Between Global Rebalancing and Structural Change: American Households and the New Economic Realities

Federal Reserve Bank of Chicago
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Agenda

1. Introduction: the need for global rebalancing
2. The labor market: jobs, wages and salaries
3. The households' balance sheet
4. Housing
5. The banking sector
6. Conclusion: the economic outlook

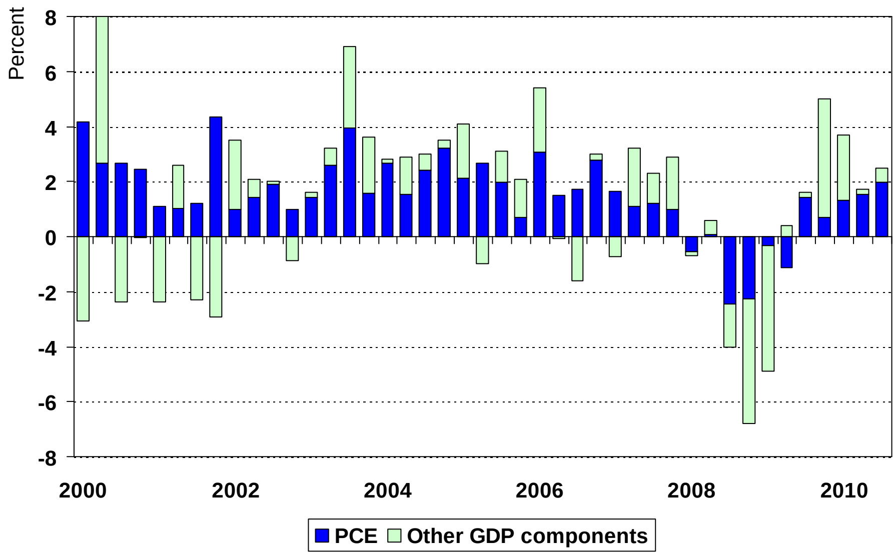
U.S. and China Before the "Great Correction"

- The U.S.
  - GDP growth between 2.5% and 3% between 2004 and 2007
  - Consumption accounted for 70% of GDP
- China
  - GDP growth between 15% and 20% between 2000 and 2008
  - Consumption accounted for 35% of GDP
- China: a development strategy based on (cheap) exports
- U.S.: a consumption-driven economy based on credit
- **The fundamental global imbalance: excess saving in Asia, excess consumption in the U.S.**
- **Economic fundamentals will not change overnight, but global rebalancing requires a greater domestic demand in China, and deleveraging in the U.S.**

The Dynamics of Global Rebalancing

- Deleveraging in the United States
  - It requires a higher saving rate
  - Possibly it stems from paying off our debts, not defaulting on our mortgages!
  - Private deleveraging cannot be offset by government re-leveraging
- Increasing final demand in China
  - The current strategy is focused on public investment
  - Building a social safety net might help to increase consumption and reduce saving
- International uncertainty
  - Dollar is the world's safe haven
  - There is no alternative to the greenback as a world reserve currency
  - Other Asian countries believe in strategic importance of deep pockets of dollar reserves
  - Demographics drive global maturity mismatches between risk-free and low risk assets, and more risky investments

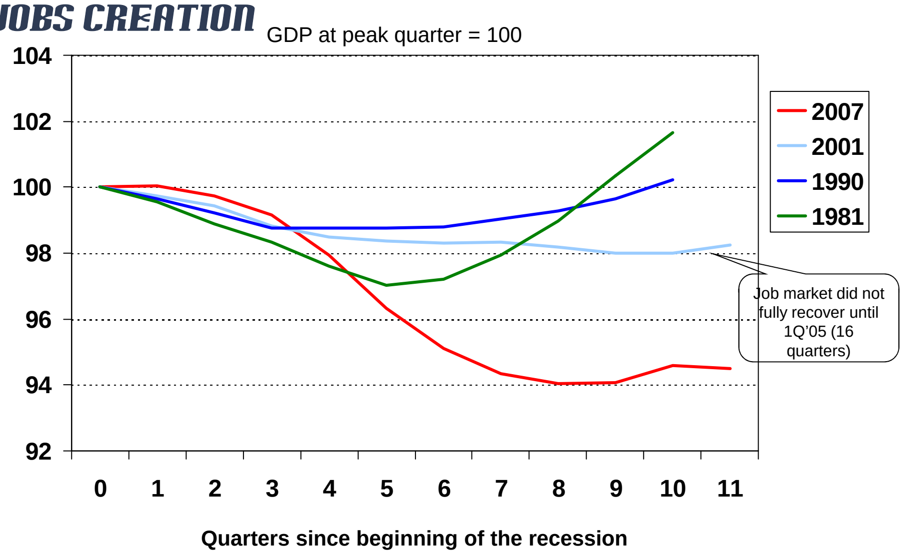
Personal Consumption: Contributions to GDP Growth, 2000-2010



A Disappointing Recovery

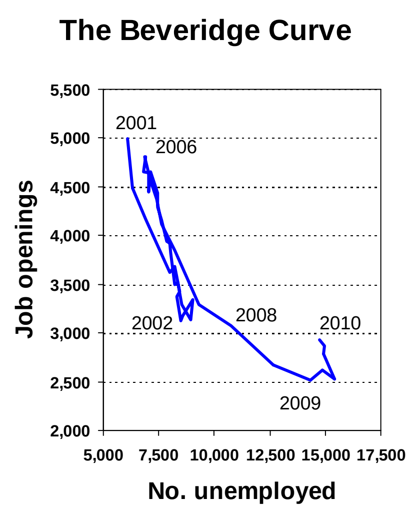
- By historical standards, growth has been a disappointment in this recovery
- A lackluster recovery is not a surprise, following a financial crisis
- 2H 2009 – 1H 2010: temporary factors contributed to macroeconomic performance, but no self-generating momentum was created
- The adjustment is structural, not cyclical
- A sobering realization: many jobs will not come back in their original form and sector
- "A number of [FOMC] participants reported that business contacts again indicated that uncertainty about future taxes, regulations, and health-care costs made them reluctant to expand their workforces." [FOMC Minutes, August 10, 2010]

A Disappointing Recovery: Lagging Payroll Jobs Creation

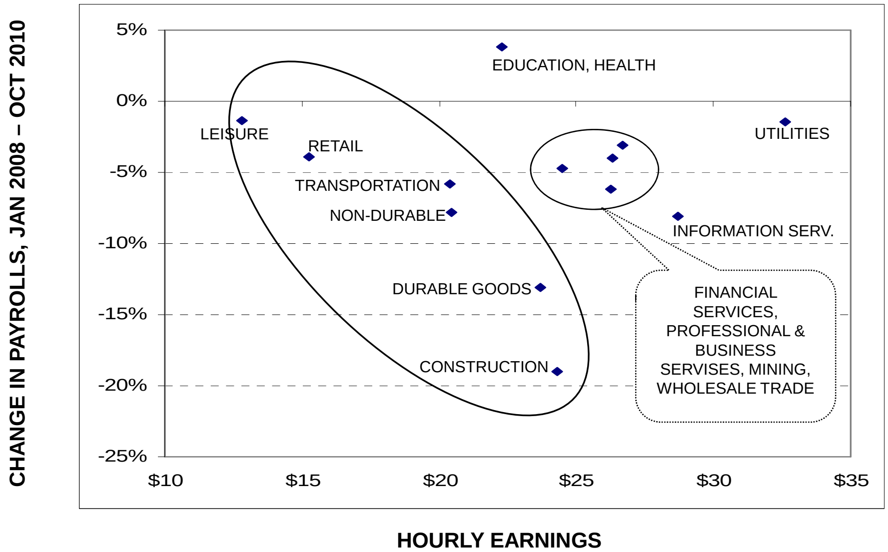


Symptoms of Structural Imbalance in the Labor Force

- Mismatch of skills: the "Beveridge curve"
- Length of unemployment
- Length of unemployment benefits
- Benefit and income replacement ratio
- Wage flexibility
- Labor force mobility
- Survey of job separation



JOBS AND INCOME LOSSES



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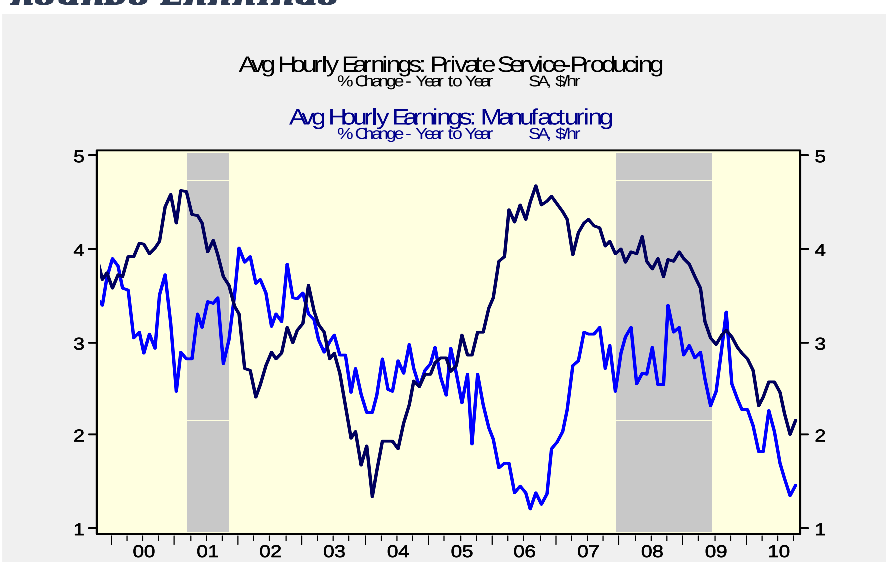
HOURLY EARNINGS



Sources: Bureau of Labor Statistics /Haver Analytics

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"A TALE OF TWO CHRISTMASES"

- 2007 Survey of Consumer Finance
  - Income growth weak or negative for the middle class
  - Income (both level and growth) higher with college degree
- High-income families are recovering faster, and doing better thanks to larger increases in their salaries and bonuses
- Low- and middle-income families suffers persisting headwinds:
  - higher unemployment
  - small or no salary increases
  - uncertainty about unemployment benefits
  - underwater mortgages
  - reduced access to credit

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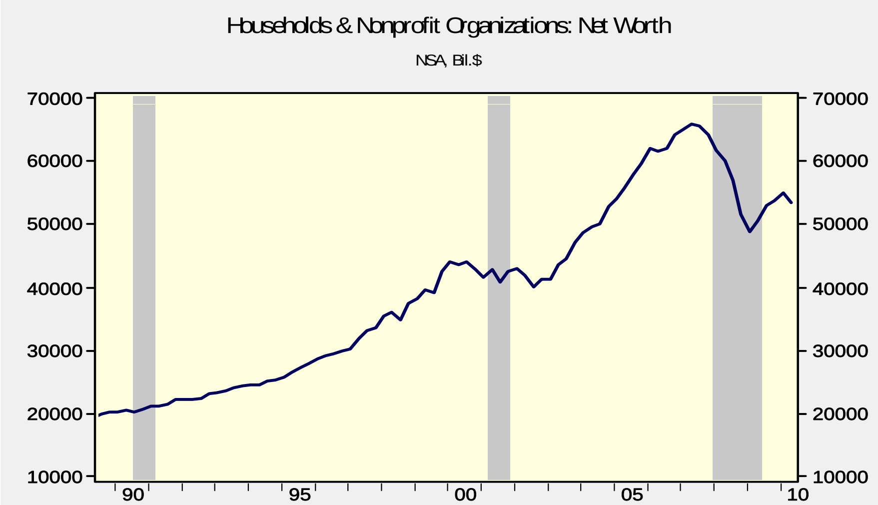
HOUSEHOLDS' BALANCE SHEET



Source: Federal Reserve Board /Haver Analytics

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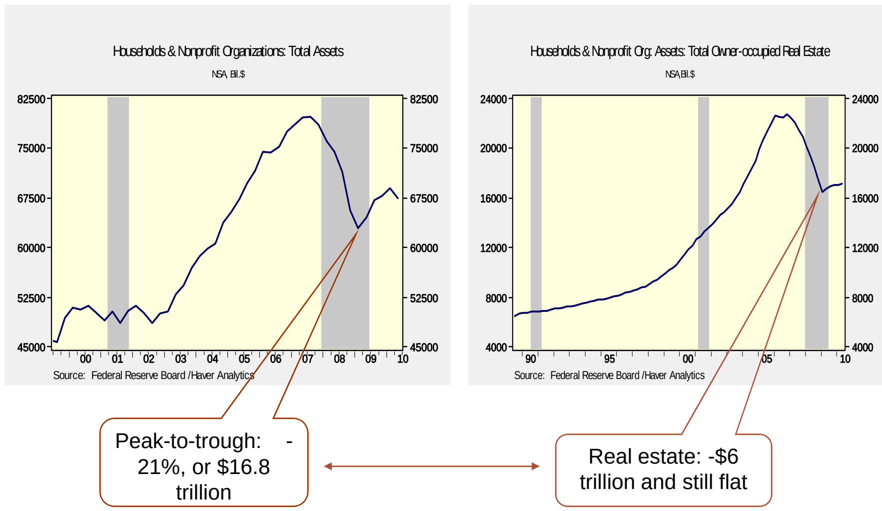
HOUSEHOLDS' ASSETS



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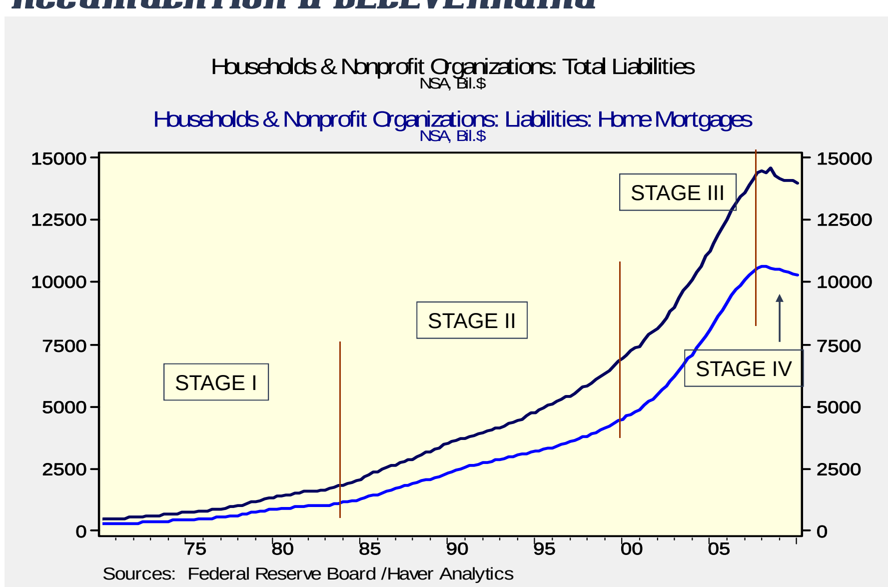
THE DYNAMICS OF REBALANCING: DEBT ACCUMULATION & DELEVERAGING



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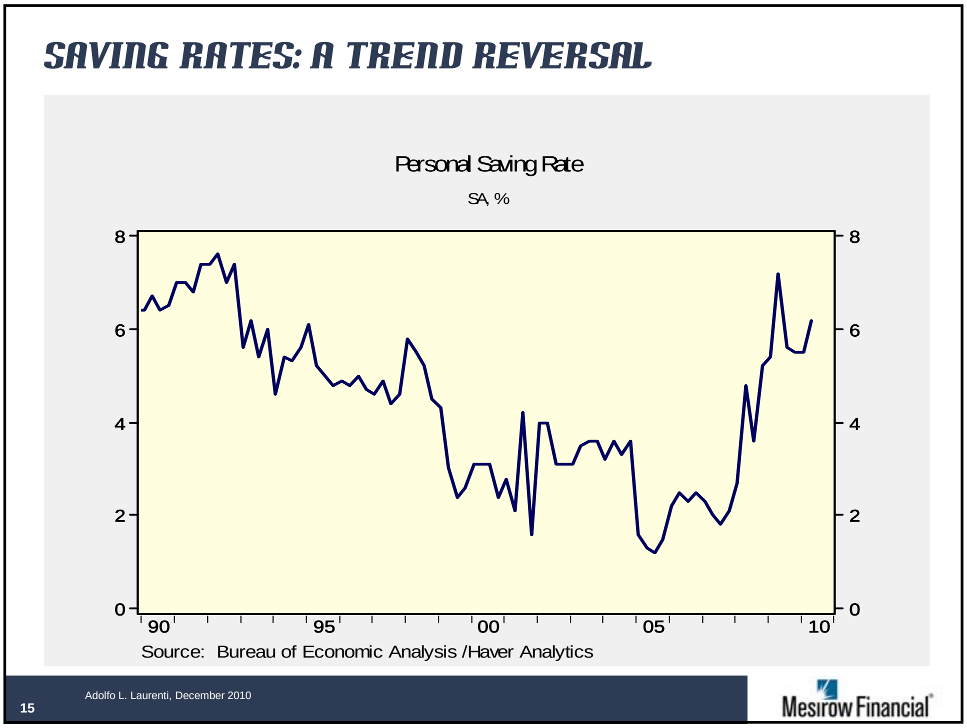
SAVING RATES: A TREND REVERSAL
Personal Saving Rate
SA, %
8
6
4
2
0
90
95
00
05
10
Source: Bureau of Economic Analysis /Haver Analytics
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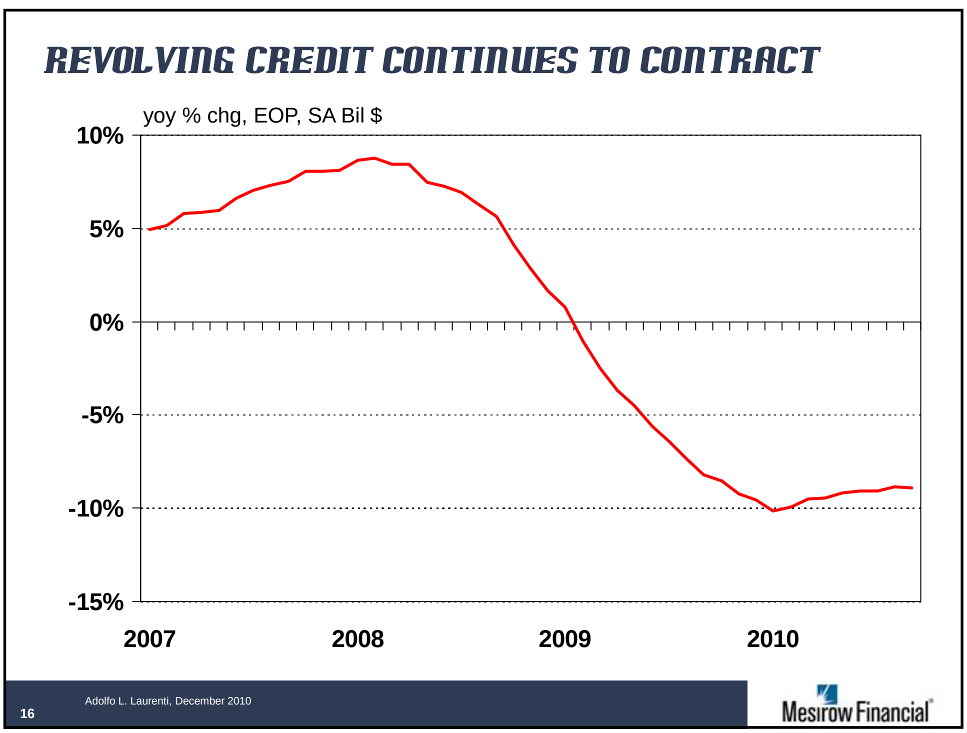
REVOLVING CREDIT CONTINUES TO CONTRACT
yoy % chg, EOP, SA Bil $
10%
5%
0%
-5%
-10%
-15%
2007
2008
2009
2010
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HOUSEHOLD DEBT: 2007 SURVEY OF CONSUMER FINANCES

- Leverage ratio [sum of the debt to sum of the assets] is 15% -- but as low as 8% for top income percentile, and as high as 25% for the middle class
- 77% of families carry debt of one sort or another
  - 49% mortgage
  - 47% installment loans
  - 46% credit card
- Incidence of credit card and installment loans higher for middle class

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HOUSEHOLDS' BALANCE SHEET AND CONSUMER FINANCES: 2007 SNAPSHOT

- 2007 Survey of Consumer Finance
  - 68.6% of families owns a primary residence
    [since 2007, homeownership fell to 66.7%]
  - 52.6% of families own retirement accounts
  - 51.1% of families own stock holdings, directly or indirectly
- Stocks represent 57% of financial assets for top income percentile, 39% of bottom income percentile
- Home represents 19% of financial assets for top income percentile, 47% for bottom income percentile

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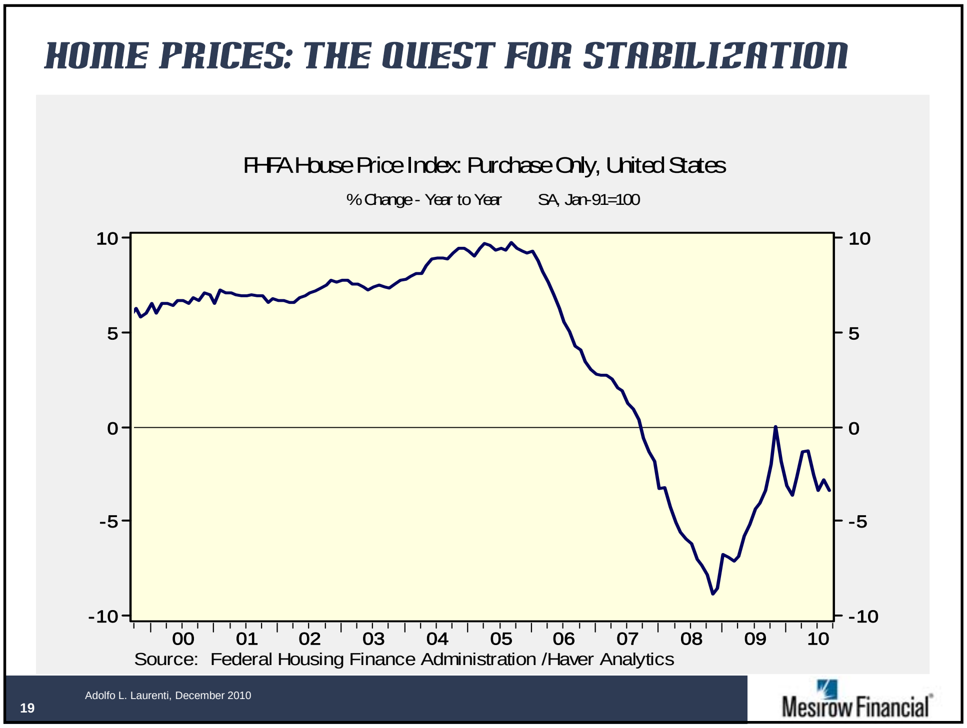
HOME PRICES: THE QUEST FOR STABILIZATION
FHFA House Price Index: Purchase Only, United States
% Change - Year to Year SA, Jan-91=100
10
5
0
-5
-10
00 01 02 03 04 05 06 07 08 09 10
Source: Federal Housing Finance Administration /Haver Analytics
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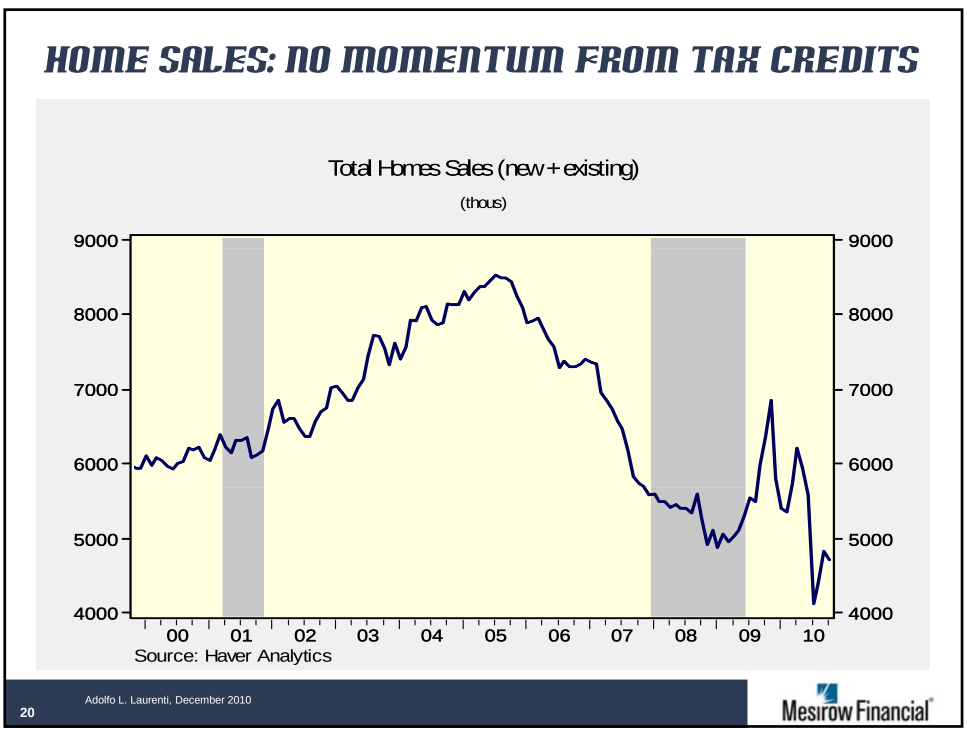
HOME SALES: NO MOMENTUM FROM TAX CREDITS
Total Homes Sales (new + existing)
(thous)
9000
8000
7000
6000
5000
4000
00 01 02 03 04 05 06 07 08 09 10
Source: Haver Analytics
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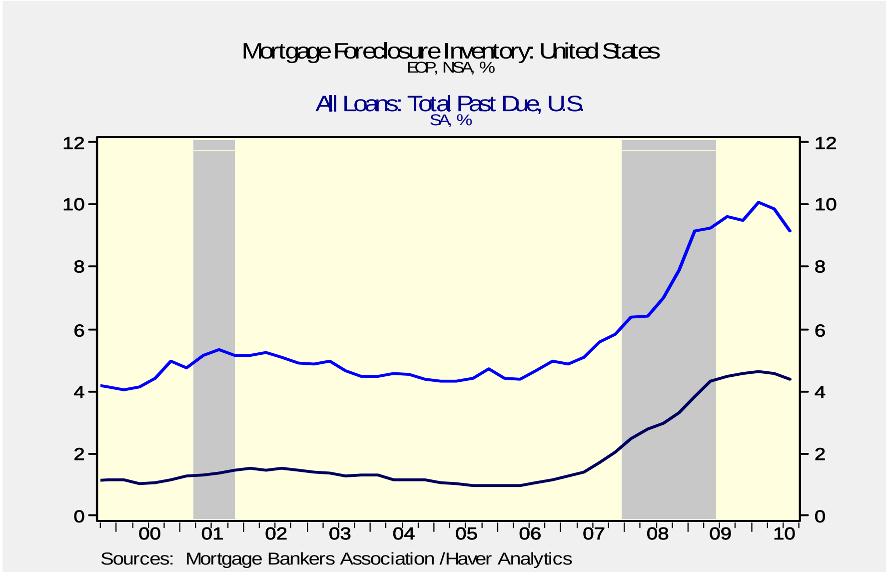
MORTGAGE DELINQUENCIES AND FORECLOSURES



THE BANKING SECTOR: HEALING, SLOWLY

- One major hurdle to resume hiring by small and medium-size businesses: banks unwillingness to extend credit
- Over-concentration of non-performing loans (mostly commercial real estate) still on balance sheets
- Unprecedented liquidity stress on banks' balance sheets is abating
- Banks are still being pulled in opposite directions:
  - Rebuilding capital, increasing reserves, loss provisions and charge-offs
  - Increasing lending – and not just to prime borrowers
- Lack of trust in the European banking stress test
- Persistent uncertainty about the new regulatory framework

THE OUTLOOK: THE 2010 SCORECARD

	2009	2010	2011
Real GDP	-2.6	2.7	2.6
Personal Consumption	-1.2	1.7	2.4
Industrial Production	-9.3	5.4	4.0
Unemployment Rate (year average)	9.3	9.6	9.5
Housing Starts (million unit)	0.55	0.59	0.69
Auto Sales (cars + light trucks)	10.8	11.9	13.2
Consumer Price Index	-0.3	1.6	1.6
Fed Funds (year-end)	0.05	0.20	0.20
10-year T-Note yield (year-end)	3.85	2.50	3.10

Source: Haver Analytics/Mesirow Financial

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SUMMARY

- The good news: financial markets and the economy are stabilizing; we do not anticipate a double dip
- The bad news: it will not be a quick transition. It will take time to restore “normal” operating conditions for the economy and, more crucially, to create jobs
- In 2010 and 2011 we’ll see some growth, but sub-par by historical standard; short-term, transitory factors will prevail on long-term, sustainable drivers
- 2011 and beyond: the economy will reaccelerate, but new risks will emerge: interest rates “normalization” (i.e. hikes by the Fed), tax increases (expiration of the Bush tax cuts), persistently elevated unemployment (“natural” rate at 6.5%?)
- The 2009 fiscal stimulus does look like a missed opportunity; the 2010 mini-stimulus is only marginally better and expected to be ineffective

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