercial banks that previously characterized the financial system. Left out of the authors’ calculations are the asset-based and balance sheet-levered activities of the now very large number of bank-like financial intermediaries such as Private Equity, Venture Capital, Hedge Funds and Sovereign Wealth Funds that have been so important in the intermediation of funds from all sources everywhere, and in energizing economic activity in the U.S. and around-the-world.

and rising inflation that has mainly stemmed from increased oil, energy and food prices, and increased costs of production, domestic and global.

This recession episode is unlikely to be short, instead “Shallow and Long” or “Deep and Long.” The shortest U.S. economic downturns previously were six months in 1980 and in 1991 and 2001 eight months each. The longest were in 1973-75 and 1981-82, each sixteen months, when crude oil and energy prices were rising sharply.

The current episode appears most similar to the late ‘70s or early ‘80s, with an unusually negative combination of elements; some new, some old: 1) a severe housing downturn (“Bust”); 2) a bursting housing asset price bubble (biggest declines in home prices since the Great Depression); 3) a credit crunch within and outside the financial system (Financial Crisis); 4) contractions in the assets and balance sheets of commercial banks and now large number of nonbank financial intermediaries such as Investment Bank/Broker Dealers, Private Equity, Venture Capital, Hedge Funds, and off-balance sheet subsidiaries of Commercial Banks (Financial Crisis); 5) a potentially considerable “Failure Fallout” of failed banks and other financial institutions, with consolidation and absorptions (Financial Crisis); and 6) the rises in oil and energy prices that have adversely affected economic activity and inflation in all oil-consuming nations. Major oil-producing countries are net beneficiaries.

The downturn and its extent and severity cannot be seen in quarterly real GDP, a measure many look to as the main summary statistic for the U.S. economy, e.g., the most recent upwardly revised 3.3% annualized rate of growth in GDP for the second quarter. Temporary tax rebates helped raise consumption, although in real terms only 1.7%, annualized, raising real GDP but probably only temporarily, along with strong growth in exports off a strong global economy and previously weaker dollar, and very strong real federal government spending.

But this quarterly summary statistic can be misleading and is not the only one used to technically define a recession.⁴ Other important monthly measures—personal income less transfers adjusted for inflation, real business sales, nonfarm payroll employment and industrial production—show peaks back in October 2007, December 2007 and January 2008, and currently stand below them. Though the declines from the peaks have been relatively small so far, the expected course for the economy suggests that its recessionary thrust will deepen and be prolonged at least until mid-2009, likely taking a turn for the worse in the third and fourth quarters and first quarter of 2009.

The expectation is for a *transitory* lift in real GDP during the second and third quarters from the temporary tax rebates and their positive effects on consumption spending, then after the rebates further retrenchment by consumers with no particular stimulus coming from any source that can be currently seen (essentially flat real GDP or declines in the 0.5% to 1% range).

Ripple effects into U.S. business sales and profits from the consumer retrenchment; cutbacks in production, spending and employment; weakness in state and local government spending from declines in tax receipts; depressed

⁴ The National Bureau of Economic Research (NBER) defines a recession as “a significant decline in activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales,” in *The NBER’s Business-Cycle Dating Procedure*, Business Cycle Dating Committee, National Bureau of Economic Research, June 18, 2003.

The Committee maintains a monthly chronology and refers to a variety of monthly economic indicators to choose months of peaks and troughs. Particular emphasis is placed on Personal Income less Transfers, in real terms, and Employment, measured by nonfarm payrolls. In addition, the Committee refers to two indicators with coverage primarily of manufacturing and goods. These are Industrial Production and Manufacturing and Wholesale-Retail Sales, adjusted for price changes. Real GDP is viewed as the single best measure of aggregate economic activity but is available only quarterly and with lags; also often is revised. Considerable weight is placed on this Bureau of Economic Analysis (BEA) measure. The NBER definition thus encompasses a wide range of economic data, mostly monthly, not quarterly, economic time-series, and not just, or mainly, real GDP. In particular, two consecutive quarters of negative growth in real GDP is *not* the definition of a recession; nor does it make technical sense that it be so.

commercial real estate activity; and continuing financial system disarray suggest a long period of economic weakness accompanied by a decline of inflation but not necessarily to acceptable levels. Weak U.S. consumption, averaging only 1.6% per annum over the last five quarters against an historical trend rate of growth of 3-1/2% per annum, can be a depressant on the export growth of numerous non-U.S. countries, in turn feeding back negatively later on the currently booming U.S. export economy.

The U.S. prospect looking forward is thus stagnant economic growth and sticky-high inflation—a generic “Stagflation” with a weak, or recessionary, economy and high inflation moving somewhat lower for awhile but not enough to represent a significant downtrend. The unemployment rate is expected to rise unevenly to a range of 6-1/2% to 7% by mid- or late-2009.

There are numerous impediments to quick and sustained recovery for the United States.

1) Crude oil and energy price inflation are negatively affecting oil-consuming economies—reducing economic growth and raising inflation. Most of the global economy falls into this category with particular exposure to rising oil and energy prices in the developed Asian world including Japan and South Korea, emerging Asian countries except to some extent China and India, much of the Eurozone, the U.S. to a significant degree, some other industrialized nations, and the majority of Emerging Europe. The oil producers of the world economy are in relatively good shape, although not all of them, e.g., Venezuela and perhaps Norway. In Latin America, Brazil and Argentina are relatively immune to higher oil and energy prices. Brazil is now a producer. So is Russia, a leading oil and gas producer, the second largest for crude oil, many oil-producing countries in the Middle East, Australia and New Zealand. But the Brazil, Argentina, Australia and New Zealand economies still are weakening from higher inflation and other

sources. Economic weakness in non-U.S. countries can later negatively affect U.S. exports.

2) *The bust in U.S. housing and crunch in mortgage credit, not just for Subprime and Alt-A loans, but generally throughout mortgage finance, as well as the inability of consumers to draw on home equity for various purposes, continues as a major drag on the economy.* The end may be in sight here as housing sales and starts appear to be bottoming-out; although not, however, for falling home prices. For awhile, the best that can be expected in house prices is less deceleration.

3) *The U.S. financial system, beset by a housing bust after an incredible boom, now is dealing with its own kind of "bust,"* an unwinding of the huge residential real estate asset price, credit and derivative financial products booms and in the businesses of the financial institutions associated with derivative securities, structured investment products, and financial business development in a benign regulatory environment. Excesses in leveraged balance sheet expansion, unprecedented in scope for the numbers of financial firms involved and the amounts, suggest an uncertain timeline for the adjustment on the recapitalization necessary at many bank and nonbank financial intermediaries. This is particularly so at commercial banks, investment bank/broker dealers, private equity, venture capital and financial firms performing similar functions, collectively now the primary credit and financial intermediary channel for the economy. Tight credit in commercial real estate, for the consumer in various dimensions of borrowing, and increasingly for nonfinancial businesses is a result, as well as a drying-up of new IPOs and private equity financing.

Writing down values from eroding or hard-to-estimate asset prices, raising and shoring up capital, cutting expenses, and tight credit are characteristics of the unwinding, the likes of which in a necessary deleveraging probably have not heretofore been seen. *How long this process lasts and the time it takes to repair*

and rebuild the U.S. financial system are extremely important for determining the length and depth of the U.S. downturn—and extremely difficult to know at this time. Extreme risk aversion by financial institutions and in the economy at-large are preventing the massive injections of liquidity by the Federal Reserve from lifting economic activity.

4) *An overhang of debt and credit for households, businesses and even states and localities,* and the necessary adjustments given a recession and declining asset values are other impediments to a sustained and sustainable pickup in economic activity.

Aggressive and widespread debt-financed expansion has left households, businesses, financial institutions and governments with excessive debt and credit relative to secure collateral, vulnerable to an extended period of subpar economic activity, and in need of restoring balance sheet stability through less spending, less borrowing, less lending, and more savings.

5) *The biggest impediment may well be the American consumer,* usually ebullient and boomy in expenditures and borrowing, as indicated by the historical trend rate of growth for aggregate consumption, adjusted for inflation, of 3-1/2% per year over the past 45 years. Given that trend rate of growth, even a reduction to a positive 1%-or-2%, although not necessarily bringing about a decline in real GDP, would be a major depressant. Inflation-adjusted consumption is now near 71-1/2% of real GDP. Significantly less growth in consumption could alter the business cycle in a fundamental way.

*Here is where the downward momentum of the U.S. business cycle is currently focused. All the fundamental determinants of aggregate consumer spending appear negative—*1) growth in real disposable income, depressed by an increasingly weakening jobs market, low growth in nominal and real wages, and high price inflation; 2) huge reductions in real household net worth on declines in real estate and stock prices, somewhere between \$3 trillion and \$4 trillion over the

past year and at a DE-estimated six cents of consumption, with lags, on a dollar of “permanently” lower real net worth, representing nearly two percentage points of lost economic growth this year; 3) consumer confidence depressed to levels previously seen only in the deepest part of recessions; 4) the inability to tap and use housing equity for spending and investing, reversed now because of foreclosures, delinquencies, and negative home equity; 5) on DE measures the most deteriorated household financial conditions since the early ‘80s; and 6) tight and tightening mortgage finance and consumer credit.

Consumption spending has grown significantly below trend for five consecutive quarters now, averaging only 1.6% growth, at an annual rate, and may even turn negative in the third quarter. This is despite a \$108 billion injection of temporary tax rebates over April-to-July, or \$432 billion, at an annual rate. This weakness in consumer spending is striking given the historical propensity for a much higher rate of spending and few periods in history where the consumer has spent weakly for any length of time.

How long this consumer weakness lasts and whether the consumer stays “hunkered-down” are keys to the timing and degree of any economic recovery.

6) *Finally, financial markets themselves, particularly an equity bear market, present impediments to a sustained pickup.* Declining stock prices negatively affect consumer sentiment and household wealth, thus consumer spending. A bear equity market presents an impediment to raising funds for new enterprise and for corporate balance sheets. Declining stock prices raise the aftertax weighted average cost-of-capital, increasing the cost of new projects. This reduces the transactions and IPOs that can support economic activity.

Stock prices go down on expectations of a weaker economy; lower stock prices act to weaken the economy; a weaker economy reduces earnings growth; stock valuations decline; the economy weakens, etc.; that is, a negative feedback loop occurs. Once the economy downturn bottoms out and declines in earnings

growth begin to reverse; in the presence of low, or falling, interest rates the stock market can start to gain and the negative feedback loop be broken. *The U.S. is not near this point at the current time.*

A long period of adjustment is thus suggested, very likely prolonged economic weakness or recession-like conditions—the “stag” part of stagflation—with sticky-high inflation rates overall and for the “core” (ex-food and energy), the “flation” side of stagflation.

Weak or Weakening Economies and High Inflation

The pattern of economic growth and inflation that is showing in the U.S. and globally is one of stagflation. The “Stagflation Footprint” appears in Table 3, with recent patterns and expectations of growth and inflation shown for several key countries and global regions. 2008:2 already is essentially known, in particular virtually all of actual inflation. Second quarter results on real GDP still are not available for a number of countries.

Weak economic growth and high or rising inflation represents two parameters that can define Stagflation. Others are jobs and the unemployment rate and the presence of pass-through from initial exogenous, or endogenous, sources of inflation such as energy inflation, wages, and nonlabor costs. The long-term presence of rising crude oil prices and lately food prices also are markers of Stagflation, certainly present in other historical episodes that have been so characterized. Crude oil prices, on average, have been rising since \$19/barrel for light crude in November 2001 and particularly so over the past year where the increases do not appear to be solely endogenous. Exactly why crude oil prices have recently risen so far, so fast, is a puzzle. But, the effects on global inflation and on the inflation rates of a large number of countries are clear in the data.

In many countries, wage inflation also is accelerating. This is particularly true in the emerging or developing world, where booms have occurred and unemployment rates moved to very low levels. Costs-of-production are rising

sharply in these countries. And, given the global nature of production and consumption, as well as the ability technologically to produce, distribute, and ship almost anywhere, the price and wage inflation of the emerging world must be regarded as a potential source of inflation everywhere.

For many countries individually, the rises of inflation appear as exogenous, rather than endogenously driven through the demand-pull of a strong economy; for example, crude oil and food prices. Cost-push to individual countries has come from rising oil, energy, food and commodity prices and generally as part of global demands and supplies, but in many countries now appears to be part of the inflationary process.

Table 3 shows a rather pervasive pattern of slowing real economic growth and rising inflation in the U.S., several key countries, and the major global regions of the world economy.

Inflation appears to have picked up significantly in the U.S. and elsewhere sometime in the fourth quarter of 2007, a little earlier in the U.K., the U.S. and Eurozone, a little later in Japan. Pronounced global regional economic weakness is more recent and has intensified in the last six months.

The rising inflation over the past six-to-nine months and its pervasiveness are striking (Tables 3, 2, and 4 below), with the number of countries showing quite high inflation, year-over-year, 6%-or-more, at 20, and 26 countries exhibiting year-over-year inflation between 3% and 5.9%. Only one country has a running inflation rate less than 3%, Japan. Table 3 also demonstrates that the more sharply rising inflation is recent and, except for the U.S., much slower growth *very* recent.

The classic “Stagflation Footprint” presents itself as a recession or stagnation that could be prolonged; stubbornly high, or rising, inflation, overall and in the “core;” pass-through to prices of higher cost inflation through wages, unit labor costs, lower productivity growth and/or nonlabor costs; and rising unemployment. Exogenous price, wage, or productivity shocks also can be

Table 3
Global and Global Regional “Stagflation?”

| | 2008:3F | 2008:2F | 2008:1A | 2007:4A | 2007:3A | 2007:2A |
|---------------------------------------------------------|---------|---------|---------|---------|---------|---------|
| Global | | | | | | |
| Real GDP Growth (Pct. Chg. Year Ago) | 2.3 | 3.0 | 3.5 | 3.7 | 3.9 | 3.7 |
| CPI Inflation (Pct. Year Ago) | 5.0 | 4.7 | 4.2 | 3.8 | 2.8 | 2.7 |
| U.S. | | | | | | |
| Real GDP Growth (Pct. Chg. Year Ago) | 1.2 | 2.2 | 2.5 | 2.3 | 2.8 | 1.8 |
| CPI Inflation (Pct. Year Ago) | 4.8 | 4.3 | 4.2 | 4.0 | 2.4 | 2.6 |
| U.K. | | | | | | |
| Real GDP Growth (Pct. Chg. Year Ago) | 1.0 | 1.4 | 2.3 | 2.8 | 3.1 | 3.3 |
| CPI Inflation (Pct. Year Ago) | 4.3 | 3.4 | 2.4 | 2.1 | 1.8 | 2.6 |
| Japan | | | | | | |
| Real GDP Growth (Pct. Chg. Year Ago) | 0.6 | 1.0 | 1.2 | 1.4 | 1.8 | 1.8 |
| CPI Inflation (Pct. Year Ago) | 2.2 | 1.4 | 1.0 | 0.5 | -0.1 | -0.1 |
| EU | | | | | | |
| Real GDP Growth (Pct. Chg. Year Ago) | 1.0 | 1.5 | 2.1 | 2.2 | 2.6 | 2.6 |
| CPI Inflation (Pct. Year Ago) | 4.2 | 3.6 | 3.2 | 2.8 | 1.9 | 2.0 |
| Eurozone | | | | | | |
| Real GDP Growth (Pct. Chg. Year Ago) | 0.8 | 1.5 | 2.1 | 2.2 | 2.6 | 2.6 |
| CPI Inflation (Pct. Year Ago) | 3.9 | 3.6 | 3.4 | 2.9 | 1.9 | 1.9 |
| G-7 | | | | | | |
| Real GDP Growth (Pct. Chg. Year Ago) | 0.7 | 1.9 | 2.1 | 2.0 | 2.5 | 2.0 |
| CPI Inflation (Pct. Year Ago) | 4.0 | 3.4 | 3.1 | 2.9 | 1.8 | 2.0 |
| OECD | | | | | | |
| Real GDP Growth (Pct. Chg. Year Ago) | 1.3 | 2.0 | 2.4 | 2.5 | 2.8 | 2.4 |
| CPI Inflation (Pct. Year Ago) | 4.4 | 3.7 | 3.3 | 3.1 | 2.0 | 2.2 |
| Latin America | | | | | | |
| Real GDP Growth (Pct. Chg. Year Ago) | 4.7 | 5.1 | 5.3 | 5.7 | 5.4 | 5.1 |
| CPI Inflation (Pct. Year Ago) | 8.4 | 7.5 | 6.4 | 5.7 | 5.3 | 5.1 |
| EMG-Asia and Developing Countries (Ex-Japan) | | | | | | |
| Real GDP Growth (Pct. Chg. Year Ago) | 7.6 | 8.2 | 9.4 | 9.9 | 10.1 | 10.7 |
| CPI Inflation (Pct. Year Ago) | 8.5 | 7.9 | 7.2 | 6.0 | 5.8 | 4.2 |
| EMG-Europe | | | | | | |
| Real GDP Growth (Pct. Chg. Year Ago) | 7.5 | 6.9 | 5.7 | 4.4 | 4.5 | 4.8 |
| CPI Inflation (Pct. Year Ago) | 8.5 | 7.7 | 7.0 | 6.2 | 5.1 | 6.4 |
| F-Forecast | | | | | | |
| A-Actual | | | | | | |

present, from economic or geopolitical sources, or both. Permissive or accommodative monetary policy has been yet another characteristic. Rising expected inflation, if possible to measure, presumably also should be present.

The policy choices, fiscal and monetary, going forward are difficult, for the U.S. and elsewhere in the global economy.

If only recession, the policy choices will be simple—easier monetary policy, perhaps aggressively so, and fiscal stimulus. But high and rising inflation in the U.S. and many other countries prevent this and present yet another challenge—how to reduce the inflation. *If only inflation*, the policy choices would be easy—for monetary policy higher interest rates and tighter credit, and/or fiscal restraint. The latter is notably difficult to implement in any country, however, at any time.

For monetary policy, the simultaneous appearance of recession and inflation presents difficult assessments and choices—whether for a central bank such as the Federal Reserve and perhaps the Bank of Japan (BOJ) that operate under a “dual mandate” of maximizing sustainable economic growth and price stability, or central banks focused on price stability with a “soft” inflation target such as the European Central Bank (ECB) and Bank of England (BOE), or by law an explicit “hard” inflation target, e.g., the Bank of Canada (BOC) and Reserve Bank of New Zealand. *Which challenge to deal with, recession or inflation, and in what sequence are major questions.*

Why U.S. “Stagflation” and Will It Persist?

Charts (1) and (2) indicate that several defining parameters of stagflation are present for the United States—a weakening or declining economy, perhaps a recession, at least on a number of monthly economic indicators, rising inflation, sharply so since 2007:3, and a rising unemployment rate. Sharply higher crude oil, energy, and food prices since mid-2007 after years of increases, on average, for crude oil and energy prices and rising expected inflation, on average for some measures, also are defining characteristics.

Chart 1
U.S. GDP, CPI Inflation and Unemployment Rate
(Pct. Chg. from Quarter One-Year-Ago for GDP and Inflation)

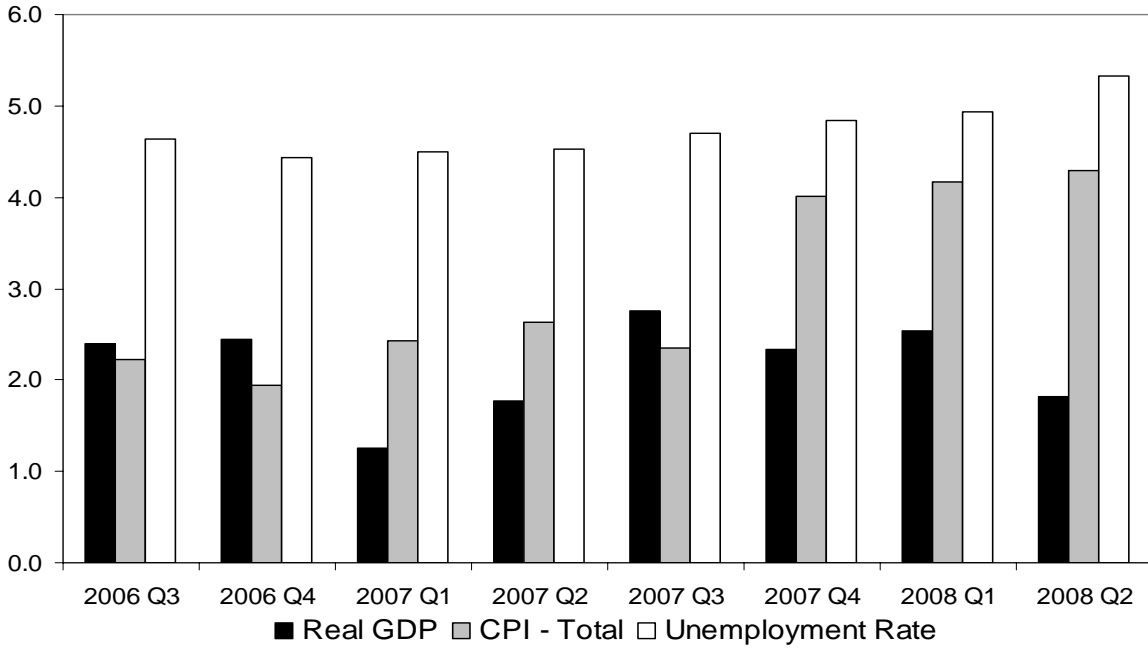
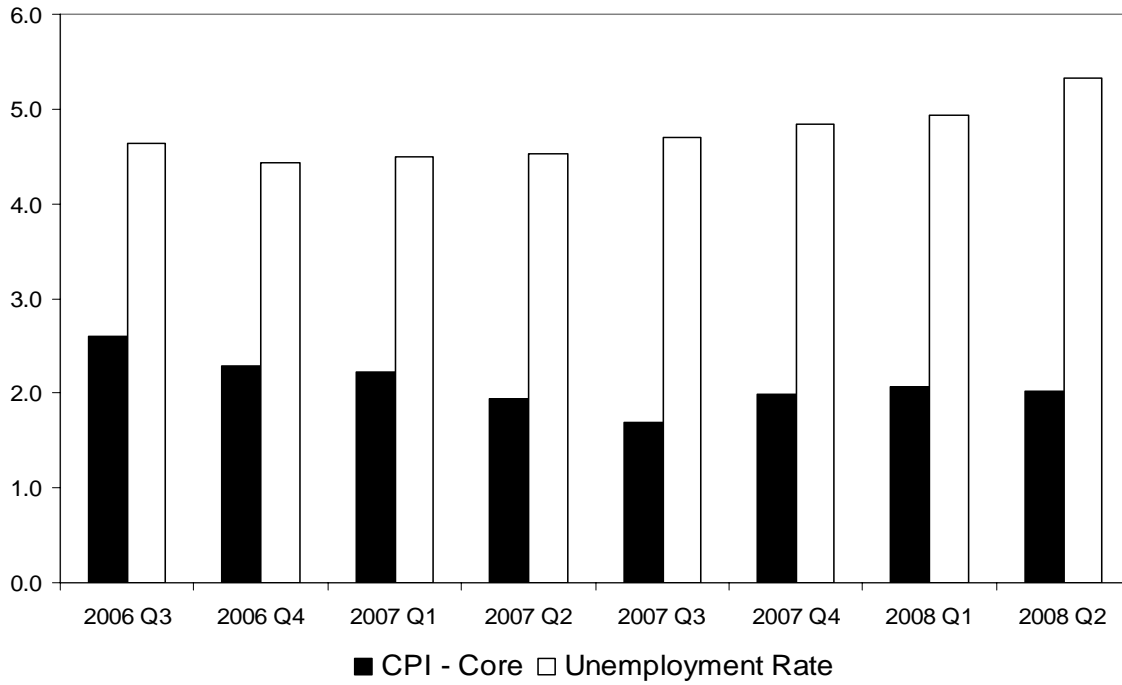


Chart 2
U.S. "Core" CPI Inflation and Unemployment Rate
(Pct. Chg. from Quarter One-Year-Ago for Inflation)



Even “core” inflation and the unemployment rate have been rising together, yet another stagflation sign. Real GDP growth is estimated to have been only 1-1/4% to 1-1/2% over the past year and core inflation, as measured by the PCE Deflator, currently stands at its cyclical high, 2.4%. Core CPI inflation is 2.5%, year-over-year. The unemployment rate, at 6.1%, compares with 4.7% a year ago and the low of 4.4% in March 2007.

Why a U.S. stagflation?

One reason is the pronounced cyclical downturn in housing, unprecedented declines in residential real estate prices, resulting financial turmoil and instability, and negative effects on consumption through deteriorating consumer confidence, reductions in household real wealth, declines in jobs, and less growth of real incomes. Deteriorated household financial conditions and the failure fallout of delinquencies and bankruptcies are other reasons for weak consumer spending. The need to rebalance imbalances in household balance sheets and existence of tight credit conditions suggest a lengthy process of adjustment for consumers.

Second is the squeeze on consumer purchasing power, also in many other countries, brought about by sharply higher oil, energy and food prices, which adds to inflation but reduces real incomes, real wealth, and real consumption.

A third reason is sharply higher crude oil, gasoline, heating, energy and food prices, which have added to overall inflation and spilled over into costs-of-production, in turn passed on into prices in order to maintain business profit margins.

Fourth is the aggressive easing of the Federal Reserve because of the U.S. financial crisis and potential risks to the financial system and the economy. Federal Reserve monetary policy has been easier than otherwise, has helped keep the dollar lower, and affected the expected inflation of U.S. consumers, global financial market participants, and businesses. Exactly how expected inflation enters actual inflation is unclear, but its rise has been correlated with rising actual

inflation.⁵ Inflation will be higher than otherwise when a central bank follows an easy monetary policy.

Fifth is the American consumer, likely to stay cautious in spending and borrowing given so many negative fundamentals. Consumption spending drives the U.S. economy; if weak, the economy must largely remain weak.

Sixth, much of the business cycle downturn looks still to-come. As yet, business capital spending has held up. Exports are booming. With business sales and earnings growth declining, indeed for the latter falling in levels, additional cutbacks in production, employment, capital spending, and new business ventures can be expected.

Seventh, as the global economy contracts, U.S. exports likely will weaken, softening what has been a significant strength.

Finally, neither monetary nor fiscal policy is being set for lasting stimulus. Too high inflation prevents the Federal Reserve from easing any more; instead, its next move on interest rates probably is up and, at some point, the huge liquidity and backstop financing that has been put-into-place will have to be withdrawn.

Why will U.S. Stagflation persist?

A stagnant economy, at the least low and subpar real economic growth, likely will continue given relatively weak consumption and continuing restraint stemming from the necessary adjustments in the U.S. financial system and private sector.

But what about inflation? With lags, shouldn't a subpar economy, rising unemployment, and lower oil and commodities prices take down inflation?

⁵ Expected inflation is a right-hand-side variable in most forms of the expectations-augmented Phillips Curve inflation paradigm that lies at the heart of current mainstream macroeconomic analysis. But, how these expectations are formed and affect price inflation, by how much, and over what timespan remains murky. A rise of expected inflation should increase actual inflation, according to this framework. But, the mechanisms by which this occurs have not been clearly spelled-out.

Certainly, for a time this seems likely later this year and next, if only arithmetically, on a year-ago basis when the much higher inflation rates that have already appeared will provide downward base drift for price inflation in the U.S. and elsewhere.

But, how much deceleration of inflation is the question. And, whether pass-through of higher prices into wages and then through costs back to higher prices will occur is another. So far, U.S. laborers are accepting losses of jobs and a squeeze on real incomes in return for job security. However, this may not necessarily persist, even with a much higher unemployment rate. And, the global nature now of the inflation process and its structure suggest that other costs, for import goods, nonlabor, and energy-derived could prevent increased economy slack from taking down price inflation to acceptable levels.

Thus, a reasonable expectation is that the U.S. economy will grow slowly, on average, if at all, with sticky-high inflation, although lower than currently, with both persisting for quite some time.

The Role of Economic Policy in the Current Circumstances

For U.S. policymakers, much effort has been expended to cushion the economic downturn and to prevent financial system disarray from taking the economy down further.

With a difficult near- and intermediate-term cyclical situation in prospect, it is tempting for policymakers to look for quick solutions, using short-run and temporary measures. However, the current U.S. cyclical downturn and perhaps to emerge in the world-at-large reflects deeper, long-run problems that require longer-run policy actions for relief.

So far, the measures taken by the Federal Reserve and other central banks and on fiscal stimulus have not resulted in much improvement, although certainly preventing even worse results from occurring. This may be because of lags in the effects of policy. Or, it may be that the excesses of the U.S. situation and

adjustments necessary to correct them are so large, and require so much time, that short-run temporary measures will not prove curative nor provide anything other than temporary relief.

Such is probably the likelihood for the “temporary” tax rebates tried in the United States. The rationale made sense, to bridge a possible downturn with help for the consumer until low interest rates and increased liquidity could lift up the financial system and the economy. Some of what was intended has happened. *But now with the rebates essentially done, all things considered, the motion and process of the current business cycle is likely to work against any further lift. There is too much to go yet in the U.S. and global business cycle downturns and in the contraction of the financial system and in credit to allow easier monetary policy to produce the hoped-for significant upward response in economic activity.* The contraction in credit and retrenchment of the financial system are likely to make the lags in monetary policy much longer-than-average, perhaps as long as in some other long episodes, at near 24 months or about *two years*. The collapse in housing activity will abate and come to an end over the next year, but housing probably will not show a significant upturn. Two years would take the U.S. economy into 2010.

For the consumer, beset by the most negative set of economic fundamentals in several decades, the outlook is problematical. The excesses and imbalances of the household sector need to be worked off to prepare for the next upturn. *How long consumption stays subpar is a key.*

Thus, the prospects for help from policy are daunting. The tax rebates have lifted consumer spending, but given the fundamentals surrounding consumption probably only temporarily so. As the end of the effects from the tax rebates approaches, there appears to be nothing fundamental, nor exogenous in source, that can lift the growth of consumer spending to any major degree.

What Then, for Future Policy? Short-Run Help in the Context of a Long-Run Rebuilding of America

In difficult economic times, it is essentially irresistible and almost politically impossible not to try and use policy for improving short-run economic performance, particularly when jobs and the economy are at stake and in an episode like the current one where the U.S. financial system is contracting so much. This is especially true in a Presidential election year, regardless of the party in power.

But, history teaches how difficult it is in the short-run to devise appropriate and properly-timed macroeconomic policies, even in the best of circumstances. *The “rush-to-help” should be disciplined by consideration of the nature of the problems and in the context of the longer-term.*

Also, it is important to coordinate policies in- and over-time, both for multiple fiscal actions that might be taken and their interactions and effects, and how current policy actions can dovetail with longer-term policies to achieve national objectives. This is similarly so for monetary policy and its interaction with fiscal policy. Macroeconomic policy effectiveness, in this sense, would be enhanced in a cost-efficient way if there were more coordinated planning and policy actions than the piecemeal, separate, approach that is normally the case.

Temporary tax reductions and hurry-up programs of government spending do not have a good history of success in U.S. economic policy. Both monetary and fiscal policies, though well-intentioned, often have erred and been mistimed. It is very difficult to design optimal policies for the short-run that can also work to achieve long-run economic objectives such as maximum growth and price stability, especially in those circumstances when the two objectives are in conflict or where there is a negative tradeoff between them.

The United States has perhaps the longest list of economic problems and backlog of societal issues in decades. Years of not facing up to big, long-run issues like energy conservation, energy independence from oil and oil derivative

products, rising structural federal budget deficits, reforming and restructuring the tax system, social security and health care, and now the stabilizing of the economy and inflation have left staggering policy challenges for the future. Added to the list, given the current financial crisis, is maintaining financial stability along with updating and changing the regulatory and supervisory framework for the U.S. and global financial systems.

One possible approach is to design short-run stimulus in the context of longer-run objectives—that is, measures or stimulus now as a step or downpayment on longer-run policies to achieve long-run objectives.

Of the many longer-run economic issues the country ultimately has to face, there are at least eight worth noting that are highlighted and dovetailed with the immediacy of the current situation. The comments here represent only a few of the possibilities on taxes, the role of the federal government, and for Congress.

These are:

– *The Economy and Jobs.* The U.S. economy is suffering cyclically and is at risk secularly, with supportive fiscal and monetary policies necessary in the short-run and for the long-run. Monetary policy has done about all it can safely do under the current circumstances. For fiscal policy, if a Pay-Go framework is applied, tax reductions for middle and lower income families financed by increased taxes on the highest income families and by reduced growth in government spending would serve to support consumption and the household balance sheet in a *permanent* way if the tax reductions were themselves *permanent*. There are other ways to accomplish this and to do so within a context of longer-run multi-year federal budget balance. *The consumer is the policy lever here given the current situation and prospect.*

– *Energy Independence and Energy Conservation.* Measures to reduce the demand for oil, gasoline and other energy derivatives as well as policies to stimulate supply and to develop alternative energy sources, both for crude oil and

the refining of gasoline, are indicated with a “Call to Mission” sense of national urgency. Had the U.S. tackled the “Energy Problem” 30 years ago, the inflation part of today’s stagflation might not be present. The dependence on crude oil by so many countries is a major source of the current economic malaise facing many of them and of too high inflation.

For the U.S., lower crude oil and derivative energy prices would go a long way toward freeing-up discretionary income for spending, reducing business costs-of-production, and make much easier the task of the Federal Reserve in stimulating and sustaining maximum economic growth. Because of the connection between the “Energy Problem” and the “Stagflation Problem,” the leverage of a big visionary program with tangible actions to reduce demands and increase the supplies of oil and energy would be very high.

Here, a Bipartisan Task Force charged with developing a National Energy Program is called for, with a charge and sense of urgency and call for response and, if necessary, sacrifice by the America people from our national leaders—that is, Washington!

– *The Infrastructure of America*—loosely defined as capital infrastructure as well as education infrastructure—needs much attention. Programs to increase infrastructure spending at the federal or state and local government level in-line with a longer-run program to Rebuild America’s Infrastructure would be appropriate. Such programs need to be carefully planned and executed, however. There is stimulus to the economy and jobs in the short-run from infrastructure spending but it can be fleeting, misdirected, and wasteful. *Planned and well-targeted infrastructure spending can enhance long-run productivity.*

– *The U.S. Financial System.* Measures taken so far by the U.S. Treasury and Federal Reserve to deal with a financial crisis probably serve only as a stopgap and raise the risk of underwriting future inflation. Constructive proposals on regulation and supervision in a New Financial World have been put forth in the

U.S. and abroad, but little more than the measures already taken seem possible over the near-term. The regulatory side needs reform and a careful restructuring. Although there is a role for the federal government, especially since there have been market failures, care should be taken so that the federal government does not depart far from its principal public sector functions and inject itself too much into the private economy and financial markets along with whatever private financial institutions are doing to self-correct and consolidate.

– *Rebuilding Housing and Restructuring Mortgage Finance.* Policy measures to enhance the demand and supply of housing, cushion the fallout of the current housing crisis, and enhance the support functions for mortgage finance were included in the Frank-Dodd bill passed by Congress. Although a step in the right direction, the measures in it can only deal with a small part of the imbalances in the supplies-and-demands for mortgages and of housing, where price erosion of residential real estate is at the heart of the financial distress. Measures to directly affect the demand and supply of housing involving the federal government are worth examining—including something like the Reconstruction Finance Corporation used in the early 1990s when the savings-and-loan industry collapsed. So is trying to determine the appropriate private sector financial institutions and intermediaries to support mortgage finance and housing. The governance structure of the current GSEs, their future role, that of others, the provision of mortgage finance to housing needs to be reexamined especially in light of the recent emergency actions taken by the U.S. Treasury and new GSE regulatory agency.

– *The U.S. Health Care System has to be Rebuilt and Reformed,* with health care inflation and the aging population major sources of federal government budget deficits and growing U.S. indebtedness in future years. More than any other factor, rising numbers of health system beneficiaries, the rising costs of health care, and a chaotic system of providing medical care services is a major

drain on future government financing. How to handle the societal, economic, financial, and inflationary problems created by health care needs to be figured-out.

A Bipartisan Commission on this great national problem, charged with getting results and taking actions, is one way to proceed. Here, as in so many of the economic and societal issues faced by the nation, strong leadership is needed—if not the federal government then some sort of public-private partnership to deal with the problems.

– *Household Savings and the Household Balance Sheet.* Here, a rebalancing and rebuilding of currently fragile household financial conditions is necessary. Years of dissaving, wealth created principally by rising prices of residential real estate, and heavy use of credit and debt have left many households in considerable financial distress. The household sector financial imbalances engendered by heavy spending, borrowing, and use of new, innovative ways to finance and tap equity in homes have left the financial condition of households in the most deteriorated state since the early 1980s. With a stagnant or slow-growing economy and rising unemployment, household financial fragility is made worse. Tax policy can play a role by providing savings incentives and through stimulus to the economy to support equity and real estate markets, the biggest base of household net worth.

– *The U.S. as a Debtor Nation.* Debt has been a way-of-life in the U.S. no matter who the borrower or lender. Now, the U.S. finds itself a large net debtor, relatively poor compared with much of the rest-of-the-world, and where currently asset collateral values are eroding. This makes the burden of debt much higher. There appears to be more debt accumulation *relative to assets* than less and the exposure varies across individual families, businesses, and government. The evolving nature of the U.S. recession, growing global economic weakness, continuing tight credit, and the need to retrench on debt and credit make the prospect for adequate future economic growth appear hard-to-reach. The

accumulation of debt can become a burden relative to assets and to income, with debt payments, across all sectors, private and public, too onerous. The exposure of households on debt and squeeze on financial conditions facing households is considerable. Similarly so, for the federal government and international fronts.

Rebuilding America means Rebuilding and Reforming the Financial System, Rebuilding Infrastructure, Reforming and Restructuring the Tax System, Building an Energy Program that achieves Energy Independence, Rebuilding and Reforming Health Care, Restoring and Maintaining Financial Stability, and most importantly Rebuilding the Economy and Jobs to make sure that enough jobs are created at low enough inflation to sustain, and maintain, full employment.