Economic Outlook in 2010

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The views expressed in this presentation are strictly those of the authors and do not necessarily reflect the positions of the Federal Reserve Bank of Dallas or of the Federal Reserve System.
Inflation or Deflation,
Tell me if you can.

Will we be Zimbabwe
Or will we be Japan?

- Merle Hazard
Where We Are Currently

Base of Stabilization

• Two quarters of GDP expansion
• Manufacturing, services, IP expanding
• Employment about flat; Temps increasing
• Consumption rising, discretionary spending still weak

Negative Surprises

• Home sales dropped over last three months
• Consumer confidence faltered anew
How Did We Get Here?
One Year Ago: 2009 Forecast

% annual rate

-2 -1 0 1 2 3 4 5 6

2005 2006 2007 2008 2009

Source: IMF World Economic Outlook, Oct. '08/'09
IMF World Economic Outlook:
What a Difference a Year Makes

One Year Ago: 2009 Forecast

<table>
<thead>
<tr>
<th>Year</th>
<th>% annual rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>4.5</td>
</tr>
<tr>
<td>2006</td>
<td>5.0</td>
</tr>
<tr>
<td>2007</td>
<td>4.3</td>
</tr>
<tr>
<td>2008</td>
<td>3.0</td>
</tr>
<tr>
<td>2009</td>
<td>-1.1</td>
</tr>
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</table>

Source: IMF World Economic Outlook, Oct. '08/'09

Current: 2010 Forecast

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<td>2009</td>
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</tr>
<tr>
<td>2010</td>
<td>2.0</td>
</tr>
</tbody>
</table>

Source: IMF World Economic Outlook, Oct. '08/'09
Job Market Seems About Flat

Source: Bureau of Labor Statistics

Total jobs lost: 5.9 million

Mar '09
Job Market Seems About Flat

Total jobs lost: 8.4 million

Source: Bureau of Labor Statistics
U.S. House Price Index (Case-Shiller)

Percent change

Source: S&P, Fiserv, MacroMarkets LLC

Note: Composite 10-City Index
Consumers Still Very Concerned About Present Economy

Source: The Conference Board
Consumers Still Very Concerned About Present Economy

Source: The Conference Board
Industrial Production and Capacity Utilization

SA, Percent of Capacity

Index, 2002=100

Industrial Production

Total Industry Capacity Utilization

Source: Federal Reserve Board
Industrial Production and Capacity Utilization

Industrial Production

Total Industry Capacity Utilization

Index, 2002=100

Source: Federal Reserve Board
Stock Market Plunged…

Dow Jones 30

Jan. 4, 2007 = 100

Source: Dow Jones
...And Has Since Recovered.

Dow Jones 30

Source: Dow Jones
Interbank Frictions Mostly Gone

Source: Financial Times, Reuters
Interbank Frictions Mostly Gone

3M LIBOR – Expected Fed Funds

Source: Financial Times, Reuters
Junk Spreads Near Pre-Crisis Levels

Source: Merrill Lynch, Moody’s, Federal Reserve Board
The Credit Overshoot Has Not Been Unwound

Source: BCA Research 2010, Martin Barnes
A Look At The Region
Texas Business Cycle Index Suggests that Recession is Over

The chart illustrates the Texas Business Cycle Index over time. The peaks and troughs indicate economic expansions and recessions. The chart suggests that the recession may be over, as indicated by the upward trend and stabilization in the index values after 2000.
Texas Manufacturing Outlook Survey Shows a Rebound in Activity
Dallas District at Front of the Pack in the Current Recovery

(3 months ending in Jan. / previous 3 months, annualized job growth by Fed District)
A Look At Banking
Loan Growth

Note: Data for 11th District banks have been adjusted to include Comerica in all time periods and exclude Wells Fargo Bank South Central.
Loan Growth
Banks with Assets < $1 Billion

Percent, Yr/yr

2005 2006 2007 2008 2009

U.S. -4.1%

11th District 1.5%
Banks Close to Beginning an Easing of Credit Standards

Source: Senior Loan Officer Opinion Survey on Bank Lending Practices (Federal Reserve Board)
But, High Number of “Problem” Institutions on the FDIC’s List

Number of banks, or
$ Billions

<table>
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<tr>
<th>Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
<th>Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
<th>Q1</th>
<th>Q2</th>
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<td>65</td>
<td>76</td>
<td>90</td>
<td>117</td>
<td>171</td>
<td>252</td>
<td>305</td>
<td>416</td>
<td>552</td>
<td>702</td>
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2007 2008 2009

Assets of problem banks $403 B

Source: FDIC
Monetary Policy
Rosenblum’s First Law

For every Federal Reserve policy action, there is an equal and opposite criticism.
Fed Balance Sheet Outstanding: Economy Still on Life Support

Week ended:
Sep. 3, 2008  $1,020
Dec. 31, 2008  $2,426
Mar. 25, 2009  $2,144
Jan. 6, 2010  $2,216

Source: Federal Reserve Board
Inflation is Muted Due to Lots of Excess Capacity

Source: Dallas Fed, NFIB and BCA Research
Inflation Expectations Subdued

Source: Federal Reserve Board

**10-year TIPS inflation expectations**

**5-year TIPS inflation expectations**

March '09

1.1

0.6
Inflation Expectations Subdued

Source: Federal Reserve Board
Timing of Exit Strategies

- FOMC will focus particularly on anticipated resource utilization, inflation and inflation expectations in its decisions on exit timing.
- Fed has **no prior experience** in creating or removing monetary stimulus of this **magnitude** and **diversity**.
“The way events have unfolded over the past few months simply has no precedent… No one knows the outcomes of an unprecedented event. No one.”

Zachary Karabell

“The Economic News Isn’t All Bleak”

*Wall Street Journal*

Economic models are like bikinis: what they reveal is suggestive, but what they conceal is vital.

- John Cassidy
Economic Conclusions

• Economy gaining some traction
• Monetary policy inflationary
• Economy riddled with deflationary forces
• Inflation not an immediate concern
• Time to develop and implement exit strategies
Forces Working to Spur Profits, Not Inflation

SA, % change, year-ago

-6 -4 -2 0 2 4 6 8 10

'00 '01 '02 '03 '04 '05 '06 '07 '08 '09

Unit labor costs

Compensation per hour

Source: Bureau of Labor Statistics
Manufacturing Orders

50+ = Expanding

Source: Institute for Supply Management
The World of Finance: What a Difference a Year Makes

• S&P 500: +68%
• Junk spread: -12.5 percentage pts.
• Libor-OIS: -1.0 percentage pts.
• 10yr-1yr Treasury: +1.1 percentage pts.
• Credit card rates: +1.6 percentage pts.
FOMC Exit from Extraordinary and Massive Monetary Stimulus

- Drop phrase “likely warrant exceptionally low rates for an extended period.”

- Allow special liquidity facilities to expire
  - Many have expired as of Feb. 1, 2010
  - TALF will soon expire

- End large-scale asset-purchase programs
  - Scheduled to end by end of 2010 Q1 with slowing pace of purchases announced
FOMC Exit from Extraordinary and Massive Monetary Stimulus (Cont.)

• To reduce the credit-growth and money-growth potential of the current $1.1 TRILLION of excess reserves:
  – Begin reverse repurchase agreement program
  – Raise interest rate on excess reserves
  – Establish a Fed term-deposit facility for banks
  – Outright sales of assets
Timing of Exit Strategies

Depends on:

- Long time lags for monetary policy to impact economic growth and inflation
- **Forecasts** of when economy will return to more normal patterns
  - Cannot wait for return to actual high resource utilization
Texas Jobs Declined at a Similar Pace as the Nation in 2009

Dec/Dec,
Texas Exports Increasing

Index, SA Real
Jan. 2000=100

2000 2001 2002 2003 2004 2005 2006 2007 2008 2009

Texas Exports Increasing

Texas
U.S. minus Texas

Research Department  FEDERAL RESERVE BANK OF DALLAS
Texas vs. Other States

• Leading indicators turning positive in most states:
  • Housing permits
  • Initial claims
  • Exports
  • Consumer confidence
  • State budgets

• Jobs declined in all states in 2009:
  • But declines have narrowed
  • 11th District at head of pack
Bank Loan Growth
Percent of Banks Increasing Lending in 2009

Percent

57% 42% 70% 46%

< $1B in Assets, U.S. > $1B in Assets, U.S. < $1B in Assets, 11th District > $1B in Assets, 11th District

Research Department FEDERAL RESERVE BANK OF DALLAS
Long-Term Willingness of Banks to Make Consumer Loans is Increasing

Net Percentage of Banks More Willing to Make Consumer Installment Loans

Source: Senior Loan Officer Opinion Survey on Bank Lending Practices (Federal Reserve Board)