

AFIRE 2011 Winter Conference: Mark Zandi's Economic Address

Mark Zandi, chief economist of Moody's Analytics, spoke to AFIRE members at the Winter Conference February 9–10, in New York City. He emphasized two thoughts in describing the situation of and outlook for the US economy: he is optimistic and there are a number of very significant economic challenges. On balance, Mr. Zandi said, his optimism wins out, but it relies on resolution of some of the concerns. (He pointed out that he had set himself a tough task in describing this balance, noting that for an economist, “the dark side rolls off the tongue more easily” than the bright outlook.)

After three very lean economic years (a year and a half of “the great recession” and a similar period of very weak recovery), “we’re on the cusp of much better growth in 2011 and 2012,” Mr. Zandi began. Having declined 2.5 percent in 2009, gross domestic product (GDP) grew almost 3 percent in 2010, and Mr. Zandi forecast growth of almost 4 percent in the next two years. The pace ought to be enough to reduce unemployment, he elaborated, since

with growth of about 2.5 to 3 percent the economy can be expected to generate enough jobs to hold unemployment steady. New private-sector jobs totaled 1.25 million in 2010 and Mr. Zandi said he expects double that many in 2011 and 2012. By the end of 2011, he expects unemployment (currently at 9.5 percent) to be at a “firm” 9 percent, and by the end of 2012 he sees it below 8 percent. He noted that these levels are still far above full employment in our economy (full employment being 5.5 to 6 percent). We might be able to dig out of the hole by 2014, he suggested. Mr. Zandi offered a number of specifics as reasons for his overall optimism.

THE REASONS FOR OPTIMISM

US Businesses Are in Very Good Shape

US businesses are very profitable at the moment, Mr. Zandi began. Admittedly, this is less true for small businesses, he clarified, but in the aggregate, corporate earnings have grown tremendously and profit margins are near their all-time high. Corporate balance sheets are extraordinarily strong, he continued: the interest coverage ratio is not at a record low, but soon will be, he predicted, and corporations’ cash on balance sheets “has gone stratospheric.” (He pointed to the ratio of corporate liquid assets to short-term liabilities, which is higher than ever by orders of magnitude.) Given this strength, he said, “the question is not business’ ability to hire, but its willingness to do so.”

He pointed to some encumbrances in the sector, such as a lack of confidence among businesses and the fact that smaller businesses still face difficulties with access to credit. The wariness arises from a couple of factors, he said. The severity of the recession produced “near-death experiences” for many in business, which they will not forget easily or soon. Further, businesses





as a whole faced tremendous uncertainty as a number of “epic” proposals made their way to the table in the past two years and were seriously considered. The magnitude and potential impacts of proposals involving health care, financial regulatory reform and tax policy specifically caused concern. And the uncertainty was warranted, Mr. Zandi pointed out, noting that until the very end of 2010, even the tax situation for the immediate future was “a complete unknown.” Similarly, even policies that were not enacted but were debated seriously engendered uncertainty, he said. Proposals like cap and trade and “card check” took away businesses’ ability to foresee the circumstances around prospective investments. And their caution was real, Mr. Zandi emphasized, pointing out that through his own experience transitioning from entrepreneur to part of a large organization he has learned that big companies “are serious about strategic planning.” Planners “need to fill every cell in the spreadsheet” before they are willing to make a move, he said, and policy debates underway last year made it impossible to quantify variables tracked in those planning tools. As such, he said, the debates were very important in curtailing hiring plans.

With the flurry of legislative activity at the end of the last congress, there is now less uncertainty, and he predicted that business will begin deploying fin resources much more aggressively. “It’s almost like someone flipped a light switch 10 or 12 weeks ago,” he said.

We Are Righting the Wrongs That Led to the Financial Panic and the Great Recession

The bad lending that brought on the financial crisis is being addressed and the system is working off the bad loans, Mr. Zandi said. The household sector is deleveraging incredibly rapidly, with total household liabilities down almost \$1 trillion since late 2008 (from \$14 to \$13 trillion). The trend continues in all areas of household borrowing, he said, including credit card, consumer installment, home equity and first mortgage debt. A signal of this deleveraging is a decline in the number of bank credit cards outstanding from its peak

of 425 million in 2008 to 315 million in December 2010. Additionally, low interest rates have brought the household sector’s debt-servicing burden close to a record low. The effects of these trends are showing up in quality measures for all credit categories, he said.

Additionally, Mr. Zandi reported, early-stage delinquency among first mortgage borrowers is low. He told of a recent chat with the head of a major collections department. The executive reported that “business was terrible” because the organization was having to lay off workers (who, incidentally, were moving to the company’s marketing division). Mr. Zandi said he had to smile at this roundabout report of improving credit quality.

The Credit Crunch Is Over and the US Financial System Is Mending Itself

Mr. Zandi stated clearly that the credit crisis is over. “This doesn’t mean that the credit spigot is wide open,” he stressed, but it is now opening. There is still trouble among smaller institutions and small banks still have a tough time raising capital, but that distress seems to be confined to the small banks, he said. Mr. Zandi expects continued small bank failures, but with minimal disruption because the FDIC has become adept at handling them smoothly (he even described its process as “a cookie-cutter”-like).

He described the bank stress tests in the US as “oppressive” but successful, pointing out that in his opinion, they have resulted in overcapitalization of big banks in the aggregate. A major change is that these institutions are beginning to change their focus from management of risk to looking for loan growth (which they can now do because of both their capital levels and improved credit quality), and they are very profitable. Loan origination is beginning to increase, particularly in auto, home equity and commercial and industrial loans.

The credit spigot will continue to open up through 2011 and 2012, Mr. Zandi predicted, pointing out poetically that “credit is the mother’s milk of economic activity” and that the economy can’t function well without it.

Overall Economic Activity Is Low Compared to Demographic Measures

The level of economic activity is “incredibly low” relative to the number of people producing it, Mr. Zandi said. He pointed in particular to numbers in the key vehicle and housing sectors, extending the point to other sectors as well. The current annualized pace of auto sales is about 12.5 million, compared to an expected pace more like 15.5 to 16 million for a normal period of functional economic growth (i.e., one with job growth and reasonably flowing credit) and given our population. Sales will pick up toward that level, he said, and additionally when they do, there will also be pent-up demand to further boost activity. These comparisons are important, he said, because the vehicle sector provides “a lot of economic juice” (meaning that its multiplier effect is significant).

He made a similar comparison in the housing sector. Single-family home production is currently at a pace of 600,000, whereas more like 1.85 million units per year would be produced in a normally functioning economy among our populace. Mr. Zandi acknowledged that currently we labor under the shadow of a significant oversupply of housing, and that it may take as much as a year and a half to work it off. He specified that the oversupply is generally limited to and concentrated in certain markets, and he mentioned Florida, Atlanta, Arizona, Nevada and the Central Valley of California. At some point, however, the expected level of activity will occur,

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he predicted. When the market is unleashed from these complications, he said, it will produce a lot of construction jobs and all the related economic activity (demand from suppliers, etc.). He looked for such activity to arise by early next year, first in multifamily and then in single-family housing markets.

The Policy Response to the Recent Financial Crisis Was Marvelous

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is somewhat controversial, Mr. Zandi was clear in his assessment that, even though certain constituencies may quibble with specific aspects of the policies adopted, the totality of the government’s response to the crisis was correct. The nature of the problems these measures addressed was so severe, he said, that massive response was

required. “It was a Hobson’s choice and we had to do something big” — measures like bailing out the banks and intervening in General Motors were not out of proportion to the situation, he said.

The “clincher,” firming his perspective, Mr. Zandi said, was the adoption of a variety of tax measures at the end of 2010, particularly the payroll tax holiday and the extension of unemployment benefits. He described another element of the tax package — the ability to expense of business investment in 2011 — as “completely underappreciated,” stressing its potential impact on business activity.



THE REASONS FOR CONCERN

The Foreclosure Crisis Persists

While reiterating his enthusiasm over the improvement in early-stage foreclosure, Mr. Zandi emphasized the extent of the foreclosure problem overall: 2 million homes are currently in foreclosure and another 2 million are approaching it. Even presuming that some of these are the eventually resolved through modification, this suggests a lot of foreclosures in the next 6–12 months, and it probably means further price declines as we work through a last “bulge,” he said.

Further deterring improvement, there are no outside stimuli that can do much to push housing prices up (“because we’re out of policy responses” — we’ve already done everything). This problem has further significance because small business owners often rely primarily on their homes for their financing. For small business, therefore, housing sector problems can keep the credit spigot from opening.

Mr. Zandi estimated that 14 million homeowners are “under water” (owing more in mortgage debt than their homes are worth), “which is the fodder for default.” He characterized this number as high enough to risk recurrence of a vicious cycle of price declines, negative equity and foreclosure that would prolong the problem. This under water overhang, Mr. Zandi said, keeps him from having full confidence in his optimistic baseline until the foreclosures are worked off.

The Situation in Europe Is Not Settled

Europe’s debt crisis has receded from the front pages, Mr. Zandi said, but it has not yet passed. Interest rates have come down and spreads narrowed, but he doesn’t think the crisis will be resolved until European policy makers (primarily the Germans) step up to make the bailout fund bigger and more flexible so that it can absorb some of the sovereign debt. He also said that the markets appear to expect these changes. Describing the European Central Bank as reluctant to take on troubled sovereign debt,

he opined that the responsibility should go to the bailout fund.

Most important, he emphasized, European banks need to go through substantive stress tests, as have US banks. He described the European round of stress tests as having been a sham (evidenced by the fact that the Irish banking system failed just two months after having been tested). Better testing does seem to be under development now, he said, noting that truly robust stress tests must be more transparent and must properly account for sovereign debt and its losses. Further, he said, such examination must lead to increases in capital. German leadership understands this, he said, but is reluctant for political reasons. Mr. Zandi said he expects the more rigorous process to be undertaken, however, and that it will occur without being a problem for the financial system in the US. Until then, however, the European debt situation remains high on his list of reasons to be worried.

The Emerging World, Particularly China, Has to “Get This Right”

The emerging economies are trying hard to land softly (variously raising interest rates and increasing bank reserves, tightening underwriting standards and even, as in Brazil, taxing short-term capital inflows). But many such countries, especially China, are trying to proceed without allowing much, if any, currency fluctuation, Mr. Zandi said. The stakes are high for global growth and, even loosening their grips on the currencies, he pointed out, these governments may not be able to engineer economic “landings” that are not disruptive. “It simply may not be possible to get it just right.”

Events in Egypt Show the Potential for Further Uncertainty

While not expressing specific concern about economic effects from the potential change of regime in Egypt (he spoke just days before the departure of President Mubarak on February 12), Mr. Zandi said that the

unrest signaled the potential for follow-on events to pose complications for the world economy. The concern is not Egypt in and of itself, he said, but the potential for a wave of revolution in energy-producing countries in the Middle East to cause spiking oil prices. Mr. Zandi expressed confidence that the developed world can digest oil at or around \$100 per barrel (referring to West Texas intermediate, a measure that is currently around \$90). But a year of oil at \$150 per barrel would amount to a tax increase of \$150 billion in the US, he said, referring to the eventuality as “a recipe for renewed recession.” Mr. Zandi said he anticipates a resolution of the uprising in Egypt that doesn’t lead to those large increases, but noted that we cannot count on it.

Finally, the US Faces Serious Fiscal Challenges

Notwithstanding his favorable view of the policy response to the financial crisis, Mr. Zandi described his grave concern about a US deficit at the level of 9 percent of GDP. The deficit can be expected to shrink as economic activity increases, he opined, maybe even to as little as 5 percent within a couple of years, but he also emphasized that even a deficit of 5 percent of GDP is not sustainable. At that level, he said, interest payments will swamp the budget, global investors will lose faith, interest rates will rise and various challenges will ensue. Very significant policy changes are necessary, specifying that they must amount to about 2.5 percent of GDP. And for the longer term, he said, we’d need to get the deficit down to about 2.5 percent of GDP (about \$375 billion annually), at which level the interest payments will be manageable. Major changes are necessary, he summed up, involving significant spending restraint and tax increases.

These fiscal changes are necessary to achieve his optimistic forecast for US and global growth, Mr. Zandi said. He is optimistic, however, that “we will come together and find a way to achieve” spending restraint and tax increases totaling 2.5 percent of GDP. He noted that such progress would likely occur “with the next president.” (An audience member later asked if

that comment was a prediction that President Obama would serve only one term, which Mr. Zandi denied.)

Before taking questions from the audience, Mr. Zandi concluded his presentation by stressing that the overall balance of the positives and negatives he had presented about the economy left him definitively optimistic.

Audience Q&A

Asked about the role and economic condition of state and local governments, Mr. Zandi pointed out that the issue had not made his list of concerns mostly because he sees the problems as very well defined and beginning to abate. In most of the affected states, revenue is particularly sensitive to economic activity, he described, such that a little bit of income growth produces a large increase in tax revenue. In most of these jurisdictions, he said, tax revenue is now rising rapidly. Additionally, the worst of the governors’ big cuts is taking effect right now — meaning that improvement will soon follow. He sees the state economies as doing better next year and is not too concerned about it, he said.

A municipal bond default would be a big problem, he said, but described “close to zero probability” of such an event. Defaults might occur on small, specific issues (“like the Harrisburg incinerator”), but the overall amounts will not be significant and these would likely arise from fraud and mismanagement. “These didn’t even make my list,” he concluded.

After stating that his comment about the next president did not amount to a prediction of President Obama’s fate, Mr. Zandi offered the alternative scenario that for the campaign season Obama may even “have the economy at his back if I’m right. Even odds.” He predicted unemployment in November 2012 would be “just about 8 percent.”

A request for his forecast of interest rates prompted the view that “they’ll be going up.” Yield on the 10-year Treasury bill, now 3.7 percent, would be 4.5 percent in a well-functioning economy, he said (meaning an economy at full employment, at a growth rate consistent with its potential and without fiscal issues).



In November of 2012, inflation will be rising rather than falling, he predicted, as the Fed will be working to drain some of the liquidity it has created in response to the credit crisis. Inflation at that point might be described as “slightly uncomfortable, but manageable,” he said.

Mr. Zandi said he sees no chance that Congress and the administration will find the political will to address our fiscal problems “without a push,” and that the push will come from global investors through the bond market. The threat of rising interest rates, falling equities and falling home prices, he said, will probably prod the politicians

to put it plainly to the public that the fiscal restraint must be undertaken or the alternatives will be worse. That means that by late 2012 or early 2013, interest rates will be measurably higher – “the 10-year yield in 2012 will be above 4.5 percent.”

A questioner asked about the fact that US housing was included in both Mr. Zandi’s lists of reasons for optimism and concerns, and about the likely fates of Fannie Mae and Freddie Mac. Mr. Zandi predicted no major changes for the agencies in the next two years, mostly because the administration and Congress won’t want to disrupt still-fragile housing values. The government (meaning Fannie Mae, Freddie Mac and the FHA) is currently making 95 percent of loans and that may fall to 85 to 90 percent by two years from now, he said. Also within that period, the size limits for conforming loans will revert to their prior, lower levels, bringing the government share down. But the government agencies will still be making most of the mortgage loans.

In the long run, nobody is comfortable with Freddie Mac and Fannie Mae’s roles, he said, predicting

an effort to privatize the system. Mr. Zandi himself advocated preserving a government presence like the FHA — a view he said he did not hold before the crisis but adopted in light of events. The government needs to have a way to provide immediate access to the capital markets, he said, and the FHA was the most efficient way to do it. As the mortgage lending system becomes mostly privatized, Mr. Zandi said, he sees a need for mortgages to be backed by some form of government catastrophic insurance, stressing that such a product must be explicitly priced. A totally private market

without a government backstop, he predicted, would push mortgage rates measurably higher and would cause credit availability to vary cyclically, which would be especially problematic in bad times. In such an environment, the 30-year fixed-rate mortgage will cease to be offered, he estimated, noting

the near-certain unpopularity of such an eventuality. Americans “really hate” the prospect of being unable to get fixed-rate loans, he said, as they hate high gas prices, gas tax proposals and the idea of limitations on their mortgage interest deductions.

He closed with an emphatic note about privatization of the system. “There is no doubt in my mind that at the end of the day, the government has the private system’s back.” In the face of potential catastrophes like Merrill Lynch or Lehman Brothers going out of business, he said, or Goldman Sachs going to Warren Buffett for funding, the government is going to step in. Given that approach, “we have to charge for the benefit.” He closed the session “a little exercised” about the subject, explaining that he has gotten resistance when expressing this view, but that he is firm in his conviction on the subject. ★

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