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The states under water - - do we throw them a life line?

In February, the Congress enacted a $787 billion stimulus package aimed at stanching some of the pain of the recession and restoring economic activity. A goodly part of the funds is to go to the States, permitting them to ameliorate hardships caused by the recession by extending unemployment compensation, reducing the costs of health insurance, providing food stamps and similar measures. In addition, the legislation provides for an increased federal share of Medicaid expenses.

All of these funds were supposed to make life easier for States and their residents. The idea was to take some of the burden off state budgets, while providing assistance to people in distress.

The problem is that the States are also victims of the recession. As people stop buying cars and other big ticket items, sales tax revenues are down. As people are laid off, income tax revenues are down. All in all, the projection for total State budget deficits (not including localities) for the 18 months from January 2009 through June 2010 is about $150 billion. Some experts expect the deficits for the twelve months following June, 2010 to be in the same ballpark.

Unlike the federal government, most of the States cannot legally engage in deficit spending, nor can they "print money" by Federal Reserve borrowings. Thus, they are forced to slash expenses and/or boost taxes, invade reserves or issue bonds to meet their shortfalls. The end result is that federal funds aimed at pain relief and stimulus are being sucked up by State deficits – a kind of economic "Whac-a-Mole".

There is one other path that could be taken to alleviate the problem: increased funding from the federal government. After all, when one recalls that the U.S. has financed AIG to the tune of some $180 billion, helping the States with similar amounts sounds like giving to children's charities. (Yes, we know that the AIG comparison has been overworked – like all the initiatives that are justified with the words "if we can put a man on the moon, we can . . .") Suggesting more money for stimulus will no doubt scare the bejesus out of budget hawks, but, if we are hoping to ride out the recession with our States intact, there may be no other way.

Another major part of the federal stimulus effort is tax reduction. Thus, raising taxes at the State level would be truly counterproductive. State budgets, like those of most economic entities, can no doubt be trimmed without hurting services. We in the steel industry have been through that process many times, each seemingly more painful than the last. But, again, major cuts in State counter-recessionary programs would simply diminish the overall effects of the stimulus package.

An aside on cutting expenditures: As governors and legislators comb through the numbers, we are likely to hear proposals for "zero based budgeting". That approach entails looking at every budget item as if it was a brand new program that has to justify the first dollar to be spent. A number of States have gone to this system, but there are serious problems that have surfaced. Zero based budgeting is extremely time consuming, as civil servants and legislators start from square one. There is plenty of other work for both groups to be doing, especially as revenues shrink. Secondly, government budgeting is essentially an account of what comes in and how it goes out; there is no measure (like profitability) of how well the programs are performing. Quality analysis is really separate from the budgeting process and can be done equally well with the usual approach to budgeting. Finally, there is little evidence that zero based budgeting actually results in decreased expenditures. What we need are legislators who can understand and evaluate programs to make sure that we are getting the best bang for our bucks without reinventing the wheel to do so.

Turning to the cost data for this month:

- <u>Scrap and Pig Iron</u>. After four months of declines, the prices on #1 dealer bundles and #1 busheling (Chicago) rose a bit this month, to $215 per mt. These were small increases compared with the huge drops during the last half of 2008, but they represented bumps of over 25%. While cost increases aren't usually welcome, this firming may represent some good news on the steel markets in general. The spot price for Brazilian pig iron remained steady at $250 per mt, well below the "hold out" price the producers tried to maintain a few months ago.

- <u>Natural Gas</u>. The Nymex contract price was up 7 cents to $3.67 per mcf, still at the lowest levels in the last six and a half years. Crude prices have been edging up, so we shall see if gas will follow that lead.

- <u>Ocean Freight</u>. The Baltic Capesize Index was up about 180 to 2868. That level is still dramatically below what it was over the last four years, but the increase may signal a flicker of firming international trade.

- Exchange Rates. As of this writing, the dollar has again weakened. The euro is worth $1.36, up seven cents from last month, and the pound is at $1.55, up twelve cents. The Canadian dollar is at 86 cents, an increase of a nickel.

We are always interested in your reactions to our thoughts, so let us hear from you. This letter, per usual, will be posted on our site www.coreysteel.com and on the international site www.steelonthenet.com.