AIER | Business-Cycle Conditions, February 2010

Fiscal Schizophrenia

The economy is showing signs of life, but a jumble of government proposals could thwart the recovery.

by Polina Vlasenko, Research Fellow

The economy began showing signs of improvement in August, when AIER's 12 primary leading indicators first posted widespread increases. This month, the primary roughly coincident indicators are also finally showing new life. A turnaround in the business cycle is either imminent or underway.

Despite this, both Congress and the Obama administration are proposing new stimulus measures that include a jobs program and targeted tax breaks. The question remains: At what cost and to what end? Besides not being helpful to the economy, these proposals also fly in the face of the government's newly found commitment to "freeze" spending.

This month, the percentage of leading indicators expanding reached 91 (10 out of 11 with a discernible trend), up from 90 last month. The cyclical score of the leaders, which is based on a separate, purely mathematical analysis, also modestly increased, from 62 to 63. For these measures, a value above 50 indicates that a recovery is likely.

Recent increases in *new orders for consumer goods*, *new orders for core capital goods,* and *new housing permits* all suggest that manufacturing activity may be picking up. In addition, the *ratio of manufacturing and trade sales to*

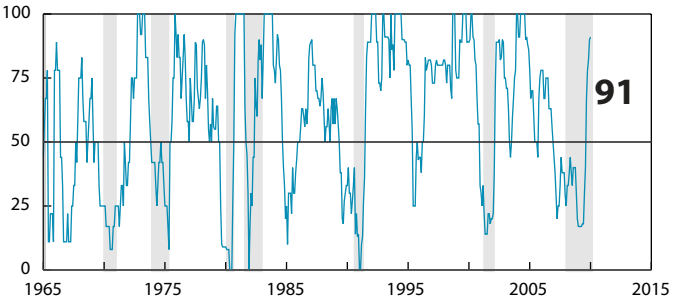
Statistical Indicators of Business-Cycle Changes

Change in Base Data					*Cyclical Status*		
Sep.	*Oct.*	*Nov.*	*Dec.*	***Primary Leading Indicators***	*Nov.*	*Dec.*	*Jan.*
+	+	+	+	M1 money supply	+	+	+
+	+	+	+	Yield curve index	+	+	+
-	+	-	+	Manufacturers' supply prices	+	+	+
+	+	+		New orders, consumer goods	-?	?	?
+	-	+		New orders, core capital goods	+?	+?	+?
-	-	+	-	New housing permits	?	?	+?
+	+			Ratio of sales to inventories	+?	+?	+
+	-	-	+	Vendor performance	+	+?	+?
+	+	+	+	Index of common stock prices	+	+	+
+	+	+	nc	Average workweek, mfg.	+?	+	+
+	+	+	+	Initial claims, unemplmt. insurance*	+	+	+
-	+	-		Change in consumer debt	-?	-?	-?
				Percentage expanding cyclically	*82*	*90*	*91*
				Primary Roughly Coincident Indicators			
-	-	+ʳ	-	Nonag. employment	-	-	-
+	+ʳ	+	+	Index of industrial production	+?	+	+
+ʳ	+ʳ	+		Pers. income less transfer payments	-	-	?
+ʳ	+			Manufacturing and trade sales	-?	-	?
-	-	+	-	Civilian emplmt. to population ratio	-	-	-
+				Gross domestic product	+	+	+
				Percentage expanding cyclically	*33*	*33*	*50*
				Primary Lagging Indicators			
-	-	-	-	Avg. duration of unemployment*	-	-	-
-	-			Manufacturing & trade inventories	-	-	-
-	-	-		Commercial & industrial loans	-	-	-
-	-	-		Ratio of cons. debt to income	-	-	-
				Chg. in labor cost/output, mfg.	-	-	-
-	-	-	-	Short-term interest rates	-	-	-
				Percentage expanding cyclically	*0*	*0*	*0*

nc No change. ʳ Revised. * Inverted. Under "Change in Base Data," plus and minus signs indicate increases and decreases from the previous month or quarter and blank spaces indicate data not yet available. Under "Cyclical Status," plus and minus signs indicate expansions or contractions of each series as currently appraised; question marks indicate doubtful status when shown with another sign and indeterminate status when standing alone.

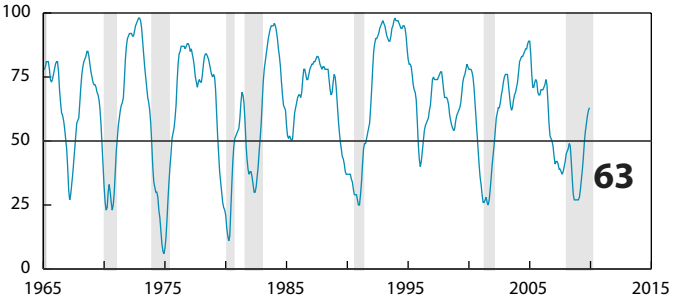
AIER Leaders Expanding and Cyclical Score Charts

Percentage of AIER Leaders Expanding



The percentage of leaders expanding is based on the analysis of 12 statistical series that move reliably in advance of general business activity. The cyclical score is based on a separate, purely mathematical analysis. For each measure, a score above 50 indicates an expansion is likely.

Cyclical Score of AIER Leaders

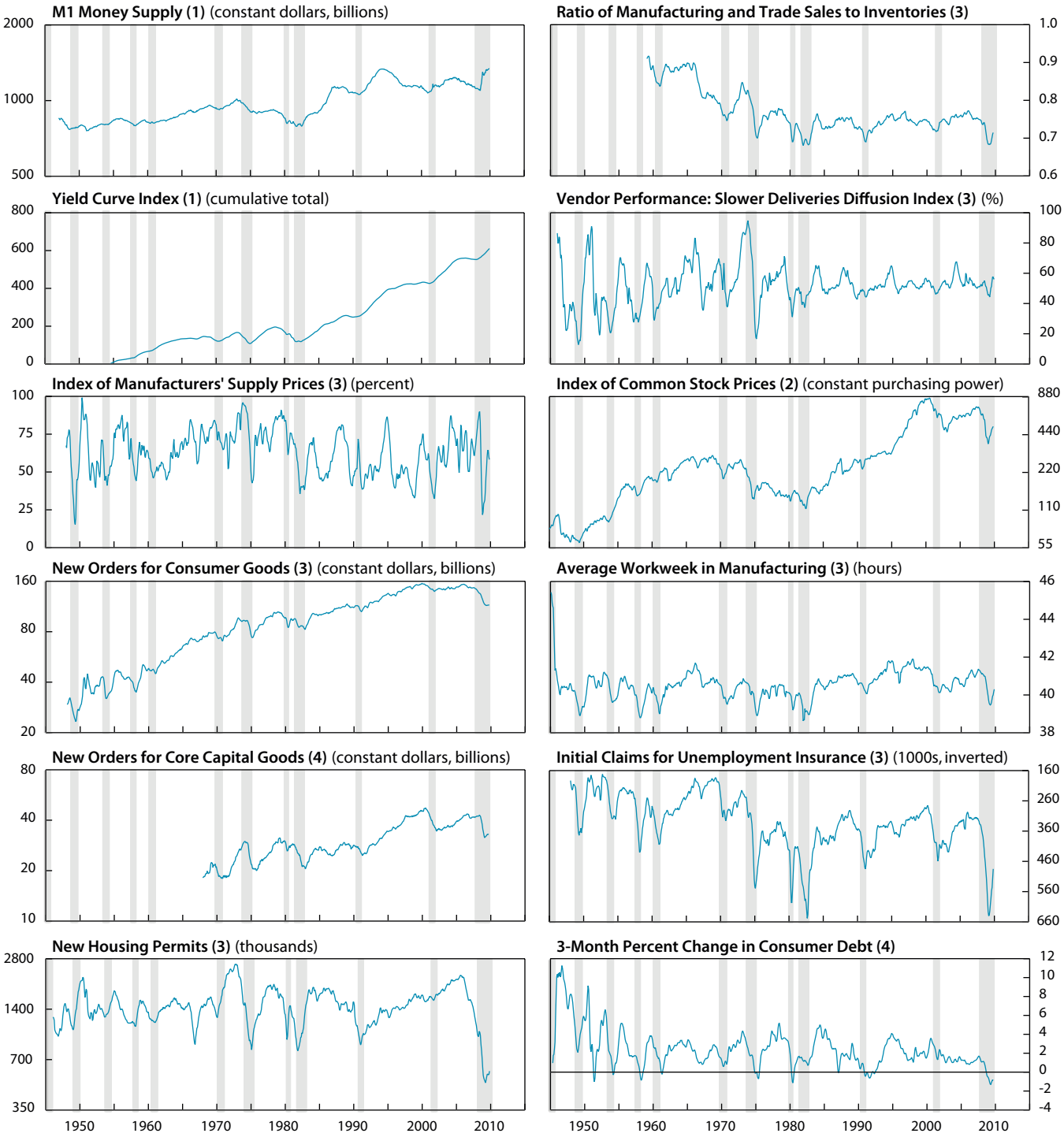


inventories rose this month because of rising sales. (For most of 2009, falling inventories drove the increase in the ratio.)

The pick-up in manufacturing finally may be spilling over into the labor market. Despite a high level of unemployment, *initial claims for state unemployment insurance*, which is inverted for analysis, fell in December and the *average workweek in manufacturing* held steady at 40.4 hours. Both series remain appraised as expanding.

The primary roughly coincident indicators also showed signs of improvement after revisions to the data prompted us to upgrade two series from clearly contracting to indeterminate. The changes show that *personal income less transfer payments* increased, rather than decreased, in September and October. They also show that *manufacturing and trade sales* increased in September instead of decreas-

Primary Leading Indicators



ing. This series also increased in October.

Significant revisions to the data are not uncommon around turning points. When releasing preliminary data, statistical agencies often extrapolate the missing information using a statistical model. The models, by their design, are best suited for extrapolating continuous trends, not changes in those trends. Later, once all data are collected, extrapolated values are replaced by actual ones, and the revised figures are released.

The changes in data and appraisals for personal income and manufacturing and trade sales bring the percentage of coinciders expanding to 50—two out of four indicators with a discernible trend. The cyclical score of coinciders also increased from 36 last month to 46 this month.

With exactly 50 percent of coinciders expanding and the corresponding cyclical score close to 50, the data suggest that the recession may be over. If gross domestic product increased in the fourth quarter (the data were released after we went to press), this would strongly indicate that a recovery is underway.

By definition, the start of a recovery marks the lowest point in the business cycle, where production and income are at low levels, and employment is depressed. That certainly is the picture today. The unemployment rate stands at 10 percent, despite the slowdown in the rate of job loss. The *index of industrial production* remains 11 percent below its peak of January 2008, despite six months of increases. And personal income less transfer payments, adjusted for inflation, remains 6 percent below its peak of September 2007.

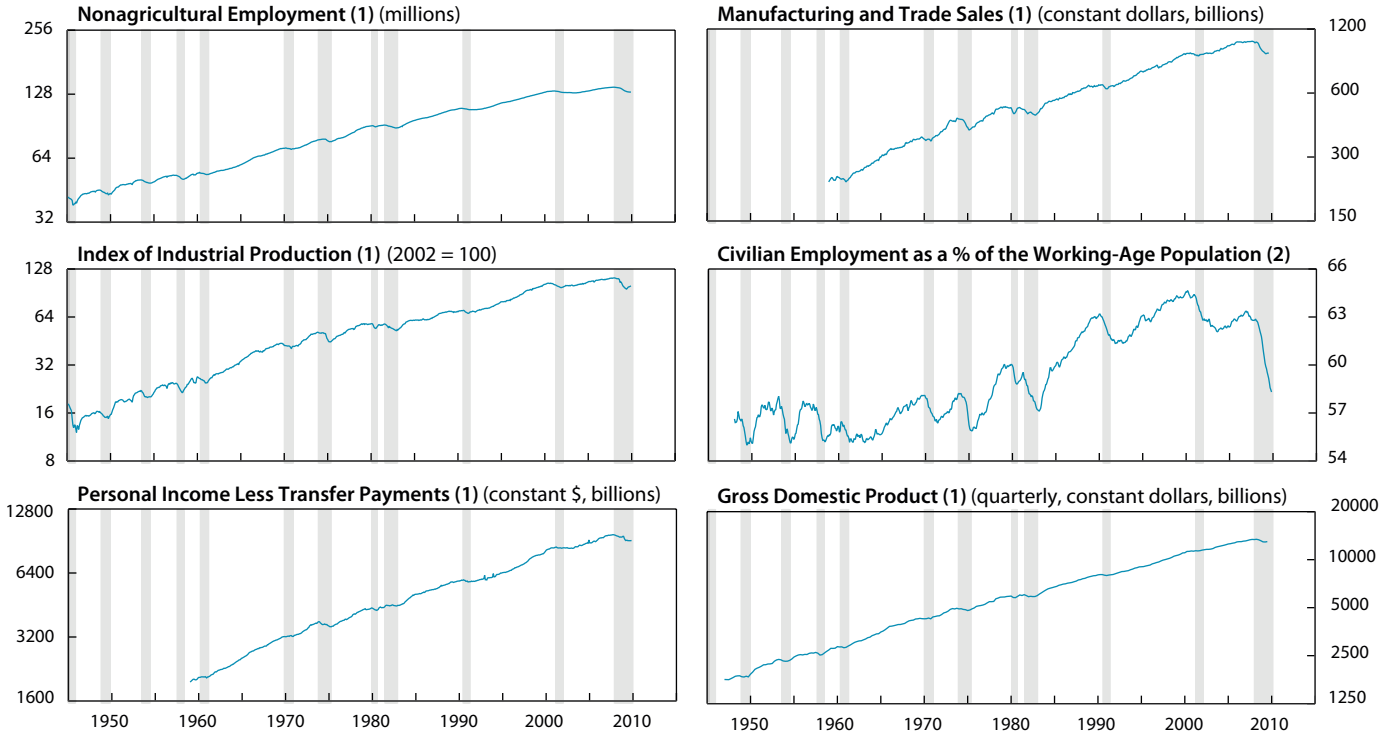
Politicians are talking more about jobs and the economy. If the economy proves slow to recover, the political push for another stimulus package will be very strong.

For individuals, these measures can translate into significant personal pain. For the economy, they mean that we may not be out of the woods yet. Households are not in a position to increase spending substantially. Companies are not able to increase production and employment. And money from the government's $800 billion economic stimulus will be running out soon.

With the midterm elections looming in November, politicians are talking more about jobs and the economy. If the economy proves slow to recover, the political push for another stimulus package will be very strong.

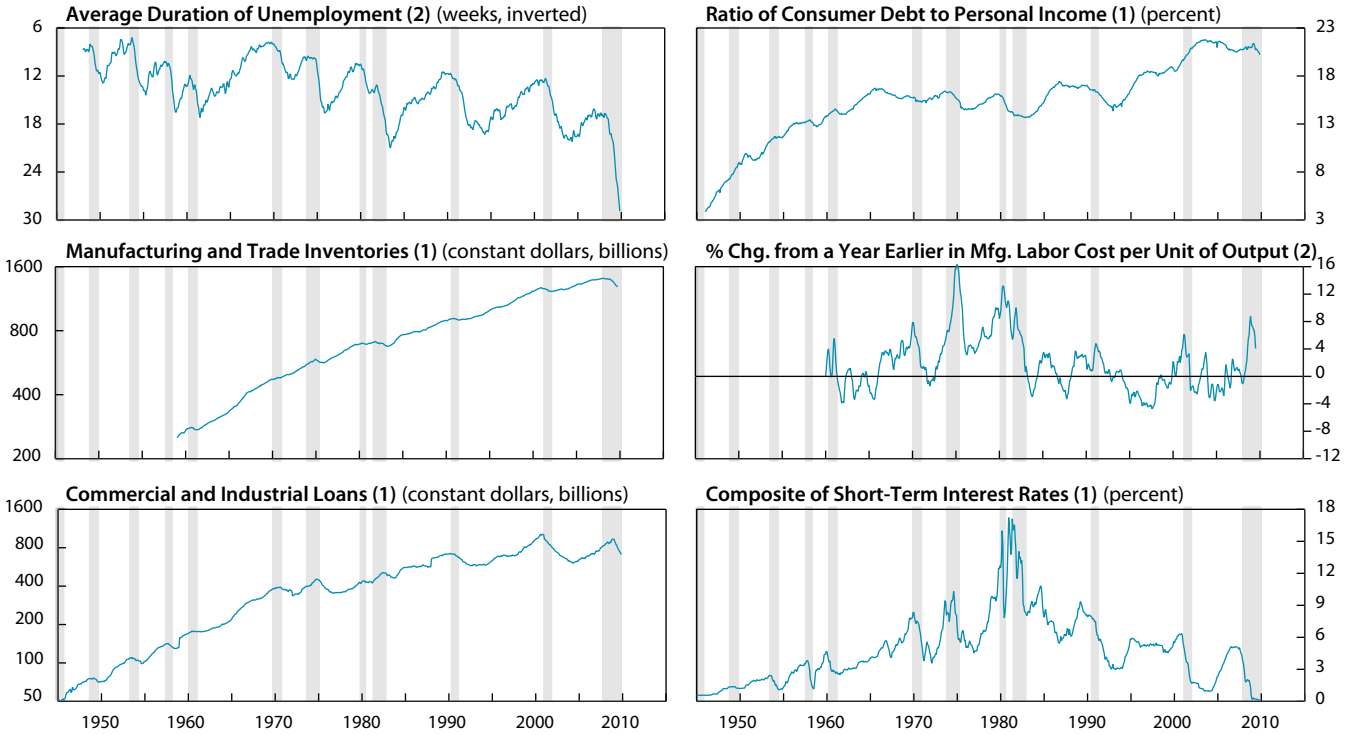
Election-year politics may have already begun with a hodge-podge of fiscal proposals currently on the table. In Congress, the House has passed a $154 billion jobs bill. It

Primary Roughly Coincident Indicators



Notes: 1) Shaded areas indicate recessions as dated by the National Bureau of Economic Research. 2) The number in parentheses next to the name of a series is an estimate of the minimum number of months over which cyclical movements of a series are greater than irregular fluctuations. That number is the span of each series' moving average, or MCD (months for cyclical dominance), used to smooth out irregular fluctuations. The data plotted in the charts are those MCDs and not the base data.

Primary Lagging Indicators



calls for additional spending on infrastructure, extended unemployment benefits, and aid to state governments to help retain teachers and firefighters. The bill still has to pass the Senate.

For his part, in advance of the State of the Union address, President Obama outlined several initiatives he said are intended "…to reverse the overall erosion in middle class security." These initiatives include an increase in the Child and Dependent Care Tax Credit; additional child-care funding for lower-income families; a lower limit, relative to income, to the federal student loan payments; a system of automatic workplace individual retirement accounts bolstered by a matching government tax credit; and expanded federal support for families caring for elderly relatives.

The bad news is that such targeted tax cuts and tax credits do not usually affect the overall economy.

If this looks like a laundry list of special projects designed to benefit select constituencies, that is exactly what it is.

The good news is that these programs do not appear to be extraordinarily expensive. In a federal budget where outlays approach $4 *trillion,* the cost estimates for these proposals are in the relatively modest range of several billion dollars. But this figure does not address hidden costs. Such special tax credits create additional paperwork, putting added burdens on tax authorities and taxpayers for small gains.

The bad news is that history shows that such targeted tax cuts and tax credits do not usually affect the overall economy. The impact of the increased child-care tax credit, for example, is likely to be limited. It does put additional money in the pockets of families with children, but only after they file taxes for the year and only if they have any tax liability. If a family does not owe any federal taxes, the additional tax credit makes no difference.

Nor will other initiatives achieve their proclaimed goals. Capping federal student loan payments, for example, and forgiving the balance of the loan after a certain number of years is touted as a way to make college more affordable. But this hidden subsidy only will increase the demand for college education and lead to rising tuition. Today's students may benefit. But students in the future may find that the cost of college education will have increased more than enough to offset any gains from loan forgiveness.

At the same time that the administration is proposing these tax breaks, it is seeking to trim the budget deficit by freezing discretionary non-defense spending. These simultaneous and contradictory moves throw into question the administration's commitment to solving the growing fiscal problems.

This attitude to deficit reduction is at best schizophrenic. It ignores the elephant in the room: The huge entitlement programs such as Social Security and Medicare that will be the driving force behind budget deficits for years to come.