

US Economic Conditions and the Credit Environment

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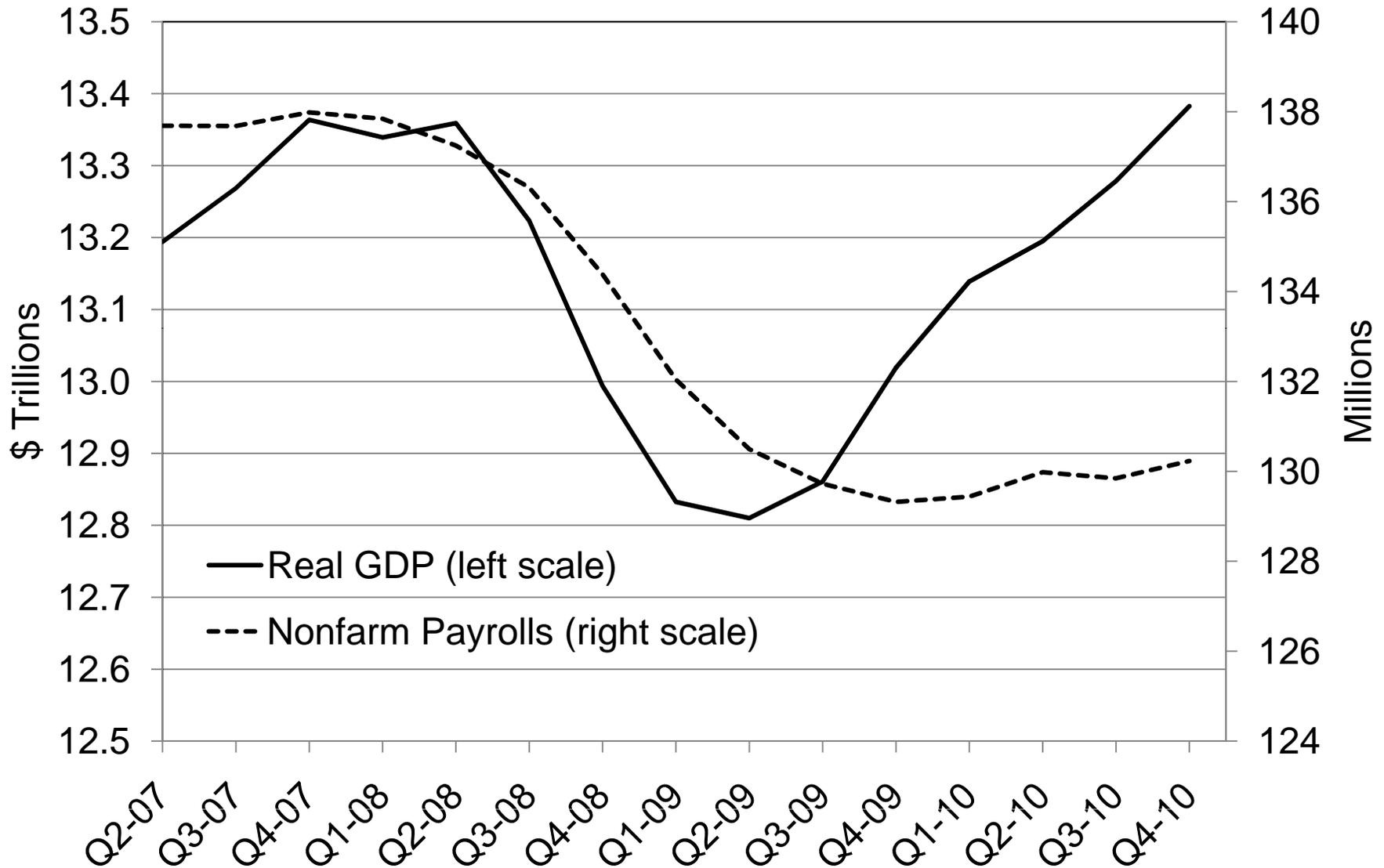
US Economy: Healthy Momentum, Temporarily Slowed by Supply Shocks

- Global view, pre-shocks: global recovery, driven by rapid growth in emerging nations
- US heads into negative impacts of higher oil prices and Japan with healthy momentum in demand and production
- Growth of consumption, real GDP moderating, but will accelerate in 2011H2
- Inflation will increase—headline and core
- Fed to conclude asset purchases with QEII, but no rate hike in 2011
 - Fed's risk-reward assessment and policies skewed toward unemployment concerns
- Bank lending environment improving: healthier credit quality, rising corporate loan demand
 - Consumer balance sheets adjusting

Pre-shocks Overview of US Economic Trends

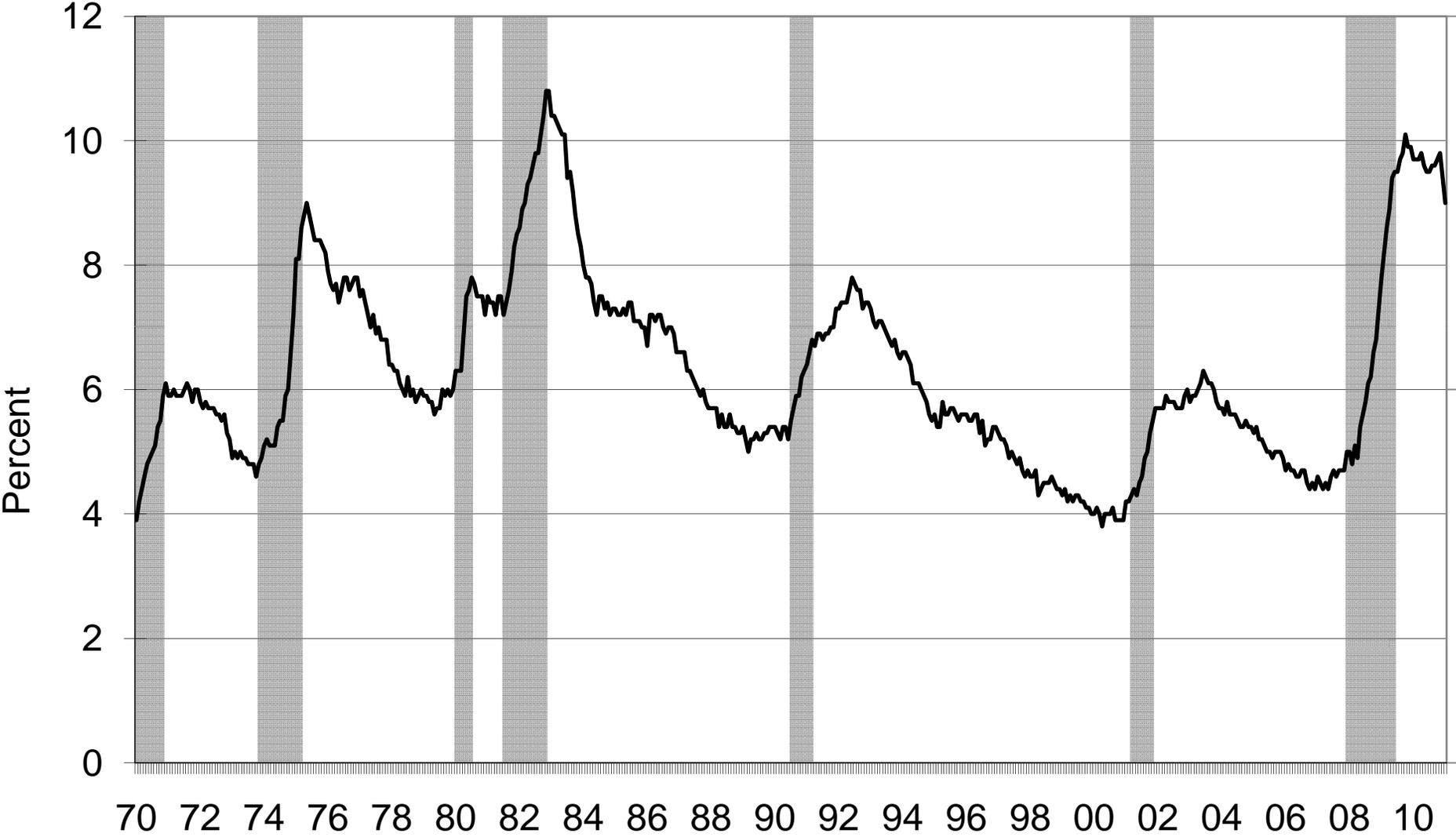
- Cyclical recovery despite housing problems
 - Consumer spending increases, supported by higher disposable income
 - Stronger exports and investment in equipment and software
- Employment lags, unemployment rate remains elevated
 - Sources: cyclical, “delayed cyclical”, structural
- Strong corporate profits and cash flows
- Housing weak despite lower home prices and mortgage rates
 - Distressed mortgages and pending foreclosures: big negatives
- Fed’s QEII boosts stock market, but distorts global capital flows
 - Don’t overstate its near-term economic impacts
- Long-run potential growth challenged by wrong-headed government fiscal policies, resource misallocations

US: Real GDP and Employment



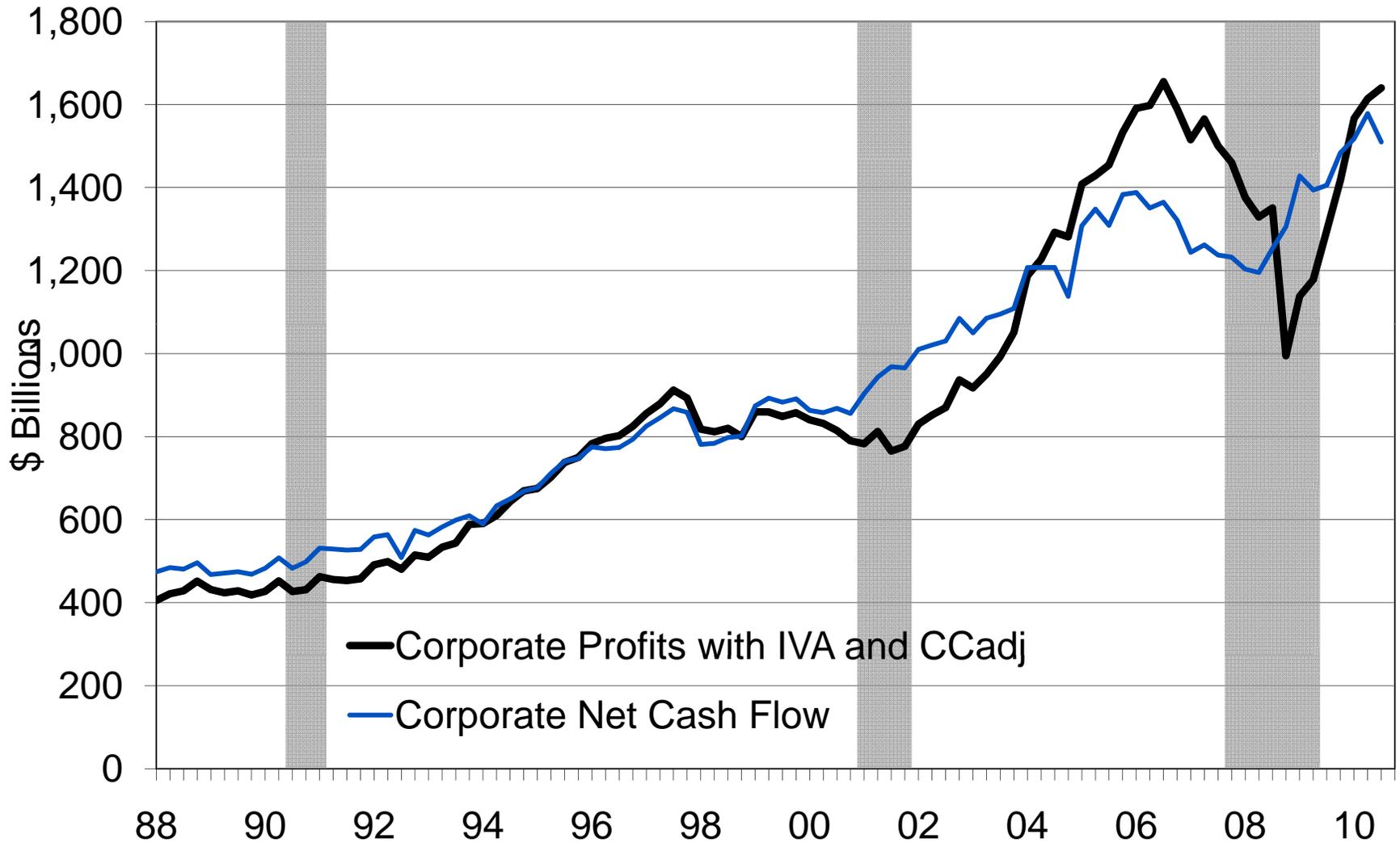
Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Haver Analytics

Unemployment Rate



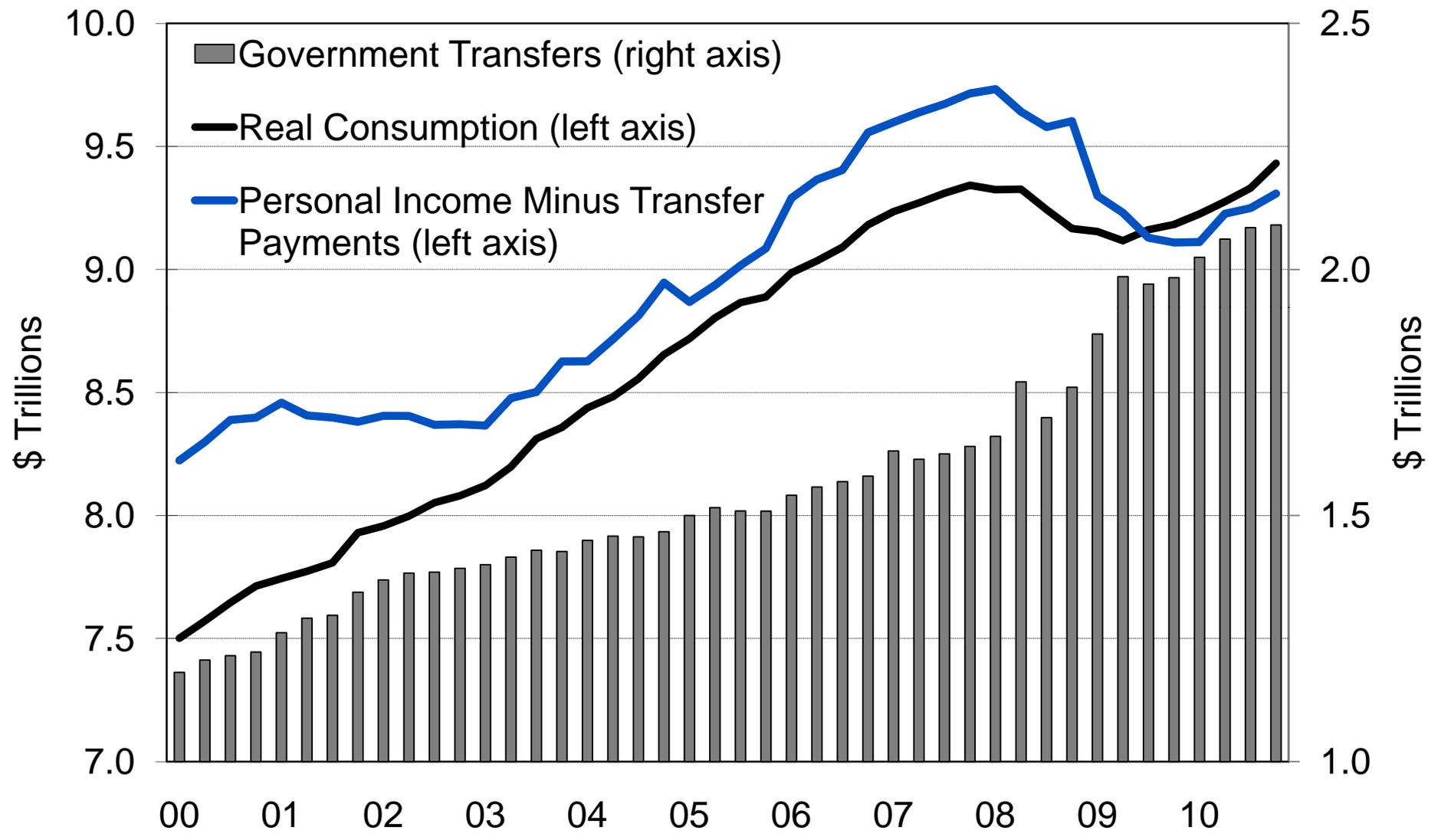
Source: Bureau of Labor Statistics/Haver Analytics

Operating Profits and Cash Flows



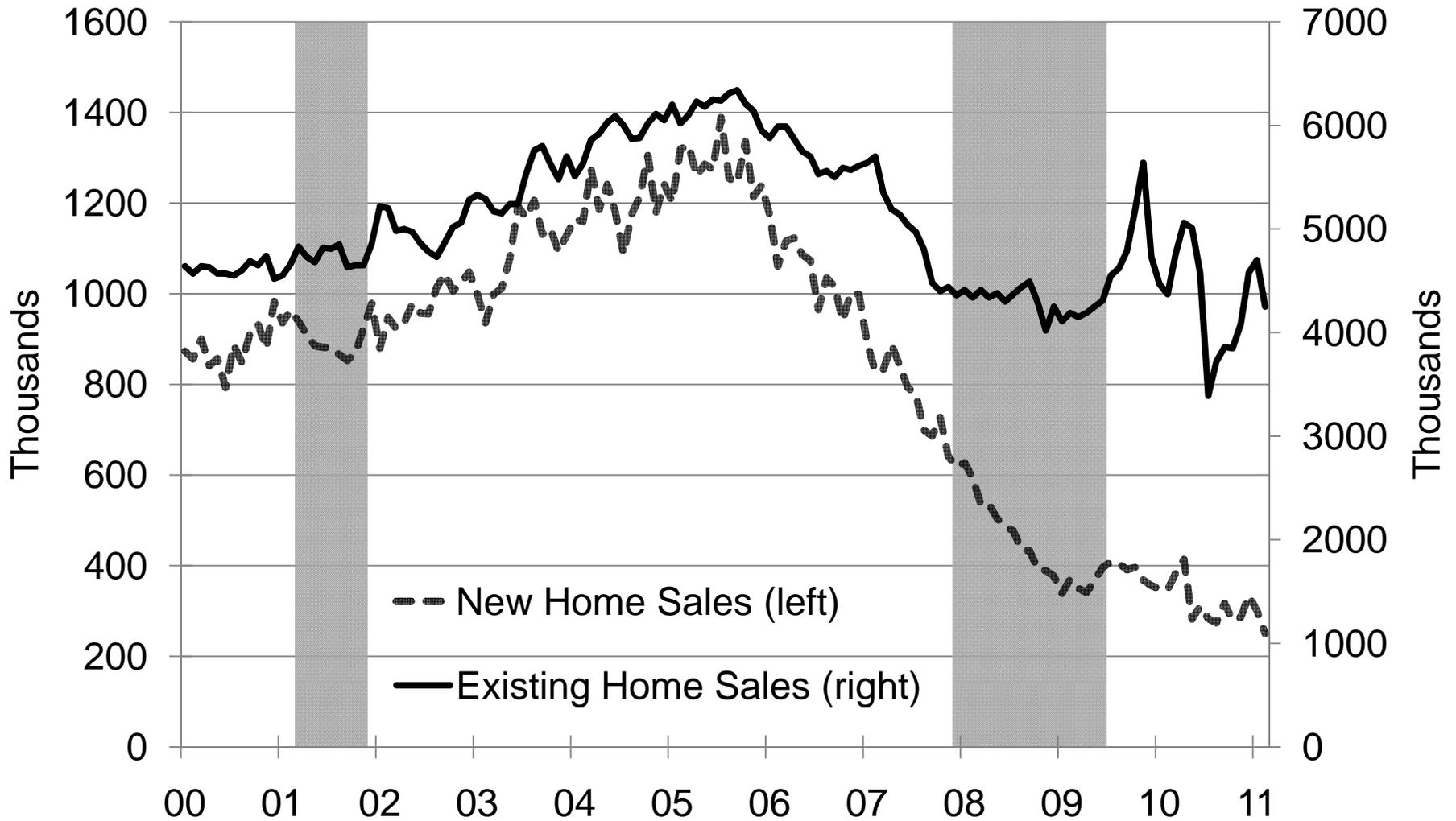
Source: Bureau of Economic Analysis, Haver Analytics

Real Consumption and Personal Income



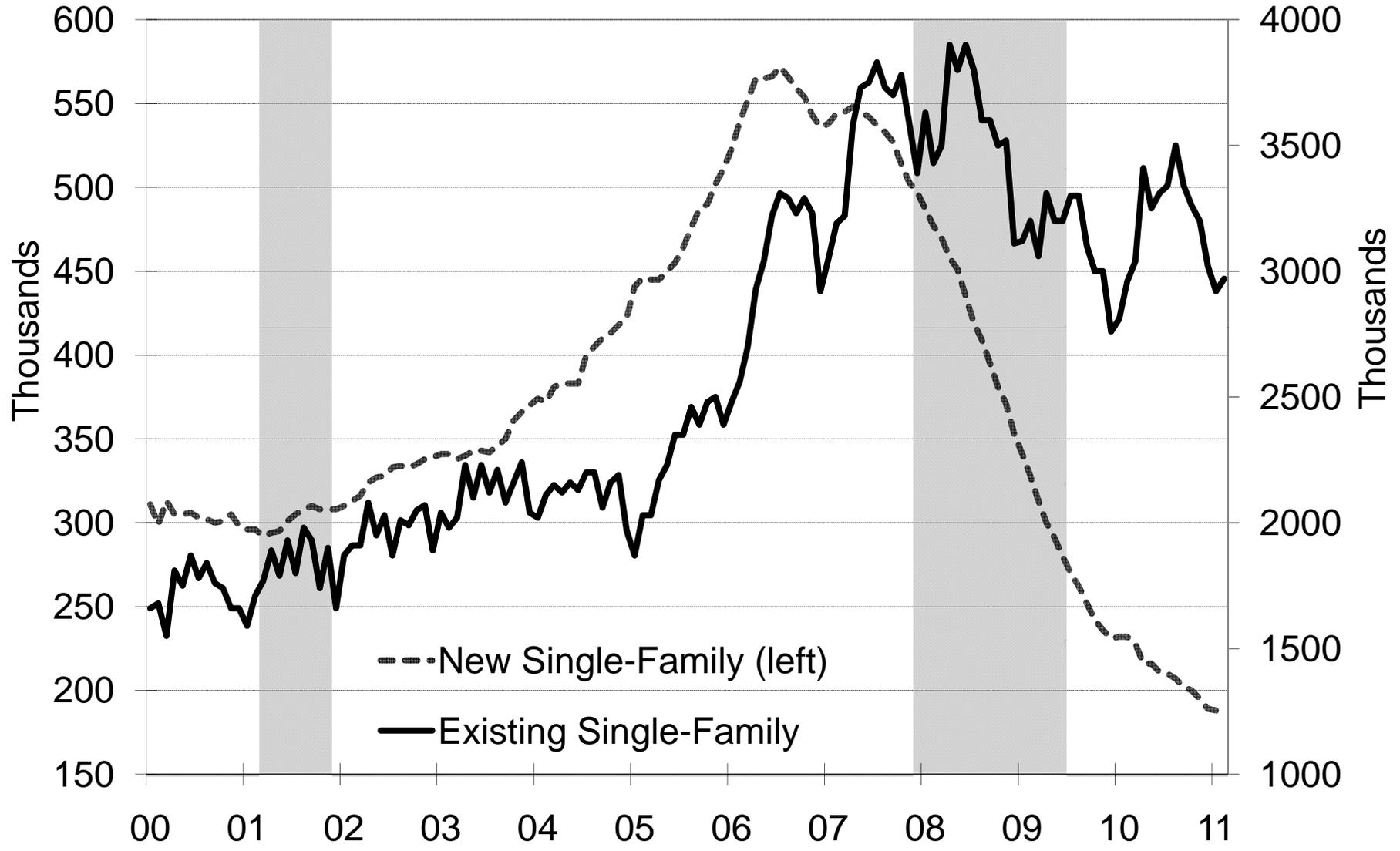
Source: BEA/Haver Analytics

Home Sales

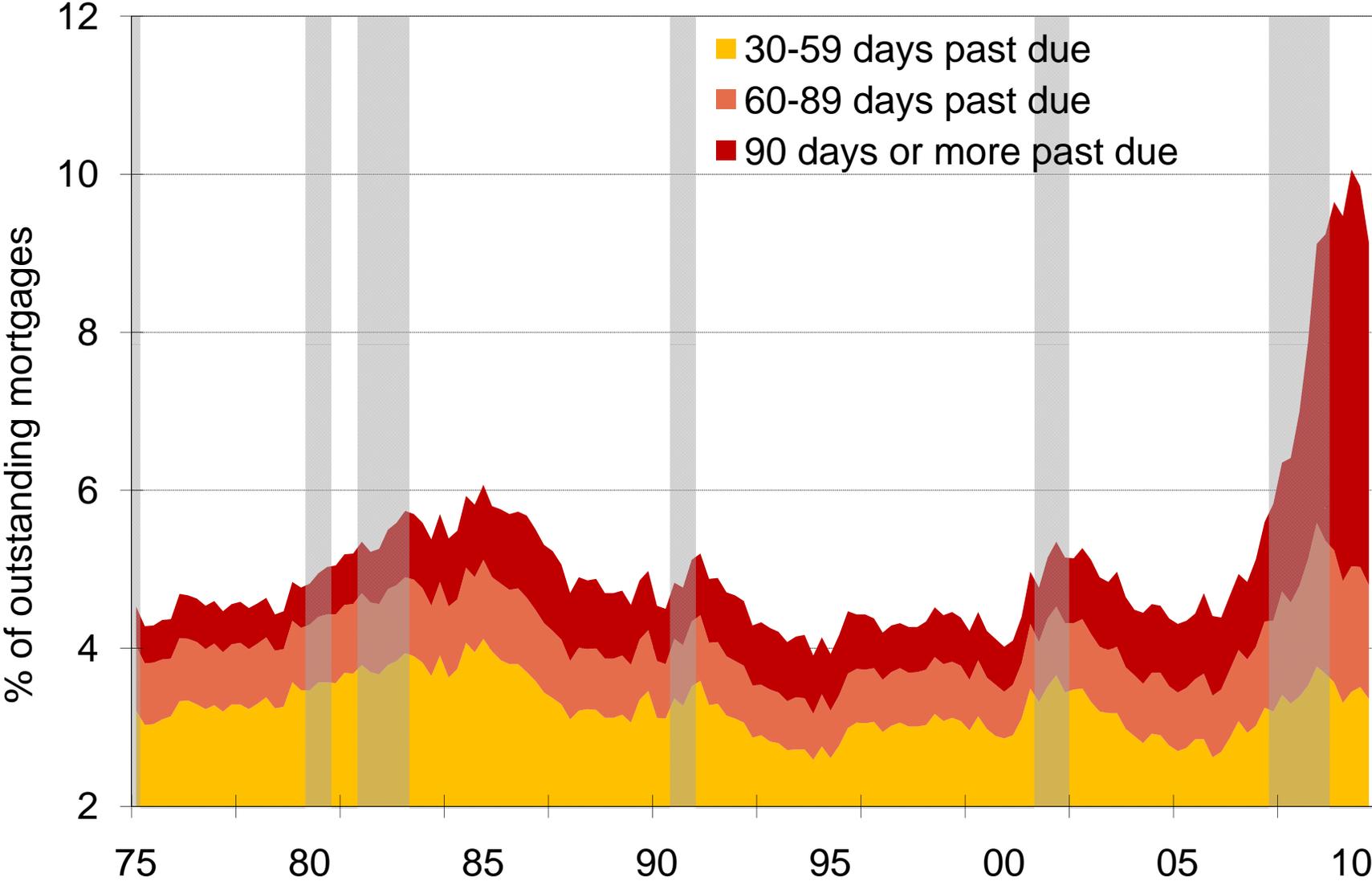


Source: Census Bureau/National Association of Realtors

Housing Inventories

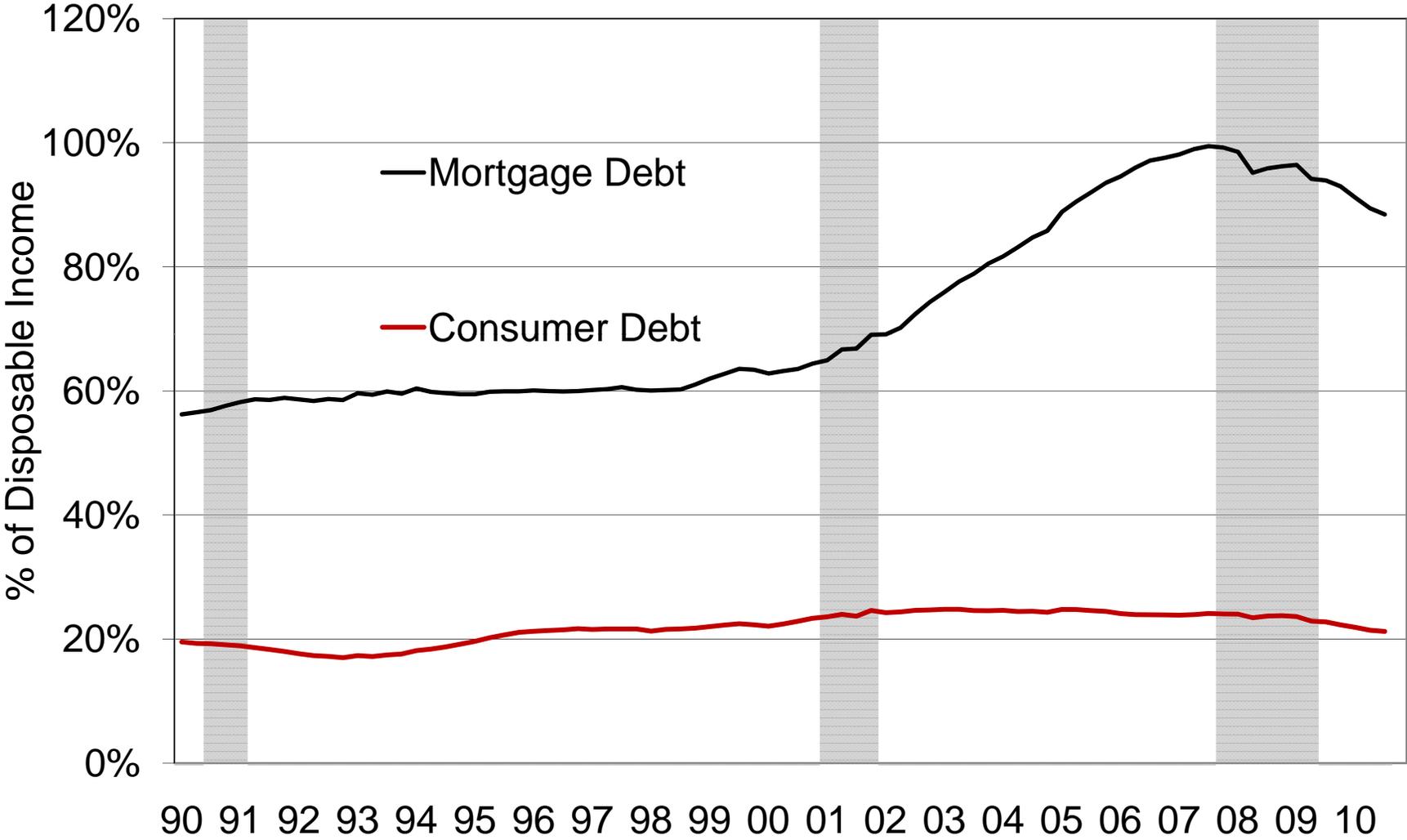


Distressed Mortgages



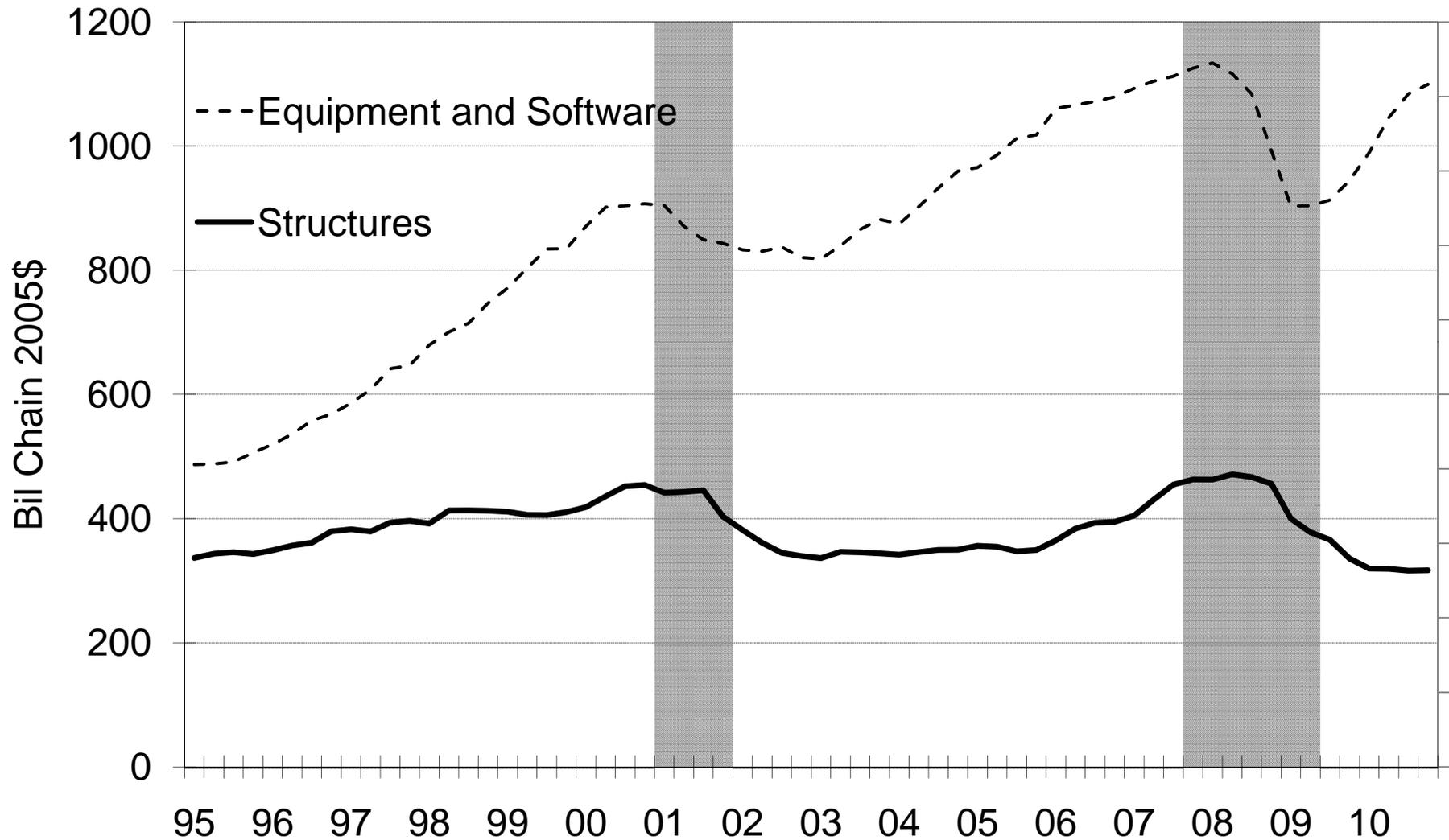
Source: Mortgage Bankers Association, Haver Analytics

Consumer and Mortgage Debt



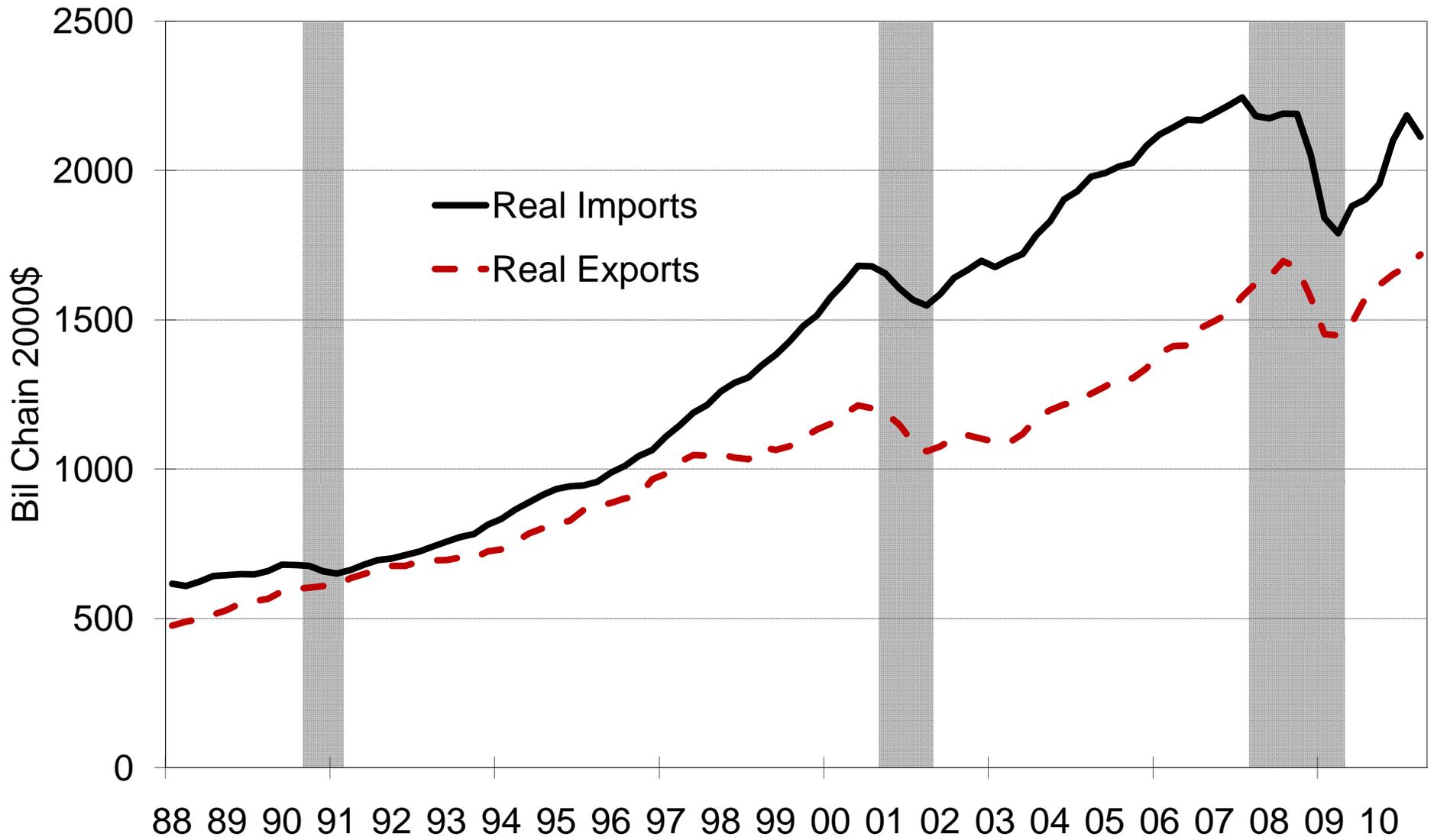
Source: Federal Reserve Board , Haver Analytics

Business Fixed Investment



Source: Bureau of Economic Analysis, Haver Analytics

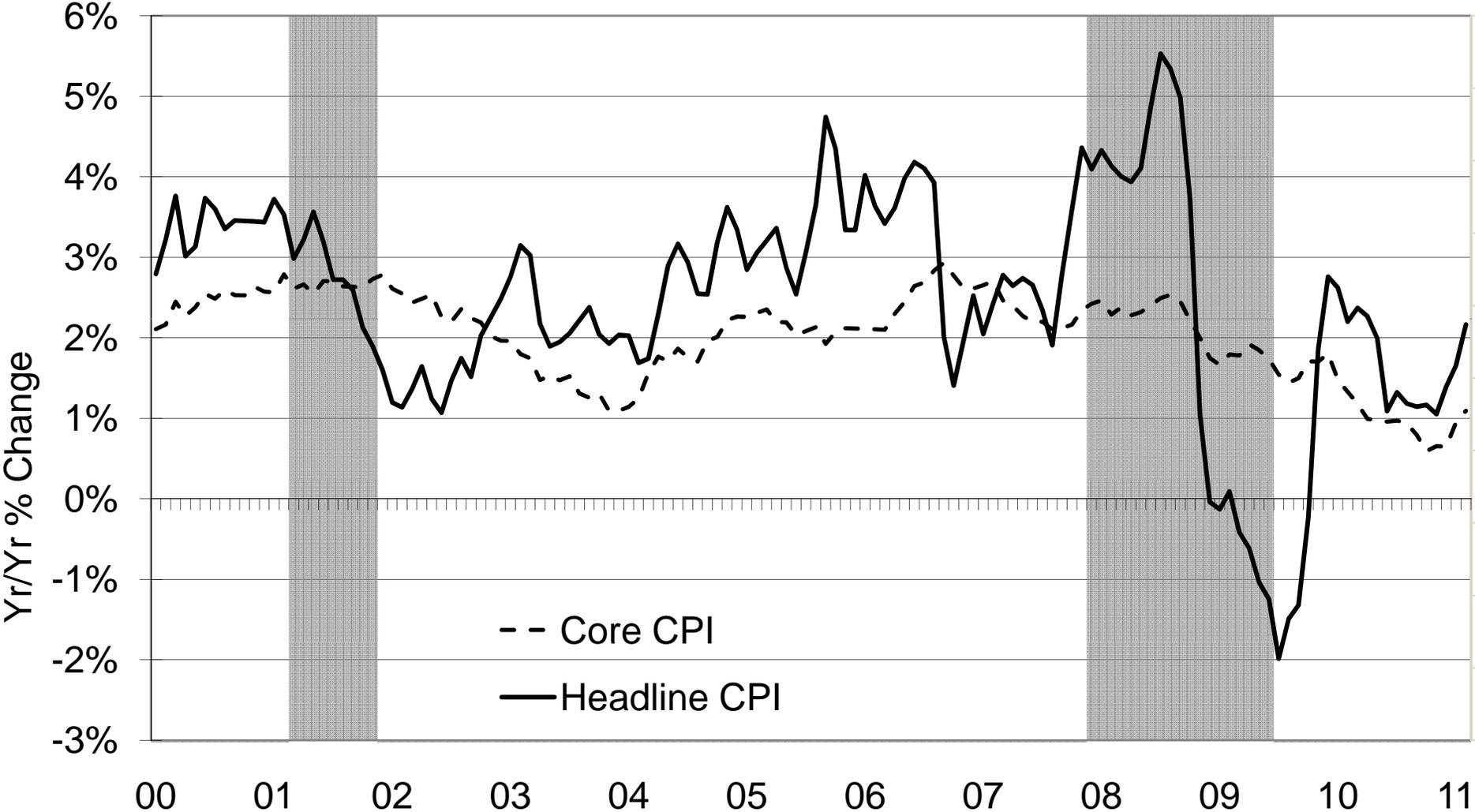
Imports and Exports



Inflation Pressures Will Mount

- Inflation has remained low in lagged response to recession, soft aggregate demand
- Inflation is rising from its trough, despite measured slack in economy
 - GDP Gap, NAIRU models will prove unreliable, once again
- Current price pressures largely in energy, food, imports
 - Accommodative monetary policy will facilitate “price pass through” from headline to core inflation
- Stronger nominal spending growth will provide businesses flexibility to raise product prices
- Outlook for 2011: moderately higher headline and core inflation
 - Biggest risk: a spike in inflationary expectations

Inflation Trends

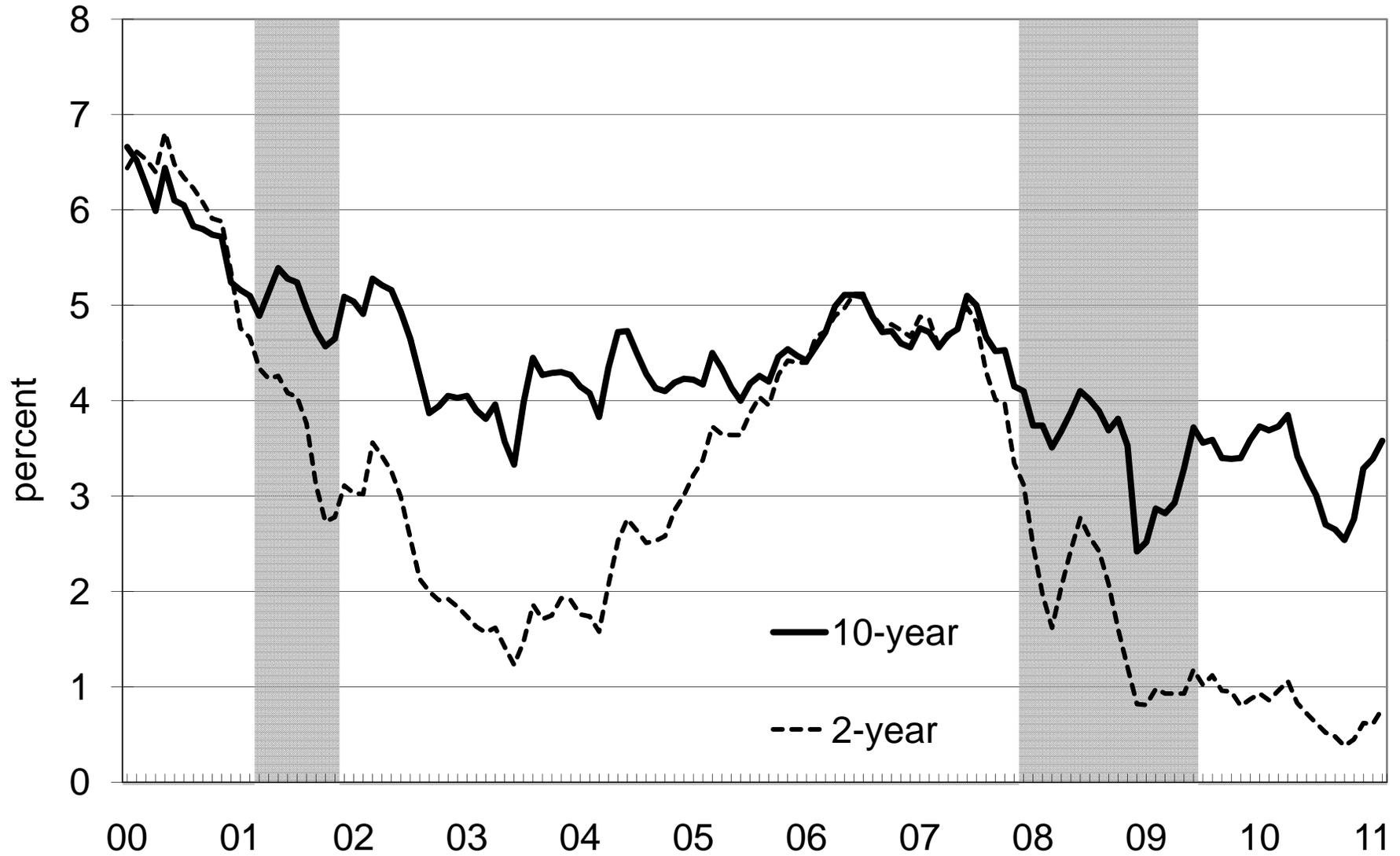


Source: Bureau of Economic Analysis/Haver Analytics

Financial Market Behavior

- Interest rates are unsustainably low and the yield curve is very steep
- Fed's QEII has pushed down US dollar, pumped up stock market, oil and global commodity prices
 - And the massive liquidity provision has distorted global capital flows
- US bond yields have risen but inflationary expectations remain tame
- Markets will anticipate conclusion of QEII, and impact on bond yields should not be jarring
 - Interest rates eventually will normalize
- Capital markets functioning normally, except for mortgage market

Selected Treasury Bond Yields



Source: Federal Reserve/Haver

The Pluses

- Significant adjustments following financial crisis
 - Households begin balance sheet repair—less debt, more saving
 - Nonfinancial businesses highly efficient (productivity gains)
 - Financial industry recapitalized; improved risk management
- Household net worth rises, partially retracing losses
- Private sector economy gaining traction
- Global economies rebounding, healthy demand for US exports
- Technological innovations and healthy entrepreneurship

The Negatives: Supply Shocks will Temporarily Constrain Demand, Supply

- Higher oil prices will slow real consumer spending and raise operating expenses
- Impacts depend on magnitude and duration of oil price increase
 - Real GDP growth to slow to approximately 2.5%-3% in Q2 and Q3
 - Future oil prices highly uncertain: event-risk driven
 - Recession highly unlikely
- Japan's tragedy—beyond the massive human suffering—will generate a temporary sharp decline in Japan GDP followed by a sharp rebound
 - Economic wealth destruction estimated \$300 billion, or 5% of GDP
 - US impacts will be modest and temporary
 - Disruptions to global supply and product chains will vary by industry

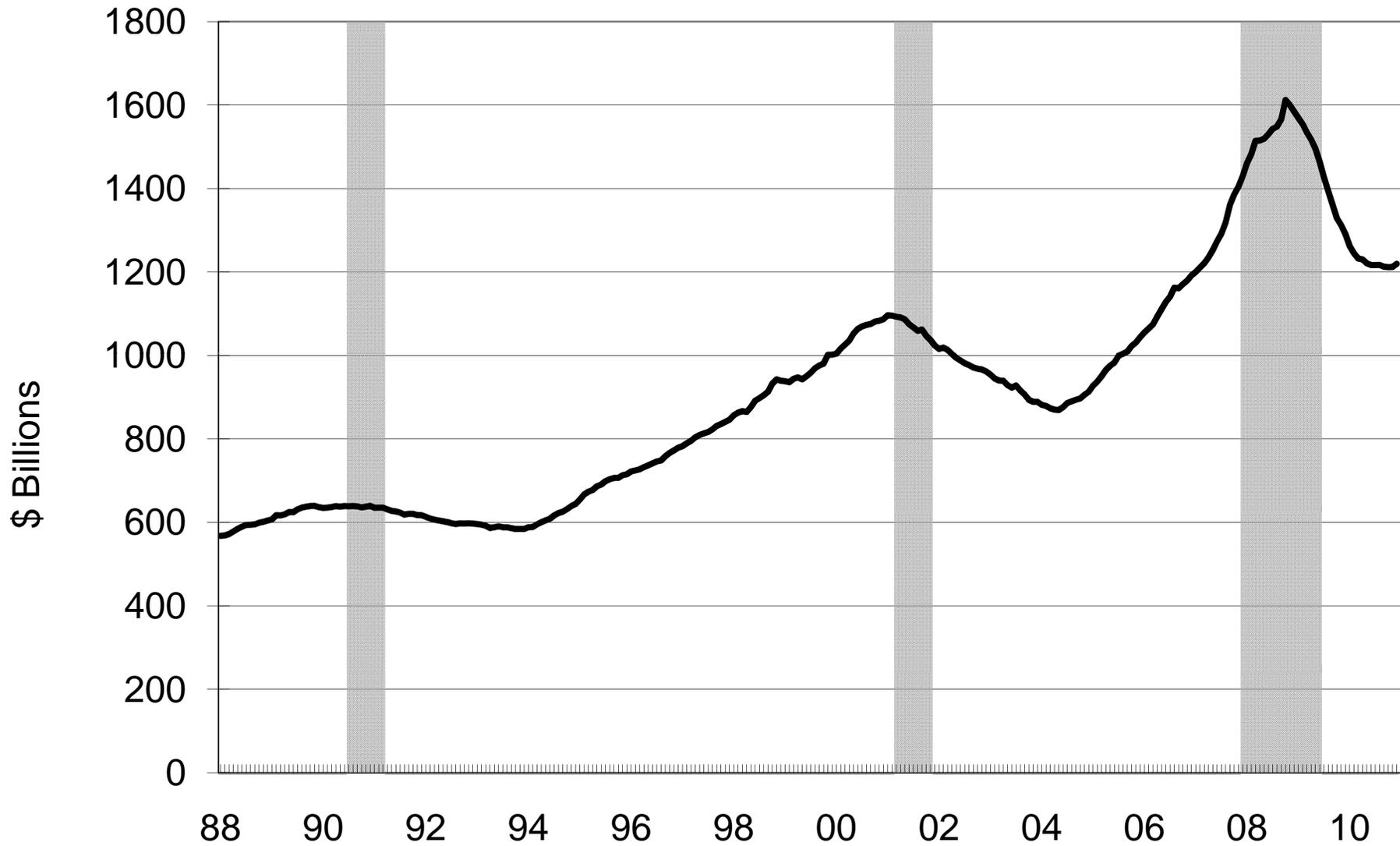
Economic Policy Challenges Beyond the Shocks

- Current unsustainable policies threaten long-run economic health
- Federal fiscal policy: significant changes are required
 - The composition of deficit cutting—and its implications for resource allocation—is as important to economic performance as the magnitude of the cuts
 - Economic effects of fiscal policy changes are complex
- Monetary policy—the Fed must establish strategy to exit from QEII and near-zero percent interest rates
- Conclude asset purchases with QEII and allow its balance sheet to shrink as assets mature
 - prepare to normalize interest rates on timely basis
- This would still leave massive excess reserves, even with sharp increases in bank lending
- Such an exit would not upset economy or financial markets, or affect bank lending

The Environment for Bank Lending

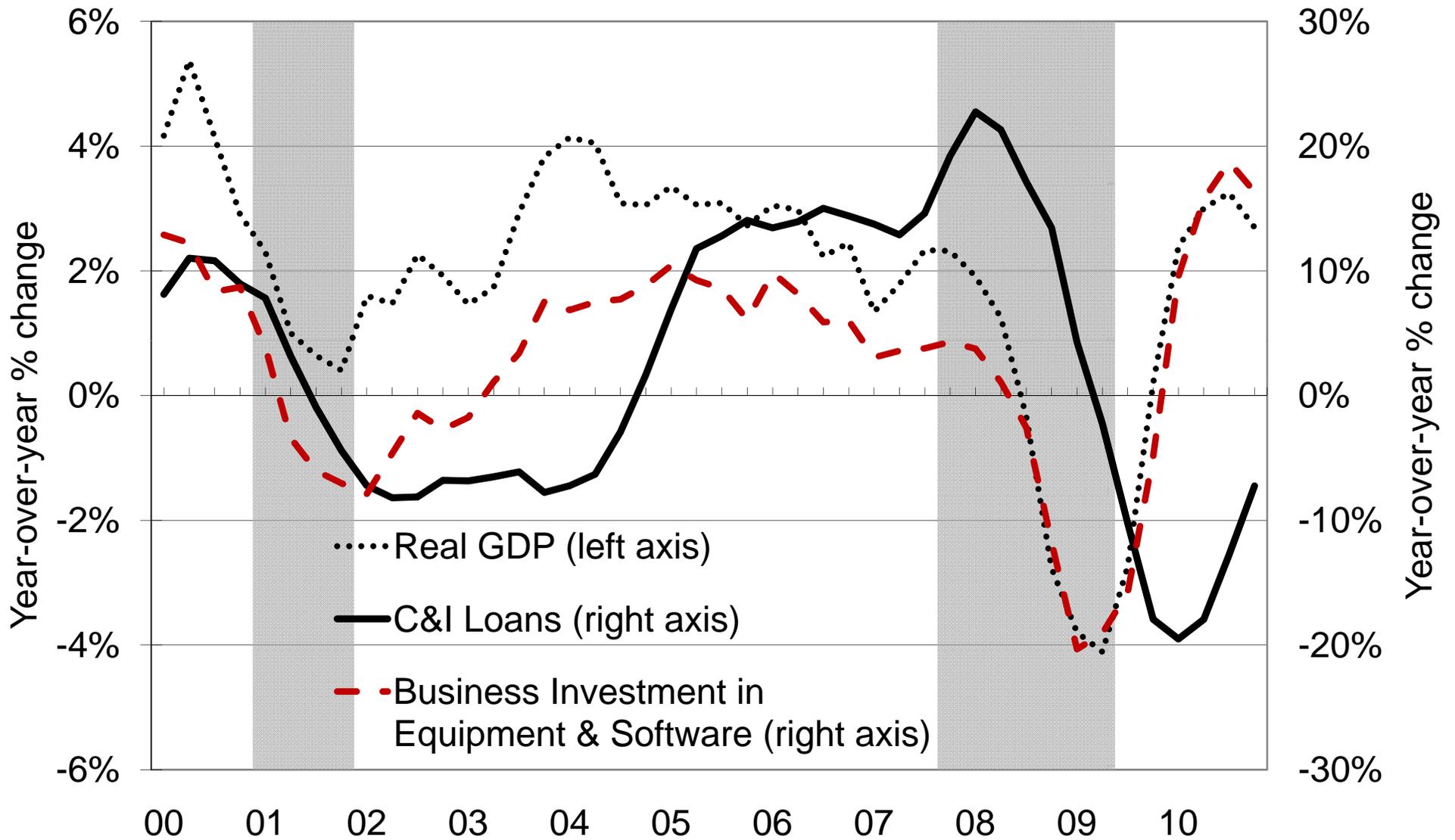
- Credit quality continues to improve significantly
- Commercial and industrial loans are rising modestly—higher demand
 - Lending to small businesses still soft—weak demand
- Credit card and home equity loans continue to recede, while consumer non-revolving loans (largely autos) are rising
 - Combination of reduced household borrowing, tighter credit standards, bank write-offs
- Massive number of distressed mortgages and pending foreclosures pose major challenge
 - New mortgage originations edging up
- New financial and consumer protection regulations add burdens and costs that hinder consumer and mortgage lending

C&I Loans



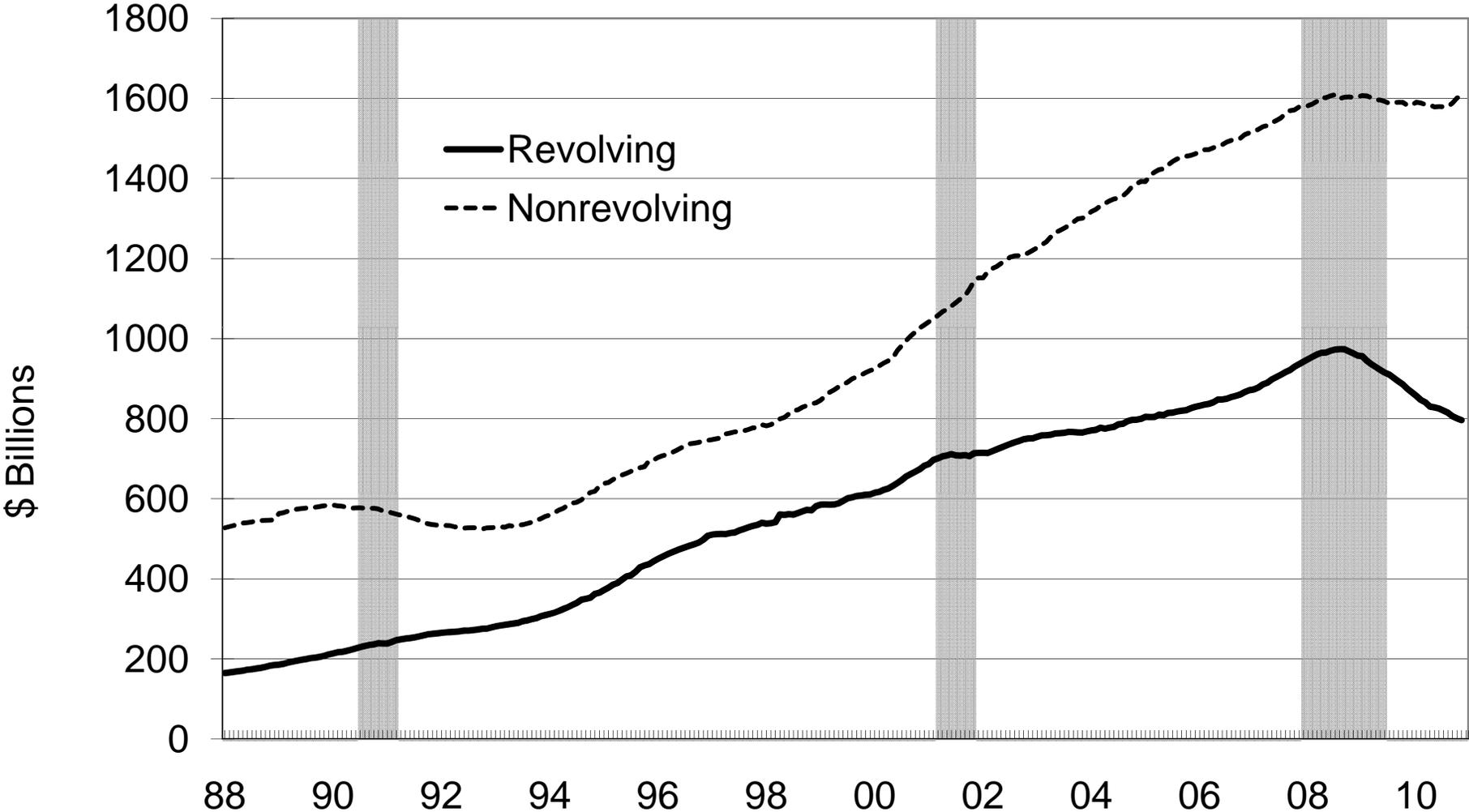
Source: Federal Reserve/Haver

C&I Loans, Real GDP and Business Investment



Source: Bureau of Economic Analysis/Federal Reserve/Haver

Consumer Loans



Source: Federal Reserve/Haver