THE ECONOMIC OUTLOOK GROUP

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ECONOMIC TALKING POINTS

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Robust consumer spending even as unemployment remains elevated. An interesting paradox.

That Americans have become enthusiastic shoppers is hardly a surprise. Steady job creation and rising household wealth certainly helps explain why consumers are growing more comfortable about spending and borrowing.

But what has perplexed many is why spending has accelerated so much when (1) the unemployment rate remains stubbornly high, (2) the labor participation rate keeps falling and (3) with more than 12 million Americans still actively looking for work? You would think high joblessness would temper household spending, but it hasn't – and it's worthwhile pondering why.

We believe one often missed factor is the strong likelihood that many of those "formally" without jobs have become part of a thriving underground economy. By underground economy, We're not talking about illicit activity, like selling stolen goods, or drugs. It's largely work where millions of unemployed have managed earn cash "off the books" by repairing computers, doing carpentry or handyman work, selling goods at flea markets, tutoring, housecleaning or using their car as a private livery service. Remember, severe recessions have historically driven jobless Americans into the shadow economy, and we suspect the destructive nature of the last downturn and the prolonged weak recovery pushed a record number of people into that murky world of cash transactions. Doing so allows them to earn money without reporting their income, leaving more available to spend.

The problem, of course, is calculating with any precision how large the underground economy has become in recent years. Such cash transactions are by definition hidden from the government, which makes official data hard to come by. But there has been some interesting academic research by Friederich Schneider (University of Linz in Austria) and Edgar Feige, emeritus professor of economics at the University of

Wisconsin–Madison. Based on their work, the total underground economy in the U.S. can amount to anywhere from about 8% to 14% of US GDP, or between $1.3 trillion to more than $2 trillion in unreported earnings. That's a lot of cash that can be spent by Americans.

Secondly, there is also inferential evidence of a thriving underground economy when you compare the historical relationships between unemployment and retail sales. Since 2009, when the recession ended, retail sales has shown quarterly growth rates that is normally associated with unemployment rates in the 5% to 6% range (Table 1). Never before (or at least not since 1992 when the government first released retail sales on a monthly basis) have we seen retail sales grow at such a vibrant pace with the unemployment rate so high. Even more remarkable is the sudden divergence between total personal consumption expenditures and the civilian labor force participation rates. Since 1950, household spending has risen alongside the increase in the labor force participation rate, as it should. With more of the working age population employed and earning money, the more resources they have to shop. But the 2007 – 2009 recession abruptly ended that relationship (Table 2). Despite the sharp drop off in the labor force participation rate, consumer spending has nevertheless continued to surge. One explanation is that many of those who have left the labor force since the last recession have managed to earn income in the shadow economy and their spending still shows up in the official retail sales and personal consumption data.

Table 1.

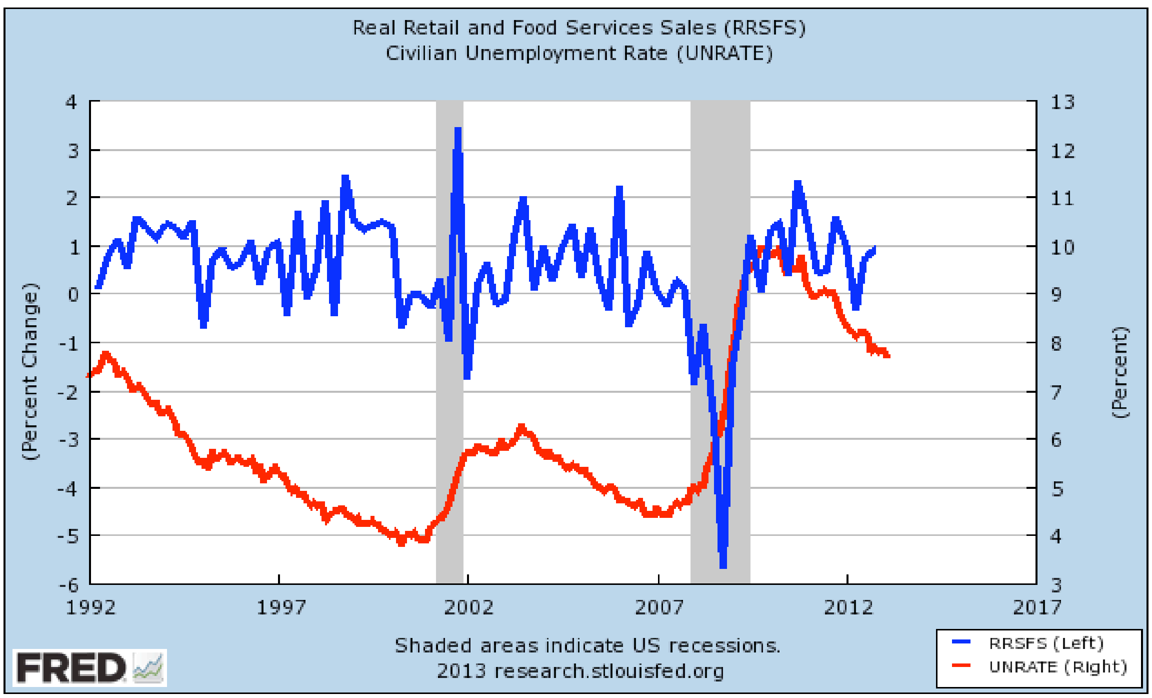
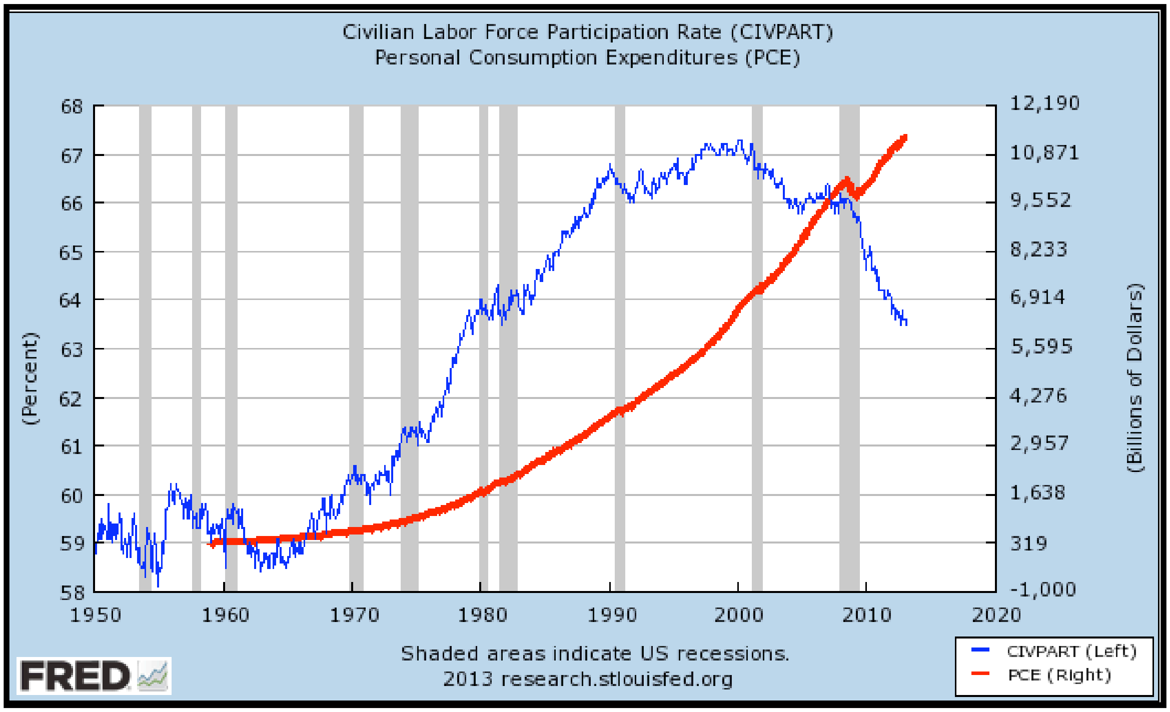


Table 2.



Finally, there is one other interesting piece of the evidence that points to a larger than expected underground economy in the US. The FDIC in September 2012 released a report entitled “National Survey of Unbanked and Underbanked Households.” The agency also found data that the proportion of Americans in 2011 who have chosen not to have bank accounts has increased. According to the report: “More than one in four households (28.3%) are either unbanked or underbanked, conducting some or all of their financial transactions outside of the mainstream banking system.” That percentage is up from 25.8% just two years earlier. Though there may be numerous reasons for this, one has to assume that those engaged in the shadow economy may prefer to keep their income at home and out of sight from the government.

	2009		2011	
	Households		Households	
Banking Status	(Millions)	Percent	(Millions)	Percent
All US Households	119.0	100.0	120.4	100.0
Unbanked	9.1	7.6	9.9	8.2
Underbanked*	21.7	18.2	24.2	20.1
Fully Banked*	84.9	71.4	82.8	68.8
Underbanked Status Unknown*	3.3	2.8	3.5	2.9

*Estimates not directly comparable across years.

Source: FDIC

Bottom line:
The robust nature of household spending has puzzled some observers since unemployment remains fairly high. One explanation for this paradox is that a large number of the unemployed may nevertheless be earning income in the underground economy. While such transactions are off the books and deprive the government of needed revenues, these funds at least surface again when these consumers go out and shop.

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