Economic Outlook

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The opinions expressed are my own and not necessarily those of the Federal Reserve Bank of Saint Louis or the Federal Reserve System.

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Who Am I?

- I am a research economist, not a forecaster.
  - My research is primarily on exchange rates.

- 3 kinds of economic communication:
  - Greek letter;
  - ups and downs;
  - popular economics.

- Economists are much better on why the past happened.
  - There is a reason for this.
Today’s Topics

- The Current Outlook
  - GDP, employment, manufacturing, housing, inflation
  - The recession was widespread

- How did we get into this mess?

- How did the Fed respond?
  - Where did the inflation go?
  - Exit strategies

- Structural issues for the U.S. Economy
  - A low savings rate/international imbalances
  - The Federal deficit
The Current Outlook

- GDP
- Employment
- Industry/manufacturing
- Construction /housing
- Credit/delinquency
- The Global outlook
The Current Outlook: GDP

2009 Q4 GDP growth was revised downward, forecasted growth rate is around 3.5% for 2010 and 2011.

Source: Bureau of Economic Analysis
Forecast: Macroeconomic Advisers and Blue Chip Economic Indicators
The Current Outlook: Civilian Unemployment

The U.S. unemployment rate is 9.7% in March.
The St. Louis Unemployment rate is 11.5% in January.

162 thousand jobs gained in March.

The Current Outlook: Long term Unemployment

Source: Bureau of Economic Analysis
The Current Outlook: Part Time Employees

Thous, SA

Source: Bureau of Labor Statistics
The Current Outlook: Creation vs. Layoffs

Source: Bureau of Labor Statistics
The Current Outlook: Industrial Production

Source: Federal Reserve Board/Institute of Supply Management.
The Current Outlook: Capacity Utilization and New Orders

Source: Federal Reserve Board and Census Bureau
The Current Outlook: Vehicle Sales

Cash for Clunkers

Source: Census Bureau
The Current Outlook: Existing Home Sales

First time homebuyer tax credit.

Source: National Association of Realtors.
The Current Outlook: New Home Sales

Source: National Association of Realtors.
Housing prices have finally stabilized.

Source: National Association of Realtors
The Current Outlook: Mortgage Delinquencies

90 days or more, %

Source: Federal Home Loan Mortgage Corporation
The Current Outlook: Commercial Real Estate Loan Delinquency Rate

Source: Federal Reserve Board
The Current Outlook: Loan Delinquency Rates

Source: Federal Reserve Board
The Current Outlook: Bank Credit

Loans continue to decrease

Source: Federal Reserve Board
The Current Outlook: Inflation

U.S. Employment has Fallen Fast Compared with Output


- **Unemployment Rise (percentage points)**
  - United States
  - France
  - Canada
  - United Kingdom
  - Japan
  - Germany

**Cumulative GDP Fall (percent)**

**NOTE:** Combinations of cumulative GDP declines and unemployment increases from 2008:Q2 through 2009:Q3 for six industrialized countries. All data are from the OECD.
The Current Outlook: A summary

- GDP: Modest growth forecast
- Employment: Lagging
- Industry/manufacturing: Strength
- Construction/housing: Weakness
- Credit/delinquency: Lagging
- The Global outlook: Recession is widespread.
The Current Outlook: Real Activity Forecasts

Figure 1. Central tendencies and ranges of economic projections, 2009–11 and over the longer run

- Change in real GDP
  - Central tendency of projections
  - Range of projections
  - Actual

- Unemployment rate

Years: 2004 to 2011
The Current Outlook: Inflation forecasts

PCE inflation

Core PCE inflation

NOTE: Definitions of variables are in the notes to table 1. The data for the actual values of the variables are annual.
The Current Outlook: A summary

❖ Why is the recession so protracted? Why all this talk about U and L shaped recessions?

  o Recessions precipitated by financial crises tend to be severe.
  o Financial firms are crucial for all sorts of economic activity.
  o Activity will resume when their balance sheets improve substantially.
How did we get into this mess?

- House prices rose well beyond historical measures.
- House prices fell; borrowers default on mortgages.
- Assets backed by mortgages lose value.
- Capital falls. Financial firms could go bankrupt.
- Huge uncertainly dries up the market for these assets.
  - What are they worth?
- No one knows who owns these risky assets.
- Bad idea to lend or trade with a risky counterparty.
- Lending and financial trading dries up.
- The whole economy suffers.
Why didn’t economists predict it?

❖ Some economists recognized the housing bubble.
  o The housing bubble wasn’t obvious in real time.
    o Changes in long-term real rates appeared to justify higher house prices.
    o U.S. house prices had not fallen, year-over-year, nationally from 1967-2006.
  o How was one to “prick” it?

❖ What if it was a bubble?
  o House price would fall; borrowers would default; bondholders would lose.
  o Interconnectedness, derivatives/leverage greatly magnified the problem.
Why didn’t economists predict it?

NAR Median Sales Price: Existing 1-Family Homes, United States

Source: National Association of Realtors / Haver Analytics
How does monetary policy work?

- Central banks buy and sell assets to change the liquidity and risk composition of assets held by the public.
  - The Fed usually transacts in T-Bills.

- Such changes influence the economy primarily through asset prices.
  - Bills, bonds, stocks and exchange rates.
Monetary policy response

- Monetary policy in normal times.
- The lender-of-last resort function.
- Monetary policy at the zero bound.
How does monetary policy work in normal conditions?

- Raise interest rates in good times and/or when inflation picks up.
  - Reduce liquid assets and increase illiquid assets.
  - Higher interest rates and lower asset prices reduce spending.

- Lower interest rates in bad times and/or when inflation is too low.
  - Increase liquid assets and reduce illiquid assets.
  - Lower interest rates and higher asset prices reduce spending.

- The interest rate cycle is driven by changes in inflation pressures the MPK.
How does monetary policy work in normal conditions?

- **Interest rate channels**
  - Direct effect on business and residential investment.

- **Effects through asset prices: stocks, exchange rates, house prices, etc.**
  - Increase net exports through currency depreciation.
  - Increase business investment through rising stock prices.
  - Wealth effect: Increase consumption/decrease precautionary savings, from a rise in stock and housing prices.
  - A rise in house prices increases demand for new housing.

- **Credit channels**
  - Reduce problems with adverse selection and moral hazard, making banks more willing to lend to firms and consumers with better balance sheets.

- All these channels require a change in interest rates.
How does monetary policy work in crises?

- The Fed was created because of the 19th century experience with bank panics.
  - Bank panics are not unique to banks.

- The “lender of last resort” function.
  - Financial markets really want safe, liquid assets when times are uncertain.
  - “Lend freely at a high rate on good collateral.” — Walter Bagehot, Editor of *The Economist*, 1860-1877

- The Fed provides liquidity to financial markets during crises, preventing illiquidity from causing recessions.
  - E.g., the stock market crash of 1987, the Russian default and 9-11-2001.
How did the Fed respond to the financial crisis?

- Goals of monetary policy
  - Stable prices & maximum employment require financial markets.

- Channels of monetary policy
  - The zero bound limits traditional policy.

- Responses to the current crisis
  - Full response of traditional policy.
  - Special programs in specific markets.
  - Quantitative easing versus credit easing. (LSAP)

- Money and inflation

- Exit strategy
How did the Fed respond to the financial crisis?

- Federal funds and Discount Rate Cuts
- Swap lines with foreign central banks
- Term Auction Facility (TAF) 12/2007
- Term Securities Lending Facility (TSLF) 3/2008
- Primary Dealer Lending Facility (PDCF) 3/2008
- ABCP MMMF LF (AMLF) 9/2008
- Commercial paper funding facility (CPFF) 10/2008
- Purchase of Agency MBSs 11/2008
- Term Asset-Backed Securities Loan Facility (TALF) 11/2008
- Purchase of long-term Treasuries 3/2009
Current Monetary Policy Situation

- The federal funds rate has been close to zero since December 2008.
- The Fed has provided enormous liquidity by lending to the private sector and buying illiquid assets.
  - The Fed has expanded the monetary base — currency plus bank reserves — enormously.
- Why no inflation?
  - Expectations have been anchored (so far).
  - Broader aggregates — e.g., M2 — have not grown very fast because banks have accumulated the additional money as excess reserves.
    - Banks are essentially lending the excess reserves back to the Fed.
  - Does slow output mute price pressures? Widely believed but not really much evidence for this.
From September 2007 to December 2008, the FOMC cut the funds target by 425 basis points and on Dec. 16, 2008, it established a 0 to 0.25 b.p. ‘Target Range.’

Source: Federal Reserve Board
Current Monetary Policy Situation

SA, Mil. $

Adjusted Monetary Base

Traditional easing starts here.

Quantitative/credit easing starts here, after Lehman Brothers.

Source: Federal Reserve Board
Current Monetary Policy Situation

- The monetary base more than doubled in a few months.
- Where did the inflation go?
  - The monetary base is not the money supply.
Current Monetary Policy Situation

% Change Year to Year

Source: Federal Reserve Board
Current Monetary Policy Situation

- There appears to be little near-term inflation risk
  - Anchored expectations, modest M growth & a weak real economy.

- Over the longer term, the Fed needs to reduce the base dramatically.
  - Some positions, such as short-term credit facilities, will unwind quickly, naturally.
  - The Fed will let some assets run off without replacing them.
  - Other assets, such as long-term MBSs and Treasuries, must be actively reduced.

- Active reduction must mean some combination of
  - Borrowing money from the public (banks) through paying interest on reserves or issuing Fed “CD’s” to borrow money from Banks.
  - Traditional Open Market Operations: Reverse repos.
  - Selling illiquid assets —Treasuries and MBSs back to the public.
Current Monetary Policy Situation

- When will short-term interest rates begin to rise?
  - The futures market provides as good a guess as any.

![Graph showing expected federal funds rate](image-url)
Structural problems with the US economy

- Private savings is very low.
- The counterpart to low savings is a current account deficit.
- Projected public deficits/dissavings are not sustainable.

- The common denominator: We consume too much and save too little.
Structural Issues for the U.S. Economy

- A low savings rate/international imbalances

![Bar chart showing personal saving rate from 1970 to 2009.](chart)

Source: Bureau of Economic Analysis
Structural Issues for the U.S. Economy

PCE as a Percent of Disposable Personal Income

Source: Bureau of Economic Analysis
Structural Issues for the U.S. Economy

Percent

U.S. Current Account Balance as a percentage of GDP

Source: Bureau of Economic Analysis
Structural Issues for the U.S. Economy: The Federal Deficit

Graph: Government Net Debt for Canada, Japan, United Kingdom, and United States
Percent of GDP, annual data

- Canada
- Japan
- United Kingdom
- United States

Year: 92, 93, 94, 95, 96, 97, 98, 99, 00, 01, 02, 03, 04, 05, 06, 07, 08, 09
Structural Issues for the U.S. Economy: The Federal Deficit

Government Net Debt for Euro Area, France, Germany, and Italy
Percent of GDP, annual data

- Euro Area
- France
- Germany
- Italy

92 93 94 95 96 97 98 99 00 01 02 03 04 05 06 07 08 09
Structural Issues for the U.S. Economy: The Federal Deficit

Government Budget Balance for Canada, Japan, United Kingdom, and United States
Percent of GDP, annual data

- Canada
- Japan
- United Kingdom
- United States
Structural Issues for the U.S. Economy: The Federal Deficit

Source: John Taylor
Structural Issues for the U.S. Economy: The Federal Deficit

percent of GDP

Year:
1975
2000
2025
2050
2075

spending
"Primary" spending
Interest payments on the debt

Source: John Taylor
Summary

• Despite positive signs, the recovery will probably not be strong or quick.
• The recent subprime crisis was actually sort of a classic banking crisis.
• Bubbles are easier to recognize in hindsight and easier to deal with on paper.
• The U.S. economy consumes too much and this cannot go on forever.
The End