

# ABA Quarterly Economic Discussion

## *Fourth Quarter 2010*

### **Economic Output**

Following the European financial panic of last spring, it appeared that the economic recovery may have been knocked off track. Economic data suggested that growth may be stalling and any hopes of a strong recovery were dashed. Though it now appears that a second recession will be avoided, the recovery picture remains only semi-sweet. Indeed, the economy is still growing. However, it is doing so at a very modest pace – a pace too slow to repair the damage in the labor markets any time soon. This realization has prompted the Federal Reserve to take its recent action and further ease monetary policy. Going forward, whether growth will begin to accelerate or not will have a lot to do with whether the Fed's gamble has paid off.

Real gross domestic product has now expanded for five consecutive quarters. From a technical standpoint, the recession has been over for more than a year. The National Bureau of Economic Research officially declared the beginning of recovery to be in July 2009. However, though expansion has been ongoing, the growth rate has largely been modest. Recovery started with solid growth rates near 5 percent annualized at the end of 2009, but this was largely due to inventory adjustments on the part of businesses. Since then, growth has been modest, coming in at about 2.0 percent annualized over the past two quarters.

Manufacturing activity was one of the prime drivers of growth early in the recovery, as output expanded in order to supply businesses with their inventory adjustment activity. The ISM manufacturing index crossed into expansionary territory over a year ago and was quite strong over the first half of this year. Autos and other durable goods manufacturing recovered swiftly over much of the past year, though output was starting at a very depressed level. However, in recent months, there has been an indication of deceleration in manufacturing activity growth. The bright side is that the service sector as a whole appears to be improving and, therefore, making up for any slowing growth in manufacturing. Employment numbers in service industries improved significantly over the past two months and the ISM Non-Manufacturing activity index hit a new cyclical high in October.

Despite this improvement, unfortunately the solid growth experienced in Q4 of 2009 and Q1 of this year was largely due to temporary factors - inventory readjustment the primary one. The real final sales indicator, which measures final demand for output, has grown at a much slower pace of only about 1.0 percent in each of the past five quarters. In the third quarter, the growth number without inventories was just 0.7 percent annualized. Growth via inventory accumulation

is not bad; however, it is only a temporary readjustment on the part of businesses bringing their stocks up to an appropriate level. Firms are now near completion of this process and are setting their production levels more in line with the current level of sales. Therefore, the growth trend moving forward will be closer to the final sales number.

Breaking down the components of real final sales brings some insight. The good news is, though still weak, consumers are fundamentally in a better shape than where they were a year or even six months ago. Households have paid down a significant amount of debt, and modest income growth has begun to return. Personal incomes have risen 3.1 percent from a year-ago basis as of September. This has allowed for consumption growth even though consumers remain cautious and have moved to increase their savings rate. Retail sales are up 7.2 percent on a year ago basis as of September. The consumption component of GDP has added 1.3 to 1.8 points to GDP growth in the past three quarters. Moving forward, as long as another economic shock does not occur, it is likely that the consumer will continue to improve its condition as the employment picture improves. Furthermore, in its recent action, it is the Fed's intention to try to further bolster personal consumption at the expense of personal savings. If all goes as planned, consumption will make up a larger portion of the growth picture and will continue to further accelerate.

These improvements in household consumption however are being at least partially negated by weakness in other areas. Housing sales and starts were only temporarily boosted due to the homebuyer tax credit in late spring. Since its expiration, housing activity has fallen off again. Considering the continuation of large housing inventories, it is unlikely that construction will add much to growth. Also, net exports have weakened considerably in part due to the fallout over the European debt crisis. Net exports, which had been an area of growth, were a major drag in Q2 and Q3, cutting 3.5 percent off growth in Q2 and 2.0 percent in Q3. It is likely not going to be a strong component moving immediately forward. Lastly, as the stimulus package effects continue to expire, government spending will be a net drag on growth for a number of upcoming quarters. In particular, state and local governments are cutting back to bring their fiscal situations into balance.

A positive factor as of late has been strong growth in fixed business investment, specifically in software and equipment, which added 0.9 percent to GDP in Q3. The ABA Economic Advisory Committee foresees this area being one of the leading drivers of growth in upcoming quarters. However, business investment has been restricted to equipment and is not growing into structures, as excess real estate inventories continue to persist. Furthermore, continued levels of spending in this area are contingent on firms foreseeing greater consumption growth in the future to drive sales. Additionally, a great level of policy uncertainty exists regarding financial rules, and the upcoming healthcare system and tax policy changes. These risks have added to the desire on the part of firms to be cautious in investment decisions. If business confidence remains weak, then this area of growth may wane as well.

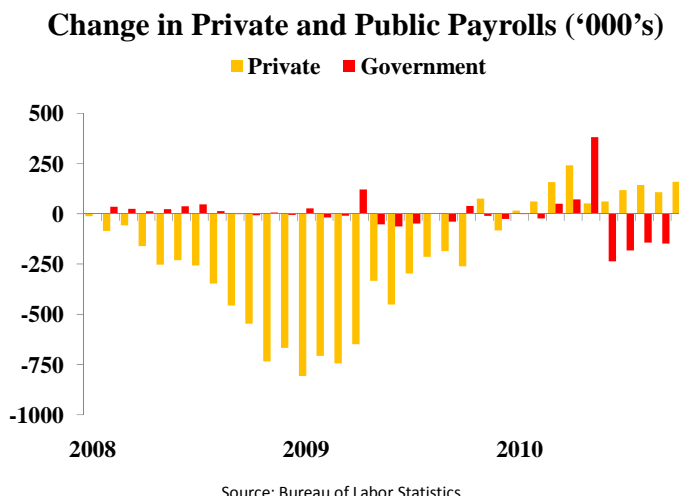
The temporary boosting effects of fiscal policy are near their end. The Fed has recently taken a bold monetary step; however, it is not clear whether this will be effective. The inventory readjustment cycle, which was crucial to growth in past quarters, is waning. With little new export demand and a housing and commercial real estate market still awash in excess inventory, the prospects of recovery in coming quarters hinge on the ability of the consumer to continue to grow consumption. Incomes are modestly rising and the employment picture is gradually improving. However, both areas remain rather weak. Any dip in the labor market or drop in consumer confidence could have the effect of stalling personal consumption. At this point, when looking at the components of aggregate demand, there would not be much left to continue to drive growth if this were to occur.

## Labor Markets

National unemployment topped 10 percent during the recession for the first time since 1983, reaching 10.1 percent in October, 2009. It fell back to 9.7 percent by January and has largely stayed in the range of 9.5 percent to 9.7 percent ever since. In comparison, the rate topped out at 7.8 percent following the 1990-1991 recession and 6.3 percent after the 2001 recession.

Modest improvement in the labor market was apparent by mid-spring of this year. From March through May, over 200,000 jobs were added to payrolls each month, with 432,000 added in May. Much of this increase was due to temporary hiring of census workers; however, about 200,000 private sector jobs per month were added in March and April. This helped to bring the unemployment rate down from its highs.

However, since May, the hiring pace has stalled. Private sector job growth has been meager, increasing by only about 50,000 per month for most of the past year. There are signs of modest improvement over the past two months' reports, where over 100,000 jobs were created in October. But even still, this is only a modest level of private sector job creation. In addition, new unemployment claims are staying stubbornly high at about 450,000 to 475,000 per week.



Much of the reason that employment growth has only been modest over the past year despite GDP expansion is due to very strong productivity gains over the last year. Labor productivity grew at an annualized rate of at least 6 percent for three consecutive quarters last year, hitting as high as 8.2 percent. Because GDP growth has been below that rate over the past year, firms have been able to largely meet this new demand without expanding their workforces. Furthermore, the great amount of economic and policy uncertainty has likely added to employers' hesitance to

expand payrolls. However, there is only so much that producers can get out of their existing workforce – productivity growth rates have been decelerating in recent quarters. Productivity gains are essential in the long-run in order to drive income growth; however, in the short-run they create a drag on employment. It seems that the drag is coming to an end and any new demand growth will have to be met with increased hiring moving forward. This bodes well for the labor market with regards to employment growth.

Even though hiring is likely to pick up modestly as the economy continues to grow, the problem is that growth is still expected to be moderate. The consensus is that growth will be modest at or below 3 percent over the next year. This is solid, but weak relative to passed recoveries from deep recessions. There were multiple quarters of GDP growth in excess of 7 percent following the 1982 recession. The Fed is trying to expand this growth rate, but even if the Fed is successful at achieving faster growth, the unemployment rate will still remain quite high for some time.

On the public employment side, local and state governments, which had been supported by the stimulus bill, are now reducing payrolls, as many states are in the midst of budget crises. Public employment, which had been an area of growth over the past two years, is no longer a support. So any gains in the private sector job market will be partially mitigated by public sector reductions.

Also, there is a potential factor of the economy having a significant structural unemployment problem. The median duration of unemployment is now about half a year, by far the highest level on record. In addition, new job openings are growing significantly faster than new hires. This relationship historically is quite correlated. Looking at these two pieces of data, it would suggest a structural unemployment component to the labor market problems. Short-term unemployed numbers have come down quite substantially in recent months. This leaves a set of workers in long-term unemployment dominating the unemployed. It is likely that some of this is due to the large extension of unemployment benefits, where workers are lax in trying to find new employment.

However, the bulk of this is probably due to structural problem where many unemployed workers who have skills in construction, manufacturing, and finance do not match well with the current needed areas of employment. An additional problem is that many people who would otherwise be willing to move to a new location in order to take on employment cannot do so because their mortgage is underwater. The percent of new job takers who have moved their residencies has fallen in half from where it was a year ago. If these structural issues are indeed significant factors, it may take years for people on net to retool, and this could mean a persistently higher level of unemployment than in recent years.

The labor market is improving modestly. Moving forward, firms will need to move to increase their payrolls as the recent productivity surge has ended. This will lead to a brisker pace of employment. However, a great level of uncertainty with regard to future sales as well as policy risk are keeping employers hesitant to hire, and structural issues may be occurring, lengthening the time that it takes for workers to find employment.

## Housing Markets

After falling for three years, home sales started to pick up in early 2009. From a pace of about 4.5 million annualized units, new and existing single family home sales jumped to a pace of over 6 million annualized by October of last year. Low mortgage rates and incentives for first-time home buyers further helped to drive this growth in sales. Along with it came stabilizing prices.

However, it is now evident that much of the recovery was dependent on policy support, and, therefore, the home sale increases seem to have been temporary. When the first-time buyer credit was expected to end last year, home sales began to fall back to levels similar to mid 2009. The credit was extended through April and a similar pattern occurred, with home sales rising through that month as buyers rushed to take advantage of the credit. Now the fall-off has occurred in the wake of its expiration. New homes sales plunged over 35 percent in May to a new cyclical low sales pace.

Roughly the entire cumulative increase in sales during the months of March and April was offset by below-trend sales in May and June. Existing home sales followed a similar pattern.

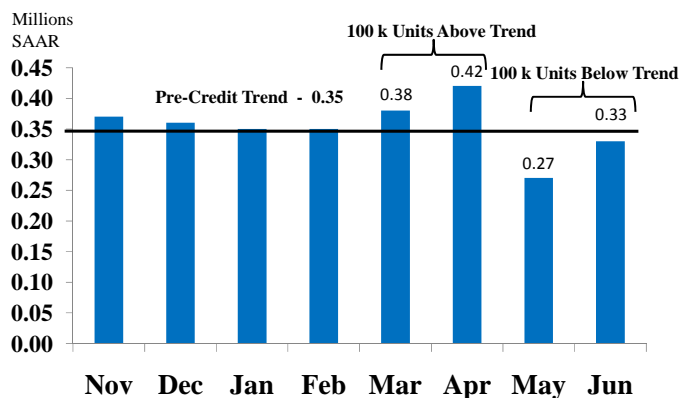
Sales have now somewhat recovered in the past couple of months back towards their pre-credit levels. This, however, is still a very slow pace, and there is little indication in the Mortgage Bankers Association

Mortgage Application Index to suggest

that purchases are accelerating at all. In addition, housing starts also plunged about 10 percent in May following the end of the credit and a prior run-up. As far as sales activity is concerned, it is quite evident that a “double dip” has occurred in the housing market.

The good news is that even with sales falling back again, home builders have continued to work off their excess inventories. The total inventory declined from a high of 572,000 in July 2006 to 205,000 in September 2010. At the current sales pace, it will take 8.0 months to clear this inventor. This is much improved from an all-time high of 12.4 months in January 2009; however, it is still quite above the historical normal of about 4 to 5 months. Historically, ratios greater than 6 have correlated to short-term price declines. The inventory picture is continuing to move in the right direction, but until inventory levels come into line with sales, the possibility of further declines in prices cannot be ruled out.

### Homebuyer Tax Credit Shifted New Home Sales Forward



Source: Census Bureau

Indeed, price stabilization is probably the most pertinent factor in recovery. Overall, the S&P/Case-Shiller Home Price Index of home values nationwide was up 1.7 percent in August from a year earlier. Though this is an increase, this is down significantly from a 5.1 percent year-over-year rise in May. Though prices are likely near a leveling point, some modest price softening in the near future appears likely.

Just as a policy driven double-dip in sales has occurred, prices could very well follow the same pattern. Policy support is continuing to be unwound and a large influx of new foreclosures is entering the market. Without stronger sales numbers, it is quite possible that this increased supply could cause downward movement in prices.

Relative to rent costs, home prices are still somewhat elevated. Rental unit vacancies are still near all-time highs and household formation has been slow. With continued frustrations in the labor markets, nominal income growth has been weak foreshadowing a likely sustained period of high delinquency and foreclosure rates. This will continue to keep the supply of homes for sale high, placing downward pressure on prices.

A positive factor for pricing is that there will likely be more pent-up demand for housing once consumer confidence improves and the labor market strengthens. Housing affordability is near an all-time high due to low interest rates and reduced prices from a few years ago. Furthermore, the Fed's quantitative easing strategy aims at further pushing down long-term interest rates. This will help to maintain historically low mortgage rates. Therefore, for those households with the ability to purchase a home, this is a very attractive time to do so. The ABA Economic Advisory Committee foresees modest price appreciation moving forward into next year, however, with this many complex policy factors to take into account, there will continue to be a high level of uncertainty.

## **Inflation**

For two years now, weak global economic activity has exerted downward pressure on prices. As recently as September 2009, the CPI on a year-ago basis was down 1.3 percent. Though now in a positive range on a year-over-year basis, the CPI has risen only minimally and core prices have essentially been flat. In September, the CPI rose 0.1 percent; however, this followed two months of 0.3 percent increases. Most of the volatility in recent months has been due to energy price changes. Core prices have been unchanged for the last two months of data. From a year prior, headline inflation was 1.1 percent and core inflation was 0.8 percent. The Fed's preferred measure, the core PCE deflator, was 1.2 percent higher on a year-ago basis as of September.

Moving forward, the inflationary picture is somewhat cloudy. The fundamentals suggest that there is still quite a lot of downward pressure on prices and therefore inflation will be quite modest in the intermediate future. A desire for personal savings has reduced credit expansion in

the system and large amounts of productive slack continue to put downward pressure on prices. Evidence of only a modest recovery has only added to market expectations that these dynamics will not change any time soon. The ABA Economic Advisory Committee foresees core PCE inflation in 2011 to be 1.1 percent.

However, uncertainty has increased due to the Fed's most recent policy of quantitative easing. The Fed has been very explicit in recent statements that it currently sees inflation as too low, in the context of achieving full employment. Through quantitative easing, the Fed wishes to modestly increase inflation. This is a difficult target to hit. It is quite possible that the Fed's action will not be successful in accelerating economic growth and raising inflation. Banks may simply increase their excess reserves held at the Fed, and market participants may not believe that the Fed will be able to further drive down long-term rates and act accordingly in their long term bond buying behavior.

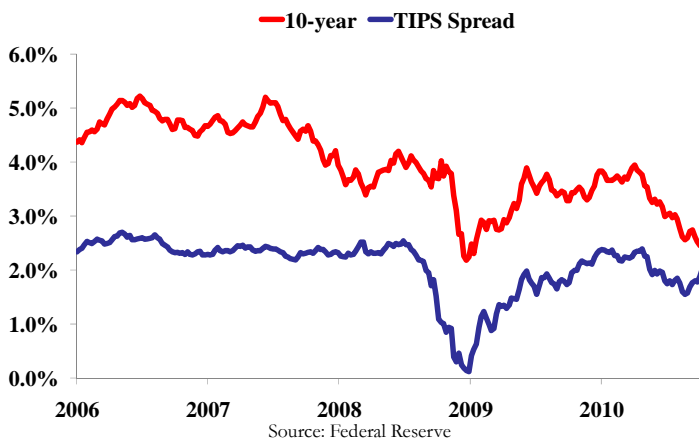
On the other end of the spectrum, the additional quantitative easing could create fear in the marketplace of large currency devaluation, monetizing debt, and much higher future inflation. This could result in the Fed overshooting its desired target. In the upcoming months, the effects of the Fed policy on the inflationary environment will likely become clearer, but until then a level of uncertainty exists.

Recent monetary policy aside, there is little inflationary pressure currently in the system. In addition to further deleveraging on the part of households, there is a very large level of slack in the labor market. Therefore, even as employment improves, workers will have very little pricing power in the aggregate. However, in some subcomponents where conditions are tighter, there may be a modest level of inflationary pressure going forward. However, inflationary pressures from the labor markets will likely be very minimal, as long as inflationary expectations remain relatively anchored. Thus far, whether measured by market indicators such as the TIPS spread or by survey methods, inflationary expectations remain tame.

Although high inflation is not expected in the upcoming year, concerns remain about future inflation. The Federal Reserve has expanded its balance sheet greatly over the past two years, almost tripling it. The recent announcement of further quantitative easing will expand it even further. In addition, large fiscal deficits have increased dependence on foreign capital inflows. It is likely that this fiscal imbalance will continue for the foreseeable future. Though these factors are being outweighed currently by excess productive slack, and a rise in domestic private savings, it is a cause for concern in the future. When demand returns to normal, there is tremendous potential for large monetary and credit expansion to occur, which would drive inflation. It is also possible that the combination of a weakening dollar and reduced foreign purchases of Treasuries could drive up interest rates and inflationary pressure. Policy makers are going to have to appropriately reverse course when the time comes, and this may prove to be difficult, particularly regarding fiscal policy. However, even the Federal Reserve may find itself in a bind if it is required to unwind its expanded balance sheet now dominated by long term securities, and its recent policy moves only exacerbates this challenge.

For now, however, the market, with the exception of the gold market, is only placing a modest risk premium on the possibility of inflation. Inflationary expectations have risen slightly since the Fed's recent announcement, but they still remain at a very tame level. The TIPS spread is still about two percent and long-run bond rates are pricing in little inflation. A similar sentiment is found via survey methods. As measured by the University of Michigan's Consumer Sentiment Survey, the one-year inflationary expectation in October was 3.0 percent, elevated slightly from recent months, but the five-year expectation was 2.8 percent, about the level it has been for the past year.

### Ten-Year Treasury Yield and TIPS Spread



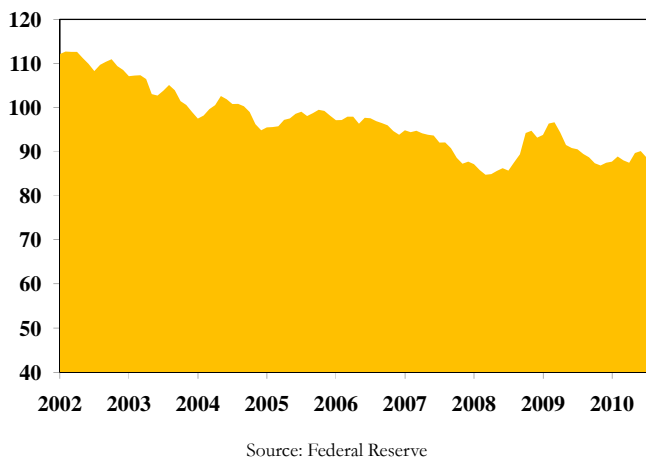
As the economy strengthens, deflationary pressures will begin to dissipate and the Fed will have its hands full unwinding policy. Our recent experience has shown just how quickly the inflationary environment can change. Two years ago, concerns of elevated inflation quickly turned into ones of deflation. This kind of quick reversal could very well happen again.

### The Valuation of the Dollar

After trending downward for most of the last decade, the value of the U.S. dollar has been through a volatile ride over the past few years. The dollar hit a low in March 2008, falling 27 percent from its peak in 2002, as compared to an inflation-adjusted, trade-weighted basket of currencies.

Since that point, it has oscillated in value with the various economic shocks of the past several years. With each period of panic, investors turned to the dollar as a safe harbor, believing dollar-denominated assets to be relatively safe. After appreciating for about a year starting in the summer of 2008, the dollar started to fall back yet

### Real Trade-Weighted Dollar



again as panic ebbed. However, with the emergence of the Greek sovereign debt crisis this spring, the dollar once again strengthened, particularly against the Euro. It has now leveled out in the last month as U.S. economic weakness became more apparent.

The fundamentals suggest that the dollar should weaken somewhat, as U.S. interest rates are low compared to most nations and the current account deficit is still large and growing again. Furthermore, though prospects for near-term economic growth are greater than that of Europe, U.S. recovery has slowed. However, as evidenced by recent events, the dollar is still seen as a safe haven, so its path is likely to be determined by events and policy responses around the world.

The big question is whether the European sovereign debt crisis is contained or if there will be more shocks in the future. The recent moves by the EU and the ECB to pledge about \$1 trillion to stabilize debt markets, coupled with the ECB purchase of Greek debt, have calmed the panic and seem to have contained the problem for now. However, risk spreads on sovereign debt of the PIGS nations, after falling due to the policy response, have been drifting back upwards. Therefore, a more widespread sovereign debt problem may still occur.

If a Greek default does occur it will likely cause risk premiums on other PIGS nations to rise, potentially leading to further defaults. There may be hesitation on the part of the major EU nations to bail out additional countries. German and French political desire to bail out their southern neighbors will only last for so long. In a worst-case scenario, the market fear of default might spread to other non-EU nations with similar situations. If this occurs, debt-heavy Japan could have a crisis on its hands. Under this scenario, another strong “flight to safety” event could occur, greatly strengthening the dollar.

If this fear spreads to the debt situation in the U.S., then perhaps foreign demand for U.S. treasuries could diminish, and the opposite effect could occur, with the dollar falling in value. However, this would require that markets generally place some other group of nation’s currencies as being safer than the dollar. If the crisis ever reached this point, there would likely be a massive global economic depression. This scenario is only the “disaster case” and is not likely. However, it remains a possibility moving forward, particularly if political forces in various countries fail to address their worsening debt issues.

If the Europeans are able to enact their austerity measures, it will alleviate the financial risk; however, it will likely come with the trade-off of diminished economic growth prospects in the short-run. This would strengthen the dollar’s relative fundamentals. But it should be kept in mind that the U.S. fiscal situation is deteriorating as well, and action here will be required in upcoming years.

On the opposite side of the equation, the Chinese have announced modest allowance of appreciation of the yuan, and the Japanese yen has strengthened greatly in recent months. This would weaken the dollar, but with a slower U.S. recovery, there is already uneasiness in these Asian countries about allowing their currencies to further appreciate, hurting their export oriented economies.

Ultimately, whether dollar value movement is relatively modest or whether we are entering another period of volatility depends on the policy actions in both the U.S. and other industrial nations. If monetary policy is timed correctly, and political forces are able to put in place fiscal policy that averts large sovereign debt concerns, then the dollar will likely remain relatively stable in the foreseeable future. However, if fear of or actual defaults begin to come into play, or countries readjust their currencies in light of the international trade environment, the dollar may still be in for a volatile ride.

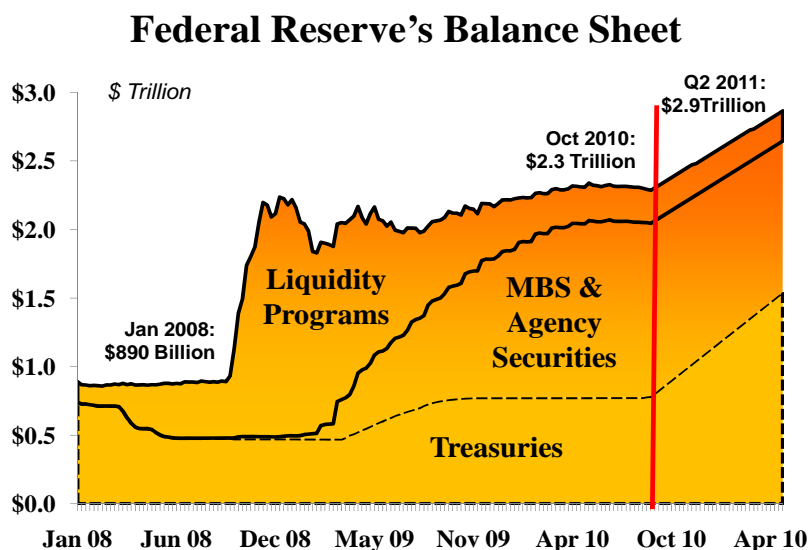
## Monetary Policy

The past two years have seen unprecedented action on the part of the Fed. The Fed's operations have been dominated by a series of programs and facilities that utilize the size of its balance sheet in order to directly affect the money supply and target specific areas for liquidity. This new form of Fed policy has had the effect of greatly increasing the monetary base, almost tripling it since the summer of 2008.

The corresponding increase in M2 over the period would seem to be very small in relation to the expansion of the monetary base. Thus far, this has been due to the fact that the bulk of the increase has occurred via excess bank reserves held at the Fed, and, therefore, has not been multiplied through the fractional banking system.

With output growth recovering for a number of quarters and the financial system stabilized, it appeared that the Fed was

taking the first steps toward moving closer to a more normal policy and the question was largely how the Fed would move to unwind. The Fed has already increased the discount window by 50 basis points, moving its spread over the fed funds rate closer to the historic norm. Furthermore, the Fed had intended to reduce its balance sheet size by allowing its immense holding of MBS to



Source: Federal Reserve

mature. With the fallout of the Greek debt crisis and the slowing recovery over the summer, the spotlight turned back to what the Fed will do to maintain recovery. In its meeting in August, the FOMC announced that instead of allowing the MBS holdings to roll off, it would instead take those proceeds and purchase long-term Treasuries. In effect, this is a modest degree of quantitative easing and it signifies a looser monetary policy relative to what had been initially intended. In addition, the Fed's language started to explicitly state that in relation to its goal of maintaining full employment, inflation was too low. The expectation was that the Fed deliberately wished to increase the inflation rate. In its most recent meeting in November, it announced its intentions to go about another round of quantitative easing. The Fed will now purchase an addition \$600 billion in long-term treasuries through the next couple of quarters.

With this policy move, the Fed is taking a big gamble. On one hand, the additional expansion of the balance sheet is designed to do two things. The first is to continue to drive down long-term interest rates in an attempt to spur greater borrowing and less saving. This will cause a greater amount of consumption growth. If a greater amount of inflation occurs, then real interest rates will drop even further. The second component is a little less overt; however, Fed speakers have not shied away from implying this – that is the goal of creating asset price appreciation, particularly in the equities markets, so that wealth effect driven consumption will expand.

This is a risky move. It could very well help to spur consumption and accelerate output and job growth. However, it complicates the Fed's eventual exit strategy and could start to trigger too great a level of inflation. The dollar may also get hit severely and market speculators may start raising their long-term inflationary expectations. If the market starts to price in inflation, it is very difficult to go back. In addition, future asset bubbles may be in the making. At least two of the Fed Bank presidents are skeptical towards this recent policy move and Governor Warsh has been hesitant. Going forward, the Fed will have a very difficult balancing act of making sure they do not let inflation get out of hand while trying to accelerate growth.