The Economic Stimulus and Sustained Economic Growth

Martin Feldstein

Full Statement
for the
House Democratic Steering and Policy Committee

January 7, 2009

Thank you for the opportunity to speak with you about the current economic situation and the appropriate policy response. I look forward to your questions after my brief statement.

The current financial crisis and economic downturn are the worst that I have experienced. I believe this will be a longer and more damaging recession than any since the depression of the 1930s.

This downturn is very different from previous recessions. Past recessions occurred after the Federal Reserve raised the short-term interest rate in order to counter rising inflation. When it felt that it had succeeded, the Fed reversed direction and lowered rates. The lower rates then caused an economic recovery, primarily by stimulating housing construction.

The current recession was not caused by Federal Reserve tightening and the Fed has therefore not been able to revive the economy by lowering rates. Because of the dysfunctional credit markets and the collapse of housing demand, monetary policy has had no traction in its attempt to lift the economy.

Stopping the decline of the economy and returning to sustainable growth will require two different kinds of policies:

- a policy to fix the housing crisis that is the fundamental cause of the financial crisis so that normal flows of private lending will resume

- a fiscal stimulus of reduced taxes and increased government spending to bring back aggregate demand

Fixing the Financial System

The Federal Reserve has worked very hard since early in 2008. It reduced both short term interest rates and now longer rates. It has taken unprecedented actions in substituting for private financial markets by buying commercial paper, mortgages, credit card debt, and other private securities.

But this has not solved the problem of getting financial institutions to lend to each other and to potential nonfinancial borrowers.

The primary reason for this absence of normal credit flows is a lack of confidence caused by the uncertain value of mortgage backed securities in the portfolios of financial institutions.

These mortgage backed securities and the complex derivatives based on them are the key to the financial sector problems.

To understand why, recall two things that happened in the housing market earlier in this decade.

First was the rise and then the fall of house prices. House prices rose dramatically until the bubble in house prices broke in the middle of 2006. In the past 12 months, the national level of house prices fell 18 percent. Experts say that prices must fall another 10 to 15 percent to get back to the pre-bubble level. And there is nothing to stop prices from falling much further than that.

Second was the change in mortgage lending practices. Mortgage loans went from 70 or 80 percent of appraised value at origination to 90% or even 100%. Refinancing and home equity loans raised the loan to value ratio of existing mortgages. When house prices fell, many loan to value ratios rose above 100 percent.

- Now 25% of all mortgages exceed the value of the home. The total value of these negative equity mortgages exceeds $2.5 trillion.

- A homeowner with negative equity has an incentive to default and walk away from the property because mortgages loans are generally non-recourse loans. That is, if a homeowner defaults, the creditor can take the property but generally cannot take other assets or attach wage income in order to recover the unpaid balance of the mortgage. Even in those jurisdictions where recourse is legally possible, it is generally so difficult that creditors do not try.

- This “no recourse” character of mortgages is unique to the United States. In every other country, mortgages are loans with full recourse. As a result, even when prices fall sharply, homeowners do not default.

- But now home mortgage defaults in the United States are up dramatically. These defaults lead to foreclosures, putting more houses on the market and depressing house prices.

- The result is a potential downward spiral of house prices that could fall much further than the 10 or 15 % needed to get back to the prebubble level.

These conditions in the housing market weaken financial institutions and make them unwilling to lend to each other and to nonfinancial companies.

Sustained long-term growth requires healthy financial institutions and renewed lending. To achieve that requires ending the risk to financial institutions of a downward spiral of house prices driven by defaults that leads to declines in the value of mortgage backed securities and the derivatives based on them.

There have been a number of proposals to help individual homeowners who are at risk of defaulting and losing their homes because they cannot afford their monthly payments. These proposals focus on lowering monthly payments to levels that individuals can afford. But they do not deal with the incentive to default that results from high loan to value ratios, i.e., from negative equity.

That's why something like one-third of homeowners who have had their mortgages restructured to make them affordable nevertheless default within a few months. In contrast, someone with positive equity is his home has no incentive to default since he can always sell the home if he cannot afford the monthly payments.

The new administration and the Congress will develop policies to help individuals who for a variety of reasons are having difficulty making their monthly mortgage payments. But this case-by-case welfare policy approach is not enough. It does not deal with the systemic effect on financial institutions of housing defaults and the risk of a downward spiral in house prices.

The key policy challenge is to allow the decline in house prices back to the pre-bubble level to occur without triggering defaults and an overshooting of house prices.

To do that requires removing the incentive to default that results from high loan to value ratios. This is a difficult problem. I have made a specific proposal based on Mortgage Replacement Loans that I believe would be a useful starting point for designing legislation to deal with this problem.

My proposal has two parts. The first part is for homeowners who now have positive equity in their homes (i.e., a loan to value ratio of less than one). The second part is for homeowners with negative equity.

The first part is designed to create a "firewall" so that homeowners who now have positive equity are not pushed into negative equity as house prices continue to fall. The federal government would offer such homeowners a Mortgage Replacement Loan with a very low fixed interest rate – perhaps 2 %.

That loan would be for 20% of the amount of the existing mortgage, with a dollar cap of $80,000. This mortgage replacement loan would be paid directly to the mortgage creditor who would be required to reduce the loan principal and the monthly payments by 20 percent. The loan from the government would be completely separate from the house and would be a full recourse loan that the government could collect just as it does a tax lien.

This mortgage replacement loan would create a firewall so that a fall of house prices would not push the homeowner into negative equity. Consider for example someone who now has a mortgage equal to 90 percent of the value of the home. If house prices fall another 15 %, that individual would have negative equity. But the 20% mortgage replacement loan would reduce the mortgage from 90% of the house value to just 72%. It would take a very unlikely 28% fall in house prices to push that individual into negative equity.

This firewall removes 75 percent of all outstanding mortgages from the risk of being pushed into negative equity by the decline in house prices back to pre-bubble levels. And it does so at no cost to the taxpayers since the very low interest rate charged to the homeowner would equal or exceed the government's borrowing rate. Any administrative cost or other expenses could be borne by the creditors in exchange for the improved security of the mortgage loans.

The problem is more difficult for the 12 million homeowners with negative equity. A low interest rate would not be enough to induce them to accept recourse on a substantial part of their loan. The government must first induce the creditors to reduce the value the mortgage to the current appraised value of the home. This will require the government to pay down part of the loan and the creditor to make the additional reduction. In exchange for this reduction of principal, the homeowner would be required to accept a full-recourse mortgage replacement loan equal to 20% of the new loan value. This full recourse loan would make the mortgage a much more secure obligation.

I have estimated that the one-time cost to the government of achieving these mortgage paydowns would be about $150 billion, an amount that could in principle be paid with the remaining TARP unds.

The combination would mean homeowners would stay in their houses and the financial sector would no longer have to worry about the defaults caused by negative equity mortgages and a downward spiral of house prices.

The Need for Fiscal Stimulus

But while fixing the credit markets is necessary for sustained economic growth, it will not bring the economy back to full employment. The continuing economic decline reflects both the collapse of credit markets and also the decline of household wealth. The fall of the stock market and the decline of home prices have together reduced household wealth by some $10 trillion. Experience with previous wealth movements implies that this massive wealth decline will cause annual consumer spending to fall by about $400 billion.

The challenge for policy is to fill this gp. Because monetary policy is not effective, reviving the economy required a major fiscal stimulus from tax cuts and increased government spending.

It pains me to say that because I am a fiscal conservative who dislikes budget deficits and increases in government spending. Budget deficits and the resulting increase in the national debt impose burdens on future generations who will, as a result, face higher tax rates that will then weaken the future performance of the economy.

But while accepting that a fiscal stimulus is necessary in the current circumstances, it is important to design the tax cuts and the spending changes in the most cost-effective way.

Tax Cuts

Earlier this year, the Congress passed a one-time tax

rebate of $80 billion and the money was in the hands of taxpayers by May and June. Unfortunately, consumer spending responded only very weakly. I presented evidence in the Wall

Street Journal (August 6, 2008) that consumer spending in the second quarter rose by only $12 billion or about 15 cents for every dollar of tax cut. The rest was saved or used to pay down debt.

Other past attempts to use fiscal policy for stabilization have also not worked well because of crowding out and because of long lags between legislation and the flow of funds. Some of these past problems in using fiscal policy to stimulate demand may be less of an impediment in the current circumstances. Government borrowing to finance fiscal deficits will not be offset by higher interest rates since the current environment is characterized by very easy money and a dysfunctional credit market. The delays in starting infrastructure projects and the long tail in that spending are not likely to be as much of a problem now because the current downturn is likely to last much longer than previous ones. In the past, the average recession lasted only 12 months from peak to trough. This recession has already lasted 12 months and probably will last a good deal longer. I believe we will be lucky if we see the recession end in 2009. Once the recovery begins, the upturn will be very slow because households need to increase their saving – i.e., to consume less -- to rebuild their wealth for retirement and other purposes. So fiscal policy is likely to be useful even if it is not strongly effective in 2009. It is not likely to overheat the economy if it continues to add significantly to demand in 2010 and 2011.

Although a one-time tax cut may not be effective, other forms of tax cutting can increase aggregate demand. During his campaign, President-elect Obama promised a permanent tax cut of $500 per employed person. That would generate an annual tax cut of about $70 billion and would probably raise annual consumer spending by about $50 billion.

Experience confirms that some form of investment tax credit or bonus depreciation could stimulate business investment, especially if it is not recaptured later. A larger R&D tax credit could help to offset the currently predicted decline in private R&D spending. And lowering the corporate tax rate to that of other industrial countries would encourage more business investment and job creation in the United States.

The president elect announced that he would postpone increasing the tax rate on high-income individuals until 2011. But taxpayers, especially higher income ones, look ahead. The future tax rise reduces the present value of their lifetime income and that can be expected to reduce current spending. A statement now by the president-elect that he will postpone those tax increases for five years or more indefinitely would raise aggregate spending now.

Finally, the taxes on dividends and capital gains are also scheduled to rise in the near future. A promise to leave those tax rates unchanged would raise share prices, offsetting some of the fall in the stock market, which would lead to more consumer spending and increased business investment.

<u>A Temporary Surge in Government Spending</u>

But while good tax policy can contribute to ending the recession, much of the heavy lifting will have to be done by increased government spending. To be effective, that spending should be big, quick, and targeted at increasing aggregate activity and employment. How big depends on the form of the spending and the timing. But with low multipliers and some relatively long spending tails, combined tax cuts and increased of $300 billion to $400 billion seem like a reasonable target for 2009 and 2010.

The speed of the outlays is an important consideration. A project that begins in 2009 but continues to spend at a high level in 2011 and 2012 is not likely to be as useful as a countercyclical instrument as one that spends quickly and is then finished.

Bottlenecks are also a potential problem that could reduce the effectiveness of a spending program. While there is no doubt a need to rebuild bridges and other infrastructure, there are limited numbers of design engineers and other bridge builders.

The plan to raise spending by some $200 billion a year, an amount equal to about 40 percent of nondefense discretionary spending, runs the serous danger of wasteful spending. To the extent that it is possible, the choice of outlays should be governed by the following four principles:

- First, they should raise demand for output and employment quickly in 2009 and 2010 with only a short tail into later years.

- Second, there should be an exit strategy. The spending should not create a political dynamic that makes it hard to stop

- Third, the spending should produce benefits beyond just creating jobs or should produce things that would otherwise have to be produced in a later year.

- And fourth, the spending should create favorable incentives and avoid unfavorable incentives effects.

As you know, President-elect Obama has identified five priority areas for increased spending: health, energy, education, infrastructure, and support for the poor. Although these important areas can benefit from increased spending, there are other parts of the budget that could also be useful as

Since the defense budget is as large as all of the other discretionary spending combined, it is surprising that defense is not proposed as a part of the overall stimulus package. It is surprising also to read in the press that there will be reductions in military spending because, according to those stories, of the weakness of the economy. That logic is exactly backwards. The overall weakness of demand in the economy implies that the next two years are a time when military spending and other forms of spending should rise.

The actions of the military in Iraq and Afghanistan have depleted supplies and increased the wear and tear on equipment. Both supplies and equipment will eventually need to be replaced. Now is the right time to do that.

Military recruiting and training could be expanded in response to the larger than usual numbers of unemployed young men and women. Raising the military's annual recruitment goal by 15 percent would provide jobs for an additional 30,000 young men and women in the first year. It would also be possible to depart from the military's traditional enlistment rules and bring in recruits for a short two-year period of training followed by a return to the civilian economy. As a minimum, this would provide education in a variety of technical skills – electronics, equipment maintenance, computer programming, nuclear facility operations, etc – that would lead to better civilian careers for this group. It would also provide a larger reserve force that could be called upon if needed by the military in the future.

A 10 percent increase in defense outlays for procurement and for research would contribute about $20 billion a year to the overall stimulus budget. A 5 percent rise in spending on operations and maintenance would add an additional $10 billion. That spending could create about 300,000 additional jobs.

The intelligence community and the FBI are also apparently facing potential budget cuts at a time of increasing terrorism and greater crime rates. A temporary increase in funding for these agencies could fill important gaps in training and facilities.

Another important omission in the current stimulus plan is funding for research. Government spending for research is projected to fall in 2009 even though additional research grants from the NIH and NSF could allow universities and hospitals to expand a wide range of useful research activities that are now unfunded because of limited grant budgets.

There are of course other important areas of government spending in which outlays can be raised rapidly on useful activities that would also raise incomes and employment. In each area, government budgeting must go beyond business as usual if it is to respond appropriately to the opportunity for a short-term spending surge.

###