

## NATIONAL FORECAST DESCRIPTION

### **The Forecast Period is the Third Quarter of 2008 through the Fourth Quarter of 2012**

While all years bring challenges, this year promises to have more than its fair share of them. The current U.S. recession is already a year old, and could turn out to be the longest recession in the past six decades. Global Insight predicts U.S. output will shrink through the first half of 2009. If this forecast holds, the recession would be about 18 months long—almost twice as long as the average for post-war recessions. The anticipated decline will also test another six-decade old record. The back-to-back declines in real GDP predicted for the fourth quarter of 2008 (5.0%) and first quarter of 2009 (3.8%) are the worst since the 1982 recession. The U.S. is not alone. Japan and some European countries (Ireland, Italy, and Germany) are also in recession, and other continental economies are expected to join them soon. This downturn will be the biggest European economic contraction since the early 1990s and the first for the Eurozone. Japan will suffer its nastiest setback since the Asian crises in 1998. Few large economies will escape the global slowdown. Even global economic wunderkind China will see its growth slow from nearly 12% in 2007 to “just” 7% in 2009.

Central banks have already begun to respond in an effort to minimize economic woes. The Federal Reserve’s Federal Open Market Committee (FOMC) lowered its federal funds rate target to the range of 0.25% to 0.0% on December 16, 2008—a move that was bolder than most Fed watchers expected. On December 4, the European Central Bank cut its overnight rate by 75 basis points to 2.5%. On the same day, the Bank of England dropped its rate by 100 basis points to 2.0%. It is assumed these central banks will drop their respective rates further to 1.0% and 0.5%. However, cutting them to zero is also possible. On December 19, 2008 the Bank of Japan lowered its uncollateralized overnight call rate by 20 basis points to 0.1%. The People’s Bank of China lowered rates 108 basis points on November 26—its largest cut in 11 years.

With U.S. interest rates already headed to zero, the Federal Reserve is running out of policy tools. As a result, it is likely the onus from restarting the economy will move from monetary policy to fiscal policy. It remains to be seen what will be the final size and shape of the fiscal policy. The incoming Obama administration has been looking at a stimulus package of between \$500 billion and \$750 billion (about 3% to 5% of GDP). In its most recent forecast, Global Insight assumes a \$550 billion package which consists of tax cuts, infrastructure spending, and other provisions. The only other country considering a major stimulus program is China. It has announced a \$586-billion plan (16% of GDP) that should add substantially to growth. The fiscal stimulus plans discussed by other countries are more modest. For example, plans being considered by the United Kingdom and Eurozone are only between one and one-half percent of GDP.

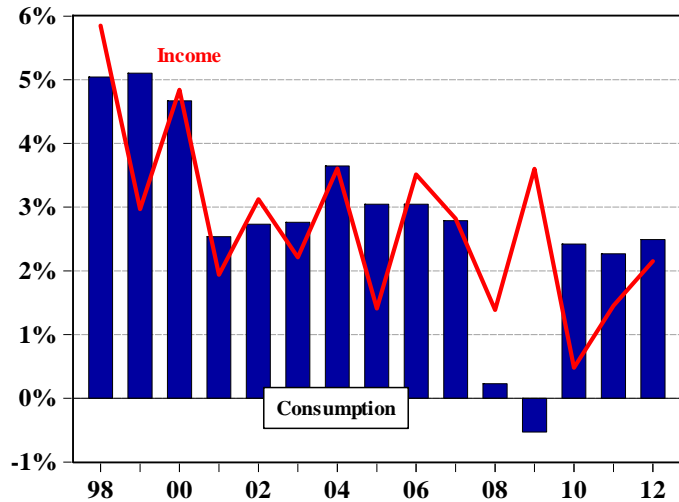
The economy will take its first, tentative steps toward recovery in the second half of this year, but not hit its stride until 2010. Hence, real GDP is forecast to decline by 1.8% in 2009 and increase 2.1% in 2010. It will pick up more steam and average about 3.0% growth in the final two years of the forecast. Employment does not fare as well. Not only did nonfarm employment begin declining before the recession began, it is not expected to recover until a half year after the downturn ends. While the economy is forecast to begin adding jobs again in 2010, most of the quarterly gains will be meager. Hiring will pick up in 2011 and 2012, however. Real personal income does not retreat over the forecast period, but it comes close in 2010.

## SELECTED NATIONAL ECONOMIC INDICATORS

**Consumer Spending:** The consumer spending retreat is expected to continue into early 2009. The predicted 2.3% peak-to-trough drop in real spending will be the biggest setback since the 1980 recession. This decline would have been more drastic were it not for the anticipated new round of fiscal stimulus and lower energy prices. This forecast assumes a \$550-billion fiscal package that includes \$250 billion in tax cuts and \$55 billion in other personal transfer payments over three years. The expected decline in gasoline prices from their 2008 third quarter peak is equivalent to a \$230-billion tax cut for consumers. The lower gasoline prices help the share of consumers' disposable income spent for energy to drop from 6.6% in the third quarter of 2008 to 4.1% this spring. Thus, despite falling employment, real disposable income is projected to rise 3.6% in 2009.

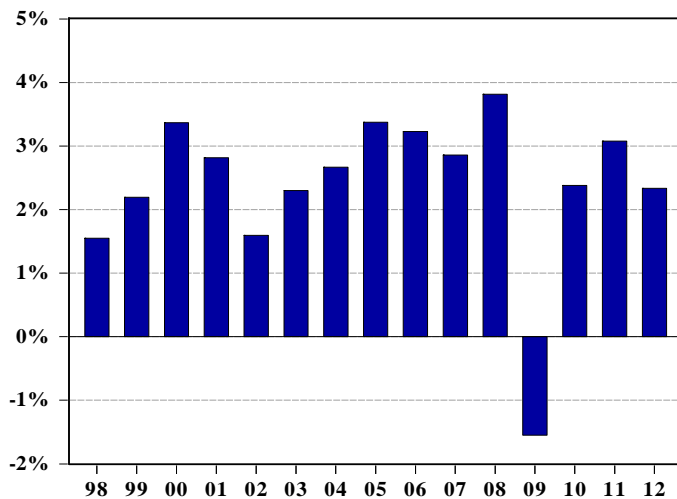
Households are expected to spend cautiously, resulting in the personal savings rate rising from 1.8% in 2008 to 5.8% in 2009—its highest level since 1992. However, the protracted decline in home prices, the expected upturn in oil prices, and rising unemployment should dampen spending growth in late 2009 and early 2010. On an annual basis, after declining 0.5% in this year, real consumer spending growth averages about 2.4% annually through 2012. One of the reasons for jittery consumers can be traced to their balance sheets. It is estimated real net worth plunged 13.0% in 2008 due in large part to the decline in housing prices and the stock market collapse. Household real net worth is expected to recover slowly, and not reach its 2007 level until after 2011.

### U.S. Real Consumption and Disposable Income Growth



Source: Global Insight

### Consumer Price Inflation



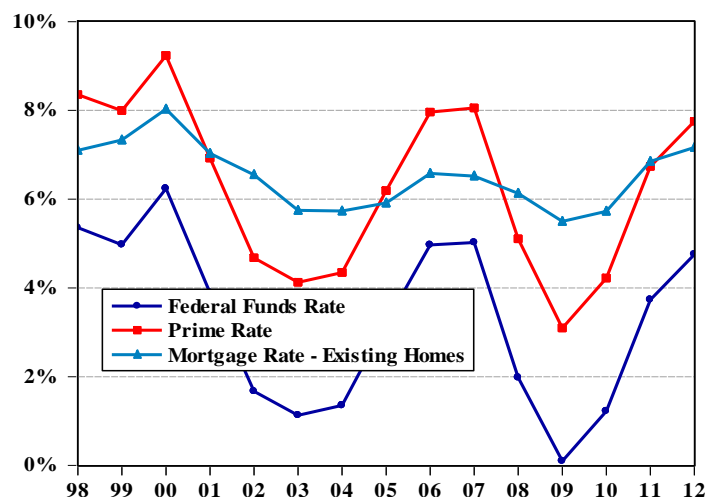
Source: Global Insight

**Inflation:** The energy price freefall is putting immense downward pressure on every inflation index. The U.S. Department of Labor reported the closely watched Consumer Price Index for all urban consumers dropped 1.7% in November 2008. Driving this decline was the 17.0% drop in the energy component of the index. (Excluding energy, the index was virtually flat.) According to the Department of Labor, the gasoline index fell 29.5% in November alone and is down a whopping 47.0% from its July 2008 peak. Consumers have experienced this decline in the form of gasoline prices which have fallen from a peak of \$3.91 per gallon in the third quarter of 2008 to \$2.28 per gallon in early November 2008. Oil prices should continue retreating due to weak global demand.

OPEC has not managed the downturn in global demand very well. From an average of \$100 per barrel in 2008, the price of West Texas Intermediate crude is forecast to average just \$43 per barrel this year. Unfortunately, oil prices are expected to rise as when the economy recovers. Specifically, its average price goes from \$57 per barrel in 2010, to \$79 in 2011, and to \$87 in 2012. Gasoline prices display a similar pattern. After averaging \$3.33 per gallon last year, the pump price for gasoline is expected to average \$1.99 this year, \$2.44 in 2010, \$2.95 in 2011, and \$3.14 in 2012. The energy index should decline 27.2% this year, rise 12.9% next year, increase 13.2% in 2011, and grow another 4.6% in 2012. Overall consumer inflation is less volatile. Prices should rise 3.8% in 2008, drop 1.5% in 2009—the first decline in 54 years, increase 2.4% in 2010, grow 3.1% in 2011, and increase 2.3% in 2012. The more modest swings in the overall index compared to the energy index largely reflects the calming influence of slower, consistent employment costs which are expected to rise about 2% annually. The low employment cost growth reflects the downward pressure of relatively high unemployment.

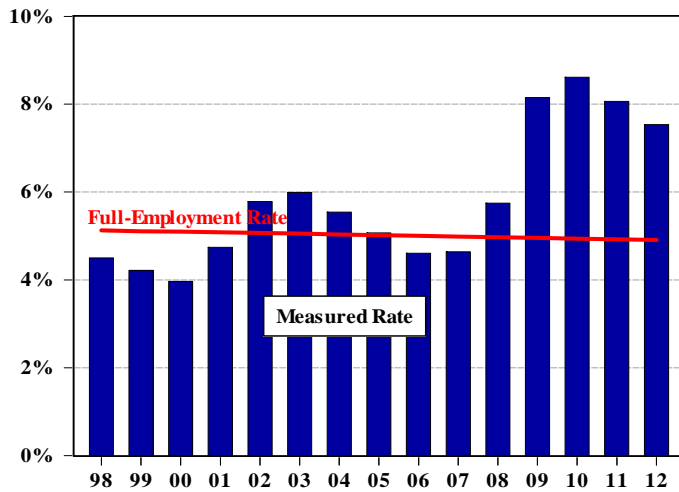
**Financial Markets:** The Federal Reserve’s Federal Open Market Committee (FOMC) lowered its federal funds rate target to the range of 0.25% to 0.0% on December 16, 2008. While the FOMC was expected to lower this rate, the change was more aggressive than the consensus expectation of economists that the target rate would be 0.50%. Global Insight is in this camp. It assumed the FOMC would lower the federal funds rate to 0.50% in December followed by another move in late January 2009 that would reduce this rate to zero. In the press release announcing its move, the FOMC stated, “Since the committee’s last meeting, labor market conditions have deteriorated, and the available data indicate consumer spending, business investment, and industrial production have declined. Financial markets remain quite strained and credit conditions tight. Overall, the outlook for economic activity has weakened further.” Clearly, the nation’s central bank has made propping the economy and supporting financial markets its top priorities. One of the reasons the FOMC can act so aggressively is inflation pressures have eased dramatically this fall. The U.S. central bank was not alone in loosening its monetary policy. The Bank of England slashed its key interest rate by 100 basis points to 2.00% in early December. Consequently, interest rates match their lowest levels since the bank’s founding in 1694. The European Central Bank cut its key interest rate by 75 basis points to 2.50% about the same time the Bank of England dropped its rate. This was the European Central Bank’s largest-single move since it assumed responsibility for the Eurozone’s monetary policy in January 1999. The Bank of Canada lowered its key interest rate by 75 basis points to 1.5% in an attempt to improve its ailing economy. Sweden’s central bank, the Riksbank, also cut its policy interest rate recently. It appears these cuts are not the final shots in the salvo against each country’s recession. With the federal funds rate at zero, the FOMC may have to engage in direct purchases of long-term Treasuries. It is already engaging in nontraditional measures to stimulate the economy such as buying commercial paper, mortgage-backed securities, credit card debt, and loans to small businesses, students, and car buyers. The FOMC is expected to hold the federal funds rate at zero through the third quarter of next year, then it will gradually raise rates as the economy begins to recover.

**Selected U.S. Interest Rates**



Source: Global Insight

## U.S. Civilian Unemployment Rate



Source: Global Insight

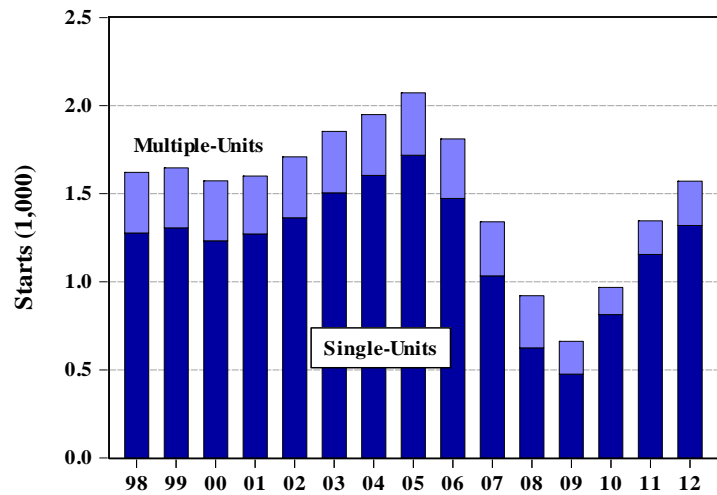
**Employment:** The nation's employment situation is expected to worsen through 2009 before starting a modest recovery in 2010. The U.S. economy has posted net job losses in every month of 2008. The latest jobs' report was particularly troubling. The consensus among economists was that nonfarm payrolls would shrink about 350,000 jobs in November 2008. The U.S. Department of Labor reported November's job base shrank by 533,000 jobs—its worst percentage drop since May 1980. The November report contained more bad news in the form of revisions that lowered the September and October estimates by a combined 199,000 jobs. Since December 2007, 1.9 million jobs have been lost. Over the same time period, the U.S. civilian unemployment rate has climbed from 5.0%

to 6.7%. The unemployment rate increase means the country's work force has gone from being nearly full employed to clearly underemployed. One statistic that is often overlooked when assessing the labor market's health is discouraged workers. These are people who would like to have a job but have stopped looking for work, so they are not included in the labor force. The Labor Department estimates the number of discouraged workers swelled by 400,000 in November 2008. Had these persons kept looking for jobs, the November 2008 civilian unemployment rate would have been even higher than had been reported. Unfortunately, payrolls are expected to keep retreating another year, resulting in a peak-to-trough drop of 3.7 million jobs from the fourth quarter of 2007 through late 2009. Job growth is forecast to resume in 2010, although average annual payrolls in that year are little different from the 2009 levels. However, more robust gains should push annual tallies between 2.0 million and 2.3 million jobs thereafter. National nonfarm employment is forecast to shrink 0.2% in 2008 and another 1.9% in 2009. It is expected to advance a meager 0.1% in 2010, 1.5% in 2011, and 1.7% in 2012. Not surprisingly, the unemployment rate also gets worse before improving. It is projected to climb another two percentage points from November's 6.7% to 8.7% in early 2010. The job recovery is anticipated to be tepid, so the U.S. unemployment rate will remain above the full-employment level.

**Housing:** The nation's housing sector is not near its bottom, and it is expected to continue sliding through most of next year. This prognosis is disappointing because a recovering housing industry is critical to the nation's economic recovery. The housing market weakness is expected to erase one percentage point of growth in both the last quarter of 2008 and first quarter of 2009. While some recent statistics may provide hope the worst is behind this sector, the preponderance of evidence point to more challenges ahead. The small decline in the Pending Home Sales Index seems to point to modest declines in existing homes sales over the rest of 2009. However, seasonally adjusted housing starts fell to a record low of 791,000 units in October 2008. In addition, housing permits dropped 12.0% in October, which increased the possibility of double-digit housing starts declines in the remaining two months of that year. On an annual basis, housing starts were forecast to drop below one million units in 2008, for the first time since 1945. They are expected to fall further to 662,000 in 2009. This year's drop reflects declines in the first half of the year followed by a rebound fueled by renewed economic growth and lean inventories. Housing starts rise to 969,000 units in 2010, 1.347 million units in 2011, and 1.571 million units in 2012. Existing home sales will also display weakness during the early years of the forecast.

Weighed down by job losses, tight credit, and low consumer confidence, existing home sales are expected to dip below five million units in the last quarter of 2008 and keep falling through 2010's first quarter. New home sales are projected to fall proportionately more than existing homes because builders, who must cover their costs, will have trouble competing in markets with high foreclosure rates. The average price for existing homes is expected to decline in all but the last two years of the forecast. Two observations regarding prices are worth noting. First, the biggest projected year-over-year decline is in 2009, which means there are harder times ahead. Second, the anticipated housing price appreciation during the last two years of the forecast will come nowhere near to offsetting the price depreciation suffered since existing home prices peaked at nearly \$270,000 in 2006.

## U.S. Housing Starts

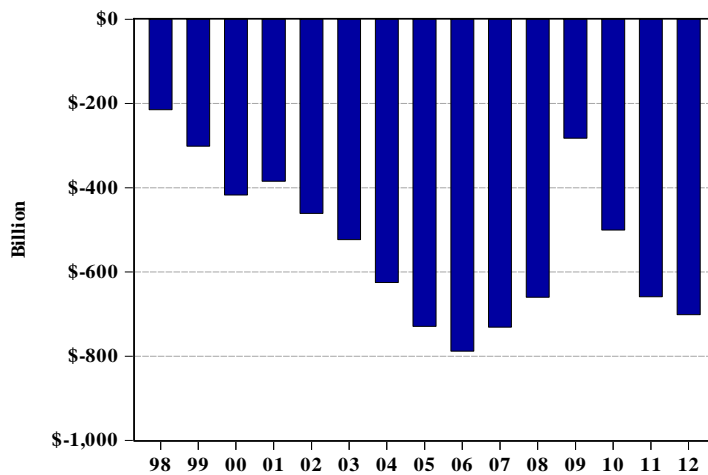


Source: Global Insight

**International:** The U.S. and world economies are expected to experience some of the worst recessions in the postwar period. The United States is now officially in a recession that started in December 2007. Japan and some European countries (Ireland, Italy, and Germany) are also in recession. Other European economies are expected to turn down soon. For Europe, this will be the most severe business contraction since the early 1990s. For Japan, it will be the nastiest recession since the depths of the Asian crises in 1998. In 2009, output is expected to decline 1.0% in Europe, 1.3% in Japan, and 1.8% in the United Kingdom. Unfortunately, the developing countries will not be immune from the economic contagion from the developed world. There are at least three transmission vectors to the emerging world. One, the collapse in commodity prices, which is already hurting countries such as Russia, Iran, Venezuela, and South Africa. Two, capital flows have dried up, which is harming economies with large current-account

balances. Three, the precipitous decline in world trade, will damage growth for the major exporting countries (almost all of which are in Asia). As a result, GDP in most emerging markets during 2009 will be roughly half the rate of 2007 and early 2008. For example, the Chinese economy, which surged 11.9% in 2007, is expected to grow just 6.9% in 2009. One positive consequence of the emerging trade picture is global trade imbalances should improve markedly. For example, the U.S. current-account deficit, which was \$731 billion in 2007, should drop to \$282 billion in 2009. It is important to remember the large deficits in the past two years have masked the significant improvement in the non-oil

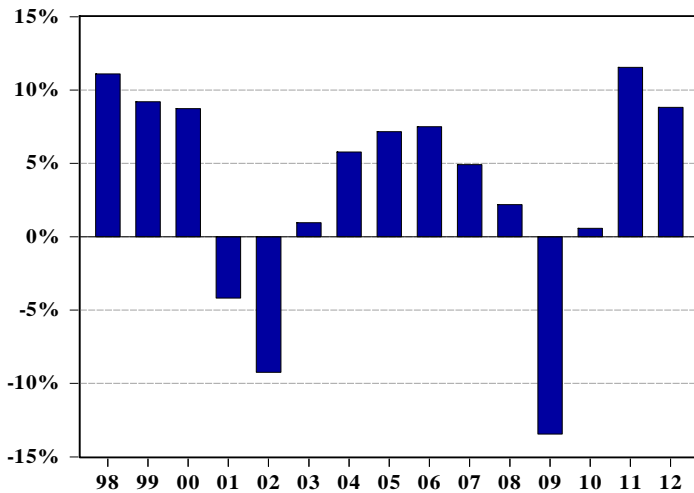
## U.S. Current Trade Deficit



Source: Global Insight

deficit, which resulted from the sharp rise in the oil import bill. With the collapses in oil prices, the U.S. current account deficit will plummet about 50%. The huge drop in commodity prices also points to a major shift in the terms of trade, in favor of the developed countries, and represents a rebalancing of growth and current account deficits, with commodity-importing countries being the major beneficiaries. After 2009, the current account deficit is forecast to rise to \$500 billion in 2010, \$659 billion in 2011, and \$702 billion in 2012.

### Real Business Investment



Source: Global Insight

**Business Investment:** Current conditions do not bode well for business investment. Businesses have few reasons to start new buildings or renovate existing ones. The economy is in recession, job losses are mounting, too many hotels and malls were put up during the most recent expansion, the securitization market for commercial real estate loans is frozen, credit is tight, and oil prices have collapsed. As a result, nonresidential construction spending is expected to drop over the first seven quarters of the forecast horizon. The decline is widespread and deep. All major building categories fall at double-digit rates this year. In summary, real nonresidential investment is projected to shrink 13.4% this year, eke out 0.6% growth next year, advance by 11.5% in

2011, and increase another 8.8% in 2012. The credit crunch is also hitting businesses in other ways. They are finding it hard to finance solid projects and are opting to preserve cash rather than fund projects they would normally undertake. One example is spending on equipment and software. In the forecast, real spending on equipment and supplies drops at about a 20% annualized rate in the last quarter of 2008, despite the boost provided by the accelerated depreciation allowances that were part of last year's stimulus package. Overall, real spending on equipment and software is anticipated to drop 2.1% in 2008, plunge 12.2% in 2009, rise 7.7% in 2010, increase 13.9% in 2011, and advance 8.6% in 2012.

**Government:** The Obama administration is expected to flex its fiscal policy muscle early in an attempt to end the recession. The President-elect has already started assembling his economic team and putting together a large-scale stimulus plan. The incoming administration has been talking about a fiscal plan package of about \$500 billion to \$700 billion. This forecast assumes a \$550 billion package over three years that includes a mixture of infrastructure spending, support for state and local governments, transfer payments to individuals, and a permanent middle-class tax cut. (However, given how quickly the economy is deteriorating, the final fiscal package could be much larger.) Specifically, the assumed plan includes \$135 billion in infrastructure spending channeled through the states, \$110 billion in other transfers to the states to support Medicaid and other current spending, \$55 billion in targeted transfer payments to the personal sector (e.g., food stamps, extended unemployment insurance), and \$250 billion in tax cuts for the personal sector. The infrastructure spending is expected to directly create jobs, but its impact will not be immediate because it will take time to ramp up these projects. The stimulus plan should be easily recognizable to anyone who has read an introductory college economics text. This fiscal

policy strategy is a standard Keynesian response when the monetary policy is facing a liquidity trap (i.e., the financial sector mops up liquidity without increasing lending) and private-sector spending is contracting. In addition, the U.S. Treasury has the authority to purchase up to \$700 billion in assets through the Troubled Asset Relief Program (TARP). It is assumed in the current forecast that \$350 billion of this amount will be used as capital infusions into financial institutions. The remaining \$350 billion is expected to be used to purchase troubled assets and to fund a foreclosure prevention program. The estimated net loss of these activities is around \$102 billion, which is included in the fiscal 2009 federal budget deficit. In total, the federal budget deficit should swell above \$1.3 trillion in 2009 and be close to \$1 trillion in 2010.

### U.S. Federal Government Surplus Unified Basis

