U.S. Macroeconomic Outlook

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February 4, 2009

This will likely be the worst year for the U.S. economy since the end of the 1930s. The recession that began 13 months ago will plague much of 2009, particularly during the first half of the year.

Real GDP is expected to fall 3% peak to trough, and close to 5 million jobs will be lost (see Table 1). The unemployment rate will surge to 9%. The drop in manufacturing will be especially severe, but the hallmark of this downturn will be its breadth across industries, occupations and regions. More than 300 of the nation's 381 metropolitan areas will be in recession; unlike in past recessions, which were regionally concentrated, there is no obvious place to move for better prospects in this downturn.

The outlook for 2009 has rapidly eroded. Just a few months ago, we expected the recession would be well over, with unemployment peaking at or below 6.5% by this summer. But the jobless rate is already over 7%. This was the largest change over such a short period since Moody's Economy.com began forecasting the macroeconomy nearly 20 years ago.

Prospects shifted dramatically this past fall, when the financial crisis worsened into financial panic. We had long warned that preconditions for a crisis were in place and were not surprised when it hit in summer 2007.[1] But we expected both the crisis and the recession to fade by mid-2008 after a strong monetary and fiscal response. As it happened, the panic intensified the downturn, making it inherently difficult to forecast the length and extent of the economic fallout. What is clear is that as long as the panic continues, risks to the outlook are all to the downside.

Policy missteps. The crisis resulted from excesses throughout the financial system, but the panic was precipitated by policy missteps, beginning with the government takeover of Fannie Mae and Freddie Mac in early September. When the Treasury Department put the GSEs into conservatorship, wiping out shareholders, it signaled to global investors that all financial institutions were at significant risk of failure. While Fannie and Freddie were probably insolvent on a mark-to-market basis, they still had sufficient capital to meet regulatory requirements. In past

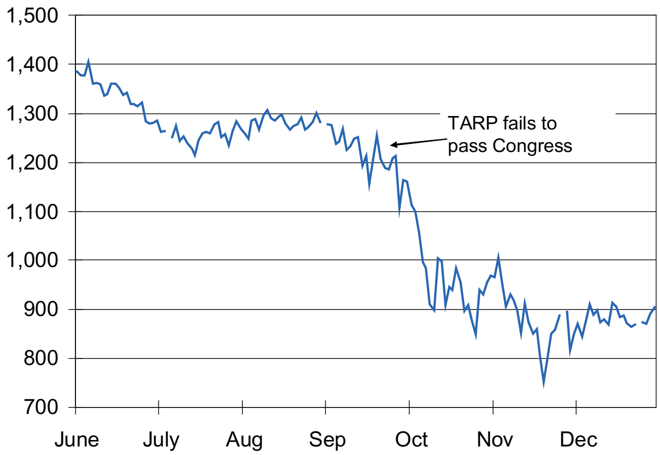
[1] We had expected the ensuing recession as early as November 2007 (see http://www.economy.com/dismal/pro/article.asp?cid=101358).

Table 1: U.S. Business Cycle Since World War II

		Duration in Months		Peak-to-Trough % Change		Jobless Rate, %		
Peak	Trough	Recession Peak to Trough	Expansion Trough to Peak	Real GDP	Nonfarm Employment	Low	High	Change, ppt.
Dec 2007	Sep 2009	21	--	-2.6	-3.6	4.4	9.1	4.7
Mar 2001	Nov 2001	8	120	-0.4	-2.0	3.8	6.3	2.5
Jul 1990	Mar 1991	8	92	-1.3	-1.5	5.0	7.8	2.8
Jul 1981	Nov 1982	16	12	-2.9	-3.1	7.2	10.8	3.6
Jan 1980	Jul 1980	6	58	-2.2	-1.3	5.6	7.8	2.2
Nov 1973	Mar 1975	16	36	-3.1	-2.7	4.6	9.0	4.4
Dec 1969	Nov 1970	11	106	-1.0	-1.4	3.4	6.1	2.7
Apr 1960	Feb 1961	10	24	-1.3	-2.3	4.8	7.1	2.3
Aug 1957	Apr 1958	8	39	-3.8	-4.4	3.7	7.5	3.8
Jul 1953	May 1954	10	45	-2.7	-3.3	2.5	6.1	3.6
Nov 1948	Oct 1949	11	37	-1.7	-5.1	3.4	7.9	4.5
Average		**10**	**57**	**-2.0**	**-2.7**	**4.4**	**7.6**	**3.2**

Sources: NBER, BEA, FRB, BLS, Moody's Economy.com

Chart 1: Stock Investors Lose Faith
S&P 500 stock index



financial crises, policymakers had shown forbearance to large institutions in similar situations: The precursor to today's Citigroup was likely insolvent during the early-1990s Savings & Loan crisis, but it was not taken over by regulators, to avoid unnerving investors.

Policymakers reinforced investor fears when they allowed Lehman Brothers to fail, one week after taking over the GSEs. That collapse forced a money-market fund that had invested in Lehman debt to break the buck—the fund's net asset value fell below the $1 per share its investors had put in. This was a shock to ordinary investors who thought money funds were as safe as the proverbial mattress, and who began withdrawing their savings. To meet such redemptions, money funds had no choice but to sell their own assets, including commercial paper—short-term IOUs of major businesses. Firms that issue commercial paper to finance their basic operations in turn scrambled for funds. At this point, the panic jumped to equity markets as stock investors realized that no business was safe from the credit crunch (see Chart 1).

Investor sentiment received another sharp blow in late September when Congress initially failed to muster enough votes to pass legislation establishing the Troubled Asset Relief Program. Neither the need for the $700 billion TARP nor how the money was to be used and overseen had been well-explained by Treasury and the Fed. There was widespread confusion about how the government would purchase distressed mortgage loans and securities, and about how this would ease the financial panic. Congress did pass the legislation a few days later, after market turmoil had grown too loud to ignore, but not before significant damage had been done. There was no longer time to begin asset purchases; the TARP money was instead used to put capital into teetering financial institutions.

While providing capital was essential, abandoning the distressed asset purchases altogether was a mistake. When Treasury Secretary Paulson announced in November that TARP funds would not be used to buy mortgage assets after all, prices of those assets caved further. The collateral damage from this decision was the near-collapse of Citigroup, which held hundreds of billions of dollars worth of these loans and securities. Ironically, the only way to avert this calamity was for the Federal Reserve to guarantee Citi's bad assets, the same assets the Treasury had decided not to buy.

Printing money. Policy missteps precipitated the financial panic and deepened the recession; but given the current situation only a concerted, comprehensive and consistent policy response will forestall a collapse of the financial system and economy. Indeed, unless policymakers can quickly quell the financial panic, our already-somber 2009 outlook will turn measurably darker.

There are some reasons to be optimistic in this regard as the Federal Reserve's recent unprecedented actions take effect. The Fed has adopted a zero-interest rate policy for overnight interbank lending, and to bring down longer-term interest rates, the central bank has made it clear it intends to keep the fed funds rate there indefinitely. The Fed is also ramping up a policy of so-called quantitative easing, in which it effectively prints money to purchase securities and extend loans to financial institutions. It is already purchasing commercial paper and will soon buy debt issued by Fannie Mae and Freddie Mac and the mortgage securities they insure. The Fed will next buy long-term Treasury bonds and perhaps eventually even municipal bonds, corporate bonds and corporate equity if conditions worsen.

Long-term Treasury yields and fixed mortgage rates have fallen to record lows in response. Ten-year Treasury yields are near 2.5% and prime, 30-year, fixed rate mortgage loans are going for close to 5%. This is having an immediate economic benefit, lowering interest payments for strapped households and sparking a massive mortgage refinancing boom. Most prime mortgages have coupons near 5.5%; at a 5% rate, refinancing becomes profitable for some $1.25 trillion in outstanding mortgages. An additional $1 trillion can be profitably refinanced if rates fall to 4.5%. Subprime and alt-A borrowers will not get any relief, nor will some prime borrowers whose equity has been eroded by falling house prices. But it is a start.

The massive liquidity provided by the Fed to the financial system has also begun to unclog money markets. Interbank lending has improved as the three-month Libor-Treasury spread has narrowed, from more than 400 basis points in early October to around 100 basis points recently (see Chart 2).

Chart 2: The Financial Crisis Appears Past Its Apex
Difference between 3-month Libor and Treasury bill yields

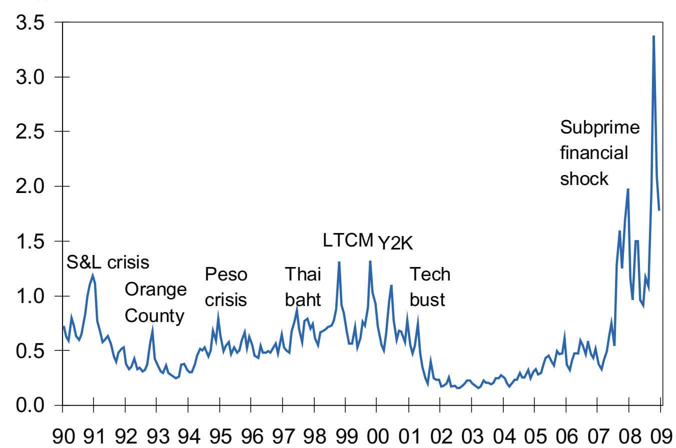
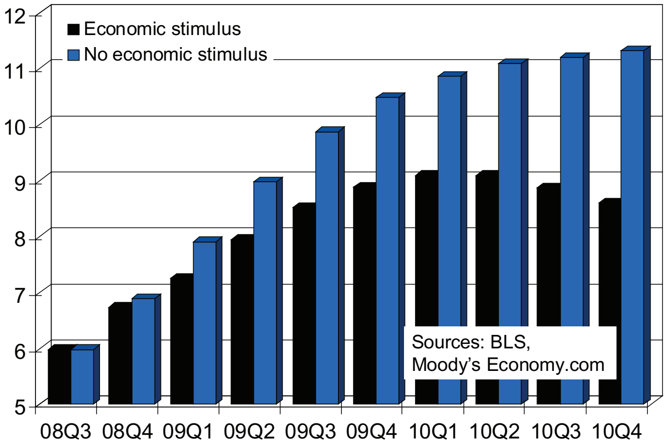


Chart 3: Fiscal Stimulus Makes a Significant Difference
Unemployment rate



Commercial paper rates have fallen and issuance of commercial paper has increased. While the financial system remains far from normal, the panic appears to be past its apex.

Economic stimulus. Even if the panic further ebbs in coming weeks, as expected, serious economic damage has been done. Congress and the Obama administration will need to respond aggressively.

A large economic stimulus is expected to be passed very soon. The package will total some $825 billion over 2009-2012 and include aid to state and local governments, greater infrastructure spending, tax cuts for lower- and middle-income households, and some business tax cuts as well (see Table 2).

The package equals approximately 5% of GDP, making it smaller than the public works projects of the 1930s, but larger than the 3% of GDP spent on stimulus during the early 1980s. The cost of the current package would thus be consistent with expectations regarding the relative severity of this downturn. Five percent of GDP would also ensure that the economy stops contracting by the end of 2009, and that GDP returns to its prerecession peak by the end of 2010; these are reasonable goals.

The mix of tax cuts and spending expected in the stimulus package is designed to provide both quick relief and a substantial boost to the struggling economy. The tax cuts will not pack a big punch, as some of the money will be saved and some used to repay debt, but they can be implemented quickly. Aid to state and local governments will not help lift the economy, but it will keep states from having to cut programs and payroll to balance their budgets. Infrastructure spending will not help the economy quickly—it will take time to get even "shovel-ready" projects going—but it will provide a significant boost. Considering that the economy's problems are not expected to abate soon, this spending will be especially helpful this time next year.

To measure the benefits of the stimulus package, the Moody's Economy.com U.S. macroeconomic model was simulated, assuming no added fiscal stimulus except for that provided by the automatic stabilizers already in place. In this scenario, real GDP declines for eight straight quarters, falling by 4.5% in 2009 and another 2.2% in 2010. Some 7.6 million jobs would be lost from late 2007 to late 2010, pushing the unemployment rate to 11.5% by early 2011 (see Chart 3). Such a jobless rate would qualify this downturn as a depression.

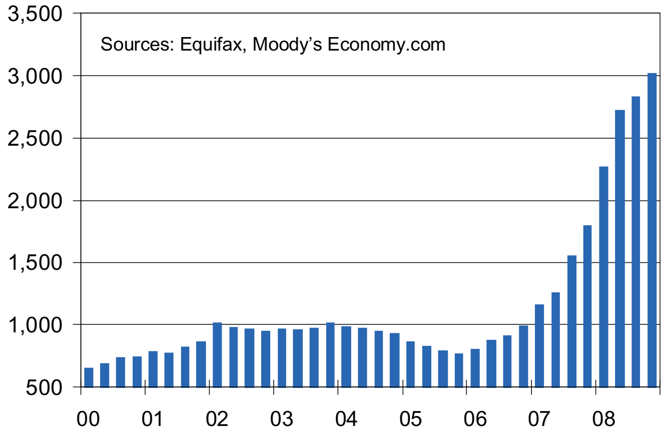
Foreclosure mitigation. The government will also need to deploy

Table 2: $825 Billion House Democratic Economic Stimulus Plan

	2009	2010	2011	2012	2009-12
Total Stimulus	224	436	121	44	825
Government Spending	145	306	88	11	550
Income support	44	58	0	0	102
Unemployment insurance benefits	18	25	0	0	43
Food stamps	9	11	0	0	20
COBRA healthcare	17	22	0	0	39
Infrastructure spending	9	77	62	11	158
Traditional infrastructure	5	46	35	4	89
Nontraditional infrastructure	4	32	27	7	70
Aid to state government	66	118	27	0	211
Medicaid match	31	52	4	0	87
Fiscal relief	23	40	16	0	79
Local school districts	11	24	6	0	41
Law enforcement	1	2	1	0	4
Healthcare/education/other	26	53	0	0	79
Tax Cuts	79	130	33	33	275
Business tax benefits	45	65	-40	-45	25
Individual tax benefits	34	65	73	78	250

Sources: BLS, BEA, Moody's Economy.com

Chart 4: The Foreclosure Crisis Intensifies
First mortgage loan defaults, ths



the $350 billion remaining in the TARP quickly. Some portion will keep the domestic automakers out of bankruptcy and help them restructure into more viable companies. A more significant portion will likely be spent on a large foreclosure mitigation plan helping millions of distressed homeowners.

This is necessary as the foreclosure crisis is exacerbating pressure on the financial system and adding to the recession's severity. Since large numbers of homeowners began to miss mortgage payments three years ago, nearly 5 million have received default notices—the first step in the foreclosure process—and 3 million have lost homes in foreclosure sales, short sales or deeds-in-lieu (see Chart 4). With falling house prices and rising unemployment in much of the country, foreclosures are sure to accelerate in the coming year, devastating families, communities, the financial system, and the wider economy.

Policymakers are working to stem the surge in foreclosures. In late 2007, FHA Secure was established to help put distressed homeowners into FHA-insured loans. Hope Now, a consortium of mortgage servicers and lenders, was created soon after to streamline foreclosure mitigation efforts. Hope for Homeowners was established this past summer to encourage mortgage owners to reduce principal owed by distressed homeowners and to refinance them into FHA loans. The FDIC has also been aggressively modifying mortgage loans of institutions it seized and controls in receivership, and Fannie and Freddie have recently announced plans to modify loans they own and insure, where the borrowers are seriously delinquent.

These efforts have been helpful but have been overwhelmed by the magnitude of the problem. Particularly worrisome is evidence that modification efforts to date have not been very successful. The Office of the Comptroller of the Currency recently reported that more than half the loans modified in early 2008 were back in delinquency within six months. The problem appears to be that most modifications have been limited to lowering interest rates and extending terms. These measures can lower monthly mortgage payments, but are ineffective when homeowners owe significantly more than their homes are worth in the market. Such people are likely to lose hope of ever building equity, and thus have little incentive to keep paying on their loans.

A consensus is building for a much larger foreclosure mitigation plan, including mortgage principal write-downs funded by taxpayers. There are many potential ideas for such a plan, although none has yet been forthcoming from the Obama administration.[2] While no plan solves all the fairness, moral hazard and other problems that arise with such an effort, such problems grow less important as the damage grows from so many foreclosures. At the same time, efforts to change bankruptcy laws to allow mortgage write-downs in some Chapter 13 filings—which have long been opposed by banking interests—appear to have a growing chance of success.

Swing factors. The unprecedented monetary and fiscal policy stimulus is expected to end the recession by late this year. Yet, beyond the speedy restoration of a more stable financial system, the length and severity of the downturn hinges on several key swing factors.

The deepening global economic recession—arguably the first synchronized global downturn since the early 1980s—poses a substantial threat to U.S. exports. Real exports are expected to remain flat in 2009, but will decline outright unless overseas markets find their footing later this year. It is thus encouraging that policymakers across the globe are acting vigorously to shore up their economies. Central banks are slashing interest rates almost everywhere. The average nominal target interest rate set by global central banks—weighted based on relative GDP—has fallen from 4.25% to nearly 1% over the past two years, and the real target rate has turned firmly negative. Large fiscal stimulus plans will soon be implemented in Germany, France, Japan, and the United Kingdom.

The U.S. is still the globe's safe haven, and must remain so. Although the global turmoil began here, the U.S. dollar has strengthened significantly, and investors are still willing to buy 10-year Treasury bonds at close to 2% and shorter-term Treasury bills for almost no yield at all. This gives policymakers significant latitude when considering the size of the economic recovery package and other costly fiscal stimulus. It would be disconcerting if global investors were spooked by the size of the U.S. government's borrowing needs, causing the dollar to weaken and interest rates to rise.

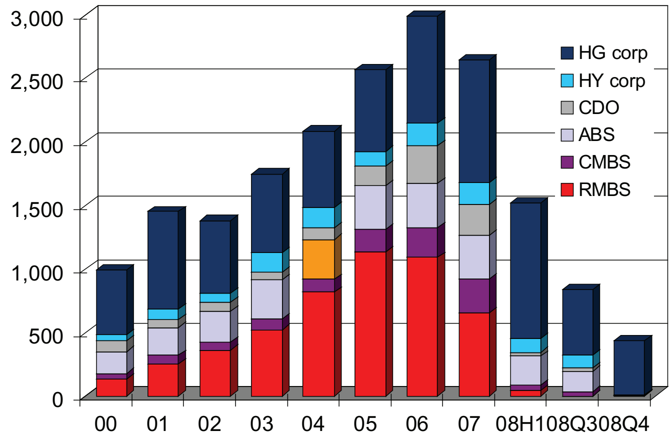
Continued low prices for oil and other commodities are also essential to the economy's prospects. With oil falling below $50 per barrel, the cost of a gallon of regular unleaded gasoline is approaching $1.50. This compares with almost $150 oil and $4 for a gallon of gasoline this past summer. Oil prices are expected to stay near $50 this year, saving American households a whopping $200 billion on their energy bills in 2009 compared with 2008. Any significant increase in oil prices—because of more significant OPEC production cutbacks, for instance—would be a very heavy weight for the economy to bear.

What then? Even if the recession ends late this year, as expected, the subsequent recovery looks to be lackluster. Real GDP is not expected to return to its prerecession peak until late 2010, and the nation will not approach a full-employment jobless rate of 5% before President Obama's term nears its conclusion in 2012.

The principal impediment to a stronger recovery is the hobbled

[2] See http://www.economy.com/dismal/pro/article.asp?cid=111220).

Chart 5: Credit Markets Are Broken
Bond issuance, $ mil



financial system and what will likely be a prolonged aversion to risk-taking. The current credit crunch will eventually abate, but it will take at least several years for credit to flow freely again. The banking system has more losses to digest—from deteriorating consumer, commercial real estate, and corporate loans—and it will be difficult for banks to attract new private capital. Lending will not normalize until capital positions are fully restored.

Credit markets will also be difficult to resurrect. Since securitization collapsed, it has become clear that this process was fundamentally flawed: No one, from lenders to investment banks to rating agencies to investors, thought they had enough at stake to make sure the underlying loans were prudently made (see Chart 5). To fill the void left by securitization, there are nascent efforts to establish a covered bond market, in which lenders would retain a larger share of the risk in loans they originate, but these have made little headway so far.

Even when lending resumes, lenders will demand substantial risk premiums in the form of higher interest rates and fees, raising the cost of capital for household and corporate borrowers. Tighter credit and higher costs mean less investment and risk-taking. Start-up companies will have a harder go of it, stifling innovation and ultimately constraining productivity gains. The economy's longer-term prospects thus appear dimmer.

Washington's eroding fiscal situation also threatens the economy's long-term growth prospects. The federal government has committed nearly $9 trillion to address the current crisis, and while not all of it will end up as part of the national debt, taxpayers' ultimate bill could very well exceed $2 trillion. By comparison, the Savings & Loan crisis of the early 1990s cost taxpayers $275 billion in today's dollars. With Social Security, Medicare and Medicaid costs set to increase substantially in coming years, policymakers will have to make very difficult tax and spending decisions.

While it is easy to be pessimistic, it is worth noting that the problems at the root of the economic crisis are being addressed. Falling house prices make homes more affordable, idled construction thins the inventory of unsold houses, the personal saving rate is rising rapidly, and the trade deficit is narrowing as consumers retrench. It was hoped that these imbalances would be corrected gradually over years, even decades, rather than months. But while working through them in such a short period is painful, it could be the catalyst for fundamental changes in our financial system and regulatory framework, and perhaps even spark an effort to finally address the nation's long-term fiscal challenges. Some economic good can still come out of all the bad that has befallen the nation.