

# E Themes on the Economy®

## A Glimpse at the Post-Recession Economy A Structural Change Watch List

By Diane C. Swonk, Chief Economist and Senior Managing Director

### Facing the Inevitable

*“You killed Santa Claus! What’s next, the Easter Bunny?”*

That is how my 14-year-old daughter reacted a few years ago when she realized that I (not my Jewish cousin Steve dressed up in red suit and white beard) purchased, carefully wrapped and tucked the gifts under the tree on Christmas Eve. Apparently, I destroyed one of her last true fantasies—that money (or gifts cards) actually grew on trees instead of in my wallet. Worse yet, she worried, in a rare moment of altruism, that I might ruin it for her younger brother, who still believed.

Indeed, reality is hard to swallow, particularly when it is being played out on as large a stage as the U.S. economy. We have collectively come to realize that the gifts under our metaphorical Christmas tree come with a price tag—and interest, if those costs are deferred.

This report examines the long-range or structural consequences of the financial crisis and how they are likely to reshape the composition of growth in the U.S. for years to come. Are consumers going to go quickly back into debt, drain their savings and return to the leverage they used in the past to support their insatiable desires to consume? Or, will consumers save more and spend less of their incomes, as we move into recovery? The answer is that, much like my daughter learned, money doesn’t grow on trees. The economy that emerges from recession will be characterized more by its austerity than its excesses.

### Structural Change: A Top-Ten List

#### #1) Financial Regulation Will Increase.

One of the most profound structural shifts

---

“The result will be a massive restructuring of the U.S. economy from a reliance on consumer demand to a reliance on investment and foreign demand.”

---

will be the rewriting of the regulations that frame our financial markets. The problem is that no one seems to be discussing what the end game should look like. That said, we are starting to get a sense of where we are going, whether we like it or not:

- Much financial market oversight will be consolidated under the umbrella of the Fed or, as famed economist Henry Kaufman suggests, under an agency with close ties to the Fed. The idea that we could somehow root out problems before they fester with a “Systemic Risk Regulator,” however, seems far-fetched.<sup>1</sup>
- Coordination of regulations across country borders is expected to increase. The push will be to level the regulatory playing field, and limit gaming of the system to avoid taxation and regulatory oversight. (Even Switzerland is now turning its bank records over to regulators.)
- The loophole, which currently prevents the FDIC and the Fed from taking bank holding companies into receivership, will be amended to allow for a more efficient restructuring of insolvent institutions. Most economists and many members of Congress, however, think that the Treasury’s push to seize and restructure *any* financial entity that it deems a risk to the system will fail.

## The Parachute Opens

Real GDP contracted at a 6.1% rate in the first quarter, after a sharp 6.3% drop in the fourth quarter. The losses in business and residential investment were particularly outsized, while inventories contracted at their fastest pace relative to GDP since 1947. Government spending also contracted, but that was largely due to the timing of some large defense contracts, and will come back fairly dramatically in the second quarter. Conversely, consumer spending actually increased and the trade deficit narrowed — imports fell even more rapidly than exports.

The contraction in growth is moderating, but is not over yet. Consumer spending is expected to continue to post modest gains, with the lift of tax cuts and \$250 checks issued to some fifty million Social Security recipients, while the housing market hits a bottom, at least in activity. Government spending should also turn around, with stimulus dollars now being spent. Business investment is expected to continue to contract, however, while the trade deficit reverses course and deteriorates. Exports to Europe are expected to be particularly weak. On net, real GDP is expected to contract in the 0.5% range, a fraction of the more-than-6% decline we saw in the fourth and first quarters, but it is still in the red.

Prospects for the second half are better, but not terrific. Growth is expected to move back into the black, but not by much. The only major upside surprise could come from inventories, especially now that both the housing market and consumer sectors appear to be stabilizing. Any blip we see related to inventories, however, is not likely to be self-feeding until we get into 2010. On net, real GDP is expected to rise between 1½% and 2½% in the third and fourth quarters, nothing to pop champagne corks over, but better than the first half of the year.

**The Fed Continues Quantitative Easing.** The Fed has made it clear that it will continue to target key credit markets for an extended period of time. The Fed has also made it clear that it expects inflation to remain low for some time to come, given the constraints in credit markets. There will come a point in time, however, when the Fed must retrace its steps and tighten. The concern is whether the Fed will have the political will and independence necessary, given efforts by Congress to increase its oversight of the Fed in recent months.

- Regulations regarding consumer lending will tighten across the board, with stricter disclosure rules and limits on the fees and interest rates that credit issuers can charge after a contract is signed. Separately, mortgage contracts will be rewritten to allow recourse, or a seizure of assets, which should limit defaults.

As a result, credit markets will end up much smaller than they were before the onset of the crisis, but deeper and more liquid than they are today. Initially, banks will benefit more than other types of financial intermediaries, as their pricing has improved and their competition has virtually disappeared. It won't take long, however, for the "too-big-to-fail" institutions to be dismantled.

Indeed, we are likely to see a reversal in bank consolidation, with riskier ventures such as investment banking, being spun back off, and incentives for bank holding companies to limit their operations to more traditional banking. The ultimate winners from these shifts are likely to be smaller, non-bank financial institutions, where the senior managers are not only compensated on the basis of, but are held responsible for, the risks they take.

### **#2) Globalization Will Slow, but Not**

**Reverse.** The global recession has reversed the pace at which countries interact with each other via trade. Populism and the backlash of protectionist policies by our trading partners will only exacerbate those trends in the near term. The "Buy American" clause for steel and the limits on hiring foreign nationals for TARP recipients were seen abroad as particularly hostile.

That said, we need the world as much as it needs us, and the world's largest economies are too integrated to disentangle. Hence, Obama's efforts to reassure the Chinese premier at the recent G-20 meetings in London that the U.S. will remain a partner in trade with China.

Separately, the Obama administration has announced plans to lift some trade and travel restrictions to Cuba. This, coupled with a 180 degree turn-around with regard to NAFTA, suggests that Obama's bark is significantly worse than his bite when it comes to protectionism.

On net, globalization will continue, but at a much more muted pace than we saw in recent years. This will slow the reallocation of resources from developed to developing

nations, which will reassure those who feel threatened by globalization. It could also curtail, however, the extent to which developing nations are willing to finance our debts, as they will be forced to stimulate their own demand before ours.

### **#3) The Federal Budget Deficit Will**

**Widen.** Everything from the costs associated with the recession (e.g., reduced tax revenues, stimulus package, unemployment insurance, food stamps and medical care) to the ongoing conflicts in the Middle East is expected to increase the size of the federal deficit over the next two years. The Social Security Administration has also warned that more "young" retirees are likely to tap into Social Security, as it is better than unemployment insurance in this environment.

Moreover, current budget proposals do very little to reverse that trend. Spending is expected to continue to rise, especially on medical costs, with little offset from increased tax revenues. This is to say nothing of the desire by the administration to increase spending on education and green technologies.

The initial response to higher deficits has been fairly mild, with higher saving rates offsetting some of the slowdown in foreign investment in the U.S. treasury market. The reserve currency status of the dollar is another plus, as it means that foreigners with dollar holdings literally have nowhere else to go.

Over time, however, something has to give: the saving rate for consumers and corporations will have to rise; exports will have to accelerate; spending will have to be cut; and tax rates will have to be increased.

Increased efficiencies in medical costs and higher taxes on the wealthiest of households will be the primary targets of the Obama administration. However, Obama is looking to simplify corporate tax rates, which could alleviate those burdens for some companies.

The result will be a massive restructuring in the U.S. economy from a reliance on consumer demand to a reliance on investment and foreign demand. The pain with which that transition occurs will depend heavily on how quickly policymakers start making major changes today.

### **#4) The Information Age Enters Phase II.**

The proliferation of the Internet triggered massive investments in computing and related technologies in the 1990s. This not only spurred growth, but also increased the

competition for firms, most notably in retail, and helped keep the lid on consumer inflation.

Now, many of those benefits have been exhausted and could be working against growth. At a recent speech for the Chicago Network, the chief information officer at Cisco, Padma Warrior, estimated that at least 60% of messages in our e-mail inboxes are nothing but noise, and are detracting from, rather than adding to, productivity.

She also noted, however, that we are on the edge of a whole new era in the information age. We are moving from Phase I, which focused on increasing the speed with which we could communicate, to Phase II, which is focused more on how to increase the portability and interaction of those communications. The Internet is not only shifting the model for entertainment (music and video), but moving closer to becoming a virtual place where individuals and firms can interact and increase the efficiency with which they communicate.

This is to say nothing of the increase in "smart" technologies, which have yet to work their way through the economy. When they do, the increases in efficiencies will benefit everything from the medical industry to the public sector, where traffic flows and transportation systems can be better optimized with the help of interactive technologies.

Moreover, a surge in the number of Millennials (people born after 1980) in the labor force will accelerate the adoption of those technologies. E-mail is already considered obsolete to this group, as they communicate more via instant messaging and social networks like Twitter and Facebook.<sup>2</sup>

### **#5) Productivity Growth Will**

**Reaccelerate.** Massive job cuts, coupled with increased pressure to improve profits and the onset of another phase in the technological revolution, all suggest that productivity growth will accelerate. The only question is: when? Credit markets are not exactly hospitable to the kind of increases in investment that we saw in the 1990s.

However, those who remain employed are required to do more with less, which by definition will increase productivity and, ultimately, cash flow. This, in turn, should help trigger a more virtuous cycle of rising productivity growth, cash flow and profits.

Moreover, the rise in productivity growth in the coming decade will be much more widespread than we saw in the 1990s. Much of the earlier gains in productivity growth were concentrated in one industry—the computer sector—as we strove to make computers cheaper and more powerful.

**#6) Inflation Will Supplant Deflation.** A heavy reliance on fiscal and monetary stimulus suggests that inflation will eventually reaccelerate. Increases in productivity growth may postpone, but can't reverse, those trends.

The good news is that the excess capacity created by the recession is likely to linger well into 2011, which means that we still have some time before price levels actually accelerate. This is to say nothing of the effect the recession is having on the resolve of OPEC nations (cheating among OPEC producers tends to rise as they struggle to replenish their government coffers).

The bad news is that the Fed may not be able to tighten monetary policy once it becomes clear that inflation could be more of a threat. Congress, in particular, is already challenging the Fed's independence, which could ultimately compromise the Fed's ability to act against inflation in a timely manner. The result would be a more problematic acceleration in inflation and a more painful adjustment by consumers later in the cycle.

**#7) The Income Gap Will Narrow.** Everything from the recession, which has knocked many of the wealthiest households out of the top income strata, to the spread of productivity growth across more industries, should help to narrow the income gap between the wealthiest and poorest of households.

An increase in the number of years younger workers are spending in school will also help, as the return to education has risen in recent years. One needs an undergraduate degree just to stay in the middle class.

Tax increases on the wealthiest households are less of an equalizer but politically expedient, given the need to reduce the budget deficit. They also help to create a sense of equality in light of recent infractions by highly paid Wall Street managers.

**#8) The Eurozone is in Jeopardy.** The financial crisis has exposed the cracks in the

foundation of the Eurozone. The region can't claim a reserve currency without the euro-specific institutions, deposit insurance and some sort of Euroland treasury to back it up. Add to that extremely diverse economic conditions within member states and a one-size-fits-all monetary policy, and it is little surprise that the region is having a bit of an identity crisis.

The former boom economies of Greece, Ireland and Spain are contracting at a particularly fast pace, with little hope that the European Central Bank (ECB) can or will do anything to stop it. This will not only be a challenge to policymakers as they try to align priorities in the region, but could challenge the existence of the euro itself. It's hard to imagine why some member countries would want stay when they could do better if they went back to their old currencies and central bank regimes.

Then there is the European banking system itself, which is even more hobbled than its counterpart in the U.S. Not only were European banks some of the largest buyers of subprime debt, but they also lent aggressively to Central and Eastern Europe, which are now imploding.

**#9) Diplomacy Will Play a Larger Role.** President Obama has already shown a willingness to engage in more diplomacy than the Bush administration when it comes to the Middle East. The goal is to try to repair some of the damage done by the previous administrations, and in so doing, marginalize the popularity of al-Qa'ida. The treatment of the prisoners of war in Iraq and the ongoing conflict between the Palestinians and Israel are particular flashpoints for the region.

Bin Laden and his followers use what many consider to be legitimate grievances with the U.S. and its dealings in the Middle East to recruit Jihadists. Europe has proven to be particularly fertile ground for recruits. More than 80% of the suicide attacks that were launched against the West (including 9/11) were carried out by well-educated Muslims in Europe, who had not only achieved some level of success, but who were not particularly religious prior to their conversions.<sup>3</sup>

More diplomacy, however, does not rule out force and economic sanctions. The risk that the Taliban could gain control over nuclear weapons in Pakistan underscores the need for force, while threats to gain nuclear weapons by Iran open the door to sanctions.

Indeed, Congress is currently considering bi-partisan legislation that would limit gasoline exports to Iran, which would further destabilize an economy that is already suffering from the drop in oil prices. (Iran pumps, but does not refine, much of its own oil and as a result, imports about 40% of the gas that it needs.)

**#10) A More Diverse Labor Force.** The aging of Baby Boomers and the influx of Millennials is expected to result in increased age diversity in the workplace. Older workers in particular are likely to retire later and stay on longer than they did in the past. (They won't have a choice.)

Racial diversity is also expected to increase, particularly among white-collar jobs. Second- and third-generation immigrants to the U.S. tend to stay in school longer than their cohorts in similar income groups and as a result are more likely to move up in income strata.

Separately, we are going to have to reverse our policy on foreign nationals if we hope to keep the edge in innovation. Some estimates suggest that we send home 60% of the engineers and scientists who we educate here. I would much rather have them innovating and paying taxes on their fortunes here than elsewhere, especially given the upward pressure that the next phase of the information age is likely to place on the demand for these workers.

The bad news, of course, is the backlash associated with diversity. Older workers are likely to clash with their younger (and often times more educated) coworkers, while membership in racial hate groups has risen in recent years in response to globalization and weakening economic conditions. (Displaced white men are a particularly angry group.) The fact that we are the only democracy in the world to actually elect a minority to its top political post, however, should give us comfort that we are up to the challenge.

---

#### Notes

<sup>1</sup> "Who is Primarily Responsible for the Credit Crisis?" Henry Kaufman, The Levy Economic Institute of Bard College, April 17, 2009.

<sup>2</sup> Padmasree Warrior, Cisco Systems' Chief Technology Officer The Chicago Network, April 21, 2009.

<sup>3</sup> *How to Win a Cosmic War: God, Globalization, and the End of the War on Terror*, Reza Aslan.

## Mesirow Financial Economic Forecast (Numbers as of May 8, 2009)

	2008(A)	2009	2010	2008:4(A)	2009:1(A)	2009:2	2009:3	2009:4	2010:1	2010:2
<b>National Outlook</b>										
Chain-Weighted GDP	1.1	-2.4	3.0	-6.3	-6.1	-0.4	1.5	2.6	3.5	3.9
Personal Consumption	0.2	-0.2	2.3	-4.3	2.2	1.0	2.0	1.9	2.2	3.1
Business Fixed Investment	1.6	-19.8	-2.9	-21.7	-37.9	-17.9	-11.3	-4.9	-1.7	1.1
Residential Investment	-20.8	-23.2	17.3	-22.8	-38.0	-28.8	-8.7	18.3	28.5	33.2
Inventory Investment (billions)	-29.0	-77.1	7.7	-25.8	-103.7	-100.0	-66.1	-38.8	-9.7	-4.9
Net Exports (billions)	-390.2	-320.6	-323.1	-364.5	-308.4	-315.9	-324.3	-333.8	-332.8	-323.6
Exports	6.0	-17.0	5.0	-32.0	-38.7	-3.7	0.3	2.8	5.9	9.1
Imports	-4.1	-15.8	4.2	-19.6	-39.4	-0.2	2.7	4.4	4.5	4.5
Government Expenditures	2.9	2.2	2.4	1.3	-3.9	8.6	2.0	3.1	1.7	1.8
Federal	6.0	7.4	5.9	7.0	-4.0	21.5	6.9	5.9	4.9	4.4
State and Local	1.1	-0.9	0.1	-2.0	-3.9	1.1	-1.0	1.2	-0.4	0.1
Final Sales	1.4	-1.9	2.2	-6.2	-3.4	-0.5	0.3	1.6	2.5	3.7
<b>Inflation</b>										
GDP Deflator	2.2	1.5	-0.1	0.5	2.9	0.2	0.9	-0.1	0.2	-0.6
CPI	3.8	-0.8	0.1	-8.3	-2.4	0.6	2.2	1.0	-0.5	-0.7
<b>Special Indicators</b>										
Corporate Profits*	-21.5	1.4	18.2	-21.5	-26.9	-21.3	-17.6	1.4	16.3	17.1
Disposable Personal Income	1.3	2.0	2.2	2.7	6.2	1.9	0.9	-0.3	4.5	3.3
Housing Starts (millions)	0.90	0.57	0.91	0.66	0.52	0.48	0.60	0.67	0.78	0.89
Civilian Unemployment Rate	5.8	9.1	9.8	6.9	8.1	9.0	9.4	9.7	9.8	9.9
Employment	-1.4	-4.3	-0.1	-6.4	-6.7	-4.0	-2.1	0.2	0	0.7
<b>Vehicle Sales</b>										
Automobile Sales (millions)	6.8	5.1	5.3	5.2	4.7	4.9	5.2	5.4	5.6	5.8
Domestic	4.5	3.3	3.9	3.5	3.0	3.2	3.4	3.5	3.6	3.7
Imports	2.3	1.8	2.1	1.7	1.8	1.7	1.8	1.9	2.0	2.1
Lt. Trucks (millions)	6.5	4.9	5.8	5.4	4.7	4.6	5.0	5.2	5.5	5.6
Domestic	5.3	3.9	4.5	4.1	3.7	3.7	4.0	4.1	4.3	4.4
Imports	1.2	1.0	1.1	1.0	1.1	0.9	1.0	1.1	1.2	1.2
Combined Auto/Lt. Truck	13.3	9.9	11.8	10.6	9.5	9.5	10.2	10.6	11.1	11.4
Heavy Truck Sales	0.3	0.2	0.3	0.3	0.2	0.2	0.2	0.2	0.3	0.3
Total Vehicles (millions)	13.6	10.1	12.1	10.9	9.7	9.7	10.4	10.8	11.4	11.7
<b>Interest Rates/Yields</b>										
Federal Funds	2	0	0	1/2	0	0	0	0	0	0
10-Year Treasury Note	3 <sup>5/8</sup>	3	3 <sup>1/4</sup>	3 <sup>1/4</sup>	2 <sup>3/4</sup>	3 <sup>1/8</sup>	3 <sup>1/8</sup>	3 <sup>1/8</sup>	3 <sup>1/8</sup>	3 <sup>1/4</sup>
Prime Rate	5	3	3	3 <sup>1/2</sup>	3	3	3	3	3	3
Corporate Bond AAA	5 <sup>5/8</sup>	5 <sup>1/4</sup>	5 <sup>1/8</sup>	5 <sup>7/8</sup>	5 <sup>1/4</sup>	5 <sup>3/8</sup>	5 <sup>1/4</sup>	5 <sup>1/4</sup>	5 <sup>1/4</sup>	5 <sup>1/8</sup>
<b>Exchange Rates</b>										
Yen/Dollar	103	76	104	96	94	99	101	102	103	103
Dollar/Euro	1.37	1.31	1.28	1.32	1.30	1.33	1.32	1.30	1.28	1.27

A= Actual; E=Estimate

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, \$ figures reflect adjustment for inflation.

\*Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change. Totals may not add up due to rounding. In 2005, GDP was \$10,989.5 billion in chain-weighted dollars.

**For additional information on Mesirow Financial, please visit our Web site at [www.mesirowfinancial.com](http://www.mesirowfinancial.com).**

Mesirow Financial refers to Mesirow Financial Holdings, Inc. and its divisions, subsidiaries and affiliates. The Mesirow Financial name and logo are registered service marks of Mesirow Financial Holdings, Inc. © 2008, Mesirow Financial Holdings, Inc. All rights reserved. The information in *Themes on the Economy*® is the proprietary and copyrighted material (the "Copyrighted Material") of Mesirow Financial. The Copyrighted Material, or any portion thereof, may not be reproduced, retransmitted, or posted on any Web site aside from [www.mesirowfinancial.com](http://www.mesirowfinancial.com) without the express written consent of Mesirow Financial. Statistical information contained herein has been obtained from sources believed to be reliable but such accuracy cannot be guaranteed. Any opinions or statements contained herein are purely the author's and may not reflect those of Mesirow Financial Holdings, Inc., or any of its affiliates and subsidiaries. The opinions or statements expressed are for informational purposes only and are subject to change without notice. This release should not be construed, considered or followed as investment advice, or anything related thereto. Mesirow Financial does not provide legal or tax advice.

For more information, contact:

Diane Swonk  
Chief Economist  
312.595.7122  
[dswonk@mesirowfinancial.com](mailto:dswonk@mesirowfinancial.com)

Olga Camargo  
Director of Economic Communications  
312.595.7128  
[olcamargo@mesirowfinancial.com](mailto:olcamargo@mesirowfinancial.com)

  
**Mesirow Financial**<sup>TM</sup>  
Independent Minds.  
Innovative Solutions.