5, 5, 5, 5, 5

93

Macroeconomic Project

Martin Maltz
December 11, 2013
Econ 610

Overview

The subprime mortgage crisis of 2006 and the banking liquidity crisis of 2007 gave rise in 2008 to the worst recession in the US since the Great Depression. This recession which began in 2008 was dubbed the Great Recession because of how severe and widespread its effects were on the US economy, and its impact on the economy is still evident today. At the worst of the recession, all areas of the economy suffered significant setbacks. Economic growth came to halt. Real gross domestic product (GDP) contracted 8.9 percent in the fourth quarter of 2008 and did not show positive growth until the first quarter of 2010.[1] In the labor market, the number of unemployed rose approximately 7.5 million by 2009, leading the Nonfarm payroll number to peak at 10.2 percent in October 2009, up from 5 percent in December 2007.[2] The housing market saw prices fall a staggering 30 percent.[3] In the financial markets, all the major indexes plummeted from their highs of October 2007.[4]

In response to this unprecedented economic downturn, the US government enacted fiscal and monetary policies to stabilize the economy and to lessen the severity and duration of the crisis. Five years later, the US economy has recovered from the worst of the recession. Real GDP has shown positive, yet weak, growth for over 20 consecutive quarters;[1] job loss has stabilized; hiring has modestly picked up; housing prices have rebounded off their 2008 lows; the stock market is at record highs and inflation expectation is very low. Clearly, the economy is on the right track to making a full recovery. However, debate and dysfunction within government leadership and the resulting fiscal uncertainty threatens to derail this fragile recovery. This paper will review the evolution of fiscal and monetary policies over the past five years and analyze the effect of current policy on the performance of the economy in the future.

Fiscal Policy

With growth in the economy picking up and job creation improving, the focus of fiscal policy has moved from stabilizing the economy, necessary during the depths of the recession, to deficit reduction, necessary for economic recovery. In 2013, the Economic Report of the President outlined the current administration's fiscal goals with Federal budget deficit reduction and debt-to-GDP ratio stabilization as their main objectives. In the short-term, the effects of government spending caps, new revenue from a revised tax code and a slowly improving economy has had a considerable effect on the deficit-to-GDP ratio. According to the Congressional Budget Office (CBO), this ratio declined to 7 percent in 2012 and is projected to further decline to below 3 percent in 2015. However, under current law, the CBO estimates that by 2023, the deficit-to-GDP ratio will rise once again together with the debt-to-GDP ratio which will be 71 percent of GDP at that point. If left unchecked, primarily due to an aging population and anticipated increased health-care expenditures, the debt-to-GDP ratio is projected to reach 100 percent by 2038. To lower the deficit, President Obama has expressed his priorities to be making cuts in government spending which are balanced with new revenues and restructuring the current tax code to make it more progressive. However, bitter partisan politics has made accomplishing these goals very challenging.[5,6]

In August 2011, the Budget Control Act was passed. Using raising the debt ceiling as a bargaining chip in negotiations, House Republicans agreed on $917 billion in spending cuts over a 10-year period without raising taxes. At the end of 2012, again because of partisan politics, no agreement was reached regarding mandatory spending cuts across all government programs and extension of Bush era tax cuts. As a result, the US economy went over the "fiscal cliff." After tense negotiations with House Republicans, the American Taxpayer Relief Act (ATRA) was passed. ATRA blunted the full effects of the "fiscal cliff" by permanently extending tax cuts for 98 percent of taxpayers while raising the average tax rate for taxpayers in the top 1 percent and 0.1 percent of earners. The ATRA, together with the Affordable Care Act (ACA) which imposes an additional medicare and investment income tax for wealthier Americans, has generated new revenue for the government through an increasingly progressive tax system that the President considers equitable and efficient.[5]

Presently, progress on passing a budget for 2014 has been stalled by partisan politics between a Republican-controlled Congress and a Democrat-controlled Senate. In October 2013, Tea Party Republicans hijacked budget negotiations and tied budget funding for 2014 to raising the debt limit and defunding the ACA. As a result of this deadlock, the government was shut down for 16 days and the US Treasury was put on the brink of defaulting on its debt. Eventually a temporary compromise was reached to fund the government and raise the debt limit, but no lasting agreements were made for reaching a budget deal. If no deal is reached by February 2014, this same scenario is likely to repeat itself, causing further uncertainty in the economy and doing untold damage to the fledgling recovery.

Monetary Policy

In September 2012, the FOMC announced it would purchase $40 billion in mortgage-backed securities on a monthly basis, raising total monthly security purchases to $85 billion. In giving future guidance, the Fed also announced that future policy decisions would be directly linked to the health of the labor market and that the Fed's main policy interest rate would stay low through mid-2015. Three months later at the December 2012 FOMC meeting, the Fed announced their dual mandate for keeping interest rates low. The mandate stated that as long as the unemployment rate was above 6.5 percent and inflation was not expected to be a 0.5 percentage point above the committee's 2 percent goal, the federal fund rate would be kept in an exceptionally low range.[7]

Most recently, at the October 2013 FOMC meeting, the Fed conveyed that they planned to forge on with their current monetary policy. The Fed will continue to purchase $85 billion in securities at a monthly pace and will continue to look for evidence of a meaningful improvement in the labor market. Fed members also noted that the short-term economic outlook remained relatively unchanged since their meeting in September, but current data suggested growth in the second half of 2013 might be somewhat weaker than what had been previously anticipated. Furthermore, uncertainty about fiscal policy was noted as a potential limiting factor for consumer confidence and undermined the short-term outlook for future consumer spending and business investment. Improvement in the unemployment rate over the last year was also discussed, with some members noting that it may overstate the degree of labor market improvement due to a decline in the labor force participation rate. However, other members noted the decline in labor force participation reflected increased retirement in the population.[8]

Looking to the future, with the economy slowly improving, and the Fed coming closer to reaching its target labor rate, albeit with inflation below its target rate, the Fed must now decide when and how to reverse its current easy money policies and shrink its colossal balance sheet, without causing harm to the economy. Unfortunately, because of government dysfunction, current monetary policy is being used as a substitute for sound fiscal policy and this makes the prospect of a taper of easy money policies less certain. In expressing this sentiment, Fed Chairman Ben Bernanke frustratingly told lawmakers in his July 2013 congressional update, "The risks remain that tight federal fiscal policy will restrain economic growth over the next few quarters by more than we currently expect or that the debate concerning other fiscal policy issues, such as the status of the debt ceiling, will evolve in a way that could hamper the recovery."[9]

Also complicating the prospect of a taper in the near future is the fact that the financial markets have become addicted to the Fed's unprecedented monetary stimulus program. As a result of sustained, historically low interest rates, corporations are presently flooded with excess cash and are posting record profits. It is no wonder that the financial markets react negatively anytime the Fed hints to a possible taper of its monthly security purchases. Regardless, continued easy money policy by the Fed is adversely affecting the natural pricing mechanisms of the financial markets and is thus distorting the true prices of real assets. Ben Bernanke and soon to be Fed Chairwoman Janet Yellen are now faced with the difficult task of balancing the needs of a sputtering economy by using monetary policy as a proxy for sensible fiscal policy with the possible adverse effects such sustained policies may have on the economy.[9]

Economic Indicators

GDP

In the third quarter of 2013, Real GDP increased by 3.6 percent. This was up from 2.5 percent in the second quarter and up significantly from 1.1 percent in the first quarter, indicating a strengthening trend in economic growth. Although this report showed the strongest quarter in over a year, the consumer spending component of GDP increased only by 1.4 percent, the lowest amount in five years, and much of the growth came from a one-time build up of inventory by businesses. In the category of durable goods that are dependent on interest rates for financing, such as automobiles, furniture and appliances, relatively stronger sales were noted, possibly indicating consumers were taking advantage of the Fed induced low interest rates. Business spending on equipment, excluding real estate, was down 3.3 percent. Government spending was up 0.4 percent with state and local government making the largest contribution. Overall, these numbers signal a decline in confidence by consumers and businesses, and show the effect government spending cutbacks has on economic growth.[10]

Nonfarm Payroll, ADP and Initial Claims

Since the end of the Great Recession in 2010, the health of the labor market has steadily improved. Over the past five years, the rate of job loss has stabilized and job growth has steadily trended to the upside. Most recently, in the Bureau of Labor and Statistics' (BLS) November 2013 nonfarm payroll employment report, job growth increased by 203,000 and the unemployment rate decreased to 7.0 percent from 7.3 percent in October. This was the biggest monthly increase since February 2013 and, on average, jobs grew by 195,000 per month for 2013, up from 155,000 in 2012 and 2011. Transportation, warehousing, healthcare, manufacturing and leisure and hospitality were sectors that saw the biggest job gains in November. Also on a positive note, in November, average hourly earnings for all employees increased by $0.04 cents and they have increased by 2 percent over the course of the year.[11]

The latest results from the ADP National Employment Report and the Department of Labor's initial claims data echo this positive trend in the labor markets. According to ADP, private sector employment grew by 215,000 jobs in November, making it the largest monthly increase since November 2012. Furthermore, initial claims for unemployment insurance for the week of November 30th numbered only 298,000, compared to 321,000 for November 23rd, 326,000 for

November 16 and 370,000 for the same time period in 2012, indicating fewer people are being laid off from work.[12,13]

These latest numbers for the labor market are unexpectedly positive considering the recent government shutdown and the debt limit uncertainty. However, closer examination of the data reveals what some skeptics might consider a less than optimistic view of the job market. Although the unemployment rate reached 7.0 percent, the lowest since November 2008,[14]one can ask whether the reason for this drop is due to the creation of more jobs or that more people have given up looking for a job, thereby leaving the job market. The numbers do not give a definitive answer to this question, but since 2012 the amount of people not in the labor force has increased from approximately 88.8 million to 91 million.[11] Further casting doubt on the health of the labor market is the large number of low quality jobs being created and the over abundance of involuntary part-time workers in the labor force. Illustrating this is the "food services and drinking places" sector of the job market. In 2013, this sector was one the highest trending sector to create jobs, adding on average 28,000 jobs per month. These jobs typically pay minimum wage and do not provide the economy with a consumer that posses the purchasing power to propel economic growth. Add to this to the fact that 7.7 million workers,[11] or about 5 percent of the workforce, are currently employed part-time because they cannot find a full-time job, and one can only be cautious about being overly optimistic with the labor market.

Standard and Poor's 500 Index

The Standard and Poor's 500 Index's (S&P 500) performance in 2013 foretells of a positive outlook for the economy in 2014. In 2013 the S&P 500 reached new milestones and broke old records. As of March 28, 2013, the S&P 500 surpassed its previous intraday all time high of 1576.09 from October 2007 and closed for the first time on November 22, 2013 at over 1800. As of December 2013 the S&P 500 posted year-to-date returns of approximately 30 percent, making it the largest annual increase in 16 years. Furthermore, at the end of November, the index recorded eight straight weeks of gains, the longest streak in over a decade. Finally, since 2009 the S&P 500 has risen over 170 percent, erasing all losses resulting from the recent financial crisis.[15]

Interest Rate Yields

Since 2009, downward pressure on interest rates by the Fed has caused yields across all maturities of the Treasury yield curve to hover around historic low levels. In May 2013, with the labor market improving and inflation still under the Fed's target rate, suggestions by FOMC members of a possible tightening of monetary policy caused a spike in the benchmark 10 and 30 year Treasury yields. At that time the 10-year Treasury yield was just below 2 percent, however, now with the expectation of a Fed taper imminent the 10-year Treasury jumped approximately 100 basis points. In December 2013, the 10 year Treasury yield hovers at just below 3 percent. Mortgage rates which mirror the movement of the 10 year Treasury have also seen significant gains since May. Rates for the 15 and 30 year mortgages have both moved up approximately 100 basis points since May 2013.[16,17,18]

Housing Starts

Housing starts data for the months of September, October, and November were delayed by the U.S. Census Bureau because of the partial government shutdown in October. Data from August though, shows a decline in housing starts thats deviates from the previous monthly trend. Since the beginning of the year housing-starts for single and privately-owned housing units showed strong gains month over month. However, in August privately-owned housing starts increased by a paltry 0.9 percent over July's numbers and for single-family authorizations increased by 3 percent over July. These outliers may represent the reaction of the housing market to the sharp rise in interest rates in the immediate preceding months.[19]

Existing Home Sales

Existing home sales, which indicate the current demand for homes, declined 3.2 percent in October to a 5.1 million units pace, which was weaker than expected. The decline was mostly in single-family sales, which declined 4.1 percent, the third consecutive monthly drop. Although the government shutdown likely played a role in recent weakness, it is still too early confirm this. Disappointingly, the cumulative decline over the last three months nearly offset the 6.3 percent increase in July.[20]

Durable Goods

New orders for manufactured durable goods decreased by 2 percent in October. This follows a 4.1 percent increase in September. Weakness was found in transportation and defense new orders. Excluding defense and transportation, new orders decreased by 1.3 percent and 0.1 percent, respectively. Weak defense spending can be attributed to the government shutdown in October.[21]

Consumer Confidence

According to the University of Michigan's Survey of Consumer Confidence Sentiment, consumers' confidence in the economy increased significantly for the month of December. With a value of 82.5 in December, and up from 75.1 in November, this month's score is the strongest since July 2013. It appears that improvements in the labor markets, the wealth effect from the financial markets and increased property values are making Americans more optimistic about the economy. To put these numbers in perspective, before the recession in 2007 the survey scored a five year average of 89 and, in contrast, a score of 64.2 on average was noted during the recession.[22]

ISM Manufacturing and New Orders

Manufacturing expanded in November with the Purchasing Managers Index (PMI) coming in at 57.3 percent, an increase of 0.9 percent compared to October's rate of 56.4 percent. This is up from a yearly low of 49 percent in May. New Orders Index was 63.6 percent in November, a rise of 3 percent compared to the October's number of 60.6 percent. This data represents growth in new orders for the sixth consecutive month, which was at a faster rate than in October.[23]

<u>Short-Term Economic Outlook</u>

The economy will most likely display overall muted growth by the end of 2013, because despite strong trends in manufacturing, labor, equities and the housing market, increased spending by consumers and investing by businesses were stymied by self inflicted wounds delivered by Washington in the form of spending cuts, tax increases and government shutdown. As a result of these economic headwinds during 2013 the CBO predicts 4th quarter Real GDP to decline, ending the year at 1.9 annual percent[24].

Entering 2014, leading economic indicators project growth to continue in all sectors of the economy. However, two key issues will potentially affect the degree of growth for the year.

These include uncertainty in government and rising interest rates. As with 2013, government dysfunction is anticipated to negatively affect consumer and business confidence, decreasing consumption and investment. Additionally, in 2014, interest rates are expected to rise when the Fed finally begins to pull back its easy money policies. Higher interest rates will make financing new homes more expensive and may result in declining new home sales, hurting the recovering housing market.

In a positive prediction for 2014, our leaders in government will likely reach a medium-term compromise on sensible fiscal policy at the end of 2013 or the beginning of 2014, and consumer and business confidence will benefit and continue to rise as a result of less uncertainty in the economy. Additionally, the housing market should continue to trend upward as rising home prices increase homeowners' equity in their property, offsetting the above-mentioned increases in mortgage rates. Finally, consumers will eventually start to spend more as the economy adapts to fiscal tightening and as consumers begin to feel wealthier as a result of rising stock and real estate prices. This will lead to a cycle of increased growth, employment, income, consumer spending and business investing. Based on this scenario, inflation expectations will be about 3 percent annually, the 10-year treasury rate will rise to 3.5 percent, and an anticipated 3.5 annual percent growth is projected for the real GDP in 2014.

References

1. http://www.bea.gov
2. http://www.bls.gov
3. http://us.spindices.com/index-family/real-estate/sp-case-shiller
4. http://finance.yahoo.com/q/hp?s=%5EGSPC+Historical+Prices
5. http://www.whitehouse.gov/administration/eop/cea/economic-report-of-the-President/
6. http://www.cbo.gov/publication/44521
7. http://www.federalreserve.gov/newsevents/press/monetary/20120913a.htm
8. http://www.federalreserve.gov/newsevents/press/monetary/20131030a.htm
9. http://aggbot.com/Headline-News/article/20000857
10. http://www.bea.gov/newsreleases/national/gdp/gdpnewsrelease.htm
11. http://www.bls.gov/news.release/empsit.nr0.htm
12. http://www.adpemploymentreport.com/2013/November/NER/NER-November-2013.ap
13. http://www.dol.gov/opa/media/press/eta/ui/current.htm
14. http://data.bls.gov/timeseries/LNS14000000
15. http://www.bls.gov/news.release/empsit.nr0.htm
16. http://finance.yahoo.com/q/hp?s=%5EGSPC+Historical+Prices
17. http://research.stlouisfed.org/fred2/graph/?id=DGS10
18. http://research.stlouisfed.org/fred2/graph/?id=MORTG
19. http://research.stlouisfed.org/fred2/graph/?id=MORTGAGE15US
20. http://www.census.gov/construction/nrc/pdf/newresconst_201308.pdf
21. http://www.realtor.org/topics/existing-home-sales/data
22. http://www.census.gov/manufacturing/m3/prel/pdf/s-i-o.pdf
23. http://www.bloomberg.com/quote/CONSSENT:IND
24. http://www.ism.ws/ISMReport/MfgROB.cfm?navItemNumber=12942
25. http://www.cbo.gov/publication/44172