

Obamanomics 101

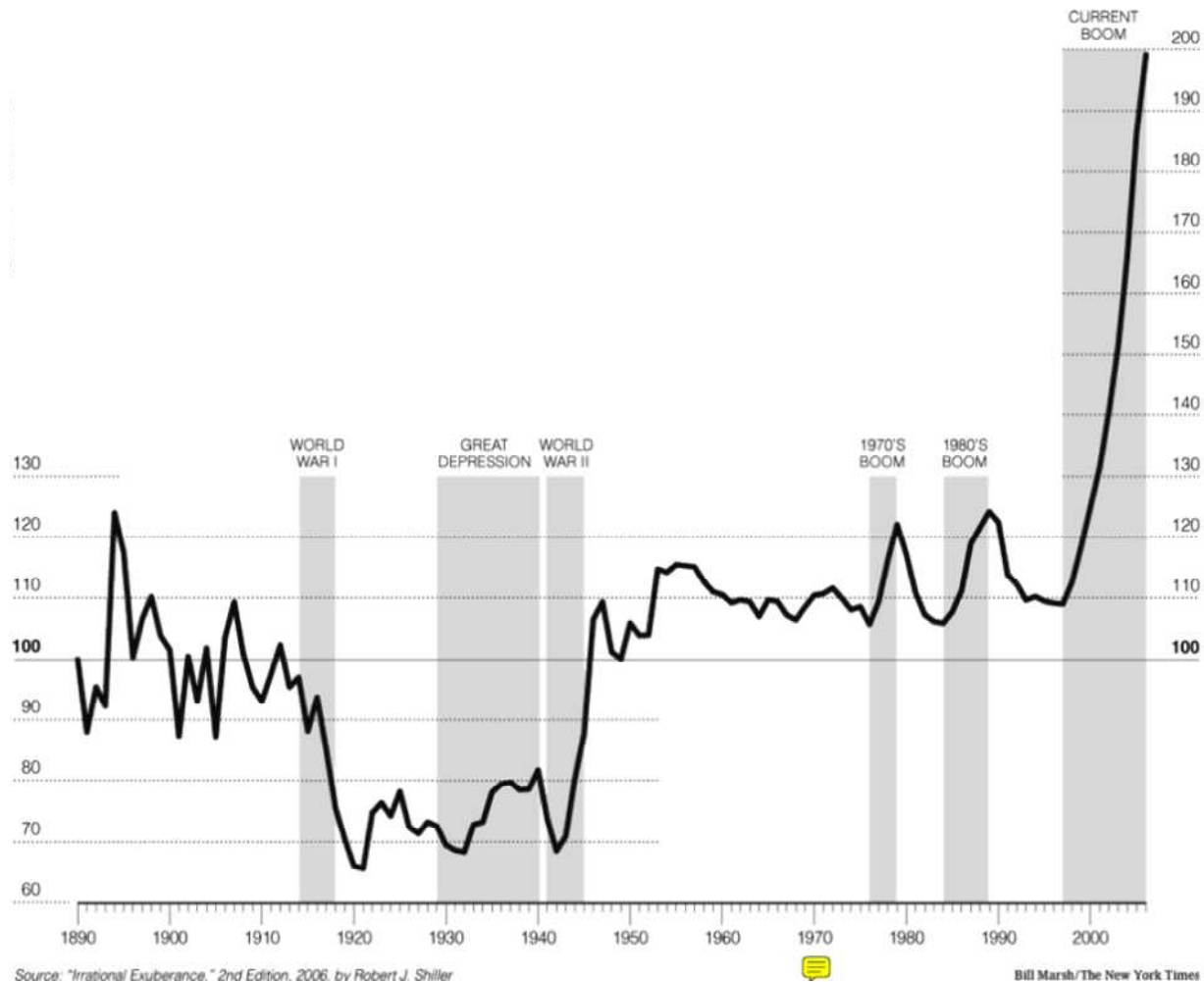
Digging Out of the “Great Recession”

LLT Elective Session
February 23, 2009

Arnie Baker
Chief Economist

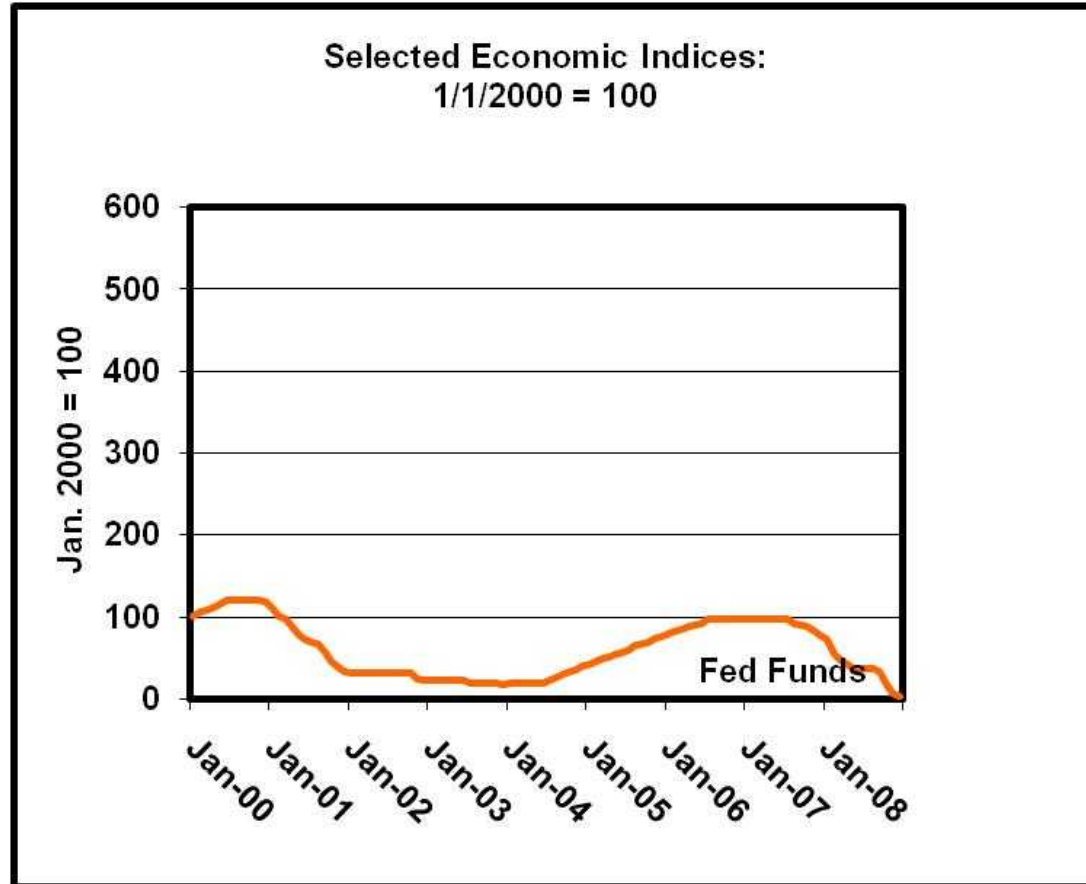


A History of Home Values



Source: New York Times, August 27, 2006, Robert Schiller

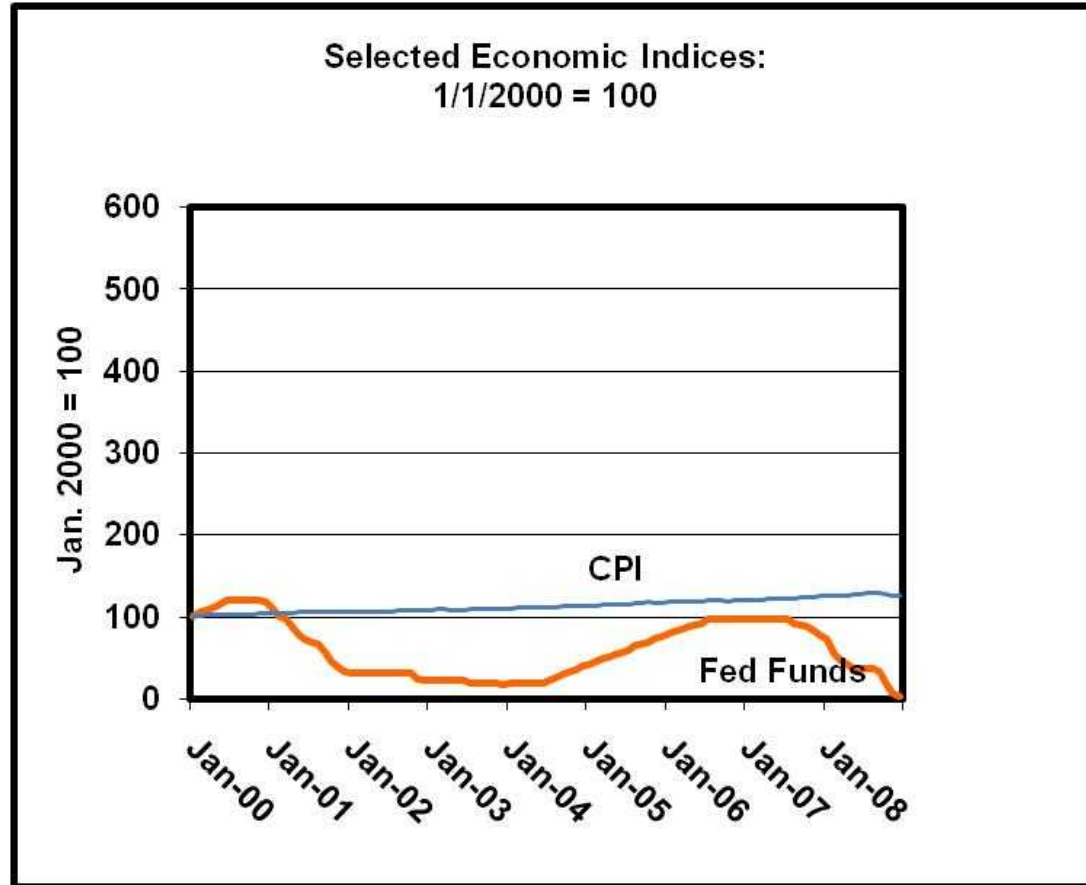
“Bubble, Bubble*” Toil and Trouble



*With apologies to William Shakespeare

Source: Monthly Data for Effective Federal Funds Rate

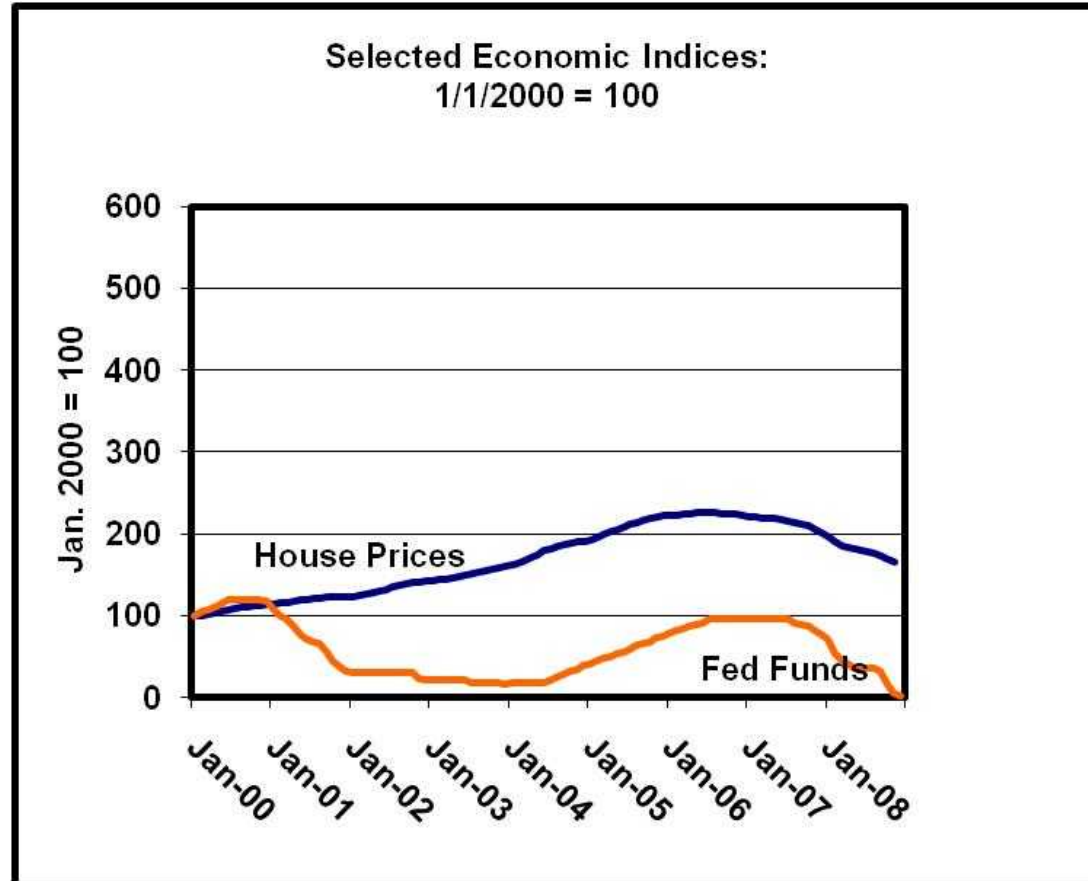
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***With apologies to William Shakespeare**

Source: Monthly Data for Effective Federal Funds Rate, CPI All Urban Seasonally Adjusted

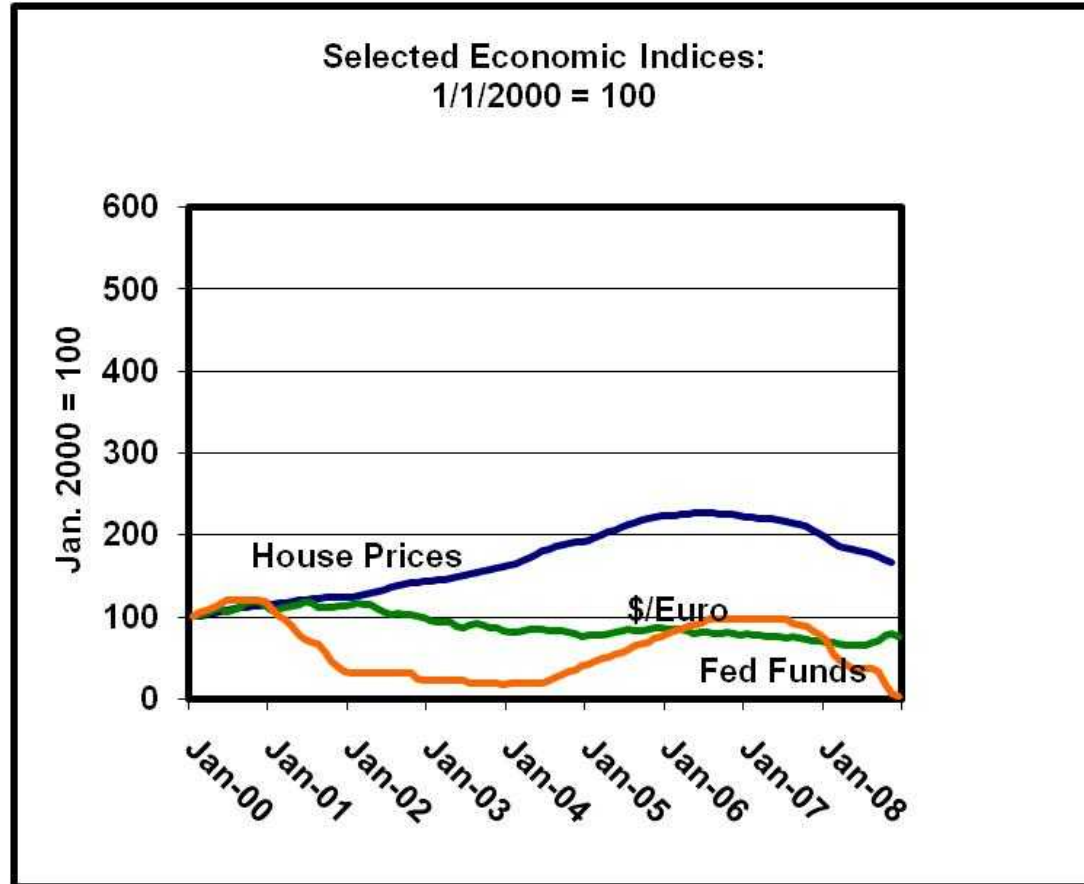
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Source: Monthly Data for Effective Federal Funds Rate, Case-Schiller 10 City Housing Price Index

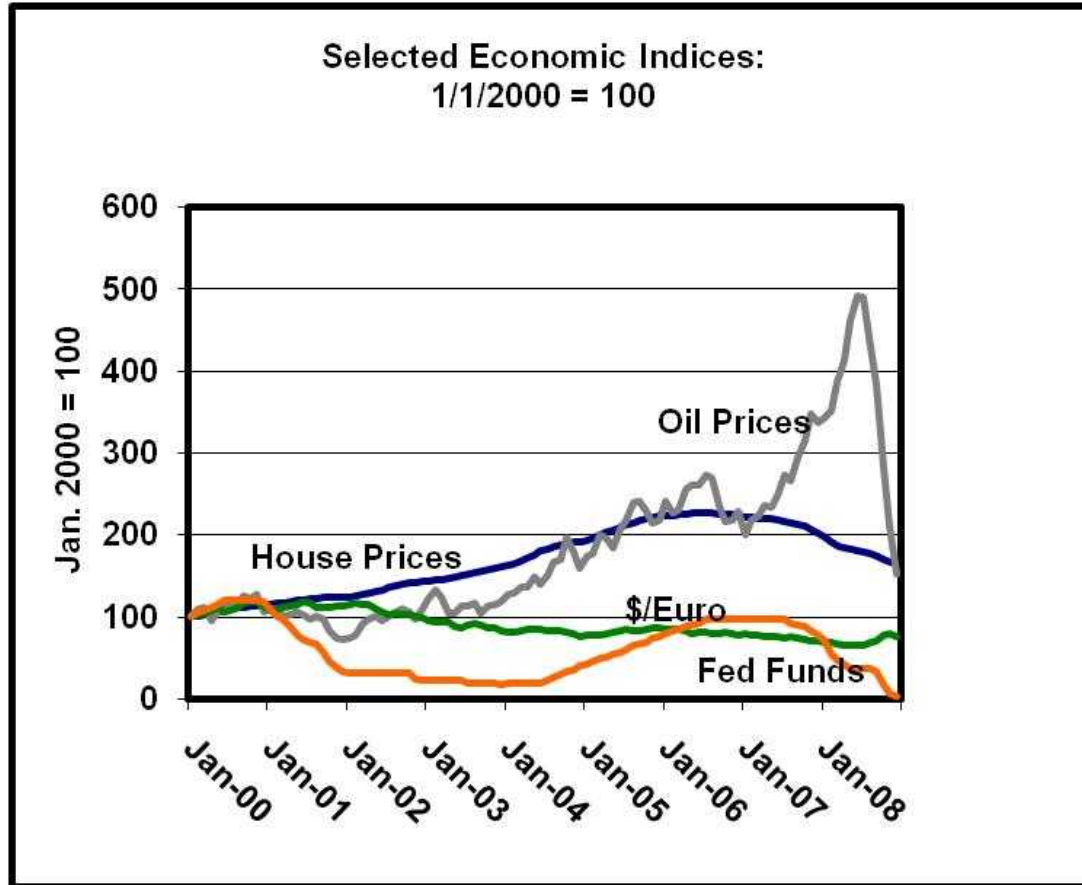
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Source: Monthly Data for Effective Federal Funds Rate, Case-Schiller 10 City Housing Price Index, U.S. \$/ Euro

“Bubble, Bubble*” Toil and Trouble



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Source: Monthly Data for Effective Federal Funds Rate, Case-Schiller 10 City Housing Price Index, U.S. \$/Euro, Nominal WTI

Déjà Vu: A Few Previous Bubbles/Financial Crises

| YEAR | COUNTRY/ REGION | PRECEDING SPECULATION IN | MONETARY EXPANSION FROM |
|---------|---|--|---|
| 1636-37 | Dutch Republic | Dutch East India Co., Tulips | Coin Debasement |
| 1720 | England, France | South Sea Co; Miss. Co. | Sword Blade Bank, John Law Bank |
| 1772 | UK/Amsterdam | Housing, Turnpkr, Canals; Dutch East India Co. | Chaining Accommodation Bills, Bank of Amsterdam |
| 1837 | U.S. | Cotton, Land | Wildcat Banks, Silver Retention |
| 1873 | U.S., Germany/Austria | Railroads, Securities; Homesteading | Securities Bought on Margin |
| 1890 | England | Argentine Securities, Pvt. Cos. Going Public | Goschen Conversion |
| 1893 | U.S., Australia | Silver, Gold, Land | Silver/gold/\$, Capital Inflow |
| 1907 | U.S., France Italy | Coffee, Union Pacific, Industrial Bak Borrowing | Trust Companies |
| 1929 | U.S. | Land to 1925, Stocks '28-9 | Stocks Bought on Margin |
| 1974-75 | U.S. | Stocks, REITs, Office Buildings | Eurodollar Mkt. Flooding in 1970-71 |
| 1979-82 | U.S., World | Third World Syndicated Loans, OPEC Price Rise, \$ | Continuation of 74/75 |
| 1982-87 | U.S. | Stocks, Luxury Housing, Office Bldg., \$ | Capital Inflow |
| 1990 | Japan | Stocks, Real Estate | 1986 Interest Rate Cut |
| 1994-95 | Mexico | Deregulation, Boom | Capital inflow, bank lending, Bank Privatization '91 |
| 1997-98 | Thailand, Korea, Malaysia, Brazil Indonesia, Russia | Deregulation, Capital Inflow, Foreign Borrowing | Bank Lending, Construction Boom, Crony Capitalism |

Source: Kindleberger, Charles, P and Albert, Robert, *Manias, Panics and Crashes*, Fifth Edition, John Wiles & Sons Inc, 2005, pp 256-265



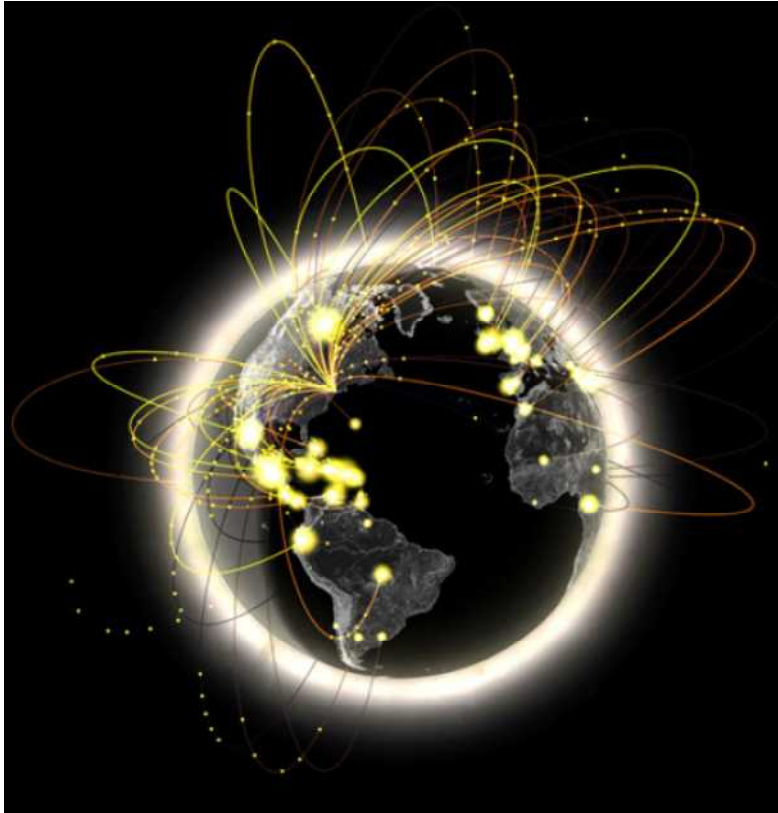
So What's Different This Time?

A More Open and Interdependent Global Framework

Speed & Market Scale

*Good Intentions, Good Computers,
Good Mathematicians, and the Fog of Finance*

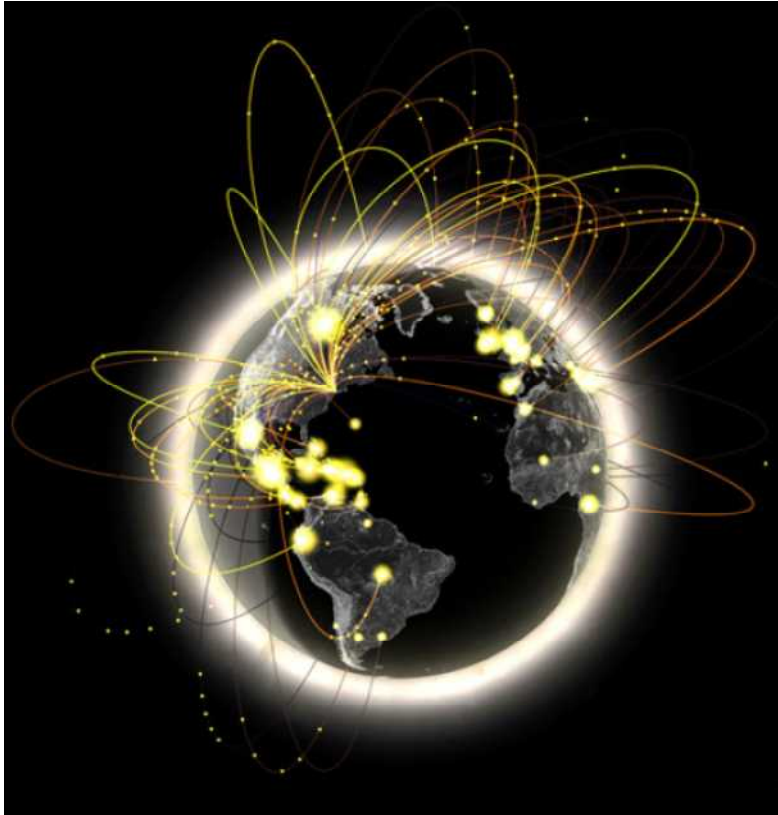
A More Open and Interdependent Global Framework



- **The Internet /silicon revolution breaking down communication & economic barriers**
 - **National borders “seamlessly” crossed**
 - » Financial markets
 - » Manufacturing & services integrated supply chains
 - » Science & technology development & transfer
 - » Distance learning
 - » Foreign campuses of domestic universities
 - **Efficiency & cost reduction**
 - **Just-in-time supply chain optimization**
 - » Reduced buffering capacity
 - **Markets & decision-making driven by instantaneous information flow**
- **Both global competition and global cooperation intensifying**

Source: New York Talk Exchange, Total IP Traffic From New York in 24 hours

A More Open and Interdependent Global Framework (Continued)



- **Countries not immune to effects of domestic policies outside their borders**
 - Food price increases from U.S. corn ethanol
 - Coal, oil, other commodity prices driven by China, India, U.S. economic growth and domestic public policies
 - U.S. housing bubble
- **Scope for national public policies with major economic/financial impact is becoming more limited**
 - Financial markets “über alles”
 - Can’t afford costs/returns out of line with competitor countries
 - Greater need for decision-making speed
 - Cost of mistakes will grow
- **Protectionist seeds**

Source: New York Talk Exchange, Total IP Traffic From New York in 24 hours

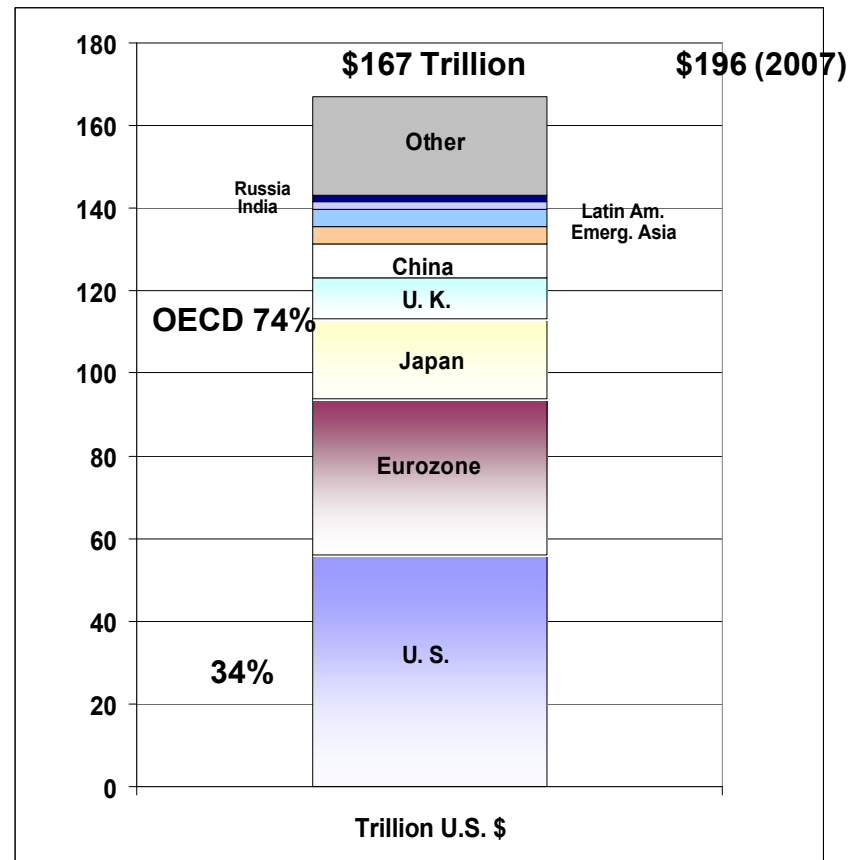
U.S. Is the Center of the World Economy But a Transitional Shift Is Underway

World GDP 2008

(Current Exchange Rates)

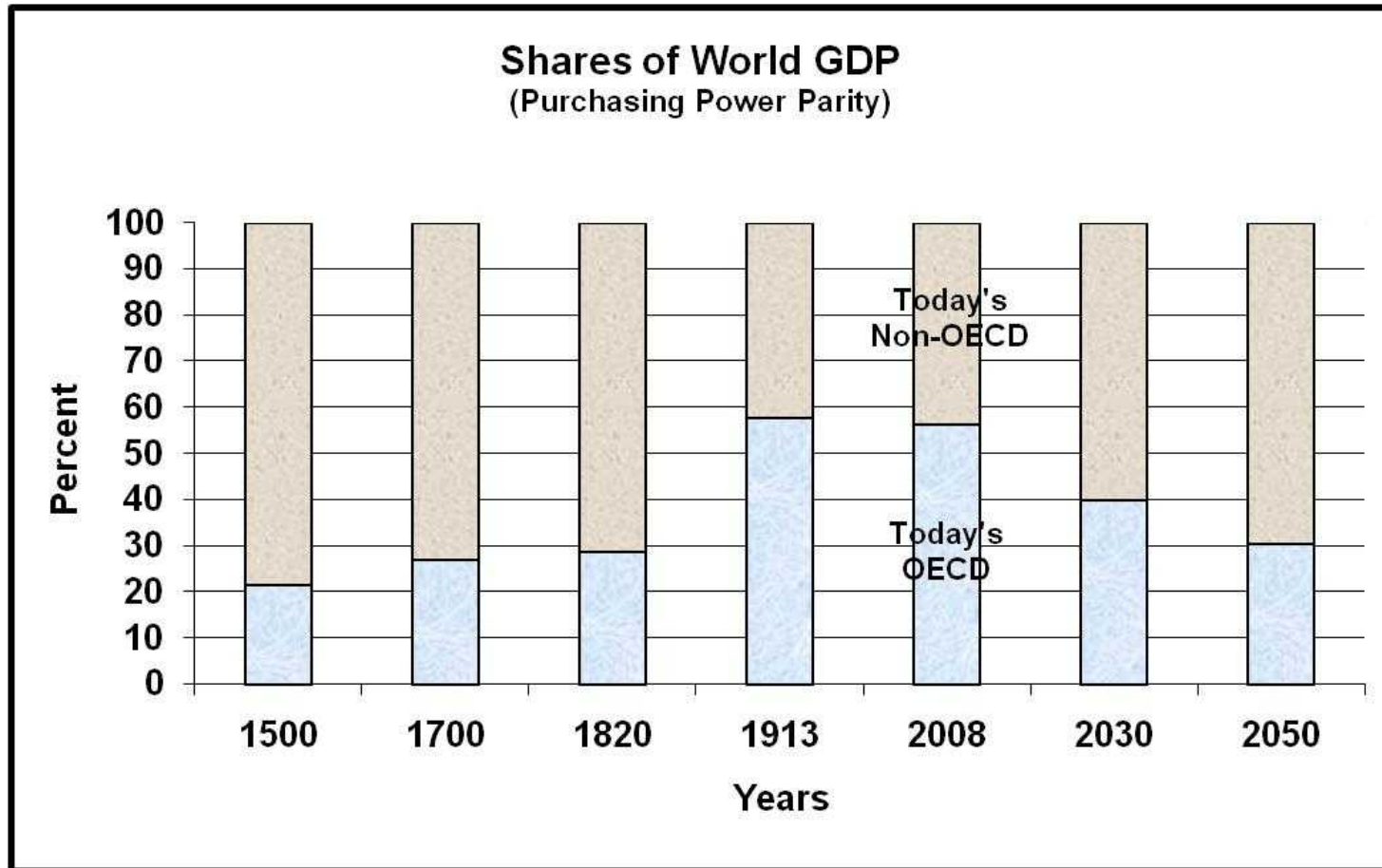
| <u>Country</u> | <u>\$Trillion</u> |
|---------------------|--------------------------|
| US | 14.3 (23%) |
| Japan | 4.9 |
| China | 4.3 (7%) |
| Germany | 3.6 |
| France | 2.9 |
| U. K. | 2.7 |
| Italy | 2.3 |
| Russia | 1.7 |
| Spain | 1.6 |
| Brazil | 1.6 |
| <u>World</u> | <u>60.8</u> |
| <u>OECD</u> | <u>43.3 (71%)</u> |

Global Financial Assets 2006



Source: Mapping Global Capital Markets, Fourth Annual Report, McKinsey Global Institute January 2008. Includes equities, private debt, government debt and bank deposits and Global Insight, February 2008

Transitional Shift (Continued)



Source: *The World Economy, OECD 2001, Angus Maddison; IHS Global Insight Detailed Forecast, December 2008, extrapolated to 2050, \$2000 PPP basis*

International Monetary System: A Confidence Game

- Nation based, run by central banks (164, 6/2008) with varying degrees of independence
 - Sweden (1668), England (1694), Federal Reserve (1913), ECB (1998)
 - Mandates differ (control inflation, prevent recession, provide financial stability)
- Money historically tied to gold/silver
 - US abandoned the gold standard in 1971; every major international currency followed suit
- Money today is “fiat” money—that is, backed by confidence in the issuing government
- Foreign exchange rates determined by relative supply/demand & expectations for each currency
 - International trade and financial flows
 - Relative interest rates and inflation rates
 - Confidence in central banks’ monetary policies and host government fiscal policies & legal frameworks
- Countries have varying degrees of capital controls and foreign investment restrictions
- Central banks cooperate (under Fed leadership)
 - To stabilize foreign exchange and the international financial system
 - To help coordinate international banking and central bank rules, regulations, & policies
- System has been under stress
 - Developing country central banks (China, Middle East, etc.) have had growing financial assets/reserves
 - Some countries (e.g., Russia, some OPEC) want to move away from dependence on U.S. dollar



Good Intentions, Good Computers, Good Mathematicians, and the Fog of Finance

- **Financial institutions are creative and outgrew well intended regulations in pursuit of profit**
 - **Mortgage lending (everyone wanted to encourage home ownership)**
 - » Rising house prices a “sure thing”
 - » Debt backed securities avoided reserve requirements; provided a risk hedge; global market
 - » “Securitization” and “bets” extended to other debt/financial instruments—CDOs, SIVs, CDSs, etc.
 - » Knit together by hedge funds
 - » Seemed to work fine until housing prices started to fall and some subprime borrowers (speculators and homeowners) began to default
 - **Financial market unraveling**
 - » Financial institutions had to begin writing down their losses/bad debts, but how much?
 - » Summer 2007: Credit markets tightened, fear of lending began (Countrywide-BofA)
 - » Fall 2007: Fed worried subprime failure lead to recession (falling house prices slow down spending) and US & global financial system would freeze up

Good Intentions, Good Computers, Good Mathematicians, and the Fog of Finance (Continued)

Hedge Funds

| | Number | Assets Under Management (\$Billion) |
|-----------|--------|-------------------------------------|
| 1990 | 600 | \$39 |
| 2000 | 3873 | \$490 |
| 2008 (Q1) | 7601 | \$1900 |

Source: Ferguson, Niall, *The Ascent of Money*, The Penguin Press, 2008 p 329

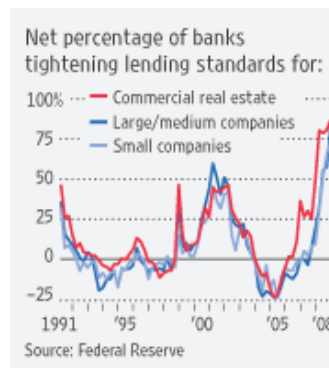


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Good Intentions, Good Computers, Good Mathematicians, and the Fog of Finance (Continued)

- **Federal Reserve-U.S. Government solutions**
 - **Liquidity/stimulus/transparency**
 - » Reduce discount rates and Fed Funds rates to add high quality liquidity
 - » 12/07 Mortgage Forgiveness Debt Relief Act (tax excl. for mortgage relief)
 - » 2/08 Economic Stimulus Act (\$152 billion)
 - » 3/08 Facilitate Bear Sterns sale (“too big to fail”) & \$30 Billion credit line to JPMorgan Chase
 - **Worked until June 2008 when inflation fears from stimulus package, mortgage relief, rising commodity prices emerged**
 - » Banks further tightened lending standards
 - » Foreign financial investors/sovereign wealth funds in U.S. began pulling back



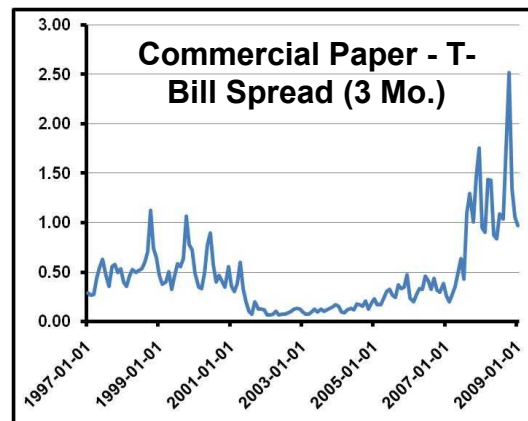
Source: WSJ, 1/21/09 P C1

Good Intentions, Good Computers, Good Mathematicians, and the Fog of Finance (Continued)

- **By early Sept. 08 a growing contagion, which the SEC/IASB mark-to-market rules may have helped fuel**
 - **Credit markets seized up**
 - » Fannie Mae/Freddie Mac placed under federal control (9/7)
 - » USG let Lehman Bros fail (9/15) (“moral hazard”), saved AIG (9/16), but underestimated Lehman’s global financial interconnections and “confusion effect”
 - » Financial Mergers (e.g., Bank of America - Merrill Lynch, JPMorganChase - Washington Mutual, Wells Fargo-Wachovia)
 - » \$700 billion TARP program; further interest rate cuts
 - » USG equity positions in largest U.S. banks; USG direct loans to corporations; FDIC insurance expansion
- **Presidential election added to confusion**
- **Wanna be a bank?**
 - **Goldman Sachs, Morgan Stanley, AMEX, CIT Group, GMAC, etc.**
 - » Access to TARP money, FED Discount Window, etc., in return for warrants/preferred stock for Treasury

Current Situation

- **Contagion seems to be slowing (at least for the moment)**
 - **Uncertainty about new Administration/Congress; awaiting further decisions on Treasury/Fed facilities to help stabilize banking/financial sectors**
 - **Markets realize we're in a serious recession (since 12/07); concern of a continuing negative feedback loop**
 - » Financial losses → credit tightening → slow economy → financial losses
- **The “Good News” is that**
 - **Weak oil/commodity prices act like a tax cut**
 - **U.S. \$ strength shows relative confidence in U.S. capital/financial markets**
 - **Policy-makers recognize need for liquidity, fiscal stimulus and restoring solvency**
 - **Credit market have begun to thaw**

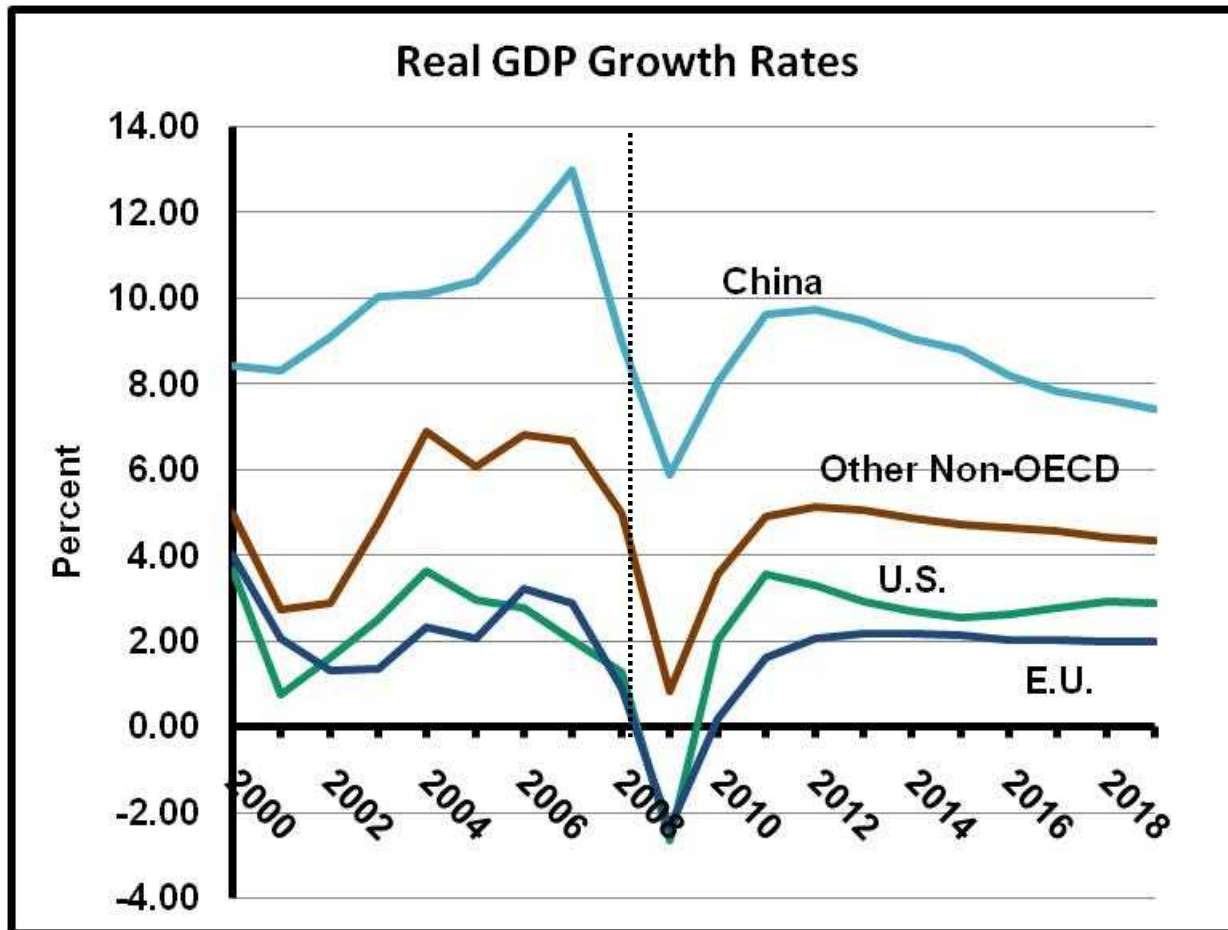


Source: Federal Reserve Bank of St. Louis Data Through 1/1/2009

Current Situation (Continued)

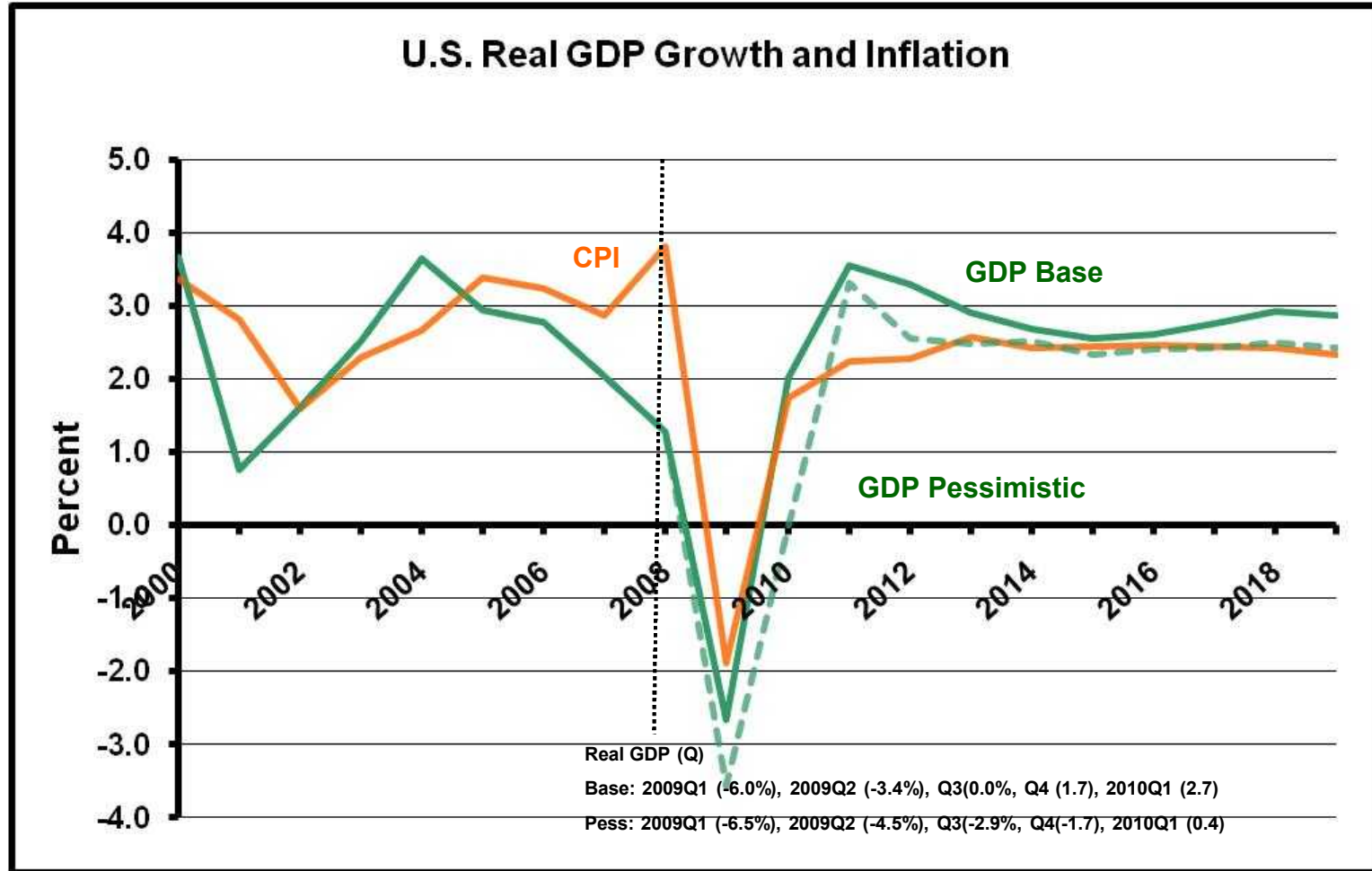
- Need to restore the “confidence to spend, borrow and lend” to business, consumers and financial institutions
- Need to recognize and write off losses, and see housing prices bottom out
 - Half of estimated \$2.1 trillion in U.S. loan losses recognized so far (Goldman Sachs)
- Need to re-think approach to U.S./global financial markets
 - How will U.S./global financial markets be “managed” in the future?
 - » Need to improve financial market transparency and regulation without politicizing or impairing functionality
 - » Fed will remain center of global financial markets, but other central banks will be increasingly important
- Recession outlook
 - Global, U.S.
 - U.S. stimulus plan and financial stability plan
- Apparent Obama approach to economic policy

World Economic Slowdown



Source: IHS Global Insight World Overview Base Case, February 2009

Outlook for U.S. Economic Growth & Inflation



Source: IHS Global Insight, Short Term Forecast 2/2009

Stimulus Package

- **Based on a Keynesian “multiplier” effect**
 - **Impact open to debate among economists**
- **By end of 2010 would create**
 - **1.2-3.6 million jobs (CBO)**
 - **3.7 million jobs (CEA Romer-Bernstein)**
- **How easy will it be to turn spigot off ?**
- **How long will it take to get the money out there?**
 - **Desire for oversight/transparency versus pressure to spend**

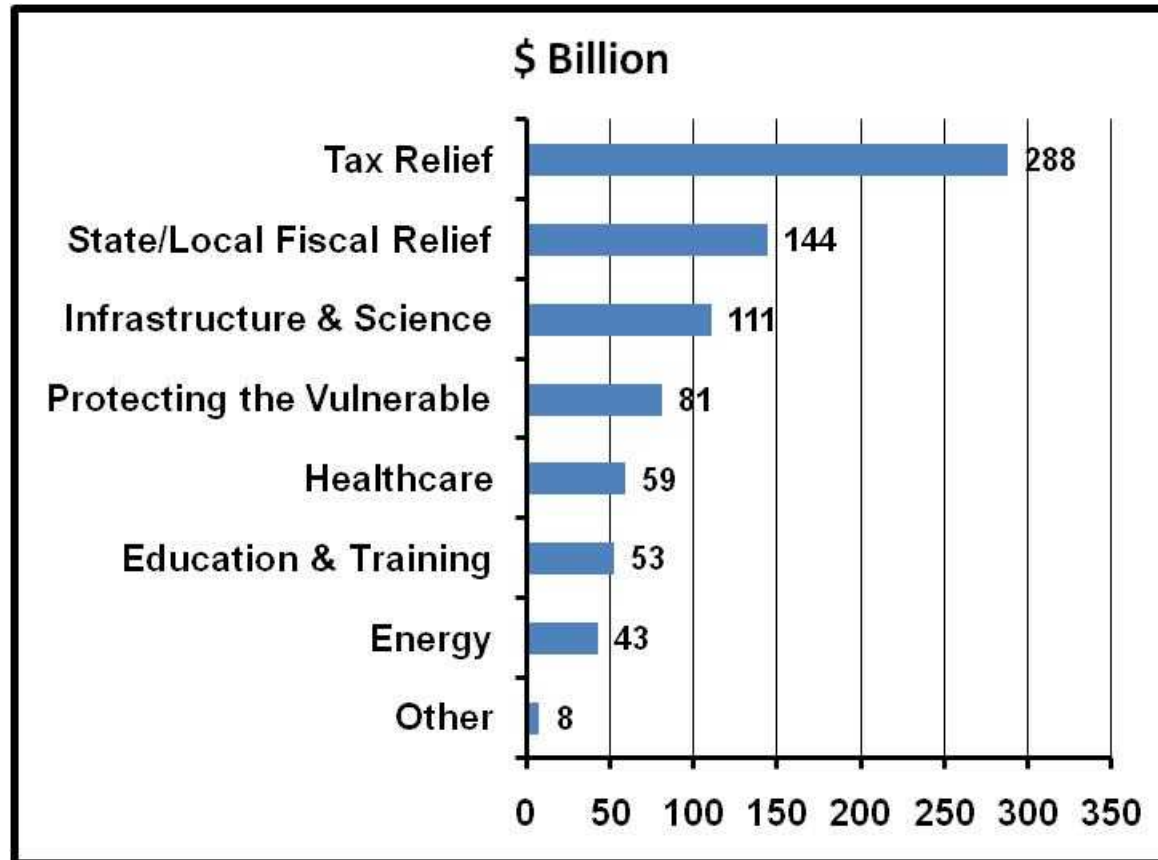


Initial Implementing Guidance for the American Recovery and Reinvestment Act of 2009

- **60 pages of requirements to meet “crucial accountability objectives”**
 - Funds are awarded and distributed in a prompt, fair, and reasonable manner;
 - The recipients and uses of all funds are transparent to the public, and the public benefits of these funds are reported clearly, accurately, and in a timely manner;
 - Funds are used for authorized purposes and instances of fraud, waste, error, and abuse are mitigated;
 - Projects funded under this Act avoid unnecessary delays and cost overruns; and
 - Program goals are achieved, including specific program outcomes and improved results on broader economic indicators
- **Detailed requirements for execution, risk management, reporting (recovery.gov), communication, etc.**

Source: Memorandum for the Heads of Departments and Agencies from Peter R. Orszag, February 18, 2009

White House Stimulus Package Breakouts



Source: www.recovery.gov. CBO estimated cost

Stimulus Package Shares

STIMULUS PACKAGE

| | <u>\$ Billion</u> | <u>% Share</u> |
|----------|-------------------|----------------|
| Spending | 311 | 39 |
| Tax Cuts | 301 | 38 |
| Aid | 178 | 23 |
| Total | 790 | 100 |

SPENDING \$ 311 Billion

| <u>Category</u> | <u>% Share</u> |
|-----------------------------|----------------|
| Aid to States | 17 |
| Transportation | 15 |
| Energy | 15 |
| Education | 14 |
| Health & Services | 7 |
| Food | 7 |
| Commerce, Science, Justice | 5 |
| Housing | 4 |
| Outdoors, Indian Res., Arts | 4 |
| Total | 88 |

TAX CUTS \$301 Billion

| <u>Category</u> | <u>% Share</u> |
|-----------------|----------------|
| Individual | 82 |
| Energy | 7 |
| Infrastructure | 7 |
| Economy | 2 |
| Business & Mfg. | 3 |
| Total | 100 |

AID \$178 Billion

| <u>Category</u> | <u>% Share</u> |
|-----------------|----------------|
| Health Care | 60 |
| Individual | 40 |
| Total | 100 |

Source: Wall Street Journal, 2/24/2009—House Rules Committee, Joint Committee on Taxation, CBO; Funds Appropriated

Treasury and Fed

Treasury financial stability plan

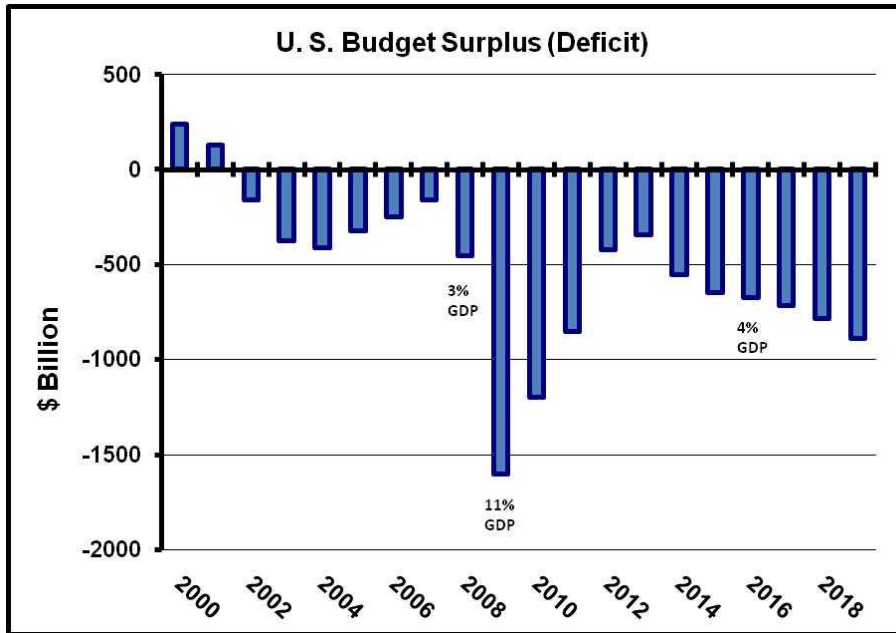
- **Most plan details TBD**
 - » **Objective: greater transparency and accountability**
- **New round of bank capital injections (\$100-\$200 billion)**
 - » **Bank stress tests on future losses; investments can be converted to equity; restrictions on participating banks**
- **Purchase toxic assets (\$500-\$1000 billion)**
 - » **Public private investment fund to attract capital; private sector determine toxic asset price**
- **Unfreeze consumer lending (up to \$1000 billion)**
 - » **Expands a proposed Fed program (Term Asset-Backed Securities Loan Facility--TALF) to finance investor purchase of securitized loans (e.g., student loans, car loans, commercial real estate, small business loans)**
- **Modify/refinance home loans (up to \$275 billion)**
 - » **Attempt to stem foreclosures and falling home prices**

Fed approach

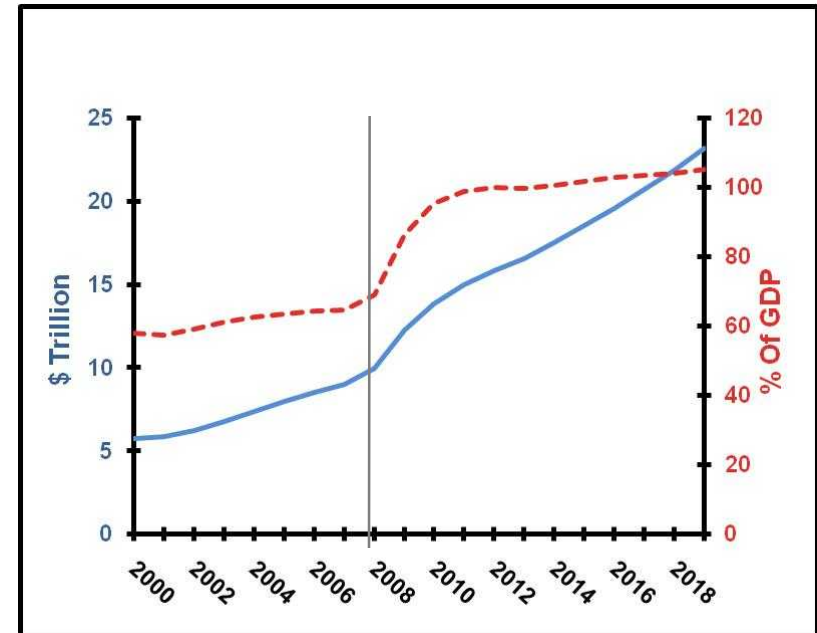
- **Continue to provide liquidity and “lender of last resort”**
 - » **Low interest rates, Central Bank coordination, lending facilities, partner with Treasury, possibly quantitative easing, etc.**
- **Longer term market vigilance**

U.S. Federal Budget Deficit and Debt

Budget Deficit



Total Federal Debt



Source: IHS Global Insight Short Term Forecast 2/2009



Protectionist Pressures

Less In, Less Out

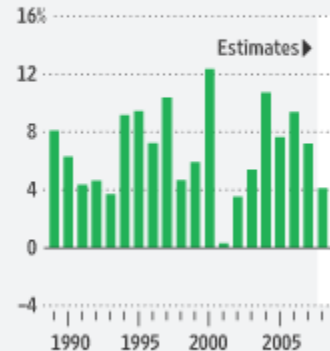
U.S. exports and imports, change from a year earlier



Source: Commerce Department

Global Retreat

Global trade volume, change from the previous year



Source: International Monetary Fund

Putting Up Walls

This year, countries all around the world have imposed trade barriers. Some examples:

- Russia has raised import tariffs on dozens of products, including cars and combine harvesters
- The European Union put antidumping duties on imports of Chinese screws
- The U.S. announced it will increase tariffs on French cheese and Italian water
- Egypt increased tariffs on sugar imports
- Brazil and Argentina have asked Mercosur, the Latin American free-trade area, for tariff increases

Source: World Trade Organization

Source: WSJ 2/06/09 P A1 and 2/12/2009 P A4

U.S. stimulus package “Buy American”
 U.S. steel industry seeking more tariffs
 China loans for natural resources

Apparent Obama Approach To Economic Policy

- **Government intervention and complexity**
 - **“Redistribute” income**
 - » Tax “rich” and spend on “poor” and “middle class”
 - **Change market direction**
 - » **Industry: reign in/regulate; take-over?**
 - ❑ GM-Chrysler bailouts-- encourage high mileage vehicles (inherited)
 - ❑ Apparent union supporter (tbd)
 - ❑ Salary caps for management
 - ❑ Healthcare
 - » **Energy: shift toward renewables and efficiency**
 - ❑ R&D and deployment
 - ❑ Regulation
 - ❑ Tradable carbon permits/taxes?
 - **Improve/spend for infrastructure development**
 - » Power grid, computerize medical records, energy efficiency, road/bridges/transit, water



LOCKHEED MARTIN 

Apparent Obama Approach To Economic Policy (continued)

- **Current stimulus focus, but how to pay for deficit in 2010+?**
 - **February 23rd Obama “Fiscal Responsibility Summit”**
 - **Raise taxes**
 - » Let (all/some) Bush tax cuts expire in 2010
 - » Higher taxes/fees on “the rich,” “sin,” “pollution,” and possibly “big business/finance”
 - » Taxes/permit fees on carbon
 - » Other?
 - **Cut spending**
 - » Reduced benefits for “the rich”
 - » Reduce spending for NW/defense
 - » Reduce R&D
 - » Other?
 - **Accelerate economic growth**
- **Where does President Obama stand on all of this relative to the Democratic Congress?**

Some Economic Policy “Boundary Conditions”

- The economic and financial marketplace is global and increasingly integrated
 - “Bad” policies will be undone
- Expectations will lead markets
 - Waiting for policy effects to kick-in
- Confidence in U.S. public policy and policy-makers is critical

A Few Economic/Financial Things to Watch in 2009+

- **Near term**
 - Obama stimulus package implementation and FY2009/2010 budgets
 - Treasury/Fed facilities for banking/finance
 - Behavior of stock markets in Q1/Q2 2009 as leading indicator
- **Near to Medium Term**
 - Response to recession and oil/commodity price weakness by
 - » Venezuela, Iran, Russia, Pakistan, Mexico, other OPEC, China, others
 - U.S. fiscal policy
 - » Dealing with budget deficits, inflation, Medicare, Social Security, health care, tax policy/2010 tax sunset provisions, etc. A “Grand Bargain?”
 - U.S. monetary policy
 - » Interest rates and inflation (2010+)
 - U.S./global financial market restructuring, regulation, and performance
 - U.S. policy toward business and regulation