RSQE FORECASTS

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The U.S. Economic Outlook for 2010–2011
Executive Summary: November 2009

Beyond the Great Recession

Based on the data currently available, the recession that began at the close of 2007 appears to have ended some time this summer. Over the six quarter interval, 2007q4–2009q2, output fell by 3.7 percent, the longest and steepest drop since the Great Depression. From December 2007 through October 2009, payroll employment plunged by 7.3 million jobs, and the unemployment rate more than doubled, topping 10 percent for the first time since June 1983.

In the postwar era, the sharper downturns have been followed by years of above-average growth. However the years following the milder 1990–91 and 2001 recessions yielded merely average growth at best.

It now appears that the upturn in output got off to a healthy start. According to preliminary estimates, real GDP rose at a 3.5 percent pace in the July–September quarter, the first increase in more than a year.

A number of policy actions contributed to that strength. "Cash for clunkers" helped boost light vehicle sales from a dismal 9.5 million unit pace in the first half of the year to 11.5 million units in the summer quarter. The first-time home-buyer credit and government efforts to keep mortgage rates low have brought some stability to parts of the housing market. And more broadly, direct government spending that is part of the fiscal stimulus has propped up demand.

Economic Headwinds

Few analysts expect that the economy will follow historical pattern and continue to grow at an above-average rate in the near term. A number of factors are producing headwinds for this recovery.

- *Although greatly improved, the financial system is not back to normal, and credit remains constrained.*
- *Gains in consumer spending will be moderate. Unemployment is high, households continue to pay down debt, and home equity can't provide the support to consumption that it had in recent years.*
- *The housing market still needs repair. The backlog of unsold homes, including those currently held off the market, will keep some downward pressure on new construction.*
- *And, the synchronicity of the global downturn makes it less likely that exports will be a really significant driver in our recovery.*

The Outlook at Year's End

We expect the recovery to proceed more slowly around the turn of the year, with output rising by 2.3 percent in the closing quarter of this year and 2.1 percent in 2010q1. Light vehicle sales retreat after their third quarter surge, and business capital spending continues to decline. Early next year, federal government purchases level out, and cash-strapped state and local units trim spending.

Employment continues to slide although the pace of job loss slows. The unemployment rate reaches 10.4 percent by the early months of next year. That's up 2.3 percentage points from the start of this year but still shy of the post-war record 10.8 percent set in November-December 1982.

Economic Policy

Aggressive monetary and fiscal policies have averted financial collapse by providing liquidity and sustaining credit, supporting banks through guarantees and capital injections, and propping up demand with fiscal stimulus. The next great challenge for policy makers will be how to successfully unwind these highly expansionary policies without either causing inflation or slowing down the recovery.

Some of the programs created to provide liquidity will scale back automatically as collateralized loans mature. Reversing purchases of long-term assets will require more deliberate policy actions. The Fed is considering a number of policies designed to absorb liquidity. We have assumed the Fed will successfully utilize these methods when needed and will wait until early 2011 to start nudging rates up off the floor, bringing the fed funds rate target from its current 0–¼ percent range to 1.5 percent by the end of that year.

Fiscal policy remains highly expansionary. Spending and tax relief from the fiscal stimulus package will *continue at high levels for the next year before beginning to shrink in 2011. Since February, Congress has enacted extensions for unemployment benefits and the home-buyer tax credit as well as additional tax cuts for businesses. On a National Income and Product Account basis, the federal deficit nearly doubled in fiscal '09, exceeding one trillion dollars, and we expect it to soar higher, to $1.5 trillion, in fiscal 2010. The deficit improves to $1.27 trillion in fiscal 2011, but that's still a whopping 8.4 percent of GDP. Once the economy is on more solid footing, the focus of fiscal policy will need to be on bringing the deficit down to more sustainable levels, including addressing the impact on the budget of the retiring baby boomers.*

The 2010–2011 Outlook

The economy strengthens in the second half of 2010, but growth remains moderate through 2011. The 2.1 percent growth rate of 2010q1 is followed by real GDP growth rates of

- *2.2 percent in 2010q2,*
- *2.9 percent during the 2nd half of 2010, and*
- *2.7 percent during 2011 (4th-qtr-to-4th-qtr).*

Business capital spending turns around next spring. Consumer spending is a stable but restrained source of growth. The recovery in residential building accelerates in 2011, but the pace of inventory building—a solid source of growth during 2010—contributes little to output growth in '11. On an annual basis, real GDP rises by 2.3 percent in 2010 and 2.6 percent in 2011 after falling by 2.5 percent this year.

Payroll employment bottoms in the first quarter of next year, but the calendar 2010 average still falls 1.2 million jobs short of the 2009 figure. The job count increases by 2.1 million in 2011.

The unemployment rate averages 10.1 percent in 2010 and then retreats to 9.6 percent for 2011.

Housing starts recover to 726 thousand units in 2010 and 1.15 million the following year, double the estimated 568 thousand starts in 2009.

Sales of light vehicles, which are on track in 2009 to register their poorest showing since 1970, improve by roughly a million units per year, reaching 11.2 million units next year and 12.1 million in 2011.

Core CPI inflation holds steady at 1.7 percent in 2010 and 2011, matching the 2009 rate. After the first decrease in the all-items CPI since 1955, headline CPI inflation rebounds to 2.6 percent in 2010, reflecting the recovery in oil prices, and then slips back to 2.3 percent in 2011.

	Actual	RSQE Forecast		
	2008	2009	2010	2011
GDP (Billions of Current $s)	14441.4	14264.1	14747.0	15379.7
Real GDP (Billions of Chained 2005 $s)	13312.2	12982.6	13282.2	13628.9
% Change: Year-Over-Year	0.4	-2.5	2.3	2.6
% Change: 4th-Qtr-to-4th-Qtr	-1.9	-0.4	2.5	2.7
Nonfarm Payroll Employment (Millions)	137.0	131.9	130.7	132.8
Civilian Unemployment Rate (%)	5.8	9.3	10.1	9.6
Capacity Utilization, Total Industry (%)	77.5	70.0	73.9	77.1
Inflation (Private Nonfarm GDP Deflator, % Change)	1.5	1.4	1.1	1.6
Inflation (CPI-U, % Change)	3.8	-0.3	2.6	2.3
Inflation (Core CPI, % Change)	2.3	1.7	1.7	1.7
Light Vehicle Sales (Millions)	13.2	10.2	11.2	12.1
Private Housing Starts (Thousands)	901	568	726	1149
3-Month Treasury Bill Rate (%)	1.4	0.2	0.2	0.9
10-Year Treasury Bond Rate (%)	3.7	3.2	3.4	3.6
Conventional Mortgage Rate (%)	6.0	5.1	5.0	5.1
Real Disposable Income (Billions of Chained 2005 $s)	9911.3	9944.4	10062.4	10037.0
% Change	0.5	0.3	1.2	-0.3
Corporate Profits After Tax (Billions of Current $s)	1170.6	1077.5	1312.6	1402.8
Value of U.S. $ (FRB Broad Index), % Appreciation	-3.5	5.8	-9.1	-5.3
Current Account Balance (NIPA Basis, Billions of Current $s)	-707.2	-442.5	-573.4	-653.1
Federal Surplus (FY, NIPA Basis, Billions of Current $s)	-540.3	-1068.2	-1504.0	-1273.3