



Economic Outlook

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The Great Recession ends, but ...



The Great Fear remains: Is the US condemned to a lost decade?



Can it happen here?

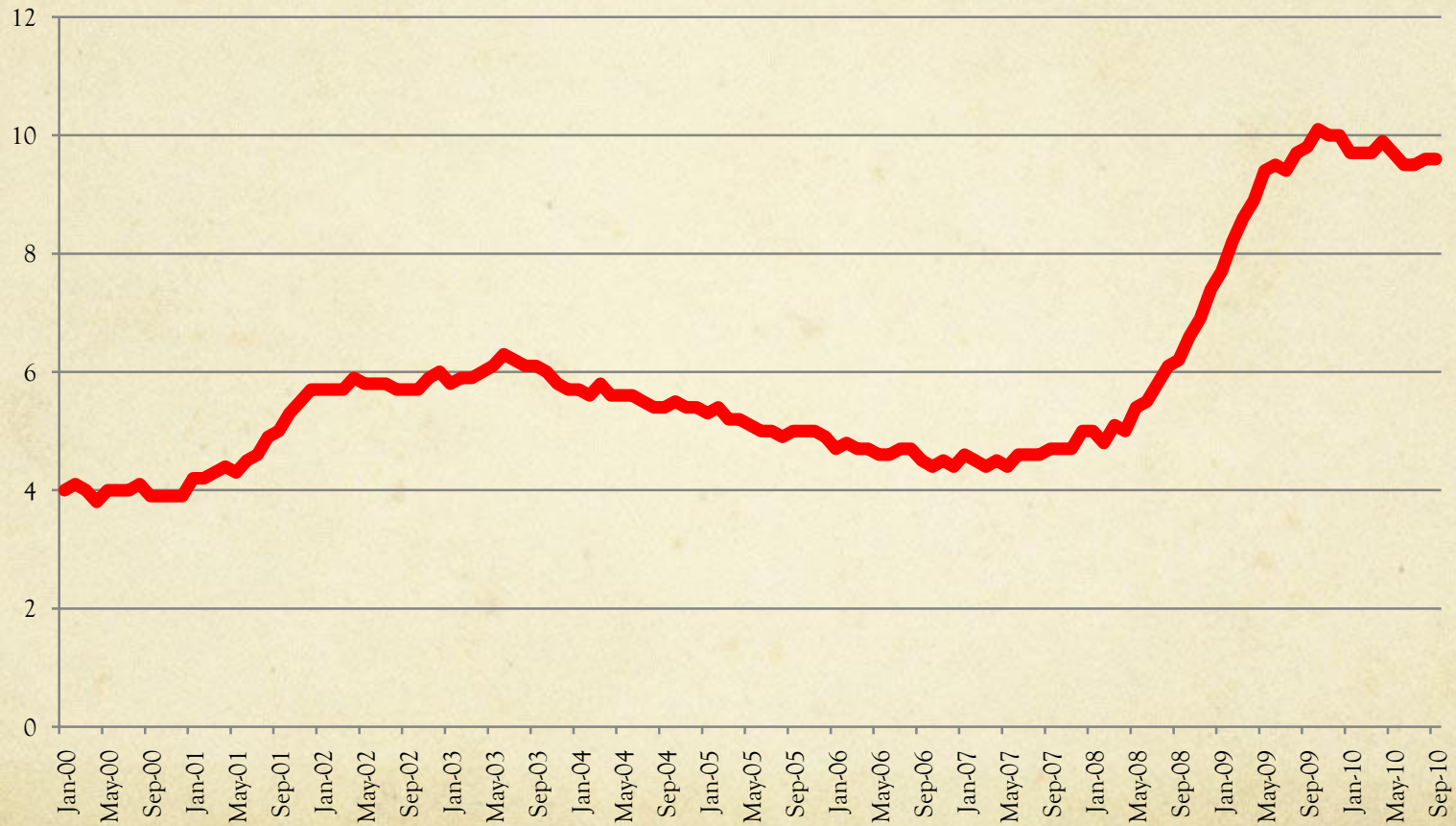
- No
 - The US economy is more
 - Diverse
 - Flexible
 - Innovative
 - We went to school on Japan
- Maybe
 - Unfavorable demographics
 - Policy paralysis
 - Foreign creditors

Three questions

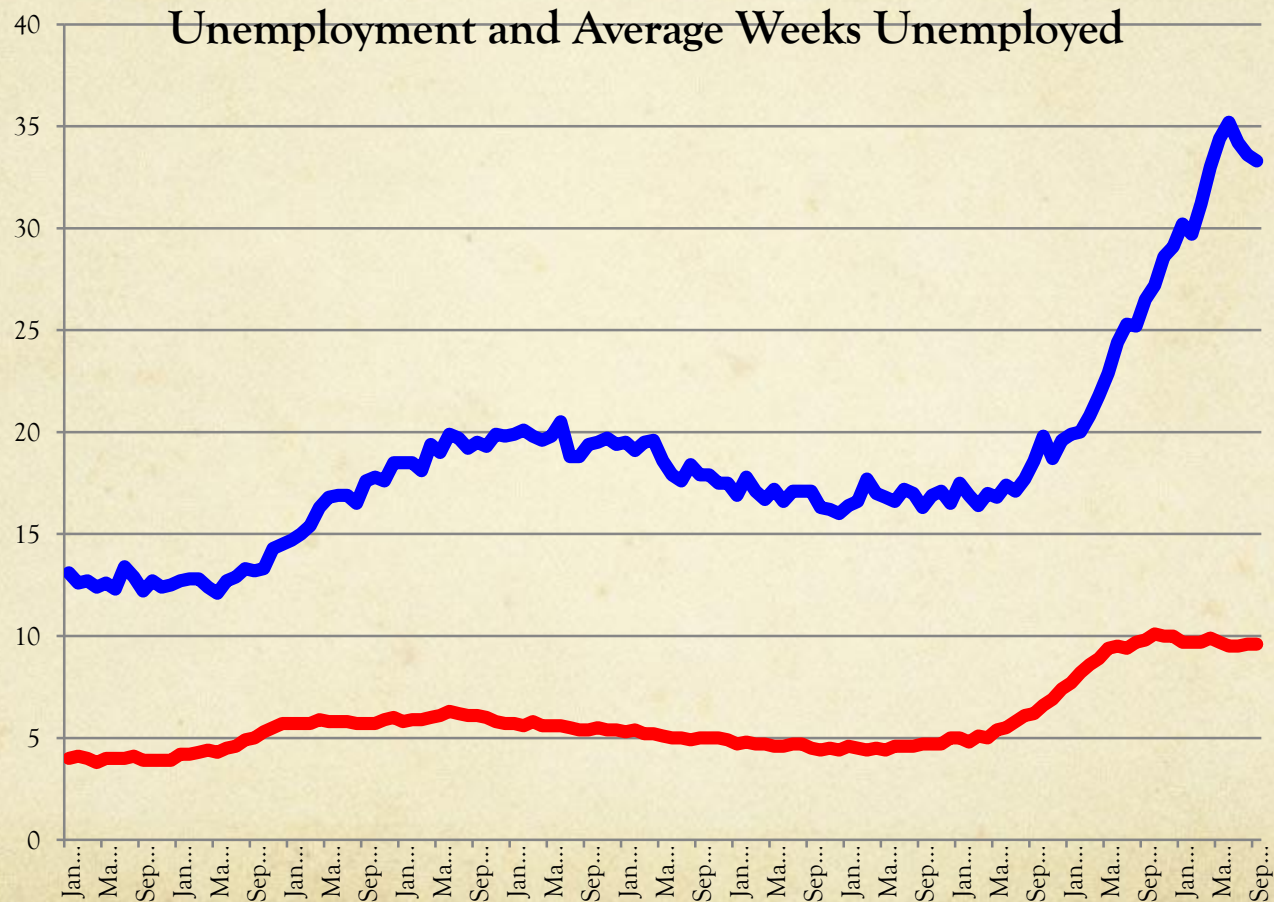
- Why has unemployment remained so high? Are the causes structural or cyclical?
- Household net worth has been decimated. Will it languish or recover?
- Financial markets caused all this. How can we be sure they won't do it again?

It doesn't feel like the recession is over

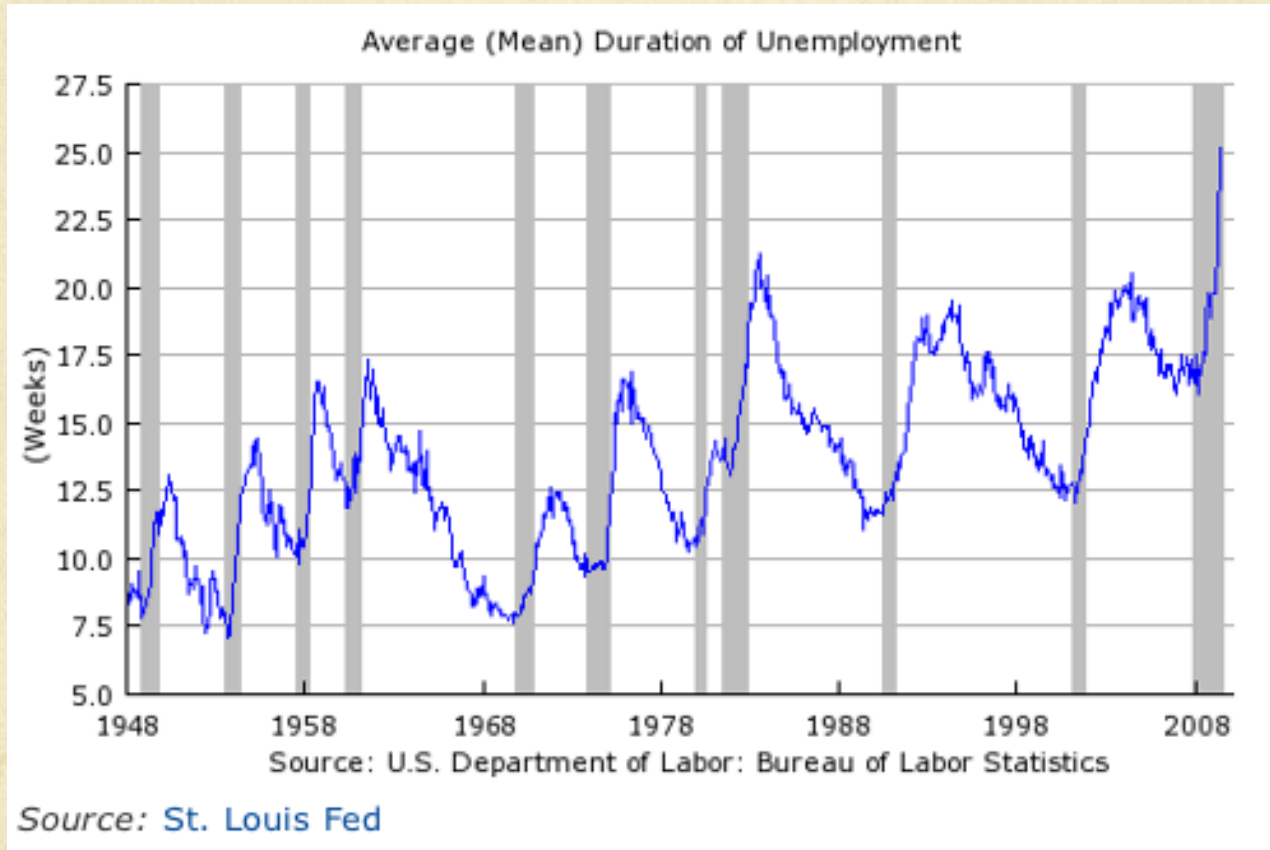
Unemployment Rate



A long time since the last paycheck



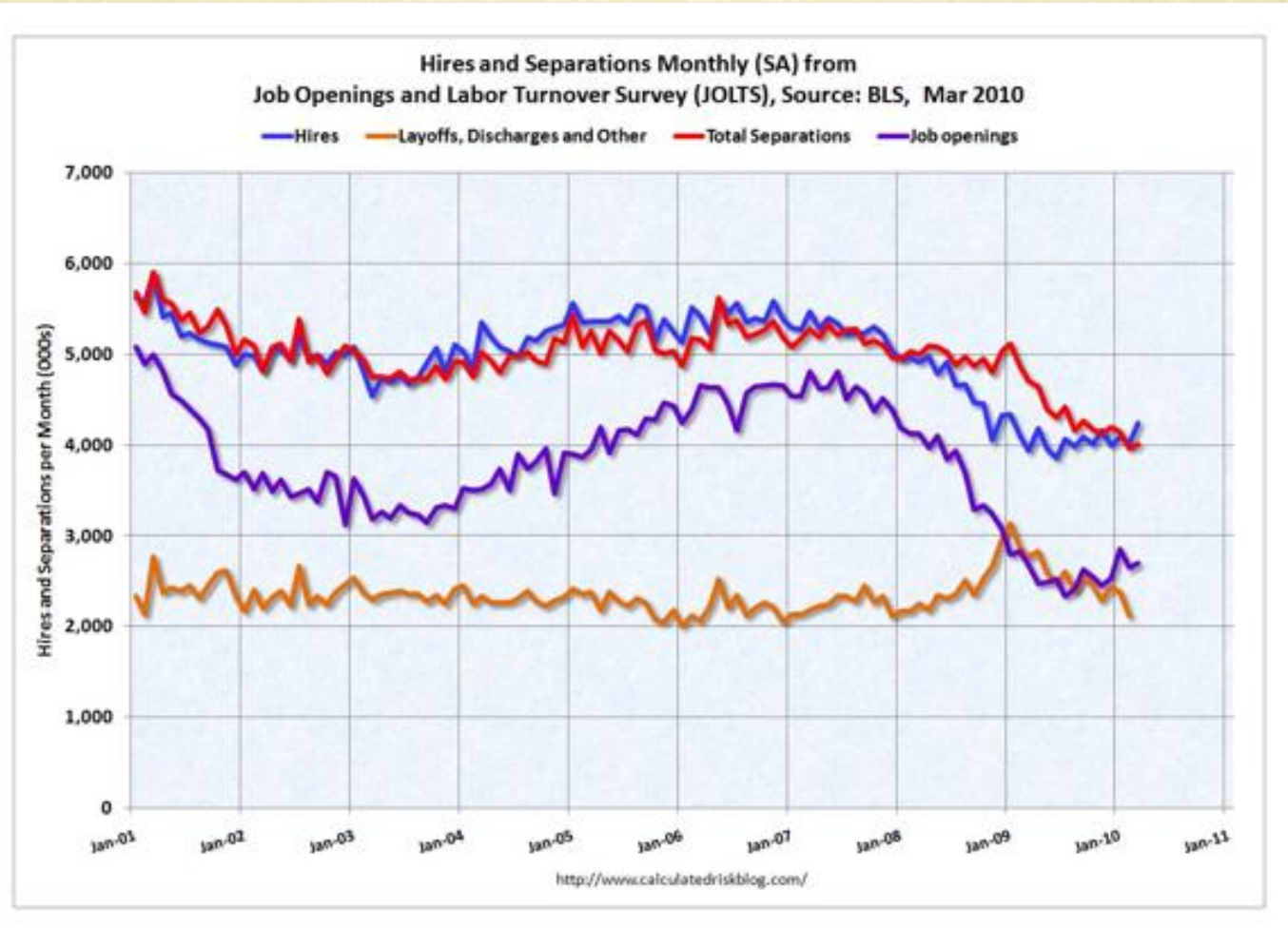
Even by historical standards



Is the problem structural?

- Structural unemployment
 - Caused by mismatches between jobless workers and available jobs
 - Dying and rising industries require different skills
 - Frictions (e.g. cost of overcoming geographic mismatches)
 - Implies uneven labor market (high demand in some places and low demand in others)

Filling job openings

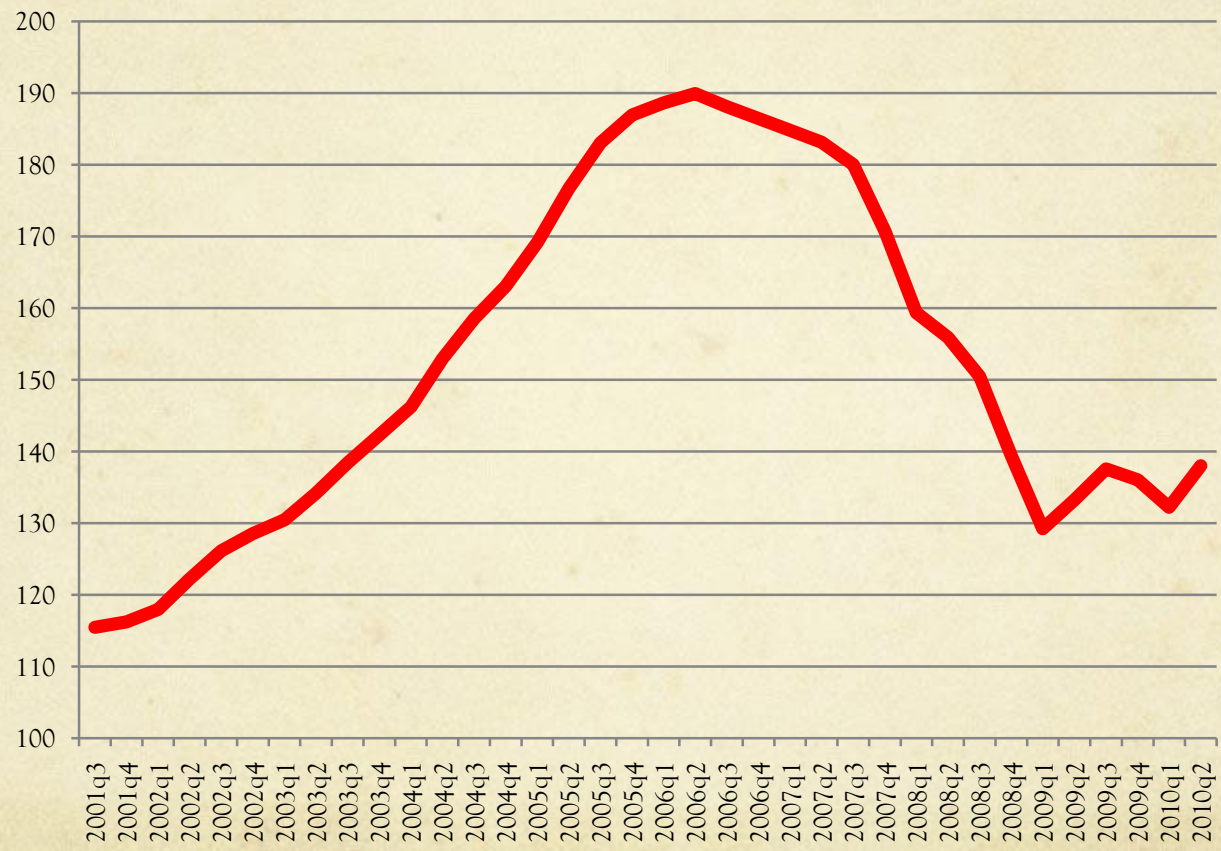


Is the problem cyclical?

- Cyclical unemployment
 - Caused by decreased demand
 - Results in across the board weakness in the labor market
 - Openings are few and quickly filled
- Substantial evidence of anemic demand
 - Decline in house prices from 2006
 - Credit crisis in 2007 further depressed asset values
 - Households struggle to repair damaged balance sheets by saving more and consuming less

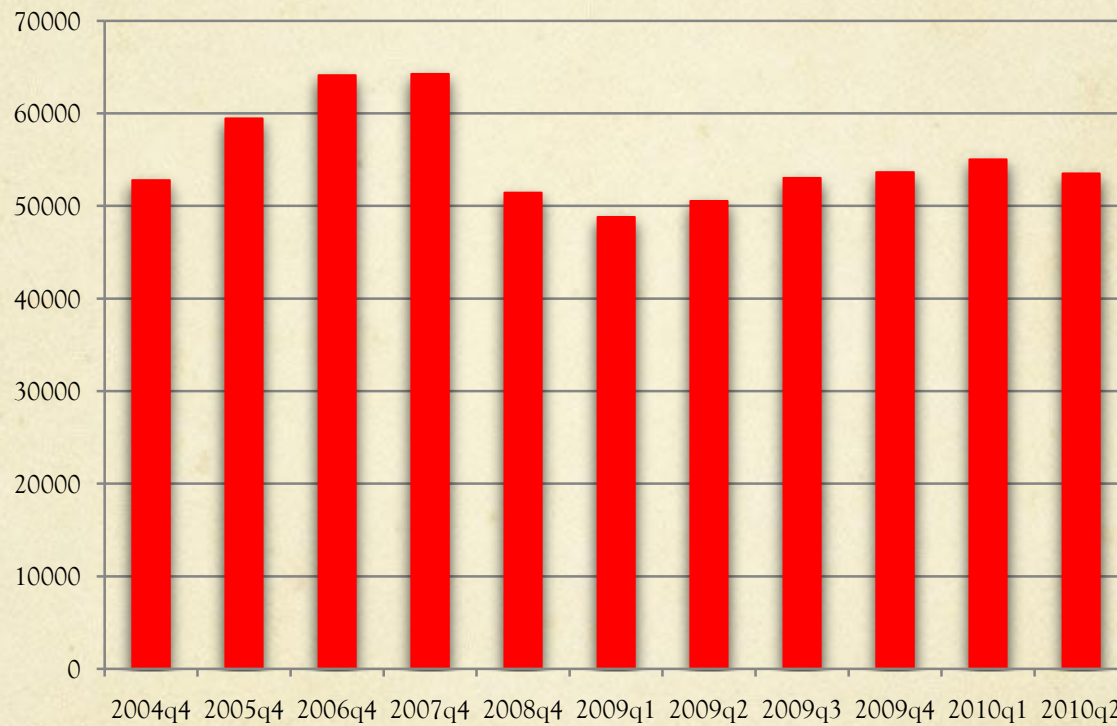
They weren't supposed to fall

Case-Schiller US Home Price Index

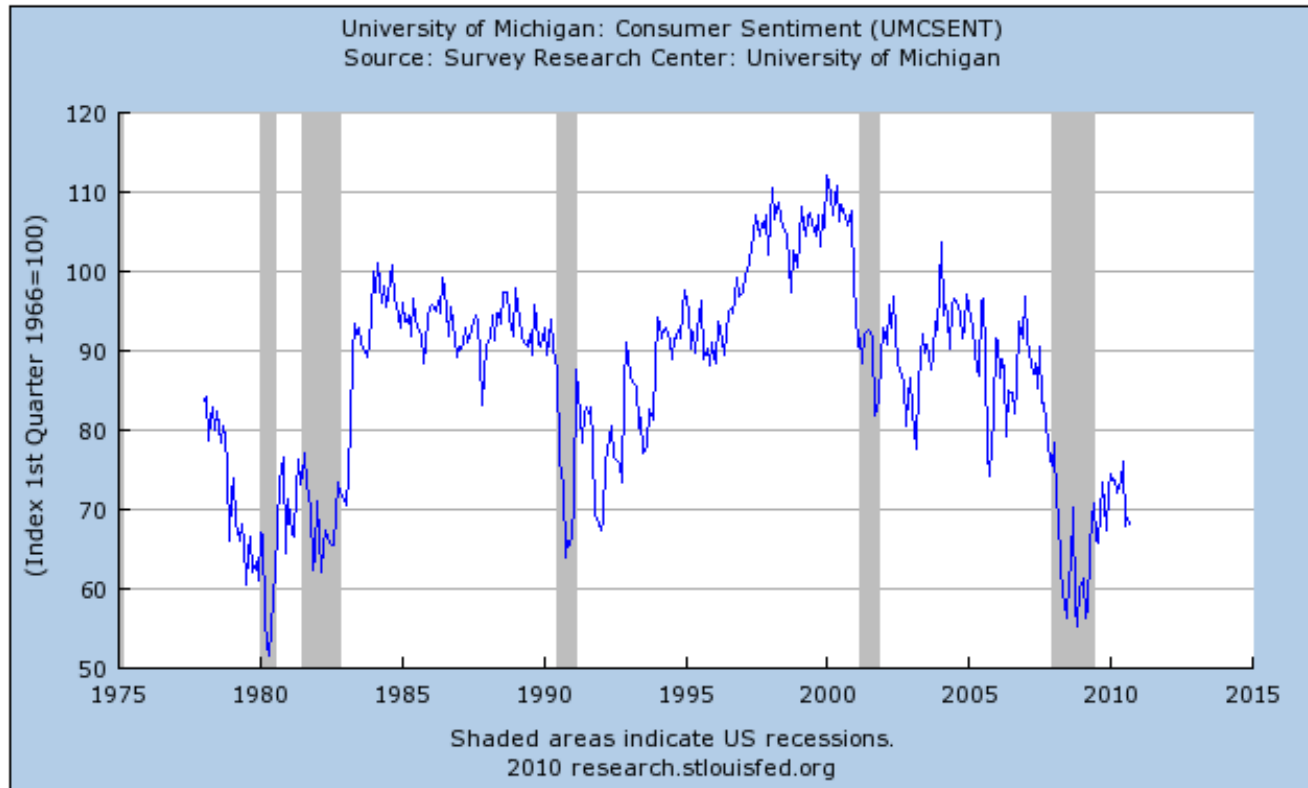


Feeling poor

Household Net Worth

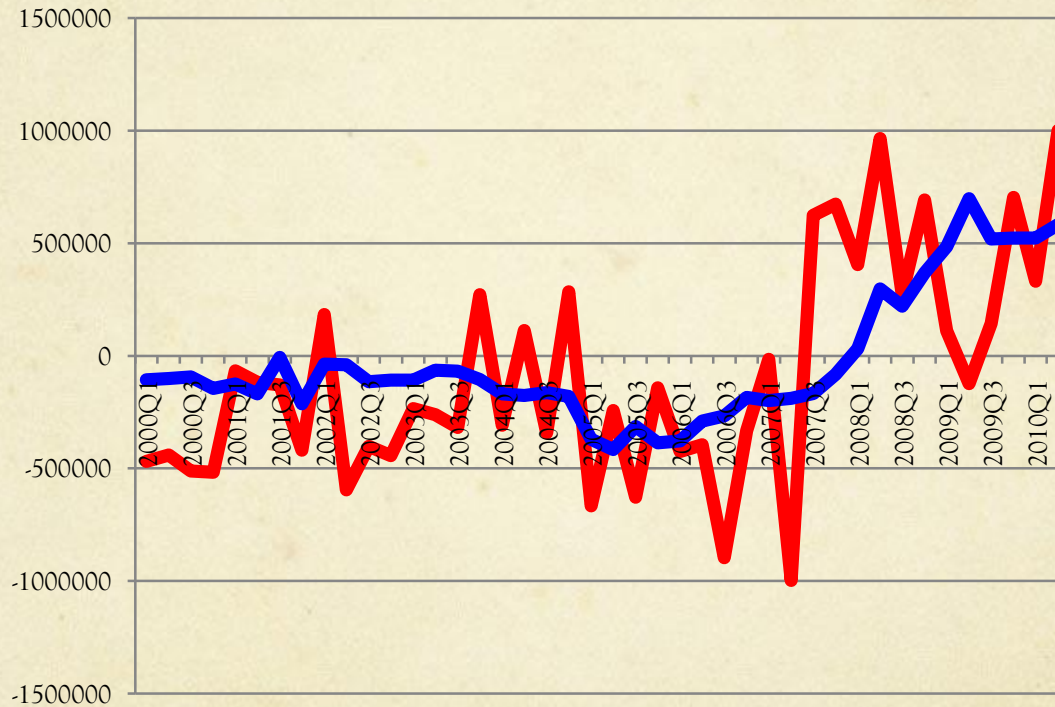


And not feeling good about it



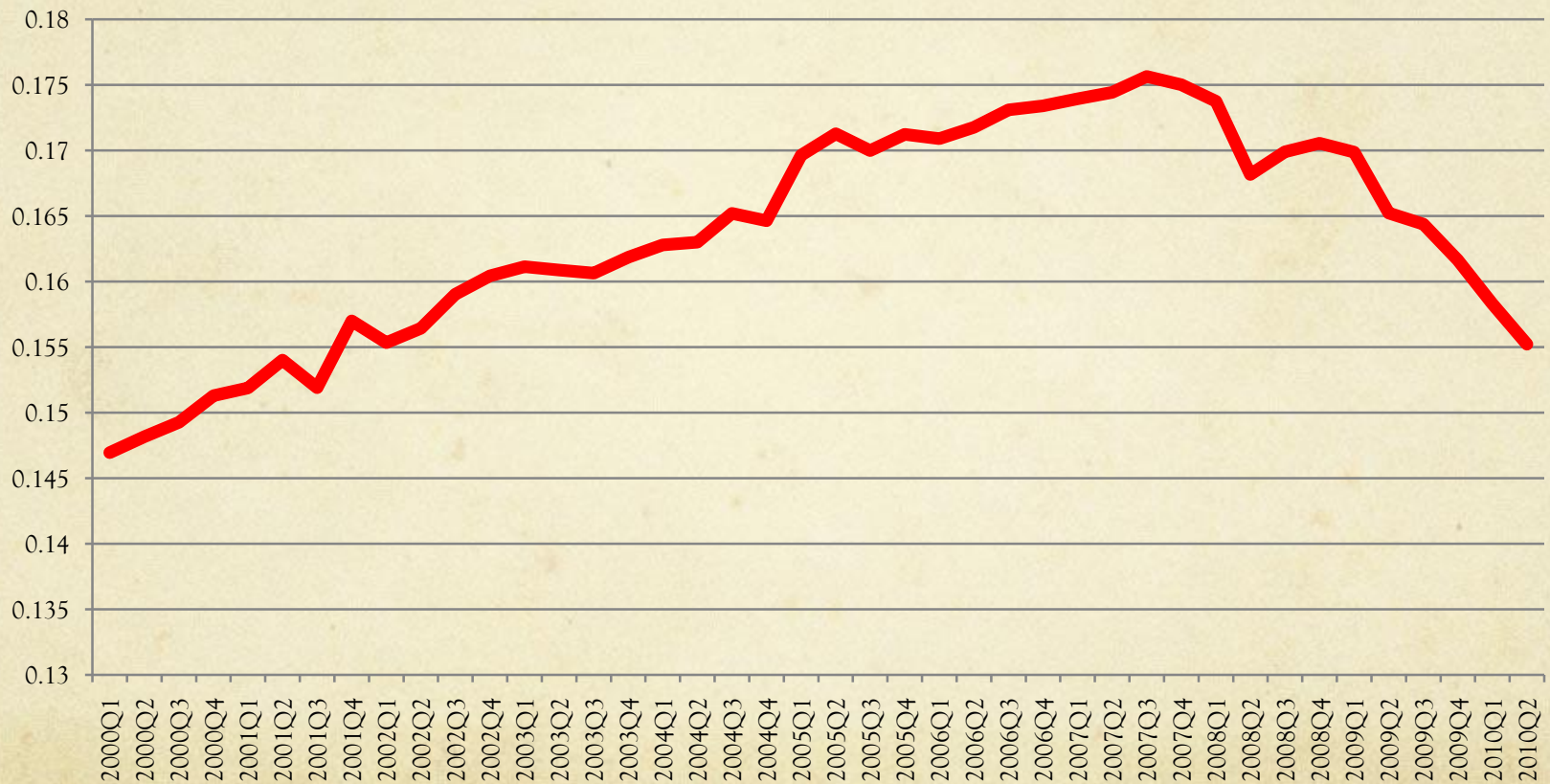
Restoration efforts

Household Saving



Deleveraging

Debt Service as Percent of Disposable Income: US Homeowners



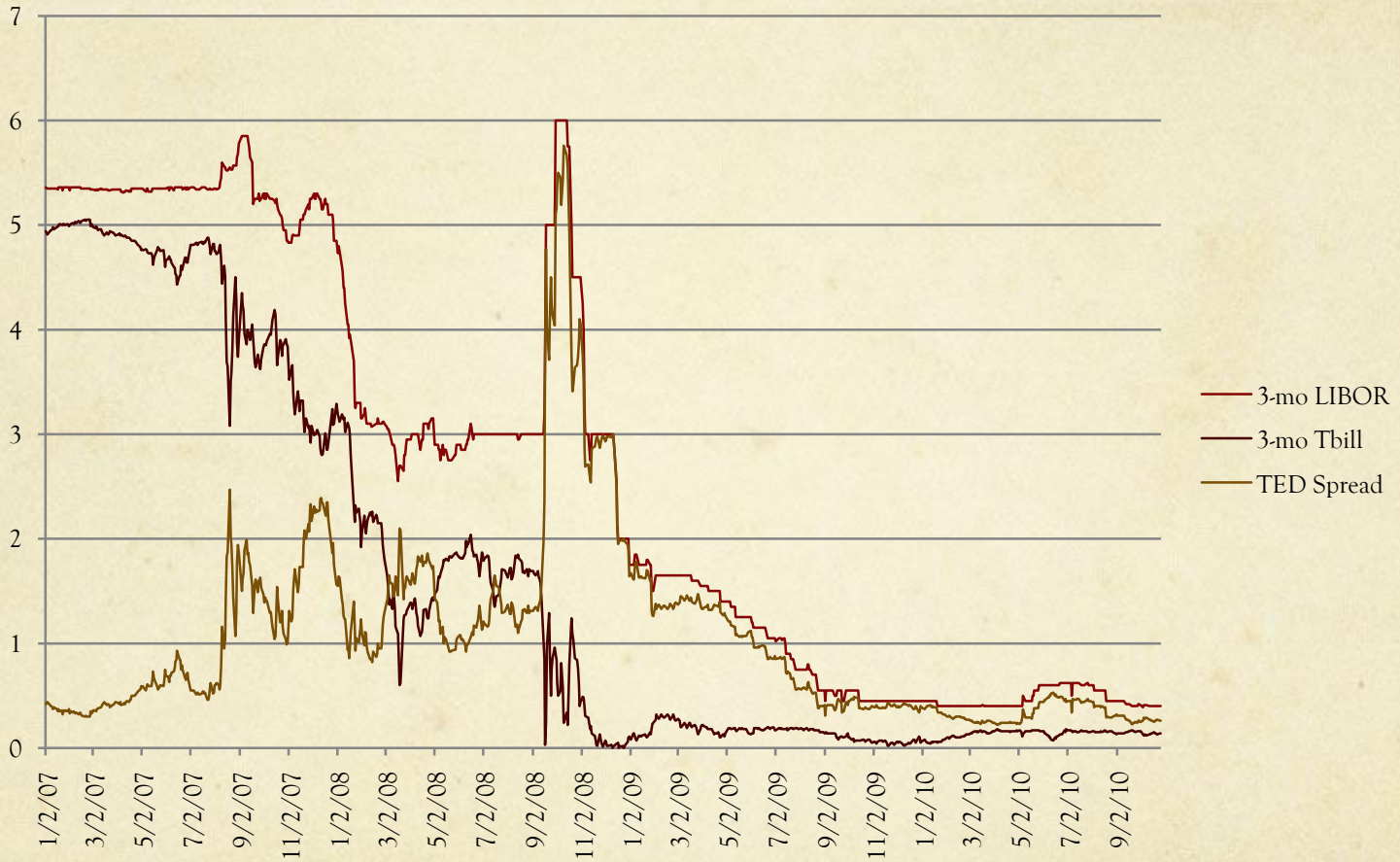
When will demand recover?

- The Great Recession was so severe because households cut back so dramatically on spending.
 - Effort to repair damaged balance sheets.
 - Progress has been made:
 - HH net worth is now about 5x personal disposable income (up from about 4.5x).
 - Assuming a target of 5.5x, we are about half-way there.
- Assuming house (and other asset) prices stabilize, household spending could recover within 3 – 4 years

A damaged financial sector

- Collapse of the shadow banking system in mid-2007
 - Extreme leverage
 - The sub-prime mess
 - Collateral cascade
 - Bear Sterns; Lehman
- Concern was not over quality of commercial borrowers, but over health of financial borrowers.
 - It was a crisis in confidence among financial institutions

Interbank Credit Crisis

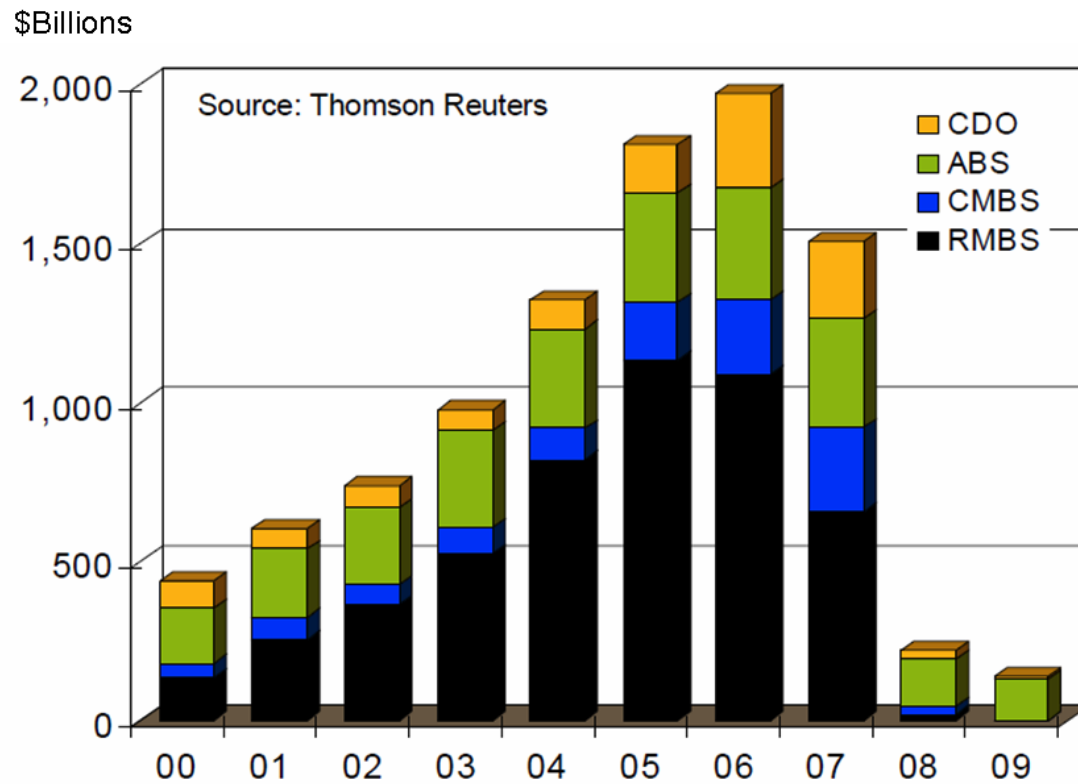


Consequences

- Credit crisis caused massive deleveraging of the financial system.
 - Demand for good collateral and margin calls
 - Rapid liquidation of illiquid assets
- Collapse of structured products markets

Collateral damage

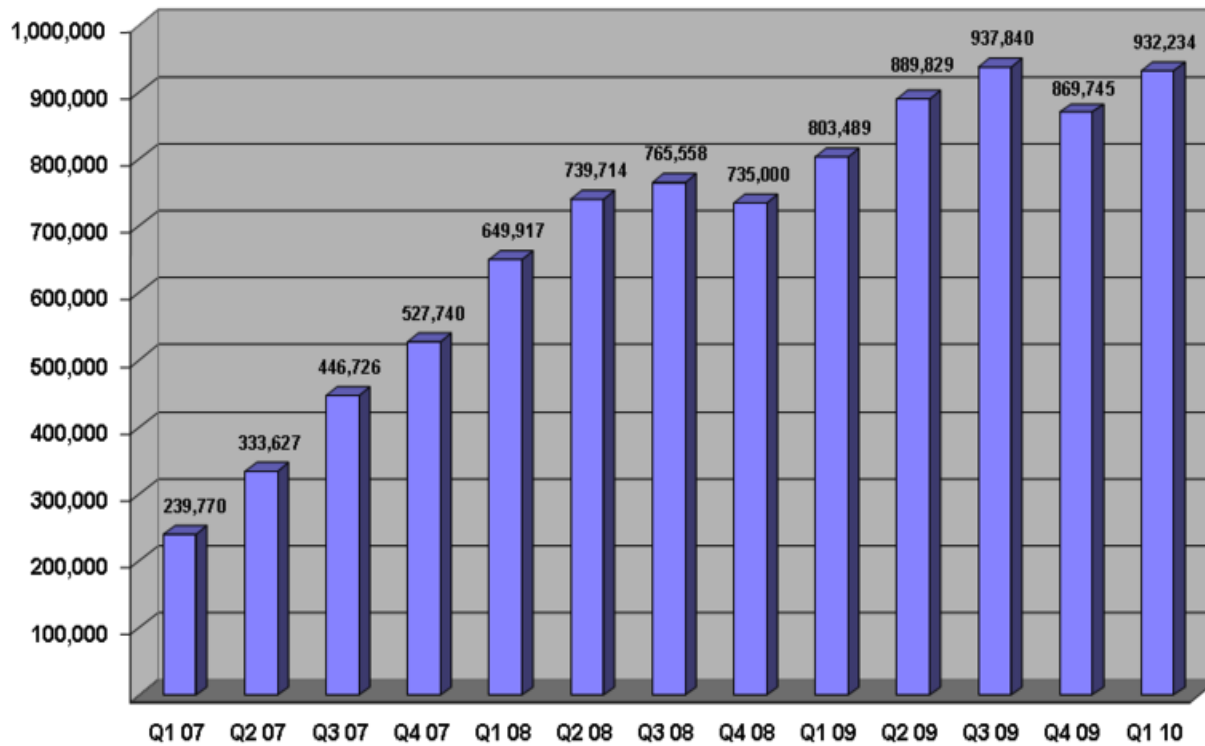
Securitization Market Activity



Unhealthy banking system

- Severe impairment of bank asset quality
- About 300 banks have failed since 2008q1, mostly by reason of insolvency.
- Foreclosure hangover

U.S. Properties with Foreclosure Activity



Source Data: RealtyTrac Press Releases of "U.S. Foreclosure Market Report"

Policy responses

- Immediate reactions
 - TARP and system rescue
 - Monetary policy
 - Zero interest rates
 - QE
 - Fiscal stimulus
- Huge public deficits

Money, money, money

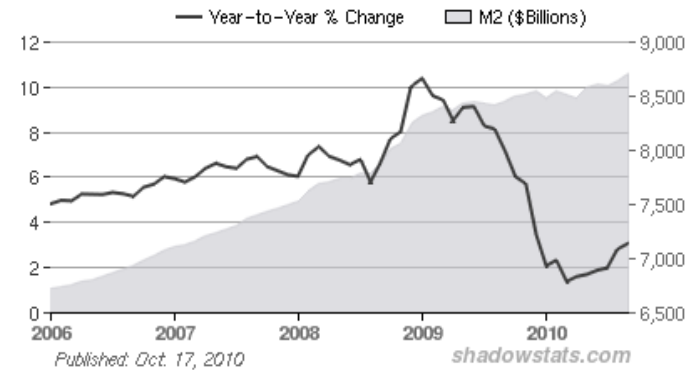
M3 Money Supply with SGS Continuation

Mthly Avg. Seasonally Adj. Jan. 2006 - Sep. 2010 (St. Louis Fed)



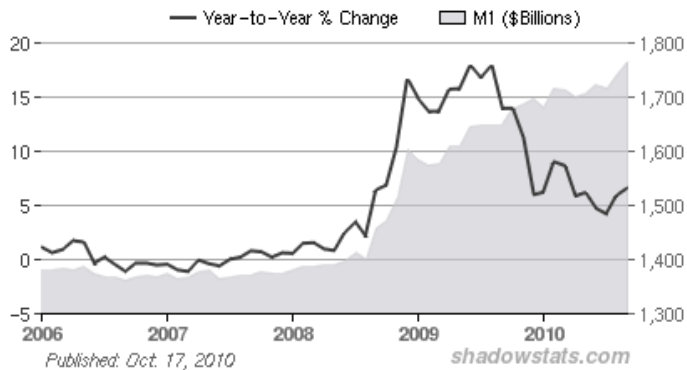
M2 Money Supply

Mthly Avg. Seasonally Adj. Jan. 2006 - Sep. 2010 (St. Louis Fed)



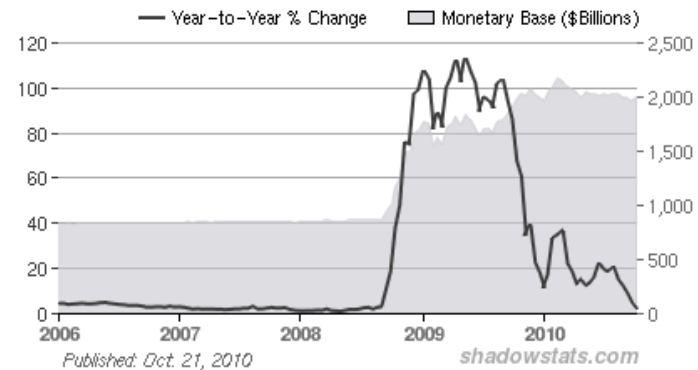
M1 Money Supply

Mthly Avg. Seasonally Adj. Jan. 2006 - Sep. 2010 (St. Louis Fed)



Monetary Base

Bi-weekly Seas. Adj. Jan. 4, 2006 - Oct. 20, 2010 (St. Louis Fed)



Prospective policy

- Near-term problem is to restore growth
 - Now is not the time to tighten
 - Best solution would be to extend the Bush tax cuts for all taxpayers
 - Tax credits for hiring firms
 - QEII
- Longer-term problem is to restore fiscal responsibility
 - Plan to achieve budget balance
 - Sensible reform of financial sector