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THE IMPACT OF THE RECOVERY ACT ON ECONOMIC GROWTH

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

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THE IMPACT OF THE RECOVERY ACT ON ECONOMIC GROWTH

THURSDAY, OCTOBER 29, 2009

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to call, at 10:02 a.m., in Room 2237, Rayburn House Office Building, The Honorable Carolyn B. Maloney (Chair) presiding.

Representatives present: Maloney, Hinchey, Cummings, Brady, and Burgess.

Senators present: Brownback.

Staff present: Paul Chen, Gail Cohen, Nan Gibson, Colleen Healy, Lydia Mashburn, Jeff Schlagenhauf, Ted Boll, and Robert O'Quinn.

OPENING STATEMENT OF THE HONORABLE CAROLYN B. MALONEY, CHAIR, A U.S. REPRESENTATIVE FROM NEW YORK

Chair Maloney. The meeting will come to order.

First, I would like to welcome all of the panelists today and note we have a special delegation visiting with us from China. They are professors and economic leaders in their country, and they are part of a State Department leadership program on economics. So I am delighted that they are joining us here today.

Today's report from the Bureau of Economic Analysis on third quarter gross domestic product provides welcome evidence that the economy is moving from recession to recovery. When the President took office in January, our economy was on the brink of an economic disaster, and we were shedding 700,000 jobs a month. There was no end in sight to the recession that started in December 2007. The idea that the economy would achieve positive growth so soon would have surprised many.

Today, it is clear that the economy is moving in the right direction. GDP rose by 3.5 percent in the third quarter, after having fallen for an unprecedented four straight quarters. This is concrete evidence of the wisdom of the Recovery Act and the positive effect it has had on the economy in just 8 short months.

Last week, Dr. Christina Romer, the President's Chair of the Council of Economic Advisers, presented us with compelling evidence that the economy is rebounding largely because of the Recovery Act. She testified that the Recovery Act added between 3 and 4 percentage points to economic growth in the third quarter, far beyond what the opponents of the Recovery Act thought possible.

Another piece of welcome news is that personal consumption grew by 3.4 percent in the third quarter, largely due to actions taken by Congress and the Administration. We are finally seeing signs that consumers are spending more, which could spur businesses to hire more workers to meet renewed demand for their goods and services.

I expect that legislation that I worked tirelessly on to end the most abusive practices of the credit card companies, the Credit Card Holders' Bill of Rights, which Congress passed on an overwhelming bipartisan basis, will help increase consumers' demand for credit and encourage creditworthy borrowers to spend.

The Financial Services Committee recently passed a bill I also introduced to speed up the implementation date so that these measures would go into effect on December 1st.

Despite significant legislative accomplishments that brought us from economic downfall, I believe we still have a long way to go before the economy fully recovers. The most pressing economic issue for the nation is job creation. The stimulus has helped Americans in need weather the storm, but we must do more to get people back to work. I look forward to the ideas that our distinguished witnesses have about translating our economic growth into job growth and their suggestions about any additional measures Congress can take to spur businesses to create more jobs.

One group that I am particularly concerned about is the long-term unemployed. The longer someone stays unemployed, the harder it is for them to find work.

The long-term unemployed are stuck between a rock and a hard place. First, they are suffering now, which is why the House has already passed legislation expanding unemployment insurance; and I am optimistic that it will soon pass in the Senate. Second, the long-term jobless, those who have been unemployed for 6 months or more, may suffer in the future. Even when the economy recovers, workers who have been unemployed for a long time may no longer have the skills necessary to be competitive in the workforce. We must come up with creative ways of helping the long-term unemployed maintain their skills or develop new skills so that once we get back on track and start creating jobs they will not be left behind.

I thank our distinguished panel of witnesses for their testimony; and I look forward to hearing their thoughts on the most important issues we face, sustaining our economic progress and creating jobs for the American people.

[The prepared statement of Representative Maloney appears in the Submissions for the Record on page 52.]

Chair Maloney. I now recognize Mr. Brady for 5 minutes.

OPENING STATEMENT OF THE HONORABLE KEVIN BRADY, A U.S. REPRESENTATIVE FROM TEXAS

Representative Brady. Thank you, Madam Chairwoman. I am pleased to join you in welcoming Dr. Landefeld and other witnesses before the committee this morning.

In its preliminary report released today, the Bureau of Economic Analysis estimates America's real gross domestic product grew at an annualized rate of 3.5 percent during the third quarter of this

year. This is good economic news after three quarters of contraction and is directly attributable to the unprecedented $1.3 trillion injection of liquidity by the Federal Reserve Board into the U.S. economy. And it should be noted that most of the growth this quarter is attributable to one-time events, the Cash for Clunkers program and the end of inventory liquidation.

While some may promote the stimulus as the savior of the economy, it is a claim only the Balloon Boy's dad would make. Since the American Recovery and Reinvestment Act was signed into law, 2.7 million payroll jobs have been lost, the unemployment rate is far above White House promises, and 49 of 50 States have fewer jobs.

The size of the much-touted stimulus is minor when compared to the massive injection by the Fed. And last week's honest admission by the Chairwoman of the President's Council of Economic Advisers that the stimulus will likely be contributing little to further economic growth by mid-2010 only confirms the critics were right. The stimulus is too slow, too wasteful, and too unfocused on jobs.

Even with today's positive news, this is no time to be conducting an end zone dance. Some economists may say the recession is over, but most American families disagree. A jobless recovery is no recovery. In fact, we may well be facing a "job loss" recovery, as UCLA economist Lee Ohanian recently warned.

To keep it in perspective, we all hope today's report signals that the economy has hit bottom, but there is a real possibility we could bounce along the bottom for some time. Looking forward, a sustainable recovery will only occur if the private sector, not the government, is the driver of economic growth.

Unfortunately, each day we hear reports of more and more American businesses who are delaying key investment decisions—and the jobs that go with it—due to uncertainty over Washington's actions on health care, cap-and-trade, burdensome new regulations, and proposed higher taxes on income, energy, and investment. Concerns are rife over the growing debt and the excessive influence of labor unions on the decisions and policies of this White House and Congress.

Amid this impulsive, government-centric environment, many CEOs and small business owners will hesitate to risk major sums of precious capital on projects whose returns could be limited or nullified altogether by the unpredictable political winds blowing through Washington on any given day. It is tough enough to predict the marketplace. Predicting the marketplace in Washington is overwhelming.

If we want a sustained economic recovery, it is time to let the market work. In addition to restoring the primacy to the free market here at home, a sizable and proven opportunity for economic recovery lies in selling American goods and services abroad. I would encourage the Obama Administration and Congress to stop ignoring the one-fifth of the American workforce whose jobs are tied directly to trade. Instead, I urge Democrats and Republicans alike to become strong advocates for opening new markets abroad and giving American companies and workers a chance to compete and win on a level playing field throughout the world. A good start is with

the potential new customers in Colombia, Panama, and South Korea.

America is falling behind in the international marketplace. It is costing us sales, and it is costing us jobs.

As I conclude, let me tell Dr. Landefeld I appreciate the Bureau's efforts to produce accurate, reliable, and timely economic data that are more reflective of today's economy. In many respects, our statistical measures were developed for an earlier industrial economy, but private service-producing industries account today for more than 68 percent of our GDP. I am encouraged by your efforts so far to improve the measurements of research and development spending and integrate the R&D satellite account in the calculation of GDP by 2013. I am interested in your efforts to improve the measurement of other types of intangible expenditures, such as the development of new business models, the creation of artistic or literary originals, and the design of new products and services. Investments in these nontechnical innovations can also generate enormous income and wealth.

Turning to international statistics, I would also like to hear what your Bureau, the Census Bureau, and the Bureau of Labor Statistics are doing to improve the measurement of trade and services.

Dr. Landefeld, I look forward to hearing your testimony.

Chair Maloney. The Chair recognizes the ranking minority member, Senator Brownback.

OPENING STATEMENT OF THE HONORABLE SAM BROWNBACK, RANKING MINORITY, A U.S. SENATOR FROM KANSAS

Senator Brownback. Thanks, Chairman Maloney. I appreciate that. And sorry for coming in late.

I want to associate myself with Congressman's Brady's comments. I think he does a good job of analyzing and putting forward the information. Looking forward to the presentation, Doctor, and also the panel afterwards, to hear that.

Before I go on—and I guess she is not in the room—but Nan Gibson, I understand, is heading over to the Council of Economic Advisers; and I want to recognize her for years of contribution. That is quite a move for her, and it is going to be a loss for the committee overall. She does a great job.

Madam Chairman, I think we need to look at the specifics of what has taken place, and hopefully with the next panel we can. Because the world community is yelling at us about our fiscal policies, saying that, yes, we need to do some of these things monetary-wise, although I think it is time we start looking at raising of interest rates, as the Australians have done and several other countries are looking at as a way of stabilizing our currency. I think what the Fed has done has been good overall, but it is time to start sending some signals in the marketplace to support the dollar, and it will be interesting to hear people coming up on that.

Also, I am delighted to see the positive economic growth after having so many quarters of negative growth. But when you parse it, a good portion of this is auto sales. And I was supportive of the Cash for Clunkers program because I thought this is an economic stimulus, not a government stimulus, which is what I thought we needed. It was also $3 billion instead of the $780 billion that was

in it. And it seems to me we ought to look at ways to pull back on the things that stimulate the government and support the things that stimulate the economy as we move forward to get our fiscal policy under control and to stimulate the thing we want rather than the thing we can't afford. And I would hope we could talk some as we move forward on this, how we can get our spending down and get our economic activity up, which is what we have got to do at the end of the day.

I am delighted to be here, look forward to some of the interaction and the testimony. Thank you, Madam Chairman.

[The prepared statement of Senator Brownback appears in the Submissions for the Record on page 52.]

Chair Maloney. Thank you, and the Chair recognizes Mr. Hinchey for 5 minutes.

OPENING STATEMENT OF THE HONORABLE MAURICE D. HINCHEY, A U.S. REPRESENTATIVE FROM NEW YORK

Representative Hinchey. Well, just briefly, Madam Chairman, thank you very much.

Dr. Landefeld, I look very much forward to hearing what you are going to tell us. Because what you are going to say is, of course, very important in describing the kind of circumstances that we have to deal with. And we know that this economic condition that we are dealing with is one of the most severe in the history of this country. It is just secondary, and secondary only because of the actions that have been taken to the collapse of 1929. It is very close to being a deep recession. So what is being done is very, very important.

No question about it that the Economic Investment and Recovery Act is entirely significant in what has been taking place. The economic conditions that we are experiencing would be far worse if it had not been for that so-called stimulus bill and the money that is being put out into this economy, addressing the needs which have not been addressed adequately for decades. And even though a fraction of that stimulus bill has only been out there, roughly 25 percent, maybe it is up to 30 percent now, the movement of that bill forward is going to continue to have significant positive effects.

Some of us believe that that stimulus bill is only about half the size that it ought to be. There ought to be a lot more stimulation going on in the context of this economy to deal with the internal needs. And the main focus of attention has to be the production of jobs, because it is the working people of this country that determine the quality of the economy. The gross domestic product is based upon, to a large extent, the activities of working Americans, blue and white collar working Americans. So we are going to continue to do everything that we can to stimulate this economic circumstance, get it back to normal, and do so in the context of creating as many jobs as possible.

And in the context of that also, the efforts that are being put forward now to stimulate new technology growth, particularly technology growth that is going to drive this country toward energy independence. All of these things are critically important, and this government has to be very carefully focused on the responsibilities

that it has to upgrade the quality of this economy and primarily upgrade the quality of the working Americans.

So I thank you very much, Dr. Landefeld, for coming here; and we very much anticipate what you are going to say.

Thank you, Madam Chairman.

Chair Maloney. Thank you very much.

I would like to introduce Dr. Landefeld. He is the Director of the Bureau of Economic Analysis. And prior to becoming Director in 1995, he served in a number of other capacities at BEA, including Deputy Director and the Associate Director for International Economics. While at BEA, Dr. Landefeld has led a number of pioneering statistical and management initiatives that have been recognized nationally and internationally.

Prior to his arrival at BEA, Dr. Landefeld served as Chief of Staff for the President's Council of Economic Advisers. He has authored numerous professional articles and has received many national and international awards for his work, including the President's Distinguished Executive Award. He holds a Ph.D. in economics from the University of Maryland.

Welcome, and we look forward to your testimony. Thank you.

STATEMENT OF J. STEVEN LANDEFELD, DIRECTOR OF THE BUREAU OF ECONOMIC ANALYSIS, U.S. DEPARTMENT OF COMMERCE, WASHINGTON, DC

Dr. Landefeld. Thank you, Madam Chair, Mr. Brownback, Mr. Brady, and Mr. Hinchey. Thank you for inviting me to describe the third quarter gross domestic product and related statistics that the Bureau of Economic Analysis released this morning.

These advance statistics are, as always, based upon preliminary source data that will be revised as more complete and accurate data become available. Tracking an economy that is changing as rapidly as the U.S. economy is changing right now is a challenging task, but we are committed to producing advance estimates that provide an accurate general picture of economic activity. That picture will become clearer as more comprehensive source data become available in the months to come. These early snapshots are designed to provide public and private decision makers with a reliable early read on the evolving U.S. economy.

Let me walk you through the details of today's release, and then I will be happy to answer any questions that you may have.

The advance estimates that we released this morning show that in the third quarter of 2009, real GDP increased 3.5 percent at an annual rate. In the second quarter, the rate of decline in real GDP moderated, decreasing 0.7 percent, following a sharp 6.4 percent decrease in the first quarter of this year. Real GDP has declined five out of the six quarters from the fourth quarter of 2007, which NBER has determined was the start of this recession, to the second quarter of 2009.

As you know, GDP is comprised of many different components. I want to discuss the highlights of changes in these components.

In the third quarter, consumer spending, inventory investment by business, residential investment, exports, and government spending all rose. These increases were partly offset by a rise in imports.

The price index for gross domestic purchases, which is the broadest measure of inflation confronted by consumers, businesses, and government, increased 1.6 percent, following an increase of 0.5 percent in the second. After falling for the first two quarters of this year, energy prices rose sharply in the third quarter. Excluding food and energy prices, inflation actually slowed.

Motor vehicles, which show up in all the components of GDP, from consumer spending to inventories, exports, and imports, raised real GDP in the third quarter by 1.7 percentage points. Excluding the effects of motor vehicles, real GDP increased 1.9 percent in the third quarter.

Consumer spending, which accounts for over two-thirds of GDP, increased 3.4 percent in the third quarter, following a decrease of 1 percent in the second. Motor vehicle purchases, spurred by the Cash for Clunkers rebates in July and August, accounted for a large share of this increase in the quarter, although real spending on other durable goods, nondurable goods, and services also rose.

Residential construction rose in the third quarter for the first increase in 15 quarters, prior to which it had subtracted almost a full percentage point from GDP growth over that period.

Business nonresidential fixed investments—investments in new plants, offices, equipment, and software, that is—fell in the third quarter but at a slower pace than in the second. Business spending on durable equipment and software rose in the third quarter. And the rate of decline in investment in nonresidential structures also slowed in the third quarter.

Business inventory investment provided a positive contribution to the change in real GDP, as businesses drew down their inventories at a slower rate than they had in the second and first quarters. Therefore, more sales were of goods and services produced in the third quarter than out of inventories.

Real exports of goods and services increased 15 percent in the quarter. This is the first increase in real exports in five quarters. Real imports of goods and services registered an even larger increase than exports, rising 16 percent in the quarter. The rise in imports partly reflects the strengthening of GDP, but spending on imports is subtracted in the computation of GDP because they do not represent U.S. production.

Turning to spending on goods and services by the Federal Government, it increased 8 percent in the third quarter, slowing from an increase of 11 percent in the second. The slowdown in the rate of Federal spending was accounted for by defense spending. Spending by State and local governments fell 1 percent in the third quarter, in contrast to an increase of 4 percent in the second.

Turning to the American household, real disposable personal income, that is personal income less personal taxes adjusted for inflation, was boosted in the second quarter by provisions of the American Recovery and Reinvestment Act of 2009. Coming off the tax reductions and government benefits included in the Recovery Act, real disposable personal income declined in the third quarter after increasing in the second. The third quarter personal savings rate was 3.3 percent, compared to 4.9 percent in the second.

Since the second panel at this morning's hearings will address the effects of the Recovery Act, let me conclude by describing how

it is reflected in GDP and the national accounts. BEA's national accounts include the effects of Federal outlays and tax cuts included in the Recovery Act, but because most of the outlays are in the form of tax reductions, grants to State and local governments, and one-time payments for retirees, their effects in GDP show up indirectly through their effects on consumer spending, on State and local government spending, and residential investment. Thus, BEA's accounts do not directly identify the portion of GDP expenditures that is funded by the Recovery Act. That is what the second panel is going to provide you with.

I would now be glad to answer any questions that you may have.

[The prepared statement of J. Steven Landefeld appears in the Submissions for the Record on page 53.]

Chair Maloney. Thank you very much for your testimony.

Can you measure the direct impact of the Recovery Act on the third quarter of GDP? Can you measure how it contributed to the 3.5 percent?

Dr. Landefeld. Well, unfortunately, our job as the producers of the national accounts is to produce estimates of what did happen. And because most of what was in the Recovery Act was in the form of things like one-time payments to Social Security retirees, reductions in taxes, outlays to State and local governments, certainly, for example, some of those State and local governments had less sharp cuts than they otherwise would have, but to know what the impact of that was requires some kind of economic model which the second panel can tell you about in terms of what the effect would be. So, to sum up, our job is to tell you what happened, and the economist's job is to tell you why it happened.

Chair Maloney. Well, would you be able to point out how much of the increase in the GDP, when you are telling us what happened, how much of it is due to increases in consumer spending or government spending? Is there any way you can track that?

Dr. Landefeld. Yes. Certainly we are able to tell you, for example, that consumer spending rose at a rate of 3.5 percent and that the largest single component of that was the Cash for Clunkers program, or I should say the increase in auto sales which were spurred by the July and August Cash for Clunkers program.

Those are the kinds of things that we can tell you about in terms of the effect on GDP. What the other factors were and how much was precisely due to those transfer payments or tax reductions is difficult to tell without sort of the counterfactual as to what would have happened to, say, spending on motor vehicles during the quarter without the Cash for Clunkers program.

Chair Maloney. You noted that for the first time the residential building and investment is increasing. Do you think that that was the home buyer tax credit? Can you tie why that is happening?

Dr. Landefeld. Well, certainly you would look to that as one of the factors. Because we had residential investment which had subtracted half a percentage point from growth in the second quarter, added half a percentage point to growth in the third quarter; and that is, as I said in my testimony, the first time we have seen that happen in 15 quarters. So presumably those lower interest rates and other factors are at work there.

Chair Maloney. And what components of GDP contributed the most to growth this quarter?

Dr. Landefeld. Well, the biggest increase was in the personal consumption expenditures, which added 2.4 percentage points to growth of that 3.5 percent growth rate in real GDP.

Other important components included the inventory investment, slowdown in inventory investment, which added about a point to real GDP growth. Exports rose, adding 1.5 percentage points to real GDP growth. And government added about a half a percentage point to growth.

And, finally, I would note, as I said in my testimony, that imports rose, which is generally considered a sign of a healthy U.S. economy. But they are a subtraction, so they subtracted 2 percentage points from real GDP growth.

Chair Maloney. Are changes in U.S. net exports consistent with growth in Latin America and Asia?

Dr. Landefeld. It is hard to tell in any particular period what is driving it. Certainly the factors include the dollar, the growth in other countries, the growth rate in particular domestic demand. That is, the financial needs of foreign nations factor into those movements. So it is hard to tell.

Generally, you tend to find during downturns in the economy the trade deficit tends to improve; and, as we are coming out, we are seeing a little bit of a change in that. But pinning it down to Latin America would require I think looking at the changes in exports and imports from and to Latin America, which is possible. We would be glad to provide you with that answer if you would like that.

Chair Maloney. And you said that net imports subtracted from GDP this quarter. Can you tell us if this is due to the increase in oil prices or did consumers just consume more?

Dr. Landefeld. Well, that particular figure I cited, which is a plus 2 percent for—I am sorry, minus 2 percent for imports, plus 1.5 percentage points for exports, is in real, that is, inflation-adjusted terms. So we have taken out of that the increase in oil prices in terms of its effect on the quantity of oil or barrels of oil. As I said, that is not a factor in that number except to the extent to which there was a reaction in terms of domestic demand to consume less as a result of higher prices in the quarter.

Chair Maloney. And you testified that net exports contributed to growth this quarter by 1.5 percentage. And what goods or services contributed the most to this growth?

Dr. Landefeld. I don't have a decomposition of that handy. Let me see if I can get that for you. I am sorry.

Chair Maloney. Thank you. If you could get that later.

Senator Brownback.

Senator Brownback. Thanks, Madam Chairman.

I wanted to go at this same export area, but I guess you don't know what areas of exports grew for us?

Dr. Landefeld. Hold on. Thank you.

Senator Brownback. Because that is an impressive increase, the 14.7 percent on exports.

Dr. Landefeld. I can tell you in terms—actually, I have gotten some numbers here.

First of all, the increase was pretty widespread in terms of exports. In terms of the largest increases, industrial supplies and materials were first, contributing 5 points to the—5 percentage points to the overall—well, that is the biggest. Let me put it—it is a little complicated to explain it in terms of the way the table runs. But industrial supplies and materials were first. Automobile vehicles, engines, and parts were second in leading the increase. But virtually all of the categories showed increases in the quarter.

Senator Brownback. Now, is that—would that be reflective of a decline in the dollar?

Dr. Landefeld. Having once been head of our international group, it is very tricky to try to pin quarterly changes in exports and imports to the dollar. It tends to be more of a phased type of effect. But certainly that would be one factor one would expect to be boosting U.S. exports.

Senator Brownback. The rising imports you cited could be oil. But is that also Cash for Clunkers because of the stimulation of the auto market and a lot of those were imports?

Dr. Landefeld. Part of that could be, because the automotive vehicles, engines, and parts was the largest single category in the rise in imports, followed by industrial supplies and material, which exclude petroleum. And, actually, the amount in real terms that petroleum contributed was relatively small to the increase. But, you know, you have a question of how much came in that quarter that was sold versus went into inventories that quarter. So, once again, based on our data, it would be difficult to tell stimulation associated with Cash for Clunkers. But that is the largest category.

Senator Brownback. And the Cash for Clunkers, you are saying without that, growth for the quarter is 1.9 percent.

Dr. Landefeld. Right.

Senator Brownback. So that one is a big impact in that quarter.

Dr. Landefeld. Yes, it is very big, 1.7 percentage points of the rise.

Senator Brownback. And you were saying it is hard then to determine in anything else there of the stimulus program or other items their impact on the overall quarter. But that one you cite to as a policy.

Dr. Landefeld. We cite that as one of the factors. We don't attribute the full increase to that. We cite it as a factor that helped spur sales, but we don't cross that line, if you will, to say that was the source.

Senator Brownback. It looks like you are pointing still to problems in the commercial real estate sector, lack of investment in offices, plants. That is still problematic.

Dr. Landefeld. Yes, that is still in decline, yes.

Senator Brownback. And you don't track credit, consumer credit?

Dr. Landefeld. No, the Federal Reserve Board tracks those as part of their flow of funds and balance sheet statements.

Senator Brownback. It seems to me that is one of the areas we continue to have a consumer deleveraging, that the credit continues to decline even though there is lots of money out there, at least the Fed is putting a lot of money out there. The lack of use

or borrowing within the system is profound, given the level of money that is out there.

Dr. Landefeld. I think Dr. Dynan on the next panel is an expert in many of those financial aspects and their impact on consumer spending and saving behavior.

Senator Brownback. Okay. Thank you.

Thank you, Madam Chairman.

Chair Maloney. Mr. Hinchey.

Representative Hinchey. Thanks, Madam Chairman. Thank you, Dr. Landefeld.

Could you tell us how you would describe the alteration in the general economic circumstances over the course of the last 6 months, particularly with regard to consumer spending and employment?

Dr. Landefeld. Well, first, let me say, in terms of employment, that is the purview of the Bureau of Labor Statistics; and it is well-known there is a significant lag between changes in real GDP, as has been much discussed, and changes in employment. The last recession we had real GDP turned up seven quarters before employment turned up there. So I really can't discuss the employment effect.

Representative Hinchey. You can't talk about the circumstances of the employment and the alteration of that employment over the course of the last 6 months?

Dr. Landefeld. No, that is really the purview of the Bureau of Labor Statistics in terms of trying to describe those changes.

I can talk about consumption spending. And certainly the picture, with a 3.4 percent increase in this quarter, is much improved. You had big decreases in those categories, particularly in the third and the fourth quarter. A lot of that has been a function of households' very large loss in net worth that they have had over time. That has had significant impact on households, because they had previously relied on capital gains to fund their increases in net worth. With the collapse in housing and stock prices, households have embarked on efforts to rebuild their balance sheets; and, not having available some of those capital gains they had in the past, they appear to be doing it much more out of saving out of current income.

Our saving rate here declined to roughly 1 percent, a low, from rates of like 7 percent in the mid-1990s to virtually 1 percent or zero recently. It bounced up in the second quarter partly in response to the increase in personal income associated with transfers in the Recovery Act to 4.9 percent in the second quarter. It has come down a bit to 3.3 percent in the current quarter, which is still low by historical standards but relative to what we have seen in recent years is quite a bit higher than what we have seen.

So that is an important factor to be borne in mind in terms of why consumer spending became so weak, why we are seeing what we have seen right now, which was basically the flip side of it is that drop in the saving rate as we saw more consumption and a little less income in the quarter. It is behind the evolution of the consumer spending.

As I said, though, the mechanism by which that is going to affect jobs is something BLS or the next panel can explain to you. But,

in general, what you see is that when the economy begins to improve, businesses wait to hire until they see a sustained recovery and an increase in capacity utilization to a point at which they wish to expand operations.

Representative Hinchey. So if I am hearing you accurately, the circumstances are more positive in the third quarter than they were in the second quarter.

Dr. Landefeld. Absolutely, yes.

Representative Hinchey. What about the first quarter?

Dr. Landefeld. The first quarter was a very large decline—I am sorry, we had a slight increase. I was thinking about the decrease in GDP. We had a slight increase. Your bigger decreases were in, actually, in the fourth quarter, where consumer spending fell 3.1 percent. In the third quarter, where it fell 3.5 percent, you saw a lot of effect in those two quarters. So it is certainly much improved since the latter half of last year.

Representative Hinchey. Just one last question. Do you have any idea about what congressional actions taken over the course of the last several months have had the most positive effect on the economy, or are you unwilling to talk about that?

Dr. Landefeld. It is not in my mission. The Bureau of Economic Analysis is a statistical agency and doesn't do policy.

Representative Hinchey. Thank you.

Chair Maloney. Mr. Brady.

Representative Brady. Thank you, Doctor.

There is a concern that—a growing concern not only in the jobless recovery but a job loss recovery, that we continue to shed jobs at an alarming rate, that the growth numbers today are won off a much smaller economic base than it was a year or so ago in that most of the growth are one-time events or Federal Government spending that can't be sustained. In the job creation area, there has been a lot of conjecture and promotion about the stimulus.

But the Associated Press today said that, after careful review in looking at the 30,000 jobs the White House has claimed from contracting through the stimulus, that those job numbers are significantly overstated. The AP reports that in some cases the job numbers were 10 times higher than the actual jobs created. In other cases, one job was counted four times. And in the case of a Georgia community college, the 280 jobs that were claimed by the White House, actually none came from the stimulus.

From the data you have, can you substantiate the claim that the Obama stimulus bill has created or saved up to 1.1 million jobs?

Dr. Landefeld. In brief, I think that is a question that needs to be addressed to the next panel. Because if you want to think about the difficulty of it, we saw, for example, state and local spending fall 1 percent in real terms in this quarter.

Representative Brady. Sure.

Dr. Landefeld. The question is, what would it have been otherwise? I know my wife is a school teacher in Prince Georges County, and they were confronting and released a budget with much larger cuts than they ultimately enacted. And at least the stated reason was offsets from——

Representative Brady. Can I ask you this? On the data that you have—we have the numbers today based on one-time events

like cars and inventory, an increase in Federal Government spending. But when you look at personal income, the driver of future demand, personal income is down, current disposable income is down, real disposable income is down 3.4 percent. Looking forward, can you build a sustainable recovery based on one-time events like Cash for Clunkers or temporary government spending? Or are we going to need a private-sector recovery driven by demand by U.S. consumers?

Dr. Landefeld [continuing]. In terms of the decrease, yes, indeed, you did see that decrease. But partly what you were seeing was an increase as a result of those one-time effects, which began to diminish, although many of them still remain in the third quarter number. Extension of unemployment benefits and those kinds of things carries through to further quarters. Once again, in terms of private versus public sector, that has to be a question for the second panel.

Representative Brady. If personal income, disposable income is going down, does demand normally go up at that point?

Dr. Landefeld. My only point was perhaps somewhat similar to yours, is that that increase you saw and then the following decrease was essentially coming off that bubble. So if I do what might be a trend line of growth, it is not clear—you might not see that decline. I don't know what the counterfactual is. But I am just saying that part of the reason for the decline was the one-time increase of $250.

Representative Brady. From an economic standpoint, is continued decline in personal disposable income troubling?

Dr. Landefeld. Yes.

Representative Brady. All right. Thank you. Yield back.

Chair Maloney. Thank you.

Mr. Cummings.

Representative Cummings. Thank you very much.

Mr. Landefeld, in lay terms, can you explain how the change in each component of the GDP shows itself to the general public, especially during a recession?

Dr. Landefeld. Well, I would think the general public should be heartened by not only the stronger consumer spending, which as we have discussed earlier was in great part related to motor vehicles, which was presumably related to the CARS program, but the news on residential housing probably is good news to many people in terms of their circumstances.

It is also heartening that businesses have slowed their rate of running down their rate at which they are running down their inventories. Because instead of selling out of inventories, then more tends to come out of production, and that requires people at some point to produce more products when you are not having it come out of inventories.

The strengthening of investment also is good news, because that indicates that businesses are beginning to get back into expansion of their capacity, which means it has implications for the labor markets and employment in the future.

Representative Cummings. So you see this as very positive, this report?

Dr. Landefeld. I think the news today of 3.5 percent increase and the components in it are hopeful news.

Representative Cummings. During a recession, are there typical changes to the composition of the GDP that you can identify?

Dr. Landefeld. Yes. Well, certainly you tend to have—well, first, as I mentioned in answering one of the earlier questions, you tend to have some improvement in net exports to the trade deficit which tends to occur because of weakness in U.S. and overseas demand and other factors that tend to occur. You have households do tend to pull back a bit on their spending, although that is difficult to do when your income is declining. You have to still spend something on the basics. And what tends to react very quickly will tend to be your inventories on the part of businesses, because those are the buffer stocks, if you will, to changes in demand.

Representative Cummings. And how does the composition of the GDP compare in this recession versus previous economic downturns?

Dr. Landefeld. In general—actually, I have a sheet here which shows the compositional changes. I think consumer spending is certainly one that tends to stand out, not with all recessions, because every recession is a little different. But certainly one of the things we are seeing in this downturn has been the sharp fall of consumer spending.

For example, in the 2001 recession, you had actually consumer spending continue to grow. Whereas we have had a significant decline in consumer spending, which is related to that phenomena of households having lost a lot in terms of their investments and their net worth and now having to save more out of current income to try and rebuild those.

Representative Cummings. And what relationship would the job loss have to that?

Dr. Landefeld. Well, since consumer spending is two-thirds of the U.S. economy, it is a very important determiner of what is going to happen to both the U.S. economy and in turn then their needs for employment.

Representative Cummings. And has loosening fiscal policy always been a hallmark of governmental responses to recession?

Dr. Landefeld. You know, I would really rather not comment on monetary policy. But that is one of the prescriptions, to increase liquidity.

Representative Cummings. All right. That is okay. That is okay.

We heard last week from Dr. Romer about the impact of the Recovery Act on the economy. In her calculations about how much of the change in GDP can be apportioned to the stimulus, do you agree with the conclusions of Dr. Romer and the Council of Economic Advisers?

Dr. Landefeld. As I said earlier, we present the basic data that the Council of Economic Advisers and others use to attempt to identify what those grants, tax reductions, and one-time payments, what their effect will be. We can identify them, we can tell you where they are in showing up in incomes, but we can't tell you how much it stimulates demand.

Representative Cummings. Just a moment ago you talked about the fact that the—I guess you were talking about the Cash for Clunkers program, and you seemed to be able to do some relationship analysis with regard to consumer spending. Did I misunderstand you?

Dr. Landefeld. What I was trying to say—and I may have been inarticulate in that regard—is that during a quarter when the Cash for Clunkers was in effect in late July and August, we saw a very sharp rise in motor vehicle sales. And I can tell you with precision how much motor vehicles contributed to the rise in consumer spending and how much the overall contribution of motor vehicles was to GDP, but exactly how much is a result of the Cash for Clunkers is something that is for CEA. And I do believe they did an analysis of how much of the Cash for Clunkers was a stimulation of demand versus a rearrangement of demand over time.

Representative Cummings. And from this report is there any way that we can determine whether these positive numbers are an anomaly or a true upward trend?

Dr. Landefeld. Again, our job is not prediction, but it is heartening to see across-the-board improvement in so many components of GDP in this quarter.

Representative Cummings. I see my time is up. Thank you, Madam Chair.

Chair Maloney. Thank you so much.

Congressman Burgess.

Representative Burgess. Thank you.

Thank you, Dr. Landefeld, for being here.

I want to stay on that point that Mr. Cummings was raising a moment ago. Because you said, if I heard you right, that the 3.5 percent increase in GDP—and you talked about the components within that 3.5 percent, but also Cash for Clunkers is indeed one of those components, so I guess the anxiety that we have here on this side of the dais is what happens? There is no more Cash for Clunkers. Was this the equivalent of pouring Red Bull into the economy and now we are going to have to come down from that caffeinated sugar high that we were able to provide in the summer?

Dr. Landefeld. Well, again, you know, I can't look to the future. I think it is worth noting that you would still have had a 1.9 increase in real GDP, which is welcome, is a positive growth rate, given how long it has been since we had one.

The other thing I think is useful to look into in considering this is that you did have real spending on durable goods, other durable goods, nondurable goods, and services also increased. So that provides some——

Representative Burgess. I don't think there is any question, and I think you have got it in your testimony, that the savings rate during the downturn took a—was markedly different from where it had been before. When you look at something like a Cash for Clunkers infusion into the economy, what is ahead, what is next as far as the decisions that people are likely to make as far as that accumulated money they have in that savings? Cash for Clunkers obviously was a way to get them to sort of shake them loose and bring them back into the marketplace.

You also have to worry about people who perhaps got back into the marketplace who shouldn't have gotten back into the marketplace and did we create a subprime loan problem within the automotive industry that will manifest itself in 6, 8, 12 months time, whenever those notes come due and people have not gotten employment or are not able to repay those loans.

Dr. Landefeld [continuing]. Again, I am going to defer to the next panel. I know many of them have looked at out quarters through 2010 and beyond in terms of the effect of the stimulus act and other governmental actions in terms of longer-term effects.

Representative Burgess. Well, let me see then if I can ask you something that perhaps you can answer.

The analogy that we heard back in 2007, early 2007, in regards to the Iraq war, we had kind of the competing visions long hard slog, last throes of the insurgency. So I heard on one of the news shows this morning that we should be playing Happy Days Are Here Again, and someone else said maybe those green shoots are just the weeds growing in the parking lot that has no cars in it. So what is your concept of the end of the recession at the Bureau of Economic Analysis? What does economic recovery really mean to your Bureau?

Dr. Landefeld. First of all, our Bureau doesn't do that. The National Bureau of Economic Research is the official arbiter of the end of recessions. In general, though, in terms of real GDP, it is interpreted as several quarters of sustained growth in real GDP.

Representative Burgess. So if we see even that 1.7 percent growth of GDP which could be sustained without Cash for Clunkers, then as a technical matter the recession is over, even though 10 percent of our population, or 17 percent of our population, depending upon who you want to read, is still out of work.

Dr. Landefeld. Some people would use it, but I think they would look at it as several sustained quarters of real GDP growth, not just one.

Representative Burgess. Several sustained quarters being more than one?

Dr. Landefeld. Yes.

Representative Burgess. Okay. Let me just ask you briefly, because you have referenced trade and the trade balance in your testimony. What is the effect of having—we have had several free trade agreements that are pending but not enacted. Panama comes to mind. I think North Korea is another one. What is the effect of having this undone work out there? Is it at this point hurtful or helpful to our overall recovery?

Dr. Landefeld. I think pinning that to an event in a particular quarter would be extraordinarily difficult, even if I were in the business of trying to do so.

Representative Burgess. But over the next year, the effect on the economy of—would we be helpful if we would pass these pending free trade agreements? I mean, Congress has sort of languished on Colombia for many months.

Dr. Landefeld. As an economist, we are all in favor of free trade.

Representative Burgess. You are in favor of free trade.

Dr. Landefeld. Historical experience and most people in the postwar era and sources of growth, free trade is part of that. As to any particular legislation——

Representative Burgess. Let the record show that was an affirmative answer. Thank you.

[The prepared statement of Michael C. Burgess, M.D. appears in the Submissions for the Record on page 55.]

[A letter from to Representative Michael C. Burgess, M.D. to Karen Dynan, Kevin A. Hassett, Simon Johnson, J. Steven Landefeld, and Mark Zandi appears in the Submissions for the Record on page 56.]

Chair Maloney. Thank you. I would like to thank you very much for your work and for your testimony today.

I would now like to introduce our second panel and ask them to come forward.

First, Dr. Karen Dynan is Vice President and Co-Director of the Economic Studies Program and the Robert S. Kerr Senior Fellow at the Brookings Institution, where she focuses on macroeconomics and household finance issues. She joined the Brookings Institution in September 2009, after 17 years at the Federal Reserve Board. She also served as a Senior Economist at the White House Council of Economic Advisers. She has published research papers; and they cover a range of issues, including household consumption and savings decisions, household financial security, mortgage servicing, and the efforts of financial innovation on economic vitality. She received her Ph.D. in economics from Harvard University in 1992.

Dr. Simon Johnson is a Ronald A. Kurtz Professor of Entrepreneurship at MIT's Sloan School of Management. He is also a Senior Fellow at the Peterson Institute for International Economics in Washington, DC; a co-founder of http://baselinescenario.com, a widely cited Web site on the global economy; and a member of the Congressional Budget Office's panel of economic advisers. Mr. Johnson appears regularly on NPR's Planet Money podcast in the Economist House Calls feature and is a weekly contributor to the newyorktimes.com's Economix, and is very active in many ways.

Professor Johnson is an expert on financial and economic crisis. As an academic and in policy roles and with the private sector over the past 20 years, he has worked on severely stressed economic and financial situations around the world. He received his Ph.D. from MIT.

Dr. Mark Zandi is the Chief Economist and Co-Founder of Moody's Economy.Com, where he directs the company's research and consulting activities. Moody's Economy.Com, a division of Moody's, provides economic research and consulting services to businesses, governments, and other institutions. His research interests include macroeconomic, financial, and regional economics. Recent areas of research include studying the determinants of mortgage foreclosure and personal bankruptcy, an analysis of the economic impact of various tax and government spending policy, and an assessment of the appropriate policy response to bubbles in asset markets. Dr. Zandi received his Ph.D. at the University of Pennsylvania.

Welcome.

Dr. Kevin Hassett is the Director of Economic Policy Studies and a Senior Fellow at the American Enterprise Institute. His research areas include the U.S. economy, tax policy, and the stock market. Previously, he was a senior economist at the Board of Governors of the Federal Reserve System, a professor at the Graduate School of Business at Columbia University, and a policy consultant to the Treasury Department during the George W. Bush and Clinton Administrations. He also served as a top economic adviser to the George W. Bush and John McCain Presidential campaigns. He holds a Ph.D. in economics from the University of Pennsylvania.

I welcome all of you; and, beginning with Dr. Dynan, you are recognized for 5 minutes. And let's proceed with testimony.

STATEMENT OF KAREN DYNAN, VICE PRESIDENT, CO–DIRECTOR OF THE ECONOMIC STUDIES PROGRAM AND ROBERT S. KERR SENIOR FELLOW, BROOKINGS INSTITUTION, WASHINGTON, DC

Dr. Dynan. Chair Maloney, Vice Chairman Schumer, Ranking Members Brady and Brownback and members of the committee, I appreciate the opportunity to appear before you today to discuss the outlook for consumer spending and the broader economic recovery.

Beginning with the outlook for consumer spending, the available information suggests that the fundamentals will support only moderate growth over the next couple of years. One factor that should restrain consumption will be tepid growth in households' labor income. Although the rate of decline in payroll employment has abated in recent months, we are unlikely to see substantial gains in the near future. If employment and average hours worked rise only slowly, labor income could advance rapidly only if compensation per hour rose rapidly. However, with the unemployment rate at its highest levels since the early 1980s, compensation is likely to continue to move up quite sluggishly.

Under current law, consumption will also be restrained by a significant increase in tax payments over the next few years, as several key tax provisions expire. The temporary higher exemption limits for the AMT are scheduled to expire at the end of 2009. If allowed to do so, this tax will apply to many more taxpayers. In addition, the 2001 and 2003 tax cuts, along with the Making Work Pay tax credit, are scheduled to expire by the end of 2010.

Other forces should damp consumption growth relative to after-tax income growth. The most powerful would be the massive declines that we have seen in household wealth. In a recent study, I estimated that the ratio of nonpension wealth to income for the median household is now below any levels seen during the past quarter century. This should induce households to reduce their consumption and increase their saving in order to rebuild their wealth.

Statistical studies suggest that one fewer dollar of wealth leads to a permanent decline in the level of household consumption of about three to five cents, with the effect occurring gradually over a few years. Based on these results, declines in wealth should damp consumption growth this year by between 2 and 3.5 percentage points and hold down next year's consumption growth by between half and 1 percentage point.

Consumption will probably also be held down by greater precautionary saving, as the severe recession may have led households to revise upward the amount of risk they see in their economic environment. For some households, the precautionary response will take the form of reduced borrowing. Borrowing should also be crimped by a more restrictive supply of credit, as lenders see higher risk in lending to households and regulatory actions restrict lending.

All told, I expect that consumer spending will move up at a modest pace in coming quarters. Moreover, none of the other major components of private demand seem poised for a sharp recovery.

In the housing sector, a strong rebound in construction is unlikely. The stock of unsold new homes remains high, and housing demand will be damped by the weak financial situations of many households and tight mortgage lending for people not qualified for government-supported loans.

Moreover, the sharp rise that we have seen in foreclosures poses a downside risk to this already weak housing outlook. Although the rate at which lenders initiate foreclosures may ease with improving economic conditions and new foreclosure prevention programs, the rate at which distressed properties are coming to market is still building.

In addition, neither business investment in equipment and structures nor net exports are poised to contribute significantly to the near-term recovery. Thus, I share what seems to be the consensus view that we are not likely to see the rapid snapback in activity that has followed many previous recessions.

As a consequence, many analysts are exploring policy actions that might spur demand. Pushing back the date at which the personal tax provisions expire would provide more support for consumer spending. However, it is imperative that policymakers form a plan to bring revenues back in line with spending over the longer run.

Among more targeted policy changes, additional aid to State and local governments would reduce the need for cutbacks in employment by those governments. Even if one thinks that State governments should restrain their activities over time, the abrupt cutbacks forced by falling tax revenue in this recession have not served the broader economy well.

Another way to encourage job creation is to offer tax credit for firms that hire new workers. Designing effective tax incentives for hiring is difficult, though, as a tax credit for all job creation tends to distribute money to many firms that would have done the same hiring anyway.

There are several possibilities that would help households who have lost their jobs sustain their spending and thereby bolster the overall recovery. First is extending unemployment insurance for those who are scheduled to exhaust their benefits by the end of this year. Second would be temporary assistance for meeting the mortgage obligations of laid-off workers. This would help support their spending and, by making mortgage defaults less likely, reduce the downside risks to the housing outlook.

Another way to support the housing market would be to extend the first-time home buyer tax credit, which is scheduled to expire

on December 1st. This would spur some new home sales, but it might be a costly way to accomplish this goal, as most of the home buyers who would receive the credit would probably have bought homes without it.

Thank you very much.

[The prepared statement of Karen Dynan appears in the Submissions for the Record on page 61.]

Chair Maloney. Thank you very much.

Dr. Johnson.

STATEMENT OF SIMON JOHNSON, RONALD A. KURTZ PROFESSOR OF ENTREPRENEURSHIP, MIT'S SLOAN SCHOOL OF MANAGEMENT, SENIOR FELLOW, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS, CAMBRIDGE, MA, AND WASHINGTON, DC

Dr. Johnson. Thank you.

Until August of last year, I was the Chief Economist at the International Monetary Fund; and I would like to put my remarks in a cross-country comparative perspective. I would like to speak specifically about the Recovery Act and then very briefly make the comparison with Japan, its experience in the 1990s, which many people think is relevant to the United States today, and conclude by talking about the adjustment process in the United States and how we are doing in that regard.

So on the fiscal points, first of all, I would say that I am usually a skeptic with regard to fiscal policy. I think discretionary fiscal policy earned a bad reputation for good reason in most industrialized countries; and I share the view and the IMF shared the view that, until about 2007, this was not a good way to respond to impending recession.

However, I think that circumstances were very different in 2008 and the beginning of this year. We were facing an extremely severe financial crisis.

I think Mr. Brady made very good points about the actions of the Federal Reserve in counteracting the crisis. But it is important when you face a major disaster—remember, it is a global financial disaster that we are looking at—to also react with discretionary expansional fiscal policy. Particularly in the United States, there are automatic stabilizers. The increase in payments to people who lose their jobs and the reduction in taxes are weaker than in almost any other industrialized country. So I think the Recovery Act was well designed.

And as you may recall, I testified before this committee about this time last year in favor of a major fiscal stimulus; and I think that it had a positive effect in terms of reducing the job losses, in terms of sustaining confidence, which has obviously been shaken very badly, as we just heard.

And I would emphasize in terms of its global impact. You must remember at the G–20 summit in April, President Obama and his Treasury team were able to take a leadership role and were able to corral support from across the world—G–20 represents 90 percent of world GDP—in favor of supportive fiscal policy and as well support for the IMF and other measures that have turned out to be very timely and appropriate.

Having said this, I would stress I am not in favor of two more stimulus. I think Chairman Maloney put her finger on the key problem we face right now, which is jobs. I think output is actually going to recover faster than the consensus. Again, the experience from many crises across many different kinds of countries is when you go down sharply you can come back sharply. This is not going to be one of the fastest recoveries on record, for sure. But the key issue is going to be the link between output and jobs, and there I would also strongly support extension of unemployment insurance.

I think measures to address the problems of long-term unemployed—Chairwoman Maloney, as you were speaking, I was thinking we should look more carefully at the experience of Australia and the United Kingdom, who introduced some serious innovations in this area. I can share those with your staff. I didn't put them in my written testimony. I think that is the key issue.

Further investment in providing skills to people who have not done well in this country over the last 20 years—they can't stay up with the modern globalized economy, with information technology and so on—is very important, even more important now. These are going be to the long-term unemployed, and I think supporting community colleges is one way to do that specifically.

So my second point—my second set of points is about Japan, and I think it is very important to distinguish and be very clear on the differences between Japan in 1990 and the United States today. Now, we both had credit booms and we both obviously had a massive amount of overborrowing. But in Japan it was the corporate sector, and in Japan it wasn't associated with a big current account deficit. They were not spending beyond their means. They just went crazy with investment.

The Japanese corporate debt at the moment of collapse and crisis was 200 percent of GDP. And they put that money into real estate, but they also put it into crazy amounts of manufacturing capacity. It took them 10 years to work that off.

That is a very different problem from what we are facing, which is much more about the household sector and an adjustment at the country level—and I think Senator Brownback said this—to overspending. There has to be an adjustment process; and the right way to do this adjustment process, as I think you all know, is to have a downward movement in consumption, to have a movement in the real exchange rate, to have the kind of increase in our exports that we are beginning to see in the data. And this reorientation of the economy will come with a fall in our income and then we can get back onto a rapid growth path.

I think, seen in those terms, our adjustment process is proceeding well. The Japanese strategy through the course of the 1990s was to try and buffer themselves against having to make their kind of adjustment, slightly different situation, with a repeated fiscal stimulus and very easy monetary policy. That wasn't a good choice for Japan particularly. They should have taken the adjustment much more in terms of the balance sheets of the corporate sector, they should have more bankruptcies, and they should have more explicit up-front recapitalization of their banking system.

And the United States I think is in the same boat. We should make this adjustment, and we are making this adjustment. I think the Recovery Act should be seen as a large one-time buffer against this very big financial shock; and, seen in those terms, it implemented well.

My final points are about what can prevent this adjustment. What held up Japan and what has prevented other countries from adjusting appropriately in a timely fashion to this kind of shock?

And let me take up also Mr. Brady's points about small business and the importance of an entrepreneurial, private-led recovery, which I completely believe in. That is the experience.

The major problem we have right now, major problem Japan had actually over the past 20 years, major problem we have now is in the financial sector. We didn't recapitalize the banks fully. The banks I think have done an enormous amount of damage—the biggest banks have done a enormous amount of damage to small banks and to small business, and that problem still remains. That is a problem that has been building for 20 or 30 years in this country. It can't be fixed in 6 months.

But that is a macroeconomic issue, the imbalances and the poor incentives and the problems, including around credit cards. Chairman Maloney, as you said, these are first-order macroeconomic issues.

So while maintaining the path or the process of macroeconomic adjustment while allowing the dollar to depreciate in real effective terms—and here, of course, the Chinese renminbi is something of an issue which we can come back to talk about, because that is not helpful, again, in the global picture. But if we proceed down this path of macroeconomic adjustment, the major risks we face in the future are going to come out of the financial sector.

Thank you.

[The prepared statement of Simon Johnson appears in the Submissions for the Record on page 66.]

Chair Maloney. Thank you. Dr. Zandi.

STATEMENT OF MARK ZANDI, CHIEF ECONOMIST, MOODY'S ECONOMY.COM, PHILADELPHIA, PA

Dr. Zandi. Thank you for the opportunity to be here, Madam Chairwoman and the rest of the committee. My remarks are my own and not that of the Moody's Corporation. These are my views.

I would like to make three points in my remarks.

First, the recession is over. The great recession is over, and the recovery has begun, and that is largely due to the monetary and fiscal stimulus that has been provided to the economy.

I don't think it is any accident that the recession has ended at the same time that the stimulus provided the maximum benefit to the economy. My estimate is that the stimulus package that was passed in February has contributed somewhere between 3 and 4 percentage points to growth, which would suggest that, without that stimulus, the economy would still be in negative territory, still contracting.

In terms of jobs, I do think it has resulted in over a million additional jobs. The number of jobs in the economy would be a million less than is currently in the economy if not for that stimulus. In

my view, the most efficacious aspects of the stimulus have been the aid to unemployed workers and the aid to State government. That has gotten into the economy very rapidly and has forestalled very significant cuts in spending, government programs, and forestalled tax increases, which would have been very debilitating at this time.

The other aspects of the stimulus, including the first-time home buyers' tax credit, Cash for Clunkers, also very important. But the UI and State government help, the most important things. So that is point number one.

Point number two, the recovery that we are now in will be tentative and fragile through all of 2010. Unemployment will continue to rise. It will probably hit 10 percent when we will get that report next week. It will be in the double digits all of next year.

The recovery has a number of very significant head winds. Let me just name a few of them.

First, hiring. All the improvement in the job market—and there has been improvement in the sense that the job losses are abating—all of that is due to fewer layoffs. There is no hiring. The reasons for that are numerous, but let me just mention two.

First is a lack of credit, particularly for small business. They rely on credit cards and small banks, and they are not getting credit. And second is confidence. Businesses have been put through the proverbial wringer, and they experienced life-threatening events 6, 9, 12 months ago, and it is going to take a while before they feel comfortable going out and hiring. So hiring is a problem.

Second, the foreclosure crisis. It continues unabated. This suggests that house prices, which have stabilized this summer, are going to fall again beginning next year. Nothing works well in our economy if house prices are falling. It is a corrosive on household wealth. No bank is going to extend credit freely as long as house prices are falling.

Third, commercial real estate. That is a really substantive problem. Prices have fallen even more in commercial real estate than in housing. You mix that with a lack of liquidity, the only lenders are a few life companies, and the fact that many mortgage loans are coming due, we are going to have many commercial loan defaults. That is, of course, going to hurt commercial construction, but it also hurts many of the small banks that have very large commercial loan portfolios. And that is another reason why they are not extending credit to small business, which is key to the job machine.

And then, finally, State and local government, they did receive help. It has been very important, as I mentioned, but their fiscal year 2011 budgets are going to be just as bad. Tax revenues continue to plummet. If they don't get more help, they have got a very large problem. They are going to have to cut programs, jobs, and raise taxes beginning this time next year.

So, in my view, I think we will avoid falling back into a recession, but the risks of recession are uncomfortably high. And if we fall back into a recession, that would be particularly worrisome. It is not going to be easy to get out of it. We have got a zero percent interest rate, and we have got a $1.4 trillion deficit. We just cannot go back into recession.

Finally, point number three, what should policymakers do about this? Let me say two things.

First, I think at the very least you should extend a number of the provisions in the ARRA that are expiring this year. That would include the aid to unemployed workers. That is a slam dunk. The higher conforming loan limits, that should be extended. The first-time home buyer tax credit, that should be extended. Bonus depreciation, net loss carryback, that should be extended; and net loss carryback should be expanded. SBA lending, some provisions in the ARRA that made it a little bit easier will expire at the end of this year. They should be extended, and the SBA program should be adjusted. A couple of things you could do to make it much more effective.

Then, finally, the second thing I would do is, if we got into next year and the economy is not engaging, if we don't get the more sanguine view that Dr. Johnson expressed and the economy is not engaging, I would consider a number of different things. Certainly aid to state and local government, very, very important. Work share programs, I think that is a very innovative way of helping to make the UI program more effective. And I would also consider expanding foreclosure mitigation. The current loan modification plan is not working well. And then, finally, perhaps a payroll tax holiday with a job tax credit twist. I think that would also be very helpful. But I would wait until we got into next year before considering that, given the costs that are involved.

Thank you very much.

[The prepared statement of Mark Zandi appears in the Submissions for the Record on page 76.]

Chair Maloney. Thank you for sharing your testimony.

Dr. Hassett.

STATEMENT OF KEVIN A. HASSETT, SENIOR FELLOW AND DIRECTOR OF ECONOMIC POLICY, AMERICAN ENTERPRISE INSTITUTE, WASHINGTON, DC

Dr. Hassett. Thank you, Madam Chairman, Ranking Members Brady and Brownback and members of the committee.

My written testimony is rather long. You might be able to save yourself a trip to the gym if you carry it around for the rest of the day. I will try to go through the highlights as quickly as possible.

The first part of my testimony concurred with the analysis of Dr. Zandi. I discuss time series models of recessions that have proven very effective in the past at dating them in a manner consistent with the judgments ultimately given by the National Bureau of Economic Research. I think the best of those is by a macroeconomist at the University of California named Marcelle Chauvet, and she has informed me that the recession ended in July and maybe August. But that is I think a call that one could have a great deal of confidence in.

I think that as we look forward that means that we can expect many quarters of positive growth, but we should be anxious because of the concerns raised by my fellow panelists that that growth will be disappointing. Accordingly, I think that we need to think about, well, what are we going to do now? With that in mind, I think looking back at the stimulus and thinking about how well

it worked is very important because we might well find ourselves in a circumstance where we want to reconsider those issues.

Now, most of the advocacy for stimulus involves simulations from computer models. The empirical literature that looks at what actually happens and data is very mixed. There is a wide range of multiplier estimates. Countries that have big deficits can sometimes actually achieve stimulus through non-Keynesian policies. There is big literature on this that actually reduced the debt with tax increases and reductions of government spending. And higher government spending actually reduces growth in the long run as well, which is a concern as we think about what we are going to do next.

I think these disappointing results are consistent with the balance of the literature, as summarized in my written testimony; and they are rather bad news for the U.S. Government—debt has expanded so rapidly during the government bailout that one might expect the high debt results to apply for us. And, in that case, the short-run positive effects that we saw last year might be minimal and might even be worse going forward.

Now, the large expansion of government spending also creates something of a problem for policymakers. I guess that is you. If you unwind the spending all at once, then you may even optimistically only postpone some subset of the recession from this year. If the government spending spike is not unwound, then the long-run negative growth effects of large government kick in.

Now the consumption stimulus—and now my remarks focus on the part of my testimony regarding mailing checks to people—is viewed by proponents as a macroeconomic success if it leads to a short-run increase in consumption. A neoclassical skeptic would emphasize that the increased saving or reduced consumption by those who anticipate future taxes might offset the increased consumption by Keynesian consumers who rush out to spend the checks that we mailed them last spring.

I have two figures in my testimony that shed some light on how we might think about the scale of those effects which might cast some doubt on assertions of big-growth effects in the most recent quarter.

Figure one suggests that—and there I assume that the deficits that we have received in 2009 and 2010 are ultimately going to have to be paid for by future taxes, which are increased according to the current distribution of taxes. And so, you know, if you pay this percent—an income group that pays this percent right now, we are going to expect that in the future we will get that much of the current deficit from them—and you can see that the future tax increases associated with deficits, which many occur because of the economy, not because of explicit policies that you have made, those tax increases are very large relative to the stimulus checks. That suggests that people who are really rational and thinking ahead would rationally save a lot of money this year in anticipation of future tax hikes.

And it might be that, even though we see that low-income people who of necessity consume the money we mailed them because they need it right now, might consume more right now because of the stimulus checks over the previous quarter, that high-income people might save more, and that might offset it.

The second chart in my testimony, which is taken from an analysis by John Taylor of Stanford and Hoover, suggests that the macroeconomic data lead one to conclude that these factors might be present and should make us a little cautious about what has happened when we mailed checks in the past and what would happen were we to do so again.

For policy alternatives, the biggest problem with the approach that we have taken so far is that we have taken fixing things off the table this year. We have focused our policy efforts on temporary measures. Yet our Tax Code is so broken that there are ample opportunities to improve the current economy without creating hangover effects associated with the removal of Keynesian stimulus. These policies would make permanent changes to provide an immediate boost to the economy and would run a smaller risk of creating a hangover.

And I give two examples in my testimony that I think probably don't pass any reasonable partisan test of being associated with either party. I think probably everybody in both parties might oppose both of them. But I give an example of the kind of thing that I think Congress should be thinking about.

First, the indexing formula for Social Security could be changed from wages to prices. A recent analysis by the Social Security Administration found that over a 75-year time horizon this would improve the long-run budget condition by $4.5 trillion in present value. If some fraction of that revenue were recycled, say through a reduction in the payroll tax, as suggested by Mr. Zandi, then one might see both a consumption increase and a positive fiscal consolidation effect that would lead us to a higher growth trajectory.

Alternatively, the government—this is the second policy that I speculate about in my written testimony—the government could announce today that the corporate tax rate would gradually be reduced from 35 percent to 25 percent, while again covering any expected revenue loss from that with the introduction of a value-added tax that did not take effect for a number of years. The declining corporate tax would act like an investment tax credit today, giving investors an incentive to pull their deductions forward into the high-tax period. The future-value-added tax would induce individuals to consume today before the consumption is taxed in the future. In addition, the move toward a consumption tax would improve the long-run efficiency and vitality in the economy and help fix the deficit problem.

Such policies would, the literature suggests, stand a much better chance of providing significant and sustained growth than those that have already been adopted. To the extent that the high level of unemployment motivates additional policies, I would urge you to consider permanent changes that can have a big kick now.

[The prepared statement of Kevin A. Hassett appears in the Submissions for the Record on page 93.]

Chair Maloney. Thank you so much.

We have been called to a vote on three different items, but I would quickly like to ask, since many of you noted that job creation is a major challenge now in our economy and in our country, what components of GDP should we focus on as far as job creation is concerned? Anyone to comment. What components of GDP?

Dr. Hassett. He is the leading expert on this.

Dr. Zandi. Well, I think the key thing is probably business investment would be the thing to watch. Obviously, businesses have to make decisions about hiring and investment; and if they are investing and if investment spending is picking up, that would be suggestive of better credit conditions, of more confidence, that they feel like they can go out and expand. And that would also mean that they are probably also going to begin to hire.

Now, on that front, we have got some reasonably good news. Investment spending in the third quarter in equipment and software turned positive after just completely cratering late last year and early this. So that would suggest that we are moving in the right direction. But the increases are very small and also suggestive of relatively modest hiring going forward. If I were going to pick a component of GDP to focus on to gauge the direction of hiring, it would be equipment and software investment.

Chair Maloney. And what can Congress do to spur that?

Dr. Zandi. I would suggest two things. I am sorry. Two things. One is, I would provide more incentive to the SBA program, because this is a way to get credit to small businesses that are a key to the job engine.

Just one quick statistic. Establishments that employ fewer than 20 employees account for 25 percent of all of the jobs in our economy, but they accounted for 40 percent of all the job creation in the last economic expansion. The key impediment to hiring and investment among small businesses is the lack of credit. The SBA program could play a big role.

Three suggestions: One, increase the size of the maximum SBA loan, which the President has already proposed, a very good idea. Second, increase the loan guarantee in the current ARRA. The loan guarantee is 90 percent. I would raise that to 95 or 97.5 percent, temporarily. And then third, and most importantly, there is an interest rate cap on the rate that the small business lenders can provide. It is 275 basis points over prime. That means that the current maximum loan rate is 6 percent or below. No one is going to make a loan at 6 percent in this credit environment. You should increase that. You should double that. And if you did those three things, credit would start to flow more freely to small business; and that would be very, very helpful.

Chair Maloney. Thank you.

We have 8 minutes left in our votes, so we are going to have to—Dr. Johnson—but then we are going to adjourn to go vote. Why don't you stay? Absolutely. Yes, but Dr. Johnson has a point to make, and I think you should continue.

Senator Brownback. I won't do anything untoward.

Chair Maloney. Pardon me?

Dr. Johnson. Just to answer your question on sectors, I think the export sector is really critical. Part of the counterpart of the statement that we have been overspending, we are living beyond our means is we have been unable to compete, unable to generate enough revenue from exports to pay for what we import. That is an adjustment that we are going to have to make.

And I think the key longer term issue there is skills. We know how the U.S. stacks up in terms of education, not of the most edu-

cated people in our society, we do well in that dimension, but in terms of the least educated 50 percent and in terms of the practical skills they have. Do they have technology skills, as Mr. Hinchey said?

There is a bright future for this country in terms of technology generation. But who are the workers? Who is going to use that? You need to have competitive workers with good skills. Otherwise, those jobs are going to go straight offshore.

Chair Maloney. Thank you.

Mr. Brownback is recognized.

Representative Hinchey. I just wanted to ask a brief question of Dr. Dynan. What do you think that we might do to improve the economic benefits of working class people across this country? Because, as we know, they drive about two-thirds of the GDP. So the main focus of our attention should be on the middle-income working class people. What do you think the most effective thing is that we could do to upgrade the quality of their economy and the quality of their lives and, therefore, the quality of the economy?

Dr. Dynan. As I said in my remarks, I think that extending—as Mark just said, I think that extending UI benefits is a slam dunk. I think that is very important to support the spending of those that have lost their jobs.

And I think also, on the topic of people that have lost their jobs, I think that current foreclosure prevention programs aren't doing a very good job of helping homeowners who are struggling to make their mortgage payments because they have lost their job and have experienced a sharp decline in income. So I would offer assistance to those households to help them make their mortgage payments until they could find another job.

Representative Hinchey. Mr. Johnson.

Dr. Johnson. I think it is about skills. The reason median income hasn't gone up much—perhaps it has even declined over the past 20 years in this country—is because the least educated people, people who haven't finished high school or just finished high school with barely any college, are not competitive in the world economy; and they are not going to become competitive unless they have opportunities to increase their skills. And that is what you have got to focus on. The community colleges are the most obvious place to help these people, but there are other ways forward as well.

Representative Hinchey. Thanks very much.

Senator Brownback [presiding]. Thank you.

You are all mine. I have been looking forward to this. I have got a bunch of questions here. So if you guys got a little bit of time, I have some questions here.

Dr. Johnson, I want to start with you and your testimony, because you say things it looks like to me that I have been thinking for some period of time. I wanted to ask and see if I am getting this right.

The Chinese exchange rate has been pegged to the U.S. dollar, effectively giving them the advantage to come into this marketplace without what would normally happen in a situation like what we had. We had this huge trade imbalance, and their currency should appreciate versus ours depreciating. Is it time to take the club out to get that exchange rate down? And, clearly, it should be different

in these two economies and that that would help get that imbalance in our trade imbalance down. But absent taking the club out—we have jawboned it for a long time. Is it time to take the club out on that?

Dr. Johnson. I would hesitate to use the word "club" in this context. There are mechanisms. It is a huge problem. It is a huge problem. It has been with us a while. It has been put on the back burner by this Administration. I think that is a mistake.

Senator Brownback. For credit purposes, I take, more than anything.

Dr. Johnson. Well, I think for purposes of not wanting to destabilize the global system and not wanting to have a big trade rally. When you say take the "club" out, the key issue is what exactly are you going to do. If you threaten trade sanctions unilaterally, that is going to raise the issue of retaliation. If you go through the IMF, which is what the previous Administration tried to do, it is a sensible approach, but it didn't work. The IMF has completely been unable——

Senator Brownback. What should we do?

Dr. Johnson [continuing]. I think the WTO should have the responsibility for overseeing exchange issues just like it does for unfair trade practices.

Senator Brownback. They don't have that now.

Dr. Johnson. They do not currently at this time, that is right. But they could get it. It has to be negotiated. Many other countries other than ourselves are very uncomfortable with the Chinese exchange rate arrangement, particularly now as the dollar depreciates. As you said, the renminbi should be appreciating. Against the dollar it is pegged so it doesn't move against the dollar, and against the euro or other major currencies it is actually depreciating, which makes no sense.

The Chinese foreign exchange reserves, which passed 2 trillion this year, are on their way to 3 trillion, probably the middle of next year. That is 20 percent of the U.S. economy.

Senator Brownback. It seems this is a real mercantilist strategy on the Chinese part, that they stimulate and keep their economy going. We get the cheap goods, but that doesn't work on a long-term basis for us. Do any of the rest of you have another strategy or a tool here, absent us just using the blunt instruments that we have?

Dr. Johnson. Well, the WTO is not a blunt instrument. The WTO is a very well-calibrated instrument with a lot of legitimacy that we use for——

Senator Brownback. I understand. But we don't have—we can't take a currency case to the WTO.

Dr. Johnson [continuing]. No. I know this Administration could launch an initiative to bring currency cases under the auspices of the WTO. As I say, lots of other countries around the would support us in that initiative. That is a much safer, much better way to proceed than unilateral——

Senator Brownback. I thought you said they didn't have the authority, the WTO didn't have the authority to bring a currency case.

Dr. Johnson [continuing]. They have to get that authority from the membership. I am saying that is a doable thing. That is a sensible course for us to take up.

Senator Brownback. Nobody else has a better idea?

Dr. Zandi. I take a different perspective. I think you are correct that the yuan is significantly undervalued, probably 25 to 30 percent undervalued vis-à-vis the dollar, and that it would be appropriate for the yuan to appreciate in value. But I think the most desirable way for that to occur is over time. So 3, 5 percent appreciation over time.

Senator Brownback. Any WTO case would take time.

Dr. Zandi. In fact, beginning in 2005, the Chinese started to allow their currency to appreciate.

Senator Brownback. Pretty modest relative to the imbalance.

Dr. Zandi. Three to 5 percent every year. I think that would be the most appropriate path going forward. If they stick to that, I think that is what we should plan for.

Senator Brownback. Dr. Johnson, I want to ask you on a separate issue here. You put in your testimony that the largest banks need to be broken up. Excess risk-taking should be taxed explicitly. I couldn't agree more with it. The Federal Reserve Chairman out of Kansas City, Tom Hoenig, has testified in front of this panel and he has a proposal that we are working with now to get in statutory form to allow a process put in place to move away from the too big to fail policy.

Have you looked at any of the outlines, what he or others have put forward on this too big to fail?

Dr. Johnson. I may not be aware of his latest proposal. I certainly talked to him earlier this year. I testified before the committee at the same time. We were absolutely on the same page. It has very much a bipartisan issue. The too big to fail banks are a major risk to our current economic situation, and there are various mechanisms that you can consider how to implement it. I am very open to proposals. I think we should be flexible and try them all. It is a very serious problem.

Senator Brownback. Is there any disagreement in the panel on this?

Dr. Zandi. I disagree in the sense that I think it makes no sense to try to work to break up large banks, that we have to embrace the fact that we are going to have institutions that are too large to fail and therefore design policies with that in mind. I think it is a privilege to be too large to fail because they are getting a taxpayer benefit, these institutions, and therefore they should pay for it in the form of higher capital ratios, more stringent liquidity ratios, greater regulatory oversight, perhaps even higher deposit insurance premiums. The mechanism proposed to levy fees on these institutions, if in fact one of their colleagues fails and it costs taxpayers money, then all these institutions should pay for compensation.

Senator Brownback. Dr. Zandi, if you did that, don't you then push business to these guys? Because you are basically saying, Now we have an official government policy of too big to fail, and we are not going to let you fail. And their risk ratios, I would think, would be different from the level just below them and cer-

tainly several levels below them. It seems you almost push business to them.

Dr. Zandi. No. First, you have to raise the cost of being big. So, as you get bigger, there are costs involved. And so their costs of capital isn't a competitive advantage against smaller institutions.

Second, don't identify institutions as too big to fail.

Senator Brownback. The marketplace will.

Dr. Zandi. Not necessarily. They are not Fannie Mae and Freddie Mac. They are not guaranteed by the Federal Government. Who knows whether a $10 billion bank or a $5 billion bank or a $15 billion bank is too big to fail? Lehman Brothers was a small broker-dealer and they were too big to fail.

So I don't think if you identify them before the fact that the market will figure it out, or at least to the point where it makes a big difference.

Senator Brownback. Dr. Johnson.

Dr. Johnson. I completely agree with you, Senator Brownback. In fact this is legislation that is being discussed today. If you want to go this route of regulating them ex ante and putting these extra costs on them, the market is going to see this. If they have a limit on their capital ratio or a hard leverage ratio, for example, of course you can figure out which ones are in this too big to fail privilege category.

You can't have it both ways. You can't create a privileged category and make that secret. The list has to be known. Mervyn King, the Governor of the Bank of England, spoke to this directly last week, he said there are two ways forward, regulate the big guys or break them up. King said regulating them is not going to work. They are going to always get ahead of the regulators. They are far too big and powerful and pay their people a lot of money to do that. You have to break them up.

Dr. Zandi. You don't have to identify them. As they grow in size, when they hit certain size benchmarks, they then get different fees and restrictions imposed on them. So at $5 billion in assets it is one thing, $10 billion, another; $15 billion. It is not like you are saying you passed over some benchmark and therefore you are too big to fail. You wouldn't do that.

Senator Brownback. This will be an extended debate, and several of us are going to try to make sure we have it because I think we need to have this as an actual debate and an actual policy issue. I sure tend to look at it that the market will identify it.

But I appreciate your arguments, and we are going to try to put this bill forward, the Hoenig bill in the Senate, get a number of cosponsors if we can on it and try to get policy debate moving forward.

Dr. Hassett, you talked about permanent changes in the Tax Code so you don't create the hangover. I like that thought. Maybe it has the Red Bull analogy; the same way. You juice the thing then there is a fallback on it. I take it your permanent changes are suggesting that you favor capital formation and you discourage consumption, would be the overarching policy move that you would say in taxes at the Federal level.

Dr. Hassett. That is the right objective in the long run. In the near term you can achieve that long-run objective if you do some-

thing that causes people to transfer future consumption to today, like putting in a value added tax in the future is one example. People won't rush out to spend money today, but ultimately we would have the benefits of a consumption tax, which would stimulate additional capital formulation.

I think that given the massive imbalance we have right now we have to take these permanent measures seriously. If when we had passed the stimulus package we had made this minor adjustment to the benefit formula that I mentioned in my testimony for Social Security benefits, then the long-run fiscal balance of the U.S. would be significantly better and we would have had a stimulus bill, and one would guess that that would have made the stimulus bill more effective.

Senator Brownback. Seems to me that that is something we are going to have to do long term to maintain economic competitiveness for us, is just to try to stimulate capital formulation and probably tax more on the consumption side of the equation.

Do any of you disagree with that policy bent for the U.S.? I say that partially, too, because we are so consumer driven as a society and it does not look like to me that is long-term sustainable, the level of consumerism that we are dependent on.

Dr. Dynan or Dr. Johnson.

Dr. Dynan. I agree with you. I think one component is personal savings needs to rise. I identified a number of things in my testimony that are going to cause the personal saving rate to be substantially higher than it was prior to the crisis. I think it does put—I think the downside of that is that it will lead to a more modest recovery. It is going to take longer to get back to full employment. It is going to leave——

Senator Brownback. But we will be different when we get back.

Dr. Dynan [continuing]. Yes. It will be more solid and sustainable.

Senator Brownback. I guess that is the thing I look at. We are going to go through pain here. We are going through pain, but let's get on the other side and show something for it.

Dr. Dynan. I think it will be more solid and sustainable both at the household level and at the national level.

Senator Brownback. Dr. Johnson.

Dr. Johnson. I agree on the consumer side. I think you have an increase in the household savings rate, as Dr. Dynan is saying. The issue at the national level is going to be what happens to the government saving or dissaving. Here, the big issue coming is obviously Medicare. The United States is not unique in this. All industrialized countries face a substantial fiscal adjustment, between 4 and 8 percentage points of GDP, assuming you go back to near full employment, in order to stabilize the public debt levels at 40 to 60 percent, whatever you think is reasonable in these countries, in the face of rising health care costs.

The only reason we are a bit more upfront about it in this country is because the CBO has a more honest accounting projection of future health care costs than does the European Union, for various interesting reasons. But if you put those numbers on a comparable basis, we and the European Union and all the rest of the OECD

are in the same very difficult boat, and this is about where do you get the revenues to finance that or what other spending do you cut in order to finance these commitments that are coming down the road. That is the big deal breaker on savings and on public finances and on sustainability.

Dr. Zandi. Can I say I think Dr. Hassett's two suggestions are fantastic. I think they are wonderful ideas. I think indexing Social Security to wages as opposed to inflation is an entirely appropriate thing to do.

Secondly, reducing the corporate tax rate and making that up through some form of VAT is also an excellent idea. I think it highlights a very important point, and that is while we are talking about stimulus and the fact that that does add temporarily to the near-term budget deficit, it is also very important for policymakers to have another track for policy, considering things to do about the long-term fiscal situation. Because if you are able to credibly address that through these kind of suggestions, then that will buy you more freedom and latitude to run near-term budget deficits and try to get this economy moving.

Senator Brownback. I am not a VAT—I don't like a VAT for the way it is so hidden. I like taxes to be apparent and people know I am paying this so they know what the cost to their government is. I know other people maybe don't look at it that way. But I can see a lot more tax on the consumption side and production, particularly us going forward and trying to be a more productive country and more export-oriented and less maybe consumption-oriented.

With that, I want to conclude on this one question. The dollar has been declining. Is it likely to decline over the next year or so relative to other major currencies, and is that something that we should be fighting back aggressively against?

Dr. Johnson. I think we probably agree the hardest thing to predict in economics is exchange rates. They really have a tendency to go the opposite way from what economists say. My answer is definitely yes. There is a tendency to depreciate, given our policy stance and given the fact we are providing cheap funding to big financial institutions that are allowed to go off and plow this money into a speculative private equity in China, for example. We have created a big carry tray out of the U.S. dollar. That is a downward pressure on the dollar. Of course, if there are major shocks around the world, any time there is a disaster, people come into dollars, because we are the ultimate safe haven. That is why it doesn't quite go definitely in the direction I am saying, but the economic dynamics are very much supporting dollar depreciation, and you shouldn't resist it. The dollar depreciation at this stage is helpful for us.

Senator Brownback. Do you all agree with that, you shouldn't resist the dollar depreciation? I don't see anybody disagreeing. I see a couple of people don't want to be on the record.

Dr. Zandi. I think so far the dollar decline is what you would expect, given relative growth rates across the global economy. There are negatives. We are paying more for oil because of the fall in the dollar. But as we saw today, it is helping to lift exports.

Senator Brownback. Looks like to me it is going to help us a substantial amount on exports over a longer term. My state is an

export state. We are grain, aviation. So you get a cheaper dollar, our products are cheaper overseas. We generally tend to do better. But a lot of people really don't like the falling dollar.

Dr. Zandi. I think what concerns them is they are worried if the dollar starts to decline in a disorderly way, that would be symptoms of bigger problems. It would mean interest rates are rising, that would mean stock prices would be falling. It is that, I think, concern that this weakening in the dollar might lead to something more serious, large declines that are indicative of a broader economic problem.

Senator Brownback. I can see that. It sure looks like to me we could start to raise interest rates some here and that the Australians were rewarded for doing that. The Fed fund rate, I am talking about. To support the dollar. But each of you are saying we shouldn't resist this fall.

Dr. Johnson. I wouldn't move the Federal funds rate to support the dollar. I think the issue is what is happening——

Senator Brownback. The Aussies were rewarded for that.

Dr. Johnson [continuing]. Right, but I am saying I don't think we should be aiming to support the dollar. I don't think that is the right policy goal here. The big constraint on raising the Federal funds rate, and I agree with you, we may get to the point where that is a good idea, because I am expecting a stronger recovery than my colleagues here, is that the banks are not well capitalized. So the recapitalization of the banks, the strategy being used now is the same strategy used in the early 1980s when Mr. Volcker was chairman of the Fed, which is keep short-term interest rates low, allow recapitalization through the yield curve, which the strategy can work, but in order to do it you have to keep the yield curve positively sloped for a number of years—2 years, 3 years, 5 years. If you fear raising interest rates because of what it will do to your banking system and because of how that will lead to further failures or further problems, with any kind of banking system that is an issue. I think that is where we are on monetary policies right now. That is a very unfortunate constraint that comes from weakness and the lack of capital.

Senator Brownback. Are the banks that weak they need us to provide that yield curve for them to do that?

Dr. Johnson. Absolutely. If you look at the impact of the discussion around GMAC right now, look at how that has affected credit default swap spreads, for example, of the major banks, including Goldman Sachs, including Bank of America. People are very surprisingly nervous, given the way the world economy is coming back. The global economy outside the United States and outside the European Union is very strong right now. People are extremely worried about the financial system because our banks don't have that much capital. I know we taught ourselves after the stress test that everything is well capitalized; don't worry. Unfortunately, that is not how the market sees it.

Senator Brownback. So the fact that these banks are sitting on large wads of cash right now, not lending it out, they are basically playing this yield curve right now and it is a way to heal and that they just need to sit there and sleep for a while. Is that what you are recommending to our banks; kind of like you got the flu,

so why don't you just lay and rest and drink lots of Fed funds for a while?

Dr. Johnson. My recommendation is quite different from that. It includes breaking them up and includes recapitalizing them.

Senator Brownback. Effectively, that is what you are saying, because they are not loaning money. The amount of credit that they are putting out is pitifully small and we are all looking at this thing saying, wait a minute, we shot big wads of money out here. I voted against a bunch of it, but it happened. I agreed with what the Fed has done, but now you are basically saying they need to kind of just sit there and play this Fed fund yield curve.

Dr. Johnson. Remember, as Dr. Dynan said, consumers don't want to worry so much. That is the counterpart of this increase in household savings, is they are cutting down on their borrowing. So in a sense I don't think a bank should be—their feet should be held to the fire particularly for this. I think that is coming from the demand side. There are many other things you should be taking to the banks, including the lack of the capital, the way they are going back to very high risk strategies on a low capital base.

Lehman Brothers, the day it failed, according to a conference call 2 days before they failed, had 11.6 percent Tier 1 capital. Okay? That is what the major banks in the U.S. are holding right now. People don't think that is enough capital, and they are right, given the strategies of these banks, given the way they are managed, given the fact they are too big to manage properly, let alone too big to fail.

Dr. Dynan. I will just echo what Simon said. It is true household credit has been falling quite impressively in the last few quarters, but it is very difficult to separate the effect of demand on supplies; very natural when consumer spending contracts to see a contraction in household borrowing because they just need less credit to finance their spending.

There are measures that show that banks are less willing to lend than they were previously. That also is a normal response to a lot of risk being out there in the economy. With the unemployment rate close to 10 percent, it is normal for banks to be less willing to lend.

Senator Brownback. The guy that is kind of new, I wouldn't put him a rock star, but he is a radio star in the Midwest, is Dave Ramsey. He has got billboards up in the Kansas City area that say: Act your wage. And he is all about burning credit cards and doing things on debit cards and just how it is that you get your own kind of fiscal house in order.

And people love the guy. They listen to him and say oh, okay, this is kind of very practical. But you can see people in their efforts to kind of unwind their credit position that they are in and just say, okay, I had a near-miss here, or we almost had this or that. I am kind of scared of this. How do I get backed away from that credit ledge?

Sure, it is kind of an interesting social phenomenon to see. And you see the numbers in personal savings rates, and looks like all the government transfers—we are doing a big portion of that—are going just to heal personal balance sheets. Just wise. It doesn't benefit the economy.

Cash for Clunkers, the auto dealers I was talking to were saying, We had a different person come in that bought in this. The person that came in generally bought with cash. So it was somebody that doesn't normally buy new. They usually by something already partially depreciated because they don't want to pay the new price. But when they did the calculus on this, they said, I can do this. So they brought the old Ford Explorer in and traded it in on a newer one, and the numbers and dollars worked. And it was a different customer that came in. That is what they were telling me. I don't know if that is backed up in the data or not.

You all are kind to be here. This was fun for me. I am told the Chair wants to come back and query a little more. If you don't mind, I will put us into a short recess until the Chair can return for further—if you need to go, I am certain she would understand. I am very appreciative of you being here, and thanks for entertaining me with the dialogue and the discussion.

We are in recess.

[Recess.]

Chair Maloney [presiding]. I would like to call us back into order and apologize that we had this vote called. And go back to job creation. I hope our other members will join us. I rushed back. Maybe they are on their way.

Dr. Dynan, you testified earlier that you were somewhat skeptical about the employer tax credit because many economists believe that the credit would be taken by many firms and that they would have created the jobs anyway. Others believe that because job creation is such a challenge right now, that these worries are misplaced.

I would just like to ask all of you whether you think that an employer tax credit is a good idea, yes or no. And then also, if there are other measures that Congress should consider to bolster job creation in both the short term and the long term. I know, Dr. Zandi, you testified to that earlier. But if we could just get a sense whether you think the employer tax credit is a good idea, yes or no.

You have already testified, Dr. Dynan, that you think this is a bad idea.

Dr. Johnson, do you think it is a good idea or bad idea?

Dr. Johnson. I think, unfortunately—it is tempting—I think it is a bad idea.

Chair Maloney. Dr. Zandi.

Dr. Zandi. I think it is a second-best idea.

Chair Maloney. Dr. Hassett.

Dr. Hassett. I think it can be a good idea if well designed. I think Ned Phelps of Columbia University has written a whole book on how an employer tax credit might be a vastly superior way to assist low-income workers than increasing the minimum wage, and I find those arguments pretty convincing.

Chair Maloney. I would just like to go down the panel if anyone has other ideas of how we can bolster job creation. That is a huge challenge right now.

Starting with Dr. Dynan.

Dr. Dynan. As I said in my remarks, I think there are strong advantages to providing for assistance to state and local govern-

ments; not so much they can create jobs, it is just they are not forced by declining tax revenues to cut jobs.

Chair Maloney. I would like to focus just on creating jobs. We did do that. We are looking at doing it again, possibly. But how do we create jobs? We can't continue to just be subsidizing jobs. We have to be creating jobs in our economy.

Any ideas of how to create jobs and help us with our economic growth?

Dr. Dynan. I will defer to the other panelists.

Dr. Johnson. I think in terms of broad creation, the broader adjustment process we were talking about before the break, that is working and it will come through. The issue I would focus on is what you highlight in your opening remarks, Congresswoman, which is the long-term unemployed.

So the experience from other industrialized countries is very clear, exactly what you said, which is that people out of work for 6 months, 9 months, start to lose the skill, start to lose the culture of work and it is very hard to get them reemployed. So even if output comes back, as I am expecting, you will have that unemployment.

So the experience and the measures taken in Australia that I mentioned earlier are to take the process of managing the long-term unemployed out of the hands of government agencies and to set up—to give out contracts to private companies that have incentives to get these people back into work, get them into decent jobs, and have them stay in jobs.

What that experience indicates—and this has been taken up to some degree also in the U.K. and in other parts of Europe—is that you get much more tailored solutions. It tends to be a one-size-fits-all, which can be appropriate in some circumstances, but not to the problem you are identifying. What the private sector tends to come up with is much more tailored counseling and tailored job-related skill creation on an individual basis, with a lot of counseling and a lot of psychological counseling as well to get people back into understanding what it is to work and how you hold a job.

I think that is what you need to look at to address the problem you rightly identified at the beginning.

Chair Maloney. One of the problems that we have in this country is for every job opening, there are now six applicants. And you read stories about a job being posted and 500 people showing up. What I am hearing from my constituency, some of whom are incredibly well educated with higher degrees in many different areas, is that the jobs are not there.

Americans work hard. They are very dedicated people and if the jobs were there, I believe that our unemployment number would not even exist. People would take those jobs.

So it seems to me that the biggest challenge that we have is how do we create these jobs. You can have a job program that tailors for medical services or whatever, but if the jobs are not there, there is no place for them to go.

Dr. Zandi, do you want to talk more about some of your ideas on job creation?

Dr. Zandi. Let me rank order things in terms of what I would do to support the job market. First is extend the UI benefits. I think that is absolutely necessary.

Second, State and local government aid, I think that is very important.

Third, expand SBA lending, going to the point that small businesses are key to the job machine and they can't get credit.

Fourth, I would extend and expand the net loss carryback provision in the ARRA. I would expand it to not all businesses but certainly much larger businesses than are currently allowed to under the ARRA. That would provide a very significant cash infusion in 2010, which is very, very important to many of these businesses.

Fifth, I would look at a payroll tax holiday, broad-based payroll tax holiday. I think I would add a job tax credit part to it. And what I would do there is I would say I have got X billion dollars to spend on the job tax credit; first come, first served. That way, you create an impetus for businesses to take advantage. Because the key problem with the job tax credit is that businesses are not going to take advantage of it because it is demanding credit that is their biggest problem. But if you give them an impetus, they may come forward and they may take advantage of it.

So, say I have got $15 billion, first come, first served, only to those businesses that can show that they expanded their wage and salary bill compared to what it was the year before. You get the credit. I would think that would jump-start creation quickly.

Chair Maloney. Dr. Hassett.

Dr. Hassett. I would disagree quite strenuously with my friend Dr. Zandi's recommendations. I don't think that we need more temporary fixes. I think what we need to do is fix things that are broken. The fact is if you look at the bipartisan support right now in California for reducing the corporate tax, because it is about the highest corporate tax State in the country—in the world, really, if you add California and the U.S. Federal tax. If you think about that and the plight at the Federal level, then there are a lot of opportunities right now for making businesses more optimistic about the future than they are right now.

If we continue to be the highest taxed place on Earth, other than pockets of Japan, then I don't know why people would want to build a plant here. The average OECD tax rate is something like 10 percentage points less than the one that we have here. And it is optimism of businesses that is going to kickstart the economy and create jobs.

Chair Maloney. Thank you. President Obama just issued a statement asking Congress to extend or pass three measures related to housing. I would like the panelists to comment on them; if they think they will work, yes or no, and why or why not.

First, to extend the homeowner tax credit with strong antifraud protections. Secondly, to extend the loan limits for mortgages and fund the Housing Trust Fund, which aids low-income families.

Again, I would like to go down the panelists. Do you support these measures, yes or no, why or why not? What alternatives do you have? I must say I would also like to ask what percentage you think housing is of our economy. I have heard ranges from 25 to

40 percent. Housing really created this problem, in many ways; the subprime mortgage crisis.

If you have other ideas of how we can get this segment of our economy working in a way that would move us forward.

So starting—why don't we start with you, Dr. Hassett, and go down the other way for a change?

Dr. Hassett. I think that one of the biggest problems with the Tax Code is that we have built in this heavy subsidy for housing and that the fraud in the first-time home buyer credit is evident. That fraud is something that is going to be very, very hard to manage because if grandpa says he just bought a house for the first time, we don't know if he owned a house back in 1960. It is going to be very hard to tell.

I think what we need to do is recognize that part of the problem previously was that we stimulated a lot of house purchases by distorting people's consumption decisions by giving a big tax-favorable treatment to housing, and that we need to move away from that gradually.

Next year, as the Tax Code opens up again, then I think that Congress is rightly going to want to consider a proposal like that that was floated by President Obama's team this year to limit the value of itemized deductions for high-income people. That will move us away from subsidizing housing. And I think that we have to do that if we want to address our long-run problems. There is a lot of money that can be had there.

So I think throwing another short-term fix at housing is a bad idea; in particular, the first-time homeowner credit really should not be extended.

Dr. Zandi. Well, I agree that the housing sector is oversubsidized, and those subsidies should be reduced, but this is no time to do it. The housing market is on life support. If we take it off, it will crater and take the rest of the economy with it. So I think this is no time to do that.

With that in mind, and just to reinforce a point, you asked what percent of the economy is related to housing. I don't know the answer to that, but what I do know is that if the housing market isn't functioning properly, meaning if house prices are still falling nothing in our economy works.

It undermines household wealth and the willingness and ability of people to spend. It is still the largest asset in the vast majority of Americans' balance sheet. No bank is going to extend credit as long as house prices are falling. So we have to end this or the recovery will not gain traction.

And that gets to what to do. I think the first-time home buyer tax credit is an inefficient form of tax subsidy, but it is in place and it would be a mistake to let it lapse. It would exacerbate conditions in the housing market. So I would extend it through at least mid next year as has been proposed.

The higher conforming loan limits which also the President is advocating for Fannie Mae and Freddie Mac, that is very straightforward. It should be done. If it is not done, that is going to undermine some key housing markets across the country in California, in Florida, in New York. That has to be done. In fact, I would even

advocate increasing the conforming loan limit for more markets across the country. It is very limited right now.

The third thing I would do and the broader thing I would consider doing is—this goes to the foreclosure crisis. The President's loan modification plan is not working well. There is not a significant amount of takeup on the plan, largely because it is not significantly reducing the probability of default.

The plan provides incentives to reduce monthly mortgage payments, but unfortunately most of these homeowners are so deeply under water that if anything goes wrong they will default. I spring a leak in the roof. If I have got to put 5K to patch the roof to live in it, I am not going to do that if I am $30, $40, $50,000 under water.

So the loan modification plan should be changed or at least adjusted to incent principal write-down, and I think there will be money there to do it because the President has allocated money from the TARP for the loan modification plan. He is not going to get the takeup he thinks. So there will be extra money sitting there, and that money should be used to provide incentive for principal write-down for a very specific group of homeowners that you can identify who shouldn't have gotten the loans in the first place. It was a regulatory failure that they got them.

So I think if we don't address the foreclosure crisis head on and more aggressively, there is a very likely possibility that house prices will continue to weaken into next year. Again, the economy doesn't work well with falling housing values.

Chair Maloney. Dr. Johnson.

Dr. Johnson. I think the first-time homeowner tax credit should be phased out. I agree with Dr. Hassett it is a very inefficient way to try and help people. I published an article on Monday where we go through the alternative estimates. It is not a good way to stimulate the economy either. There are much better ways to spend that money. But I agree with Dr. Zandi that you don't want to shock the housing market at this point; particularly, reasonable estimates are house prices are still somewhat overvalued relative to their medium-term fundamentals. Of course, Dr. Zandi is right, that if you hit people's wealth in this way, you are going to make them more uncertain. They are going to want to save more and consumption is going to decline.

So phasing it out is the way I would frame that. I agree—we are all agreeing there is too much subsidies for home ownership in this country relative to rent. I think Dr. Hassett is right; it is a longer term issue that needs to be taken on.

In terms of specifics, I think in this regard I would emphasize that Fannie Mae and Freddie Mac now work for the government. These are branches of the government. They were taken over, as you know.

In terms of loan modification in terms of how do you deal with people who are losing their homes, Fannie and Freddie have a lot of very good people who can be put to work, more focused, I would argue, on making sure that people get an opportunity to rent when they have fallen behind on their mortgages. So converting from home ownership to renting.

I think this fascination with home ownership and trying to boost the home ownership has got us into a lot of trouble, and we should back away from that. You need to even the playing field.

Chair Maloney. Ms. Dynan.

Dr. Dynan. Starting with the importance of housing to the economy, it was of course very important during the boom. I think, looking ahead, I agree with the other panelists, the main channel through which it is potentially going to affect the economy and be a downside risk to the economy is not through construction. Construction is so small now that any boost or any drag on construction is not going to be very important to GDP. But the channel is through house prices.

I think house prices further declining could have very important effects on the economy, and we want to protect against that.

With regard to the President's proposals, I agree with the other panelists that extending the first-time home buyer tax credit will spur new sales, but it is a very expensive way to do it because you are going to be paying many people who would have bought a house anyway, and it doesn't address the fundamental problem of oversupply in the housing market.

On the conforming loan limits, I agree with Mark that that is a very good idea.

I am not so familiar with the third thing he was suggesting. I do think it is related to something to mitigating the costs of foreclosures. And here I want to go back to what Mark said about the Administration's plan to reduce foreclosures.

I think it will help many homeowners avoid foreclosure, but I do agree with Mark that it is a limitation that it doesn't address principal write-downs. Now, personally, I am not supportive of a program that would pay for large principal write-downs. I think it is a very expensive way to try to spare households from foreclosure. I think dollars could be better used trying to mitigate the cost of foreclosures that need to occur—people who are deeply under water, for whom it would be difficult to get them back in a sustainable position with regard to their mortgages.

So I think you could take the money and put it towards offering homeowners assistance to relocate, to offering communities assistance in terms of dealing with vacant properties, and in other challenges that tend to hurt the neighborhood and bring house prices down.

Chair Maloney. Well, actually, the third point that the President suggested is exactly what you are supporting, and that is a grant to States to fund construction and maintenance of affordable rental housing and vacant lots and so forth.

Dr. Dynan. I do support that.

Chair Maloney. I would like to ask Dr. Zandi, in your testimony you talked about work-share programs. Can you give more detail about expanding funding of work-share programs and what can Congress do to encourage businesses and states to participate in the program?

Dr. Zandi. The work-share idea is a really interesting idea. I believe it is 17 states now that have work-share as part of their UI benefits. The idea is that if a business doesn't lay off workers and

reduces hours for a broad base of workers, the UI would be used to compensate those workers in part for those lost hours.

So what that would do is it would reduce the number of layoffs that would occur. It would keep people employed, just at reduced hours, and they would get some compensation from the UI program. This, of course, will help reduce or mitigate a whole lot of costs. For example, when a business lays off a worker. There are all kinds of severance costs. They have to rehire that worker back or hire another worker, there are training costs. Of course, it eliminates all kinds of costs for the workers themselves; the pain and suffering going through unemployment.

So I think it provides significant benefits to the employer and to the employee, and it is a way of keeping people on payrolls and not going out into the darkness of unemployment and not being able to get back.

Work share is a very effective idea. If you look at the data from ETA, the folks that collect this data, you can see in different states like California—and New York—that it is saving a lot of jobs. I think in New York I saw Governor Paterson's office just released a press release showing that it has helped to preserve 13,000 jobs, I want to say, but there is a release that they just put out a day or two ago. Saved in the sense that these are workers that would have been lost, and they have been put on work-share up to this point.

So the problem is to expand this more universally across the country. At this point, States are in no financial position to do it. They need some money to really set up the program, to get it going, to get the process going. I think that would be a reasonable thing for Federal policymakers to do. Perhaps an element of state and local government aid: Here is some seed money, set up this work-share program. Let's get going and we will help you with it, at least early on, because it seems to be working quite well.

Chair Maloney. Dr. Hassett.

Dr. Hassett. I would encourage you, given your remarks and your focus on job creation, to study the German experience, because it has really been quite remarkable in this episode that unemployment in Germany hasn't really gone up at all during this recession because their work-sharing program is so extensive.

I think we have kind of an old-fashioned unemployment insurance system and we are seeing other countries pursue policies that really are more effective. And we need to study them and perhaps, again, if we are going to take another bite of the apple of stimulus, that we should really consult experts on the German program before we decide what to do with unemployment insurance.

Chair Maloney. Thank you. I would like both of you to give us more information on it. I will certainly take it to my colleagues on both the German experience and the work-share program and look at possibly expanding it to a national program in the context of future aid to our states.

I have been told that other members are coming back, some of them.

I would like to get back to the small businesses and helping them generate jobs and certainly support the efforts of the SBA, and your ideas. What I am hearing from my constituents, businesses

large and small, is a lack of access to credit. The government has taken steps to help SBA expand.

You mentioned, Dr. Zandi, ways we could strengthen that. Do you have any other ideas of ways to expand access to credit, which even very established profit making businesses are telling me they are having a terrible time.

Any comments on how to expand access to credit?

Dr. Zandi. Well, the other thing I suggested that would buy—in my view, the credit problem is a problem of time. We need to give the banking sector some time to get its capital where it needs to be and to get the confidence necessary to go out and extend credit.

So if we can buy some time, I think the credit will start to flow by this time next year. So we need about a year.

So what would really be helpful, I think, would be an expansion of the NOL carryback. These businesses that are really cash constrained and credit constrained are losing money. Through the NOL carryback they can take that loss and use it as a deduction against past profits and get a tax refund. So they will get a check. For a number of small, midsized, even reasonably large businesses, this is real money. It is not insignificant.

It is costly in the first year. In fact, through my calculation, if you did it for all but the very largest businesses—businesses that employed over a thousand employees, let's say we cut it off there, because I don't think they are credit constrained, but a thousand and below—it would probably cost you about $60 billion in fiscal year 2010.

Now that wouldn't be the cost over the 10-year budget window because what you are doing is tax shifting. So you are shifting the tax burden out into the future and so their tax burden would rise and so the net cost over the 10-year budget window would be somewhere close to $15 billion.

But you would be putting a cash infusion into the economy to these businesses at just the right time, and you would be buying time. You would be buying time.

Chair Maloney. Thank you. Another grave challenge that we have right now that some of you mentioned was the commercial real estate industry. It is staggering. A lot of commercial real estate have told me that they are carrying buildings that are paying for themselves. So that they have the money coming in to sustain their business, yet they have balloon mortgages that are coming due in the next 2 years and the banks are calling them.

And it is next to impossible to get a loan on commercial real estate now. I am told you cannot—you can have a building worth $80 billion or $80 million, they are not going to give you a loan on it. I have heard it over and over again.

So it is dried up, the credit market for commercial real estate. Yet, it seems to me if we have buildings that are carrying themselves, should we have a temporary program that just kicks the can down the street a while instead of buildings that are carrying themselves that we ask the government to require that the banks not call these balloon loans? Any other idea that you have on the commercial real estate side?

Again, Dr. Zandi, you pointed out that most of these commercial loans are with small and regional banks. So it is going to be a big, huge blow to the banks. In hearings that we have had at this committee and others, the Treasury Department has testified that they are not willing to look at any program to help commercial real estate. Their focus is keeping the heart of the economy moving, keeping the financial services—banks and institutions operating, and propping up these commercial—these smaller banks and regional banks that may face extreme challenges because of the commercial real estate challenge.

It seems to me if we could figure out some way to just soften the blow it would help not only the banking system, but certainly the real estate industry, the overall economy.

So I would like to open that up to anyone, and start with you, Dr. Zandi.

Dr. Zandi. You are right, I think it is a very significant problem; not directly through the loss of—the defaults in commercial mortgages and its impact on construction. That is a negative, but it is a small negative. The real impact is through the impact on the banking system and then the provision of credit to everybody else, including, and most importantly, small business.

So I think it is a very large problem that should be addressed. I will give you a couple ideas. Unfortunately, the government doesn't have an easy tool. It is not like the residential mortgage market, where the government can step in through the FHA or through Fannie and Freddie or even through the Fed and do it.

But one thing you could do is Fannie Mae and Freddie Mac do make multifamily mortgage loans. So commercial real estate mortgage debt outstanding is $4 trillion. To give you context, there is $10 trillion in residential mortgage debt, $1 trillion is multifamily debt. Fannie Mae and Freddie Mac could be empowered to be more aggressive in extending out credit to multifamily property.

Moreover, you could empower Fannie Mae and Freddie Mac to provide some loans into other types of commercial real estate. Maybe into retail, office space. That might be a natural extension.

Unfortunately, this will take time to do properly, but this problem is not going away. It is going to be with us for a couple or 3 years.

The other thing that I think would be important but is in the purview of the Federal Reserve is the other source of credit for commercial real estate is the commercial mortgage securities market, the CMBS market. At the peak of the CMBS market back 3 years ago, it was $300, $400 billion in mortgage credit every single year. It is literally zero today.

The Federal Reserve has established, through the TALP program, a mechanism to providing cheap loans to investors to buy CMBS, but that program is not working at all. There have been no CMBS TALP deals.

So there would be a way to provide more—the Treasury could provide more backstop to the CMBS TALP activity to promote more CMBS deals, or at least get some of them going again.

Chair Maloney. Thank you.

Dr. Johnson.

Dr. Johnson. I am very uncomfortable with all of these proposals. I think that we can find many ways to put taxpayer money into the economy and we can create many justifications for it, but you have to draw lines. The impact on the banking system, I think, as Dr. Zandi said, that is what you are worried about. Not all small banks have this kind of experience in commercial real estate. We have a very competitive small banking sector.

The idea that healthy small businesses who are creditworthy and who want to borrow won't be able to borrow now obviously because of the disruptions, we agree with that, but won't be able to borrow in 6 months or 12 months, I am very skeptical of that.

I think there are major problems in the financial system. I emphasize them all the time. But they are in a different place than down here. CIT Group, just to be very concrete, 3 or 4 months came to the government for a bailout and said, If you don't bail us out, all the small- and medium-size businesses we work with will have their credit disrupted. According to the evidence I have seen on this, they were turned down for a bailout. They are going through a renegotiation process with the creditors, which is what the commercial real estate developers should do, too, and what they will do if you don't give them a bailout.

My understanding is that some of the CIT Group customers are getting credit from other people, some are facing a 20, 25 basis point increase in the cost of the credit. There is no evidence that I have seen that what has happened at CIT has caused this kind of massive disruption through the rest of the credit system.

So I am sure Fannie and Freddie could be induced into this market. They probably would be happy to have this kind of opportunity. This is how we got ourselves into trouble the last time around. I think you should be careful about expanding their mandates in this subsidized fashion. Once you are in, it is very hard to get out.

Chair Maloney. I want to thank all of you for your responses and recognize my dear friend and colleague from the great state of New York, Congressman Hinchey.

Representative Hinchey. Thank you very much. I am sorry I missed some of this because of the votes that we had, but I want to thank all of you very much for being here and for everything that you said in the context of the testimony that you presented.

I wanted to ask at least one additional question having to do with this economic crisis that we are now confronting, and including in that the potential that it could get worse at some time over the course of the next few years, and it could get worse unless appropriate action is taken to prevent that situation from getting worse.

The main cause of the economic recession that we have been experiencing was the deregulation of the banking industry, which initially came about in the context of the late 1980s into the 1990s by the Federal Reserve and the then-Chairman of that Federal Reserve and then ultimately the repeal of the Glass-Steagell Act in the legislation which was passed in 1999.

So we see on that basis that there was a big conscientious movement over a long period of time to achieve those objectives, and the achievement of those objectives was not based on anything that

was positive for the country. It was based upon what was interpreted as being positive for the people who are regulating the banks. And so when you had the repeal of Glass-Steagall, we experienced that situation where there was no longer a separation of commercial and investment banks. Also, the congressional ban on the regulation of credit default swaps was a major part of that.

So I think that this is something that should be on all of our minds. We see with the effect of the stimulus bill creating some positive effects, all of that. But, nevertheless, unless this situation is corrected, as it was done in 1933 in the context of the Great Depression and how that provision established in 1933 had such a positive effect on the long-term operation of the commercial investment regulatory system in this country, up until recently.

So I wonder what you might think about this. What do you think that we should do, Dr. Johnson?

Dr. Johnson. I think the way you have articulated the problem is exactly right. This is a major risk to the recovery. And even if we can get a good 2 or 3 years of solid growth and get our jobs back, it is still going to be a major problem.

I think you also identified exactly the two major tendencies, the deregulation of restrictions around banks and the Commodities Future Modernization Act, and everything that led up to that.

I think we need to break up the biggest banks. I would not try to reimpose Glass-Steagall. I think that is trying to make fish out of fish soup, which is a pretty hard thing to do. Once you have made the fish soup, you are pretty stuck with it.

But I think you can take these very big banks that are able to take these massive risks and put the downside onto us—create this big, long-term unemployment issue. You can take them out of the picture. You can downsize them.

Goldman Sachs, just to take one example, was a $200 billion bank in 1998. Now it is a trillion-dollar bank. People are telling you, you couldn't possibly downsize the banks. They are essential to the global economy. That I would contest on absolutely every detailed point that the people make.

But ask yourself this: Why is a trillion dollars the right side for Goldman Sachs? If they were a perfectly fine bank at $200 billion, $250 or so in 1998, why isn't that the right size for banks now? Lehman was a small broker-dealer back in 1998. It was a $600 billion bank. The bankruptcy was $640 billion when it failed.

That is too big to fail safely. That is what we have got to avoid. That is what we have got to get rid of.

Representative Hinchey. The allegation is it is too big to fail safely. And that is one of the reasons why there is this initiative to try to create these big banks so that people who are creating them can say, Look, I know we did a lot of bad things. We made a lot of mistakes. The whole place is in deep trouble. But, look, we are too big. You can't just collapse this.

Dr. Johnson. Absolutely. So the latest data we have, the CIT group was allowed to fail, go through its own bankruptcy. $80 billion assets. GMAC, which is currently on the table—I would suggest prepackaged bankruptcy for them, by the way, not a bailout, but prepackaged bankruptcy, arranged with the help of the government—this is over $200 billion in assets.

So I think they may well get a bailout. If they do, that is going to give you the dividing line. You want more things like CIT Groups, fewer things like GMAC if we are going to have a safe financial future.

Representative Hinchey. Anyone else? One of the things that we have just seen, we have lost about 110 banks this year alone. That is likely to continue. As it continues, all of these banks, which are so important in communities, particularly small communities all over the country, it is going to have a very negative effect on the economic conditions there in those areas, and that is something that we need to try to stop, because those small banks are critically important to everything that goes on in those communities.

There is another aspect of the economic circumstances that I find troubling, and that is the concentration of wealth in the hands of fewer and fewer people. We now have a set of circumstances that if you look at the top 1 percent, you have the same amount of wealth in the hands of the top 1 percent, the wealthiest 1 percent of the people, that you did in 1928 and 1929, right now. And if you look at the top 10 percent, you have a little bit more in the hands of the top 10 percent right now than you did in 1928, 1929.

Now that is something else that is having the effect of downgrading the whole economic circumstances of this economy all across this country. Isn't there something we should be doing about that?

Dr. Johnson. I couldn't agree more. I think it is a symptom of the kind of economy that we have created. And I think that has to be addressed through—specifically, I would say taking on the financial sector. The big banks are your major problem. It is obviously affecting the concentration of wealth.

I think breaking them up would not undermine the dynamism of the economy in any way. I think we were discussing perhaps when you were out of the room there is a major fiscal adjustment that is going to be required in not just this country but all industrialized countries. If you want to stabilize public debt as a percentage of GDP, given health care costs that are coming to us and all other OECD countries, the state-of-the-art forecasts are a 4 to 8 percentage point adjustment in structural fiscal positions across all of these countries that have to be new taxes or spending cuts. That is not even economics, that is just the arithmetic of stabilizing debt levels.

I think in that context you need to ask who benefited on what basis and what are the ways. The tax on excessive risk-taking is an idea taken up at the G–20 level. It was in their communique from Pittsburgh. Buried in the fine print, but definitely there.

This is something that would probably generate no more than half a percentage point of GDP in the United States. These issues are before us now.

Representative Hinchey. Well, thanks very much. Madam Chairman, thank you very much.

Chair Maloney. Thank you. I have one final question on credit. Some economists believe that the supply of credit has fallen because of actions that Congress has taken and the Administration and the Fed to restrict certain predatory practices in the mortgage and credit card markets.

Before this committee Professor Stiglitz testified this past spring that predatory practices reduced the demand for credit. And, on balance, I would like to ask any or all of you, do you think that restricting these practices will increase or decrease the amount of credit in the market? Anyone?

Dr. Johnson.

Dr. Johnson. I would put it this way. Predatory practices in the credit industry have massively damaged this economy. Why so many people spend beyond their means is they were lured, duped into various kinds of loans they couldn't afford. If there is a reduction in credit coming out of the kind of proposal you propose, I welcome it. I think those predatory practices are appalling from a moral point of view and very bad economics. They have added up to a first order macroeconomic disaster that we are now trying to extricate ourselves from.

Chair Maloney. It might create economic stability in the financial sector.

Dr. Zandi. I certainly agree with Simon. It is almost hard to understand that if you limit predatory practices that will restrain credit. I think that is just silly on the face of it. But I do think the uncertainty created by the debate with regard to regulatory reform is probably playing a role in the provision of credit, that until the rules are defined, at least a little bit more clearly, these institutions don't know how to do the math. When they don't know how to do the math, they don't do anything.

So basic kinds of stuff like: Will there be a CFPA, what will it look like, what are the rules of that going to be? Things with regard to the securitization process, how much "skin in the game" do investors need or institutions need to be able to issue securities? A whole range of issues.

So I think one of the key reasons credit—there are many reasons, and this isn't the most important one, but one of the key reasons for the lack of credit is the still very high level of uncertainty. As soon as you can get that nailed down, or closer to getting it nailed down, I think the more likely credit will start to flow.

Dr. Johnson. One reason there is so much uncertainty is because the credit industry has been pushing back so hard against the consumer protection initiatives. They are fighting this tooth and nail, right, in this building and around here and that is creating an enormous amount of uncertainty. So it is not something descended from heaven. It is really created by the opponents of sensible reform.

Chair Maloney. Thank you.

Dr. Hassett.

Dr. Hassett. Speaking of opponents of sensible reform, I think that reform will move forward if we recognize that the morality of the previous episode is really quite challenging in every direction. There were predatory lenders, there were predatory borrowers. There were people who didn't really think they were going to pay stuff back. There were a lot of people that got tricked into doing things and other people that did things that are incorrect.

I think that if we look at some of the positions of lenders, that they come from a defensiveness that is created by a climate that

is one-sided and doesn't recognize that they have to deal with people that don't want to pay them back at times, too.

Chair Maloney. Thank you.

Dr. Dynan, you have the last word.

Dr. Dynan. Thank you. I want to say I do think there were excesses in the middle part of the decade, no doubt, and I do think it is appropriate that we have regulation that protects against predatory policies.

We do need to make sure that we don't overreact. We need to remember that prior to the excesses earlier this decade, there were many—credit supply was increasing. And there were many advantages to that.

That said, I agree with Dr. Johnson in that the goal of regulation should be to prevent credit cycles like these and meltdowns like these and ultimately, by lending that security to the economy, it is going to be a good thing.

Chair Maloney. Thank you. I want to thank all of you for your hard work, for your testimony today. You gave us a great deal to think about and gave us some new ideas and explained others. Thank you so much.

[Whereupon, at 12:45 p.m., the committee was adjourned.]

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF REPRESENTATIVE CAROLYN MALONEY, CHAIR, JOINT ECONOMIC COMMITTEE

Today's report from the Bureau of Economic Analysis on 3rd quarter gross domestic product (GDP) provides welcome evidence that the economy is moving from recession to recovery.

When the President took office in January, our economy was on the brink of an economic disaster.

There was no end in sight to the recession that started in December 2007.

The idea that the economy would achieve positive growth so soon would have surprised many. Today, it is clear that the economy is moving in the right direction.

GDP rose by 3.5 percent in the third quarter, after having fallen for an unprecedented four straight quarters.

This is concrete evidence of the wisdom of the Recovery Act and the positive effect it has had on the economy in just eight short months.

Last week, Dr. Christina Romer, the President's Chair of the Council of Economic Advisers, presented us with compelling evidence that the economy is rebounding largely because of the Recovery Act.

Indeed, she testified that the Recovery Act added between three and four percentage points to economic growth in the third quarter, far beyond what the opponents of the Recovery Act thought possible.

Another piece of welcome news is that personal consumption grew by 3.4 percent in the third quarter, largely due to actions taken by Congress and the Administration.

We are finally seeing signs that consumers are spending more, which could spur businesses to hire more workers to meet renewed demand for their goods and services.

Moreover, I expect that legislation that I worked tirelessly on to end the most abusive practices of credit card companies, the Credit Card Holders' Bill of Rights, which Congress passed on an overwhelmingly bipartisan basis, will help increase consumers' demand for credit and encourage creditworthy borrowers to spend.

The Financial Services Committee recently passed a bill I also introduced to speed up the implementation, so that these measures would go into effect on December 1st.

Despite significant legislative accomplishments that brought us from economic abyss, I believe we still have a long way to go before the economy fully recovers.

The most pressing economic issue for the nation is job creation.

The stimulus has helped Americans in need weather the storm, but we must do more to get people back to work.

I look forward to the ideas that our distinguished witnesses have about translating our economic growth into job growth, and their suggestions about any additional measures Congress can take to spur businesses to create more jobs.

One group that I'm particularly concerned about is the long-term unemployed.

The longer someone stays unemployed, the harder it is for them to find work.

The long-term unemployed are stuck between a rock and a hard place.

First, they are suffering now, which is why the House has already passed legislation expanding unemployment insurance.

I am optimistic that the Senate will pass this soon.

Second, the long-term jobless—those who have been unemployed for six months or more—may suffer in the future.

Even when the economy recovers, workers who have been unemployed for a long time may no longer have the skills necessary to be competitive in the workforce.

We must come up with creative ways of helping the long-term unemployed maintain their skills or develop new skills so that once we get back on track and start creating jobs, they will not be left behind.

I thank our distinguished panel of witnesses for their testimony, and I look forward to hearing their thoughts on the most important issues we face—sustaining our economic progress and creating jobs for the American people.

PREPARED STATEMENT OF SENATOR SAM BROWNBACK, RANKING REPUBLICAN

Thank you Chairman Maloney for scheduling today's hearing on "The Impact of the Recovery Act on Economic Growth," and thank you Dr. Landefeld and other witnesses for taking the time to join us this morning.

Before making my opening comments, I'd like to pause to recognize Nan Gibson, the committee's Executive Director, to thank her for her years of service to the committee—even if it was on the wrong side of the aisle, and to wish her the best as she leaves us to join the staff of the Council of Economic Advisers.

This morning's report on GDP provides uplifting news that our economy has finally returned to positive growth. Despite the significant turnaround in growth, from an annual rate of −0.7% in the 2nd quarter to an annual rate of 3.5% in the 3rd quarter, I would like to point out that our economy has only grown by $113 billion in "real" 2005 dollars (at an annual rate), and that total GDP remains $128 billion below where we were at the end of 2008.

While the turnaround in GDP is positive news to us here in Washington, it provides little solace for the more than seven million workers who have lost their jobs since the start of recession and the hundreds of thousands of workers who will lose their jobs over the coming months. Proponents of the stimulus claimed that it would prevent the unemployment rate from rising above 8% or 9%, and yet it is already at 9.8% and will most likely be over 10% by the end of the year.

I voted against the $787 billion stimulus package because I viewed it as a largely wasteful use of taxpayers' dollars, not to mention a means to permanently increase the size of government. I am deeply troubled by the massive run-up in our national debt. Whereas we used to argue over millions of dollars, and then billions, we are facing annual budget deficits in excess of $1 trillion for the foreseeable future and our gross national debt will approach 100% of GDP within the next ten years. These figures are astounding and they should cause every one of us great concern and apprehension about the future we are leaving for our children and grandchildren. Our generation has been afforded the benefit of relatively low taxes despite high levels of government spending, but our children and grandchildren will pay for our fiscal negligence through excessive tax rates that confiscate more than half of their hard-earned incomes. Meanwhile, we will be enjoying retirement benefits far in excess of our contributions.

Of the $787 billion in appropriated stimulus funds which were purported to be spent quickly and efficiently, only $195 billion—about 25%—was spent through the 3rd quarter of 2009. When the stimulus was passed, promises were made that the money would go out the door quickly. As the figures show, this has not been the case.

The $195 billion in stimulus money that has been spent to date has no doubt caused a boost—even if temporary and artificial—to GDP growth, but in the long run, GDP will be lower as a result of this massive government spending package. Furthermore, it seems, based on comments by Administration officials which indicate that the greatest impact of stimulus was felt in the 2nd and 3rd quarters of 2009, that there is little benefit left to be realized by the nearly $600 billion in remaining stimulus funds.

The Administration and other forecasters who advocate Keynesian notions of government spending have provided some very rosy estimates of the effects of the stimulus on GDP growth. These estimates have been countered with less favorable estimates of relatively small stimulus impacts on GDP growth. The overly optimistic estimates imply that the stimulus alone is responsible for the turnaround in growth. This is to suggest that the massive actions taken by the Federal Reserve and the Treasury—to the tune of trillions of dollars, and most of which were initiated long before the fiscal stimulus took effect—contributed very little to the turnaround in growth. Regardless of whether or not one believes these massive interventions by the Federal Reserve were appropriate, they have no doubt contributed significantly to stabilizing and improving the functioning of our deeply troubled financial system. Were it not for these actions by the Federal Reserve and Treasury, there is little doubt that today's report would not indicate the highly positive economic growth that it does, and credit for the recovery should be given where credit is due.

PREPARED STATEMENT OF J. STEVEN LANDEFELD, DIRECTOR, BUREAU OF ECONOMIC ANALYSIS, U.S. DEPARTMENT OF COMMERCE

Madame Chairman and other Members of the Committee:

Thank you for inviting me to describe the third-quarter gross domestic product (GDP) and related statistics that the Bureau of Economic Analysis released this morning. These "advance" statistics are—as always—based on incomplete and preliminary source data that will be revised as more complete and accurate data become available. Tracking an economy that is changing as rapidly as the U.S. economy is changing right now is a challenging task, but we are committed to producing advance estimates that provide an accurate general picture of economic activity. That picture will become clearer as more comprehensive source data become available in the months to come. These early snapshots are designed to provide public and private decision makers with a reliable early read on the evolving U.S. econ-

omy. Let me walk you through the details of today's release, and then I'll be happy to answer any questions that you may have.

The advance estimates that we released this morning show that in the third quarter of 2009, real GDP increased 3.5 percent at an annual rate. In the second quarter, the rate of decline in real GDP moderated, decreasing 0.7 percent, following a sharp 6.4 percent decrease in the first quarter. Real GDP declined in 5 out of the 6 quarters from the fourth quarter of 2007, which NBER determined was the start of this recession, to the second quarter of 2009.

As you know, GDP is comprised of many different components, and I would like to discuss highlights of the major components. In the third quarter, consumer spending, inventory investment by businesses, residential investment, exports, and government spending all rose. These increases were partly offset by a rise in imports.

The price index for gross domestic purchases, which is the broadest measure of inflation confronted by U.S. consumers, businesses, and government, increased 1.6 percent, following an increase of 0.5 percent in the second quarter. After falling for the first two quarters of the year, energy prices rose sharply in the third quarter. Excluding food and energy prices, the price index for gross domestic purchases increased 0.5 percent in the third quarter after increasing 0.8 percent in the second.

Motor vehicles, which show up in all the components of GDP—consumer spending on autos and trucks, business and government investment in autos and trucks, investment in inventories by motor vehicle manufacturers and dealers, and exports and imports—raised real GDP growth in the third quarter by 1.7 percentage points. Excluding the effects of motor vehicles, real GDP increased 1.9 percent in the third quarter after decreasing 0.9 percent in the second quarter.

Consumer spending, which accounts for over two-thirds of GDP, increased 3.4 percent in the third quarter, following a decrease of 0.9 percent in the second. Consumer spending on durable goods increased 22.3 percent. Motor vehicle purchases, spurred by "cash for clunkers" rebates in July and August, accounted for most of this increase, although, real spending on other durable goods, nondurable goods, and services also increased in the third quarter.

Residential construction rose by 23.4 percent in the third quarter, the first increase in 15 quarters. Prior to the third quarter increase, residential investment fell at an average annual rate of 20.9 percent since the fourth quarter of 2005.

Business nonresidential fixed investment—investments in new plants, office buildings, equipment, and software—fell 2.5 percent in the third quarter, compared with a decrease of 9.6 percent in the second. Business spending on durable equipment and software rose 1.1 percent in the third quarter after falling 4.9 and 36.4 percent in the second and first quarters of 2009, respectively. The rate of decline in investment in nonresidential structures decreased 9.0 percent after decreasing 17.3 and 43.6 percent in the second and first quarters, respectively.

Business inventory investment provided a positive contribution to the change in real GDP, as businesses drew down their inventories at a slower rate than they had in the second quarter. Therefore, more sales were of goods and services produced in the third quarter and less out of inventories. Inventories fell about $131 billion in the third quarter, compared with a decrease of about $160 billion in the second quarter and a decrease of about $114 billion in the first.

Real exports of goods and services increased 14.7 percent in the third quarter, in contrast to a decrease of 4.1 percent in the second. This is the first increase in real exports in 5 quarters. Real imports of goods and services increased more than exports, rising 16.4 percent in the third quarter, in contrast to a decrease of 14.7 percent in the second.

Spending on goods and services by the federal government increased 7.9 percent in the third quarter, compared with an increase of 11.4 percent in the second. The slowdown in federal spending was accounted for by defense spending. Spending by state and local governments fell 1.1 percent in the third quarter, in contrast to an increase of 3.9 percent in the second quarter.

Turning to the American household, real disposable personal income, that is personal income less personal taxes adjusted for inflation, declined 3.4 percent in the third quarter after increasing 3.8 percent in the second. The third-quarter decline reflected the pattern of tax reductions and government social benefits provided for by the American Recovery and Reinvestment Act (ARRA) of 2009, including the Making Work Pay Credit and the one-time payments of $250 to recipients of social security and other benefits. Excluding these tax reductions and government social benefits from ARRA, real disposable personal income decreased 2.0 percent in the third quarter after decreasing 0.9 percent in the second. The third-quarter personal saving rate was 3.3 percent, compared with 4.9 percent in the second quarter and 3.7 percent in the first.

Since the second panel at this morning's hearing will address the effect of the ARRA, let me conclude by describing how it is reflected in GDP and the national accounts. BEA's national accounts include the effects of the federal outlays and tax cuts included in the ARRA. Because most of the outlays and tax reductions from ARRA during the last three quarters were in the form of grants to state and local governments, tax reductions for individuals and businesses, and one-time payments to retirees, their effects on GDP show up indirectly through the effects on GDP components such as consumer spending, residential investment, and state and local government spending. Thus, BEA's accounts do not directly identify the portion of GDP expenditures that is funded by ARRA. During each of the second and third quarters, the Making Work Pay Credit lowered personal taxes and raised disposable personal income about $50 billion (annual rate). During the second quarter, ARRA provided payments of $250 to beneficiaries of social security and other programs that raised disposable personal income about $55 billion. ARRA also provided special government benefits for unemployment assistance, for student aid, and for nutritional assistance; these special benefits raised disposable income about $49 billion in the third quarter and about $35 billion in the second quarter. ARRA also funded grants (such as Medicaid) and capital grants (such as highway construction) to state and local governments of about $75 billion in the third quarter and $85 billion in the second quarter.

My colleagues and I now would be glad to answer your questions.

PREPARED STATEMENT OF REPRESENTATIVE MICHAEL C. BURGESS, M.D.

It's easy for all of us sitting here to talk about any alleged economic growth brought about by the February $787 billion stimulus bill. We're all employed. But the reality is twofold.

First, while I did not vote for this stimulus bill, $787 billion was made available for spending to stimulate the economy, but as of today, only $173.2 billion has been spent. Why hasn't the other $613.8 billion been spent?

We should have Jared Bernstein here, who oversees the stimulus efforts for the Vice President, to inform us why a mere 22% of stimulus dollars have been spent.

Second, President Obama sold the stimulus on the idea that it would stop unemployment and Members of Congress voted for this stimulus bill to stop the tide of job losses, so unless you can show that unemployment has gone down, there is no economic growth.

And the jobs just aren't there.

Since the stimulus passed, 15.1 million Americans are unemployed. This is nearly DOUBLE the number of unemployed Americans since before the stimulus passed last February.

15.1 million Americans unemployed is nothing compared to the same Bureau of Labor Statistics report which states that 17 percent of all American adults—or one out of every six civilians—are (1) not working or looking for work but say they want and are available for a job; (2) discouraged workers; or (3) workers who want to work full-time but due to the economy had to settle for part-time work. This is the "U-6" report by the Department of Labor and it's this 17% unemployment number which has all of us deeply concerned.

How many Americans are taking their law degrees and going to work picking up garbage? For some this might sound like a promotion, but the reality is there are many hardworking Americans who want to work and so take a part time job in the hopes of finding a better job.

So knowing that 35.6% of unemployed have been without work for more then 27 weeks is unacceptable when there was legislation passed by this Congress less then eight months ago to stimulate the economy with 72% of its funds not spent.

What's being spent apparently isn't working.

If it's not being spent, then don't spend anymore.

At a time when our national deficit is skyrocketing and our national debt is beyond our ability to even comprehend, we need some perspective. With the stimulus bill, we could have paid off the $550 billion in outstanding student loan debt in the U.S. and still have $237 billion left over.

There are currently 1,509,180 elementary school teachers in the U.S. With the stimulus bill, we could have paid every elementary school teacher's salary in the U.S. for ELEVEN YEARS.

But instead, we used the stimulus bill to lose nearly seven million jobs.

That's not economic growth no matter how you try to qualify it, and we shouldn't have to pay for incompetence.

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CONGRESSIONAL HEALTH CARE CAUCUS,
CHAIRMAN

November 4, 2009

Dr. Karen Dynan
Vice President and Co-Director
Economic Studies Program
Robert S. Kerr Senior Fellow
Brookings Institution
1775 Massachusetts Avenue, NW
Washington, DC 20036-2188

Dear Dr. Dynan:

Thank you for your participation at the Joint Economic Committee's hearing "The Impact of the Recovery Act on Economic Growth." I have one follow-up question for you below and look forward to receiving your response.

QUESTION FOR THE RECORD

In comparison with the Federal Reserve's massive 'adrenaline shot' of $1.3 trillion of liquidity last fall, only $173 billion, or 22 percent of the $787 billion authorized in the Obama stimulus bill in February, has been spent as of October 8th. The Federal Reserve's liquidity injection is more than 7 and one-half times as large as all spending and tax reductions under the Obama stimulus bill so far.

a. How do you differentiate and quantify the supposed effects of $173 billion in stimulus spending, much of which was spent very recently, from the effects of the Federal Reserve's $1.3 trillion injection of liquidity last fall?
b. Does the Federal Reserve deserve the bulk of the credit for any stabilization during the second quarter and growth during the third quarter of this year?

With regards,

Michael C. Burgess, M.D.

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November 4, 2009

Dr. Kevin Hassett
Senior Fellow and Director of Economic Policy
The American Enterprise Institute
1150 17th Street, NW
Washington, DC 20036

Dear Dr. Hassett:

Thank you for your participation at the Joint Economic Committee's hearing "The Impact of the Recovery Act on Economic Growth." I have one follow-up question for you below and look forward to receiving your response.

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November 4, 2009

Dr. Simon Johnson
Ronald A. Kurtz Professor of Entrepreneurship
Sloan School of Management
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77 Massachusetts Avenue
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Dear Dr. Johnson:

Thank you for your participation at the Joint Economic Committee's hearing "The Impact of the Recovery Act on Economic Growth." I have one follow-up question for you below and look forward to receiving your response.

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CHAIRMAN

November 4, 2009

Dr. J. Steven Landefeld
Director
Bureau of Economic Analysis
U.S. Department of Commerce
1441 L Street, NW
Washington, DC 20230

Dear Dr. Landefeld:

Thank you for your participation at the Joint Economic Committee's hearing "The Impact of the Recovery Act on Economic Growth." I have one follow-up question for you below and look forward to receiving your response.

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OVERSIGHT AND INVESTIGATIONS

JOINT ECONOMIC COMMITTEE

CONGRESSIONAL HEALTH CARE CAUCUS,
CHAIRMAN

November 4, 2009

Dr. Mark Zandi
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Dear Dr. Zandi:

Thank you for your participation at the Joint Economic Committee's hearing "The Impact of the Recovery Act on Economic Growth." I have one follow-up question for you below and look forward to receiving your response.

QUESTION FOR THE RECORD

In comparison with the Federal Reserve's massive 'adrenaline shot' of $1.3 trillion of liquidity last fall, only $173 billion, or 22 percent of the $787 billion authorized in the Obama stimulus bill in February, has been spent as of October 8th. The Federal Reserve's liquidity injection is more than 7 and one-half times as large as all spending and tax reductions under the Obama stimulus bill so far.

a. How do you differentiate and quantify the supposed effects of $173 billion in stimulus spending, much of which was spent very recently, from the effects of the Federal Reserve's $1.3 trillion injection of liquidity last fall?
b. Does the Federal Reserve deserve the bulk of the credit for any stabilization during the second quarter and growth during the third quarter of this year?

With regards,

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PREPARED STATEMENT OF KAREN E. DYNAN, BROOKINGS INSTITUTION [1]

Chair Maloney, Vice Chairman Schumer, Ranking Members Brady and Brownback, and members of the Committee, I appreciate the opportunity to appear before you today to discuss the outlook for consumer spending and the broader economic recovery.

THE OUTLOOK FOR CONSUMER SPENDING

I will begin with the outlook for consumer spending on goods and services, as it is the largest component of GDP, and it played an important role fueling the economic expansion earlier in the decade. The available information suggests that the fundamental determinants of consumption will support only moderate growth in consumption over the next couple of years.

One factor that will probably restrain consumption will be tepid growth in households' labor income. As you know, the sharp decline in aggregate demand for output has led to one of the largest percent declines in employment since the Second World War. Payroll employment has fallen by more than 7 million since the recession began, and, although the rate of decline has abated in recent months, we are unlikely to see substantial gains in employment in the near future. When labor demand picks up again, firms are likely to increase workers' average hours—which fell noticeably during the downturn—before increasing the number of workers they employ. Firms tend to pursue this strategy because raising hours is less costly and easier to reverse than hiring new workers if the recovery proves transient. Of course, longer workweeks would increase workers' earnings, but the magnitude of this response is also likely to be muted.

If employment and average hours worked rise only slowly, labor income could advance rapidly only if compensation per hour rose rapidly. However, compensation has been moving up quite sluggishly in recent quarters, and, with the unemployment rate at its highest level since the early 1980s, it is likely to continue to do so.

Of course, one caveat to this perspective is that household income is not independent of consumer spending. If, for example, the other fundamental determinants of consumption were to change in a favorable way, then consumer spending would likely grow more rapidly, which would, in turn, feed back into greater strength in income. However, as conditions stand now, the most likely outcome is for lackluster income growth over the next couple of years.

Under current law, consumption will also be restrained by a significant increase in tax payments over the next few years, as several key tax provisions expire. First, the temporary higher exemption limits for the Alternative Minimum Tax (AMT) are scheduled to expire at the end of 2009; if allowed to do so, many more taxpayers will be subject to the AMT. Second, the tax cuts provided by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), along with the Making Work Pay tax credit enacted in the American Recovery and Reinvestment Act (ARRA), are scheduled to expire by the end of 2010.

Moreover, additional forces should damp consumption relative to after-tax income. Compared with the situation prior to the crisis, saving is likely to represent a markedly higher share of after-tax income, and consumption is likely to represent a markedly lower share of after-tax income.

The most powerful of these forces is the massive declines that we have seen in household wealth. In the years leading up to the financial crisis, the saving needs of many households were met by substantial capital gains on homes and on holdings of corporate equities. However, the sharp reversals in the prices of these assets over the past couple of years have changed the picture dramatically. I recently studied data from surveys of household finances done in 1962, 1983 and then every three years since 1989. I estimated that recent declines in asset prices have reduced the ratio of non-pension wealth to income for the median household below the levels seen over the past quarter-century and similar to the level seen in the early 1960s. [2]

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[1] Robert S. Kerr Senior Fellow, Vice President, and Co-director, Economic Studies Program. The views expressed are my own and do not necessarily reflect the views of other staff members, officers or Trustees of the Brookings Institution.

[2] See Karen E. Dynan, "Changing Household Financial Opportunities and Economic Security," forthcoming in the Fall 2009 issue of the *Journal of Economic Perspectives*. The comparison is based on data from 1962 Survey of Financial Characteristics of Consumers; the 1983, 1989, 1992, 1995, 1998, 2001, 2004, and 2007 Surveys of Consumer Finances; and an imputation of the wealth of respondents to the 2007 Survey of Consumer Finances as of the end of 2008. Since

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Households above the median have been left with about as much wealth relative to income as their counterparts in the late 1980s and only slightly more than their counterparts in the early 1960s. Meanwhile, households at the 25th percentile have seen their wealth-to-income ratio fall to the level recorded in the early 1960s, and households at the 10th percentile have negative wealth for the first time in at least half a century.

The recent declines in wealth should have the opposite effect of the earlier increases in wealth—they will likely induce households to reduce their consumption and increase their saving in order to rebuild their wealth. Indeed, the weight of evidence from statistical studies over the years suggests that one fewer dollar of wealth leads to a permanent decline in the level of household consumption of about three to five cents, although this range does not encompass the conclusions of every researcher. For the most part, the evidence in these studies also suggests that households move toward their new lower levels of spending gradually over a period of one to three years.

Applying the results of these studies to the declines in wealth that households have seen over the past couple of years, I estimate that wealth effects should damp consumption growth this year by between 2 and 3½ percentage points and hold down next year's consumption growth by between ½ and 1 percentage point. In doing this calculation, I assumed that household wealth rises at about the same rate as disposable income through the end of next year. The negative wealth effects could be even larger if stock prices turn down again or house prices continue to fall (a topic to which I will return later in my remarks).

The personal saving rate will probably also be boosted by factors beyond wealth. Earlier this decade, many analysts came to the view that the economy had entered a "Great Moderation," a marked long-run reduction in economic volatility. The experience of the past couple of years has presented a substantial challenge to that view. Many households have likely revised upward the amount of risk they see in their economic environment. Accordingly, one would expect households to reduce their spending so as to raise their precautionary savings.

Part of this increase in precautionary saving may occur as a reduction in borrowing. Households have just had a vivid lesson about the risks associated with high leverage, and many will be more reluctant to take on large amounts of debt to fund spending.

Households' borrowing to finance consumption is also likely to be crimped by a more restrictive supply of credit. Since the financial crisis and economic downturn began, lenders have sharply reduced their willingness to extend credit to households. With unemployment rates remaining very high in coming quarters, lenders are likely to continue to see heightened risk in lending to households for some time to come. Further, the supply of credit seems unlikely to return to the levels seen earlier this decade even after the economy returns to full strength, as lenders, like households, have probably marked up their expectations of economic volatility over the long run. Regulatory actions should serve to reinforce the greater restrictiveness of lenders; indeed, the Federal Reserve and Congress have already taken steps to restrict some types of mortgage lending and certain practices among credit card lenders.

All told, I expect that consumer spending will move up at a modest pace in coming quarters because of weak income growth as well as higher saving and lower borrowing. Although this outlook contributes importantly to my expectation of a relatively weak overall recovery, I should note that higher household saving and lower household borrowing have the important positive aspect of leaving the economy in a more solid and more sustainable position. At the household level, the restructuring of balance sheets will leave households less vulnerable to disruptions to their incomes and to unexpected spending needs. At the national level, higher saving will help to correct what many analysts believe are unsustainable imbalances in trade and capital flows between countries.

THE OUTLOOK FOR THE BROADER ECONOMY

Turning to the broader economy, I share what seems to be the consensus view that we are not likely to see the rapid snapback in activity that has followed many previous downturns. As with consumer spending, the most probable outcome seems to be a moderate expansion of economic activity over the next couple of years.

To be sure, the consensus view may not turn out to be correct. Two years ago, for example, most analysts did not foresee the deep recession that we have experi-

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the end of 2008, movements in home prices and equity prices have had opposing effects on household wealth.

enced. Similarly, the recovery could well be stronger or weaker than most forecasters now expect.

That said, although the economy appears to have reached a turning point, none of the major components of private aggregate demand seem poised for a sharp recovery. As I have just described at length, consumer spending is unlikely to expand robustly over the next year or so. Indeed, consumer spending has rarely led the way out of downturns in the past. All recoveries are different, of course, but, on average, the saving rate has tended to move sideways after the economy hits bottom, implying that consumer spending has generally increased as rapidly as income and overall economic activity.

In the housing sector, the long contraction appears to have come to an end, with residential construction, home sales, and homes prices all showing signs of firming in recent months. Indeed, homes are much more affordable than they were a few years ago, with national home prices now down more than 30 percent from their peak in 2006 and interest rates on conforming mortgages roughly 1.5 percentage points below their average over the past decade. However, a strong rebound in construction seems very unlikely. The stock of unsold new homes remains very high, particularly when measured relative to sales. In addition, housing demand will likely be held back for some time by the weak financial situations of many households. Moreover, many households that are not qualified for government-supported mortgages—either with backing from the government-sponsored enterprises or through the Federal Housing Authority or the Department of Veterans Affairs—are finding it extremely difficult to obtain a mortgage.

One downside risk to this already soft outlook stems from the foreclosure crisis. In 2008, lenders initiated more than 2¼ million foreclosures, up from a pace of 1½ million in 2007 and an average of less than 1 million over the preceding three years. With various foreclosure moratoria expiring in early 2009, the rate at which foreclosures were initiated shot up to an annual pace of 3 million.[3] Foreclosure starts generally affect housing markets with a substantial lag, as the foreclosure process can take many months or even years to complete. Thus, although improvements in economic conditions and this year's government initiatives to prevent foreclosures may damp the foreclosure start rate, the rate at which distressed properties are coming to market is likely still building. We lack good estimates of how large the influx will be and how it will affect the housing market, but one cannot dismiss the possibility that these properties will depress housing construction and home prices yet further.

Business investment in equipment and structures is likely to be held down by the large amount of excess capacity. Falling demand for manufactured products over the past two years has left capacity utilization in that sector extremely low relative to historical norms. Outside of manufacturing, the financial sector, which traditionally has invested heavily in high-tech equipment, has shrunk markedly and is likely to stay much smaller than its pre-crisis size. More broadly, weak demand for output should damp business investment in many sectors. Business spending on structures is likely to be particularly sluggish, amid high vacancies in the office sector and very tight financing conditions for firms that do wish to start new projects.

Business investment in inventories is probably contributing to growth in the second half of this year. The sharp reduction in demand for goods led businesses to liquidate their holdings of inventories at a staggering rate in the first half of the year. But, with the recent stabilization of demand, the pace of destocking should be slowing, and, at some point, firms will begin to rebuild inventories. This pattern appears to have been boosting production of late and should continue to do so for several quarters. However, inventory investment cannot be counted on as a source of sustained growth as its effects on production tend to be neutral once inventories are brought in line with sales.

Foreign growth has picked up of late, particularly in many Asian nations. This recovery has led to an increase in demand for U.S. exports. However, imports have also turned around with the firming of domestic demand. On balance, net exports appear to be contributing little to the U.S. recovery at this point.

In sum, economic activity is on track to expand over the next couple of years but only at a modest pace. As a result, the economy is unlikely to see full employment for many years, prolonging the current economic distress for millions of households.

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[3] See Larry Cordell, Karen E. Dynan, Andreas Lehnert, Nellie Liang, and Eileen Mauskopf, "The Incentives of Mortgage Servicers and Designing Loan Modifications to Address the Mortgage Crisis," in Robert W. Kolb, ed., *Lessons from the Financial Crisis* (forthcoming).

POLICY OPTIONS

In light of the expected slow pace of the recovery, many policy analysts and other observers are considering possible policy actions to spur demand for output and employment. Some of these policy actions would be broadly stimulative, while others would have narrower, targeted effects.

As I noted earlier, under current law, households' disposable income will be reduced by the expiration at the end of this year of the higher exemption limits for the Alternative Minimum Tax and the expiration by the end of next year of the 2001 and 2003 tax cuts and the Making Work Pay tax credit. According to the Congressional Budget Office (CBO), these developments will depress disposable personal income in 2011 by a projected $300 billion or nearly 3 percent.[4] Pushing back the date at which these provisions expire would provide more support for consumer spending.

That said, policymakers should be mindful of the long-term need for fiscal discipline. Even with the expiration of these tax provisions, CBO projects that U.S. budget deficits will be more than 3 percent of GDP five to ten years from now and that federal debt held by the public will be rising relative to GDP. High budget deficits reduce saving and investment and, in turn, damp economic growth; they also risk inducing a crisis in which the holders of U.S. debt lose their appetite for that debt. Thus, while it may make sense for Congress to take steps that reduce taxes on households in the short run, it is imperative that policymakers form a plan to bring revenues back in line with spending over the longer run.

More targeted policy changes can generally be divided into those that bolster job creation and those that provide other relief to households that have suffered job losses. In the former category, additional aid to state and local governments would reduce the need for cutbacks in employment by those governments and by related private-sector entities. Even if one thinks that state governments should restrain their activities and employment over time, the abrupt cutbacks enforced by falling tax revenue in this recession have not served the broader economy well.

As another strategy for encouraging job creation, some analysts have proposed offering tax credits for firms that hire new workers. Designing and implementing effective tax incentives for hiring is difficult, however. One challenge is that, in the dynamic U.S. job market, many firms are creating jobs even in tough economic times. Therefore, a tax credit for all job creation tends to distribute money to many firms that would have done that same hiring anyway. On the other hand, restricting a tax credit to employment increases that would not otherwise have occurred is hard.

With regard to initiatives that provide other types of relief to households that have suffered job losses, several possibilities would help households sustain their spending and thereby bolster the overall recovery. For example, the efforts that Congress is making to extend unemployment insurance for those who are scheduled to exhaust their benefits by the end of this year would be helpful. Likewise, an extension of the subsidy of COBRA health-insurance premiums for laid-off workers would also be helpful.

Policymakers could also adopt policies to help homeowners who have lost their jobs meet their mortgage obligations. The Administration's loan modification program, the Home Affordable Modification Program, should help many borrowers for whom a moderate permanent adjustment to mortgage payments would make those payments sustainable over the long run. However, the program is not well-suited to cases where homeowners have suffered large temporary declines in income, because the required modifications will often be too costly to qualify for the program.[5] Nor do costly permanent modifications make sense for these cases, as they should not be needed once the homeowners have found other jobs. Instead, temporary assistance for meeting mortgage obligations would help support the spending of laid-off workers, and, by making mortgage default less likely, reduce the downside risks to the housing outlook that I noted above.

Another way to support the housing market would be to extend the first-time homebuyer tax credit, which is scheduled to expire on December 1st of this year. This approach would likely spur some new home sales. However, as my colleague Ted Gayer at the Brookings Institution has argued, the tax credit may be a costly

[4] See Congressional Budget Office, "The Budget and Economic Outlook: An Update," August 2009.

[5] For more discussion of the Home Affordable Modification Program and its limitations, see Larry Cordell, Karen E. Dynan, Andreas Lehnert, Nellie Liang, and Eileen Mauskopf, "Designing Loan Modifications to Address the Mortgage Crisis and the Making Home Affordable Program," Federal Reserve Finance and Economics Discussion Series Paper No. 2009-43, October 2009.

way to accomplish this goal, as most of the homebuyers expected to receive the credit would probably have bought homes without the credit. In addition, to the degree that the tax credit simply shifts additional households from renting to owning, it does not address the fundamental problem of oversupply in the housing market.[6]

CONCLUSION

Recent economic data point to a decided firming of economic activity. A great deal of uncertainty surrounds the question of the strength and speed of recovery, but the most likely course for the economy seems to be gradual expansion. Consumer spending on goods and services, the largest component of aggregate demand for output, is likely to be held to a modest upward trajectory over the next of couple years by weak income growth, higher saving, and lower borrowing. Likewise, the fundamental determinants of other major components of private demand appear to be supportive of only moderate growth in these categories. Policymakers have some options that would bolster the recovery and increase the speed with which the economy returns to full employment; considerations of such actions should be mindful not only of the short-run benefits but also of the potential long-run costs, particularly in terms of the budget deficit.

Thank you very much.

[6] See Gayer, Ted "Should Congress Extend the First-time Homebuyer Tax Credit?" at *http://www.brookings.edu/opinions/2009/0924_tax_credit_gayer.aspx*.

Testimony submitted to the Joint Economic Committee, hearing on "The Impact of the Recovery Act on Economic Growth", October 29, 2009 (embargoed until 10am).

Submitted by Simon Johnson, Ronald Kurtz Professor of Entrepreneurship, MIT Sloan School of Management; Senior Fellow, Peterson Institute for International Economics; and co-founder of http://BaselineScenario.com.[1]

Main Points

1. The world economy is experiencing a modest recovery after near financial collapse this spring. The strength of the recovery varies sharply around the world:
   a. In Asia, real GDP growth is returning quickly to pre-crisis levels, and while there may be some permanent GDP loss, the real economy appears to be clearly back on track. For next year consensus forecasts have China growing at 9.1% and India growing at 8.0%; the latest data from China suggest that these forecasts may soon be revised upwards.
   b. Latin America is also recovering strongly. Brazil should grow by 4.5% in 2010, roughly matching its pre-crisis trend. We can expect other countries in Latin America to recover quickly also.
   c. The global laggards are Europe and the United States. The latest consensus forecasts are for Europe to grow by 1.1% and Japan by 1.0% in 2010, while the United Sates is expected to grow by 2.4% (and the latest revisions to forecasts continue to be in an upward direction). Unemployment in the US is expected to stay high, around 10%, into 2011.
2. The current IMF global growth forecast of around 3 percent is probably on the low side, with considerably more upside possible in emerging markets (accounting nearly half of world GDP). The consensus forecasts for the US are also probably somewhat on the low side.
3. As the world recovers, asset markets are also turning buoyant. Recently, residential real estate in elite neighborhoods of Hong Kong has sold at $8,000 US per square foot. A 2,500 square foot apartment now costs $20 million. Real estate markets are also showing signs of bubbly behavior in Singapore, China, Brazil, and India.
4. There is increasing discussion of a "carry trade" from cheap funding in the United States towards higher return risky assets in emerging markets. This financial dynamic is likely to underpin continued US dollar weakness.
5. One wild card is the Chinese exchange rate, which remains effectively pegged to the US dollar. As the dollar depreciates, China is becoming more competitive on the trade side and it is also attracting further capital inflows. Despite the fact that the Chinese current account surplus is

[1] This testimony draws on joint work with Peter Boone, particularly "The Next Financial Crisis: It's Coming and We Just Made It Worse" (*The New Republic*, September 8, 2009), and James Kwak. Underlined text indicates links to supplementary material; to see this, please access an electronic version of this document, e.g., at http://BaselineScenario.com, where we also provide daily updates and detailed policy assessments for the global economy.

now down to around 6 percent, China seems likely to accumulate around $3 trillion in foreign exchange reserves by mid-2010.

6. Commodity markets have also done well. Crude oil prices are now twice their March lows (despite continued spare capacity, according to all estimates), copper is up 129%, and nickel is up 103%. There is no doubt that the return to global growth, at least outside North America and Europe, is already proving to have a profound impact on commodity markets.
7. Core inflation, as measured by the Federal Reserve, is unlikely to reach (or be near to) 2% in the near future. However, headline inflation may rise due to the increase in commodity prices and fall in the value of the dollar; this reduces consumers' purchasing power.
8. This nascent recovery is partly a bounce back from the near total financial collapse which we experienced in the Winter/Spring of 2008-09. The key components of this success are three policies.
   a. First, global coordinated monetary stimulus, in which the Federal Reserve has shown leadership by keeping interest rates near all time lows. Of central banks in industrialized countries, only Australia has begun to tighten.
   b. Second, global coordinated fiscal policy, including a budget deficit in the US that is projected to be 10% of GDP or above both this year and next year. In this context, the Recovery Act played an important role both in supported spending in the US economy and in encouraging other countries to loosen fiscal policy (as was affirmed at the G20 summit in London, on April 2nd, 2009).
   c. Third, after some U-turns, by early 2009 there was largely unconditional support for major financial institutions, particularly as demonstrated by the implementation and interpretation of the bank "stress tests" earlier this year.
9. However, the same policies that have helped the economy avoid a major depression also create serious risks – in the sense of generating even larger financial crises in the future.
10. A great deal has been made of the potential comparison with Japan in the early 1990s, with some people arguing that Japan's experience suggests we should pursue further fiscal stimulus at this time. This reasoning is flawed.
11. We should keep in mind that repeated fiscal stimulus and a decade of easy monetary policy did not lead Japan back to its previous growth rates. Japanese outcomes should caution against unlimited increases in our public debt.
12. Perhaps the best analysis regarding the impact of fiscal policy on recessions was done by the IMF. In their retrospective study of financial crises across countries, they found that nations with "aggressive fiscal stimulus" policies tended to get out of recessions 2 quarters earlier than those without aggressive policies. This is a striking conclusion – should we (or anyone) really increase our deficit further and build up more debt (domestic and foreign) in order to avoid 2 extra quarters of contraction?
13. A further large fiscal stimulus, with a view to generally boosting the economy, is therefore not currently appropriate. However, it makes sense to further extend support for unemployment insurance and for healthcare coverage for those who were laid off – people are unemployed not

because they don't want to work, but because there are far more job applicants than vacancies. Compared with other industrial countries, our social safety net is weak and not well suited to deal with the consequences of a major recession.

14. The first-time home buyer tax credit should be phased out.
15. GMAC should not receive a further infusion of government money. It should be turned down for any kind of additional bailout; as with CIT Group earlier in the summer, this would force a negotiation with creditors and some losses for bondholders (most likely through a pre-packaged bankruptcy process). This would not cause a general financial panic; probably it would actually strengthen the overall process of economic recovery, as it would move incentives in the right direction.
16. The lack of skills among people who did not complete high school or who did not attend college is a critical longer term problem in the United States. The impact of the recession will exacerbate the problems in this regard. We should respond by further strengthening community colleges, allowing them to offer more vocational skills classes and to provide a viable way for more people to work their way into four-year colleges.
17. America is well-placed to maintain its global political and economic leadership, despite the rise of Asia. But this will only be possible if our policy stance towards the financial sector is substantially revised: the largest banks need to be broken up, "excess risk taking" that is large relative to the system should be taxed explicitly, and measures implemented to reduce the degree of nontransparent interconnectedness between financial institutions of all kinds.

The remainder of this testimony reviews current U.S. macroeconomic issues in broad terms, assesses the lessons of Japan's experience in the 1990s, and make proposals for further essential reform (both fiscal and financial).

Current U.S. Issues

To be a strong global leader in the future, America needs to generate an environment where entrepreneurship, technological innovation, and immigration ensure that the nonfinancial private sector can continue to propel the US economy.

It is premature to argue that the US economy has stumbled into a "new normal" paradigm that involves slower growth. The factors that drove our growth over the last 150 years, particularly entrepreneurial startups and the commercialization of invention, remain despite the crisis. Indeed, these drivers of growth may become even stronger in the future, if we can reduce the wasteful financial sector activities that grew since the 1980s (and really flourished over the past decade) and allocate resources to more productive activities in the future.

America needs a new framework to harness that growth. That framework needs to address the following problems with our current economic structure.

Problem 1: With the recent financial sector bailouts, we have sent a simple message to Americans: The safest place to put your savings is in a bank, even if that bank is so poorly managed, and has such large balance sheet risks, that just six months ago it almost went bankrupt.

Despite being near to bankruptcy six months ago, Bank of America credit default swaps now cost only 103 basis points per year to protect against default, and the equivalent rate for Goldman Sachs is a mere 89 basis points. Goldman Sachs is able to borrow for five years at just 170 basis points above treasuries. This is not a sign of health; rather it indicates the sizable misallocation of capital promoted by current policies. American's leading nonfinancial innovators would never be able to build the leverage (debt-asset ratio) on their balance sheet that Goldman Sachs has, and then borrow at less than 2% above US treasuries. The implicit government guarantee is seriously distorting incentives.

Problem 2: We have not changed the incentive structures for managers and traders within our largest banks. Arguably these incentives are more distorted than they were before the crisis. So the problems of excessive risk taking and a new financial collapse will eventually return. Financial system incentives are a first-order macroeconomic issue, as we have learned over the past 12 months.

Today bank management is strongly incentivized to take large risks in order to raise profits, increase bank capital, and pay large bonuses to "compete for talent". Since they have access to a pool of funds effectively guaranteed by the state through being "too big to fail", there is the potential to make large profits by employing funds in risky trades with high upside. Such activities do not need to be socially valuable, i.e. it could be that the expected return on the investments is negative, but as the downside has limited liability, the banks can go ahead.

Problem 3: We have not changed the financial regulatory framework in a substantive way so as to limit excessive risk taking. The proposals currently proceeding through Congress are unlikely to make a significant difference.

Problem 4: The policy response to this crisis, with very low interest rates and a large fiscal stimulus, is merely a larger version of the response to previous similar crises. While this was essential to stop a near financial collapse, it reinforces the message that the system is here to stay.

Problem 5: The public costs of this bailout are much larger than we are accounting for, and people who did not cause this crisis are ultimately paying for it. Taxpayers and savers are the big losers each time we have these crises. We are failing to defend the public purse.

Our financial leaders have emphasized that our banks are well capitalized, and no new public funds are likely to be needed to support them. This is misleading. The current monetary stance is designed to ensure that deposit rates are low, and the spread between deposit rates and loan rates is high. This is a massive transfer of public funds to the private sector, and no one accounts for that properly.

It is striking that the Chairman of the Federal Reserve himself, in a recent speech, stated that no more public funds were needed to bail out banks. His institution continues to provide massive transfers to the banking system through loose credit and low interest rate policy. That credit could instead go to others; the Federal Reserve has chosen to transfer those funds to banks. This policy was used in the past to recapitalize banks (e.g., after 1982), but we have now a very different financial sector – with much more capacity to take high risks and a greater tendency to divert profits into large cash bonuses.

Today, depositors in banks earn little more than the Federal Funds rate and are effectively financing our financial system. We are giving them very low returns on their savings because the losses in the financial system were so large in the past. This is essentially public money – it is the pensioners, elderly people with savings, and other people who have no involvement in the financial system, that are being required to suffer low returns to support the banks.

We Are Not Japan

After the bursting of its real estate bubble, at the end of the 1980s, Japan faced a serious problem in its financial sector. This fact has inspired many people to look for parallels with the current US situation, and – in some cases – to draw the implication that we should pursue further large-scale fiscal stimulus today.

There is a cautionary tale to be learned from the Japanese experience – on the need to promote, rather than to prevent, appropriate macroeconomic adjustment. But this does not encourage a further expansion in the budget deficit at this time.

The property bubble and general credit bubble in Japan were actually much larger than what we recently experienced in the U.S. The implied price of the land in the Emperor's Palace, in central Tokyo, was worth more than all of California (or Canada) at its peak. Land prices collapses and never recovered. US house and land prices never got so far out of line with the earning capacity of homeowners.

The Japanese stock market rose to price-earnings ratio of around 80 (depending on the exact measure), also as a direct result of the credit bubble. The US did not experience anything similar in the last few years.

Japan was – and largely remains – a bank-based finance system. And their nonfinancial corporate sector was generally much more indebted (often using borrowed money to buy land, but also over-expanding their manufacturing capacity) than was the case in the US. Total Japanese corporate debt was 200 percent of GDP in 1992 – more than double its value in 1984. The implication was a long period of disinvestment and saving by the corporate sector – in fact, this change from the 1980s to 1990s explains most of Japan's increased current account surplus after the crisis. Since Japanese corporates had accumulated too much capital, they exhibited low returns in the post-crisis period. The US has strong bond and equity markets, and our corporate sector is not heavily indebted – so the cash flow of the nonfinancial sector should bounce back strongly.

In contrast to Japan, the US consumer has much more debt and saves less – in fact, on average over the past decade, the our household sector has saved roughly nothing (partly due to the effects of rising wealth, from higher house prices). This sector will be weak in the US. In contrast, in Japan during the 1990s there was no significant increase in household saving (and thus no contribution from this sector to their current account surplus.)

The obvious solution for any country in the situation faced by the US is to let the economy adjust, which implies and requires that the real exchange rate depreciates – so our exports go up, our imports (and consumption) go down. This is a level adjustment downward in our GDP and standard of living, but then growth will resume on this new basis.

In contrast, Japan did not grow largely due to their over-investment cycle (in real estate, but also plant and equipment). This created a much more difficult adjustment process, which worked for manufacturing primarily through depreciation of installed capacity and a gradual movement of production off-shore (e.g., to China and other Asian countries).

In addition, another major cause of Japan's poor performance was its demographics, and the relatively lackluster growth of its trading partners in Asia due to the Asian crisis. With its working population peaking in 1995, Japan lost a major driver of growth. The country still has strong enterprises and decent productivity growth in the manufacturing sector, which allows them to grow. But the pace is naturally slower than when they were "catching up" through the 1980s. During the last ten years Japan's has grown around the same pace as some of the continental European nations with better but also poor demographics, such as Italy and Germany (the comparison is from Q1 1998 to Q1 2008).

The Japanese policy reaction was to run budget deficits and maintain very loose monetary policy for over a decade, in an attempt to stimulate the economy and obviate the need for painful adjustment (including job losses, recognizing losses at major banks, and properly recapitalizing those banks). Today Japanese gross debt to GDP is at 217%, and it is still rising (net debt, even

on the most favorable definition, is over 110% of GDP). The working population of Japan is now declining quickly, and so those people that are required to pay back the debt face ever rising burdens. There is a real risk that Japan could end up in a major default, or need a large inflation, to erode the burden of this debt since their current path is clearly unsustainable.

Japan's policy approach from the 1990s – repeated fiscal stimulus and very easy money – is not an appealing model for the U.S. today. All dynamic economies have a natural adjustment process – this involves allowing failing industries to decline, and letting new businesses develop where there are new opportunities.

In fact, while Japan hesitated for over a decade to let this process work (particularly protecting the insiders at their major banks), it has finally moved in this direction. Unit labor costs in Japan have declined sharply over the last ten years, helping making the country a more competitive exporter. The forced recapitalization of some major banks, at the end of the 1990s, was also a move in the right direction.

The process of deflation – spoken of with terror by some leading central banks around the world today – actually makes industry more competitive, and while there are negative aspects to it (particularly if the household sector is heavily indebted, as in the US), the modest price declines seen in Japan are not a disaster. In fact, real GDP per worker in Japan – annualized over the past 20 years – has increased by 1.3 percent per annum; while the comparable number in the US is 1.6 percent. Over the past 10 years, real GDP per worker (annualized) increased by 1.3 percent in both Japan and the US – and now it turns out that much of the GDP gains in the US financial sector may have been illusory.

The Japan-US comparison is not generally compelling, particularly as Japan ran a current account surplus even during its destabilizing capital inflows of the 1980s. The current US experience more closely matches the experience in some emerging markets, which have in the past run current account deficits, financed by capital inflows – with the illusion that this was sustainable indefinitely.

The long and hard experience of the International Monetary Fund (IMF) with such countries that have "lived beyond their means" – or over-expanded in any fashion – is that it is a mistake to try to prevent this process of competitive adjustment, i.e., bringing spending back into line with income, which implies a smaller current account deficit or even a surplus. The adjustment can be cushioned by fiscal policy – and here the IMF has changed its line over the past few years, now offering sensible support for this approach. But attempting to postpone adjustment with repeated fiscal stimulus is almost always a mistake.

Japan did not want to force its corporate sector to adjust (i.e., in the sense of going bankrupt and renegotiate its debts), so it offered repeated stimulus. As a result, it has become stuck with a "permanent" fiscal deficit program which is now threatening their survival as a global economic power, and will – regardless of the exact outcome – burden future generations for decades.

Some analysts further claim that Japan's early withdrawal of stimulus is a major factor explaining why they have not returned to robust growth rates. It is true that Japan introduced a new VAT tax in April 1997 not long before the Asian Financial Crisis began, and the Bank of Japan raised interest rates by 25 basis points in August 2000. Subsequent to these changes the economy slowed down.

However, each of these measures were relatively small. The Bank of Japan reversed course on interest rates quickly, and a negative turn in the economy was surely already in the cards – this occurred at the same time as the global economy slowed down, and a great stretch to argue that a 25 basis point move could explain the poor performance of Japan's economy for years or decades subsequent.

As long as there are not major adverse shocks from the rest of the world, the US will experience higher savings, a fall in consumption, a recovery in investment, and an improvement in the its net exports (so the current account deficit will become smaller, or stay at its current level even as the economy recovers). Growth will resume, driven by demographics, technical progress, and entrepreneurship. The high level of unemployment also implies that rapid growth will be fuelled by willing workers, subject to the right skills being available.

Proposals For Change

The main threats to the recovery scenario come from the financial system, which has developed serious and macro-level pathologies over the past two decades.

We have weak bank regulation and supervision. Politically we can't let banks fail: they bend or lobby to change the rules in order to grow big, and then we bail them out.

New theories of deflation and zero interest rate floors attempt to explain why we need unprecedented large bailouts – with the experience of Japan and the Great Depression of the 1930s offered as partial justification. More likely, we are on an unsustainable fiscal path with the potential for new financial bubbles.

The following changes should be priorities.

1. Reduce the impact of financial sector lobbying on bank regulation and supervision. Today the US Treasury is filled with former finance sector workers in key positions responsible for

financial sector reform and bailouts. This is too large a conflict of interest. We need to close the revolving door between government and the financial sector.

2. Put far greater regulation and closer supervision on the large remaining banks that are clearly too big to fail. These should be broken up into much smaller pieces, so we have a more competitive system.
   - When major financial institutions request additional help from the government, such as GMAC, they should be turned down. This would force their bondholders to take a loss and lead to better incentives for the future. It is highly unlikely that it would cause a major financial panic. The financial system is experiencing a sharp bounce back more broadly and GMAC can likely arrange a pre-packaged bankruptcy that would actually allow its debt to rise in value.
   - Banks can syndicate if they need to do large transactions. This is actually what they do for most capital raising transactions.
   - Banks should draw up "living wills" and raise additional capital as they become larger relative to the system.
3. We should also toughen our monetary policy to send a clear message that we will not maintain a pro-cyclical monetary policy which bails out banks at the end of each crisis. The cross-liabilities on banks' balance sheets should be reduced as far as possible to lower the risks involved with letting one fail. By doing this, we would free the hands of those running our monetary policy to take tougher actions to stop the next bubble.
4. We need to address the inequality driven by our bailouts as a gesture to show that we will defend the public purse beyond the simple accounting in the budget.

- Increasingly, there is discussion of taxing "excess risk taking" (reflected in high profits and bonuses) in the financial sector, particularly if that is large relative to the system. The terms in this debate have not yet been clearly defined and this initiative could go in the wrong direction. But we should recognize that mismanagement at major banks has created huge negative externalities both for the financial system and for the economy as a whole. Taxing activities that generate such externalities is entirely appropriate in other sectors, and the same reasoning is likely to be applied for banking also.
- In addition, we should also require that Goldman Sachs, GMAC, and other non-banks (i.e., those operating without deposit insurance) with access to the Federal Reserve's window pay a substantial long term annual fee to compensate taxpayers for that access. This is a valuable insurance policy which they have – at this point – been given for free.

5. We should withdraw the fiscal stimulus over 5 years and aim for fiscal consolidation, including Medicare costs, at that time. We should use extra spending to target specific issues that will help people improve their skills, but wind down the temporary public works programs that build jobs in the public sector.
6. All industrialized countries need to make a substantial fiscal adjustment over the medium-run, in order to stabilize public debt levels. The size of this adjustment depends on assumptions (and policies) regarding longer-run medical costs as the population ages and medical technology

becomes more expensive. The US and almost all other members of the OECD most likely require a fiscal adjustment in the range of 4-8 percentage points of GDP. In that context, further unfunded or nontransparent contingent public liabilities vis-à-vis the financial sector are untenable; the Japanese experience should be taken as a warning sign in this regard.

7. For the longer-run, we should focus on measures that improve skills for people with fewer years of formal education. Supporting the expansion of community colleges and other practical skills training is the best way forward, although this will take some time to scale up.

Written Testimony of Mark Zandi
Chief Economist and Cofounder of Moody's Economy.com

Before the Joint Economic Committee

The Impact of the Recovery Act on Economic Growth

October 29, 2009

The Great Recession has finally come to an end, in large part because of unprecedented policy efforts by the Federal Reserve and fiscal policymakers. The cost to taxpayers has been substantial but would have been even greater if aggressive action was not taken and the financial crisis and recession had been allowed to continue unchecked.

Now, although the financial system is stable and the recession is over, the recovery is still fragile. There will be times in coming months when the economy will appear to be performing well, but there will be other times when it seems liable to falter again. It is growing clear that more policy help will be needed to ensure that the tentative recovery evolves into a self-sustaining expansion.

This policy help should extend, and in some cases expand, efforts already underway such as aid to unemployed workers. State and local governments may also require more help, along with housing and mortgage markets. This help could involve expanding SBA lending and extending and expanding tax incentives to promote business investment and hiring.

Economic recovery

The Great Recession has finally given way to recovery.[i] This downturn will go into the record books as the longest, broadest and most severe since the Great Depression (see Table 1). The recession was twice the length of the average economic contraction, and it dragged down nearly every industry and region in the country. Its final toll in terms of increased unemployment and falling real GDP will be greater than that seen during any other recession on record.

Table 1: U.S. Business Cycle Since World War II

		Duration in Months		*Peak-to-Trough % Change*					
		Recession	Expansion	Real	Industrial	Nonfarm	Jobless Rate		
Peak	Trough	Peak to Trough	Trough to Peak	GDP	Production	Employment	Low	High	Change
December 2007	**August 2009**	**20**	**73**	**-3.9%**	**-19.2%**	**-6.2%**	**4.4%**	**10.3%**	**5.9%**
March 2001	November 2001	8	120	-0.4%	-6.3%	-2.0%	3.8%	6.3%	2.5%
July 1990	March 1991	8	92	-1.3%	-4.3%	-1.5%	5.0%	7.8%	2.8%
July 1981	November 1982	16	12	-2.9%	-9.5%	-3.1%	7.2%	10.8%	3.6%
January 1980	July 1980	6	58	-2.2%	-6.2%	-1.3%	5.6%	7.8%	2.2%
November 1973	March 1975	16	36	-3.1%	-14.8%	-2.7%	4.6%	9.0%	4.4%
December 1969	November 1970	11	106	-1.0%	-5.8%	-1.4%	3.4%	6.1%	2.7%
April 1960	February 1961	10	24	-1.3%	-6.2%	-2.3%	4.8%	7.1%	2.3%
August 1957	April 1958	8	39	-3.8%	-12.7%	-4.4%	3.7%	7.5%	3.8%
July 1953	May 1954	10	45	-2.7%	-9.0%	-3.3%	2.5%	6.1%	3.6%
November 1948	October 1949	11	37	-1.7%	-8.6%	-5.1%	3.4%	7.9%	4.5%
Average		**10**	**57**	**-2.0%**	**-8.3%**	**-2.7%**	**4.4%**	**7.6%**	**3.2%**

Sources: NBER, BEA, FRB, BLS, Moody's Economy.com

GDP growth resumed this past summer as the financial system stabilized. Major financial failures have abated, money markets and equity markets are much improved, and the severe credit crunch of early this year has moderated substantially. This is largely due to aggressive action by the Federal Reserve, the FDIC, the U.S. Treasury, and other financial regulators. Their interventions ranged from the Fed's establishment

of various emergency credit facilities to the FDIC's guarantees on bank debt and its increase in the deposit insurance limit. Perhaps most important were the stress tests imposed on the nation's 19 largest bank holding companies this past spring.[ii]

The housing market crash that was at the recession's center is also moderating. House prices are probably not done falling, but home sales have come off the bottom, and the free fall in housing construction is over. After reducing housing starts to levels last seen during World War II, builders have finally begun to put up a few more homes. There is still a surfeit of vacant existing homes for sale and rent, but inventories of new homes are increasingly lean in a number of markets.

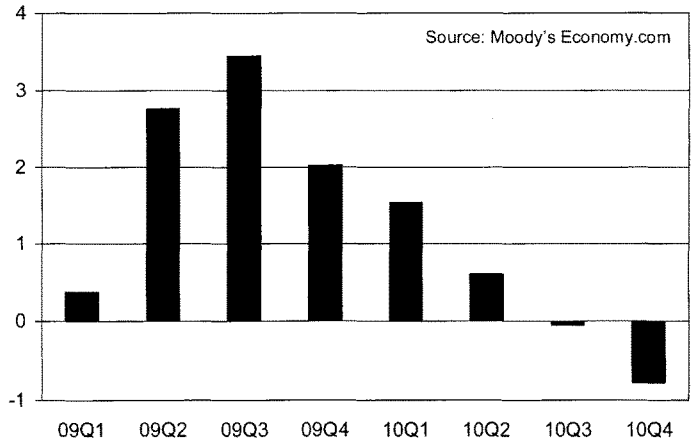
Retailers and manufacturers have also worked hard to reduce bloated inventories. The plunge in inventories in the second quarter was the largest on record and came after a year of steady destocking. Inventories are now so thin that manufacturing production is picking up quickly, as otherwise stores will not have enough on their shelves and in warehouses to meet demand even at currently depressed levels.

Sales to overseas customers are also reviving. Exports, which were plunging just a few months ago, are expanding again as the global economy stabilizes. Behind this turnaround is an end to the global downturn, driven by the massive monetary and fiscal stimulus throughout much of the globe. Most notable has been the revival in the Chinese economy, which is lifting much of the rest of the Asian economy. Even the European downturn is winding down, as growth has resumed in the region's biggest economies, Germany and France.

The fiscal stimulus is working

The fiscal stimulus is also working. The American Recovery and Reinvestment Act passed early this year has reduced payroll tax withholding, sent checks to Social Security recipients, and provided financial help to unemployed workers whose normal benefits have run out. The cash for clunkers program revved up vehicle sales, and the housing tax credit has boosted home purchases.[iii] It is no coincidence that the Great Recession ended just as the stimulus began providing its maximum economic benefit (see Chart 1).[iv] The stimulus is doing what it was supposed to do: short-circuit the recession and spur recovery.

Chart 1: Recession Ends as the Fiscal Stimulus Kicks in
Contribution to real GDP growth, ppt



Criticism that only $175 billion of the $787 billion stimulus plan has been distributed through tax cuts and increased government spending is misplaced (see Table 2).[v] What matters for economic growth is the pace of stimulus spending, which surged from nothing at the beginning of the year to about $80 billion in the third quarter. That is a big change in a short period and is why the economy is growing again after more than a year.

Table 2: Fiscal Stimulus Spending
$ bil

	Available	Paid Out	Jan-09	Feb-09	Mar-09	Apr-09	May-09	Jun-09	Jul-09	Aug-09	Sep-09
Infrastructure and other spending	**91.2**	**14.4**	**0.0**	**0.0**	**0.0**	**0.0**	**1.5**	**3.7**	**1.7**	**3.2**	**4.3**
Traditional infrastructure	28.9	3.1	0.0	0.0	0.0	0.0	0.2	0.2	0.8	1.2	0.7
Transfers to state and local governments	**113.0**	**52.1**	**0.0**	**2.0**	**6.6**	**5.8**	**9.4**	**7.4**	**7.2**	**6.4**	**7.4**
Medicaid	45.4	32.5	0.0	2.0	6.6	5.4	4.8	3.7	3.5	3.3	3.3
Education and other	67.6	19.6	0.0	0.0	0.0	0.3	4.6	3.7	3.7	3.2	4.1
Transfers to persons	**75.1**	**50.0**	**0.0**	**0.0**	**1.3**	**6.0**	**17.5**	**7.5**	**6.0**	**6.0**	**6.0**
Social Security	13.1	13.1	0.0	0.0	0.0	0.0	11.6	1.5	0.0	0.0	0.0
Unemployment assistance	32.2	24.3	0.0	0.0	0.0	4.1	4.1	4.1	4.1	4.1	4.1
Food stamps	5.8	3.8	0.0	0.0	0.0	0.6	0.6	0.6	0.6	0.6	0.6
Cobra payments	24.0	8.8	0.0	0.0	1.3	1.3	1.3	1.3	1.3	1.3	1.3
Tax cuts	**80.0**	**59.3**	**0.0**	**0.0**	**0.0**	**1.8**	**3.5**	**21.5**	**3.5**	**3.5**	**25.5**
Businesses and other tax incentives	40.0	40.0	0.0	0.0	0.0	0.0	0.0	18.0	0.0	0.0	22.0
Individuals excluding increase in AMT exemp	40.0	19.3	0.0	0.0	0.0	1.8	3.5	3.5	3.5	3.5	3.5
Total	**359.3**	**175.8**	**0.0**	**2.0**	**7.8**	**13.5**	**31.9**	**40.1**	**18.4**	**19.1**	**43.1**

Sources: Treasury, Joint Committee on Taxation, Recovery.gov, Moody's Economy.com

The part of the stimulus providing the biggest bang for the buck—the most economic activity per federal dollar spent—is the extension of unemployment insurance benefits (see Table 3). Workers who lose their jobs before the end of 2009 can temporarily receive more UI, food stamps, and help with health insurance payments. Without this extra help, laid-off workers and their families would be slashing their own spending, leading to the loss of even more jobs.

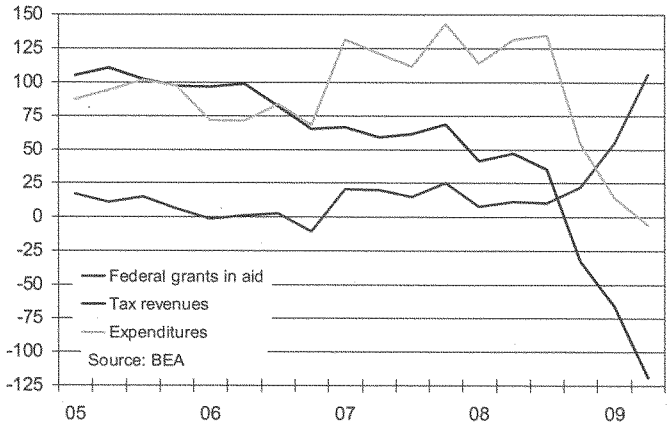
Table 3: Fiscal Stimulus Bang for the Buck

	Bang for the Buck
Tax Cuts	
Nonrefundable lump-sum tax rebate	1.01
Refundable lump-sum tax rebate	1.22
Temporary tax cuts	
Payroll tax holiday	1.29
Across-the-board tax cut	1.02
Accelerated depreciation	0.25
Loss carryback	0.21
Housing tax credit	0.90
Permanent tax cuts	
Extend alternative minimum tax patch	0.51
Make Bush income tax cuts permanent	0.32
Make dividend and capital gains tax cuts permanent	0.37
Cut in corporate tax rate	0.32
Spending Increases	
Extending unemployment insurance benefits	1.61
Temporary federal financing of work-share programs	1.69
Temporary increase in food stamps	1.74
General aid to state governments	1.41
Increased infrastructure spending	1.57

Note: The bang for the buck is estimated by the one-year dollar change in GDP for a given dollar reduction in federal tax revenue or increase in spending.
Source: Moody's Economy.com

Federal aid to strapped state and local governments also is providing significant economic benefits, lessening their need to slash programs and jobs or to hike taxes and fees. State and local tax revenues have fallen by nearly $120 billion during the past year, but government expenditures have merely gone flat, because federal grants in aid have soared by almost $110 billion (see Chart 2).[vi] The decline in income, sales, property and capital gains taxes has been unprecedented and shows only marginal signs of abating.

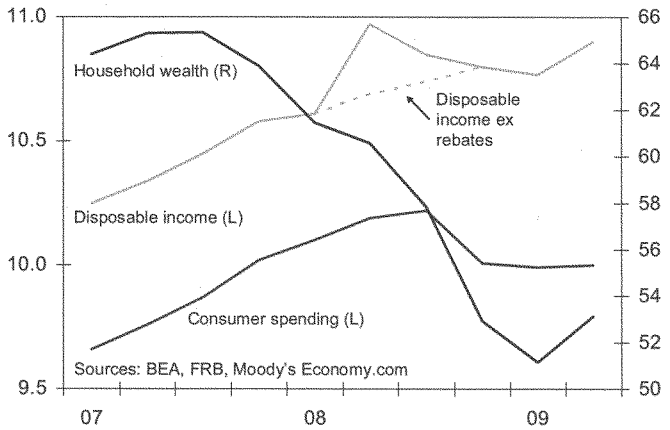
Chart 2: S&L Tax Revenues Collapse, but Spending Does Not
% change yr ago, $ bil



Arguments that tax cuts in the stimulus program are not supporting consumer spending are incorrect.[vii] Although spending has not rebounded sharply, without the stimulus, it would still be declining. The plunge in stock and house prices has forced families to save more for college or retirement, while the credit crunch has made it all but impossible for many households to borrow. Without the stimulus' support to household income, consumers would still be cutting back. Instead, spending has stabilized, and the recession has ended.

The benefit of the tax cuts to consumer spending is best seen from the experience of the 2008 tax rebates that were mailed to households during the spring of that year. While these rebates significantly lifted after-tax income in the period, consumer spending did not follow, at least not immediately. The reason lay in the income caps on the rebates, which meant higher-income households did not receive them. Because of rapidly falling stock and house prices, these same households were saving significantly more and spending less (see Chart 3). The saving rate for households in the top quintile of the income distribution surged from close to nothing in early 2007 well into the double digits by early 2008.[viii] Lower- and middle-income households did spend a significant part of the rebates they received, but the sharp pullback by higher-income households significantly diluted the impact of the tax cut on overall spending.

Chart 3: Tax Cuts Have Supported Consumer Spending
$ tril



Criticism that infrastructure spending funded by the stimulus has been slow to get started is valid. But this is partly because safeguards against funding unproductive or politically driven projects have slowed things down. Infrastructure projects are now gearing up, however, and this will be particularly helpful next year, when the recovery will still be fragile.

Although the recession is over, the economy is struggling. Job losses have slowed significantly since the beginning of the year, but payrolls are still shrinking, and unemployment is still rising. The nation's jobless rate will top 10% in coming months—higher than the Obama administration forecast when it was trying to get the stimulus passed early in the year. That fact, however, says nothing about the program's efficacy. If anything, it suggests the $787 billion stimulus was too small. Administration economists, like most private forecasters—including Moody's Economy.com—underestimated how hard the financial shock would hit the U.S. job market.

The question of how much the fiscal stimulus has helped cannot be settled through an accounting exercise. Washington's statisticians cannot canvas the country and pick out which jobs have been created or saved by the stimulus and which have not. The best tools available involve statistical analysis that is subject to a range of uncertainties. But although the exact number of additional jobs that would have been lost without the fiscal stimulus will never be known, it is clear that the number is significant. The research of Moody's Economy.com suggests that a million fewer jobs would exist today, while the unemployment rate would already have risen well into double digits.

These estimates are not an idle academic exercise. Whether the current fiscal stimulus is deemed successful will determine how policymakers respond if the recovery does not take root, or worse, if the U.S. slides back into recession. Although a double-dip downturn is less than likely, meaningful threats to the recovery still exist. Most notable are the intensifying stresses in the job market, the ongoing foreclosure crisis, the boom and bust in the commercial real estate market, the dysfunctional structured finance market, and the fiscal woes of state and local governments.

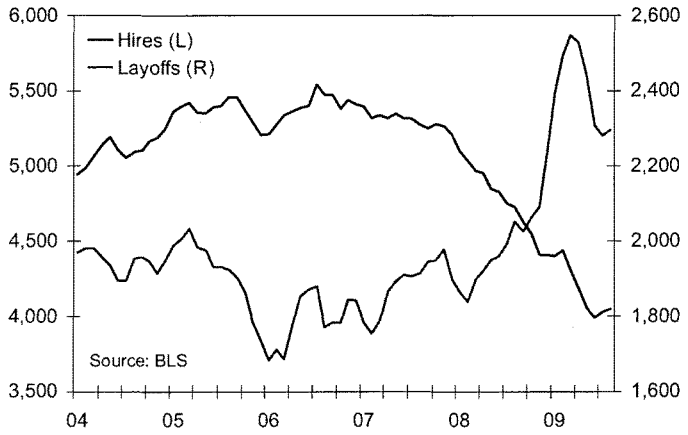
Stressed job market

Whether the recovery becomes self-sustaining or recedes back into recession depends first on how businesses respond to recent improvements in sales and profitability. As the benefit of the stimulus fades, businesses must fill the void by hiring and investing more actively. To date, there is not much evidence that they are doing this. At most, firms are curtailing layoffs and no longer cutting back on orders for equipment and software.

Businesses' reluctance to expand is clearest with respect to jobs. More than 250,000 jobs were lost on net again in September, bringing total losses since employment peaked nearly two years ago to nearly 8 million (after accounting for upcoming revisions to the employment estimates). For context, the peak-to-trough decline in employment during and after the 2001 recession was about 2 million jobs.

Job losses have moderated since the beginning of 2009, when they averaged closer to 700,000 per month, but this is entirely due to fewer layoffs; hiring continues to weaken (see Chart 4). Unless hiring revives, job growth will not resume and unemployment will continue to rise, depressing wages and ultimately short-circuiting consumer spending and the recovery itself.

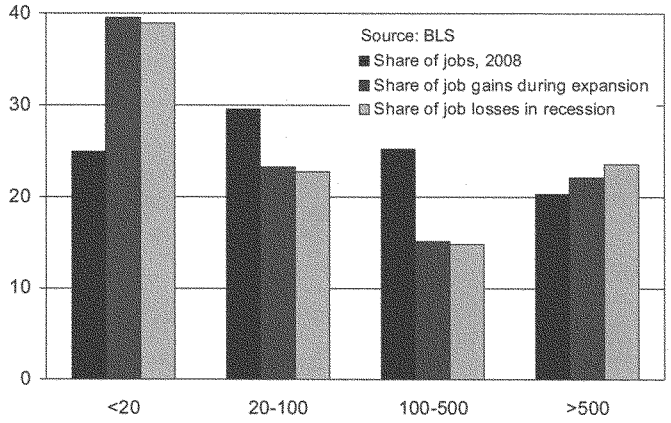
Chart 4: No One Is Hiring
Ths, 3-mo MA



It is possible that firms will resume hiring soon. There is historically a lag between a pickup in production and increased hiring. In the past, however, during the gap between increased production and increased full-time hiring, businesses boosted working hours and brought on more temporary employees. None of this has happened so far; hours worked remain stuck at a record low, and temporary jobs continue to decline.

A more worrisome possibility is that firms are too shell-shocked to resume hiring. Smaller businesses are struggling to obtain credit; their principal lenders, small banks, face intense pressure, while another key source, credit card lenders, has aggressively tightened its underwriting standards. As a result, a growing share of job losses are occurring at small businesses (see Chart 5). Establishments with less than 20 employees account for approximately 25% of all jobs but accounted for closer to 40% of the job losses during the first year of the recession.[ix]

Chart 5: Small Businesses Are Doing Most of the Layoffs
Share of jobs by establishment size



Larger firms are also nervous about navigating the coming changes in healthcare, financial regulation and energy policy. Businesses may also wonder if demand for their products will soon fade, given that the recent improvement is supported by the monetary and fiscal stimulus and an inventory swing, all of which are temporary.

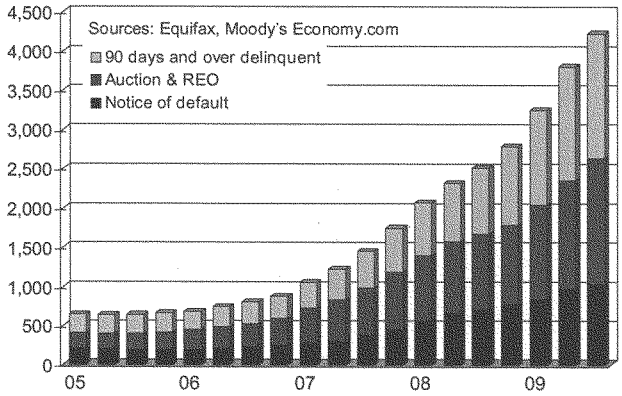
Whatever the reason, unless hiring resumes soon, the severe stress in the job market will not abate. With nearly 26 million workers—17% of the workforce—unemployed or underemployed, and those with jobs working a record-low number of hours, workers' nominal compensation threatens to decline. It is not unusual for real compensation—nominal compensation adjusted for inflation—to turn down in a recession, but it would be unprecedented, save during the Great Depression, for nominal compensation to decline.

Falling nominal compensation will further corrode already-fragile consumer spending. Lower- and middle-income households, who are saving little and cannot borrow, will be forced to rein in spending. The transition from recovery to expansion will be anything but graceful and could even be short-circuited.

Foreclosure crisis

Another worrisome threat to the nascent recovery is the residential mortgage foreclosure crisis, which shows no indication of letting up. Based on credit file data, at the end of September, there were 2.6 million mortgage loans at some stage of the foreclosure process and an additional 1.6 million loans 90 days or more past due and thus headed toward foreclosure (see Chart 6).[x] An astounding 8% of the 52 million first mortgage loans outstanding are in deep trouble.

Chart 6: The Foreclosure Crisis Continues to Mount
Ths of first mortgage loans



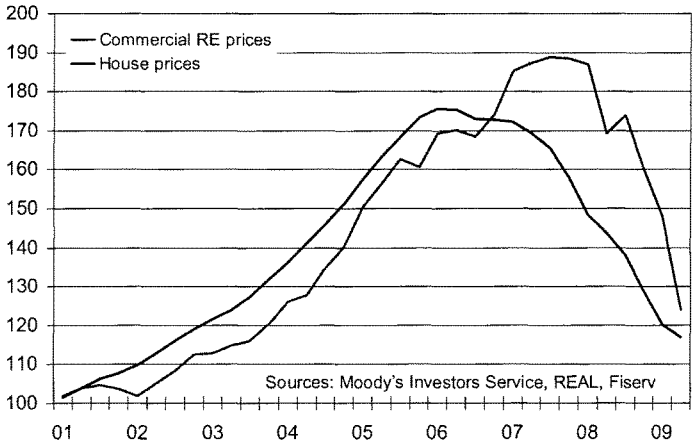
The glut of loans in the foreclosure pipeline is due in large part to delays in the process created by the Obama administration's loan modification plan. The Home Affordable Mortgage Plan is a complicated arrangement that has only recently been fully implemented. Mortgage servicers have delayed pushing loans through foreclosure until they know which homeowners qualify for the plan. A drop in foreclosure sales, along with stronger nondistressed home sales due to the first-time homebuyer tax credit, resulted in more stable house prices this summer. Yet while some 1.5 million homeowners are eventually expected to be put in the plan, most will not qualify.[xi] As servicers figure this out, they will resume pushing loans through to a foreclosure sale early in 2010.

House prices are likely to fall further as foreclosure sales pick up. Nothing works well in the economy when house prices are falling; as household wealth erodes, consumers lose the ability and willingness to spend, and the financial system loses the ability and willingness to extend credit. The recovery will not gain traction until the foreclosure crisis ends and house prices fully stabilize.

Commercial real estate bust

The earlier boom and current bust in the commercial real estate market also pose a serious problem for the recovery. With absorption of commercial space still falling and vacancy rates rising, rents and property prices are under severe pressure. The near doubling in commercial real estate prices during the first half of this decade was even greater than the increase in house prices, and the subsequent bust was more severe. Prices are down a whopping more than 35% from their peak two years ago (see Chart 7).[xii]

Chart 7: Commercial Real Estate Busts
Price indices, 2000Q4=100



More disconcerting is that even property owners with substantial equity, solid tenants, and positive cash flow are unable to refinance mortgages as they come due. Most commercial mortgages have maturities of around five years, meaning that loans originated during the boom times in the mid-part of this decade will come due in the next several years. Unfortunately, the commercial mortgage securities market remains closed, and traditional portfolio lenders, including banks, insurance companies and pension funds, are not offering to refinance because of heightened risks and the lenders' desire to reduce exposure to commercial real estate.

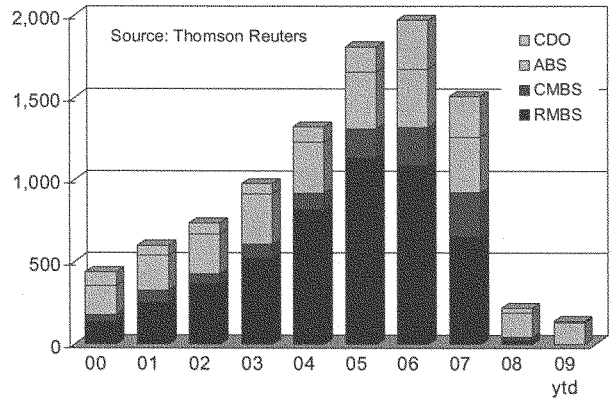
Falling prices, combined with reluctant lenders, will lead to hundreds of billions of dollars in commercial mortgage defaults over the next two to three years. This threatens to upend hundreds of banks whose portfolios of commercial real estate loans are large relative to their capital bases. As of June, over 2,800 banks, accounting for more than one-third of all banks, had made commercial mortgage loans outstanding worth more than 200% of their equity capital. These banks held $1.6 trillion in total assets, equal to 12% of all assets in the nation's banking system. So far this year, the FDIC has resolved more than 100 banks; nearly 500 more are on the FDIC troubled-bank list, in most cases because of problems in commercial real estate.

Hard-pressed banks across the country have little choice but to tighten lending standards, to the detriment of their small-business customers. According to the Federal Reserve's senior loan officer survey, underwriting standards on commercial and industrial loans made to small and midsize companies remain extraordinarily tight, and according to a survey by the National Federation of Independent Businesses, small businesses are increasingly complaining about tight credit conditions. All of this adds to the problem in the labor market, since small businesses are so important to job creation. During the last economic expansion, establishments employing less than 20 employees accounted for almost 40% of the job creation despite employing less than 25% of all workers.

Dysfunctional credit markets

Credit is also impaired because the securitization markets are frozen, as investors anticipate more loan losses and are uncertain about various legal and accounting rule changes and regulatory reforms that are likely to occur. Private bond issuance of residential and commercial mortgage-backed securities, asset-backed securities, and CDOs peaked in 2006 at close to $2 trillion (see Chart 8). So far this year, private issuance is running less than $150 billion annualized, almost all of it being asset-backed issuance supported by the Federal Reserve's TALF program to support credit card, auto and small business lenders. Issuance of residential and commercial mortgage-backed securities and CDOs remains completely dormant.

Chart 8: Credit Markets Remain Dysfunctional
Bond issuance, $ bil, annualized

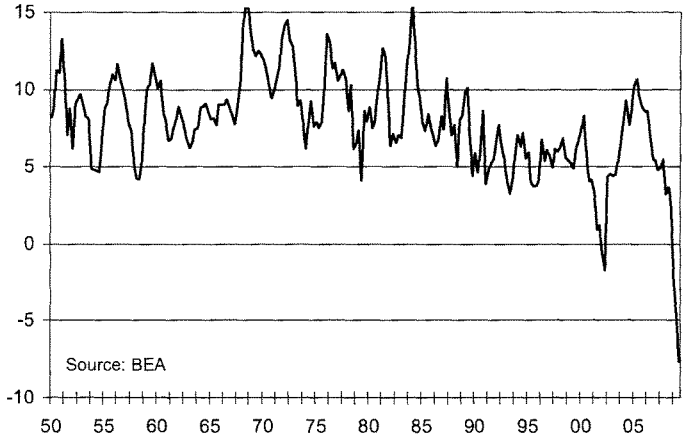


The credit crunch is not getting worse, as the federal government has aggressively stepped up its direct lending to consumers and businesses, but credit remains severely impaired. According to credit file data, household debt outstanding has declined by close to $450 billion—a stunning 4%—since peaking in the summer of 2008. Credit card, auto, consumer finance and mortgage debt is falling. Some of this reflects the desire of households to reduce their debt loads, but it also stems from lenders' inability to lend. Without the ability to sell the loans they originate to investors in the securities markets, banks and other lenders do not have the capital sufficient to significantly expand their lending. The recovery will struggle to gain traction until credit flows more freely, which requires a well-functioning securities market.

State and local fiscal crisis

Despite the massive financial aid provided by the stimulus to state and local governments, their budget problems continue to intensify. Tax revenues are plunging, off an astounding 9% during their fiscal 2010 (see Chart 9). This is far and away the largest decline on record going back to just after World War II. Personal income, capital gain, sales, corporate income and property tax revenues are all off sharply. Adding to the budgetary pressures, rainy-day funds in most states are depleted, and it has become much more difficult for municipalities to issue bonds not supported in some way by the federal government.

Chart 9: State and Local Government Revenues Collapse
% change year ago in S&L tax revenues



Even if federal policymakers come forward with more financial help, many state and local governments have exhausted their resources and will be forced to raise taxes and/or cut programs and jobs. The drag on the economy by this time next year could be substantial. Historically, state and local governments have been a small but steady source of economic growth, adding on average 25 basis points to annual real GDP growth since World War II. For state and local governments to turn into a weight on growth will be a meaningful impediment to the broader recovery's prospects.

Fiscal policy prescriptions

With the recovery likely to struggle, it is prudent for fiscal policymakers to consider what policy help they can provide next year to ensure the expansion fully takes hold. It would be particularly helpful if policymakers were to extend some elements of the current fiscal stimulus package that are due to expire by the end of this year, including:

1) The top priority should be extending unemployment insurance benefits for workers who lose jobs through 2010. The current plan limits extended benefits to workers who become unemployed in 2009. Given prospects for double-digit unemployment next year, extending the financial safety net is vital to support consumer spending and confidence. Nothing is scarier than losing a job without some means of cushioning the blow. The cost to extend the current stimulus UI provision through year-end 2010 is estimated at $75 billion.

2) In response to the housing crisis, conforming mortgage loan limits were raised in a number of higher-priced housing markets across the country. Under the stimulus legislation, the conforming loan limits are due to revert by the end of this year. With private lenders still reluctant to offer jumbo mortgages, extending the higher loan limits through 2010 will support home sales in some of the hardest-hit communities in the country. The cost of extending the higher conforming loan limits through the end of 2010 is under $2 billion.

3) Extending the first-time homebuyer tax credit until mid-2010 would also provide important support to the housing market. Under the current stimulus legislation, homebuyers must close on their purchases by the end of November 2009 to take advantage of the tax credit. The credit increased home sales this summer by an estimated 375,000 units, helping to stabilize house

prices.[xiii] If the credit is not extended, home sales could weaken appreciably and house prices resume their decline. Extending the credit as it is currently structured through the end of May 2010 will cost an estimated $9 billion.

4) Under the fiscal stimulus, SBA loan guarantees were raised to 90%, and various loan origination fees were waived. Extending these incentives for small business lending through the end of 2010 would help alleviate the credit crunch that many of the businesses are struggling with. The cost of this extension is less than $1 billion.

5) Businesses could also use more incentives to expand again. The current stimulus provides tax benefits via accelerated depreciation for big businesses and expensing and a net operating loss carryback provision for small businesses. While such incentives have historically not been particularly effective as a stimulus—they do not induce much extra near-term investment—they are not very costly to taxpayers, and they could arguably be more potent in the current economic environment. Extending the current accelerated depreciation benefits and extending and expanding the NOL carryback to benefit larger businesses would provide a meaningful boost to the economy. The cost of this change would be close to $16 billion.

If policymakers adopt each of these measures, then the total cost to taxpayers would be near $100 billion. Policymakers may also wish to consider a number of other measures if the recovery remains tepid into early next year, including:

6) Additional financial help to state and local governments. Fiscal 2011 budgets, which begin next July for most states, are likely to be more troubled than those for the current year. Tax revenues and new borrowing capacity are weakening. Unless municipalities receive more help from the federal government, they will be under intense pressure to cut jobs and programs and to raise taxes and fees. This will be a serious drag on the economy at just the wrong time. To avoid this, more federal aid to states for their FMAP and educational obligations may be necessary. The cost of this help will be at least $75 billion.

7) Expanded lending by the Small Business Administration. This could help alleviate the impact of tight credit on small businesses, in turn aiding the job market and the broader economy. To increase lending by the SBA, the federal government could temporarily increase its loan guarantee from its current 90% to 97.5%, raise the maximum loan size to $3.5 million, and raise the interest rate cap from the current level—the prime rate plus 275 basis points—to prime plus 500 basis points. Lenders are reluctant to extend small-business loans at the current top lending rate of below 6% because of significant credit risks. SBA oversight of lenders would have to be strengthened and penalties on poor lending increased to ensure that the SBA does not take on too much credit risk. The cost of expanding SBA lending through 2010 is estimated at under $5 billion.

8) Facilitate the expansion of work-share programs. Seventeen states offer some type of work-share program in which employers reduce their workers' weekly hours and pay, often by 20% to 40%, and then states make up some of the lost wages, usually half, from their unemployment insurance funds. Like the temporary extension of unemployment insurance benefits, work share has a high bang for the buck, as it provides financial help to distressed workers who are likely to quickly spend any aid they receive. Work share's bang for the buck is even larger than that of UI benefits, as the reduction in unemployment means that the pecuniary and psychological costs to workers and their employers of lost layoffs can be avoided. It is particularly helpful for businesses who expect any workforce reductions to be temporary; work share allows these firms to avoid severance costs and any costs associated with rehiring and training. The cost for providing seed money to establish work-share programs in other states and to fund the program through 2010 is no more than $2 billion.

9) Adjustments to the administration's mortgage loan modification plan. Encouraging principal write-downs in such loan modifications would go a long way toward quelling the foreclosure crisis and putting an end to national house price declines. Under the current HAMP, most modifications offer

only to reduce homeowners' mortgage payments for up to five years. This may not be sufficient to end the foreclosure crisis quickly, given the high expected default rates on these types of modifications. Providing subsidies to lower the mortgage principal on loans that were inherently unaffordable when they were first made—those where the debt-to-income ratio exceeded 30% and the cumulative loan-to-value ratio was over 90%–would significantly increase take-up and lower future redefault rates. The cost of extending the HAMP plan could be as much as $50 billion; this could be at least partly funded by TARP money that will not be used given the low take-up rate of the current HAMP plan.

10) A job tax credit for businesses that expand payrolls. The size of the credit could be set to equal the payroll tax costs of new hires for at least one year, and perhaps two. While businesses are more focused on the demand for their goods and services and the availability of credit when making hiring decisions, the cost of labor, which this credit targets, is also important. The credit could be made more effective by allocating a set amount—say $10 billion—for those businesses that hire first. This would encourage firms to act quickly and accelerate the benefit of the credit on hiring.

Other policy considerations

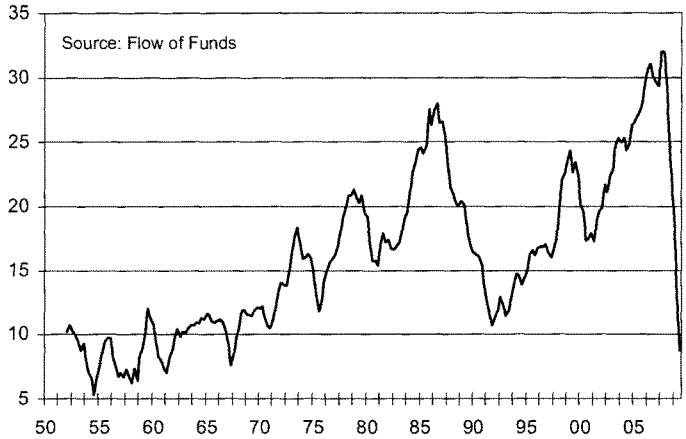
In addition to the prospects for a weak and fragile recovery that is at an uncomfortably high risk of faltering, there are a number of other reasons why fiscal policymakers may want to take additional actions to shore up the economy.

Key among these reasons is the difficulty the Federal Reserve will have in responding more aggressively if the economy falters. The federal funds rate is near zero, and the monetary authorities are very reluctant to further expand their credit easing efforts.[xiv] They have committed to purchasing an additional $600 billion in Fannie Mae- and Freddie Mac-insured mortgage securities through next March—this is on top of the $1.15 trillion in Treasury and Fannie and Freddie securities they have already purchased—but are loathe to do more than this. The Fed has effectively become the nation's predominant residential mortgage lender, which is something it would like to bring to an end as soon as possible.[xv] If the Fed winds down its purchases as planned, then mortgage rates will rise by as much as a full percentage point next spring, about the time foreclosure sales are expected to increase. The pressure on house prices and the broader economy could be significant.

Purchasing more Treasury securities also seems out of the question, given the angst the previous Fed purchases created among investors, who were fearful that this signaled policymakers' willingness to monetize the nation's debt. While an unfounded worry, investors' concerns were strong enough that long-term interest rates began to rise despite the Fed's bond purchases.

Further supporting aggressive actions by fiscal policymakers is evidence that the government's record borrowing is not crowding out private investment. Despite the federal government's record $1.4 trillion fiscal 2009 deficit and robust municipal borrowing, total borrowing, including that done by households, nonfinancial businesses and financial institutions, has fallen sharply. As a share of GDP, total borrowing is about as low as it has been since World War II (see Chart 10). Household, business and financial concerns are rapidly deleveraging, allowing more than enough room for increased government borrowing without driving up interest rates.

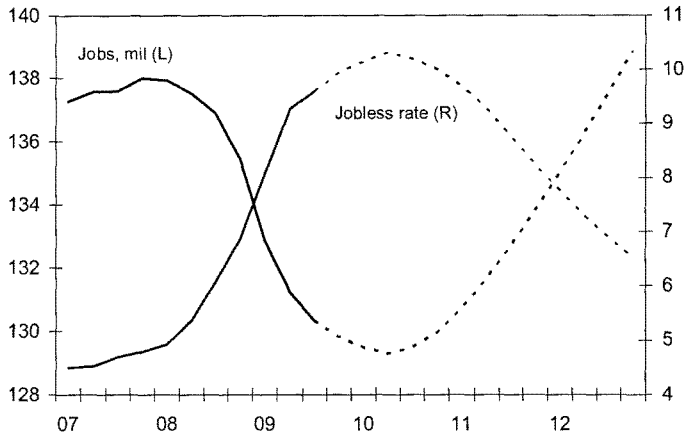
Chart 10: No Crowding Out
Total borrowing as a share of GDP



This will not continue for long once the recovery gains traction and private credit demands rebound. If budget deficits and government borrowing are not receding at the same time, interest rates will rise sharply. Policymakers thus have the latitude to provide more near-term support to the soft economy through temporary increases in borrowing to finance more tax cuts and spending increases but need to also address the increasingly worrisome longer-term fiscal outlook. Healthcare reform and how policymakers decide to deal with the tax increases legislated for the start of 2011 are important in this regard.[xvi] Indeed, the more credible these policy efforts are in reducing future projected budget deficits, the more room policymakers will have to help the economy in 2010.

Not taking more aggressive fiscal policy actions now may also cost the economy significantly in the long run. Even under the best of circumstances, unemployment is likely to remain uncomfortably high for a very long time. Assuming that policymakers do extend the provision of the current fiscal stimulus as recommended, payroll employment is expected to fall by 8.75 million jobs from the peak in December 2007 to the trough at the start of 2010 and not to return to its previous peak until the very end of 2012 (see Chart 11).[xvii] The unemployment rate is expected to peak at 10.5% in the late spring of 2010 and not to fall back to a rate consistent with full employment until 2013 (see Chart 11).

Chart 11: A Tough Job Market for a Long Time to Come
Sources: BLS, Moody's Economy.com



The full-employment unemployment rate is rising, as those losing their jobs are staying unemployed for increasingly long stretches, undermining their skills and marketability as workers. Workers in their late 40s and 50s will have a particularly difficult time getting back into the workforce. This structural unemployment is also increasing given the weakening in labor force mobility considering the large number of homeowners underwater on their homes.[xviii] Historically, those losing their job in one part of the country could readily move to another part of the country where a job was available. This is much more difficult to do if a homeowner needs to put more equity in their home before they move.[xix] The full-employment unemployment rate has already risen from less than 5% prior to the Great Recession to an estimated 5.3%. Under the best of circumstances, it is expected to rise to near 6% by early in the next decade.

The longer unemployment remains elevated, the more the full-employment unemployment rate will increase. This kind of hysteresis has long plagued European labor markets, whose experience illustrates how pernicious a problem this can be. The more aggressive policymakers can be now to ensure that the recovery quickly evolves into an economy that is able to generate a substantial number of jobs, the less likely the U.S. economy will suffer these same longer-term ills.

Conclusions

The Great Recession is over, but the recovery will be a difficult slog through much of next year. The risks are also uncomfortably high that the economy will backtrack into recession. This would be an especially dark scenario, as the economy would almost certainly be engulfed in a deflationary cycle of falling wages and prices. The Federal Reserve and fiscal policymakers would also have fewer options and resources with which to respond.

A range of problems suggest that such a scenario cannot be easily dismissed. Most obvious are the very high and rising unemployment and increasingly weak wage growth, the mounting foreclosure crisis, rising commercial mortgage loan defaults and resulting small bank failures, budget problems at state and local governments, and dysfunctional structured-finance markets that are restricting credit to consumers and businesses.

Policymakers should provide more help to the economy to ensure that the recovery becomes self-sustaining. The Federal Reserve must not raise interest rates too soon or exit its credit easing efforts too quickly. Congress must provide more resources to unemployed workers whose benefits are running out, to state governments unable to balance their budgets, and to households and businesses looking to buy homes and invest.

All this help comes at significant cost. While the fiscal stimulus has been vital, it helped produce a $1.4 trillion budget deficit this past fiscal year and will lead to another $1 trillion-plus deficit in the current one. Yet the cost to taxpayers would have been measurably greater if policymakers had not acted aggressively. The recession would still be in full swing, undermining tax revenues and driving up government spending on Medicaid, welfare, and other income support for distressed families.

It is a tragedy that the nation has been forced to spend so much to tame the financial crisis and end the Great Recession. Yet it has been money well spent. The fiscal stimulus is working to ensure that the recent dark economic times will soon be relegated to the history books.

[i] The official arbiters of the beginning and ending of recessions—the business cycle dating committee of the National Bureau of Economic Research—will likely not fix the end of the Great Recession for some time. The committee aims to be correct rather than timely in making its determinations. But based on the same statistics and methodology used by the committee, we can say the recession likely ended in August 2009.

[ii] In the stress testing this past spring, the nation's 19 largest bank holding companies were required to determine and raise capital sufficient to withstand an economic scenario similar in severity to the Great Depression. The process restored confidence in the banking system, as is evident from the sharp narrowing in credit spreads during the period.

[iii] Cash for clunkers is estimated to have resulted in 420,000 incremental new vehicle sales during July and August 2009. The housing tax credit, which expires on December 1, is expected to increase new- and existing-home sales to first-time homebuyers by 380,000.

[iv] The methodology used to derive these results is described in "The Economic Outlook and Budget Challenges," Mark Zandi, January 27, 2009, testimony before the House Budget Committee.

[v] This excludes the monies related to the AMT patch, which was included as part of the ARRA.

[vi] This is based on National Income and Product Account data available through the second quarter of 2009.

[vii] This criticism is most cogently expressed in "New Keynesian versus Old Keynesian Government Spending Multipliers" by Cogan, Cwik, Taylor and Wieland, February 2009.

[viii] Saving rates by income group can be calculated by combining data available from the Federal Reserve's Flow of Funds and Survey of Consumer Finance. These data are available upon request.

[ix] This statement is based on the BLS report Business Employment Dynamics, which is currently available through the fourth quarter of 2008. The recession began in the fourth quarter of 2007.

[x] This is based on a 5% randomized sample of all the credit files in the country maintained by the credit bureau Equifax.

[xi] This is well below the 3 million to 4 million loans the administration expects to be offered under the plan. The administration is overestimating the take-up on HAMP, because it is underestimating impediments such as the large number of homeowners in deep negative equity positions. For these homeowners, a modification will not keep them out of foreclosure long. See Zandi, M., "Obama's Housing Policy," *Regional Financial Review*, March 2009.

[xii] This is based on the Moody's/REAL repeat-sales commercial property index. The measured decline in prices may overstate the actual price declines given the low number of property sales, many of which are distressed, but the price declines are severe by any measure.

[xiii] See Zandi, M., "Expand the Housing Tax Credit," June 12, 2009, The Dismal Scientist.

[xiv] Most versions of the Taylor rule suggest that the current appropriate federal funds rate—given high unemployment and low and slowing inflation—is firmly negative. The Moody's Economy.com Taylor rule is signaling a funds rate target of close to -2%.

[xv] Since Fannie and Freddie together account for approximately two-thirds of all purchase residential mortgage loans being originated, and the Fed is purchasing the bulk of the securities backed by these loans, the Fed is financing nearly two-thirds of the nation's mortgage lending.

[xvi] Without legislative changes, cuts in personal income, capital gains, dividend income and estate taxes implemented early in this decade are set to sunset at the start of 2011.

[xvii] This estimate includes the impact of the benchmark employment revisions recently announced by the BLS but that will not be incorporated into the official payroll employment data until January 2010.

[xviii] An estimated 16 million homeowners with first mortgages owe more on their first and second mortgages than their home is worth. This is nearly one-fifth of all owner-occupied homes.

[xix] An increasing number of homeowners are walking away from their mortgages, but this comes with significant financial costs as well.

"The Impact of the Recovery Act on Economic Growth"
Testimony to the Joint Economic Committee

Dr. Kevin A. Hassett
Senior Fellow and Director of Economic Policy Studies
American Enterprise Institute
October 29, 2009

Chair Maloney, Vice Chairman Schumer, Ranking Members Brady and Brownback, and members of the Committee, it is an honor and a pleasure to be with you today.

I. Introduction

As the world's economy slowed dramatically over the last few years, an interesting policy revolution took place. Until recently, there was wide consensus among macroeconomists that activist fiscal policy was inadvisable. But in a now prescient piece, Blinder (2004) began a reconsideration of the case against fiscal policy, stating that 'virtually every contemporary discussion of stabilization policy by economists – whether it is abstract or concrete, theoretical or practical – is about monetary policy, not fiscal policy.'[1] Taylor (2009) alludes to a similar consensus, referring to his past work (Taylor 2000), to Feldstein (2002), and to Eichenbaum (1997), who quite pointedly added that, 'there is now widespread agreement that countercyclical discretionary fiscal policy is neither desirable nor politically feasible' (Taylor 2009, p. 2). These reviews generally found that stimulus measures were ineffective in the past, and were usually implemented at the wrong time.

[1] Blinder 2004, p. 1

Despite these admonitions, one thing is certain: countercyclical discretionary policy is now politically feasible. Around the world, significant temporary stimulus packages have been implemented. In the United States, government economists have even gone so far as to assert that stimulus actions have the consensus support of economists. In an article in the New York Times earlier this year, Christina Romer, chair of the Council of Economic Advisors, said that 'aggressive, well-designed fiscal stimulus is critical to reversing this severe decline'. The article then continued, 'the vast majority of the nation's economists agree that [fiscal stimulus] is necessary, and soon.'[2]

This generalization did not allude to evidence gathered from a survey of economists. It was merely an assertion. Given that Blinder in 2004 stated the opposite, it raises the question: "what new evidence emerged after 2004 that changed the decades-old consensus in academic literature advising against discretionary stimulus?" The answer, of course, is that there have been no dramatic new scientific breakthroughs. Conclusions concerning the views of the majority of economists should be drawn only after a proper survey. My view is that such a survey would show, as it would in most areas of economics, a significant difference of opinion concerning optimal policy responses to a recession. The basis for this view is presented below.

My testimony will be broken up into four parts. The first will be a brief review of the state of the economy. The second part will discuss the state of the economic literature concerning stimulus plans in general. The third part will discuss a few specifics of the latest stimulus effort. The final section will discuss the merits of alternative policies to those that were enacted this year.

[2] Uchitelle 2009

II. The State of the Economy

There are many signs that the economy has finally turned the corner. While there are many interesting individual data items, a useful summary statistic is a model of recessions that has been developed by University of California economist Marcelle Chauvet and her coauthors. Chauvet's model takes monthly economic numbers and uses them to estimate whether or not the economy is in recession. The model's key output is a recession probability, that can be thought of as being analogous to a weather forecast for the current state of the economy. When the probability of recession climbs above 50 percent, then the economy is said to be in recession. When it drops below 50 percent, then we are out of recession. Her model is quite remarkably; it has correctly predicted every postwar recession, and never given a false signal.

In a recent correspondence, Chauvet communicated to me that the latest read on the recession probability suggests that the recession most likely ended in July, or August at the latest. That means that we can expect that third quarter growth was much improved, and that growth will continue to be positive going forward.

I should add a note of caution, however. Just because the economy is growing, it does not mean that all of the slack has been taken up. In this recession in particular, the enormous increase in the number of long term unemployed is a deep policy concern, and it may be prudent to consider additional policies that hasten the rate at which the long term unemployed return to the labor market. I return to this issue in the final section of my testimony.

III. The Academic Stimulus Debate

This section will review the arguments for activist fiscal policy, and discuss the lessons

the literature has to offer concerning its form.

On the favorable side, a recent and influential summary of the arguments for short-run fiscal stimulus was provided by Elmendorf and Furman (2008). Most of the compelling arguments for activist fiscal policy rely on simulations of Keynesian models, such as Elmendorf and Reifschneider (2002). A number of extensive reviews indicate that there is a wide array of Keynesian models that suggest economic stimulus can be very effective.[3] For the most part, fiscal multipliers range from slightly below one to perhaps as high as 1.4, suggesting potential benefit in these models from significant short run stimulus.

While Keynesian models suggest that large stimulus effects are possible, these effects are part of these models by construction. Neoclassical alternatives to the Keynesian approach, such as that offered by Barro (1981) or Baxter and King (1993), suggest that in many cases, private actions can largely offset a fiscal stimulus. The question, then, is an empirical one. Fortunately, there is a large literature to draw on. I will look at each of the most important questions in turn, including the impact of government spending on output, the impact of temporary tax reductions on consumption, the impact of temporary business tax reductions on business capital spending, and the effects of fiscal consolidations.

Temporary Tax Cuts and Consumption

The U.S. Congress provided economic stimulus in the form of rebate checks in 2001 and 2008, and evidence from the first episode about the efficacy of this type of measure is mixed. Economists have studied the effects of the 2001 rebate checks extensively. Johnson, Parker and

[3] For other examples see Barrel et al. (2004) or Roeger and Veld (2004).

Souleles (2006) used Consumer Expenditure Survey data that provided special details on the timing of the rebate checks. They found that total expenditures did not respond to these checks if one included durable spending in the analysis, but that there was a significant response for nondurable consumption. In the first quarter following the checks' disbursement, response of consumption to the checks was 37.1 percent, with the two quarter effect about double that. Agarwal, Liu and Souleles (2007) found evidence that money not spent was used to buy down credit card balances, making room for additional purchases. Slemrod and Shapiro (2003a, 2003b) provide survey evidence that is also roughly consistent with these results.

It is possible, of course, that the stimulus effect of the 2001 tax reductions might have been larger than that of the 2008 rebates, because the 2001 tax cuts may have been perceived to be permanent. In that case, both "Keynesian" consumers who spend their entire income, and unconstrained consumers who obey the Permanent Income Hypothesis, might have responded to the stimulus.

The evidence regarding the effectiveness of the 2008 cuts is still emerging. Slemrod and Shapiro (2008) found that only one-fifth of respondents planned to increase spending in response to their stimulus checks. This result suggests that the stimulus effect of the tax cuts may have been relatively small.

It is worth noting that the opposing view voiced by neoclassical economists argues that individuals increase their savings in anticipation of future tax increases. To the extent that this microeconomic evidence is based on the responses of low-income consumers relative to higher-income consumers, it may be that the macroeconomic effects of the stimulus would be smaller than these results imply. If consumption is reduced by the relatively wealthy who pay the

majority of taxes (but received little stimulus), then we might see differing consumption patterns in micro data that do not lead to big changes in aggregate consumption because reductions in the consumption of the wealthy offset increases by low income individuals. Given that there is some evidence that macro consumption has been disappointing during stimulus episodes (a point I return to below) this concern must be taken seriously.

The Impact of Government Spending on Output

Textbook Keynesian models suggest that government spending can increase aggregate output with a multiplier significantly greater than one; the neoclassical theory disagrees. This alternative theoretical argument is described in detail in Barro (2008), which draws heavily on Barro (1981). There he documents that the long run effect in a neoclassical model of higher government spending is likely very close to zero, but that the short run effect can be positive. He provides aggregate time series evidence consistent with these two theories. Also, Barro (1981) distinguishes between the effects of spikes in military and nonmilitary government spending on aggregate output. He finds that increases in military spending raise output, but with a multiplier that is less than one. When government spending was above trend, there were shortfalls in private investment and net exports.[4] However, Barro (1981) does not find that non-military government spending has any positive effects on output. This suggests that, if past incidents are an indication of future results, the current wars may be more productive fiscal policy than the stimulus package.

A very large literature has subsequently emerged that explores these issues, both in the short term and in the long term. Blanchard and Perotti (2002), Mountford and Uhlig (2002),

[4] Barro (1981) p. 377

Perotti (2005) and many others find that vector auto-regression (VAR) settings that near term shocks to government spending lift GDP, consumption, and real wages. These results are more consistent with the Keynesian stimulus view, but they have been challenged by an equally extensive literature.

Most notably, Ramey and Shapiro (1999) and Ramey (2008) use exogenous military shocks to identify the effect of government expenditure on growth. The Ramey-Shapiro results are highly consistent with neoclassical predictions: indeed, they conclude in their introduction that "[w]hen shocks to defense spending rather than overall spending are identified using a standard VAR, I find that the Keynesian effects on consumption and real wages disappear."[5] Ramey and Shapiro also reconcile their results with those of the more Keynesian structural VARs. They find that the VARs tend to use a government shock identification approach that leads to a mistiming of the results. Additional work by Edelberg, Eichenbaum, and Fisher (1999) leads one to conclude that the government spending shocks have a positive short run effect that peaks in about a year, but this effect declines and can even turn negative shortly thereafter. Tenhofen and Wolff (2007) provide a neat bridge between the VAR and the Ramey and Shapiro literatures, finding that they can roughly reproduce Ramey and Shapiro's results inside the structural VAR framework by including a model of consumer expectations toward government policy. Given the earlier indictment of VAR timing by Ramey and Shapiro, this result closes the circle.

Hemming, Kell, and Mahfouz (2002) document an extensive VAR literature that, across many countries, finds short term effects of government spending on growth that imply

[5] Ramey (2008) p. 3.

multipliers that are quite small when compared to the predictions of Keynesian models. Nonetheless, this literature makes it clear that a government spending boom in the U.S. is likely to lift output to some degree above its counterfactual path. However, this may come at some short term cost in reduced private activity. In the long term, one needs to factor in two other literatures before assessing the net costs and benefits of the current actions.

Finally, one should note that this literature, combined with an earlier public finance literature, raises questions concerning the welfare gain associated with short term increases in spending. Ballard, Shoven and Whalley (1985) for example, find that the marginal cost of $1 of public expenditure is about 17 cents. Browning (1987) finds that the marginal cost ranges widely, between 10 and 300 percent. Thus, the welfare costs of paying the bill may be greater than the short term boost to the economy from the most optimistic estimates.

The non-Keynesian effects of fiscal consolidations

Giavazzi and Pagano (1990) began an enormous literature when they studied the impact of fiscal contractions. They found that in some cases--the first identified were Ireland and Denmark--a country can have a dramatic reversal in economic growth when it achieves a successful fiscal consolidation; that is, when it cuts rather than increases government spending, and raises rather than lowers taxes. Similar results have been found for other countries by Alesina and Perotti (1997), Alesina and Ardagna (1998), and Alesina, Perotti, and Tavares (1998).

It is necessary, of course, to attempt to find a roadmap that allows one to predict when a country can expect a non-Keynesian effect of a fiscal consolidation, and when it cannot. Perotti

(1999) finds that Keynesian effects seem to be most likely when a government begins the episode with relatively low debt. Jonsson (2007) finds that a consolidation is most likely to stimulate growth if it cuts transfers. Hjelm (2002), in a cautionary tale, finds that the results may be significantly influenced by exchange rate swings, something that might make an expansionary consolidation more likely in a relatively small country with a questionable government prior to the consolidation. Reading through the literature, it is clear that fiscal consolidations can be stimulative, and even when they are not, their presence provides significant challenges to Keynesian models with large multiplier effects.

A possible theoretical path that could produce non-Keynesian results would be dismay over the possibility that a government might deviate from its long run budget constraint. Canzoneri et al. (2002) use the term Ricardian in the Woodford (1995) sense: A Ricardian regime means that future and discounted budget revenues are expected to pay future government spending and interest on debt (budget surpluses satisfy a present value budget constraint for any prices and discount factors). A non-Ricardian regime means that there is no guarantee that budget revenues will pay for future spending and debt.

The authors show that in non-Ricardian regimes, fiscal policy determines price levels. If taxes are cut in an economy with flexible prices and wages, real households have increased wealth, which puts pressure on the aggregate demand and raises prices.

Canzoneri and Diba (1998) and Canzoneri, Cumby, and Diba (2001) argue that monetary policy loses its ability to restore prices in the non-Ricardian scenario. The Fed cannot raise the interest rate enough to make the selling of bonds offset the decrease in revenue created by tax

cuts. Since a government flipping to non-Ricardian status is a doomsday scenario, a fiscal consolidation might have an enormous positive impact on expectations.

The negative impact of government in the long run

While there is a good deal of uncertainty concerning the size of the government multiplier effect in the short run, the long run impact of government spending on growth has a fairly robust underpinning in the empirical growth literature. Barro (1989, 1991) examines the impact of government consumption and investment spending on economic growth in a series of cross-country growth regressions. He concludes that public consumption spending has a robust negative relationship with growth and investment while public investment spending has an insignificant effect on economic growth. Grier and Tullock (1989) find that a one standard deviation increase in government growth reduces average GDP growth by 0.39 percentage points. In other words, there is a strong negative effect of the growth of government consumption as a fraction of GDP. Alesina, et al. (1999) find similar negative results of government spending on economic performance, as measured by business investment, in an analysis of OECD countries. Folster and Henrekson (1999 and 2001) find a negative growth effect of large public expenditures in cross-country analysis.

Other notable papers examining the long run economic impact of government spending include Landau (1983), Barth and Bradley (1987), and Kormendi and Maguire (1985).[6] Grossman (1988) examines the impact of government expenditure on economic growth in the United States from 1929-1982 and concludes that the negative impact of rent-seeking behavior

[6] For a review of the literature evaluating the empirical relationship between government spending and economic growth in a cross-country setting, see Slemrod, Gale and Easterly (1995).

and the misallocation of resources has considerable costs. In fact, the positive impact of increased government size was offset by the inefficiencies of the provision process. He also notes that the size of these negative effects is likely to increase with the relative size of government.

Summing Up

Since the short run effects of Keynesian policies are uncertain, and the long run effects likely negative, one might wonder whether on balance, activist countries are serving their citizens. One study that looked at this question is Fatas and Mihov (2003). Looking at a panel of 91 countries, they found that

> "(1) governments that use fiscal policy aggressively induce significant macroeconomic instability;
>
> (2) the volatility of output caused by discretionary fiscal policy lowers economic growth by more than 0.8 percentage points for every percentage point increase in volatility;
>
> (3) prudent use of fiscal policy is explained to a large extent by the presence of political constraints and other political institutional variables."[7]

Hemming, Mahfouz and Schimmelpfennig (2002) provide a useful case history of past recessions. Based on data from all OECD recessions between 1971 and 1998, they find that the impacts of expansionary policy were barely noticeable, and may at times have been negative. Consistent with the pattern one would expect from the fiscal consolidation literature, they find that countries with high debt positions that pursued fiscal expansions in their recessions saw their

[7] Fatas and Mihov, (2003) p 1419.

growth rate drop 4.3 percent below trend growth, on average, during the recession in question. Countries that had high debt positions and contracted their fiscal position posted rates 3.8 percent below trend growth. For lower debt countries, the pattern was reversed. Those countries that pursued fiscal contractions had posted rates that were 5.3 percent below trend, while those with fiscal expansions grew at 4.4 percent below trend growth.

These disappointing results are consistent with the balance of the literature as summarized above, and rather bad news for countries attempting Keynesian stimulus at the moment. Government debt has expanded so rapidly during the government bailout that one might expect the high debt results to apply in most countries. In that case, then, the short run positive effects may be minimal. The large expansion of government spending also creates something of a problem for policy makers. If they unwind the spending all at once, then they may, even optimistically, only postpone some subset of the recession. If the government spending spike is not unwound, then the long run negative growth results kick in.

IV. A Look at the Latest Stimulus Effort

This year's stimulus bill consisted of an attempt to stimulate consumption through temporary tax cuts, a few targeted programs such as the First-Time Homebuyer Tax Credit and the "cash for clunkers," and increases in government spending.

Consumption Effects

The consumption stimulus is viewed by proponents as a macroeconomic success if it leads to a short-run increase in consumption. A neoclassical skeptic would emphasize that the increased saving (reduced consumption) by those who anticipate higher future taxes might offset

the increased consumption by "Keynesian" consumers who rush out to spend their checks from the government.

Figure 1 suggests that the scale of the concern is significant. In Figure 1, I assume that the deficits for fiscal years 2009 and 2010 will be closed via future tax increases to maintain that maintain the distribution of tax payments. I compare the current value of this expected future tax increase at each income bracket to the size of the stimulus check. Clearly, if consumers are even a little bit worried about future taxes, it could offset the stimulus.

Cogan, et al. (2009) has analyzed the macroeconomic movements in consumption behavior this year, and compared them to personal income movements. Taylor (2009a) has updated their analysis, presented in Figure 2. While there are many moving parts, and one should be wary of reading too much into such a simple chart, it suggests that we should be cautious about concluding that a massive stimulus to consumption has occurred. Indeed, the stimulus checks visibly affect income but not consumption. If this is the case, it is because reductions in consumption from non-Keynesian consumers offset the increases of the Keynesians.

I should add a note that even if stimulus did motivate consumption, it is not obvious that it made consumers better off. If consumers do consume their stimulus checks because they ignore the possible future tax increase, then they will likely regret that choice when the inevitable tax increase occurs.

Targeted Measures

While I am unaware of the existence of a detailed study, there is no question that the cash for clunkers program stimulated automobile purchases. The First-Time homebuyer Tax Credit,

however, is something of a case study of the perils of rushing government cash out the door. The issue is that the IRS did not require documentation to prove eligibility for the credit, and a review of the program by J. Russell George, the U.S. Treasury inspector general for tax administration, has exposed extensive fraud.

According to George's investigation which he revealed in a recent testimony, ``we identified more than 19,300 electronically filed 2008 tax returns on which taxpayers claimed the First-Time Homebuyer Credit for a home which had not yet been purchased." In addition, George said his office found almost 74,000 claims ``by taxpayers who had indications of prior home ownership within the preceding three years." Some taxpayers were able to claim the credit by purchasing a house for a child. George testified that ``more than 580 taxpayers younger than 18 years of age who claimed almost $4 million in First-Time Homebuyer Credits. The youngest taxpayers receiving the credit were 4 years old."[8]

The problems with the homebuyer credit expose the flawed Keynesian reasoning behind this year's stimulus efforts. There is no question that the credit's stimulus effect was likely magnified by these frauds. After all, checks were mailed, and individuals who bought beach homes in the names of their children likely used the government checks to purchase furniture for their new vacation paradise. The question is not whether it is feasible to use policy to provide a short run boost to the economy, the question is, what is the best way to provide the boost? I return to the latter question in the final section of my testimony.

Government Spending

[8] George (2003)

The final major stimulus effort focused on government spending through infrastructure and other measures. I should add that since infrastructure spending is likely far below its optimal level in the U.S., much of this portion of the stimulus bill represents prudent policy. But it was probably not much use in providing stimulus.

A recent analysis of government spending by Alex Brill of AEI and his colleague Rachel Forward concluded that stimulus money has "gone out the door" at about the expected pace, but that the composition has been much different than expected. After a detailed analysis, they concluded that "Transfer payments to states and individuals for unemployment insurance and education have far exceeded initial projections, while spending for construction and infrastructure projects, designed to fuel job creation, is far below the original plan."[9]

Regardless of what one assumes the government spending multiplier to be, it is simply impossible to assert that higher government spending has done much so far. The higher transfer payments did, however, undoubtedly boost consumption at the margin. Looking ahead, Brill and Forward's analysis suggests that a good deal of additional stimulus is in train.

V. Policy Alternatives

One argument in support of economic stimulus that has received significant attention in Washington is the view that stimulus cannot hurt. If Keynesians are correct, the argument goes, then the economy will be stimulated. If Keynesians are incorrect, then consumers increase savings to offset the stimulus, but, since they then have the savings, the policy is a wash. Either way, the policy should be adopted because any positive probability of Keynes being correct (and that probability cannot be zero) would imply the policy would have a positive impact.

[9] Brill and Forward (2009)

The problem with this argument is that it assumes that the alternative to Keynesian stimulus is doing nothing. Sadly, this argument is the source of a significant policy error, which is to accept without question the view that a recession is a bad time to fix something that is broken, or that it is wrong during a recession to pursue policies that are not temporary. There really is no rational support for this view, unless we accept that sounder policies are politically impossible. By refusing to acknowledge the opportunity to improve broken policies, we have, perhaps ironically, wasted the crisis.

As we look ahead to many months--if not years--of unemployment that is far higher than what is desirable, we must consider policies that help the economy reach full employment more quickly while providing a sustained basis for long run recovery. Several policies come to mind that are likely to be more effective than those adopted so far, and that draw on the extensive academic literature on discussed earlier. These policies would make permanent changes to provide an immediate boost to the economy, and would run a smaller risk of running into problems highlighted by the fiscal consolidation literature.

First, the indexing formula for Social Security could be changed from wages to prices. A recent analysis by the Social Security Administration found that over a 75 year time horizon, this would improve the long run budget condition by $4.5 trillion in present value.[10] If some fraction of that revenue were recycled, say, through a reduction in the payroll tax (increasing monthly take-home pay), then one might see both a consumption increase and a positive fiscal consolidation effect. The consumption increase would be dramatic if it improved recipients' confidence that they will receive benefits, thus increasing their perceived permanent income.

Alternatively, the government could announce today that the corporate tax rate would gradually

[10] Social Security Administration (2008)

be reduced from 35 percent to 25 percent, while again covering any expected revenue loss from that with the introduction of a value added tax (VAT) that does not take effect for a number of years. The declining corporate tax rate would act like an Investment Tax Credit today, giving investors an incentive to pull their deductions forward into the high tax rate period. The future VAT would induce individuals to consume today, before consumption is taxed. In addition, the move toward a consumption tax would improve the long run efficiency and vitality of the economy. The lower corporate tax rate would be a long overdue response to our many competitor countries that have already reduced their rates.

Such policies would, the literature suggests, stand a much better chance of providing significant and sustained growth than those that have already been adopted. To the extent that the high level of unemployment motivates additional policies, it would be unfortunate if such permanent fixes were again taken off the table.

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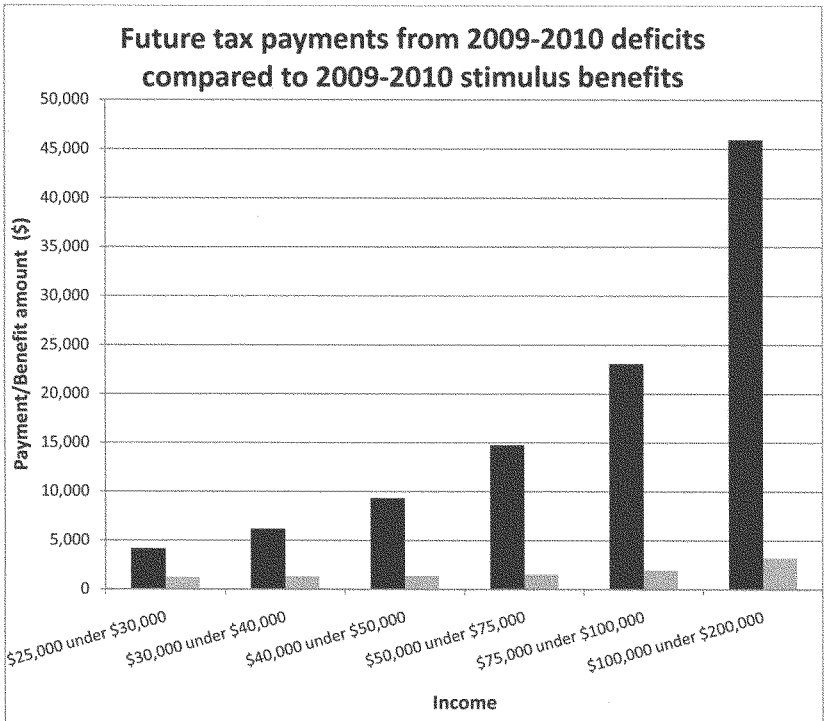
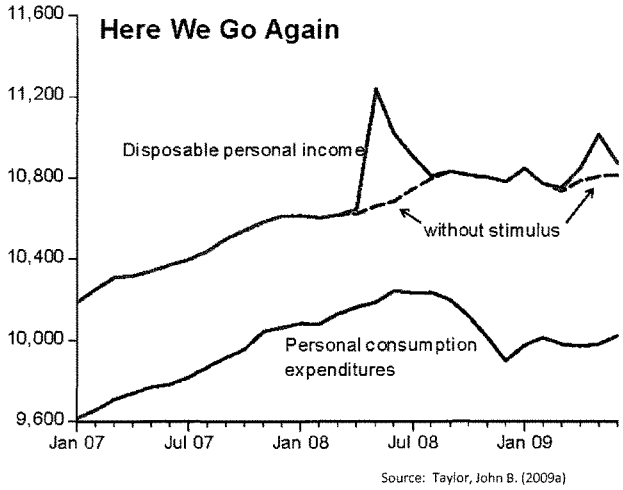
Figure 1.



Sources: The author's calculations are based on data from the Brookings–Urban Tax Policy Center and IRS Statistics of Income. Notes: The combined $2.78 trillion deficit for FY 2009 and 2010 is assumed for future tax burden calculations. Black bars indicate the additional tax burden associated with the 2009-2010 projected deficit for each income category. The deficit is distributed across taxpayers according to the distribution of 2006 tax liabilities. If the distribution of the income tax is unchanged, and the deficit is ultimately paid for via income taxation, then the table indicates the additional burden associated with the projected deficit. Grey bars show the distribution of individual income tax changes from The American Recovery and Reinvestment Tax Act of 2009 as estimated by the Brookings–Urban Tax Policy Center and the author's calculations. Income categories are based on adjusted gross income for tax year 2006; income tax amounts are based on "income tax before credits." Incomes below $25,000 are assumed to have zero or negative income tax liability.

Figure 2.


Here We Go Again
11,600
11,200
10,800
10,400
10,000
9,600
Disposable personal income
without stimulus
Personal consumption expenditures
Jan 07
Jul 07
Jan 08
Jul 08
Jan 09
Source: Taylor, John B. (2009a)

AMY KLOBUCHAR
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JOINT ECONOMIC COMMITTEE
JUDICIARY

United States Senate
WASHINGTON, DC 20510

Joint Economic Committee
The Impact of the Recovery Act on Economic Growth
Questions for the Record
Senator Amy Klobuchar
October 29, 2009

Questions for Any Witness

1. Recently, 9 of my Senate colleagues and I sent a letter to the Senate Majority Leader stating that the Congress needs to adopt a special process to deal with our long term fiscal imbalances. I firmly believe we need to bring our deficits and our debt down.

    a. Could you discuss the long term implications of not bringing our deficits and our debt under control?

    b. What are your suggestions for how to deal with these long term fiscal imbalances?

Additional Questions for Dr. J. Steven Landefeld, Director of the Bureau of Economic Analysis, U.S. Department of Commerce.

1. Today, we learned that the third-quarter personal saving rate was 3.3 percent, which is lower than the 4.9 percent personal saving rate in the second quarter. What impact did this reduction have on the economy in the 3rd quarter?

Additional Questions for Dr. Simon Johnson, Ronald A. Kurtz Professor of Entrepreneurship at the MIT Sloan School of Management and Senior Fellow at the Peterson Institute for International Economics.

1. In your testimony, you state that banks are "strongly incentivized to take large risks in order to raise profits, increase bank capital, and pay large bonuses to compete for talent". How do you suggest we reform these incentives so that excessive risks are not taken?

Additional Questions for Dr. Mark Zandi, Chief Economist at and Co-Founder of Moody's Economy.com.

1. In your testimony, you note that "criticism that only $175 billion of the $787 billion stimulus plan has been distributed through tax cuts and increased government spending is

misplaced. What matters for economic growth is the pace of stimulus spending." Why is the pace so important?

2. As part of your policy prescriptions, you mention that the top priority should be to extend unemployment for jobless workers through 2010 and that the cost to extend the current stimulus UI provision through year-end 2010 is estimated at $75 billion. As you may know, I am very concerned about our ever increasing deficits and our national debt, how do we justify this cost, if we cannot find an offset?

Additional Questions for Dr. Kevin Hassett, Senior Fellow and Director of Economic Policy Studies, American Enterprise Institute for Public Policy Research.

1. In your testimony, you note "several policies come to mind that are likely to be more effective than those adopted so far." What other policy recommendations do you have in addition to the ones already described in your testimony?

BEA
BUREAU OF ECONOMIC ANALYSIS

U.S. Department of Commerce
Economics and Statistics Administration

Response to Questions for the Record from Senator Klobuchar
Joint Economic Committee
October 29, 2009 Hearing

Question: Today, we learned that the third-quarter personal saving rate was 3.3 percent, which is lower than the 4.9 percent personal saving rate in the second quarter. What impact did this reduction have on the economy in the 3rd quarter?

Response: The data we released on October 29th captured personal saving in the third quarter of 2009, which is one part of the overall saving picture. Additional data on saving are also important to understanding economic impact, however, they will not be available until later this year. Moreover, both saving and spending play important roles in the economy, and in most cases, they should be examined jointly, and over time, rather than in isolation at a single point in time.

Putting the saving data into further context, national saving – saving by households, businesses, and government – is also an important source of funds for investments in plant and equipment and in housing, which help raise standards of living and productivity. Although BEA produces data on overall national saving, as well as household, government, and business savings [or saving?], estimates on national saving and business saving (adjusted undistributed corporate profits) will not be available until the second estimate of the third quarter, which will be released on November 24, 2009. It will be useful and important to consider these data as well, in order to gain a more complete understanding of economic impact.

Returning to the October 29th personal income data, the decline in the personal saving rate from 4.9 percent in the second quarter of 2009 to 3.3 percent in the third quarter reflect an increase in consumer spending and a decrease in disposable personal income in the third quarter. (Personal saving is equal to disposable personal income less consumer spending.)

Real, inflation adjusted, consumer spending on goods and services increased 3.4 percent in the third quarter, after dropping 0.9 percent in the second quarter. Higher spending on motor vehicles, in part, spurred by the "Cash for Clunkers" program, and spending on other products and services, together contributed about 2.4 percentage points, or about 70 percent, to the 3.5 percent growth in real GDP in the third quarter.

Disposable personal income declined 0.7 percent in the third quarter, following a 5.2 percent increase in the second quarter. Disposable personal income in the second quarter had been boosted by payments to social security recipients and other benefits enacted under the American Recovery and Reinvestment Act.

By comparison, the personal saving rate in 2008 was 2.7 percent, a rate well-below the long-term average saving rate over the last 25 years of 5.0 percent. While many economists believe that the personal saving rate will rise closer to its long-term average, if it rises too rapidly, it can slow the rate of recovery in consumer spending, which accounts for about 70 percent of GDP.

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Dear Senator Klobuchar:

Thank you very much for the opportunity to respond to your questions.

I share your concern regarding the nation's long-term fiscal situation. It is the nation's most serious long-term economic challenge and it is imperative for policymakers to significantly reduce future budget deficits once the economy stabilizes and the risk that the current economic recovery may unravel back into recession measurably abates. Without significant changes to long-term federal spending and tax policy, deficits will remain very high and ultimately significantly undermine the growth in our living standards. The goal should be to reduce expected deficits to more than 3% of GDP by the end of the budget window in fiscal year 2019. This can only be accomplished by policy changes that reduce the growth in entitlement programs and raises tax revenues. These are of course very complex and very difficult policy decisions and will very likely require a change in the budget process. A budget process similar to that adopted by Congress not too long ago to determine which military bases should be closed should be adopted. This worked well in closing unneeded bases and would well to determine how best to cut future government spending and raise more revenue.

With regard to your question about the cost of expanding unemployment insurance benefits for workers that lose their jobs in 2010, it will indeed be very costly. But this is a temporary benefit and will thus not add to long-term budget deficits. Moreover, I believe this benefit is very important to ensuring that the economy does not slide back into recession. With the unemployment rate likely to remain in the double-digits throughout 2010, many workers who lose their job will not be able to find another quickly. Without extended benefits they will likely run out of financial resources and will be forced to significantly cut back on their spending, further exacerbating the difficult economic conditions. The broader hit to consumer confidence and thus spending from unemployed workers running out of benefits could also be very significant. Nothing has a large economic bang for the buck than increased unemployment insurance benefits. It is very important for policymakers to remain aggressive in the next 6-12 months in providing support to the economy via such things as extended unemployment insurance benefits to ensure that the economy does not fall back into recession. If that were to happen, then the cost to taxpayers would be measurably greater.

I hope I have adequately answered your questions. I, of course, would be happy to elaborate on any of this if you feel it would be helpful.

All the best,

Mark Zandi