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U.S. Macro Outlook 2012

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BY MARK ZANDI

The U.S. economy's performance improved in the closing months of 2011. Real GDP looks to have grown more than 3% at an annualized rate in the fourth quarter, up from less than 2% in the third and 1% during the first half of the year. Employment is reviving, with the private sector adding nearly 150,000 jobs per month and unemployment back below 9%.

While 2011 closed on a stronger note, the year was a disappointment overall. A surprising surge in commodity prices—affecting gasoline, food and apparel—sapped consumer purchasing power. U.S. automakers and other manufacturers had their operations significantly disrupted by Japan's March earthquake and tsunami. Sentiment and thus the broader economy were seriously hurt when political acrimony nearly shut down the federal government in the spring and nearly caused the Treasury to default on the nation's debt in the summer.

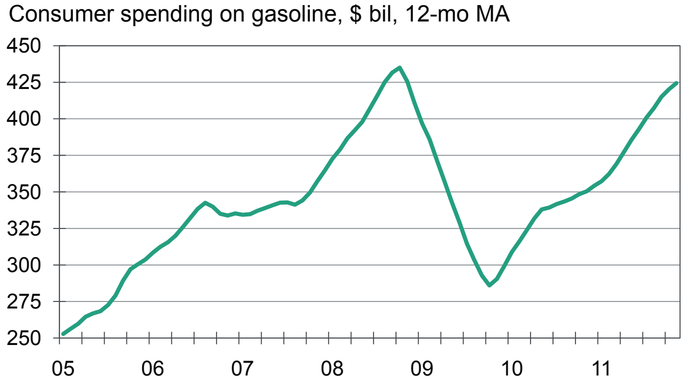
The U.S. economy is expected to perform a bit better in 2012, but this depends critically on policy decisions being made in Europe and Washington. The Europeans are fighting to keep the euro zone together, while U.S. policymakers are struggling to find an appropriate amount of fiscal austerity. We assume this will all work out in a reasonably graceful way, but it is a big assumption. It also depends on how the foreclosure crisis plays out. More house price declines are coming, but they are expected to be modest.

There are some reasons for optimism. Most notably, the economy's prospects should be buoyed by significant progress in fixing the problems that caused the Great Recession. Businesses are in good financial shape, the financial system has been recapitalized, and—aside from those struggling to hold on to their homes—most households are quickly putting their balance sheets in order. The issue is no longer whether firms can hire, banks can lend, and consumers can spend more aggressively than in the recent past, but whether they have the confidence to do so.

It is hard to imagine confidence reviving in 2012, given the uncertainty emanating from Europe, falling house prices, and a heated presidential election campaign. But after the election, such a revival seems more than likely. The economy's longer-term prospects are thus better than pessimists believe.

Chart 1: Payroll Tax Cut Pays for Gasoline Bills

Consumer spending on gasoline, $ bil, 12-mo MA



Source: BEA

A disappointing year

The economy's performance in 2011 fell far short of expectations. When all the data are in, real GDP will have grown slightly less than 2%, about half as much as projected at the start of the year. Payrolls expanded by 1.5 million jobs during the year, also half the amount anticipated.[1]

The forecast missed in large part because of an unexpected surge in commodity prices.[2] Energy, food and apparel prices jumped as demand from fast-growing emerging economies intersected with limitations on supply.[3] Most notably, gasoline rose more than a dollar per gallon between late 2010 and its peak during the spring of 2011. Although prices declined later in the year, U.S. households spent almost $100 billion more to fill their tanks in 2011 than they had the year before (see Chart 1). This almost equaled the amount workers received from the 2-percentage point cut in payroll taxes that took effect in 2011. Instead of lifting consumer spending as anticipated, the tax cut was used to fill households' gas tanks.

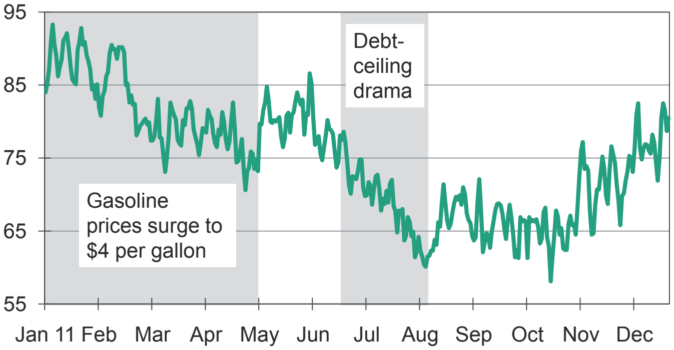
1 This is based on the Moody's Analytics January 2011 forecast. Job growth is measured on a fourth quarter-to-fourth quarter basis.

2 More precisely, of the 2-percentage point error in the forecast for 2011 real GDP growth, almost 1 percentage point was due to higher commodity prices. A quarter-point stemmed from the Japanese earthquake, and the remainder resulted from other factors, most importantly a drop in confidence during Washington's summer political battles.

3 Commodity prices had been expected to increase in 2011, but not by as much as they did. For example, gasoline was predicted to rise from an average $2.80 per gallon in 2010 to $3 per gallon in 2011. U.S. pump prices actually averaged more than $3.50 for the year.

Chart 2: Debt-Ceiling Drama Hits Confidence

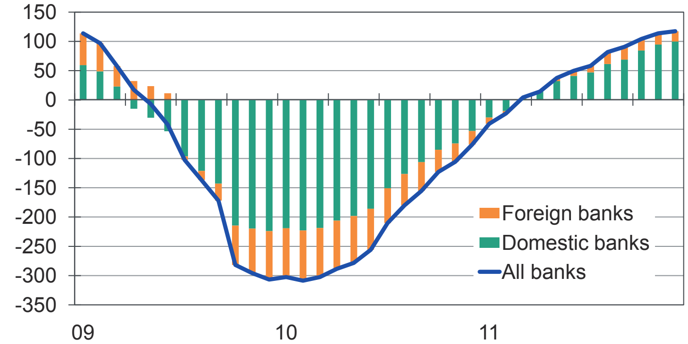
Consumer confidence index, Oct 2001=100



Source: Rasmussen Public Opinion Research

Chart 3: Domestic Banks Offset Foreign Banks

Yr-over-yr change in C&I loans outstanding, $ bil



Source: Federal Reserve Board

The Japanese earthquake also hurt growth significantly in 2011. Given Japan's importance in the global supply chain for vehicles and electronics, the disaster severely disrupted U.S. manufacturing, a key driver of the economic recovery. From the start of the recovery in mid-2009 to March 2011, when the earthquake hit, manufacturing accounted for almost half of U.S. GDP growth. Japan's production has largely been restored and U.S. manufacturing has rebounded, but the hit to 2011 growth was significant.

Gauging the impact of the rancor that afflicted Washington all year is more difficult. Political debate is often heated, but it was astonishing to see the government brought near to default. Catastrophe was averted when policymakers agreed to raise the U.S. debt ceiling at the last minute, but the process was still damaging. Standard & Poor's downgraded the nation's debt and the collective psyche suffered a blow (see Chart 2). A less fragile economy might have taken Washington's spectacle in stride, but after the experience of recent years, the fragile recovery was nearly derailed. Consumers and businesses did not retreat—if they had, it would have meant a double-dip recession—but they did turn cautious, substantially slowing growth.

That the U.S. was able to avoid another recession is encouraging, and growth has reaccelerated as the mishaps of 2011 fade. But while the economy is starting 2012 on a more solid footing, it remains vulnerable, with many serious threats still present. Most significant is the turmoil in Europe.

European turmoil

A seemingly interminable debt crisis has pushed Europe into recession, with growing repercussions for the U.S. The U.S. economy can tolerate a mild and short-lived European downturn—our baseline outlook assumes one—but anything more severe would be difficult for the U.S. to shrug off. How dark the scenario will be depends on European policymakers.

Events in Europe affect the U.S. economy most immediately through the stock market. Movements in U.S. share prices have been closely tied to Europe's crisis since it erupted in early 2010. This is not surprising; U.S. multinationals are deeply involved in Europe as they are across the globe. Although stock prices have essentially gone nowhere during the past two years, they have swung widely up and down. Wealthier households have had difficulty determining their net worth, which weighs on their willingness to spend. Such spending counts for a lot; households in the top 20% of the income distribution account for almost 60% of all consumer purchasing.

Europe's crisis may also impair the availability of credit, putting pressure on financial systems on both sides of the Atlantic. European banks make approximately a fifth of all U.S. commercial and industrial loans and are tied to big U.S. banks through a number of business channels. If European banks hit the rocks, it will threaten the health of their U.S. counterparts. According to the Federal Reserve's senior loan officer survey, foreign banks have tightened their C&I lending standards, but the impact on credit flows has yet to show up (see Chart 3). U.S. banks may be able to fill the void, but this deserves close attention.

A European recession will further weaken global trade, hurting U.S. exports. One-fourth of U.S. exports are destined for Europe, but exports to the rest of the world are hurt as well, as all economies struggle with the effects of Europe's downturn. Asia seems particularly vulnerable. Exacerbating this threat is a rising U.S. dollar.[4] The greenback has strengthened significantly against the euro since the summer and is also up strongly against the currencies of most emerging economies. Even the Chinese yuan appears to have slowed its appreciation against the dollar.

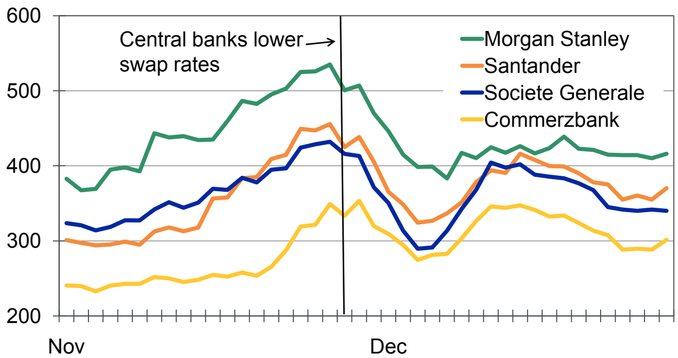
Europe's downturn is expected to be mild, lasting through the middle of 2012, with real GDP in the euro zone falling no more than 1.5%.[5] However, this depends on how quickly policymakers can stabilize financial markets. It is encouraging that the European Central Bank has teamed up with the Federal Reserve and other key central banks to provide cheap funds to the stressed banking system. The ECB is also providing longer-term financing and easing collateral requirements for banks seeking loans. To the relief of financial markets, this signals clearly that monetary policymakers will not allow a major bank to fail because of a lack of liquidity (see Chart 4).

4 The euro trades at close to $1.30, down from almost $1.45 in the summer of 2011.

5 Europe is defined as the 27 countries that comprise the European Union.

Chart 4: Central Banks Reduce Funding Pressure

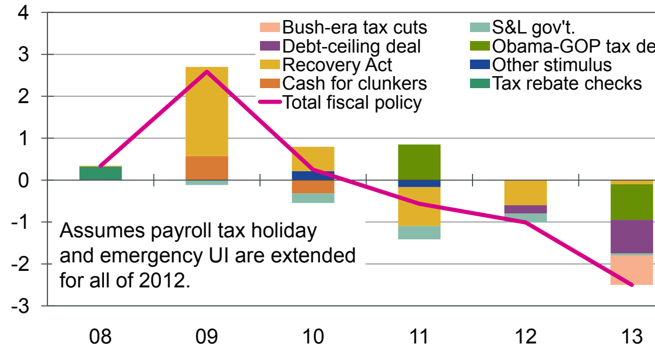
CDS spreads



Source: Bloomberg

Chart 5: Federal Fiscal Drag Intensifies

Contribution to real GDP growth, %



Source: Moody's Analytics

Financial markets should also be cheered by the increasing commitment of European policymakers to fiscal discipline. The most profligate nations have replaced their governments and appear to be implementing serious austerity programs. Collectively, European Union governments have agreed to stiffer fiscal rules, more stringent oversight, and harsher penalties for violations. Officials also say they will enlarge the European bailout fund and the International Monetary Fund to help fiscally troubled governments. This should allow the ECB to continue buying enough debt to keep these governments' borrowing costs from spiraling out of control.

It is not hard to construct darker scenarios in which Europe loses the political will to keep the euro zone together in its current form and its economy enters a deep downturn, with serious repercussions for the U.S. But these events appear less likely, as Europe's leaders seem able to act when they need to.

U.S. fiscal austerity

The U.S. economy's performance in 2012 also depends on what Congress and the administration do, first about the payroll tax cut and emergency unemployment insurance benefits. Policymakers bought time late in December when they agreed to extend these programs through February, and an extension through the rest of 2012 is widely expected. This is assumed in our baseline outlook.

Extending the two programs will be costly, coming to almost $175 billion for the full year. There is no consensus yet on how to pay for it; still, not extending the tax cut and jobless benefits could cost taxpayers even more. A new recession remains a consequential threat, particularly early this year; if the two programs expire, the economic hit would be greatest just as the economy is struggling with fallout from the European debt crisis.

Even if the programs are extended, moreover, federal fiscal policy will be a significant drag on the economy this year. As the remaining stimulus from the 2009 Recovery Act fades, and as spending cuts agreed to in the August debt-ceiling deal kick in, the changes will shave 0.8 percentage point from 2012 real GDP growth. Spending cuts by local governments will shave another 0.3 percentage point from growth (see Chart 5).

The fiscal drag will intensify substantially further in 2013 under current law. If policymakers make no legislative changes, not only will the payroll tax holiday and emergency UI programs expire again, but spending cuts that were part of the debt-ceiling deal will be in full swing. Marginal tax rates for individuals will also rise as the Bush-era tax cuts end. Fiscal policy would thus slash nearly 2.5 percentage points from 2013 real GDP growth.

Policymakers will surely attempt to change some of what is coming in current law. Many legislators are uncomfortable about planned cuts in the defense budget, and probably most do not want marginal tax rates to rise. Another increase in the debt ceiling may also be necessary before the year is over. The presidential election only complicates matters. While we assume policymakers will rise above partisan politics to address these policy issues productively, there clearly are many opportunities to misstep, as 2011's experience demonstrates.

Falling house prices

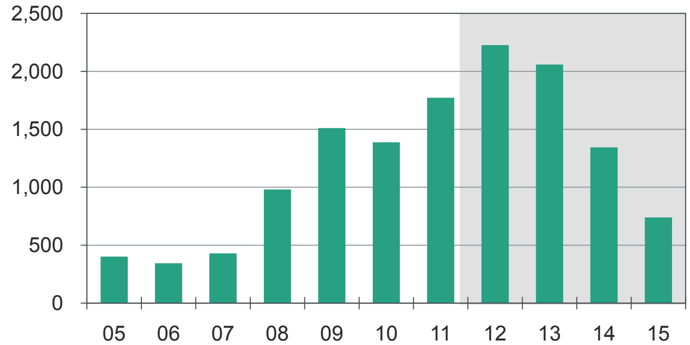
The six-year housing crash is easing, but it is not over and remains a problem for the economy. Home sales and housing construction have already hit bottom, and multifamily construction is picking up, but prices continue to slump. Average nationwide prices are down about a third from their peak, falling almost 4% in 2011, and have further to go before they turn upward.

Behind this pessimism is the expectation that the share of distress sales, including foreclosures and short sales, will increase this year (see Chart 6). Distress sales occur at a large price discount; as they grow in proportion to the overall housing market, prices decline. The volume of distress sales was constrained last year because of the robo-signing scandal and other foreclosure process issues, which prompted regulatory and legal action against large mortgage servicers. The largest of these still outstanding is a suit filed by state attorneys general against the servicers. Once it is settled—most likely early this year—the foreclosure process will ramp up again, the number of distress sales will rise, and house prices will fall further.[6]

6 Gauging the settlement of this lawsuit has been difficult. We originally expected a settlement in the spring of 2011 and thus forecast house prices to hit bottom in the fall of 2011. The longer the suit drags on, the longer it will take for house prices to stop falling.

Chart 6: More Distressed Sales Coming

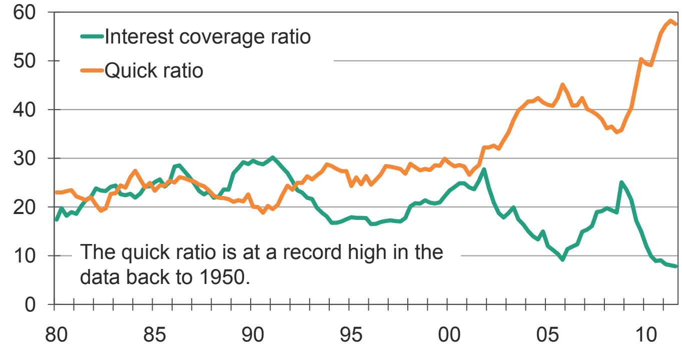
Foreclosures, short sales, deeds in lieu, ths



Sources: FDIC, Equifax, RealtyTrac, Moody's Analytics

Chart 7: Business Balance Sheets Are Healthy

Nonfinancial corporate businesses



Sources: Federal Reserve, Moody's Analytics

Prices are expected to fall only modestly from here, declining another 5% at most. Limiting the downside is sturdy investor demand for distressed properties; prices have fallen enough and rents are strong enough for investors to cover their costs while they wait for markets to firm. Unlike house flippers, who infected the market during the bubble, today's investors have longer horizons. Prices for nondistressed properties are also holding up well, suggesting the market for these has its own separate dynamic.

Nonetheless, the economy's prospects remain questionable as long as house prices are falling. A house remains the most important asset for most middle-income Americans; small-business owners tap home equity for seed money and collateral, and property taxes fund most local governments. Most worrisome is the chance of another vicious cycle in house prices, similar to that seen during the depth of the Great Recession: As prices fell, more homeowners were pushed under water, producing more mortgage defaults, foreclosures and distress sales and thus more price declines. With nearly 15 million home loans estimated to be under water, this is a serious threat. Worse, policymakers are unlikely to respond to a new downturn, given the lack of funds and political will.[7]

Making lots of money

While the economic recovery faces substantial hurdles, there are still reasons to be upbeat. Significant progress has been made righting the wrongs that caused the Great Recession and slowed the subsequent recovery. Fundamentally, the panic and recession occurred because financial institutions made too many bad loans—loans that could not be repaid even under reasonable economic assumptions—and businesses and households took on too much debt. While there is more work to be done reducing debt, particularly mortgage debt, the private sector has made rapid strides. The nation's public debt load is still rising, but if Congress and the administration stick roughly to what is in current law, that will also soon stabilize.

Nonfinancial businesses have done an especially good job fixing their finances. While small businesses are not doing nearly as well as big firms, American companies in aggregate have slashed costs and improved profit margins to their widest levels in 50 years. Earnings have hit records despite modest sales growth. Profits are up widely across industries and reflect domestic as well as overseas operations.

Businesses are sitting on an astounding amount of cash, more than $2 trillion.[8] This is much more than is needed to satisfy creditors. The quick ratio—liquid assets relative to debt due within one year—has soared above 50%, the highest since World War II (see Chart 7). While businesses are borrowing modestly, their debt burdens have never been lighter. The interest coverage ratio for nonfinancial corporations—the ratio of interest payments on their debt to cash flow—has fallen sharply.

Yet to maintain their profitability, companies will need to use these prodigious financial resources to pursue more revenue opportunities. Hiring has improved a bit, and investment spending on equipment and software has revived, but firms remain extraordinarily cautious. Hiring rates are up only modestly since the recession and investment continues to fall well short of internally generated cash flow.[9] Businesses have the financial firepower to expand more aggressively, but they remain reluctant to deploy it.

Banks recapitalize

The financial system has also successfully recapitalized itself. The amount of capital financial institutions are holding as a proportion of assets has surged to a record high (see Chart 8). This reflects banks' aggressive efforts since the financial panic, often under significant pressure from regulators, and improved profitability. Commercial banks' return on assets has yet to return to prerecession levels, but it has come back strongly, particularly for large institutions.

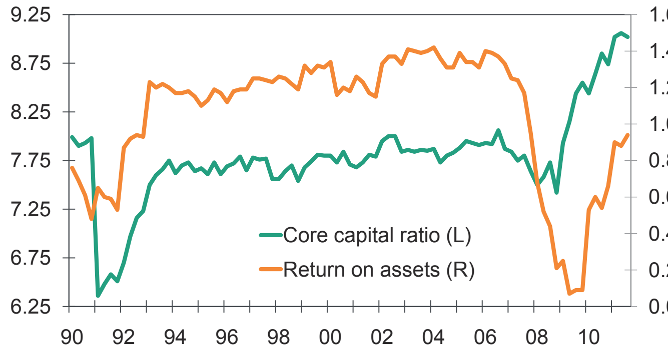
7 We estimate there were 14.7 million homeowners with negative equity as of June. Of these, nearly half were under water by more than 30%. Even a small push could induce many of these homeowners to default.

8 This is based on data for nonfinancial corporations from the Federal Reserve's Flow of Funds.

9 The financing gap—the difference between investment and internally generated cash flow—is also from the Fed's Flow of Funds and is a good barometer of businesses' risk-taking. The current negative financing gap is indicative of businesses' nervousness.

Chart 8: Banks Well Capitalized and Profitable

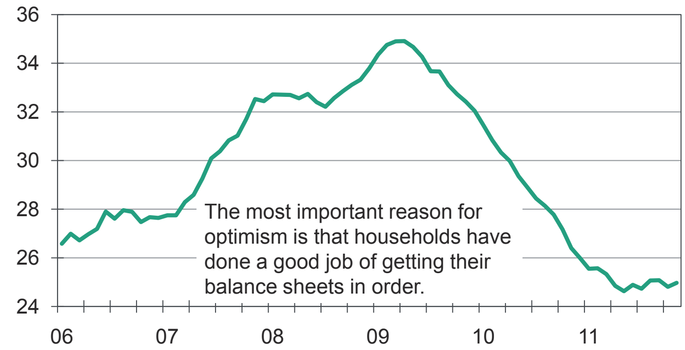
Commercial banks



Source: FDIC

Chart 9: Households Right the Wrongs

Number of delinquent household loans, mil, SA



Sources: Equifax, Moody's Analytics

Financial institutions are more profitable mainly because credit quality has improved. Loss rates are still high by historical standards, especially for mortgage loans, but they have fallen sharply. Institutions have made good progress charging off bad loans and securities, and because lending standards have been exceptionally high in recent years, the quality of new loan originations is stellar. Net interest margins—the difference between the interest banks collect and the interest they pay—also remain reasonably wide despite the Federal Reserve's quantitative easing policy, which lowered long-term interest rates, including the rates banks can charge on loans.

Bank profits would be even higher if loan growth were stronger. Institutions have eased standards a bit as credit quality has improved, so origination volume is slowly picking up. The volume of commercial and industrial loans is growing at a high single-digit pace, and originations of credit card, auto and consumer finance loans are on the rise.[10] But while the credit spigot has opened some since the post-financial panic crunch, it is not yet open enough to fuel an expanding economy.

Getting the house in order

Households have more work to do, but they are quickly getting their finances in order. Americans owe $1.3 trillion less than they did three years ago, a 10% decline. Borrowing costs have fallen as well, so debt-service burdens have plummeted: The share of after-tax household income needed to stay current on debt is likely to hit a record low in 2012.[11]

This is reflected in improved credit quality. In early 2009, nearly 35 million household loans were delinquent, including credit card accounts, residential mortgages, and student loans. At the end of 2011, only 24 million loans were delinquent, fewer than before the recession (see Chart 9). Delinquency rates on credit cards, auto loans and consumer finance have hardly ever been lower.

Much of the improvement in credit quality results from creditors charging off bad loans.[12] This is less desirable than having households become current, but charge-offs can still be therapeutic. While losing a home is wrenching, a former homeowner who now rents has halved the cost of housing. Foreclosure undermines credit scores, generally by around 150 points, but the foreclosed ex-homeowner likely will not be looking to borrow soon anyway. And lenders are already beginning to open their doors to borrowers with lower credit scores.[13]

A significant number of households are still struggling to keep their homes. Some 3.3 million homeowners are either in foreclosure or more than 90 days delinquent. While working through this mountain of troubled loans remains a formidable task, it is encouraging that the number of mortgage loans 30 and 60 days delinquent is falling fast. Indeed, there are fewer 30-day delinquent first mortgage loans today than there were at the height of the housing bubble. The number of 60-day delinquent loans has also come nearly full circle.

The downward trend in household debt levels should end this year. U.S. households will not resume borrowing aggressively soon—although loan originations are already picking up—but they will stop reducing their debt obligations. Such deleveraging has weighed heavily on consumer spending, and as that weight lifts, households will be able to spend more freely.

Fiscal sustainability

As the private sector has unloaded debt, the federal government's indebtedness has ballooned. The federal government's debt-to-GDP ratio has risen by 30 percentage points during the past four years. At close to 70%, it is the highest debt load since just after World War II (see Chart 10).

The government's tenuous fiscal situation largely reflects the impact of the recession on tax revenues and government spending and the policy response to the recession. Policymakers aggressively used government resources to fill the hole created by the collapse in private sector demand, putting more than $1.3 trillion into fiscal stimulus

10 According to the FDIC, C&I loans to small businesses are also rising solidly on a year-over-year basis.

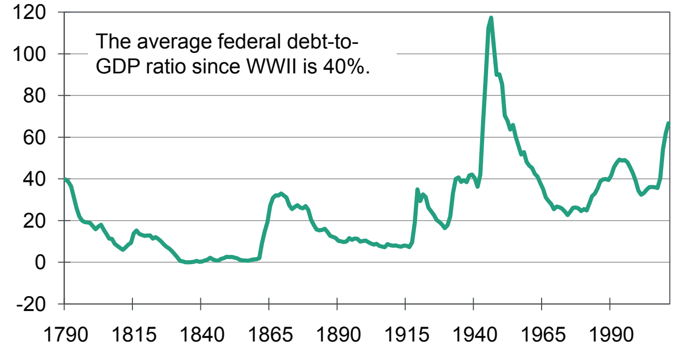
11 Household debt-service and financial-obligation data are available from the Federal Reserve back to 1980.

12 Of the $1.3 trillion reduction in household liabilities outstanding from the peak, almost $1 trillion is estimated to be due to charge-offs, with the remaining $300 billion from voluntary repayments.

13 Among first mortgage loans, the share made to borrowers with credit scores below 660 (the cutoff for prime status) rose from a low of 5% in the fourth quarter of 2010 to 9% in the second quarter of 2011 (the most recent data available from Equifax). In the first half of 2006, the share was 30%.

Chart 10: Our Collective Indebtedness Balloons

Federal publicly traded debt-to-GDP ratio



Sources: Treasury, Moody's Analytics

programs during the past four years. While not responding to the recession would have cost taxpayers even more, given what would have arguably otherwise been an economic depression, the government's actions have been extraordinarily costly.[14] And the costs continue to mount, as this year's federal budget deficit will again equal 8% of GDP.

Returning the government to fiscal sustainability—defined as a stable debt-to-GDP ratio—will be difficult, but it is doable. Indeed, fiscal sustainability is achieved under current law. That is, if policymakers simply punt and do not change current tax and spending policy, under reasonable economic assumptions, the nation's debt-to-GDP ratio should stabilize by mid-decade.

If anything good came out of the debt-ceiling fiasco last summer, it was that lawmakers agreed on the need to cut the deficit by some $4 trillion over 10 years. Congress got more than half way to this goal when it agreed to cut spending by more than $2 trillion over the next decade. The expiration of the Bush-era tax cuts at the end of this year will generate an additional $3.5 trillion in revenue. More than enough austerity is baked into current policy to achieve fiscal sustainability.

Congress will likely attempt to alter this script in 2012 and 2013, however. A significant amount of hand-wringing has greeted the prospect of large cuts to the defense budget. Lawmakers are also likely to balk at raising marginal tax rates for all income groups. The scale of these forthcoming policy changes depends in part on how this year's election goes, but under most scenarios it is likely that the nation's daunting fiscal challenge will be successfully met.

Leap of faith

Although much progress has been made repairing the problems that caused the current mess, it is still hard to see 2012 as a breakout year for the economy. The collective psyche remains shell-shocked from the effects of the Great Recession and discombobulated by events in Washington. Given that 2012 is an election year, the political and policy uncertainty will only intensify.

Historically, recoveries have evolved into self-sustaining expansions when businesses expanded without knowing for certain that they would succeed. When managers could no longer increase profits by cutting costs, they took a leap of faith. Better profits and healthier finances fueled the expansion as firms sought new revenue opportunities. Banks acted on faith as well, even before credit quality returned to normal. Financial institutions realized they needed to grow or risk being gobbled up by a more aggressive competitor. As jobs increased, and credit became more ample, households grew more confident and spent more freely.

The current business cycle seemed to be following this pattern early in 2011. But this positive dynamic was short-circuited by the surge in commodity prices, the Japanese disaster, and the spectacle in Washington. The U.S. economy was not thrown back into recession—although it came close this past fall—but the evolution into a self-sustaining expansion was delayed. How long it will take to get the business cycle back into gear is not yet apparent, but it seems unlikely to happen until after the 2012 election. Perhaps it will be the election itself, and the preceding debate, that spurs businesses to get their groove back.

With businesses remaining cautious, 2012 will likely be another middling year for the economy. Real GDP is expected to post respectable growth of 2.6%, about the economy's potential rate; thus, there will be little improvement in job growth and no significant reduction in the unemployment rate. With modest growth and stubbornly high joblessness, inflation and interest rates are expected to remain low.

Core consumer price inflation will stay well below the Federal Reserve's implicit 2% target, allowing the Fed to easily continue its zero-interest rate policy. Long-term interest rates are expected to move higher by the end of 2012, but if they rise too quickly and threaten the recovery, the Fed could launch another round of quantitative easing. The more restrictive fiscal policy becomes this year, the more accommodative monetary policy will be.

While the U.S. recovery is not expected to gain much traction in coming months, the economy's recent performance—holding up in the face of many adverse shocks—testifies to its resilience. It also suggests that while the economy this year may not be all one might hope, it is shaping up to exceed expectations by mid-decade.

14 See Blinder and Zandi, "How the Great Recession Was Brought to an End," Moody's Analytics Special Study, July 2010. http://www.economy.com/mark-zandi/documents/End-of-Great-Recession.pdf

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Mark Zandi is chief economist of Moody's Analytics, where he directs research and consulting. Moody's Analytics, a subsidiary of Moody's Corporation, is a leading provider of economic research, data and analytical tools. Mark is the author of Financial Shock, an exposé of the financial crisis. His forthcoming book, Paying the Price, provides a road map for meeting the nation's daunting fiscal challenges. He is on the board of directors of The Reinvestment Fund, a Philadelphia nonprofit that marries public with private capital to make investments in inner cities, and MGIC, a publicly traded firm that is the nation's largest private mortgage insurer. Dr. Zandi received his PhD at the University of Pennsylvania, where he did his research with Gerard Adams and Nobel laureate Lawrence Klein, and received his B.S. from the Wharton School at the University of Pennsylvania.

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