

The Economy ... Blip or Dip

Presentation to The Commissioners of the
Revenue Association

Robert P. Vaughn, Staff Director
House Appropriations Committee
September 13, 2010



True Statements

"From a technical perspective the recession is very likely over at this point."

Federal Reserve Chairman Bernanke

"The end of the recession only marks the *trough* in economic activity, and tells us nothing about the strength and durability of the subsequent recovery"

Jim Welsh, Welsh Money Management

"Give an economist another quarter of actual data and he will give you another forecast."

Robert Vaughn, HAC Staff Director



A Guide To A Recession

- Recessions are determined by the National Bureau of Economic Research (NBER), an independent group of economists
- Conventional definition of a recession is 2 quarters of negative gross domestic product (GDP)
- New definition is “a significant decline in economic activity spread across the economy, lasting more than a few months, as seen in GDP, employment, real income, industrial production and wholesale-retail sales”
- Recessions apply to the U.S. economy as a whole, not to a particular state
 - Not all states are impacted the same in a recession – some states lead, others lag going into and out of a recession
 - Tax revenues generally lag the recovery due to the lagging nature of employment recovery



A Guide To A Recession

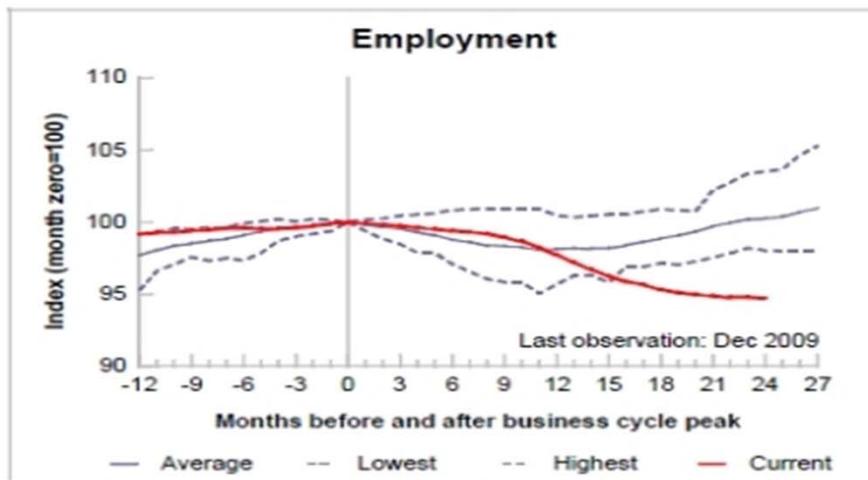
- Industrial production and corporate profits can be leading indicators of a recovery
- Job losses and gains generally lag in a recession
- Consumer spending accounts for two-thirds of total economic activity
 - Recovery cannot fully engage without consumers
- While economic indicators signal the direction of the economy, the inflection point – the point at which the recovery fully engages – is hard to predict



Key Indicators Used to Track a Recession

- These are the 4 main indicators that are used by NBER to gauge a recession
- 2007-2009 recession (red line) has been worse than the average of the last 6 recessions (solid black line) for all 4 indicators
 - Dotted lines represent the best and worst of the last 6 recessions

A Look at Key Indicators Underscores the Severity of the Great Recession



Data last updated 2010-01-08.



View of National Experts at End of 2009

■ **Longer and deeper recession than originally anticipated**

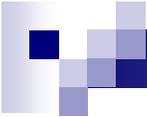
- Financial and banking crisis continues to grow
- Credit crunch (lack of liquidity)
- Loss of wealth and uncertainty reduced consumer confidence/spending
- Lack of demand and credit hurt employers
- Unemployment could reach 10%

■ **When will it end?**

- Recession ended in summer of 2009, lasting 6 to 8 quarters from January 2008 (longest post WWII recession)
- Labor markets would remain weak until late 2010
- Unsold housing inventory gradually recedes (must stabilize to recover)
- Consumer confidence takes time to restore
- Federal stimulus acting more like safety net, not economic ladder

■ **Slower growth for some time to come**

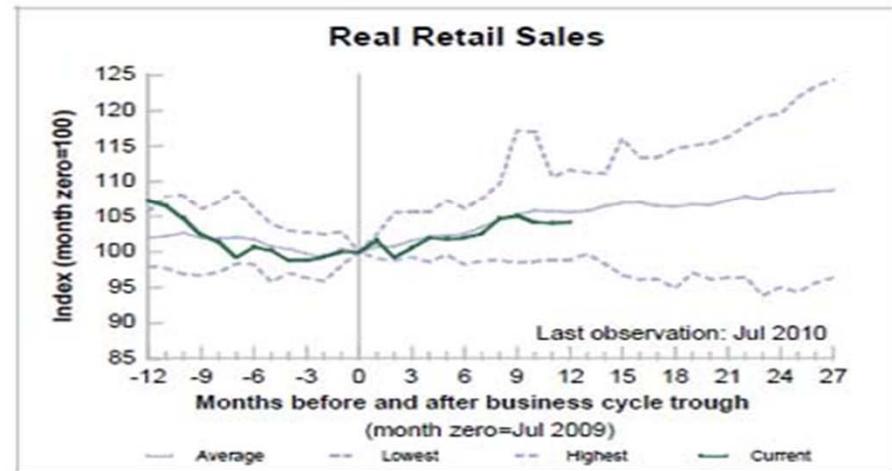
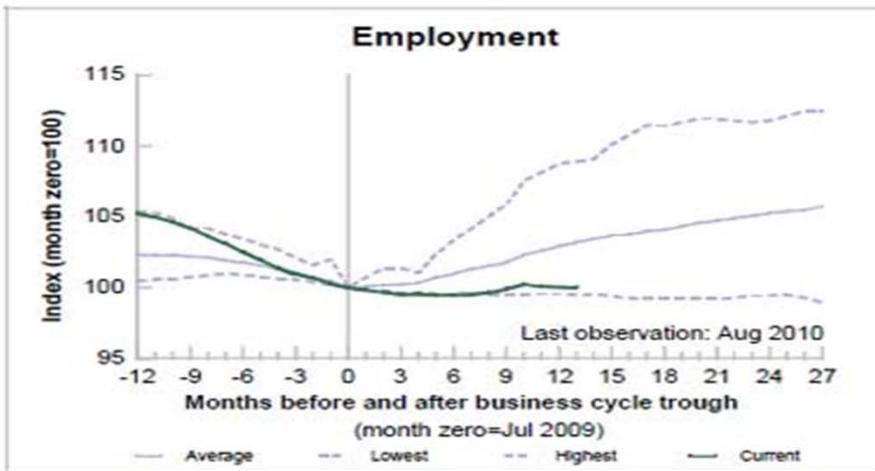
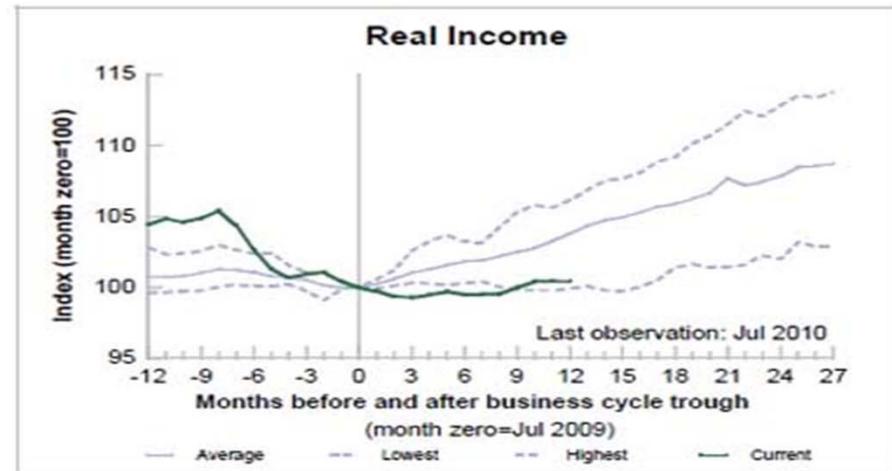
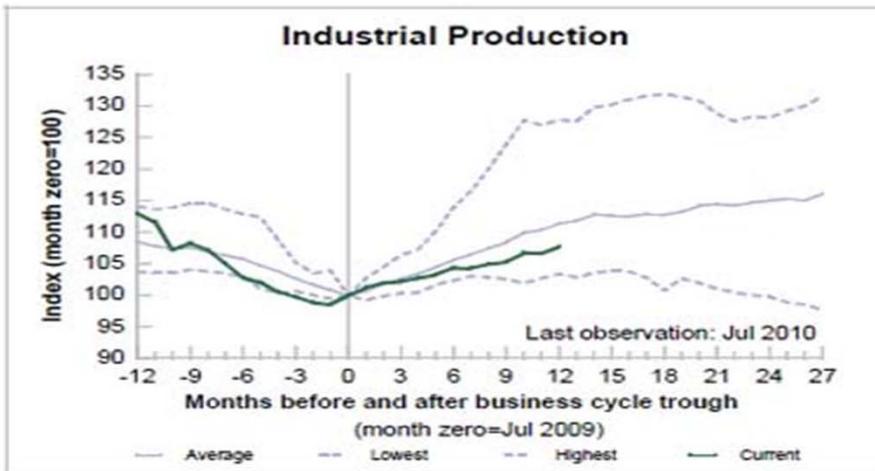
- No artificial “bubble” stimulus (dot.com or housing)
- Growth will settle in at more sustainable long-term trend



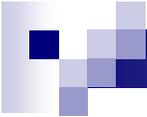
How Has The Economy Fared Since the Trough?

- Since the beginning of the year, the economy has zigzagged,
 - Slow down began in the second quarter as the boost to manufacturing waned and the impact of the federal stimulus abates
- Unemployment remains high, with lack luster job growth
 - Since August 2009, job gains (all sectors) have totaled less than 300,000
- “Wealth” effect is also playing against the consumer, as both housing values remain stagnate and the stock market has yet to recover all of the losses
 - Estimated that between \$10 to \$15 trillion in lost value
- Consumers continue to deleverage, while savings rates have increased
 - Consumer borrowing has dropped 17 times over the last 18 months – annual drop of \$3.6 billion.
 - Savings rate is about 5.8%, compared to 2.1% in 2007
 - Short-term pain, but longer term could be good as consumers come out of the recession with a stronger balance sheet
- Consumers remain cautious, spending on replacement items
 - Spending to take advantage off federal incentives and rebates, i.e., cash for clunkers, rebates for energy efficient appliances and HVAC
 - Deferring major discretionary purchases
- As consumers continue to holdback spending, businesses holding back on hiring
 - Companies continue to hoard cash, in part because of the uncertain economic recovery and the fear that they won’t have access to credit. They slashed costs and cut jobs

How Has The Economy Fared Since the Trough?



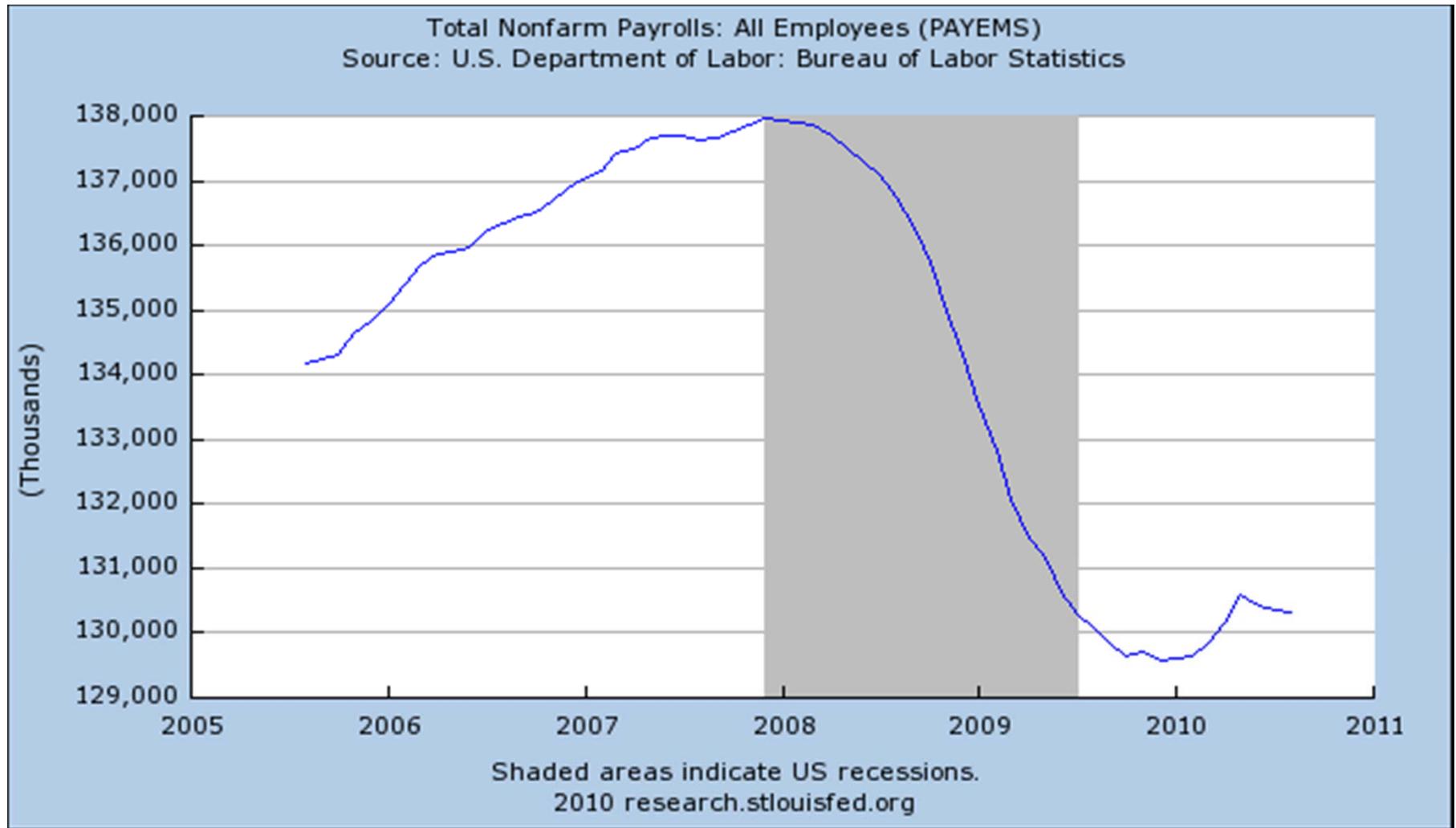
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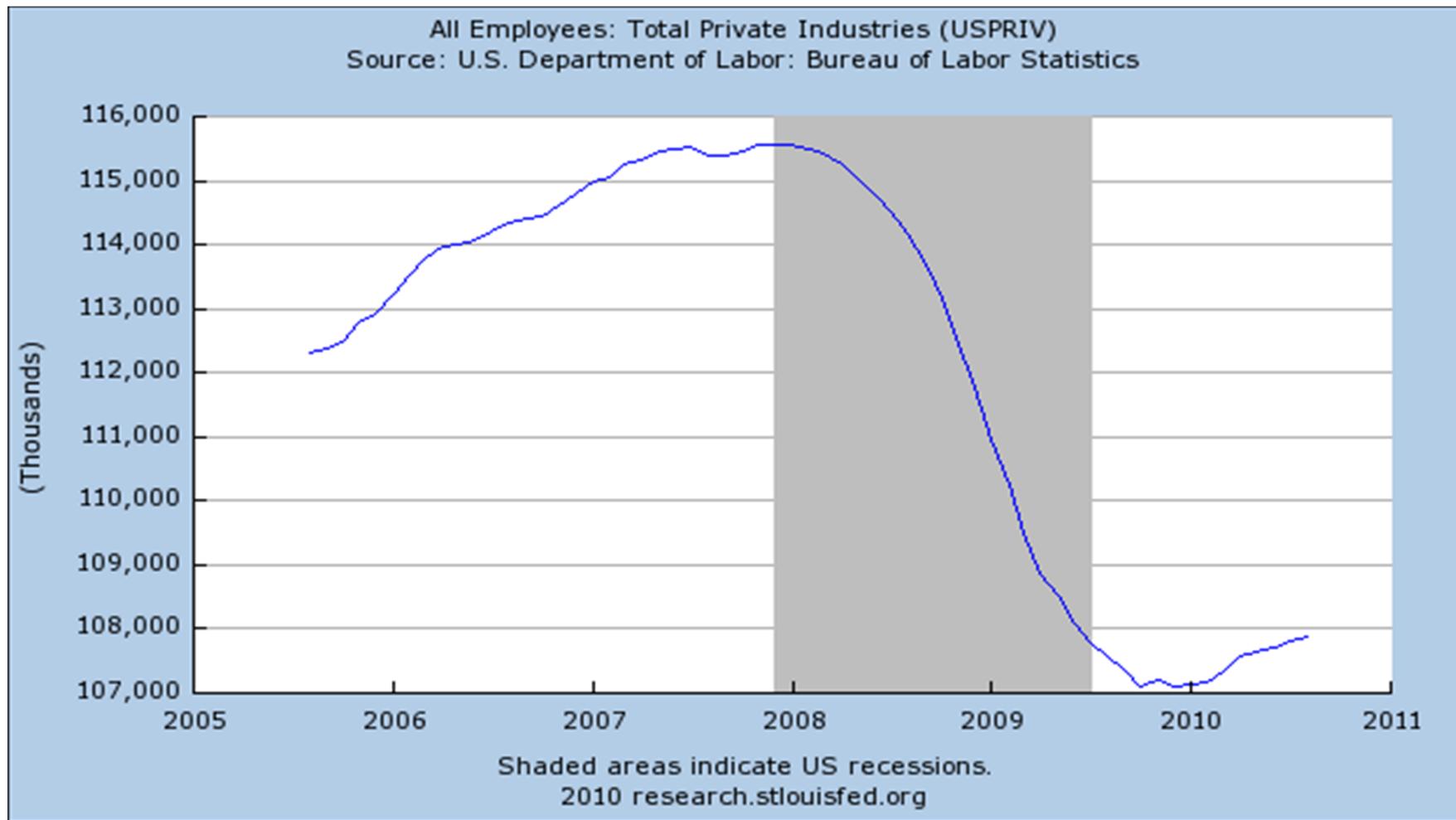
National Employment Indicators

- The national unemployment rate remained unchanged at 9.6% in August
 - Still double the national unemployment rate in December 2007, which was 5.0%
- After 5 months of job gains (Jan.-May), the national labor market edge downward in June (175,000), July (54,000) and August (54,000)
 - Private sector has continued to add jobs as government employment has declined
- Since its recent low in December 2009, private sector employment has risen 763,000 jobs
- Companies continue to utilize temporary employment, increasing the hours worked and overtime as a means to meet their employment needs, a necessary precursor to new hiring

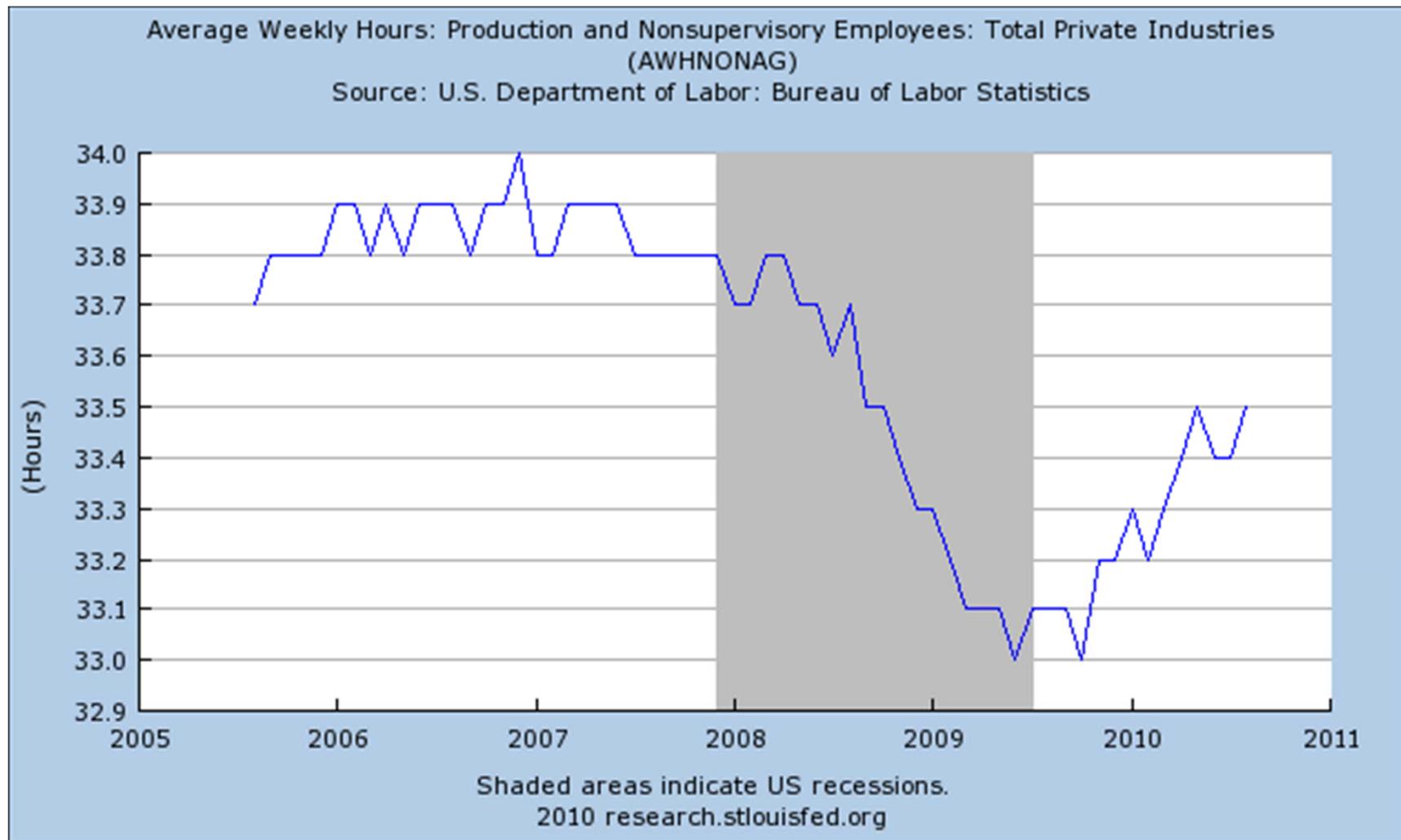
U.S. Employment



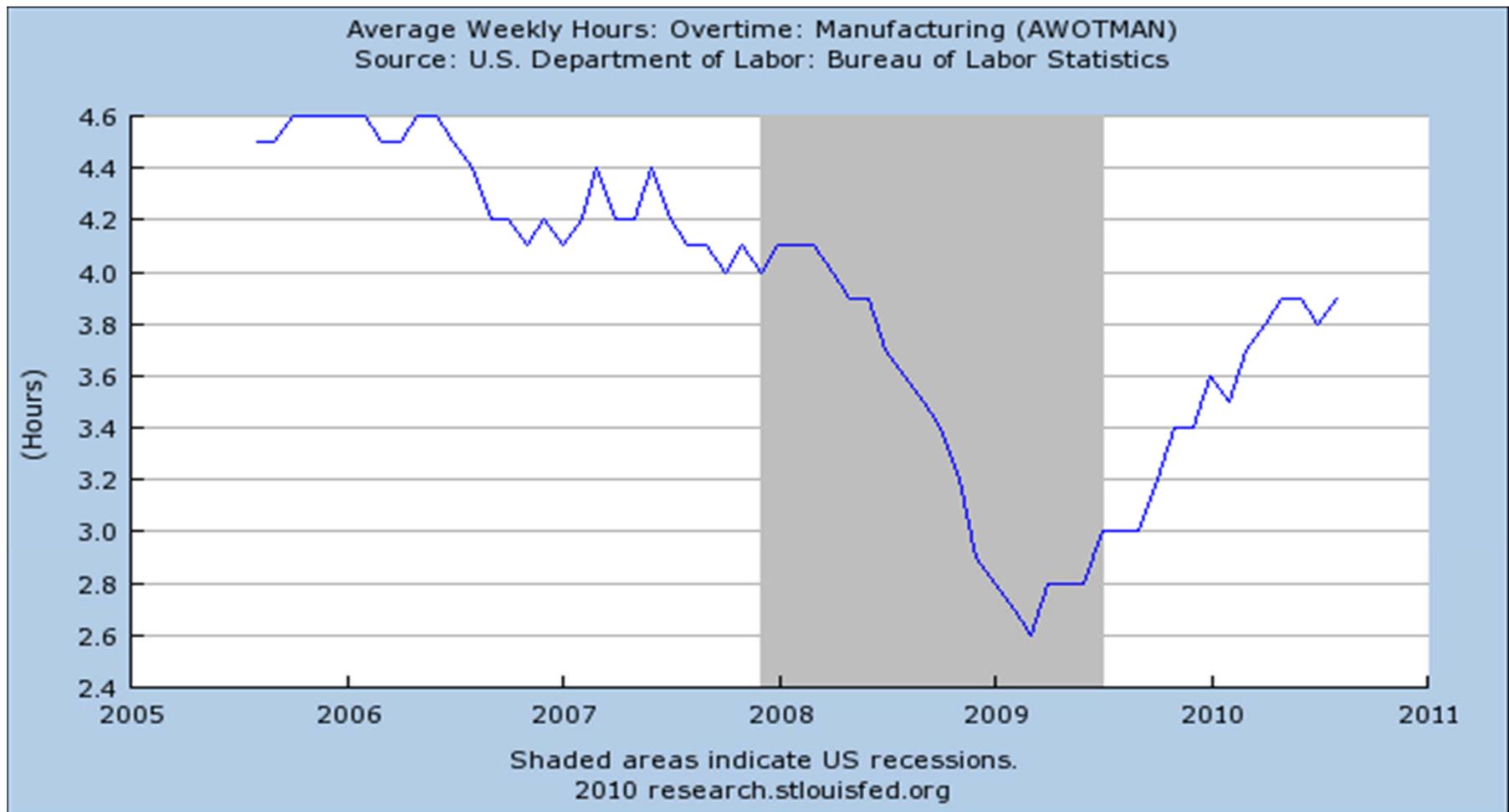
Private Sector Employment



Average Work Week



Overtime Hours in Manufacturing



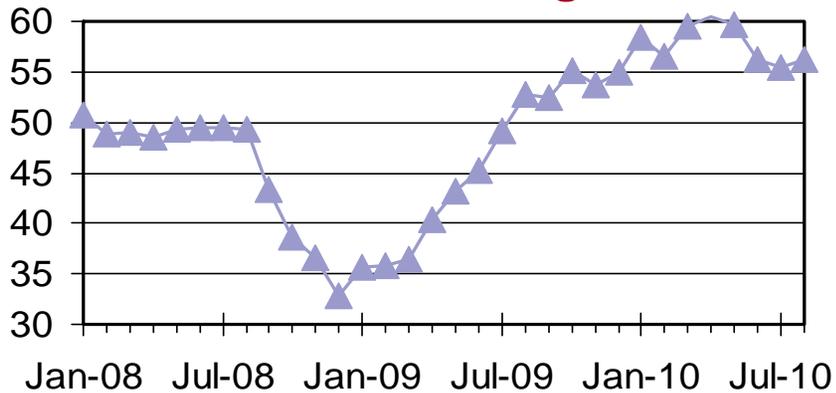


Institute of Supply Management

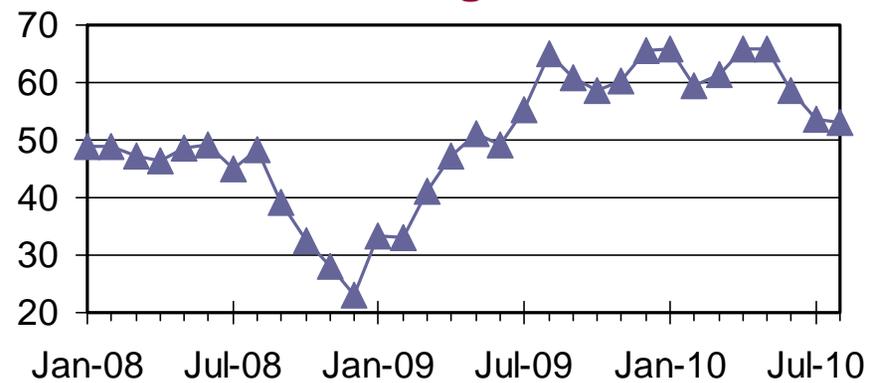
- ISM Index gauges the health of manufacturing in the U.S.
- Readings above 50 indicate manufacturing is expanding
- August represented the 13th consecutive month of growth, with 11 of the 18 industries reporting growth
- Manufacturing, while still growing, the rate of growth has slowed in the last couple of months

Manufacturing Sector Continues to Expand -- 13 Consecutive Months, with 11 of 18 Manufacturing Industries Reporting Growth in August

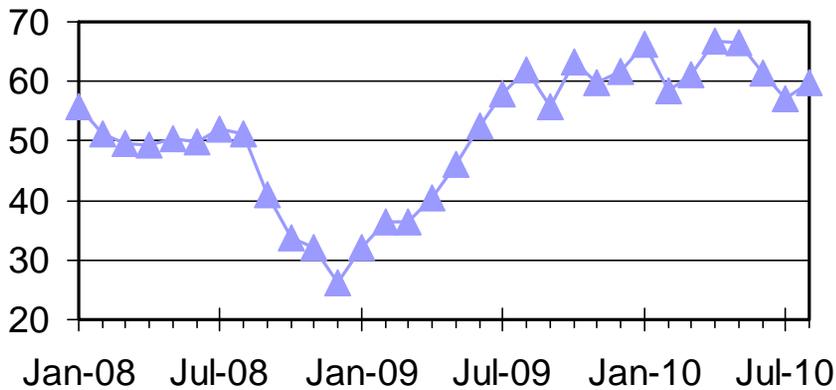
ISM Manufacturing Index



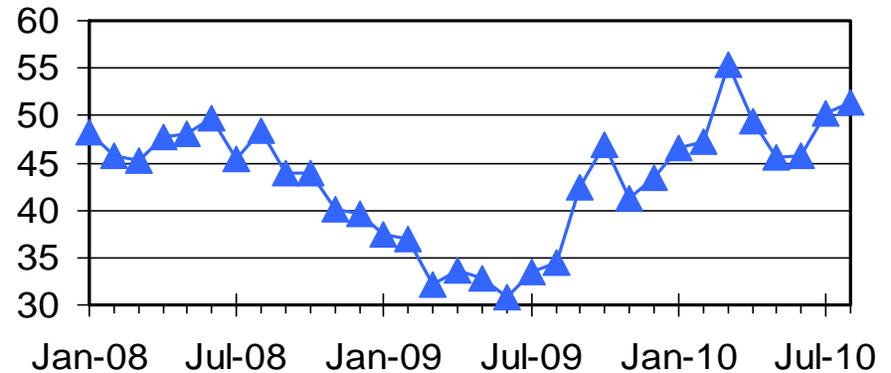
ISM Manufacturing New Orders Index



ISM Manufacturing Production Index



ISM Manufacturing Inventories Index



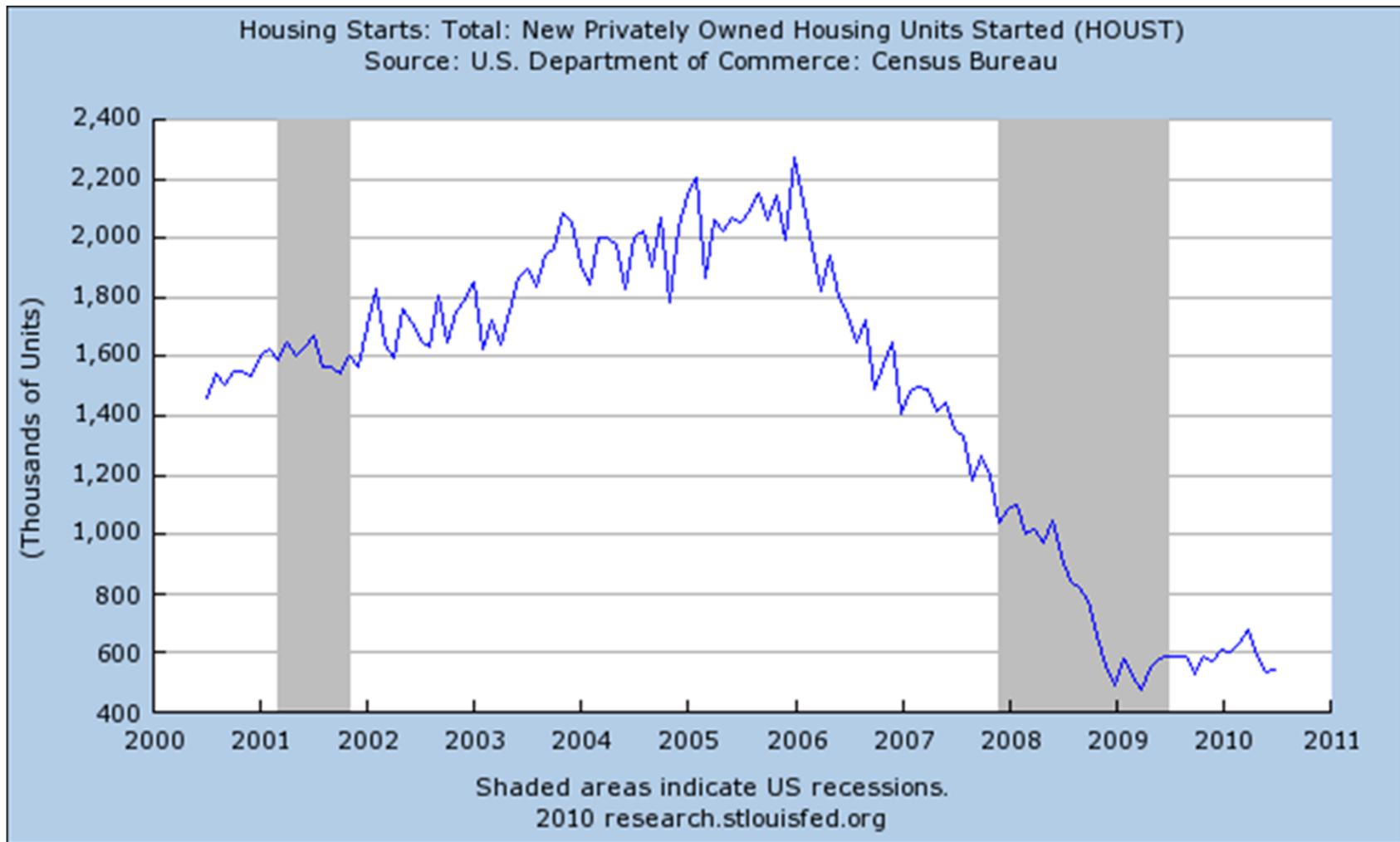
All indicators are diffusion indexes

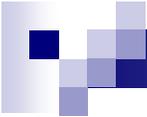


Can You Say Housing

- Housing remains weak due to the job situation and credit
 - July year-over-year existing homes sales has declined 25.5%
- Tight credit, despite low interest rates
 - Banks have become more stringent in their underwriting
 - Jumbo home loans are hard
- Housing values continue to be negatively effected by an foreclosures driven by:
 - Job loss
 - Home owners underwater – loan value greater than home value
 - Strategic foreclosures
- Federal housing tax credit helped stimulate the purchase of lower value homes, with approximately one-third of the purchases being foreclosed properties

Housing Has A Long Way To Go

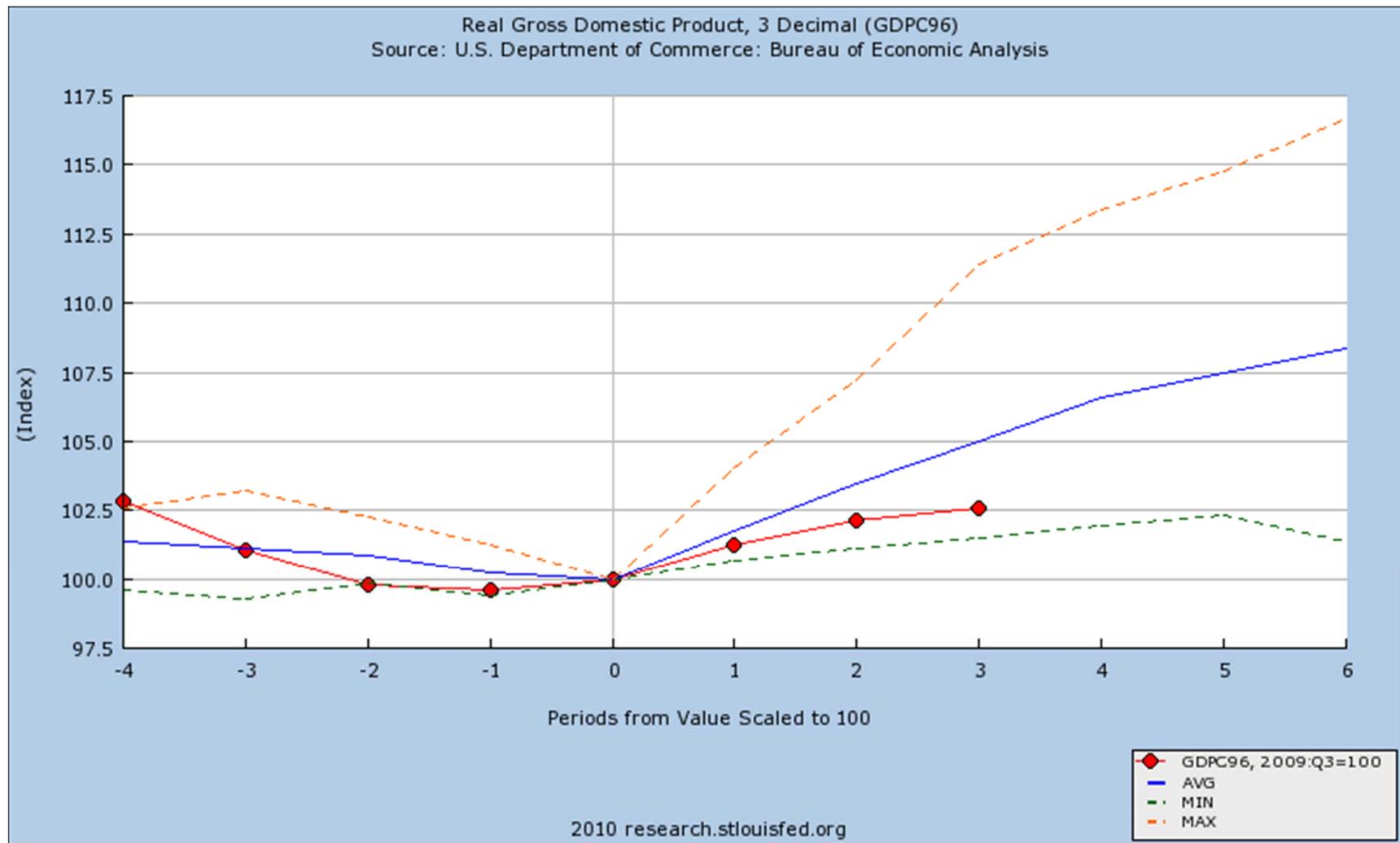


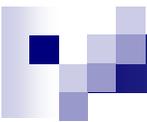


Global Insight's Outlook Has Become More Uncertain

- Global Insight's August Outlook has been revised downward for the remainder of calendar year 2010 and for 2011, although they still do not predict a V-shaped recovery
 - Economy set to grow 2.8% in CY 2010, compared to October forecast of 3.1%
 - The reductions for 2011 are from 2.7% to 2.4%
- The initial estimate of second-quarter GDP growth of 2.4% has been revised downward to 1.6%, well below the 3.7% first-quarter GDP
 - Third-quarter GDP is estimated at 1.7%, as residential construction softens due to the expiration of the homebuyer tax credit and the federal stimulus continues to abate. They expect consumer spending to pick-up and be slightly better than the second-quarter
- While Global Insight's outlook does not believe the signals are indicating a "double dip", they believe that momentum has slowed and that any major shock could tip the balance downward, as a result, they have assigned a 25% probability

GDP Compared to Previous Expansions





If Not an Expansion or a Double Dip, Then What?

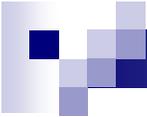
- The U.S. economy may be experiencing a growth recession
 - An economy that is growing at such a slow pace that more jobs are being lost than are being added. The lack of job creation makes it "feel" as if the economy is in a recession, even though the economy is still advancing.
- Many economists believe that between 2002 and 2003, the United States' economy was in a growth recession
 - Over the past 25 years the U.S. economy has experienced a growth recession. That is, in spite of gains in real GDP, job growth was either non-existent or was being destroyed at a faster rate than new jobs were being added.

Economic Outlook Assumptions Underlining Virginia's Budget

- Budget is based on Global Insight's October economic outlook
- Growth rates are based on the Global Insight Standard Forecast which assumes that employment will bottom out in the first half of calendar year 2010 (end of FY 2010)

	FY 2010		FY 2011		FY 2012	
	VA	Nat'l	VA	Nat'l	VA	Nat'l
Employment	-2.3%	-2.9%	1.1%	1.0%	2.1%	2.3%
Personal Income	1.6%	-0.2%	3.0%	3.8%	3.7%	4.6%
Avg Wages/Salaries	2.7%	0.9%	1.9%	2.5%	1.6%	2.0%
Wages/Salaries	0.4%	-2.1%	3.0%	3.5%	3.7%	4.4%

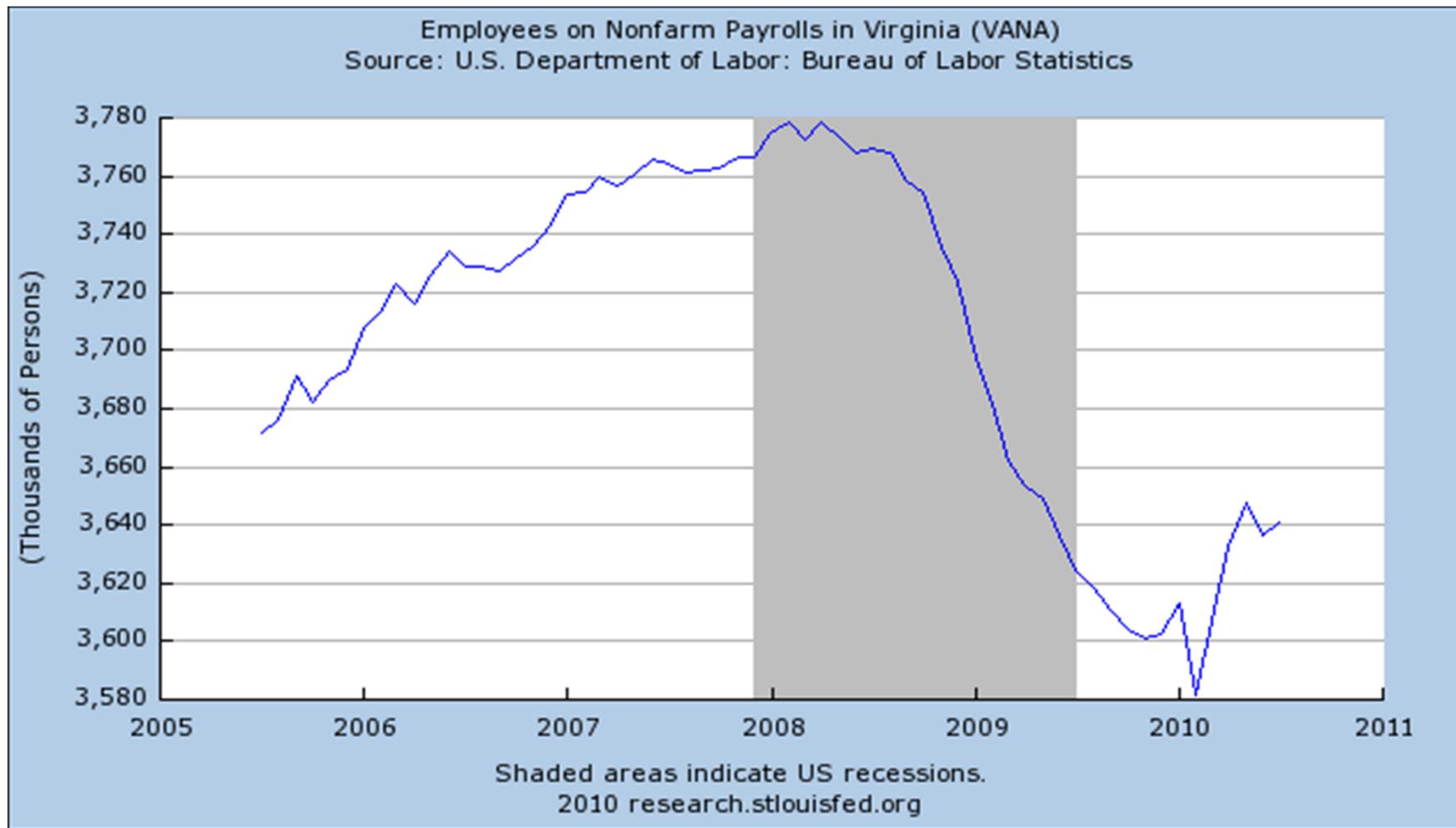
- Recovery assumed to be a prolonged U-shaped one, rather than a V-shaped recovery
 - Lackluster consumer demand and continued high unemployment rates will stifle growth
 - Concern about commercial real estate market another negative factor



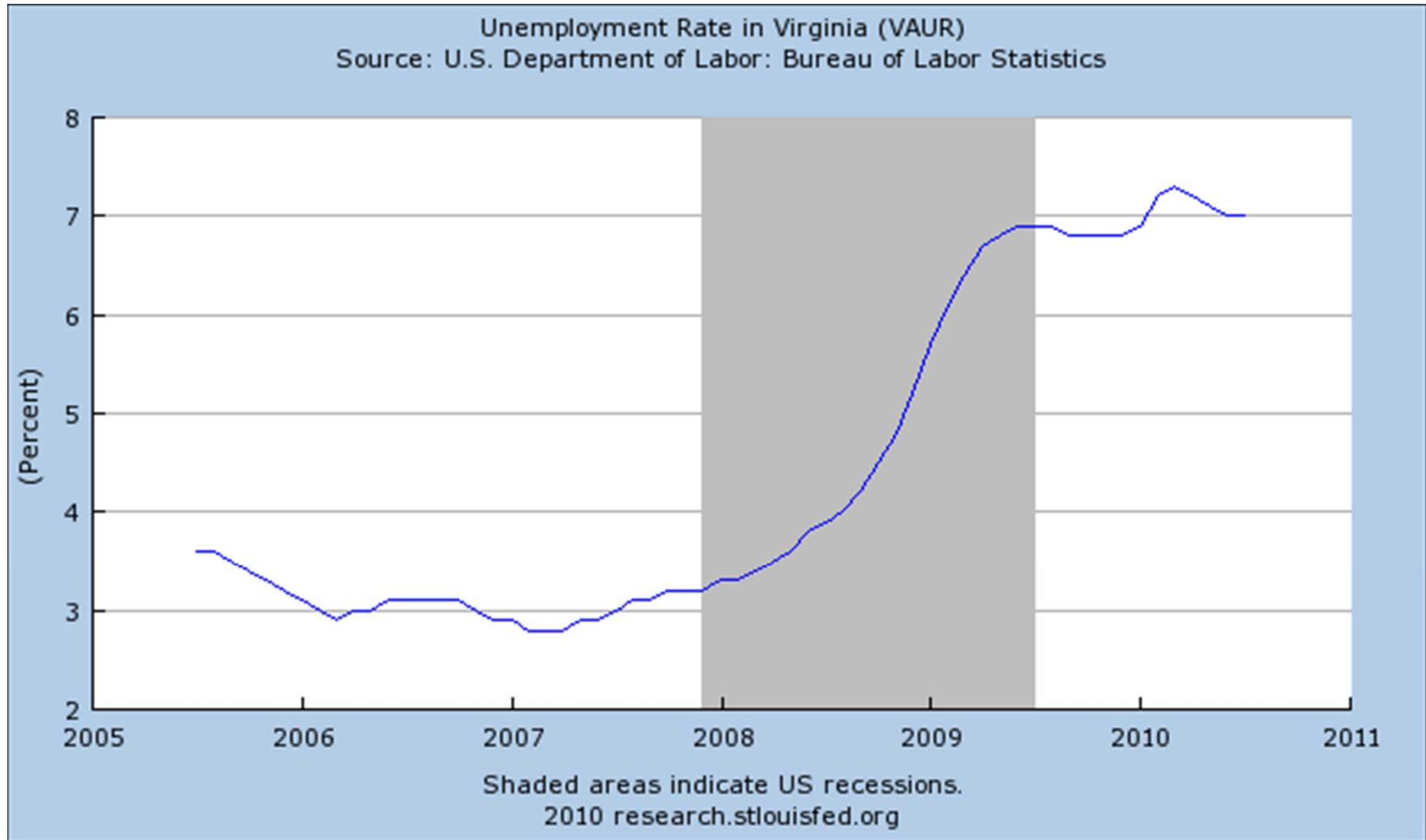
State Employment Indicators

- Virginia's unemployment rate stands at 7.0% in July, up from 6.9% in July of 2009
- Employment losses in FY 2010 were less than expected, while wage and salary growth remains flat
- In the year-over-year comparison (July 2009 to July 2010), nonfarm payroll employment was up 12,500 jobs, the first time in almost two years that employment was above the year-ago level
- Northern Virginia region has seen jobs growth, having recovered about half of their job loss
- The number of Virginians receiving a regular unemployment benefit payment was 71,400 in July 2010, which was up from 67,600 in June 2010 but down from 99,600 in July 2009
 - Cumulative initial claims for July 2010 totaled 35,200, compared to 31,200 in June 2010 and 41,400 in July 2009
- Virginia's payroll withholding tax, which is 60% of general fund collections, grew a meager 0.4% in fiscal year 2010

Virginia's Employment



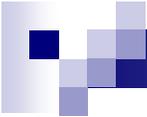
Virginia Unemployment Rate





Fiscal Year 2010 Revenues Exceed Expectations -- Don't Get Too Excited

- FY 2010 revenues exceeded forecast by \$228.5 million
 - Revenues were negative 0.7% versus negative 2.3%
 - Two consecutive years of negative growth
 - 1991 and 2002 were the only other years we saw negative revenue growth
- Corporate and Nonwithholding taxes accounted for \$170.0 million (75%) of surplus
 - These two sources represent 20% of general fund revenue
 - Corporate reflects cost cutting measures as companies squeeze profits and hoard cash
 - Nonwithholding reflects gains in the stock market and decision by individuals to take capital gains prior to expiration of Bush tax cuts
- Payroll withholding (64% of total GF) grew 0.4%
 - Underscores weakness in employment and wages and salaries
 - Growth occurred in the last quarter
- Sales tax revenues experienced another decline
 - April through June sales tax saw an increase of 12.8% over the same period in FY 2009
- While these indicators point to a slight economic improvement, the rate of growth is below the forecast
 - Nature of tax collections is that revenue growth lags coming out of recessions



So Does FY 2010 Performance Suggest a Stronger FY 2011?

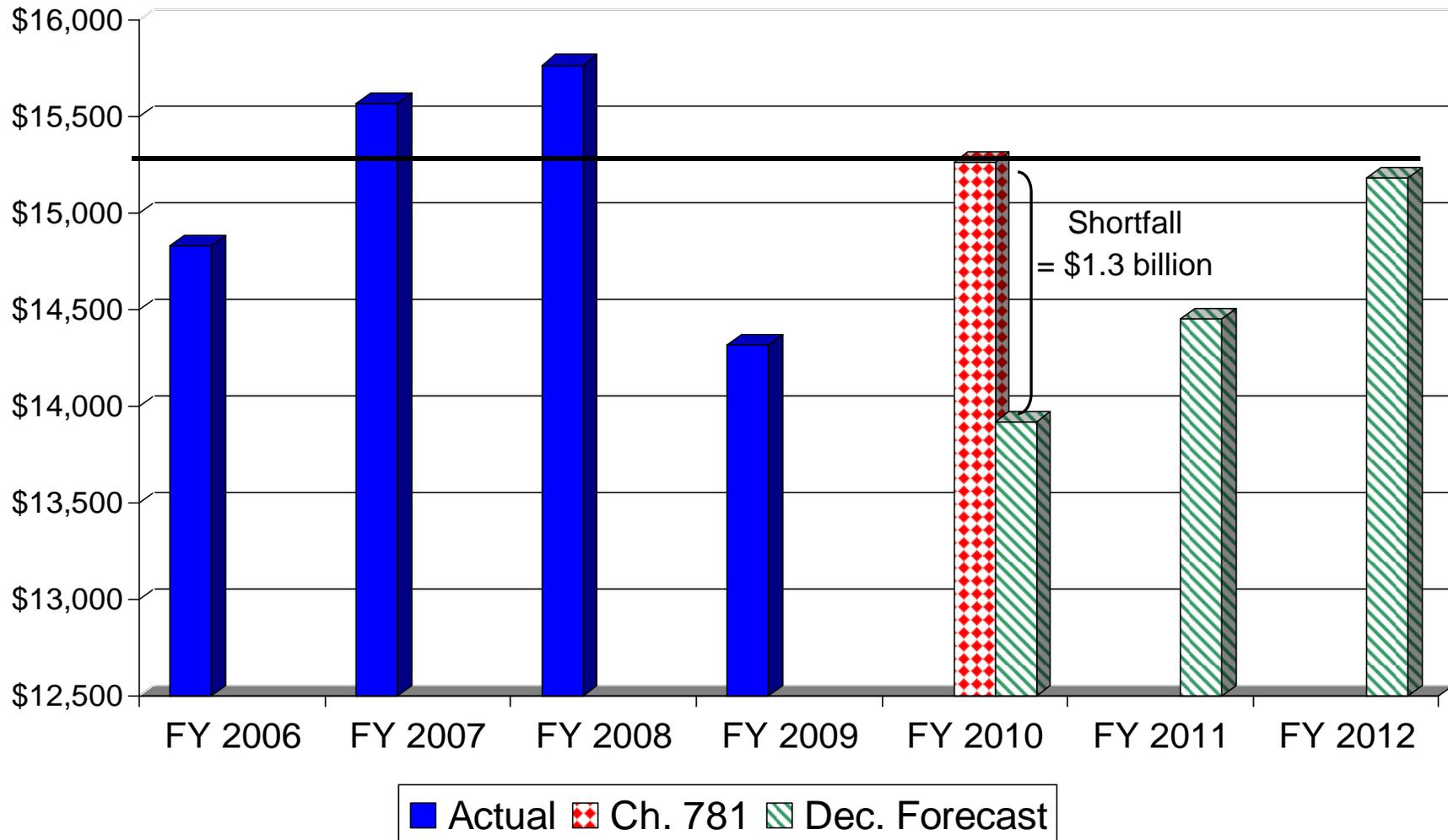
- While revenues performed better than expected, the payroll and sales tax collections – which are about 80% of general fund revenues continue to perform at anemic levels
- In order for both sources to make significant advances, stronger growth in jobs and income are necessary
 - NoVa is the only region to have any significant growth – driven by the federal government
- At this point in the process, it is too early to tell whether adjustments to the forecast are warranted
 - September and October are important months for revenues, with nonwithhold and corporate due
 - Corporate has performed slightly better than forecast
- National headwinds would suggest continuation of a conservative forecast would be prudent



FY 2010-2012 Biennial Forecast

- The revenue forecast for the FY 2010-12 biennium reflects the ripple effect of the \$1.5 billion revenue reduction in FY 2010
- The overall GF growth rates for 2010–2012 assume:
 - FY 2011: 3.8% (5.2% without tax policy adjustments)
 - FY 2012: 5.1%
- Even with these growth rates, the total GF revenue forecast for FY 2012 will be below actual FY 2007 revenue collections

FY 2012 General Fund Revenues Below FY 2007 Levels

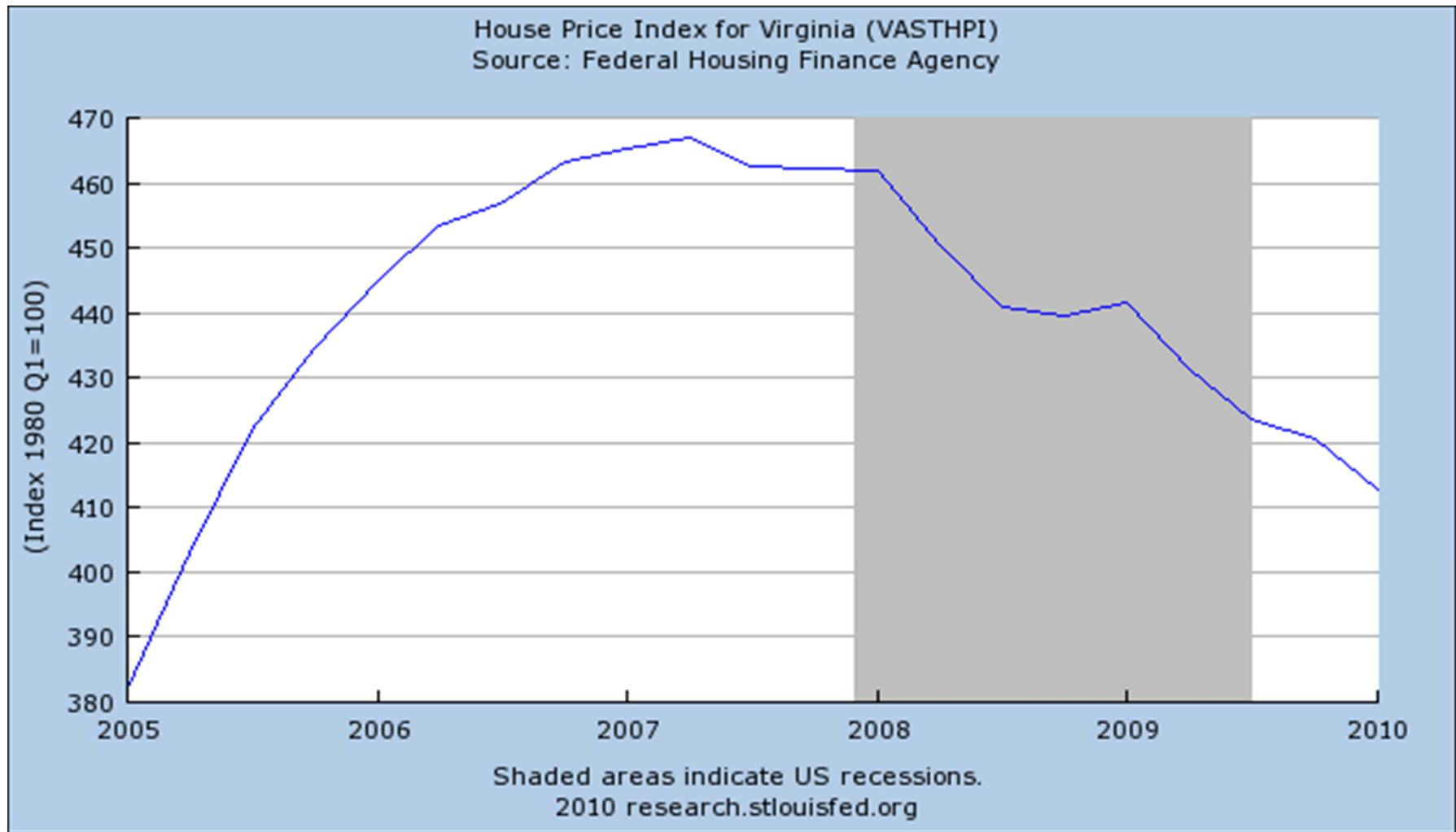




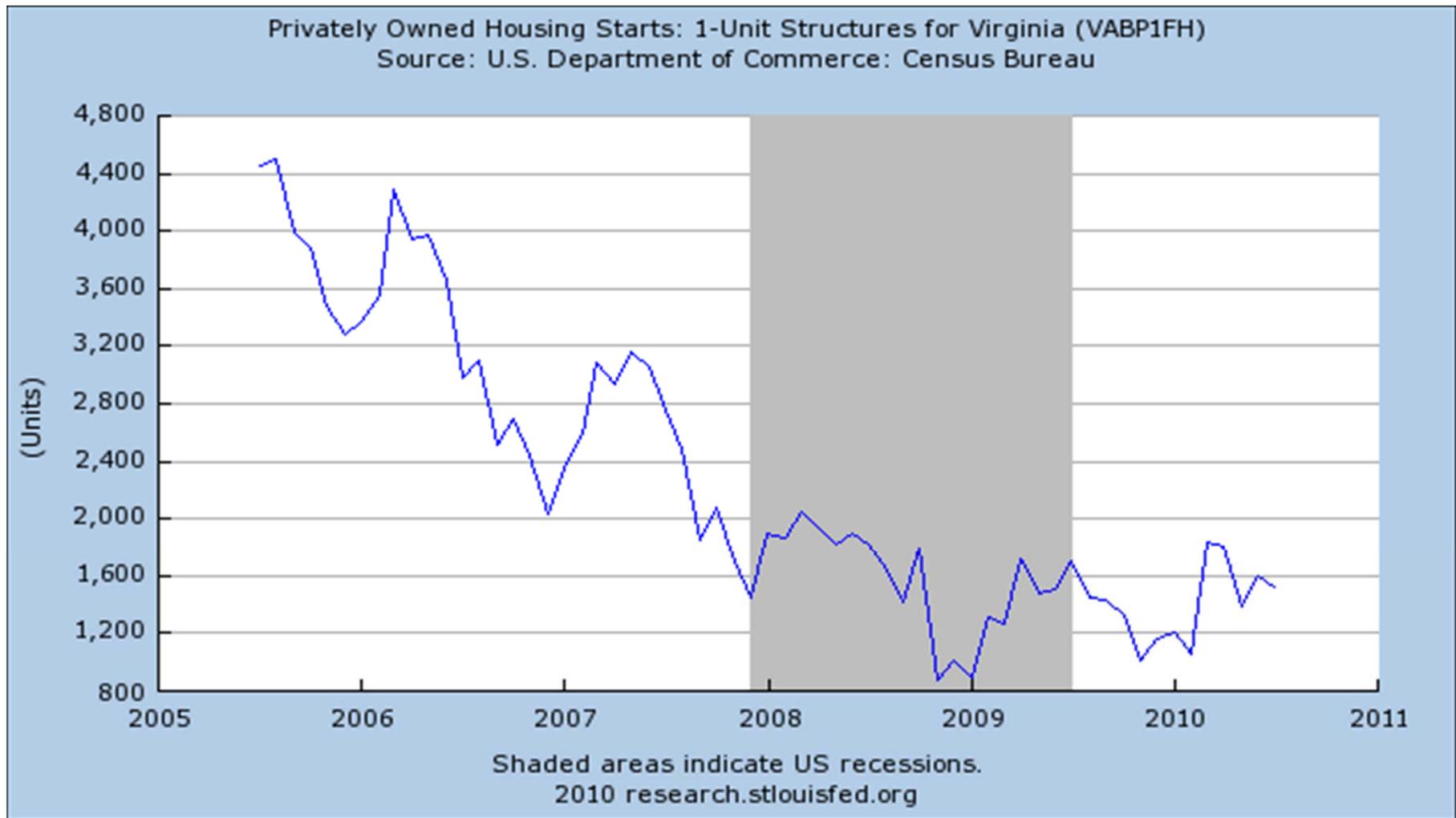
Landscape for Local Governments

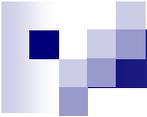
- Local governments will continue to feel the effects of flat to declining property values
 - Localities that re-assess every 4 or 5 years may be spared from steep property value declines
 - In Northern Virginia, average prices have declined in excess of 20%
 - 30% - 40+% declines in Prince William Co, Stafford
 - However, in remainder of state pricing declines have been in 10 - 15% range
- Foreclosure rates have increased dramatically
 - About 70% of all Virginia foreclosures are in NoVa
- Recordation tax revenues will continue to be weak
 - Outside of Northern Virginia this is driven by low volumes more than price declines
- Sales tax revenues, after negative growth of 5.6% in FY 2009 and negative 1.5% in FY 2010 will begin to see moderate growth
 - FY 2011 will be flat, with growth in the low 3% range in 2012
- Personal property tax will continue to be negatively impacted due to declining used car prices (primarily light trucks and SUV's) and the fall off in new car sales

Housing Price Index For Virginia



Virginia Private Housing Starts





Final Thoughts

- Consumers account for two-thirds of overall economic activity and will remain cautious due to job loss fears and negative wealth effect
 - Consumer discretionary spending remains dampened -- very price conscious
 - This will continue to have a negative impact on large purchases, i.e., homes and autos
- Extended job losses will continue to exacerbate the decline in home prices and foreclosures
 - Pushing back the housing recovery
- Federal deficit reduction efforts could impact defense spending
 - Federal spending constitutes 35 percent of NoVa's economy, with procurement spending representing over 50 percent of total
- Virginia, which typically out performs the nation, will continue to experience below trend revenue growth in FY 2011 and FY 2012
- The 2012-14 biennium will continue to be a challenge
 - Health care, loss of federal stimulus, required Rainy Day deposit, VRS rates