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The Economy: Where Are We Going?

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Networking Group
St. Louis, Missouri

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Outline of Today's Talk

- The Big Picture
- Current Conditions: Adjustment to Normal
- Going Forward: The Near-term Outlook and the Legacy of the Financial Crisis and Great Recession

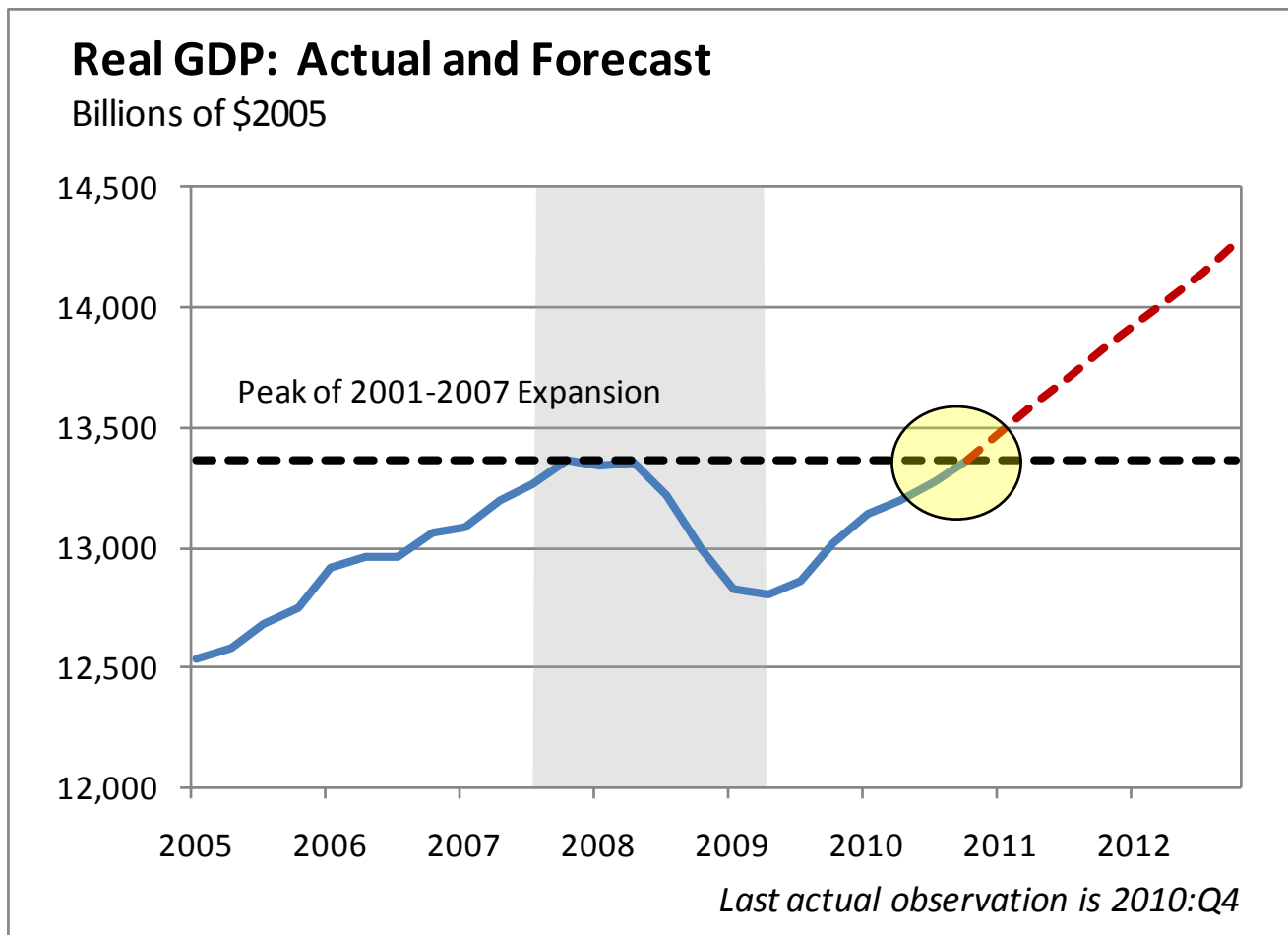
Disclaimer

The views I will express are my own and do not necessarily reflect the positions of the Federal Reserve Bank of St. Louis or the Federal Reserve System.

The Big Picture

- The economy has entered the expansion phase of the business cycle; this is important.
- Labor markets are improving, but the severe recession and financial crisis took a heavy toll.
- Threats to the economy: rising oil prices, geopolitical risks, the budget deficit.
- Financial markets and forecasters continue to have a lot of confidence in the Fed's ability to manage its exit strategy properly.

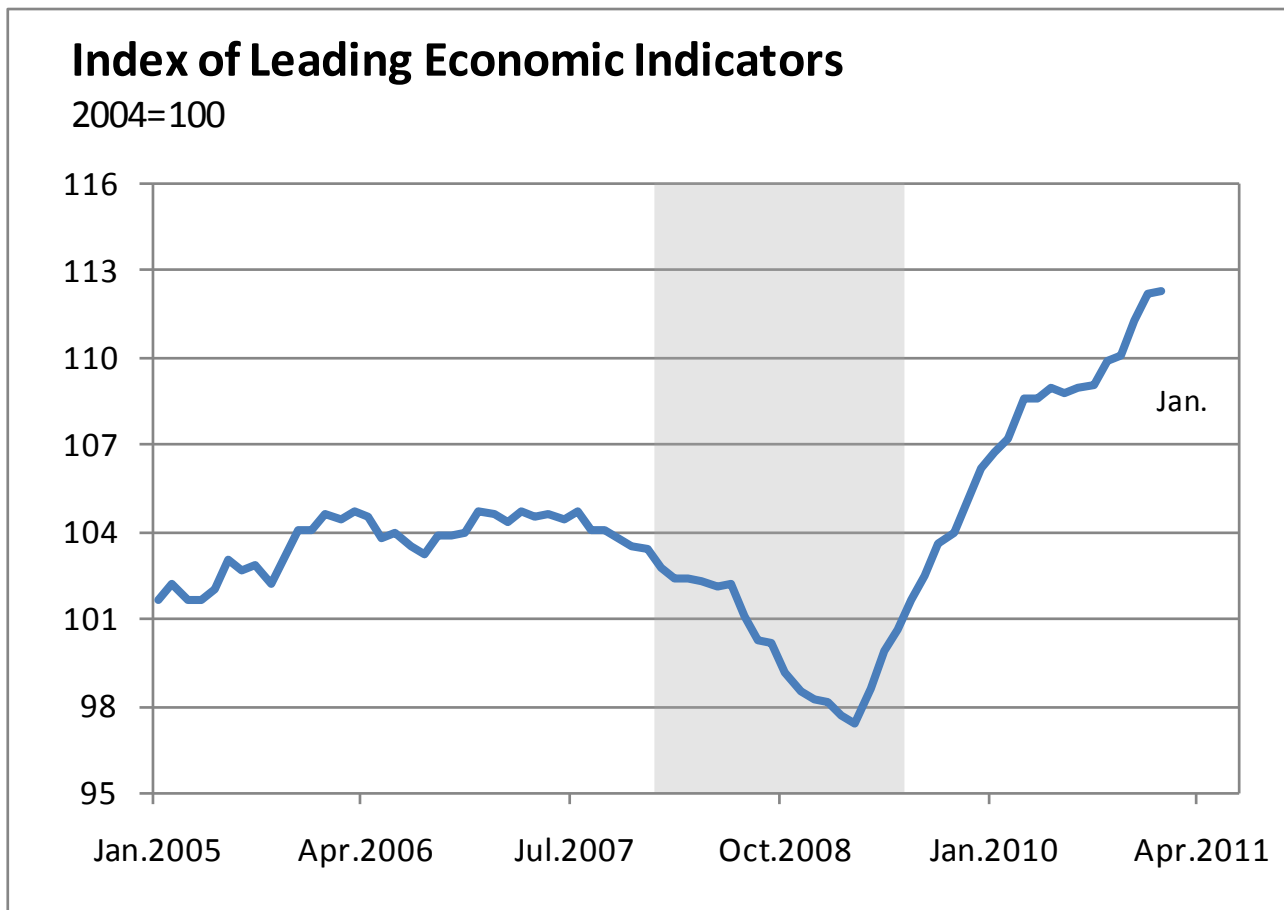
- The economy exited the recovery phase of the cycle in 2010:Q4. This is important.



Many of those in the business world refer to this as the closing of the “effective output gap.”

It is at this point that businesses begin to plan capacity and work force expansions.

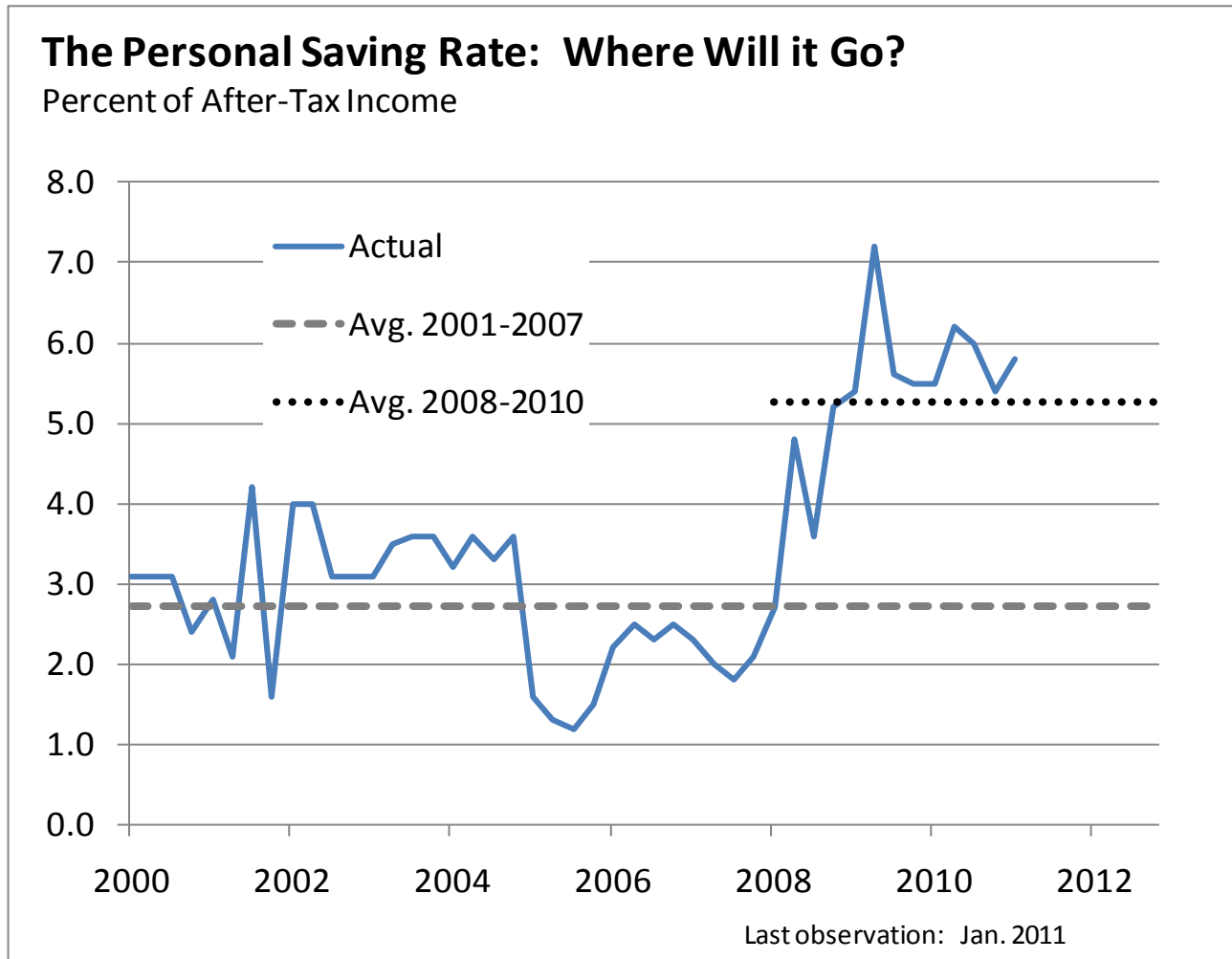
- The economy appears to have a fair bit of forward momentum in early 2011.



The index of leading economic indicators has risen sharply, though the rate of gain slowed in January.

Weather considerations?

- **Are consumers ready to start saving more?**



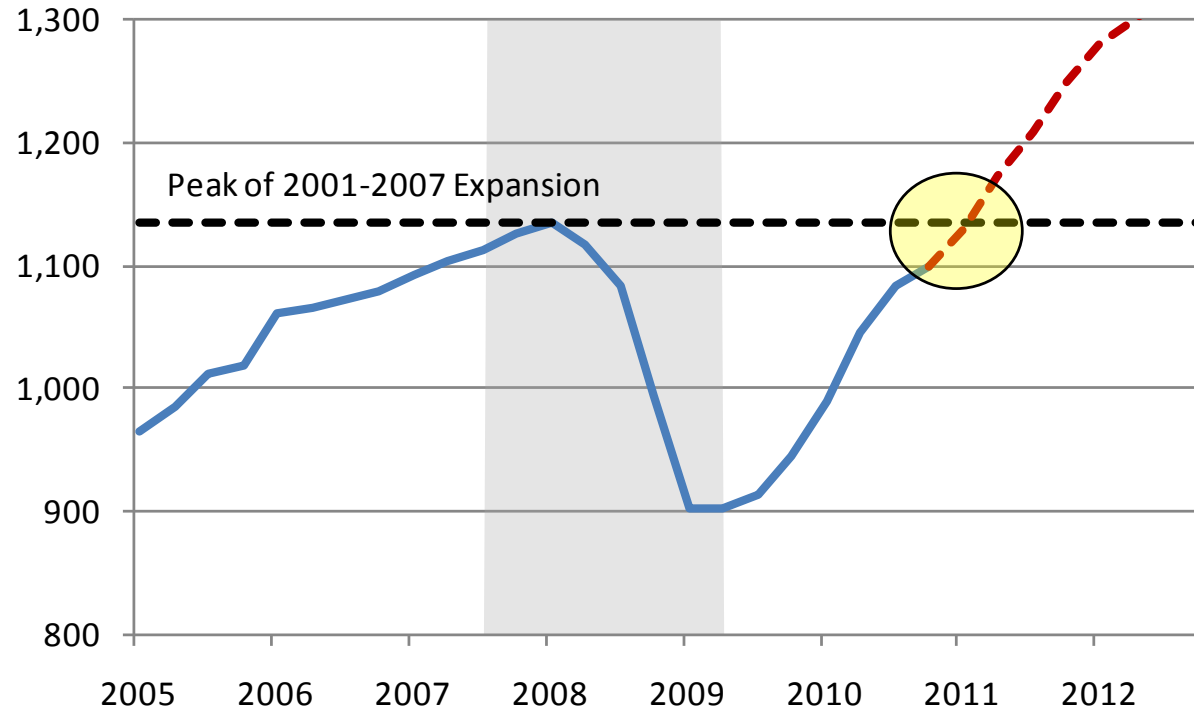
A key unknown is whether saving rate will remain above 5 percent, or drift back down to under 3 percent.

This has implications for the strength of consumer spending and thus real GDP growth.

• Business Capital Spending: A Source of Strength

Real Business E&S Spending: Actual and Forecast

Billions of \$2005



E&S: Equipment and software

Last actual observation is 2010:Q4

Economists carefully examine trends in business capital spending. Why?

First, it's a signal of near-term optimism.

Second, capital spending on E&S has important long-run implications.

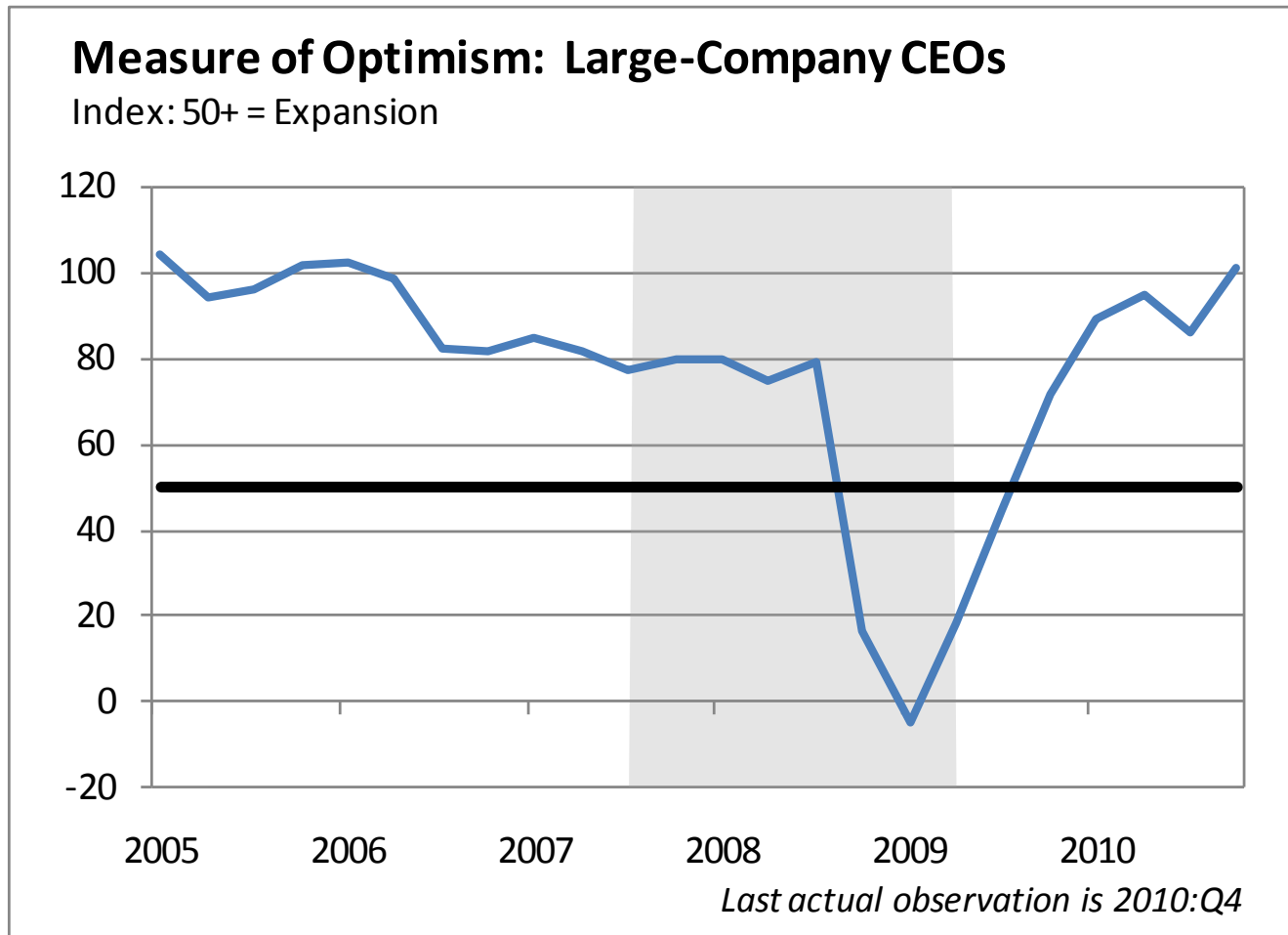
- **U.S. exports: Another Source of Strength**



The strong global recovery has benefited U.S. manufacturers and service-providers that have a strong overseas sales component.

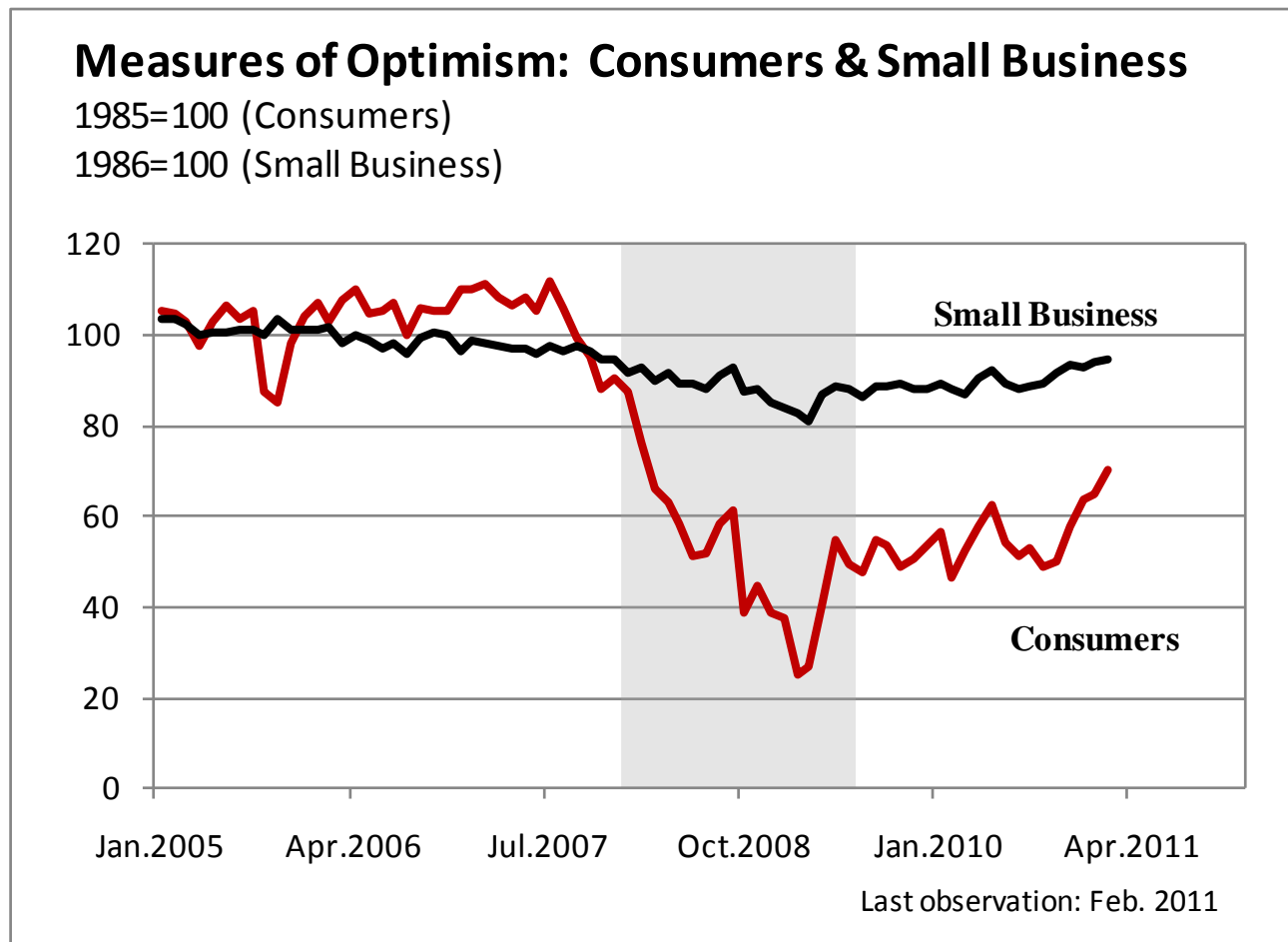
The Midwest has large manufacturers that benefit from this development.

- **Large Company CEOs are an Optimistic Bunch**



The confidence of large-company CEOs is well above pre-recession levels and it is approaching the highs of the previous business expansion.

- Optimism of consumers and small businesses has rebounded modestly since the end of the recession.



Small businesses are not quite as bullish on the economy.

The plunge in house prices and 401(k)s has taken a toll on small business and consumers, not to mention a high unemployment rate.

- **What concerns small business?**

What are Small Business Most Concerned About

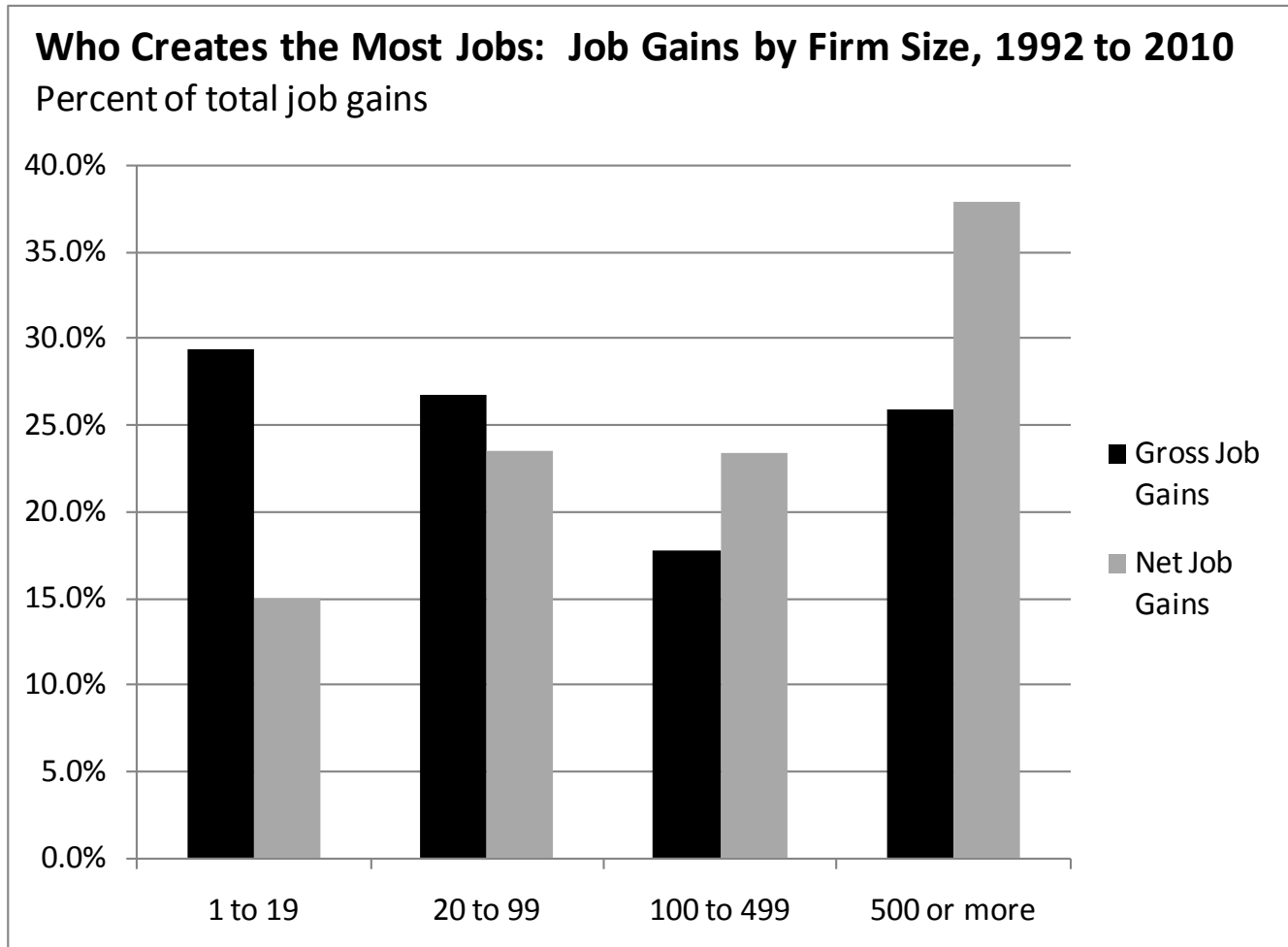
Percent reporting single most important problem

	Survey Period		
	Feb. 2010	Feb. 2011	Change
Competition from Large Businesses	6	5	-1
Insurance Cost/Availability	7	8	1
Cost of Labor	3	3	0
Financial & Interest Rates	3	4	1
Govt. Requirements	12	19	7
Inflation	3	5	2
Other	5	4	-1
Poor Sales	34	28	-6
Quality of Labor	4	7	3
Taxes	23	17	-6
Total Optimism Index	88	94.5	7

SOURCE: National Federation of Independent Business

Small business remain most concerned about poor sales, with government regulations and taxes the next most important concerns.

- **Who creates the most jobs? Big or small business?**



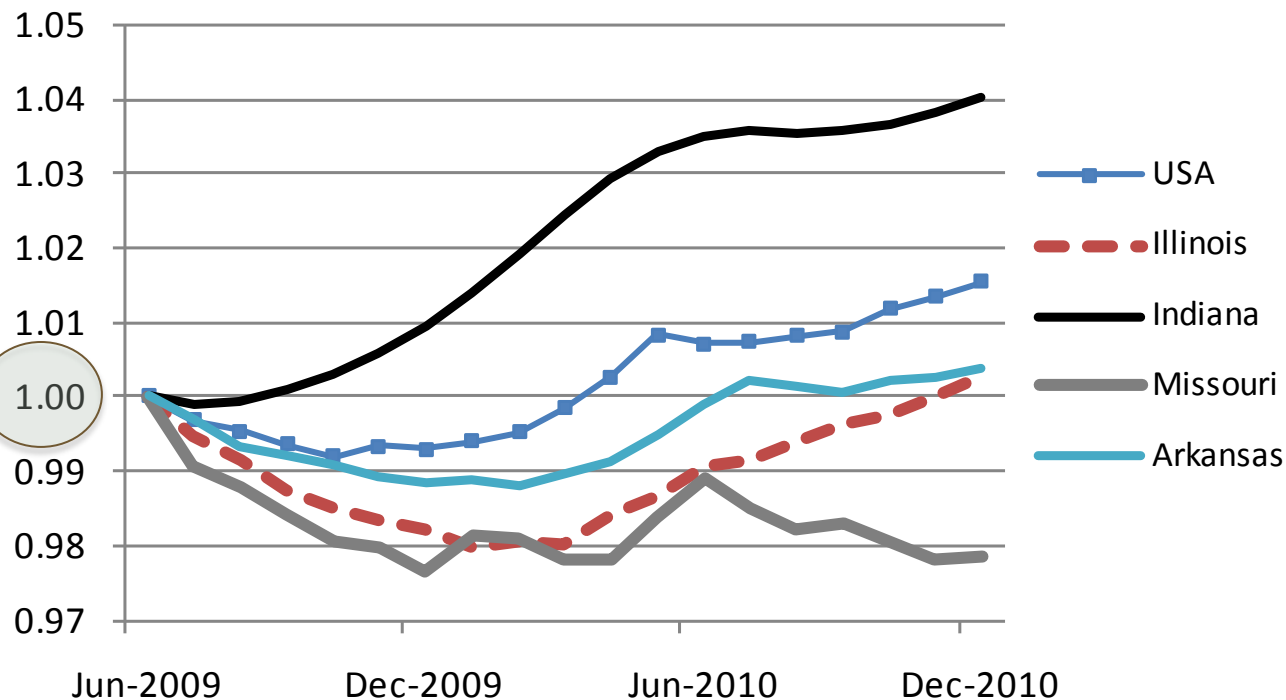
Policymakers often argue that small businesses create the most jobs—so policy should be formulated accordingly. True?

It depends on how you define “small businesses” and whether you count gross job gains or net job gains.

Regional Economic Developments

State Indexes of Economic Activity

June 2009 = 1.0



Missouri has become the “woe is me” state.

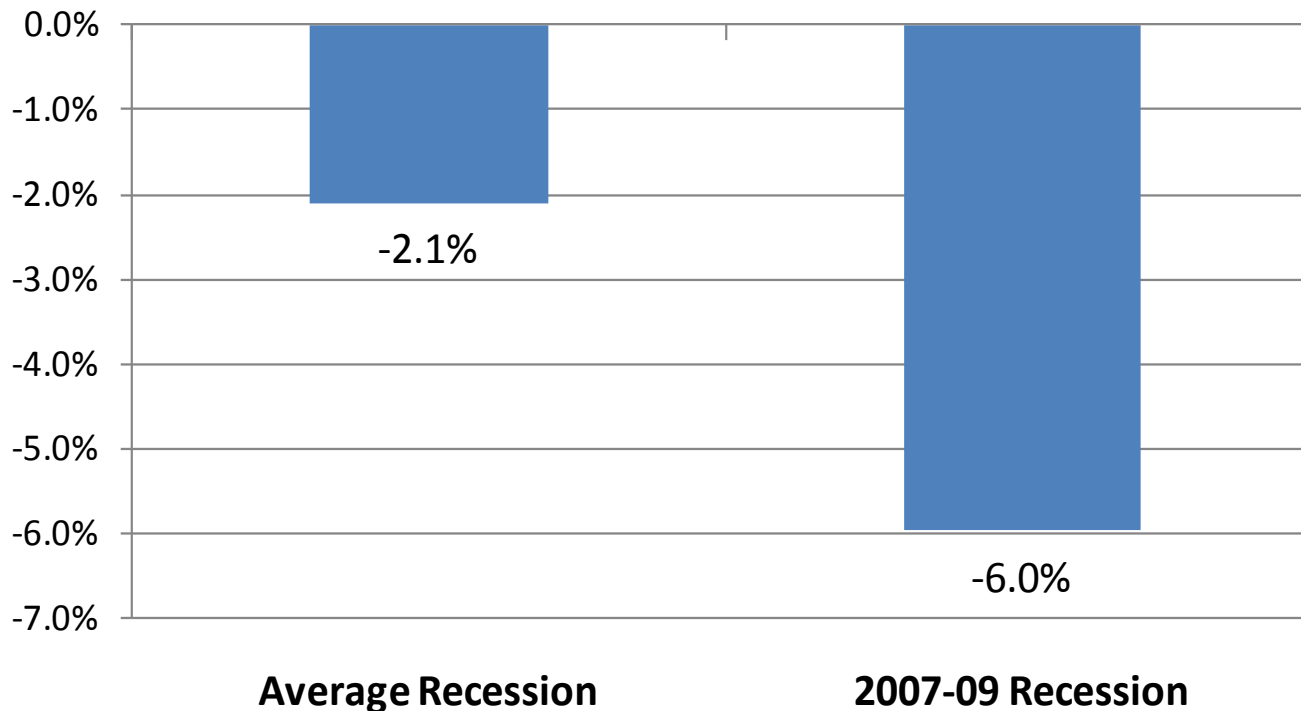
Since the recession ended in June 2009, economic activity has continued to contract in Missouri.

Employment patterns look similar.

U.S. Labor Markets

Peak to Trough Employment Declines During Recessions

Percent



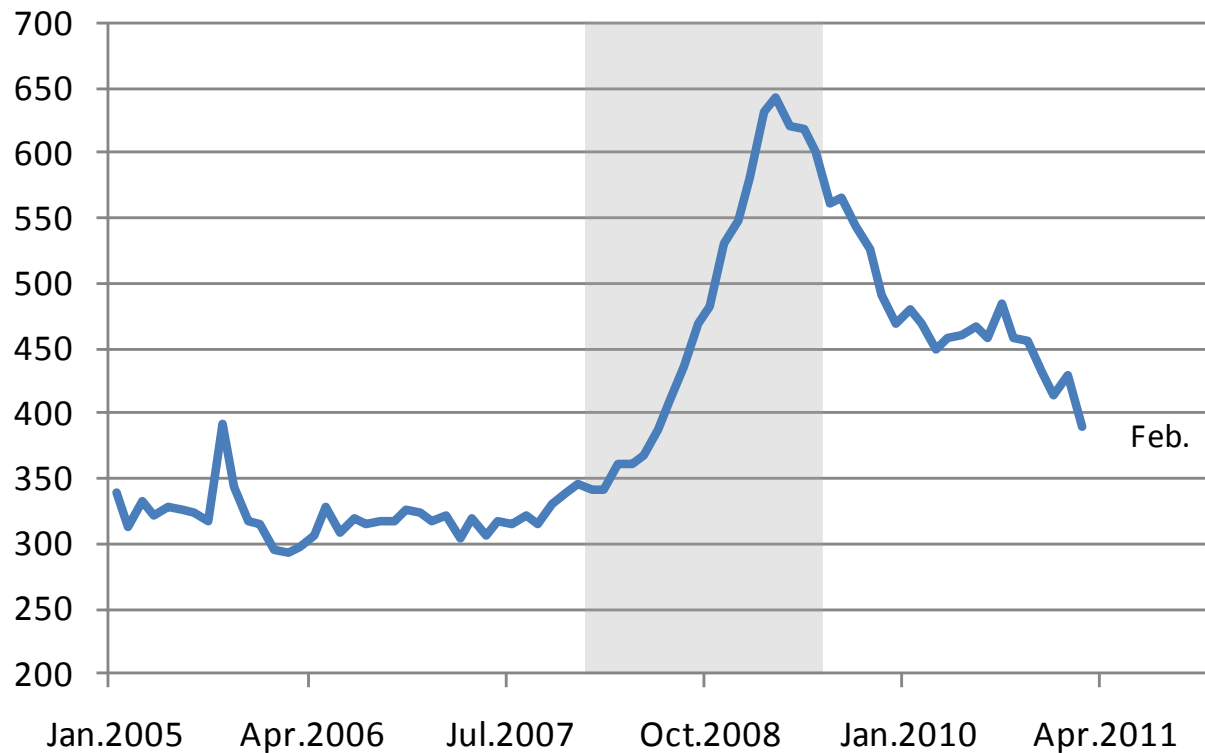
Firms reduced their labor costs by much more than average during the past recession.

Monthly job gains need to exceed 125K to generate a sustained decline in the unemployment rate.

U.S. Labor Markets

Initial Unemployment Insurance Claims

Thousands of Jobs

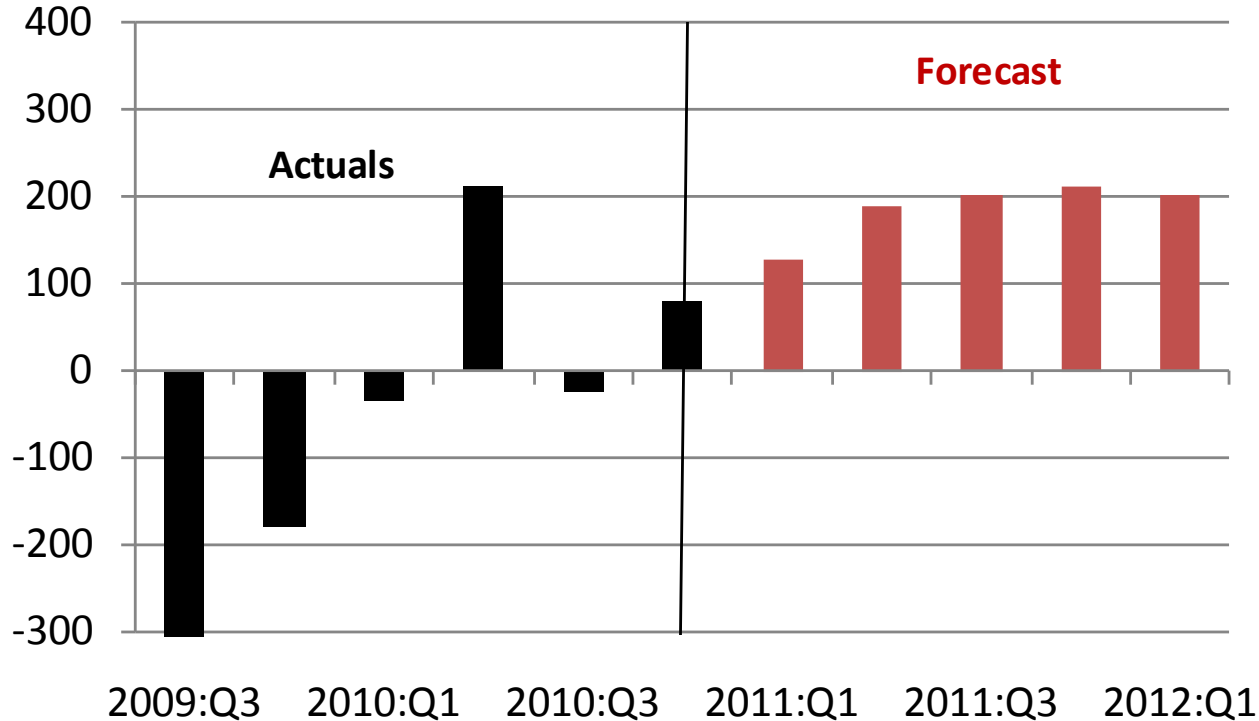


This is a really good sign: Initial claims for unemployment insurance benefits have broken through the 400,000 barrier.

U.S. Labor Market Developments

What Are Forecasters Predicting for Employment

Thousands of Jobs per Month



SOURCE: Survey of Professional Forecasters, Feb. 2011.

February job gains in the private sector were more than 200,000.

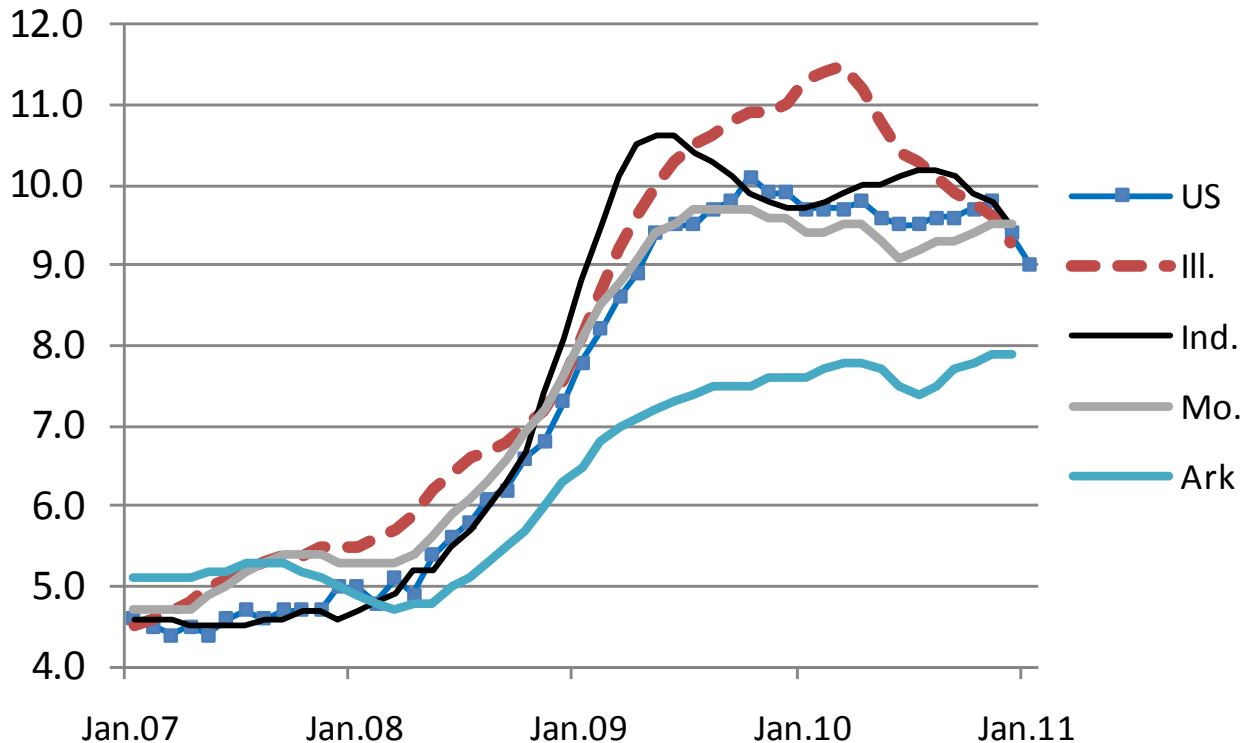
This is just the beginning, according to forecasters.

The so-called “hours gap” supports this outlook.

Regional Economic Developments

State Unemployment Rates

Percent



SOURCE: Bureau of Labor Statistics

In December 2010, unemployment rates in Missouri were comparable to those in Illinois, Indiana, and for the U.S..

Arkansas unemployment rates are much lower, but they have been drifting upward.

Key Areas of Focus for Eighth District Economies Going Forward

1. A rising tide lifts all boats.
 - State revenues are on the rise, but markets beginning to focus on longer-term budget issues.

**State Pension and Long-Term Debt Liabilities as a
 Percent of State GDP and S&P Bond Rating**

	Fiscal Liability	Bond Rating
Mississippi	15.9	AA
Kentucky	14.2	AA-
Illinois	13.6	A+
Arkansas	4.7	AA
Missouri	2.8	AAA
Tennessee	1.9	AA+
Indiana	1.7	AAA

Addendum:

California	7.4	A-
New York	4.4	AA
U.S.	94.4	AAA

SOURCE: Moody's Investor Service, Jan. 27, 2011

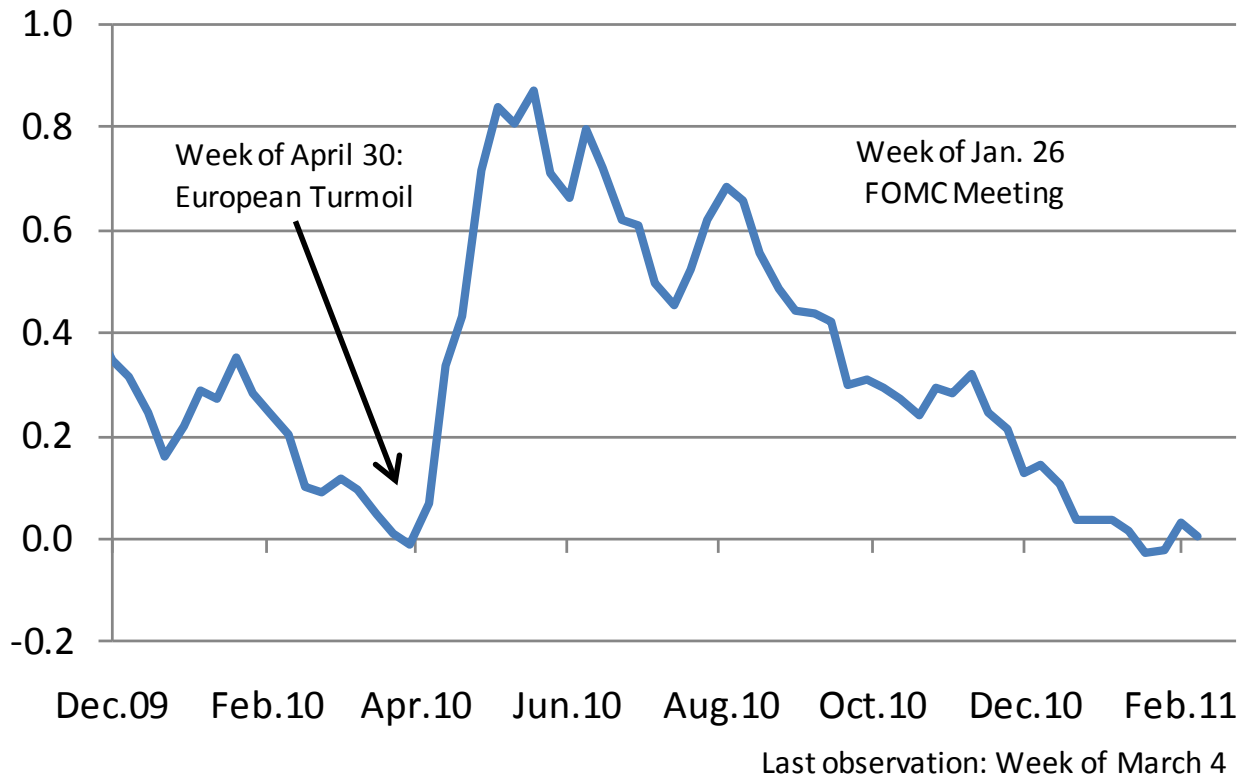
Key Areas of Focus for Eighth District Economies Going Forward

1. A rising tide lifts all boats.
2. More agricultural states benefiting from the boom in commodities and farm income. But . . .
 - A replay of the 1970s?
3. Global recovery helps those states that have relatively more export-focused industries.
 - One potential risk is a hard landing in China, which would slow growth of emerging market economies.

Financial Market Developments

The St. Louis Financial Stress Index

Weekly data



Financial market conditions appear to have returned to “normal.”

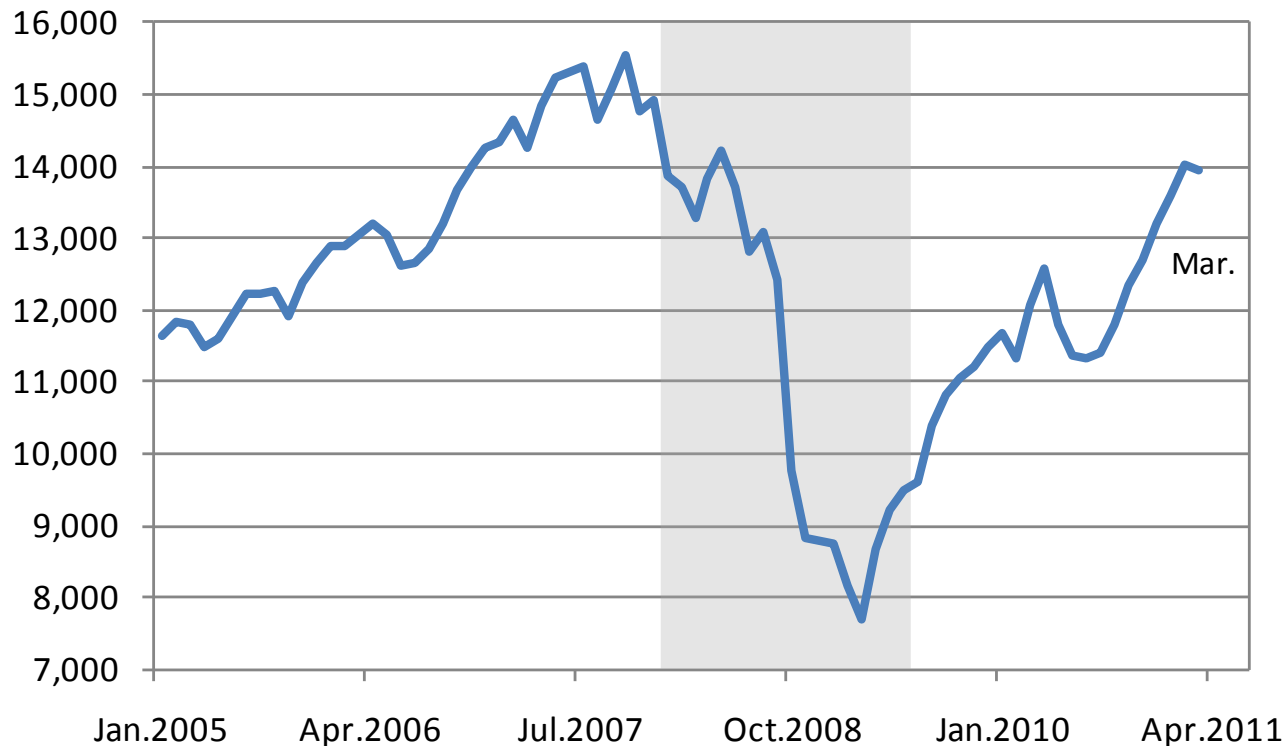
The dip below zero is potentially worrisome.

It will be interesting to see how the index reacts to the rise in oil prices.

Financial Market Developments

Stock Prices (Wilshire 5000)

Avg., Dec. 31, 1970 = 830.27

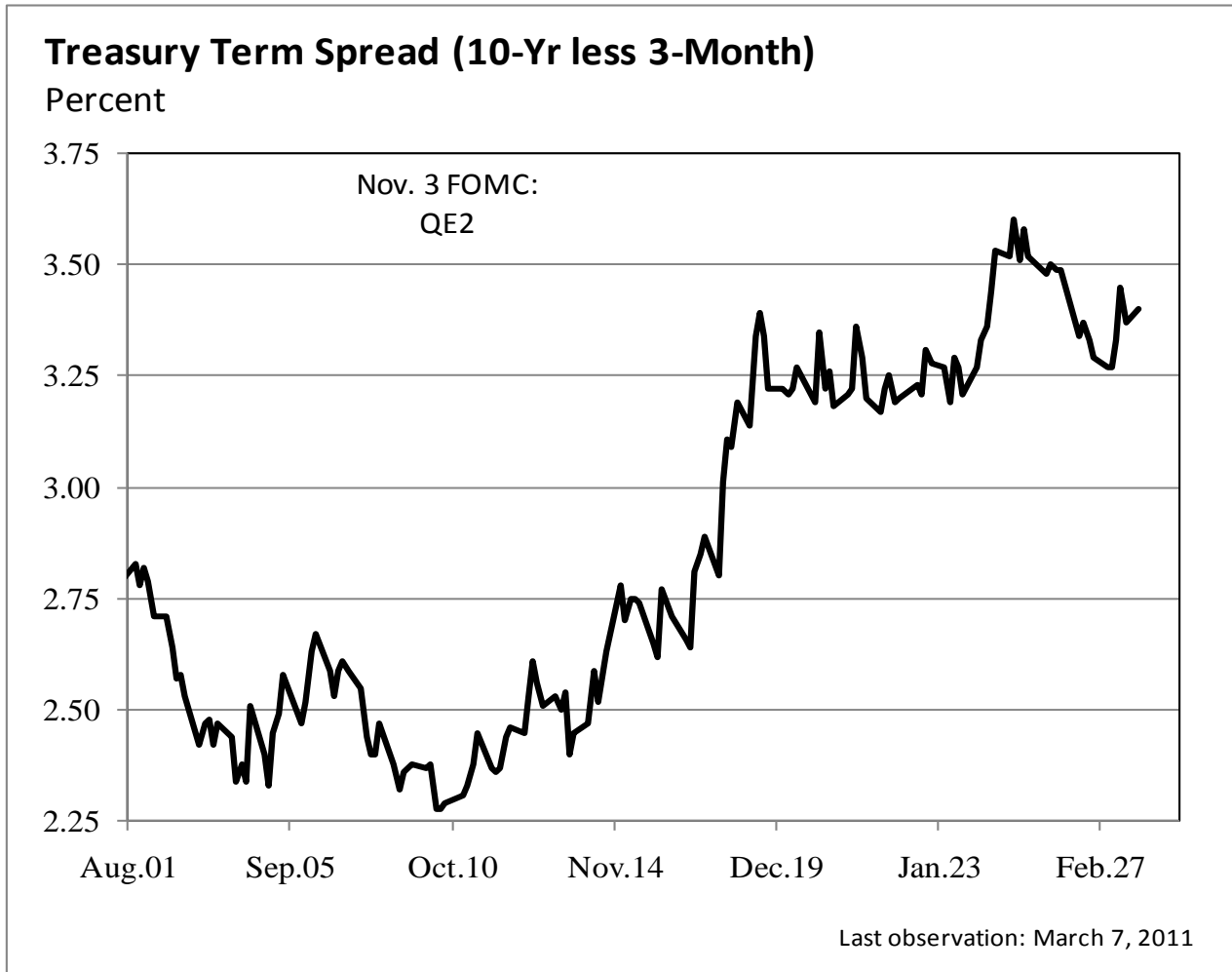


Stock prices were moving higher until oil prices began to surge.

Stock prices have retreated modestly thus far in March.

Market volatility will likely remain high until energy markets stabilize.

Financial Market Developments



A widening of the Treasury yield curve suggests several things:

1. Expectations of improving economic conditions.
2. Higher future short-term interest rates.
3. Higher inflation.

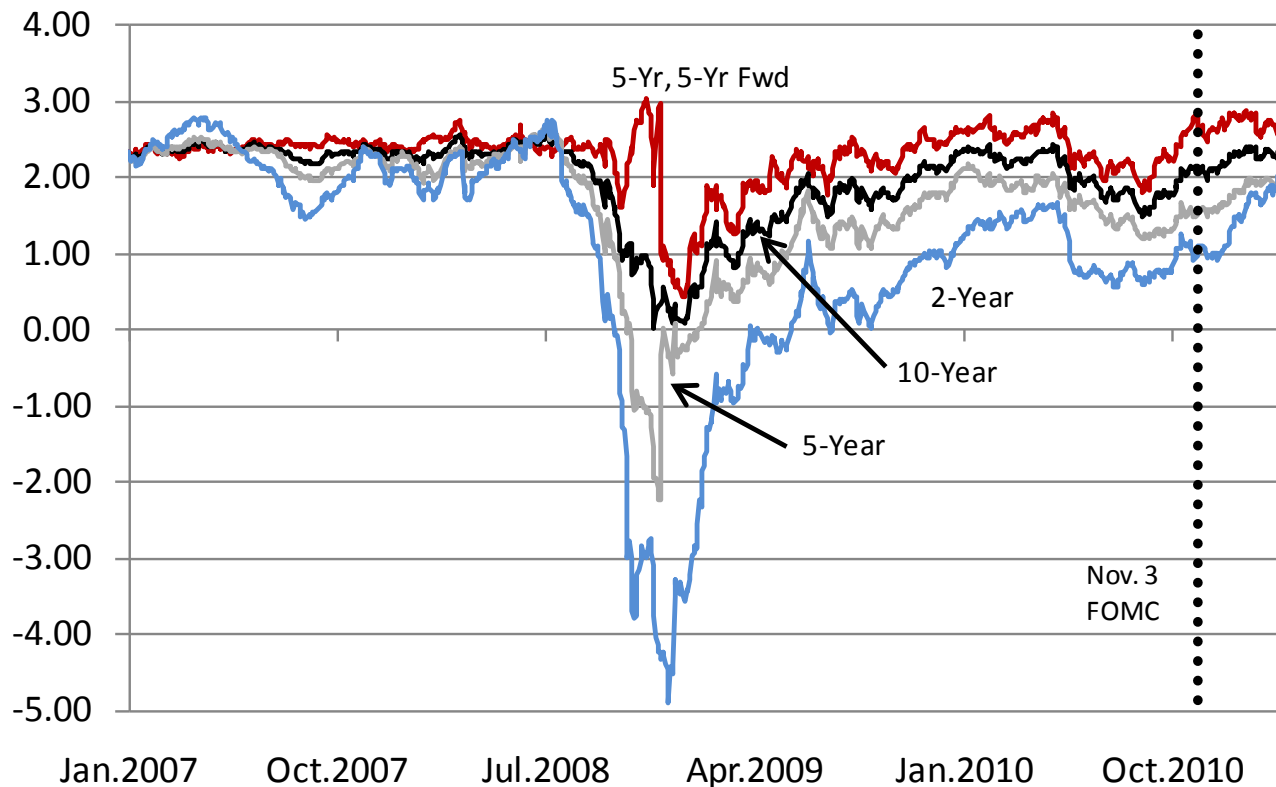
Inflation “Facts”

1. Deflation threat appears to be over.
 - Inflation expectations have returned to their pre-crisis levels.

Inflation Expectations

Market-Based Inflation Expectations, 2007 to Present

Percent



NOTE: Last observation is March 7, 2011.

The sharp decline in inflation expectations in late-2008 and early 2009 caused some policymakers to worry about deflation.

More recently, short-term inflation expectations are rising rapidly.

Inflation “Facts”

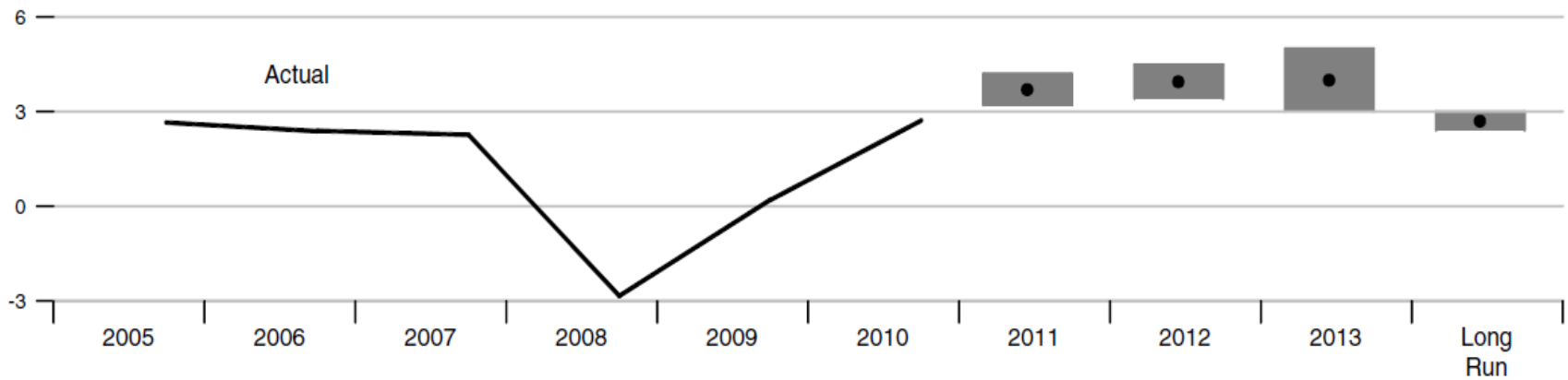
1. Deflation threat appears to be over.
2. Rising oil prices will exert some drag on growth, some upward pressure on inflation.
 - Net effect will depend on the magnitude and duration of the increase.
 - Net effect also depends on initial economic conditions.
3. Commodity prices are also rising.
4. Many firms are seeing margins squeezed; efforts to pass along price increases to the customer are increasing according to the latest Beige Book.

The Fed's Current Economic Projections

January 2011 FOMC Projections

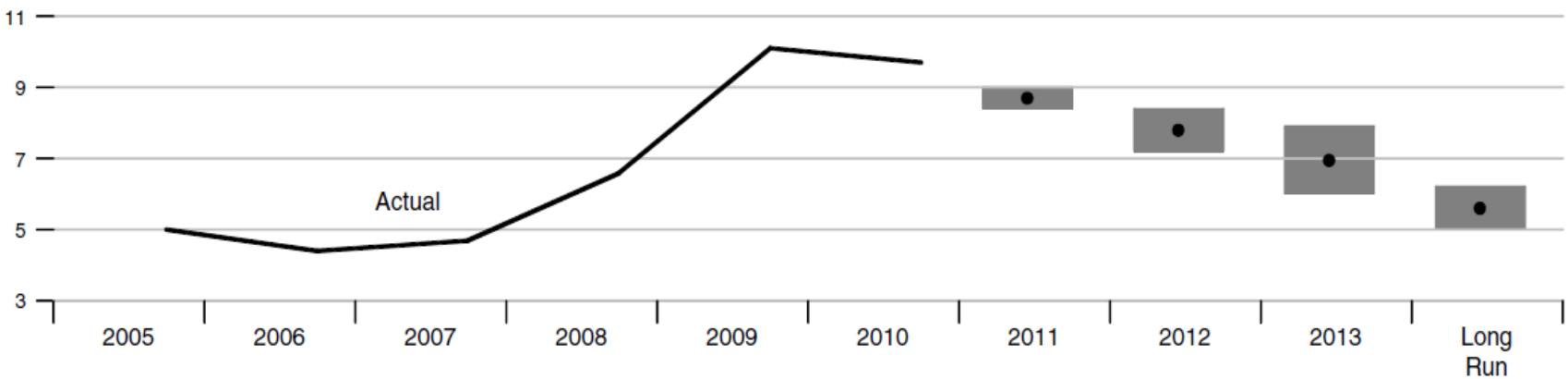
Change in Real GDP (Q4/Q4)

Percent

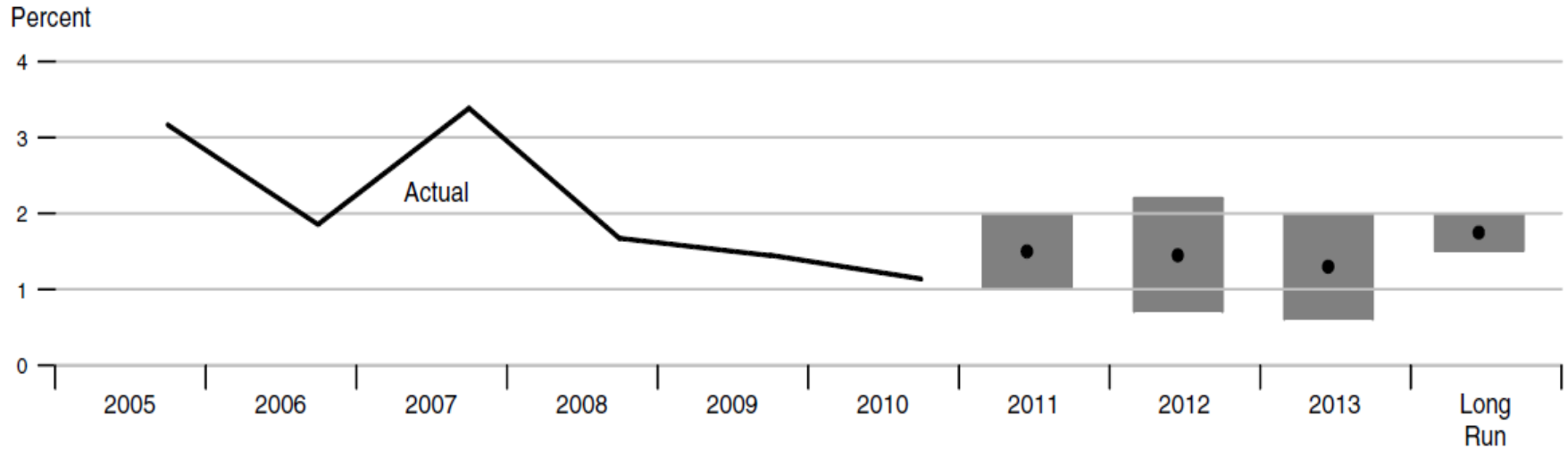


Unemployment Rate (Q4)

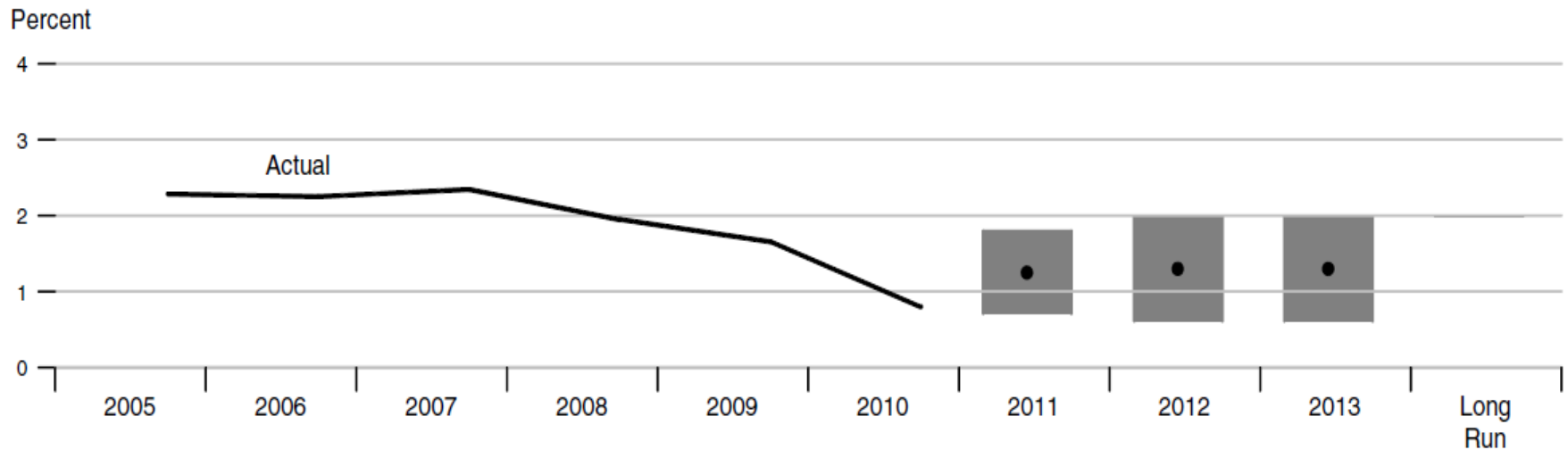
Percent



Change in PCE Price Index (Q4/Q4)



Change in PCE Price Index Excluding Food and Energy Prices (Q4/Q4)



Going Forward

“For a nation, the choices that determine whether income doubles with every generation, or instead with every other generation, dwarf all policy concerns.”

Paul Romer, “Economic Growth,” *Fortune Encyclopedia of Economics* (1993), p. 183.

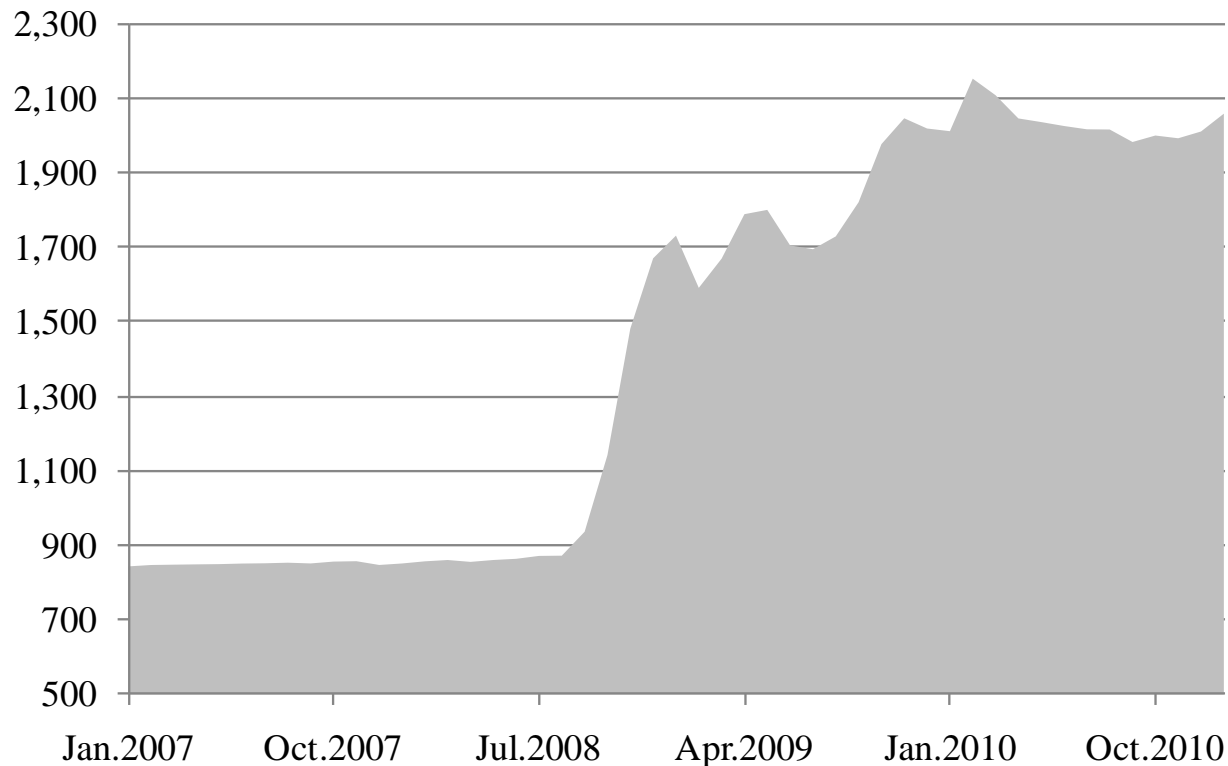
1. When discussing the economic outlook, it is vitaly important to distinguish the short- and medium-run outlook (say, 1 to 5 years) from the longer run outlook.
2. The near-term outlook, in my opinion, looks fairly good—though some sectors of the economy are still clearly in recovery mode.
3. Importantly, as the economy continues to recover, policies put in place over the last few years will need to be normalized to prevent further instabilities.

4. Among the most important policies are those put in place reduce the size of the deficit, keep inflation and interest rates low and stable.
 - Policy normalization must occur.
 - The question is whether markets will force the adjustment (e.g., Greece and Ireland) or whether the adjustment will occur voluntarily (e.g., U.K.)?

Fed Policy is Abnormally “Easy”

High-Powered Money (the Adjusted Monetary Base)

\$Billions



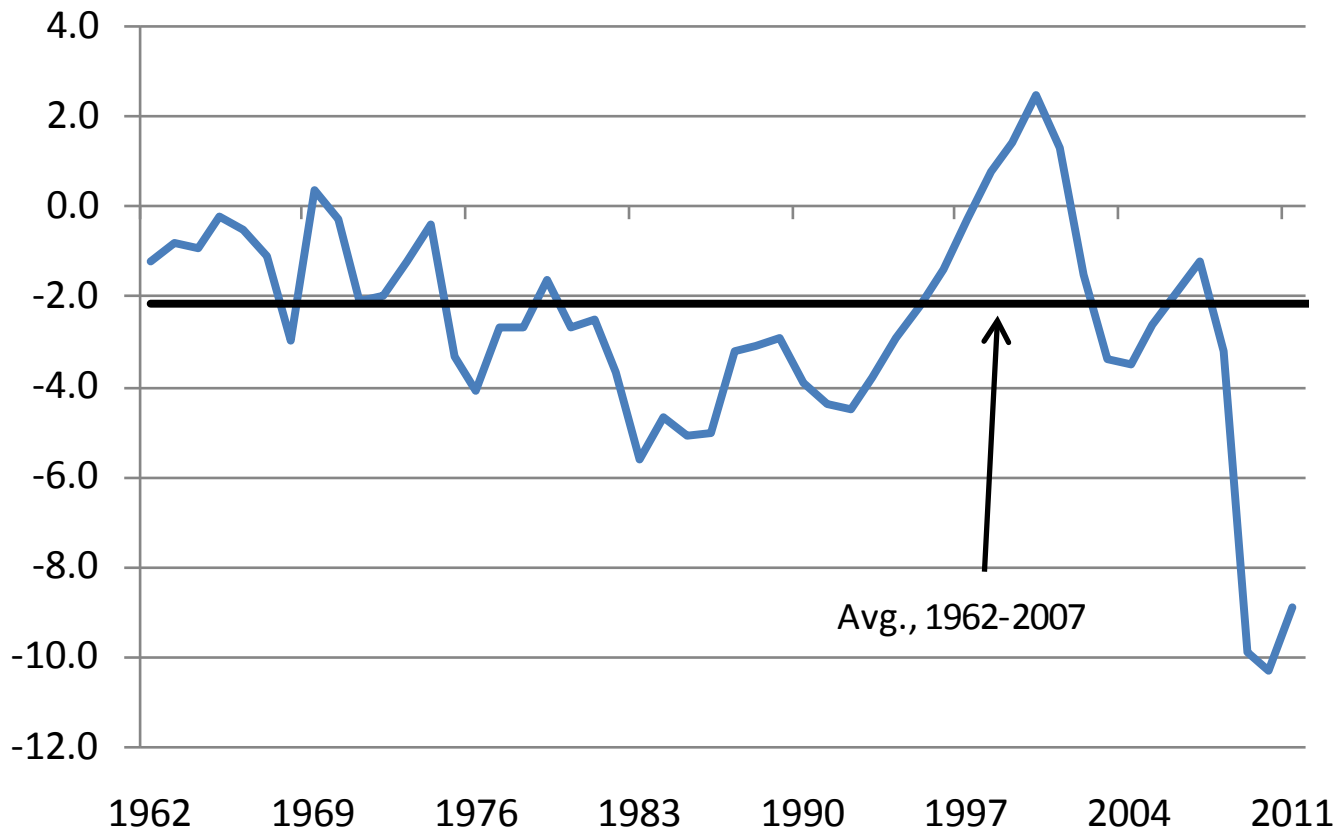
The Fed's most aggressive response began in Sept. 2008, when it began to expand that size of its balance sheet. By December 2008, the federal funds target was effectively zero.

SOURCE: FRB St. Louis

Last actual observation is Jan. 2011

Fiscal Policy is Abnormally “Easy”

Federal Budget Deficit as a Percentage of GDP



On the fiscal side (tax and spending), two major fiscal stimulus bills, the TARP legislation, and other actions helped push the budget deficit to levels not seen since WW II.

5. Another key aspect of the policy process is to put in place policies that encourage entrepreneurialism and innovation.
6. What will the economy look like 5 or 10 years from now?
 - Prediction is very difficult—especially if it's about the future.” (Nils Bohr)

“The essential point to grasp is that in dealing with capitalism we are dealing with an evolutionary process. . . Capitalism, then, is by nature a form or method of economic change and not only never is but never can be stationary.”

Joseph Schumpeter, *Capitalism, Socialism and Democracy* (1950, 3rd ed.), p. 83.

Legacy Effects

1. Housing and—perhaps—finance will comprise a smaller share of the economy.
2. Labor markets may be changing in ways we do not yet understand.
3. Challenges confronting monetary policymakers appear to have mounted.
4. The public must be convinced that long-term fiscal problems gripping the country can only be fixed by addressing the big entitlement programs.

End

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Questions?