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Chicago Fed Letter

Economy to turn the corner in 2010

by William A. Strauss, senior economist and economic advisor, and Emily A. Engel, senior associate economist

According to participants in the Chicago Fed's annual Automotive Outlook Symposium, the nation's economic decline is forecasted to bottom out this year; solid economic growth is expected in 2010—with inflation staying contained but the unemployment rate remaining high. Light vehicle sales are predicted to fall sharply this year and then to improve in 2010.

The Federal Reserve Bank of Chicago held its sixteenth annual Automotive Outlook Symposium on June 4–5, 2009, at its Detroit Branch. More than 90 economists and analysts from business, academia, and government attended the conference. This *Chicago Fed Letter* reviews last year's forecasts for 2008, analyzes the forecasts for 2009 and 2010 (see figure 1), and summarizes the presentations at this year's conference.[1]

1. Median forecast of GDP and related items

	2008 (Actual)	2009 (Forecast)	2010 (Forecast)
Real gross domestic product[a]	–0.8	**–1.8**	**3.2**
Real personal consumption expenditures[a]	–1.5	**0.8**	**2.3**
Real business fixed investment[a]	–5.2	**–18.8**	**2.0**
Real residential investment[a]	–19.4	**–16.8**	**5.8**
Change in private inventories[b]	–25.8	**–10.0**	**28.1**
Net exports of goods and services[b]	–364.5	**–333.8**	**–339.2**
Real government consumption expenditures and gross investment[a]	3.2	**1.7**	**2.9**
Industrial production[a]	–6.7	**–7.5**	**5.4**
Car and light truck sales (millions of units)	13.2	**9.7**	**11.3**
Housing starts (millions of units)	0.90	**0.53**	**0.74**
Unemployment rate[c]	6.9	**9.9**	**9.5**
Consumer Price Index[a]	1.5	**–0.5**	**1.6**
One-year Treasury rate (constant maturity)[c]	0.99	**0.71**	**1.30**
Ten-year Treasury rate (constant maturity)[c]	3.25	**3.02**	**3.75**
JPMorgan Trade-Weighted Dollar Index[a]	9.2	**3.9**	**0.9**
Oil price (dollars per barrel of West Texas Intermediate)[c]	58.37	**56.00**	**65.50**

[a]Percentage change, fourth quarter over fourth quarter.
[b]Billions of chained (2000) dollars in the fourth quarter at a seasonally adjusted annual rate.
[c]Fourth quarter average.
Note: These values reflect forecasts made in May 2009.
Sources: Actual data from authors' calculations and Haver Analytics; median forecast from Automotive Outlook Symposium participants.

The U.S. economy's output peaked in December 2007; the U.S. entered a recession in January 2008. However, for the first eight months of 2008, conditions were relatively flat (in fact, gross domestic product, or GDP, rose 2.2% in the first half of 2008, compared with the first half of 2007). It was not until the financial crisis began in September 2008 that economic activity began to decline, falling in the third quarter 0.5% (seasonally adjusted annual rate, or SAAR) from the second quarter. Output fell by a more significant 6.3% in the fourth quarter of 2008 and by 5.5% in the first quarter of 2009.

The dramatic decline in lending activity that began in September 2008 brought an already elevated risk to the economic outlook to a tipping point. For instance, borrowing costs from the risky high-yield corporate bond market rose from around 8% in the middle of 2007 to 11.5% at the end of August 2008. By the end of September, this interest rate rose to nearly 14%; then it moved up to nearly 19% by the end of October; and then it increased to more than 21% at the end of November. Between June 2007 and August 2008, this rate rose 350 basis points, but the credit crisis in September caused the rate to increase an additional 1,000 basis points in just three months.

Prior to September 2008, it was a challenge to find parts of the real economy that were being materially affected by the turmoil in the financial markets. The dichotomy between the performance of Wall Street firms and Main Street firms was often mentioned. However, because of the financial crisis in September, nonfinancial firms and individuals began to experience reductions of available credit. As an illustration, the economy began shedding jobs in January 2008, but for the first eight months of 2008, losses averaged 137,400 jobs per month. During the following ten months, job losses averaged 536,100 jobs per month.

With job losses, consumer spending began to retrench, falling 3.8% and 4.3% in the third and fourth quarters of 2008, respectively, and then rising 1.4% in the first quarter of this year. For the first three quarters of 2008, light vehicle sales (car and light truck sales) averaged 14.1 million units (SAAR)—12.8% below the comparable year-earlier period. However, between October 2008 and June 2009, sales fell to 9.8 million units (SAAR)—35% below the comparable period in 2007–08.

Light vehicle sales are predicted at 9.7 million units in 2009 and 11.3 million units in 2010.

In order to combat the weakness in the economy, the Federal Reserve began lowering short-term interest rates in September 2007. The federal funds rate was reduced from 5.25% to nearly 0% by the end of 2008. In addition, the Federal Reserve increased the term lengths of some of its lending and provided loans to specific stressed markets.

Forecasts versus results

At last year's symposium, participants forecasted an anemic 1.2% rate of growth for the economy in 2008, but the previously mentioned financial crisis led to real GDP falling 0.8%. The unemployment rate was forecasted to rise to 5.4% by the end of 2008—much lower than the 6.9% that the unemployment rate averaged in the final quarter of last year. Inflation, as measured by the Consumer Price Index (CPI), was predicted to average 3.9%—off significantly from the actual 1.5% increase in prices that occurred during 2008. In large part the inflation forecast was wrong because of a substantial miss on energy prices: Oil prices were anticipated to average around $105 per barrel in the fourth quarter of 2008, but oil prices plunged to average below $60 per barrel in the final quarter of last year. Light vehicle sales were expected to fall substantially, from 16.1 million in 2007 to 15.2 million in 2008. The actual drop was much greater, with light vehicle sales falling to 13.2 million in 2008. The housing sector was predicted to be quite weak in 2008, and the actual results were just a bit weaker than expected. Housing starts were forecasted to fall to 0.97 million units in 2008, but actually fell to 0.90 million units. Similarly, residential investment was predicted to decline by 16.3%, but actually fell by 19.4%.

Outlook for 2009 and 2010

The forecast for 2009 is for economic growth to fall during the first half of the year. But it is predicted to rise fractionally, by 0.2%, in the third quarter of 2009 and then faster in the final quarter, by 1.7%. For the year as a whole, real GDP is predicted to fall by 1.8%. The economy is then forecasted to rise by 3.2% in 2010. While this slightly-above-trend rate would be the best growth rate since 2003, it would be considered relatively restrained compared with the historical performance of the economy following a sharp contraction in GDP. With the economy struggling, the unemployment rate is expected to rise to 9.9% by the fourth quarter of 2009 and then edge just a bit lower to 9.5% by the final quarter of 2010. Inflation, as measured by the CPI, is expected to turn negative in 2009, declining by 0.5%; and then it is anticipated to rise next year by 1.6%. This pattern is being largely driven by the movement of oil prices, which are predicted to average $56 per barrel in the final quarter of this year and about $66 per barrel at the end of 2010. Personal consumption expenditures are forecasted to expand by a tepid rate, 0.8%, in 2009 and then rise by a slow rate, 2.3%, in 2010. Light vehicle sales are expected to fall to 9.7 million units this year and then improve to 11.3 million units next year. Business fixed investment is expected to fall by a substantial 18.8% in 2009 and then rise by 2.0% in 2010. Industrial production is forecasted to decrease by 7.5% this year and then rise to a strong 5.4% next year.

The housing sector is forecasted to bottom out this year. Residential investment is predicted to fall by an additional 16.8% this year, a little less of a drag than in 2008. The quarterly pattern of the forecast implies that the consensus group expects the housing market to stabilize in the final quarter of this year. Housing starts are anticipated to reach the bottom in the second quarter of this year, at 0.50 million starts (SAAR). Residential investment is then expected to rise 5.8% next year. Housing starts are predicted to rise from 0.53 million units this year to 0.74 million units in 2010.

The long-term interest rate (ten-year Treasury rate) is forecasted to decrease 23 basis points in 2009 and then rise 73 basis points in 2010. The short-term interest rate (one-year Treasury rate) is expected to decline 28 basis points this year and then rise 59 basis points next year. The trade-weighted U.S. dollar is predicted to rise 3.9% this year and then rise 0.9% in 2010. The trade deficit (net exports of goods and services) is predicted to continue to improve this year and then deteriorate slightly in 2010.

Auto sector outlook

Ted Chu, lead economist, General Motors Corporation, delivered the economic and auto industry outlook, with a focus on the Detroit Three.[2] On the economic front, Chu said, many of the recent "worst fears," such as a complete market meltdown or rising protectionism, never materialized. He added that, while he sees no strong economic recovery in the near future, there are some monthly data series—e.g., retail sales and industrial production—that are starting to stabilize. On the automotive side, Chu said that total vehicle sales in the U.S. are predicted to rise above 16 million units by the end of 2012. Chu turned his attention to China's automotive market, pointing out that China's volume (numbers of cars produced) overtook that of the U.S. sooner than he had expected.

This happened mostly because of the recent drop in U.S. auto sales. Chu explained that once the pace of sales in the U.S. accelerates, China will again trail behind the U.S. in industry volume for a short period, after which it will permanently outpace the U.S.

Kenny Vieth, partner, Americas Commercial Transportation Research Company, presented the outlook on the medium- and heavy-duty truck industry. Vieth explained that with the weak economy, the U.S. is not generating as much commercial freight to haul in 2009 as last year. Given the current volume of freight, there is an excess capacity of heavy-duty trucks of approximately 6% (about 200,000).

Vieth also spoke about the upcoming U.S. Environmental Protection Agency's (EPA) emissions mandate, which will take effect in 2010. These new emissions regulations for trucks had been expected to speed up the normal cyclical process of buying trucks in 2009. However, strong "prepurchases" of trucks that meet the current EPA standards (but not the 2010 standards) have not materialized because of the economic downturn. This lack of prepurchases sharply contrasts with the patterns of prepurchases that were witnessed shortly before the 2002 and 2007 EPA emissions mandates.

Another factor affecting the trucking industry, Vieth noted, is the tightening of supply chains among the companies whose freight it hauls. On account of the higher fuel prices in 2008, most truckers increased the product they carried per load. This caused some companies to reexamine their bulky packaging, creating a packaging revolution. Three examples of this new packaging style are square milk containers, flat products (instead of inflated ones), and concentrated products (which have had water removed). Companies have also tightened their supply chains by producing closer to their end markets. These strategies result in truckers driving fewer miles.

According to Vieth, there is a strong correlation between the trucking market and the housing market. So, while there will always be a demand for trucking, he said, the trucking market will not fully recover until the housing market returns to approximately 1.5 million starts per year.

David Andrea, vice president, Original Equipment Suppliers Association (OESA), presented the outlook on the auto parts suppliers, with a focus on restructuring efforts throughout the sector. Overall, most suppliers, especially smaller firms, are hurting. There is uncertainty surrounding original equipment manufacturers' future production schedules; recently, monthly supplier receivables have stabilized, but they continue to be a source of concern; and suppliers continue to battle low cash flows, low working capital, and longer than normal periods of work stoppage. However, Andrea explained that many suppliers, according to the OESA's *Supplier Financial Health Survey* in May 2009, have restructured their businesses, so they should be able to break even at the lower volumes that are expected in the next couple of years.

Andrea forecasted North American light-duty production to be at 7.95 million units in 2009 and 9.67 million units in 2010. He said he expected it to finally break the 10-million-unit mark in 2011, with 11.85 million units anticipated that year.

Paul Taylor, chief economist, National Automobile Dealers Association, presented the light vehicle sales outlook from the dealers' perspective. Even with the recent increases in automakers' financial incentives for consumers to purchase new vehicles, Taylor forecasted 10 million to 12 million light vehicle sales for 2009—down from the already low 13.2 million units in 2008. Taylor said that the drop in new vehicle sales can be partially attributed to falling home equity values. Even though consumers are not borrowing against their home equity, they perceive the equity in their homes as a gauge of how well they are doing overall.

With high fuel prices and the weak economy, all car segments showed negative growth in 2008. However, sales of both small cars and CUVs (crossover utility vehicles, or utility vehicles built on passenger car platforms) experienced smaller declines. This trend has continued into 2009, Taylor said. Looking forward, Taylor said he expected 2010 to be weak for light vehicle sales, with pent-up vehicle demand showing up in the marketplace in 2011.

Mike Jackson, chairman and CEO, AutoNation, delivered a presentation on the new economic realities in the U.S. and how they affect the auto industry. He discussed several factors affecting auto sales, focusing in particular on credit availability and gas prices.

A 20% drop in vehicle sales occurred immediately after the investment bank Lehman Brothers collapsed on September 15, 2008. One of the causes for this large drop in sales, Jackson said, was the general withdrawal of credit in the wake of that bank's demise. This lack of credit availability was seen in the decline in loan acceptances at the finance company GMAC (General Motors Acceptance Corporation), as well as at Chrysler's and Ford's finance companies. From December 2007 to December 2008, AutoNation's loan approvals from GMAC plunged almost 100%, from 1,527 loans to 9; over the same period, loan approvals from Chrysler's finance company fell 97%, from 823 to 22, while the decline in loan approvals from Ford's finance company was not as extreme —they fell 24%, from 1,642 to 1,235.

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Jackson also talked about gas prices and fuel efficiency. Because of U.S. consumers' short-term memories with respect to gas prices, they have once again shifted toward bigger, less fuel-efficient vehicles as gas prices have fallen since reaching $4.00 per gallon in the summer of 2008. Even though 5% of the current U.S. population claims to care about going "green" when buying a vehicle, Jackson said, that is not enough to shift the majority of the country's population into smaller cars. However, because of the new CAFE (Corporate Average Fuel Economy) standards called for by the Obama administration, automakers selling cars in the U.S. will need to be more concerned with fuel efficiency. One way to get U.S. consumers (and automakers) to care more about fuel efficiency, Jackson explained, is to tax gas like Europe and Japan. In Europe, gas is $8.24 per gallon, of which $4.87 is tax (more than 12 times the amount in the U.S.); similarly, in Japan one gallon of gas costs $5.30, of which $2.09 is tax. Europe has achieved an average of 36 miles per gallon for the vehicles on its roads, and Japan has reached an average of 31 miles per gallon. Jackson argued that higher fuel costs have motivated vehicle buyers in Europe and Japan to choose vehicles with higher fuel efficiency. He argued that the U.S. needs to follow their lead, since an average gallon of gas in the U.S. is $2.46, and only $0.40 of it is tax. Not surprisingly, the U.S. also lags behind Europe and Japan on fuel efficiency; the U.S. average is only 21 miles per gallon. Jackson contended that it does not work to be pro-energy-independence and pro-fuel-efficiency, *as well as* pro-cheap-gas. He said that the U.S. needs to develop a more comprehensive energy policy.

According to Jackson, the automotive industry is currently in a catastrophic situation, but he said he remains optimistic about the future because the industry's old business model of high fixed costs will be destroyed as many companies restructure.

Conclusion

The participants at this year's Automotive Outlook Symposium predicted the recession to end around the middle of this year. But because of the fallout from the financial crisis, economic growth going forward is expected to be muted, with the unemployment rate remaining high. Light vehicle sales this year are forecasted to be the lowest in over 40 years, but some modest improvement is expected next year.

[1] Some materials presented at the symposium are available at www.chicagofed.org/news_and_conferences/conferences_and_events/2009_aos.cfm. The presentations about fuel efficiency on June 4 will be summarized in an upcoming *Chicago Fed Letter*.

[2] The Detroit Three are Chrysler Group LLC, Ford Motor Co., and General Motors Corp.