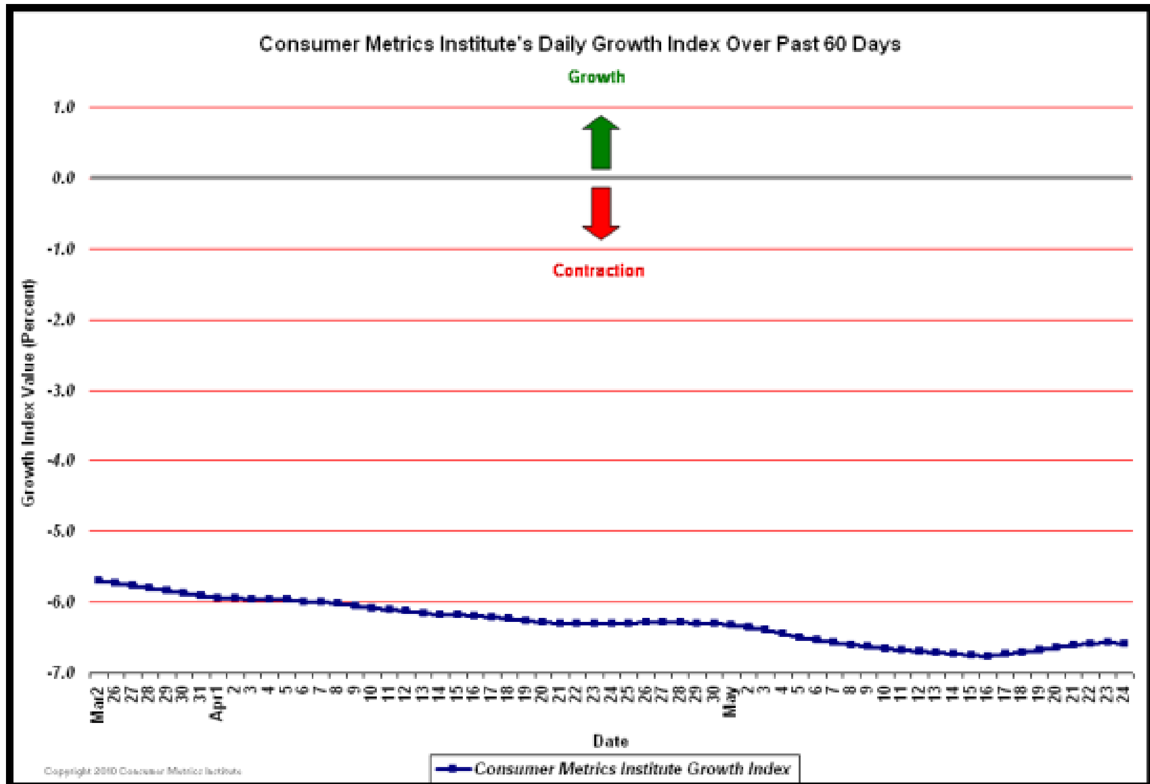
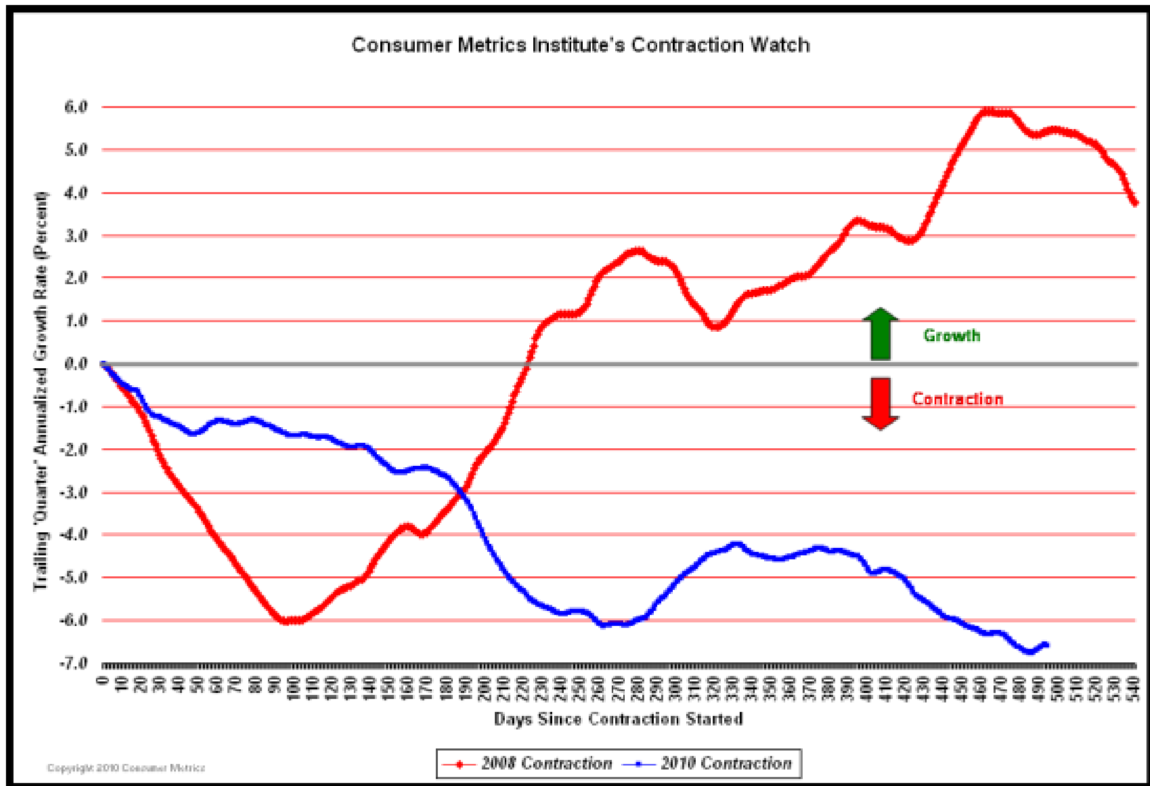
Consumer Metrics Institute Members News

May 20, 2011: A Pause in the Ongoing Contraction; Incorporating Debt/GDP End-Games

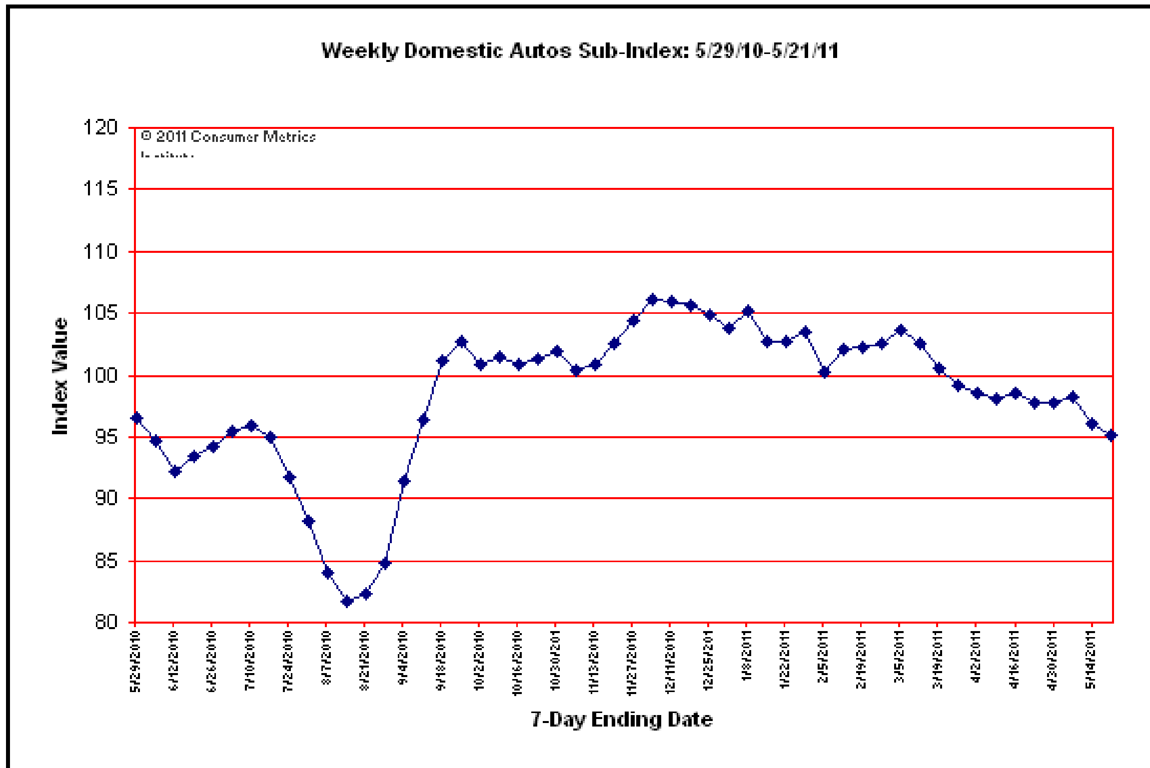
For the first time since late April the decline in our Daily Growth Index has stalled and even rebounded very slightly to a -6.71% year-over-year contraction (after bottoming at a -6.76% on May 16, 2011)**:**



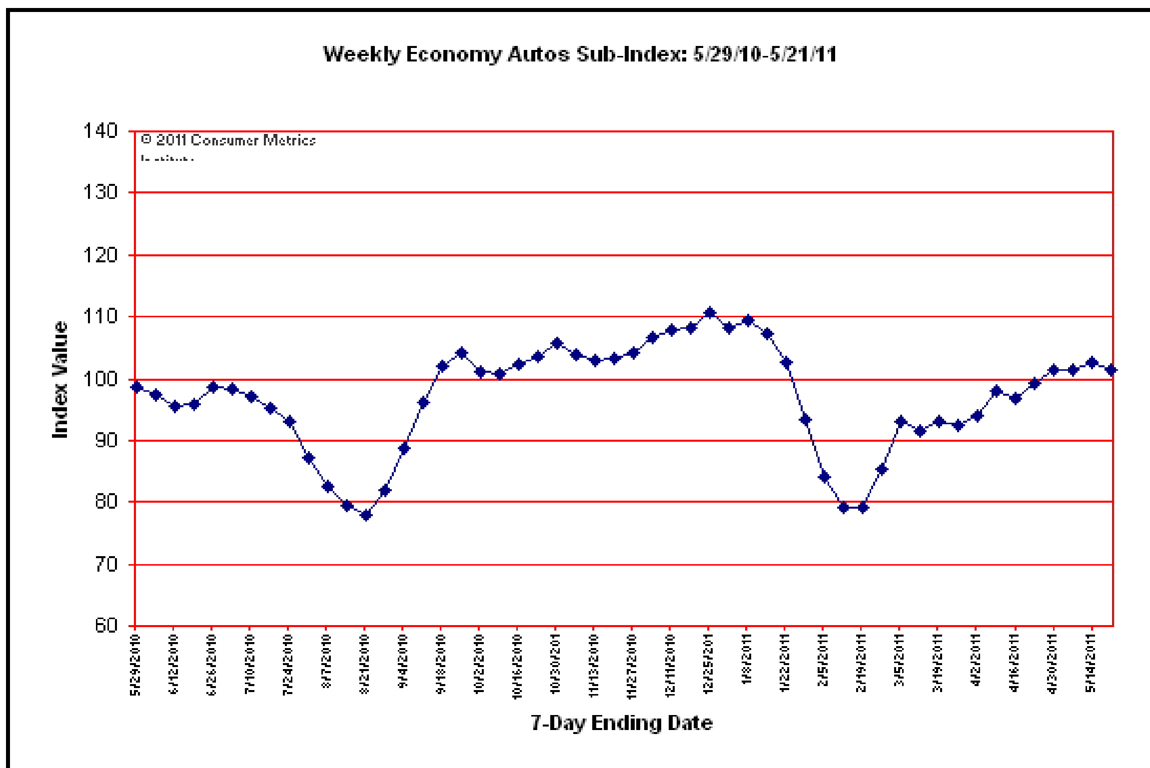
The improvement was caused less by upward movement in the current values of our Weighted Composite Index than by some really bad values from mid-February "falling out" of the 91-day moving average. In fact, the current values of the Weighted Composite Index are only slightly better than the average itself, and absent any substantial change in the daily values we can at best hope for bottom "bouncing" in this region for some time**:**



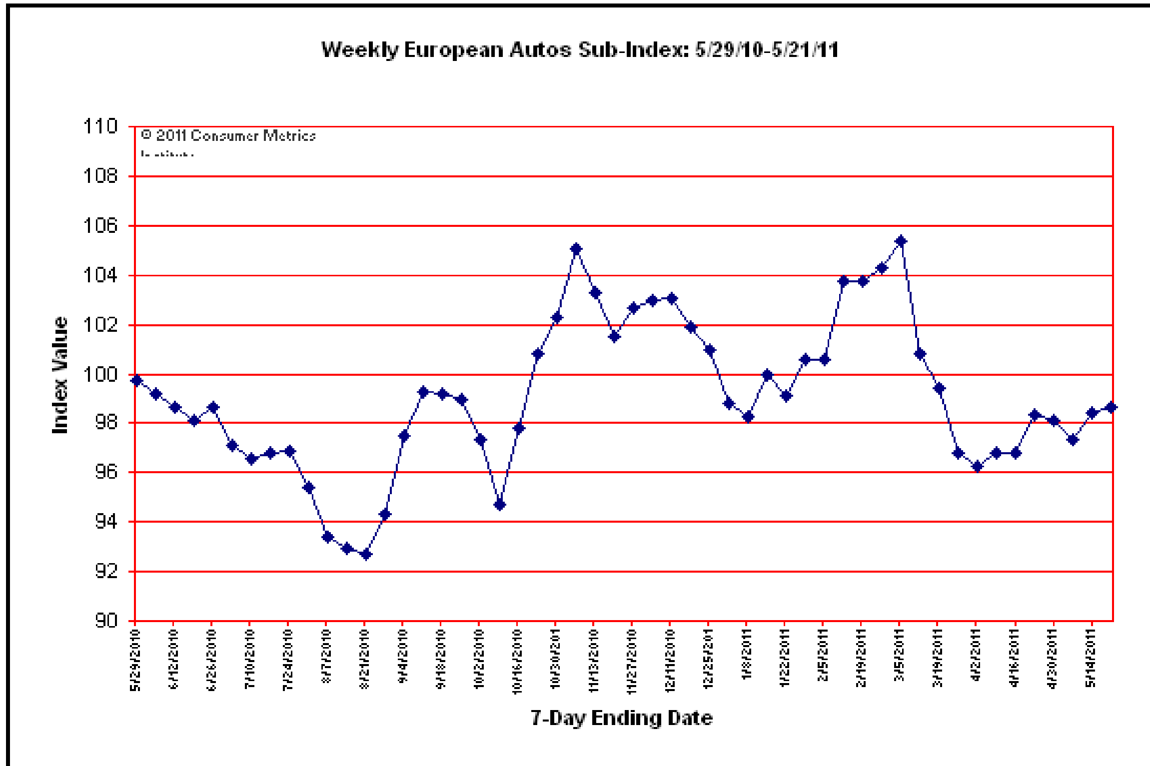
One of our recurring themes has been the uneven nature of the recent "recovery," with some parts of the consumer economy performing vastly differently from others. Our Automotive Sector perhaps best shows these market share divergences, which shifted several times during the past year. For example, overall consumer demand for the Domestic brands of autos has tracked as follows over the past 48 weeks**:**



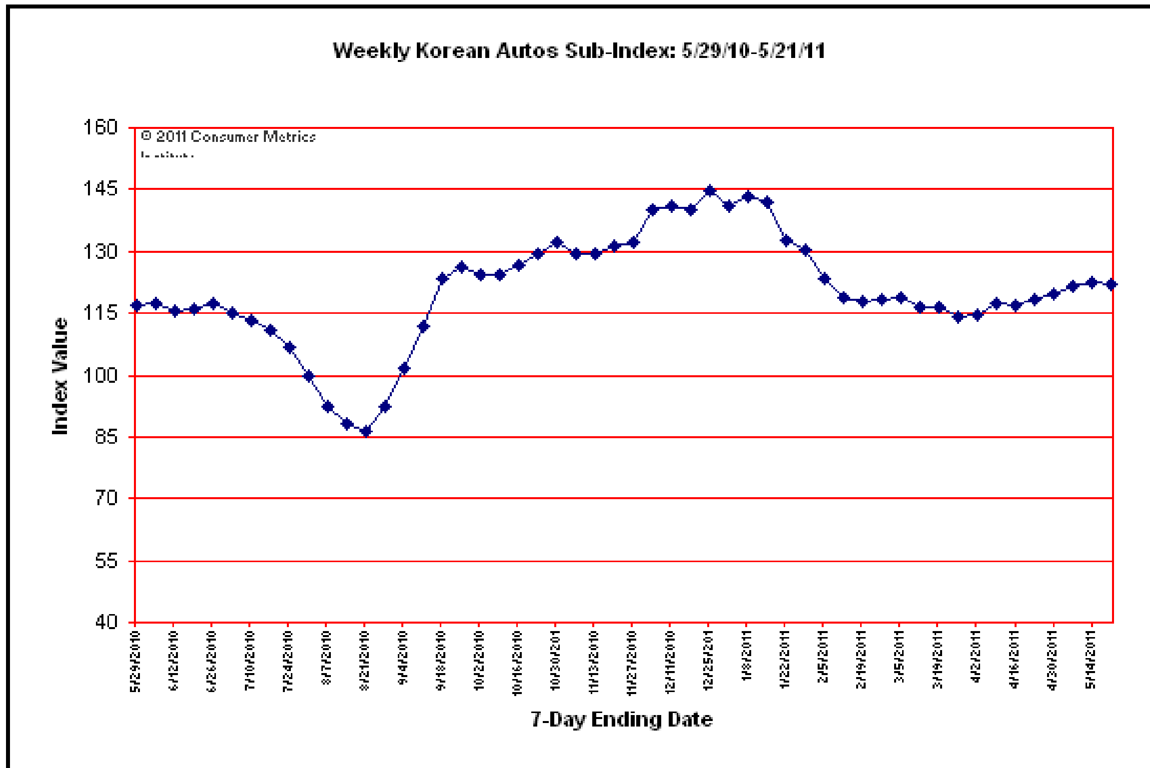
Meanwhile, just the "economy" brands (both imports and domestic) have behaved somewhat differently**:**



European badges have followed yet another course**:**

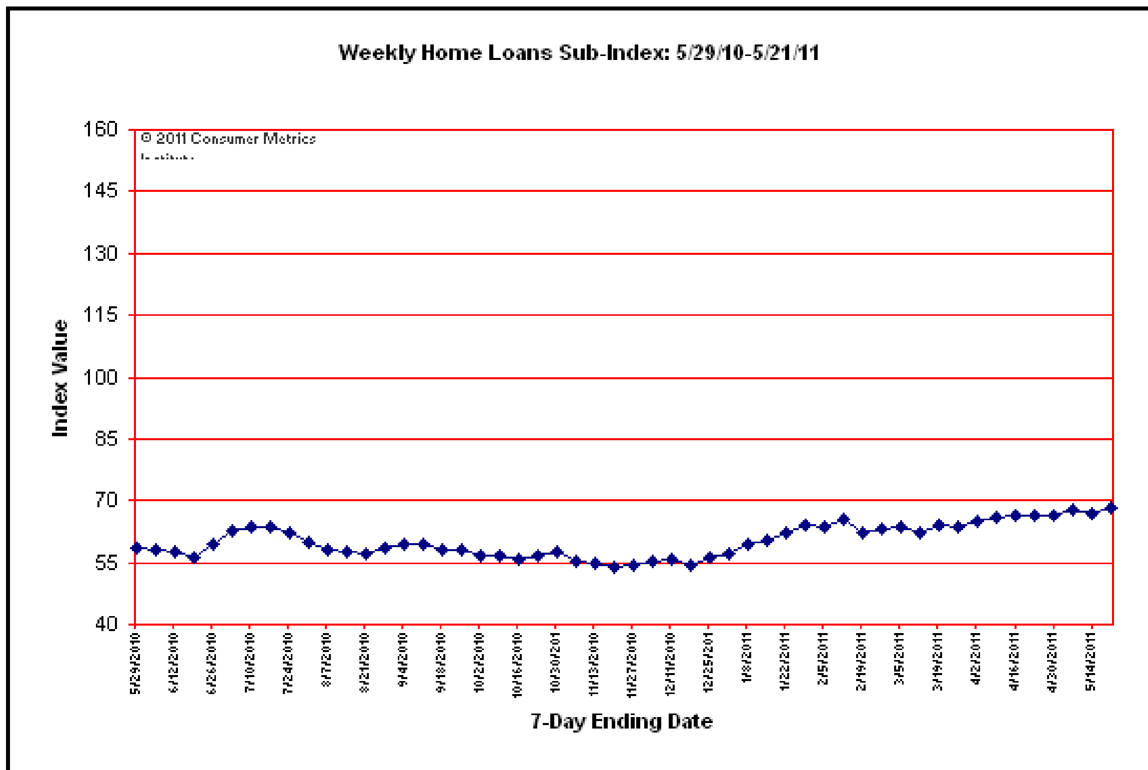


And Korean brands continue to pull in new market share with significant (and now compounding) year-over-year gains:

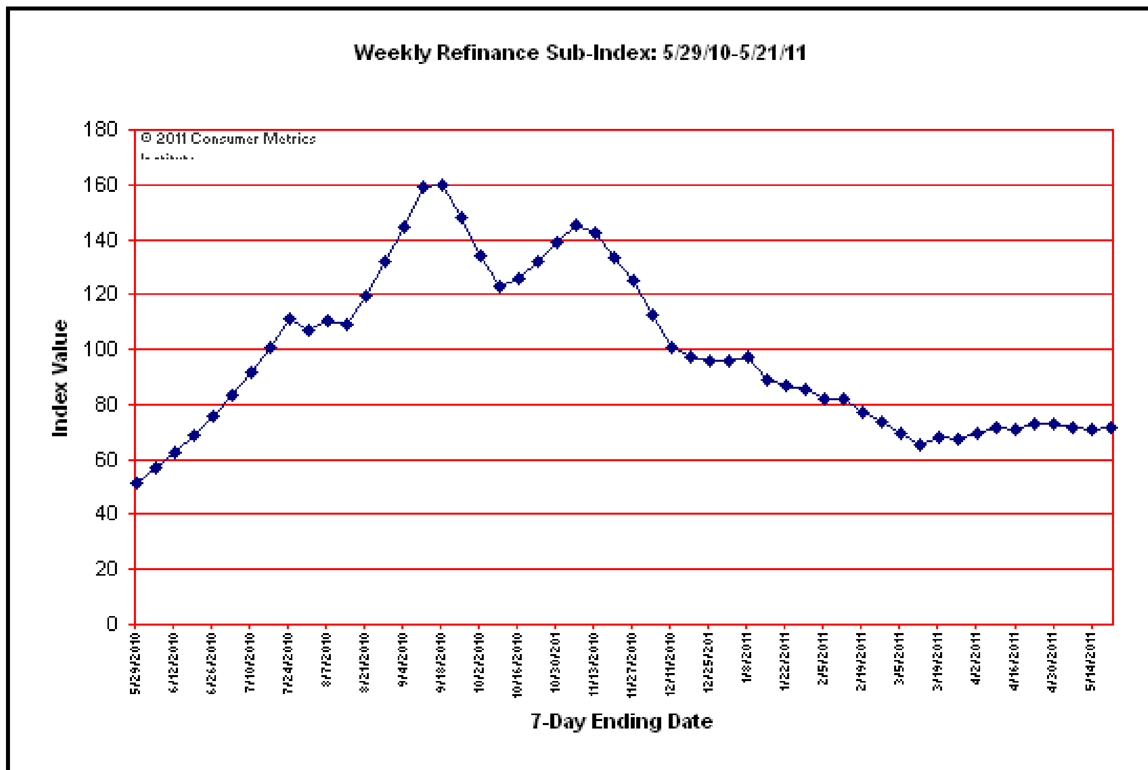


We continue to be asked why our Weighted Composite Index has remained weak even as (for example) portions of our Retail Sector have been showing substantial year-over-year growth. The reason is relatively simple**:** our Weighted Composite Index weights every single transaction that we capture by the economic value of that transaction (as reflected in the BEA's NIPA tables), and the transactions in the Housing Sector carry by far the greatest weight of any part of the consumer economy.

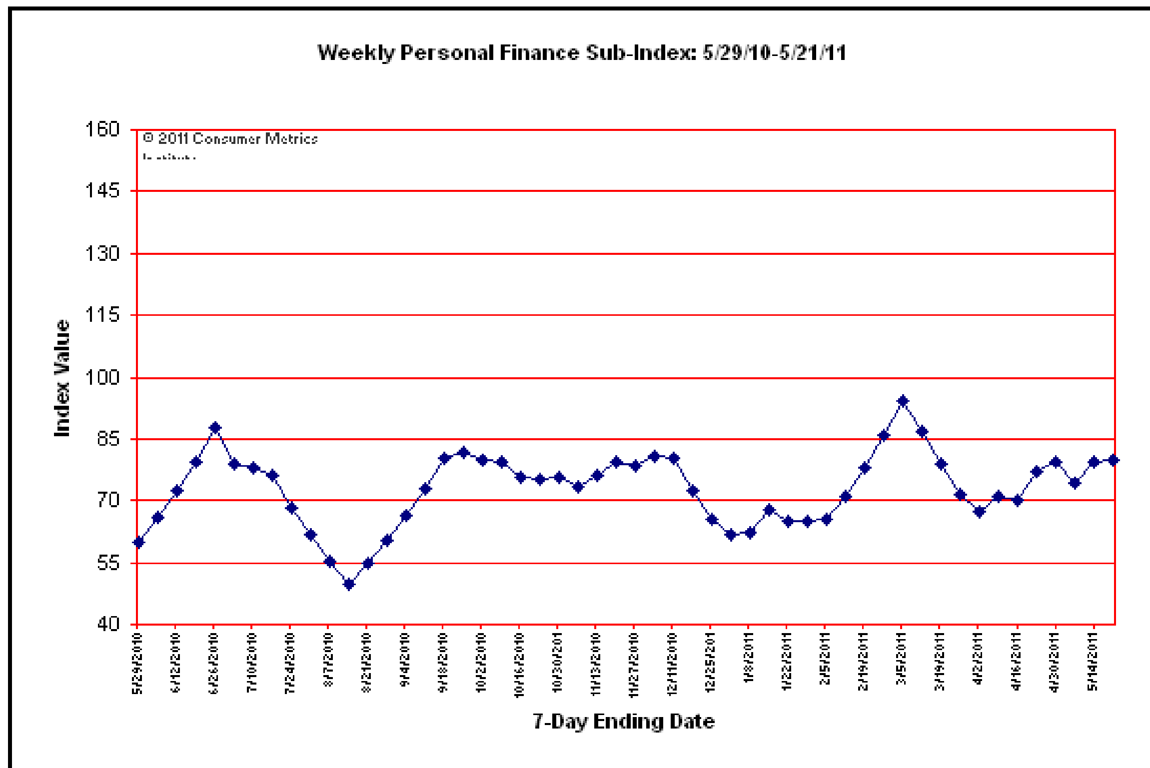
In that light, we continue to see only modest improvement in the year-over-year contraction rates for loans for new residential housing**:**



When reading the above chart it is important to remember that the year-over-year contractions are now compounding -- i.e., the shown contractions are against values from last year that were already in sharp decline. And even residential mortgage refinancing activities are still plateaued at readings that are down substantially from the same time last year**:**



All of this can be wrapped up in one of our favorite charts, our Personal Finance index, which plots the "financial comfort" of our consumers. In effect it reflects the sense of financial well-being felt by our consumers by capturing (and inverting) the interest that they are currently showing for services and products that can assist them in foreclosure, default and bankruptcy situations (up in the chart means fewer concerns, down is greater angst)**:**



The chart more or less says it all**:** our consumers are bouncing along in a state of ongoing gloom.

Incorporating Change

(Over the past few months we have explored a number of ways to address the current U.S. debt/GDP ratio based on the premise that once all the conventional and painless options prove useless, something previously "unthinkable" will happen. In several recent articles we have explored potential "unthinkable" solutions to the U.S. sovereign debt problem, including some that were mundane, some more imaginative, others requiring modest regime change, yet more that involve radical regime changes, and one that uses regime change to de-securitize the mortgage industry. These articles are part of an ongoing series designed to stimulate discussions about full range of options available to the solve the U.S. economic malaise.)

While some pundits have assumed that an unsustainable U.S. debt/GDP ratio will ultimately be solved only by either hyperinflation or by defaults during a crushing deflationary depression (or by both serially, as experienced during the Weimar Republic), we have been considering a number of less painful exit strategies that are, nonetheless, "unthinkable" in the context of today's political, financial and economic status quo. We have assumed that eventually some program of rigorous budget balancing will be implemented, and we have taken the report from the Simpson-Bowles commission as an example of that rigor -- primarily for the purposes of understanding the economic impact of sudden fiscal sanity. In a nutshell, any true budgetary reform will suck about 14% from the U.S. GDP through a combination of fiscal austerity and tax increases, leading to an economic contraction that would meet the clinical definition of a depression.

To offset that 14% contraction we have postulated the need for stimulation of the economy sufficient to cause a net 3% excess annual growth in the U.S. GDP that could be sustained for half a decade, and all done without U.S. Federal fiscal deficits. Among the obvious options we have previously discussed were monetary policy "gone wild" and the re-flation of credit in the private sector through real and radical reforms of the financial industry (e.g., going back to the future -- circa 1933). Unfortunately recent experiments with unconventional monetary policy have failed to ignite the economy, and no amount of banking reform will prove stimulative if the private sector is still suffering from "credit revulsion." Clearly something else will also be needed.

Part of that "something" could be simple: stimulate those parts of the economy that have yet to show signs of "recovery."

Asymmetrical Recovery

The income statements and balance sheets for a significant portion of "large cap" corporate America would indicate that we have experienced a full recovery from the "Great Recession"**:** projected S&P 500 earnings for 2011 are over $98/share, nearly 12% higher than the previous record set back in 2006, and cash reserves on corporate balance sheets have reached an all-time high of nearly $1.2 trillion dollars -- nearly 80% higher than a year earlier. In stark contrast to the S&P 500 financials, a Gallop poll of "Main Street" U.S. consumers reported that over half of them think that the "Great Recession" has never ended. The poll responses are understandable**:** even if we ignore unemployment and the housing market for the moment, the BEA's real per capita disposable personal income for the first quarter of 2011 was $33,362 -- still less than the $33,480 recorded nearly three years earlier during the second quarter of 2008, in the midst of the official recession. And another Gallop poll of small business owners indicates that the "full recovery" experiences of "large cap" corporate America have not been shared by a substantial portion of their smaller brethren.

We suspect that:

-- The asymmetry of the recovery is real, and

-- It is likely because "large cap" corporate America had asymmetrical access to capital, credit, stimulus monies, export markets and cheap foreign labor.

We also suspect that further attempts to stimulate the economy with "more of the same" will merely result in a widening gap between the "large cap" corporations and everyone else on "Main Street." More to the point, even given the "full recovery" being experienced by the "large cap" firms, at last glance the total economy was growing at a feeble 1.75% annualized rate -- nearly two years after the National Bureau of Economic Research has declared the "Great Recession" had ended. This leads us to another conclusion:

-- The asymmetry is also a major contributing factor to the current overall poor growth rate of the economy.

In 1953 Charles Erwin Wilson, then CEO of General Motors, stated during Congressional hearings that "for years I thought what was good for the country was good for General Motors ***and vice versa***." While the first part of that statement may still be true, the "vice versa" has always been at best debatable. And at least in the context of the current recovery, what has been good for GM's brethren in the S&P 500 has not yet trickled down to "the country" as a whole.

Even if the asymmetries were created purely by the happenstance of scale, it is likely that at some point in time the mood of the voting public will turn into a foreboding sense of unfairness, betrayal, exploitation and/or predation at the hands of those benefiting from the asymmetries -- thereby laying the groundwork for a political upheaval on the scale previously seen in the United States only after the elections of Andrew Jackson and Franklin Roosevelt.

(It doesn't take long for the deep American sense of fair play to feel betrayed: Roosevelt was elected in a repudiating landslide only four years after a booming economy sent Herbert Hoover to the White House with similar electoral margins, and merely 7 years after Calvin Coolidge's famous observation that "the chief business of the American people is business." *Roosevelt's inaugural address made clear his differences with Coolidge, stating that the practices of the economic status quo* "stand indicted in the court of public opinion, rejected by the hearts and minds of men ... The measure of the restoration lies in the extent to which we apply social values more noble than mere monetary profit."*)*

Tapping New Energies

Ironically, the "Great Recession" may have resulted in an unprecedented burst of entrepreneurism. Part of this creative energy was driven by pure necessity -- people becoming self employed (and paying themselves starvation wages) simply because their previous good paying jobs had vanished. But this entrepreneurism is exactly where the greatest growth opportunity in the economy lies, and it is the clearest (and the currently most untapped) way to potentially provide a 3% per annum excess growth in the economy -- especially when provided with real incentives to grow.

Simpson-Bowles (S-B) involves a vast reformation (and simplification) of the tax code. A key part of the proposed reformations are stripping out what the S-B commission called "back door spending hidden in the tax code" (i.e., special tax breaks provided to certain industries or their customers in lieu of outright "spending" subsidies). However, S-B did not seek to increase revenues through the tax break eliminations, since it also included lowering the tiered tax rate schedule as offsetting compensation for the disallowed deductions -- meaning that the tax code reformations were intended primarily to make the tax code less cumbersome and inherently fairer. The "less cumbersome" part of the S-B reformation is crucial for the effective management of the debt, because the current code is so chaotic that tight control of tax revenues is almost impossible. But the "fairness" part is simply good politics, appealing to Roosevelt's "hearts and minds of men."

The proposed S-B corporate tax rate (after the elimination of the tax breaks) drops from a current progressive final rate of 35% (with the first $50,000 of net income being taxed at a 15% rate) to a new flat rate of somewhere between 23% and 29%. With respect to small businesses the S-B proposal is highly regressive, potentially doubling taxes on the new entrepreneurs critical to GDP growth. As an alternative, we would make the corporate tax schedule even more sharply progressive by having the first $100,000 be tax free -- and adjusting the rest of the scale to keep the total corporate tax revenue unchanged (to prevent the dreaded "back door spending"). A zero-rate first dollar tax schedule was common for U.S. corporations until 1932, and it could be found in the individual tax rate schedule until 1987. The primary purpose of a sharply progressive corporate tax scale should be to provide real entrepreneurial incentives to accumulate meaningful earnings until they can be used to expand the business and create new jobs.

Giving Due Credit

We have previously also suggested measures that a radical Federal Reserve and Congress could take to get substantial amounts of real credit into the hands of small businesses. These measures have included the Federal Reserve's expanded use of the "Maiden Lane" type of funds to get credit flowing more directly to small businesses, and financial industry reforms reminiscent of Glass-Steagall, but also aimed at fixing the worst abuses of the recent mortgage crisis -- especially those involving the neglect of appropriate underwriting while using "securitization" to distribute the amplified risks. A common thread in all these prior commentaries was the bypassing of the asymmetrically connected S&P 500 members of the financial industry to engage all of the Fed's 2,500 member banks (or perhaps even all demonstrably solvent banks) -- moving the funds and relief much closer to the real needs of "Main Street" America.

There is no magic bullet for stimulating the small business part of the American economy. But there are millions of new entrepreneurs who have the energy and creativity to provide just that stimulation -- ironically because at the moment they are the very epitome of Coolidge's 1925 era Americans whose "chief business" was business. What they need is a simple combination of available credit and a tax code that allows for the untaxed accumulation of modest levels of working capital. The proper incubation of those entrepreneurs could go a long way towards providing the additional 3% annualized growth needed to forestall a Simpson-Bowles induced depression.

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