The Outlook for the U.S. Economy: Recovery and Long-Term Challenge

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Overview

• Current conditions
  – Severe recession coming to an end
  – Improving financial conditions
• Medium-term outlook for U.S. economy: gradual recovery and low inflation
• Long-term challenge: sustainable fiscal policy
Current recession: Worst post-war

Changes in GDP and Unemployment During Severe Recessions

<table>
<thead>
<tr>
<th>Year</th>
<th>Unemployment Rate</th>
<th>GDP (percent change)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1957-58</td>
<td>4</td>
<td>0</td>
</tr>
<tr>
<td>1973-75</td>
<td>4</td>
<td>0</td>
</tr>
<tr>
<td>1981-82</td>
<td>4</td>
<td>0</td>
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<tr>
<td>2007-09</td>
<td>4</td>
<td>0</td>
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</tbody>
</table>
One key factor in recession: Unprecedented housing bust
Another key factor: Financial crisis
Monetary policy response: (1)
Aggressive cuts in fed funds target
Monetary policy response: (2) Large purchases of long-term assets

![Graph: Federal Reserve Banks' Assets]

- **Trillions $**
  - Short-term lending to financial firms
  - Other
  - Treasures, MBS, etc

- Jan-08 Apr-08 Jul-08 Oct-08 Jan-09 Apr-09 Jul-09
Fiscal policy response: Large stimulus package

Composition of Federal Stimulus Package

- **Spending**
- **Tax cuts**

<table>
<thead>
<tr>
<th>Fiscal years</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>Total (right axis)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Billions $</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>2009</td>
<td>60</td>
<td>50</td>
<td>10</td>
<td>120</td>
</tr>
<tr>
<td>2010</td>
<td>200</td>
<td>250</td>
<td>50</td>
<td>500</td>
</tr>
<tr>
<td>2011</td>
<td>40</td>
<td>25</td>
<td>10</td>
<td>70</td>
</tr>
<tr>
<td>Total</td>
<td>300</td>
<td>250</td>
<td>35</td>
<td>585</td>
</tr>
</tbody>
</table>
The recession seems to be ending:

(1) Housing has improved
Recession ending: (2) Consumer spending has leveled off
Recession ending: (3) Manufacturing has picked up
Outlook: Most forecasters expect recovery to start with 2009:Q3
Unemployment will likely edge higher before declining
Most forecasters expect core inflation to remain low.
Why not a stronger recovery? (1)

International crisis experience

![Unemployment Rate in Sweden, 1988-2004](chart.png)
Why not…? (2) Still a way to go in financial market functioning
Why not…? (3) Problems in commercial real estate

Delinquency and Vacancy Rates

- Office space vacancy rate
- Delinquency rate, CRE loans
Implications for monetary policy

• Lesson from the 1930’s: don’t tighten too soon, to avoid choking off recovery
• Lesson from the mid-1970’s: don’t tighten too slowly, to avoid rising inflation
• Probably begin tightening before financial markets are fully normalized, but not so soon as to jeopardize continued normalization
Fiscal policy: Federal debt has risen significantly

Federal Debt Held by the Public, 1960-2010

CBO projection
Long-term challenge: Fiscal policy sustainability

Federal Debt Held by the Public, 1930-2050

- Actual
- CBO projection 2009 onward
Ramifications of growing federal debt

• Potential implications:
  – higher interest rates
  – reduced investment
  – reduced productivity and GDP

• Hard choices:
  – Higher taxes
  – Reduced benefits
Summary

• The sharpest recession of the post-war period is coming to an end.
• Most forecasters expect a gradual recovery and low core inflation through 2010.
• Long term, the sustainability of fiscal policy poses a significant challenge.
  – Social Security and Medicare