Testimony Prepared for the Hearing: Economic Recovery: Options and Challenges

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By

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Key Points in this Testimony

- The steps now being taken to ease the financial crisis are the right ones and I expect to see credit conditions easing gradually.
- The Main Street economy of jobs and production is now very weak and the housing market has not yet stabilized. We are in a recession and the only question is how deep it will be.
- Policymakers are debating a fiscal stimulus package of between $150 billion and $300 billion and that is the right range to be thinking about.
- According to the Blue Chip forecast, GDP declined in the third quarter and there will be a mild recession with a further decline in the fourth quarter. With a mild recession scenario like this, a stimulus package of $150 billion would be enough to get the economy back on a growth path.
- The Blue Chip is too optimistic, however, and the chances for a severe recession are pretty high, in which GDP would decline at a 4 percent annual rate in both the fourth quarter of 2008 and the first quarter of 2009, with continuing but smaller declines until late in 2009. Under this scenario a stimulus package of $300 billion would be enough to ameliorate the recession substantially, although it would not eliminate it.
- Given the uncertainty involved, I recommend an immediate stimulus package of $200 billion and the preparation of an additional stimulus of $100 billion that is triggered if unemployment goes over 7.5 percent.
- It is vital to stabilize the housing market. Some of the funds in the financial rescue package should be used to help households directly. If more funds are needed, a portion of the stimulus package should be used for this purpose. Enabling families to move into 30-year fixed rate mortgages through Fannie and Freddie at a rate of interest between 5 and 6 percent is an attractive approach to providing this assistance.
- It is vital that a stimulus work quickly and provide as much boost to spending as possible. A further round of tax rebates to be distributed this fall would get help to the economy quickly.
- Other possible approaches include assistance for unemployment insurance, and aid to states and localities. The latter could include funds for infrastructure, provided this does not slow down disbursement. Increased maintenance of our existing infrastructure is vital and would add to jobs quickly.
- The explosion of federal debt is very troubling and must be addressed by Congress once the crisis is past. Concerns about the marketability of Treasury securities and about inflation are real but not great enough to counter the urgent need for a new fiscal stimulus.

The Outlook for the U.S. Economy[1]

The U.S. and global economies have been severely stressed by the crisis in financial markets. The drying up of lending has adversely impacted both the business and consumer sectors. Many economists at Brookings, along with others, have advocated the use of direct capital injection into financial institutions to recapitalize them and allow the resumption of bank lending and thanks to the actions of Congress, the Treasury has both the funds and the authority to accomplish this and has now started the process of recapitalization. It would have been better had this process started earlier, but I am cautiously optimistic that the steps now being taken here in the United States as well as by other countries will be enough to stabilize the financial sector. Given that this crisis has repeatedly turned out to be worse than expected, however, that may not be the case and Congress and the Administration must stand ready to do whatever is needed to restore an effective financial sector. A strong financial sector is essential to overall economic growth and the recovery of Main Street. It is reasonable to expect that taxpayers be protected as far as possible and

[1] The discussion in this section has benefitted from my work as an advisor to the McKinsey Global Institute. I have also benefited from the analysis of Macroeconomic Advisers and other forecasters. The views are the author's own.

share in any future capital gains that result from the rescue, but it would be a terrible mistake to let this sector go under, even though Wall Street has caused many of its own problems.

Even though the financial sector is likely on the right track, the housing market remains very depressed and home prices are still falling. The most important factor determining whether homeowners default is whether or not they are under water, with outstanding mortgage debt exceeding the value of the house. However, with a recession underway, families that face unemployment or loss of income for other reasons will find that it is impossible for them to pay their mortgages or credit card bills and they lose their homes. Policies have been put in place already to help homeowners, but they may not be enough. If the American economy is to move to a sustainable recovery, the housing market has to stabilize.

The economy of Main Street is headed in the wrong direction, with employment falling, unemployment rising and monthly data that suggest that GDP has been declining since mid year. GDP growth will likely turn negative when the data for the third quarter are tabulated, and the decline will be much larger in the fourth quarter of this year. GDP can be expected to fall for one or two more quarters in 2009. The biggest weight pulling the economy down has been the residential housing sector and, so far, there is no clear evidence that this has turned a corner. The data on housing starts released October 17 continue to show a pace of rapid decline and I expect to see further reductions in residential construction for the rest of this year and perhaps into 2009. The numbers on retail sales released last week were very weak especially since the figures for earlier months were revised down, auto sales are low, and industrial production is falling. Consumption is being adversely affected by the huge loss of wealth from the decline in home prices and equity prices and can be expected to decline at about a 3 percent annual rate in the second half of this year. Business investment held up well in the early stages of the crisis, but is now falling also. The U.S. economy is in a recession and the only question is how deep it will be. Unemployment tends to lag behind the business cycle and often continues to rise even after a recovery is underway. Based on the economic trends now at work, it is very probable that unemployment will hit the range of 7 to 8 percent and a deeper recession is quite possible. Unemployment hit 10 percent in the 1982 recession and, while I do not think we will reach that level in this recession, we cannot rule it out. It takes GDP growth at a rate between 2½ and 2¾ percent to keep unemployment from rising, and a higher growth rate to bring unemployment down. We may see a solid bounce back in growth in the second half of 2009, but it is more likely that it will take until 2010 before unemployment declines again.

One of the bright spots this year has been the performance of U.S. exports. After adjusting for inflation, exports grew at over 12 percent at an annual rate in the second quarter and are likely to match that pace or more in the third. In addition, inflation-adjusted imports are weak as a result of the fall in the dollar that began in 2002 and the weakening U.S. economy. Domestic demand actually remained flat in the second quarter and all of the GDP growth was accounted for by the improvement in net exports. Exports have been keeping us out of the graveyard. Looking ahead, I expect that exports will remain a positive and that imports will still be weak, but the effects of trade will not be large enough to offset falling consumption and investment. Currently, both Europe and Japan are weakening and likely will head into their own recessions, making for a slowing of U.S. export growth. The dollar has recovered some ground against the euro also, which will trim U.S. export gains.

One economic factor that is clearly helping and is likely to remain a positive is commodity prices. The price of oil fell below $70 a barrel on October 16th, less than half of the peak price it hit earlier this year. Commodity prices fluctuate greatly and it is hard to tell exactly where they are headed, but a weakening global economy can be expected to depress commodity prices, so it is unlikely that they will return to anything close to their peak levels. The United States, of course, is a producer of commodities as well as a consumer, so there are companies and workers that are hurt

when commodity prices fall. On balance, however, U.S. economic growth benefits from a fall in commodity prices, especially oil and food prices which very quickly affect the wallets of consumers. There is nothing like seeing oil at $140 a barrel to make oil at $70 a barrel look good.

In the early stages of the financial crisis it was notable that jobs and GDP were holding up rather well; in fact there was 2.8 percent growth in the second quarter. That good news about growth was deceptive, however. The financial crisis has set in motion the dynamics of an economic downturn. Even though the financial sector is probably on the road to recovery, its negative impact on growth will remain with us for a while yet.

This recession was not inevitable. Almost everyone was caught up in the belief that housing prices would keep rising and this encouraged speculation and over-borrowing by households, lax lending standards by mortgage providers and a failure to supervise and regulate banks effectively. Wall Street banks as well as foreign banks became overleveraged and took on excessive risks, credit rating agencies failed to do their job.[2] There is plenty of blame to go around. Congress, the Administration and the Federal Reserve should have done more to help and so should the economics profession. Given what has happened, there is nothing that Congress can do now that will allow us to avoid a recession, and so the goal now is damage control, avoiding a deep recession and putting in place the basis for a solid recovery.

What Can Policymakers Do to Ameliorate the Recession?

Given the economic weakness, there is a strong case for a new fiscal stimulus package that would boost spending and offset the chain reaction of declining spending and employment. Historically, the use of fiscal policy to smooth the business cycle has had a mixed record. It is hard to assess where the economy stands, so that fiscal stimulus can sometimes have an impact when the economy is already recovering and does not need the help. That problem does not apply to the current situation. It is clear that the economy is trending down and needs help to sustain aggregate demand and private sector employment. The more serious objection to a stimulus package is that it will contribute to the budget deficit and that is indeed a valid argument, but it does not carry the day. If the economy goes into a severe recession, tax revenues will fall sharply and the impact on the budget deficit will likely be even worse than the impact of the fiscal stimulus. Even if a stimulus package creates a net cost to the deficit, that cost is worthwhile to avoid the damage of a severe recession.

How large should the stimulus package be? Assume that there is a stimulus passed this fall that injects $100 billion into the economy in the first quarter of 2009, and that around 80 percent of this amount is spent over the first three quarters of 2009—$40 billion in the first quarter and $20 billion in each of the subsequent two quarters. (I have used $100 billion as a round number to make the arithmetic easier to follow. There is a good case for a larger stimulus package than this.) Such a package would add about 1.1 percent to GDP growth in that quarter about O.75 percent to the GDP growth rate in the second and third quarters of 2009. The overall, the increment to GDP growth in 2009 would be a little under 0.7 to the growth rate for the year (averaging the quarterly effects of 1.1, 0.75, 0.75 and 0.15). A larger stimulus package, I assume, would scale up the impact proportionately, with a package of $150 billion being 50 percent larger and a package of $300 billion having three times the impact.[3]

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[2] See the Brookings website for links to recent papers on the financial crisis and what to do about it.

[3] The U.S. economy produces and spends about $14 trillion a year or $3.5 trillion in each quarter. The first round effect of an additional $40 billion in spending, therefore, is to add 1.1 percentage points to the GDP growth rate in the first quarter of 2009. That increment to growth would drop to 0.55 percentage points in the second and third quarters. In a slack economy, a positive increment to consumer spending is likely to have a second round effect, as the increase in retail sales or other spending puts more money into the hands of the workers and businesses that provide the goods and services. I assume there would be the equivalent of about another $50 billion as a secondary effect for each $100 billion of initial stimulus. It is hard to know the timing of this secondary effect—it would likely be spread over 12 to 18 months after the passage of the stimulus package. To get a rough magnitude, I assume that the secondary impact would add 0.2 percent to growth in the second quarter of 2009, another 0.2 percent in the third quarter, 0.15 in the fourth quarter and the rest spread further into the future.

The current Blue Chip consensus forecast says that GDP declined 0.3 percent in the third quarter of this year and will decline 1.1 percent in the fourth quarter. The Blue Chip then says that GDP will decline by only 0.1 percent in the first quarter of 2009 and will resume positive growth after that. If this Blue Chip forecast is correct, a package of $150 billion would boost growth to 1 percent in the first quarter of 2009, and as high as 2.9 percent in the second quarter. Under this scenario, a stimulus of $150 billion seems plenty.

The Blue Chip consensus is too optimistic and many of the forecasters who contribute to this consensus have been revising down their forecasts. Consider a pessimistic scenario where there is about a 4 percent GDP decline in the fourth quarter of this year, about the same in the first quarter of 2009, about a 1.5 percent decline in the second quarter of 2009, about a 1 percent decline in the third quarter and a small positive growth rate in the fourth quarter. I do not think we will see a recession quite that bad, but that scenario is not out of the bounds of possibility. There is about a 25 percent probability that we will see a recession of this severity in the absence of offsetting policy actions. Suppose Congress were to enact a stimulus package of $300 billion—a number that is around the high end of the current debate. This would boost growth but even so there would be a GDP decline of 0.7 percent in the first quarter of 2009, followed by positive growth of about 0.75 in the second quarter and growth of just over 2 percent in the third quarter. The fourth quarter of 2009 would remain sluggish unless the stimulus had succeeded in reviving consumption. Under this scenario, a $300 billion stimulus would not result in buoyant growth in 2009, but it would substantially offset the severe recession.

What are the uncertainties around these estimates? I have assumed that 40 cents of each dollar of stimulus is spent in the quarter in which the money is received by families and 80 cents is spent over three quarters. Some economists will judge these numbers are too high and point to the impact of the first stimulus package in 2008 where consumption fell in the second quarter and is expected to fall in the third, despite the rebate checks. The difficulty with that view is that we do not know the counterfactual, what the situation would have been without the tax rebates. Very likely, consumption would have been significantly lower. Given that American consumers on average have been spending nearly all of their disposable income for many years, I find it hard to believe that they will save a huge fraction of any additional income from a new stimulus package for more than a few quarters. Initially, the 2008 tax rebates went into savings accounts or to pay off debts, but this strengthening of consumer balance sheets is allowing them to weather the economic conditions of today with smaller cutbacks in spending.

It is quite possible, however, that the lags will be longer than specified in this example. A stimulus package passed this fall might not get money into people's hands until the second quarter of next year and the impact of that on spending might be lagged into the latter half of 2009 or into 2010. If the Blue Chip forecast turned out to be correct and, in addition, it took a while for the stimulus to work, we could find that the policy had over-stimulated an economy that was already well into recovery. My own judgment is that this recession is likely to be prolonged, so I am not too worried about that possibility. In addition, monetary policy could act to slow the economy if it turns out that it is overheating.

Given the dangers the economy is facing, I view $150 billion as being about the minimum amount that will have a serious impact on economic growth in 2009. Given the concerns about the budget deficit that I articulate shortly in this testimony, I would not exceed a $300 billion package. My specific proposal within this range of numbers is therefore to prepare a stimulus package in two tranches. The first to be enacted immediately would be for $200 billion. The second tranche for an additional $100 billion would be ready to go and would be enacted on the basis of a trigger. One possible trigger would be that if the unemployment rate moves over 7.5 percent, the second tranche is released.

What Form Should the Stimulus Package Take?

The important factors to consider are well-known to this committee and I recommend the analysis of stimulus design provided this spring by the Congressional Budget Office. In order to alleviate a recession that is already underway, it is important to get the money into the hands of Americans quickly and that this addition to income translates into additional spending as close to dollar for dollar as possible. Given the problem of the exploding budget deficit, it is important that the changes be temporary and do not contribute unduly to the worsening of the deficit in the long run.

- **Stabilizing the Housing Market.** The economy will not return to sustained economic growth while the housing market continues to fall. And there is a two-way interaction between these two factors because supporting economic growth will help stabilize the housing market. Congress has already agreed to a substantial investment of capital into the GSEs to support the mortgage market. And the terms of the $700 rescue package allow for the purchase of mortgages as well as mortgage-backed assets. Since I do not know how much money it will take to recapitalize the banking system, so I am not sure how much is available for direct support of the housing market. If there is not enough money already approved, then I would urge the Committee to support additional funds for families facing default. It is very hard to do this without rewarding past misbehavior by either lenders or borrowers, but I find attractive the proposal from both Republican and Democratic economists to allow households to roll existing mortgages into new 30-year fixed rate mortgages available through Fannie and Freddie at an interest rate between 5 and 6 percent. These would particularly be valuable to families caught in interest rate re-sets to high levels, and the pre-payment penalties could be adjusted and rolled into the new mortgage, or eliminated altogether. The program would be restricted to owner-occupied properties.
- **Tax rebates**. I urge the committee to pass quickly a new tax rebate package. If this were done very quickly, the IRS could use the same taxpayer list that was used earlier this year and the money would be released this fall. Having the rebates be refundable ensures that low and moderate income families get a benefit. The IRS got the rebate checks out quickly earlier this year and using this approach is simple and quick.
- **Unemployment Insurance.** This program has traditionally been a backstop for the economy, serving as an important automatic stabilizer. With the job situation deteriorating there are many workers reaching the point where benefits are exhausted and it would make sense to extend the duration. Over the years, the fraction of the unemployed receiving benefits has declined and women seem particularly disadvantaged because they often work part-time. In 1975 Special Unemployment Assistance was enacted by a Democratic Congress and signed by President Reagan to help persons that were not eligible under the usual rules. I would support such a program again now, particularly to help single mothers or fathers who have lost jobs but are not eligible for standard UI benefits and who will find it difficult to qualify for welfare. This program should be funded by the federal government and not by the states (the program was federally funded in 1975).
- **Infrastructure.** Many house members are concerned about the deplorable state of the nation's infrastructure and would like to devote some fraction of the stimulus package to infrastructure investment. I share the concerns about the state of our roads and bridges, but I am also aware of the objection to using infrastructure investment as a stabilization policy because it can be too slow to work. There are two ways in which this problem could be overcome: First, there is great need for improved maintenance of the infrastructure, including crumbling roads that need repair and bridges that may age prematurely or even collapse because they have not been looked after. Looking after the existing infrastructure is not as exciting as cutting ribbons on new projects, but it could generate jobs quickly and meet an important need. Second,

there are state and local projects that are being cancelled because of the short term budget pressures. Sustaining such projects would avoid layoffs that would otherwise take place.

- **Aid for States and Localities.** There are many states and localities that are feeling tremendous budget pressures because of the weak economy and the decline in property tax revenue. Providing assistance to them would prevent or ameliorate the cutbacks in spending that would otherwise occur.
  - General budget assistance, targeted perhaps to states with high unemployment and mortgage default rates
  - Assistance to sustain Medicaid spending. Some states are finding it difficult or impossible to sustain support for health care because of budget pressures.
- **Business Tax Changes.** The marginal rate of corporate tax is higher in the United States than in many other countries with whom we compete internationally. At the same time, corporations do not pay a lot of tax—the average rate of taxation is pretty low. As part of a long run package of tax reforms I support the idea of broadening the base of corporate tax and lowering the rate. In my judgment, however, adjusting business taxes now is not attractive as a response to the recession. Capital gains taxes are already low. Investors are staying on the sidelines of the stock market because they are concerned about market risk and volatility, not because of concerns about the taxes they might pay on capital gains. In the past several years, non-financial corporations have improved their balance sheets and added to their cash holdings. It is much more important to get the balance sheets of the financial sector into better shape and free up lending to businesses and consumers. The fiscal stimulus package is sufficiently important, however, that if business tax changes are necessary to obtain bipartisan support for the package, I would support them on that basis.

The Threat of Inflation and the Fiscal Challenge: $700 billion here, $300 billion there and pretty soon we are talking about real money

A year or so ago, when the economy was still growing it was clear that the problem of chronic budget deficits was real and urgent. We have known for years that the population is aging and living longer and that Medicare, Medicaid and, to a lesser extent, Social Security were going put pressure on the budget for years to come. I support fiscal discipline and believe that the federal budget should be balanced on average over a period of years. Can we really afford to pay for a fiscal stimulus package over and above the $700 billion for the rescue package together with the funds for Fannie, Freddie, AIG, and Bear Stearns? There are two possible economic arguments for why we might find it unwise to expand the deficit for a stimulus package. The first would be that it caused a flight from U.S. Treasury securities and perhaps a run on the dollar. The second is that it would result in inflation. It would take more space than is available to go into these issues in depth, but the simple answer is that neither concern is large enough to prevent passage of a fiscal stimulus.

Investors here in the U.S. and around the globe know the fiscal situation of the federal government and anticipate the likely expansion of the national debt. Despite that, there is no shortage of buyers for U.S. Treasuries. The interest rate on 10-year notes is under 4 percent and the U.S. dollar has appreciated against the euro in the past year and stands now at about $1.34. There has been a "flight to quality" recently as a result of the crisis and the benchmark of quality remains U.S. Treasury securities. I am deeply troubled by the persistence of federal deficits, the over dependence on foreign borrowing and the lack of a national debate about how to pay for federal spending and how to moderate its growth. But letting the economy go into a deep recession is not going to solve the long run fiscal challenge facing America. Global financial markets will let us borrow to pay for the stimulus package and we should go ahead and do that.

There is a working model of inflation that has guided policymakers over the years and its first ingredient is that inflation will increase when commodity prices go up and will decrease when these prices decline. Commodity prices are set in global markets and are only partly under the influence of the state of our own economy or our monetary policy. The second ingredient is that inflation will increase when there is excess demand in the economy, production capacity is strained and labor is in short supply. It will fall when there is slack in the economy. The third ingredient is linked by most economists to inflation expectations, so that when higher inflation is expected it can actually cause higher actual inflation. Of these three ingredients, the first two are pointing to an easing of inflationary pressures: commodity prices have come down and seem likely to stay well below their peak. The U.S. economy already has slack capacity and will have much more in the year ahead. For the third ingredient, there have been signs of an upward adjustment of inflation expectations, something that has troubled the FED in the past year. That seems to be fading, however, as the other drivers of inflation ease off. Adding huge amounts to federal borrowing is not a good thing for inflation, but that concern is not enough to change the case for the stimulus. I am old-fashioned enough to think about wage-price spirals as much as expectations, and on this score, there is little sign of the kind of wage price spiral that was so difficult to deal with in the 1970s. With good productivity growth, businesses are not facing an upward push of labor costs.

Conclusion

The American economy is in trouble and the balance of risks strongly favor a substantial fiscal stimulus. I urge Congress to act on this proposal as soon as possible.