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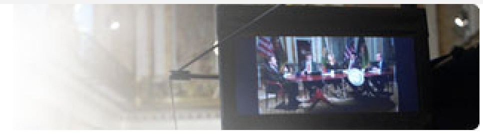

Statement for the Treasury Borrowing Advisory Committee of the Securities Industry and Financial Markets Association Alan B. Krueger Assistant Secretary for Economic Policy & Chief Economist

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The U.S. economy continues to recover after suffering through the deepest downturn in postwar history. Real GDP grew for a fourth straight quarter in the three months ended in June, and the economy now appears to be on the path of an investment-led recovery. Private domestic demand has strengthened, reflecting strong growth of business investment. Businesses have started to hire again, adding nearly 600,000 workers to private sector payrolls so far in 2010. Nevertheless, unemployment remains high. The housing market is still weak, in part reflecting the extent of joblessness, but it is generally more stable than a year ago. Financial markets in the United States have been buffeted by developments in Europe, leaving equities lower than at the start of the year. Even so, financial and credit market conditions remain far better now than they were during the depths of the 2008 financial crisis. While some sectors have been slower to recover than others, the outlook for the economy continues to be positive. A consensus of economists expects real GDP to grow at a moderate pace through the remainder of this year and sees the unemployment rate declining gradually as firms continue to add jobs. The improving economy is expected to help narrow the federal budget deficit, which is projected to peak at $1.47 trillion (10 percent of GDP) during the current fiscal year.

New data released last week by the Bureau of Economic Analysis (BEA) show that the recent recession was more severe than previously estimated, particularly at the end of 2008. From late 2007 through mid 2009, real GDP fell by a cumulative 4.1 percent (revised from 3.7 percent) – the largest output loss and thus deepest recession in postwar U.S. history. Since the middle of 2009, real GDP has regained about three-quarters of the recession's decline; from 2009Q2 through 2010Q2, real output rose by 3.2 percent. Although the rebound in growth is not as strong as that seen in the four quarters after previous deep downturns, it still represents a solid gain given the depth of the recession and severity of the turmoil in financial markets.

In the most recent quarter, real GDP increased at a 2.4 percent annual rate. That followed an upwardly-revised gain of 3.7 percent in 2010Q1. Despite the more moderate pace of headline growth – which reflected a sharp pickup in imports (a subtraction from GDP) and slowdown in inventory accumulation, private demand strengthened considerably. Growth of private final demand (the sum of consumption and fixed investment) roughly doubled to about 4 percent in Q2. Business spending on equipment and software grew at a rapid pace for a third straight quarter and outlays for business structures rose for the first time in two years. Residential investment increased at its fastest rate since 1983, partly due to home builders and home buyers rushing to beat the April 30th expiration of the home buyer tax credit. The surge in residential activity contributed 0.6 percentage point to real GDP growth, following a string of nearly continuous declines dating back to early 2006. Consumer spending continued to grow at a moderate pace in Q2, and accounted for roughly half of the increase in real GDP.

Although the housing market is widely expected to continue the recent underlying trend of modest improvement, significant near-term volatility is likely in home sales and housing starts. The recently-expired home buyer tax credit contributed to a steep run-up in housing starts and home sales this spring, just before the April 30th expiration date. Since then, homebuilding activity and home sales have slowed. Housing starts fell in both May and June, leaving them at their lowest since last October and roughly 6 percent below their June 2009 level. Existing home sales also dropped in both May and June, although sales were still up nearly 10 percent over the past year. New home sales jumped in June following May's steep plunge, but the June sales pace was the second slowest on record. Despite these swings, housing indicators still appear to suggest that the underlying level of housing market activity has stabilized, although at a low level.

National measures of home prices have also stabilized, and have registered small gains in recent months. The Federal Housing Finance Agency (FHFA) purchase-only house price index rose for a third straight month in May and is up by about ½ percent so far this year after falling nearly 2 percent during 2009. The S&P/Case-Shiller 20-city composite index edged up in both April and May after seasonal adjustment to post a 1.0 percent gain so far in 2010. This measure fell about 3 percent during 2009. Some analysts attribute the spring strengthening at least partly to the home buyer tax credit. If so, these measures could signal some softening in prices in the near term. The large inventory of homes on the market relative to the sales pace, along with a significant number of homes in foreclosure also poses a downside risk to prices.

The high level of unemployment has also weighed on housing. Recently, the labor market has begun to show signs of recovery, although joblessness remains elevated. Employment in the private sector has increased steadily since the end of 2009, with nearly 600,000 jobs added to payrolls so far in 2010. The bulk of these jobs have been in the service-providing industries but manufacturing – a sector hit particularly hard by the downturn – has also added workers to its payrolls. In the first six months of 2010, factory employment rose by 136,000, accounting for about a quarter of private-sector job gains during this time period. Despite these welcome gains, there were 7.9 million fewer private sector payroll jobs in June 2010 than in December 2007, when the recession began. The unemployment rate has eased from a 26-year high of 10.1 percent in October 2009 to 9.5 percent in June but is still almost double its pre-recession level. The share of workers unemployed for 27 weeks or more is at a record level of nearly 46 percent (roughly 6.8 million workers). In all, 14.6 million workers were unemployed in June, with roughly another 11 million underemployed (including, among others, those working part time though they want a full-time job and those who want a job but have become too discouraged to search).

The wide margin of labor market slack along with a low level of capacity utilization is keeping inflation in check. Headline consumer price inflation increased in the past year but remains very low. Over the twelve months ending in June, the consumer price index (CPI) rose 1 percent, after falling almost 1-1/2 percent during the previous year. The pickup in the headline CPI reflected the pass-through of higher oil prices to consumer energy prices. Excluding energy and food prices, the core CPI increased 0.9 percent over the year ending in June. That was down from 1.7 percent a year ago and matched the March and April readings as the smallest twelve-month increase since 1966.

Financial market volatility has increased in the past few months, equity markets have slipped, and interest rate spreads have widened. Even so, financial and credit market conditions remain far better than during the height of the 2008 financial crisis. The S&P 500 is up about 60 percent from its March 2009 low, and interest rate spreads are well below their late 2008 levels, with conventional mortgage rates at historically low levels.

Looking ahead, the economy is expected to grow at a moderate pace through the end of the year. Private forecasters generally expect real GDP to grow by about 2-3/4 percent at an annual rate in each of the final two quarters of 2010, putting the increase over the four quarters of the year at just under 3 percent. The Administration's most recent economic forecast for 2010 in the Mid- Session Review of the FY2011 Budget is very close to the private consensus. According to the Administration assumptions, the economy is expected to strengthen in 2011 as the recovery solidifies. Over the Administration's 10-year forecast window real GDP growth is projected to average 3.3 percent, reflecting economic recovery from the deep recession early in the forecast horizon. Once the economy has reached full employment, growth is expected to average around 2½ percent per year, very close to the long-term growth projections of private forecasters.

The U.S. fiscal situation is expected to improve substantially as the economy strengthens and temporary spending programs aimed at combating the effects of the recession phase out. In the Mid-Session Review budget forecast released in late July, the projected FY2010 deficit was revised down from 10.6 percent of GDP to 10.0 percent. The deficit is forecast to decline to 9.2 percent of GDP in FY2011 and is projected to average 3.7 percent of GDP during FY2015-FY2020.

In sum, significant progress has been made since the recovery began in mid 2009. The economy is now growing solidly, with business investment on the rise, and firms once again adding to their payrolls. Real GDP is expected to grow at a moderate pace going forward, producing gains in private payrolls, although the unemployment rate – which is typically slow to decline – will likely remain elevated in the near term. Partly as a result of improving economic conditions, the federal deficit is expected to fall over the next several years, although achieving fiscal sustainability over the longer term remains a major challenge.

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