The U.S. Economy: Prospects and Policies

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Views expressed are those of the speaker alone and should not be reported as representing the official position of the International Monetary Fund.
Financial markets in turmoil

Money Market Spreads & Treasury Yields
(basis points)

Cost of Insuring Against Default
(five-year CDS spreads; basis points)
Financial markets in turmoil (cont’d.)
Consumer credit starting to shrink

Real Consumer Credit Growth
(3-month percent change, annual rate)
Substantial and long-lasting implications for the real economy

Shocks to date have long-lasting effects

Financial Conditions and Growth
(percentage points of real y/y GDP growth)

Further shocks are likely

Senior Loan Officer Survey
(net percentage of domestic respondents tightening standards for C+I loans to large and medium firms)
Activity indicators already softening

**Labor Market**

- Unemployment Rate (percent; right scale)
- Change in Nonfarm Payrolls (thousands; left scale)

**Consumption Indicators**

- 3-month percent change, annual rate
- Real Personal Consumption Expenditures
- Real Retail Sales Ex. Food, Beverages, and Gasoline
Activity indicators already softening (cont’d.)

Manufacturing IP and ISM Manufacturing Index

Durable Goods Orders (12-Month Percent Change)
Housing still deteriorating

Housing Starts and New Home Inventories

House Prices
(index, Jan. 2000=100)
Output declines in the next quarters and slow recovery probable

Contributions to Growth
(percentage points, annual rate)

Real GDP Growth

- Private Consumption Expenditure
- Private Fixed Investment
- Change in Private Inventories
- Government consumption and investment
- Net Exports

Forecast →
Output declines in the next quarters and slow recovery probable (cont’d.)

<table>
<thead>
<tr>
<th>Real GDP Growth (percent change)</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual Average</td>
<td>2.0</td>
<td>1.6</td>
<td>0.1</td>
<td>2.0</td>
</tr>
<tr>
<td>Q4/Q4</td>
<td>2.3</td>
<td>0.7</td>
<td>0.4</td>
<td>2.8</td>
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</table>
Slow recovery reasonable given experience with housing busts

Recoveries from U.S. Regional Housing Busts
(unemployment rate; percent)

Real GDP in Downturns and Recoveries (yr/yr percent change)


Typical advanced economy path following housing correction

Average for Regional Recessions Without a Housing Bust

Average for Regional Recessions With a Housing Bust

Current Forecast

-2M -4M -8M -12M -16M -20M -24M -28M -32M -36M -40M -44M -48M

16M 20M 24M 28M 32M 36M 40M 44M 48M

0 2 4 6 8 10

0 2 4 6 8 10

-2 -1 0 1 2 3 4 5

-2 -1 0 1 2 3 4 5

-4Q -2Q 0Q 2Q 4Q 6Q 8Q 10Q 12Q

-4Q -2Q Onset 2Q 4Q 6Q 8Q 10Q 12Q
Many analysts pessimistic

Forecast Comparisons
(percent change, a.r.)

Latest IMF Forecast
Consensus Forecast
September 8, 2008
Blue Chip Financial Forecast
October 1, 2008
Macroeconomic Advisers
October 8, 2008

Goldman Sachs
JPMorgan
Inflation unlikely to be a problem

Consumer and Oil Price Inflation and Output Gap (percent)
Large risks to the forecast

Growth Risks to the Downside

Real GDP (y/y percent change)

- Skew (mean less mode)
  - Upside risks 2008 2009
  - Net exports 0.00 0.08

- Skew (mean less mode)
  - Downside risks 2008 2009
  - House prices -0.02 -0.07
  - Financing conditions -0.04 -0.24

Inflation Risks Balanced

CPI Inflation (y/y percent)

- 90 percent confidence interval
- 50 percent confidence interval

- Skew (mean less mode)
  - Upside risks 2008 2009
  - Fuel/food prices 0.03 0.07
  - Domestic demand 0.03 0.07
Policy Messages

- U.S. authorities have acted promptly and decisively.
- RECAPITALIZE BANKS! Do it directly and soon using authority provided by EESA.
- Avoid paying inflated prices for bank assets.
- Best information versus timeliness: U.K. model can be useful.
Policy Messages (cont’d.)

- In the meantime, more liquidity facilities (and, possibly, wider guarantees).
- Recapitalization/Liquidity/Guarantees enacted simultaneously.
- Further interest-rate cuts may be warranted. Fed should tighten once recovery begins.
- Further fiscal stimulus, if needed, targeted to the housing and financial sectors, but other measures (e.g., state aid, infrastructure investment) could be useful.
Entitlement reform is key to LT fiscal sustainability, while achievement of MT aims hindered by nontransparent budgeting.

The Treasury blueprint provides a useful starting point for financial regulatory reform, but gaps should be addressed.

In particular, need for (i) medium-term plan for GSEs; (ii) rules to mitigate procyclicality of banks’ balance sheets; and (iii) better clarification of systemic supervisor’s role.