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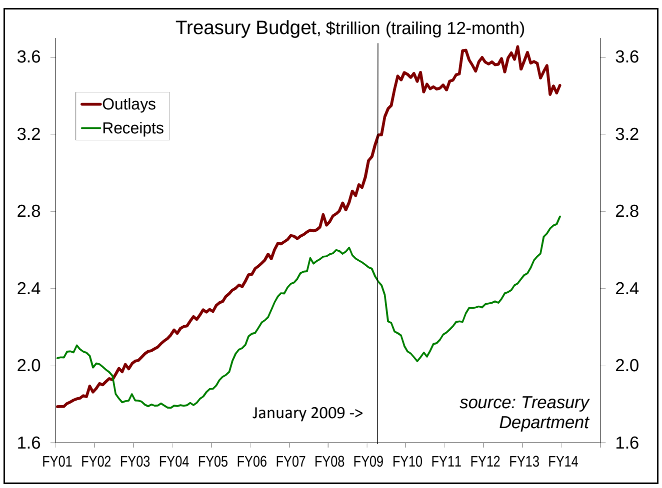
Monthly Economic Outlook

Fiscal and Monetary Policies in Different Directions

- *The partial government shutdown and debt ceiling crisis are expected to have had a negative, but temporary, impact on economic growth. Still, the underlying pace of GDP growth in 2H14 is likely to be disappointing relative to earlier expectations.*
- *While another government shutdown in early 2014 is possible, it is also unlikely. Lawmakers of both parties will work toward limiting the sequester cuts that are set for mid-January.*
- *Federal Reserve officials have left the door open for a possible reduction in the pace of asset purchases at the December policy meeting. The tapering decision will depend on the economic data, as well as financial conditions.*

About 800,000 federal workers were furloughed from October 1 to October 17 and about another 1.3 million worked without pay. All were paid retroactively (including those furloughed), but the disruption in income likely had some impact on consumer spending. The shutdown also hurt private contractors and tourism. In addition, firms may have been reluctant to hire workers or make capital expenditures amid the uncertainty. The economy should rebound quickly from the shutdown effects, but fiscal policy had been a significant headwind even before the shutdown.



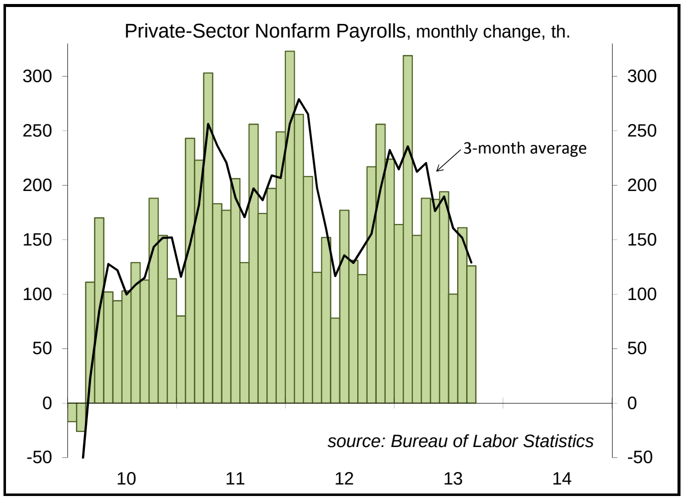
In the early years of the recovery, the contraction in state and local government was a significant drag (and job losses were large), but the sector is likely to add slightly to overall growth in the quarters ahead. On the federal side, the Congressional Budget Office (and others) have estimated that the payroll tax hike and sequester spending cuts would likely shave 1.5 percentage points or more from GDP growth this year. The government shutdown should reduce GDP growth by an additional few tenths of a percentage point. Growth for 2013 is likely to be 1.5% to 2.0% (4Q-over-4Q), but might have been 3.5% or more if not for contractionary fiscal policy.

The federal budget deficit narrowed to $680 billion in FY13 (about 4% of GDP), vs. $1.089 trillion (6.8% of GDP) in FY12. Outlays fell 2.4% from a year ago, the second consecutive annual decline, and were 8.3% lower than they were projected to be back in the summer of 2008. Note that September federal payrolls were reported at their lowest since August 1966 (that's not a misprint). Tax revenues rose 13.3% y/y (individual +16.3%, corporate +11.6%, payroll taxes +12.1%).

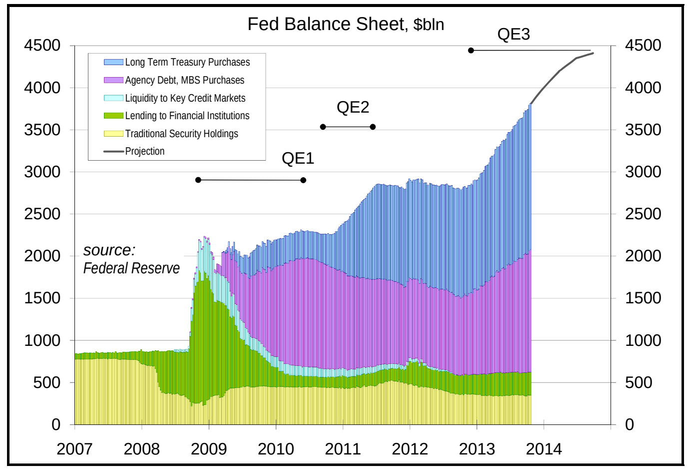
The Continuing Appropriations Act, 2014, as the agreement to end the shutdown is called, funds the government to January 15 and suspends the debt ceiling until February 7. The law calls for a bipartisan House/Senate conference on the budget, which is to report to Congress by December 13. Lawmakers are not expected to reach a long-term agreement on the budget, but they should be able to agree to kick the tougher choices down the road, either for a few months at a time or through the end of the fiscal year (September). Beyond February 7, Treasury should be able to use extraordinary measures to continue borrowing for a few weeks (and perhaps several months).

The major budget issue in the near term is the sequester cuts set for January 15. Recall that the agreement to end the debt crisis in the summer of 2011 set up a supercommittee of Republicans and Democrats to work on long-term deficit reduction. The failure of that committee to reach an agreement would set off across-the-board cuts to discretionary spending. Sequester cuts were meant to be so onerous to both parties (about half of the cuts are in defense) that they would lead lawmakers to work together. However, from the start, the supercommittee seemed doomed to fail. Republicans were never going to vote for tax increases and Democrats would not accept massive cuts to Social Security and Medicare. The sequester cuts were set to begin in January, but were delayed (as part of the fiscal cliff agreement at the start of the year) until March 1. The sequester cuts, as expected, have been hugely unpopular with both parties, but lawmakers have not been able to come together to do anything about them. The impact has been mitigated somewhat by delayed maintenance and other efforts that will be difficult to repeat (someone likened it to going through your couch for coins to pay the rent – you can't do that every month). The FBI has indicated that it will be forced to cut about $800 billion from its budget for the current fiscal year and might close its offices and furlough workers for two or more weeks in 2014 to save money (some criminal cases are being closed). Head Start eliminated services for 57,000 children due to sequester cuts. The government has scaled back funding on research and development by about 7% (set to remain flat to 2021), which will have a number of long-term consequences (such as fewer advances in medicine).

The January round of sequester cuts would reduce GDP growth to some extent, but not derail the recovery. Growth should still be at least at a moderate pace, supported by accommodative policy and further improvement in housing.



The Federal Open Market Committee surprised the markets when it decided in mid-September to delay the initial reduction of asset purchases (currently $85 billion per month). That delay allowed the Fed more time to observe the impact of tighter financial conditions. Concerns about the low trend in inflation and uncertainty about negotiations on the federal budget and debt ceiling were also factors. In the October 30 policy statement, the FOMC noted that *"the recovery in the housing sector slowed somewhat in recent months,"* but it jettisoned the phrase (from the September statement) that *"the tightening of financial conditions observed in recent months, if sustained, could slow the pace of improvement in the economy and labor market."* This suggests that the door is still open for a possible December taper.



The best argument for an initial tapering in the pace of asset purchases is that it has to start sometime. The Fed's balance sheet would still be growing as it tapers and it would still be adding accommodation. The October policy statement noted that it still sees *"the improvement in economic activity and labor market conditions since it began its asset purchase program as consistent with growing underlying strength in the broader economy,"* but the FOMC *"decided to await more evidence that progress will be sustained before adjusting the pace of its purchases."* Many Fed observers believe that credit was too loose in the early spring, but too tight by late summer. The decision to taper should not have had a big impact, but the markets believe that it does – so it does. At this point, the odds of a December tapering are less than even, but it's not out of the question. The Fed's decision will depend on the economic data and the reaction in the financial markets.

The outlook for the economy is "more of the same." That is, a lackluster to moderate pace in the near term, but picking up gradually over the next few quarters.

	4Q12	1Q13	2Q13	3Q13	**4Q13**	**1Q14**	***2Q14***	***3Q14***	***4Q14***	2012	**2013**	**2014**	**2015**
GDP (↓ *contributions*)	0.1	1.1	2.5	**1.6**	**1.7**	**2.3**	***2.7***	***2.9***	***3.0***	2.8	**1.5**	**2.3**	**3.0**
consumer durables	*0.7*	*0.4*	*0.5*	***0.4***	***0.1***	***0.3***	***0.3***	***0.3***	***0.3***	*0.5*	***0.5***	***0.3***	***0.3***
nondurables & services	*0.4*	*1.1*	*0.8*	***0.6***	***1.1***	***1.3***	***1.4***	***1.5***	***1.5***	*1.0*	***0.8***	***1.2***	***1.5***
bus. fixed investment	*1.1*	*-0.6*	*0.6*	***0.3***	***0.4***	***0.5***	***0.6***	***0.7***	***0.7***	*0.8*	***0.3***	***0.5***	***0.7***
residential investment	*0.5*	*0.3*	*0.4*	***0.4***	***0.4***	***0.3***	***0.3***	***0.3***	***0.3***	*0.3*	***0.4***	***0.3***	***0.3***
government	*-1.3*	*-0.8*	*-0.1*	***-0.3***	***-0.3***	***-0.2***	***0.0***	***0.0***	***0.1***	*-0.2*	***-0.4***	***-0.1***	***0.1***
Domestic Final Sales	1.4	0.5	2.1	**1.4**	**1.7**	**2.3**	***2.6***	***2.8***	***2.9***	2.5	**1.5**	**2.2**	**2.9**
exports	*0.2*	*-0.2*	*1.0*	***0.3***	***0.4***	***0.5***	***0.6***	***0.6***	***0.6***	*0.5*	***0.3***	***0.5***	***0.6***
imports	*0.5*	*-0.1*	*-1.1*	***-0.2***	***-0.2***	***-0.4***	***-0.5***	***-0.5***	***-0.6***	*-0.4*	***-0.2***	***-0.4***	***-0.6***
Final Sales	2.2	0.2	2.1	**1.5**	**1.9**	**2.4**	***2.7***	***2.9***	***3.0***	2.4	**1.4**	**2.2**	**2.9**
ch. in bus. inventories	*-2.0*	*0.9*	*0.4*	***0.1***	***-0.2***	***-0.1***	***0.0***	***0.0***	***0.0***	*0.2*	***-0.1***	***0.0***	***0.0***
Unemployment, %	7.8	7.7	7.5	7.3	**7.2**	**7.1**	***7.0***	***6.8***	***6.7***	8.1	**7.5**	**6.9**	**6.4**
NF Payrolls, monthly, th.	209	207	182	143	**150**	**185**	***195***	***200***	***210***	183	**171**	**198**	**196**
Cons. Price Index (q/q)	2.2	1.4	0.0	2.6	**1.8**	**1.9**	***1.9***	***1.9***	***2.0***	2.1	**1.5**	**1.9**	**2.0**
excl. food & energy	1.7	2.1	1.4	1.8	**1.7**	**1.8**	***1.8***	***1.8***	***1.9***	2.1	**1.8**	**1.7**	**1.9**
PCE Price Index (q/q)	1.6	1.1	-0.1	**2.1**	**1.7**	**1.8**	***1.8***	***1.8***	***1.9***	1.8	**1.2**	**1.7**	**1.9**
excl. food & energy	1.3	1.4	0.6	**1.6**	**1.6**	**1.6**	***1.7***	***1.7***	***1.7***	1.8	**1.3**	**1.6**	**1.7**
Fed Funds Rate, %	0.16	0.14	0.12	0.09	**0.10**	**0.12**	***0.16***	***0.20***	***0.22***	0.14	**0.11**	**0.18**	**0.91**
3-month T-Bill, (bond-eq.)	0.1	0.1	0.1	0.0	**0.0**	**0.1**	***0.1***	***0.1***	***0.2***	0.1	**0.1**	**0.1**	**0.9**
2-year Treasury Note	0.3	0.3	0.3	0.3	**0.3**	**0.4**	***0.6***	***0.8***	***1.0***	0.3	**0.3**	**0.7**	**1.6**
10-year Treasury Note	1.7	2.0	2.0	2.7	**2.6**	**2.8**	***2.9***	***3.0***	***3.4***	1.8	**2.3**	**3.0**	**4.1**