



The National Economic Crisis and the Illinois Economy

How might recession affect Illinois?

The National Economic Crisis and the Illinois Economy

By J. Fred Giertz

(Editor's note: To better understand the fiscal crisis facing Illinois, we believe it beneficial to have some context. This look at the recent national economic crisis and the recent economic history of Illinois provides that context. It draws on a number of articles previously published by the author.)

The panic. Aside from the presidential election, the economy was the dominant issue for the United States in 2008. Few people under age 75 have experienced anything as troubling as the economic turmoil of the past year. A panic is not simply an economic slowdown or recession, or even a depression. The *Encyclopedia Britannica* defines a panic in economic terms as an “acute financial disturbance, such as widespread bank failures, feverish stock speculation followed by a market crash, or a climate of fear caused by economic crisis or the anticipation of such crisis.”

The U.S. and world financial systems did indeed experience true panic in late September and early October 2008. Investors focused on the underlying safety of assets, which often caused what is known as a flight to quality with wild fluctuations in asset values. For one of the few times since the Great Depression, investors were primarily driven not by the search for high returns, but by the fear that they might lose everything.

Financial innovation in recent years has blurred the lines between traditional banking and other financial services. Many financial organizations devised highly leveraged strategies that enhanced their profitability in normal times but created systematic risk. Systematic risk is a situation where the failure of one financial institution can create general problems for the whole system. This is related to the “too big to fail” concept, which holds that the government cannot let certain major financial institutions and markets fail because of the broader impact on

the financial sector and, ultimately, the overall economy. The Great Depression was the most prominent example.

Early on, the government attempted to address the failure or impending failure of financial institutions on a case-by-case basis, including Bear Stearns, Fannie Mae and Freddie Mac during the summer and the massive American Insurance Group in September. This ad hoc approach was not sufficient to calm the markets. A more aggressive approach was required and Congress approved multi-billion-dollar bailouts.

The last quarter of a century has been a period of considerable success for macroeconomic policy both in the U.S. and around the world. This period has come to be known as the Great Moderation, where recessions have been infrequent and moderate and inflation generally has been contained. Credit has been given to the Federal Reserve and other central banks for these results. However, the recent panic presented a huge new threat beyond the bounds of recent experience. In more normal times, the Fed has been concerned with incremental decisions such as whether interest rates should be raised or lowered a fraction of a point. In a crisis situation, these types of policy tools are inadequate.

The recession. The scope of government action to deal with the panic has been monumental. If it works and the panic is quelled, attention will focus not on the financial markets, but on the performance of the broader economy. Here, the news is not good either. From the summer of 2007 until the fall of 2008, there was believed to be a firewall of sorts between the financial sector and its problems and the rest of the economy. With the panic and the decline in asset values, this firewall has been breached. In fact, the National Bureau of



The question asked since mid-2007—whether there would be a recession—has been definitively answered. Now the question is how long and deep will it be?



Most observers now expect the downturn to be more severe than the mild recessions of 1990 and 2001.

Economic Research, the organization that dates business cycles, concluded in early December 2008 that the economy has been in a recession beginning in December 2007.

The question asked since mid-2007—whether there would be a recession—has been definitively answered. Now the question is how long and deep will it be? A year ago, the consensus among economists suggested that there was a 50/50 chance of a recession, but only a very small probability of a severe downturn. With Europe, Japan and the U.S. already in recession, some are suggesting this may be the worst recession since the Great Depression.

The financial panic has had a chilling effect not only on the public, but on economists and government officials as well. Until recently, we believed that while policymakers could not guarantee a perfectly stable economy, we still had the tools and know-how to avoid the major cyclical fluctuations. This belief is being tested.

Most observers now expect the downturn to be more severe than the mild recessions of 1990 and 2001, but less damaging than the twin recessions of the early 1980s when unemployment reached double-digit levels for the only time since the 1930s. However, an even more serious downturn cannot be ruled out if problems in the financial sector persist. Also, the timetable for recovery has been pushed back. Until recently, it was believed that a slow second half of 2008 would be followed by expansion in early 2009. Now, the recession is expected to continue through at least the first half of 2009.

It is all but certain as 2009 begins that there will be another economic stimulus package similar to, but larger than, the one approved in 2008. Many economists argue that while the actions in the monetary arena by the Federal Reserve and Treasury Department were and are vital for the stability of the financial system, a fiscal policy response (tax cuts and rebates along with

greater government spending) also is needed. Regardless of the economic merit of another stimulus package, politics make it a virtual certainty. However, the new stimulus package will be just a Band-Aid for the economy, not a cure.

The precipitous decline in the price of oil is like a mini-stimulus package. When consumers purchase gasoline at less than \$2 a gallon compared to more than \$4 a few months ago, the savings will be injected for the most part into domestic spending rather than for imported oil.

Illinois and the recession. It is clear that Illinois will not avoid the worldwide recession. However, there is little reason to believe that the impact will be disproportionate, as was the case in the early 1980s when Illinois and the rest of the industrial heartland were devastated by the rust-belt phenomenon connected to the decline of the old manufacturing base. Illinois has not been affected disproportionately by the subprime lending problems and the state is not overly dependent on the automobile industry, like Michigan. However, factors that have helped the Illinois economy in the export arena in recent years—a declining dollar and strong worldwide demand for our products—will no longer be a driving force because of the worldwide economic weakness. In the current turmoil, internal factors at play in Illinois are clearly of secondary importance to national and global economic forces.

Unfortunately, the Illinois state government is ill-prepared to address the challenges of the recession. Most states have improved their fiscal positions during this expansion, but not Illinois. The state enters the recession with a budget already out of balance, and it will only deteriorate with declining tax receipts. Further, rather than paying down its backlog of bills during the good years, state government enters the recession with billions of dollars in delinquent payments. If there is a bright spot,



the recession may provide an impetus for the state to finally undertake a much-needed capital development program to upgrade its infrastructure.

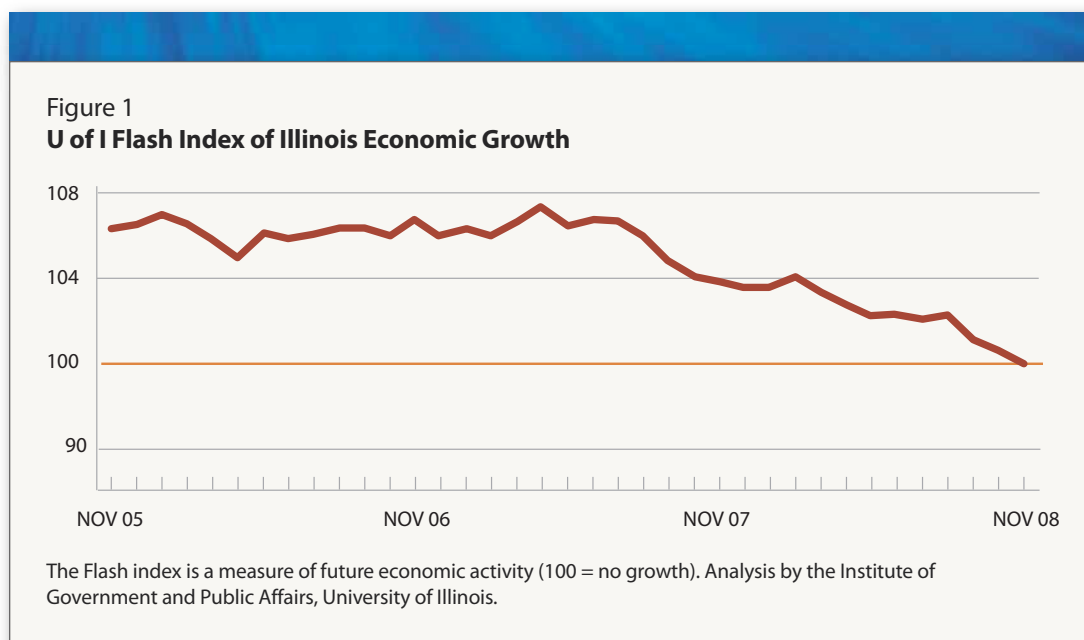
The recent slowing of the Illinois economy can be seen in the University of Illinois Flash Index as portrayed in Figure 1. The Institute of Government and Public Affairs created the Flash Index 13 years ago to provide an instantaneous reading of the performance of the state economy and it has become the most widely used monthly economic indicator in Illinois, appearing in many newspapers and on broadcast news outlets.

The adjective “flash” is the key to the U of I Flash Index. It was designed expressly to provide a quick reading of how the state’s economy is doing. Other commonly-used measures such as gross state product, industrial production, personal income and retail sales are not available for six months to a year after the end of the period they measure. In contrast, the Flash Index is compiled on the first business day of each month using data from the preceding month. Data from the Illinois Department of Revenue are used to provide estimates of economic activity in the state. Individual income tax receipts reflect personal in-

come; corporate receipts are a surrogate for business profits; and sales tax receipts measure retail sales. Each index is based on the preceding 12 months and is constructed with the reading of 100 as the dividing line between expansion and contraction. Consequently, the key focus of the index is not whether it is increasing or decreasing, but whether and how much it is above or below the 100 level.

The three-year performance of the Illinois economy displayed in Figure 1 shows that the economy began to slow significantly in September 2007. With minor exceptions, this weakness has continued until November 2008 (the last reading available before *The Illinois Report* went to press) when the index reached 100. This decline has been accompanied by increasing unemployment rates in the state and declining levels of employment. Given the world and national trends, the slide in Illinois is likely to continue well into 2009. If there is any surprise in the results, it is that the state’s performance has not been even more anemic.

While the Flash Index has been in existence for only about 13 years, the index has been constructed with historic data using the same methodology going back to July 1981.



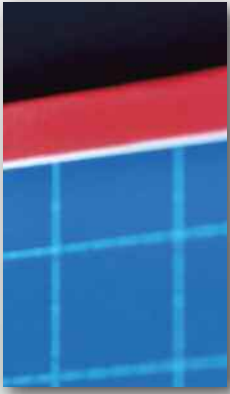


Figure 2 shows the performance of the index since then. This provides a view of the three previous downturns including the severe twin recessions in the early 1980s and the more recent recessions in 1990 and 2001. Note the seriousness of the decline in the early 1980s when the Flash Index fell well below 90. There was, however, a vigorous recovery starting in mid decade.

By comparison, the recessions of the early 1990s and 2001 were considerably milder, but the recoveries were less robust. If the current recession is more severe than the two most recent downturns, but falls short of the problems of the early 1980s as many are predicting, the Flash Index may fall to near or slightly below 90 and remain below 100 for two years.

2008 was clearly a trying year for the economy. If things go well, the financial panic will recede to be followed by a painful but bearable recession. Few would have imagined a year ago that a relatively normal recession would be considered a positive outcome compared to the dangers of a financial panic and economic meltdown.



J. Fred Giertz is on the faculty of the Institute of Government and Public Affairs at the University of Illinois and is a professor in the Department of Economics at the University of Illinois at Urbana-Champaign since 1980. He received his Ph.D. in economics from Northwestern University in 1970. Giertz's 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.

Figure 2
U of I Flash Index from July 1981 – November 2008



The Flash index is a measure of future economic activity (100 = no growth). Analysis by the Institute of Government and Public Affairs, University of Illinois.