

# Chicago Fed Letter

## Economic Outlook Symposium: Summary of 2009 results and forecasts for 2010

by William A. Strauss, senior economist and economic advisor, and Britton Lombardi, associate economist

According to participants in the Chicago Fed's annual Economic Outlook Symposium, solid economic growth is forecasted for the nation in 2010, following a very sharp contraction during 2008 and the first half of 2009; inflation is expected to increase in 2010; and the unemployment rate is predicted to peak early in 2010 and edge lower throughout the year.

The Federal Reserve Bank of Chicago held its twenty-third annual Economic Outlook Symposium on December 4, 2009. More than 120 economists and

analysts from business, academia, and government attended the conference. This *Chicago Fed Letter* reviews the forecasts from the previous Economic Outlook Symposium for 2009 and then analyzes the forecasts for 2010 (see figure 1) and summarizes the presentations from the most recent symposium.<sup>1</sup>

The fallout from the financial crisis that began in September 2008 weighed heavily on the economy in the fourth quarter of 2008 as real GDP (gross domestic product) declined by 5.4% (seasonally adjusted annual rate, or SAAR); in the first quarter of 2009, output fell at an even greater 6.4%. Economic activity continued to contract into the second quarter of 2009, but at a significantly slower pace, 0.7%. Real GDP fell 3.8% from its peak—the steepest decline since the Great

Depression. Conditions in the financial markets improved markedly throughout 2009, although even by the end of the year conditions would still have been considered “tight.”

In part supported by the federal government's Car Allowance Rebate System (more commonly known as the cash-for-clunkers program), output growth moved substantially higher in the third quarter of 2009. Real GDP rose by 2.2% in the third quarter, the fastest quarterly growth rate in two years.

The housing sector, which has been contracting since 2005, continued to be a substantial drag on the economy through the first half of 2009. Residential investment fell by over 30% (SAAR) in the first half of 2009. Residential investment as a share of GDP fell from a record 6.3% in the fourth quarter of 2005 to 2.4% in the second quarter of 2009. In what appears to be the start of the recovery for the housing sector, residential investment increased 19.5% (SAAR) in the third quarter. In addition, housing starts plunged from over 2.1 million units (SAAR) in first quarter of 2006 to just under 0.53 million units in the first quarter of 2009; they have since risen to 0.59 million units by the third quarter of 2009.

Probably one of the most troubling parts of the economic downturn has been

### 1. Median forecast of GDP and related items

	2008 (Actual)	2009 (Forecast)	2010 (Forecast)
Real gross domestic product <sup>a</sup>	-1.9	-0.4	2.5
Real personal consumption expenditures <sup>a</sup>	-1.8	1.0	2.0
Real business fixed investment <sup>a</sup>	-6.0	-14.8	3.5
Real residential investment <sup>a</sup>	-21.0	-11.8	11.4
Change in private inventories <sup>b</sup>	-37.4	-66.9	25.0
Net exports of goods and services <sup>b</sup>	-470.9	-355.0	-375.0
Real government consumption expenditures and gross investment <sup>a</sup>	3.1	2.0	1.4
Industrial production <sup>a</sup>	-6.7	-5.5	4.0
Car and light truck sales (millions of units)	13.2	10.2	11.4
Housing starts (millions of units)	0.90	0.57	0.74
Unemployment rate <sup>c</sup>	6.9	10.1	9.8
Consumer Price Index <sup>a</sup>	1.5	1.2	2.2
One-year Treasury rate (constant maturity) <sup>c</sup>	0.99	0.45	1.20
Ten-year Treasury rate (constant maturity) <sup>c</sup>	3.25	3.41	4.00
J. P. Morgan Trade-Weighted Dollar Index <sup>a</sup>	9.2	-5.7	-1.8
Oil price (dollars per barrel of West Texas Intermediate) <sup>c</sup>	58.37	77.50	82.51

<sup>a</sup>Percent change, fourth quarter over fourth quarter.

<sup>b</sup>Billions of chained (2000) dollars in the fourth quarter at a seasonally adjusted annual rate.

<sup>c</sup>Fourth quarter average.

NOTE: These values reflect forecasts made in November 2009.

SOURCES: Actual data from authors' calculations and Haver Analytics; median forecast from Economic Outlook Symposium participants.

the significant loss of jobs. The unemployment rate rose from 4.8% in the fourth quarter of 2007 to 6.9% in the fourth quarter of 2008; it then surged to 10.0% in the final quarter of 2009. The economy began shedding jobs in January 2008; for the first eight months of 2008, losses averaged 137,400 jobs per month. During the last four months of 2008, however, they averaged 494,800 per month. Job losses accelerated to average 691,300 per month in the first quarter of 2009 and then moderated to a still deep loss of 428,300 per month

estimated to have fallen by 0.4%. (The remaining comparisons for GDP components use the consensus estimate from the most recent Economic Outlook Symposium for the fourth quarter of 2009 to calculate the annual values.) This overestimation of the economy's performance carried through to pretty much all sectors of the economy, especially the investment sector. Business fixed investment was predicted to contract by 3.9% in 2009, but it is now expected to be down by 14.8%. The unemployment rate was expected to rise

near trend, the unemployment rate is still expected to rise to average 10.3% in the first quarter of 2010 and then only edge lower to average 9.8% in the fourth quarter of 2010. Because economic growth is expected to improve, inflation, as measured by the CPI, is predicted to rise from an estimated 1.2% in 2009 to 2.2% in 2010. Oil is anticipated to rise somewhat, averaging around \$83 per barrel by the end of 2010. Personal consumption expenditures are forecasted to expand by 2.0% in 2010. Light vehicle sales are expected to rise to 11.4 million units this year. Business fixed investment is expected to increase 3.5% in 2010. Industrial production is forecasted to rise 4.0% this year.

**The forecast for 2010 is for economic growth to be solid: The economy is expected to expand at 2.5%.**

in the second quarter. The moderation continued into the final two quarters of 2009, with job losses averaging 199,000 per month in the third quarter and 69,300 per month in the fourth. Since the onset of the recession in December 2007, the economy has shed more than 7.2 million jobs, representing a 5.2% drop from the business cycle's previous peak.

Between 1999 and 2007, light vehicle sales (car and light truck sales) averaged 16.8 million units each year. Sales fell to 13.1 million units in 2008, and then they declined further to average 9.5 million (SAAR) during the first half of 2009. This reduced selling rate, coupled with the tight financial markets, forced two of the major domestic auto producers—Chrysler and General Motors (GM)—into bankruptcy. Helped by the cash-for-clunkers program, the selling rate improved in the third quarter of 2009 to 11.5 million units (SAAR); the fourth quarter's rate slipped to 10.8 million units, although this was still well above the first half's selling pace.

#### **Performance versus forecasts**

At the 2008 Economic Outlook Symposium, participants expected the economy to expand at a 0.7% rate in 2009. According to the consensus forecast for fourth quarter 2009 real GDP growth from the most recent Economic Outlook Symposium, real GDP is

to 7.8% in the final quarter of 2009; however, with GDP growth well below potential, the actual unemployment rate rose quite sharply to 10.0%. Inflation, as measured by the Consumer Price Index (CPI), was predicted to average 2.0% during 2009, higher than the 1.2% rate now expected for the year. In part, this gap is explained by oil prices. Oil prices were forecasted to average \$70 per barrel during 2009, but they actually averaged around \$62 per barrel, 12% lower than predicted. Light vehicle sales were predicted to come in at 12.7 million units; this was clearly overly optimistic compared with the 10.4 million actually sold during 2009. Housing starts were predicted to fall to 0.87 million units in 2009; however, housing starts actually decreased to 0.55 million units (SAAR) for the first 11 months of 2009. Similarly, residential investment was forecasted to decline by 1.7%, but it actually fell by a much greater 11.8%. One-year and ten-year Treasury rates were predicted to rise to 1.95% and 4.00%, respectively, by the end of 2009; however, they actually declined to 0.35% and 3.46%, respectively.

#### **Economic outlook for 2010**

The forecast for 2010 is for economic growth to be solid. In 2010, the economy is expected to expand at 2.5%, following an estimated 0.4% decrease in 2009. Even with economic growth anticipated

The long struggling housing sector is predicted to have strong growth in 2010. Residential investment is forecasted to increase 11.4% in 2010—its best performance since 2003. Housing starts are also anticipated to rise quite sharply, increasing from 0.57 million starts in 2009 to 0.74 million starts in 2010—a nearly 30% increase. While improved, the anticipated 2010 level would be roughly half of the 20-year average of 1.46 million starts.

The ten-year Treasury rate is forecasted to increase by 59 basis points (to 4.00%) in 2010, and the one-year Treasury rate is expected to rise by a somewhat larger 75 basis points (to 1.20%).

The trade-weighted U.S. dollar is predicted to edge lower in 2010, with a decrease of 1.8%; and the trade deficit is predicted to increase somewhat.

#### **Financial and consumer outlook**

Diane Swonk, Mesirow Financial, noted that the credit crunch, whose effects we are still wrestling with, started in August 2007; severe credit market problems first hit Wall Street firms but eventually spread to Main Street firms over the next year. The tipping point was the collapse of Lehman Brothers in September 2008. For example, retail sales had been steady for most of 2008, but they plummeted 10.7% year over year in November and December of that year.

According to Swonk, the recession ended, technically, in June 2009; she said a modest recovery is forecasted in part because of

the greatly diminished financial markets. She added that the “era of consumerism” is over; the U.S. economy is undergoing a major structural shift to a more “austere, export-driven, and investment period.”

Swonk forecasted only a limited real income recovery in 2010 for individuals, and she expected the high unemployment rate to keep downward pressure on nominal wages. Swonk said she anticipates another economic stimulus package<sup>2</sup> in 2010, which should provide further unemployment insurance creating a floor for consumer spending. Given that most consumers see their homes as their largest investment, said Swonk, their sense of wealth will be negatively affected in 2010 by drops in home values. Consumers are expected to adjust their spending to reflect lowered home equity values.

There is a possibility of a second credit tightening due to cyclical losses and defaults of mortgage-backed securities (MBS), Swonk warned; furthermore, uncertainty about the MBS market may grow when the Federal Reserve begins unwinding its intervention in this market.

Swonk said she expects the Fed to normalize the federal funds rate in 2010 from the nearly zero mark to about 2% over a short period and then to hold this rate constant until the economy picks up. Although Swonk predicted overall inflation would accelerate in 2010, she said she expected core inflation (which excludes food and energy) to remain weak.

### **Automotive outlook**

Charles Chesbrough, CSM Worldwide, explained that vehicle sales follow consumer confidence and housing starts very closely. As both of these economic indicators plummeted during the most recent recession, so did auto sales. Vehicle sales have a nearly inverse relationship with the personal savings rate; as the latter increased during the recession, vehicle sales decreased.

The recession took a heavy toll on the Detroit Three—Chrysler Group LLC, Ford Motor Co., and General Motors Co. In 2009, Chrysler and GM filed for bankruptcy. The U.S. government bailed out these two companies and assisted the auto industry with the cash-for-clunkers

program, which artificially stimulated demand in the short run. The total cost of all this support was \$120 billion.

Chesbrough anticipated further consolidation within the Detroit Three. Each automaker needs to reduce its number of products, suppliers, and dealers to create a more efficient manufacturing and sales process. According to Chesbrough, the Detroit Three market share in the U.S. is expected to drop to 40% by 2015 because of regulations, liabilities, and dealer contracts that will hinder their restructuring.

Higher vehicle demand is predicted to come from emerging markets, providing other sales opportunities to offset domestic declines. Chesbrough noted, however, that a worldwide growth in vehicle demand will increase the price and volatility of gas supplies; this, in turn, will prompt consumers to shift to small, fuel-efficient vehicles—a segment in which the Detroit Three currently lag their competitors. Lastly, he explained that a significant amount of uncertainty remains around which “green” technologies will succeed in the marketplace.

### **Steel outlook**

Robert DiCianni, ArcelorMittal, described the unprecedented fast and steep drop in U.S. raw steel production capacity utilization<sup>3</sup> (from about 90% to nearly 30%) in the fourth quarter of 2008. After bottoming out at the end of 2008, capacity utilization has since increased slowly to above 60% in October 2009. In 2009, raw steel production declined 38% year over year as U.S. steel service centers depleted their inventories.

DiCianni forecasted for 2010 a gradual improvement in the steel sector. He expected higher demand for steel from the recovering automobile industry, as well as from appliance makers. Assuming credit conditions ease, DiCianni anticipated the demand for steel from the U.S. energy market to accelerate. For example, he expected the wind energy sector to eventually build over a million windmills; this sector is already causing a worldwide shortage of ball bearings. In a recent trend, pipe and tube manufacturers are locating in the U.S., which

will increase U.S.-based production while reducing imports. If another stimulus bill passes in 2010, DiCianni forecasted an additional demand for 2.8 million to 2.9 million tons of steel. Over the next few years, he explained, the demand for steel by U.S. manufacturers could be dampened by the enactment of a carbon emissions cap-and-trade bill; this might lead to manufacturing operations being moved overseas. That said, given the projected surges in energy (and transportation) costs, many manufacturers may locate their plants closer to their final markets in the U.S., potentially increasing the demand for U.S. steel.

### **Heavy machinery outlook**

Frank Manfredi, of Manfredi and Associates, noted that agricultural equipment markets peaked in 2007 and then slowed in 2009, though the inventory-to-sales ratio should return to normal by the end of 2009. Tractor sales generally rise and fall as commodity prices and net farm income do, and the trends in 2009 were no exception: Drops in both prices and income led to lower total sales of tractors, though self-propelled combines did see an uptick in sales. Manfredi forecasted further weakening in all tractor markets in 2010, with the largest year-over-year

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decline of 6.2% for both two-wheel-drive tractors with 100 horsepower and over and four-wheel-drive tractors.

The U.S. construction machinery market was hit very hard in 2009 as retail sales fell to 1992 consumption levels—a decline of 67% from their peak in 2006–07. Rental equipment purchases plummeted 75.4% in the first quarter of 2009 year over year, and rental fleets were down 30% to 40% as well. Also, Manfredi noted that dealer networks for the distribution of equipment to consumers have dwindled because of manufacturers' reductions and dealers' bankruptcies and closures. Manfredi warned that the diminished networks will limit the growth of small- to medium-sized manufacturers because they would have to invest more funds to either improve current distribution channels or create more of their own dealer networks. He also expected more mergers and acquisitions activity in early 2010 because manufacturers have accumulated and held cash during the recession. Lastly, Manfredi forecasted a modest rebound for most construction machinery in 2010 relative to 2009.

### **Jobs outlook**

Edward Gordon, Imperial Consulting Corporation, stated that the U.S., as well as the rest of the world, is in a severe job and talent crisis. The world has entered

the “cyber-mental age,” in which rapid technological advances have dramatically reduced low-skilled jobs but increased high-skilled ones. Gordon stressed that the U.S. is not adequately preparing its students and workers for these high-skilled jobs, as evidenced by its large high school dropout rate and poor literacy levels. In addition, both developing and developed countries are working hard to attract and retain knowledge workers and high-tech businesses. This makes it even more challenging for the U.S. to maintain its competitive edge.

Gordon projected 12 million to 24 million job vacancies in the U.S. over the period 2010–20 because U.S. workers will not have the necessary skills to fill them. He argued that states need to revamp their education-to-employment systems so that all students graduate from high school and gain some form of postsecondary education. He also recommended joint efforts between local and regional employers and education systems to match the skills taught in schools with the needs of employers. Gordon argued that community-based organizations and nongovernmental agencies could help rebuild the pipeline of talented individuals. Additionally, Gordon emphasized that employees' skills should be regularly updated through employer-provided training and development or

post-college coursework. The American virtues of flexibility, renewal, and growth, Gordon contended, can help produce a work force that can thrive in this new age.

### **Conclusion**

In 2009, the U.S. economy was still challenged by the financial crisis that began in September 2008. However, by the middle of 2009, the decline in economic activity had bottomed out. Economic conditions became better in the second half of the year: The housing sector began to expand; auto sales improved with each passing month; and job losses moderated substantially. The housing sector is predicted to improve markedly in 2010, and light vehicle sales are expected to rise from extremely low levels. The nation's economic growth in 2010 is expected to be solid, with inflation rising and the unemployment rate edging down.

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<sup>1</sup> Also see [www.chicagofed.org/webpages/events/2009/economic\\_outlook\\_symposium.cfm](http://www.chicagofed.org/webpages/events/2009/economic_outlook_symposium.cfm).

<sup>2</sup> To address the financial crisis, the first economic stimulus package—the American Recovery and Reinvestment Act—was enacted in February 2009.

<sup>3</sup> Capacity utilization is calculated as the actual output produced with installed equipment divided by the potential output that could be produced with it if used to its full capacity.