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# Economic Review



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The economy has been picking up some momentum in recent months. While jobs are still growing slowly, they should soon strengthen. By the way, have you wondered why the recession ended and why the economy is growing? As discussed below, many of those controversial government programs implemented over the past couple of years have had a major effect.

**The Economy:** Real Gross Domestic Product (GDP) rose almost 4 percent in the final quarter of last year, about double the pace of the two previous periods. Stronger car sales helped and so did exports. For the year, GDP rose about 3 percent. This has reduced fears of a “double dip” return to recession. Widespread bad weather is temporarily weakening some activity early this year. It has also driven energy prices up and made me very grumpy...

I'm predicting GDP will rise a little more than 3 percent this year. Some forecasters see considerably faster growth, but I'm concerned about the ongoing drag from real estate (both residential and commercial) as well as fiscal tightening at the state and local level – among other things.

The labor market should look better in 2011. Job gains ought to be double the 90,000 per month generated last year even though the GDP increase is about the same. Businesses will hire more people for two reasons. The increase in average hours worked per week will be smaller than last year and productivity will rise less.

Unemployment will decline by half a point to nine percent – about the same drop as in the previous year. The reason why increased job formation doesn't make the unemployment rate fall faster in 2011 is that more people will enter the work force as labor market conditions improve.

**The Counter What?** The past four years have seen the most extensive (some would say intrusive) implementation of government economic programs since the Great Depression. Starting in 2007, the Federal Reserve quickly cut short-term interest rates to zero. During 2008, the Fed started purchasing large amounts of debt securities under the so-called “quantitative easing” (QE) policy. The much maligned TARP program, where the government purchased assets and equity from financial institutions, and corporate bailouts were concentrated in 2008. And the \$800 billion stimulus package consisting of tax cuts, infrastructure spending and aid to state governments was enacted in 2009.

There's considerable argument over how effective these measures have been. Did they end the recession? Are they responsible for the recovery? Some of the controversy stems from ideological differences: conservative vs. liberal, small role for government vs. large role, etc. However, I agree with whoever said we're all entitled to our own opinions, but not to our own set of facts.

Furthermore, you cannot answer the question by scrutinizing the economic data, no matter how hard you try. Counting the number of jobs created simply does not indicate whether the program was effective. This is not an accounting exercise.

Rather, you have to be able to tell what *would have happened without the policy* and compare that with the results shown with the policies. Economists have a fancy name for this approach, which they call constructing the *counterfactual*. And in order to do this, you need sophisticated models of the economy capable of translating different assumptions and policies into GDP, jobs, incomes and other key economic indicators. For example, how do tax cuts affect consumer spending and what is the impact of lower interest rates on business investment decisions? What are the lags and how do these ripple through the economy?

There have been several recent studies of this type. One was conducted by the noted economists Alan Blinder and Mark Zandi. Zandi is a highly respected pragmatist, equally at home advising Republicans and Democrats. His consulting firm has built large, complex models of the global, national and regional economies that are used extensively by businesses and governments. Alan Blinder

## Musings & Amusings

Really Bad Puns from *Prairie Home Companion*

No matter how much you push the envelope, it'll still be stationery.

A vulture boards an airplane, carrying two dead raccoons. The stewardess says, 'I'm sorry, sir, only one carrion allowed per passenger.'

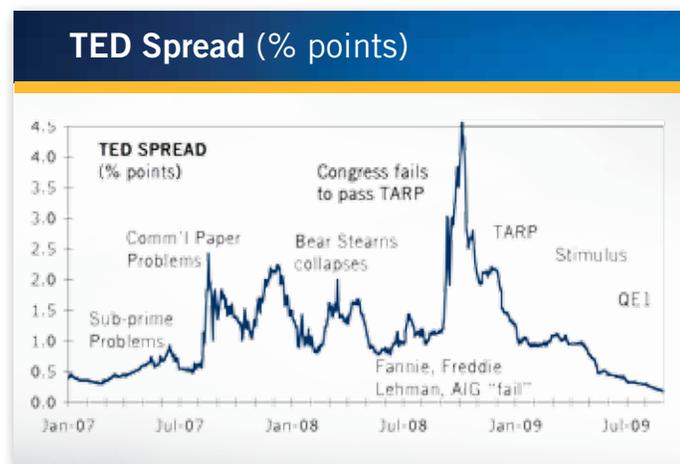
A person sent ten puns to friends, hoping at least one would make them laugh. No pun in ten did.

is an economics professor at Princeton and former Vice Chairman of the Federal Reserve. He left the Fed in 1996 – long before the recent financial crisis.

Zandi and Blinder first explored the impact of the stimulus package. They ran the models with and without the stimulus program. They found that the recession would have been several quarters longer and unemployment would have been about a point and a half higher than otherwise.

Assessing the impact of TARP and highly aggressive monetary policy, including QE, is much more difficult. They focused on interest rate risk premiums and how these affect the economy. The deep recession plus severe financial crisis made these credit spreads widen dramatically. Zandi and Blinder contend that the actions taken by the federal government then caused them to narrow dramatically.

One of these risk premiums is shown in the chart. The “Ted Spread” is the difference between the yield on 3-month U.S. Treasury bills and 3-month eurodollars deposits. Think of the eurodollar market as a huge, offshore fed funds market, where banks borrow from each other in dollar denominated loans. By the way, eurodollars have nothing to do with the Euro currency.



Normally, the Ted Spread is about 20 basis points (100 basis points equals a percentage point), reflecting the greater liquidity and risk-free nature of T bills. During the height of the crisis, it exploded to almost 500 basis points as financial markets worried about the ability of banks borrowing in the eurodollar market to repay their loans.

By including a variety of credit spreads, Zandi and Blinder found that without the stimulus program, TARP, QE, etc. GDP would have fallen 12% instead of the actual 4%. Unemployment would have hit 16.5% instead of 10% and deflation would have broken out. The counterfactual

would certainly have been classified as a depression by economists.

Surely, many actions could have been done better. Did Lehman Brothers really have to go into bankruptcy? Shouldn't the Fed have been tougher on the counterparties to AIG's credit default swaps by forcing them to take sizable losses? But we're talking about decisions that had to be made within a matter of a couple of days and even a few hours. The global financial system was on the verge of collapse! Last November, the legendary investor, Warren Buffett, wrote an op ed “thank you” note in the *New York Times* to “Uncle Sam” for these very policies we have been discussing. Buffett said

**So, again, Uncle Sam, thanks to you and your aides. Often you are wasteful, and sometimes you are bullying. On occasion, you are downright maddening. But in this extraordinary emergency, you came through – and the world would look far different now if you had not. Your grateful nephew, Warren**

More recently, a group of economists from the Federal Reserve published a study focusing solely on the effectiveness of quantitative easing. Using a model-based approach similar to the above, they conclude that QE1 lowered bond yields by 50 basis points. While this may not seem like much, other research indicates that a reduction of long term rates of this magnitude is several times more potent than a 50 basis point cut in the fed funds rate. As a result, today's unemployment rate is ¾ point lower than it would otherwise be. They also conclude that the full-effects, including an estimate for the recently announced QE2, will reduce unemployment 1½ points by 2012 below what it would otherwise be.

Bond yields have risen since the Fed first started hinting about QE2 last August. However, this doesn't mean that the latest round of quantitative easing is a failure. The strengthening of the economy has reduced the risk of deflation. The spread between Treasury coupon notes and Treasury Inflation Protected Securities (TIPS) has widened from 1.7 points in August to about 2.2 points at present, indicating an modest increase in expected inflation.

### 10-year Treasury Note

	8/10	12/10
Coupon Note (%)	2.70	3.29
Minus: TIPS	1.02	1.04
Equals: Expected Inflation	1.68	2.25

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