Fiscal Stimulus and the Economic Outlook

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Testimony before the House Budget Committee

January 27, 2009

Chairman Spratt, Ranking Member Ryan and, and Committee members:

Thank you for giving me this opportunity to share with you Macroeconomic Advisers' assessment of the near-term outlook for the economy. The forecast incorporates a fiscal stimulus package that we believe closely resembles the plan initially set out by the then President elect's transition team and we believe the plan being considered by the House would have a very similar impact. I have submitted for the record two reports that provide detail on our forecast and our analysis of the prospective fiscal stimulus.

Before proceeding further let me remind you of what I am sure you already know: Forecasting the macro economy in the best of times is challenging, but this is even more so today, given the unprecedented nature of shocks to the financial and real economy and uncertainties about the aggressiveness and effectiveness of non-conventional monetary policy options being pursued by the Fed and about the size, composition, and effectiveness of a prospective fiscal stimulus package. Nevertheless, in deciding whether to implement a fiscal stimulus package and how to calibrate its appropriate size, the point of departure should in our view be a disciplined assessment of how the economy would likely behave in the absence of the fiscal stimulus, followed by a disciplined analysis of the impact of the fiscal stimulus. This is what I hope to offer the Committee this morning.

We are today, almost surely, in a deep recession, possibly the worst in the postwar period. We expect that real GDP declined at about a 5½% annual rate in the fourth quarter of last year and will fall at about a 4¼% rate in the current quarter. In the absence of fiscal stimulus, we expect the economy would continue to decline slightly in the following two quarters, and begin to move to stronger growth next year. The unemployment rate, which is currently 7.2%, would peak at above 9% in the middle of next year and still be close to 9% at the end of next year. And, by the way, we are viewed as optimists.

The economy is being weighed down by three powerful and interrelated shocks. The first is the housing correction, including the sharp decline in home prices. The second is a dramatic deterioration in credit conditions, including a sharp rise in credit risk spreads in the corporate bond and mortgage markets and a tightening in lending standards at banks. The third is the very weak state of the banking system, with large losses, pressure on balance sheets, and potentially a diminished flow of credit to households and businesses. The impact of these three weights has been amplified by the accompanying sharp decline in equity prices.

I like to say we know why the economy will recover, we just don't know when. The recovery story has two parts. The first is an overwhelming policy response, fiscal as well as monetary. The second is diminished drag from the three weights discussed above: stabilization and then a rebound in housing from an extraordinarily low level; gradually improving credit conditions; and some improvement in the health of the banking sector, reflected in an and improved flow of credit to households and businesses.

Even with the assumed fiscal stimulus and diminishing drags, we expect a tepid recovery in the second half of this year, but a rebound to above trend growth in 2010. The unemployment rate in this case is expected to peak at about 8½% at the end of this year and decline to about 7½% at the end of 2010.

The fiscal package we incorporate into the forecast assumes a cumulative stimulus of $775 billion by the end of next year, including increase in discretionary spending of about $250 billion through 2010, a cumulative increase in mandatory spending of about $200 billion, and a cut in tax revenue of more than $300 billion.

To incorporate the fiscal stimulus into our forecast, we had to assume spend out rates for the various spending provisions, determine whether households and businesses will perceive the tax cuts (and indeed spending increases) as temporary or respond as if they are permanent, and then let the model determine the expected effects on spending, employment and inflation.

We set the spending pay-out rates consistent with what we believed the transition team was aiming for. We will reassess this in our next forecast round, in light of CBO’s apparently lower assumed spend out rates for discretionary spending.

The effects on aggregate spending determined by the model are often described in terms of "multipliers", that is, the increase in real GDP per dollar of spending or revenue loss. Note however that, because almost all of the provisions in the fiscal stimulus package are temporary, it has a peak effect on the level of GDP, in 2010 in our forecast, and then the fiscal "stimulus" begins to slow growth relative to what it otherwise would have been for a period of time. I will be happy to elaborate on the multipliers for our model during the discussion that follows the opening statements, if the Committee wishes.

One important consideration in affecting the size of the multipliers is whether households and firms treat the tax cuts (and indeed spending increases) as transitory or permanent. We assume households respond to the increases in spending and to the cuts in personal taxes as if they were permanent, while businesses respond to the business tax cuts as if they were transitory. Given time, I would be happy to explain our treatment, but the decision here will have an important effect on the effectiveness of the stimulus package.

The effect of the fiscal stimulus, based on the assumed size, spend-out rates, and the model multipliers, is to raise the level of real GDP by about 3¼% by the end of 2010, to raise the growth rate over each of the next two years by about 1½ percentage points, to lower the unemployment rate by about 1¾ percentage points by the end of 2010, and to create 3.3 million jobs (that is, comparing the level of employment at the end of 2010 with what it would have been in the absence of fiscal stimulus).

The projected stronger growth both this year and next allows the unemployment rate to peak at about 8½% at the end of this year, and then to decline to about 7½% by the end of next year. While this is still well above estimates of the sustainable rate at full employment, the effect of the fiscal stimulus is still to speed the return toward full employment and protect against the possibility that the economy will slip into deflation as early as next year.