The Economic Outlook
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*The views expressed here are those of the author and do not necessarily reflect those of the Federal Reserve Bank of Philadelphia or of the Federal Reserve System.

“A good forecaster is not smarter than everyone else, he merely has his ignorance better organized.”

Anonymous

• Review 2010 economic performance
• Discuss the forecast for 2011 and 2012
We expected a modest recovery to continue in 2010, with weak labor markets and subdued inflation, and this is what happened.

<table>
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<th>FOMC Central Tendency in January 2010</th>
<th>Actual for 2010</th>
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</thead>
<tbody>
<tr>
<td>Real GDP Growth (4Q/4Q)</td>
<td>2.8% to 3.5%</td>
<td>2.8%</td>
</tr>
<tr>
<td>Unemployment Rate (4th quarter average)</td>
<td>9.5% to 9.7%</td>
<td>9.6%</td>
</tr>
<tr>
<td>Total PCE Inflation (4Q/4Q)</td>
<td>1.4% to 1.7%</td>
<td>1.2%</td>
</tr>
<tr>
<td>Core PCE Inflation (4Q/4Q)</td>
<td>1.1% to 1.7%</td>
<td>0.8%</td>
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</table>

The U.S. economy performed much better in 2010 than in 2009, but the labor market remained weak and housing was moribund.

**The Good**
- Growth accelerated in 2010 as the recovery got underway in earnest.
- Firms and households made progress on deleveraging, which supported spending.
- Financial markets stabilized and banks became more willing to lend.
- Firms began to hire.

**The Bad**
- The economy lost over 8 million jobs between Dec 2007 and Dec 2009.
- It has gained only about 1 million job since then.
- Payroll jobs are below their January 2000 level.
- The unemployment rate remains high at 9.0%.
- Average unemployment duration is 37 weeks.

**The Ugly**
- The only signs of life in housing last year were due to the buyers’ tax credit.
- House prices continue to fall.
- House construction is at a post-WWII low.
- 1 in 12 first-lien mortgages is in foreclosure or likely to default.
Growth started the year fairly strong, hit the summer doldrums, and then picked up momentum in the fourth quarter.

At the end of 2009, activity was contracting in many states, including PA and DE. (It was flat in NJ.)

Philadelphia Fed Current Economic Activity Indexes, annualized growth over the three months ending in November 2009.
By the end of 2010, activity was expanding in many states, including PE and NJ.

Philadelpia Fed Current Economic Activity Indexes, annualized growth over the three months ending in December 2010

Last year, firms began to rebuild inventories, adding to growth. Overall business fixed investment strengthened, as firms invested in equipment and software. Investment in structures continued to contract.
Manufacturing activity in the nation and in our region was a bright spot last year, despite the summer doldrums. Our February 2011 survey shows continued strong activity.

Business Outlook Survey: General Activity Index
Future General Activity Index

Reflecting higher profits and continued recovery, broad stock price indexes rose over 10% last year and have continued to rise this year. The S&P500 and Dow are more than 2/3s of the way back to their October 2007 peaks.

Source: FRB Flow of Funds, annual data for 1990-2009; quarterly data for 2010 Q3

Household debt-to-disposable income has fallen but households will continue to deleverage

Quarterly data: Last point plotted is 2010 Q3
Consumer spending strengthened last year, supported by fiscal and monetary stimulus

Real personal consumption
4Q/4Q growth, SAAR*

Labor market conditions are improving, but January’s payroll employment growth was disappointing

Thousands of jobs
Monthly change in nonfarm payrolls

Last month plotted is January 2011
Average monthly gains for each year are indicated by the grey lines
Employment in our three states rose about 1/2% last year, about half the pace for the U.S.

The pattern was uneven, with gains in PA and DE, and losses in NJ.

Year-to-date annualized payroll job growth, as of December 2010

The unemployment rate is still high but it has fallen by 0.8 percentage points over the past two months

Extended unemployment insurance benefits have added about 1% pt to the unemployment rate
Housing markets were considerably weaker in 2010 than most economists had forecasted. The homebuyers’ tax credit affected the quarterly pattern.

Real residential investment
Quarterly growth, SAAR

Home sales and housing starts continued to trend downward after the extended homebuyers tax credit expired

Thousands of units
Privately owned housing units started (left axis)
Existing single family home sales (right axis)
New single family home sales (left axis)

Quarterly data: Last point plotted is 2010 Q4
Inflation decelerated last year raising concerns among some about the possibility of sustained deflation. Higher food and energy prices are beginning to put upward pressure on headline inflation.

The deflation scare is over: Our SPF respondents put low odds on deflation this year or next.
Non-energy commodity prices have risen sharply since the summer.

Weekly data: Last point plotted is February 8, 2011
Source: Commodity Research Bureau

Regional manufacturers are facing higher input costs and are starting to pass these higher costs onto customers. Both price indexes are at their highest levels since 2008.

Business Outlook Survey: Prices Paid Index
Prices Received Index

Index represents percentage of respondents reporting an increase minus percentage reporting a decrease.
Monthly data: Last point plotted is February 2011.
Many of our BOS firms said they have already raised their prices or plan to do so over the next three months

Since the beginning of the year, how much have you increased your prices?

Over the next three months, how much will you increase your prices?

Long-term inflation expectations remain anchored

Daily data: Last point plotted is February 4, 2011 for inflation compensation and First Quarter 2011 SPF for 10-year CPI inflation expectations
To support the recovery, the FOMC kept monetary policy very accommodative in 2010:
the Fed funds rate was kept at essentially zero;
the first round of large scale asset purchases was completed;
the large size of the Fed’s balance sheet was maintained via reinvestments;
a second round of longer-term Treasury purchases was begun.

Treasury securities have become a smaller share of the assets on the Fed’s balance sheet:
First TAF auction, 12/17/2007
First agency MBS purchase, 1/5/2009
First longer-term Treasury purchase, 3/25/2009
Reinvestment of maturing agency MBS in longer-term Treasuries, 8/10/2010
Second round of longer-term Treasury purchases, 11/3/2010
Fed and private sector forecasters expect growth to accelerate this year and next as the recovery takes hold. The unemployment rate will decline gradually.

<table>
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<tr>
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<th>Central tendency of Fed Governors and Presidents January 2011 Forecasts</th>
<th>Survey of Professional Forecasts 2010 Q1 Forecasts</th>
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<tbody>
<tr>
<td></td>
<td>2011</td>
<td>2012</td>
</tr>
<tr>
<td>Real GDP Growth*</td>
<td>3.4 to 3.9%</td>
<td>3.5 to 4.4%</td>
</tr>
<tr>
<td>Unemployment Rate in Q4</td>
<td>8.8 to 9.0%</td>
<td>7.6 to 8.1%</td>
</tr>
<tr>
<td>PCE Inflation (Q4/Q4 growth)</td>
<td>1.3 to 1.7%</td>
<td>1.0 to 1.9%</td>
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*Q4/Q4 growth for Fed forecasts and 2011 SPF, and annual growth for 2012 SPF
Our latest *Survey of Professional Forecasters* forecasts sustained moderate growth this year

Hatched bars are median forecasts from the 2011Q1 Survey of Professional Forecasters

Our latest *Survey of Professional Forecasters* indicates the unemployment rate will continue to decline over the year but will remain high

Dotted line is median forecast from the 2011Q1 Survey of Professional Forecasters
Headline and core inflation are expected to accelerate as the economy strengthens. Our SPF forecasts inflation will be 1.25 to 2% over the next two years.

The forecast includes the effects of the new fiscal stimulus package and the effects of accommodative monetary policy

- New fiscal stimulus package adds 1/2 to 3/4 % pt to real GDP growth in 2011 and subtracts 1/4 % pt from growth in 2012 as provisions expire.
  - Package costs around $900 billion over two years compared to current law.
    - Extends Bush tax cuts for all income brackets for two years.
    - Extends emergency unemployment benefits for 13 months.
    - Reduces Social Security payroll tax for employees by 2 % pts.
    - Allows firms to deduct 100% of cost of most capital expenditures made in 2011 and 50% in 2012.
- “The Committee ... continues to anticipate that economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels for the federal funds rate for an extended period.” (January 26, 2011 FOMC Statement)
As always, there are risks to the baseline forecast

• The risks to growth are balanced
  – Fiscal issues remain a concern
    • Near term: state and local government finances are in poor shape; any problems in the municipal bond market may spill over to banks
    • Medium to long term: Federal government budget deficits running 7 to 10% are not sustainable
    • Abroad: Sovereign debt problems in Europe are not resolved
  – Housing markets may not have bottomed; foreclosures may be a larger drag than expected; Not yet known how GSE reform will look
  – Internal dynamics of the economy + effect of accommodative fiscal and monetary policy may be stronger than we think
• The risks to inflation are balanced in the near term but are on the upside in the medium term
  – The success of the Fed’s exit strategy from the period of extraordinary monetary accommodation is key to anchoring inflation expectations
  – Concerns about large looming fiscal deficits may increase inflation expectations
  – Events in the Middle East => oil prices are even more of a wild card than usual

The sovereign debt problems in Europe continue to be a risk to the forecast especially if they spill over to the banking system

Percent

Spread of 10-year government bond
over 10-year German government bond

Greece
Ireland
Portugal
Spain
Italy

Daily: Last point plotted is February 8, 2011
The U.S. has a large budget deficit it will have to resolve

Federal surplus as % of FY GDP, OMB projections

Federal outlays were 24% of GDP in 2010. A large share of government expenditures are on defense, Social Security, Medicare, and Medicaid.

2010 Federal Outlays

- Medicare & Medicaid = 23%
- Social Security = 20%
- Defense = 20%
- Net Interest on Debt = 6%
- Safety Net Programs = 13%
- Other = 19%
  - Science and Medical Research = 2%
  - Transportation & Infrastructure = 3%
  - Education = 3%
  - All Other = 11%

Source: Haver Analytics/Congressional Budget Office

Items do not sum to 100 due to rounding.
The baseline forecast

• The economic recovery strengthens in 2011 and 2012, with growth somewhat above trend – around 3.5%.
  – Improvement in labor market conditions and households’ balance sheets, and the fiscal stimulus, will support stronger consumption growth
  – Supported by strong profits, businesses continue to invest in equipment and software at a healthy pace and hiring strengthens
  – Residential investment bottoms out

• Labor markets improve. Payroll growth picks up to a moderate pace by mid-year, which is maintained over the next two years. The unemployment rate starts to fall but only gradually, remaining near 8% by the end of next year.

• Inflation remains low but accelerates over the next two years back to 2% as the economic recovery is well underway.