

Outline for the 2010 Outlook for Economic Recovery

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Presented at Booth School of Business “Business Forecast Lunch”

December 2-3, 2009

1) Economic Outlook

- a. Choppy data, more job losses but optimism for growth in 2010 (forecast of 3.4 percent real GDP growth) because
 - i. Although unemployment up to 10.2 percent, we have been losing jobs at a declining rate (new data will be reported on Friday December 4)
 - 1. 190,000 losses last month, but steady reduction in number of losses since the second quarter
 - 2. Gradual reduction in losses in payroll employment data, probably turning positive by the second quarter of next year
 - 3. Unemployment rate will be choppy (smaller sample than the payroll employment numbers and the answers about whether someone is “in the labor force” are variable) and moves with a bit of a lag
 - ii. Productivity at record levels – and strength through the sharp downturn
 - 1. This is similar 2001/2002 but contrast with further past
 - 2. Testament to the flexibility of US labor markets and is key to the willingness of businesses to invest as cash flows and profits return (recall that labor costs are on average 70 percent of total costs)

3. This is part of the reason why I do not believe that the “trend rate” or “potential” growth rate has taken a hit
 4. As cash flows and profitability come back, firms will be able and willing to invest out of free cash flow (despite tight credit conditions), jobs will then return
 5. Unit labor costs have been declining, so no price pressure from labor market
 6. Subdued inflation going forward
- iii. Housing market stabilizing but uneven across the country
1. At the Fed, I visited many cities around the country to see the challenges of foreclosures first hand (e.g., Cincinnati, Cleveland, Oakland, etc.)
 2. Policies to reducing borrowing costs and first time homebuyer credits
 3. Will not fully recover until resolution of Freddie and Fannie, the forgotten behemoths
- iv. Fed monetary policy has become MORE stimulative over last nine months even though no change in NOMINAL interest rates because
1. Inflation expectations have switched from DEflation to moderate INflation, so REAL Fed Funds rate is lower
 2. Risk spreads have come down so the impact so borrowing costs, for a given Fed Funds rate, is lower
 3. No near term inflation pressure
- v. Main impact of fiscal stimulus will hit in 2010
1. Somewhat surprising that we haven’t seen more of an impact of the large deficits and projected increase in Debt/GDP
 2. Too much, too late?

3. But the Treasury can still borrow today at relatively low rates. How?

vi. Savings/Consumption/Confidence

1. Partially explained by increase in **SAVINGS** rate from 0 to 4.5 percent, which helps to finance Treasury borrowing
2. Will consumers go back to a long run average savings rate of 7 to 8 percent, or even higher
3. What lesson will they take from the recent crisis?
4. Great Recession, not Great Depression
5. Gradual move to roughly 5 percent
6. Holiday season will tell us a lot (probably better than last year but probably not to levels of two years ago) about consumer's willingness to spend and whether the savings rate will flatten around where we are or go up

vii. Thus, combination of monetary and fiscal stimulus will lead to a strong 2010

viii. But watch out for 2011/2012 when there will have to be some pull back in both monetary and fiscal stimulus

ix. Could we be back in the bad old days of policy-induced business cycles?

1. Could we have a rerun of 1936/37 (sharp contraction due to monetary and fiscal pull-back after strong recovery after the bottom in 1933?)
2. Now turn to exit strategy discussions today

2) Federal Reserve Exit Strategy and the Most Recent FOMC Statement

- a. The “extended period “ language in the FOMC statement means just that – rates will be held low for a significant period of time
- b. In the most recent Federal Open Market Committee (FOMC) statement and minutes, they have clearly announced the criteria that they will use -- “resource slack, inflation trends, inflation expectations” -- to determine when to exit
 - i. Also, the just-released minutes of the November FOMC meeting contain the first discussion I have seen of asset-price bubbles
- c. No evidence of inflation pressures but some recent rise in inflation expectations
- d. Resource slack continuing
- e. But Fed can manage a large balance sheet WITHOUT causing inflation
 - i. Interest on reserves is an important tool for managing excess reserves
 - ii. In the past, as the Fed would raise rates, the opportunity cost of holding non-interest bearing reserves would increase, thereby giving increasing incentive for banks to lend out those reserves
 1. That then leads to greater credit creation and an expansion of the money supply that can bring higher inflation
 - iii. With the ability to pay interest on reserves (a power granted by Congress last fall), however, the Fed can keep that opportunity cost constant by raising interest on reserves when it raises the target federal funds rate, thereby reducing the incentive for banks to lend out the excess reserves and giving the Fed greater ability to prevent rapid growth of credit and the money supply
 1. It can also offer term deposits to banks

2. It can also do “reverse repurchase agreements” that permit the Fed to hold a large portfolio but drain reserves from the system to prevent money supply growth
- f. The passage of an amendment that would make *monetary policy* decisions subject to formal Congressional Government Accountability Office (GAO) investigation (Congress explicitly exempted monetary policy decisions in 1978) could delay exit by pressuring the Fed not to raise rates
- i. Decisions on when to raise rates are always difficult ones, especially when unemployment rates are still elevated
 - ii. To avoid inflation, rates must be raised in anticipation of inflation, not after it appears
 - iii. Since inflation pressures are particularly difficult to forecast when coming out of a contraction, the threat of an investigation (that will also have benefits of 20-20 hindsight) may make the central bank slower to raise rates to avoid inflation
 1. Studies (such as by Alberto Alesina and Larry Summers, now head of the National Economic Council) show a very strong correlation between greater central bank independence and lower and more stable inflation
 2. In the early 1980s, could Paul Volker have been able to raise rates and stop high inflation at the cost of a deep recession if we did not have the 1978 exemption?
 3. Important to avoid short-term political pressures on Fed monetary policy decision-making to give the greatest chance for success of a smooth exit strategy that avoids high inflation