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

Oklahoma Economic Forums

Craig S. Hakkio
Special Advisor on Economic Policy
Federal Reserve Bank of Kansas City
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 Interval</th>
<th>Unemployment Rate</th>
<th>GDP (percent change)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1957-58</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1973-75</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1981-82</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2007-09</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Percent Percent
One key factor in recession: Unprecedented housing bust
Another key factor in recession: Financial crisis

3-Month Libor-Treasury Spread

Percentage points

Jan-07 Jul-07 Jan-08 Jul-08 Jan-09 Jul-09

Percentage points
Monetary policy response: Aggressive cuts in fed funds target
Monetary policy response: Large purchases of long-term assets

Federal Reserve Banks' Assets

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

Trillions $
Fiscal policy response: Large stimulus package
The recession seems to be ending: Housing has improved
The recession seems to be ending: Consumer spending has improved
The recession seems to be ending: Manufacturing has picked up.
Most forecasters expect recovery to start with 2009:Q3
However, unemployment will likely edge higher before declining.
Most forecasters expect core inflation to remain low.

Core PCE Inflation (Q4/Q4)

- Actual
- Survey of Professional Forecasters’ forecasts
Why not a stronger recovery? International crisis experience

Unemployment Rate in Sweden, 1988-2004
Why not a stronger recovery?
Still a way to go in financial market functioning
Why not a stronger recovery?
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
Long-term challenge: Fiscal policy sustainability
Ramifications of growing federal debt

- Potential implications:
  - higher interest rates
  - reduced investment
  - reduced productivity and GDP

- Hard choices:
  - Higher taxes
  - Reduced benefits
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