The Economic Outlook for 2014—U.S. and Illinois

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4 themes

• The Great Recession was characterized by the build up of financial leverage. The recovery has been about rebuilding balance sheets and reducing leverage. A necessary first step in the process to growth.

• Good news, leverage has been significantly reduced...bad news we didn’t grow very fast in 2013. Why? Maybe uncertainty, maybe the recovery has been unevenly distributed

• Goolsbee...waiting for the bus that is never coming

• However, maybe some of the things that reduced growth in 2013 won’t be as much of a problem in 2014
Plus, recent evidence has been promising

• Latest Case-Schiller housing price index (20 large metros) was up 13.6% in October (vs. 2012). US home prices have risen for 20 consecutive months

• Consumer confidence in December hit 78.1 (vs. 72 in November) highest in 5 years

• December ISM manufacturing index hit 57 (anything above 50 indicates expansion) hovering near 2 ½ year high.

• Private construction spending has taken up the slack in the public sector. Spending has grown for 8 straight months and is at an annual rate of $934.4 billion...highest level since March 2009.
Recession Comparisons

Percent Change 22 Quarters After the Start of the Recession

Source: Author’s calculations using data from the BEA
GDP—second half of 2013 showed gains--and (Q3) 4.1%, (Q4) 3.2% but growth for the year was only 1.9%
Unemployment rate continues to fall, although not entirely for the right reasons—now 6.7% but December job growth was disappointing at 74K—6 month average is 172K
2014...no boom, but better growth

• Most economists expect some lift in 2014 to at least 3% GDP growth (of course they predicted this in 2013)
• WSJ (1/2/2014) Four building blocks for optimism
  – **Balance sheets are better.** Businesses have built up cash and enjoyed large profit margins. Banks have rebuilt capital and households have reduced debt levels.
  – **Some Consumers are buying.** Those with money and credit are buying. Consumer spending ended 2013 up solidly. Big-ticket items, cars, houses and appliances all doing well. Automakers had best year since 2007 in 2013.
  – **Businesses poised to spend.** Demand is firming and uncertainty about government fiscal actions lessens.
  – **Government headwinds subside.** The fiscal drag from spending cuts and tax hikes in 2013 will lessen. Fed policy remains favorable even with reduced QE
• Energy continues to be a plus...Low natural gas prices, potential to be energy independent
The Current Forecast

• Last FOMC (December, 2013) central tendency projection for GDP growth in 2013 is for 2.2% to 2.3% and 2014 for 2.8% to 3.2%. 2015 projection is 3.0% to 3.4%. Long-run 2.2% to 2.4%.

• Inflation appears contained. CPI and core have seen either declines or minimal growth, although gas/food prices might cause a blip. FOMC forecast has PCE at 0.9% to 1.0% (2013), and 1.4% to 1.6% (2014) and 1.5% to 2.0% (2015). Long-run estimate is at 2%.

• FOMC forecast has unemployment at 7.0% to 7.1 (2013), and 6.3% to 6.6% (2014), 5.8% to 6.1% (2015). Long-run—5.2% to 5.8%

• QE3 and low Fed Funds rate—targets 2.5% inflation/6.5% unemployment
A brief word on Fed policy

• The dual mandate
• Policy at the zero bound
• Quantitative Easing, 1, 2, 3—getting liquidity into the economy, getting the economy back to potential
• Is it the right medicine? Aggregate demand vs structural change
• The issue of commitment. Setting policy thresholds for inflation (predicted inflation rate for one to two years exceeds 2.5%) and unemployment (6.5%). These aren’t triggers they are thresholds.
• Forward guidance
Illinois...the song remains the same

- State continues to underperform the nation in the current recovery. Unemployment stays high and growth is slow
- Is the issue fiscal uncertainty? State and Chicago finances are shaky and solution is uncertain. The state faces its own “fiscal cliff” in 2015 as income tax rate rollback is possible.
- State and Chicago fiscal problems are more than pensions. The state still has $7 billion in unpaid bills even after the income tax hike. Much of the increase in income tax receipts were used to back-fill Federal ARRA dollars
- Question for business...Illinois tax structure in the future will look like.....?
Going back further in time, IL higher unemployment rate is not unknown.
Illinois scheduled hikes in income taxes

<table>
<thead>
<tr>
<th>Calendar Year</th>
<th>Pre-2011</th>
<th>2011-14</th>
<th>2015-24</th>
<th>Post-2024</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personal Rate</td>
<td>3.0%</td>
<td>5.0%</td>
<td>3.75%</td>
<td>3.25%</td>
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<tr>
<td>Corporate Rate</td>
<td>4.8%</td>
<td>7.0%</td>
<td>5.25%</td>
<td>4.8%</td>
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</tbody>
</table>
IGPA estimate of Illinois Budget Gap
(Total Revenue - Total Spending = Budget Gap in billions $)

Tax rates drop as scheduled
Tax rates extended
Exercise: What do Illinois state budget gaps (all funds) look like going forward (if pensions paid on 30-year ARC, without any income or other tax increases)?

<table>
<thead>
<tr>
<th>Year</th>
<th>Baseline gap</th>
<th>Without tax increase</th>
<th>No increase and paying the ARC</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>7.0</td>
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<td>10.1</td>
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<tr>
<td>2012</td>
<td>6.2</td>
<td>13.2</td>
<td>13.2</td>
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<tr>
<td>2013</td>
<td>4.9</td>
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</tr>
<tr>
<td>2014</td>
<td>1.6</td>
<td>8.9</td>
<td>12.4</td>
</tr>
<tr>
<td>2015</td>
<td>4.1</td>
<td>9.1</td>
<td>12.6</td>
</tr>
<tr>
<td>2016</td>
<td>6.0</td>
<td>8.7</td>
<td>11.9</td>
</tr>
<tr>
<td>2017</td>
<td>6.5</td>
<td>9.3</td>
<td>12.3</td>
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<tr>
<td>2018</td>
<td>6.8</td>
<td>9.7</td>
<td>12.4</td>
</tr>
<tr>
<td>2019</td>
<td>7.0</td>
<td>10.0</td>
<td>12.4</td>
</tr>
<tr>
<td>2020</td>
<td>6.4</td>
<td>9.5</td>
<td>11.6</td>
</tr>
<tr>
<td>2021</td>
<td>6.7</td>
<td>9.9</td>
<td>11.7</td>
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<tr>
<td>2022</td>
<td>7.1</td>
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<td>11.8</td>
</tr>
<tr>
<td>2023</td>
<td>7.5</td>
<td>11.0</td>
<td>12.0</td>
</tr>
</tbody>
</table>

Average: 6.0 | 10.1 | 12.0

% of FY2010 GDP: 0.9 | 1.6 | 1.9

Source: University of Illinois Institute of Government and Public Affairs Fiscal Futures Model.

[http://igpa.uillinois.edu/fiscalfutures](http://igpa.uillinois.edu/fiscalfutures)
The recent Illinois tax rate hikes on personal and corporate income would not have covered this shortfall.

Tax Revenues as a Percentage of GDP FY1995-FY2010

Own Source Revenues as a Percentage of GDP FY1995-FY2010
Illinois Pension Reform—reduces state payments by $160 billion over 30 years and fully funds pensions by 2044

Specifically the legislation:

- Reduces public employee annual contributions by 1 percentage point
- Limits future cost-of-living increases to 3% multiplied by the number of years worked times $1,000 ($800 if the recipient is eligible for social security). The base numbers will be adjusted for inflation.
- Further limits cost-of-living adjustments for pensions above $25,000 per year
- Skip some cost-of-living increases for current workers based on age.
- Raises retirement age by five years for workers 46 or younger
- Creates a 401(K) type plan as an option for workers to choose if they are not interested in the traditional defined benefit plan
- Permits a retirement system to sue the state to make required annual payments to the pension fund
How does all of this translate to local governments?

• Faster US growth will help with improving housing and retail sales. Property taxes have held up surprisingly well over the last business cycle so local revenues have done better than many had suspected. On a national level, local fund balances are surprisingly good.

• The big issue will be fiscal contagion from poor performance of state finances. This has shown up in Michigan where Detroit’s bankruptcy has led to higher borrowing costs for local governments even if they have sound balance sheets. Ratings analysts suggest that much of this is not because of actions by the local government but rather with the uncertainty around the state’s role in intervening/supporting local governments.

• Illinois structural budget deficit produces several potential problems for local governments. These can include—delayed aid payments, reduced state-aid, cost shifting. Mostly it will introduce uncertainty for local policymakers and officials.
Conclusions

• US economy may be ready to grow at 3%+ in 2014. Impediments to growth from 2013 are waning. Economic indicators for manufacturing, housing, consumption and labor all improved toward the end of 2013.

• In Illinois fiscal issues still dominate. Growth has lagged the nation and the Midwest. Pension reform will help (if it holds up in court) but state still has a structural budget gap even if the “temporary” income tax rate increases are made permanent.