

The Economic Outlook: Risks and Uncertainties

Testimony of Joel Prakken, Macroeconomic Advisers

Senate Budget Committee

January 26, 2012

Chairman Conrad and distinguished members of the Committee. My name is Joel Prakken. I am Senior Managing Director of Macroeconomic Advisers, a forecasting firm in Saint Louis that I co-founded in 1982. Thank you for inviting me to this hearing to discuss the risks and uncertainties surrounding the U.S. and global economic outlook for 2012, and what policymakers might do to improve it.

A Guarded Outlook

Our outlook for 2012 is guarded. We see the nation's real Gross Domestic Product growing only about 2¼% over the year. This is not fast enough to lower the unemployment rate below the current 8½%. Indeed, unemployment could drift up modestly from here. Given that much slack in labor (and product) markets, "core" inflation will remain subdued; consumer prices likely will rise only about 1½% over the year. With the unemployment rate above "full employment" and inflation below the 2% we believe the Fed (implicitly) targets, monetary policy will remain accommodative and interest rates extraordinarily low by historical standards.

Consumer spending will grow at about the same pace as GDP. Gross private domestic investment will grow somewhat faster. A narrowing trade deficit will be a modest boost to growth, but fiscal policy will restrain the recovery. This fiscal restraint has three components. First, the stimulus associated with the American Recovery and Re-investment Act of 2009 is abating. Second, the caps on discretionary spending passed as part of the Budget Control Act of 2011 will start to bite. And third, in the face of ongoing fiscal pressures, state and local governments will continue to trim spending and boost taxes in order to comply with their balanced-budget mandates. For fiscal 2012, we

expect the federal deficit (on a unified budget basis) to top \$1.1 trillion for the fourth consecutive year.

Where are We in the Deleveraging Process?

It is generally accepted in the forecasting profession that economic recoveries following recessions precipitated by financial crises are slowed by the process of “deleveraging”. So far, the ongoing recovery in the U.S. appears to be no exception to this rule, especially when compared to the strength of the recovery normally associated with an “output gap” as large as that which developed in 2009.

At least at the aggregate level, there are indications the U.S. is nearing the end of the first stage of the deleveraging process. Corporations — well, at least large corporations—are flush with internally generated funds and boast well-structured balance sheets. The personal saving rate appears to have stabilized far short of the 8% to 10% that some pundits (although not this one!) were forecasting a few years back. House prices have fallen back into proximate historical alignment with incomes and rents. Thanks to consumers’ retrenchment and very low interest rates, the ratio of households’ debt service to disposable income has retreated to a very low level.

Yet this steadily brightening picture masks other legacies of the “great recession.” A sizable percentage of homeowners remain “underwater” on their mortgages, and there can be little doubt this is both a drag on consumer spending and an impediment to labor mobility that contributes to high “structural” unemployment. Furthermore, the deleveraging process has other “secondary” dimensions now coming more forcefully into play as the economy strains to expand. Credit standards have tightened, especially in the residential mortgage market where qualifying credit scores and loan-to-value ratios linger well above recent historical norms. It can prove difficult to secure financing or re-financing for commercial real estate projects, especially those originated or re-financed at the height of the real estate “boom” five years ago. Federal regulations intended to define, identify, and curtail systemic financial risk are under development. These

secondary dimensions of the deleveraging process might safeguard the economy and improve the “quality” of the expansion, but they do also restrain the pace of recovery.

Through the Looking Glass

Economists, especially economists with computers (like me; OK, including me!) produce forecasts that can convey a false sense of understanding and precision. In that regard, in my 30 years in this business, I have never known as much uncertainty to surround our forecasts as is the case today. The distribution of possible outcomes is not tightly or even symmetrically clustered around a central tendency. Indeed, recently I find myself thinking that our clients might be better served if we gave them a long list of alternative outcomes or scenarios, each dependent on a particular set of assumptions, and let them choose for themselves the assumptions (and hence outcomes) that they believe are most likely. To clarify my angst over all this, I want to discuss briefly five areas of risk and uncertainty critical to how the economic environment may evolve over the next several years—areas about which many economists disagree.

Fiscal Policy

We prepare our forecasts using an economic model that requires us to make explicit assumptions about future fiscal policies. This was a lot easier in the “old days!” Changes in the formulas governing “mandatory” benefits, changes in the tax code, and major changes in discretionary spending were relatively infrequent and usually considered permanent in nature. Now the fiscal landscape is cluttered with temporary policies the extensions, modifications, or expirations of which can have measurable, indeed sizable, impacts on our forecast.

Will the current “payroll” tax holiday and federal emergency unemployment benefits be extended beyond February? If so, will they be extended beyond 2012? How will they be paid for? When will they be paid for? Will the “Bush tax cuts”, either in part or in their entirety, sunset in 2013? Will the “AMT patch” and the “Doc fix” be extended (again)?

Will the Affordable Healthcare Act and the related tax increases scheduled for 2013 be repealed after the upcoming presidential election? Will there be a “sequester” of discretionary spending in 2013 because the Congressional “Super Committee” “failed,” or will some form of that Committee reconvene during 2012 and “succeed?”

I don't pretend to know for sure how all this will play out, and I'd be suspicious of any forecaster that claims he or she does know. For what it is worth, our forecast assumes the payroll tax holiday and emergency unemployment benefits are extended through December but will be paid for gradually over the next decade, that the AMT will be patched, that “docs” will be fixed, that healthcare reform will not be repealed, that most of the Bush tax cut will be extended, that a full sequester will be avoided, and that a grander bargain on gradual deficit reduction will be achieved. However, imagine the enormous fiscal drag in 2013 — roughly 5% of GDP — should, either by political design or political miscalculation, the tax holiday, unemployment benefits, the AMT patch, the Doc fix and the Bush Tax cuts all expire even as the new health care taxes take hold and discretionary spending is sequestered. Furthermore, all this could occur in a still-sputtering economy when the Fed, having already fired most of the arrows in its monetary quiver, cannot respond aggressively or, even worse, might be politically constrained from responding at all. In our modeling, that is a recipe for at least a “growth recession”, if not an outright one.

And then there is this: a relatively new but growing and interesting empirical literature suggests that the very existence of such policy uncertainty restrains economic growth. The intuition is simple to grasp. If you don't know in what policy environment you will be spending, saving, investing, and working, there is natural inclination simply to delay important decisions and actions until more clarity is achieved. Alas, with the growing number of temporary provisions clouding the fiscal crystal ball, opaqueness is trumping clarity, and quite handily.

Monetary Policy

The Federal Reserve Open Market Committee is in uncharted territory, never before having used the unconventional policy tools wielded of late or having to contemplate an “exit strategy” that simultaneously envisions raising short-term interest rates off the “zero bound” and shrinking, as economic conditions dictate, a temporarily bloated balance sheet while restructuring both the composition and the duration of its portfolio. “On paper” the FOMC knows how to do all this while preserving its credibility as stalwart against inflation. Still, the novelty of the situation implies risks not previously encountered. We assume the Fed engineers an eventual graceful return to both normal interest rates and a normal balance sheet, but others are less sanguine about this. In the meantime, however, the FOMC is not well-positioned to respond to a near-term adverse economic “shock”, and this inflexibility heightens downside risks to the outlook.

Euro Crisis

We view the slow motion train wreck that is the European sovereign debt crisis as the single largest downside risk to continued economic recovery here in the United States. Slower growth in the Euro-zone means slower growth in U.S. exports to the region; it could also mean a higher value of the dollar, which makes goods and services produced in the U.S. less competitive in global markets. But far more important would be the financial contagion that could spread around the globe, without regard to borders, if an uncontrolled “Lehman event” occurs within the European financial system this year. The prices of risky assets around the world would decline together even as the dollar strengthened. If the financial tsunami was severe enough it could tip the U.S. into the back end of a “double dip” recession. And this doesn’t even consider dissolution, either in part or in full, of the Euro itself, the near-term economic consequences of which would, in our judgment, be much more severe.

Our forecast assumes that a sharp but not unprecedented recession in Europe started in the fourth quarter of 2011 but that it will end by mid-year, and that the policy response unfolding in Europe is enough to head off the worse scenario mentioned above. Recent developments out of Europe are promising. In particular, the decision by the European Central Bank to lend to private banks so they, in turn, can buy troubled sovereign debt seems to be working...for now. Alas, this hasn't fixed the fundamental fiscal imbalance at the heart of the problem in the "PIGS" and other peripheral European countries, and circumstances in Europe could quickly deteriorate very quickly and at any moment. Furthermore, colleagues with an ear close to the European third rail, as it were, suggest to us that the odds of something so untoward happening are about as high as the happier outcome we've assumed. I might add, however, that the recent European experience should give pause to those who argue that sharp fiscal contractions are expansionary in the short run!

House Prices

During the great recession residential construction fell from roughly 6% of nominal GDP to hardly more than 2%, seemingly too small to even matter anymore. Even so, we believe it unlikely that the U.S. can enjoy really robust growth without housing sharing prominently in the recovery. The issue, of course, is that homebuyers and homebuilders delay buying and building if the expectation is for further declines in house prices. The consensus forecast, which we have adopted, is for house prices to begin rising modestly next year (that is, 2013). That would certainly be good news. Rising, rather than falling, house prices would lower the "real" or inflation-adjusted cost of mortgage finance, thereby supporting housing demand. They also would boost households' net worth and prevent foreclosures, thereby supporting consumer spending. Unfortunately, it is difficult to be confident in the consensus forecast for house prices. For one thing, not that long ago the consensus was for house prices to turn up... in 2011! For another, no one knows for sure how large is the "shadow inventory" of houses that could be brought to market the moment potential sellers sense that prices have bottomed out, thereby renewing the

downward pressure on prices all over again and delaying for even longer the eventual turn-around in housing.

Now when that turnaround finally does come, it could be strong indeed. Steadily accumulating pent-up demographic demand suggests the U.S. will have to build an average of perhaps 1.5 million units per year over the coming decade. This implies about a 300 percent (yes, 300 percent) increase from current levels. Importantly, the tilt of reviving construction could be towards multi-family rental units as today's new financial realities discourage home ownership.

In the meantime, one has to wonder whether more couldn't be done to support house prices with relatively (if any) net risk to taxpayers. The price of a house can fall dramatically when the property enters foreclosure, so policies that prevent foreclosures—especially so-called “strategic foreclosures”—could pay considerable economic dividends. Recent Administration efforts to facilitate mortgage re-financing and modification could and, in our judgment, should be widened to cover as many mortgages as is reasonably possible. Perhaps lenders could be allowed to share in future house price appreciation as a way to coax them to the refinancing table. Proposals for the GSEs to bulk sell properties for rental use also hold some promise.

Labor Force Participation

Over the past several years large numbers of people have stopped looking for work. The resulting decline in the labor force participation rate mitigated what otherwise would have been a much larger increase in the unemployment rate. Indeed, over the last year the unemployment rate has declined by about a percentage point despite anemic economic growth well below historical estimates of “trend”.

There is an active debate in the forecasting profession over whether this decline in participation is mostly cyclical—and so likely to be reversed as the economy improves—or more permanent or “structural” in nature. The answer to this question is important

partly because it determines the economy's potential for non-inflationary growth which, in turn, bears importantly on the deficit projections that will serve as the baseline for the fiscal wars sure to be waged over the next several years. Our work suggests there will be a cyclical rebound in labor force participation that will permit strong growth in the middle part of the coming decade—between 4% and 5% in some years—with a decline in the unemployment rate gradual enough to curtail any inflationary threat. Others, including the CBO, have a less optimistic take.

Concluding Remarks

As the economy approaches the 3-year mark of this recovery, the coming year or two are likely to see growth and utilization rates that, while not especially surprising given the circumstances, will nonetheless feel disappointing. Furthermore, the risks to the forecast and the uncertainties surrounding it have seldom, if ever, been as varied or as prevalent as they now are, and neither our monetary or fiscal authorities are well-positioned or even inclined to counter adverse shocks to the economy. In short, these will be trying times. But call me a cockeyed optimist because, at least from my viewpoint, I can imagine worse outcomes than the ones I do consider most likely.

I thank you for your kind attention today and for the opportunity to offer advice. I would be happy to answer any questions you may have.

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