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From Wall Street

to Main Street

2009: Unprecedented Economic Challenges

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2009: Unprecedented Economic Changes

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Preface

This is the first paper in NJLM Foundation's "Friends of Local Government" Policy Paper series. These papers will offer perspectives and analysis from organizations that are often heard on West State Street, but not necessarily on Main Street.

This paper, authored by Dr. James Hughes and Dr. Joseph Seneca from Rutgers, the State University of New Jersey, offers analysis on the impact of the global economic recession on local governments, and, by extension, our taxpayers.

On behalf of the Board of the NJLM Educational Foundation, we thank Dr. Hughes and Dr. Seneca for these contributions, and believe you will find this paper informative.

We would also like to note the support of the Foundation's Board for this project, as well as staff from the New Jersey State League of Municipalities, including Bill Dressel, Michael Darcy and Taran Samhammer.

The cover page includes a photo of the Union Township Municipal Building (Union County) and photos of Main Street in Lawrenceville.

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The good news is that 2008 is now history. It was a year when, unfortunately, the most dire national and global economic forecasts were realized. The bad news is that 2009 could actually be worse. The cascade of grim economic statistics is not likely to abate anytime soon. The result of the steep economic decline has been to create the most perilous municipal fiscal conditions since the Great Depression.

Some of the most overused words in economic analysis are: This time it's different! However, this recession *really* is different. It is certainly not your standard-issue interstate economic downturn. America's current economic condition is unprecedented in the post-World War II era. Every private business sector of both the nation's and New Jersey's economy (with the exception of health care) is in serious contraction. And there is still a fear that this deep recession could evolve into something far more ominous.

A frequently heard question is: When will things get back to normal? This is probably the wrong question, since the economic conditions that not so long ago were regarded as "normal" may never return. Instead, a more appropriate question is: What will the new post-recession "normal" look like? The world as we knew it is not coming back. The economy is in the midst of a fundamental transformation that will redefine the operating parameters of municipal governments. While only the most omniscient seer would be able to fully grasp this emerging future, some elements of the "new normal" that are likely to emerge from it can now be discerned. But before we describe those, let's first review our current economic condition, which is without precedent in the last half-century.

Where Are We in the National Business Cycle?

On December 1, 2008, the Business Cycle Dating Committee of the National Bureau of Economic Research (NBER) – the private, nonprofit, nonpartisan, research organization that decides when recessions and expansions begin and end – first told us that the United States entered a recession in December 2007. Thus, America was already

one full year into a recession before the Committee believed it had sufficient evidence to tell the nation that we were actually in one! Then, just one month later, on January 1, 2009, the United States found itself in the 2007-2009 recession, already spanning all or parts of three years.

The longest post-World War II recessions (1974-1975 and 1981-1982) were 16-months long, measured from economic peak to economic trough.[1] This record will be broken in May 2009, when the current recession will be 17-months long. Regrettably, it could stretch into next year and become the 2007-2010 recession.

How Deep?

One way to look at the performance of the United States economy is in terms of employment. The national economy created more than 7.5 million private-sector jobs in a 53-month period between 2003 and 2007, a powerful growth surge. But in 2008, this great "American Job Creation Machine" expired and was replaced by the great "American Job Destruction Machine." The United States experienced private-sector payroll employment declines every month in 2008, and by year's end nearly 3.2 million private-sector jobs were lost (chart 1, page A-1.) In terms of absolute private-sector job losses, 2008 was the worst year since 1939, the first year that payroll employment statistics were compiled in the United States. In terms of percentage loss, it was the third worst year. This is a traumatic labor market retreat.

Then, in the first two months of 2009, an additional 1.3 million private-sector jobs were lost, bringing the total to date of the now 14-month (through February 2009) recession decline to nearly 4.6 million jobs lost. Chart 1 (page A-1) shows a labor market falling completely out of bed starting last September. Since employment is typically a lagging indicator, the worst of the employment decline may not be over. Nearly 675,000 private-sector jobs were lost in each of the last three months (December 2008 to February 2009), yielding a total three-month employment loss of 2,016,000 jobs. This translates into 22,400 private-sector jobs lost per day, or 933.3 jobs per hour!

[1] It should be pointed out that the period of employment decline may not match exactly the period of recession as defined by the NBER Dating Committee. For example, the NBER-defined 2001 recession was eight months long (March 2001-November 2001). However, total employment in the United States peaked in February 2001 and bottomed out in August 2003. Thus, the employment downturn lasted 30 months. At the state level, recessions can be measured only by employment peaks and troughs.

Another economic performance measure is the change in Gross Domestic Product (GDP), the total output of goods and services of the United States economy. Inflation-adjusted GDP decreased by 0.5 percent in the third quarter of 2008, and then tumbled by 6.2 percent in the fourth quarter. This was the worst quarterly decline in more than 25 years. The current consensus estimate is that GDP will continue to decline in the first quarter of 2009 at a similar rate. It is possible that the GDP contraction in this recession could surpass that of the very painful 1974-1975 and 1981-1982 downturns.

The Perfect Economic Storm

At the same time that the U.S. economy is declining, the world economy has slipped into a synchronized global recession. Worldwide GDP has the potential to decline for the first time since World War II. Thus, it appears that we are entering the perfect economic storm. New Jersey and its municipalities are being swept along by very powerful global and national economic tides, and it will be very difficult for the state to swim upstream.

New Jersey's Business Cycle Conditions

New Jersey had little employment growth momentum *before* the great 2008 economic meltdown unfolded. This is apparent in the state's business cycle of the past 28 years. Chart 2 (page A-2) presents annual private-sector employment change annually from 1980 to 2008 (there is no intended political significance to this, but blue bars represent employment growth, while the red bars indicate employment decline!). Thus, the blue bars represent economic expansion years, while the red bars represent recessionary years. For example, in 1983, New Jersey gained 148,300 private-sector jobs, one of the greatest job growth years in the state's history. In contrast, in 1990, the state lost 136,800 jobs, one of the state's worst annual employment losses.

Chart 2 (page A-2) starkly reveals the extraordinarily weak annual job growth of the 2003-2007 employment expansion. Certainly, in chart 2 the height of those blue bars is stunted during that period compared with the towering bars of the previous expansions. Starting in 2003, the first post-recession year to show employment growth, New Jersey's job base just did not grow at a rate anywhere near the pace that historically accompanied

an economic expansion in the state. Chart 3 (page A-2) presents a baseline comparison. During the previous two expansions in the state, 1982 to 1989 and 1992 to 2000 (defined to the specific month at the bottom of the chart), New Jersey added approximately 74,000 private-sector jobs *per year*. This is a reasonable estimate of what the state should have gained during the March 2003 to December 2007 expansion period. Instead, New Jersey added on average just 19,000 private-sector jobs per year, or about one quarter of that expected – 19,000 versus 74,000. And during 2007, the last year of the expansion, we gained only 5,300 private-sector jobs (chart 2, page A-2.) Thus, we flat-out flatlined in 2007. To put this into perspective, New York State – propelled by Wall Street financial services – gained approximately 86,000 private-sector jobs in 2007 – or 16 times that of New Jersey. Thus, the state never really gained significant employment traction during the good times of the 2003-2007 expansion.

For a broader perspective, during the entire 2003-2007 period, the nation's private-sector job base grew by 7.0 percent, while New Jersey's rose by only 2.6 percent, slightly more than one-third that of the nation. Then, after badly lagging the national economy for four straight years, we finally started to track the nation quite closely in 2008. But, just as we started to track the nation, the nation unfortunately plunged into recession. In 2008, the United States and New Jersey experienced substantial private-sector job losses. As can be seen in the far right bar in chart 2 (page A-2,) New Jersey lost 88,700 private-sector jobs in 2008, the worst year since 1990. This took place while the nation lost 3.2 million jobs (chart 1, page A-1.) In percentage terms, New Jersey lost 2.6 percent of its private-sector employment base in 2008, while the nation lost 2.7 percent. So, both the state and the nation are heading in the wrong direction at a rapid pace as 2009 unfolds.

Historical Analogies: Downturn Examples

Given the preceding benchmarks and trendlines, where can they possibly lead? The top half of chart 4 (page A-3) presents the current downturn in the context of the preceding two recessions, measured from total employment peak to trough. The *first* is the severe March 1989 to May 1992 employment downturn, when 265,100 private-sector

jobs were lost over a record-long 38 months. The *second* is the milder December 2000 to March 2003 employment downturn, when 84,800 private-sector jobs disappeared over 27 months. In contrast, during the current downturn – which started in December 2007 – 98,000 private-sector jobs have been lost through January 2009. So, to date, we have already eclipsed the losses of the 2000-2003 downturn.

There will be substantial employment losses to come if the past is a prelude to the future. This is shown in the bottom half of chart 4 (page A-3.) If the length of the current downturn follows the mild 2000-2003 downturn, which lasted 27 months, the current employment recession would end in March 2010. If, however, it follows the more severe 1989-1992 experience, the current downturn would end in February 2011. Moreover, since we have already surpassed the employment declines of 2000-2003, the 1989-1992 job loss is our most recent comparable recession. That downturn, like this recession, was characterized by a housing market and stock market collapse, but it did not have the added and significant burden of a credit market crisis. If New Jersey follows the employment pattern of 1989-1992, an additional 167,100 private-sector jobs could be lost.

So based simply on historical analogy – again this is *not* a forecast, but simply a historical analogy – the current employment downturn would end sometime between March 2010 and February 2011, and the state could experience an additional employment loss of approximately 167,100 private-sector jobs.

The New Normality

Now let's return to the key question raised at the start: What will the new normal look like? And, rest assured, the new normal will be very different from the old normal. That is because the sources of our current economic difficulties were the unsustainable bubbles that shaped that old normal. Four are of major importance: financial activities' economic dominance, an unprecedented global credit surge, unconstrained consumer spending, and a homeownership bubble. As the full aftershocks of the collapse of each of these are absorbed, a new operating environment will impact every municipality in the United States, and particularly so in New Jersey.

The New Financial World

High-end investment banking activities (such as Goldman Sachs) and the financial supermarket business model (e.g., Citigroup) entered the first decade of the twenty-first century like economic lions. They are exiting it like wounded economic lambs. The financial sectors' share of all corporate profits in America jumped from generally below 20 percent in the early 1980s to above 40 percent at its peak. An unsustainable lending and borrowing binge, with unprecedented leverage and ultra-thin capital, generated unprecedented wealth on Wall Street. There were record deals, record profits, record pay, and record bonuses, and this was a key engine of regional prosperity that spilled over into New Jersey. But this over-leveraged, debt-driven era is now history.

The five great Wall Street investment banks are no more. Wall Street as we knew it for 75 years – loosely regulated, daringly risky, and ultra-lavishly rewarded – was obliterated in a matter of months. The world's financial system is now being remade at lightning speed, with deleveraging and recapitalization the dominant goals of financial institutions. A new era of lower Wall Street returns, thinner profits, fewer financial jobs, lower compensation, smaller bonuses, and much more rigorous financial regulation is now unfolding. The financial sectors' share of all corporate profits in America has already fallen to 30 percent, and it will probably go lower. This will be one key part of our emerging new normal.

Now what does this broad national and global transformation mean to New Jersey municipalities? It translates directly into a weakened state fiscal structure. One dimension of this is the state income tax. Fully 40 percent of the state's gross income tax is paid by the top 1 percent of tax filers, and a large part of this top 1 percent is strongly tied to Wall Street. Thus, the state's income tax revenues will take significant hits in the short term, and diminished expectations long term. In the current fiscal year, gross income tax revenues are likely to fall by close to 11 percent compared with collections in fiscal year 2008. This will hinder the state's capacity to provide aid to municipalities for the foreseeable future.

The New Credit Reality

A seemingly inexhaustible mountain of cheap global credit, accompanied by risk amnesia, drove not only Wall Street but also the broader economy from 2000 to 2006. This made many real estate, housing, and development projects possible that simply weren't possible before. However, they were made possible because of easy credit, not underlying economic-market fundamentals. But the platinum years of seemingly unrestrained financial activities propelling real estate markets to new heights are now history; the era of severely underpriced risk has fully receded into the distant past. The rediscovery of risk and tightened lending standards will make many projects impossible again. Exuberance and excess spawned by cheap credit is making way for prudence and pragmatism. This will reverberate throughout New Jersey. Both nonresidential and residential ratable growth will be much slower in the years ahead. Many projects that went forward in the 2000-2006 period will not be the type of projects going forward in the new normal.

Long-Term Consumer Retrenchment

The once all-powerful economic locomotive of consumer spending has finally run out of steam. For two decades, Americans and New Jerseyans became unrepentant shopaholics – became the most overextended consumers in world history – by spending all their income, maxing out on plastic credit, and using their houses as ATM machines. Chart 5 (page A-4) provides the evidence. At the top is the savings rate – personal savings as a percentage of disposable income – in the United States for the 1970 to 2008 period. For the first 16 years – 1970 to 1986 – America was relatively virtuous, with the savings rate averaging roughly 10 percent. Then, the long sustained slide began, reaching *zero* percent by 2005. A zero savings rate is not sustainable.

Not surprisingly, and directly related, personal consumption during this period as a percentage of Gross Domestic Product (GDP) soared. The bottom half of chart 5 (page A-4) reveals that from 1970 to 1982, personal consumption accounted for roughly 63 percent of GDP. But by 2002, it exceeded 70 percent. Consider that year the start of America's great consumption bubble. The nation went on the greatest spending spree in the history of the planet. But that level of consumption was not sustainable. It was

achieved only by spending every dollar of the paycheck, by depleting home equity, and overdosing on credit. At that same time, a large part of that spending was on foreign goods, driving the nation's trade deficit to record highs. Households now have too little savings, too much debt, and their balance sheets are stretched to the limit at a time when home prices and financial assets are still declining and labor markets are continuing to weaken. It has just been reported by the Federal Reserve that American households lost $11.1 trillion in wealth (financial and home equity) in 2008. This represents an annual rate of decline of 18 percent, the worst in the 57-year history of the data series. To illustrate just how staggering this loss of wealth is, the second largest annual rate of decline took place in 2002, when household wealth fell by 3 percent. The 2008 decline was six times that loss! Future historians will probably label this the Great Wealth Wipeout.

The bottom line is that an era of significant consumer retrenchment is upon us. Just like financial institutions, households are being forced to deleverage and recapitalize. The broad New York metropolitan region has been one of America's most potent consumer markets – a virtual retail and distribution paradise. However, change is taking place. The new post-spending spree normal will now be defined by a new sustainable life-style, and consumption as a share of GDP will decline as the savings rate rises. This will ripple through the economy. As this adjustment process evolves, there will be a general lack of consumer support for new retail facilities. Implications for municipalities are that state sales tax revenues are likely to have only modest growth when the recession ends, and retail ratables will remain vulnerable as a result of constrained rates of consumer expenditures.

Homeownership Retreat

The home price and homeownership rate corrections have unfortunately not run their courses. Since the size of the national housing bubble was unprecedented, the correction is going to be a multi-year phenomenon. We are starting to see a retreat to sustainable homeownership rates. As shown in chart 6 (page A-5) the national homeownership rate was 64 percent in 1994. That was roughly the long-term average homeownership rate of the preceding decades. However, the rate soared to 69 percent by

2004, before starting to retreat. The increase of 5 percentage points – from 64 percent to 69 percent – may not have been sustainable and represented a homeownership bubble. Many households in that 5 percent probably shouldn't have become homeowners. And they may not be homeowners again in the years to come.

In any case, a new "homeownership normal" is about to emerge. The homeownership rate in the third quarter of 2008 fell to 67.9 percent, the same level as 2002. This will be manifested in New Jersey, suggesting that many housing projects of the type that were prevalent in the 2000–2006 period will not be feasible going forward. A much more conservative housing reality is emerging.

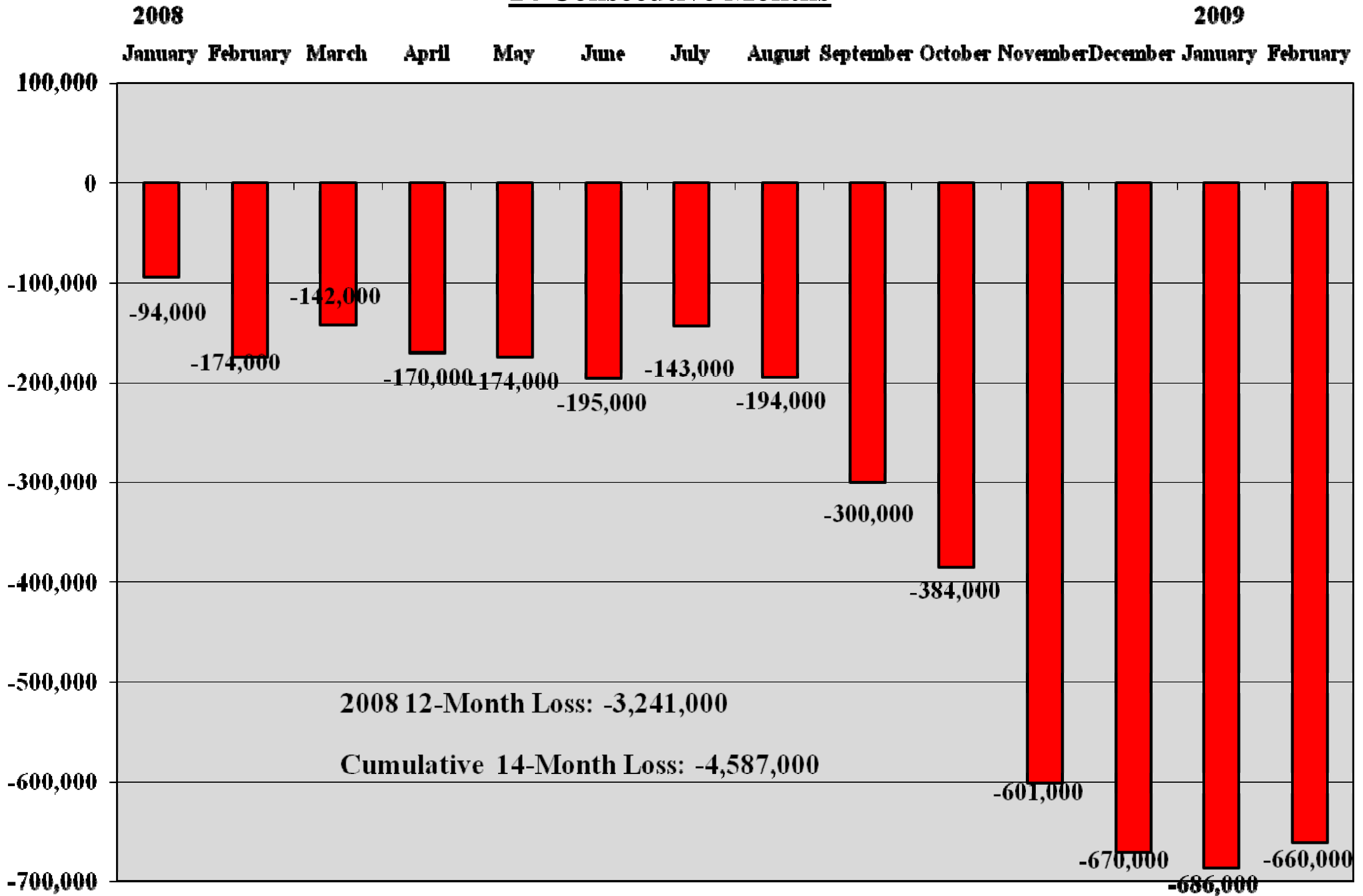
The Bottom Line

Eventually, the current downturn will end, and both the United States and New Jersey will move into a post-recession future. While we have attempted to look at some of the potential parameters of that future, the crystal ball remains cloudy. We can probably be a bit more certain about what it will *not* look like. And that is, it will not look like the boom years earlier in the current decade. The years between 2000 and 2006 were ones of unprecedented, over-exuberant excesses. They are the worst years to use as a set of expectations for the future. They are the worst years to use as a projection baseline. Thus, they tell us what the future will *not* be like.

The post-recession years going forward will require significant and ongoing adjustments by New Jersey municipalities, particularly if lagging economic growth continues to plague the state. But, realizing the need for successful adjustments, particularly on the cost side of municipal operations, is the result of understanding that when the economic debris of 2007-2010 is swept away, the United States and New Jersey will be a very different place, characterized by a new normal. Expecting a return to a past, which it turns out in painful retrospection was based on unsustainable financial and economic bubbles, is neither a fruitful nor a useful guide for municipal operations. The successful business models of the past era will not be the successful business models of the future.

CHART I

U.S. Private-Sector Employment Losses
<u>14 Consecutive Months</u>



Source: U.S. Bureau of Labor Statistics.

CHART 2

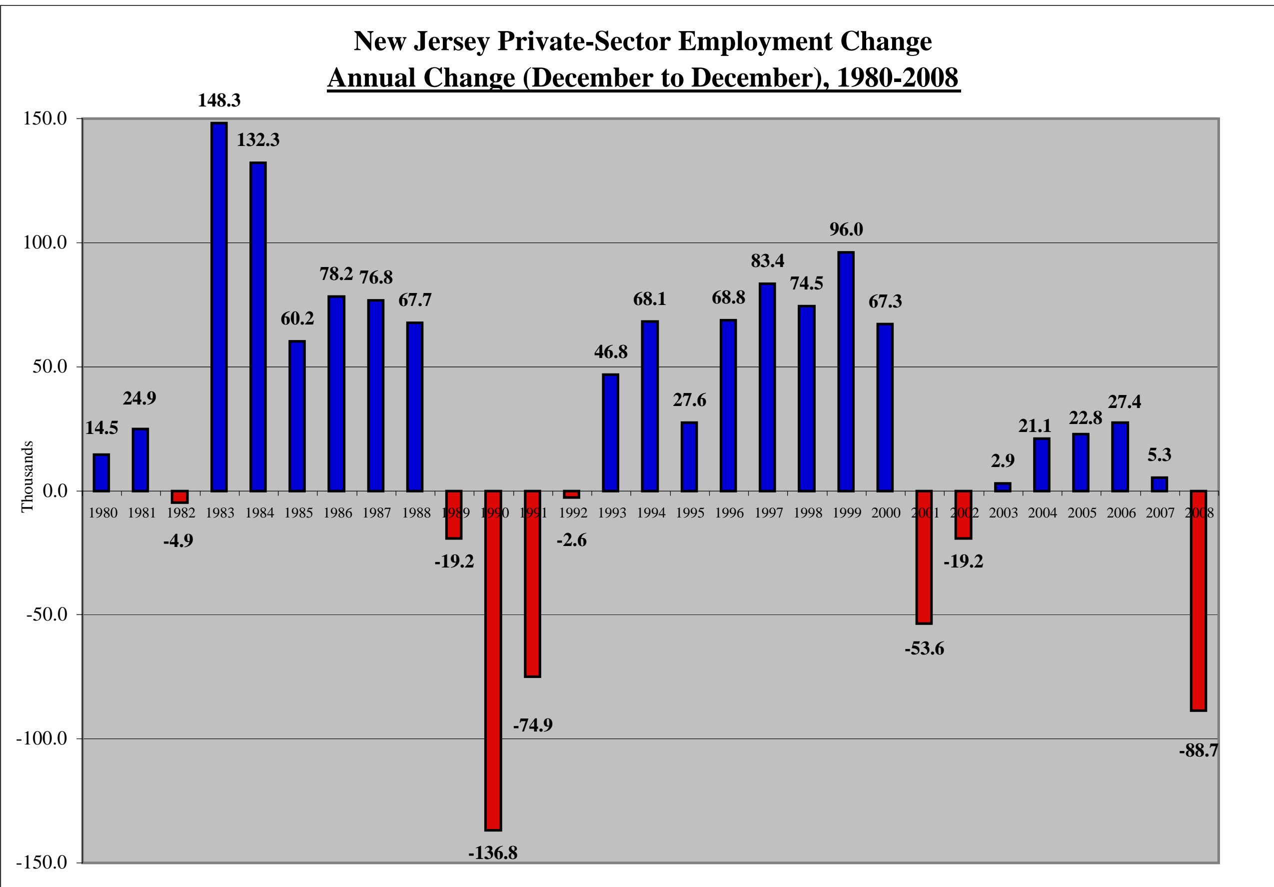
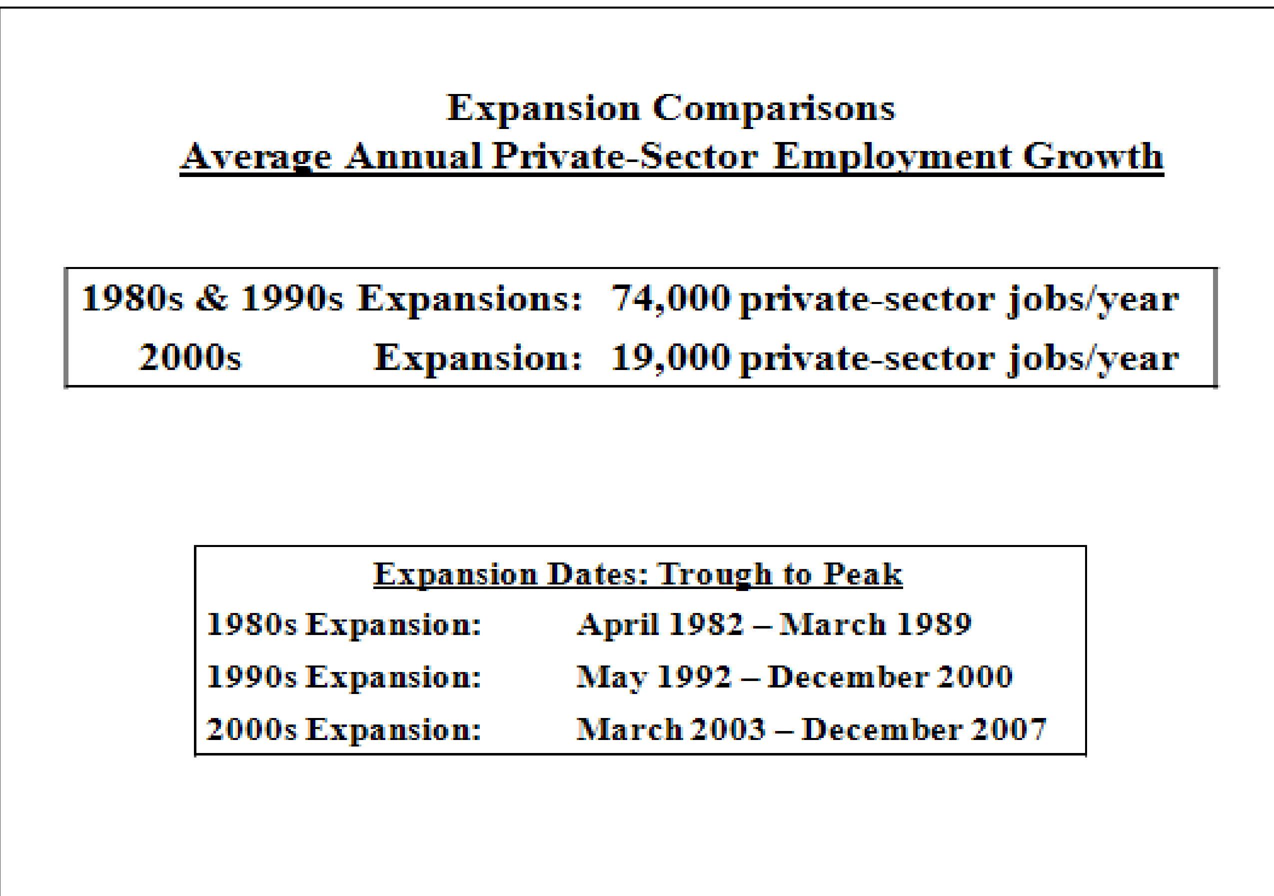


CHART 3



Source: New Jersey Department of Labor and Workforce Development

Chart 4

Recession Comparisons

Recession Dates: Peak to Trough

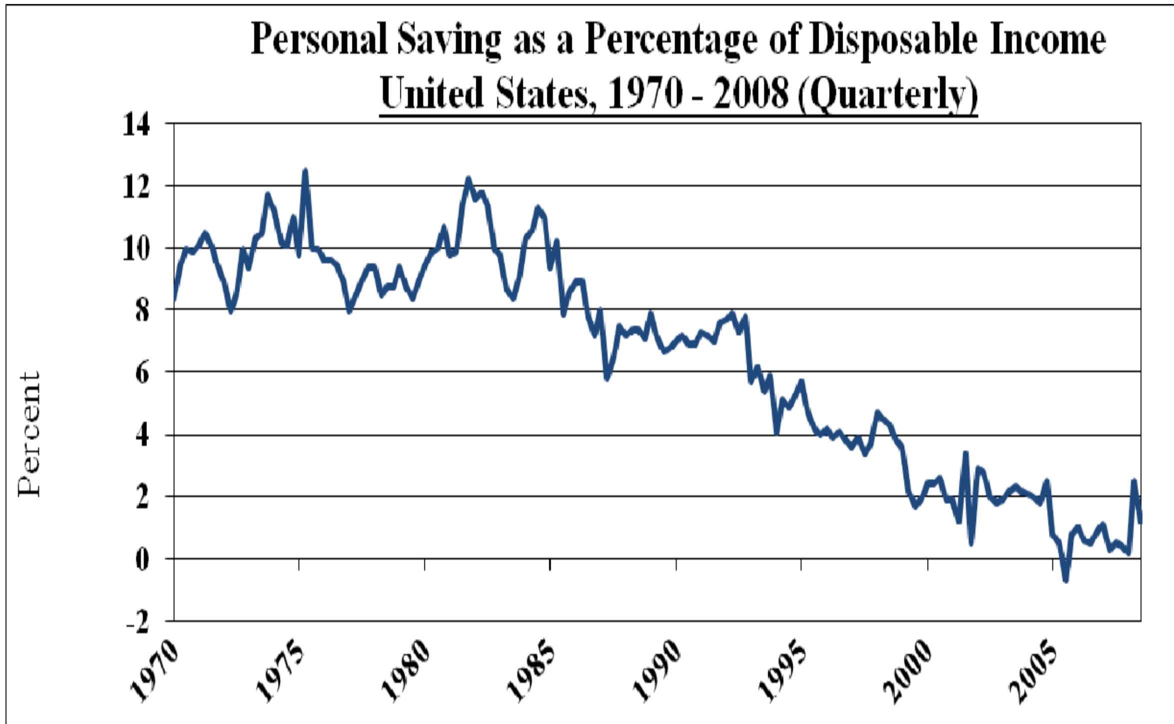
Date	Length	Private Sector Employment Loss
March 1989 – May 1992	38 months	-265,100 jobs
December 2000 – March 2003	27 months	-84,800 jobs
December 2007 – January 2009	13 months to date	-98,000 jobs

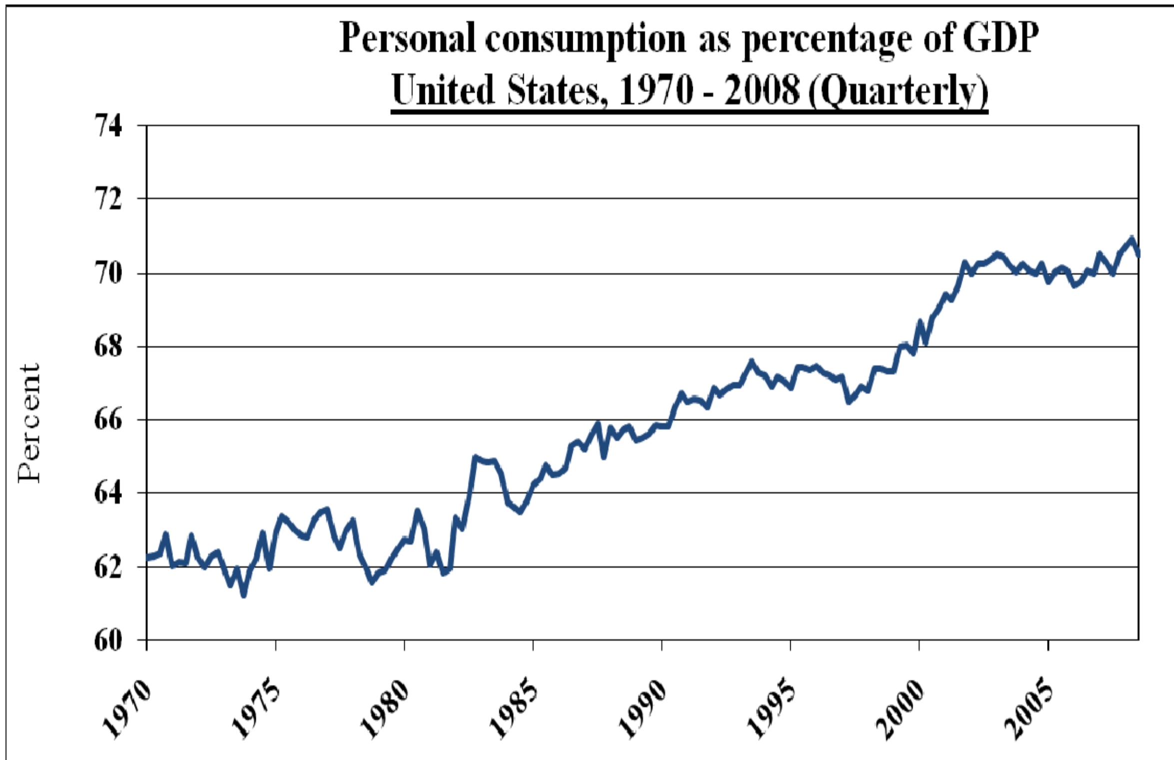
Future Scenario: Historical Analogy

Scenario	Recession End	Private-Sector Employment Loss To Come
1989-1992 Model	February 2011	-167,100 jobs
2000-2003 Model	March 2010	---

Source: New Jersey Department of Labor and Workforce Development

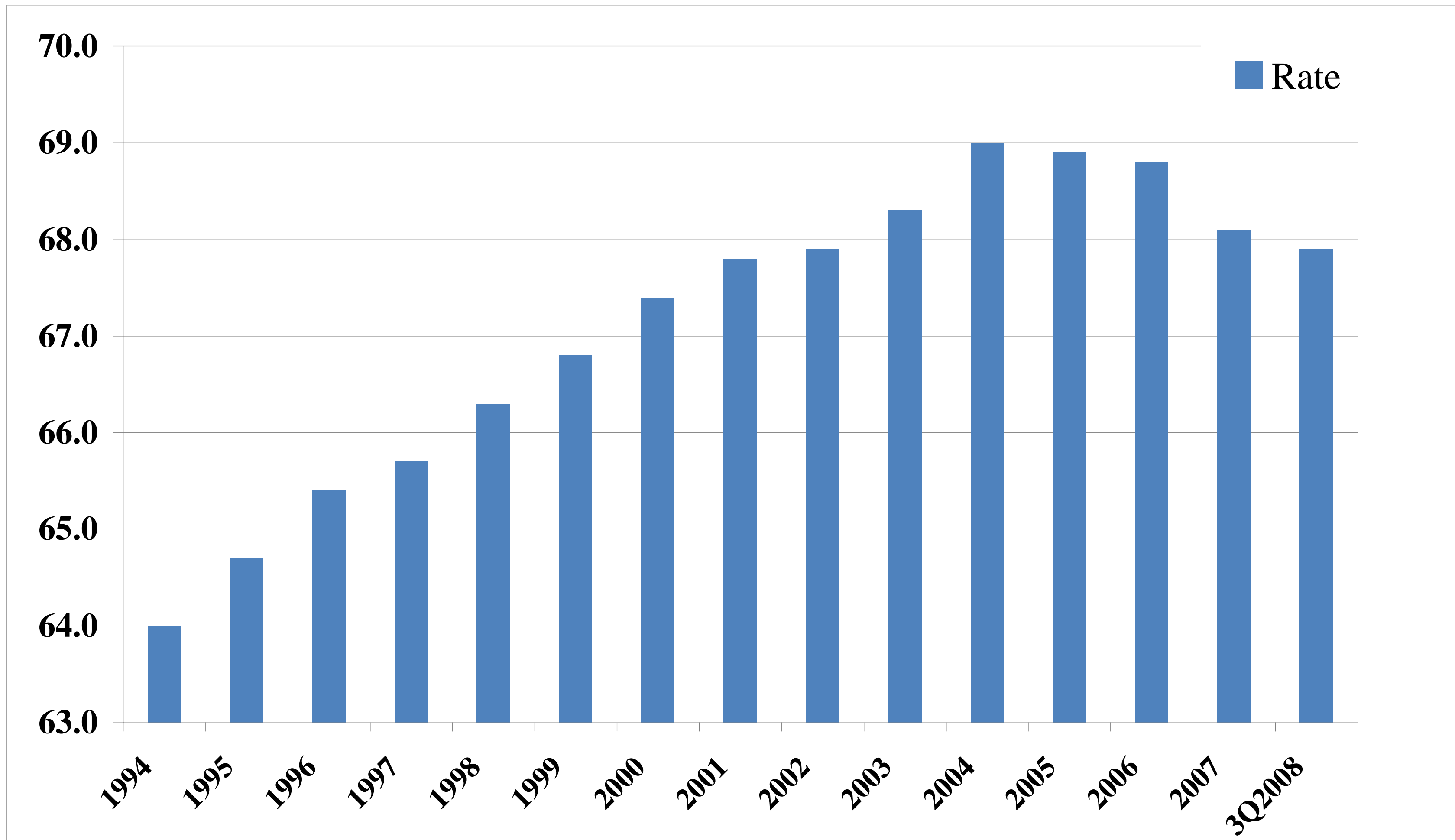
Chart 5





Source: U.S. Bureau of Economic Analysis

Chart 6



Source: U.S. Census Bureau.

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