

Winter recovery?

Although significant challenges remain, the economy is showing signs of strength.

Officially, the current economic recovery has been under way since June 2009, when the economy as a whole began growing again. Unofficially, many Americans have remained skeptical of such pronouncements, given the persistence of high unemployment. But the skepticism seemed to give way in the 2010 Christmas shopping season, when consumers opened their wallets a bit wider than expected. Early projections tracked a 5.5% increase in retail spending in the 50 days before Christmas, compared to the year earlier.

Gross Domestic Product (GDP) grew by an annualized rate of 3.7% in the first quarter of 2010, then slowed to 1.7% in the second quarter before increasing to 2.6% in the third quarter. The final quarter of 2010 is expected produce a gain in the 3% area, and some experts forecast 4% growth for 2011. Double-digit gains for 2010 in the stock indices would seem to confirm that judgment.

Some credit the bipartisan deal on extending the “Bush tax cuts” for two years as a key turning point. The chairman of the Council of Economic Advisors, Austan Goolsbee, was quoted as saying, “There aren’t many policies which, on the day Washington announces them, lead most private-sector forecasters to publicly and significantly revise their forecasts upward. This one did.”

Another important positive factor is the Federal Reserve Board’s decision to continue “quantitative easing,” an accommodative monetary policy intended to head off deflation and the possibility of a double-dip recession. Some economists are optimistic that this combination of fiscal and monetary stimulus will help lead to better unemployment numbers as 2011 wears on.

Housing

However, there are plenty of danger signs to fuel the concerns of the bears. One is the continuing weakness of the housing market. Despite historically low mortgage interest rates, the sale rate of single-family homes in November was down 20% compared to the year-earlier figure, well below analysts’ expectations. The actual number of homes sold in November was the lowest on record. New home sales in August 2010 were the lowest since compilation of such data began in 1963.

The absence of a recovery in housing led to an estimated drop in aggregate home values of \$1.7 trillion in 2010, according to housing price data provider Zillow, Inc. That brings the total wealth evaporation for this asset class to some \$9 trillion since the June 2006 housing peak. This loss of value could retard economic recovery, as most consumers will no longer be able to tap their home equity for major purchases.

Loss of paper wealth coupled with persistently high unemployment may have been responsible for the surprise drop in consumer confidence recorded in December. Given that the November figure had been revised upward to 54.3, some analysts had expected the December figure to push ahead to 56 or so. Instead, the Conference Board reported that the confidence index fell to 52.5. This data is inconsistent with the good retail sales news, and it may suggest that growth won’t accelerate off the strong Christmas selling period.

Muni bonds

Perhaps the biggest cloud overhanging the economy is the condition of state and municipal finance. Tax collections are down throughout the country, attributed primarily to the recession. The Recovery Act enacted early in the Obama administration helped ease this problem, but that support is expiring now and isn't likely to be renewed in 2011. One specific measure, the Build America Bonds, helped localities gain access to credit. The federal government subsidized the interest payments on such bonds, but their authorization expired at the end of 2010. A series of very painful choices await state and local officials.

Nowhere is this more important than when it comes to funding pensions for public employees. A recent study from Northwestern University estimated that total unfunded public pension liabilities come to some \$574 billion. Chicago alone has \$44.8 billion in such unfunded obligations, for example. However, taxpayers have little awareness of the scope of the problem. That has led to the introduction of the Public Employee Pension Transparency Act in Congress, to shed more light on the situation and head off any attempt to pass the buck to the federal government.

Only when these challenges have been addressed can we feel confident that the economy is back on a sustainable growth path.