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The Economy

The American economy remains in a highly uncertain state with very significant risks to the downside. Weak employment statistics, contracting credit, diminishing confidence, likely further declines in housing prices, and a slowing global economy all place negative pressures on the US economy. While strong exports, declining commodity prices, and yesterday's actions to shore up the housing finance system are welcome developments, the preponderant probability is that we are a year or so away from a resumption of strong economic growth.

Even after the downturn ends and growth resumes the economy will be producing output significantly short of its potential. Experience in the United States and abroad suggests that downturns associated with asset price collapses and financial sector problems such as the one we are now experiencing tend to be especially protracted. Moreover, unemployment typically continues to rise well past the business cycle troughs with peak levels of unemployment occurring as in the last cycle as much as two years after recessions end.

As a consequence, the balance of risks in the American economy is now towards contraction and a vicious cycle in which declining economic performance exacerbates financial strains which feed back to hurt the economy rather than towards overheating and rising inflation. While this has been my reading of the balance of risks consistently over the last year it has been reinforced by the declines in commodity prices, increases in the value of the dollar, and increases in unemployment over the last several months.

<u>Losses in output relative to potential are likely to cost the economy $300 billion a year or more than $4000 for the average family of four</u>. The economic downturn will also place pressure on the Federal budget, reduce productive investment in plant and equipment, and delay recovery in housing. Inevitably the burdens of economic slowdown are felt most acutely by minority groups and those struggling to rise on the economic ladder.

The Case for Fiscal Stimulus

There are a number of reasons why monetary policy is unlikely to provide stimulus going forwards: (i) It would be difficult to lower interest rates further without putting the US dollar and commodity markets at risk. (ii) In an environment where banks and other firms are constrained by lack of capital, it is not clear that lowering interest rates will have a substantial effect on lending and borrowing. (iii) There are long lags between monetary policy changes and changes in the performance of the economy. As the recent takeover of Fannie Mae and Freddie Mac illustrates, financial authorities will face important challenges simply maintaining adequate liquidity in financial markets in the coming months.

Given all that has happened in the housing and financial sector, many observers have been surprised that overall economic performance has not been worse. This is in significant part a result of the stimulus to the economy provided by legislation passed last winter. Without that stimulus which is wearing out now, our economic situation would likely be even worse.

If new policy action is going to support the economy by raising the demand for goods and services, it likely will have to come on the fiscal side. Indeed, in a situation of excess capacity and a situation where interest rates are likely to be relatively rigid because of financial strains, the multiplier from fiscal policy is in the short run likely to be larger than normal. There is a strong case for the prompt enactment of further timely, targeted and temporary fiscal stimulus…

Fiscal Responsibility

While there is a strong case for new fiscal stimulus measures which by definition increase the deficit in the short run, the long term Federal budget situation remains a matter of great concern. Excessive accumulation of Federal debt over the next decade threatens to reduce investment and slow growth, compromise financial stability, increase America's vulnerability and reduce its influence in the world. It is critical to recognize that large permanent increases in Federal deficits are likely to slow the economy by raising capital costs and by undermining confidence as investors recognize that ultimately they will have to pay higher taxes to service the interest or repay the principal on debt incurred. These concerns are exacerbated by our very low level of national saving, by the likely budget costs of supporting the financial sector and by the imminent beginning of the retirement of the baby boom generation.

Measures such as pre-committing now to large new unpaid tax cuts or spending programs that will only take effect several years from now are likely to have adverse effects on near term economic growth and exacerbate the current downturn. This is just the mirror image of the success the economy had in the mid 1990s following enactment of a credible medium term program of deficit reduction.

It follows that in enacting fiscal stimulus measures care should be taken not to raise projected deficits beyond a short horizon of a year or at most two. Beyond this horizon it is essential that any new spending or tax cutting be offset by measures that reduce projected deficits. Ideally, at least a portion of any new stimulus enacted over the next couple of years would be matched by actions with a longer horizon to reduce deficits so that over a five or ten year horizon the enacted program was budget neutral.

The Composition of Stimulus

In many ways the composition of a fiscal stimulus program is a decision that goes to value rather than economic judgments. It seems to me however that particularly strong arguments can be made for the following components:

Support for low income families and for those who have been laid off is much more likely to be spent rapidly than support diffused more widely throughout the economy. Possible vehicles here include food stamps and extensions of unemployment insurance.

There is a compelling case for significant new commitment to infrastructure spending. <u>While infrastructure spending is often seen as operating only with significant lags, I have become convinced that properly designed infrastructure support can make a timely difference for the economy</u>. Evidence from the Minneapolis bridge collapse suggests that it is possible to launch infrastructure programs where the vast majority of the money is spent within a year. Moreover, the combination of declining trust fund revenues, and dramatic (more than 70 percent) increases in some categories of construction costs mean that there are a large number of projects that are currently on hold, slowed down, or contracted and awaiting funding. <u>Properly designed infrastructure projects have the virtue of being helpful as short run stimulus, especially for the employment of the workers most hard hit by the housing decline, while at the same time augmenting the economy's productive potential in the long run.</u>

State and local governments are facing grave budget pressures resulting in forced cutbacks that in many cases compromise either very vulnerable populations, or necessary long term investments. While it is true that some state and local problems are consequences of imprudent tax cutting during the good times, there is a strong case that properly targeted assistance perhaps through temporary changes in Medicaid reimbursement rules could provide valuable stimulus to the economy while at the same time avoiding dangerous cutbacks.

Other areas that should receive consideration include compensating consumers in the most affected regions for the effects of higher energy prices through LIHEAP, beginning a process of making necessary investments in energy efficiency and renewable energy and where appropriate, responding to the adverse impacts of the ongoing financial turbulence.