Testimony of

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"The Need for a Stimulus Package Now"

The House Budget Committee

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Mr. Chairman and Members of the Committee:

I am happy to be here this morning to urge Congress to enact a stimulus package quickly. In brief, I believe that:

- A well-designed stimulus package is needed now as an insurance policy to reduce the risk of recession or mitigate its severity if it occurs;
- The compromise worked out by the President and Speaker Pelosi is well-designed to stimulate spending quickly, because it focuses on low- and moderate income people, and should be enacted as soon as possible;
- The Congress should resist the temptation to delay the package by adding other elements, however worthy, at this time;
- Risks posed by the package—that it will aggravate inflation or add to the long-run deficit—are worth taking to help stabilize the economy in the months ahead.

I will elaborate briefly on each of these points.

Why an insurance policy is needed

The economy clearly slowed sharply in the fourth quarter of 2007 after growing strongly in the third, and the current quarter is beginning with signs of weakness as well. Unemployment rose in December—although 5 percent is still a pretty good number—and employment increases stagnated. Retail sales have fallen off, and the housing sector continues to plunge. Although some indicators, notably exports, are positive, it is clear

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that the economy is in a period of slow growth, possibly headed for a recession. Some economists are predicting a long or deep recession. The gloomiest forecasts are coming from economists associated with major financial institutions. The truth is: we simply do not know. Economists are notoriously bad at predicting turning points in the economy and frequently over-predict recessions or miss their beginnings.

The slowing of the economy is no surprise; indeed, many were expecting it sooner. The rapid increase in housing prices in many parts of the country, led to a big upswing in home building, some of it speculative. We simply built too many houses. When prices peaked and began to decline, housing construction fell off, construction workers were laid off, and the fall-out spread from the home construction, real estate, finance and insurance industries, to other sectors, especially in areas where house prices had risen most and home-building was frenetic. Consumers, who had been spending out of their rapidly-increasing home equity, found it leveling off or falling and began to retrench.

The housing boom was financed by the combination of low interest rates and a rapidly expanding market for mortgage-backed securities. Even without the explosion of sub-prime lending, the rapid upswing in housing construction and prices would have run its course and put some downward pressure on the economy. However, instead of a normal housing cycle we had a perfect storm—a lethal combination of historically low interest rates, widespread public conviction that housing prices could only go up, enthusiastic experimentation with sub-prime and other unfamiliar mortgage instruments, failure of the fragmented regulatory system to rein in irresponsible mortgage lending behavior, and failure of risk managers at financial institutions and rating agencies to anticipate the fall in value of mortgage-backed securities that would inevitably occur when housing prices peaked and foreclosure rates rose.

The economy is now being pummeled from above and below. In addition to the fallout from declining housing and rising foreclosure rates, we have seen massive losses to

financial institutions on Wall Street and in other financial centers, whose ultimate magnitude is still unclear, continuing uncertainty about the ultimate value of the assets backing many securities, and a sharp contraction in the willingness of financial institutions to lend--even to each other. The risk that the slowdown could be prolonged or turn into a serious downturn has clearly risen considerably in recent weeks.

The Federal Reserve has moved aggressively to lower interest rates and infuse liquidity into the banking system. However, monetary policy may act slowly, and putting total reliance on monetary policy to stimulate spending carries some risk. Given recent experience with asset price bubbles, pushing interest rates toward zero, as the Federal Reserve did in response to the 2001 recession, seems like an invitation to another bubble, and widening the gap between interest rates in the U.S. and other currencies could cause a more rapid than desirable fall in the value of the dollar. Hence, it seems sensible to take out an insurance policy by adding a quick-acting fiscal stimulus to the monetary stimulus already underway.

Strengths of the proposed package

The whole point of a stimulus package is to put money into the hands of people who will spend most of it when they get it, and the proposal negotiated by the Speaker with the Administration is well designed to do that. The idea is quite simply to send checks to working people with low or moderate incomes. Under the proposal everyone who earned $3000 or more in 2007 would get $300 ($600 per couple plus $300 per child), even if they did not earn enough to pay income tax. Those who did pay income tax would get up to $300 ($600 per couple) more. The amounts are big enough to make a significant difference in consumption, especially for low income families with children. The Center for Budget and Policy Priorities calculates that a couple with two children and earnings of $35,000 would get a rebate of $1800. The plan phases out payments for those with incomes over $75,000 ($150,000 per couple), which allows the payments to be larger (for a given total revenue loss) and more concentrated on low- and middle-income workers.

The package is considerably more progressive than the plan originally floated by the Administration.

The investment incentives in the package would add modest inducements for businesses to spend more on plant and equipment in 2008. The proposal also increases the loan limits for Fannie Mae, Freddie Mac, and the Federal Housing Administration (FHA), which rising home prices in many areas had made obsolete. The formula would tie the loan limits to median house prices in the metropolitan area. This new flexibility should help these entities operate more effectively to facilitate home financing and refinancing, especially in areas where prices rose most rapidly, and may avoid some foreclosures. (I believe the government should intensify its efforts to work with lenders and community groups to keep families who have been making their payments in their homes where possible. But these additional efforts do not belong in a stimulus package.)

Quick passage is more important than improvement

There are persuasive arguments for adding other elements to the proposed stimulus. Increasing Food Stamp benefits temporarily would get additional resources into the hands of very low income people, including needy seniors, many of whom will be missed by the current proposal. Extending unemployment benefits by 13 or 26 weeks, which has been done in prior recessions, is especially appealing now, because long-term unemployment is disproportionately high. A strong case can be made for assisting the states, most easily by increasing the federal contribution to Medicaid. Such aid would help forestall state tax increases or benefit cuts--actions that states often take to balance their budgets in a slowing economy and that tend to make recessions worse. Personally, I would favor all these measures, especially if the economic indicators turn more negative, but I believe it would be a mistake to slow down enactment of the current proposal by adding controversial amendments to the package now.

In particular, Congress should resist the temptation to add construction projects to the stimulus bill. Building and repairing infrastructure can contribute to long-run growth and

productivity, but such projects spend out too slowly to provide economic stimulus in time to be an effective antidote to recession.

Why the risks are worth taking

Is a stimulus package without risk? Of course not! With core consumer price inflation running somewhat above 2 percent and the threat that rising energy prices will cause other price increases to accelerate, stimulus could add to inflationary pressure, especially if the slowing economy turns around quickly. The inflationary risk appears small, however. In recent years, the economy has proved itself much less inflation prone than it was when oil price surges led to stagflation in the 1970's. The American economy is more energy-efficient, more flexible and competitive, more exposed to downward pressures on prices and wages in the global economy, and less unionized than in previous decades. As a result inflation expectations, which can become self-fulfilling prophesies, remain low. Moreover, the Federal Reserve, which cherishes its credibility as an effective inflation fighter, can be counted on to keep a close eye on price trends and to suspend monetary easing if it detects a serious inflationary threat.

The bigger risk is that the stimulus package, especially with major add-ons, will exacerbate the already ominous long-run deficit picture. Looking ahead, the United States faces mounting spending pressures as the baby boom generation retires and the growth of medical spending continues to rise faster than the economy can grow. The Congressional Budget Office's long run budget projections show clearly that, if past trends continue, spending for Medicare, Medicaid and Social Security alone will swell to equal the proportion of total economic output currently devoted to the whole federal government. The cost of fulfilling promises made under the three major entitlement programs has put the whole federal budget on an unsustainable track and will force hard choices that the political system is simply not recognizing at present. Indeed, our high and rising debt already constrains federal policy, including efforts to move aggressively against recession. In this situation is it irresponsible to enact a stimulus package that will add to the debt that we are passing on to future taxpayers?

I believe that the stimulus package should be paid for over a five-year period. The PAYGO principle has never been more important and should be honored. Making exceptions can become a dangerous habit. Nevertheless, even if it is not subjected to the PAYGO rules, the proposed stimulus will not add significantly to the long-run deficit problem. The rebates are one-shot payments with much less deficit impact than a permanent reduction in tax rates. Moreover, if the combination of monetary and fiscal policy is successful in stimulating the economy and attenuating a downturn, bigger increases in the deficit may be avoided. Hence, if Congress can resist the temptation to add permanent spending increases or revenue losses to the stimulus package, I believe the deficit increase associated with the stimulus represents a risk worth taking in order to reduce the chances of recession or mitigate its impact.

Thank you for listening. I would be happy to answer questions.