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Economic Research

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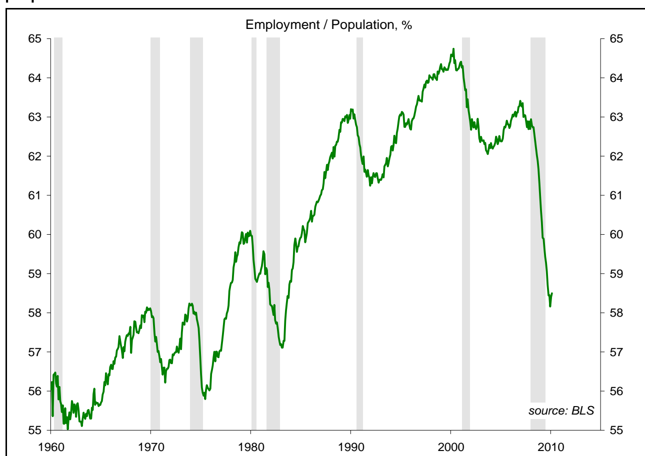
Monthly Economic Outlook

The Long Road Back

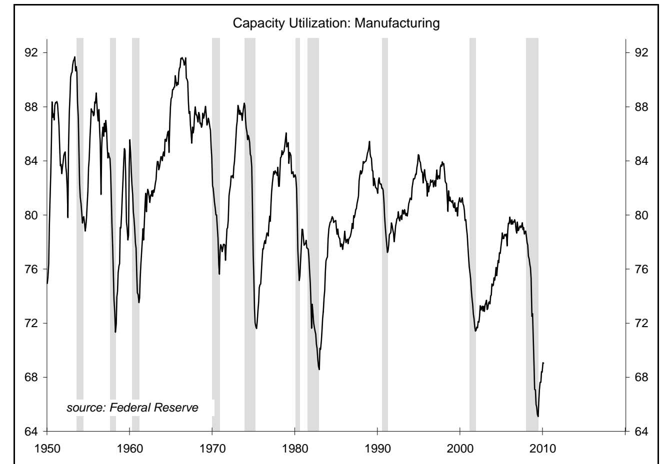
- *The recovery has progressed further in the first quarter of 2010. The pace of job losses has continued to slow and the economy appears to be on the verge of employment growth.*
- *However, a number of serious headwinds remain, restraining the pace of improvement for the next few quarters.*
- *Federal Reserve policymakers have already unwound most of the special liquidity facilities set up during the financial crisis and the normalization of monetary policy will continue. However, the Fed is expected to keep the federal funds rate low well into the second half of the year and probably into 2011.*

Real GDP rose at a 5.9% annual rate in the government's second estimate of fourth quarter growth. About two-thirds of that increase was due to a slower pace of inventory reductions (the *change* in inventories contributes to the *level* of GDP, the *change in the change* in inventories contributes to GDP *growth*). The inventory correction appears to be nearly complete, but will contribute further to GDP growth in the near term. There will be no major restocking of inventories that will contribute to growth. Rather, inventories are likely to begin rising roughly in line with the pace of final sales. Consumer spending growth is likely to remain moderate, helped by a turn in the labor market over the next few months. Business fixed investment has been mixed, with strength in spending on equipment and software, but weakness in structures.



The pace of job losses slowed significantly over the course of last year, but new hiring has not picked up much in 2010. Average weekly hours have been trending higher, temp-help employment is on the rise, and productivity growth numbers have been screaming, all suggesting that the economy is on the cusp of a wave of new hiring. Surveys of hiring intentions show a pickup in the second quarter, but not particularly strong. At the peak, the Census Bureau will have 800,000 temporary workers for the 2010 census, which will boost payroll numbers in March, April, and May (losing them in June – September).

The near completion of the inventory correction and a rebound in global economic growth have contributed to improvement in manufacturing activity in recent months. While capacity utilization levels in manufacturing are off their lows, they are still depressed by historical standards. Manufacturers continue to be squeezed by higher costs of raw materials and price competition from foreign goods, but conditions have improved significantly over the last year.



On March 16, the Federal Open Market Committee left the target range for the federal funds rate (the rate that banks charge each other to borrow excess reserves) at 0% to 0.25% and repeated that economic conditions (*"including low rates of resource utilization, subdued inflation trends, and stable inflation expectations"*) are likely to warrant exceptionally low levels of this rate *"for an extended period."* In early February, the Fed ended most of the special liquidity facilities created during the financial crisis. On February 19, the Fed's Board of Governors approved a 25-basis-point increase in the discount rate (the rate the Fed charges banks for short-term borrowing) to 0.75% and returned the length of discount window loans to an overnight basis (the Fed had widened the terms to 90 days during the financial crisis). These moves were not expected to lead to tighter credit for consumers and businesses. Rather, the changes were part of a normalization of monetary policy. The discount rate was 100 basis points above the federal funds rate during the financial crisis. The spread was dropped to 25 basis points to ease strains in the banking system. During the crisis, the Fed was granted the authority to pay interest on bank reserves held at the Fed. Eventually, the federal funds rate target will lie below the discount rate and above the Fed's interest rate paid on excess reserves. However, as Fed Chairman Bernanke testified in early February, the federal funds rate may for a time become a less reliable indicator of conditions in the short-term money markets – and the Fed could rely on the interest rate paid on reserves and a target for bank reserves as a guide to its policy stance.

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Still, there is no pressing need for the Fed to tighten monetary policy as long as the unemployment rate remains elevated, core inflation continues to trend low, and inflation expectations remain well-anchored. The labor market is the widest channel for inflation pressure. Wage pressures have been moderate and productivity figures have been strong. There is plenty of excess capacity in manufacturing (no bottleneck inflation pressures). There has been some inflation in commodity prices, but it takes a huge increase in the price of raw materials to have much of an impact at the consumer level.

The exception is oil, which is more pervasive within the economy. The price of oil is always a wildcard in the economic outlook, but has remained relatively range-bound over the last several months. However, in contrast to the Great Inflation of the 1970s and early 1980s, the experience of the last few years suggests that the price of oil will be less of a driver of the core inflation trend and more of a determinant of the pace of economic growth. A rise in oil, say to more than $100 per barrel, would dampen the recovery and raise the odds of a double dip. A drop, say to below $60 per barrel, would be helpful to the outlook for consumer spending growth.

The economy will continue to face a number of serious headwinds in the near term. The residential housing hangover will continue for some time. While the rate of delinquencies and foreclosures should trend lower, the pace is likely to remain elevated. While much smaller than residential mortgage troubles, commercial real estate problems will be an issue for many small to medium-sized banks. The Federal Deposit Insurance Corporation now classifies one out of ten U.S. banks as "problem" institutions – however, these banks represent just 3% of all bank assets (suggesting a lot of problems at a lot of small banks). The Fed should be reluctant to tighten credit in the face of these concerns.

State and local budgets generally remain in difficulty. The recession has reduced tax revenues considerably for most states. Some of the federal fiscal stimulus was given to the states to ease these pressures, but not enough to make up the difference completely. State balanced-budget requirements are leading to increases in taxes and cuts in basic services. Economic growth will help relieve these pressures, but strains in state budgets are expected to continue for some time.

The federal fiscal stimulus is currently peaking. The key question is whether the private-sector economy will be improving enough as the stimulus ramps down into 2011. Most likely, it will, but it will be virtually impossible for Congress to pass another stimulus measure if needed. The extension of unemployment benefits has played a key role in reducing the consequences of a weak job market. In 4Q09, wage and salary income was down 4.2% from a year earlier. However, disposable income rose 2.3% y/y, as personal tax payments fell 25.8% and government transfer payments rose 14.3%. These measures have reduced the downside of the recession, buying some time as the private sector recovers.

Inventories are expected to begin rising within the next couple of quarters. The shift (from declines to increases) will add to GDP growth in the near term, although the timing and magnitude are uncertain (adding some volatility to the headline GDP figures). Underlying domestic demand should continue to grow, but headwinds are expected to restrain the pace of recovery. We could get lucky and grow more rapidly, but the pace is unlikely to push the unemployment rate down by much. Downside risks are still apparent, especially as we head into 2011 (as the fiscal stimulus fades and the Bush tax cuts are set to expire). Inflation is expected to remain low. Based on the current weakness in loan demand, the Fed seems unlikely to start tightening monetary policy until early next year.

	1Q09	2Q09	3Q09	4Q09	1Q10	2Q10	3Q10	4Q10	1Q11	2Q11	2009	2010	2011
GDP (↓ *contributions*)	-6.4	-0.7	2.2	5.9	3.7	3.3	3.0	3.1	2.7	3.0	-2.4	3.4	3.1
consumer durables	0.3	-0.4	1.4	0.0	0.4	0.3	0.3	0.3	0.1	0.3	-0.3	0.4	0.3
nondurables & services	0.2	-0.2	0.6	1.2	1.3	1.5	1.6	1.8	1.5	1.6	-0.1	1.2	1.7
bus. fixed investment	-5.3	-1.0	-0.6	0.6	0.4	0.4	0.5	0.5	0.5	0.6	-2.2	0.2	0.6
residential investment	-1.3	-0.7	0.4	0.1	0.3	0.3	0.3	0.4	0.3	0.4	-0.7	0.2	0.4
government	-0.5	1.3	0.6	-0.2	0.4	0.3	0.1	-0.1	-0.1	-0.1	0.4	0.3	0.0
Domestic Final Sales	-6.4	-0.9	2.3	1.6	2.8	2.9	2.9	2.8	2.4	2.8	-2.8	2.3	2.9
exports	-4.0	-0.5	1.8	2.3	1.1	0.9	0.7	0.8	0.8	0.8	-1.2	1.2	0.8
imports	6.6	2.1	-2.6	-2.0	-1.3	-1.1	-0.9	-0.9	-0.7	-0.8	2.2	-1.3	-0.8
Final Sales	-4.1	0.7	1.5	1.9	2.6	2.7	2.7	2.8	2.5	2.9	-1.7	3.2	3.0
ch. in bus. inventories	-2.4	-1.4	0.7	3.9	1.1	0.5	0.3	0.3	0.2	0.1	-0.7	1.1	0.2
Unemployment, %	8.2	9.3	9.7	10.0	9.7	9.5	9.5	9.4	9.4	9.4	9.3	9.5	9.2
NF Payrolls, monthly, th.	-753	-477	-261	-90	5	160	50	105	95	135	-347	80	144
Cons. Price Index (3 mo)	2.5	3.7	2.5	2.5	2.4	1.9	1.9	1.9	2.0	2.1	2.7	2.2	2.2
excl. food & energy	2.3	2.2	1.4	1.3	0.5	1.5	1.5	1.6	1.6	1.7	1.8	1.6	1.8
PCE Price Index (q/q)	-1.5	1.4	2.6	2.6	2.7	1.8	1.9	2.0	2.0	2.0	0.2	2.3	2.0
excl. food & energy	1.1	2.0	1.2	1.3	1.3	1.6	1.6	1.7	1.7	1.7	1.5	1.4	1.7
Fed Funds Rate, %	0.19	0.18	0.15	0.12	0.14	0.21	0.24	0.25	0.29	0.70	0.16	0.21	0.97
3-month T-Bill, (bond-eq.)	0.2	0.2	0.2	0.1	0.1	0.2	0.3	0.3	0.4	0.8	0.2	0.2	1.0
2-year Treasury Note	0.9	1.0	1.0	0.9	0.9	1.3	1.7	2.2	2.4	2.5	1.0	1.5	2.6
10-year Treasury Note	2.7	3.3	3.5	3.5	3.7	3.8	3.8	3.9	4.0	4.1	3.3	3.8	4.1

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