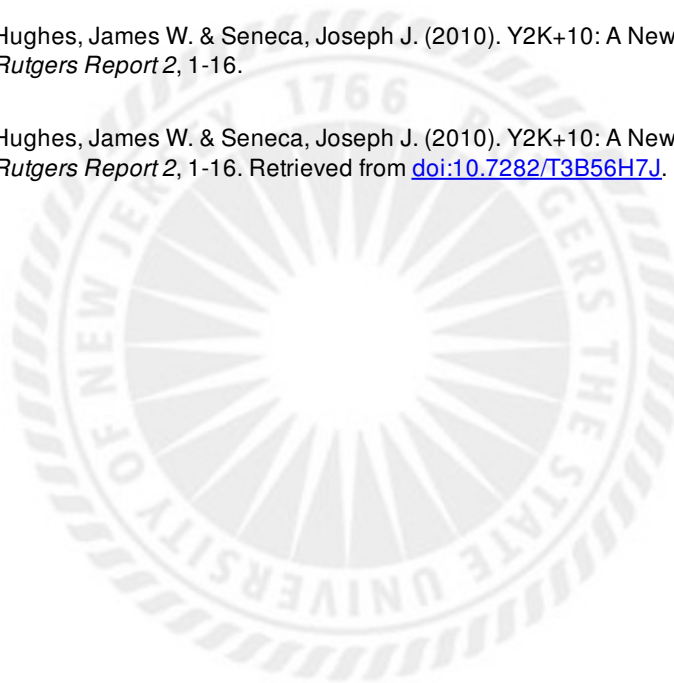


Y2K+10: A New Decade Unfolds

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Citation to Publisher Hughes, James W. & Seneca, Joseph J. (2010). Y2K+10: A New Decade Unfolds. *Advance & Rutgers Report 2*, 1-16.

Citation to *this* Version: Hughes, James W. & Seneca, Joseph J. (2010). Y2K+10: A New Decade Unfolds. *Advance & Rutgers Report 2*, 1-16. Retrieved from [doi:10.7282/T3B56H7J](https://doi.org/10.7282/T3B56H7J).



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ADVANCE & RUTGERS REPORT

Issue Paper Number 2 • February 2010

An Analysis of Economic,
Business & Demographic Trends

Y2K+10: A New Decade Unfolds

by James W. Hughes and Joseph J. Seneca



James W. Hughes



Joseph J. Seneca

We have just passed through a decade of economic disruptions that we just didn't see coming. Deceptively, this past decade's opening year (2000) provided only pleasant surprises, beginning with the fizzled failure of the over-hyped and much-dreaded Y2K bug to appear and solid job growth that seemed to promise there would be no interruption of a long period of unrelenting American prosperity.¹ Between November 1982 (the end of the deep 1981–1982 recession) and March 2001 (the end of the 1991–2001 expansion), total employment in the United States increased by an astounding 43.7 million jobs, with 38.8 million of these gained in the private sector. Visions of an ebullient post-millennial economy abounded. Unfortunately, the reality turned out to be punishingly different.

Fast forward a decade. It is now Y2K+10. Already one-tenth of the twenty-first century is gone. But, most of the nation should be very happy that it is gone! In retrospect, the century's opening 10-year period comprised America's lost economic decade.² For the first time since the 1930s, the nation experienced a loss in private-sector jobs, shedding more than 2.9 million private-sector jobs during the entire decade. The "Great American Job Creation Machine" that generated over 38 million jobs during the late twentieth century stalled badly in the new millennium.

¹The end-of-century period of extraordinary job growth, November 1982 to March 2001, was punctuated only by a very mild and shallow 8-month-long recession (July 1990–March 1991). During this entire 18-plus-year period, the United States was transformed from a fading manufacturing dynamo into a powerful post-industrial, knowledge-based, information-age economy.

²We measure the decade from December 1999 to December 2009, recognizing that there are alternative starting and ending dates that are used to define decades.

During the decade, the nation did experience a mid-period economic expansion (November 2001–December 2007) that was, in fact, considerably longer (73 months) than the average length (57 months) of the 10 preceding post-World War II expansions. But, it was bookended by two severe recessions: 2001 when the tech bubble burst, and 2007–2009 when the housing bubble burst. And the economic expansion, while relatively long, was weak in terms of job growth. It was also, as it turned out, debt-driven and ultimately proved unsustainable. Its main products were unprecedented housing and credit bubbles, rather than lasting income and employment gains.³ And the widespread aftershocks of the bursting bubbles sent America into the Great Recession (2007–2009), the worst economic decline since the Great Depression. The good news is that this decade has now been relegated to the history books.

As the first year of a new decade unfolds, the nation is no longer staring at the depths of recession but rather is anticipating potential economic recovery. Accordingly, it is now time to look forward with the perspective of hindsight and assess some key lessons of recent post-millennial events, particularly those that led to the seismic economic downturn. This report will focus on a series of observations and questions about our recent economic past, about the prospects for the current year, and about the likely economic context for the second decade of the twenty-first century. *(continued on page 2)*

³Trillions of dollars were poured into housing, dubious financial products, and excessive personal consumption expenditures rather than into the wealth- and job-creating economic foundations of tomorrow.

A Message from Advance Realty

A New Decade, New Challenges



Peter J. Cociello

As we rang in the New Year, many of us were as relieved to see 2009 laid to rest as we were excited to welcome 2010. The past year was a hard one, full of record-setting negative numbers, including job loss, stalled development, and a growing federal deficit. As described in this latest issue of the *Advance & Rutgers Report*, “Y2K+10: A New Decade Unfolds,” 2009 was a stark contrast to the beginning of the decade, when new heights of prosperity were being reached across a variety of sectors.

So much has happened over the past decade. For those of us in the real estate world, less bad has become the new good. Those who weathered the market downturn saw demand for new construction and commercial space dwindle virtually overnight. With unemployment numbers skyrocketing and consumer confidence diminished, the Great Recession forced us all to reevaluate our perceptions of what a truly robust and sustainable economy should look like.

Fortunately, that process has already begun. As noted by Professors James W. Hughes and Joseph J. Seneca in this report, construction of new homes finally stabilized in late 2009, making it the likely real estate sector to rebound first. But as the federal government pulls out its backing of mortgages, we will see just how stable this market truly is.

At Advance, we have seen firsthand an increase in commercial leasing activity during the last two quarters of 2009, as well as a “flight to quality” in the marketplace, with businesses increasingly looking to take advantage of market conditions to occupy prime commercial space. Downward pressure on rental rates, coupled with historically high vacancy rates, have made the current market an opportunistic one for creditworthy companies to negotiate lease renewals or make the move to new buildings. And while concerns persist in the marketplace that the numerous commercial real estate loans made during boom times soon to come due will deal another blow to the industry, the overall outlook among industry professionals is dramatically improved today from just one year ago.

One thing is certain: We can’t go back again. Credit and demand aren’t suddenly going to blanket the market as they did in the early years of the past decades. The consumer engine is out of steam and companies are learning to do more with less.

We need to rebound from the Great Recession with an eye on the recent past, ensuring that the same mistakes that were made then aren’t repeated. The upside is that we have a remarkable opportunity to reshape our economy, rebuild confidence in our businesses, and replace the jobs lost during the past years.

Coming out of 2009, a year that suffered tremendously—arguably because of shortsighted decision making—it’s time to seek sustainable solutions to the challenges we face. I can think of no better time than a new year and a new decade to start.

Peter J. Cociello, Founder and CEO—Advance Realty

Executive Summary

America entered 2010 with a stabilizing economy, and the nation is now poised to experience economic recovery. However, 2010 will just be the start of a very long road back. Under optimistic assumptions, it could take at least four years to recover the more than 8.5 million private-sector jobs lost during the Great Recession, and then an additional four years to get back to pre-recession labor market conditions.⁴ A key question is whether accelerating off-shoring, automation, efficiency gains, and information technology and management advances have permanently changed U.S. labor-market and job-creation “normalcy.”

Real estate development will probably hit its cyclical bottom in 2010. However, the industry will still continue to be constrained by a lack of demand in its many dimensions—tepid private-sector employment growth, corporate cost-cutting and efficiency efforts, small business stuck in survival mode, stifled household formation, and consumer retrenchment following an era of overconsumption. In fact, slack or moribund demand will hinder a substantial real estate market rebound for the early part of this decade.⁵ Still, it is a *new* decade, and even in distressed economic environments, new opportunities always emerge.⁶

- An optimistic America entered 2000 with strong economic tailwinds emanating from the last stages of a record-long economic expansion. In contrast, a pessimistic America entered 2010 facing strong economic headwinds, the result of the last stages

4. In addition to making up the recession’s job losses, America’s economy also has to provide employment for a labor force estimated by BLS to be growing at 1.28 million persons per year. The nation’s unemployment rate was 5 percent in December 2007. It will be many years before such labor market conditions return. See, *Advance & Rutgers Report*, Issue Paper Number 1 (September 2009).

5. Slower job growth will lessen the demand for new office space, corporate efficiency efforts will lead to less office space per worker and more requests for rent reductions, young graduates without jobs will refrain from forming households and from renting apartments, and ongoing consumer retrenchment will weaken demand for retail and distribution space.

6. Despite the massive problems in the credit commercial real estate markets, 2010 could present a rare opportunity to acquire distressed properties at bargain basement prices—an unprecedented acquisition environment for liquid investors.

of a record-long economic contraction. What a difference a decade made!

- The nation entered 2008 just as the mid-decade economic expansion came to an end. A year later, it entered 2009 staring into the economic abyss. It then entered 2010 reassured that economic and financial catastrophe had been avoided. So, the start of 2010 is starkly different from the start of 2009—the nation is now eagerly looking at economic recovery versus staring last year, numbly, at economic Armageddon. What a difference a year made!
- During 2009, the second year of the *Great Recession*, many of our dire economic forecasts were realized. But, by the end of the year, the *Great Recession* had been supplanted by the *Great Stabilization*.
- Still, a final retrospective on 2009 shows that it was a record-setting year, though unfortunately these records were negative ones! The year's annual job loss was the highest since payroll employment statistics were first compiled in 1939. The year's level of housing production was the lowest since housing-start statistics were first compiled in 1959. And the federal budget deficit (FY 2009) was the highest since the founding of the republic. The best news, perhaps, is that 2009 is now finally history.
- The final retrospective on the decade of the 2000s shows that it, too, was a dubious record-setter. The decade was the first since the 1930s to have ended with fewer private-sector jobs than when it started. And, the decade contained the three worst private-sector job loss years ever in the history of the country: 2009, 2008, and 2001 (in descending order).
- Thus, the three biggest job loss years of the 71 years of record keeping happened during the first decade of the twenty-first century. This is certainly not what we expected from the new millennium.
- The performance of the economy in 2010 and beyond has not yet been determined. The anticipated recovery could take many forms.

An economic “calligraphy,” based on historical evidence, describes the alternative possibilities.

- One precedent is that deep recessions have traditionally been followed by strong and robust recoveries. This would lead to a “*V-Shaped*” *Recovery*—a sharp employment rebound.
 - A second precedent is that recessions caused by deep financial crises usually produce weak recoveries. This would lead to an “*L-Shaped*” *Recovery*, i.e., labor markets bouncing along an employment bottom for an extended period of time.
 - Since the Great Recession was characterized by both types of crises, a combination of the two would lead to a “*Reverse Square Root*” *Recovery*! The sharp decline in economic activity would initially be followed by a sharp rebound. But before full recovery is achieved, the economy levels out, though an extended period of minimal growth ensues.
 - There is yet a fourth possibility that would stem from an economy initially rebounding from a recession only to relapse into a second downturn. This “*W-Shaped*” *Recovery* is also known as a “double-dip” recession, or a “second leg down.”
- The *Great Stabilization* of 2009—the aversion of economic and financial catastrophe, and the probable end of recession—was largely the result of unprecedented governmental fiscal stimulus and monetary interventions, and temporary rebuilding of inventories by the private sector. What is the fiscal exit strategy in 2010, and what are its potential problems? The answers to these questions will determine the year's economic performance.
 - Will 2010 begin a new era of consumer retrenchment and mark the end of over-dependence on over-consumption to drive the economy? Is the current consumer frugality simply a temporary artifact of a painful business-cycle correction? Or, is it a seismic permanent shift in consumer culture? The answers to these questions will have powerful ramifications for many real estate

markets in 2010 and the overall performance of the nation's economy.

- How do we now forecast new development baselines? The boom years between 2000 and 2007 offer little guidance. These years defined a period of epic abnormality, driven by a tsunami of abundant, seemingly risk-free, global credit and extraordinary low interest rates. The credit and demand futures will not look like the past, and new real estate development paradigms are destined to emerge in 2010. Economic and financial reality will be back in charge.
- Is housing production destined to be the first real estate sector to rebound? Construction finally stabilized in 2009, following nearly three years of freefall, but only because it was placed on a large amount of federal life support. What will happen when the adrenaline of such support is withdrawn? Will private investors, who have been largely absent from the mortgage-backed securities (MBS) market, return as buyers and take the federal government's place? If they do, will they demand a higher rate of return on the securities, increasing mortgage interest rates and threatening the recovery? Will households buy homes without tax incentives and federally supported mortgages?
- Will commercial real estate (CRE) finally bottom out in 2010? With rents falling and vacancies rising, it now confronts the classic *over and under* problem: *over-valued, over-leveraged, under-leased, and under-cash-flowed*. A record number of CRE loans made during the boom years are coming due and must be refinanced over the next three to five years. This may be a monumental problem, particularly given the complicated tranche structures that may have to be unwound and disentangled in the commercial mortgage-backed securities (CMBS) markets. Hopefully it will be the last big challenge to the financial system—the final stage of the global debt problem.
- A key question is whether CRE will face the same scale of financial aftershocks and mortgage pain that hit housing as its price and MBS bubbles burst. Will a federal rescue for CRE be necessary in 2010? Can a new CMBS model be devised?

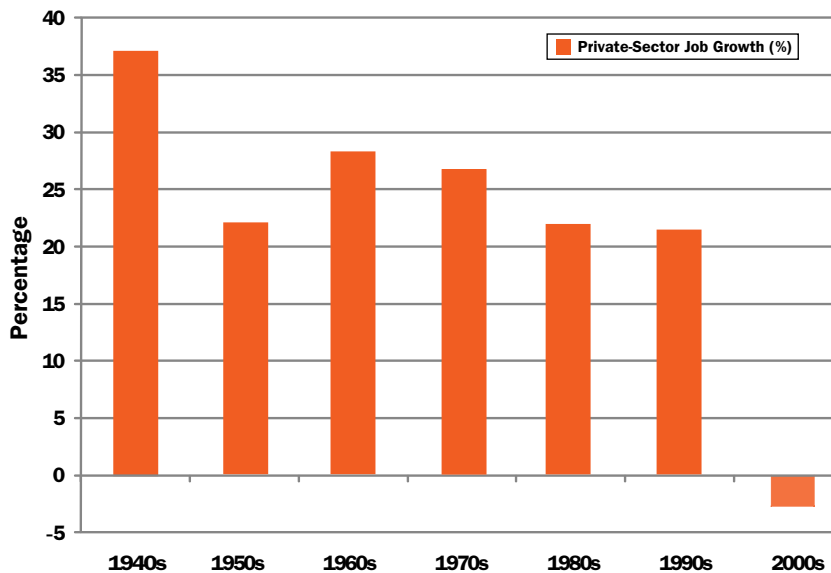
- Will small business return in 2010? Small business, variously defined, has been the major employment generator in the United States and has, by far, the largest share of the nation's jobs. Consequently, restarting America's job creation machine in 2010 depends on small business.
- While most large firms have been able to obtain credit without great difficulty as 2009 came to a close—mainly through access to public equity and bond markets—the credit crunch continues for small business, which depends heavily on bank lending and credit card lines. But bank lending contracted sharply through 2009, and banks continued to tighten the terms on which they extend credit. Unless small businesses can access credit, they can't grow and they can't hire, greatly inhibiting the recovery.
- Looking forward, the new decade will have to confront a new problem: the *Great Reckoning*. This will be the bill for the *Great Stabilization*—namely, paying for the massive fiscal and monetary stimuli and the record budget deficits that helped to halt the decline in the nation's economic output. Will the glut of public debt and monetary expansion ultimately be a drag on economic growth in the years ahead?

What a Difference A Decade Makes!

If 2010 were to have a theme song, "*What a Difference a Decade Makes!*" would be highly appropriate. The first year (2000) of the first decade of the twenty-first century turned out to be the tail end of the *Great Transmillennial Expansion*, the record 10-year-long economic upswing (March 1991 to March 2001), during which the United States gained 21.5-million private-sector jobs. The year 2000 also followed a record employment-growth decade, when the nation added 19.3 million private-sector jobs.⁷ Employment increases then slowed somewhat in 2000.⁸ Thus, America entered

7. Again, we measure the decade from December 1989 to December 1999, a 120-month period.

8. In 2000, employment increased by 1.7 million private-sector jobs; the inflation rate (CPI—all items) was 5.6 percent.

FIGURE 1. United States Private-Sector Job Growth (%)

Source: U.S. Bureau of Labor Statistics.

the then new decade with powerful economic tailwinds, unbridled optimism, and substantial employment growth momentum. However, just 15 months later the economy would falter badly as the March 2001–November 2001 recession began.

In contrast, 2010 is a year in the immediate aftermath of the *Great Recession*, the deepest slump since the Great Depression.⁹ America has now entered the second decade of the twenty-first century with powerful economic headwinds—burdened by an unemployment rate of 10 percent and an underemployment rate of 17.3 percent (December 2009)—as well as unbridled pessimism. The year 2010 also followed the *lost employment decade*, a ten-year period when the nation lost 2.9 million private-sector jobs.¹⁰ This unprecedented job decline is put into perspective in figure 1, which shows private-sector employment growth rates by decade since the 1940s. Until the 2000s, private-sector employment growth for a decade never fell below 22 percent! What a stark difference exists between the start of the last decade and that of the current decade!¹¹

9. The recession officially started in December 2007, according to the Business Cycle Dating Committee of the National Bureau of Economic Research (NBER). As of this writing, NBER has not declared its end. However, the change in Gross Domestic Product turned positive (+2.2 percent) in the third quarter of 2009, setting expectations that the recession ended in

And, What a Difference A Year Makes!

A second official 2010 song may also be highly appropriate: “*What a Difference a Year Makes!*” The nation entered 2008 just as the November 2001–December 2007 expansion expired. It was the first year of the *Great Recession*, with the downturn intensifying as the year matured: The economy got worse at an *accelerating* pace, culminating in the failure of Lehman Brothers in the autumn. America then entered 2009 in the midst of a virtual economic cataclysm; panic abounded and financial markets were close to collapse. In January alone, 806,000 private-sector jobs were lost, a historic record (absent unique circumstances).¹² The nation was

the summer of 2009. An advance estimate by the U.S. Department of Commerce puts fourth quarter 2009 GDP growth at 5.7 percent.

10. This was the first time since the 1930s that America ended a decade with fewer private-sector jobs than it started with.

11. Another stark yearly comparison concerns the nation’s fiscal condition. In 2000, the first year of the decade, the U.S. federal budget was in *surplus*. In FY 2009, the nation had a record \$1.4 trillion *deficit*.

12. These will be detailed subsequently.

staring into the economic abyss. Then, as the year advanced, the employment decline continued, but at a *decelerating* pace. This became popularly known as the “good news” employment second derivative (from Calculus 101), a declining rate of change of the negative rate of job change.¹³ In any case, by the end of the year, panic had abated, and financial markets stabilized.

Thus, 2009 turned out to be the year when many of our most dire economic forecasts were realized.¹⁴ But, it also was the year that economic catastrophe was avoided—a year when the *Great Recession* was supplanted by the *Great Stabilization*.¹⁵ So, the start of 2010 is starkly different from the start of 2009—the nation is anticipating an economic recovery versus staring at an economic Armageddon. If 2010 were to be a movie, its title would aptly be “From Eternity to Here”—with eternity consisting of a crushing, seemingly-without-end, recession that has been replaced by the here and now of an economy that has been stabilized.

2009 in Retrospect: A Record-Setting Year

Multiple records were set in 2009. Unfortunately, these were not records that anyone would ever want to experience, since all were highly negative. Measures for both the scale of private-sector job losses and for the duration of a post-World War II recession set new records. Before the Great Recession, the longest a postwar recession had lasted was 16 months.¹⁶ This happened twice—during the recession of November 1973 to March 1975, and again during the recession of July 1981 to November 1982. The Great Recession officially started in December 2007. It became 16 months long in April

13. Technically, the second derivative of the employment function with respect to time became positive.

14. For example, the nation lost 4.7 million private-sector jobs in 2009, the worst employment contraction year in history. That year supplanted the previous record-holder, 2008, when more than 3.8 million jobs were lost.

15. *The Economist*, December 19, 2009, p.15.

16. The official dates of the Great Depression were from August 1929 to March 1933, a duration of 44 months.

2009, and, as a result, matched the length of the 1973–1975 and 1981–1982 downturns. Accordingly, in May 2009, a new record was set—17 months and counting. As the year closed, the nation was still experiencing private-sector employment declines.

The National Bureau of Economic Research is likely to eventually determine that the Great Recession ended sometime in the third quarter of 2009, when the change in Gross Domestic Product (GDP), the total output of the U.S. economy, turned from negative to positive. In that quarter, GDP grew at a 2.2 percent annual rate after declining previously for four straight quarters.¹⁷ Nonetheless, even if the recession ended in that quarter, it will still be the longest postwar downturn.

The scale of employment losses was also record-setting. The once “Great American Job Creation Machine” fully expired in the past two years and was replaced by the “Great American Job Destruction Machine.” The first year that payroll employment statistics were compiled was 1939. The two largest *annual* private-sector job losses of the subsequent 71-year period (through December 2009) occurred in 2009 and 2008. In 2008, a new record was set when 3.8 million private-sector jobs were lost. But that year quickly relinquished this dubious title! It was supplanted by the 4.7 million private-sector jobs lost in 2009, which became the new all-time annual job loss record-holder.

But wait, unfortunately, there’s more! The third worst annual private-sector employment loss since 1939 occurred in 2001 (-2.3 million jobs). Thus, the three largest job loss years of the 71 years of record-keeping all occurred during the first decade of the twenty-first century! The end result was the lost employment decade described above.

The worst *monthly* private-sector employment loss of the 2007–2009 recession was January 2009 (-806,000 jobs). This could also be considered a record even though it technically ranks third in the 851 months of record-keeping (January 1939–December 2009). Two other months had greater losses, but these were both the result of unique one-time special events. In September 1945, private-sector employment in the United States

17. GDP then grew in the fourth quarter by 5.7 percent (U.S. Department of Commerce, advance estimate).

declined by an astounding 1,773,000 jobs. This was caused by the abrupt demobilization of America's great World War II arsenal of democracy.¹⁸ As military production was dismantled, it began to be supplanted by civilian-goods production. In fact, the very next year, 1946, had the greatest private-sector employment growth in history (+4.4 million jobs), as the transition to a peace-time economy reached warp speed. The second worst employment-loss month was October 1949 (-814,000 private-sector jobs). But this loss was precipitated by a vast nationwide steel strike that started the first day of that month.¹⁹ At that time, the steel industry was a powerful locomotive of a manufacturing-dependent American economy, and the strike rapidly rippled through other sectors, producing the large monthly job loss.

So absent such special, deliberative actions—the shutting down of the military production machine and a precipitous nationwide strike in a key industry—January 2009 could be considered the dubious record-holder, adding to the year's other dismal trophies: namely, the longest post-World War II recession and the largest annual private-sector employment loss. Finally, the federal budget deficit in FY 2009 (\$1.4 trillion) was the largest in the nation's history. The previous record deficit was \$459 billion, and that occurred in 2008! The good news is that 2008 and 2009 are now both in the history books.

The Shape of the 2010 Recovery: Economic Calligraphy

Historical precedents suggest two different patterns of economic recovery and employment growth for 2010 (figure 2). The first is that deep recessions have traditionally been followed by strong

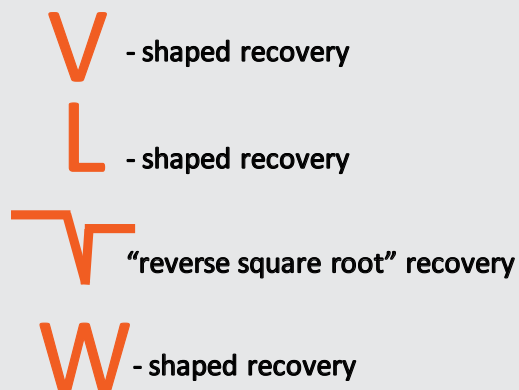
and robust recoveries. And, as we have seen, the Great Recession of 2007–2009 has been the steepest downturn since the Great Depression. In the current context, the sheer severity of the employment losses recorded to date may include a panic-induced overreaction—too many workers were eliminated too fast. Anorexia-driven, cost-conscious corporations tightened their belts till they didn't have a waist! Consequently, these businesses may now be caught short when the recovery gathers momentum. This suggests a strong employment bounce-back. In terms of economic calligraphy, this would be a “*V-Shaped*” *Recovery*, a sharp employment rebound following an extraordinarily steep decline.

The second historical precedent is that recessions that have been caused primarily by deep financial crises usually produce extended weak recoveries.²⁰ In the current context, where the nation has just experienced a near financial panic and despite extraordinary absolute employment cuts, lean hiring may, nevertheless, still ensue because of the scale of underemployment that now exists. Many companies, rather than laying off even more workers, reduced their hours and placed workers on part-time or furlough status. As evidence, the average work week in November 2009 was close to a record low: 33.2 hours. This indicates that there is a large amount of room to expand the hours worked of the existing labor force. Thus, underutilized workers will first be more than fully utilized before new hiring takes place, i.e., there will be a continuum of employment recovery that moves workers from part-time to full-time to overtime prior to the hiring of additional workers. In terms of economic calligraphy, this would lead to an “*L-Shaped*” *Recovery*, i.e., labor markets bouncing along the employment bottom for an extended period of time. This is also known as a “hockey stick” recovery, where an economy stays down in terms of employment gains for a long period following a steep plunge. Such a pattern commonly emerges following a downturn triggered by the bursting of an asset bubble.

18. The cessation of military production led to the February 1945–October 1945 recession. During 1945, 2.2 million private-sector jobs were lost. This remained the worst post-recession job-loss year until the first decade of the 2000s, when, sequentially, 2001, 2008, and 2009 each surpassed it and each other!

19. Approximately 500,000 CIO steel workers closed down the nation's foundries, steel and iron mills, joining 400,000 coal miners on strike.

20. The usual poster-child example is Japan and its loss of two decades of economic growth following the collapse of its overleveraged, under-risk-assessed financial sector in early 1990.

FIGURE 2. Economic Calligraphy

Source: *Advance & Rutgers Report*, Issue Paper No. 2, February 2010.

Thus, two historical constructs—the sharply different aftereffects of deep recessions versus those of deep financial crises—produce diametrically opposite expectations for employment growth in 2010. Combining them (since both conditions were present in the Great Recession) produces a result that is best captured by a “*Reverse Square Root*” Recovery! The sharp decline in economic activity would initially be followed by a sharp rebound. But before full recovery is achieved, employment gains level out and are followed by an extended period of minimal growth. This could also be labeled a “half-fledged” recovery, as distinguished from a full-fledged V-shaped recovery, and further distinguished from a “no-fledged” L-shaped recovery.

There is yet a fourth (and less likely) possibility that would stem from an economy initially rebounding from a recession only to relapse again into a second downturn. This “*W-Shaped*” Recovery is also known as a “double-dip” recession, or a “second leg down.” The fragility of America’s post-stimulus economy—and the questionable return of private engines of economic growth—could produce this outcome.

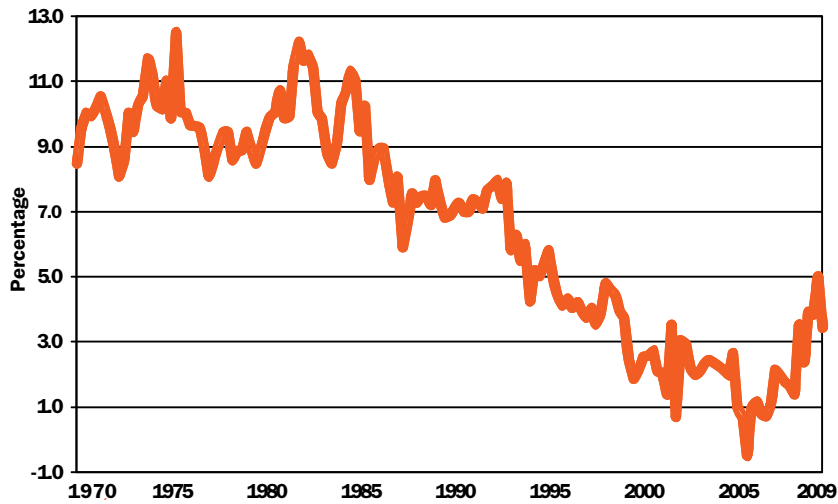
Therefore, there are many alternative economic paths for the United States in 2010, and the precise outcome among these possibilities is not yet clear.

The Post-Stimulus Economy: An Exit Strategy and Private-Sector Response

The *Great Stabilization* of 2009—the aversion of catastrophe, and the probable end of recession in the third quarter of that year—was largely the result of an unprecedented federal fiscal stimulus and major monetary interventions, helped by the temporary rebuilding of very-much-depleted inventories by the private sector. Gross Domestic Product (GDP) expanded in the third (+2.2 percent) and fourth (+5.7 percent) quarters of 2009, following four straight quarters of decline. This suggested that the recession may have technically ended in the third quarter. However, this return to growth has been driven by federal fiscal stimulus—the \$787 billion of the American Recovery and Reinvestment Act, which will continue to be spent well into 2010—and a series of drastic monetary policy interventions by the Federal Reserve (“the Fed”), the Treasury, and the Federal Deposit Insurance Corporation. The Fed has kept short-term interest rates near zero since December 2008 and has made massive purchases of long-term U.S. bonds, residential mortgages, consumer debt, small business debt, and other debt instruments. As a result, there have been large injections of liquidity into the financial system, and the precarious national and global credit market conditions of late-fall 2008 have stabilized. In addition, special actions have protected money market funds, raised deposit insurance limits, and provided direct lines of credit to banks and other large financial institutions.

However, these extraordinary interventions are destined to fade in 2010. If final private demand—business investment, foreign purchases of U.S. exports, and consumer spending—does not accelerate and replace the slack created by diminished federal spending, then the dreaded “double-dip” recession becomes more likely. Therefore, if private spending does not step up, there will be pressure for additional federal stimulus spending. But such spending becomes ever-more problematic given the size of the fiscal deficit. Thus, decisions on the extent, timing, and content of the monetary and fiscal policy exit strategy will critically determine economic performance in 2010. Adding to

**FIGURE 3. Personal Savings as a Percentage of Disposable Income
United States, 1970–3Q 2009 (Quarterly)**



Source: U.S. Bureau of Economic Analysis.

this complexity is the fact that 2010 is a Congressional election year, and political pressures to generate employment growth will increasingly conflict with political concerns about fiscal discipline.

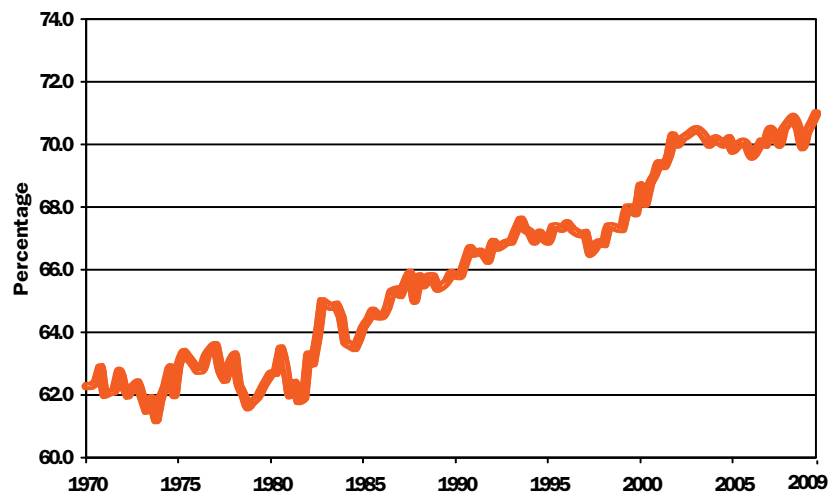
Is the Era of Consumer Retrenchment Upon Us?

Has the once all-powerful locomotive of consumer spending run out of steam? Is the current consumer frugality simply a temporary artifact of a painful business-cycle correction, or is it a fundamental secular shift that reflects a broad post-recession societal reset? The answer to this question has powerful ramifications for many real estate markets in 2010 and for the performance of the overall economy.

For two decades, shopping and consumption were like a drug for most Americans. Seemingly, U.S. households became unrepentant shopaholics—became the most overextended consumers in world history—by maxing out on plastic credit and using their houses as ATM machines. We were living in happy-happy land, spending what we did not have, living the debt-fired dream of consumption without end and without limit.

Figure 3 presents the U.S. savings rate—personal savings as a percentage of disposable income—from 1970 to 2009. For the first 16 years—1970 to 1986—America was relatively prudent, with a savings rate averaging roughly 10 percent. Then, a long sustained slide began, and the savings rate reached zero by 2005! At the same time, personal consumption as a percentage of GDP soared in the United States (figure 4). From 1970 to 1982, personal consumption accounted for roughly 63 percent of GDP. Thus, consumption made up 63 percent of the nation's total economic output. By 2000, it hit 68 percent. That year can be considered the start of America's great consumption bubble. Over the next seven years, the nation went on the greatest spending spree in the history of the planet, and consumption spending rose to more than 70 percent of GDP. These biblical "seven years of plenty" became the engine of global economic growth. But, the extraordinary spending binge in the United States—which was built on debt and was at the heart of global financial imbalances—may no longer be sustainable. So, the adage "When the going gets tough—the tough go shopping" may now be history. Significant consumer retrenchment now characterizes America.

**FIGURE 4. Personal Consumption as a Percentage of GDP
United States, 1970–3Q 2009 (Quarterly)**



Source: U.S. Bureau of Economic Analysis.

Just like financial institutions, households have been forced to deleverage and recapitalize. They have too much debt and too little savings, and their balance sheets are stretched to the limit at a time when home equity has been greatly reduced, financial assets remain significantly below their 2007 peaks, and labor markets are still weak. This is a bad, bad combination for the consumer in the short term and has led to a rebound in the savings rate—which reached 4.7 percent in November 2009 as consumers shed their spendthrift ways. However, a key question is whether this household response is cyclical or whether it constitutes a structural change in consumer behavior. Will households return to their profligate ways once the economy recovers, or will the shift from spendthrift to penny-pincher endure? Will the current frugality morph into spending excesses again, or will it lead to a new normal, defined by more sustainable, practical lifestyles, with consumption as a share of GDP declining, savings rates rising, and lower household debt-to-income ratios? It is difficult, at this point, to see another consumer spending binge driven by easy access to low-cost credit. However, a permanently reduced level of consumer spending would have profound impacts, in particular, on

housing, retail, and other commercial real estate markets, and it would send a powerful long-term ripple through the economy.

Forecasting New Baselines: New Development Paradigms

What is the broad reference framework for viewing the future of both residential and commercial real estate development? A look in the economic rearview mirror is often an informative place to seek guidance. Unfortunately, the years between 2000 and 2007 defined a period of epic abnormality—a unique time of unprecedented over-exuberant excesses. A tsunami of abundant, seemingly risk-free, global credit and extraordinary low interest rates drove Wall Street and the broader economy of the period. It made many real estate, housing, and development projects possible that simply weren't feasible before. They were made so because of cheap, easy credit and risk amnesia, not because of strong underlying economic-market fundamentals.

But the era of severely underpriced and under-acknowledged risk has passed from the scene. The

return to rational lending standards will make many projects impossible again. Clearly, the platinum years of financial market innovations that propelled real estate markets to new heights are past. Prudence and pragmatism now define an “old-is-new again” credit reality. Development projects will have to meet much stricter market tests and equity requirements. A much-chastened real estate sector, formerly addicted to highly leveraged and cheap-and-easy financing, is surely destined to be fundamentally reshaped.

Consequently, 2000 to 2007 are the worst years to use as a set of expectations for the future. They are the worst years to use as a projection baseline. What they most likely, in fact, tell us is what the future *will not* be. Thus, many of the business models that flourished during the 2000–2007 period are not the appropriate business models going forward. Moreover, the development paradigms that flourished during this period are also obsolete. They will have to be reshaped and recalibrated to function within the constraints of the new financial norms. While the ultimate shape of the latter is not yet clear, we can be certain we are not going back to the real estate world as it was between 2000 and 2007. The future will not look like the past, and new development paradigms are destined to emerge in 2010.

Can the Life-Support Plug Be Pulled on Housing in 2010?

The American housing-construction machine finally stabilized in 2009, following nearly three years of freefall (figure 5). Housing starts plummeted from an annualized peak monthly rate of more than 2.2 million units in 2006 to below 600,000 units at the end of 2008.²¹ Starts then plateaued at that level throughout 2009, but only because housing was placed on massive federal life support.²² Since the advent of the housing crisis, the federal government has provided most of the liquidity in the nation’s

21. This is the lowest level of housing production in the 50 years of record-keeping that started in 1959—another dubious economic record achieved in 2009.

22. Robust federal intervention on both the demand and supply sides of the housing market has made the U.S. government the dominant, if not arguably the sole, force in housing.

mortgage market, effectively guaranteeing more than 90 percent of all home loans issued in the United States. This is double the share before the housing bubble burst. While this has stabilized housing, a key question is what will happen when this adrenaline of support for housing financing is withdrawn. How will housing fare when the government spigots are turned off? And if they are not turned off, will production and demand be able to rise above 2009’s stabilized, but still record-low, levels?

A major catalyst for stabilization was the Federal Reserve program that is purchasing \$1.25 trillion of mortgage-backed securities issued by the beleaguered government-sponsored entities (GSEs), Fannie Mae and Freddie Mac.²³ This action helped push long-term 30-year fixed-interest rates below 5 percent by the end of 2009. The weekly Freddie Mac interest rate survey was initiated in 1971. The all-time weekly low occurred in the first week of December 2009, when rates fell to 4.71 percent.

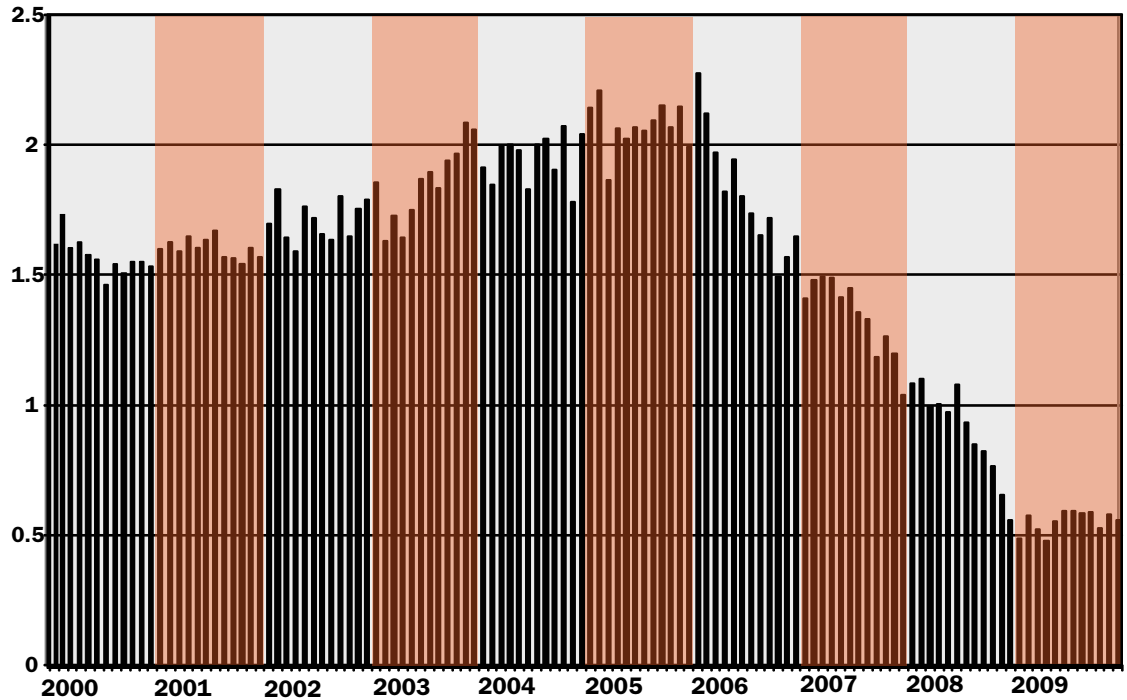
But, by the end of March 2010, the Federal Reserve is expected to start reducing, and not adding to, their holdings, thus ending their new purchases of the mortgage-backed securities of Fannie Mae and Freddie Mac. The U.S. Treasury will also end its purchases of their mortgage-backed securities. Thus, a major support of the housing market will be reduced. Will private investors, who have been largely absent from the market, return as buyers and take the Fed’s place? If they do, will they demand a higher rate of return on the securities compared to the Fed, thereby increasing mortgage interest rates and negatively affecting housing demand?

Other support structures will remain. Fannie Mae and Freddie Mac—mortgage giants that combined have a \$1.5 trillion portfolio of mortgage-related securities—are bolstered by a \$400 billion equity lifeline from the Treasury to cover their losses.²⁴ They were supposed to be weaned from this lifeline, but on

23. Fannie and Freddie provide vital liquidity to the mortgage industry by purchasing home loans from lenders and selling them to investors. Together, they own or guarantee almost 31 million home loans worth about \$5.5 trillion, or about half of all mortgages.

24. Combined, the two enterprises have already used \$111 billion in 2009 to keep solvent. Threatened by mounting mortgage defaults, they were facing collapse before the December 24, 2009 credit expansion by the Treasury.

**FIGURE 5. Monthly Housing Starts at an Annual Rate
United States, 2000–2009
(seasonally adjusted, in millions)**



Source: U.S. Census Bureau.

December 24, 2009, significant new financial support was announced, effectively removing the \$400 billion financial cap for three years. In addition, the two GSEs were originally supposed to shrink their giant mortgage portfolios by 10 percent in 2010. This requirement has been relaxed, and they will be allowed to reduce these holdings more slowly. Such a sweeping increase in the government's commitment to backstop the two entities may be an implicit acknowledgment by the Treasury that private lenders would be reluctant to invest in these securities without government guarantees.

Another component of the federal life support, this one on the demand side, is the tax credit for new home buyers. This credit was originally set to expire on November 30, 2009, but has been both expanded and extended to April 30, 2010 (home purchase contracts must be signed as of this date).

The expanded program now includes existing homeowners.²⁵ Will the credit be extended past April, or will housing consumers be weaned off this subsidy?

With Fannie Mae and Freddie Mac hemorrhaging loan losses, the Federal Housing Administration (FHA) has also ramped up its program of insuring home loans with down payments as low as 3.5 percent, effectively becoming the nation's subprime lender. This prop is likely to continue. These actions combined suggest that there is little confidence that housing will be ready to stand on its own in 2010.

25. The initial program provided for an \$8,000 tax rebate for first-time buyers—those who have not owned a home for the past three years. The expanded program retains that and also includes a \$6,500 credit for repeat buyers—those who have owned and occupied a residence for at least five of the past eight years. In addition, the income eligibility was raised from \$150,000 to \$225,000 for couples, and from \$75,000 to \$125,000 for individuals.

A more nuanced problem may also have been created: The demand subsidies elicit a rational strategy by potential home buyers to withhold demand in periods when the federal subsidy is not present, only to rush to take advantage of the subsidy when it is present. This can create booms and busts in housing demand. By withholding demand, home buyers generate market and political pressures to restore the subsidy, a problem that auto producers encountered when trying to stop incentive programs put into effect during the 2001 recession.

Commercial Real Estate 2010: The Last Challenge (Hopefully)

With rents falling and vacancies rising, commercial real estate (CRE) faces the classic *over and under* problem in 2010: *over-valued*, *over-leveraged*, *under-leased*, and *under-cash-flowed*. During the 2004–2007 heights of the CRE boom, with the availability of extraordinarily cheap capital desperately seeking higher yields while being afflicted with risk amnesia and overly optimistic projections of future rent levels (and therefore overly optimistic estimates of future values), investors used significant leverage to purchase, build, or reposition income-producing commercial properties. The issuance of commercial mortgage-backed securities (CMBS) soared, peaking in 2007, and helping to propel commercial markets to new highs.

However, as the Great Recession began, rent and vacancy fundamentals started to erode, a process that accelerated as the recession intensified. With many overleveraged commercial properties now underwater—mortgages in excess of current building value—the CMBS market in the United States has virtually evaporated. A record number of commercial real estate loans made during the boom years are coming due and must be refinanced over the next three years.²⁶ This may be a monumental problem, particularly given the complicated tranche structures that may have to be

26. The amount of such loans estimated to roll over is about \$250 billion annually for the next three years (see, “Capitalist Fools,” *The Atlantic*, January/February 2010).

unwound. Hopefully, however, this will be the final big challenge to the financial system—the final stage of the global debt problem. A key question is whether CRE will face the same scale of financial aftershocks and mortgage pain that hit housing as its price and mortgage-backed securities (MBS) bubbles burst.

Banks have postponed the day of reckoning by loan extensions, by resisting the taking of properties from underwater borrowers, by not marking their commercial real estate assets to market, and by refusing to sell assets. The worst-case scenario is that office and commercial real estate financed during the credit bubble will ultimately generate another wave of severe bank losses. Consequently, 2010 could turn out to be a long and cold CRE winter.

Whatever the ultimate severity of the crisis, it has the potential to impact even well-positioned, financially sound commercial properties. Already there have been incidences of distressed properties purchased at bottom-feeding prices, and—after building improvements of various levels—reentered into the market at significantly below-average rents. This not only threatens the loss of tenants from sound commercial properties but also has the capacity to push down the rent structures of entire markets, lowering rental incomes and creating further negative effects on refinancing.

The Return of Small Business

While much of Washington’s recession attention has been focused on big business—such as large financial institutions and the legacy automobile producers—small businesses have received much less attention as the nation’s employment rolls tumbled by more than 8.5 million private-sector jobs (December 2007–December 2009).²⁷ But we should not lose sight of the oft-repeated fact that small business is responsible for most of the employment growth in the country and employs, by far, the largest share of the nation’s workers.

In the first quarter of 2009, the last available employment data, establishments with 500 or more employees

27. The U.S. Small Business Administration has established two widely used size standards for small business—500 employees for most manufacturing and mining industries, and \$7 million in average annual receipts for most nonmanufacturing industries. There are many other definitions for other industry sectors.

TABLE 1

**U.S. Private-Sector Employment by Establishment Size:
First Quarter 2009 and First Quarter 2003–First Quarter 2008 Expansion**

Establishment Size (Number of Employees)	Q1 2009		Expansion Period Change: Q1 2003–Q1 2008		
	Number	Share	Number	Percentage	Share
All Establishments	107,121,765	100.0	7,164,506	6.8	100.0
< 5	8,043,107	7.5	724,369	9.9	10.1
5–9	9,055,069	8.5	501,169	5.7	7.0
10–19	12,371,450	11.5	944,723	8.1	13.2
20–49	18,642,361	17.4	1,556,890	8.7	21.7
50–99	14,317,167	13.4	1,219,030	8.8	17.0
100–249	17,301,858	16.2	1,475,134	8.6	20.6
250–499	9,740,085	9.1	630,390	6.4	8.8
500–999	6,815,650	6.4	271,475	3.9	3.8
1,000+	10,835,019	10.1	-158,673	-1.4	-2.2

Source: U.S. Bureau of Labor Statistics, *Quarterly Census of Employment and Wages*.

accounted for just 16.5 percent (or, 17.7 million jobs) of America's total private-sector employment of 107.1 million jobs (table 1). In contrast, smaller establishments, with 499 or fewer employees, accounted for 83.5 percent (89.5 million jobs). So the vast majority of the nation's employment is concentrated in smaller firms.

The role of small business is even more significant in terms of employment growth. Between 2003 and 2008, when the nation added 7.2 million private-sector jobs, more than three out of ten (30.3 percent, or 2.2 million jobs) were created by establishments with 19 or fewer employees; more than five out of ten (52.0 percent, or 3.7 million jobs) were created by establishments with 49 or fewer employees; nearly seven out of ten (69.0 percent, or 4.9 million jobs) were created by establishments with 99 or fewer employees; nearly nine out of ten (89.6 percent, or 6.4 million jobs) were created by establishments with 249 or fewer employees; and more than nine and one-half out of ten (98.4 percent, or 7.1 million jobs) in establishments with 499 or fewer employees. So, the latter category (499 or fewer employees), while accounting for 83.5 percent of all jobs in 2009, accounted for 98.4 percent of the nation's employment growth in the 2003–2008 period.

In contrast, only 1.6 percent (113,000 jobs) were created in establishments with 500 or more employees

even though these establishments represented 16.5 percent of total employment. And all of the jobs created in establishments of 500 or more employees took place in the 500–999 employee category (271,000 jobs). Very large-scale establishments—those with 1,000 or more employees—actually contracted in size even during this period of economic growth (-159,000 jobs). The bottom line is that small business has accounted for the lion's share of employment growth and represents an increasing share of total employment in America, while big business employment has been largely stagnant or declining.

Consequently, the long-sought return to employment growth in 2010 depends on small business. However, credit is still tight for this sector, and this could significantly inhibit job growth. While most large firms were able to obtain credit without great difficulty as 2009 came to a close—mainly through access to public equity and bond markets—the credit crunch has continued for small business, which depends heavily on bank lending and credit card lines. But bank lending contracted sharply through 2009, and banks continued to tighten the terms on which they extend credit. Unless small businesses can access credit, they can't grow and they can't hire. The major job-growth locomotive will remain on the siding.

Lessons Learned and Not

The Great Recession of 2007–2009 did not descend into the second coming of the Great Depression of 1929–1933. But the lessons learned from the Great Recession, as of this writing, appear destined to pale against the lessons learned from the Great Depression, out of which powerful financial reforms and overhauls were set in place that helped provide more than a half-century of general economic and financial stability.²⁸ The current financial system has been rescued due to extraordinary federal government interventions, but the system has not yet been reformed. While there have been ambitious proposals—a council of regulators to oversee systemic risk, a national consumer protection agency, and stricter standards for hedge funds, private equity firms, bank-holding companies, and credit-rating agencies—there is now fear that the window of opportunity for instituting reforms is quickly closing and that the momentum for fundamental change is waning.²⁹ Key questions for 2010 are whether significant, systemic financial regulatory reform will occur, or whether any reform will be so diluted as to diminish its ability to prevent a future financial system crisis.

The Great Reckoning

Lexicographers and pundits struggling to label the century's first decade came up with the "aughts" or the "aughties" as possible solutions. But given the dismal performance of the economy, the more appropriate name for this period might be the "naughts" or the "naughties." While the "naughties" did end with the Great Stabilization supplanting the Great Recession, the century's second decade will eventually see the Great Reckoning—the aftereffects of the stimulus binge that produced the stabilization.³⁰ While massive fiscal stimuli and record budget deficits did effectively help to halt the decline in the nation's

economic output, there is a cost that still must be borne during the current decade: a glut of public debt that will be a drag on economic growth to come. Will the ever-growing mountain of public debt crowd out private borrowing? Will it cause interest rates to rise? Will taxes have to be increased significantly as many economists expect, with negative effects on private-sector growth? Have low interest rate and monetary expansion policies created another asset bubble? The answers to these questions will define the economic outcomes of the Great Reckoning. Oversimplistically, growth was borrowed from the future to rescue the economy today. But, it will have to be paid for. The decade of reckoning is about to unfold.

Conclusion

The nation has survived a damaging and long recession. The staggering job losses and stubbornly persistent high unemployment levels created by the recession continue to impose painful human, social, and economic costs. There are valid questions about the strength and sustainability of the nascent economic recovery, particularly as to the ability of the private sector to replace the federal spending and monetary interventions that have successfully stabilized the nation's economy and credit markets.

The new year and the new decade, nevertheless, present opportunities to reform financial markets, restore business confidence, see through the lingering problems in commercial real estate and housing, and start on the long road back to full employment. Much difficult work remains to be done. While 2009 was a year marked by great economic damage, it was also a year that ended with improving business conditions and a realization that a financial collapse had been avoided. Learning from the harsh lessons of the past economically dismal decade, and acting wisely on these lessons, represents the policy challenge for the nation in 2010. ■

28. The Glass-Steagall Act was established in 1933 as a result of the collapse of the large segments of the nation's commercial banking system. This provided a new system of financial regulation. One of its provisions was the separation of regular commercial banking from Wall Street investment banking. This provision was repealed by the Gramm-Leach-Bliley Act of 1999, allowing depository institutions to operate in deregulated financial markets. This repeal played an important role in the credit crisis and the depth of the 2007–2009 recession.

29. Alison Vekshin and Dawn Kopecki, "Not So Radical Reform," *Bloomberg Business Week*, December 30, 2009, pp. 24–29.

30. William Pesek, "After the Stimulus Binge, A Debt Hangover," *Bloomberg Business Week*, January 25, 2010, p. 14.

The authors thank Will Irving for statistical assistance, Arlene Pashman for editorial and production support, and Marcia Hannigan for distribution assistance.

Advance & Rutgers Report is published by the Edward J. Bloustein School of Planning and Public Policy with support from Advance Realty.

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Peter J. Coccoziello, President and CEO
Advance Realty

James W. Hughes, Dean
Edward J. Bloustein School of Planning and Public Policy

Joseph J. Seneca, University Professor
Rutgers, The State University of New Jersey

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Advance Realty
1430 U.S. Highway 206, Suite 100
Bedminster, NJ 07921
908.719.3000
www.advancerealtygroup.com

Edward J. Bloustein School of Planning and Public Policy
Rutgers, The State University of New Jersey
33 Livingston Avenue
New Brunswick, New Jersey 08901-1981
www.policy.rutgers.edu