

# The U.S. Economic Outlook, Fiscal Issues and European Crisis



FEDERAL RESERVE BANK *of* KANSAS CITY

September 2012

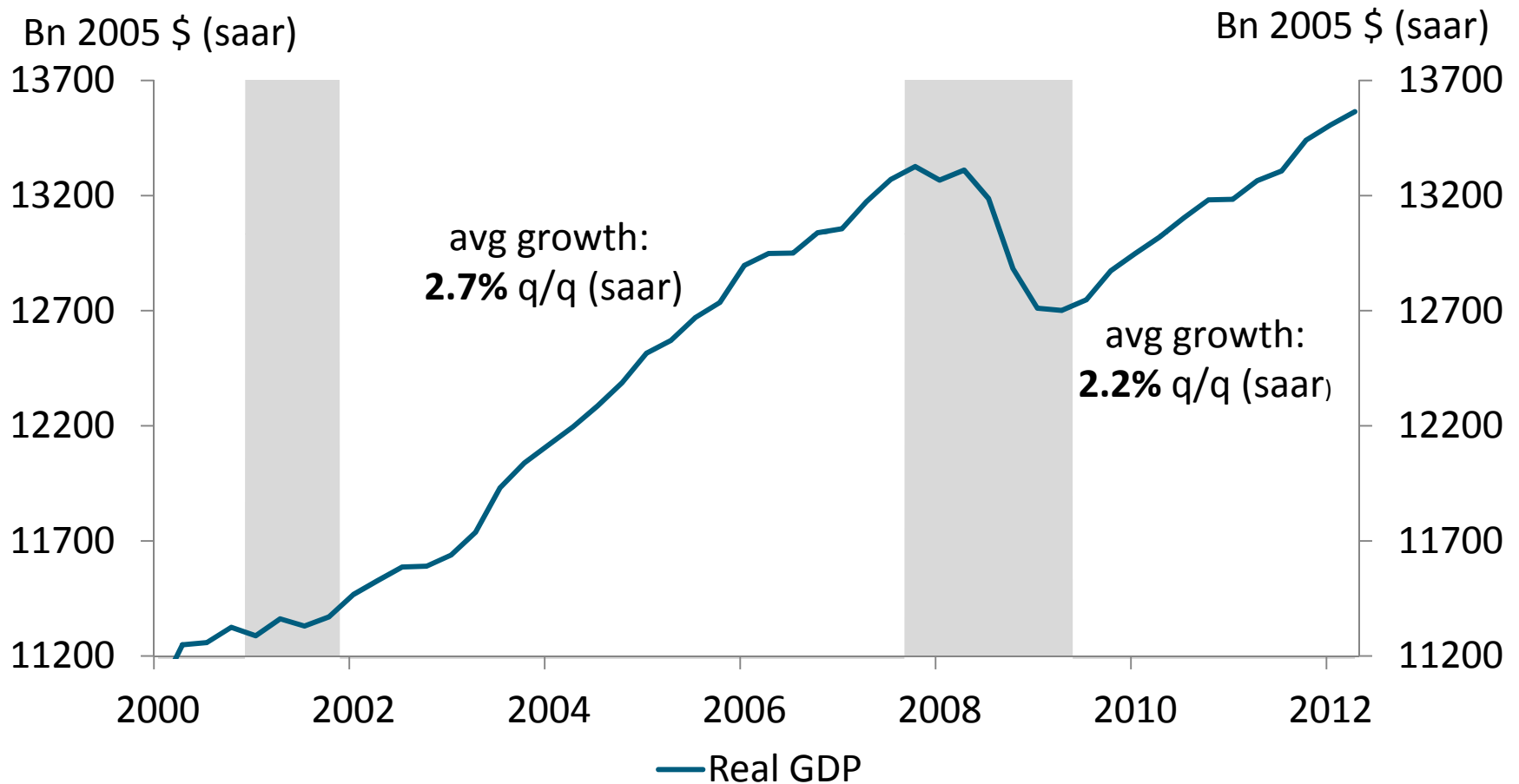
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## Outlook themes

- The US remains in a moderate growth environment
- The unemployment rate is 8.1%, close to its value in January
- The recovery in the housing sector is gaining traction
- Core measures of inflation remain in line with 2% goal, with upside risk to headline measures due to food and energy
- Major risk factors: Europe and the fiscal cliff



## Since the end of the recession, growth has been moderate



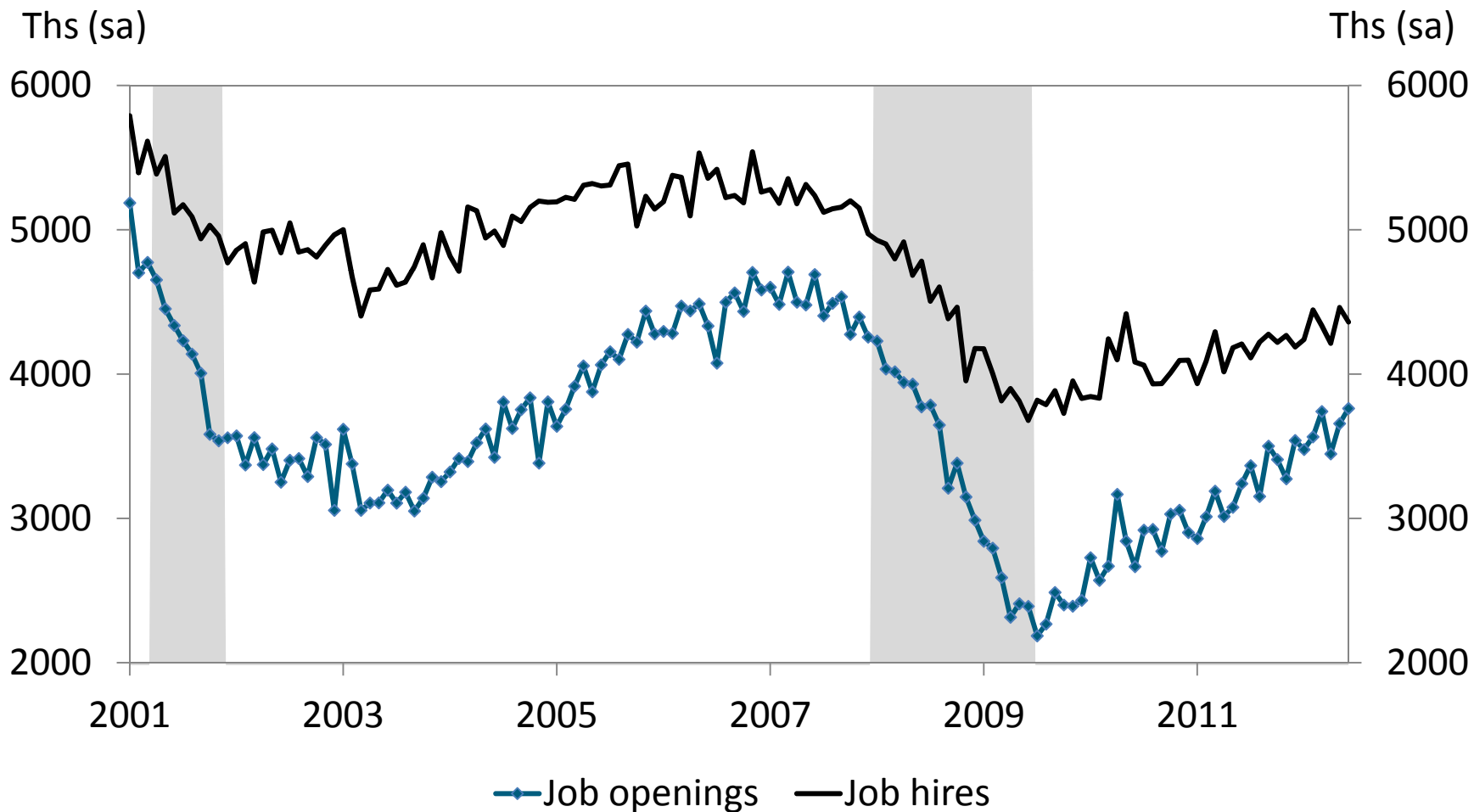
Source: Bureau of Economic Analysis, Haver Analytics

## The unemployment rate is little changed since January



Source: Haver Analytics, Bureau of Labor Statistics

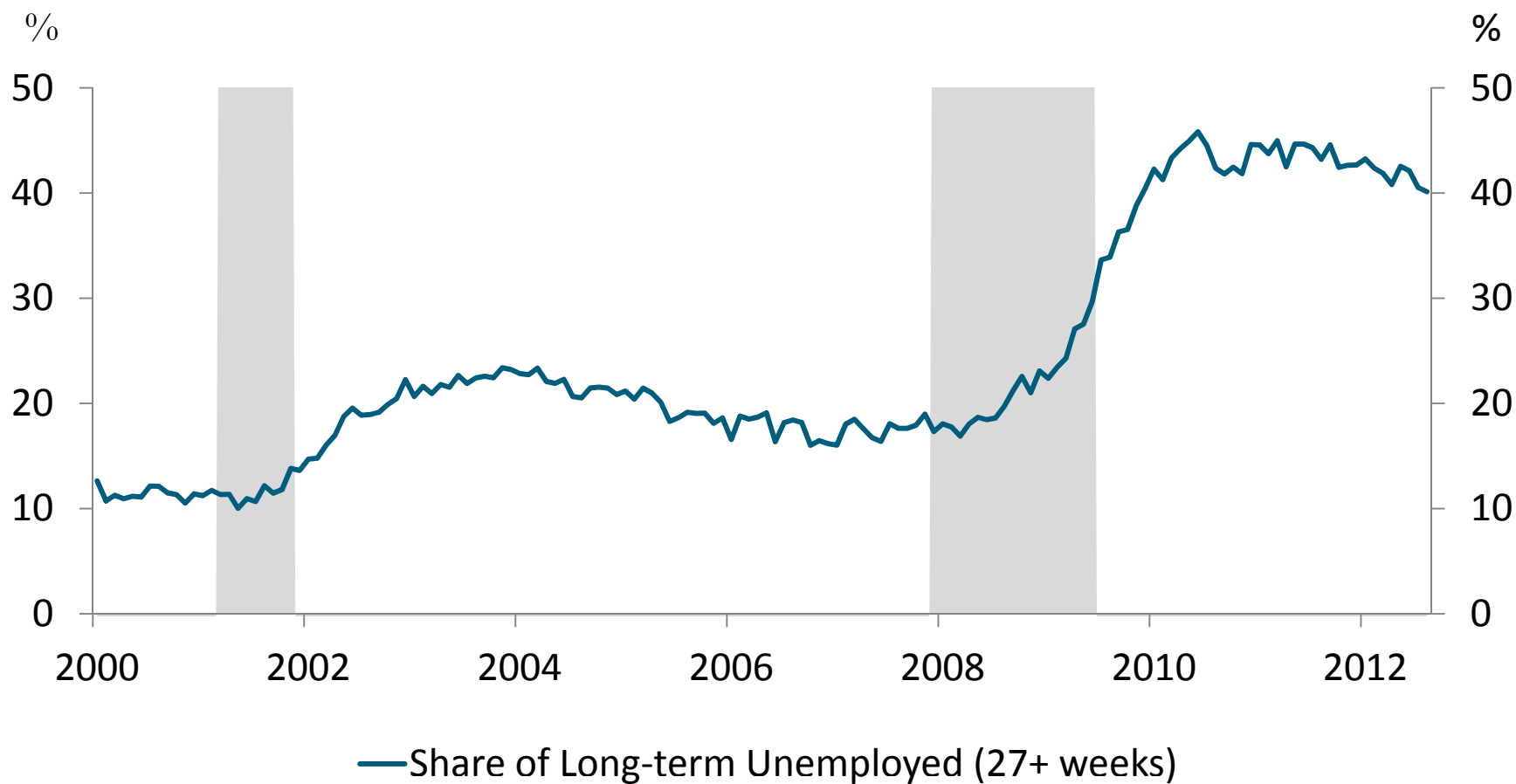
# Gains in job openings continue to outpace gains in hiring



Source: Bureau of Labor Statistics, Haver Analytics



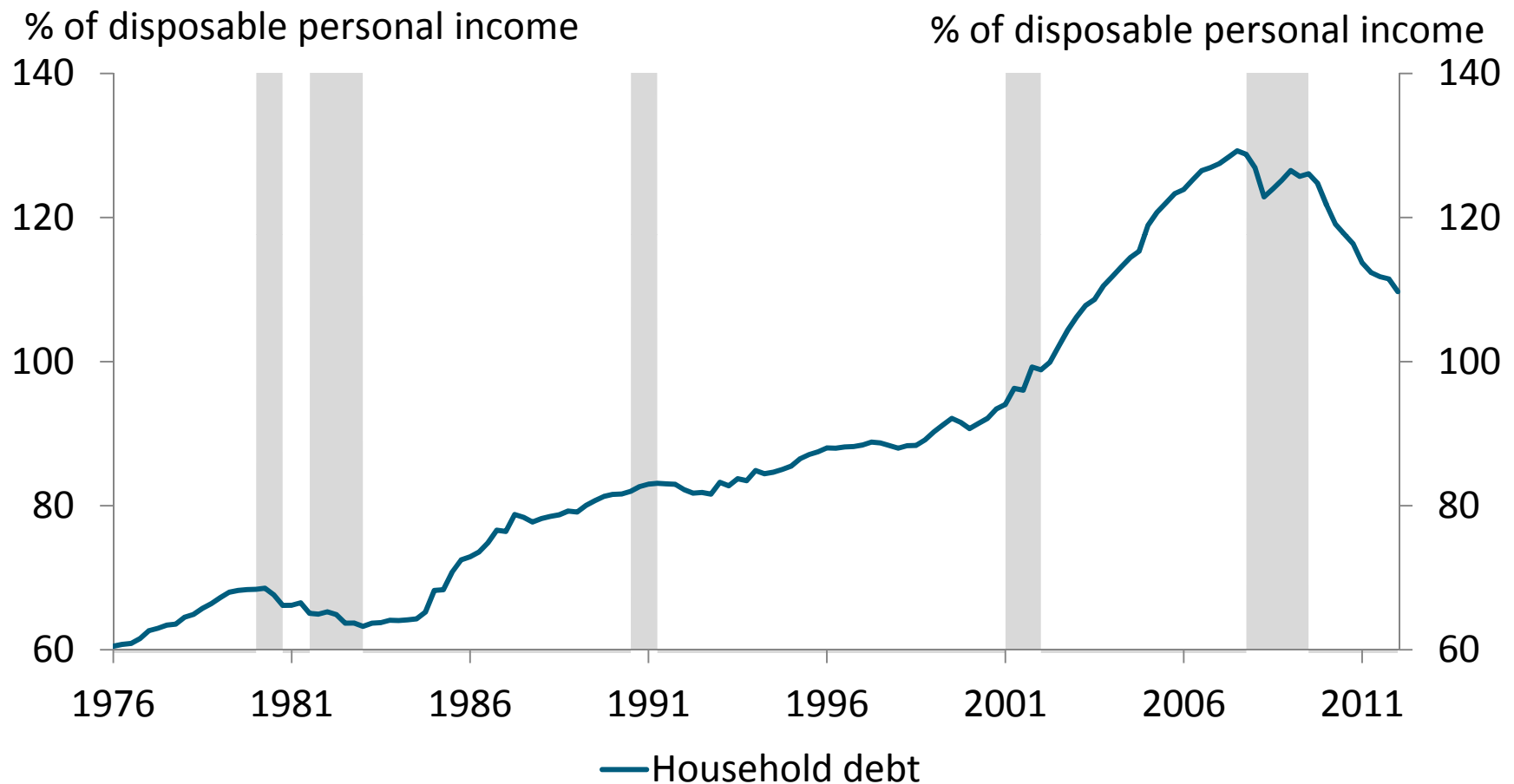
## Long-term unemployment remains elevated



Source: Bureau of Labor Statistics, Haver Analytics

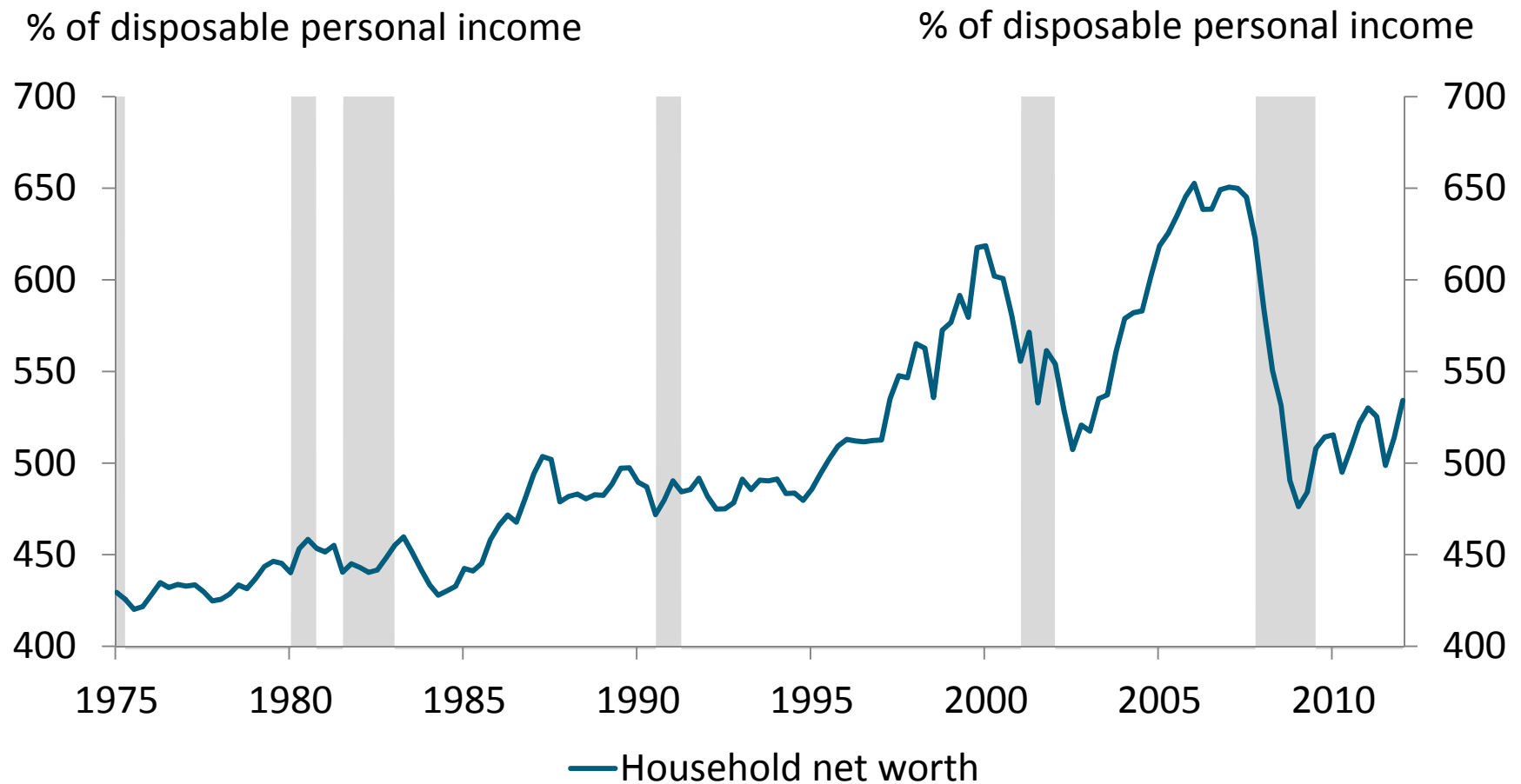


## Consumers still remain heavily indebted, but have made substantial progress in deleveraging the past few years



Source: Federal Reserve Board, Bureau of Economic Analysis, Haver Analytics

# Household wealth has fluctuated over the past 15 years, but remains above its level from 1985-1995

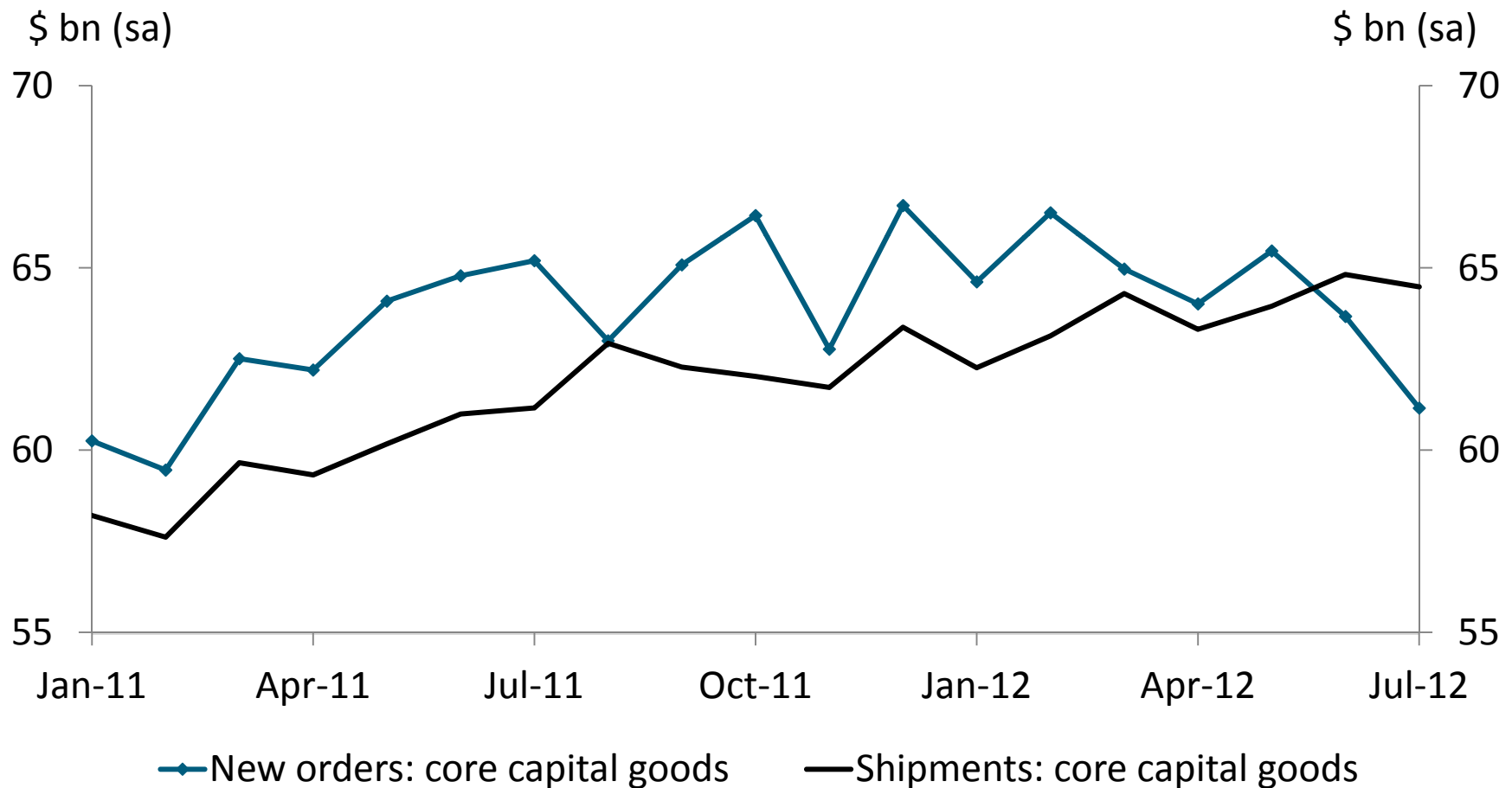


Source: Federal Reserve Board, Bureau of Economic Analysis, Haver Analytics



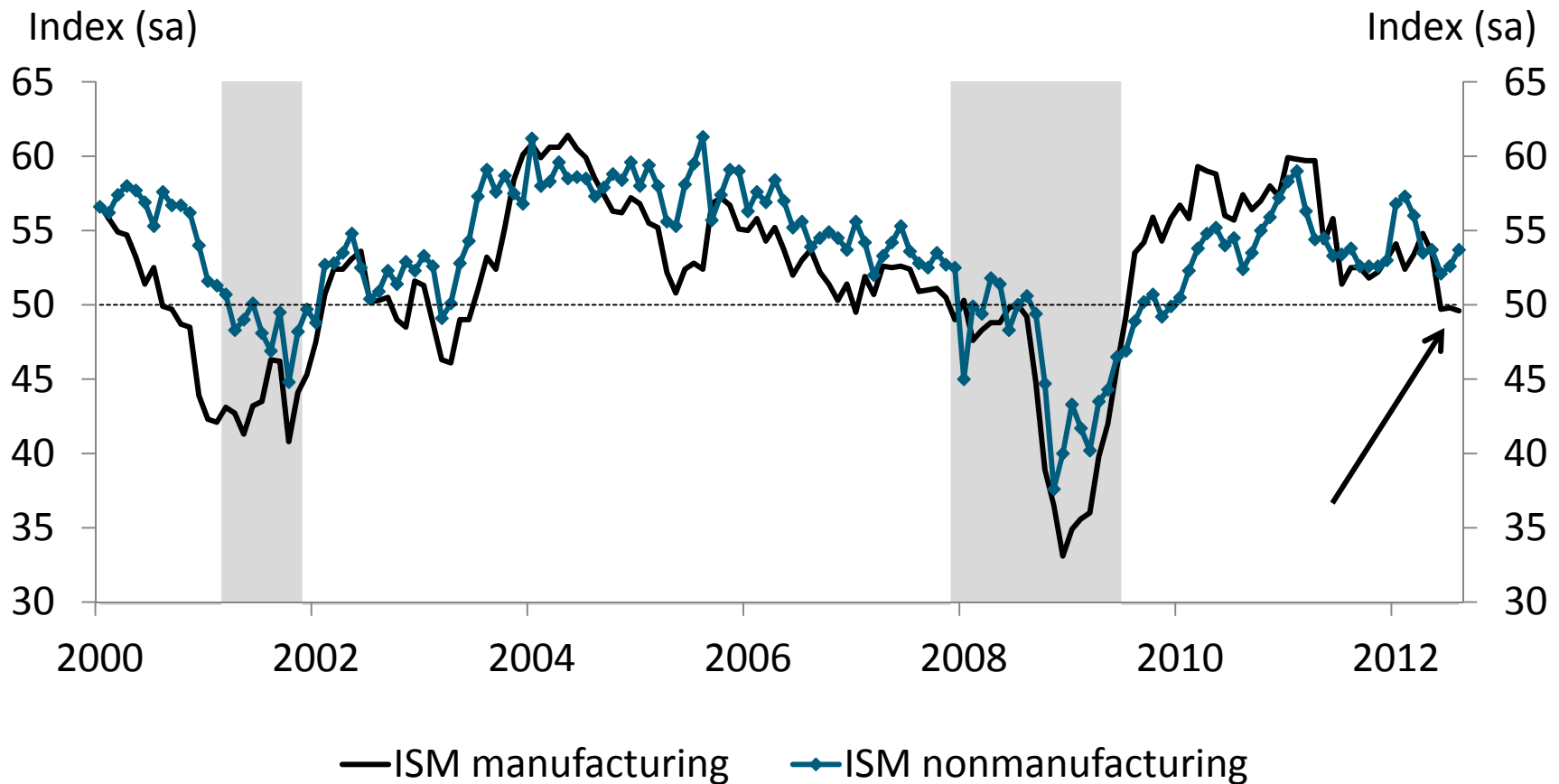


## Companies appear cautious about their capital spending, as orders for new capital equipment have been declining



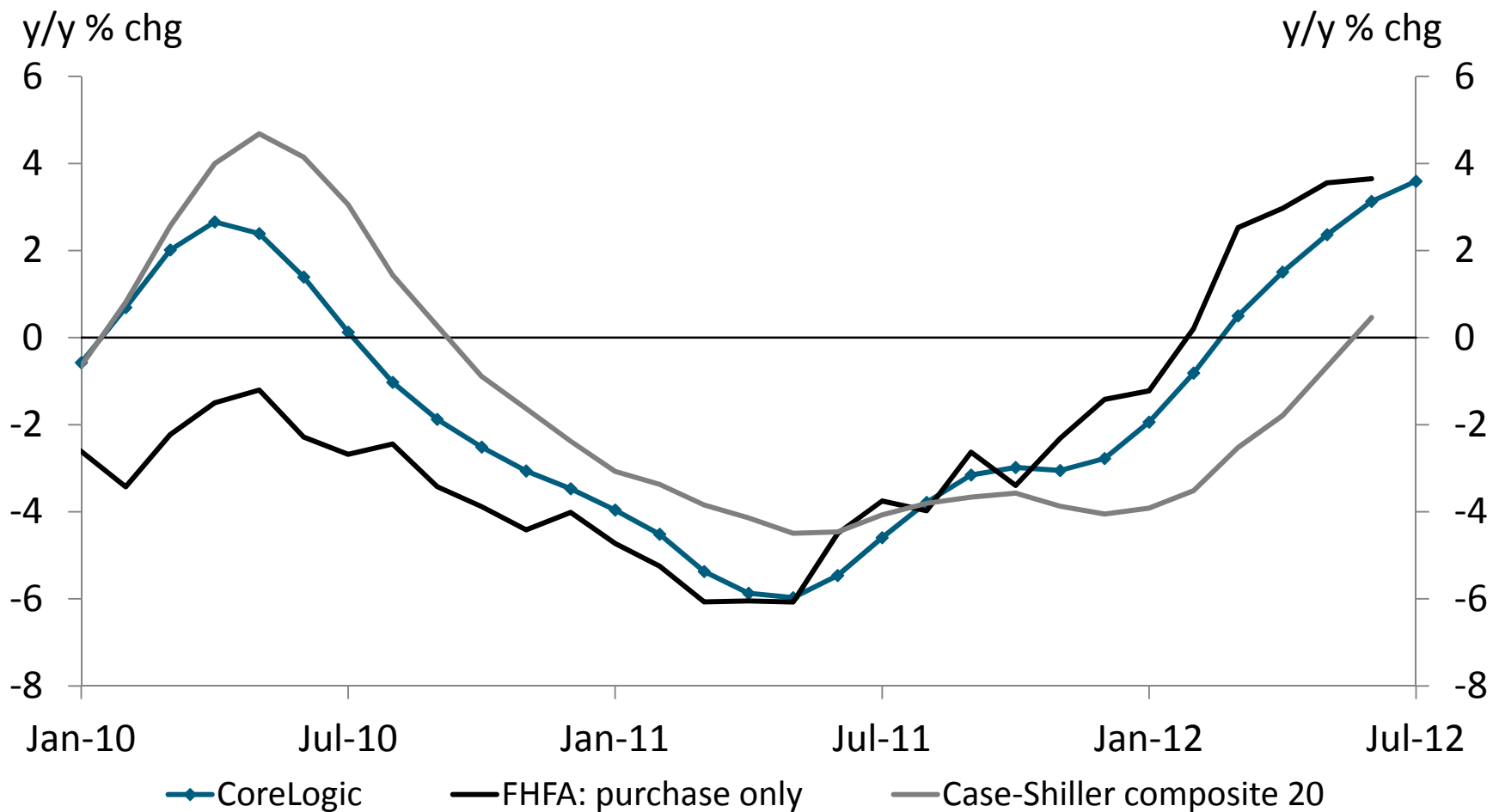
Source: Census Bureau, Haver Analytics

# Manufacturing activity has slowed according to the ISM, but nonmanufacturing activity continues to expand



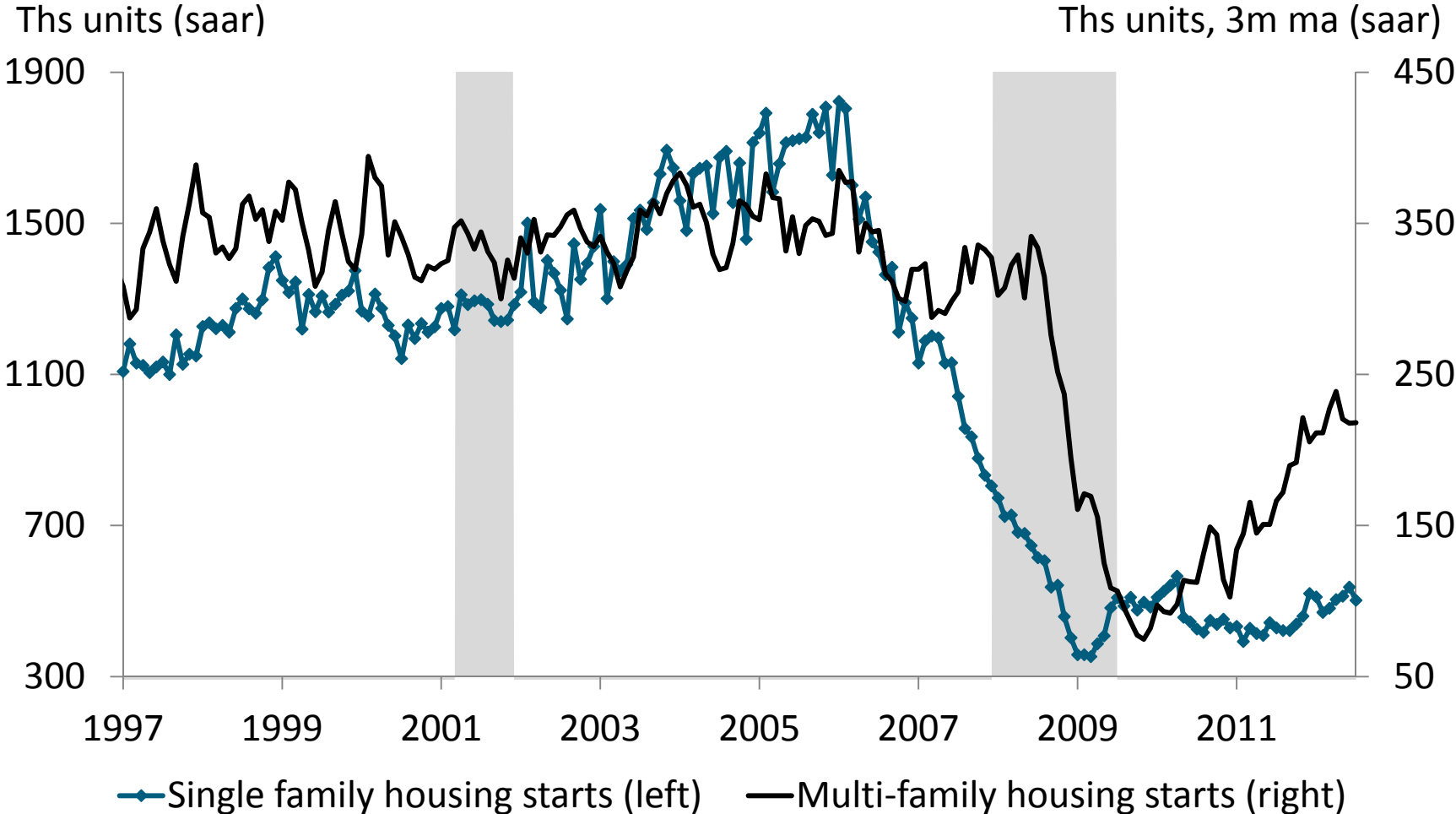
Source: Haver Analytics, Institute for Supply Management

# House prices are showing convincing signs of increasing



Source: CoreLogic/ Haver Analytics, Federal Housing Finance Agency, S&P/Fiserv/MacroMarkets LLC

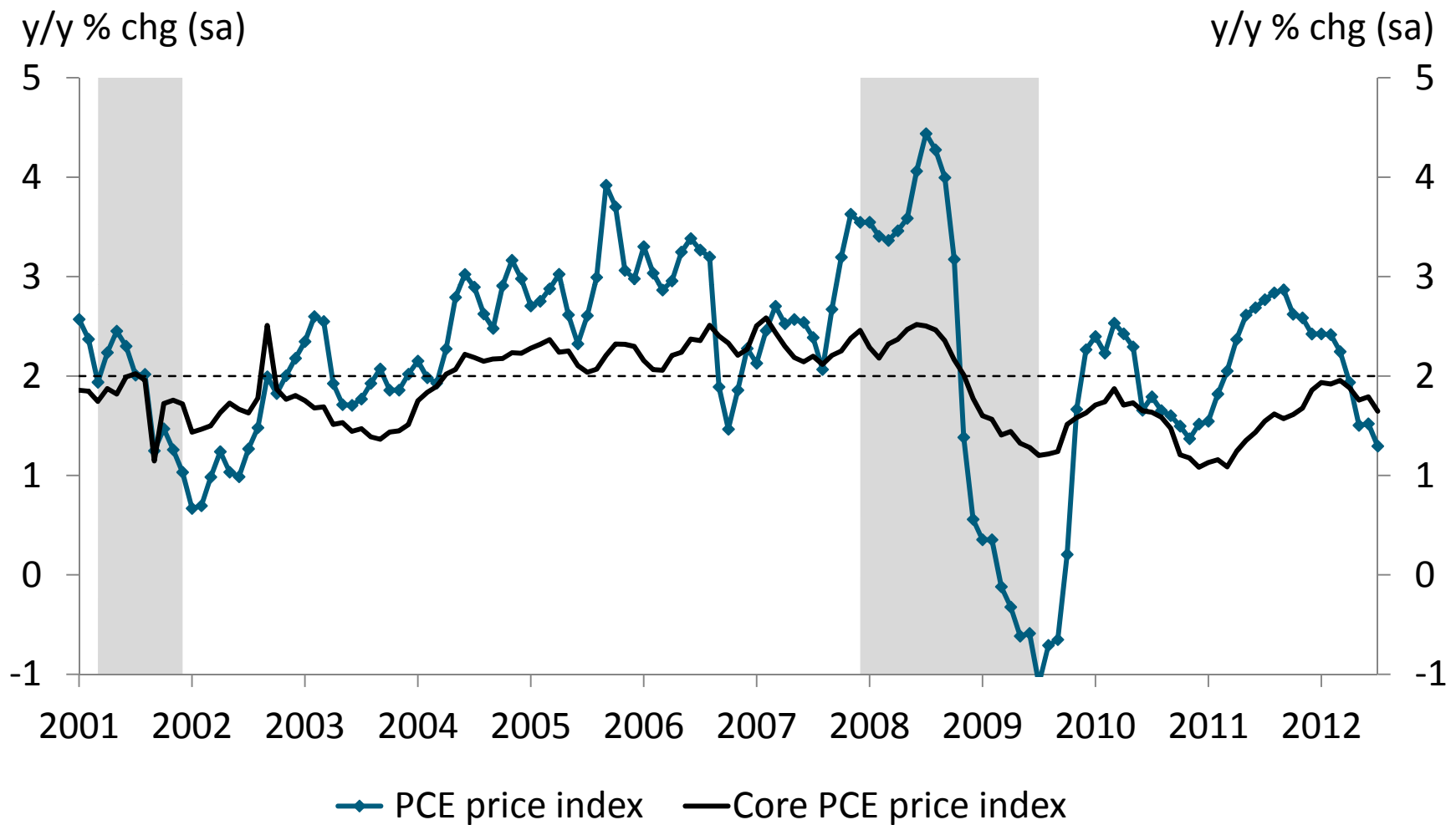
# Construction of multi-family housing units continues to trend higher



Source: Census Bureau, Haver Analytics



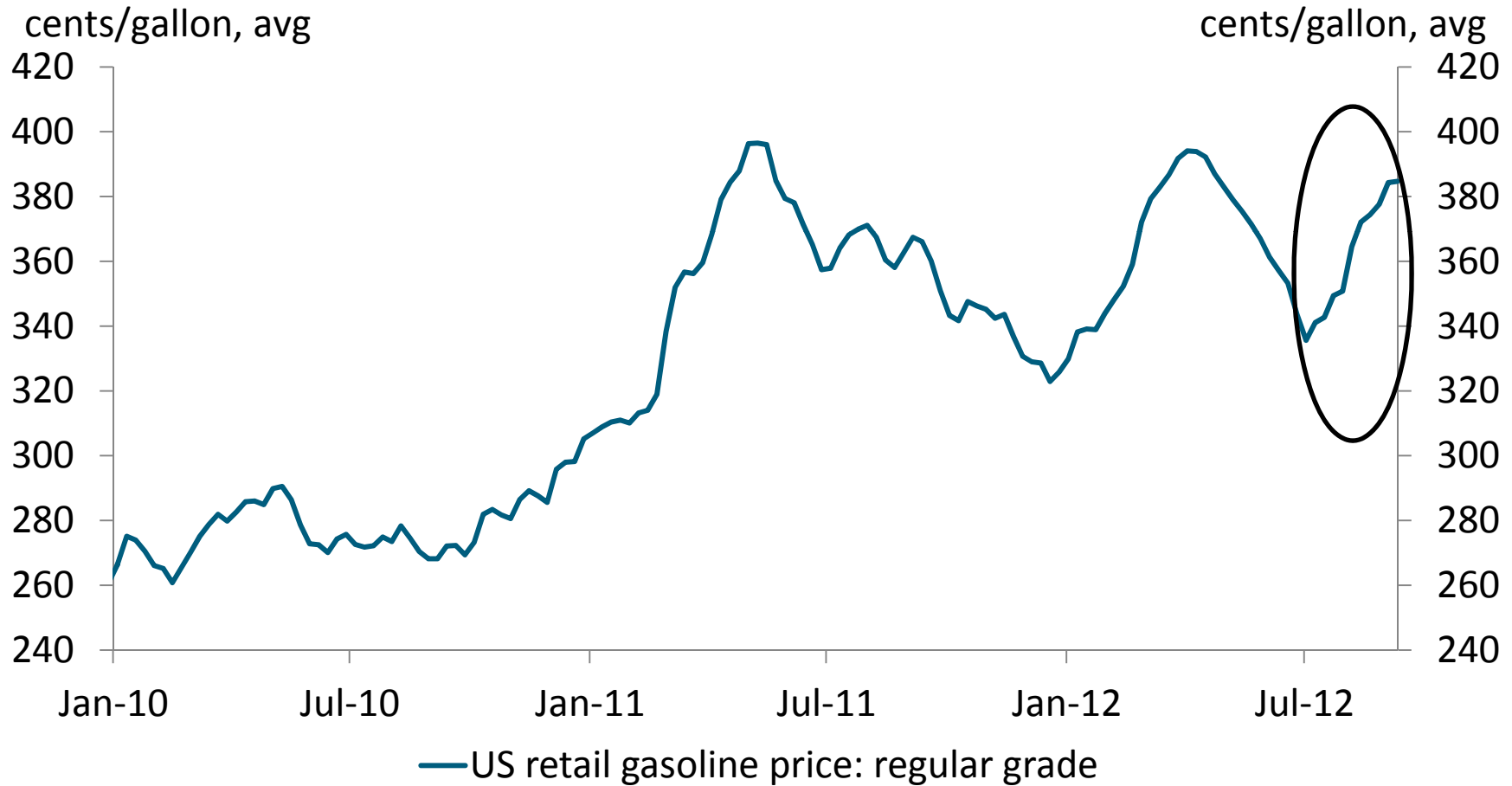
## Inflation is running a bit below 2%



Source: Bureau of Economic Analysis



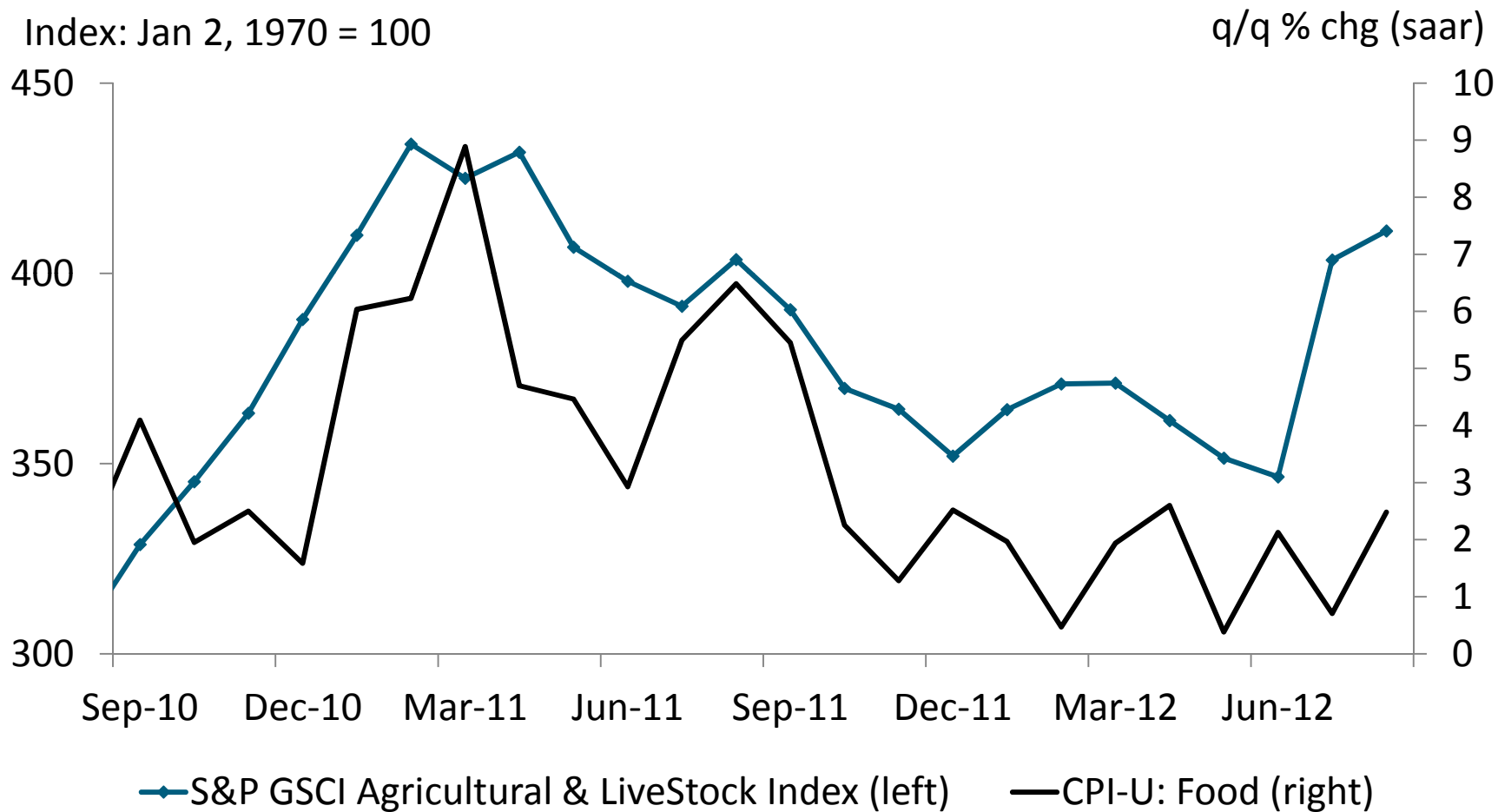
## Retail gasoline prices have moved up sharply over the past month



Source: Energy Information Administration, Haver



# Retail food prices are likely to move higher in coming months



Source: Standard & Poor's, Bureau of Labor Statistics, Haver Analytics



## **Risk Factor #1: The European trilemma**

Sovereign debt crisis – Poor fiscal management and rising bond yields in some countries threaten fiscal sustainability.

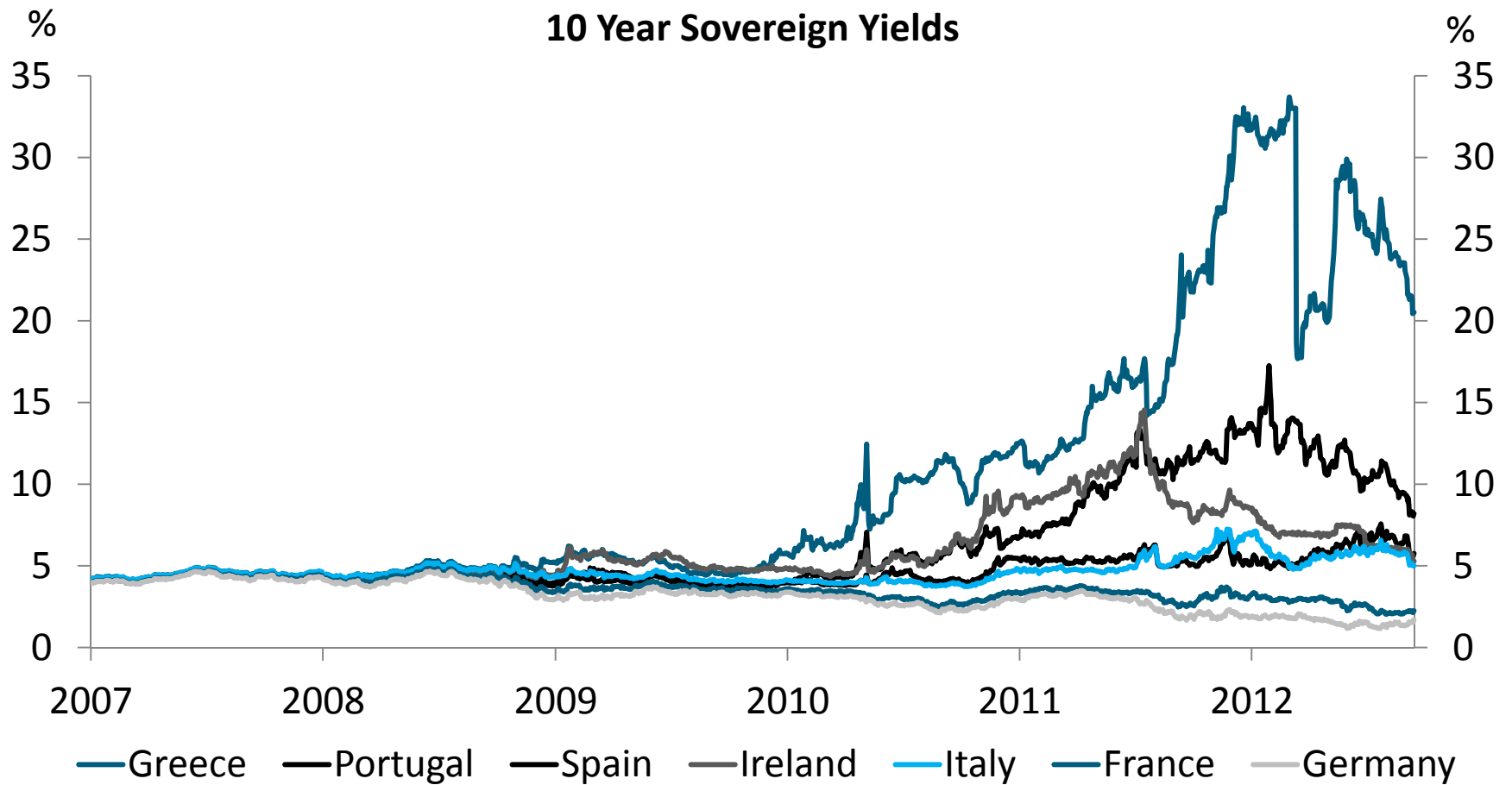
Banking crisis – A property bust in some markets and a decline in sovereign debt values have impaired the balance sheets of some Euro zone banks.

Slow growth and recession – Tighter fiscal policy and financial conditions, plus the uncertain climate, is weighing on European growth.





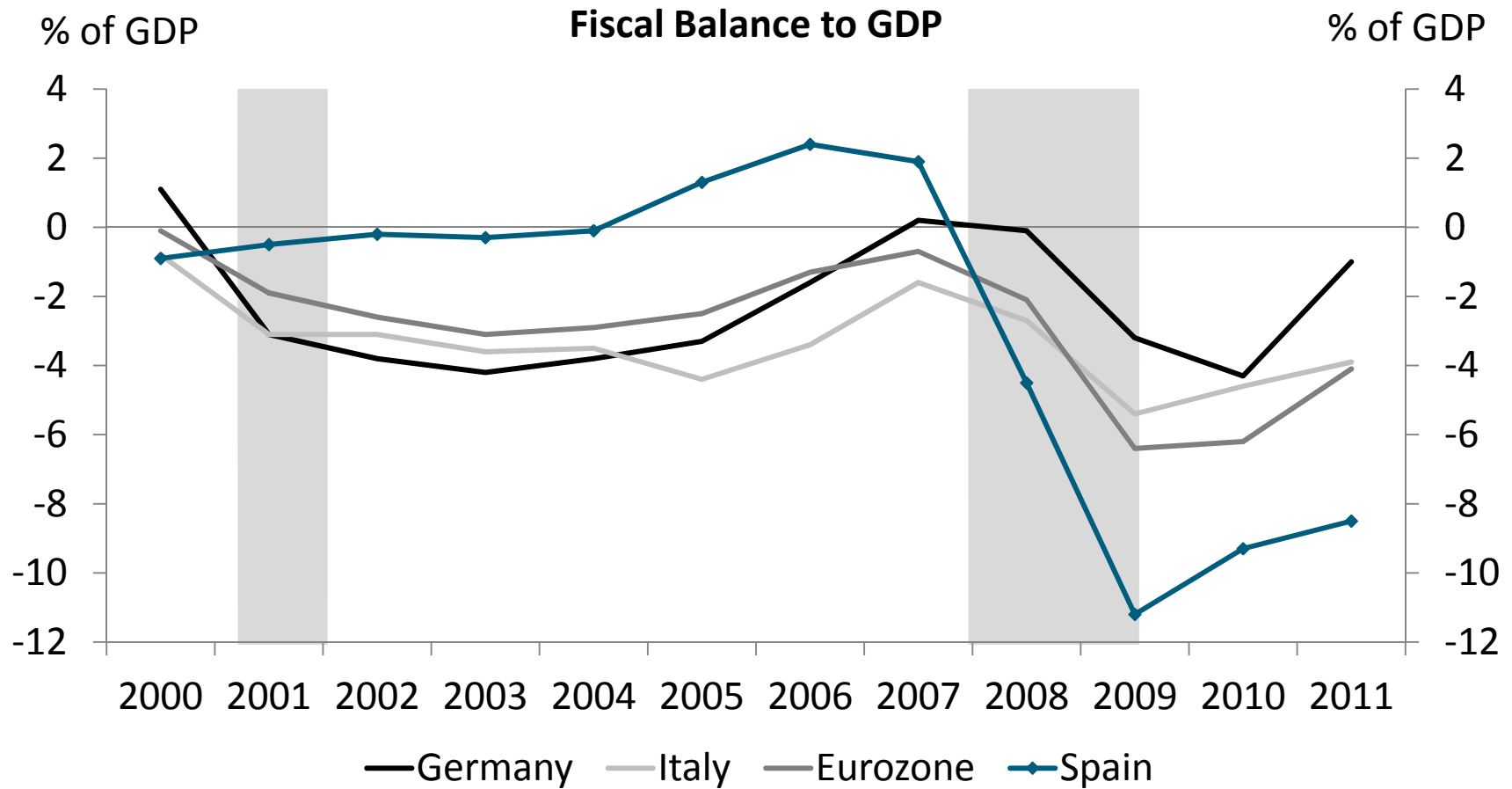
# Sovereign yields have diverged



Source: Bloomberg



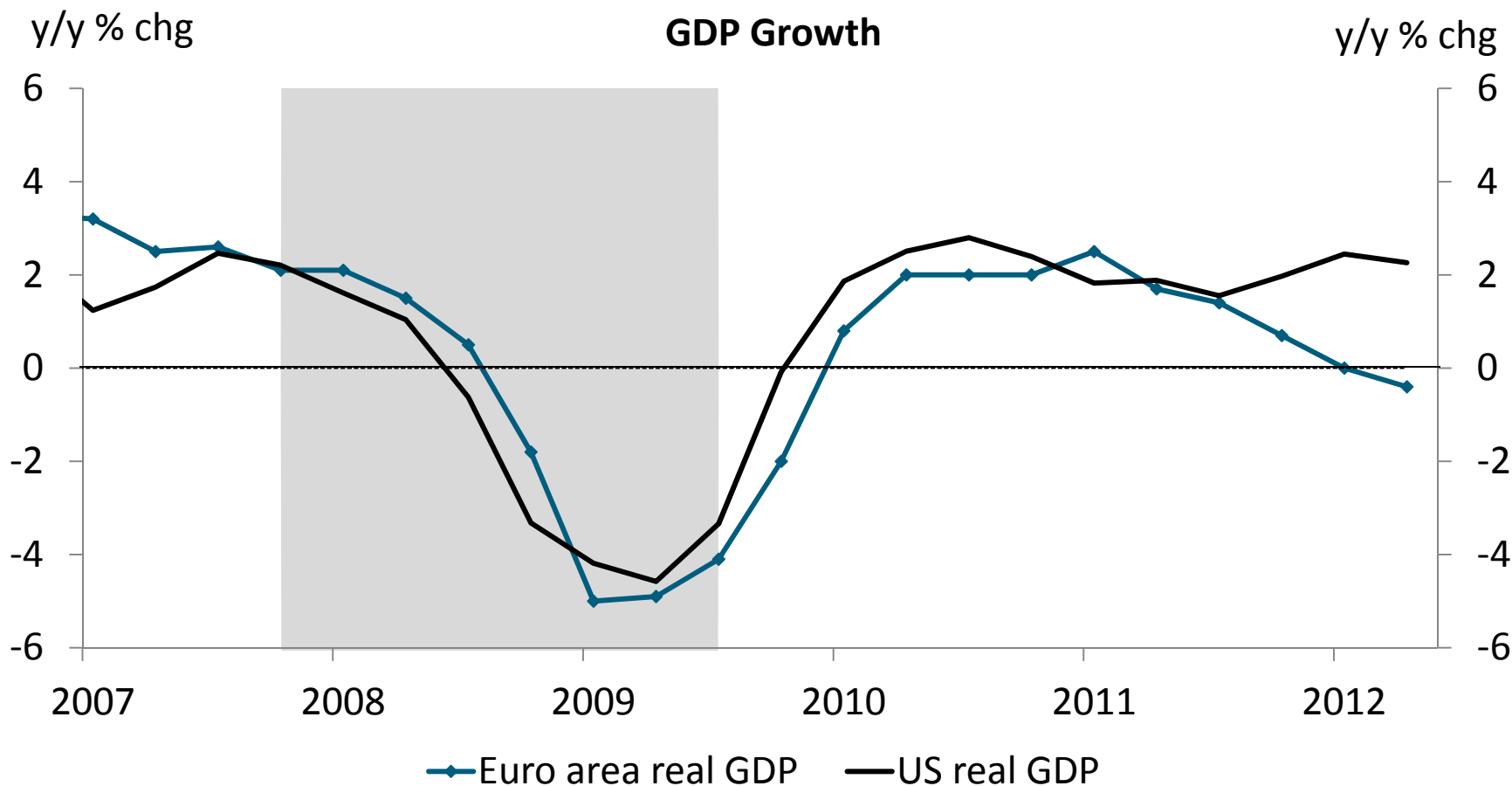
## The rise in sovereign yields reflects concerns over fiscal sustainability



Source: Bloomberg, Eurostat

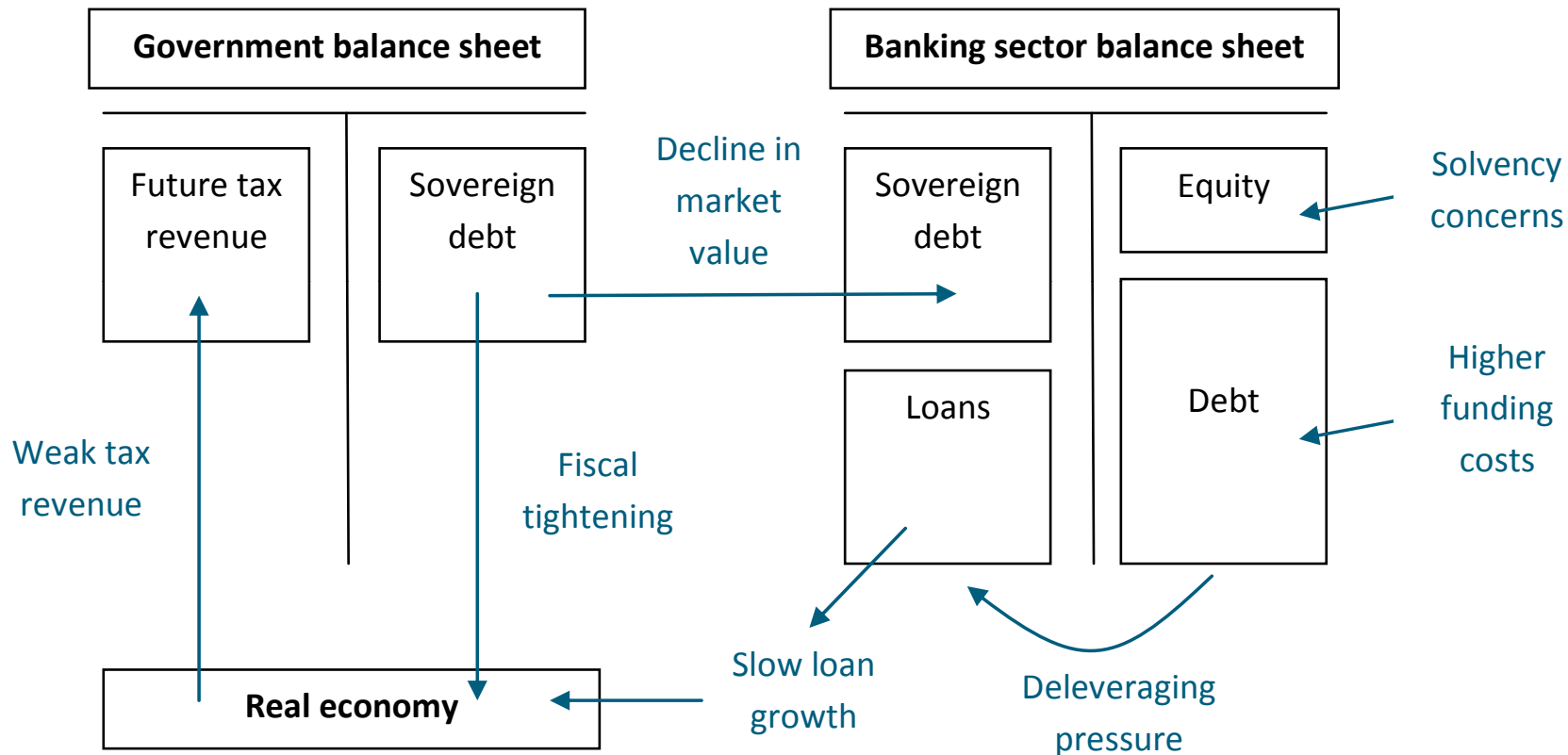


# Euro area and US growth looked similar during the recession, though Euro area growth has now stalled

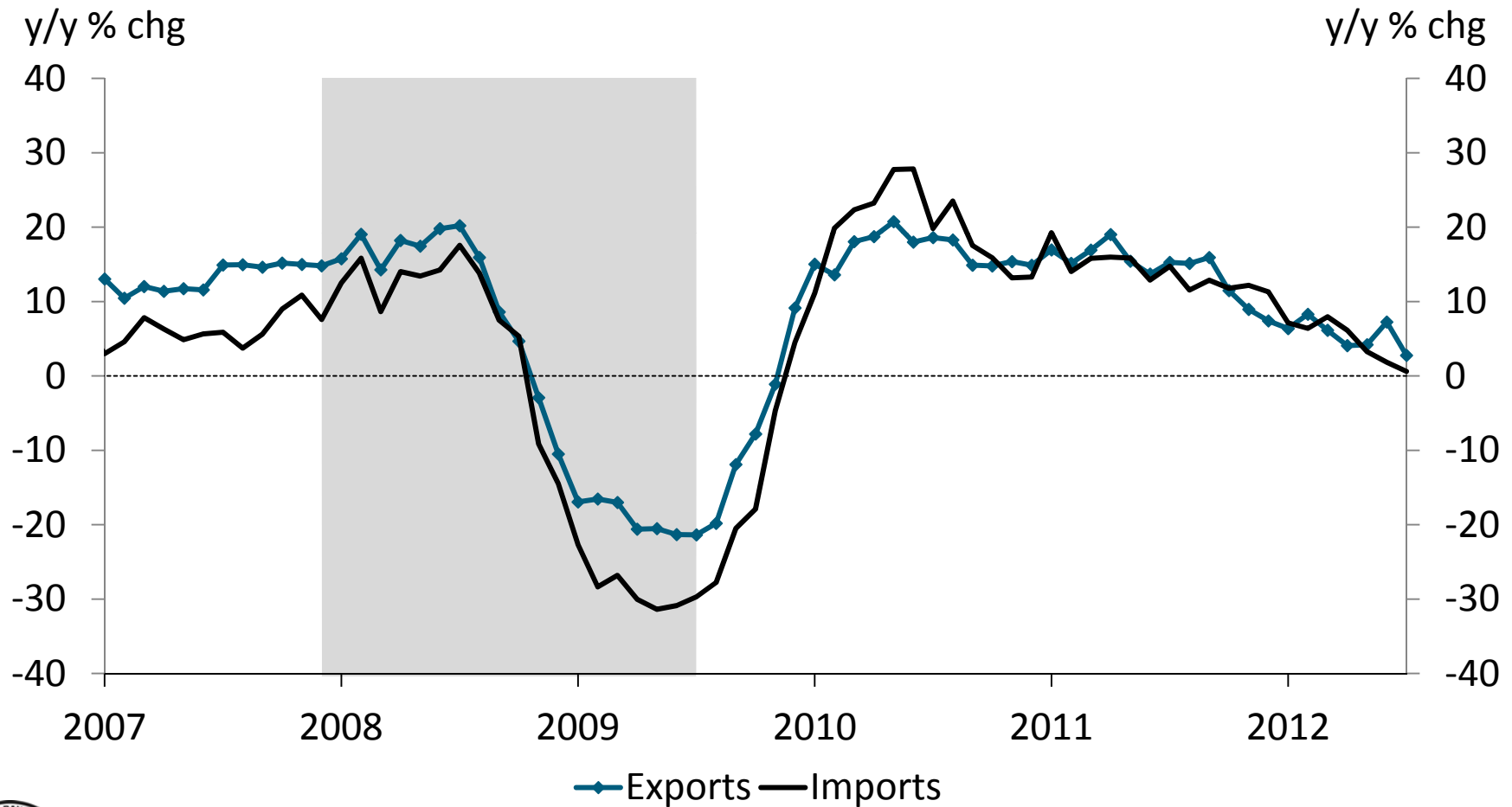


Source: Bureau of Economic Analysis, Statistical Office of the European Communities, Haver Analytics

# A challenging negative feedback cycle...



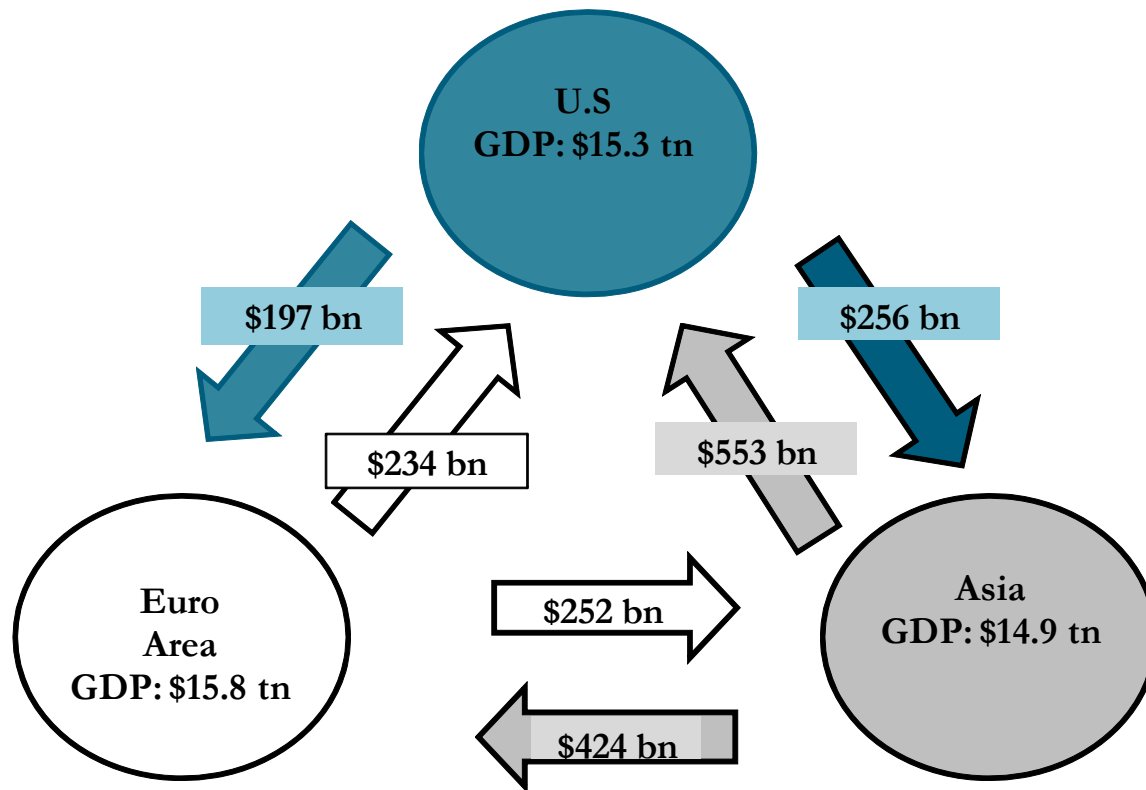
## U.S. trade growth has been steadily slowing



Source: Haver Analytics, Census Bureau

# The slowing in trade activity is likely reflecting the Eurozone crisis

Trade Flows of Goods as a Share of US GDP



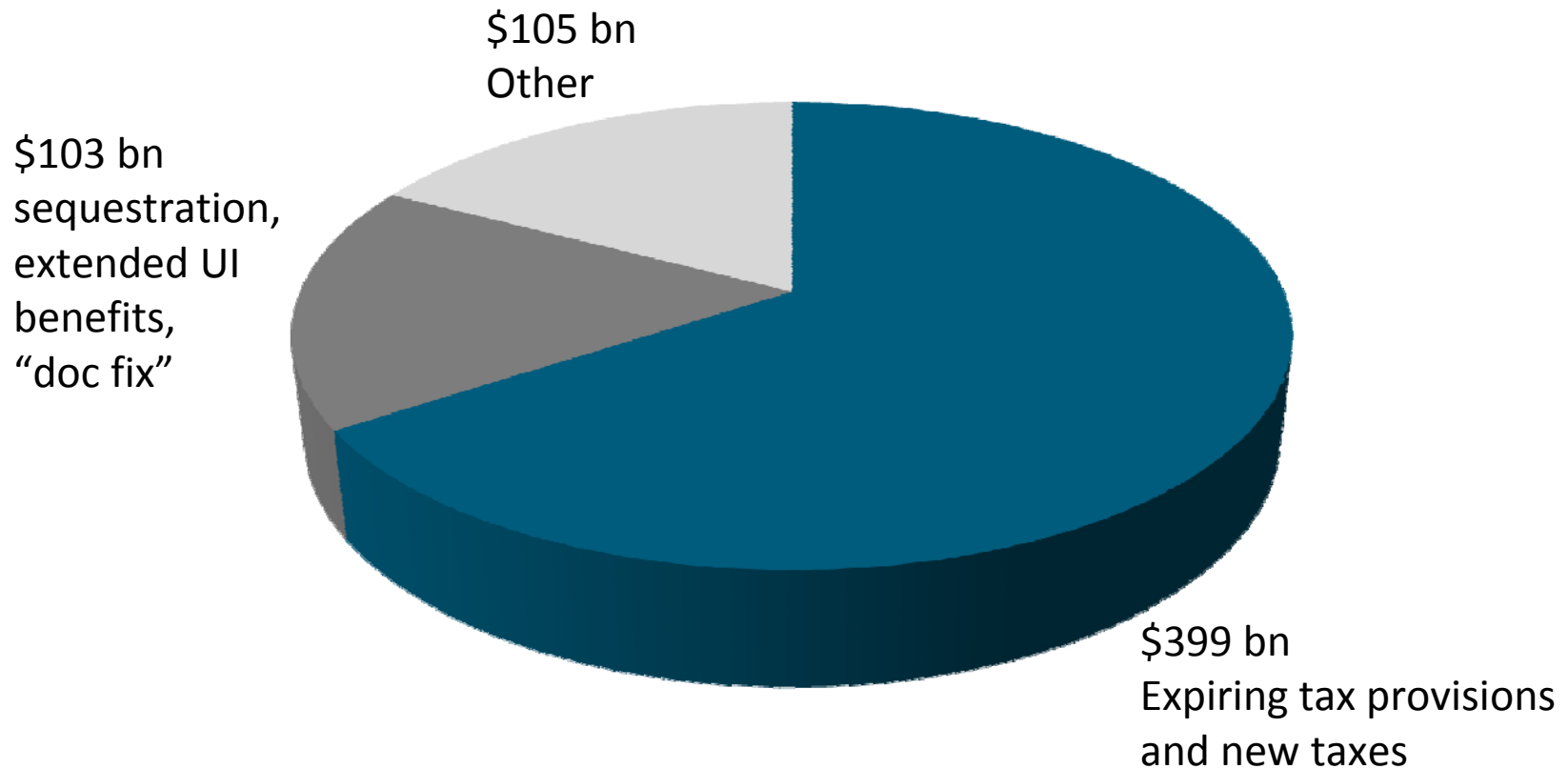
Source: IMF

## Risk Factor #2: US fiscal policy

- According to the Congressional Budget Office, realizing the full impact of the “fiscal cliff” will cause a recession in the first half of 2013
- Fiscal deficits are likely to improve in the next few years, but will also remain large by historical standards
- Debt accumulation will continue at an unsustainable pace and without fiscal reform, will likely accelerate later this decade



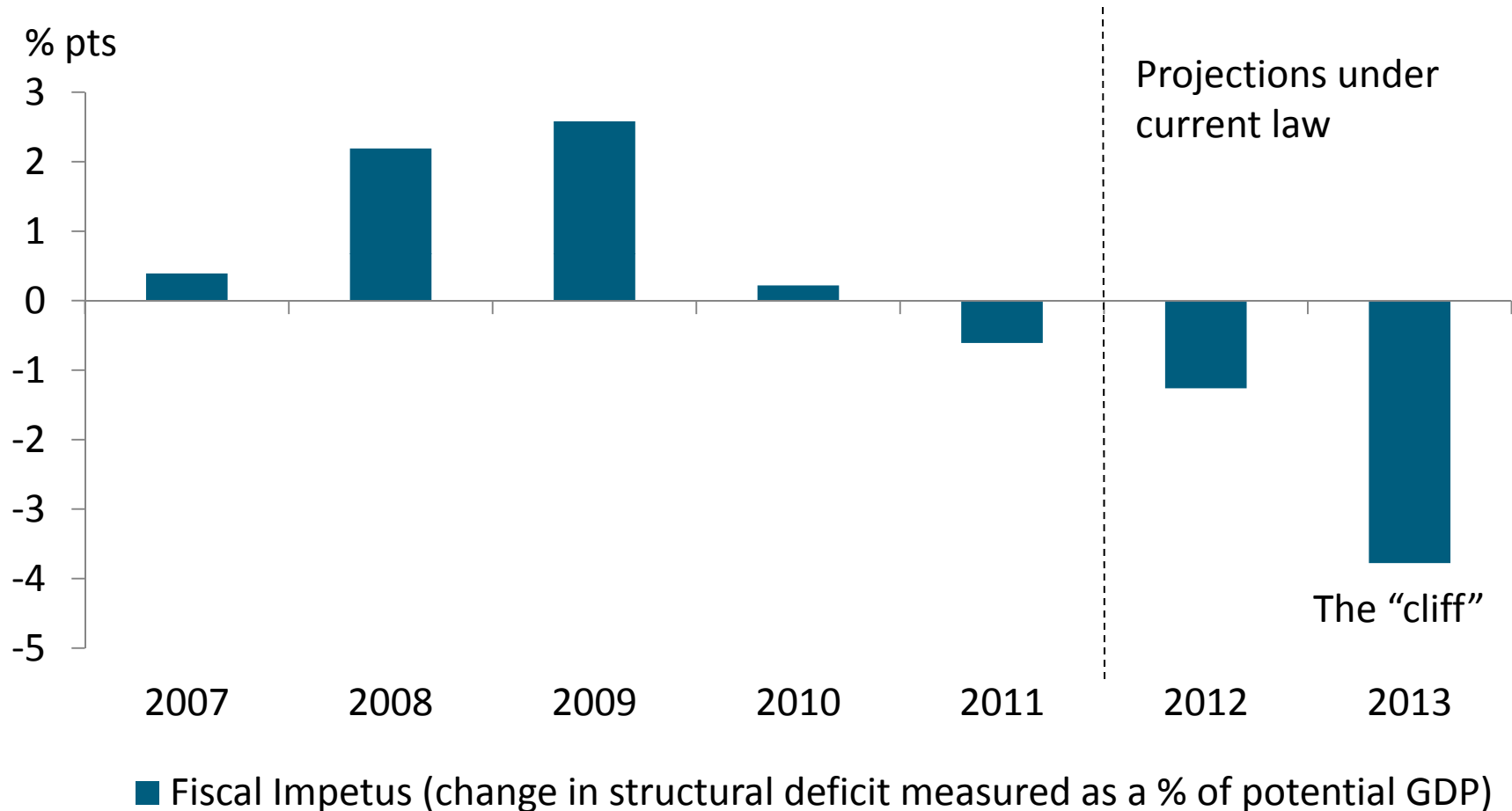
## Without Congressional action, US federal fiscal policy will tighten by about \$560bn in 2013



Source: Congressional Budget Office



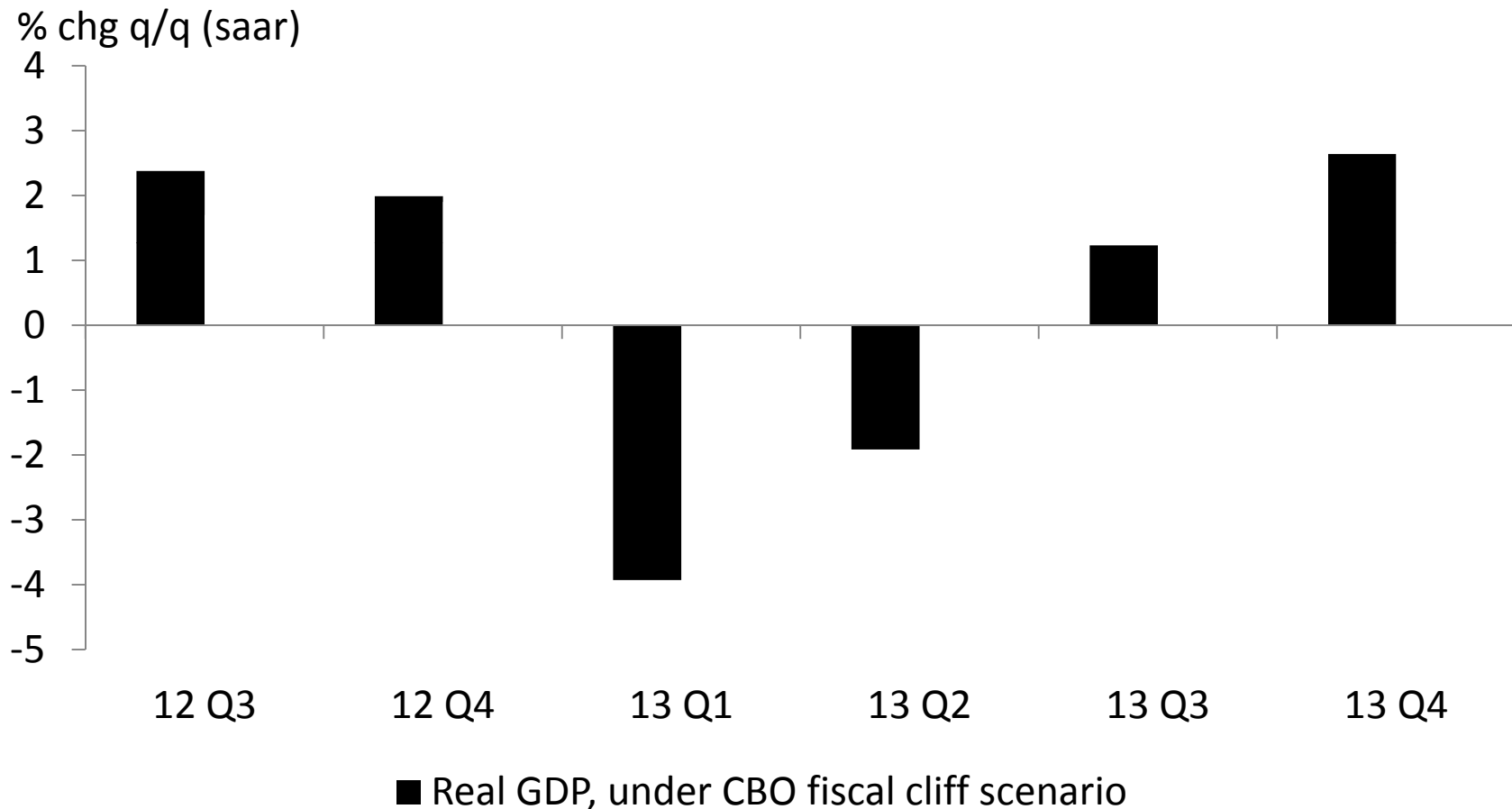
## The “cliff” is nearly 4% of GDP and would be one of the sharpest fiscal contractions in over 50 years



Source: International Monetary Fund, Haver Analytics, Author's calculations



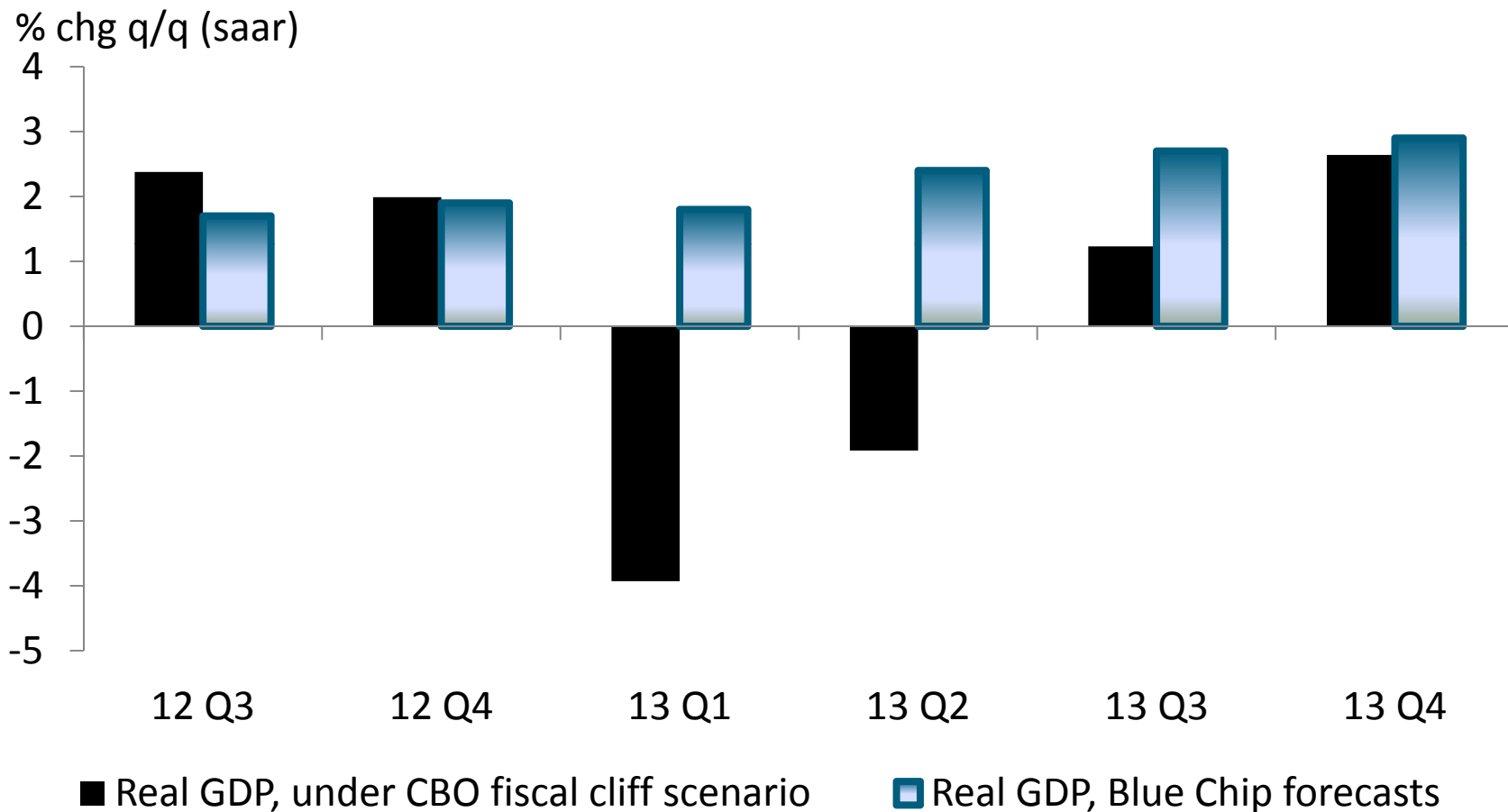
## The Congressional Budget Office is forecasting a recession under current law (i.e. the fiscal cliff is fully realized)



Source: Congressional Budget Office, Haver Analytics



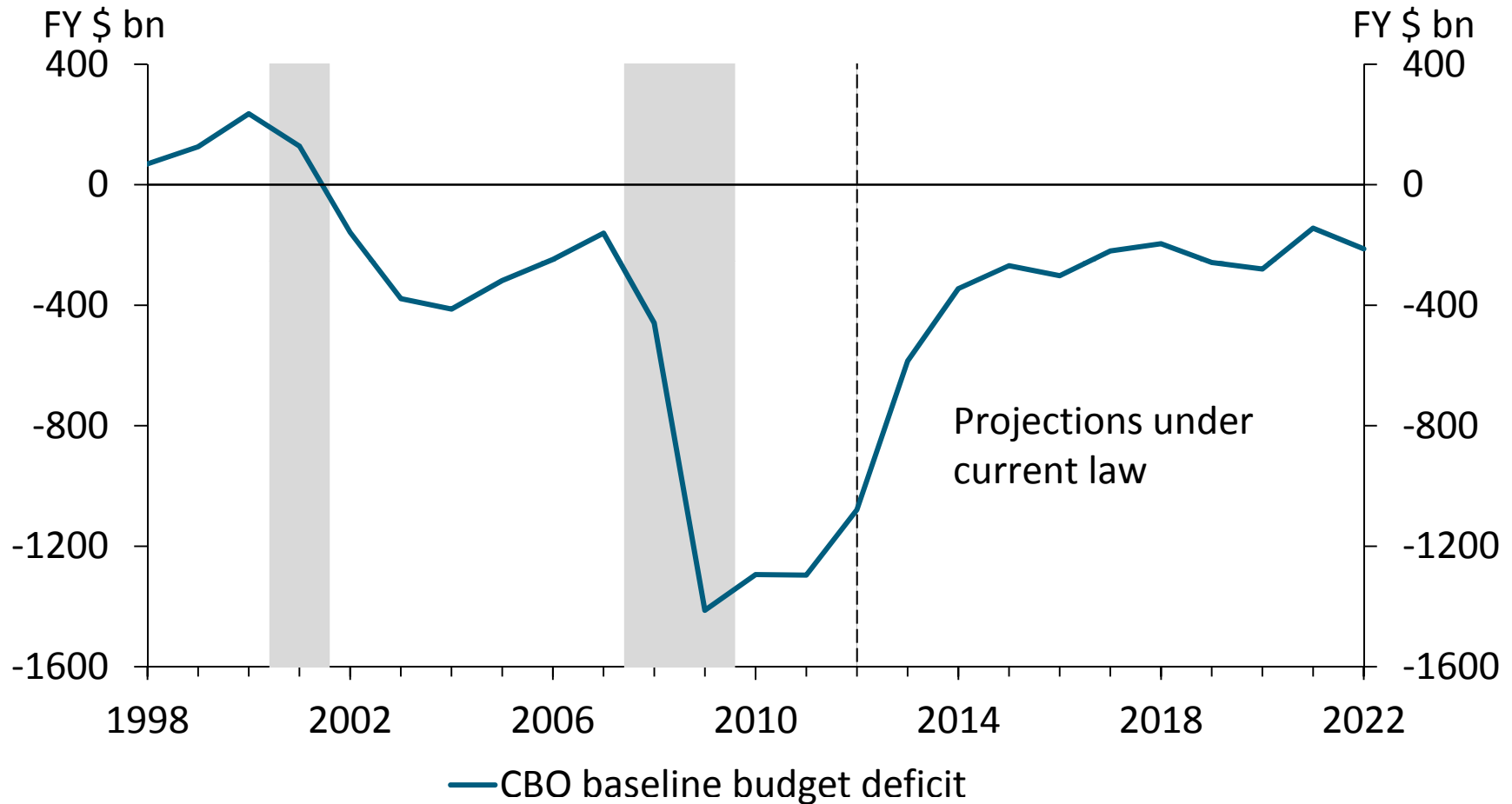
## Private forecasters project continued growth and presumably, that the fiscal cliff will be avoided



Source: Blue Chip Economic Indicators, Congressional Budget Office, Haver Analytics

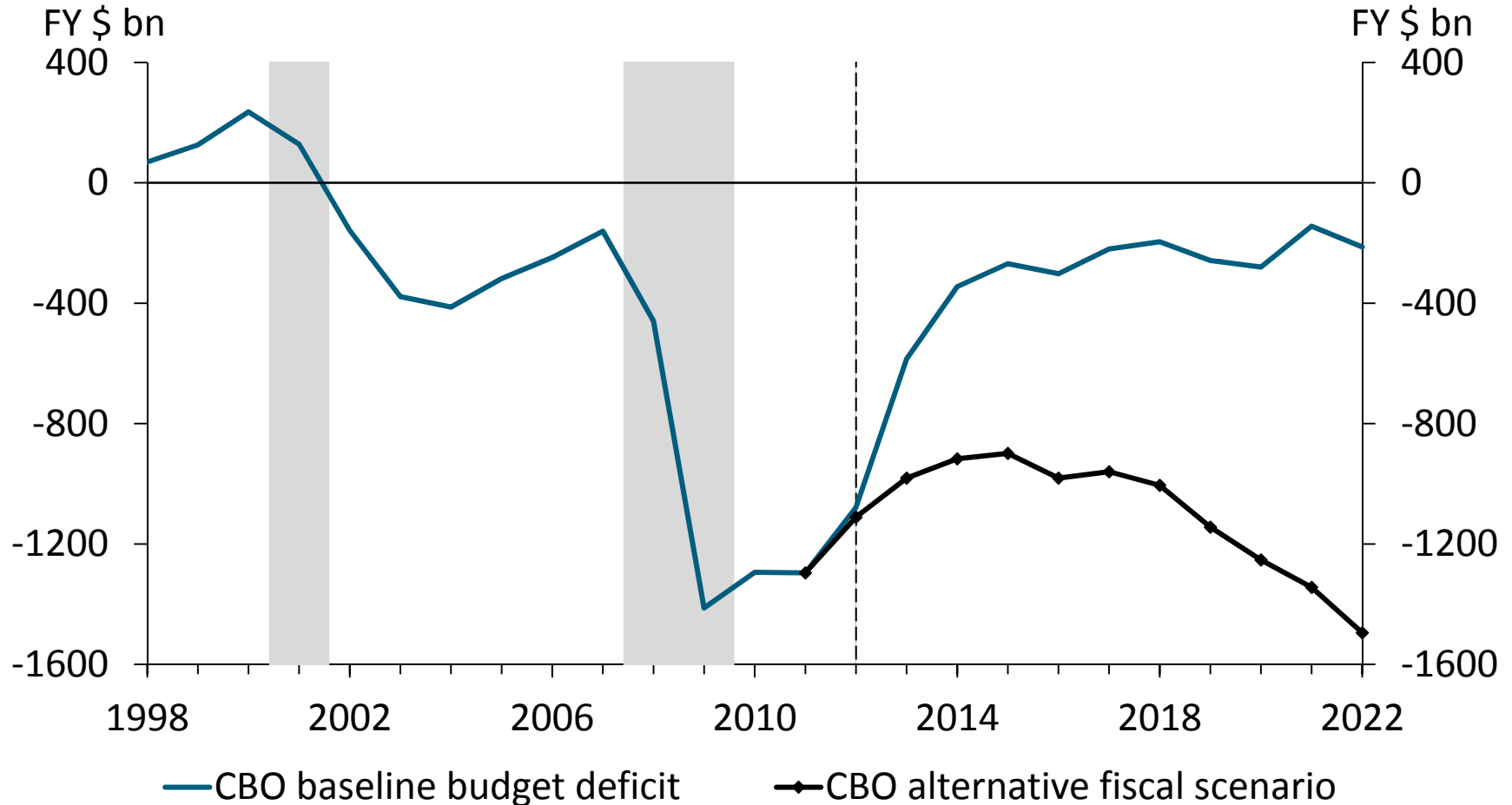


# Hitting the cliff may be undesirable in terms of growth, but would notably decrease deficits in the coming years



Source: Congressional Budget Office, Haver Analytics

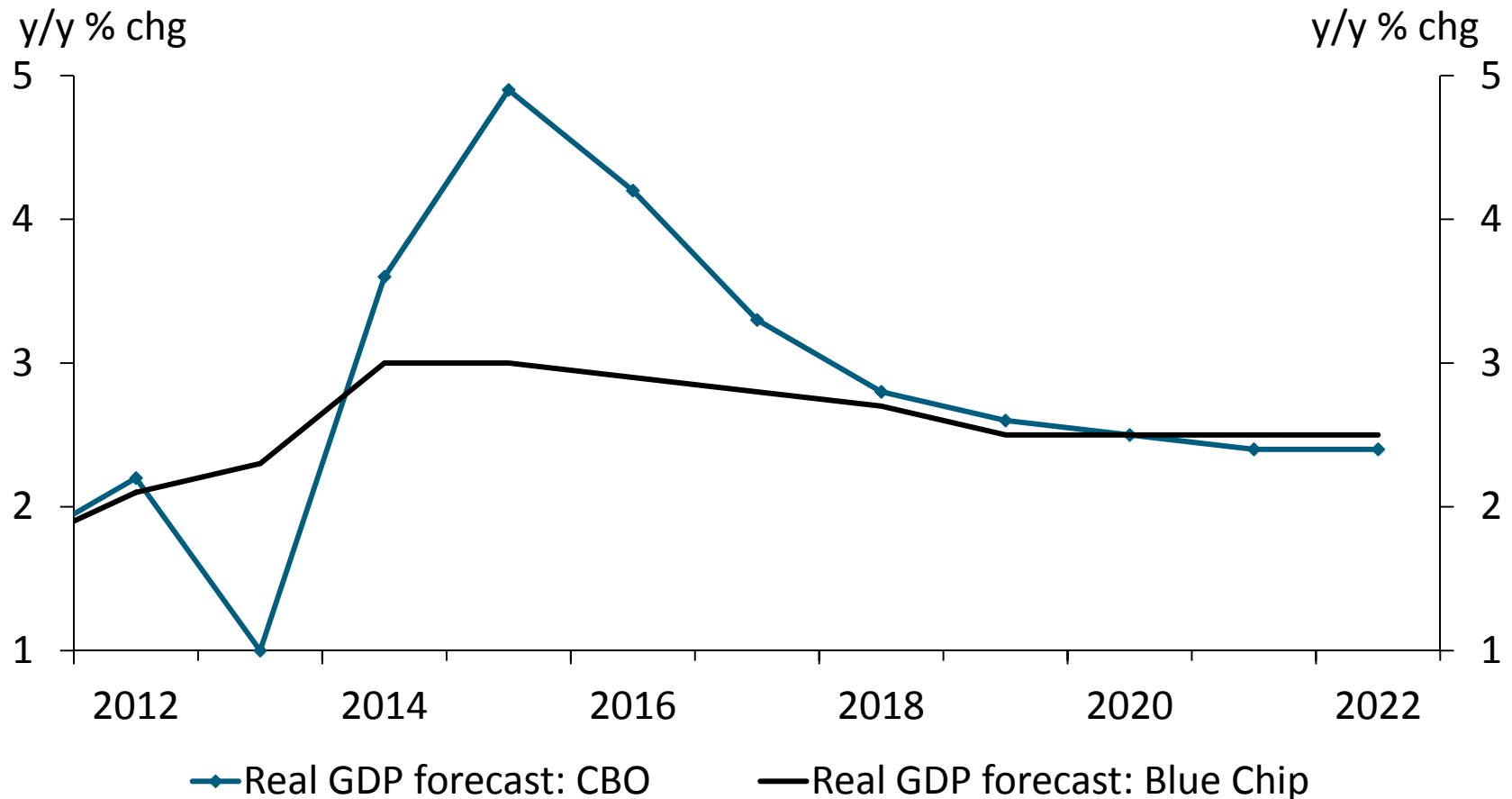
# Extending existing policies will cause deficits to widen dramatically



Source: Congressional Budget Office, Haver Analytics

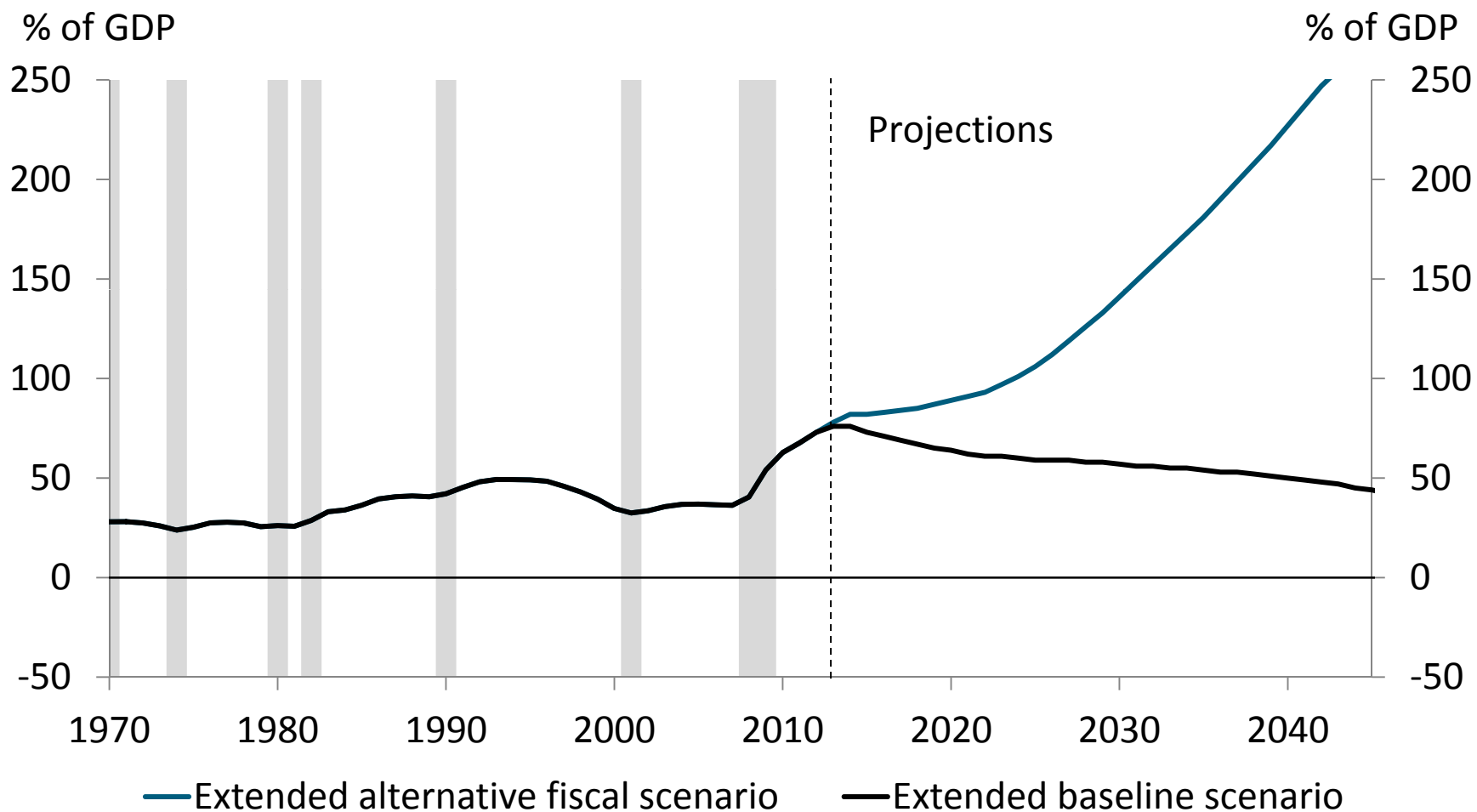


## Deficits could begin persistently widening sooner than 2015 if growth disappoints



Source: Congressional Budget Office, Office of Management and Budget, Haver Analytics

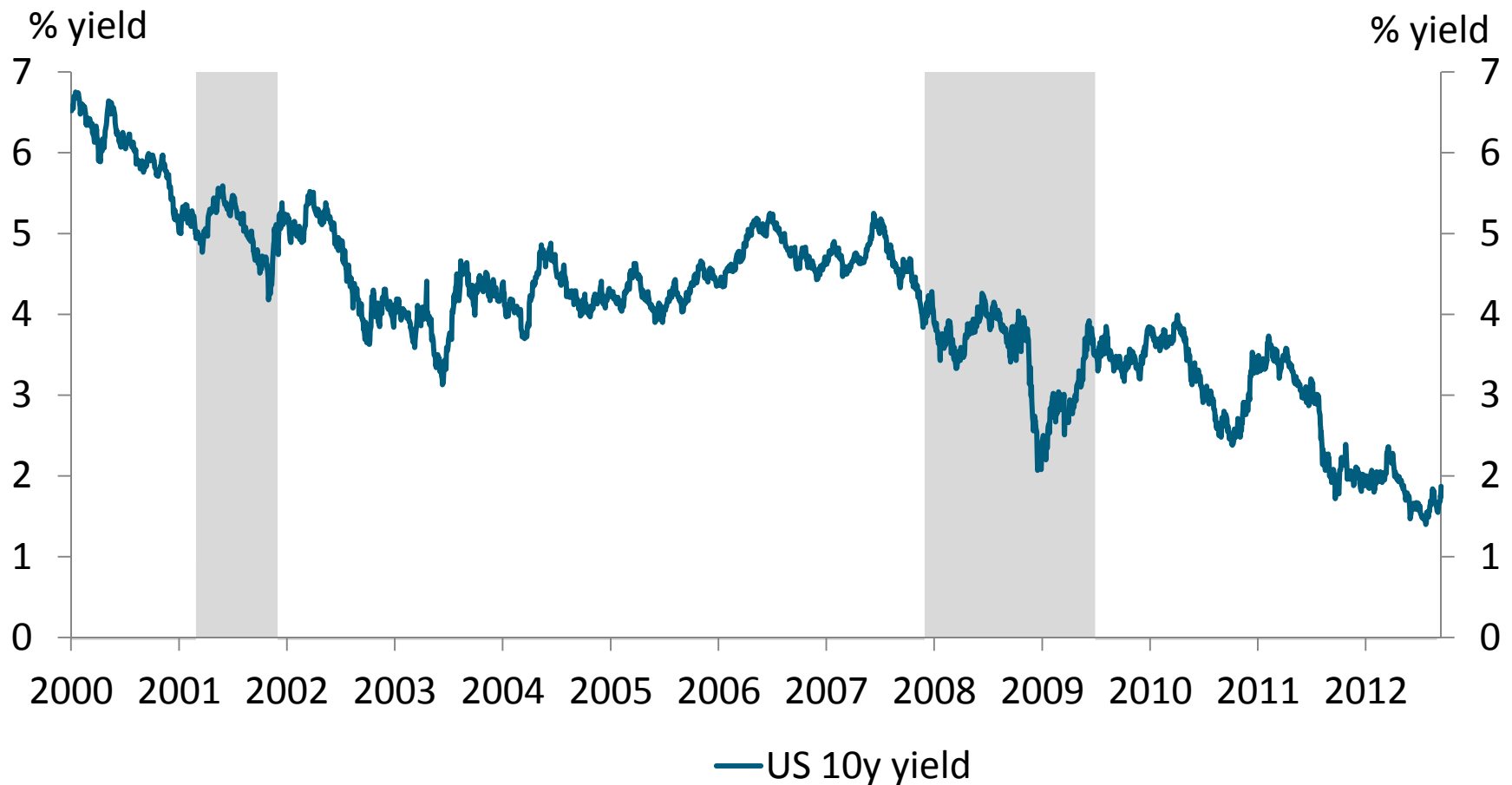
# Extending existing policies will create a mountain of debt



Source: Congressional Budget Office, Haver Analytics



## Despite forecasts of rapidly rising debt levels, yields continue to decline

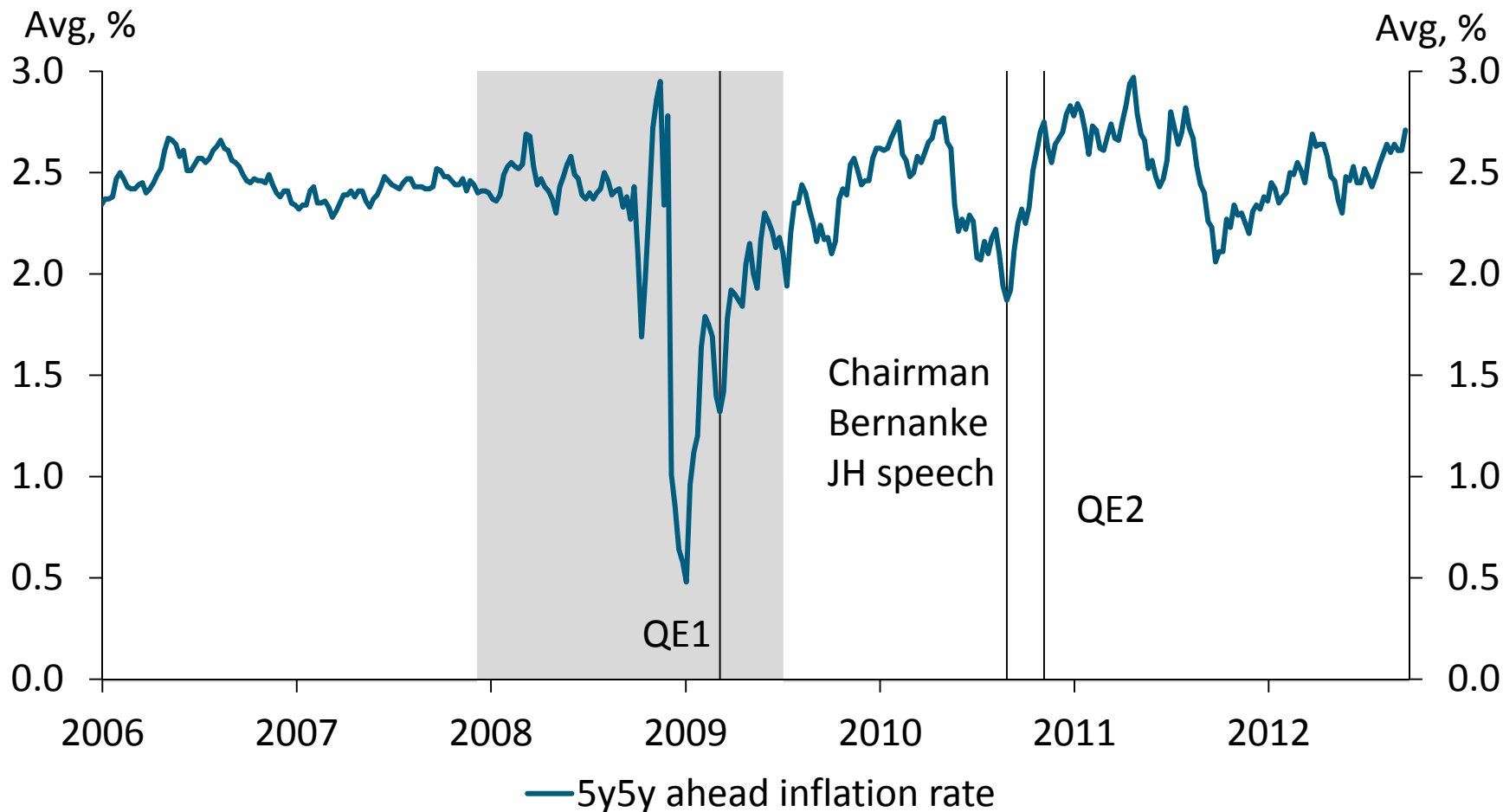


Source: Financial Times, Haver Analytics



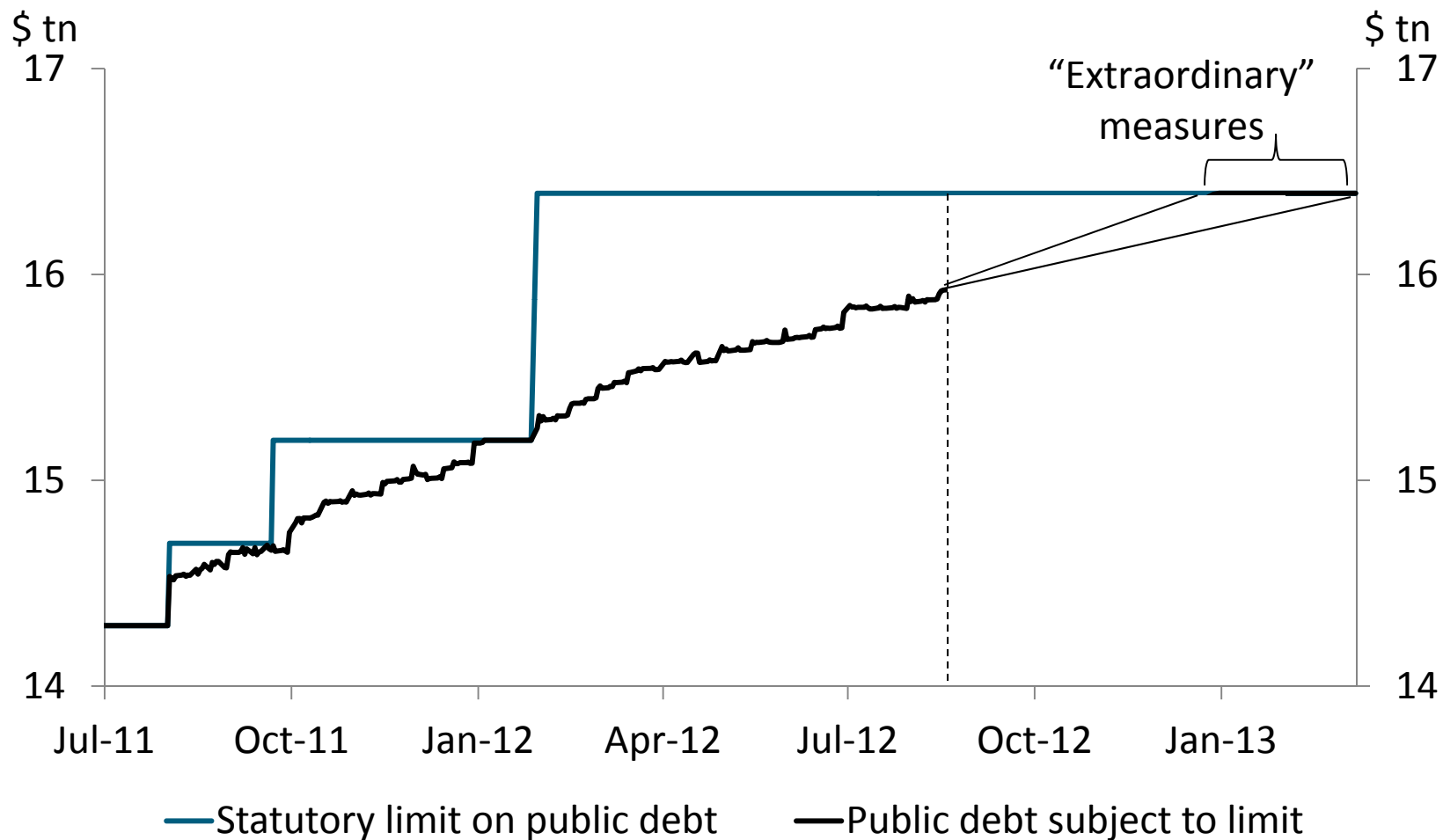


## Forecasts of large fiscal deficits have not caused inflation expectations to rise



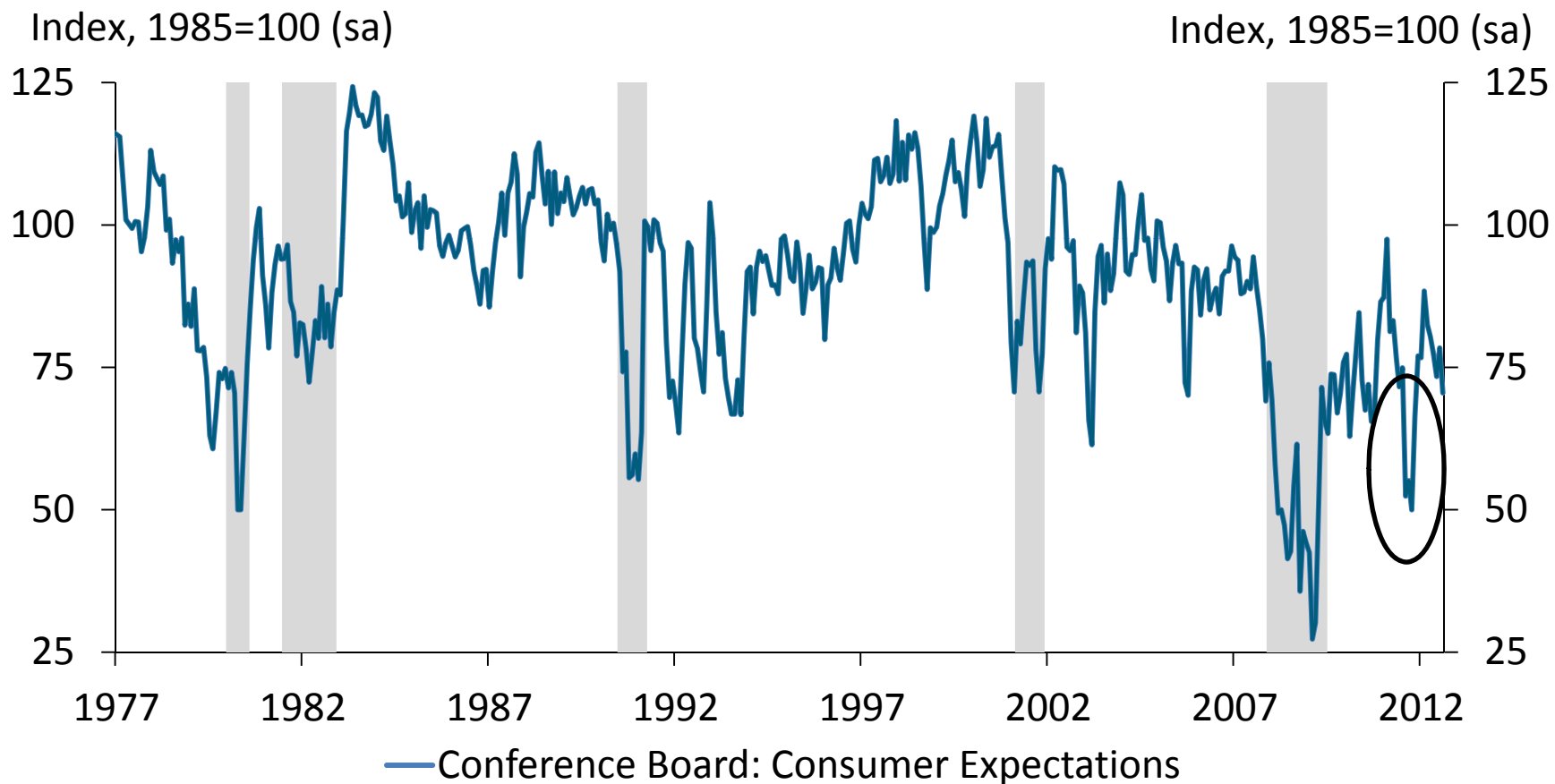
Source: Federal Reserve Board, Haver Analytics

## The debt ceiling is again on the horizon



Source: U.S. Treasury, Haver Analytics

# The debt ceiling debate in August 2011 pushed consumer confidence to its lowest non-recessionary reading in history



Source: The Conference Board, Haver Analytics



## Final points

- The Congressional Budget Office forecasts that the US will experience a recession if the fiscal cliff is fully realized
- A fiscal tightening, however, will notably improve medium- and longer-term deficit projections
- A “grand bargain” before Dec 31, 2012 that smoothes out the timing of the fiscal tightening is the best option





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