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CENTRAL to AMERICA'S ECONOMY™

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.

I thank Brett Fawley for his able assistance in constructing this presentation.

Who Am I?

- ❖ I am a research economist, not a forecaster, not a business economist.
  - o My research is primarily on exchange rates.
- ❖ Economists are much better on why the past happened.
  - o 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.

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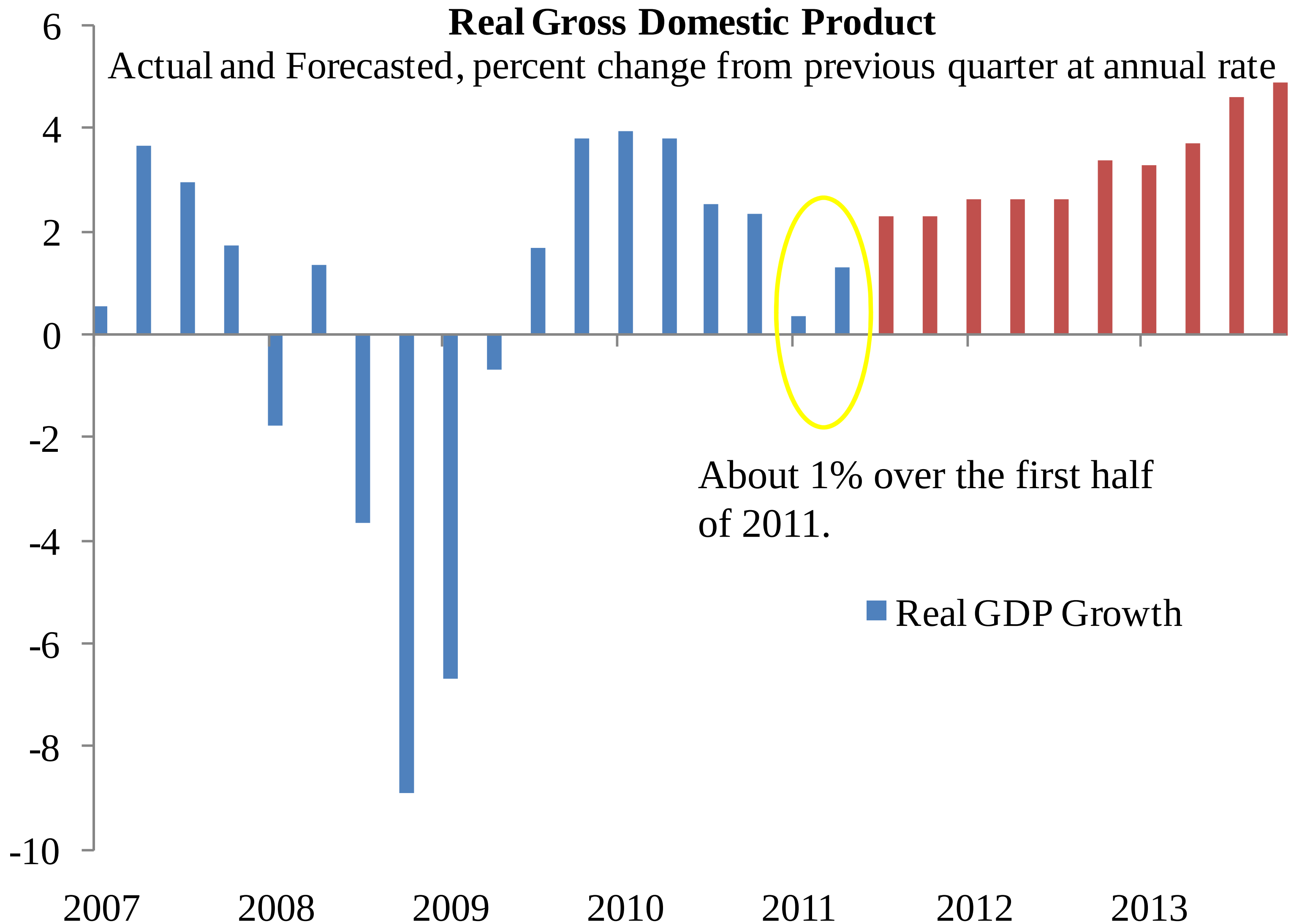
Today's Topics

- The Current Outlook
  - GDP, employment, manufacturing, housing, inflation, financial markets
  - Fiscal policy and inflation
- Additional topics?
  - Fed Policy & Quantitative Easing

The Current Outlook

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

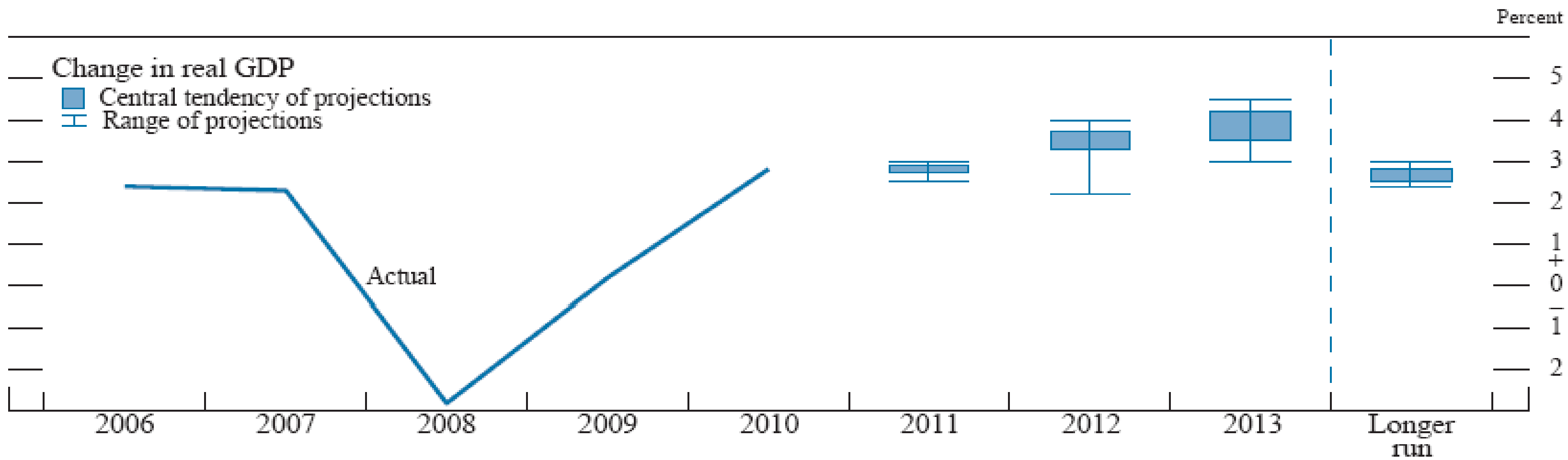
The Current Outlook: GDP



Source: Bureau of Economic Analysis/Macroeconomic Advisers

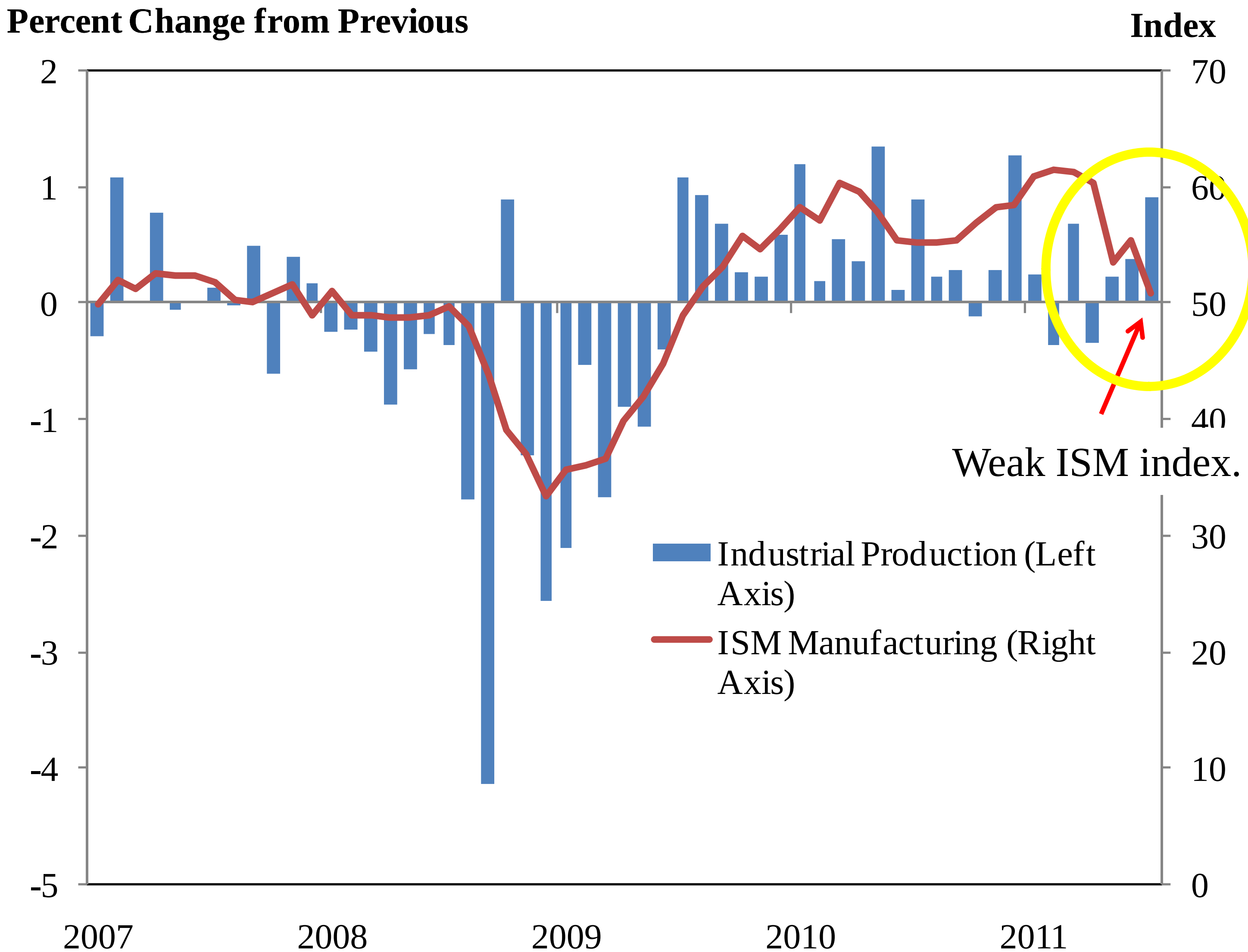
The Current Outlook: Real GDP Forecasts

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



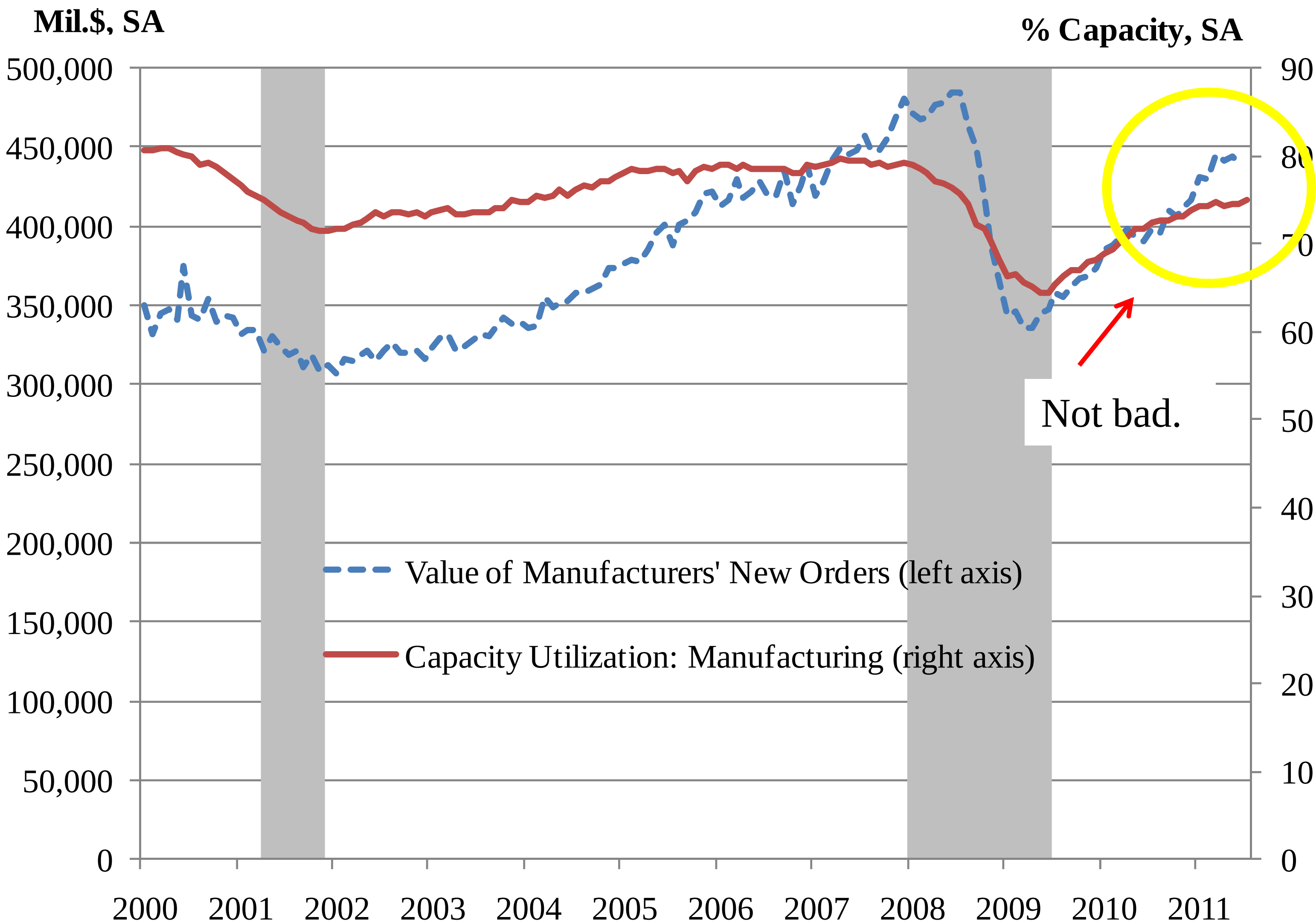
Economic projections from the July 2011 Monetary Policy Report to Congress

The Current Outlook: Industrial Production



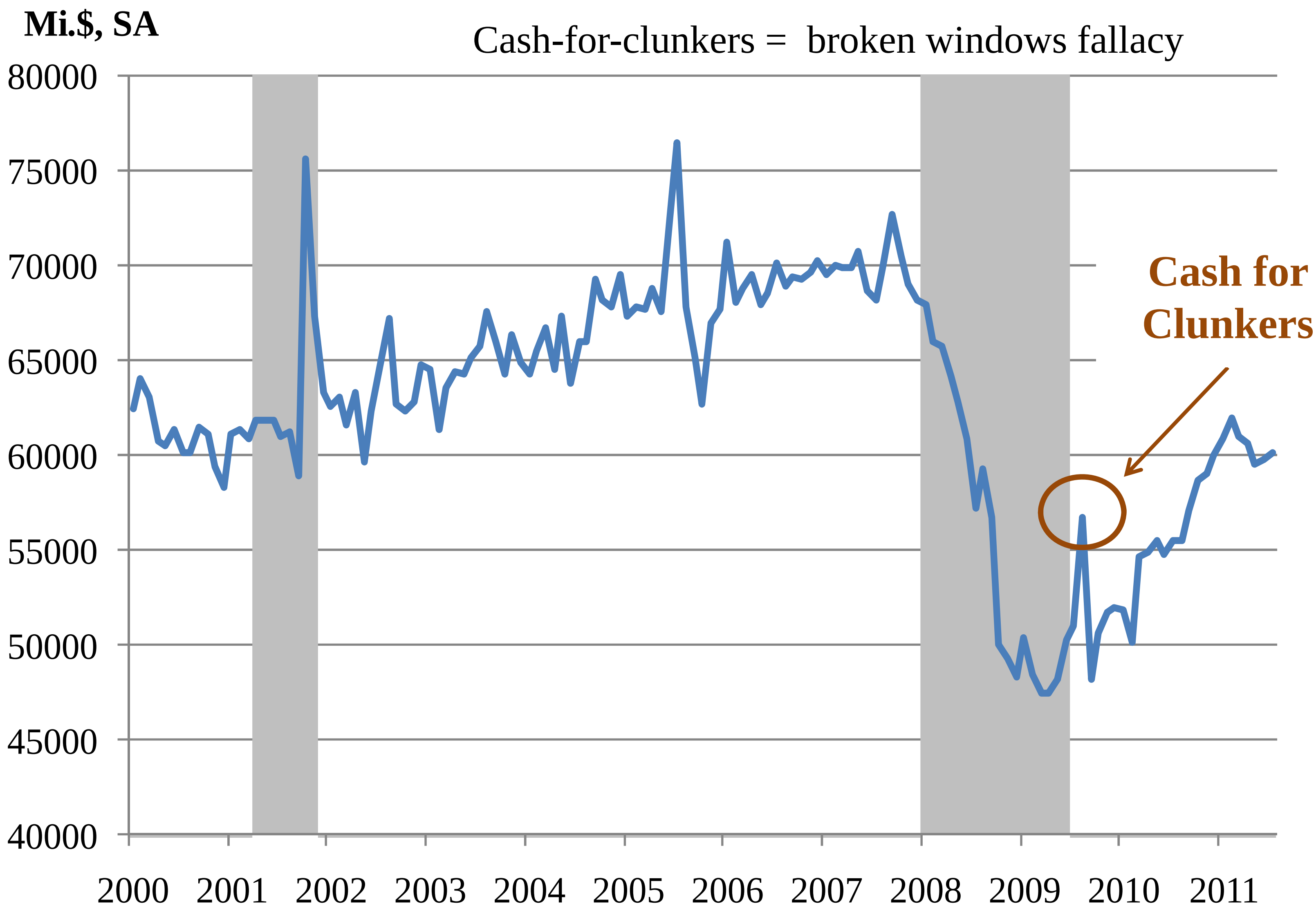
Source: Federal Reserve Board/Institute of Supply Management

The Current Outlook: Capacity Utilization and New Orders



Source: Federal Reserve Board and Census Bureau

The Current Outlook: Vehicle Sales



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.

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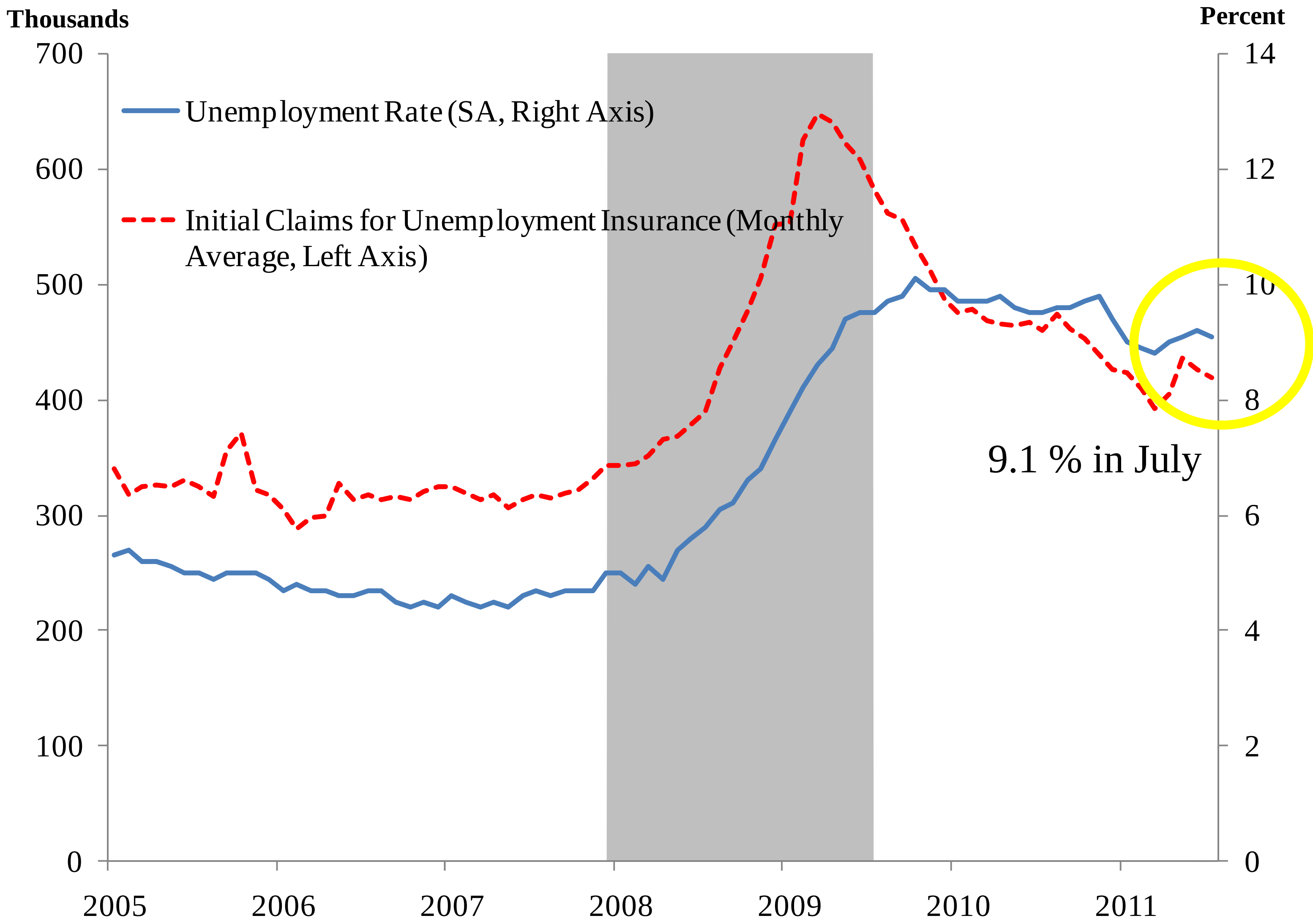
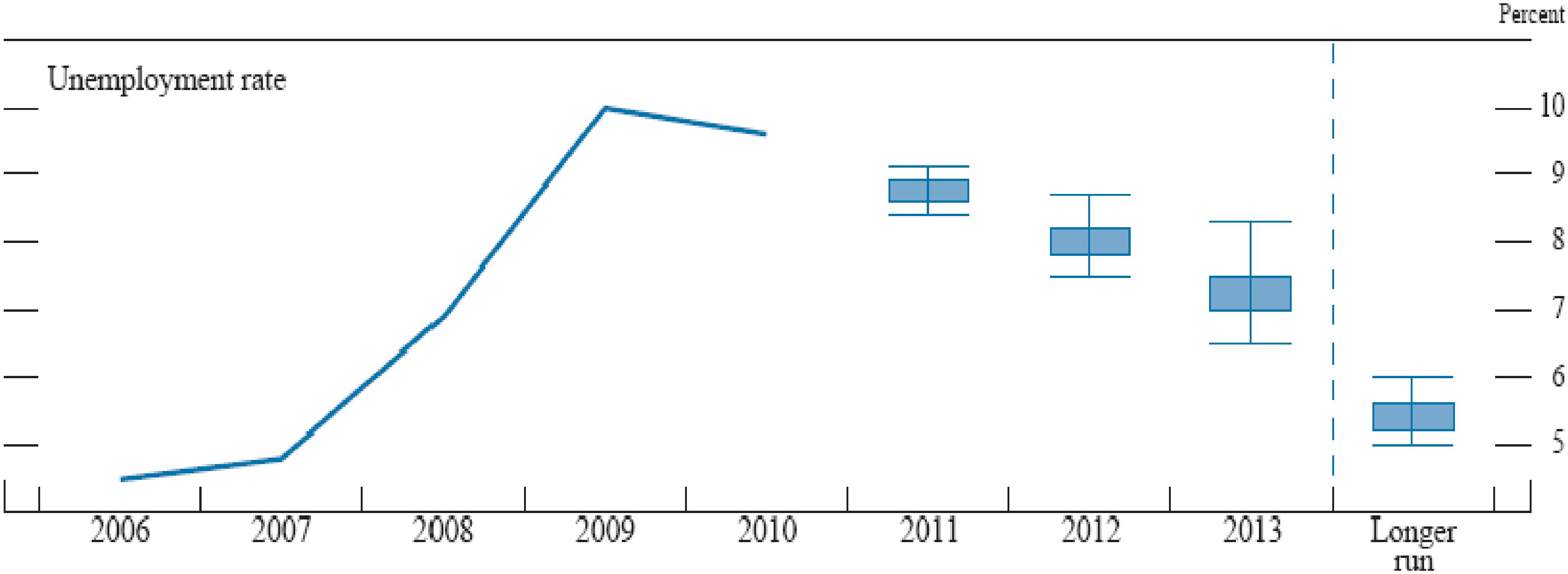
The Current Outlook: Civilian Unemployment



Source: Bureau of Labor Statistics/Department of Labor

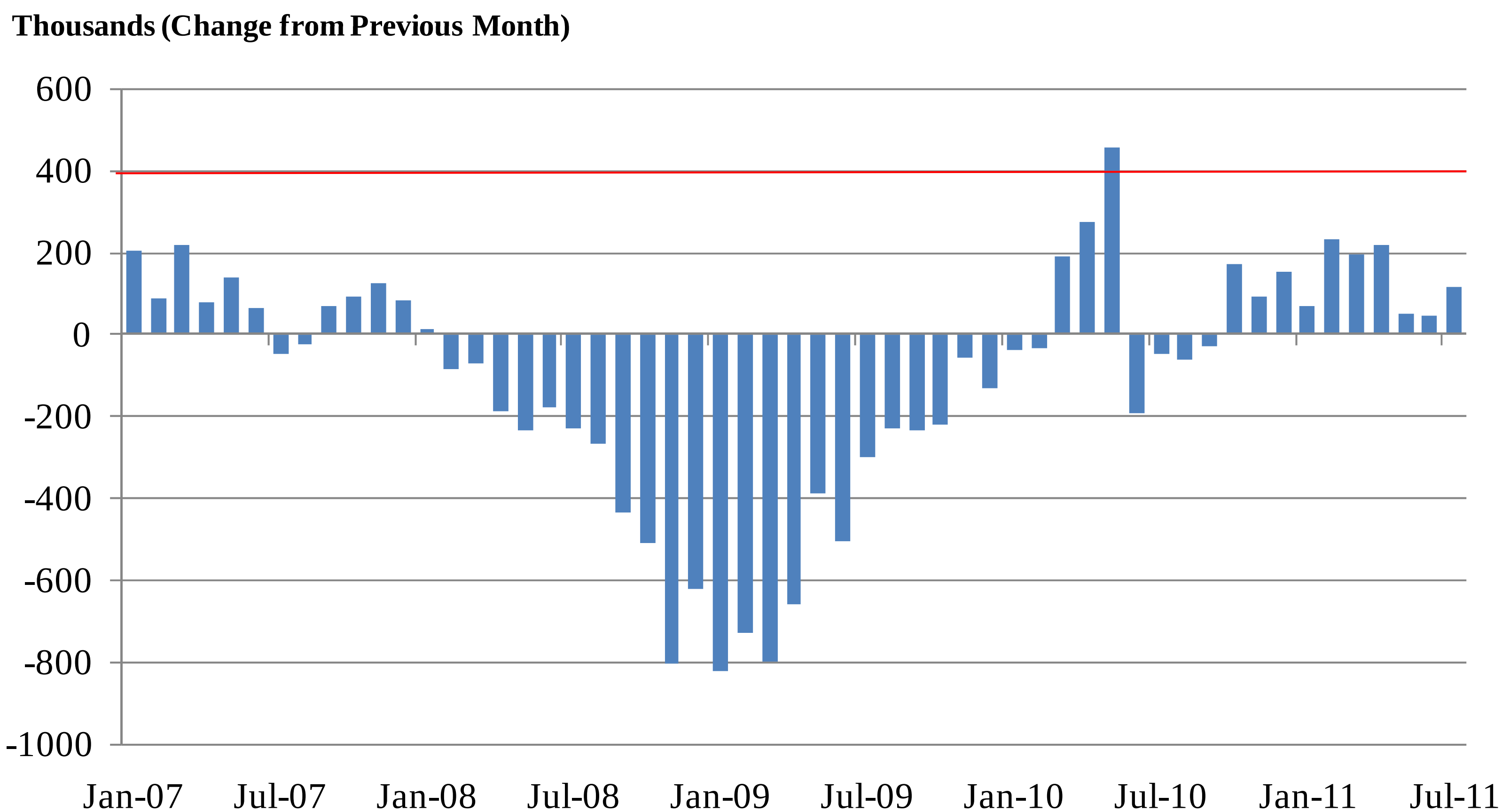
The Current Outlook: Unemployment Forecasts



Unemployment has fallen slowly over the last several recessions. But it has usually fallen slowly, between ½ and 1 percentage point per year.

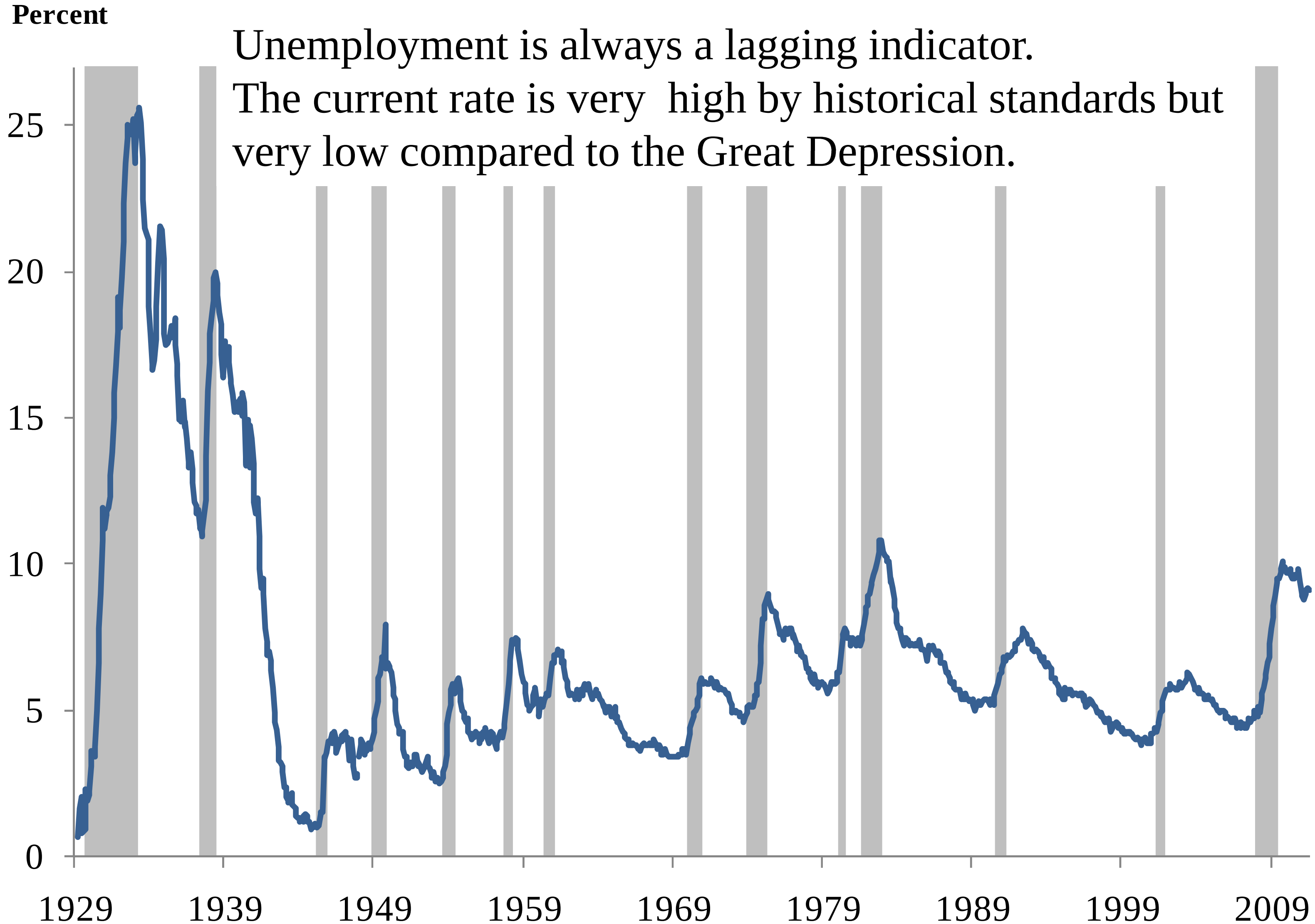
The Current Outlook: NFP Employment

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



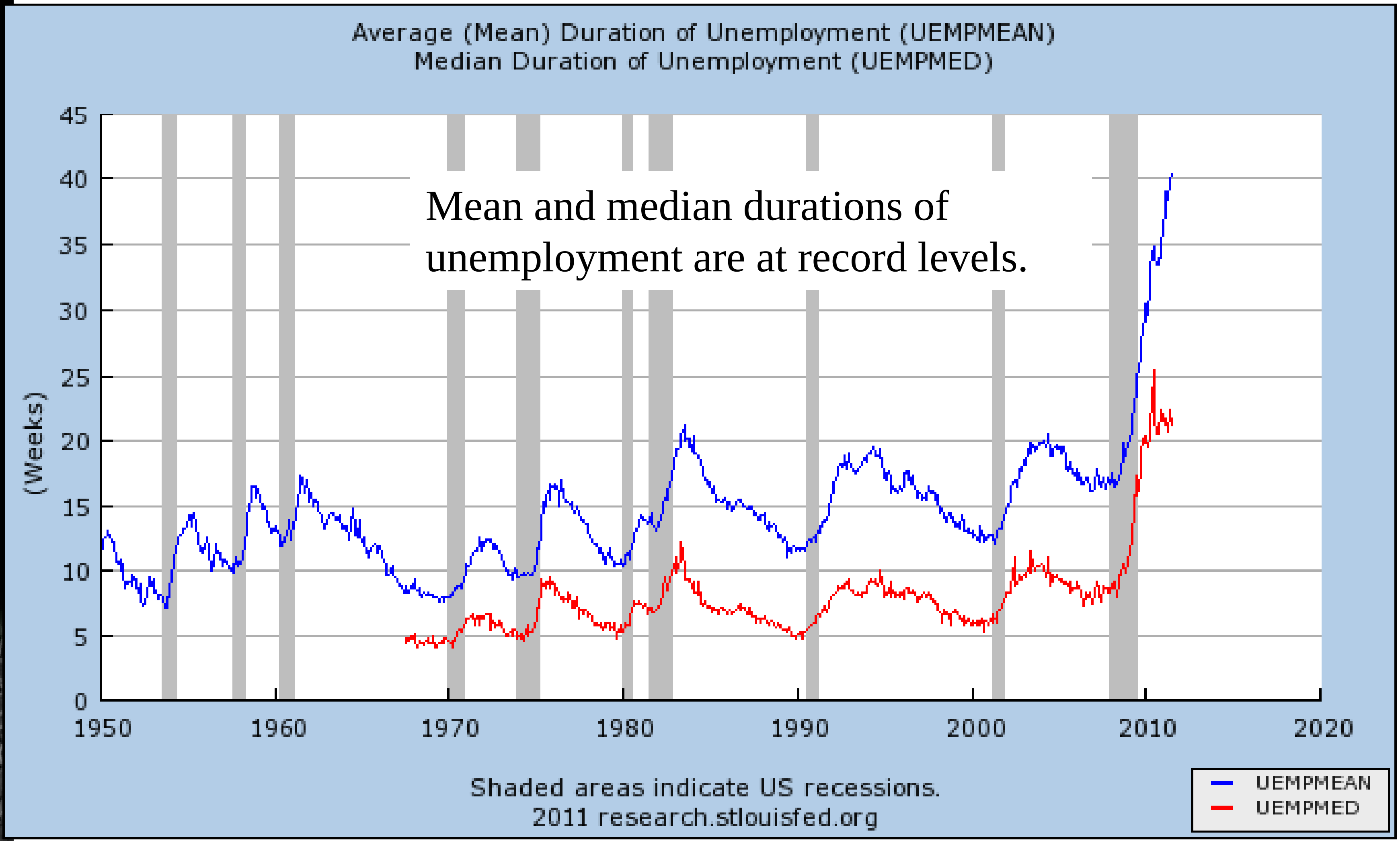
Source: Bureau of Labor Statistics

The Current Outlook: Long term Unemployment



Source: Bureau of Economic Analysis

The Current Outlook: Long term Unemployment

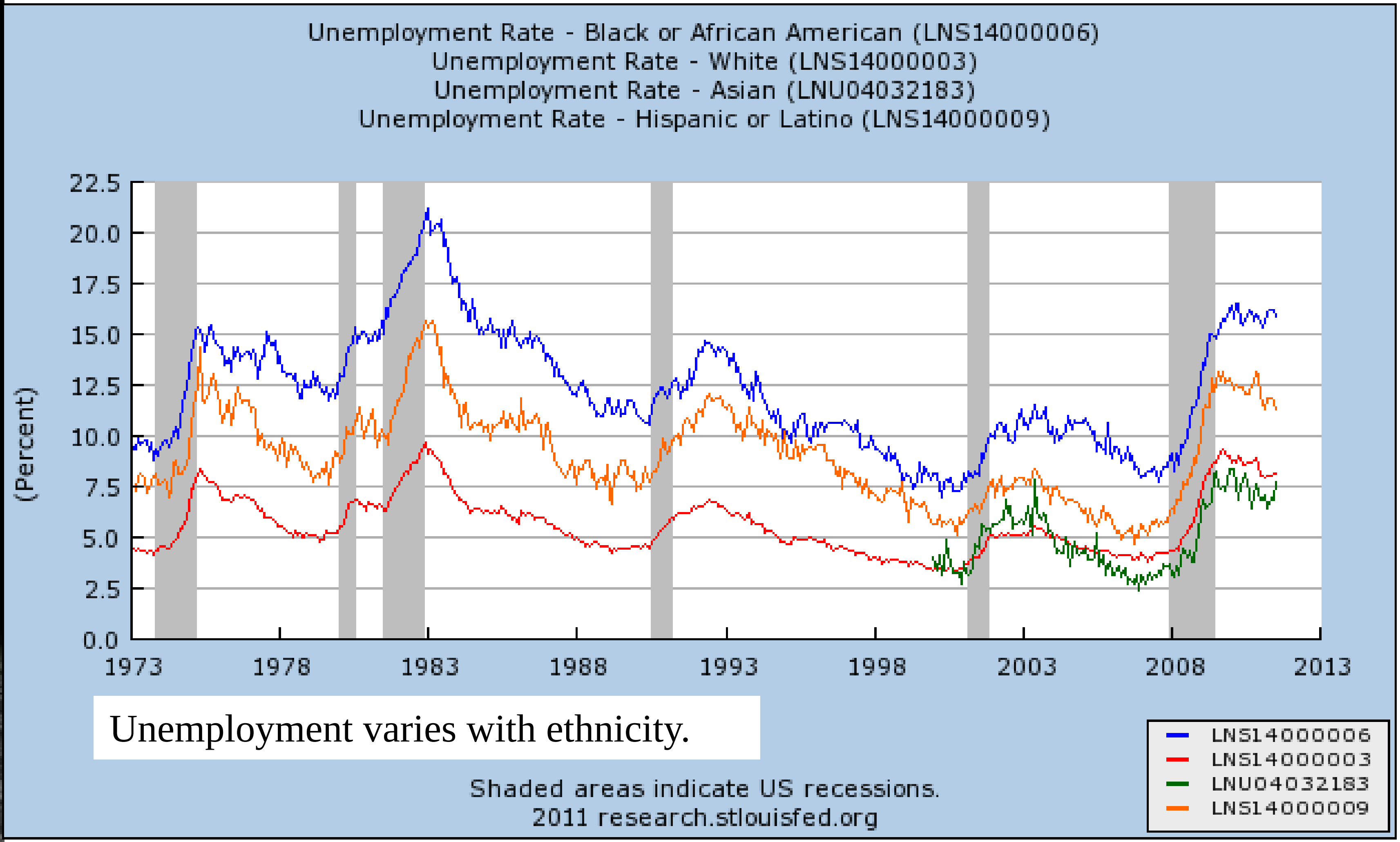


The Current Outlook: Long term Unemployment

- 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



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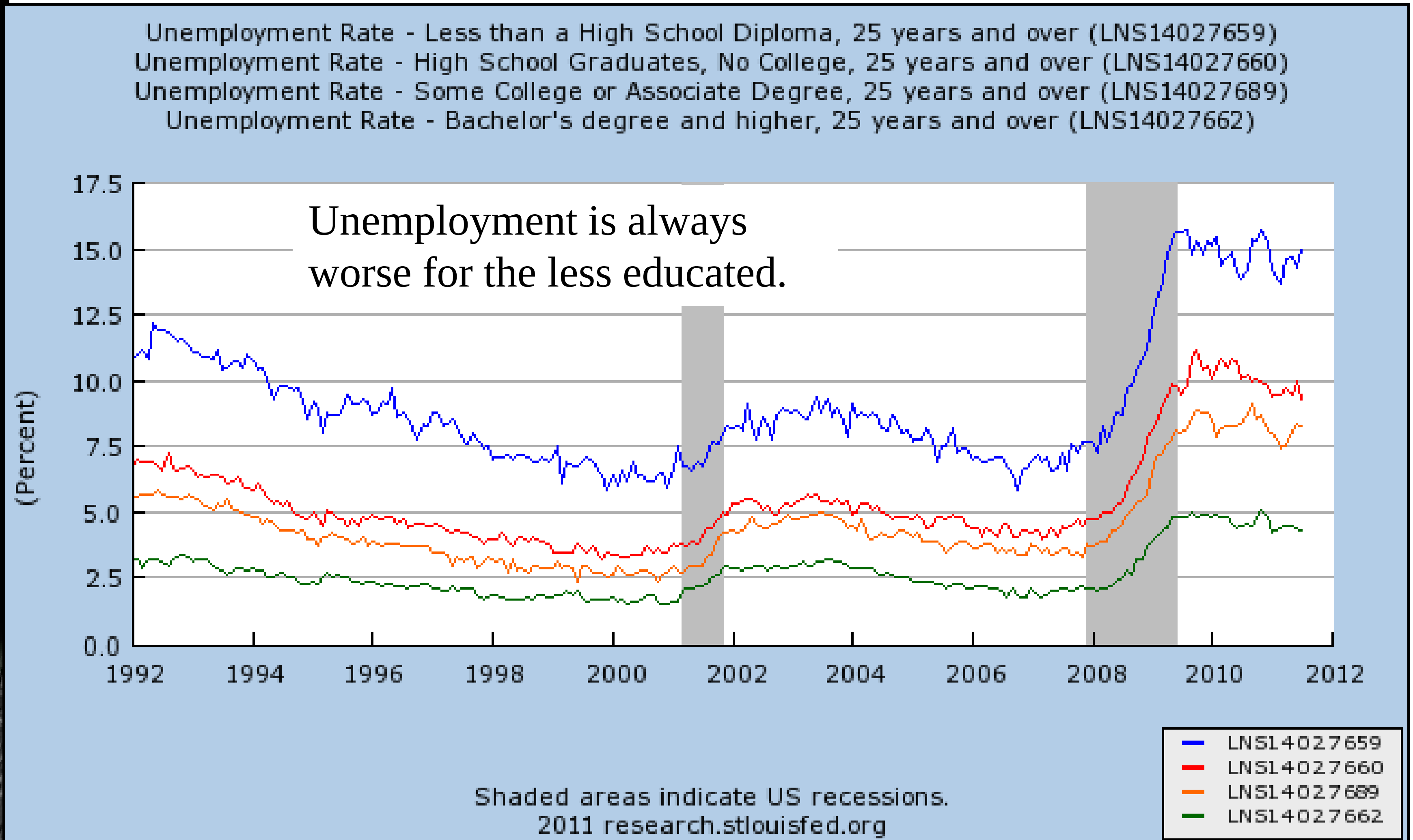
The Current Outlook: Unemployment by Education



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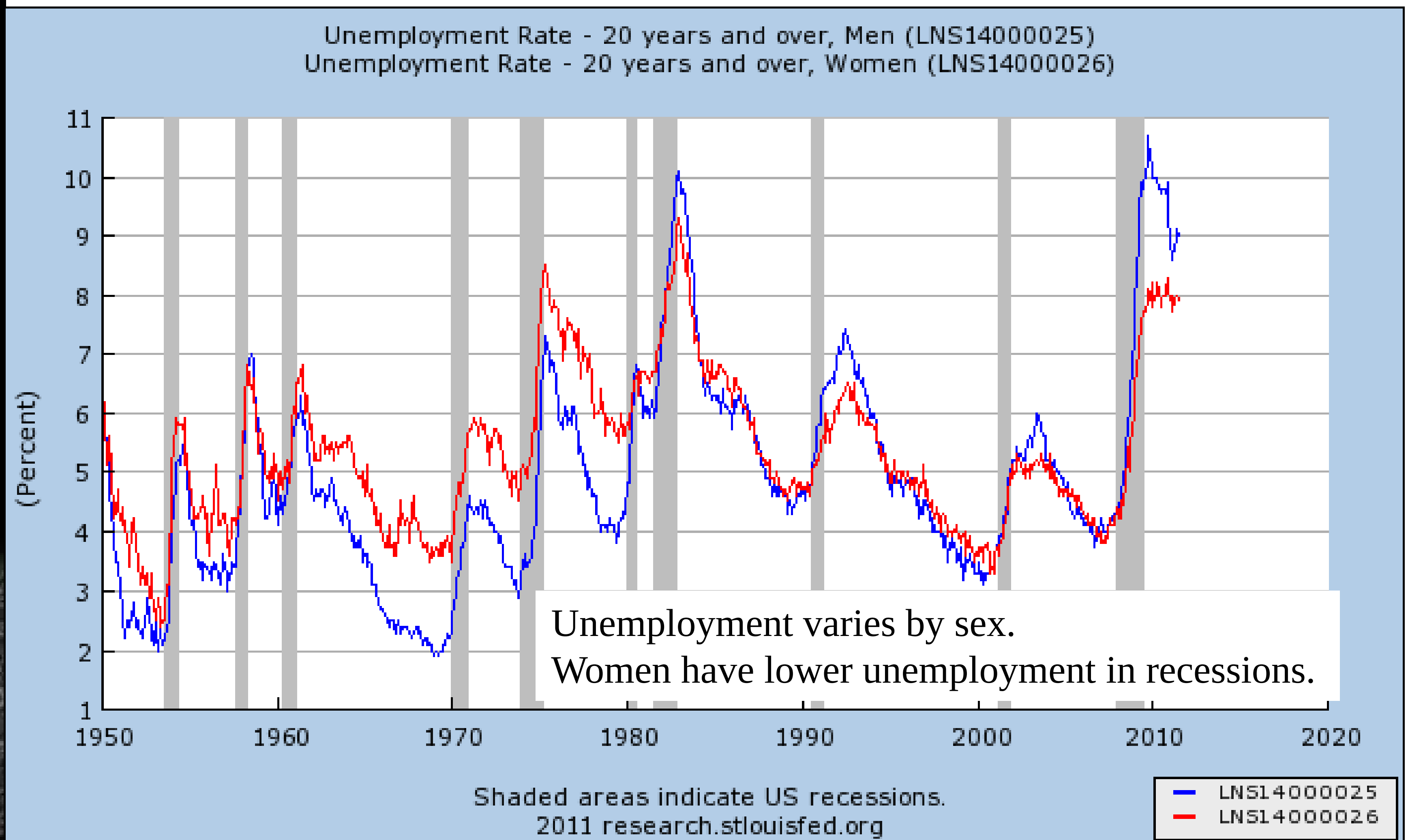
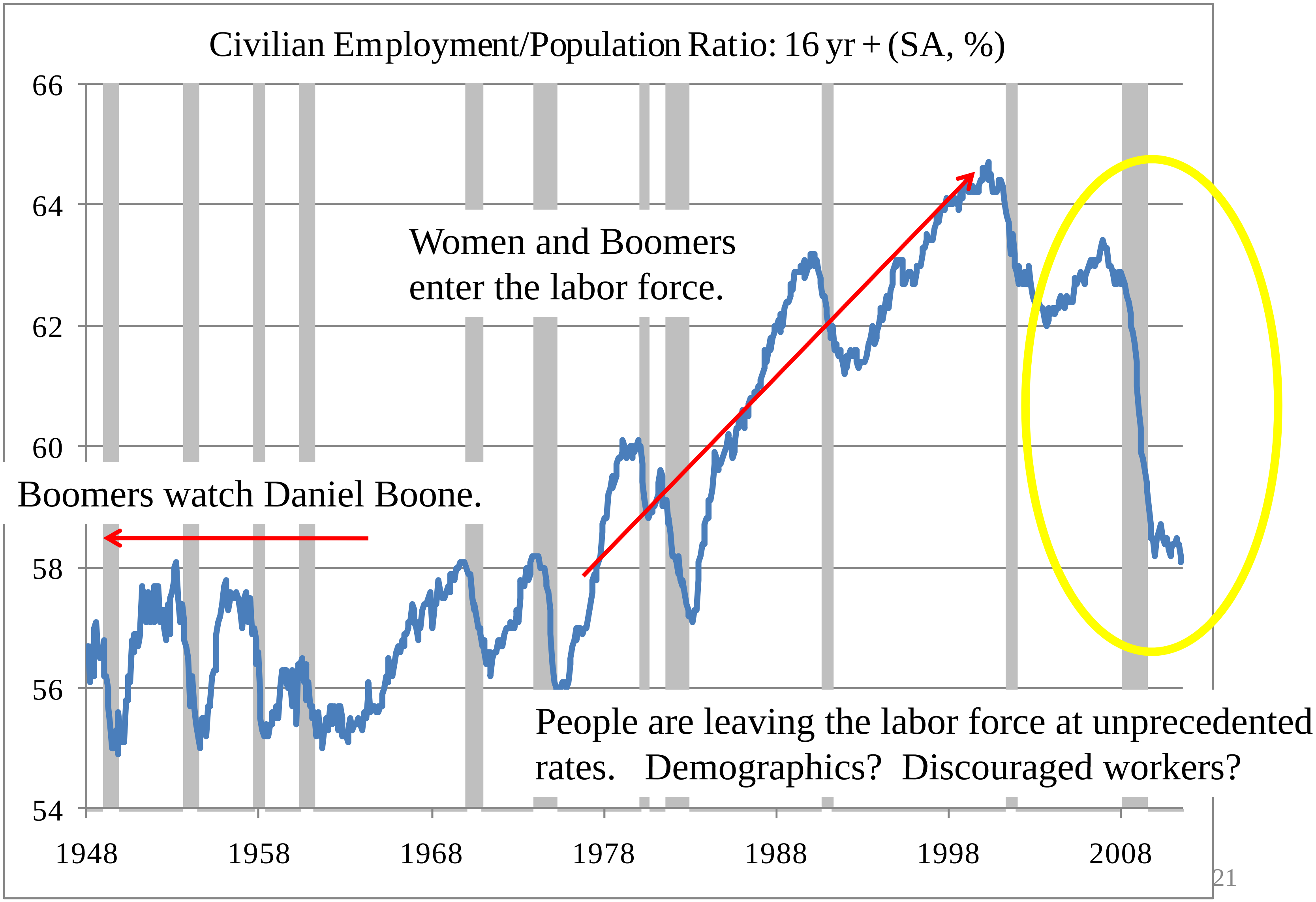
The Current Outlook: Unemployment by Sex

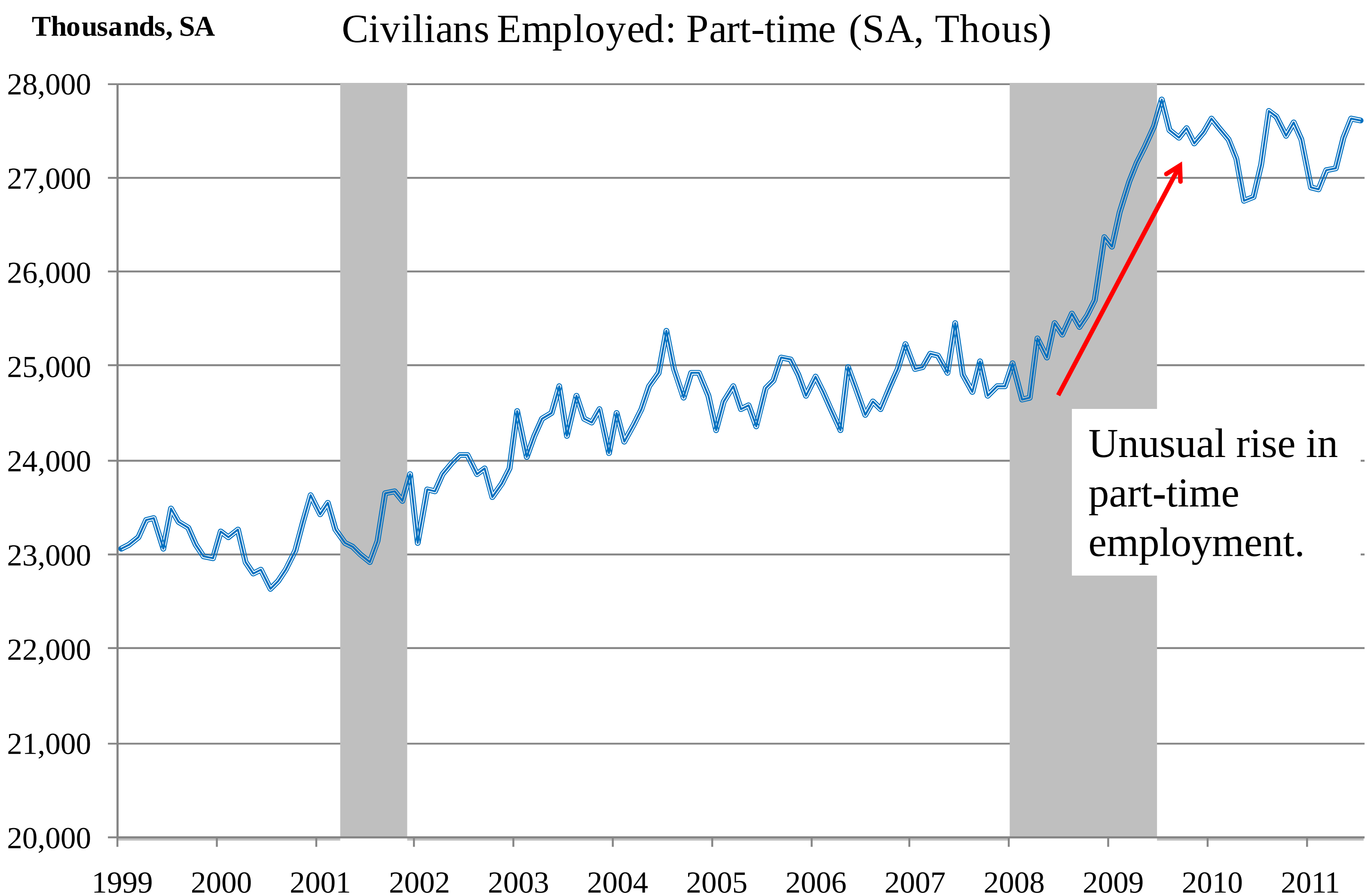


Unemployment varies by sex.
Women have lower unemployment in recessions.

The Current Outlook: Employment/Population Ratio



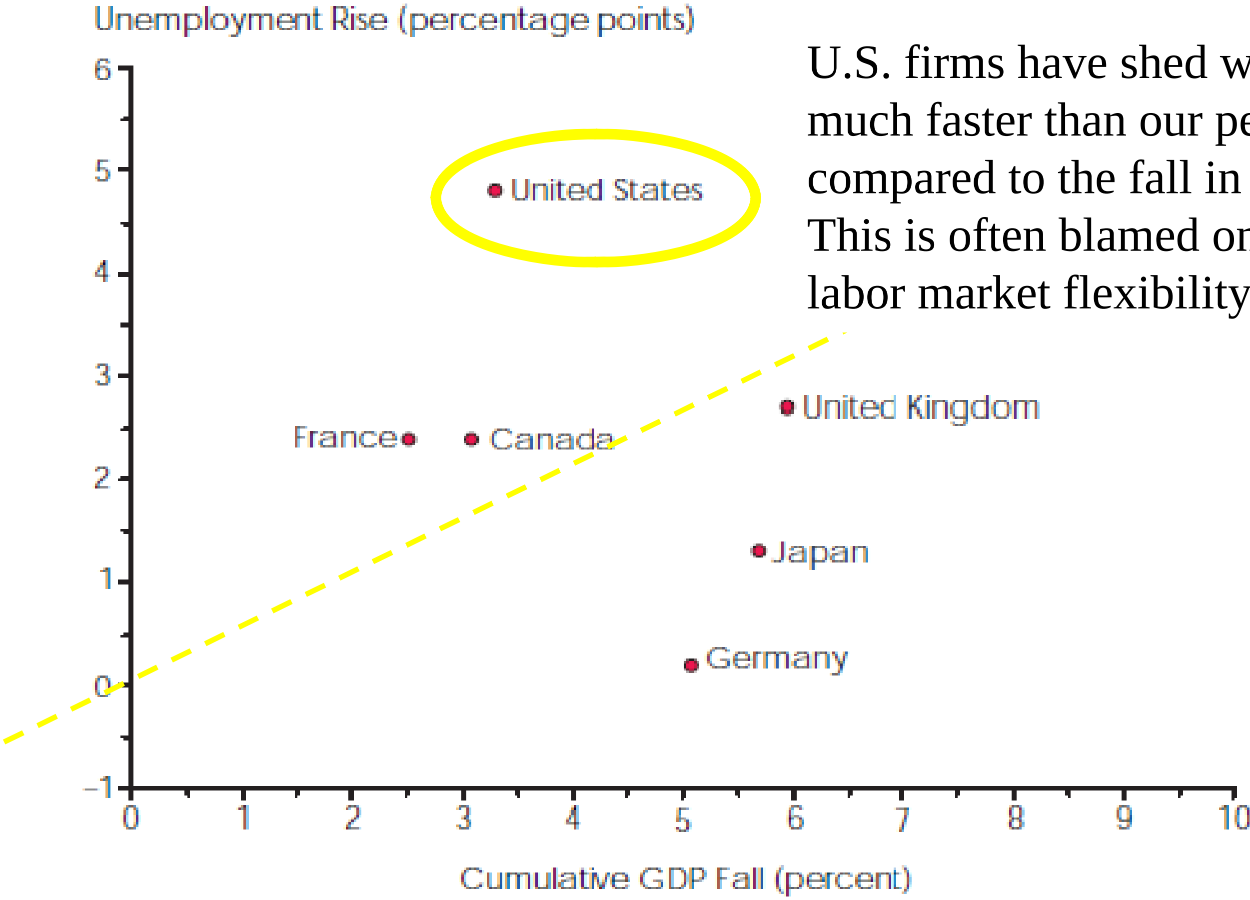
The Current Outlook: Part Time Employees



Source: Bureau of Labor Statistics

U.S. Employment has Fallen Fast Compared with Output

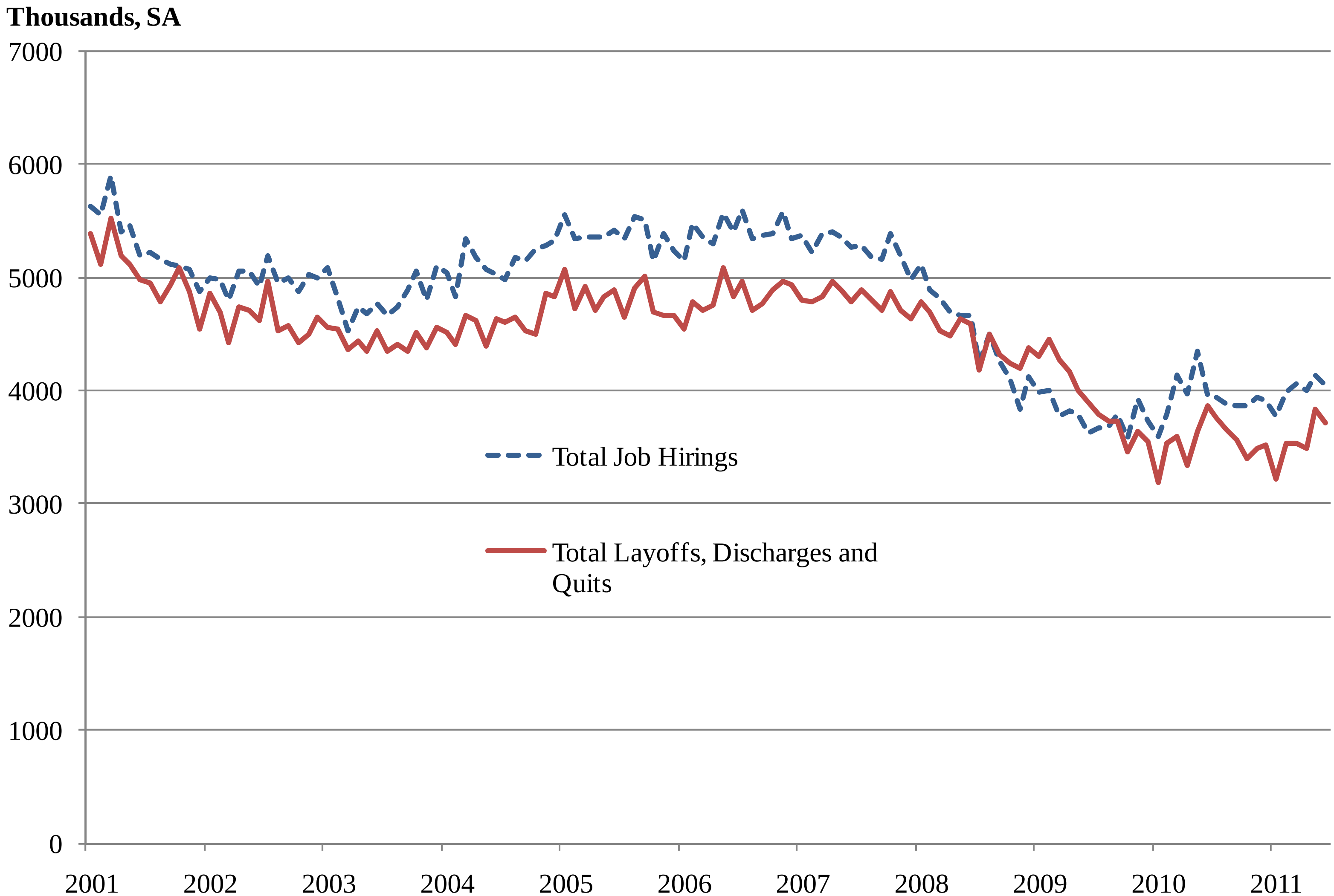
Okun's Ratios: 2008:Q2–2009:Q3



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.

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: Creation vs. Layoffs

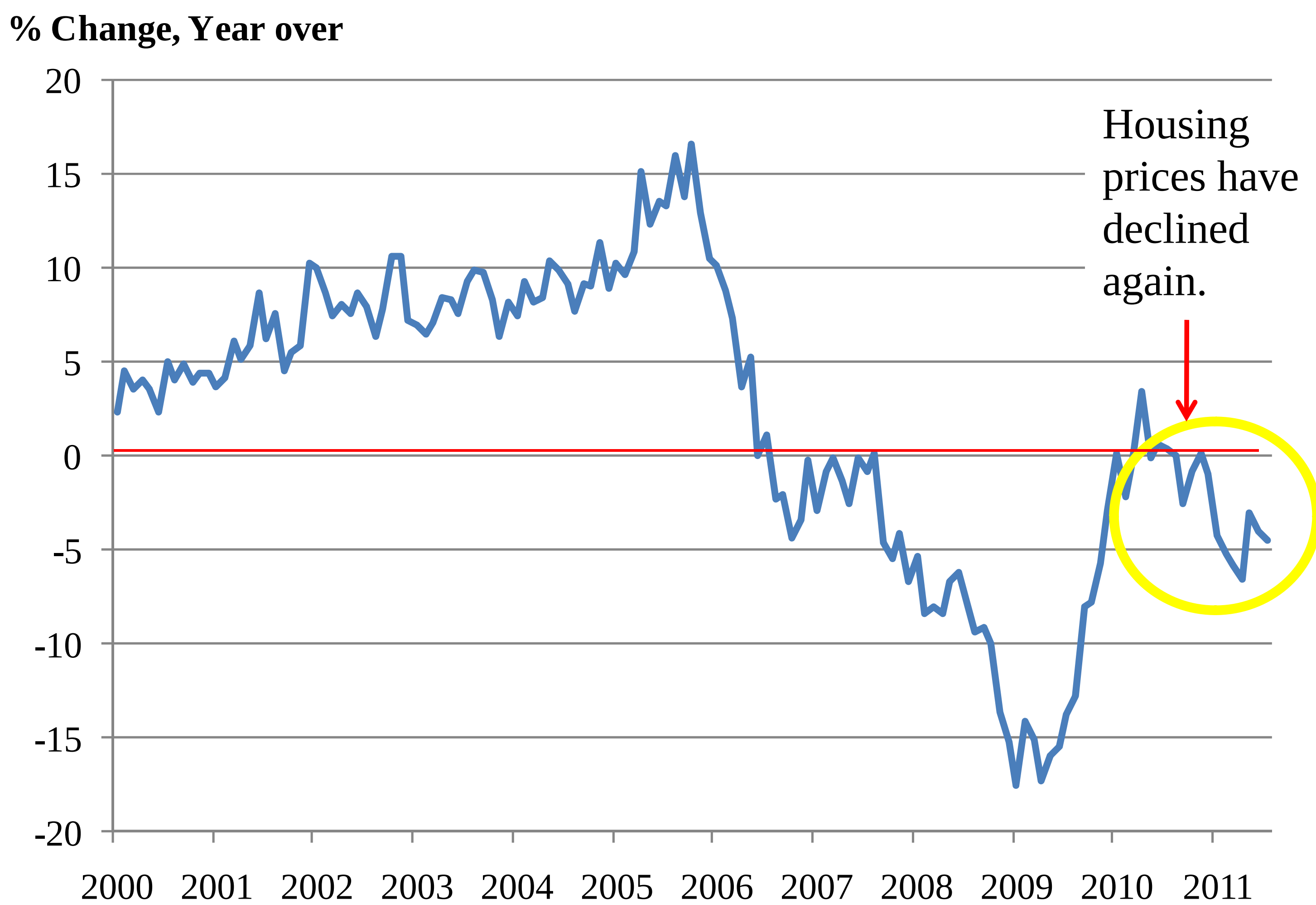


Source: Bureau of Labor Statistics

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



Source: National Assoication of Realtors

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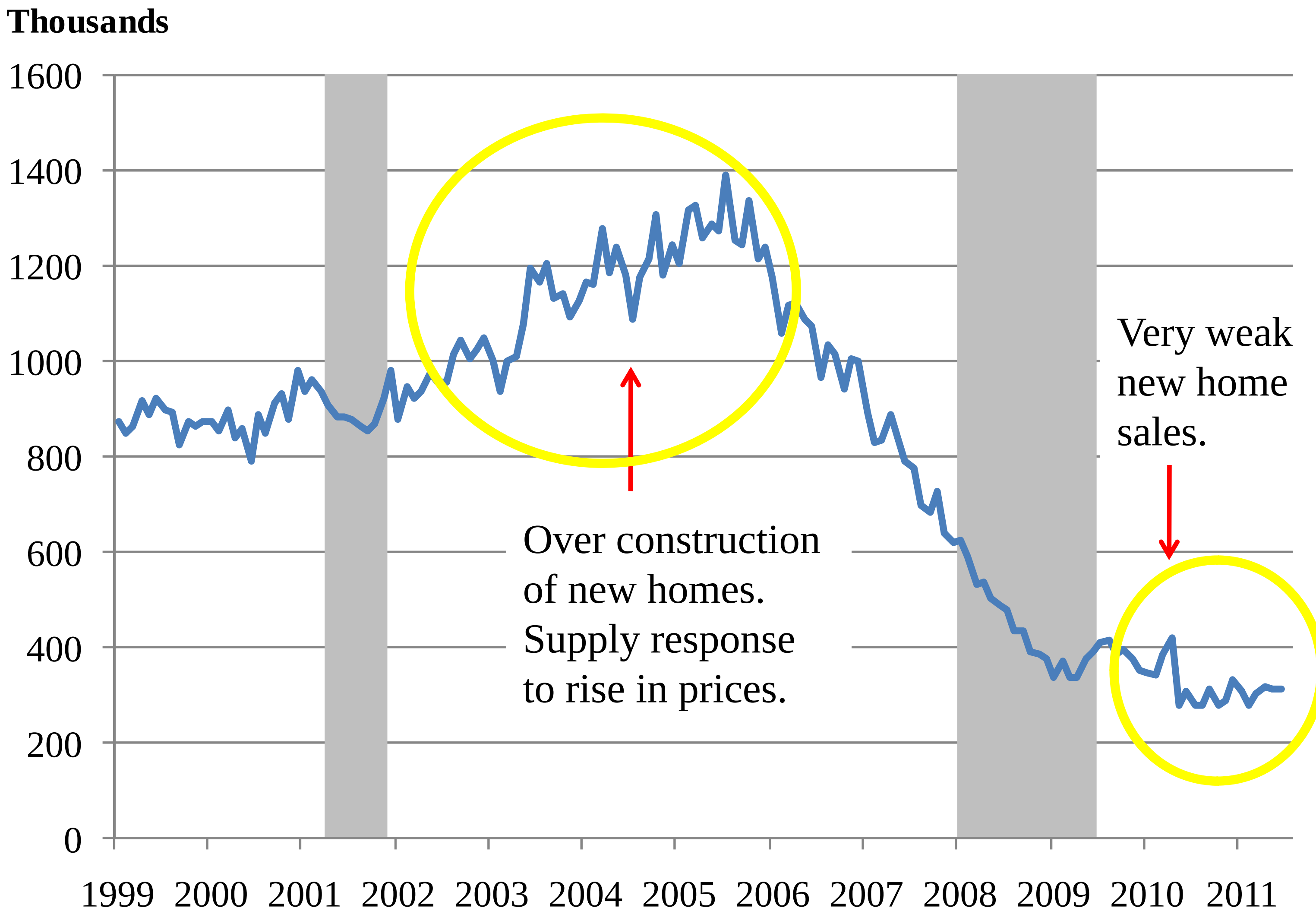
The Current Outlook: New Home Sales



Source: National Assoication of Realtors

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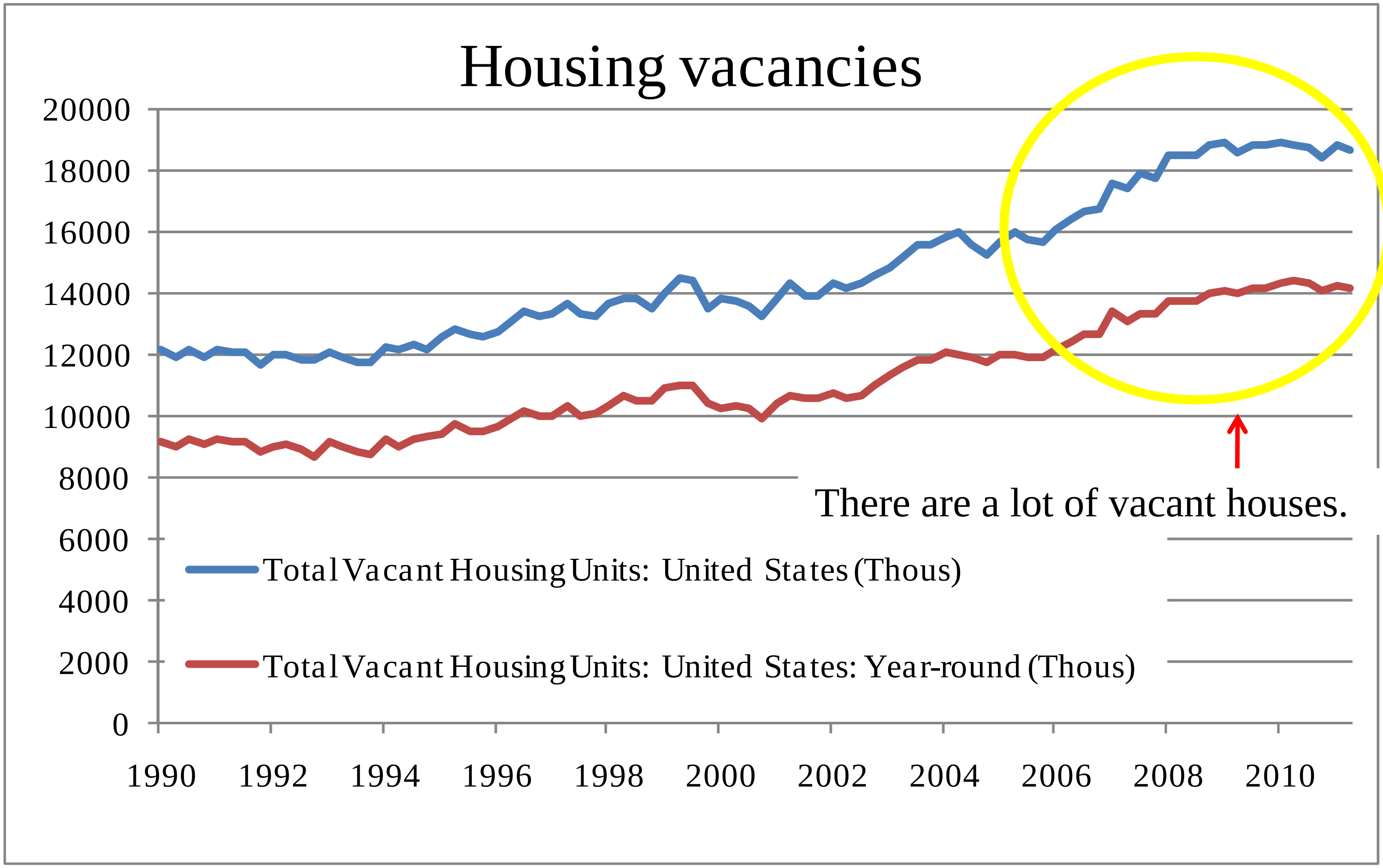
The Current Outlook: Housing



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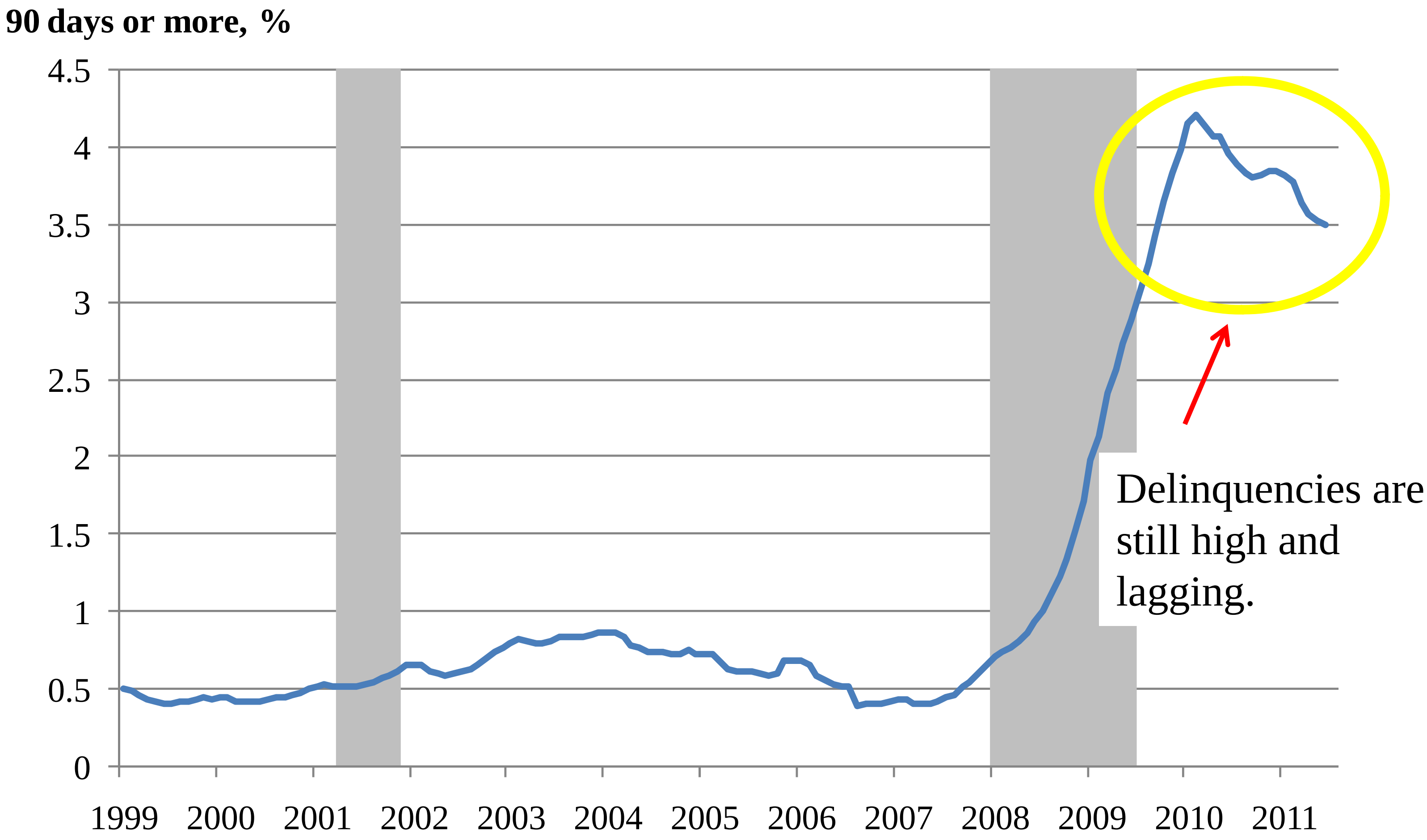
The Current Outlook: Housing

- 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

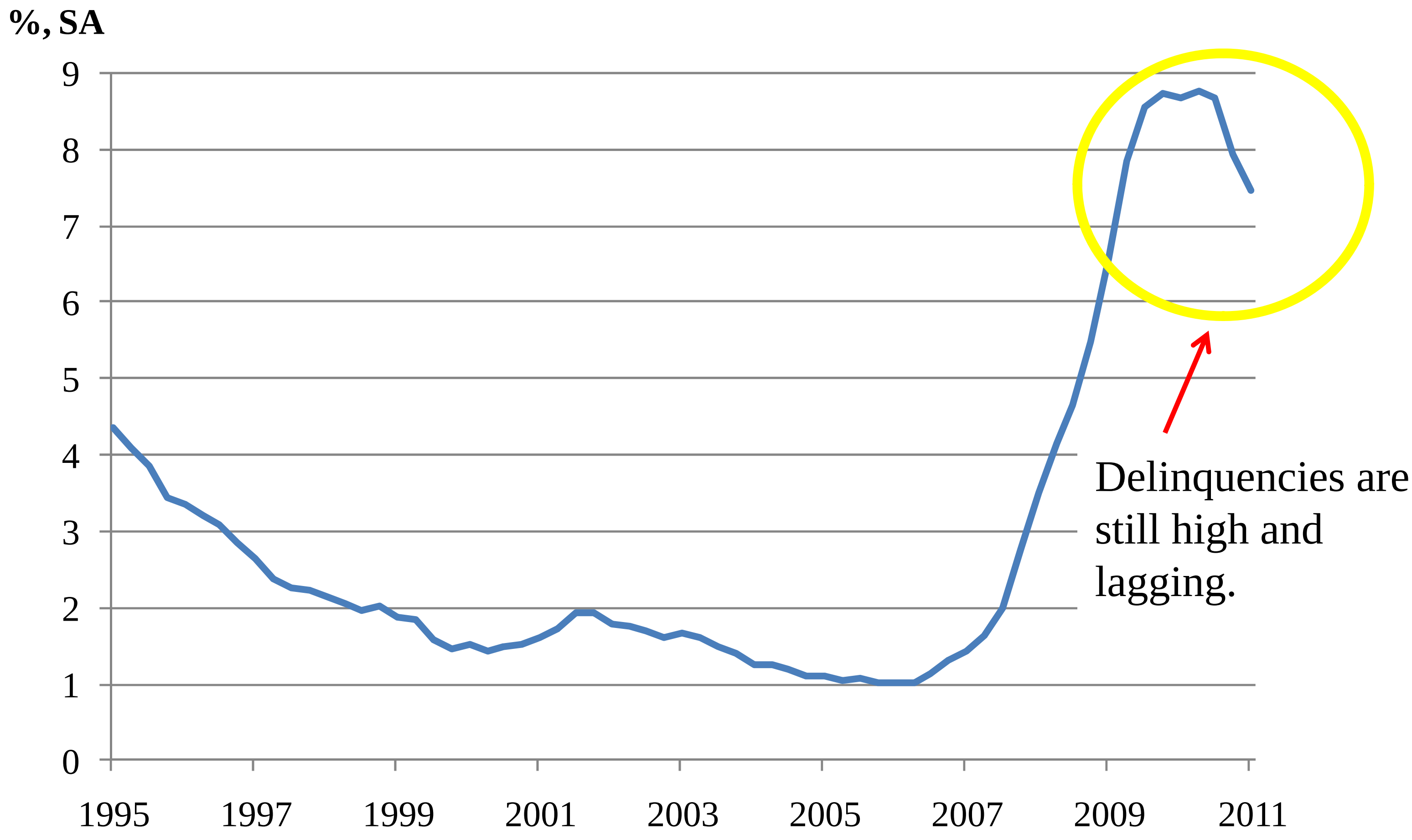
"Neither a borrower nor a lender be."– Ben Franklin

The Current Outlook: Mortgage Delinquencies



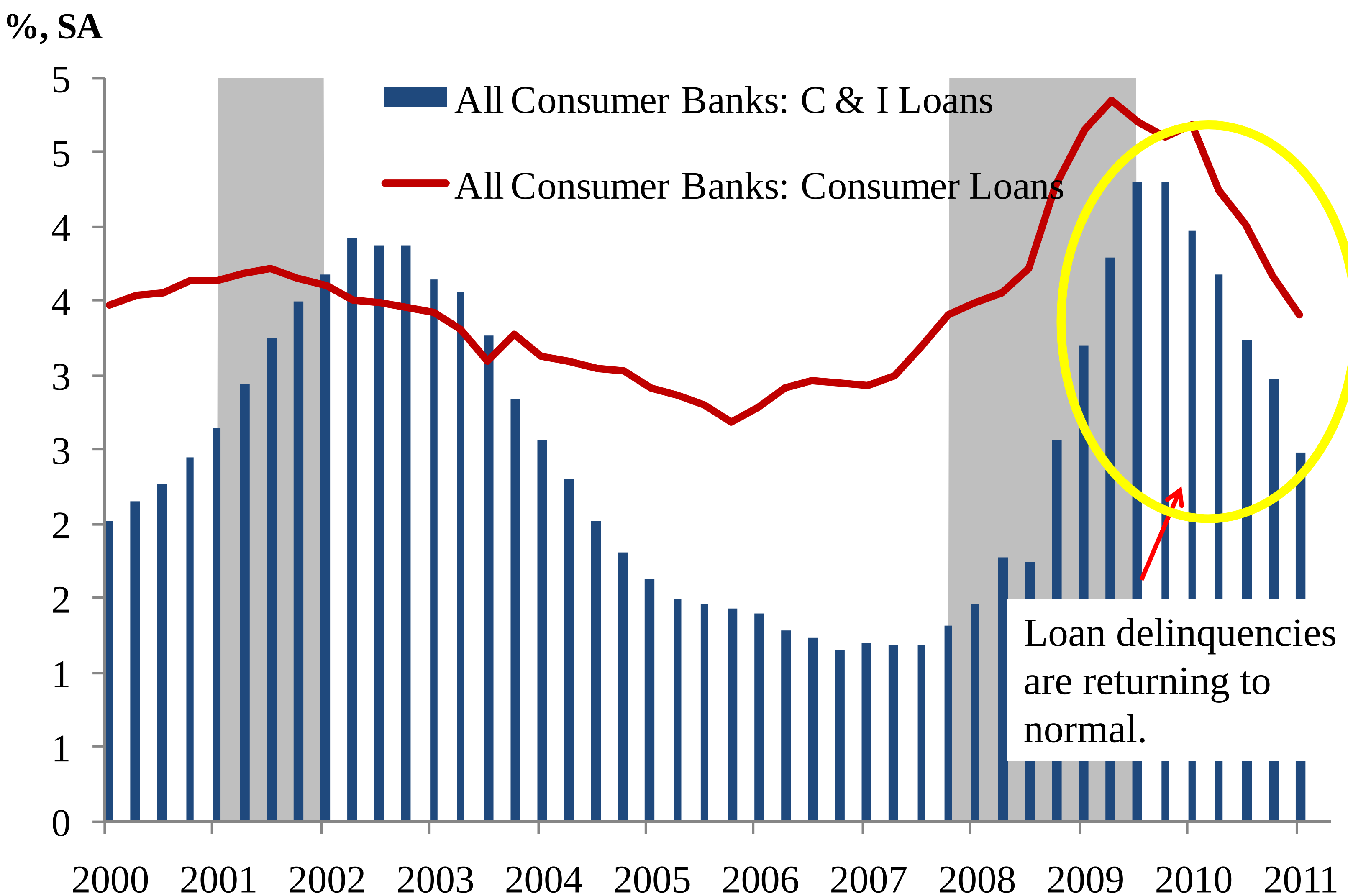
Source: Federal Home Loan Mortgage Corporation

The Current Outlook: Commercial Real Estate Loan Delinquency Rate



Source: Federal Reserve Board

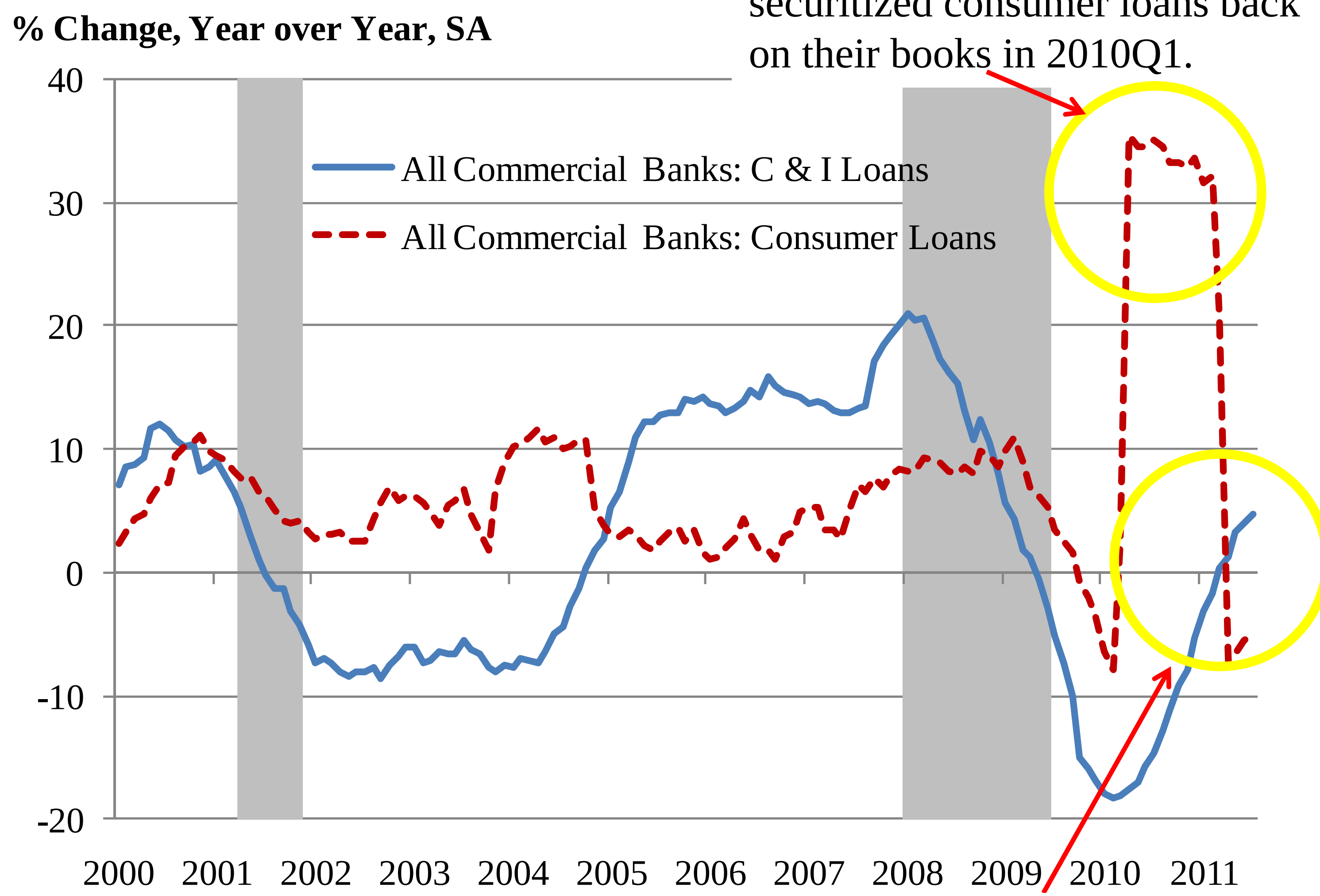
The Current Outlook: Loan Delinquency Rates



Source: Federal Reserve Board

The Current Outlook: Bank Credit

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



Source: Federal Reserve Board

C&I loans recover somewhat faster than in 2001 recession.

The Current Outlook: Loan Delinquency

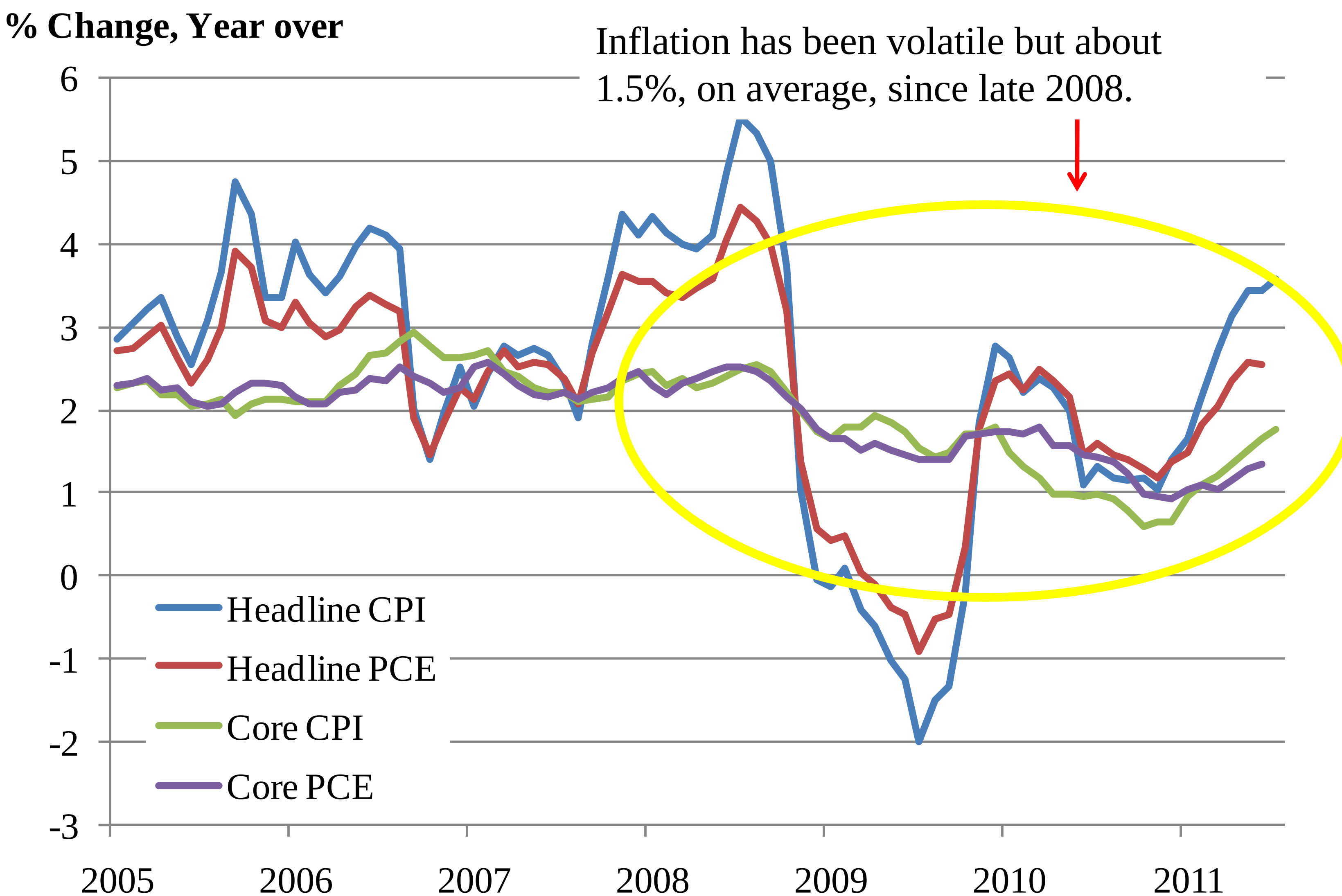
- Real estate loan delinquencies are still very high but falling. They are lagging.
- Other loan delinquencies are high but declining and closer to normal.

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



Source: Bureaue of Economic Analysis/Bureau of Labor Statistics

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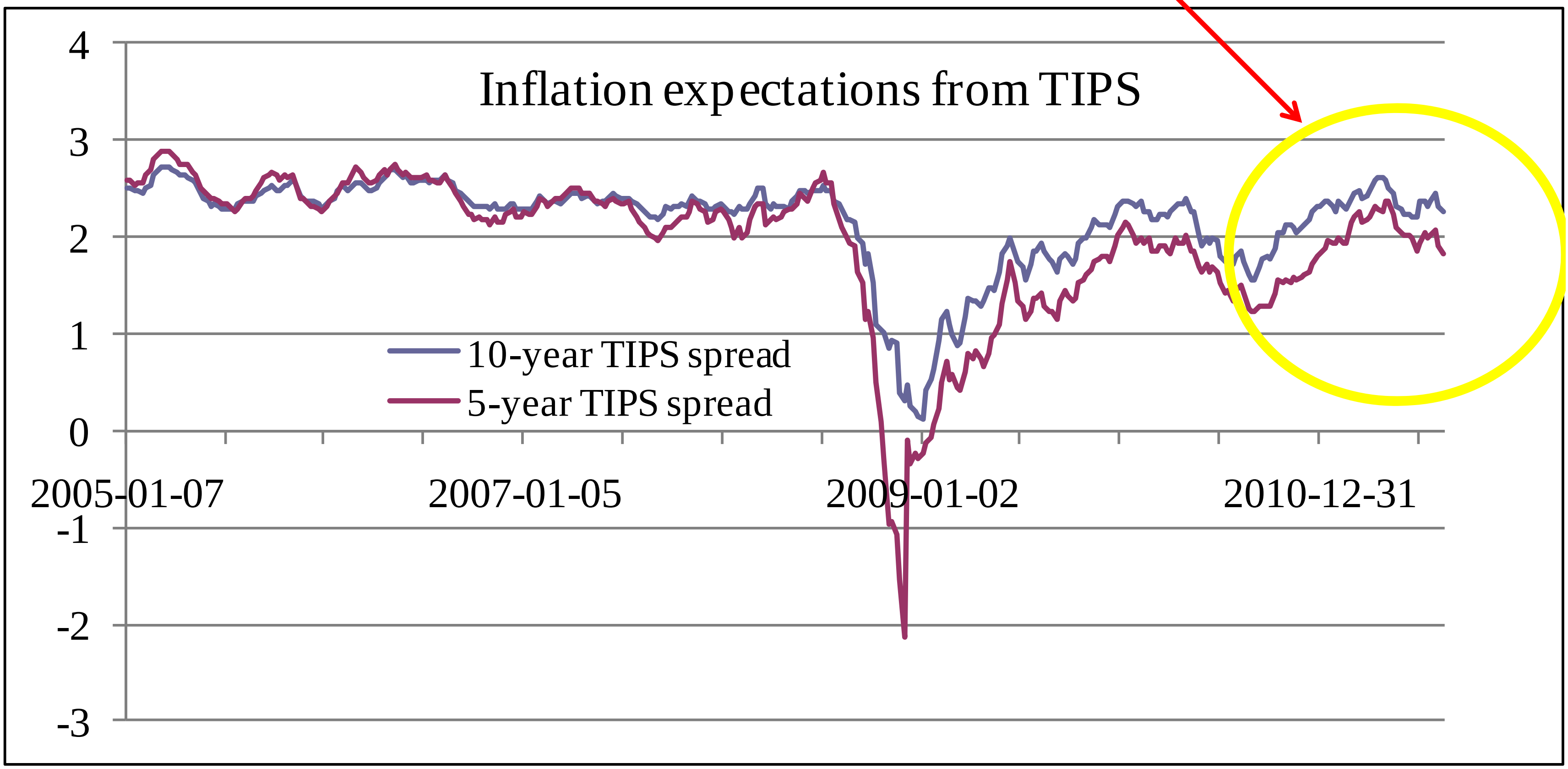
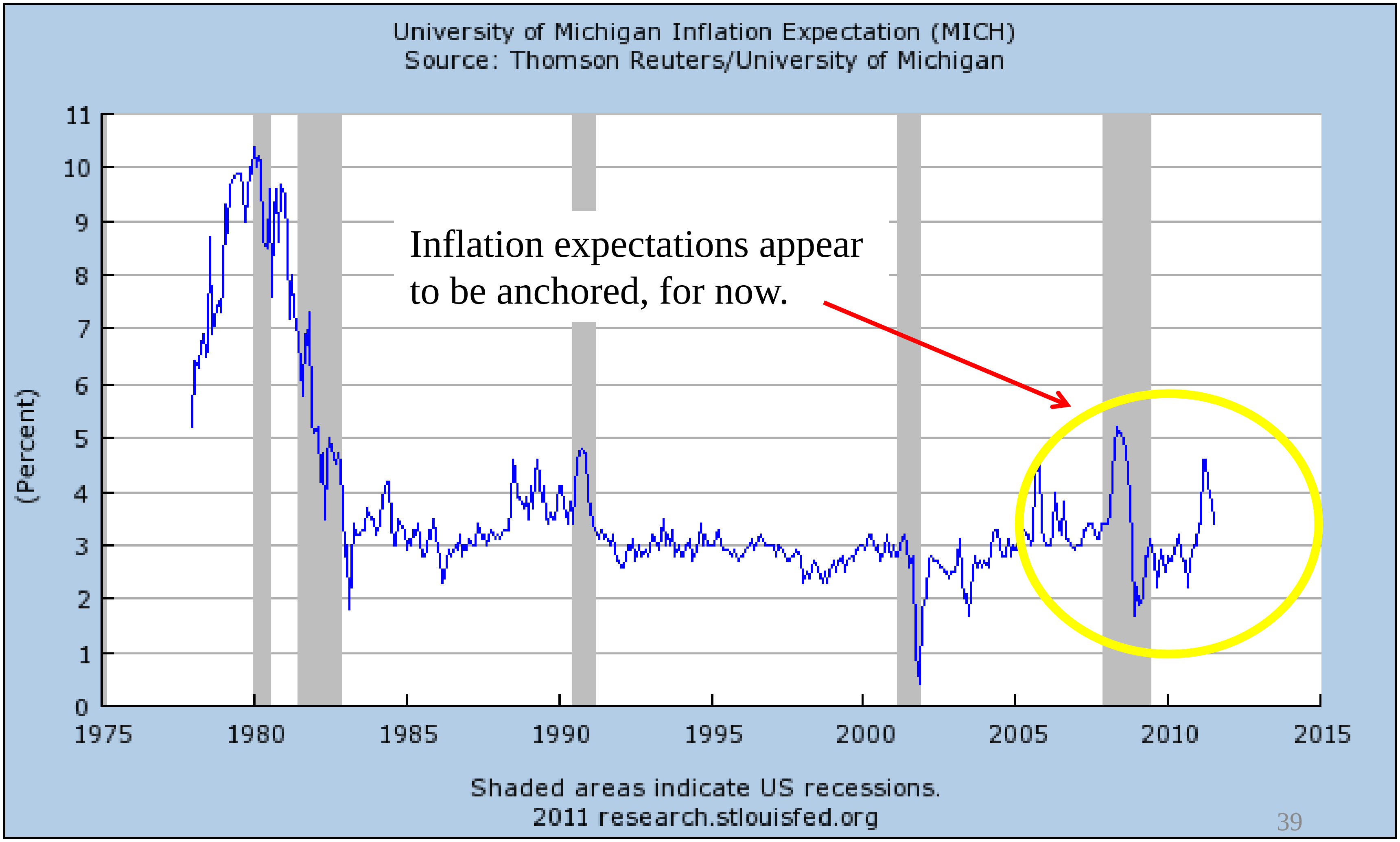
The Current Outlook: Inflation

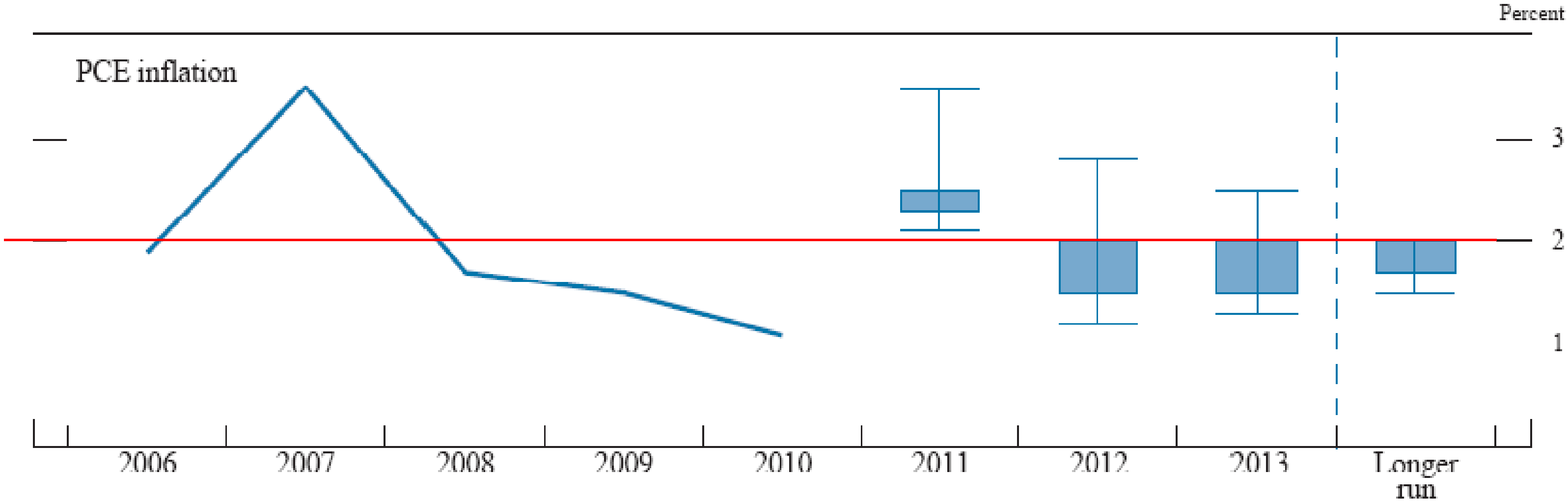
Inflation expectations appear to be anchored, for now.

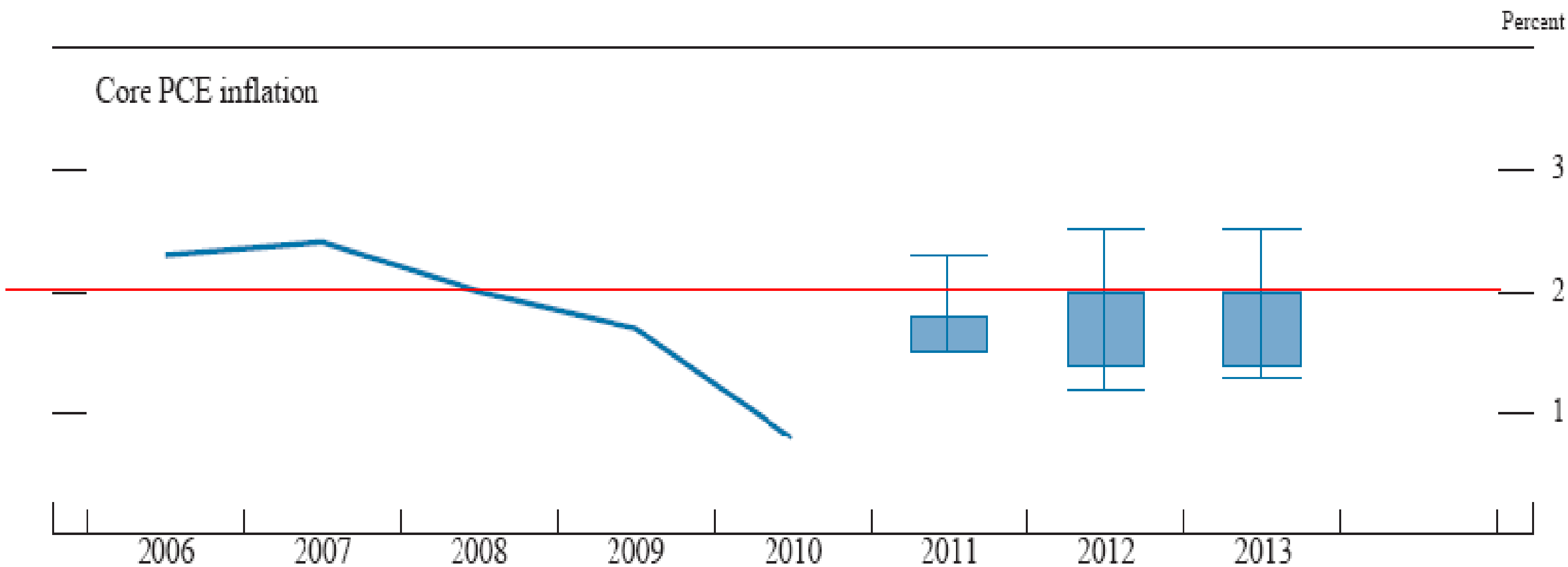


The Current Outlook: Inflation



The Current Outlook: Inflation forecasts

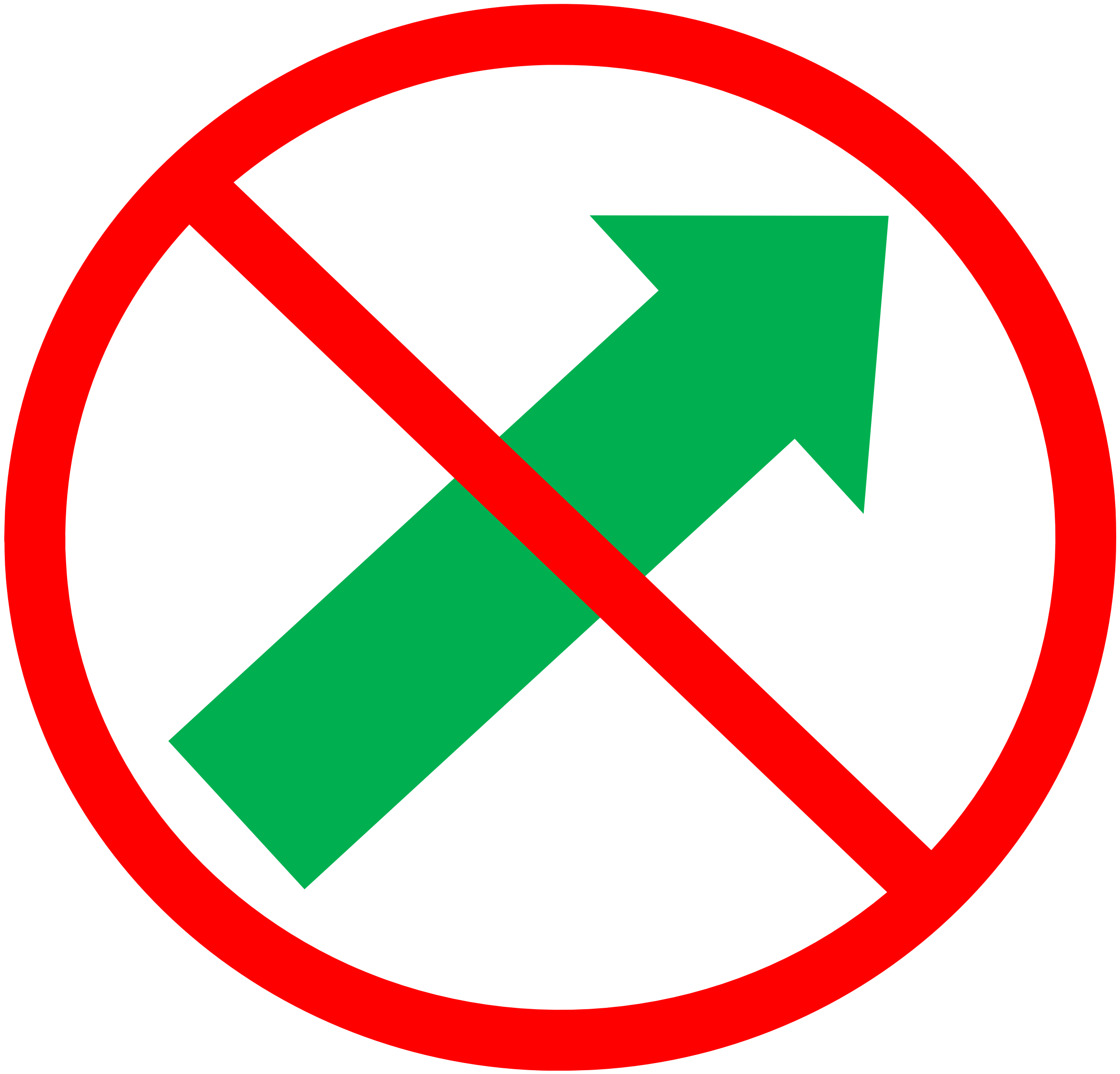




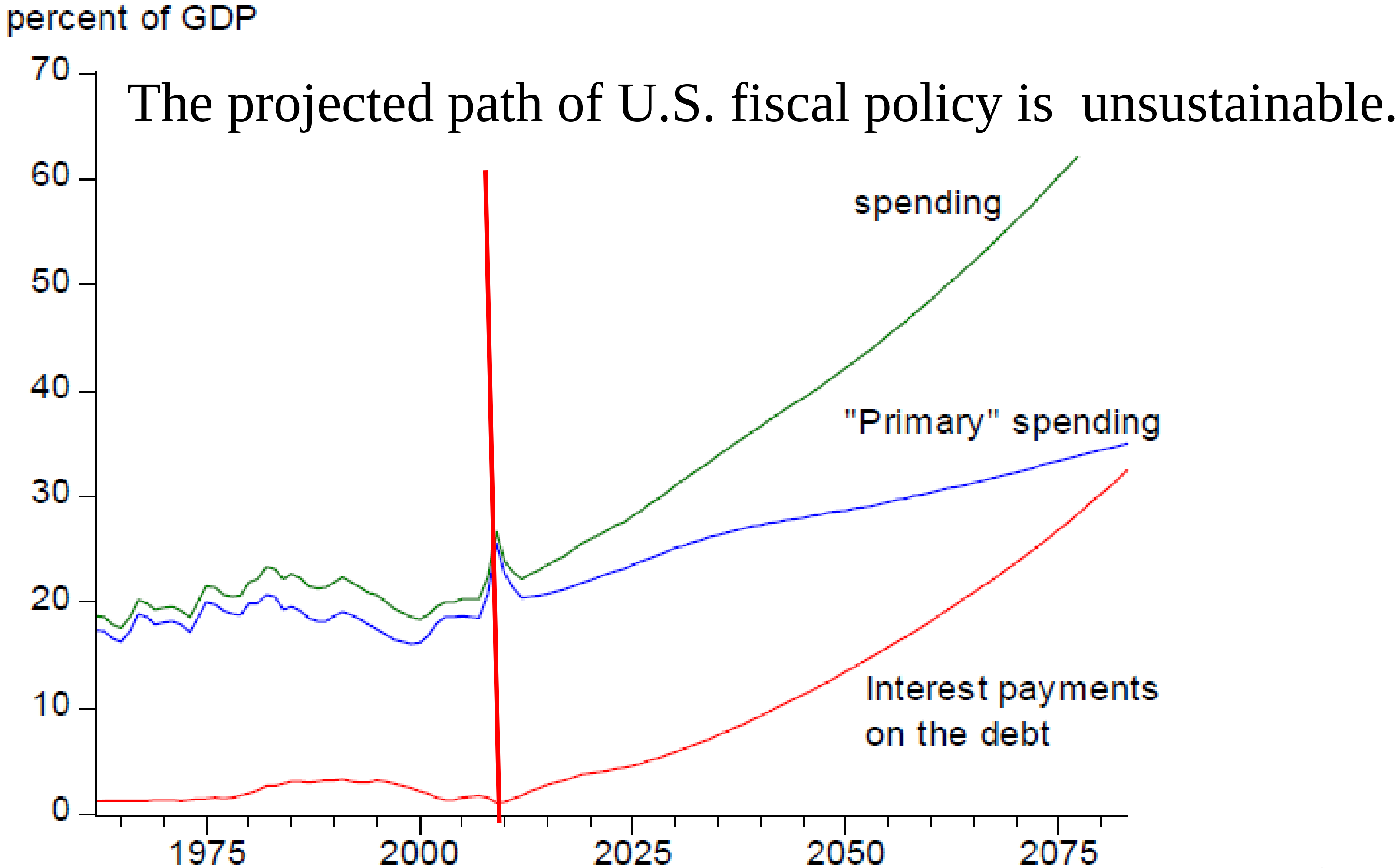
The Current Outlook: Fiscal Policy and Inflation

- 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



Source: John Taylor

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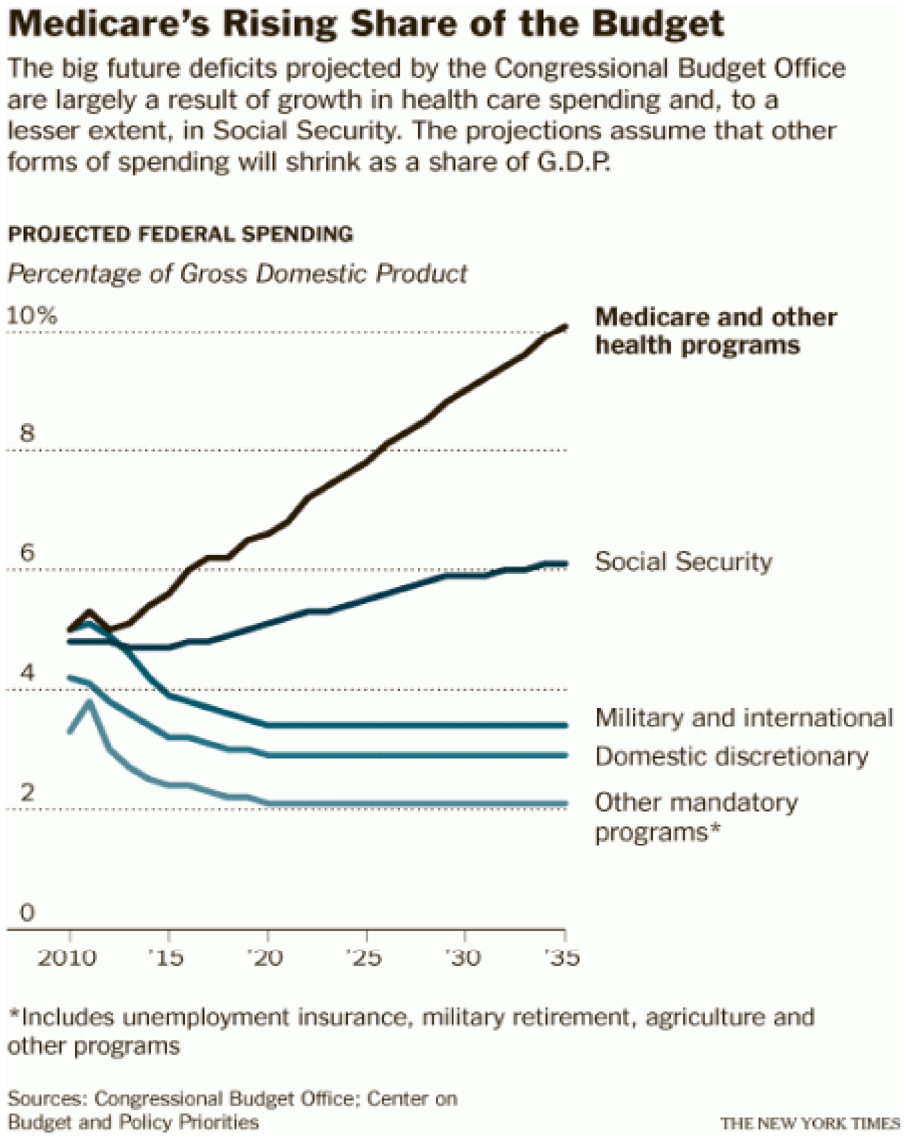
The Current Outlook: Fiscal Policy and Inflation



Medicare is largely the culprit in exploding spending.

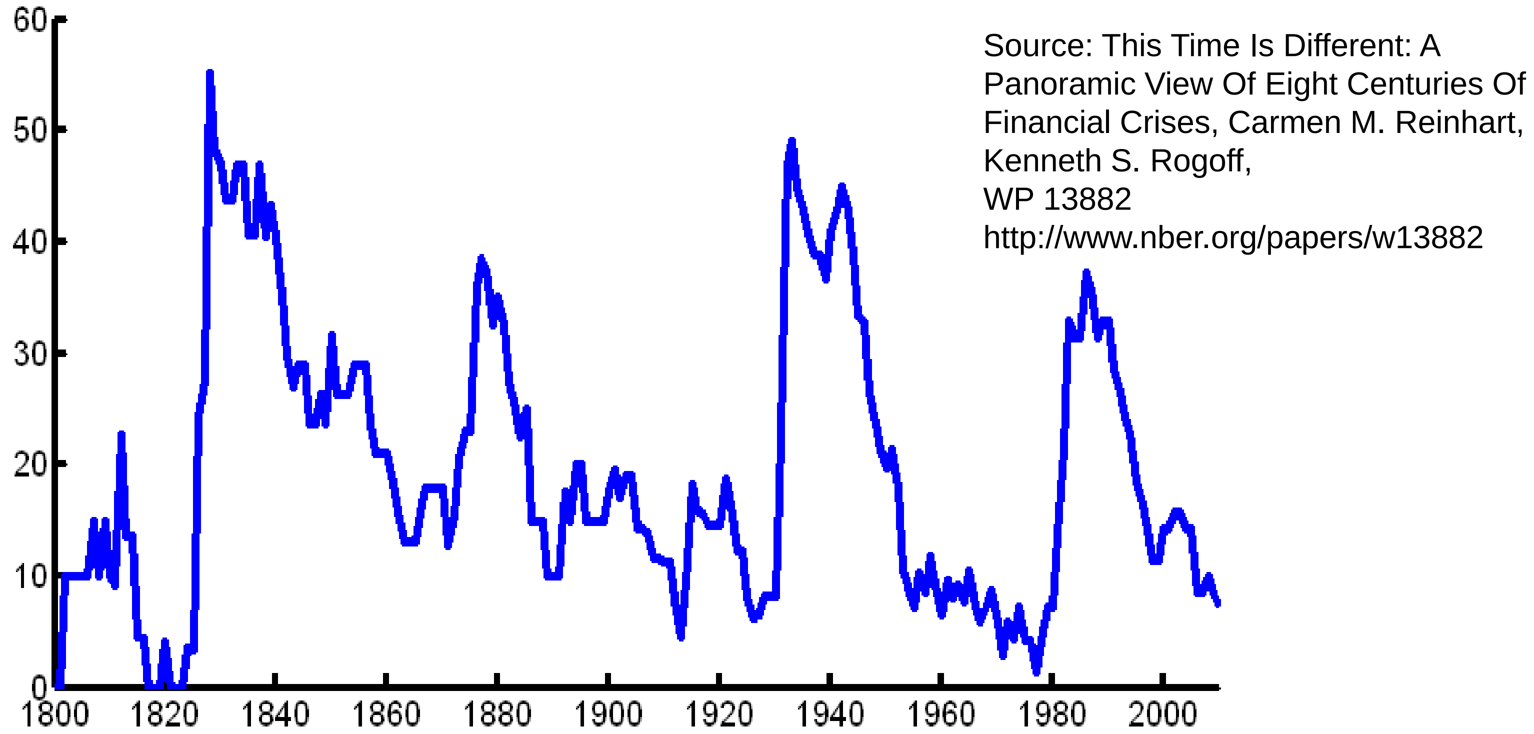
Private expenditures on medical care have also been rising.

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.

Percent of Countries in Default or Restructing



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.
  - http://research.stlouisfed.org/publications/mt/20110301/cover.pdf

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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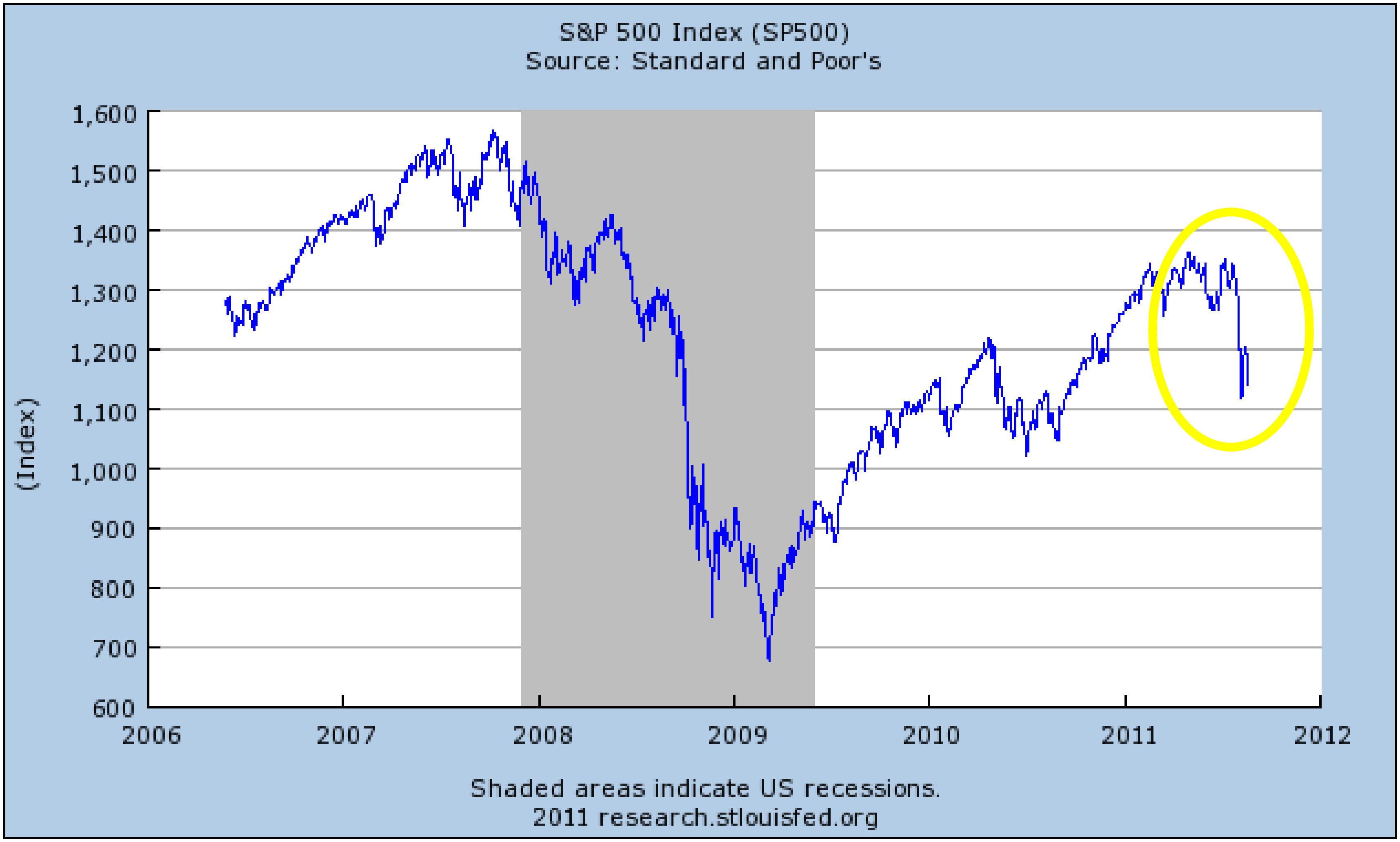
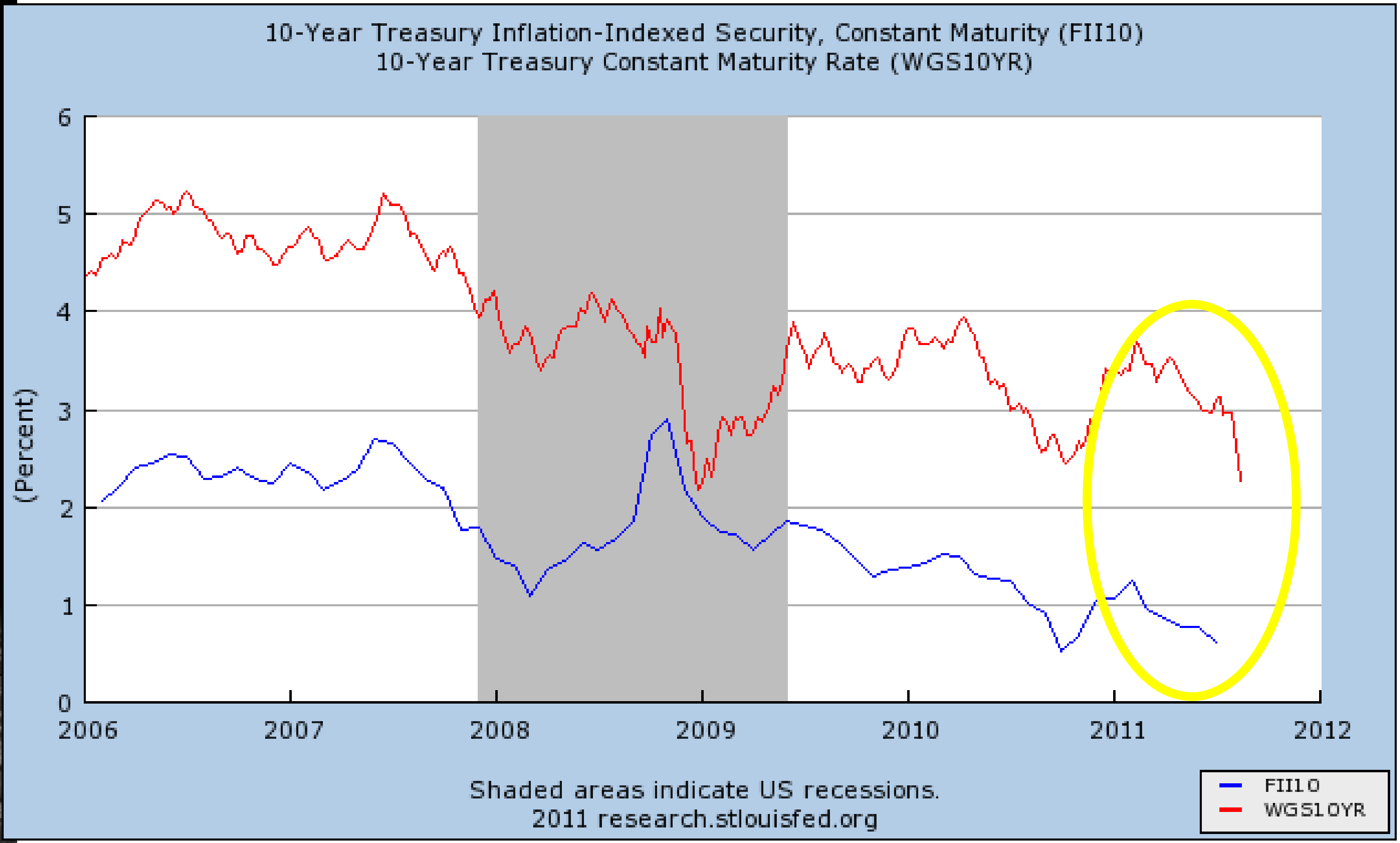


The Current Outlook: Financial Markets



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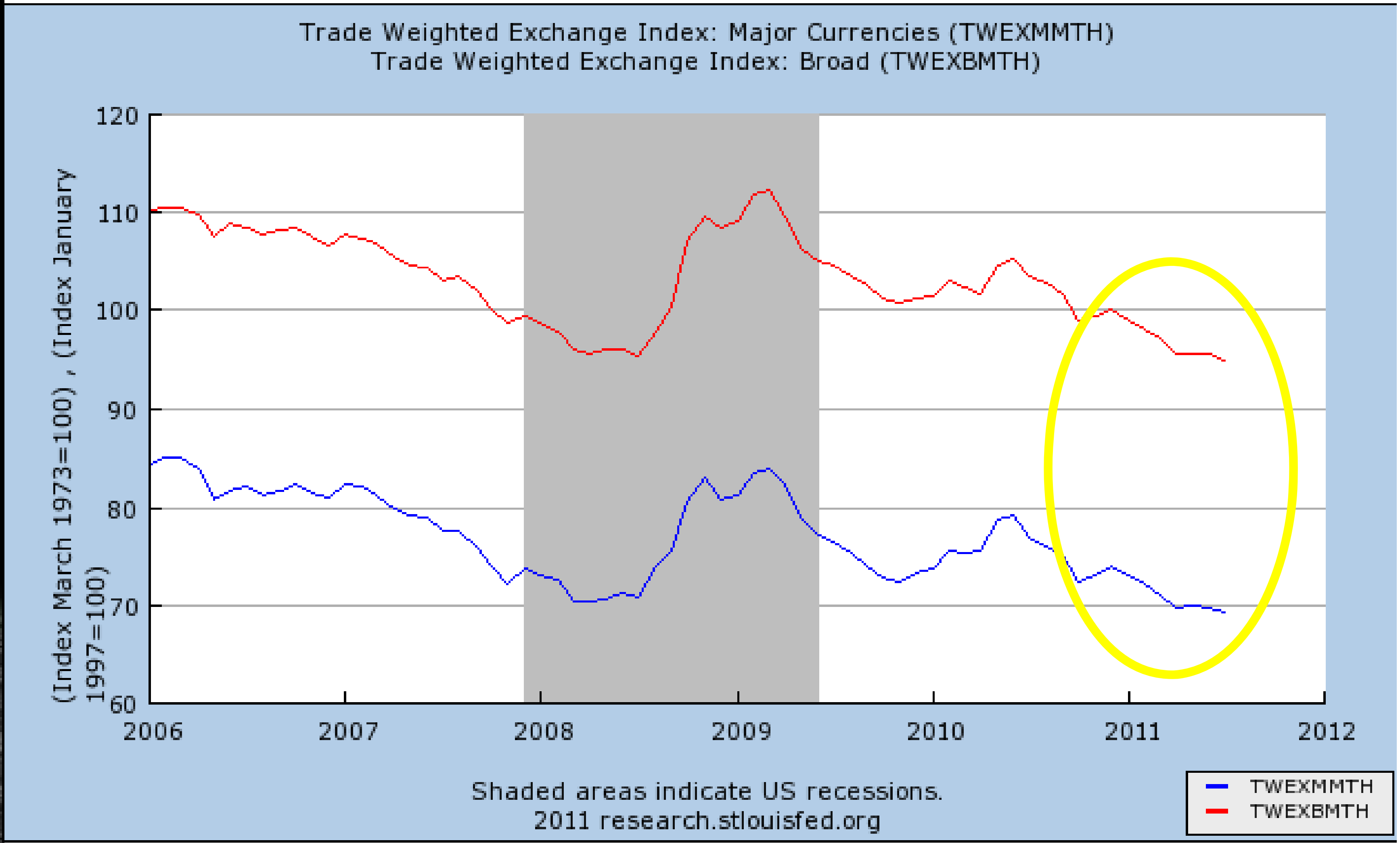
The Current Outlook: Financial Markets



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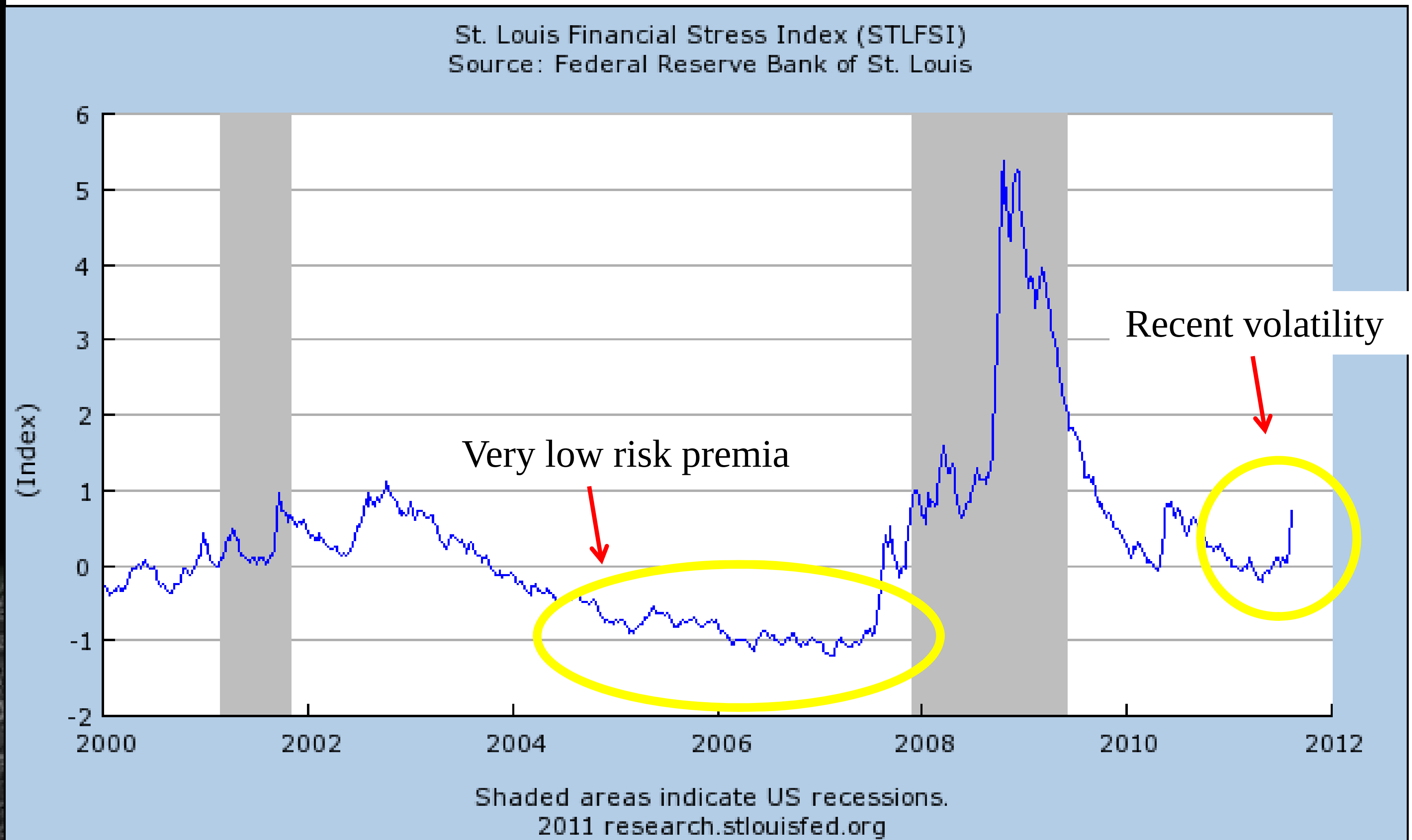
The Current Outlook: Financial Markets

http://research.stlouisfed.org/publications/net/NETJan2010Appendix.pdf



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 <u>greatly</u> 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:
  - The European fiscal situation.
  - The U.S. fiscal situation.
  - U.S. commercial real estate.
  - Chinese banking balance sheets.

Conclusions

- A retrospective on the financial crisis of 2008:
  - 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.
  - Financial crises tend to take a long time to resolve due to their effect on financial firms’ and consumer balance sheets.
  - We had overbuilt residential housing and this will take a long time to fix.

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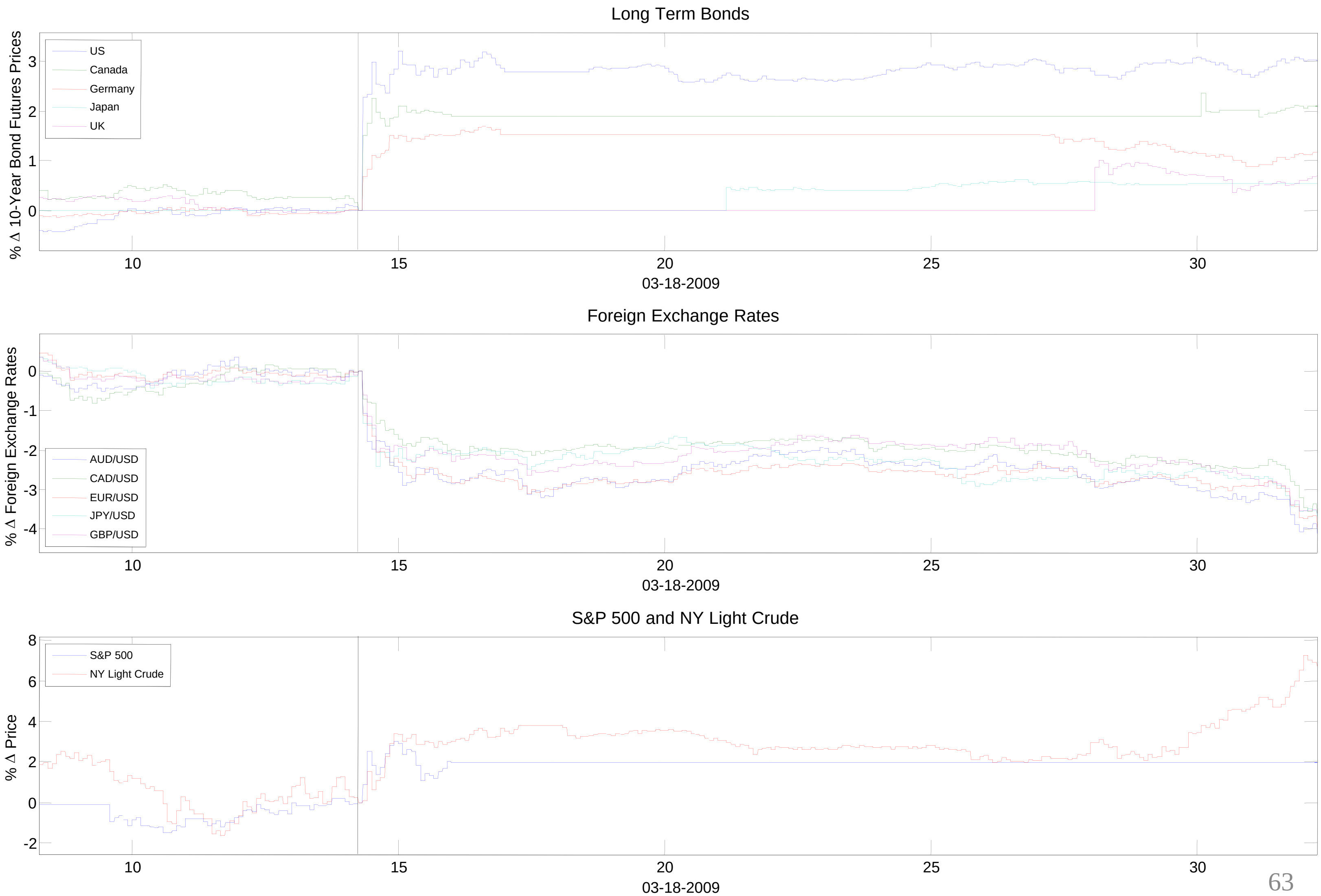
The End

QE’s impact on financial markets



Spending on medical care