Economic Outlook and Current Topics

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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, not a business economist.
  - My research is primarily on exchange rates.
- Economists are much better on why the past happened.
  - Economic events should be difficult to forecast for the same reason that financial markets are hard to forecast.
- Economics has recently become much more controversial.
- I try to be as objective as possible.
Today’s Topics

❖ The Current Outlook
  o GDP, employment, manufacturing, housing, inflation, financial markets
  o Fiscal policy and inflation

❖ Additional topics?
  o Fed Policy & Quantitative Easing
The Current Outlook

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

Real Gross Domestic Product
Actual and Forecasted, percent change from previous quarter at annual rate

About 1% over the first half of 2011.

Source: Bureau of Economic Analysis/Macroeconomic Advisers
The Current Outlook: Real GDP Forecasts

Figure 1. Central tendencies and ranges of economic projections, 2011–13 and over the longer run

Economic projections from the July 2011 Monetary Policy Report to Congress
The Current Outlook: Industrial Production

Weak ISM index.
The Current Outlook: Capacity Utilization and New Orders

Value of Manufacturers' New Orders (left axis)

Capacity Utilization: Manufacturing (right axis)

Not bad.

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

Cash-for-clunkers = broken windows fallacy

Source: Census Bureau
The Current Outlook: Industrial activity

- GDP has increased very modestly – at about 1% per annum– since the beginning of 2011.
- Forecasts for GDP growth in the next 2 years range from 2% to 4%.
- Industrial production is not strong but an area of relative strength.
- Vehicle sales are weak.
The Current Outlook: Civilian Unemployment

Unemployment Rate (SA, Right Axis)

Thousands Percent

Initial Claims for Unemployment Insurance (Monthly Average, Left Axis)

Source: Bureau of Labor Statistics/Department of Labor
The Current Outlook: Unemployment Forecasts

Unemployment has fallen slowly over the last several recessions. But it has usually fallen slowly, between $\frac{1}{2}$ and 1 percentage point per year.
The Current Outlook: NFP Employment

117K jobs gained in July, somewhat better than the 90K expected.

Source: Bureau of Labor Statistics
Unemployment is always a lagging indicator. The current rate is very high by historical standards but very low compared to the Great Depression.
The Current Outlook: Long term Unemployment

Mean and median durations of unemployment are at record levels.
The Current Outlook: Long term Unemployment

- Long-term unemployment has costs.
  - Reduced attachment to the labor force.
  - Loss of skills.
  - Lower GDP growth in the future.

Source: Bureau of Economic Analysis
The Current Outlook:
Unemployment by Ethnicity

Unemployment varies with ethnicity.
The Current Outlook:
Unemployment by Education

Unemployment is always worse for the less educated.
The Current Outlook: Unemployment by Sex

Unemployment varies by sex. Women have lower unemployment in recessions.
The Current Outlook: Employment/Population Ratio

Civilian Employment/Population Ratio: 16 yr + (SA, %)

Women and Boomers enter the labor force.

People are leaving the labor force at unprecedented rates. Demographics? Discouraged workers?

Boomers watch Daniel Boone.
The Current Outlook: Part Time Employees

Unusual rise in part-time employment.

Source: Bureau of Labor Statistics
U.S. Employment has Fallen Fast Compared with Output

U.S. firms have shed workers much faster than our peers, compared to the fall in GDP. This is often blamed on U.S. labor market flexibility.
The Current Outlook: Creation vs. Layoffs

Source: Bureau of Labor Statistics
The Current Outlook: Labor market

- Unemployment remains stubbornly high.
  - Usual patterns of unemployment by ethnicity and education remain.
  - Unemployment is higher for men than women, as it has been in recessions since the 1970s.

- Unemployment is of unusually long duration.
  - Unusual extension of unemployment benefits might add 1 percent to the measured rate.

- Hypotheses about skill mismatches or immobility due to housing prices do not hold up well in the data.
The Current Outlook: Existing Home Sales Price

Housing prices have declined again.

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

Very weak new home sales.

Over construction of new homes.  Supply response to rise in prices.

Source: National Association of Realtors
The Current Outlook: Housing

Housing vacancies

There are a lot of vacant houses.

Total Vacant Housing Units: United States (Thous)

Total Vacant Housing Units: United States: Year-round (Thous)
The Current Outlook: Housing

- The house price boom was accompanied by over construction of new houses. We have too many houses.
- House prices have begun to fall again.
- New home sales are very weak.
Credit markets

“Neither a borrower nor a lender be.” – Ben Franklin
The Current Outlook: Mortgage Delinquencies

Delinquencies are still high and lagging.

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

Delinquencies are still high and lagging.

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

Loan delinquencies are returning to normal.

Source: Federal Reserve Board
The Current Outlook: Bank Credit

FAS requires banks to take securitized consumer loans back on their books in 2010Q1.

C&I loans recover somewhat faster than in 2001 recession.
The Current Outlook: Loan Delinquency

- Real estate loan delinquencies are still very high but falling. They are lagging.
- Other loan delinquencies are high but declining and closer to normal.
Inflation

“Stop worrying and learn to love inflation.”– Paul Krugman
<http://www.pkarchive.org/theory/LoveInflation.htm>

“The expansion of money, given an increase in the monetary base, is inevitable, and will ultimately result in higher inflation and interest rates. In shorter time frames, the expansion of money can also result in higher stock prices, a weaker currency, and increases in commodity prices such as oil and gold.”–Arthur Laffer
<http://online.wsj.com/article/SB124458888993599879.html>
The Current Outlook: Inflation

Inflation has been volatile but about 1.5%, on average, since late 2008.

Source: Bureau of Economic Analysis/Bureau of Labor Statistics
The Current Outlook: Inflation

Inflation expectations appear to be anchored, for now.

Inflation expectations from TIPS

- 10-year TIPS spread
- 5-year TIPS spread
The Current Outlook: Inflation

Inflation expectations appear to be anchored, for now.
The Current Outlook: Inflation forecasts

- PCE inflation

- Core PCE inflation
The Current Outlook: Fiscal Policy and Inflation

The projected path of U.S. fiscal policy is unsustainable.

There are three ways that the situation can be resolved:

- Reform of fiscal policy: Some combination of reduced spending and/or increased taxes to gradually reduce the debt as a % of GDP.
- Explicit default by the U.S. government. (Very bad.)
- Implicit default through inflation. (Even worse, probably.)
The Current Outlook: Fiscal Policy and Inflation
The Current Outlook: Fiscal Policy and Inflation

The projected path of U.S. fiscal policy is unsustainable.

Source: John Taylor
The Current Outlook: Fiscal Policy and Inflation

Medicare is largely the culprit in exploding spending.

Private expenditures on medical care have also been rising.

Source: New York Times
The Current Outlook: Fiscal Policy and Inflation

- Government defaults are common.
  - See Reinhart and Rogoff: “This Time Is Different.”
  - Explicit vs. implicit (inflation) defaults.

Source: This Time Is Different: A Panoramic View Of Eight Centuries Of Financial Crises, Carmen M. Reinhart, Kenneth S. Rogoff, WP 13882 http://www.nber.org/papers/w13882
The Current Outlook: Fiscal Policy and Inflation

The U.S. paid down high levels of debt after WWII and lower levels of debt after prior wars.

**U.S. Gross Government Debt as a % of GDP**

The Current Outlook: Fiscal Policy and Inflation

How do markets expect the U.S. fiscal situation to be resolved?
1. Fiscal reform?
2. Default?
3. Inflation?
The Current Outlook: Fiscal Policy and Inflation

- Treasury yields remain low.
- CDS rates on U.S. bonds are still low but have risen substantially, indicating increased expectations of explicit default.
- Expected inflation is still stable.

The Current Outlook: Fiscal Policy and Inflation

- It appears that markets still place a very high probability on some sort of U.S. fiscal reform.
- Permitting a permanently high level of debt has costs. Debt crowds out private investment and reduces growth.
The Current Outlook: Inflation

- Inflation has been very volatile since 2008 but has averaged about 1.5 – 2%, which is consistent with stated FOMC goals and the Congressional mandate.
- Commodity prices have been very volatile as political factors (e.g., the Libyan situation) and expectations of future real activity fluctuate.
- Inflation expectations appear to be anchored.
The Current Outlook: Financial Markets
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S&P 500 Index (SP500)
Source: Standard and Poor's

Shaded areas indicate US recessions.
2011 research.stlouisfed.org
The Current Outlook: Financial Markets
The Current Outlook: Financial Markets


The chart shows the St. Louis Financial Stress Index (STLFSI) from 2000 to 2012. It highlights two key points:

1. Recent volatility: The index experienced significant fluctuations around 2008, indicating high levels of financial stress.
2. Very low risk premia: Prior to 2008, the index was relatively stable, suggesting low risk premia in financial markets.

Shaded areas indicate US recessions. The chart is sourced from Federal Reserve Bank of St. Louis.
The Current Outlook: Financial Markets

- Financial markets were supportive of growth in the first half of 2011.

- But stock and bond markets have mirrored the pessimism of the last few weeks.

- The St. Louis Fed’s “Financial Stress Index” has risen very sharply lately.
The Current Outlook: A summary

- GDP: Growth has slowed. Industry/manufacturing: Relative strength
- Employment: Lagging
- Construction /housing: Weakness
- Inflation: Recent volatility but expectations remain anchored, for now.
- Credit/delinquency: Lagging
- Financial markets: Turmoil for the past few weeks.
Why is the recession so protracted?

• Recessions precipitated by financial crises tend to be severe.

• Financial firms are crucial for all sorts of economic activity.

• Activity will increase as balance sheets improve.

• Consumers’ net worth has also taken some big hits. Negative wealth effects and uncertainty reduce consumption.

• There might be significant mismatches in skills and geography but studies cast doubt on this.
Why didn’t economists predict it?

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

- What if it was a bubble?
  - House price would fall; borrowers would default; bondholders would lose.
  - Interconnectedness, derivatives/leverage greatly magnified the problem.
Conclusions

• There are renewed fears of a double dip recession; forecasters have recently estimated the probability at about 26%. (That is quite high.)

• The recovery will not be strong or quick.

• Some potential trouble spots:
  o The European fiscal situation.
  o The U.S. fiscal situation.
  o U.S. commercial real estate.
  o Chinese banking balance sheets.
Conclusions

• A retrospective on the financial crisis of 2008:
  
  o The recent subprime crisis was actually sort of a classic banking crisis.
  
  o Bubbles are easier to recognize in hindsight and easier to deal with on paper.
  
  o Financial crises tend to take a long time to resolve due to their effect on financial firms’ and consumer balance sheets.
  
  o We had overbuilt residential housing and this will take a long time to fix.
The End
QE’s impact on financial markets

**Long Term Bonds**

- US
- Canada
- Germany
- Japan
- UK

**Foreign Exchange Rates**

- AUD/USD
- CAD/USD
- EUR/USD
- JPY/USD
- GBP/USD

**S&P 500 and NY Light Crude**

- S&P 500
- NY Light Crude
Spending on medical care