



## U.S. Macro Outlook: Easing Past the Darkness

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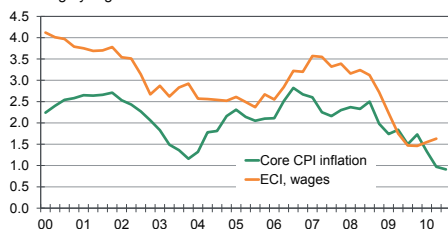
- » With odds of a renewed recession uncomfortably high, a policy error or economic shock could undermine the recovery and set off a deflation spiral.
- » Fed policymakers plan to resume large-scale asset purchases next month; markets expect the central bank to buy up to \$1 trillion in Treasuries.
- » Quantitative easing promises to lower debt costs and raise stock prices, sending a positive signal for investment and spending.
- » The Fed's plan could make it harder to unwind the stimulus after the economy strengthens and complicate global currency problems.
- » A darker outlook for 2011 does not change the forecast for 2012 and beyond, when better fundamentals will produce stronger growth.

The U.S. economy is growing at a rate that is meaningfully below its potential. Real GDP is tracking close to 2%, compared with its estimated potential of 2.75%, and about 75,000 jobs are being added a month on average, about half the pace needed to maintain a stable unemployment rate. Unemployment is expected to edge back into double digits in coming months.

The odds of a double-dip recession in the coming year are uncomfortably high at one in three. A significant policy error such as allowing the Bush tax cuts to expire or another economic shock such as a renewal of the European debt crisis would undermine the fragile U.S. recovery.

### Deflation Risks Rise

% change yr ago



Source: Bureau of Labor Statistics

### DEFLATION THREAT

Renewed recession would raise the specter of deflation. Businesses would not only slash payrolls in a downturn but could also impose permanent, nominal pay cuts on remaining workers, which could ignite a vicious, self-reinforcing downward wage-price spiral.

The Federal Reserve is fearful of this dark scenario and has strongly signaled its intention to resume large-scale purchases of Treasury securities in November. The question now is how large these purchases will be and over what period they will occur; the consensus seems to be up to \$1 trillion through next summer.

In anticipation of more quantitative easing, markets have already lowered 10-year Treasury yields by an estimated 30 basis points; lowered the value of the trade-weighted dollar about 5%, and lifted stock prices by a like amount. Based on simulations of the Moody's Analytics macro model, this effect should boost real GDP by about 15 basis points in 2011, which should mean a quarter-million additional jobs and a 0.2-percentage point reduction in the unemployment rate.

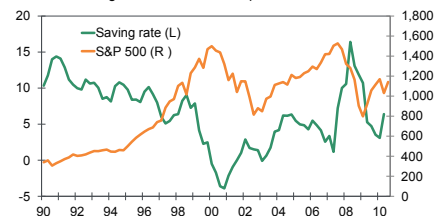
### SIGNALS IN THE STOCK MARKET

Higher stock prices are a particularly important channel through which quantitative easing benefits the economy. Businesses often use stock prices as signals guiding investment and hiring, while high-net worth households are quick to change their spending behavior as the size of their nest eggs changes. Last spring's slump in stock prices in the wake of the European debt crisis hurt confidence, hiring, and consumer spending. The recent revival in stock prices in anticipation of more Fed action is thus a significant plus.

Quantitative easing will help lower debt burdens through refinancing and deleveraging. Businesses are locking in rock-bottom borrowing costs by issuing record amounts of corporate bonds and using the proceeds to pay off higher cost debt. The interest coverage ratio for nonfinancial corporations—the percent of cash flow businesses

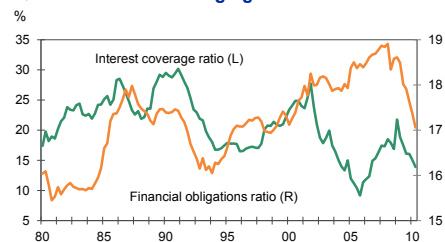
### Sensitive to Stock Prices

Personal saving rate for families in top fifth of income distribution



Sources: S&P, Federal Reserve, Moody's Analytics

### QE Facilitates Deleveraging



Sources: Federal Reserve, Moody's Analytics

devote to debt repayments—is likely to reach a record low by this time next year.

Homeowners are also refinancing at faster rates to take advantage of record-low fixed mortgage rates. When combined with deleveraging—household liabilities have shrunk by some \$900 billion, or 8%, during the past two years—debt service burdens are falling fast. At the current pace, household debt burdens will be about as low as they have ever been by this time next year. The deleveraging process will then likely wind down, removing a heavy weight from future economic growth.

### QE COSTS AND BENEFITS

The macroeconomic benefits of quantitative easing shouldn't be overstated, but the policy will provide a meaningful boost. Perhaps more importantly, it offers the Fed a mechanism to quickly expand its intervention in financial markets if the recovery falters further. It is even conceivable that under some circumstances policymakers would return to credit easing, expanding the central bank's purchasing program to include mortgage-backed securities and other financial assets.

Quantitative easing comes with costs: It will complicate the Fed's eventual effort to end its monetary stimulus in a graceful way. It will be difficult for the Fed to drain the liquidity it is providing to the economy quickly enough to avoid igniting inflation at some point in the future. Policymakers will be reluctant to tighten aggressively until it is absolutely clear the economy is off and running. Unfortunately, it won't be easy, in the fog of real-time economic data, to determine precisely when that occurs.

### A SIGN OF PANIC?

There is also a reasonable concern that quantitative easing may signal to investors and businesses that the Fed is panicking and that they should as well. This mindset would be counterproductive, but it hasn't happened yet, as the recent stock market rally attests. Yet, if the recovery fails to gain traction, additional Fed easing may prove ineffective.

More aggressive Fed action could also bring a significant cost in the form of increased tension in global financial markets. The U.S. dollar has fallen measurably in value vis-à-vis the euro, Japanese yen, and a number of emerging economy currencies. While the dollar's decline is a plus for U.S. trade and growth, it poses a hardship for these

other economies. Adding substantially to the problem is the fall in the relative value of the Chinese yuan and other Asian currencies pegged to the U.S. dollar.

The appreciating euro is aggravating concerns about the fragile European economy. Germany, the engine of European growth, is especially dependent on exports and is thus vulnerable to the euro's appreciation. The export-sensitive Japanese economy is also struggling with an appreciating yen. The yen's strength is particularly surprising given Japan's persistently weak economy and partly reflects yen-based asset purchases by the Chinese, who have been looking to diversify their rapidly growing foreign currency reserves beyond dollar assets.

Even fast-growing emerging economies are nervous about what rapidly appreciating currencies may do to their growth. Brazil has imposed taxes on foreign purchases of Brazilian assets in an effort to stem capital inflows and slow the real's appreciation. A number of other countries have taken the same step.

### ANGER RISING

Given all these concerns, global criticism of the Fed's developing quantitative easing policy has intensified, as has anger over China's currency peg. European Union and U.S. Treasury officials have openly criticized the peg, calling on the Chinese to revalue their currency more rapidly. The Chinese resumed revaluation earlier this year, but the yuan has risen no more than 3% since then. Given that the yuan appears undervalued by as much as 30%, Western officials would like to see the yuan gain about 10% per year over the next three years.

The Chinese are unlikely to revalue so quickly, however, seeing problems for their

manufacturers and their own economy. Yuan revaluation of 5% per year appears more likely. Meanwhile the Chinese are pushing back against critics, taking small steps such as redirecting some investments, imposing minor import restrictions, and limiting exports of important heavy metals. But the risk that global currency tensions will boil over in a more substantive way are rising.

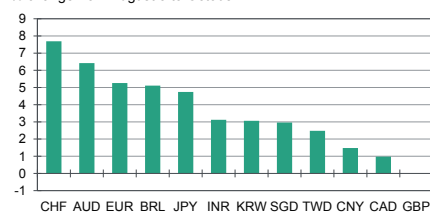
### IMPROVING FUNDAMENTALS

Quantitative easing isn't a silver bullet for the fragile U.S. recovery, but the benefits significantly trump the costs. Given uncomfortably high odds that the economy could backslide into recession next year—and the very dark deflationary scenario that could take hold if it does—the Federal Reserve has little choice but to respond aggressively. It will, and—assuming the economy is not sideswiped by another negative shock—it should succeed. Real GDP is expected to expand by 2.5% to 3% this year and to post a similar gain in 2011.

While 2011 growth prospects have been steadily marked down in recent months, our much better outlook for 2012-2013 remains unchanged. While it is difficult to recognize it in the current fragile environment, the underlying issues that caused the Great Recession and that still weigh on the recovery are being resolved. Households and businesses are rapidly deleveraging, corporations have slashed costs and are very profitable, and the overbuilding that occurred in the boom is being absorbed. Getting through the next 12 months will be difficult, but by this time next year, these improved fundamentals should become evident.

#### Global Currencies Rise vs U.S. Dollar

% change from August 3 to October 12



Sources: NY Fed, Moody's Analytics