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Economy Faces Test With End Of QE2, Rising Oil Prices, Debt Limit Fight

By William Alden
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NEW YORK -- Recent fears of weakening economic growth have been tied to broad trends: falling home prices, the high unemployment rate and the tendency of rising energy prices to make Americans spend less money.

But going forward, economists' concerns center on a few crucial policy decisions, which in the coming months will help determine the nation's -- and the world's -- economic health.

The U.S. government is scheduled to reach its debt limit by mid-May, at which point the Treasury Department will resort to emergency measures to avert default if that ceiling is not raised. The Federal Reserve, meanwhile, will be finishing its $600 billion asset-purchase program, ending one of the economy's major support systems. As policymakers gradually rein in stimulus measures, some experts fear the world's economies are still too weak to survive without that boost.

"There are a number of forces that are restraining economic growth. That puts the Fed into a position where they're more likely to be cautious and careful going forward," said Kevin Logan, chief U.S. economist for HSBC.

"After all, this is one grand experiment," he added.

The so-called quantitative easing program, in which the Fed has been buying U.S. government debt from big banks in an effort to lower interest rates and augment the flow of money through the economy, is scheduled to end in late June.

To some extent, that policy appears to have succeeded: Interest rates have sat at rock-bottom lows and the stock market has enjoyed a rally. Since the Fed announced the move last fall, the Standard & Poor's 500 stock index has risen by 12 percent. The Dow Jones Industrial Average has climbed 11 percent.

That growth has come in spite of weak economic fundamentals. As stock markets have surged, home prices have fallen. The unemployment rate remains near 9 percent. Oil prices have reached a level not seen since 2008, when a summer of record-high prices helped drag the economy further into recession. Gas prices at the pump are approaching $4 a gallon, reducing many Americans' driving and raising fears that further increases could seriously impair the nation's economic growth.

When the Fed stops buying, it's not clear how the markets or the broader economy will respond. Since quantitative easing began last fall, 70 percent of annualized U.S. debt issuance has been bought by the Fed, according to Bill Gross, a founder and co-chief investment officer of Pimco, who runs the world's biggest bond fund. Declining demand for U.S. debt could cause bond prices to fall and interest rates to rise, a scenario that could challenge economic growth still further.

"That remains a very big question, once the Federal Reserve is no longer a buyer," said **Bernard Baumohl,** chief global economist of the Economic Outlook Group. "After the second quarter, assuming that there is no other quantitative easing, we can expect to see yields on Treasury securities move higher, and with it other loans -- mortgages, car loans -- will begin to move up."

In effect, higher interest rates would challenge the progress that the Fed program has made. But not all economists see that scenario playing out. Some foresee rates staying low or even falling -- which isn't necessarily a sign of strength. In that case, low rates could be an indication of broader economic weakness, as investors leave risky assets and turn toward the safety of Treasury bonds.

Moreover, the most important concern isn't that demand for U.S. debt will fall off, said Logan, the HSBC chief economist. Rather, he said, it's that the weak fundamentals of the economy will finally express themselves in markets without the crutch of government support.

"It's not necessarily the flow, but it's the long-term outlook that sets the price," Logan said.

The economy, in any case, will be missing a major source of support. As broader strains -- energy prices, home prices, unemployment -- continue to weigh on markets, some economists fear that a move away from stimulative policies may be premature.
But global leaders appear to be moving in that direction. The European Central Bank raised its benchmark interest rate by a quarter of a percentage point last week, citing concerns of inflation. Such tightening is designed to stem the flow of money through the economy, as borrowing becomes more expensive. It was the first time the bank has increased rates since 2008.

"The ECB made a mistake," said Gus Faucher, director of macroeconomics at Moody's Analytics. "There's the potential there for a double-dip European recession, given tighter monetary policy, and given the debt problems there."

Added Faucher: "That could rebound on the U.S."

All of this uncertainty isn't helped by the gridlock in Congress, which nearly caused the federal government to shut down Friday night. In the past weeks, a fierce clash of wills in the upper echelons of U.S. political power has stalled progress on legislating a budget. That stalemate has shown no signs of fading.

Treasury Secretary Tim Geithner delivered the May debt-limit deadline last week in testimony before a Senate subcommittee. The government needs to borrow to pay for its existing debt and other obligations; if the government can't issue any more debt, it risks entering default.

A missed debt payment, which could come as soon as July if the limit is not raised, could trash the nation's credit rating, raise borrowing costs for the government and all of its citizens and infect global markets with panic. It could set off a crisis worse than the one the nation is still recovering from, Geithner said.

Economists tend to agree. "If the debt ceiling were not passed, the consequences could be horrific," said Nariman Behravesh, chief economist at IHS Global Insight, a financial and economic analysis firm.

The coming months will be decisive. As the debt ceiling debate will likely be contentious, investors will keep a close eye on interest rates in the wake of quantitative easing. And as fighting continues in the Middle East, sustaining fears of an oil supply disruption, energy prices will likely continue to rise.

"Oil prices are still the wild card," Behravesh said. "That's probably the single biggest risk right now."