THE ECONOMIC OUTLOOK GROUP

475 Wall Street
PRINCETON, NEW JERSEY 08540 Tel: 609 - 529 - 1300
www.economicoutlookgroup.com

ECONOMIC TALKING POINTS

Bernard Baumohl
Chief Global Economist

October 23, 2012

Romney vs. Obama: How will a Bernanke departure affect the economy?

As the FOMC commences its two-day meeting, many are pondering ***not*** what kind of policy changes the Fed may announce tomorrow (we expect nothing new to emerge!), but whether Ben Bernanke will stay on as Fed Chairman when his term expires early in 2014. There has been a spate of articles recently noting that Bernanke wants to step down when his second term expires and these stories have begun to take their toll on the financial markets. Today's *New York Times* lead business story caused enough investor worry to contribute (along with weak IIIQ earnings) to this morning's near 250-point slide in the Dow.

Let's begin with our first conclusion, which is that the current FOMC session will produce no new policy initiatives this time. The only major change we expect to see in the FOMC statement tomorrow is a brief reference to signs of recent economic improvement. The low interest rate environment has evidently lifted new and existing home sales, encouraged more home construction, fueled retail sales, and even accelerated hiring in the third quarter. The Fed will also reiterate its commitment to purchase $40 billion in mortgage back securities (MBS) each month for an indefinite period. There will likely be a sentence or two on the main constraints to faster growth, such as the fiscal paralysis in Washington and lingering concerns about the European debt crisis. The bottom line, however, is that with the presidential election just two weeks away, the Fed understandably wants to stay out of the political spotlight. Or at least try.

They did not quite succeed. The spotlight has pivoted back to the Federal Reserve now that the press has focused on the possibility the Bernanke era is coming to a close, and that instantly raises questions about the future course of monetary policy.

Here are some scenarios to consider:

If President Obama secures a second term, he would of course prefer to reappoint the current Chairman for a third four-year term. Bernanke has been the most innovative and transparent leader in the history of the Federal Reserve --- and perhaps more to the point for the White House--- the most accommodating too. By using the Fed's balance sheets to buy more than $2 trillion in Treasuries, agency bonds, and MBS, Bernanke has pounded interest rates down to record lows across the entire maturity spectrum. The strategy has clearly helped keep the U.S. economy growing, even as the rest of the world is either slowing or in recession.

Should Bernanke choose to step down, however, Obama will certainly pick a successor who shares the same dovish views. Among the front line candidates here are Janet Yellen, Larry Summers, and Bill Dudley (New York Fed President). All will continue essentially the same monetary strategy as Bernanke's because it has helped support equity prices, firm up real estate values, and improve household wealth --- all goals the Obama White House seeks.

A Romney presidency would follow a very different track, one that would, at least initially, unsettle financial markets largely because of the perception that the days of monetary accommodation would soon be replaced with monetary restraint.

Romney has long criticized current Fed monetary policy and he made no secret of his desire to replace Bernanke in 2014. Such an expected change, however, will leave consumers and business leaders wondering for months who will next lead the Fed and what that person's philosophy will be. This introduces a major element of uncertainty for both the real and financial sectors of the economy. The mere anticipation of a less accommodative Federal Reserve could prompt *market rates* to march higher early in 2013 and that would place a chill over two key interest-rate sensitive sectors of the economy--- autos and real estate --- *just as they are turning around.* Among the leading candidates Romney is said to contemplate for the Fed post are John Taylor, Glenn Hubbard, and Martin Feldstein. All have criticized the central bank's large-scale asset purchase program, arguing it debases the dollar, can fire up inflation, and achieves virtually nothing in bringing down unemployment.

So what's next?

Clearly the political backdrop is now so fluid that all forecasts on the economy and financial markets are tentative. Our baseline forecast includes the assumption that Obama will win a second term and the current policy of monetary accommodation will remain in place. (It's the baseline forecast simply because there is a preponderance of polls that show the President still has a slight edge following the final debate.)

We also have crunched the numbers in the event Romney wins the election.

It is true that, historically, presidential elections do not precipitate a significant change in an economy's path, at least not in the short term. But that is not the case this time given the profound differences in monetary and fiscal policy goals between Democrats and Republicans.

Key forecasts and a summary analysis are presented below:

Baseline forecast for 2013:
Assumption - Obama secures a second term;
Balance of power in Congress remains unchanged – with Republicans in charge in the House and Democrats in the Senate.

<u>GDP growth (2013):</u> 3.2%
<u>Unemployment rate:</u> Will rise to 8.3% (as more people re-enter workforce) before falling end of year to 7.3%
<u>Payrolls:</u> Gain 2.5 million jobs
<u>Budget deficit:</u> $850 billion

Analysis:

- Obama, concerned about his legacy, will edge closer to center early in his second term.
- Moderate Republicans to stage revolt; blame election loss on extreme right wing faction of party; the GOP begins to shift away from far right.
- The result: less obstructionism in Congress and more earnest work to achieve a long term deficit reduction plan in 2013.
- Should Bernanke step down in 2014, Obama will appoint someone who will continue to pursue accommodative monetary policies. Financial markets are comforted.

Backup forecast for 2013:
Assumption - Romney is victorious:
Republicans sweep both houses of Congress.

GDP growth (2013): 2.0%
Unemployment rate: year-end at 7.9%
Payrolls: Gain 1.5 million jobs
Budget deficit: $925 billion

Analysis:

- Large cuts in government spending expected; Will further reduce current demand.
- Bernanke to be replaced in 2014; Change will unnerve financial markets in 2013.
- Monetary policy to tighten in 2014; Market rates likely to move higher early next year and dampen sales of autos and houses.
- Tax cuts planned, but they will not immediately revive private sector spending; The calculus that goes into spending and investment decisions are influenced by many variables, not just tax cuts.