Click here to return to the original story

Column: Oncoming recession to challenge state

My wife, Judy, hates it when I write my annual mid-winter column analyzing the economic outlook.

"What will happen to us if you're right?" she asks.

Good question.

In December 2004, I wrote that George W. Bush would be the Herbert Hoover of the 21st century. Hoover was the guy who was president when the Great Depression unfolded in 1932. I said what's ahead for the American economy could be worse than the Great Depression. Judy cringed.

The rapid unraveling I anticipated didn't play out as quickly as I predicted - it's taken four years instead of two, but my take on the source of the economic downturn has held up. It boils down to too much borrowing.

In 2004 our international trade was $495 billion in the red. The deficit for 2007 will exceed $700 billion. We financed these deficits by borrowing, mostly from foreigners.

The gap between what the government collects in taxes and what it spends, also financed by borrowing, has also grown. The nonpartisan Congressional Budget Office warned a few days ago that the federal deficit would increase by more than 50 percent in 2008, not counting the cost of an economic stimulus program.

We've heard about crushing burdens of mortgage debt, but a more ominous overhang is consumer borrowing: The Federal Reserve says it's reached $2.5 trillion, and is growing at a 7.5 percent annual rate, way faster than household income.

Huge inflows of foreign capital have financed the growth in household and government consumption, but how long that flow will continue is unclear. Bureau of Economic Analysis data show an ominous trend: Net inflows declined by 39 percent in the third quarter of 2007. Since then the inflow may have increased a little, as government-run funds in Asia and oil rich Middle East countries took advantage of hard times at distressed banks and brokerage firms to buy ownership on the cheap. That's ominous in its own way.

The stimulus of Federal Reserve interest rate cuts and a federal economic package could keep the U.S. economy growing for a while, maybe even beyond when Bush leaves office. But when growth falters, as it eventually must, the foreign money will dry up, and Americans will be in for some serious belt tightening.

Can Alaska and Alaskans protect our economy, our investments and our jobs from the effects of the economic unraveling? To some extent, yes, and where we can't, thoughtful planning can lighten the blow.

The largest impacts are likely from falling worldwide demand for oil, lower oil prices and lower state revenue. That typically means less state cash on the street. It also causes private investors to scale back private projects. Construction jobs, already in decline, are most at risk.

One bright spot is that the declining value of the dollar will make Alaska exports such as fisheries products and tourism services more affordable for foreigners, and attract American buyers who can no longer afford foreign fish and foreign vacations. Jobs in those sectors could increase.

Double-digit inflation is likely. In 2007 consumer prices grew 4.1 percent, up sharply from 2006. In the final quarter of 2007 the CPI rose at a sizzling 5.6 percent annual rate. Federal stimulus schemes to keep the economy growing will make inflation worse. State and federal retirees, most of whose annuities are only partially adjusted for inflation, can expect to be squeezed. The Alaska Permanent Fund's ability to pay dividends and still inflation-proof the principal will also be challenged.

Individuals can prepare for a further decline in the value of the dollar and double-digit inflation by shifting a part of their portfolios to foreign securities and away from investments in assets that are likely to be hurt by rising interest rates. In the short run, the cut in interest rates will prop up real estate, but inflation will eventually cause borrowing rates to soar, and residential and commercial real estate will slump. Now might be the time to reduce one's exposure in Alaska real estate. Inflation-protected fixed-income securities may be a relatively safe place to park these assets.

In the end, though, Alaskans, like Americans everywhere, will suffer as the collapse of foreign financing leads us to end our economic profligacy. We will have to cut consumption, increase savings, bring trade and government spending to a better balance, and hopefully renew investments in human capital and public infrastructure. For our grandchildren that will be all to the good.

• Economist Gregg Erickson is the owner of a Juneau consulting firm (www.EricksonEconomics.com). He can be reached at gerickso@alaska.com.

Click here to return to story:
http://www.juneauempire.com/stories/012708/opi_240865723.shtml