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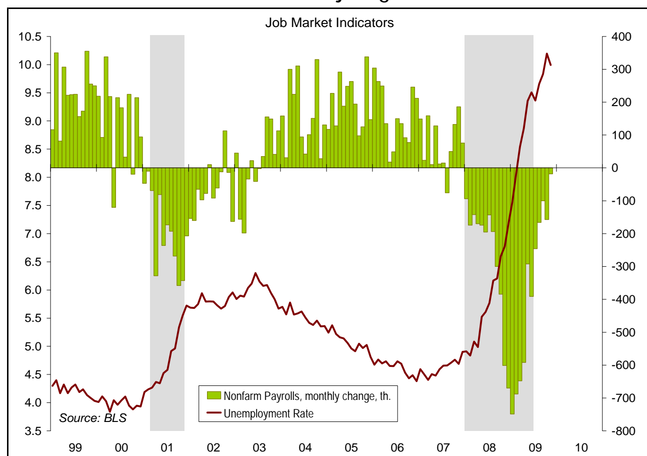
The 2010 Economic Outlook

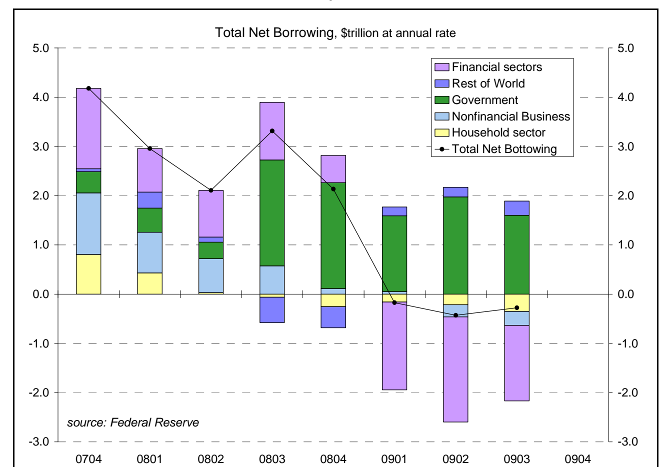
- *The economic expansion should continue in 2010, but at a moderate pace as the economy continues to work through financial difficulties. The outlook for 2011 is more clouded as the Bush tax cuts are scheduled to sunset at the end of 2010.*
- *The key factor in the growth outlook will be bank lending to consumers and small businesses. Credit should loosen over time.*
- *Conditional on an elevated unemployment rate, a subdued inflation trend, and well-anchored inflation expectations, the Federal Reserve is expected to keep short-term interest rates at exceptionally low levels well into the second half of next year and probably won't start raising rates until 2011.*

The U.S. economy began 2009 in freefall. The economy shed nearly 700,000 jobs per month in the first quarter. That pace moderated considerably over the course of the year, supported by accommodative monetary and fiscal policies. Real GDP rose at a 2.8% annual rate in third quarter, according to the government's 2nd estimate, and would likely have been negative if not for fiscal stimulus (which also lessened the decline in GDP in 2Q09). By most accounts, the rate of job destruction continued to moderate in the fourth quarter. Announced corporate layoff intentions for October and November were the lowest for those months since 2000. Weekly jobless claims are trending lower, a good sign, although not yet at a level that would be consistent with overall job growth.



Small businesses, those with fewer than 50 employees, accounted for a third of net job growth in the last two expansions, but experienced a disproportionate amount of job losses in this downturn. Following the credit disruptions in the fall of 2008, bank credit was tightened considerably for consumers and small businesses. Many small firms had their lines of credit scaled back sharply or cut completely. Large firms have been able to raise funds in the equity and bond markets. Bank lending to small businesses should loosen up over time. In addition, we may see further policy efforts directed toward improving small business credit in 2010.

The fiscal stimulus and the bank bailout have been costly, no doubt. The federal budget deficit for FY09 was $1.42 trillion and a somewhat smaller deficit is expected for FY10. A large amount of the surge in the deficit has been either cyclical or temporary. Tax receipts fall during recessions, but pick up again as the economy recovers. The bank rescue and the fiscal stimulus do not last forever. In fact, the government is seeing a return on its TARP investments. Still, after the economy has recovered and the temporary spending has faded, the federal budget deficit is expected to remain relatively high, at 3.0% to 3.5% of GDP. Entitlements are the key factor in the long-term budget outlook, with Medicare spending boosted by rising healthcare costs. It remains to be seen whether healthcare reforms will be sufficient to keep such inflation in check.



While the government has borrowed a lot more in recent quarters, private-sector debt has contracted – so much that overall debt has declined. The largest part of the private-sector debt contraction has been a deleveraging in the financial sector. Households and non-corporate businesses have also paid down debt. That may leave them with in a better financial position, but the transition is painful. The economy cannot expand without credit growth – no loan growth, no economic growth.

With the benefit of time, it's always easy to criticize decisions that were made in the heat of battle. The bank rescue was not pretty and has clearly been unpopular with the American public, but it worked. The Troubled Asset Relief Program (TARP) was not carried out to its original intent (to buy troubled assets). Instead, funds were used largely to recapitalize the banking system. It wasn't exactly fair, but it was the right thing to do. The financial system has stabilized. There is substantially less risk of a systemic failure. The TARP, along with the Fed's efforts to promote liquidity and lending, helped prevent a broader economic collapse.

The fiscal stimulus will continue to add to the level of real GDP in early 2010, but it's maximum impact on GDP growth is already behind us. The fiscal stimulus will ramp down in the later part of 2010, effectively acting like a drag on GDP growth.

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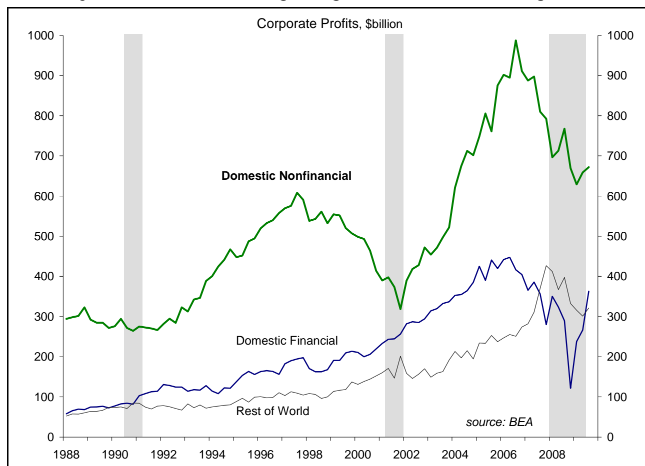
The idea behind the fiscal stimulus is to provide temporary support while the private sector begins to recover. Hopefully, the underlying economy will be improving as the fiscal stimulus is pared away. Yet, we know that recessions that are caused by financial crises tend to be more severe, longer lasting, and with more lengthy recoveries – and perhaps most importantly, there is a danger of removing stimulus too soon. Fed Chairman Bernanke is well aware of this issue, but there may not be much choice with fiscal policy. That is, it will be politically difficult to legislate more stimulus even if needed. And clearly extra effort is needed in the form of job creation and credit to small banks. More worrisome, the Bush tax cuts expire at the end of 2010. A tax increase in a fragile economic recovery is not a good thing. Most likely, some of these tax cuts will be extended (middle class tax cuts), some trimmed (a somewhat higher capital gains tax) and some allowed to expire (higher margins tax rates at the high end). However, none of that is at all clear at this point. There is likely to be a lot of horse trading in Congress, especially with an eye toward reducing long-term federal budget deficits.



Corporate profits improved in the third quarter, but this was largely a consequence of cost containment rather than top - line growth. Firms responded to the financial problems of late 2008 by trimming the size of their workforces and slashing capital expenditures. Inventories are also leaner. With that corrective phase having run its course, the economy is set up for improvement. However, tight credit is a major restraint.

One major positive in 2009 was the bottoming and improvement in the global economy. The fear was that the rest of the world would tank as the U.S. demand for foreign goods dried up. However, clearly the world economy is in better shape and more flexible than was commonly thought. In many cases, growth was boosted by government spending – as with the U.S., a helpful transition, but not a long-term recipe for growth.

Real GDP growth is likely to advance at about a 3% annual rate over the course of 2010. In the near term, inventories will provide some boost. Remember that inventories do not have to rise to add to GDP growth – they only have to fall at a slower rate, which is almost certain. If inventories stop falling quickly, which is suggested by the October figures (the only data available for 4Q09 and which is subject to revision), they could add quite a lot to GDP growth. Underlying demand should see moderate growth in the early part of the year, hopefully picking up over time, but growth is not likely to be strong enough to push the unemployment rate down by much. Hiring for the 2010 census should provide some support to the job market in the first half of the year. These jobs are temporary and will be shed in the second half of the year, but could work as a bit of pump priming, as census workers will earn a paycheck and likely spend it. Inflation is expected to remain relatively low – but, as usual, oil prices will remain an important wildcard in the outlook for both consumer spending growth and inflation. The Fed is unlikely to start raising short-term interest rates until 2011.

	4Q08	1Q09	2Q09	3Q09	**4Q09**	**1Q10**	**2Q10**	**3Q10**	**4Q10**	2008	**2009**	**2010**	**2011**
GDP (↓ *contributions*)	-5.4	-6.4	-0.7	2.8	**4.4**	**3.0**	**3.0**	**3.0**	**3.0**	0.4	**-2.4**	**3.0**	**3.1**
consumer durables	*-1.6*	*0.3*	*-0.4*	*1.3*	***-0.3***	***0.2***	***0.2***	***0.3***	***0.3***	*-0.4*	***-0.3***	***0.2***	***0.3***
nondurables & services	*-0.5*	*0.2*	*-0.2*	*0.7*	***1.4***	***1.3***	***1.4***	***1.5***	***1.6***	*0.2*	***-0.1***	***1.2***	***1.6***
bus. fixed investment	*-2.5*	*-5.3*	*-1.0*	*-0.4*	***-0.3***	***0.1***	***0.3***	***0.4***	***0.5***	*0.2*	***-2.1***	***0.0***	***0.5***
residential investment	*-0.8*	*-1.3*	*-0.7*	*0.5*	***0.2***	***0.3***	***0.3***	***0.4***	***0.4***	*-1.0*	***-0.7***	***0.3***	***0.4***
government	*0.2*	*-0.5*	*1.3*	*0.6*	***0.6***	***0.4***	***0.3***	***0.1***	***-0.1***	*0.6*	***0.4***	***0.4***	***0.1***
Domestic Final Sales	-4.9	-6.4	-0.9	2.7	**1.5**	**2.3**	**2.6**	**2.8**	**2.8**	-0.3	**-2.8**	**2.2**	**3.0**
exports	*-2.7*	*-4.0*	*-0.5*	*1.7*	***1.3***	***1.0***	***0.8***	***0.7***	***0.5***	*0.6*	***-1.3***	***0.9***	***0.6***
imports	*3.1*	*6.6*	*2.1*	*-2.5*	***-1.6***	***-1.2***	***-1.0***	***-0.8***	***-0.7***	*0.5*	***2.3***	***-1.1***	***-0.7***
Final Sales	-4.7	-4.1	0.7	1.9	**1.2**	**2.0**	**2.4**	**2.6**	**2.7**	0.8	**-1.7**	**2.9**	**3.1**
ch. in bus. inventories	*-0.6*	*-2.4*	*-1.4*	*0.9*	***3.2***	***1.0***	***0.6***	***0.4***	***0.3***	*-0.4*	***-0.7***	***1.0***	***0.2***
Unemployment, %	6.9	8.1	9.2	9.6	**10.1**	**10.2**	**10.1**	**10.0**	**10.0**	5.8	**9.3**	**10.1**	**9.7**
NF Payrolls, monthly, th.	-553	-691	-428	-199	**-50**	**55**	**120**	**50**	**100**	-257	**-342**	**81**	**149**
Cons. Price Index (3 mo)	-12.4	2.2	3.3	2.5	**2.2**	**1.8**	**1.9**	**2.0**	**2.1**	0.2	**2.6**	**2.0**	**2.2**
excl. food & energy	0.2	2.2	2.4	1.3	**1.6**	**1.4**	**1.5**	**1.6**	**1.7**	1.7	**1.9**	**1.6**	**1.8**
PCE Price Index (q/q)	-5.0	-1.5	1.4	2.7	**2.4**	**1.8**	**1.8**	**1.9**	**2.0**	3.3	**0.2**	**2.0**	**2.0**
excl. food & energy	0.8	1.1	2.0	1.3	**1.7**	**1.5**	**1.6**	**1.6**	**1.7**	2.4	**1.6**	**1.6**	**1.7**
Fed Funds Rate, %	0.53	0.19	0.18	0.15	**0.13**	**0.22**	**0.24**	**0.25**	**0.25**	1.94	**0.16**	**0.24**	**0.97**
3-month T-Bill, (bond-eq.)	0.3	0.2	0.2	0.2	**0.1**	**0.2**	**0.2**	**0.3**	**0.3**	1.4	**0.1**	**0.2**	**1.1**
2-year Treasury Note	1.2	0.9	1.0	1.0	**0.9**	**1.0**	**1.4**	**1.8**	**2.3**	2.0	**1.0**	**1.6**	**2.6**
10-year Treasury Note	3.2	2.7	3.3	3.5	**3.4**	**3.6**	**3.7**	**3.8**	**3.9**	3.7	**3.3**	**3.7**	**4.1**

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