

### **What's in Worse Shape, the Economy or Fiscal Policy?**

The economy is in deep recession, but fiscal policy is in much worse shape. The factors are in place for the economy to rebound, even though the road to sustained expansion may be slow or bumpy. But fiscal policy has deteriorated dramatically: deficit spending and government debt are surging to unprecedented peacetime levels, and fiscal policymakers have lost any sense of fiscal responsibility and they are not coming to grips with challenges critical to long-run growth.

### **Achieving Sustainable Economic Expansion Will Require Patience**

The US economy has contracted significantly and no sector has been spared. Historically, sharp economic declines tend to be followed by rapid rebounds. The unprecedented monetary and fiscal stimulus would seem to support this view. Yet it's not likely. High household debt and a damaged financial industry, the ongoing jarring adjustment in housing and the global slump point toward a slow recovery.

The recession deepened in the second half of 2008, fueled by the failure of Lehman and the intensification of the financial crisis. Consumption fell sharply, as confidence swooned, wealth plunged as equity and real estate valuations eroded, and credit tightened. Housing activity continued its steep decline, as sharply falling home prices failed to stabilize demand. Businesses slashed production and payrolls, and investment spending fell over 20% annualized in 2008Q4 in response to falling demand, sharp declines in profits and higher costs of capital. Global economies plummeted in concert. Consequently, US exports, the strongest sector of the economy for several years, nosedived by 20%+ annualized.

In 2009Q1, amid soaring unemployment, consumer spending began to stabilize, supported by sharply lower energy prices and mortgage rates, large tax rebates and expectations of tax reductions. But businesses continued to slash production, employment and investment spending, while recession overseas deepened. International trade is falling at an accelerating rate, hurting export-oriented emerging nations, including China.

***There are several prerequisites for sustained US economic improvement. The monetary policy transmission channels must be unclogged; a loosening of credit availability is required for a return to normal business activity. And housing activity and prices must approach stability.*** Residential construction has been a large economic drag since 2006, while uncertainty about how far home prices will fall has undercut the valuations of mortgage backed securities and financial market stability.

So far, these prerequisites have not unfolded. Capital and balance sheet constraints in banks and the dysfunctional syndication markets have inhibited credit availability, and credit demand is falling with recession. While some credit markets have loosened, benefiting from the government's aggressive liquidity infusions, including the Federal Reserve's open market purchases of mortgages, GSE debt and more recently Treasuries, the credit channels remain impaired. Consequently, the ballooning of the Fed's monetary base and its efforts to flood markets with liquidity have increased excess bank reserves while the money multipliers fall. Money velocity is similarly declining, reflecting the spike in cautionary money demand.

Nor has the housing market shown signs of stabilizing. Significant declines in home prices and lower mortgage rates, at least for conforming mortgages, have yet to support demand. Housing inventories have inched down, but remain very high, and point toward further price declines.

Despite these obstacles, real GDP is expected to rise modestly in the second half of 2009. Speedy private sector adjustments—including dramatic declines in home prices, rapid adjustments in inventories and employment--remain incomplete, but will help support demand and achieve a trough. Fiscal and monetary policies have been extraordinarily aggressive, purposely in sharp contrast to policy mistakes and tentativeness of the US during the Great Depression and Japan in the 1990s. No doubt these government policies will generate lasting negative effects—stemming from the government’s soaring debt and its greatly expanded role in the economy, and the Fed’s unprecedented quantitative easing--but they will lift economic activity in the near term.

The Fed’s massive quantitative easing potentially is highly inflationary. But excess money is a necessary, not sufficient condition for higher short-run inflation. In the near term, inflation will stay low, reflecting declining aggregate demand. However, unless the Fed reverses its quantitative easing and drains the excess money, rising aggregate demand eventually will exceed productive capacity, and inflation will rise, potentially significantly. Well before that occurs, fears of higher inflation may drive up bond yields and/or depress the US dollar. ***Whether the Fed drains the excess money and hikes rates on a timely basis--or will be constrained from doing so by political pressures—is a critical issue.***

The fiscal package is designed poorly, but the surge in deficit spending financed by the Fed’s money creation will stimulate demand. Low and middle income households will benefit from tax reductions and the other subsidies provided by the American Recovery and Reinvestment Act of 2009 (ARRA). Fed purchases of mortgages have lowered mortgage rates. Energy prices have fallen sharply. Consumer spending should rise, even with higher rates of personal saving, while government purchases for infrastructure building will directly boost GDP. If consumption continues to stabilize in coming months, businesses cuts in production and employment will moderate.

Several factors likely will slow recovery. ***Like traditional fiscal stimulus packages, the ARRA aims to boost consumption, but households need to raise personal saving rates to replenish lost wealth and repay debt, which may contribute to several years of weak, below trend consumption.*** Also, business responses may be subdued if the pick up in demand is expected to be temporary or if other factors, such as higher taxes or regulatory burdens, discourage production, hiring or investment.

Secondly, whereas housing construction has lead prior recoveries, a typical rapid rebound in housing seems unlikely. Housing activity is expected to stabilize later 2009, following a jarring 4 year correction, but more cautious expectations of future home prices and tighter mortgage credit may constrain rebound. Thirdly, global economies are in recession, and international trade is falling. US exports will pick up only when global demand rebounds, which may lag the US recovery.

In contrast, a faster-than-expected rebound would trigger sharp increases in interest rates, with adverse economic consequences. A slow or bumpy recovery seems more probable than a smooth normal one. Accordingly, real GDP will not regain its prior expansion peak until late 2010 or early 2011.

### **Fiscal Policy: Populist Politics and Crisis Policies Overwhelm Fiscal Responsibility**

The deterioration in the US budget and broadening scope of fiscal policy has been stunning. The rush to provide short-term stimulus and income support, bail out financial institutions and the auto industry, and to implement President Obama’s broad-ranging economic agenda has overwhelmed any sense of fiscal responsibility. Amid recession and financial crisis, some initiatives have been focused effectively. But many have been politically-charged responses to financial crisis and recession, or not well thought-out. They have populist appeal, but are bad

policies that have adverse economic consequences. An early return to normalcy is not in the cards.

The ballooning federal spending, deficits and debt reflect the government's new priorities and larger role. Spending will soar to a peacetime record, estimated to exceed 28 percent of GDP in Fiscal Year 2009 and 25 percent in 2010, although some of this surge reflects TARP outlays that will be repaid. President Obama's FY2010 budget proposes that spending will grow rapidly and average over 23 percent of GDP and rise to 24.5 percent in 2019, well above its long-run average. Note that these spending totals do not include the budgets of Fannie Mae and Freddie Mac, even though these GSEs are under the Treasury's conservatorship and their activities and expected subsidies (and losses) to the housing sector rightly should be in the unified budget (The CBO concurs.) Tax receipts, after slumping to a recession low of 15.5 percent of GDP in 2009, are projected to rise toward 19 percent of GDP, only slightly above their long-run average.

The deficit for FY2009, including the AARA but excluding President Obama's spending and taxing proposals in the FY2010 budget, is estimated to exceed \$1.7 trillion. Including those proposals, the CBO estimates the deficit would rise to \$1.8 trillion, over 13 percent of GDP, more than double the record deficit of the mid-1980s, far higher than any year during the Depression and exceeded only by World War II budgets. Again, TARP repayments would lower these estimates modestly. Certainly, the extraordinary deficits in 2009-2010 reflect cyclical trends and the government's countercyclical stimulus, but the CBO estimates that they would remain about 2 percent of GDP in later years.

Strikingly, the CBO estimates that President Obama's new budget proposals would add \$4.8 trillion in deficit spending to the CBO's baseline projections, resulting in \$9.3 trillion in deficit spending in the 10-year projection period. **Deficits would remain between 4-6 percent of GDP toward the end of the projection period when the economy is operating at full potential; these structural deficits would be larger than the cyclical deficits during most prior recessions.** And even these projections are subject to risks—particularly higher inflation and interest rates—and do not include the costs of the GSEs.

Such deficit spending would double the government's publicly-held debt to 82 percent of GDP from 41 percent. It is truly ironic that the title of the President's *Budget of the United States Government: Fiscal Year 2010* is "A New Era of Responsibility: Renewing America's Promise."

How these fiscal policies will affect future standards of living depends critically on what is the deficit spending for, how will it be financed and with what economic and financial effects. **My overall assessment is the dramatic expansion of spending programs will add little to productive capacity, despite great political fanfare, while financing the enormous increase in debt will pose challenges. The net effect is lower long-run potential growth.**

The largest portion of the ARRA and the government's stimulus programs and bailouts in place does not add to productive capacity. Examples abound. Not surprisingly, the temporary refundable tax credits of 2008's fiscal stimulus program, designed to smooth consumption and demand over the cyclical downturn, did little to boost spending and effectively substituted government debt for higher saving and debt repayment by lower income households. Government subsidies to distressed homeowners and the bailouts of Fannie and Freddie eased the debt burdens of lower income homeowners and maintained the earlier surge in homeownership, despite their iffy mortgage credit quality and questionable sustainability. This increased allocation of national resources to housing may serve to delay the eventual necessary adjustment. The net costs of the TARP and other bailouts subsidized the deleveraging of financial institutions and the artificial propping up of the auto industry. The financial burdens will be shifted to future taxpayers.

The ARRA--nearly \$780 billion in increased deficit spending--may be appropriate in magnitude relative to the depth of recession, but the composition and design of its spending and tax

programs are poor. Heavily influenced by old-fashioned pork-barrel politics, it has too little up-front stimulus and too little infrastructure spending; its tax reductions are primarily in the form of targeted tax credits and exemptions rather than cuts in marginal rates; and it includes a lot of wasteful spending. Moreover, while some of the ARRA is temporary countercyclical deficit spending, a large portion involves permanent changes in programs and government benefits that will add to the structural budget deficit. It misses an important opportunity. Less than one-sixth of the spending is allocated to infrastructure building that may add to productive capacity, while most of the spending is for income security, income redistribution and random programs.

Similarly, the Obama 2010 budget proposals focus on a wide array of government programs and income redistribution rather than long-run growth. ***There are far too few resources allocated to infrastructure or the nation's capital base. These characteristics coupled with the burdens of financing the expanded government programs may constrain economic growth and dilute the intentions of the budget proposals.*** An extension of the refundable credits and targeted exemptions of ARRA and the portion of the Bush tax cuts that applied to middle and lower income households will be offset by higher marginal tax rates on higher income individuals. These big jumps in marginal rates for higher income taxpayers will also affect a high portion of small entrepreneurs who are Subchapter S corporations. Other tax provisions will push up effective rates on businesses and raise operating costs.

These budget proposals include provisions to enhance benefits for Medicare and Medicaid, but they do not take any significant steps toward reforming health care or Social Security. The costs of these delays rise dramatically as the post-war baby boom children retire.

The uncontrolled surge in government debt poses many challenges. The Fed now shares in the financing of the runaway deficit spending, and its balance sheet is bulging with credit-related assets. Has the era of "unpleasant monetarist arithmetic" arrived, with an undesired twist? Meanwhile, foreign demand for the Treasury's massive bond issuance may diminish, as formerly "excess saving nations" have less capital to export, and they express mounting concerns about the inflation and US dollar impacts of the Fed's monetization. The ballooning debt will push up the US current account deficit and heighten reliance on net foreign capital inflows. Realities require that eventually, the US must produce more and consume less. US fiscal policies are inconsistent with these necessary adjustments, and policymakers have not come to grips with these challenges.