FedViews

April 9, 2009

« Past issues

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- The economy has been suffering from an adverse feedback loop in which losses by banks and other lenders have led to a tightening of credit availability, which in turn has crimped spending by households and businesses. The resulting reduction in demand has dragged down the housing sector and the broader economy, contributing to greater losses on loans and even tighter credit.

- The housing sector has been at the center of the economic and financial crisis. After years of healthy increases, house prices have plummeted during the past three years. Based on the historical relationship between house prices and rents, house prices appear to be still well above their long-run trends. Forecasts suggest that house prices will fall about 20 percent over this year and next year, and will then be close to the "normal" level relative to rents.

- The collapse of house prices and the worsening economy have led to rising mortgage delinquencies and foreclosures, even for "prime" borrowers. During the housing boom, mortgage delinquencies were very low, reflecting the effects of the rapid accumulation of home equity and the relatively strong economy. Since house prices started falling, delinquency rates for borrowers with high credit scores have risen sharply. Delinquency rates for borrowers with low credit scores have skyrocketed, exceeding 40 percent for adjustable-rate mortgages and 15 percent for fixed-rate mortgages.

- The housing boom was financed by an unprecedented increase in debt, with household debt rising to over 130 percent of disposable income. The debt service burden—measured as the ratio of payments on debt to income —also reached an all-time record. But lower interest rates have brought this ratio down a bit.

- Consumers have been hit hard by losses on the values of their homes and stocks, a weak and uncertain economy, and tight credit. Sharp declines in housing and stock prices sent household net wealth tumbling by $11 trillion in 2008, bringing down the ratio of wealth to disposable income to levels last seen during the mid-1990s. The combination of these factors and a desire to bring debt down to manageable levels portends several years of rising saving and tepid consumption growth.

- Employment continues to plummet, with over 660,000 nonfarm jobs lost in March. The unemployment rate rose to 8.5 percent from 8.1 percent. Recent data on initial claims for unemployment insurance point to further large job losses this month.

- A key issue for the outlook is whether this recession will be followed by a robust "V-shaped" recovery or a more subdued "U-shaped" recovery. A rapid V-shaped recovery has been the typical pattern in severe recessions during the postwar period. The sharp declines in new home construction, automotive purchases, and business inventories point to considerable pent-up demand that could rebound quickly. Moreover, sizable fiscal and monetary stimulus—both conventional actions and unconventional monetary policy actions—should contribute to spending growth.

- However, other factors suggest a more gradual recovery. Banking and financial crises tend to be followed by slow recoveries, in part reflecting the time needed for the financial sector to heal. Also, the crisis has severely shaken household and business confidence. This heightened uncertainty about the future may continue to damp spending and investment for some time. Finally, this recession has been truly global. Many central banks around the world have found traditional monetary policy action limited by the zero lower bound on interest rates. According to forecasts, other major industrial economies are likely to suffer even deeper and longer-lasting recessions than the United States. As a result, foreign demand and monetary policy may provide less of a boost to growth than in past severe recessions.

- Some preliminary signs suggest that the economy may be stabilizing and that the period of rapid economic contraction that started this past fall may be nearing an end. Housing market indicators have stopped their headlong plunges and show some tantalizing signs of improvement. The significant drop in conforming mortgage rates over the past few months should provide a boost to this sector. Similarly, sales of motor vehicles picked up in March. And the Institute of Supply Management index of new orders has rebounded in recent months, although it still points to further declines in the manufacturing sector. However, it is too soon to tell whether these improvements will prove to be the beginning of a sustained turnaround or ephemeral.

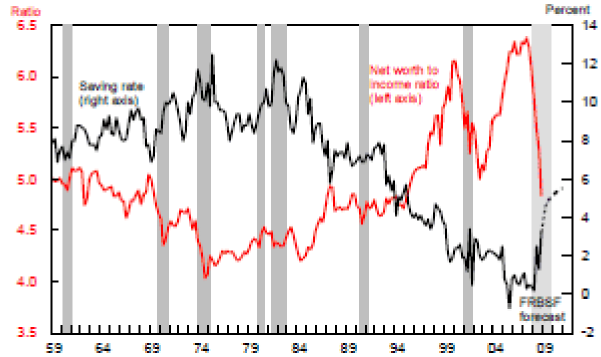
- After contracting sharply in the fourth quarter of 2008 and the first quarter of this year, we expect real GDP to decline at a significantly more modest 1-1/4 percent annual rate in the current quarter. This improvement reflects positive contributions from consumer and government spending, and less of a drag from inventory investment. Looking further ahead, we expect the recession to end in the latter part of this year and to see a gradual U-shaped recovery in 2010. With output growth expected to fall short of its potential for several more quarters, we expect the unemployment rate to continue to rise, peaking at 9-1/2 percent. As the expansion gains steam next year, the unemployment rate should start to edge down. Of course, this forecast is highly uncertain and there is a significant risk of a larger and more sustained downturn, accompanied by higher unemployment.

- Core and overall measures of price inflation have fallen considerably, reflecting declines in commodity prices and the emergence of considerable economic slack. We expect core inflation to continue to edge down, reaching 1 percent in 2010. Given the weakness of the U.S. and global economies, the outlook for inflation is highly uncertain. Some Phillips-curve inflation forecasting models based on the view that inflation expectations are unanchored predict a high probability of deflation next year. In contrast, Phillips-curve models based on the well-anchored inflation expectations seen over the past 16 years indicate little probability of deflation and predict inflation rising towards 2 percent over the next two years.

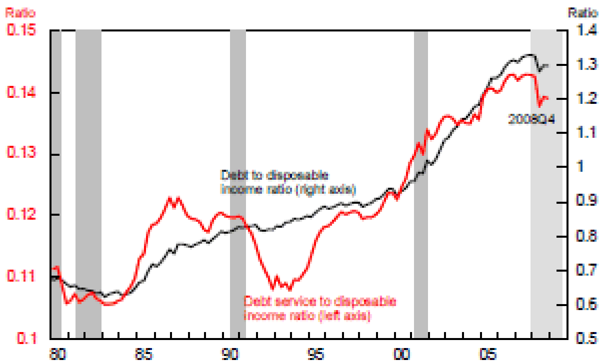
Key Issues

- Adverse Feedback Loop
- V-Shaped or U-Shaped Recovery?
- The Risk of Deflation

and Suffering from Fall in Wealth

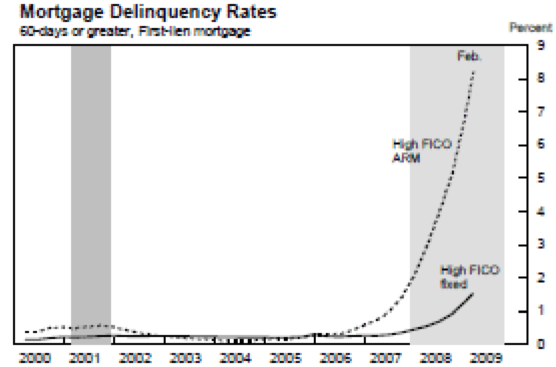


Households Deep in Debt…



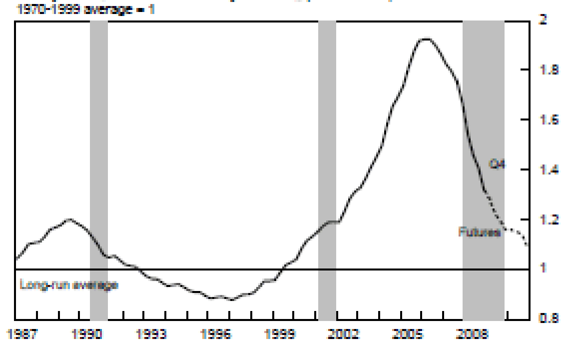
It Started with Subprime, then Spread to Prime

Mortgage Delinquency Rates
60-days or greater, First-lien mortgage



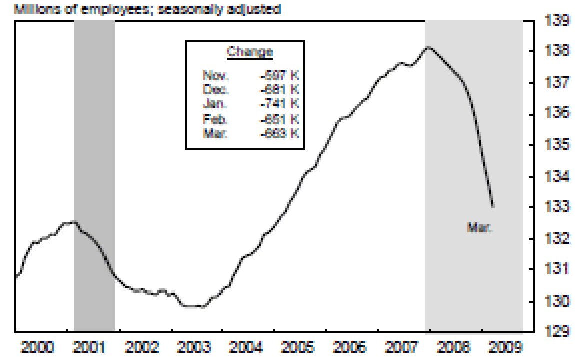
House Prices Closing in on "Normal" Level

Ratio of House Prices to Rent
10-City Case-Shiller Index divided by Owner's Equivalent Rent;
1970-1999 average = 1



Over 5 Million Jobs Lost So Far

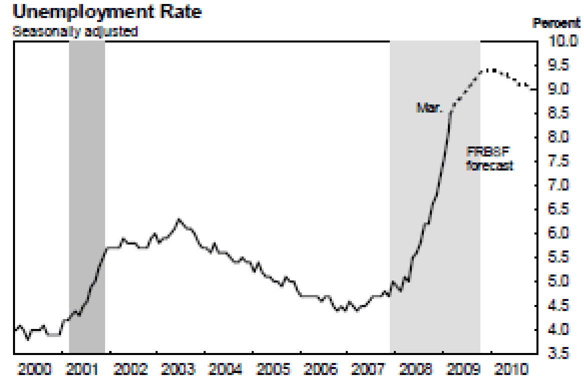
Nonfarm Payroll Employment
Millions of employees; seasonally adjusted



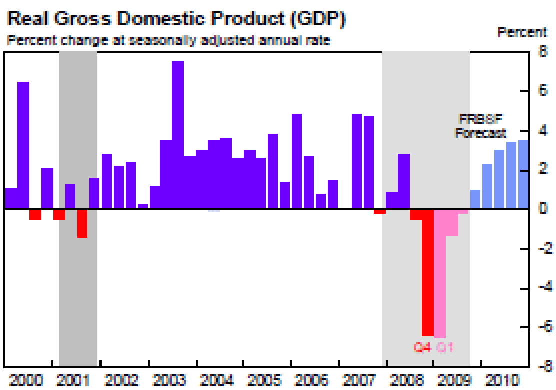
V-Shaped or U-Shaped Recovery?

Arguments for V-Shaped Recovery	Arguments for U-Shaped Recovery
• Typical pattern of past severe recessions • Pent-up demand for housing and cars, and inventory rebuilding • Sizable monetary and fiscal stimulus	• Banking/financial crises followed by slow recoveries; healing of banks will take time • Heightened uncertainty exerts drag on investment • Global recession • Monetary policy limited by zero bound

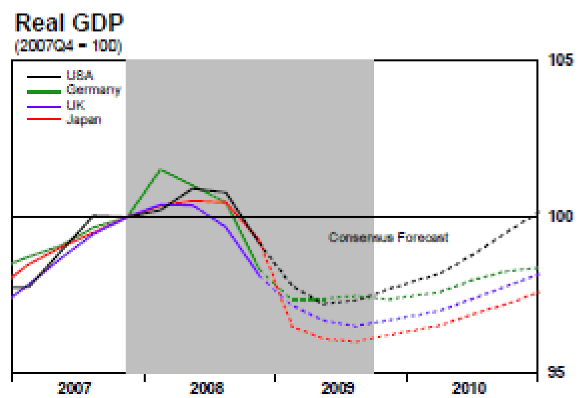
Unemployment Continues to Rise



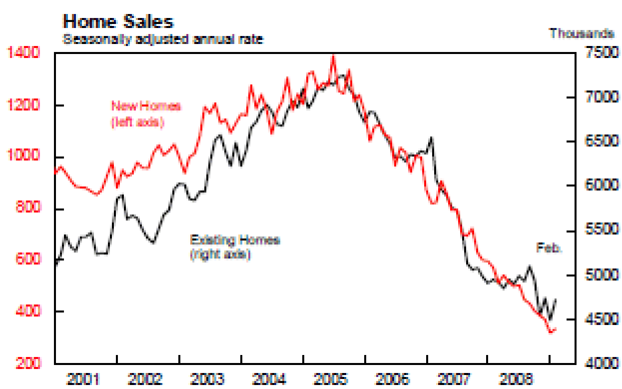
Gradual Recovery



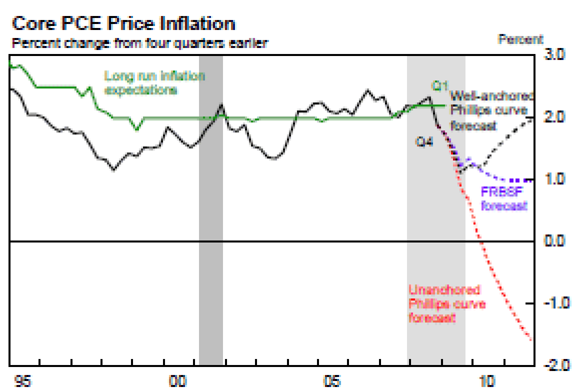
Global Recession



Has Housing Hit Bottom (Again)?



The Risk of Deflation



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