

THE LOWE DOWN

LOWE INSTITUTE OF POLITICAL ECONOMY

A bi-annual newsletter summarizing the programs and activities of the Lowe Institute.

Fall 2012 • Volume V, Issue 1

Inland Empire Forecast Conference

by Gabriel Sunga, CMC '16

The Inland Empire Center held the fourth CMC-UCLA Inland Empire Forecast Conference at the Citizens Bank Arena in Ontario on October 9, 2012. The forecast provided an analysis of the state of the U.S., California, and Inland Empire economies. The conference also featured concluding panels on election year politics and economics, an Ontario Airport Update, municipal insolvency, and the future of retailing. The conference was a great success, with attendance from the Inland Empire's eminent business and political leaders, convening at the Citizen's Bank Arena to listen to the forecasters from CMC and UCLA.



Photo credit: Gabriel Sunga

is still below historical average GDP growth of 3%. For the U.S. economy, Nickelsburg projects that there will be no double-dip recession in the future. However, the data on Real GDP Growth Rate forecasts slow economic growth from 2013 to 2014.

The economic forecast began with an opening statement from Professor Janet Kiholm Smith of CMC and a presentation from Jerry Nickelsburg of UCLA Anderson Forecast. Nickelsburg provided analysis on the current and future growth of the U.S. and California. In his analysis, Nickelsburg forecasted "A slow, risky climb" for the U.S. and California economy. Although the Great Recession ended in 2009, growth in the U.S.

Nickelsburg provided signs of the recovery, illustrated by projections from UCLA Anderson, the U.S. Department of Commerce, and the Bureau of Economic Analysis. The projections for the U.S. economy are generally optimistic, showing retrenching in state and local Government, an increase in exports, and deleveraging among consumers. However, the optimism was tempered with data on the unsustainable U.S. deficit,

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Message from the Director

The Lowe Institute held the Third Annual CMC-UCLA Forecast Conference at the Citizens' Business Bank Arena in Ontario last September. The conference attracted 450 people. Professor Jerry Nickelsburg of UCLA Anderson presented the economic forecast for the United States and California. Professor Marc Weidenmier of CMC presented the economic forecast for the Inland Empire. The conference also had panels discussing municipal bankruptcy and the fate of strip malls in the Inland Empire. The Lowe Institute, in conjunction with the Rose Institute of Local Government, will sponsor the second annual Coachella Valley forecast conference with UCLA Anderson in April at the Miramonte Resort and Spa in Indian Wells, CA. We are also looking into the possibility of holding a forecast conference with UCLA in the Temecula/Southwest Riverside Region.



Kris Mitchener of Warwick University came to the Athenaeum to discuss the provision of liquidity by central banks during a financial crisis. In addition to our regular Lowe-Athenaeum speaker series, the Lowe Institute plans to invite an outstanding teacher-scholar to provide some instruction in statistics/econometrics to students in 2013. Mushfiq Mobarek, associate professor of development economics at Yale will give a talk at the Athenaeum in February. Hilary Hoynes, the current editor of the American Economic Review --top ranked journal in economics--, will give a talk in the Athenaeum in the April as part of the Southern California Conference in Applied Microeconomics.

The Lowe Institute also hosted the Senior Writer's Conference in December. Professor Mary Evans chaired the conference. Four seniors presented their theses to faculty and students after dinner. We strongly encourage underclassmen to attend the event so that they gain insight into writing a senior thesis.

Going forward, the Lowe Institute would like to fund a networking trip for students to Washington DC. We are also interested in developing a summer internship program for students with an interest in economics and public policy. We envision a program where the Lowe Institute provides financial support for students to work at a public policy institute for eight to ten weeks during the summer.

I would like to thank student and board members for their support.

See you in the spring!

Best,

Marc

Coachella Valley Conference

by Crawford Taylor, CMC '15

CMC and UCLA presented their first ever Coachella Valley Economic Forecast conference this past May. The two schools have paired up in the past to present conferences on the Inland Empire as a whole, the third of which just occurred in October. As the twelfth largest Metropolitan Statistical Area (MSA) out of 366 in the U.S., the Inland Empire deserves attention simply because of its size. But UCLA's Anderson School and the Lowe Institute have now decided to delve into subregions of the Inland Empire such as Coachella Valley. Local business owners, politicians, and many others filled the room to hear the economic predictions.

The overall format consisted of economic forecasts followed by two panel discussions. Jerry Nickelsburg of UCLA kicked off the conference with a presentation of the national economic picture, as well as that of California. CMC Professor of Economics Marc Weidenmier followed, presenting specifically on Coachella Valley. The first panel was on "Life after Redevelopment" and the second on election year politics and economics, featuring CMC Government professors Andrew Busch and John J. Pitney and Economics Professor Manfred Keil.

The conclusions of the conference were uplifting in that recovery from the worst post-World War II recession has finally begun even in the Inland Empire and the Coachella Valley—and can be expected to continue. But the road to full recovery is a long one, especially for Coachella Valley, which has an economy highly dependent on the tourism industry. This makes the Coachella Valley much more vulnerable to national recessions than other areas in the Inland Empire and California. For example, most of Southern California was unaffected by the 2000 dot-com recession, but Coachella Valley was hit.

Professor Keil of the Robert Day School (RDS) and Senior Research Analyst for the Lowe Institute likened the recovery to a thawing of a frozen lake. "Think of the U.S. economy as a large lake and the formation of ice as the onset of a recession. Lakes freeze from the periphery first until eventually the center also shows solid ice." Now that we are in the recovery phase, the lake will start to thaw from the outside-in. Areas such as the Inland Empire are metaphorically located on the periphery; such areas would be the first to slow down but also the first to recover. The economic condition of such areas can be used as

predictor for national performance.

The Lowe Institute was able to generate GDP measures for the Coachella Valley by linking monthly employment data and general annual measures of sectoral worker productivity. Since it is not practical to commute from the Coachella Valley into the Greater Los Angeles area, this method captures most of the income generated by Coachella Valley's residents. Lowe analysts made projections about the recovery based on trends in GDP. GDP has begun to pick up, but it will be a while before full recovery.

This kind of analysis is difficult to find; the Lowe Institute is the only research body that has constructed GDP for Coachella Valley thus far. National GDP is available quarterly, state GDP annually since the early 60's, and MSA GDP annually starting in 2001. However, MSA GDP figures for 2010 have still not been released. This makes planning rather difficult for local business owners. While employment figures are available monthly by zip code, they present a different aspect of economic activity than GDP. Employment fails to capture a fall in output when the economy is restructuring, meaning that workers are shifting from more industries with a higher value added factor, such as manufacturing and construction, to less productive industries such as retail. In constructing local GDP, the Lowe provides an invaluable service to local planners.

On the political side, Professor Keil worked with the Lowe's Senior Student Manager Yijing Shen '13 to produce an election model, with approval ratings as a main indicator. The Keil-Shen model predicted that 53% of the popular vote would go to the incumbent President Obama. This was predicted half a year before the election, while national unemployment was still above 8%. Keil explained that they expected Obama's personal popularity to outweigh the poor state of the national economy. The model was quite accurate, as President Obama won about 51% of the popular vote.

The conference was successful. Participants left with a much better sense of the upcoming economic climate. Given the demand for the conference, the Lowe Institute will be only happy to supply and do its part to restore market equilibrium. The Lowe Institute will reunite with UCLA's Anderson School this spring to host their second Coachella Valley Conference.

Baker-Lowe Scholars Spotlight: Artemis Shen '13 and Will Dodds '13

by Caroline Lu, CMC '16

Artemis Shen '13 and Will Dodds '13 both started working for the Lowe Institute the summer after sophomore year. They engaged in economic forecasting for the Inland Empire region and worked closely with Professor Manfred Keil on his research projects. At the end of that summer, the two friends decided to apply for the Baker-Lowe Scholarship in order to turn their findings into a more complete research paper, and they both successfully achieved it. *The Lowe Down* had a chance to interview Artemis and Will about their experience, which they discuss below:

Interview with Will Dodds

Q: What have you done for the Lowe Institute?

A: As a research analyst, my job is to compile indices of economic indicators for the Los Angeles region. In the past, the Lowe Institute specifically built an economic index for the Inland Empire called Coincident Economic Index. The project for Los Angeles is similar to that for the Inland Empire. The essential idea behind this is that we are trying to map economic activity over time in this given area at a higher frequency than GDP did, as a variable. Although GDP is the best indicator for economic activity, for the LA region, or even at the state level, GDP data is only available annually. Therefore, our goal is to compile measures of economic activity that are available at a higher frequency, such as monthly. These measures of economic activity include unemployment, volume of imports, or even number of film stars working in Hollywood.



Photo credit: Anna Eames

Q: What are some real-world implications of your research?

A: Our model basically shows the same trend of economic activity as most leading economic indicators do. However, the index is, in theory, able to predict economic activity three or four months ahead of time. Businesses and government officials can use it as a reference for decision-making.

Interview with Artemis Shen

Q: What kind of work have you done for the Lowe Institute?

A: I was an analyst first when I started it, and then I worked on the Inland Empire Project, which is doing economic forecasting on the city level. It was a great summer, and I loved it. After the summer, I was promoted to be the student manager of the Lowe Institute and continued working on the same project. I also worked exclusively with Professor Keil on a project about the presidential election which we used to predict the outcome of the election.

Q: Can you tell us more about the presidential election model you have been working on with Professor Keil?

A: Professor Keil is an econometrics professor at CMC, and building models to predict election outcomes is a pretty big and interesting field in econometrics. Professor Keil is always interested in that, and he has been looking for a new approach to the same problem for a long time. For our model, we explored more variables than those that are traditionally used. We also built a panel in a time series innovatively. Professor Pitney also gave us some help. As a matter of fact, Professor Keil and I subconsciously put more weight on the economic variables, but soon we found out that some of these economic variables will be outweighed by the candidate's personality and how weak his opponent is.

Q: What did you learn from working for the Lowe Institute, and what are some challenges you faced?

A: I really enjoy working for the Lowe Institute and the relationships I built with other students and professors. Most of the

time, Professor Keil and I just talk. If there is anything interesting we read last week, we will try to figure out a way to incorporate that interesting variable into our model. Normally I collect and analyze data. Then I will bring the results to Professor Keil and discuss what the next step for our project is.

During the whole process, I constantly face the challenge of implementing an idea into a model. The challenge is how

to modify our model when the real-life data is imperfect. I am eager to see the actual outcome of the presidential election, which is coming out so soon. (At the point this interview was conducted, Obama was expected to be reelected President by 51% to 48% in popular vote—exactly the 3% difference that the Keil & Shen model predicted.)

● ● Inland Empire Forecast Conference, cont. from page 1

the dismal projection on 10-Year Treasury bond yields, and permanent displacements in the construction, manufacturing, retail, and finance and legal services industries. Nickelsburg's forecast for California was "cautiously optimistic." California's unemployment rate is predicted to decrease 2.2%, payroll employment to increase 0.6%, and personal income to increase 2.2% from 2012 to 2014.

Professor Marc Weidenmeir, Director of the Lowe Institute of Political Economy at CMC, presented the economic forecast for the Inland Empire relative to the U.S. and California recovery. Along with the U.S. and California, the unemployment rate in the Inland Empire is dropping. Employment in the ten largest California Metropolitan Statistical Areas (MSAs) from 2011 to 2012 show positive gains.

Employment in Professional and Business Services in the Inland Empire increased to 15,000 jobs during the recovery. Foreclosure figures in the Inland Empire show a decrease from 2008 to 2012, while house prices are up 10.5% in Riverside County and 12.0% in San Bernardino County. Weidenmeir likened California's recovery to a "Great Thaw" following the Great Recession of 2009.

Following the economic forecasts, the panel on election year politics and economics was moderated by Jay Orr, County Executive Officer of the County of Riverside, and featured Andrew Busch, Professor of Government and Director of the Rose Institute of State and Local Government at CMC; Kenneth Miller, Associate Professor of Government at CMC; and Rachel Van Sickle-Ward, Assistant Professor of Political Studies at Pitzer College. The panel discussed 2012 California ballot propositions, analyzing the nature of propositions 30, 38, 39, which focused on tax increases for education and multistate businesses, and Proposition 34, which concerned the repeal of the death penalty. According to the panel, the result of these ballot propositions has far-reaching consequences for California, influencing the political and economic developments of the near future.

Following the discussion was an update on the Ontario Airport by Chris Hughes, City Manager of the City of Ontario. According to Hughes, the airport's overstaffing has adversely affected operations. The efficient number of employees should be 100 fewer workers than the current number of 250 workers. Hughes also made a point of noting other problems of staff inefficiencies, referring to the lack of employee placement at key airport terminals and the complications of illegally parked vehicles. Hughes asserted that regional authorities should address Ontario Airport's future. Hughes believes that the recently formed Ontario International Airport Authority will attract both passengers and airlines through its cost-reducing measures.

Following Mr. Hughes was a discussion of options on the issue of municipal insolvency by John Brown, Mathew Richardson, and Frank Adams, partners at Best Best & Krieger. According to the panel, bankruptcy is an expensive and difficult process with long-term consequences; municipalities who choose Chapter 9 should consider it as a last resort, utilized only when negotiating with creditors and attempts at government restructuring fail. The panel observed that San Bernardino's Chapter 9 filing was necessary and effectively secured time for the city to develop further measures to achieve sufficient financial stability.

The conference wrapped up with a panel discussing the future of retailing, moderated by Larry Kosmont, President and CEO of Kosmont companies. On the panel were Doug Jensen, Senior Vice President of MuniServices, Randall Lewis, Executive Vice President of Lewis Operating Companies, and Scott Kaplan, Senior Vice President of CB Richard Ellis. The panel reported fewer bankruptcies, an improvement in products, and redevelopment in the Inland Empire. New patterns in consumer behavior were also scrutinized, highlighting the consumer's propensity to choose the best and most trusted brands. Analysis of new consumer behaviors in response to the Internet was also discussed, as speakers cited the increasing development of shopper tracking and purchasing technology and the emergence of Internet brick and mortar stores that have the potential to change the traditional retail model.

Kris Mitchener Ath Talk Summary

by Crawford Taylor, CMC '15

The Lowe Institute was privileged to have Professor Kris Mitchener present a recent discovery of his on November 27, 2012. The talk was titled “What Does History Have to Teach Us about Banking Panics and Central Bank Responses to them?” Professor Mitchener is currently on leave from Santa Clara University and teaches Economics at the University of Warwick. He is also a Research Associate at the National Bureau of Economic Research. In the past he has published numerous papers with CMC Professor Marc Weidenmier as well as one with both Professor Weidenmier and Professor Richard Burdekin.



Before delving into the findings of his recent paper, Mitchener began with an overview of the 2008 financial crisis, emphasizing the Federal Reserve’s response. Soaring unemployment and an 8.9% drop in GDP Q4 of 2008 accompanied the collapse of the financial system. In response, the Federal Reserve implemented both conventional and unconventional measures to prevent utter chaos in the banking system. The Fed purchased short-term securities to lower short-term lending rates to near zero. On the unconventional side, the Fed opened up new lending facilities and began purchases of both mortgage-backed securities and commercial paper. The hope was that a lower federal funds rate would lower general interest rates and in turn boost spending.

As a transition to his research, Mitchener showed a video clip from Jimmy Stewart’s *It’s a Wonderful Life*. The scene takes place at a bank, where anxious depositors are swarming the teller station, wanting to withdraw their deposits. However, Stewart explains that the money is not in the bank, but has been lent out to the community.

This was an appropriate transition into an introduction on the interconnectivity of liquidity and solvency problems. Mitchener first addressed the need for lending to distressed banks. Banks are conduits of real economic activity. Loans, investment, and spending all rely upon a sound banking system. Furthermore, the banking system is highly interconnected, and a shock anywhere in the system can ripple out, similar to a contagion. Walter Bagehot, former Editor in Chief of the *Economist*, wrote that central banks should lend to banks at a penalty rate during a crisis. An implication of this is that central banks should not lend to insolvent banks due to the moral hazard.

Mitchener challenged this implication and argued that illiquidity and insolvency are inevitable mixed up. Fears of poor asset quality, whether founded or unfounded, can lead to runs. Runs force banks to seize up, precipitating a fall in confidence. As trust falls, demands for liquid assets increase. This could force a bank to conduct a fire sale and dump assets. Whether or not there was a solvency issue to begin with, a drop in confidence can bring about a liquidity problem, which can in turn either exacerbate or create a solvency problem. It is difficult to disentangle the two phenomena in past crises. The Great Depression has not yet been explained using a liquidity/solvency framework.

Mitchener and his two co-authors, Mark Carlson and Gary Richardson, have discovered a forgotten historical episode that sheds some light on this topic. This episode occurred in Florida in 1929 and was initially clearly a solvency issue. This crisis started in April with a Mediterranean fruit fly infestation. Due to the potential destructiveness of the infestation, the Federal government employed the National Guard to enforce three zones of quarantine. Groves within the quarantines were “cleansed” with rather destructive chemicals. Additionally, neighboring states banned the import of Floridian fruits. All these measures raised concerns regarding Floridian farmers’ ability to pay back their loans. The uncertainty of whether or not the infestation could be dealt with was followed by a Congressional failure to provide any form of compensation before recessing in June.

This created a solvency crisis for banks in Florida. Depositors soon realized that many of the banks’ assets, the loans to farmers, had severely declined in value. Bank runs ensued, and liquidity issues emerged. During one week in July alone, 21

banks closed. Due to Florida's regulations, any bank that closed was liable for an inspection. Most banks that closed were shown to be insolvent and were not able to re-open. On July 17, Citizens Bank and Trust Company, a key correspondent group, failed.

Prospects looked very grim for banks in Florida. Fortunately, the Atlanta Federal Reserve took innovative measures to contain the illiquidity. The Atlanta Fed requested that the board in Washington allow them to loan to non-Fed members. Additionally, the Atlanta Fed sent millions in cash to the two remaining large correspondent banks, the First National Bank and Exchange National Bank, and set up revolving currency funds. The sight of huge stacks of cash was sufficient to calm depositors and to stem the runs.

The decisive actions of the Atlanta Fed, to provide transparent targeted liquidity support, limited the damage of the panic. The subsequent successful eradication of the fly infestation further helped the system.

Mitchener and his co-authors were curious, however, as to what would have happened had the Atlanta Fed not acted decisively. They used regression analyses to see what would have happened if currency depots had not been set up at the two large correspondent banks, and if they had instead failed. The results predicted double the failures of banks. Mitchener mentioned that this was a conservative estimate, due to the static nature of the analyses, which cannot capture the dynamic aspect of a shock rippling through the banking system.

Mitchener concluded that the Atlanta Fed's actions were necessary and prevented the crisis from escalating. Furthermore, these unconventional measures serve as precedent, albeit a forgotten one, for some Fed Chairman Bernanke's recent policies. Bernanke even cited this paper. Mitchener's other point was that banks have a difficult job. It is usually very difficult to pinpoint the cause of a banking crisis. More study is needed in this area, but the Florida Banking Crisis of 1929 is a good place to start.

IPO Spillover Effects

by Gabriel Sunga, CMC '16

Professor Janet Kiholm Smith is the Von Tobel Professor of Economics and Director of the Center for Innovation and Entrepreneurship at CMC. With support from the Lowe Institute of Political Economy, Professor Smith has been conducting research on the way new firms foster growth in the overall economy. Professor Smith tests the hypothesis that IPOs produce spillover benefits for other firms.

According to Professor Smith, "An IPO is a liquidity event for the firms that go public, and this increase in liquidity may produce benefits to other firms in the supply chain. If these other firms see increased liquidity or increased demand for their products or services or both, then the IPO can create positive spillovers that lead to even more growth for the economy."

To test this idea, Professor Smith had to gather data on suppliers and customers of IPO firms. According to Professor Smith, "This type of data is not available in the US, but it is in Japan. So my co-authors from Kobe University constructed a database from several sources, so that we have data on all recent IPO firms and their related firms, both public and private." Professor Smith and her colleagues then observed whether these related firms experience an increase in liquidity or an increase in sales,

and whether these increases are the result of internal investments.

"We find compelling evidence of spillover benefits because we find that both suppliers and customers of IPO firms also increase their own expenditures on property, plant, and equipment following the IPO," said Professor Smith. "The mechanism by which this new investment occurs, however, differs. For suppliers of IPO firms it appears that increased demand for their products translates into increased investment. For customers, it appears that their trading partner's IPO benefits increase by their liquidity."

Professor Smith's research has overarching implications. The research on growth spillovers resulting from IPOs contributes to the knowledge of the process of economic growth. According to Professor Smith, "The research suggests that economic policy that contributes to the efficiency of public equity markets can have significant benefits for other firms in the supply chain. By extension this could contribute to job creation, which in the current economic environment is an important benefit for the economy as a whole."

Professor Smith will be presenting her paper in January at Kobe University, Japan.

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Calendar of Events

8 • 31 • 12 Lowe Institute recruits
at the Job Fair at Collins Dining Hall
CMC

9 • 14 • 12 Lowe BBQ for Students,
Faculty and Staff at Green Beach at
CMC

10 • 9 • 12 CMC-UCLA Inland Em-
pire Forecast Conference at Citizens

Business Bank Arena, Ontario, CA

11 • 27 • 12 Kris Mitchener, Professor
of Economics at the University of War-
wich - Lowe Athenaeum Speaker Series

12 • 10 • 12 Lowe Senior Thesis Writ-
er's Conference at the Marian Miner
Cook Athenaeum at CMC

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