The U.S. and Midwest Economic Performance

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* The views expressed herein are my own and do not necessarily represent those of the Federal Reserve Bank of Chicago or the Federal Reserve System.

Presentation Road Map

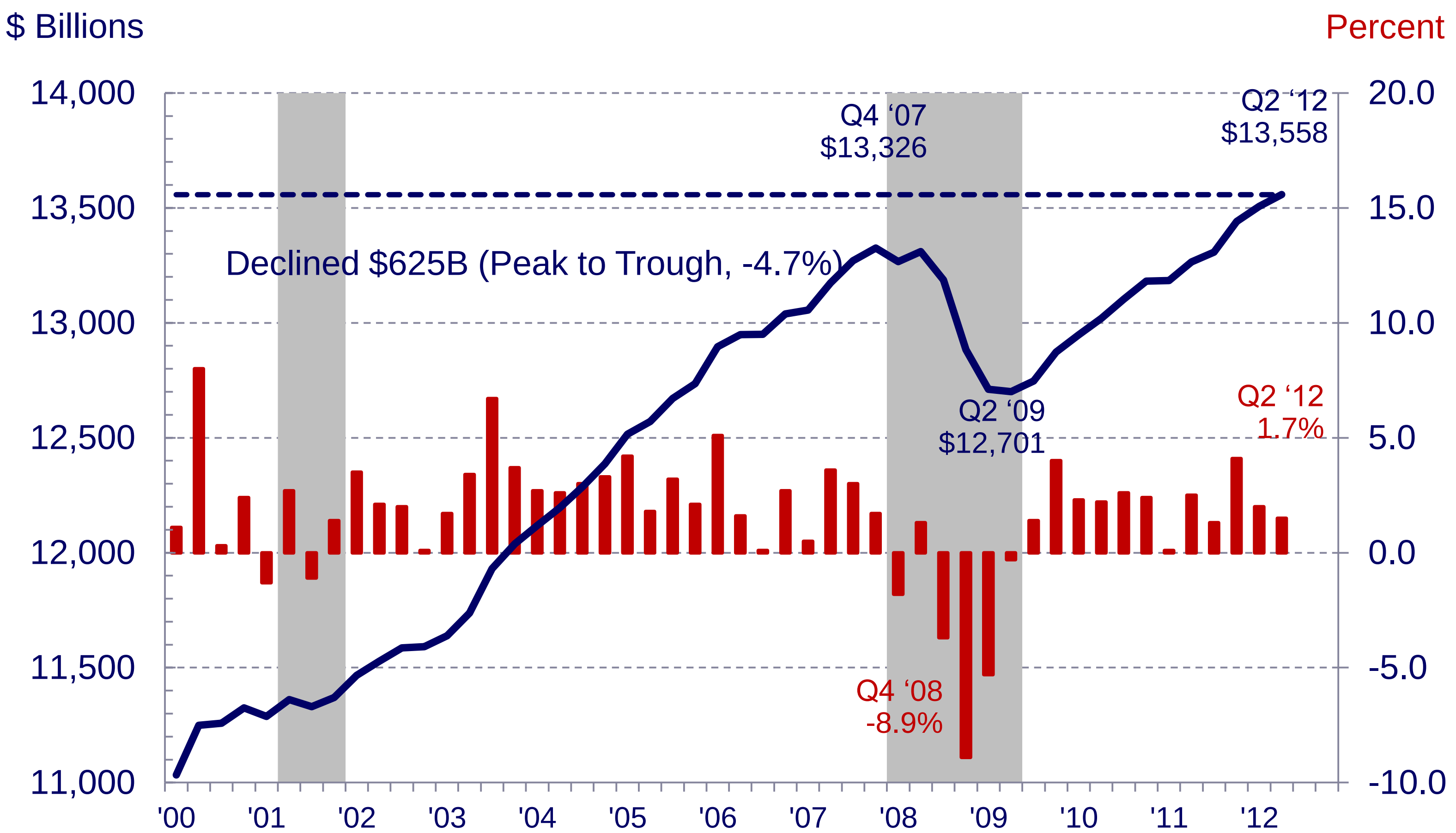
- **Understanding The Great Recession**
- **What is the recovery looking like?**
  - What is lagging?
  - Any good news?
  - Will the economy reach “escape velocity” in 2012 or 2013?
  - A word about Fed policy—QE 3 (Infinite)
- **How does the Midwest fit into the national pattern?**

GDP growth has been disappointing

- **2011 underperformed (Q1: 0.4%, Q2: 1.3%, Q3: 1.8%, Q4: 4.0%--revised up)**
- **2012 Q1 (2.0%) and Q2 were underwhelming. Second quarter slowed to 1.7%. Moving in the wrong direction.**
- **In 2011 some of the disappointing performance was blamed on special factors, Japan, supply chain disruption, Greece, oil prices have brought down growth)**
- **In 2012, continued issues in the Eurozone, slowdown in Asia growth and high gas prices**
- **State and local sector continues to be a drag on the economy**
- **FOMC central tendency forecast in September placed 2012 estimated growth at between 1.7% and 2.0% which was a reduction from the June forecast of 1.9% to 2.4%.**
- **2013 projection is for 2.5% to 3.0% (revised up) and 2014 for 3.0% to 3.8%. Long-run 2.3% to 2.6%.**
- **Certainly not the usual pattern**

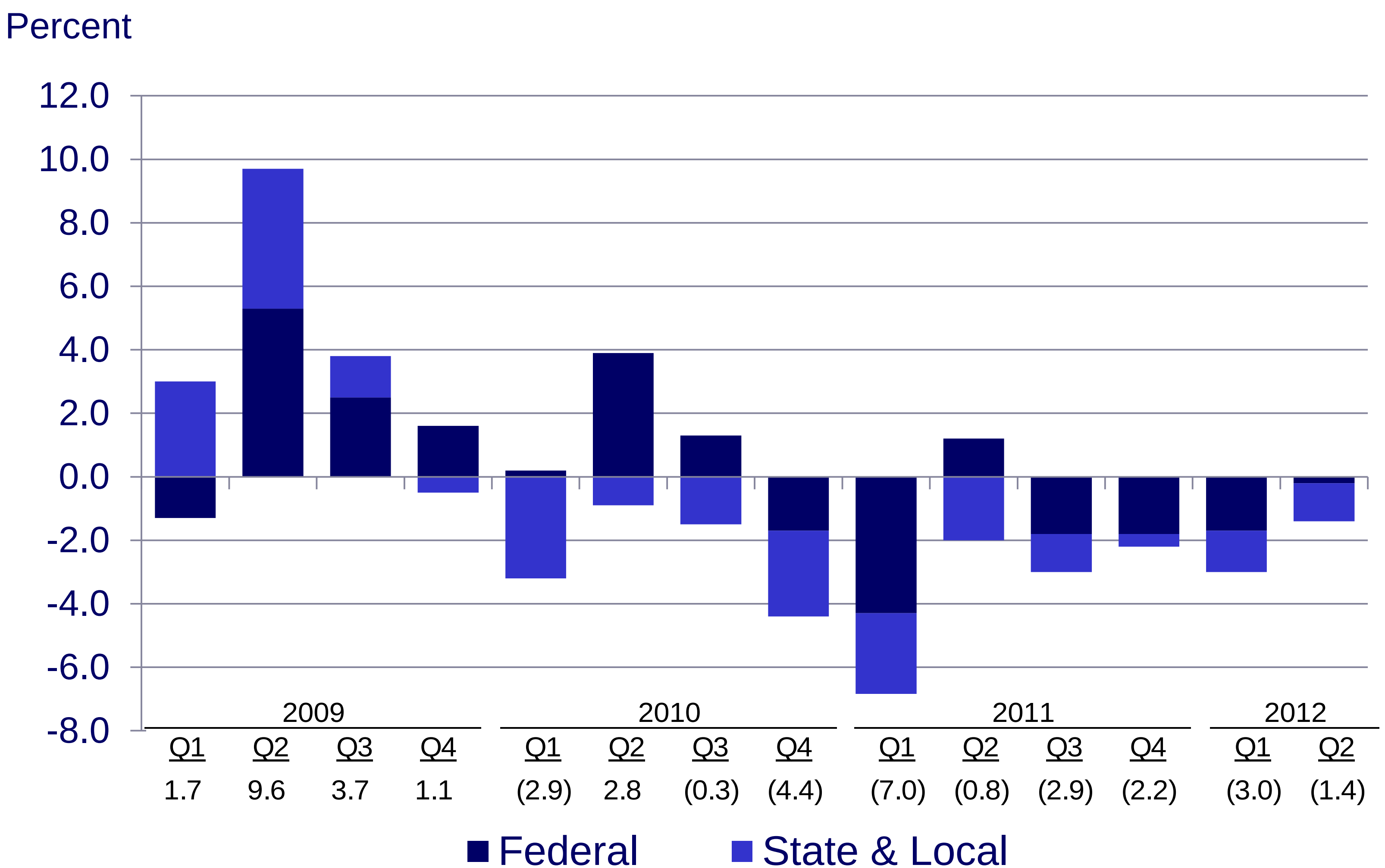
U.S. Real GDP

Billions Chained $2005, % Change Q/Q at SAAR



Contribution to Percent Change—State and local drag

Government Consumption & Investment, % Change Q/Q at SAAR



Why was this recession so different?

- **One word—”leverage”**

- **Why will the recovery be so different?**
  - One hyphenated word—de-leverage

- **Big issue—repricing risk**

- **The New Normal**

CDOs of subprime mortgage backed securities

(issued 2006-07, McKenzie)

	Estimated 3-year Default Rate	Actual Default Rate
AAA	0.001	0.10
AA+	0.01	1.68
AA	0.04	8.16
AA-	0.05	12.03
A+	0.06	20.96
A	0.09	29.21
A-	0.12	36.65
BBB+	0.34	48.73
BBB	0.49	56.10
BBB-	0.88	66.67

All adds up to a slower climb out

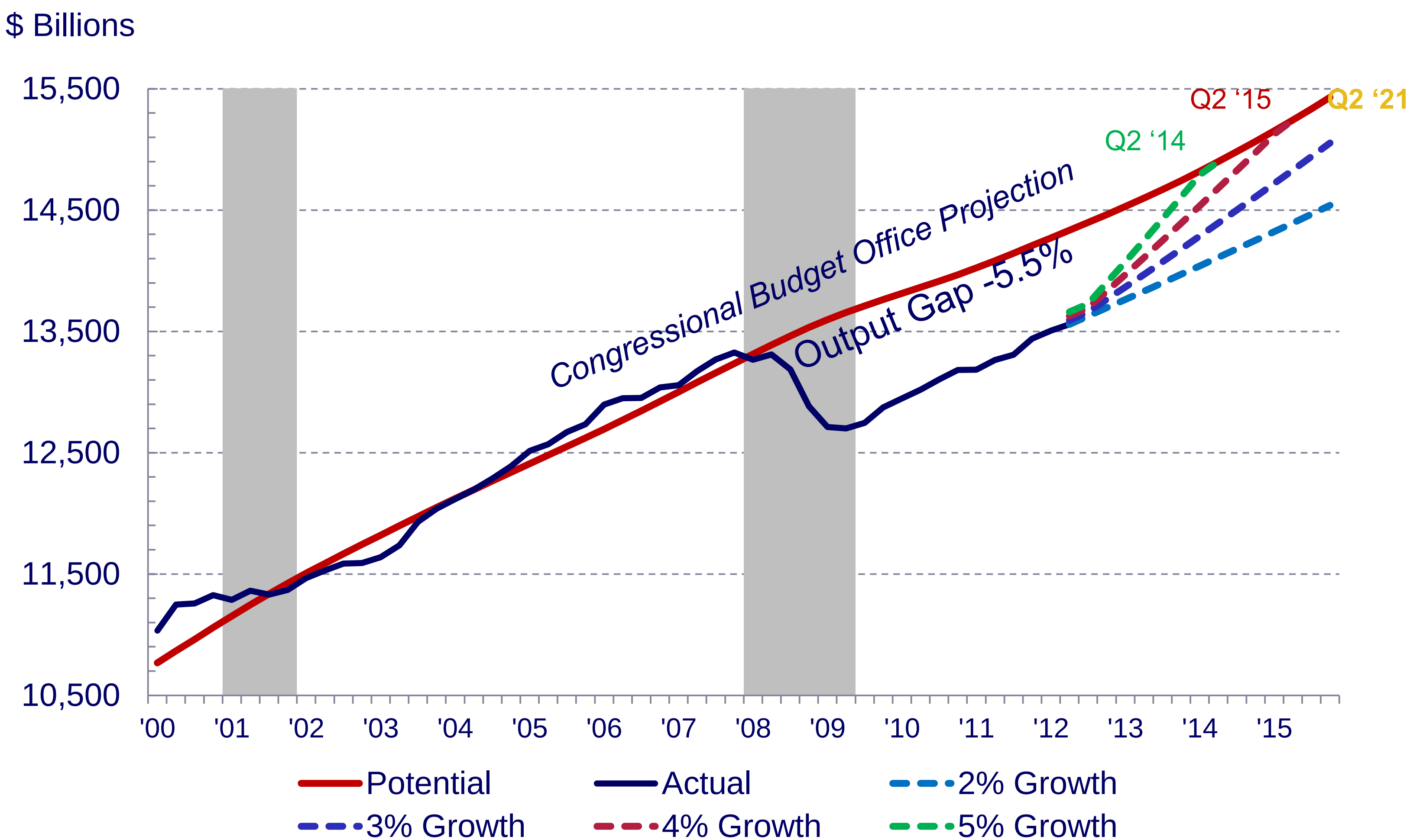
- **Financial recessions are different (Rogoff/Reinhart)**
- **Still lots of slack in labor and housing and soft demand**
- **Everyone is still repairing their balance sheet**

How far behind are we and when will we catch up?

- **Growth must be much faster to close the output gap for GDP and labor growth**

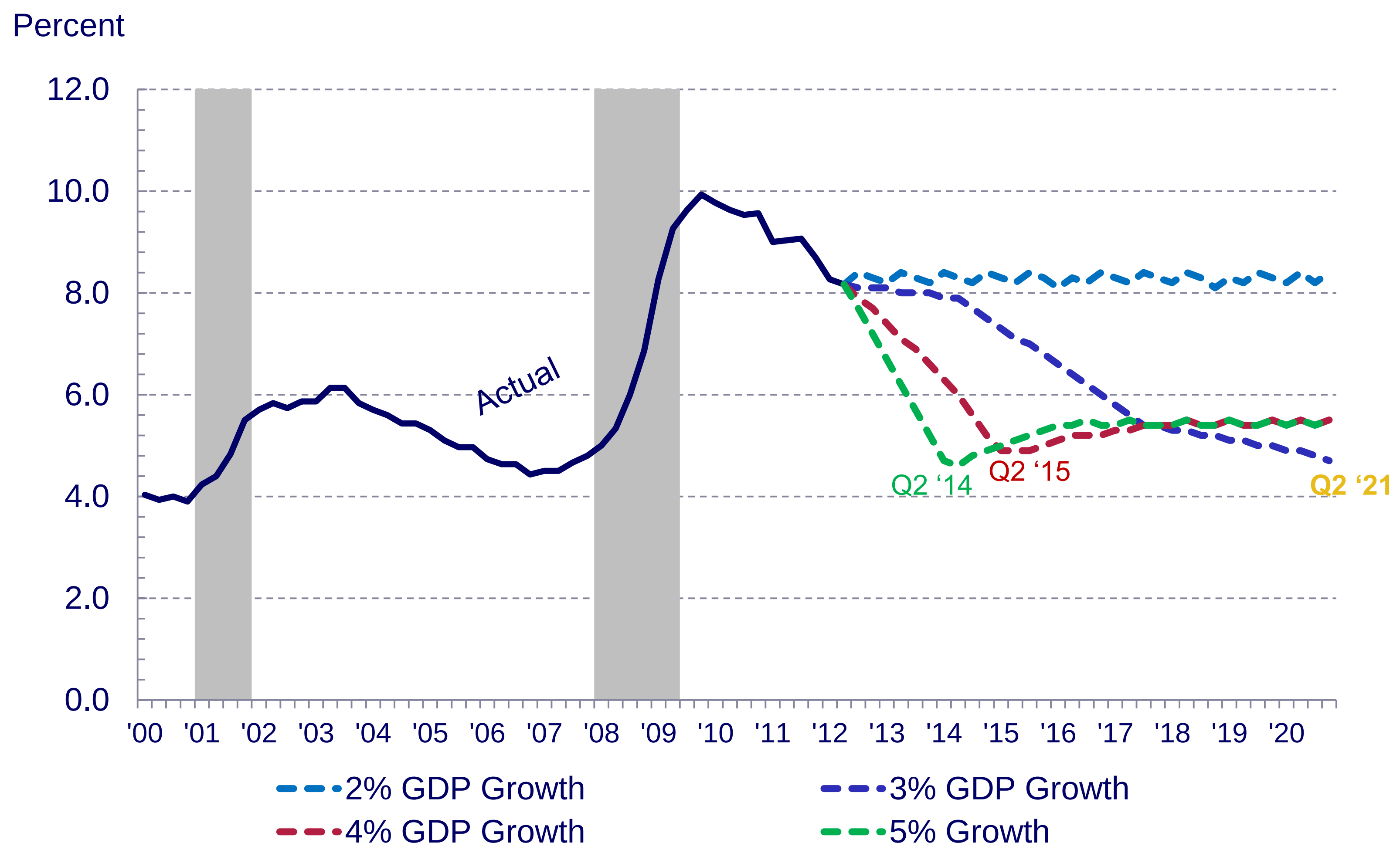
Closing the Output Gap

Actual / Projected Growth Rate Scenarios



Unemployment Rate

Unemployment at Varying GDP Growth Rates



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Closing the Output and Employment Gap

GDP, Productivity and Employment Assumptions

GDP	GDP Potential Reached	Productivity Rate	Employment Growth Rate	Jobs Per Month
2% Growth	Never	1.16	0.84	100
3% Growth	Q2 '21	1.18	1.82	230
4% Growth	Q2 '15	1.20	2.80	330
5% Growth	Q2 '14	1.21	3.79	430

Note: Growth is assumed at Q/Q annualized rates. Productivity is the average from Q3 ’12 until GDP Potential is reached.

The big hangover—employment, housing and the government sector

- **Some life in labor markets but monthly numbers have been uneven**

- **Housing—still working through foreclosures, inventory is too high and lack of demand even with record low mortgage rates**

- **Government sector is out of money and debt is piling up**

- **Fiscal Cliff—CBO says this can send us into recession**

Employment is the number 1 concern

- **Nearly 40% are "long-term" unemployed (more than 6 months)**
  - Skills atrophy
  - Wages are not recovered
  - Need for retraining

- **Lack of labor recovery undermines consumer confidence**

- **Need consistent monthly gains of 200K to make a dent in unemployment. September report was a disappointment with 96K and 8.1% unemployment rate. Job openings have been strong but quits are still lagging. Some research suggests firms aren't looking that intensively.**

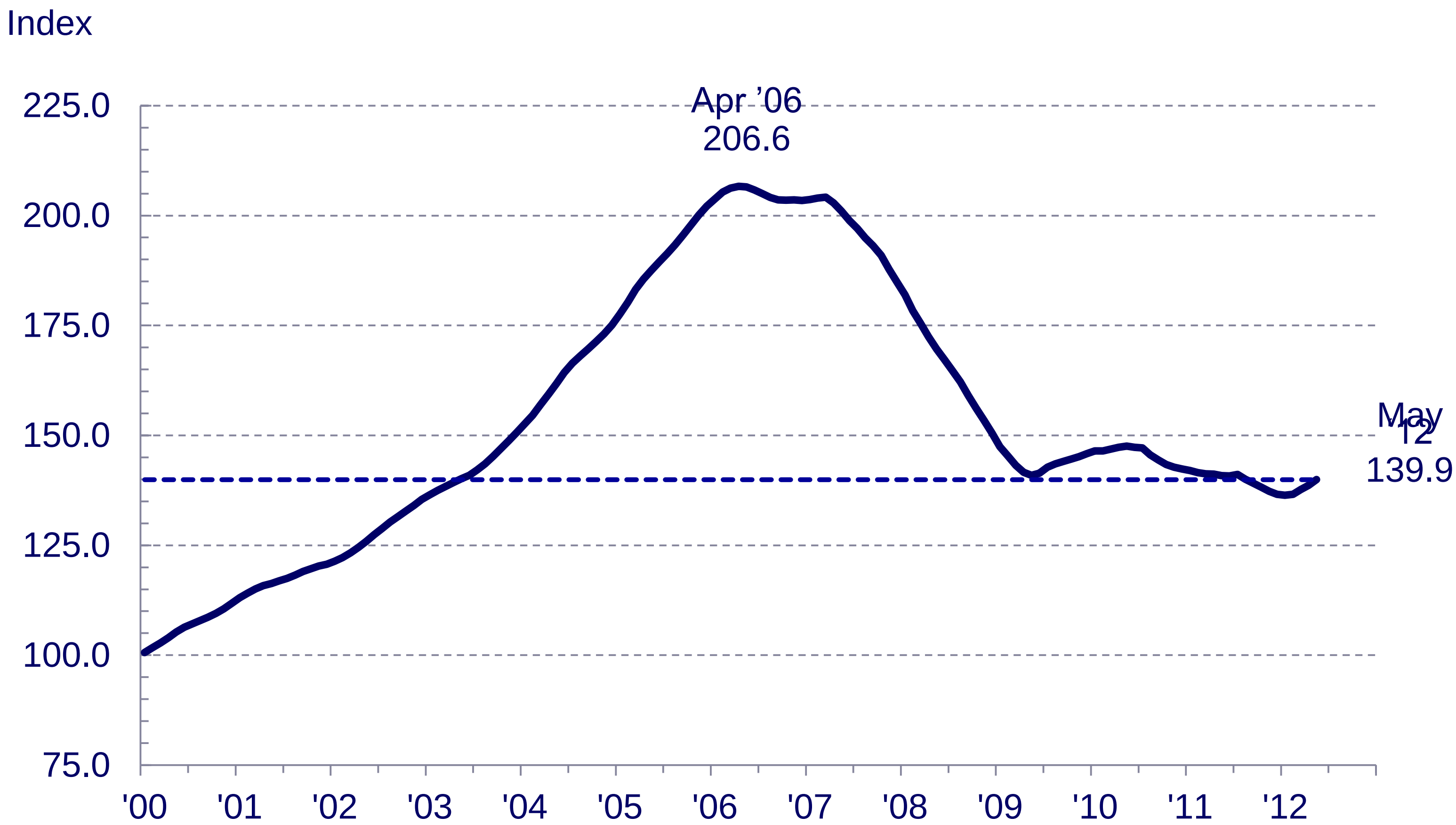
- **FOMC forecast has unemployment at 8.0% to 8.2% (2012), 7.6% to 7.9% (2013) and 6.7% to 7.3% (2014). Long-run—5.2% to 6.0%**

Housing

- **Sales are up but prices are bumping along the bottom-March sales had prices at 2002 levels**
- **Still too many foreclosures**
- **A couple of markets are stable/recovering, but**
- **Homeowner finances are tenuous-but showed some improvement in Q1 2012—700K gained positive equity due to increasing prices**
  - CoreLogic estimates (Q1 2012) states with negative equity (mortgage worth more than the house)
    - **Arizona 43.4%**
    - **Florida 45.1%**
    - **Nevada 61.2%**
    - **California 30.5%**
    - **U.S. 23.7%**
    - **Illinois 28.0%**
    - **Michigan 35.6%**
    - **Best---Alaska and North Dakota at a little over 5%**

Home Prices

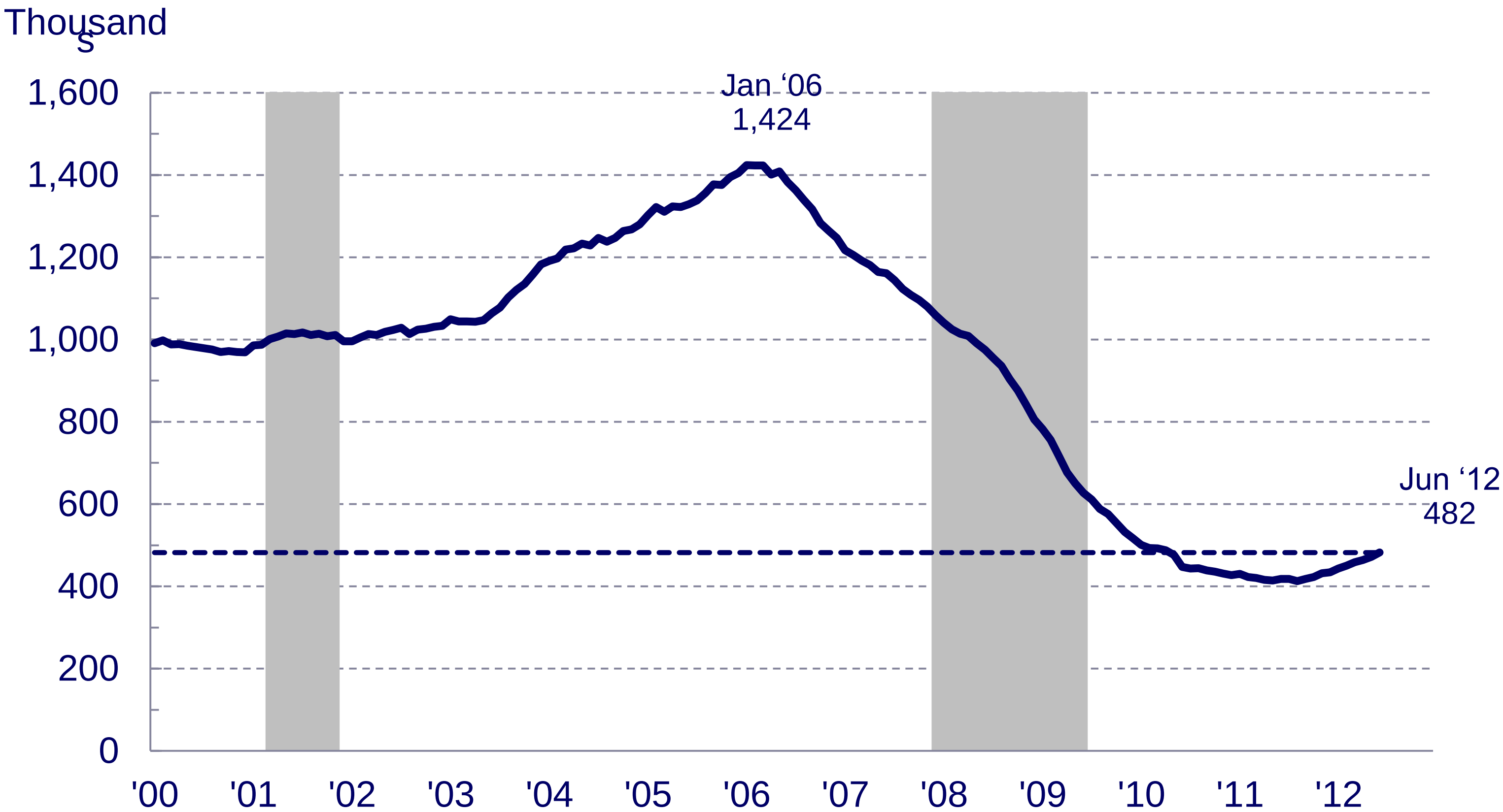
S&P Case-Shiller 20 City Home Price Index, January 2000 = 100



Source: S&P Case-Shiller U.S. National 20 City Index

Residential Construction

New Privately Owned Housing Units Under Construction



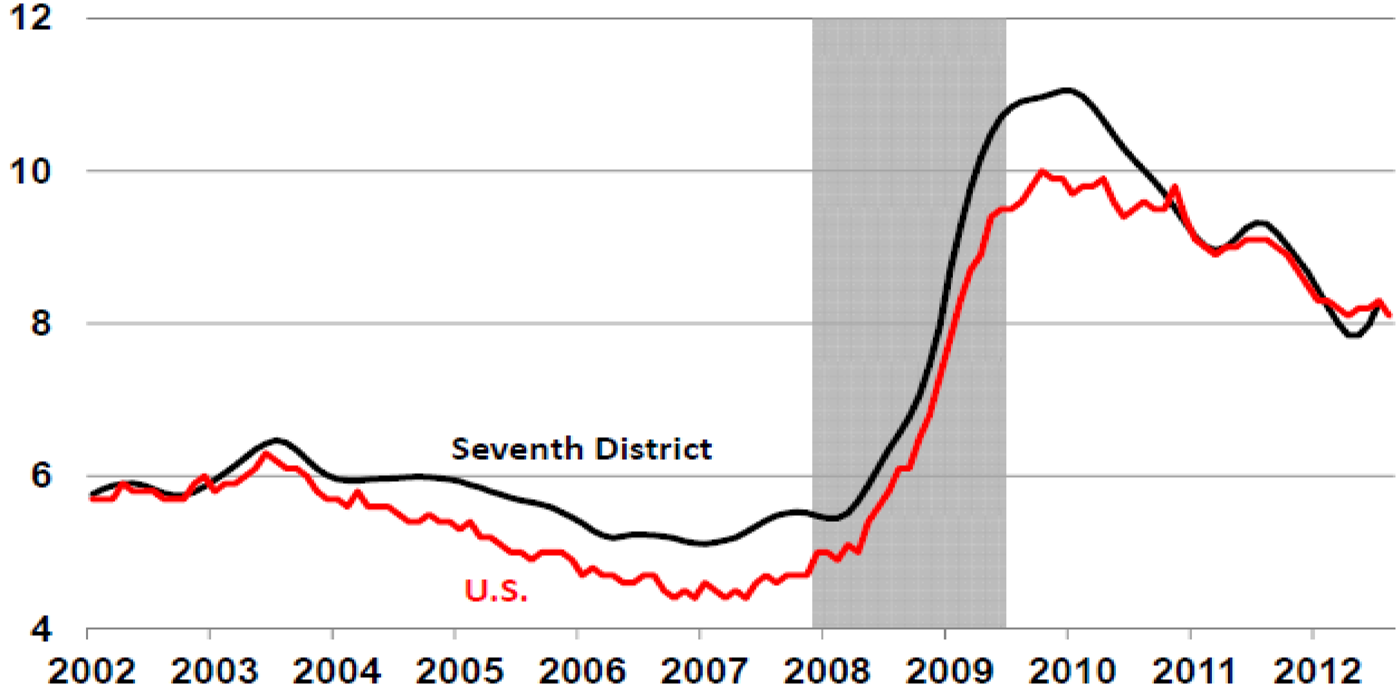
Any good news?

- **We are saving again (or at least shedding debt)**
- **Large banks have recapitalized, but lending activity appears constrained, although lending showed a big pick up in late 2011. FDIC reports that lending was up $130 billion in the last quarter marking the largest quarterly increase in 4 years.**
- **inflation appears contained? CPI and core have seen either declines or minimal growth, although gas/food prices might cause a blip. FOMC forecast has core PCE at 1.7% to 1.9% (2012), 1.6% to 2.0% (2013) and longer run still below 2%**
- **Consumer is coming back—sort of.**
- **Manufacturing, Agriculture have been doing well—Midwest is actually doing better than South or West**
- **Large firm profits have been strong—but not necessarily from orders—small firms are another story**

Turning to the Midwest

- **Parts of the recovery have favored us**
- **Manufacturing rebound has been strong—particularly, autos and heavy equipment**
- **Agriculture has seen high crop prices and record land values. Farm income has risen**
- **2012 Drought will have a significant impact on production**
- **Starting to see recovery in sectors like business services and professional services**
- **Region is generally performing somewhat better than the US as a whole**

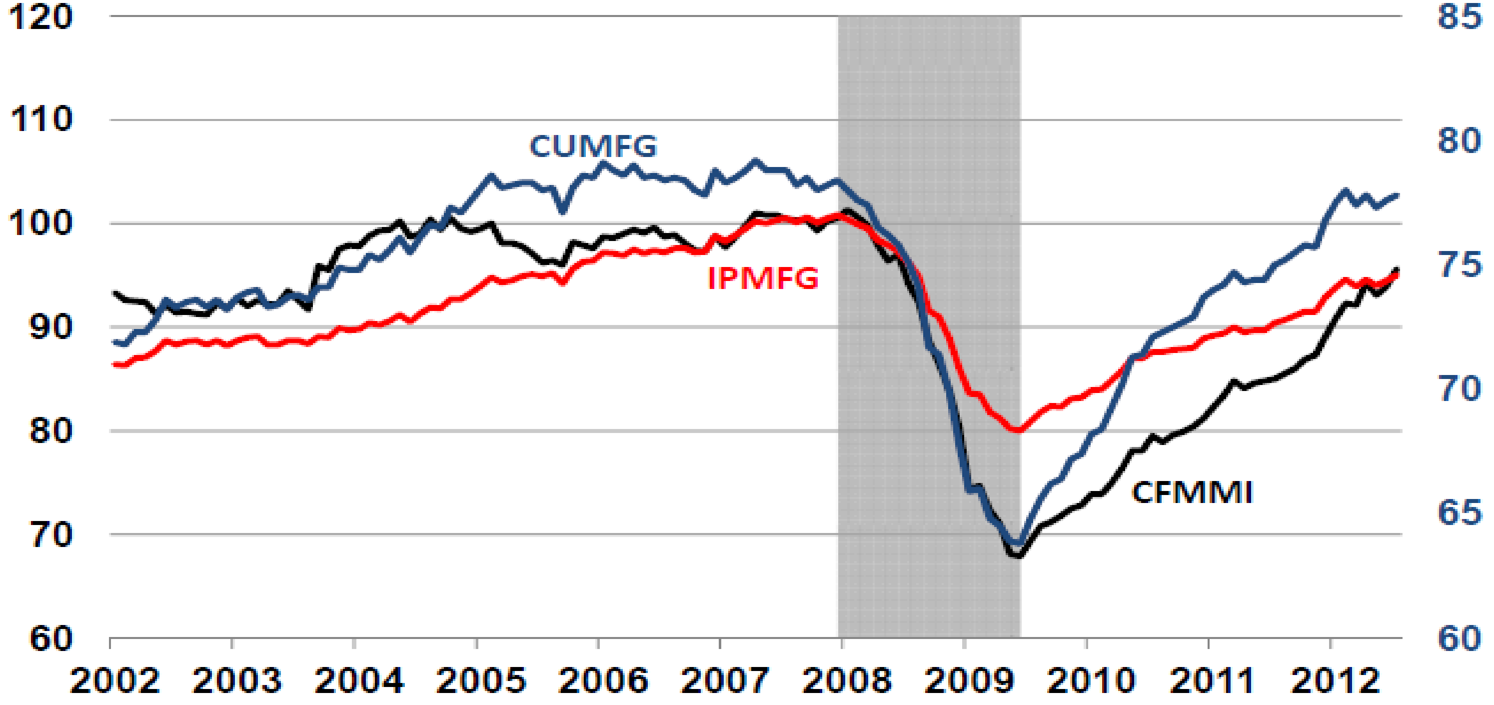
Unemployment Rates
(US through August 2012, District through July 2012)
percent



Manufacturing Production & Capacity Utilization

(through July 2012)

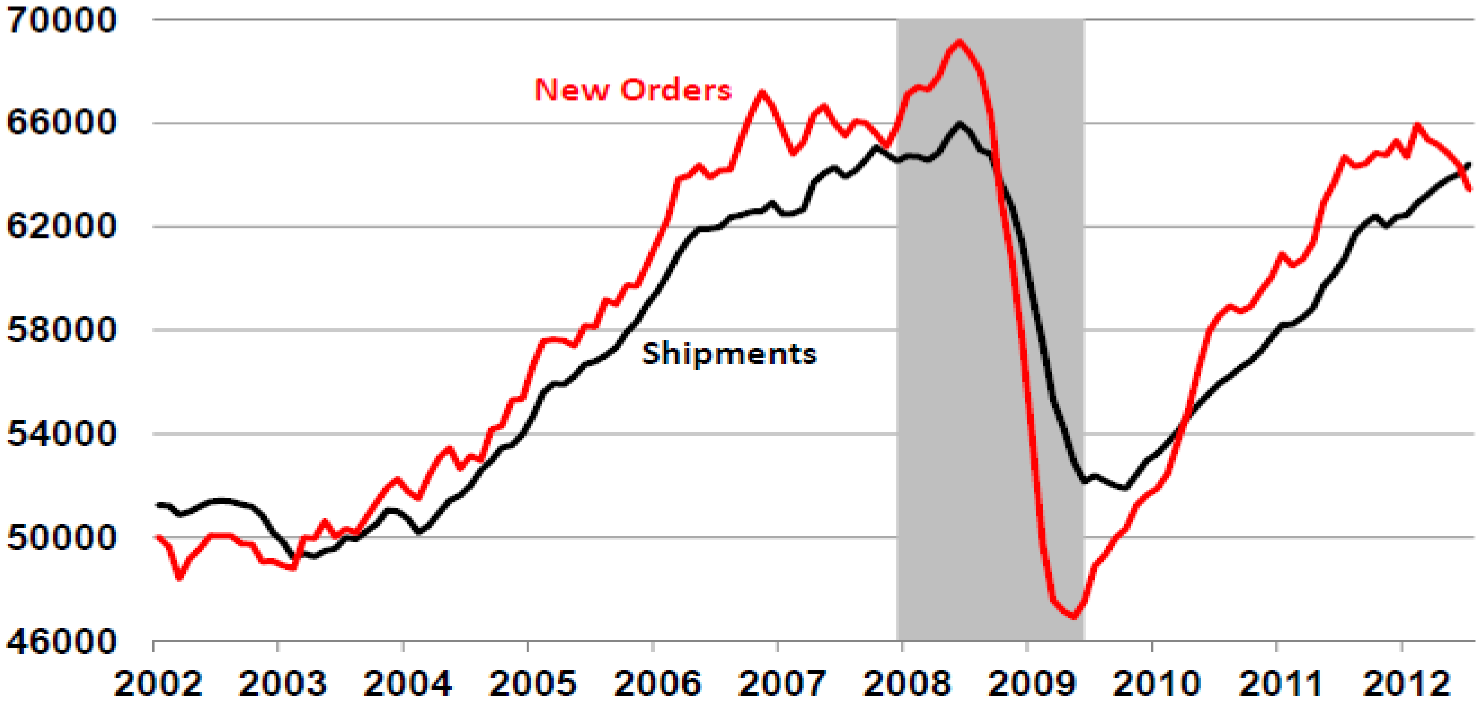
index, 2002 = 100 (IPMFG, CFMMI) *percent (CUMFG)*



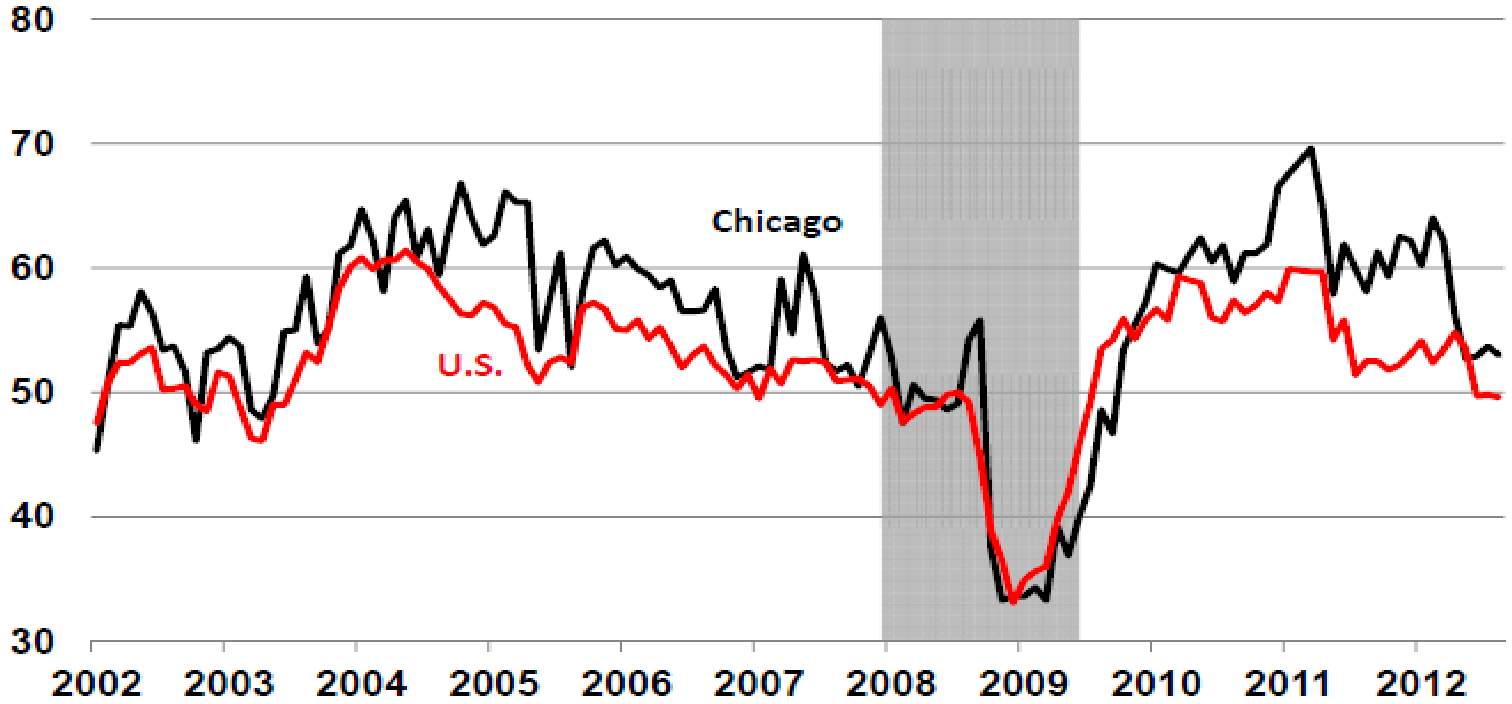
Nondefense Capital Goods ex. Aircraft

(through July 2012)

Mils. $, 3-month MA



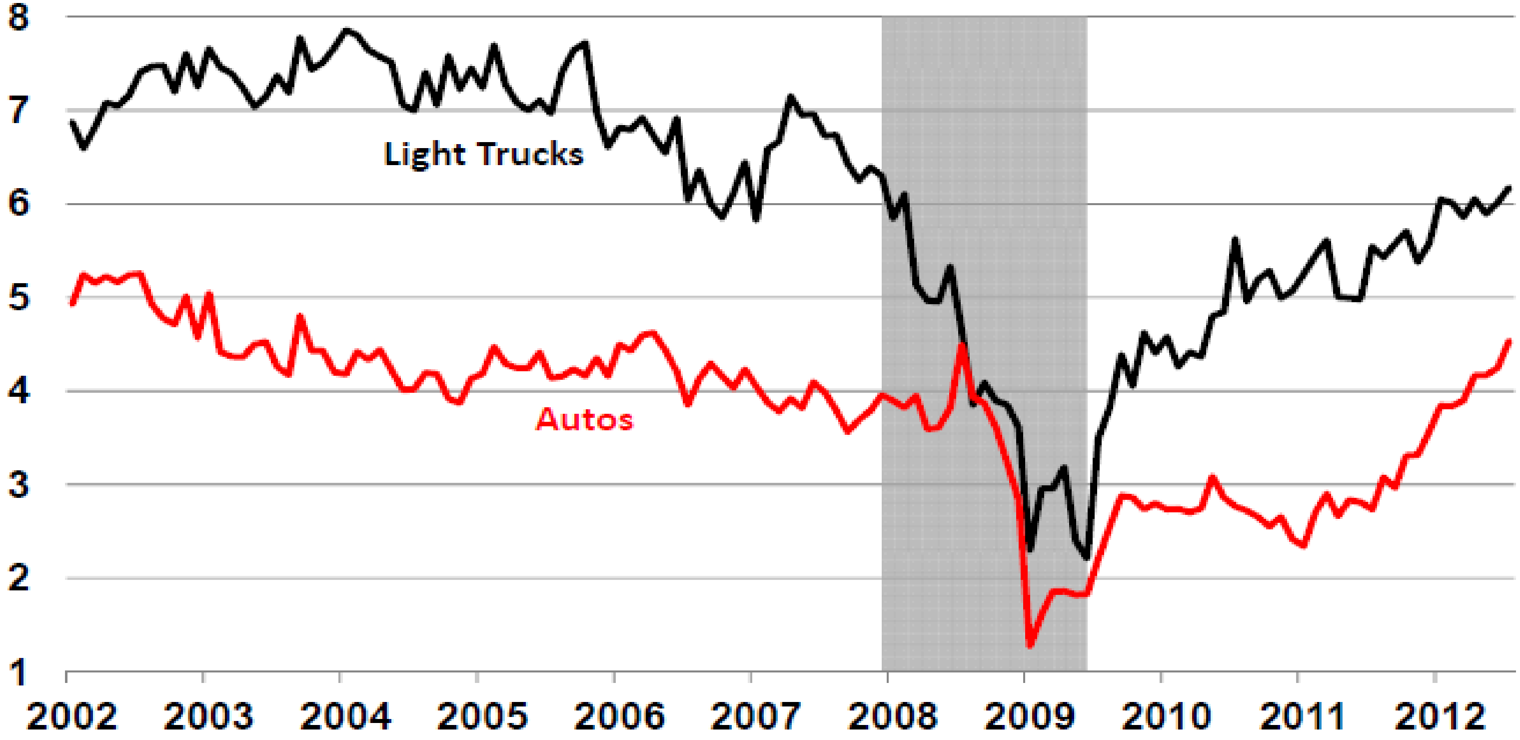
Purchasing Managers' Surveys
(through August 2012)
percent



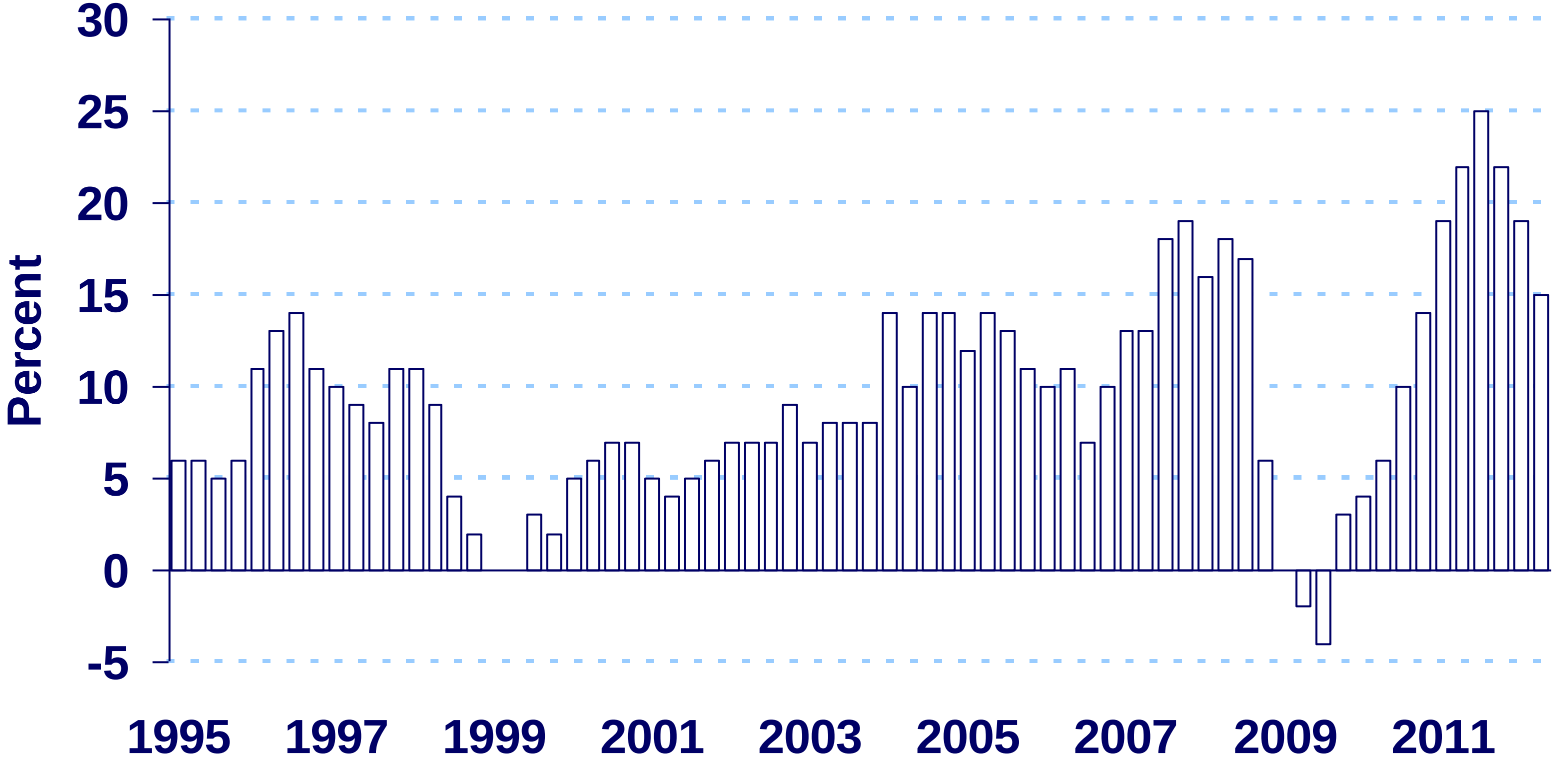
Light Vehicle Production

(through July 2012)

millions of units, annual rate

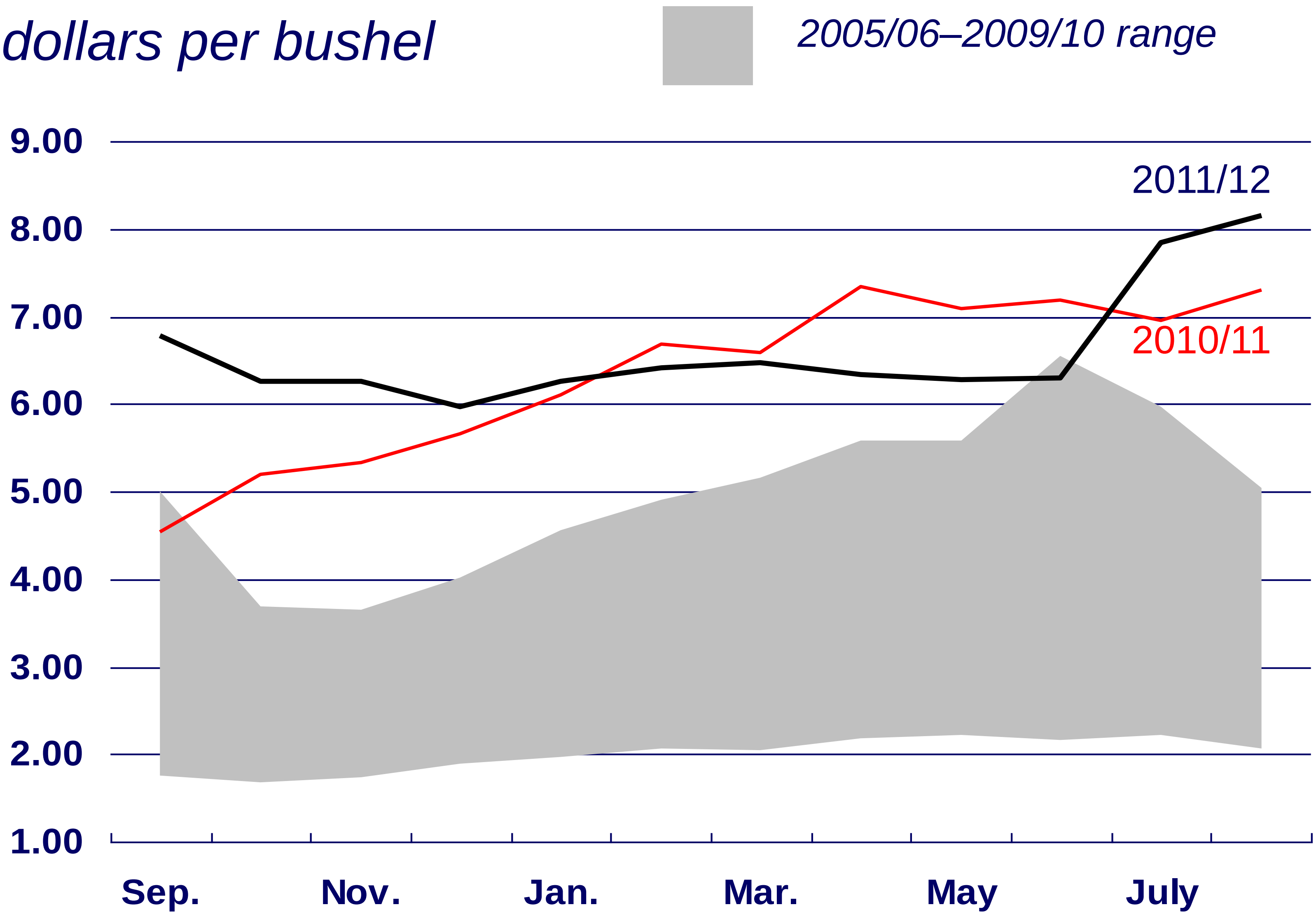


Year over year changes by quarter in farmland values in the Seventh Federal Reserve District



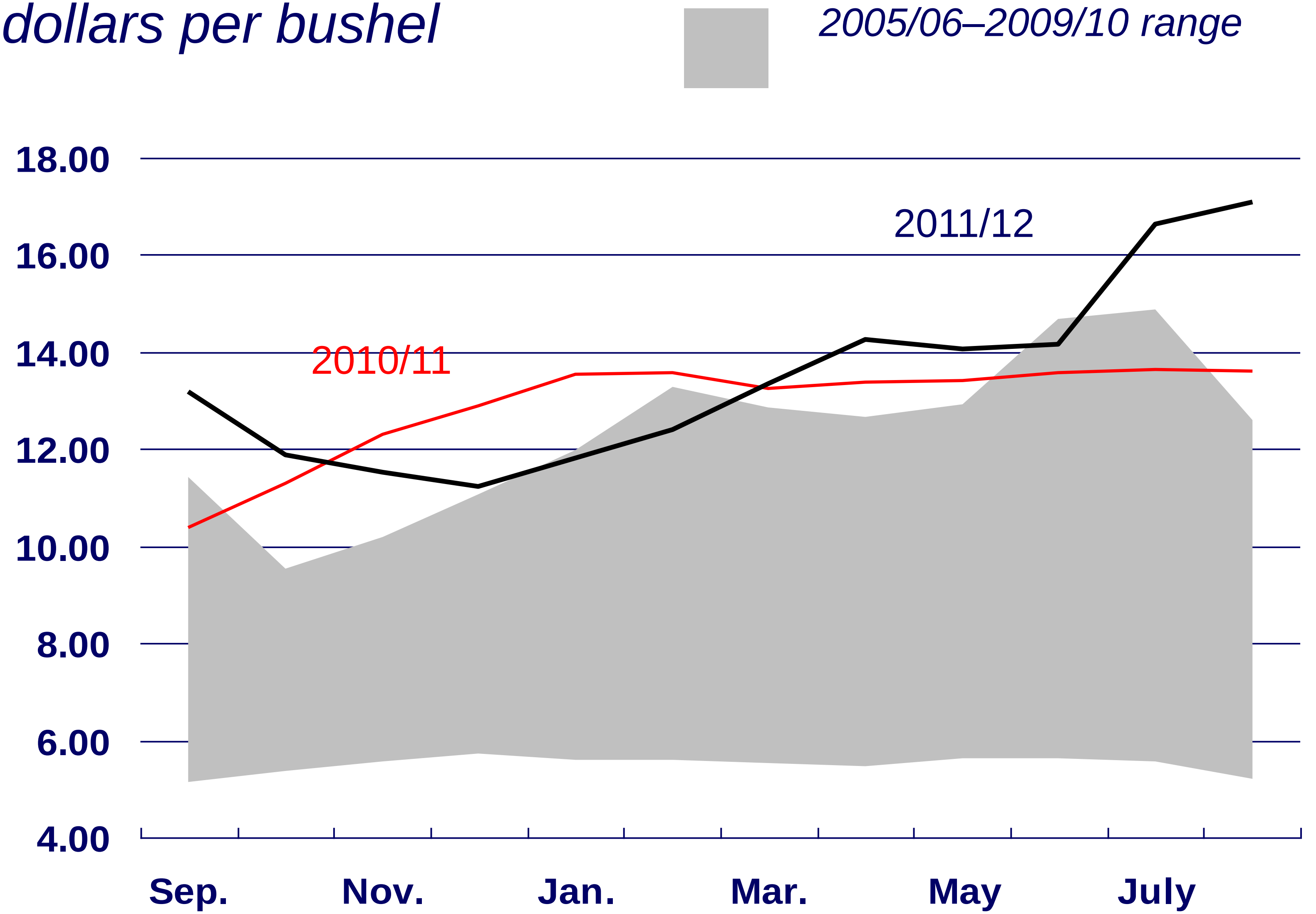
Corn Prices

dollars per bushel



Soybean Prices

dollars per bushel



A brief word on Fed policy

- **The dual mandate**
- **Policy at the zero bound**
- **Quantitative Easing, 1, 2, 3—getting liquidity into the economy, getting the economy back to potential**
- **Factors restraining growth—Global Economic Slowdown (particularly Asia/China), European Crisis, Fiscal Cliff**
- **The issue of commitment**

Summary

- **US performance still faces headwinds. Deleveraging, risks in world economy (Europe meltdown, China/Asia slowdown, oil prices). Fiscal cliff looming**

- **Midwest has benefited from current cycle helping manufacturing and agriculture but future gains will need faster US growth**