Using Fiscal Policy to Bolster the U.S. Economy

Testimony to House Committee on the Budget

Brian S. Wesbury
Chief Economist
First Trust Portfolios LP
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I would like to thank Chairman Spratt and the Ranking Member Ryan for the opportunity to come before this committee to discuss the economy and the extremely important subject of economic stimulus. I would also like to remind the committee that as I speak today, I am speaking for myself and not for my employer, First Trust Portfolios LP.

I respectfully ask that my written testimony be included in the record in its entirety.

As we all know, the economy and financial markets have been buffeted by turbulence in recent months. As far back as August 2007, credit markets began to price in significant financial market problems. Since then, defaults and delinquencies on mortgages (especially sub-prime mortgages) have risen rapidly, home prices have fallen, the unemployment rate has moved higher, major U.S. financial institutions have taken large write-downs, and many of these companies have been forced to raise significant sums of capital, some of it from overseas.

Obviously, we are here today to discuss what Congress and the Administration can or should do about all of this.

But, in order to understand today's policy discussion, and its implications, I think it is important to put the current environment in the context of history. A series of five questions should put current economic issues and their policy implications in context.

1) How did we get here?
2) How bad is it?
3) Are Fed rates cuts enough?
4) Is more stimulus necessary?
5) Is there anything else that would help?

How Did We Get Here?

Twenty-five years ago, in the late 1970s and early 1980s, most intellectuals and many politicians were convinced that America's dominance in world economic matters had come to an end. The sun had set on the American Dream.

Between 1969 and 1982, America was in recession roughly 1/3 of the time – one out of every three years. At their peaks, both the unemployment rate and the inflation rate were above 10%, while the misery index – the combination of unemployment and inflation – rose to 21.9% in May 1980. Oil and gasoline prices, adjusted for inflation were little different than they are today, even though consumers had much less purchasing power. In 1981, the 30-year mortgage rate rose to a peak of 18.5%, while the prime rate hit 20.5%. President Carter called it a "malaise."

But in a surprise to the pessimists of twenty-five years ago, the US economy has boomed. Since 1982, the US economy has been in recession only 5% of the time. Over the past 20 years, inflation as measured by the consumer price index has averaged 3.1%, while the unemployment rate averaged 5.4%. The prime rate and 30-year mortgage rate have averaged 6% in the past five years, while the federal funds rate has averaged 3%.

This long boom, with its non-inflationary, low interest rate, recession-free environment, encouraged an increased appetite for leverage and risk by consumers and creditors. While much of this risk was prudent, and was based on a correct belief that incomes would continue to rise, at its fringes, credit standards and personal responsibility frayed to levels that could not be sustained.

This process accelerated between 2002 and 2004 when the Federal Reserve, in a battle against deflationary forces, drove interest rates down to levels not seen in almost 50 years. With the federal funds rate at 1%, the prime rate at 4%, and mortgage rates below 5%, exuberance gripped the housing market. Sub-prime loans, amounting to roughly $1 trillion dollars were issued. This is "ground zero" for the current financial problems facing the US today.

How Bad Is It?

Despite significant dysfunction in the mortgage market, it is hard to imagine that there is any time in history when such rampant pessimism about the economy has existed with so little actual evidence to back it up.

Some data has been weak. For example, retail sales fell 0.4% in December and fourth quarter real GDP appears to have grown at a subdued 1.5% annual rate. It is also true that in the past six months manufacturing production has been flat, new orders for durable goods have fallen at a 0.8% annual rate and the unemployment rate has blipped up to 5.0%. Soft data for sure, but nowhere near the end of the world.

It is most likely that this recent weakness is a payback for previous strength. Real GDP jumped 4.9% at an annual rate in the third quarter, while retail sales surged 1.1% in November.

Just a year ago, most economic data looked much worse than it does today. Manufacturing production fell 1.1% during the six months ending February 2007, while new orders for durable goods fell 3.9% at an annual rate during the six months ending in November 2006. Real GDP grew just 0.6% in the first quarter of 2007 and retail sales fell in January and again in April. But the economy came back and roared, with real GDP averaging 4.4% growth between April and September 2007.

A weak housing market helps explain recent softness in production and durable goods orders. But housing is now such a small share of GDP (4.5%) and it has fallen so much already, it is highly unlikely to drive the economy into recession all by itself.

Exports are 12% of the economy, and are growing at a 13.6% rate. The boom in exports is overwhelming the loss from housing. This can be seen in the fact that initial claims for unemployment insurance have averaged just 314,750 in the past four weeks, and are currently 301,000, a far cry from recession.

Personal income is up 6.1% during the year ended in November, while small business income accelerated in October and November during the height of the credit crisis. In fact, after adjusting for inflation and then subtracting income taxes, and payments on rent, mortgages, car leases/loans, credit card interest, and property taxes, real personal income is up 3.9% during the year through September.

Commercial paper issuance is rising again, as are mortgage applications, Libor spreads have returned to more normal levels, while commercial and industrial loans are up 29.7% at an annual rate in the past six months. In addition, firms and sectors of the economy that have experienced large declines in equity values, or large losses, are attracting capital from private and foreign sources. Presumably, these buyers and investors are well aware of the problems that exist, yet see great opportunity.

In other words, not only is a recession unlikely, but it appears capital markets are already deep into a process that will lead to a full recovery of the financial system. When combined with rapid and large cuts in the federal funds rate, the economy is poised to grow rapidly for the remainder of 2008.

Are Fed Rate Cuts Enough?

The Federal Reserve has cut the federal funds rate from 5.25% to 3.5% in the past five months. The most recent rate cut, of 75 basis points on January 22nd, was the largest single Fed rate reduction in a quarter of a century.

The federal funds rate is now well below the trend rate of nominal GDP growth. In addition, with the consumer price index rising 4% during the 12 months ending in December, the real (or inflation-adjusted) federal funds rate is now negative. In other words, monetary policy is highly accommodative.

This alone should be enough to hold off a recession. Every single recession since 1913 has been associated with overly tight monetary policy. As a result, the probability of a recession at the current time is much less than many fear.

The argument that “this time it is different” is not overly compelling. Yes, it is true that many money center banks in the US have seen their capital eroded, and it is also true that credit markets have been dysfunctional.

However, there are an infinite number of channels in which the money multiplier process can work. Even if some large financial institutions are impaired, other well-capitalized regional and community banks who did not participate in the sub-prime loan market are still lending. Private equity firms and foreign investors also have liquidity as do non-financial corporations in America with more than $1.1 trillion dollars in liquid assets.

Is More Stimulus Necessary?

Fears that current financial market problems could spread and create a Japanese-style market crash, credit crunch and economic downturn are remote. The Japanese central bank continued to hike rates in 1990, even after their stock market had fallen sharply. And it took three years before Japan’s short-term interest rates fell back to even 1988 levels. Japan also lifted tax rates during this time of extreme market uncertainty. The result was a deflationary recession.

Today, in the US, monetary policy is nothing like that of Japan in the 1990s. In fact, the risk of an overly loose policy that creates inflation is much larger than a recession caused by excessively tight policy.

Moreover, other fundamental drivers of economic growth are still solidly in place. Tax rates remain relatively low, and productivity is growing strongly. The entrepreneurial side of the US economy remains healthy.

And because recent Fed rate cuts will take roughly six to nine months to affect the economy, by the time any rebate checks could be in the hands of consumers, the economy will already be accelerating.

As a result, the stimulus plan, because it will increase the budget deficit in 2008, will engender rising expectations of future tax hikes. This concern will lead to a reduced willingness by US and foreign investors to invest in long-term projects which could create jobs and lift growth in the US.

Congress should consider three other issues when making a final decision on whether to pass fiscal stimulus. First, it sends a mixed message. Yesterday, many analysts and politicians were worried about excessive consumer spending, a lack of saving, exploding debt levels, and federal budget deficits. Today, these arguments seem forgotten as we run full speed ahead with plans to encourage more borrowing, and consuming, while at the same time running up the budget deficit.

Second, rebates will not change the long-term path of the US economy. Consumers make decisions about spending based on their long-term income expectations, not on their current income. A rebate will not change long-term spending habits. Moreover, no retailer or manufacturer is likely to build another outlet or manufacturing facility based on a temporary consumer-oriented stimulus. In other words, temporary stimulus does not create new jobs or investment.

Third, while I do not subscribe to the view that budget deficits increase interest rates, it is clear that government spending crowds out private investment. The money to send rebate checks in 2008 will need to be borrowed. Therefore, the very funds necessary to pay for this increase in consumer spending will reduce the availability of funds in other parts of the private sector for investment. This would be counterproductive at a time when markets are in turmoil and many financial institutions are in need of low cost capital.

Is There Anything Else That Would Help?

Yes. The expected sunset of the 2003 tax cut in 2011 is becoming a real impediment to long-term investors. As an active participant in the US financial markets, I already hear on a daily basis how the potential of higher tax rates is reducing the incentive to invest today.

The stock market is especially at risk. If the 2003 tax cuts are allowed to expire, the real cost of capital for American corporations will rise by at least 1%. This, in turn, will result in a 20% drop in US equity valuations.

A key determinant of long-term economic growth and rising asset values is stability in the value of money, the political environment and with future tax rates. If passing a stimulus package now increases the odds of tax hikes before 2011 because it lifts the deficit in 2008 and 2009, this would act as an offset to any positive impact of a stimulus package.

In addition, as we can see in record-high gold prices and a falling value of the dollar, inflationary pressures are already on the rise. As a result, it seems clear that recent interest rate cuts will be reversed at some future date.

A reversal of recent accommodative monetary policy along with rising odds of tax hikes could hurt the economy at some point in the years ahead. In other words, policy actions to help the economy today could very well have a negative impact in the future.

As a result, it is important that current policy be designed with long-term economic activity in mind. I propose three policy changes that would boost investment, innovation and productivity in the years ahead and help offset the virtually certain shift in monetary policy toward a more restrictive stance.

1) Make permanent the Bush tax cuts of 2003.
2) Cut the corporate tax rate to 25%.
3) Index capital gains to inflation for taxation purposes.

These three proposals will boost America's competitiveness, lift entrepreneurial activity and create a vibrant, long-term growth path that will be less inflationary, and more resilient.