

# The Macro Policy Outlook

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October 11, 2011



# Summary

- ✓ The Fed is largely done with its third wave of easing, but it still has some options left.
- ✓ Although there's little evidence to back it up yet, we think there will be a positive outcome to the special fiscal committee (not ideal, but better near- and longer-term fiscal policy)
- ✓ There's a long way to go before European policymakers have a convincing "Plan B" in place
- ✓ 2012 election – Obama needs real income growth about a point higher than it is now for re-election

# Overview

Looking ahead to November:

- Nov 2 – FOMC meeting ends (Bernanke press conference follows)
- Nov 3-4 – G20 Meeting (effective deadline for action on European banking/sovereign issues)
- Nov 19 – Temporary US govt funding measure expires, shutdown threat
- Nov 23 – Deadline for special committee to vote on recommendations

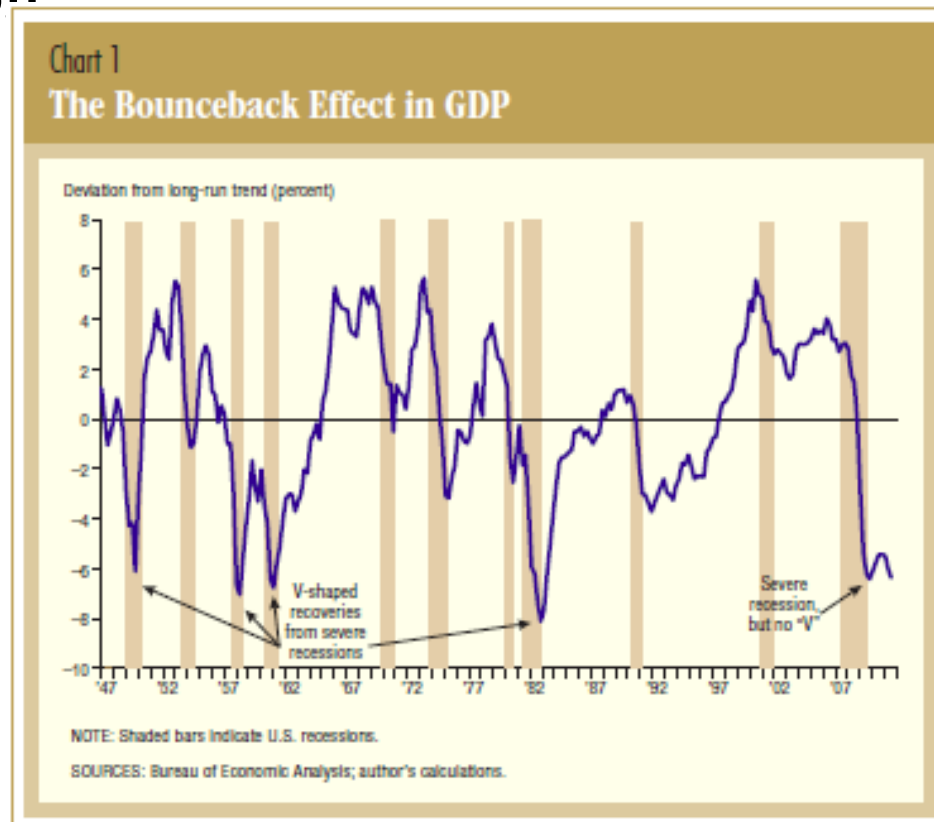
# Using the Post-Crisis Framework to Analyze Macro Policies

## Characteristics of a post-crisis business cycle:

- ✓ Real growth  $\approx$  1% lower than pre-crisis trend
- ✓ Big government budget deficits
- ✓ Despite deficits, low interest rates
- ✓ Low inflation
- ✓ Persistently high unemployment
- ✓ Unhappy voters

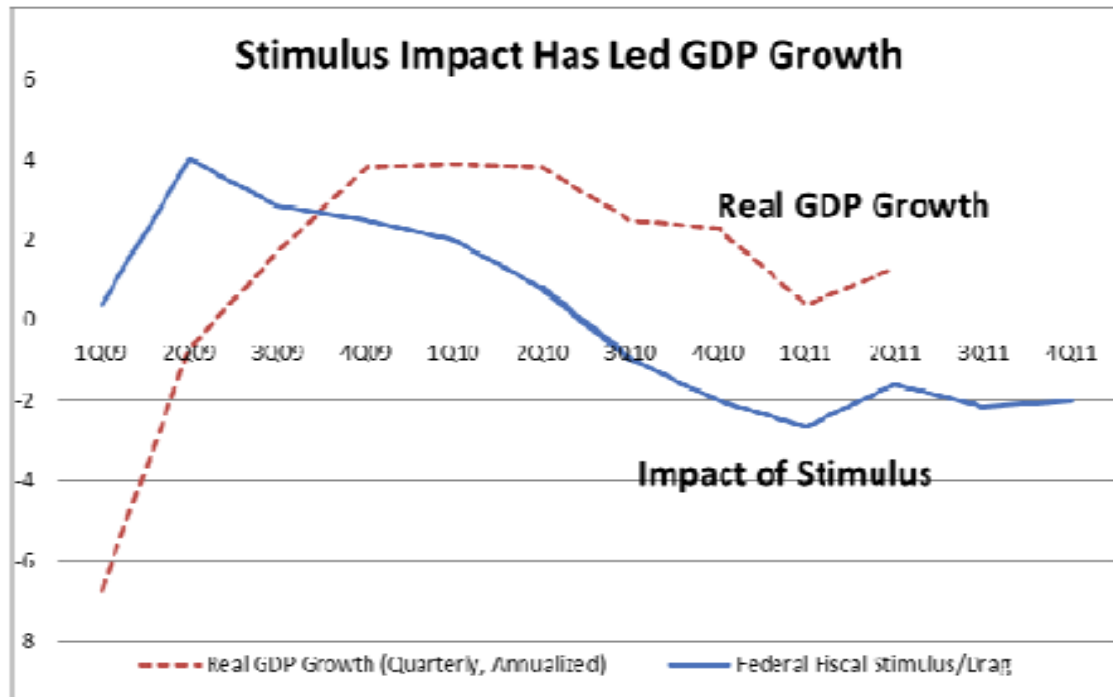
# Macro Policy

In a normal business cycle one round of macro monetary and fiscal stimulus is enough to produce a strong recovery and expansion



# Macro Policy

Post-crisis economies are more dependent on stimulus



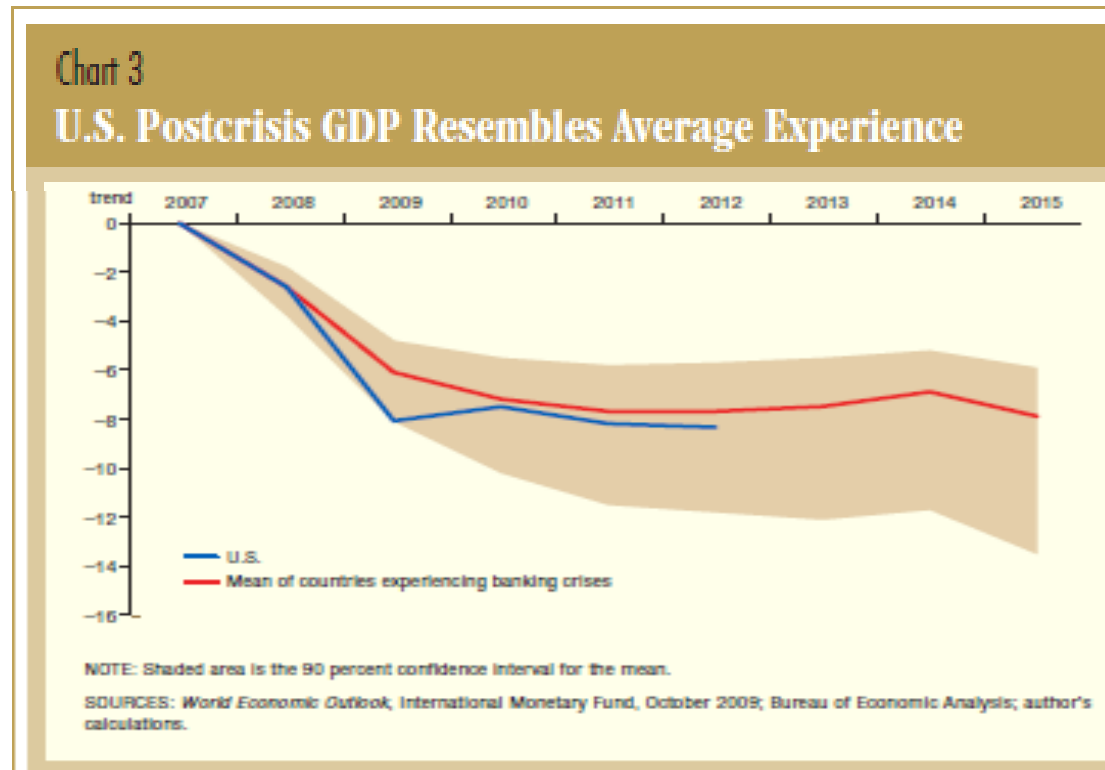
# Macro Policy

Post-crisis economies are more dependent on stimulus



# Macro Policy

Despite disappointment, US economic performance is typical for post-crisis economies





# Macro Policy

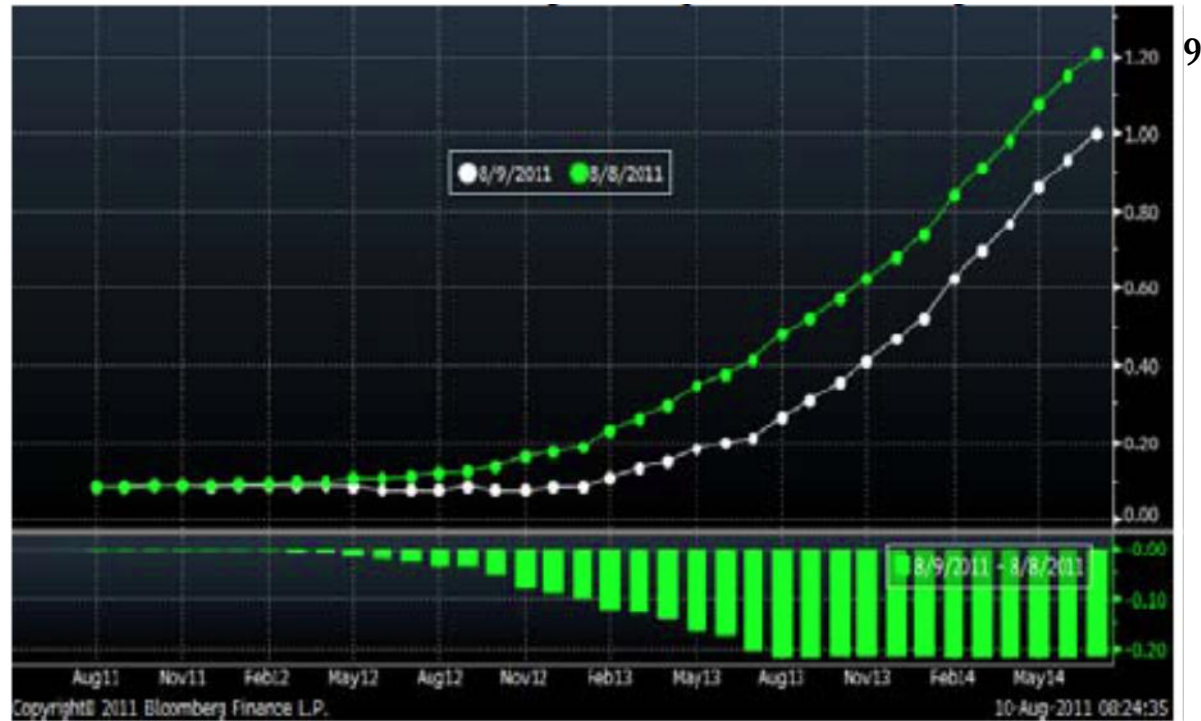
The US is now in its third wave of stimulus.

- 1) First wave was QE1 (March '09 FOMC meeting) and the '09 stimulus bill.
- 2) Second wave was 2H10, with QE2 (Nov '10 FOMC meeting) and the extension of the Bush tax cuts (Dec '10).
- 3) Third wave zero-rate commitment (Aug '11), then Operation Twist (Sep '11); Obama has proposed more fiscal stimulus

# Monetary Policy

In August the Fed committed to keep the fed funds rate at 0-0.25% until mid-2013 (conditional on inflation remaining under control)

The Fed was able to push expected Fed Fund rates in 2013 down by 20bp



# Monetary Policy

## Actions at the September 21 FOMC meeting:

- ✓ Buy \$400 billion of longer-term bonds, matched by sales of Treasuries with maturities under 3 years, over the next 9 months
- ✓ Reinvest maturing MBS in MBS rather than Treasuries
- ✓ Kept an easing bias

# Monetary Policy

## Extend duration of Fed portfolio

- Before QE, the duration of the Fed's portfolio was 2-3 years
- Now the Fed holds about \$1.6 trillion in Treasury notes and bonds, with a duration of 4.91 years
- If they sold all maturities under 3 years that would equal \$520 billion.
- If all that were invested in 7-30 year Treasuries duration would lengthen to 7.4 years

# Monetary Policy

## Impact of “Operation Twist”

- This can be thought of as “sterilized QE” – more long-term treasuries are being purchased but the size of the balance sheet is not changing, as the purchases are matched by sales of short-term securities
- Those who believe the impact of unconventional policies comes from liquidity (size of the balance sheet) or from excess reserves will be disappointed
- But the Fed sees the real impact coming removing risk from private portfolios, thus pushing private investors into somewhat riskier securities

# Monetary Policy

## FOMC options for future FOMC meetings:

- 1) Reduce interest paid on excess reserves – likely  
at some point
- 2) Change the zero-rate commitment from a time frame (mid-2013) to economic conditions (such as achieving an unemployment rate) – quite possible in Nov
- 3) Further define the inflation mandate
- 4) Increase the inflation target - unlikely

# Monetary Policy

## Reduce interest paid on excess reserves

The point of the IOER rate is to have banks keep reserves on deposit at the Fed, and this can be accomplished with a lower rate

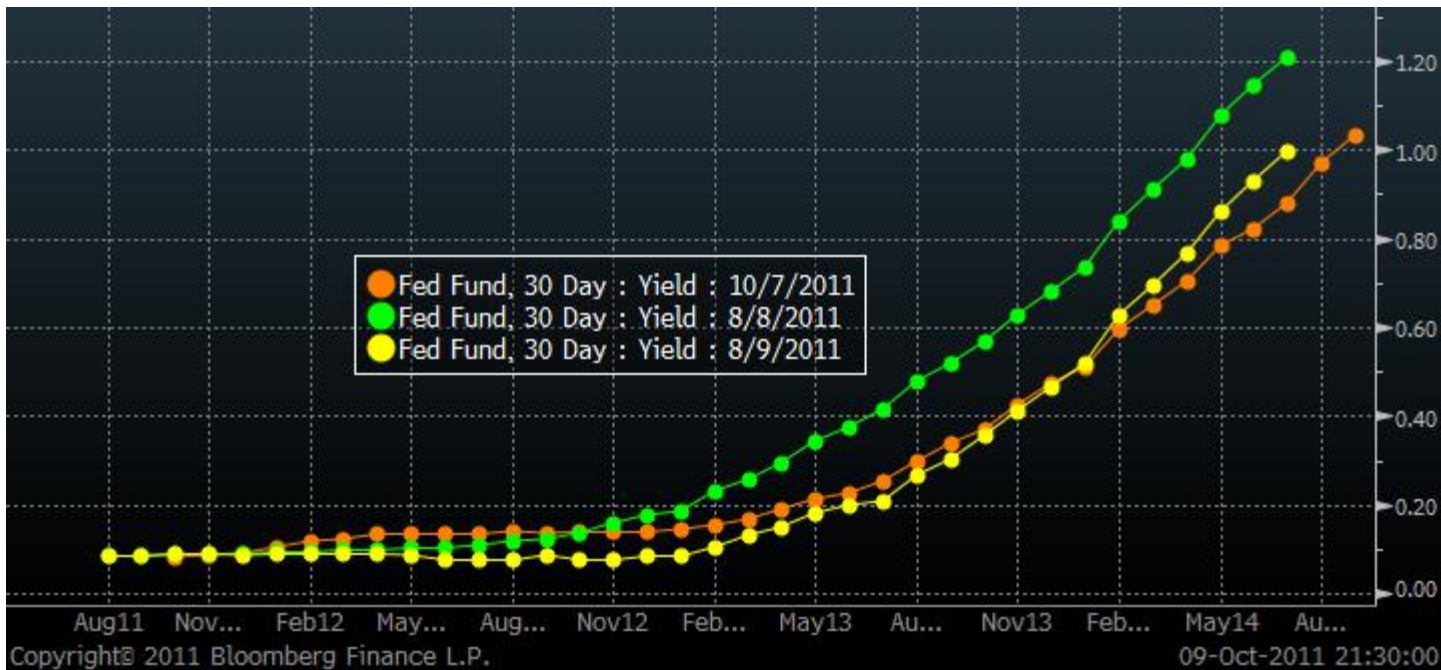
2yr Treasury vs the IOER Rate, late-2008 to present



# Monetary Policy

## Rate Guidance

The Fed Could Adjust Its Rate Guidance from ZIRP till mid-2013  
Fed Funds Futures Have Moved Little Since the Aug FOMC Meeting





# Monetary Policy

The ability of monetary policy to influence the economy is impaired in a post-crisis economy (the most important transmission channel, the impact on private borrowing costs, is less effective due to deleveraging). Monetary policy is less effective, but not ineffective.

We downplay this model, which puts too much emphasis on QE for stocks...



...while we prefer this one, which says QE helps stocks if it lifts the economy



# Macro Policy

In the US, the more effective policymakers (the Fed) are in charge of the less effective policy, while the less effective policymakers (Congress, the President) are in charge of the more effective policy (fiscal policy).

# Fiscal Policy

Optimal fiscal policy would look like this:

- 1) Longer-term credible deficit reduction (because deficits are unsustainable, and action on this front would give policymakers credibility to act in the short-term)
- 2) Near term, fiscal policy should offset the drag that will occur under current policy in 2012

# Fiscal Policy

Structural Budget Deficits (% of potential GDP, IMF estimates)					
Country	Level in 2008	Annual Change			
		2009	2010	2011	2012
USA	-4.6	-2.1	-0.8	0	+2.2
Euro-Area	-2.8	-1.8	+0.3	+1.1	-0.6
Germany	-0.9	-0.2	-1.3	+0.5	+0.6
UK	-5.9	-2.6	+0.5	+1.5	+1.4
Japan	-3.7	-3.3	-0.7	-0.4	+0.4

Source: IMF, author adjusted USA 2012 figure to reflect current law

# Fiscal Policy

All the major fiscal decisions, including action on Obama's stimulus proposals, are likely to be made by the special committee on deficit reduction, which was set up by the debt ceiling compromise

- It has a target of \$1.2-1.5 trillion in deficit reduction over 10 years
- Its deadline to report its recommendations is November 23
- If it meets that deadline, both chambers of Congress are required to have an up-or-down vote on the recommendations by December 23
- Failure to pass would result in automatic cuts of about \$1.1 trillion in defense, domestic discretionary, and Medicare programs over 10 years

# Fiscal Policy

Conventional wisdom is that fiscal policy will fall short, based on expectations for the special committee set up by the debt ceiling deal:

- There are no “fiscal heroes” on the committee – no one appointed has taken chances with their political base on entitlements/taxes
- The penalty for not passing (across-the-board spending cuts) doesn’t apply for 12 months
- So the better bet is for stalemate this year, with a lame duck session in 2012 to address the expiration of the Bush tax cuts and the possible automatic spending cuts

# Fiscal Policy

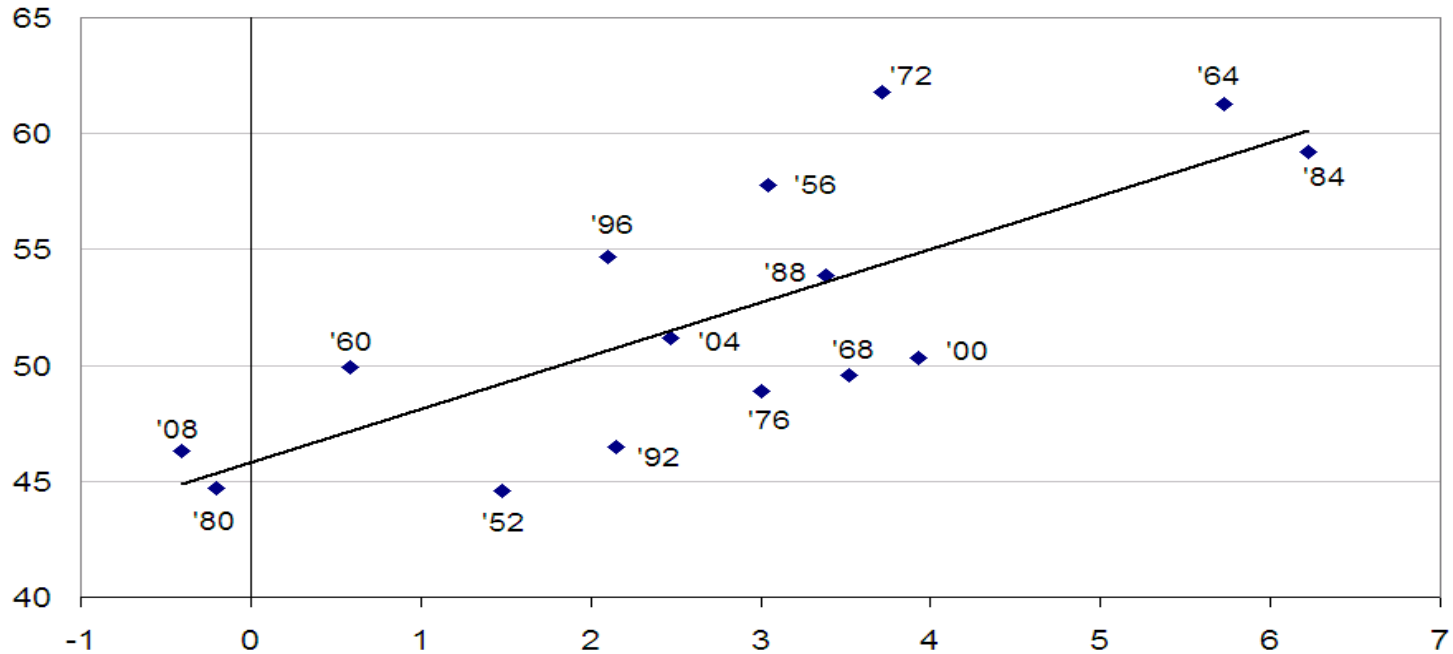
What the conventional wisdom misses:

- ❑ Fiscal drag becomes a big factor in 2012, hurting Obama's re-election chances
- ❑ The automatic spending cuts would produce a 10% cut in defense spending in January 2013, which concerns many Republicans
- ❑ There could be a round of downgrades of US Treasuries in 2012, with Moody's and Fitch downgrading and S&P having another downgrade
- ❑ So we are more optimistic that something more constructive will emerge from the special committee process, one that will produce a smaller fiscal drag in 2012 and one that provides material deficit reduction in the longer run

# 2012 Election

Election Outcomes Are Highly Correlated with Economic Outcomes

**Incumbent Party's Vote Share In Presidential Election and Real Disposable Personal Income (Per Capita Y/Y 4Q Moving Avg)**

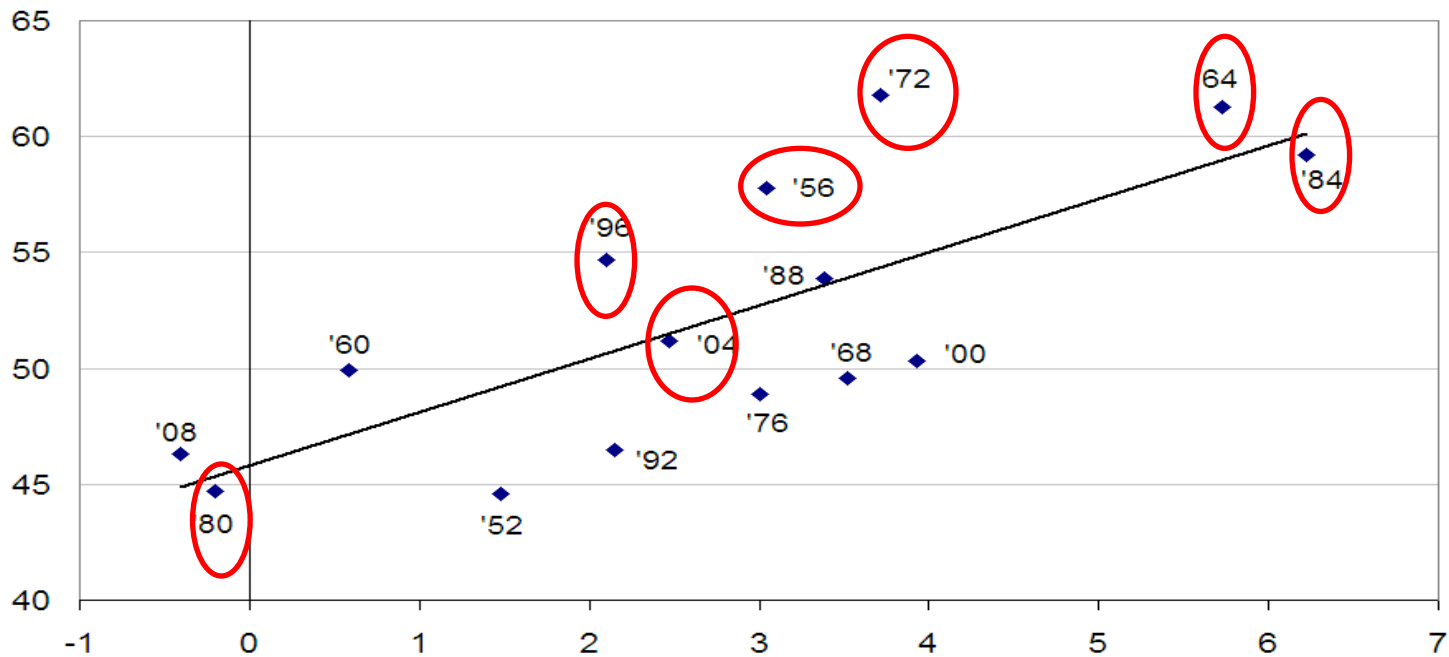




# 2012 Election

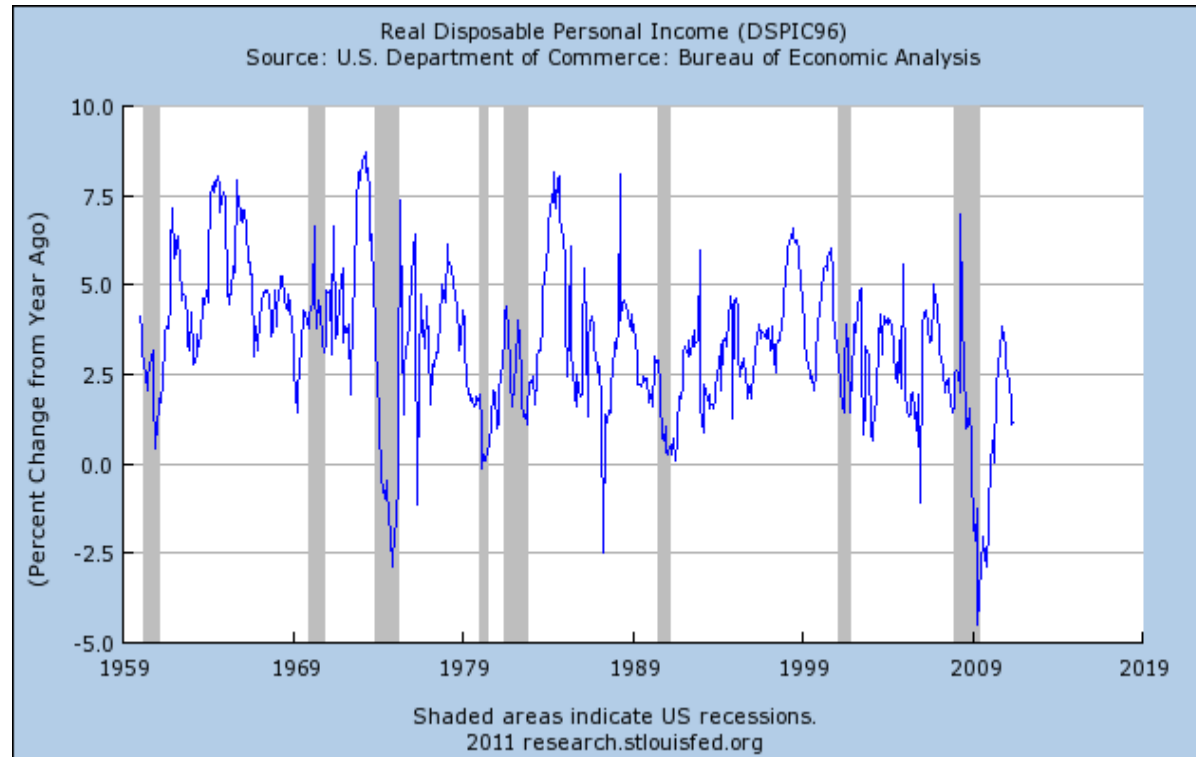
The Circled Elections Are the Precedents for 2012 (First-term Presidents After a Party Change in the WH Seeking Re-election)

**Incumbent Party's Vote Share In Presidential Election and Real Disposable Personal Income (Per Capita Y/Y 4Q Moving Avg)**



# 2012 Election

Obama needs real disposable personal income growth to be about a percentage point higher to feel good about his re-election chances.



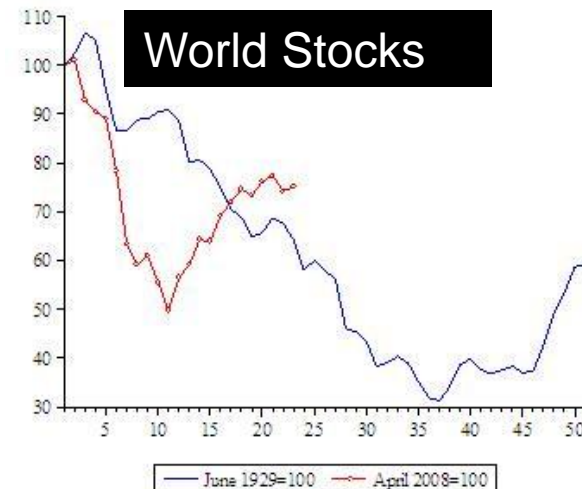
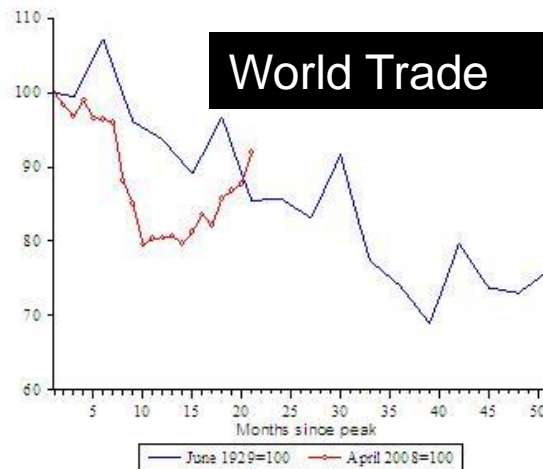
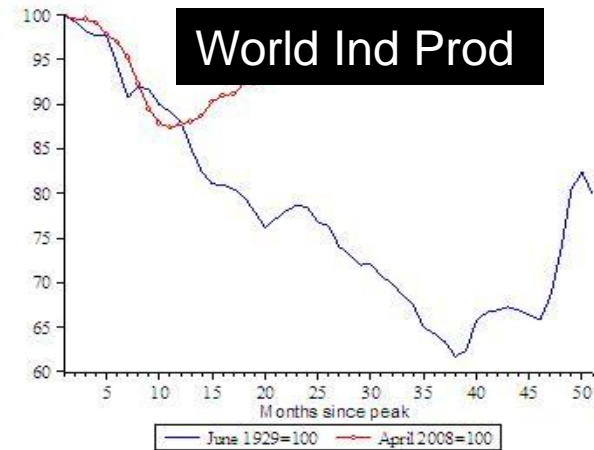
# 2012 Election

For financial markets, the consequence of the election is a pivot from activism to austerity in macro policies

- All Republican candidates have said they would replace Bernanke
- Republicans make deficit reduction a top priority, but while they would pursue spending cuts they may also pursue tax cuts at the same time, leaving a small impact on deficits near-term

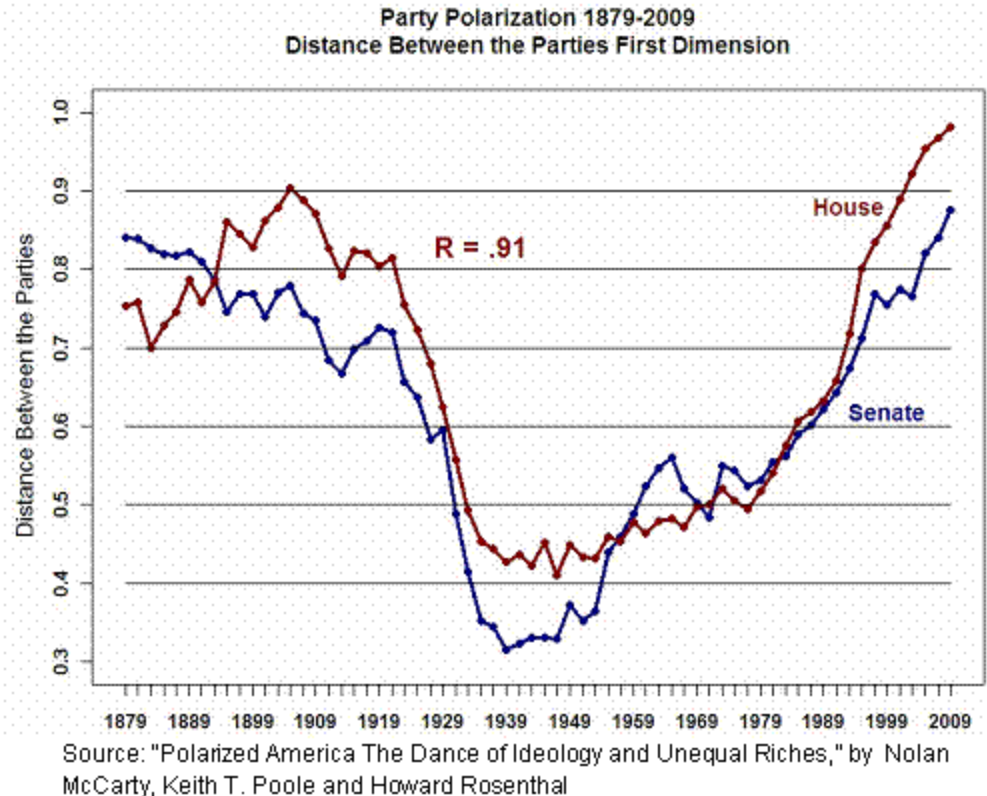
# Activist Policies

The main difference between the 1930s and now is that in the 1930s policymakers didn't save the financial system. But while activist policies succeeded in minimizing output loss, they haven't succeeded in restoring acceptable growth rates.



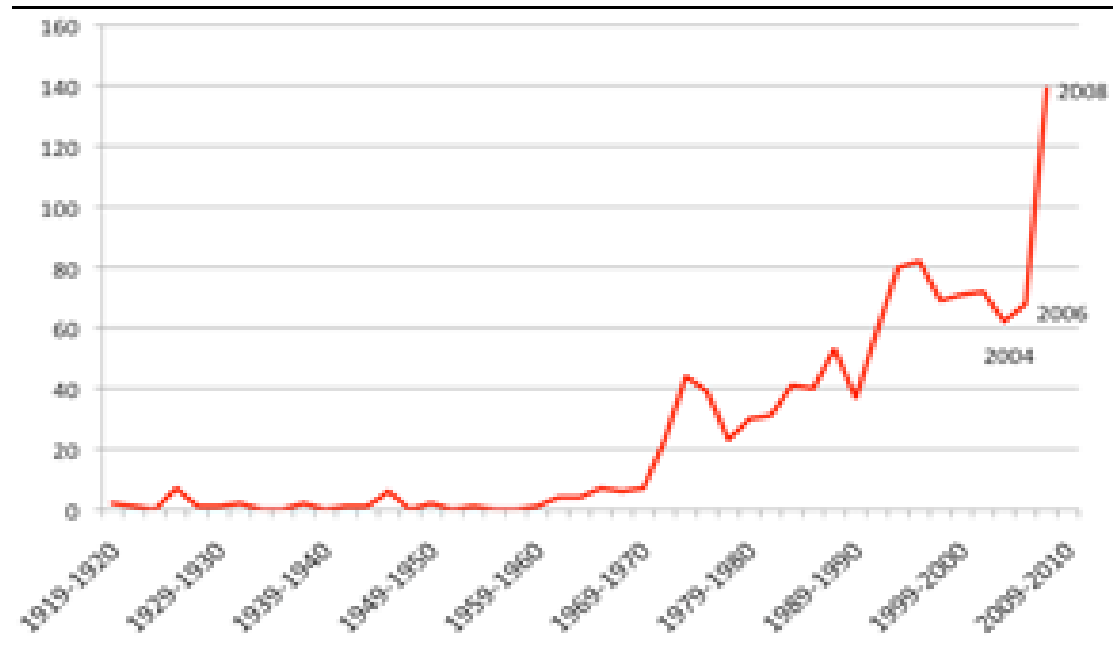
# Political Polarization

By this measure, Congress is more polarized at any time since Reconstruction, and it's polarized along the role of government in the economy. So the activist response to the crisis hit a raw political nerve.



# Polarization in Congress

## Number of Senate Filibusters By Year



Unlike previous periods of high polarization, the Senate now routinely operates on a supermajority basis.

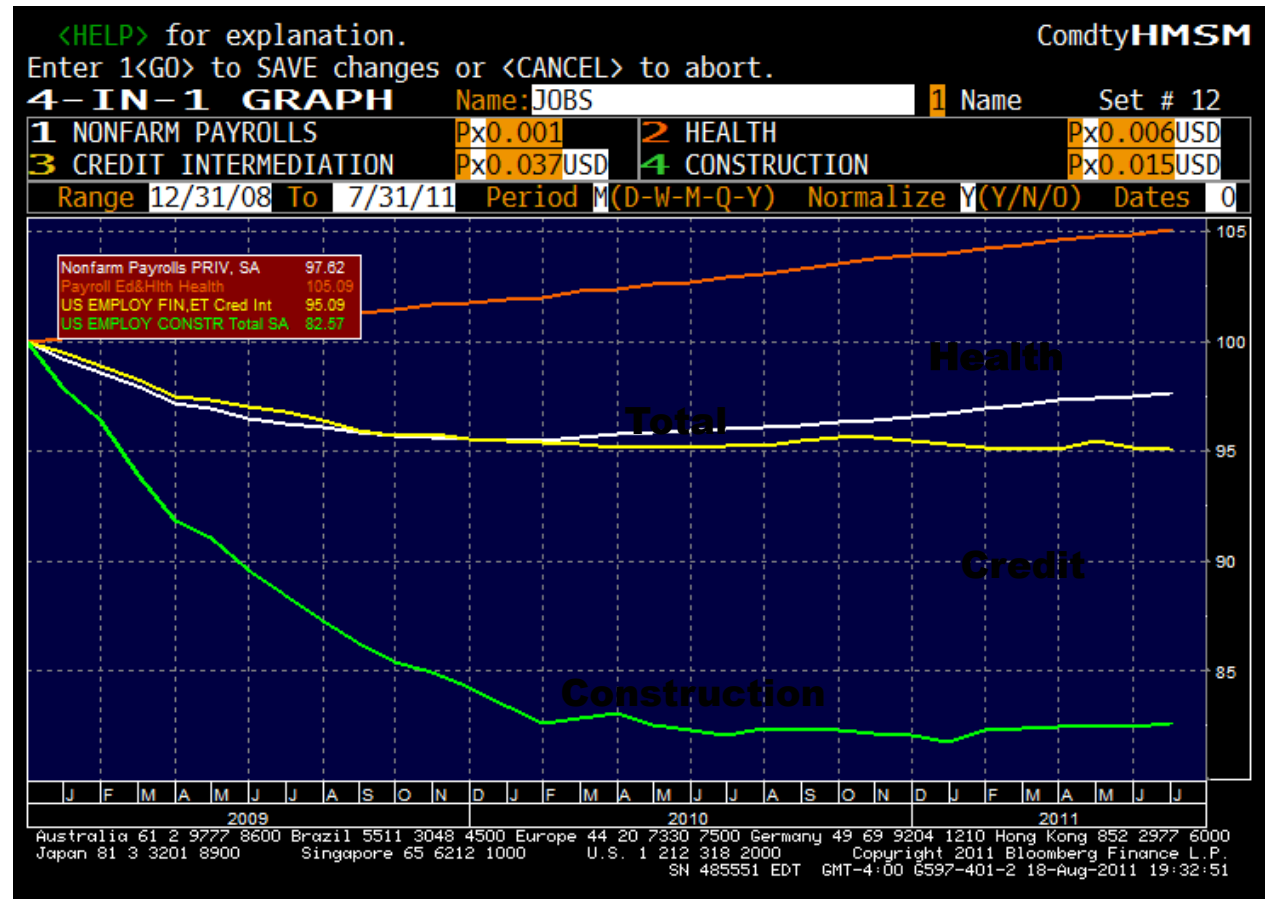
# Is Political Dysfunction an Economic Negative for the US?

This is a survey of business executives on their perception of the effectiveness of their national legislatures. Only the US has seen a steady decline over the last decade (during all types of political configurations).



# Is Policy Activism the Problem?

Job losses have not been concentrated in the sectors subject to the greatest policy uncertainty.



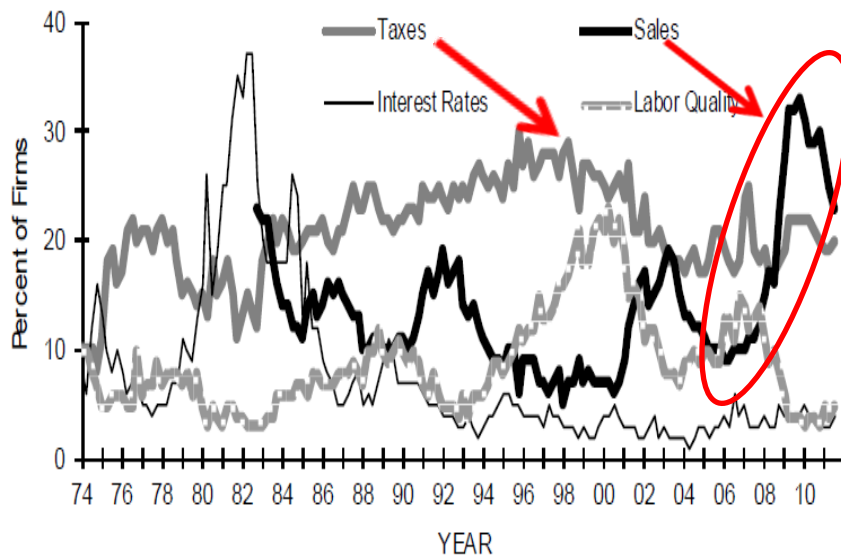


# Policy Uncertainty as an Alternative Explanation

The NFIB survey has weak demand as the major issue.

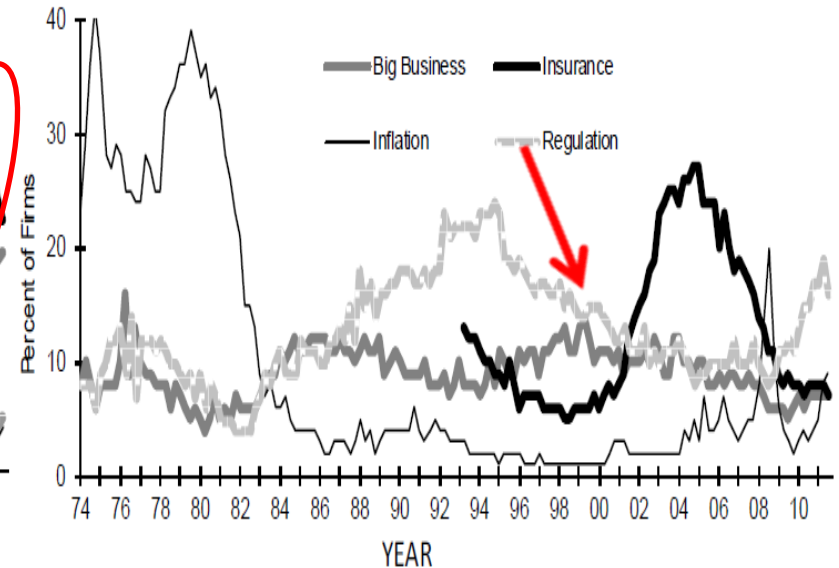
SELECTED SINGLE MOST IMPORTANT PROBLEM

Sales, Fin. & Interest Rates, Labor Cost, Labor Quality, and Taxes  
*January Quarter 1974 to July Quarter 2011*



SELECTED SINGLE MOST IMPORTANT PROBLEM

Insurance, Big Business Competition, Inflation, and Regulation  
*January Quarter 1974 to July Quarter 2011*



# Is Policy Activism the Source of Today's Economic Problems?

The fiscal story is a complicated one.

