ECONOMIC OUTLOOK 2011-2012

The University of Arizona’s
Thirtieth Annual
Forecast Luncheon

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OVERVIEW

- Recovery hit a “soft patch” in 2\(^{nd}\) half
- Headwinds have slowed recovery
  - National factors
  - Unique to Arizona
- New tax package ensures stronger pace
- State fiscal update

Real GDP, U.S.
Trillions of 2005 dollars

Household Credit, U.S.

Business Credit, U.S.
Consumer Confidence Index
(1985=100)

Source: Behavior Research Center, Inc.

BUSINESSES ARE CAUTIOUS

- Uncertainty over future taxes
- Rising health care costs
- New financial regulations yet to be written
- Weak demand

HEADWINDS UNIQUE TO AZ

- Enormous inventory of vacant housing
  - 130,000 vacant addresses, 4.9% rate
  - Normal is 1.5%
- Mobility remains at the lowest level in 60 years
  - Credit squeeze and inability to sell house
    - half of AZ homeowners are “upside-down”
- Household formation near zero
  - Doubling up due to poor economy and high unemployment

RESIDENTIAL VACANCIES
AZ METROS, SEPT. 2010

<table>
<thead>
<tr>
<th>Area</th>
<th>Total Number</th>
<th>Vacant</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Flagstaff</td>
<td>49,117</td>
<td>830</td>
<td>1.7</td>
</tr>
<tr>
<td>Lake Havasu-Kingman</td>
<td>100,061</td>
<td>7,209</td>
<td>7.2</td>
</tr>
<tr>
<td>Phoenix-Mesa-Glendale</td>
<td>1,861,570</td>
<td>91,687</td>
<td>4.9</td>
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<tr>
<td>Prescott</td>
<td>97,710</td>
<td>1,328</td>
<td>1.4</td>
</tr>
<tr>
<td>Tucson</td>
<td>454,559</td>
<td>26,826</td>
<td>5.9</td>
</tr>
<tr>
<td>Yuma</td>
<td>69,874</td>
<td>2,103</td>
<td>3.0</td>
</tr>
<tr>
<td>Metro Arizona</td>
<td>2,632,891</td>
<td>129,983</td>
<td>4.9</td>
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</tbody>
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Source: U.S. Department of Housing and U.S. Postal Service
**HOUSING STILL AT BOTTOM**

- Home-buyer tax credit ended, “payback”
  - Building permits
  - Existing home sales
  - Home prices
  - Foreclosures
  - AZ ranked 3rd worst in October (NV, FL worse)
    - 1 in 165 homeowners received a notice
    - Pinal County 1 in 94, Maricopa 1 in 134, Pima 1 in 264

**Building Permits, TUS**

(seasonally adjusted annual rate)

**Existing Home Sales, MLS**

000s units, seas adj annual rate

**Median Price of Homes Sold**

MLS
Economic Outlook 2011-2012

Nonfarm Jobs, TUS
seasonally adjusted

UNEMPLOYMENT PAINFULLY HIGH

- Nationwide 9.6% in October
  - AZ 9.5%
  - PHX 8.5%
  - TUS 8.3%
  - Flagstaff 7.9%
  - Prescott 9.7%
  - LHC-Kingman 10.9%

RECENT EMPLOYMENT TRENDS, TUS

<table>
<thead>
<tr>
<th>Growing</th>
<th>Stable</th>
<th>Declining</th>
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</thead>
<tbody>
<tr>
<td>Health Care/Soc. Serv.</td>
<td>Information</td>
<td>StL. Non-Ed</td>
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<tr>
<td>Federal Government</td>
<td>Transportation/Ware.</td>
<td>Prof. &amp; Bus. Serv.</td>
</tr>
<tr>
<td>Accommodations</td>
<td>Food &amp; Drinking Places</td>
<td>Manufacturing</td>
</tr>
<tr>
<td>Mining</td>
<td></td>
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</tr>
<tr>
<td>Financial Services</td>
<td>Employment Serv.</td>
<td>Wholesale Trade</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Grocery Stores</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Clothing</td>
</tr>
<tr>
<td></td>
<td></td>
<td>StL. Education</td>
</tr>
</tbody>
</table>

State & Local Government Less Education Employment, TUS
seasonally adjusted
**NEAR-TERM OUTLOOK**

- Credit creation is key
  - Mobility of population improves
  - Absorb inventory of vacant houses
  - Start building homes
- Modest improvement as 2011 progresses
  - Spending will improve
  - Hiring will strengthen
STATE FISCAL UPDATE

- AZ ranks 4th in severity (NV, IL, NJ are worse)
  - 38% shortfall current year (NASBO)
- Current year ending June $825 mil shortfall
- FY 2012 deficit of $1.2 bil
  - Excludes over $1 bil in suspended formulas

BUDGET “SOLUTIONS”
($12.5 BILLION SINCE FY ‘08)

- Fed. Assistance $2.4b 19%
- Permanent Spending Cuts $2.3b 17%
- Fund Transfers $2.0b 16%
- Permanent Revenue $0.4b 4%
- Rainy Day fund $0.7b 6%
- Sales tax increase $0.9b 7%
- Rollovers $1.5b 12%
- Other $0.3b 2%

ECONOMIC OUTLOOK
2011-2012

Gerald J. Swanson, Ph.D.
Professor of Economics
Thomas R. Brown Professor in Economics Education
BELIEVE IT OR NOT
THE “GREAT RECESSION” HAS BEEN OVER FOR 18 MONTHS!

UNEMPLOYMENT
- December 2007: 5.0%
- November 2010: Up from 9.6% to 9.8%
- Currently over 15.1 million unemployed
- 6.8 million have been unemployed for six months post WWII record

INFLATION
- CPI Annual Rate
  - November 2010 = 1.6%
- Core Annual Inflation Rate (no food or energy)
  - November 2010 = 0.6%
LOWEST RATE EVER!

GROWTH IN GDP
- An economy that is growing at a very slow pace
  - 2009 GDP
    - Q1 -6.4%
    - Q2 -0.7%
    - Q3 1.6%
    - Q4 5.0%
  - 2010 GDP
    - Q1 3.7%
    - Q2 1.7%
    - Q3 2.0%
- Too slow to significantly change unemployment rate.
Consumption

- Consumers are slowly starting to spend again
- Consumers’ psyches remain fragile
- Reduced incomes and housing values are still constraining spending

The minimalist consumer

- Consumers are living off of inventory
  - Your food stock
  - Your clothing stock
  - Your transportation stock

Consumption

- Consumers are paying down debt at lightning-fast pace
  - Record 26 months of declining credit card balances
  - Mortgage defaults
    - Strategic mortgage defaults

INVESTMENT SPENDING

- Business confidence slowly improving
- Businesses have over $1 trillion in cash

THINK - Debt destruction, not repayment
**INVESTMENT SPENDING**
- Manufacturing capacity utilization slowly improving
- Second quarter 2010 74%
- Last year 68%
- 80%+ = Normal

**FISCAL POLICY**
- Deficit
  - Fiscal 2009 $1.4 Trillion
  - Fiscal 2010 $1.3 Trillion
  - Projected 2011 $1.3 Trillion

**GOVERNMENT SPENDING**
- Lots of federal government stimulus
  - $787 billion 22 months ago
  - Stimulus impact ending

**GOVERNMENT SPENDING**
- States are increasing spending
  - Up 5.3% from last year
- States very dependent on federal government subsidies
  - 28% of state total budgets in fiscal 2010
- $43.2 billion of federal government money used to plug holes in state budgets
**GOVERNMENT SPENDING**
- Total national debt = $13.9 Trillion
- Debt held by foreign govs. = $4.2 Trillion
- Debt held by U.S. citizens = $4.7 Trillion
- Debt held by trust funds = $4.6 Trillion
- Debt ceiling is about to be hit - $14.3 Trillion

Will Congress shut down government?

**FISCAL POLICY**
- For all practical purposes ...

Fiscal policy is dead!

**FISCAL POLICY**
- 37% of federal government spending is currently being financed by borrowing

Not sustainable!

**FISCAL POLICY**
- Mandatory spending
  - 1965 29% of budget
  - 2010 66% of budget
- Add defense
  - 83% of budget
  - 17% discretionary
**UNFUNDED LIABILITIES**

- 2010 Social Security and Medicare Trustee’s Report
  - Medicare unfunded liability $89 Trillion
  - Social Security unfunded liability $18 Trillion
  - Total unfunded liability $107 Trillion

**DEBITS AND UNFUNDED LIABILITIES**

- Solution!
  - National Commission on Fiscal Responsibility and Reform
  - Will its recommendations be accepted?

**TITLE OF THE COMMISSION’S REPORT**

“The Moment of Truth”

**COMMISSION’S GOALS**

- Make America better off than it is today
- Don’t disrupt fragile economic recovery
- Cut red tape and unproductive government spending
- Protect the truly disadvantaged
- Cut spending we can’t afford
- Demand productivity and effectiveness from Washington
- Simplify and reform tax code
- Don’t make promises we can’t keep
HOW MANY OF YOU WANT TO:
- Increase Social Security retirement age to 69?
- Eliminate mortgage interest rate deduction?
- Increase federal gas tax by 15 cents?
- Cut federal workforce by $10 billion?
- Lower top marginal tax rate from 35% to 25%?
- Cap defense budget?
- Eliminate earmarks?

FISCAL POLICY
- We cannot grow ourselves out of this deficit.

It is a structural deficit.
- The problem is real and the solution will be painful.

EURO ZONE RISK
- Once there were three little pigs
- Now there are four little PIGS
  - Portugal
  - Ireland
  - Greece
  - Spain
- Why isn’t the U.S. in this group?

EURO ZONE RISK
- Euro zone countries do not control their own currencies
  - Can’t print money to pay debt
- Result
  - Force austerity budgets
  - OR DEFAULT
**World Deficits**
- 15 major advanced countries’ governments, including the U.S., will have to borrow a total of $10.2 trillion in 2011 (IMF)
- U.S. will have to borrow $4.2 trillion

**Monetary Policy**
- New policy tools
  - Quantitative easing
  - Interest on bank reserves
  - Zero interest rates

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**Could the U.S. Face a Sovereign Debt Crisis?**
- Forced austerity or default
  - No and Yes

**Monetary Policy**
- Not your textbook monetary policy

**FED is Pushing on a String**
**MONETARY POLICY**

- QE2 is not a luxury cruise ship
  - $600 billion big bet
  - Fed targets long-term interest rates
  - Very controversial

- Reaction to QE2
  - Real interest rates

  \[
  \text{NOMINAL RATE} - \text{INFLATION RATE} = \text{REAL INTEREST RATE}
  \]

- Last year Fed Funds Rate 0.09%
- Today Fed Funds Rate 0.12%
  - Can’t go lower!

- Some banks appear to be stabilizing
  - 140 banks failed in 2009
  - 149 banks have failed in 2010

- 940 banks on FDIC watch list
  - One out of every 10 banks!

- Is the Fed’s monetary policy gun out of bullets?
  - Zero interest rates for 24 months

- Injected approx. $2 trillion in excess reserves

  **What next?**
MONETARY POLICY
- Big question --
  Is QE2 the only policy option left to get this economy moving?

MONETARY POLICY
- Hyperexpansionary monetary policy
  - The Federal Reserve's balance sheet has exploded!
    - August 2007 $800 Billion
    - December 2010 $2.3 Trillion
  - Where did the Fed get the money to buy $1.5 trillion in additional assets?
  - Where will it get $600 billion for QE2?

WE HAVE A BIG OVERHANG OF UNCERTAINTY
- Lots of Angst.

CONCLUSION
- The recession will not be viewed as over until
  “The Unemployed Fat Lady Sings”
- No concert scheduled in 2011
CONCLUSION
- We must be patient!
- We must first do no harm!
- We must shift to long-run solutions!
- We must be grateful for what we have!

CONCLUSION
- Thank you!
- Thank you!
- Thank you!
  For joining us today

- Go forth and buy those great bargains
  Happy Holidays!