As we head into the upcoming year, all the data is pointing in the wrong direction. Attendees of this year's Southwest Business Forum came away with very little to cheer about on the national economy.

Given yesterday’s inauguration of a new president I am going to summarize current hurdles to economic well-being.

**Current Situation**

The challenges in the near term are quite transparent. As many have already discussed, we are on the verge of what could be the worst economic downturn in over 75 years. So let’s dive right in.

Currently, the unemployment rate is about 7.2%, – a broader measure of unemployment has hit 13.5% – or approximately 2 percentage points above its long run rate. Figure 1, below, shows the actual unemployment rate; estimated “full employment” level of unemployment, or natural rate of unemployment; and “cyclical unemployment”, which represents the short deviations of unemployment from the long run.

As can be seen cyclical unemployment is rising sharply and we can see an upturn in the natural rate, which fluctuates over long periods of time. Most economists believe unemployment will reach somewhere between 9-10% before the economy begins to recover – or about 2.5-3.5% over the natural rate.

Closely associated with the natural rate of unemployment is the potential level of real gross domestic product (GDP). This what the economy produces in when working at “full capacity” without over- or under-utilizing resources. When actual real GDP deviates from this level of output the economy goes through expansionary, if real GDP is above potential GDP, or recessionary, if it falls below, “output gaps”.

In July 2008, the most recent data available, the output gap hit –2%, and is heading the wrong direction, see Figure 2. As can be seen, we are getting close to the size of the “.com” recession – though still quite a distance from the Reagan-Volcker recession of the early 1980s. However, a quick “back of the envelope” calculation reveals the December gap has fallen to about –5%.
If you had asked me a year ago about the other worry, inflation, I would have been very concerned about a spiraling supply side inflationary spiral – a.k.a. stagflation. If, on the other hand, you had asked me about inflation four months ago, I wouldn’t have worried about it all. But, now I am worried about the possibility of deflation, “negative” inflation. Annualized inflation rates are falling dangerously close to zero, about 0.1% in December. In the last quarter of 2008 monthly inflation rates were negative. The October-December 2008 compounded annual inflation rate was –12.7% – prices fell 1.7% in November, the furthest in the post-War period, and a further 0.7% in December, see Figure 3 (the red/blue line is the monthly/annual inflation rate).
Falling prices are associated with declines in aggregate demand for goods and services, and while falling prices are good for purchasing power, they are bad for the costs-revenue calculations for firms. As output prices fall firms pull back on their payroll to trim costs which raises unemployment, further dampening demand, and the economy enters into a vicious downward spiral.

** Fixes? **

Economic policy makers have two tools they can use to combat: monetary and fiscal policy. Monetary policy is simply how the Fed changes money supply to repress or encourage short term interest rates to move to buttress or slow the economy. To date, this has been a complete failure. Uncertainty has forced the Fed to push policy interest rates to zero. This should encourage lending, but something has gummed up the pipeline, and that “something” is uncertainty and lack of confidence. Despite the Fed’s best intentions the money supply is *shrinking* – theory suggests that with zero interest rates money should become infinite.

With monetary policy effectively sidelined we must rely on fiscal policy to pull out of the hole. The current price tag of the Obama fiscal stimulus is $825 billion. And while that may seem to be a lot of money, well it is, it is a lot less than the Federal government would have to spend if nothing was done. Economic stagnation and high rates of unemployment would be much longer lived costing the Government much more over, perhaps, a decade of economic doldrums.

Support for this fiscal stimulus has almost universal support from both sides of the congressional aisles. The only true difference is how the money will be spent. Tax cuts? Road construction? Education? Energy?

My two cents are the following: temporary tax cuts are useless. On aggregate, US households have amassed $13.9 trillions of debt (pink line in Figure 4 below) while after tax income is $10.7 trillion (blue line); the green is the percentage of disposable income-to-debt ratio in percentage terms, currently about –20%. We have literally borrowed ourselves into the poor house. Thus, temporary tax breaks will most likely be used to pay down debt and/or increase savings – which is also close to zero, by the way. Any tax relief should be of the permanent variety not like many of the Bush “permanent” tax cuts which are set to expire in 2011.

![Figure 4. Household Debt and Income](image)

*Source: Bureau of Economic Analysis, Board of Governors*
Nor, should the fiscal stimulus package be used for long term investments in human capital, new energy technologies, or other long term programs. These are excellent long term investments in the future of the US economy, but will have relatively little impact over the next 6 – 18 months when we need it. Rather, we should concentrate on projects which pump cash into the economy yesterday not five years. Infrastructure repairs is a sensible start, with a couple of caveats. First, it is no substitute for investment in new infrastructure investment along the lines of the intercontinental railway, telecommunications, or the interstate highway system. And second, it remains to be seen how far reaching road and bridge repairs will be. How much income/employment will be “created” for each dollar spent?

Another interesting idea is a mix of fiscal and monetary policy – mortgage rate reform. Now that the Federal Government owns Fannie Mae and Freddie Mac, these institutions should allow refinancing of mortgages. This will allow household considering foreclosure to get in at a safer low interest rate mortgages. And current home owners would be able to free up a considerable amount of monthly income to be spent on other stuff, or pay down existing debt. This would free up about $100 per month on a $100,000 if households were allowed to refinance at 4.25% rather than 6%. And it would bolster the housing market.

Of course mortgage rates are heading down, but banks seem less the willing to make new loans, or reluctant to let “high quality” borrowers have the opportunity to enjoy lower rates as it negatively impacts the asset side of their balance sheet.

Also, congress must decide to take a “pork” vacation. Well, perhaps, pork should be retired permanently, or limited to projects which require less than, say, $1 million.

We are in for a long haul. 2008 Nobel winning economist Paul Krugman is quoted as being “frightened” about the near future, and economists are used to being pessimistic. I believe that whoever was elected last November would arrive at the same conclusion – the economy needs a kick start. And a substantial one at that.