

FedViews – May 15, 2009

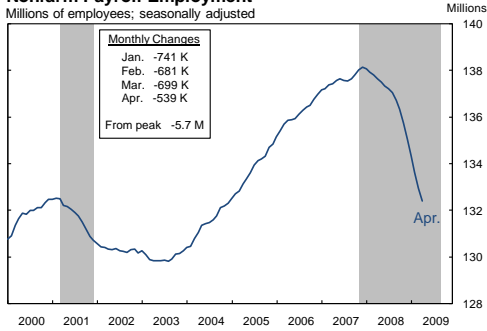
Bart Hobijn, research advisor at the Federal Reserve Bank of San Francisco, states his views on the current economy and the outlook:

- The economy shows many signs of continued weakness. That said, several indicators suggest that the pace of contraction is slowing. This does not mean that economic activity is increasing, but that it might bottom out in coming months. Historically, such indicators have signaled a turning point in the business cycle and the onset of a recovery. Given current circumstances though, we expect the subsequent recovery to be very slow compared to previous ones.
- Continued weakness is particularly evident in the recent labor market data. Nonfarm payroll employment declined by a substantial 539,000 jobs in April, as firms, operating in a weak and uncertain sales environment, continued to cut costs. The very thin silver lining is that the April job decline was significantly smaller than those in the previous three months. However, the unemployment rate has increased to 8.9 percent.
- The main drag on economic activity has been investment. This consists of four main components: housing construction; commercial construction (offices, industrial buildings, retail space, and other commercial real estate); purchases of equipment and software; and changes in inventories.
- The commercial real estate market is going through a correction very similar to that of the housing market. Prices of commercial real estate almost doubled between 2000 and 2007 and have since declined by more than 20 percent. Vacancy rates have increased, the delinquency rate on commercial mortgages has risen, and the pace of construction has slowed to a crawl. Starting in June, commercial-mortgage-backed securities (CMBS), which are an important source of financing in the commercial real estate market, will be eligible collateral under the Federal Reserve's Term Asset-Backed Securities Loan Facility (TALF). Almost no CMBS have been issued in the U.S. since the summer of 2008.
- The current technology-sector slowdown is of the same order of magnitude as the tech bust of 2001. However, in this downturn, the inventory levels in the tech sector are much lower than in 2001. This suggests that production might pick up relatively quickly when demand strengthens and inventories are replenished. We expect such inventory replenishments to extend well beyond the tech sector and emerge as one of the sources of GDP growth in the second half of the year.
- Not all economic news has been dire over the last couple of months, supporting the view that the economy might be close to its trough. The financial sector is showing signs of stabilization and earnings reports of many Standard & Poor's 500 companies have exceeded—admittedly low—market expectations. As a result, stock market valuations have had a large rebound.

- Most importantly, we have seen the resumption of securities issuances in several financial markets that had come to a virtual standstill after September 2008. For example, substantial amounts of consumer asset-backed securities (ABS) were issued in March and April. Such issuances were almost nonexistent from October 2008 through January 2009. These issuances have coincided with a continued narrowing of credit spreads across a wide range of markets.
- In addition, the Federal Reserve Board's Senior Loan Officer Opinion Survey indicates that substantially fewer banks are tightening lending standards now than at the end of 2008. This will presumably lead to easier access to credit for creditworthy consumers and businesses going forward.
- These developments suggest a deceleration of the adverse feedback loop that is at the heart of the current economic downturn. This loop is a cycle in which losses by banks and other lenders lead to a tightening of credit, which in turn reduces spending by households and businesses. The resulting drop in demand drags down the housing sector and the broader economy, contributing to greater loan losses and tighter credit. This slowdown of the adverse feedback loop, as well as the easing of the pace of job losses, have contributed to a jump in consumer confidence.
- Going forward, stabilization of financial markets and institutions as well as fiscal and monetary stimulus will provide momentum for positive economic growth by the end of this year. We do not expect policy measures to be the only source of such momentum. Currently, some types of economic activity are so unsustainably below trend, that we expect substantial corrections over the next year.
- One example is consumer purchases of durable goods. Auto sales are currently about 3 million units a year below the estimated number of cars scrapped annually. If this level of sales persisted, then the number of registered light vehicles in the U.S. would decline by more than 1 percent in 2009 alone, a historically unprecedented decline in the stock of cars. Instead, it is more likely that households and businesses will end up making at least a fraction of those postponed replacement purchases in the coming months.
- Residential investment is also far below trend. A conservative estimate of the trend level of housing starts is about 1.55 million a year. Between the beginning of 2001 and end of 2006 about 1.7 million excess housing units (above trend) were started. In other words, in those six years, the U.S. housing boom generated an overhang equivalent to more than a year of housing starts. A correction of 1.1 million units of this overhang has occurred since the start of 2007 because of the reduction in residential investment. If activity returns to trend in 12 months, then the rest of this overhang would be worked off. This is a very optimistic scenario, positing a high growth rate of residential investment. If the return to trend is slower, an "underhang" in residential investment would most likely occur. Either way, it is unlikely that residential investment will remain at its current depressed levels for a long time.
- In sum, we expect GDP growth to turn positive by the fourth quarter of this year. However, we envision a much slower recovery than those of the past four recessions. In fact, we only expect GDP growth to return to its trend level by the end of 2010. The result is a gap between GDP and potential GDP in excess of 6 percent.
- We expect this persistent slack in the economy will result in a peak unemployment rate of around 9.5 percent and a very slow decline in the rate during 2010 and 2011.
- Finally, in light of the large degree of economic slack we are forecasting over the next two years, we expect inflation to remain relatively low.

Job losses continue to pile up

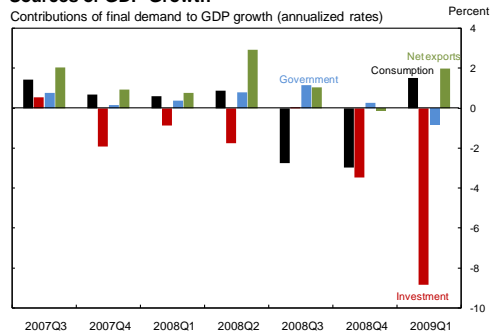
Nonfarm Payroll Employment
Millions of employees; seasonally adjusted



Investment main drag on economy

Sources of GDP Growth

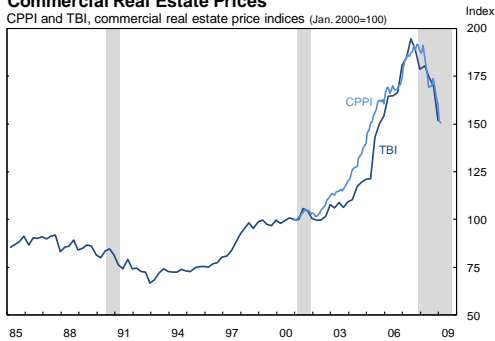
Contributions of final demand to GDP growth (annualized rates)



Commercial real estate prices falling

Commercial Real Estate Prices

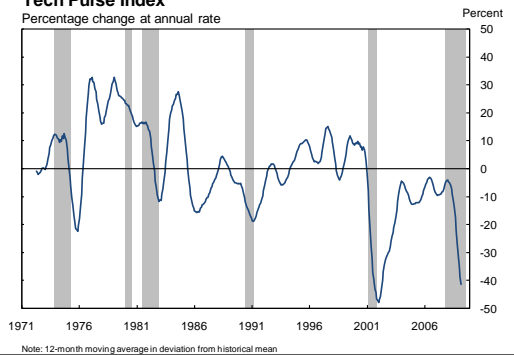
CPPI and TBI, commercial real estate price indices (Jan. 2000=100)



Lack of investment pulling down tech

Tech Pulse Index

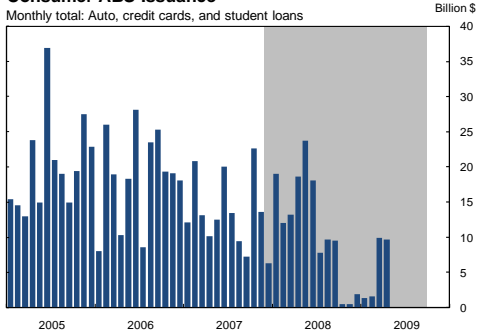
Percentage change at annual rate



Some thawing of credit markets

Consumer ABS Issuance

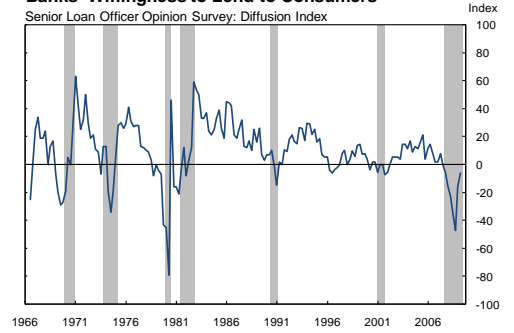
Monthly total: Auto, credit cards, and student loans



Fewer banks tighten lending standards

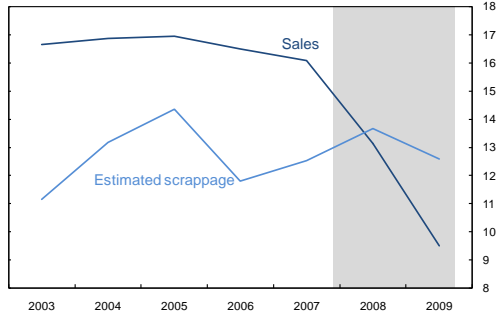
Banks' Willingness to Lend to Consumers

Senior Loan Officer Opinion Survey: Diffusion Index



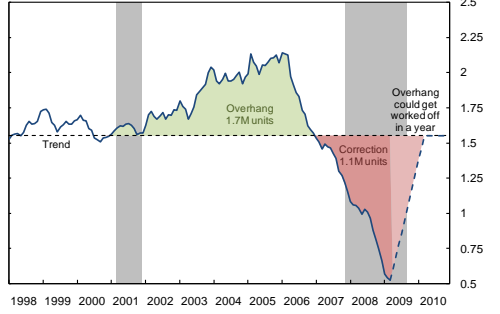
Car sales lower than scrappage

Light Vehicle Sales
Annual unit sales (millions of vehicles)



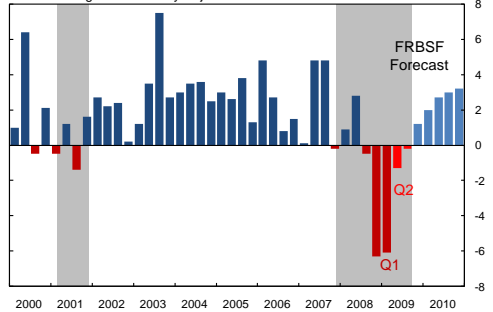
We are working off housing overhang

Housing Starts
Seasonally adjusted annual rate, three-month moving average



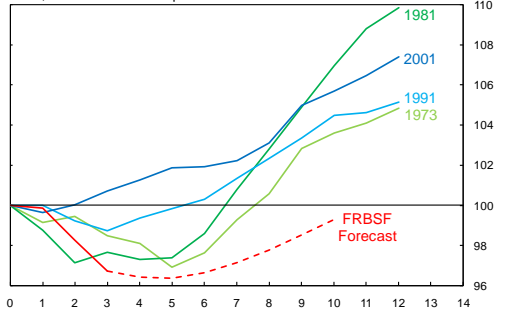
Expect gradual recovery

Real Gross Domestic Product (GDP)
Percent change at seasonally adjusted annual rate



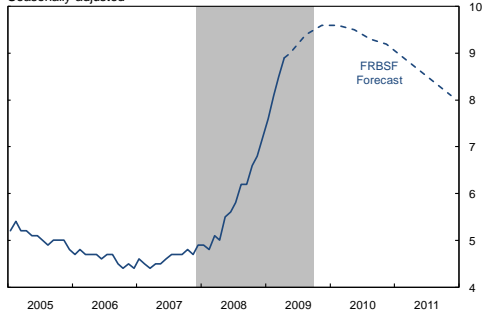
Slow recovery compared to past

Real Gross Domestic Product (GDP)
Index, normalized at 100 at peak of GDP



Unemployment outlook

Unemployment rate
Seasonally adjusted



Continued slack reduces inflation

Core PCE Price Inflation
Percentage change from four quarters earlier

