The U.S. Economy at a Crossroads: The Dynamics of Recession and Recovery

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Global Insight
The Worst Is Yet to Come for the U.S. Economy

- Financial crisis has deepened
- Economy was already tipping into recession
- Households, businesses, state and local governments face tighter—or shut-off—credit
- Global economy also going into recession
- Risks are rising of U.S. recession comparable to worst since WWII
GLOBAL INSIGHT OUTLOOK SEMINAR
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Where Do We Stand in the Financial Crisis?
Cyclical Pressures, Housing Deflation = Escalating Stresses Financial Capital

U.S. residential mortgages:

Global gross losses: US$650 (4.5% of GDP)
Sub-prime: US$350 (~50% non-U.S.)
U.S. financial system: US$475 (3.3% of GDP)
U.S. c/i banks: US$375 (25–40% bank capital)

U.S. business and other consumer loans:

Global gross losses: US$950 (6.6% of GDP)
Premature Fed Tightening Signals June–August 2008 — Mortgage Rates Jump

Federal funds futures spiked in June 2008

FOMC minutes August 5: “Although members generally anticipated that the next policy move would likely be a tightening...”

[Graph showing mortgage rates and federal funds futures]

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Recapitalization of Financial System Hits Roadblocks

- Recapitalization efforts hit major roadblocks in 2008:Q3
  - Accelerated destruction of financial system capital
    - IndyMac failure, GSEs, Lehman, AIG, WAMU, Wachovia
    - Asset deflation broadens and accelerates
  - Foreign investors pull away from U.S. financial markets
  - Sovereign wealth funds/“white knights” back off
Risk Aversion Spikes “Off the Chart”: Negative Feedback Loops Intensify

TED spread - 3 months
(Percent, 3 day moving average)
Risk Aversion Spikes: As Negative Feedback Loops Intensify

Borrowing spreads continue tracking higher
(Percent, 5 day moving average)
Asset Price Deflation Broadens and Accelerates…

…Stock market collapse comparable with worst seen since Depression

Peak-to-Trough Percent Change in Dow Jones Industrial Average

-100 -90 -80 -70 -60 -50 -40 -30 -20 -10 0


To Oct 27, 2008
Asset Price Deflation Broadens and Accelerates...

...Scrap steel prices down from US$500 to near US$100/ton (levels in late 2002/2003)

Global Insight Industrial Materials Price Index
(2002:1 = 1.000)
Deleveraging Accelerates & Credit Growth Decelerates Alarmingly

Consumer credit growth decelerating, mortgage credit growth collapsing

Consumer and mortgage credit growth nose-diving

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Fed, TARP programs providing life-support for business lending…

Business credit growth bounces back from contraction

![Graphs showing business credit trends]

- **Commercial, industrial, real estate loans, bn 3 mma**
- **Non-financial commercial paper, bn, 3 mma (right)**

- **Business credit, total, 3 mma, yearly percent change**
- **Gross domestic product, 3 mma, yearly percent change**
G7+ Finally Launches Coordinated Emergency Action

- G7+ coordinated rate cuts on October 8, 2008
  - G20 emergency meeting November 15 in Washington, D.C.

- Euro zone and Britain amplify the policy response
  - Deposit insurance ramped up
  - Roughly US$2.5 trillion to support the banking sector
    - 250 billion euros (US$341 billion) for equity infusions
  - Britain to guarantee bank debt
  - ECB/BoE cut rates 50/150 basis points in early November

- U.S. TARP program
  - Mandate expanded—direct equity infusions to the banking sector
  - Resources likely to be expanded from original US$700 billion
U.S. Policy Response to Be Further Amplified

- Additional fiscal stimulus measures
  - Infrastructure, tax rebates and/or cuts, housing programs, income security transfers, grants-in-aid relief for the states
  - Package expected to be near US$200 billion, impacting the economy in 2009:H1

- Federal Reserve switches to “no holds barred” approach
  - FOMC now focused on deflationary threat
  - “Super-leverage” and expand balance sheet by US$2 trillion +
  - Bernanke gives Congress green light for more fiscal stimulus
  - Federal funds rate expected to decline to 0.5%
The Fallout for the Real Economy
NBER’s Key Monthly Recession Indicators

- **Employment**: Peak in Dec 2007.
- **Industrial Production**: Peak in Jan 2008.

*Billions of 2000 dollars, SAAR; **Billions of 2000 dollars, SAAR; ***Millions, SA; ****Index, 2002=100, SA
GDP Declines in Post-War Recessions

Peak-to-Trough Percent Change in Real GDP

Dated by Year of the Peak


Baseline

Pessimistic
Why Not Even Worse?

- Oil prices heading for US$50/bbl (like a US$185 billion tax cut)
- Fiscal stimulus coming (US$200 billion?)
- Service sector is a larger share of the economy than in the past
- Inventories better managed than in the past
The Outlook for GDP Growth

(Annualized rate of growth)

-6 -4 -2 0 2 4 6

2007 2008 2009 2010

Baseline (60%)  Pessimistic Scenario (25%)
Unemployment Outlook

(Percent)

2001 2002 2003 2004 2005 2006 2007 2008 2009 2010

Baseline (60%) Pessimistic Scenario (25%)
Housing Starts Dip Further, Prices to Fall Sharply in 2008

(Million units) vs. (Year/year percent change)

- Housing Starts (Left scale)
- OFHEO House Price Index (Right scale)
Bad News Almost Everywhere for Consumer Finances

**Negative Forces**
- Falling employment
- Falling real wages
- Declining housing wealth
- Declining stock market
- Tightening credit conditions
- Mounting debt burdens
- Low saving rate

**Positive Forces**
- Gasoline is below its peak
- More stimulus coming from the government
Consumption Boom Over

(Percent growth, real)

Real Consumption  Real Disposable Income
The Business Capital Spending Cycle

(Percent change from a year earlier, real spending)

Software & Equipment
Buildings
Exports Are Now at Risk

(ISM Manufacturing Export Orders, Diffusion index)
Export Growth Has Peaked

(Percent change from a year earlier, volumes)

- Real U.S. Exports
- Real U.S. Imports
The U.S. Dollar: How Big a Bounce?

(2000=1.0, inflation-adjusted)

Major Currency Index

Other Important Trading Partners Index
Headline CPI Will Decline; Core Inflation Rate Will Fall

(Percent change from a year earlier)
It Was the Economy, Stupid

(Percentage of 2-party presidential vote for incumbent party)
The Economy Is Now Obama’s Problem

(Federal deficit, percent of GDP)
Bottom Line

• Economy tumbling into recession—it won’t be mild
• Potentially worse than 1982 but…
• …More fiscal action on the way…
• …Lower oil helps…
• …Fed will cut rates further
• Election: the economy won it for Obama; it’s now his problem
## U.S. Economic Growth by Sector (Baseline; 60% odds)

(Percent change unless otherwise noted)

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP</td>
<td>2.0</td>
<td>1.3</td>
<td>-1.0</td>
<td>1.7</td>
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<tr>
<td>Domestic Demand</td>
<td>1.4</td>
<td>-0.1</td>
<td>-1.8</td>
<td>2.3</td>
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<tr>
<td>Consumption</td>
<td>2.8</td>
<td>0.4</td>
<td>0.2</td>
<td>1.8</td>
</tr>
<tr>
<td>Light Vehicle Sales (Mill)</td>
<td>16.1</td>
<td>13.3</td>
<td>12.2</td>
<td>14.0</td>
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<tr>
<td>Residential Investment</td>
<td>-17.9</td>
<td>-21.4</td>
<td>-16.6</td>
<td>18.4</td>
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<tr>
<td>Housing Starts (Millions)</td>
<td>1.34</td>
<td>0.93</td>
<td>0.72</td>
<td>1.08</td>
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<tr>
<td>Business Fixed Investment</td>
<td>4.9</td>
<td>2.7</td>
<td>-11.0</td>
<td>-0.5</td>
</tr>
<tr>
<td>Government</td>
<td>2.1</td>
<td>2.6</td>
<td>0.3</td>
<td>-0.3</td>
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<tr>
<td>Exports</td>
<td>8.4</td>
<td>8.4</td>
<td>0.7</td>
<td>1.1</td>
</tr>
<tr>
<td>Imports</td>
<td>2.2</td>
<td>-2.4</td>
<td>-4.8</td>
<td>5.6</td>
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## Other Key Indicators (Baseline; 60% odds)

(Percent unless otherwise noted)

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<tr>
<td><strong>Industrial Production (% gr)</strong></td>
<td>1.7</td>
<td>-0.9</td>
<td>-3.5</td>
<td>0.9</td>
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<tr>
<td><strong>Employment (% growth)</strong></td>
<td>1.1</td>
<td>-0.1</td>
<td>-1.5</td>
<td>0.1</td>
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<tr>
<td><strong>Unemployment Rate</strong></td>
<td>4.6</td>
<td>5.7</td>
<td>7.7</td>
<td>8.2</td>
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<tr>
<td><strong>CPI Inflation</strong></td>
<td>2.9</td>
<td>3.9</td>
<td>-0.9</td>
<td>2.4</td>
</tr>
<tr>
<td><strong>Oil Prices (WTI, US$/bbl)</strong></td>
<td>72</td>
<td>101</td>
<td>53</td>
<td>63</td>
</tr>
<tr>
<td><strong>Core PCE Price Inflation</strong></td>
<td>2.2</td>
<td>2.3</td>
<td>1.4</td>
<td>1.5</td>
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<tr>
<td><strong>Federal Funds Rate</strong></td>
<td>5.02</td>
<td>2.04</td>
<td>0.50</td>
<td>1.22</td>
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<tr>
<td><strong>10-year Govt. Bond Yield</strong></td>
<td>4.63</td>
<td>3.80</td>
<td>3.63</td>
<td>3.88</td>
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<td><strong>Dollar (Majors, 2000=1)</strong></td>
<td>0.77</td>
<td>0.73</td>
<td>0.78</td>
<td>0.76</td>
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# Pessimistic Scenario Summary (25% odds)

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Thank You

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