

January 13, 2012

Puget Sound Economic Outlook 2012

Remarks by Dick Conway
enterpriseSeattle 40th Annual Economic Forecast Conference
January 12, 2012.

Thank you very much.

New Year is a time to look ahead. It is also a time to look back and take stock. Thirty-one years ago, I established my practice in regional economic research and consulting. Nineteen years ago, Doug Pedersen and I published the first issue of *The Puget Sound Economic Forecaster*. In 1992, twenty years ago, I gave my first talk at this conference.

It was a follow-up to a presentation I had made at the Leadership Conference in Vancouver in early 1990. Entitled “Some Changes in the Wind,” that talk predicted a substantial slowdown in the Seattle area economy.

My message was not well received, since statistics showed that the local economy was still booming. In 1989, employment increased 6 percent, while the unemployment rate fell below 5 percent. In the housing market, home sales and building permits hit seven-year highs. As I said in my talk, “...it is difficult to imagine a slowdown.”

But the regional economy applied the brakes later in 1990. Over the next two years, the nation slipped into a recession, Boeing began a round of lay-offs, and a housing bubble burst. Fueled by speculation, local home prices had climbed 40 percent between 1988 and 1990, causing a collapse of the housing market. By January 1992, employment growth had ground to a halt. Consequently, the central question of my first talk to this august group was—is Washington in a recession?

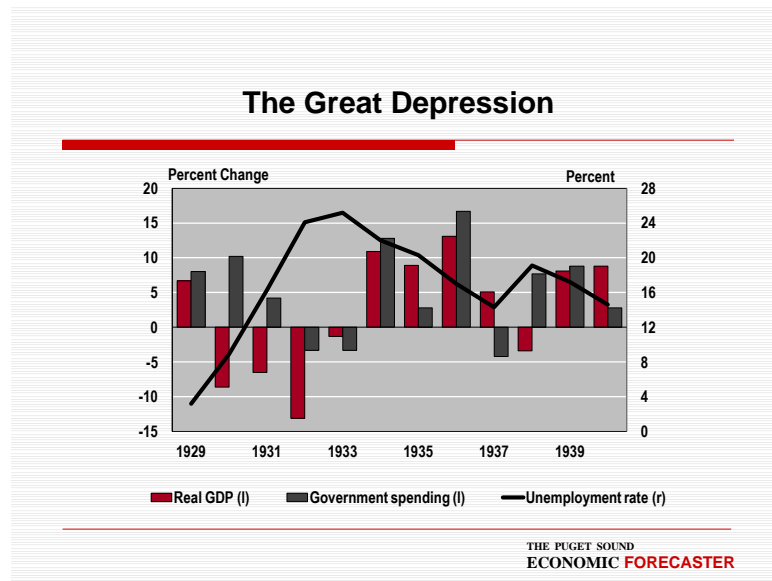
Something that happened two decades ago may seem irrelevant today, but it has much in common with our current economic predicament: the volatility of the regional economy, our dependence on the U.S. economy, the importance of Boeing, and a housing bubble. As I study the Puget Sound economy, I am constantly reminded that the more it changes, the more it stays the same.

THE GREAT DEPRESSION

Another past event that resonates today is the Great Depression. The Great Depression and the Great Recession are remarkably similar. Both started with a speculative bubble, resulted in a big drop in output and employment, caused widespread personal suffering, and experienced uneven recoveries because of missteps in economic policy.

This chart plots the history of the Great Depression. The red bars show the growth rates of real Gross Domestic Product (GDP), the gray bars show the growth rates of government spending, and the black line traces the unemployment rate.

After the stock market crashed in October 1929, national output fell 30 percent over the next three years, while unemployment climbed to 25 percent.



Initially, little was done to arrest the downturn. At the time, monetary policy policy—the ability to increase the money supply, lower interest rates, and combat deflation—was hamstrung by the gold standard. Moreover, most economists believed that the depression was self-correcting.

But it only got worse. Thus, in 1933, newly-elected President Franklyn Roosevelt initiated sweeping changes to economic policy, which he called the New Deal. He took the United States off the gold standard, created the Reconstruction Finance Corporation to increase the liquidity of the economy, and provided jobs for destitute workers through programs like the Civilian Conservation Corps (CCC) and the Works Progress Administration (WPA).

In Washington state, the federal government financed construction of three Columbia River dams during the depression. At one point, Grand Coulee Dam employed 8,800 construction workers and supported hundreds of trade and service jobs in the settlements where the dam-builders lived and spent their wages.

While scholars continue to debate the relative importance of fiscal and monetary policies in pulling the economy out of the depression, it is clear that federal intervention worked. Between 1933 and 1937, real GDP advanced at a 9 percent annual rate. Overall, output expanded 43 percent, creating 7 million payroll jobs and lowering the unemployment rate to 14 percent. By

1937, the Great Depression was essentially over, as output and jobs, if not the unemployment rate, returned to pre-depression levels.

The Great Depression and the New Deal were not without cost, as the federal debt more than doubled between 1929 and 1937. In an attempt to balance the budget—still considered a virtue—government expenditures were cut by 4 percent in 1937, throwing the nation back into recession. In 1938, real GDP declined 3 percent, 2 million jobs were lost, and the unemployment rate climbed back to 19 percent.

Unwilling to prolong the misery as well as needing to gear up for a possible war, the federal government immediately returned to an expansive economic policy, boosting spending by 18 percent over the next two years. The economy then grew at an 8 percent rate until World War II finally ended the debacle.

One curiosity of the Great Depression was the sharp rise in income tax rates. The highest bracket jumped from 25 percent in 1929 to 79 percent in 1936. This slowed the growth of the federal debt but probably lengthened the depression by reducing the effectiveness of the measures to stimulate the economy.

GREAT RECESSION AND RECOVERY

As bad as it has been, we should not mistake the Great Recession for the Great Depression. While the Great Recession elevated the national unemployment rate to 10 percent, the Great Depression sent it soaring to 25 percent.

This table shows three phases of the Great Recession and recovery: the free-fall, the upturn, and the brush with a second recession in 2011.

Great Recession and Recovery			
	2008.3- 2009.2	2009.2- 2010.4	2010.4- 2011.3
Real GDP growth (%/year)	-5.5	3.0	1.2
Employment change (mils./year)	-7.6	-0.6	1.6
Unemployment rate* (%)	9.3	9.6	9.1
Housing starts change (mils./year)	-0.4	0.0	0.1

*End of period.

THE PUGET SOUND
ECONOMIC FORECASTER

When President Obama took office in the first quarter of 2009, the fear of a depression was justified. In that quarter, real GDP was plunging at a 7 percent annual rate, jobs were disappearing at a rate of 9 million per year, and the stock market was down 50 percent.

With the help of President Bush, Obama and the Federal Reserve acted quickly to right the economy. They had two objectives: stabilize the housing and credit markets and stimulate the economy. The stimulus package, much of which went for infrastructure projects and transfer payments to state and local governments, amounted to \$750 billion.

Considering how fast the national economy was falling, it responded quickly to the federal intervention. Output turned up in the third quarter of 2009 and grew at a 3 percent annual rate (close to the long-term trend rate) until the end of 2010. Despite the expansion of output, most businesses waited to rebuild their workforce until convinced that the recovery had taken hold. This reluctance to hire is common during early stages of an upturn. Consequently, jobs did start rising again until the second quarter of 2010.

But critics argued that Obama's recovery plan was ineffective, pointing to the lack of significant progress in creating jobs and lowering the unemployment rate. In the 2010 elections, disappointed voters gave control of the House of Representatives to the Republican Party.

Reminiscent of the 1938 recession, the new Congress turned its attention to balancing the budget. The reversal in fiscal policy meant that the economy would at best slow down. As infrastructure spending wound down, the homebuyer's tax credit terminated, and transfer payments to state and local governments dried up, the economy decelerated in the latter half of 2010.

In 2011, matters only got worse. Bad weather, spiraling gasoline prices, and the Japanese earthquake and tsunami—combined with less government spending—slowed the economy to a crawl in the first half of 2011. Real GDP grew at a sluggish 0.8 percent annual rate. Were it not for the stimulating effect of the payroll tax deduction instituted at the beginning of 2011, the economy could well have succumbed to a short and shallow recession.

Then, last summer, as if insensitive to the fragile state of the economy, Congress conducted a protracted debate on raising the debt ceiling. After the nation was taken to the brink of default, Standard & Poor's lowered its long-term credit rating, the stock market plunged, and consumer confidence slumped to its recession low.

THE GREAT RECESSION—EMPLOYMENT CHANGE

It is not entirely clear where we go from here. Blue Chip economists predict that real GDP will expand 2.2 percent in 2012, one-half the growth of a typical recovery year. A year ago, the panel predicted a 3.2 percent gain in 2012. The Economic Research Cycle Institute, which predicted the last seven recessions, contends that the U.S. economy is just a misstep away from another downturn.

The uncertainty implied by these forecasts is no surprise. The nation could stumble if Congress failed to extend the payroll tax cut and the Eurozone financial crisis took a turn for the worse. With fingers crossed, our outlook assumes that neither of these problems will arise.

The Great Recession Employment Change		
	Puget Sound	United States
Peak to trough (quarters)	8	8
Employment (% change)	-7.6	-6.2
Construction	-36.4	-25.3
Financial activities	-17.5	-7.2
Peak unemployment rate (%)	9.5	10.0
Unemployment rate (% change)*	5.5	5.5

*Percentage point increase.

THE PUGET SOUND
ECONOMIC FORECASTER

Let me make one more point before we discuss the prospects for the regional economy. As shown in this table, the Puget Sound region suffered a relatively severe recession. Regional employment fell 7.6 percent, significantly greater than the 6.2 percent national loss. This suggested that the region would take a bit longer than the nation to fully recover.

SOME ENCOURAGING NEWS

Before working on our December newsletter, I told Doug that I was tired of writing gloomy articles. Luckily, there has been some encouraging news of late. In fact, I have come to believe that unless someone throws a monkey wrench into things, we might finally be on the path to recovery.

Here are five reasons to be optimistic about the Puget Sound region: (1) in the forty years that I have been in Seattle, I cannot remember a time when the outlook for Boeing was better; (2) in spite of, or perhaps because of, our deeper recession, the region is outpacing the nation; (3) consumers are trying hard not to follow their pessimistic sentiments; (4) much of our economic strength stems from international trade; and (5) our region is blessed with some of the best companies in the nation. Let me elaborate.

Some Encouraging News

- **Boeing outlook has hardly looked better**
- **In terms of job growth, region is outpacing nation**
- **Retail sales are a pleasant surprise**
- **Foreign exports giving region a lift**
- **Four companies touted for best customer service**

THE PUGET SOUND
ECONOMIC **FORECASTER**

BOEING OUTLOOK

Although the Puget Sound economy has expanded and diversified over time, The Boeing Company, with 75,000 employees, is still the region's largest private employer. A simulation with our forecasting model indicates that the company's total impact amounts to 200,000 jobs, one out of every nine jobs in the region.

Thus, it was good news when Boeing all but announced that it was here to stay. In December, Boeing and the machinists union signed a four-year contract that puts to rest their unproductive bickering, gives union members a generous pay package as well as a \$5,000 bonus, and ensures that the 737 MAX, the latest version of Boeing's most popular jet, will be built in Renton.

Boeing Outlook

- **787 has been launched**
- **Unfilled airplane orders top 3,500**
- **Boeing signs labor contract with machinists**
- **Generous pay package plus \$5,000 bonus**
- **Guarantee to build 737 MAX in Renton**

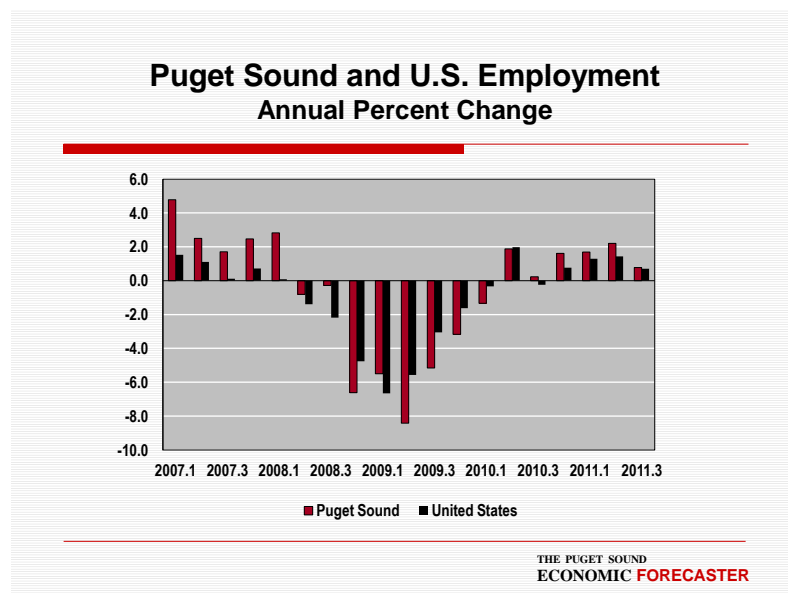
THE PUGET SOUND
ECONOMIC **FORECASTER**

Boeing has orders for approximately 3,500 airplanes, including 850 for the newly launched 787. The backlog is big enough to keep the company's assembly lines humming for seven years at the current production rate. Throw in the 737 MAX and the long-range outlook for the airplane company is about as good as it gets.

PUGET SOUND AND U.S. EMPLOYMENT

National employment has not only advanced fifteen months in a row, but the pace of job growth is picking up. The nation added 900,000 jobs in 2010 and 1,600,000 jobs in 2011.

With a boost from 7,000 new Boeing jobs, the region has performed even better than the nation during the recovery. Between the first quarter of 2010 and the third quarter of 2011, the region regained 36,000 of the 141,000 jobs lost during the recession. This represented a 2.1 percent increase in total employment, 0.6 percentage points greater than the national gain over the same period.



PUGET SOUND RETAIL SALES

Falling home and stock prices hammered consumer spending during the recession. Consequently, most analysts believed that households would be a drag on the economy during the recovery. Instead, consumers have been a pleasant surprise. Since the recession's trough, the 2.2 percent annual growth rate for real consumer expenditures has almost matched the 2.4 percent pace of real GDP. Particularly surprising has been the rebound of consumer goods (registering a 3.9 percent growth rate), especially cars, electronics, and other durables (a 7.6 percent growth rate).

Puget Sound Retail Sales*
Percent Change

	2009	2010	2011	Average 2009-11
Retail Sales	-4.2	4.2	5.4	4.8
Durables	-13.5	2.1	7.4	4.7
Nondurables	-0.9	5.0	4.3	4.6
Other	4.3	5.6	5.3	5.5
Personal income	-0.9	3.3	5.3	4.3

*Current dollars.

THE PUGET SOUND
ECONOMIC FORECASTER

The strong showing of consumer goods is evident in local retail sales. Spurred by a 7.4 percent jump in durable sales, current-dollar retail sales increased 5.4 percent in 2011, according to preliminary estimates. Held down by new construction, which is struggling to get off the mat, taxable retail sales rose just 2.5 percent.

FOREIGN EXPORTS LEAD RECOVERY

Since 1978 I have conducted three studies on Washington international trade. Key findings include: (1) on a per capita basis, Washington is the nation's top exporter; (2) one in four state jobs depends on foreign exports; and (3) foreign exports have been the fastest growing sector of the state economy.

Foreign Exports Lead Recovery

- Per capita, Washington is nation's top exporter
- One in four jobs depend upon foreign exports
- Foreign exports are state's fastest growing sector
- U.S. exports now growing at 10 percent annual rate
- Manufacturing leading regional job recovery
- Microsoft pay raise added \$600 million to economy

THE PUGET SOUND
ECONOMIC FORECASTER

During the recovery, U.S. real exports have expanded at a 10 percent annual rate, four times faster than real GDP. Little wonder that Boeing is producing 500 airplanes per year, two-thirds of which will be delivered to foreign carriers. Or that manufacturing employment, which is up 5 percent from the bottom, is leading the regional job recovery.

Microsoft is our other major international player. Although sales have risen 20 percent since 2009, the company has not increased its local workforce. But the software giant did give its 40,000 employees a big pay hike, which put approximately \$600 million into the regional economy. Consequently, Washington ranked first among states in personal income growth in the third quarter of 2011.

CONSUMER REPORTS TOP TEN COMPANIES WITH BEST CUSTOMER SERVICE

Of the top ten companies recently recognized by *Consumer Reports* for good consumer policies—liberal returns and green packaging—four were born and bred right here: Costco, Microsoft, Amazon.com, and REI. From a statistical standpoint, this is an amazing accomplishment. With only one percent of the nation’s population, we have forty percent of *Consumer Reports* top ten picks.

**Consumer Reports Top Ten
Companies with Best Customer Service**

Consumer Reports picks:

- Costco
- Microsoft
- Amazon.com
- REI

My picks:

- Starbucks (“lattes to the world”)
- Alaskan Airlines (“easy air”)
- Nordstrom (“a good fit for 100 years”)
- Boeing (“safest way to get from here to there”)

THE PUGET SOUND
ECONOMIC FORECASTER

It is easy to make light of this, but as a regional economist I think this tribute is significant. The foundation of a solid economy is world-class businesses, and *Consumer Reports* confirms that we have more than our share.

PUGET SOUND ECONOMIC FORECAST

How will the Puget Sound economy fare in 2012 and 2013? Assuming no monkey wrenches—or no additional stimulus for that matter—the forecast calls for continued growth at half speed.

After rising 1.5 percent in 2011, employment is predicted to increase 1.6 percent in 2012 and 1.6 percent in 2013. This amounts to about 30,000 jobs per year. If the payroll tax deduction is terminated at the end of this year, current-dollar personal income will advance 5.1 percent in 2012 but then slow to 3.9 percent in 2013.

Puget Sound Economic Forecast				
Percent Change				
	2010	2011	2012	2013
Employment	-1.6	1.5	1.6	1.6
Personal income	3.3	5.3	5.1	3.9
Consumer price index	0.3	2.6	2.1	2.2
Housing permits	31.4	13.8	7.1	18.8
Population	1.0	0.9	1.1	1.1

THE PUGET SOUND
ECONOMIC FORECASTER

Slower income growth will keep employment from accelerating in 2013. In 2014 and 2015, however, jobs are predicted to increase 2.1 percent and 2.3 percent, respectively, according to our ten-year projections. We now expect that regional jobs will not return to their pre-recession level until the fourth quarter of 2014. At that time, the unemployment rate will be down but only to 7.7 percent.

With a high jobless rate, the inflation rate should remain low, around 2 percent per year in 2012 and 2013. Homebuilding will continue to improve, but the 15,000 building permits predicted for 2013 will be just two-thirds of what we consider normal.

PUGET SOUND ECONOMIC FORECAST (2)

Except for 2013, when the loss of the payroll tax deduction reduces the income growth rate by about one percentage point, nominal retail sales should continue to expand at a respectable rate. If the construction sector steadily improves, as we predict, taxable retail sales will accelerate over the next two years.

Closed home sales, like housing permits, should climb at a good clip, ultimately making a full recovery around 2015. A large number of distressed sales (foreclosures and short sales) depressed the average home price in 2011. As distressed sales decline, simple arithmetic indicates that the average home price will eventually rise, perhaps impressively. The apartment

market is expected to remain strong for another year or two. But what happens when the single-family housing market breaks out of the recession's grip? Given the affordability of homes, will people empty out of apartments?

Puget Sound Economic Forecast (2) Percent Change

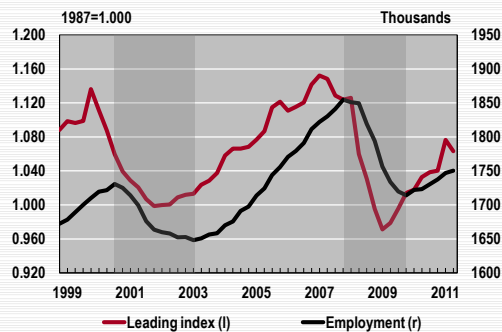
	2010	2011	2012	2013
Retail sales	4.2	5.4	5.9	3.7
Taxable retail sales	-0.2	2.5	4.9	5.4
Home sales	2.7	10.0	15.8	12.4
Average home price	-0.8	-8.1	2.8	6.5
Apartment vacancy (%)	5.5	5.0	5.1	5.5

THE PUGET SOUND
 ECONOMIC FORECASTER

PUGET SOUND LEADING INDEX AND EMPLOYMENT

The quarterly Puget Sound Index of Leading Economic Indicators, which is designed to anticipate the economy's turning points, as measured by employment, reflects the fragile state of the economy.

Puget Sound Leading Index and Employment



Note: Shaded areas designate recessions.

THE PUGET SOUND
 ECONOMIC FORECASTER

After climbing 10.8 percent over eight straight quarters, the leading index reversed course in the third quarter of 2011 and fell 1.2 percent. Dragging down the composite index were a shortening of the manufacturing workweek, a drop in the number of online help-wanted ads, a narrowing of the spread between long-term and short-term interest rates, and a decline in residential building permits.

The one-quarter downturn in the leading index does not mean that a recession is imminent, but it is a sign of caution.

WASHINGTON STATE GOVERNMENT EXPENDITURES AND TAX REVENUE

Permit me one last editorial comment. Every governor wants to do well for the state. Whether he or she succeeds depends greatly upon the hand dealt by the economy. Governor Gregoire has been holding the worst cards since the Great Depression. As a member of the Governor's Council of Economic Advisors, I think she has done a remarkable job of making the best of a very painful chapter in our economic history.

The next governor will inherit a better economy but also a broken tax system. Over the past four biennia, state tax revenue, adjusted for inflation and population change, has declined about 15 percent, while state expenditures have fallen about 20 percent. This means that for each Washington resident state government is currently providing one-fifth less in goods and services—education, safety, healthcare, and infrastructure—than it did six years ago.

As for real per capita income, it has increased 3 percent over the period. The vast disconnect between rising personal income and falling state tax revenue and expenditures is just one example of our failing tax system.

Washington State Government Expenditures and Tax Revenue Per Capita in 2005 Dollars

	Expenditures	Tax Revenue	Personal Income ¹
FY 2005-07	4,489	4,062	76,800
FY 2007-09	4,271	3,572	80,029
FY 2009-11	3,741	3,403	76,640
FY 2011-13	3,512	3,456	78,929
Percent change ²	-21.8	-14.9	2.8

¹Total income earned in the biennium per person.

²Between FY 2005-07 and FY 2011-13.

In the future, the new governor, working with the legislature, will have to make some difficult choices. For instance, Washington is known as having the most unfair tax system in the nation because of its extreme reliance on sales taxes. But sales taxes are also inefficient, meaning that in the long run they do not keep pace with the growth of the economy, as measured by personal income. Our forecasts suggest that to generate adequate tax revenue in the future—that is, tax revenue that grows with personal income—the King County sales tax rate will have to climb to 13 percent by 2020.

Should we raise the sales tax rate, thereby making our tax system even more regressive? Or, should we look for another tax base, such as personal income, that is more fair and efficient? Or, should we continue to whittle away at the state government's ability to provide the public goods and services needed to make our economy and community strong?

Thank you very much. I wish you a happy and prosperous new year.

For a related article by Dick Conway, see "Economic Outlook 2012," *Seattle Business*, January 2011, pages 29-35 (www.seattlebusinessmag.com).

The copyright notwithstanding, this presentation may be freely distributed to other interested persons.