Arizona forecast: Getting from the current pain to the future promise

by Elliott D. Pollack

The economic outlook is not good. This is true despite the passage of the congressional rescue plan designed to resolve capital issues at banks and boost confidence in the banking system. The goal is improved capital flow, allowing banks to ease their lending standards, at least to qualified borrowers. However, there is certainly no guarantee it will work to the extent many politicians are hoping. As of the beginning of October, the plan has not worked. If banks do not start easing their lending standards the economy will continue to deteriorate further.

Essentially, the economy floats on a sea of credit. People need to borrow to buy cars and other durables, to send their kids to school, to buy a home and to consolidate debt. Businesses need to borrow to build, expand plants, buy new equipment that will make workers more productive, and make payroll. Even cities need to borrow for capital projects. Without that credit, the economy will rapidly deteriorate, even below the weak current conditions.

The most immediate impact that is actually traceable, if the plan does work, will be enhanced lending between banks. Interestingly, the publicity of a bail out plan actually took the credit crunch to crisis, as financial institutions waited to see how the government would intervene. Credit flows have yet to improve.

The government is partially to blame for the public’s misunderstanding regarding the recently approved credit package. In very simple terms, if the government purchases these risky loans from banks, it will not only create a price for these loans (which doesn’t currently exist) but also inject additional funds into the system to lend while instilling at least some level of confidence among lenders.

The government is also partially to blame for the public’s misunderstanding regarding the recently approved credit package. In very simple terms, if the government purchases these risky loans from banks, it will not only create a price for these loans (which doesn’t currently exist) but also inject additional funds into the system to lend while instilling at least some level of confidence among lenders.

Consumers

The rescue plan is not a full solution to the problems facing the economy, however.

The economic possibilities for 2009 range from a bad year to a terrible year, depending on how financial markets and banks react to the rescue plan and any other financial action by the government.

Consumers are not in good shape. The average American consumer still has high levels of debt despite some recent improvement. Consumers also have low levels of traditional savings. The amount of money the average person may commit to savings or invest in stocks or home equity has diminished greatly over the last year. Now, for the first time, perhaps since the 30’s, the U.S. consumer is suffering a negative wealth effect (feeling poor because of diminishing assets). On top of that, both employment and hours worked are declining. In this environment the consumer is likely to pull back.

The pull back will be primarily in durable goods such as autos, electronics, appliances and home furnishings, but will spread to non-durables and services as well. While the latter category will not realize a decline similar to consumer durables, the rate of growth will nonetheless diminish significantly. Consumers are likely to remain cautious for quite some time, or at least until they restructure their balance sheets to reflect diminished debt levels and higher levels of traditional savings.

Business

The other side of the coin relates to business operations.

Business has been the rare bright spot in the economy. Because of the weak dollar that makes our goods less expensive overseas and foreign goods more expensive here, exports have been booming. Indeed, exports account for the majority of growth in the first half of 2008.

However, with Japan and Europe in recession and the slowdown in China and other Asian countries becoming worse, the positive effects of the diminished value of the dollar will be less pronounced over the next year. While business spending on plants has been unusually strong, plant spending will slow as will spending on equipment

Housing

The supply/demand situation in the housing market has improved in some markets across the country, but in major markets such as Florida and California (and Arizona) the supply/demand situation remains bad.

The result will be continued downward pressure on prices in those markets, at least through the first half of 2009. By the second half of 2009, declining housing prices will probably be less of a drag on the economy but new permitting will continue to be slow for a bit longer. One additional concern is that by late 2009, commercial construction in response to declines in employment and retail sales will significantly diminish. That leaves the government sector to buoy the economy.

Government

Tax rebates in the second quarter certainly helped personal income, but given the size of the federal deficit, how much more stimulus the government can provide is open to question. Thus, even if the bank rescue plan works, the demand side for money will be weak over the next year.

Indeed, the range of possibilities for 2009 ranges from a bad year if things go well to a horrific year if things don’t go well. Local government spending will not be as robust. Many states, including Arizona, are in major budget crises and spending must slow. This is also true of county and city government spending.

Arizona

Arizona has been one of those areas in the country that has been hard hit by the national slowdown and the bursting of the housing bubble.

Across the nation, the areas hardest hit include the four major housing bubble states (Arizona, Nevada, California, and Florida).The industrial Midwest, (Michigan, Wisconsin and Ohio, to name a few) is down because of durable manufacturing declines.

While Arizona historically is first, second, or third in terms of employment growth, so far in 2008 it is 49th out of 50 states in terms of such growth. This is a remarkably poor performance. Even during the real estate debacle of 1988 through 1992, Arizona's worst relative performance was 38th in 1988.

Arizona is now paying the piper for the housing boom, which led to substantial overbuilding of single family homes. One need only look at Arizona construction employment, down 23.2 percent from the peak compared to 8.6 percent nationally, to see such an effect.

Greater Phoenix Housing

There are several factors in the local market that make economists worry.

First, the supply/demand situation remains terribly out of balance. For example, in Greater Phoenix there are probably 20,000 excess units in the Multiple Listing Services (MLS) alone. If we compare population based permitting activity (i.e. demographic demand and not speculation demand) through the housing boom with what was actually permitted and built, the excess supply may have reached between 45,000 and 75,000 units.

Greater Phoenix is absorbing this excess supply at a rate that suggests supply and demand will not be back into the normal range this year, by 2009, and perhaps not even by 2010. Population flows have weakened substantially and now it appears that commercial construction will slow dramatically by 2009.

This is without a doubt the bleakest forecast that Arizona has faced, at least in the 39 years I have been a practicing economist. The only good news is that the long-term outlook remains bright. We are simply in an over-supply situation in terms of real estate which will take some time to work through.

Once supply and demand get back into balance, however, growth should again accelerate. This assumes that taxes stay reasonable and red tape does not become more of a problem. It is, after all, our ability to attract industries that have the option to move to other, competitive states that will allow us to enjoy more jobs creation and higher wages. It is a competitive world and we must never forget that. The underlying dynamics at this point appear to remain in place. Long-term forecasts remain positive.

The problem will be getting from the current pain to the future promise.

Elliott D. Pollack *is president of Elliott D. Pollack and Company in Scottsdale, an economic and real estate consulting firm established in 1987.*