

Illinois and the National Economy in 2010

Will recovery find its way to our state?

Illinois and the National Economy in 2010¹

By J. Fred Giertz



¹ This summary of economic activity for 2009 draws on a number of previously published articles by the author.

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The year 2010 promises to be better economically for Illinois and the nation. By most estimates, the recession ended in the last half of 2009 and growth will continue in the new year. However, many of the problems of the recession remain, most notably high rates of unemployment.

It should be noted that the end of a recession does not mean an instant return to prosperity. Recessions and expansions refer to the direction of the economy, not the absolute level of activity. A recession ends when the economy ceases to contract and begins to recover. Such a point represents the nadir of the business cycle when most economic measures are still unfavorable when compared to previous good times.

Measures that are forward looking, such as stock market indices where values are based upon expectations about the future, tend to respond first. The low point in U.S. equities occurred in March 2009, with a strong expansion through the remainder of the year. However, unemployment, which shows where the economy is now, tends to be a lagging indicator. For example, the national unemployment rate reached 10.2 percent in October 2009, the highest of the recession compared with 6.6 percent a year earlier and 7.6 percent in January 2009. In Illinois, the October 2009 rate was 11.0 percent, up from 6.8 percent a year earlier and up from 7.8 percent in January.

Review of 2009

Despite the lingering problems, the economic outlook at the end of 2009 was markedly improved from the end of 2008. Unlike 2008, there was never a doubt about whether the national and Illinois economies were in recession during 2009. There was still debate during the summer of 2008 whether the economy was just

slowing or actually in a recession, even though in retrospect the recession has now been determined to have begun in December 2007.

The question was answered definitively in the last half of 2008, especially in September and October, when a true financial panic occurred. A panic differs from a recession in that it is not simply an economic downturn, but a widespread loss of faith in the banking and, this time, the broader national and world financial systems. Panics in countries like the United States are rare compared to recessions and add to the severity of an otherwise ordinary downturn, sometimes with disastrous consequences, such as those in the Great Depression.

This was the case when panic and the associated uncertainty caused a precipitous decline in economic activity during the last half of 2008 and the first half of 2009. Most economic policy during that period focused on this issue. First was the so-called bailout that began in the last months of President Bush's administration and continued in President Obama's administration.

The bailout was viewed as the top priority in dealing with the economic crisis and the most important step toward recovery. This was highly controversial in that the government provided a huge infusion of ad hoc aid to a variety of financial organizations. The goal was to shore up the financial system where systemic risk (where the failure of one financial institution can create general problems for the whole system) threatened an economic meltdown. Anecdotal reports that have come to light suggest that the economy was closer to the abyss than many people knew at the time. The overriding goal was to avoid an economic catastrophe similar to the Great Depression of the 1930s.

In retrospect, the bailout appears to have been a relative success in that the financial panic has ebbed. The bailout policy was messy and inelegant, but it seemed to work. The bailout funds used to support the financial system are actually being paid back sooner than expected.

By mid 2009, the major economic focus was on the recession, not the economic crisis. The major element of policy to address the recession was the massive (nearly \$1 trillion) stimulus package that was approved by Congress in early 2009. This was actually a second stimulus package in that there was an earlier and smaller program during early 2008. The results of the Obama-backed stimulus plan are still in question and the subject of considerable debate.

First, there are some who dismiss such a stimulus as futile or even counterproductive. Even among those who support the idea in the abstract, there are concerns about whether the program as approved in early 2009 will be effective. One concern is that the plan was hastily drafted and, in the opinion of many, poorly targeted. In addition, there are the normal and expected issues, such as the ability to get the stimulus funds spent quickly enough. Despite the promise of “shovel-ready” projects, a majority of the stimulus funds are yet to be spent.

This raises a more fundamental question about current economic policy. During the first year of his administration, President Obama appeared to be following the advice of his chief of staff, Rahm Emanuel, to “never allow a serious crisis to go to waste. There is an opportunity to do big things.” The crisis in point is the recovery from the recent recession. Rather than focusing primarily on the recovery, the president has chosen to tackle a number of other major issues including health care reform and global

warming (through a cap-and-trade plan) while the country is still engaged in expanded military actions in Iraq and Afghanistan.

This approach is in stark contrast to the unsolicited advice that John Maynard Keynes, the dominant economist in the first half of the 20th century and father of the stimulus idea, gave to President Franklin D. Roosevelt.

In an open letter to the president on December 31, 1933, Keynes offered a number of suggestions, mostly about economic policy. However, he provided some political advice as well. Keynes was concerned that the Roosevelt administration was spreading itself too thin and not concentrating enough on the prime goal of recovering from the depression.

Keynes wrote:

“You [Roosevelt] are engaged on a double task, **recovery** and **reform**. For the first (recovery), speed and quick results are essential. The second (reform) may be urgent too; but haste will be injurious, and wisdom of long-range purpose is more necessary than immediate achievement. ... For [reform] will upset the confidence of the business world and weaken their existing motives to action, before you have had time to put other motives in their place. It may over-task your bureaucratic machine ... And it will confuse the thought and aim of yourself and your administration by giving you too much to think about all at once.”

This advice given 76 years ago, which was not heeded by Roosevelt, appears to be relevant today. Regardless of their intrinsic merits, the health care plan and the cap-and-trade legislation now under consideration promise to have huge and uncertain

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impacts on the economy and the plans of individual businesses and investors. Even if these programs are not ultimately approved, the debates, in Keynes words, “upset the confidence of the business world and weaken their existing motives to action.” Obviously, just as the lack of confidence in the economy and especially the international financial system was a key element leading to the current recession, anything that undermines confidence during the recovery will be counterproductive.

The last part of Keynes’s political advice is telling as well. While the Obama administration has indeed not let the economic “crisis go to waste” by pursuing an aggressive agenda of both recovery and reform, the president’s resources appear to have been “over-tasked” with the resultant confusion of “thought and aim.” A common thread in the formulation of the stimulus package, the cap-and-trade legislation, and health care reform has been the outsourcing of the details to congressional Democrats. The administration has provided little leadership in regard to the substance of these programs. In the case of the stimulus package, many believe that this resulted in a poorly targeted, unwieldy spending program that still has not had its full impact.

There appears to be a strong undercurrent of unhappiness about the apparently successful bailout program that dealt with the panic. An unusual coalition of the left and right is attacking the independence of the Federal Reserve System, attempting to impose more congressional oversight. This displeasure is likely the result of the perception of unfairness regarding the financial bailout in that it appeared to favor the rich financial sector (which may have been partly responsible for the panic) while ignoring the broader population in distress. The possible intrusion on the relative independence of the Fed is a source of concern among many economists who believe that central banks such as the Federal Reserve operate most effectively when

insulated as much as possible from political micromanagement.

Preview of 2010

Even though there is no final judgment about the success of the first Obama stimulus package, some are advocating another successor program, possibly using the funds repaid by various financial organizations from the bailout program. This program would be more directly focused on creating jobs. As noted earlier, there is a natural dissatisfaction with the pace of recovery as evidenced by the continuing high unemployment rates. However, this is a usual occurrence during this stage of a recovery.

An additional problem with another stimulus is the impact on the deficit. To stimulate the economy, both the Bush and Obama administrations undertook aggressive new spending programs at a time when tax revenue was falling precipitously. This resulted in huge deficits that were justified for their countercyclical impact. At some point, however, these deficits must be reined in to address the nation’s looming structural problem that will arrive in full force in a decade or so with the retirement of the baby boom generation.

There is much discussion about the strength of the recovery with some fearing a second (double-dip) recession similar to the early 1980s. While a double dip is unlikely, most observers dismiss the likelihood of a strong “V-shaped” recovery because of the lingering structural problems from the financial crisis and recession. Often a sharp downturn such the one the U.S. economy experienced is followed by a strong, rapid recovery. This is not likely this time. More likely is a moderate recovery of economic activity as evidenced by output measures such as GDP and an even slower recovery in jobs.

Surprisingly, productivity continued to increase at a relatively strong pace in recent

years. This is a double-edged sword. In the long run, productivity growth leads to faster economic growth and higher wages. In the short run, however, increased efficiency means that businesses need fewer workers to produce the same output. Even when demand increases during the recovery, hiring will still lag.

In summary, 2010 appears to be better than 2009, but this may be cold comfort because 2009 was an unusually weak year. The most positive news is that the financial crisis is over. This crisis became the Great Recession, one unlike any in the post-World War II era. The end of the crisis will provide a sounder basis for recovery, but the expansion will be slow – for many, painfully slow.

Illinois

The state of Illinois has not been the focus of the nation's economic problems the last two years. It has not been at the center of the financial crisis involving the residential real estate market or distressed financial institutions. Nor has it been disproportionately affected by the implosion of the automobile industry in the United States. Nevertheless, Illinois eventually felt the brunt of the recession with unemployment rates rising significantly to 11 percent with the state rate about one percentage point above the national rate in October 2009. In such a widespread downturn, there is no place to hide.

The state's problems are confirmed by the University of Illinois Flash Index, a widely reported monthly barometer of economic activity in the state, prepared by the Institute of Government and Public Affairs. The index fell below 100 (the dividing line between growth and decline) in December 2008 and continued to fall until slight increases were registered in October, November, and December. The index fell to 90 in September, the lowest level since the twin recessions of the early 1980s.

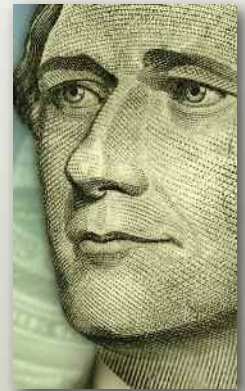


L. Brian Stauffer, U of I News Bureau

J. Fred Giertz is on the faculty of the Institute of Government and Public Affairs at the University of Illinois and has been a professor in the Department of Economics at the University of Illinois at Urbana-Champaign since 1980. He has served as interim Head of the department for the past two years. Giertz received his PhD in economics from Northwestern University in 1970. His major research interests are in the areas of public finance and regional economic development. He specializes in state and local taxation and expenditure analysis and in regional economic development issues. He has consulted with a number of state agencies, writes frequently on the Illinois budget and general economy, and compiles the U of I Flash Index, a monthly indicator of the Illinois economy.

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Illinois, however, has the additional burden of fiscal problems that promise to be daunting. Almost all states are experiencing fiscal distress because of recession-induced declines in revenue. Unfortunately, Illinois enters this period with lingering problems that have not been addressed since the aftermath of the 2001 recession. These problems (which are discussed in the following chapters of this report) must be addressed as part of a successful recovery.



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