MOODY'S
ANALYTICS

August 26, 2011

SPECIAL REPORT

Global Policy Prescriptions: How Another Recession Can Be Avoided

Prepared by
Mark Zandi
Chief Economist
+610.235.5000

Global Policy Prescriptions: How Another Recession Can Be Avoided

BY MARK ZANDI

The economy is struggling to avoid recession. The political spectacle over the debt ceiling and Standard & Poor's downgrade of Treasury debt have upended the already-fragile collective psyche. Consumers and businesses appear frozen in place. They are not pulling back yet, but to avoid a downturn it is vital for policymakers to act aggressively to stabilize sentiment.

There is reasonable concern that policymakers are limited in how they can respond to the crisis of confidence. Interest rates are already extraordinarily low, the federal government is running unprecedented deficits, and the Europeans are struggling to find the resources to keep the euro zone together. The political will to act is also impaired by the polarization of political and economic views. A loss of faith in the political process is significantly contributing to the loss of faith in the economy.

But policymakers are not out of options. The Federal Reserve's bold action to state its intention to keep short-term interest rates near zero until mid-2013 has brought down long-term interest rates and supported stock prices. It can provide even more help by extending the maturity of the Treasury bonds it already owns and by purchasing more bonds through another round of quantitative easing. More QE is not without its problems, but they are outweighed by the positives.

European policymakers' recent agreement to expand the flexibility of the bailout fund for troubled sovereigns and provide financial aid to resolve troubled banks is significant. Until these new powers are up and running, the European Central Bank is once again buying sovereign bonds. The Europeans need to get ahead of worried financial markets by dramatically expanding the size of the bailout fund. This in effect would push Europe down the path to the adoption of a euro bond and fiscal integration, which is necessary to fully quell the debt crisis.

Most important, President Obama and Congress must come to terms in a reasonably graceful way in the next few months on the rest of the debt-ceiling deal. Another round of political vitriol will be too much for the collective psyche to bear. As part of this process, policymakers must also agree to scale back the significant fiscal restraint that is fast approaching and provide more support to the beleaguered housing market. Given the economy's current difficulties, it is hard to see how it will be able to manage through these headwinds. Tax reform is not immediately necessary, but it is key to achieving fiscal sustainability.

Another recession would be debilitating. Unemployment would quickly return to double digits and could conceivably remain there for years. Our daunting fiscal problems would become overwhelming as tax revenues fell and demands on government programs to help the economically hard-hit rose. This dark scenario can be avoided, but only if policymakers act definitively and deftly.

Recession threat

Recession risks are so uncomfortably high largely because confidence is so low. The economy continues to grapple with a number of fundamental problems, most notably the foreclosure crisis, a surfeit of homes and vacant commercial space, and yawning government deficits. But even more serious is that investors, consumers and businesses appear shell-shocked by recent events.

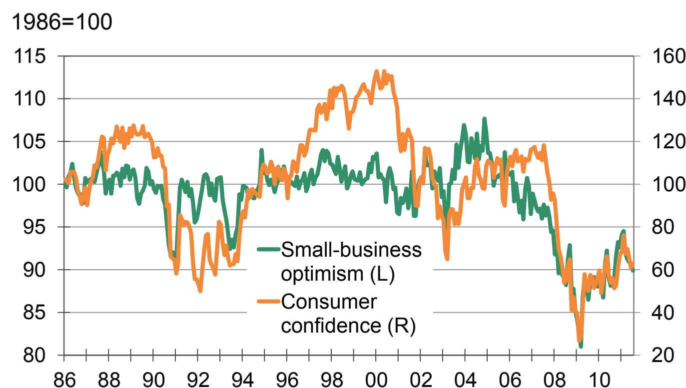
Confidence normally reflects economic conditions; it does not shape them. Consumer sentiment falls when unemployment, gasoline prices or inflation rise, but this has little impact on consumer spending. Yet at times, particularly during economic turning points, cause and effect can shift. Sentiment can be so harmed that businesses, consumers and investors freeze up, turning a gloomy outlook into a self-fulfilling prophecy. This is one of those times.

The collective psyche was already very fragile coming out of the Great Recession. The loss of 8.75 million jobs and double-digit unemployment have been extraordinarily difficult to bear. Businesses have also struggled with a flood of major policy initiatives from Washington, led by healthcare and financial regulatory reform. Other major policy debates, over issues such as immigration, energy and unionization, produced no legislation but still left businesses nervous.

The drama over raising the nation's debt ceiling, and especially S&P's downgrade of U.S. debt, eviscerated what confidence re-

Chart 1: A Very Fragile Collective Psyche

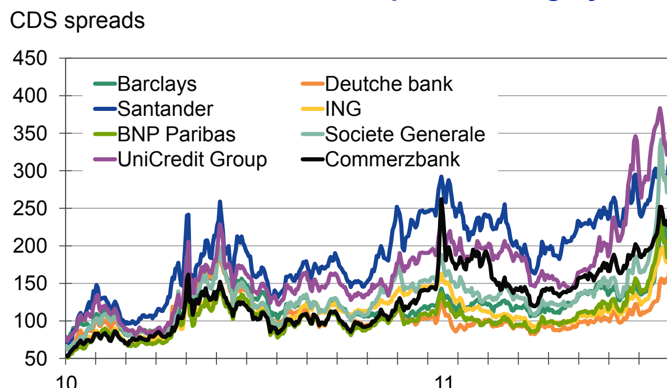
1986=100



Sources: National Federation of Independent Business, Conference Board

Chart 2: Stress Rises in Europe's Banking System

CDS spreads



Source: Bloomberg

mained. While losing the AAA rating has little actual significance—Treasury yields have fallen since the downgrade—it apparently unnerved investors, judging by the plunge in stock prices. Consumer and small-business confidence gauges are as low as they have been outside the Great Recession (see Chart 1).[1] The Moody's Analytics business survey has held up better, but it also has weakened significantly in recent weeks, with expectations regarding the outlook into next year and hiring intentions turning notably softer.

A loss of faith in the economy can quickly become self-fulfilling. A key conduit is the stock market. Since equity prices peaked in late April, well over $3 trillion in wealth has evaporated. Since every $1 decline in stock wealth is estimated to reduce consumer spending by 3 cents, the loss to date means spending will take a $100 billion hit over the coming year.[2] This in turn will reduce real GDP growth by about two-thirds of a percentage point.

Stock prices also serve as signals to businesses, letting firms know when it is time to expand as well as providing the means to do so. Rising stock prices embolden managers to take risks and seek growth opportunities, and a rising market allows firms to issue more equity to fund investment, hire, or acquire other businesses. Conversely, falling stock prices weigh heavily on those animal spirits so vital to a well-functioning economy.

A crisis of confidence can also impair the financial system. Banks and other financial institutions borrow heavily from one another to fund their activities. Much of this is overnight or short-term borrowing; thus, even a brief disruption in money flows can trigger a financial crisis. While such a scenario seems unlikely at the moment, serious stress lines are developing, particularly in Europe. The Euribor interbank lending rate—the rate European banks pay to borrow for brief periods—has almost doubled over the past several weeks. European banks also appear to be turning to the European Central Bank to maintain liquidity, and CDS spreads—a measure of the cost of insuring against defaults on bonds issued by banks—have risen sharply (see Chart 2). The same stresses are not as evident in the U.S., although the Libor-Treasury (TED) and CDS spreads have risen in recent days.

Whether the current crisis of confidence becomes self-fulfilling and ignites a double-dip recession critically depends on how effectively policymakers respond. Policymakers must act aggressively to stabilize sentiment and lift flagging expectations.

Europeans must go all-in

European policymakers will have to act most quickly given the mounting turmoil in the region's banking system. It is not that policymakers have stood still; they have taken numerous actions to address the region's debt crisis since it began more than a year ago. But they have made several missteps, and they desperately need to convince investors that they are fully committed to keeping the euro zone together (see Table 1).

The European Central Bank has been especially important to the policy response so far, providing emergency funding to the stressed banking system and buying the debt of sovereigns, including most recently Italian and Spanish debt. All told, the ECB has committed more than $600 billion—$150 billion in sovereign bond purchases and $450 billion in loans to banks in the periphery countries—to battle the crisis. These actions have helped forestall bank failures and push down governments' borrowing costs. Before the ECB acted, 10-year yields on Italian and Spanish debt had spiked above 6%, an important threshold. Beyond that level, a country's interest payments rise so quickly that debt loads become overwhelming. Italian and Spanish bond yields are closer to 5% (see Chart 3).

However, the ECB has erred. Tightening monetary policy by hiking interest rates twice earlier this year in response to what will prove to be a temporary, energy-price driven acceleration in inflation was a mistake. When combined with the Federal Reserve actions to ease monetary policy through QE2, the value of the euro has risen significantly against the U.S. dollar. Given the Chinese yuan's peg to the dollar, the euro has appreciated against the yuan as well. This is hard on European exporters, weakening an important source of the Continent's growth. While it will be difficult for the ECB to reverse its rate hikes any time

1 The Rasmussen daily survey of households is especially helpful in gauging consumer sentiment in real time. While it is off the low hit at the height of the debt-ceiling debate, it remains very weak.

2 This stock wealth effect may be larger in the current context. High net worth households appear to be particularly sensitive to asset changes and, most especially, stock values. Many of these households are in their 40s and 50s and, given their much diminished nest eggs, probably feel ill-prepared for retirement.

Table 1:

Time Line of the European Policy Response to the Debt Crisis

Event	Date
ECB extends the availability of short-term liquidity operations.	4-Mar-10
ECB President Jean-Claude Trichet says his bank will accept softer rules on collateral (accepting BBB instead of the standard A- bonds).	25-Mar-10
EMU leaders agree on bailout plan for Greece. Terms are announced for €30 billion of bilateral loans (about 5% for a three-year loan).	11-Apr-10
Greece reaches agreement with EU-IMF for loan of €110 billion (the number includes the €30 billion offered before).	2-May-10
ECB suspends minimum threshold for Greek debt until further notice, which means bonds will remain eligible for collateral even with junk status.	3-May-10
ECB starts buying government bonds.	6-May-10
The 27 member states of the European Union agreed to create the European Financial Stability Facility (EFSF). The EFSF's size is €440 billion, with an additional €60 billion loan coming from the European financial stabilization mechanism and €250 billion from the IMF. So total worth of rescue mechanism is €750.	9-May-10
The First EU bank stress test results published.	23-Jul-11
€85 billion loan agreed to by Ireland with the IMF and EU.	29-Nov-10
EU announces that a new permanent crisis mechanism, the European Stability Mechanism (ESM), will be set up in the euro area as of mid-2013, following the expiry of the EFSF.	1-Dec-10
ECB extends the availability of short-term liquidity measures.	3-Mar-11
EU agrees to expand lending capacity of the EFSF to the full €440 billion, reduce the EFSF and ESM lending margin, and agree on the potential for the EFSF and ESM to buy government debt in the primary markets. It also agrees that the ESM's effective lending capacity will be €500 billion. Greece is given more time to repay its official loans, and the interest rate charged is reduced by 1 percentage point from 5.2% to 4.2%	12-Mar-11
€78 billion loan agreed to by Portugal with EU-IMF.	16-May-11
ECB extends the availability of short term liquidity measures	9-Jun-11
The second EU bank stress test results published.	15-Jul-11
New bailout package for Greece that involves a selective default (official loans €109 billion and private sector will contribute about €37 billion). Ireland and Portugal are given lower interest rates and the length of their repayment maturities is extended. EFSF is made more flexible and will be given the power to buy bonds in the secondary market.	21-Jul-11
The ECB announced a new six-month liquidity program for banks and a revival of the bond-purchase program, which "was never dormant."	5-Aug-11

Source: Moody's Analytics

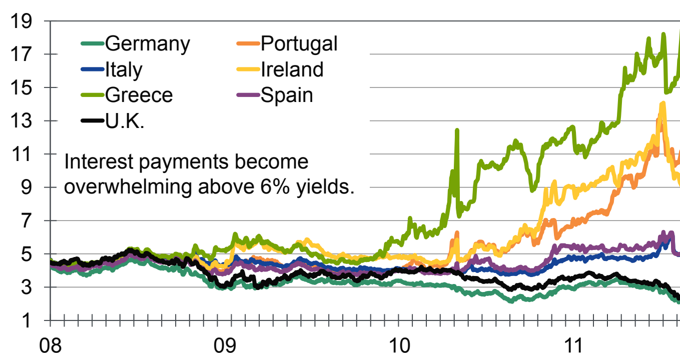
soon, it could provide a de facto easing in monetary policy by changing its policy of sterilizing its bond purchases and allowing its balance sheet to expand.

The $1 trillion European Financial Stability Facility has also been critical in addressing the debt crisis. The EFSF has been used so far to bail out Greece, Ireland and Portugal, and it will soon take on much more responsibility. Parliaments across Europe will vote in coming months to grant the EFSF the authority to charge lower interest rates on loans to distressed nations, provide funds to sovereigns to resolve their problem banks, and even take over the ECB's role of purchasing the debt of distressed sovereigns.

To be effective, the size of the EFSF must be significantly increased. Investors are rightly skeptical about whether the facility has the financial resources needed to help if Italy, Spain or even France gets into trouble. Expanding the EFSF will also allow it to purchase more sovereign debt and in effect create a euro bond—the EFSF will issue debt backed by all of the euro zone nations to help individual sovereigns finance themselves. There are legitimate concerns that committing such resources may result in France and possibly Germany losing their Aaa credit rating, but not doing so will almost surely mean continued financial turmoil and ultimately an unraveling of the euro zone.

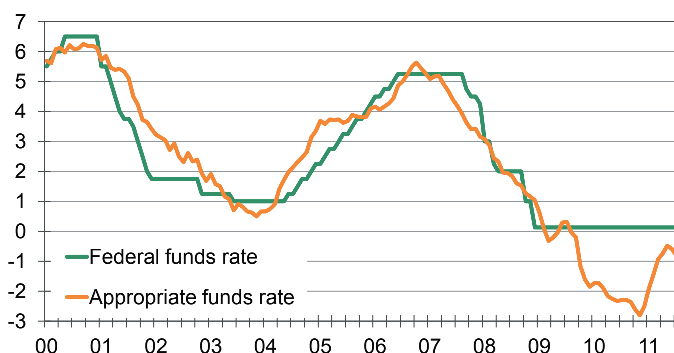
Chart 3: ECB Bond Purchases Help

10-yr sovereign yields



Sources: Bloomberg, Moody's Analytics

Chart 4: The Federal Reserve Must Ease More



Sources: Federal Reserve, Moody's Analytics

European policymakers must also require their banks to go through another round of stress testing. The first round of stress tests a year ago was obviously inadequate, as the Irish banks failed soon thereafter. The second round of stress tests completed a few weeks ago was better, as the tests provided a greater level of transparency, but they did not envisage a sovereign default and did not result in much additional capital coming into the banking system. The next round of tests must be very stringent, and with a newly empowered EFSF, banks that fail should have to raise capital, and if they are unable to, they should be taken over. Investors must be convinced that the European banking system has a fortress balance sheet.

More monetary easing

The Federal Reserve acted admirably in responding to the financial panic and Great Recession and has been instrumental in propping up the weak recovery. The Fed established a wide range of new liquidity facilities to support the financial system, lowered short-term interest rates effectively to 0%, and expanded its balance sheet dramatically to bring down long-term rates (see Table 2). It will need to ease monetary policy further. With no room to further lower short-term rates, policymakers must work to bring down long-term rates even more.

Policymakers opened the door for additional easing moves at the most recent FOMC meeting, and soon they will have to go through it. The appropriate federal funds rate—the funds rate consistent with unemployment, inflation, the health of credit markets, and other monetary easing steps taken by the Fed—has been consistently negative since early 2009 and has turned decidedly more negative in recent months with the erosion in unemployment and the turmoil in financial markets (see Chart 4).[3] The appropriate fund rate will become even more negative in coming months as unemployment edges higher and inflation moderates with the recent decline in oil and other commodity prices. While the Fed could conceivably simulate a negative federal funds rate by taxing bank reserves, this has serious downsides and is not practical. Instead, policymakers will work to reduce long-term interest rates.

The Fed's most recent step of all but promising to keep the federal funds rate near zero until mid-2013 has helped lower long-term rates; fixed mortgage rates have fallen to a 50-year low of 4%. This unprecedented step should allow debtors to refinance and further lighten their debt burden and encourage more risk-taking by creditors. At least as important, the Fed's action has buoyed confidence, at least for a while; it was a bolder step than investors had expected and helped to stanch the bleeding in the stock market.

Concern that this commitment could be a serious mistake if inflation were to accelerate substantially before its expiration is overdone. Even if the economy were to expand surprisingly strongly in the next couple of years, there is little chance that unemployment would fall sufficiently to generate significant wage and price pressures. If, for example, real GDP expanded by a 5% per annum pace during this period, unemployment would still be near 7% when the Fed's commitment ended. This is still well above the full-employment unemployment rate estimated to be no more than 6%.

The next most straightforward way to bring down long-term rates is for the Fed to extend the duration of the Treasury bonds it already owns. As its existing bond holdings matured, the Fed would use the proceeds to purchase longer-dated Treasury bonds. The size of the Fed's balance sheet would remain unchanged, but it would hold more longer-term bonds. Some $20 billion of the Fed's current $2 trillion in Treasury bonds and mortgage securities matures each month.

However, this will likely quickly prove insufficient, and the Fed will need to expand its balance sheet further through additional quantitative easing. To magnify the benefit of additional QE, the Fed may need to become more creative. For example, instead of announcing a specific total dollar amount of bond purchases over a specific period of time, as it did in the first two rounds of QE, policymakers would be more open-ended this go-around. The Fed could stipulate that it plans to purchase, say, $75 billion in bonds per month—similar to that under QE2 and equal to the new Treasury issuance each month and the amount maturing—until further notice.

Policymakers are likely to hold off on more QE until later in the year, after it is

3 This is derived from an estimated monetary policy reaction function. The federal funds rate is modeled as a function of the unemployment rate, core consumer price inflation, structured finance bond issuance as a measure of the health of the financial system, a high-yield corporate bond spread to Treasuries as a measure of developing asset bubbles, and the size of the Fed's balance sheet to account for large-scale asset purchases.

Table 2:

Monetary Policy Response to the Financial Panic

$ bil

	Originally Committed	Currently Provided
Total	Unlimited	2,203
Term auction credit	900	0
Other loans	Unlimited	13
Primary credit	Unlimited	0
Secondary credit	Unlimited	0
Seasonal credit	Unlimited	0
Primary Dealer Credit Facility (expired 2/1/2010)	Unlimited	0
Asset-Backed Commercial Paper Money Market Mutual Fund	Unlimited	0
AIG	26	0
AIG (for SPVs)	9	0
AIG (for ALICO, AIA)	26	0
Rescue of Bear Stearns (Maiden Lane)	27	24
AIG-RMBS purchase program (Maiden Lane II)	23	11
AIG-CDO purchase program (Maiden Lane III)	30	24
Term Securities Lending Facility (expired 2/1/2010)	200	0
Commercial Paper Funding Facility** (expired 2/1/2010)	1,800	0
TALF	1,000	12
Money Market Investor Funding Facility (expired 10/30/2009)	540	0
Currency swap lines (expired 2/1/2010)	Unlimited	0
Purchase of GSE debt and MBS (3/31/2010)	1,425	1,024
Guarantee of Citigroup assets (terminated 12/23/2009)	286	0
Guarantee of Bank of America assets (terminated)	108	0
Purchase of long-term Treasuries	300	1,095

Sources: Federal Reserve Board, Treasury Department, Moody's Analytics

clear that inflation is decelerating and inflation expectations have declined.[4] The surge in oil and other commodity prices earlier this year has bled through to underlying core inflation, and inflation expectations remain at the high end of the range that policymakers would view as acceptable. Inflation pressures should moderate quickly given the recent decline in oil prices and the flagging economy.

4 Consumer price inflation expectations as measured by five-year, five-year forwards are 2.4%. This is down from a peak of more than 2.8% as recently as late July but well above the 2% that prevailed prior to QE2 last summer.

Quantitative easing has been controversial, and while there are negatives, on net the policy has been a meaningful positive for the economy. Each $1 trillion increase in the Fed's balance sheet results in an estimated 50-basis point decline in the 10-year Treasury yield. Given that the Fed's balance sheet has grown by more than $2 trillion since the financial panic, 10-year yields are approximately 100 basis points lower today than they would be otherwise. That is, instead of their current 2.25%, yields would be closer to 3.25%. Bond yields are affected by numerous factors, but more QE will ensure that 10-year yields will remain well below 3% through this time next year.

The decline in interest rates has facilitated the deleveraging process through more refinancing, and it has buoyed stock valuations and prices. The dollar has also fallen in an orderly way, supporting continued improvement in the trade balance. The weaker dollar has also contributed to higher prices for oil and other commodities that are dollar-denominated and raised tensions among emerging economies worried that their own currencies were appreciating too quickly, but these are modest downsides. Concern that QE will make it difficult for the Fed to unwind all of this monetary stimulus before there is a severe problem with inflation is not misplaced, but it is overdone and not particularly relevant given the gravity of the current situation.

Fiscal policy two-step

The Obama administration and Congress arguably have the most difficult policy challenge. They must accomplish two seemingly contradictory things at the same time in the next several months: Follow through on the debt-ceiling deal and agree to additional long-term deficit reduction while also scaling back the near-term fiscal restraint that is already intensifying.

The debt-ceiling deal achieved in early August is a substantive step; it does not solve the nation's fiscal problems, but it goes more than halfway to the $4 trillion over 10 years in deficit reduction necessary to achieve fiscal sustainability—a stable debt-to-GDP ratio. The deal cuts as much as $2.4 trillion in government spending over the next decade, of which $900 billion has already been identified and the remaining $1.5 trillion is to be determined by a super-committee of legislators by the end of November (see Table 3). If the super-committee process fails, there will be $1.2 trillion in automatic spending cuts over the next 10 years beginning in 2013 and distributed evenly between defense and nondefense (mostly nonentitlement) outlays.

Policymakers have been able to circumvent budget rules in the past, beginning with Gramm-Rudman in the late 1980s, but this budget mechanism appears much more durable. Judging by the loud protests from

Table 3:

Deficit Reduction Under the Debt-Ceiling Deal

Fiscal yrs, $ bil

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012-2021
Discretionary spending	-25	-46	-58	-66	-73	-79	-87	-95	-103	-111	-741
Mandatory spending	3	5	2	-3	-4	-4	-4	-5	-5	-5	-20
Debt service costs	0	-1	-3	-6	-10	-15	-20	-26	-33	-40	-156
Total excluding committee/triggers	-21	-42	-59	-75	-87	-99	-112	-126	-141	-156	-917
Committee/triggers											-1,500
Total											**-2,417**

Sources: CBO, Moody's Analytics

those in Congress opposed to such cuts, they think so too.

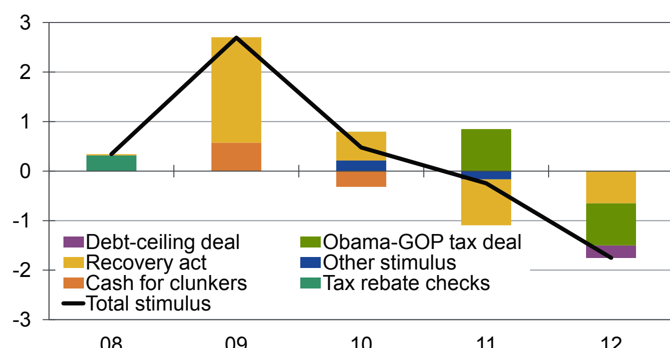
The spending cuts will not be enough to achieve fiscal sustainability; policymakers will also likely need to raise tax revenues. However, this is not likely until the lead-up to the expiration of the Bush tax cuts, which under current law happens at the start of 2013. Since there is little political appetite for letting tax rates rise for everyone, policymakers could instead agree to tax reform that reduces the more than $1 trillion in annual deductions and credit (loopholes) in the corporate and personal tax code.

These so-called tax expenditures—because from an economic perspective they act no differently than government spending—are costly, add significantly to the complexity of the tax code, and generally benefit higher-income households. Limiting these loopholes and broadening the tax base could potentially raise a substantial amount of tax revenue and thus achieve fiscal sustainability, make the Bush tax cuts permanent, and even lower marginal rates for corporations to improve the nation's global competitiveness.

Of course, tax reform will be politically difficult to pull off given that each loophole has a strident advocate willing to go to the mat for it. A plausible fallback would be to simply allow marginal personal tax rates to rise for those in the top income bracket making more than $250,000 annually. This would generate just enough revenue to get close to fiscal sustainability. Many Republican legislators who have signed on to a no-tax pledge will not be happy with this, but they may have no choice, given the alternative of higher tax rates for everyone.

Near-term fiscal support

Complicating matters further for fiscal policymakers is that while negotiating serious long-term deficit reduction, it is also important that they agree to reduce the fiscal restraint already in train. Under current policy—if no changes are made—federal fiscal policy will go from being a small drag on growth this year to subtracting 1.7 percentage points from real GDP growth. For context, at the peak of the fiscal stimulus in 2009, federal fiscal policy added 2.6 percentage points to real GDP growth (see Chart 5). With such fiscal restraint, for the economy to simply grow at its potential in 2012—estimated to be 2.7%—private sector GDP would need to grow by well over 4%. Given the currently very weak recovery, this seems unlikely.



The most straightforward way to reduce some of the coming fiscal restraint is to extend for another year both the current 2% employee payroll tax holiday and the emergency unemployment insurance program. Under current law they expire at the end of this year. If they are not extended, real GDP growth will be nearly a percentage point slower in 2012 and there will be approximately one million fewer jobs by year's end (see Table 4). There are some downsides to doing this; some of the payroll tax break will be saved, particularly by higher-income households, and emergency UI creates disincentives to work and adds somewhat to unemployment.[5] But on net they would provide important support to the soft economy.

President Obama will unveil a jobs package in September that will likely include these policy steps and a number of additional efforts to jump-start job creation. A likely proposal is some form of job tax credit that would entail a payroll tax holiday for employers who hire additional workers. A

5 A number of studies of the disincentive effects of the emergency UI program suggest that it has added approximately 1 percentage point to current unemployment. Here and here.

Table 4:

Fiscal Restraint in 2012 Under Current Policy

	Cost		GDP Impact	
	$ bil	% of GDP	$ bil	% of GDP
Change in Deficit, 2011 vs. 2012	-340	-2.3	-261	-1.7
Cyclical Deficit	-65	-0.4	0	0.0
Structural Deficit	-275	-1.8	-261	-1.7
2% payroll tax holiday	-110	-0.7	-68	-0.5
Emergency UI	-50	-0.3	-58	-0.4
Accelerated depreciation	-22	-0.1	-5	0.0
State & local government aid	-50	-0.3	-56	-0.4
Infrastructure spending and other	-43	-0.3	-46	-0.3
Debt-ceiling deal	-31	-0.2	-28	-0.2

Source: Moody's Analytics

small job tax credit was offered to businesses in 2010, permitting employers to forgo paying any payroll tax during the year for anyone they hired who had been previously unemployed for more than two months. There is also a $1,000 bonus for each of those workers still employed one year after their hire.

It is still not known what impact the program has had on job growth, as businesses are still filing their tax returns, but at the time of its implementation it was thought it would add as many as a quarter-million jobs by the end of 2010.[6] This seems rather insignificant given the scale of the current problems, and any job tax credit proposed by the president will need to be substantially larger in scale and scope to make a difference. A reasonable criticism of such a tax credit is that it applies to all new hires, even those that would have taken place anyway. It thus does not pack a very large bang for the buck—it does not generate much GDP and jobs given the costs. Indeed, a plain-vanilla job tax credit has a meaningfully lower multiplier than an employee payroll tax cut like the one in place (see Table 5). Thus, unless the job tax credit is well designed and targeted, it is arguably better to give the money directly to households that will spend more of what they get.

The president may also propose some changes to the unemployment insurance system. One idea to facilitate getting the unemployed back to work is to scale up a program called Georgia Works, a Georgia program in which unemployed workers receiving UI work voluntarily at companies for up to eight weeks at no charge to the businesses. The unemployed receive a small stipend for transportation and other expenses, some training, a tryout by the employer, and the hope of ultimately landing a job. Employers could potentially abuse the program by recycling unemployed workers, but the program seems to have had some success since it began in 2003.[7]

It would also be a good idea to help states with their depleted unemployment insurance funds. Most states have been forced to borrow money from the federal government to pay for their share of the costs of UI. They have to start repaying some of these loans or face stiff financial penalties. To avoid this, states will likely hike their levies on businesses, particularly those hard-pressed companies that were forced to lay off more workers during the downturn. This would be counterproductive, and thus the federal government could give states another year before their UI bills come due.

While less likely to come to fruition, state and local governments could also use some additional financial aid to help forestall some of their current severe cuts to budgets and payrolls. More than 600,000 jobs have been slashed from state and local government payrolls since they peaked three years ago. While state governments are getting a grip on their near-term budget problems, local governments are still struggling as property-tax revenues continue to flag. Federal government help with schools' capital projects, for example, would free up funds to reduce some of the layoffs at K-12 schools, community colleges and state universities.

Additional infrastructure spending will also likely be part of the president's plan. Infrastructure development has a large bang for the buck, particularly now when there are so many unemployed construction workers. It also has the potential for helping more remote hard-pressed regional economies and has long-lasting economic benefits. It is difficult to get such projects up and running quickly—"shovel ready" is in most cases a misnomer—but given that unemployment is sure to be a problem for years to come, this does not seem in the current context as significant a drawback.

More serious concerns are that infrastructure projects are expensive and often determined by political considerations and not objective economic analysis. A creative way to address these concerns is the formation of a so-called infrastructure bank. The I-bank would be a government entity with an endowment from the federal government to extend loans and limited loan guarantees to jump-start private projects that are financially self-sustaining. This might include roads that collect tolls, energy facilities that collect user fees, or airports that impose fees on travelers and goods. Private investors and developers would determine which projects to pursue based on what works financially and not what works politically.[8] The I-bank will take time to get off the ground, however, and thus may not make into the president's plans.

6 See "Jump-Starting the Job Market: How Well Will a Job Tax Credit Work," Mark Zandi. Moody's Analytics Special Report, February 8, 2010.

7 Since the program's launch, not quite one-fifth of those who have participated have been hired by their employers. Funding issues have forced Georgia to scale back the program over the past year.

8 A recent proposal from Senators John Kerry and Kay Bailey Hutchinson would form the American Infrastructure Financing Authority with $10 billion in seed money.

Table 5:

Fiscal Policy Multipliers

As of 2011Q2

Tax Cuts	Bang for the Buck
Refundable Lump-Sum Tax Rebate	1.22
Nonrefundable Lump-Sum Tax Rebate	1.01
Temporary Tax Cuts	
Child Tax Credit, ARRA parameters	1.38
Payroll Tax Holiday for Employees	1.27
Earned Income Tax Credit, ARRA parameters	1.24
Job Tax Credit	1.20
Making Work Pay	1.19
Payroll Tax Holiday for Employers	1.05
Across-the-Board Tax Cut	0.98
Housing Tax Credit	0.82
Accelerated Depreciation	0.29
Loss Carryback	0.25
Permanent Tax Cuts	
Extend Alternative Minimum Tax Patch	0.53
Make Dividend and Capital Gains Tax Cuts Permanent	0.39
Make Bush Income Tax Cuts Permanent	0.35
Cut in Corporate Tax Rate	0.32
Spending Increases	
Temporary Increase in Food Stamps	1.71
Temporary Federal Financing of Work-Share Programs	1.64
Extending Unemployment Insurance Benefits	1.55
Increased Infrastructure Spending	1.44
General Aid to State Governments	1.34
Low Income Home Energy Assistance Program (LIHEAP)	1.13

Note: The bang for the buck is estimated by the one-year dollar change in GDP for a given dollar reduction in federal tax revenue or increase in spending.

Source: Moody's Analytics

There are many potential impediments to getting any of these proposals through the political process, including their cost. Under reasonable assumptions, the cost of the total package of proposals would be somewhere close to $250 billion, equal to 1.7% of GDP, and precisely the magnitude of the fiscal drag expected next year. Given the current focus on fiscal austerity, this seems like a stretch, and any proposals that are adopted will have to be paid for through greater deficit reduction in the future. Thus, the bigger the fiscal package to support the economy in the near term, the more difficult the job of the super-committee.

Housing policy

Policymakers should also consider taking additional steps to support the housing and mortgage markets. With some 3.5 million first-mortgage loans in the foreclosure process or pretty close and more house price declines likely, it is hard to be enthusiastic about the recovery's prospects. A house is usually a household's most important asset; many small-business owners use their homes as collateral for business credit, and local governments rely on property tax revenues tied to housing values.

Most worrisome is the risk that housing will resume the vicious cycle seen at the depths of the last recession, when falling prices pushed more homeowners underwater—their loans exceeded their homes' market values—causing more defaults, more distress sales, and even lower prices.[9] That cycle was broken only by unprecedented monetary and fiscal policy support.

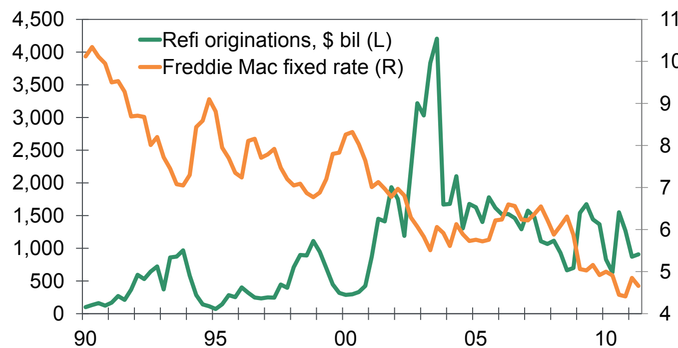
The most efficacious policy step that could make a meaningful difference quickly is to facilitate more mortgage refinancing.[10] This looks especially attractive now given that 30-year fixed mortgage rates are closing in on 4%. For millions of homeowners, mortgage refinancing could significantly lower monthly payments, reducing the odds they will default and boosting their financial fortunes.

The Obama administration has tried to facilitate more refinancing, but its efforts have fallen flat (see Chart 6). The Home Affordable Refinancing Program was introduced in early 2009 to help refinance loans insured or owned by Fannie Mae and Freddie Mac; at the time, the administration said the program would allow four million to five million homeowners to lower their interest rates to market levels. Yet to date, approxi-

9 There are an estimated 14.8 million underwater homeowners (28% of homeowners with first mortgages) as of 2011Q1. Nearly half of these are under water by more than 30% and are thus at significant risk of default if anything at all goes wrong in their financial life.

10 For a more detailed discussion of the housing market and several policy steps to address the housing crash, see "To Shore Up the Recovery, Help Housing," Mark Zandi, Moody's Analytics Special Report, May 25, 2011. In addition to a mass refi proposal, other proposed steps include extending the current higher conforming loan limits and supporting more mortgage loan modifications—with principal reductions—more aggressively. Although these steps are not particularly satisfying or likely to be popular, the outcome will be worse if policymakers stand by while a weakening housing market undermines the economic expansion.

Chart 6: Rates Plunge, Refis Putter



Sources: Federal Reserve, Freddie Mac, Moody's Analytics

mately 800,000 homeowners have been assisted by HARP.[11]

This is especially disappointing, since HARP provides significant incentives for borrowers to refinance up to 125% of a property's value, specifically to help underwater borrowers. To qualify, a homeowner's recent payments must have been on time, meaning no more than 30 days late within the past year, and borrowers must be able to show sufficient income to meet the new payment schedule.

But none of this has helped raise the level of participation, in part because Fannie and Freddie have imposed additional interest rate charges—called loan level price adjustments—for refinancers with higher loan-to-value ratios or lower credit scores. This is an especially large problem in parts of the country where the housing market crash and economic downturn have been most severe—which are the same areas where HARP was supposed to help.

Fannie and Freddie are not breaking precedent in charging higher interest rates to borrowers with less equity and weaker credit. The two mortgage companies have always done so, because such borrowers are more prone to default. But this standard practice is weakening HARP. It also is not clear the traditional rules should apply in this situation, since Fannie and Freddie already insure these loans and are on the hook if they default. HARP refinancing would lower borrowers' monthly mortgage payments, increase the chance they will stay current, and thus reduce the payouts on the insurance Fannie and Freddie provide.

Jump-starting HARP could be straightforward. Fannie and Freddie could simply suspend add-on rates, even for refinancing borrowers who have lost a lot of equity or have relatively low credit scores.[12] Fannie and Freddie already bear the credit risk on these loans; anything that makes it easier for borrowers to pay their mortgages on time and avoid default will reduce the agencies' ultimate cost.

Economic logic strongly favors action to promote refinancing. With current mortgage rates near 4% and the median rate on outstanding mortgages near 5.5%, the potential rate reduction could average almost 150 basis points. If all agency and government borrowers with rates above the median refinance at 4%, the gross saving to borrowers would be around $45 billion a year (15 million Fannie and Freddie borrowers x $200,000 average mortgage balance x 1.5%). Clearly, not all this saving would be realized, but even a fraction would be a big plus.

There are costs involved with facilitating more HARP refinancings. Fannie and Freddie would receive less in interest, as would other private investors in mortgage securities backed by Fannie and Freddie loans. But Fannie and Freddie (and thus taxpayers) would be made substantially whole because of the reduced default rate. Most global investors, meanwhile, are surprised they have not already been refinanced out of more loans.

Conclusions

Recession risks are as high as they have been since the Great Recession ended more than two years ago. A string of unfortunate shocks and a crisis of confidence are to blame. Surging gasoline and food prices and fallout from the Japanese earthquake hurt badly in the spring; more recently the debt-ceiling drama, a revived European debt crisis, and the S&P downgrade have been especially disconcerting. Confidence, already fragile after the nightmare of the Great Recession and Washington's heated policy debates, was severely undermined.

Whether the loss of faith in our economy results in another recession critically depends on how effectively policymakers respond. Whether policymakers will succeed in shoring up confidence is a difficult call. The odds of a renewed recession over the next 12 months are 40%, and even these odds feel shaky given the turmoil in financial markets. The old adage that the stock market has predicted nine of the last five recessions is apt, but the recent free fall is disconcerting. Markets and the economy seem one shock away from dangerously unraveling. Policymakers must work quickly and decisively.

11 The HARP program is set to expire in June 2012.

12 A thorough description of this policy proposal is described in "Restringing HARP: The Case for More Refinancing Now," Mark Zandi and Cris DeRitis, Moody's Analytics Special Report, October 7, 2010.

About the Author

Mark Zandi

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 roadmap 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 Ph.D. 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.

About Moody's Analytics
Economic & Consumer Credit Analytics

Moody's Analytics helps capital markets and credit risk management professionals worldwide respond to an evolving marketplace with confidence. Through its team of economists, Moody's Analytics is a leading independent provider of data, analysis, modeling and forecasts on national and regional economies, financial markets, and credit risk.

Moody's Analytics tracks and analyzes trends in consumer credit and spending, output and income, mortgage activity, population, central bank behavior, and prices. Our customized models, concise and timely reports, and one of the largest assembled financial, economic and demographic databases support firms and policymakers in strategic planning, product and sales forecasting, credit risk and sensitivity management, and investment research. Our customers include multinational corporations, governments at all levels, central banks and financial regulators, retailers, mutual funds, financial institutions, utilities, residential and commercial real estate firms, insurance companies, and professional investors.

Our web and print periodicals and special publications cover every U.S. state and metropolitan area; countries throughout Europe, Asia and the Americas; and the world's major cities, plus the U.S. housing market and other industries. From our offices in the U.S., the United Kingdom, and Australia, we provide up-to-the-minute reporting and analysis on the world's major economies.

Moody's Analytics added Economy.com to its portfolio in 2005. Its economics and consumer credit analytics arm is based in West Chester PA, a suburb of Philadelphia, with offices in London and Sydney. More information is available at www.economy.com.

© 2011, Moody's Analytics, Inc. and/or its licensors and affiliates (together, "Moody's"). All rights reserved. ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY COPYRIGHT LAW AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSFERRED, DISSEMINATED, REDISTRIBUTED OR RESOLD, OR STORED FOR SUBSEQUENT USE FOR ANY PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON WITHOUT MOODY'S PRIOR WRITTEN CONSENT. All information contained herein is obtained by Moody's from sources believed by it to be accurate and reliable. Because of the possibility of human and mechanical error as well as other factors, however, all information contained herein is provided "AS IS" without warranty of any kind. Under no circumstances shall Moody's have any liability to any person or entity for (a) any loss or damage in whole or in part caused by, resulting from, or relating to, any error (negligent or otherwise) or other circumstance or contingency within or outside the control of Moody's or any of its directors, officers, employees or agents in connection with the procurement, collection, compilation, analysis, interpretation, communication, publication or delivery of any such information, or (b) any direct, indirect, special, consequential, compensatory or incidental damages whatsoever (including without limitation, lost profits), even if Moody's is advised in advance of the possibility of such damages, resulting from the use of or inability to use, any such information. The financial reporting, analysis, projections, observations, and other information contained herein are, and must be construed solely as, statements of opinion and not statements of fact or recommendations to purchase, sell, or hold any securities. NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH OPINION OR INFORMATION IS GIVEN OR MADE BY MOODY'S IN ANY FORM OR MANNER WHATSOEVER. Each opinion must be weighed solely as one factor in any investment decision made by or on behalf of any user of the information contained herein, and each such user must accordingly make its own study and evaluation prior to investing.

CONTACT US
For further information contact us at a location below:

U.S./CANADA
+1.866.275.3266

EMEA
+44.20.7772.5454

ASIA/PACIFIC
+852.3551.3077

OTHER LOCATIONS
+1.610.235.5299

Email us: help@economy.com
Or visit us: www.economy.com

Copyright © 2011, Moody's Analytics, Inc. All Rights Reserved.

Moody's
ANALYTICS