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"Policy Prescriptions for the Economy"

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The economy is on the cusp of recession. The political fight over the debt ceiling and Standard & Poor's downgrade of U.S. Treasury debt have rattled the already-fragile collective psyche. Consumers and businesses appear frozen in place. They are not yet pulling back, but to stabilize sentiment and avoid a downturn, it is vital for policymakers to act aggressively.

There is reasonable concern that policymakers can do little to alleviate the crisis of confidence. Interest rates are already extraordinarily low, the federal government is running unprecedented deficits, and European leaders are struggling to keep the euro zone together. The will to act is also impaired by a polarization of political and economic views. A loss of faith in the political process is significantly contributing to the loss of faith in the economy.

But policymakers are not out of options. The Federal Reserve's bold announcement of its intention to keep short-term interest rates near zero until mid-2013 has brought down long-term interest rates and supported stock prices. The Fed can provide even more help by extending the maturity of its Treasury bond portfolio and purchasing more bonds in another round of quantitative easing. More QE would not be without its problems, but they would be outweighed by the positives.

EU policymakers' recent agreement to increase the flexibility of their stability fund and to help resolve troubled banks is significant. Until these new powers are up and running, the European Central Bank is once again buying sovereign bonds. The Europeans need to get ahead of worried financial markets by dramatically expanding the size of the bailout fund. This in effect would push Europe down the path to the adoption of a euro bond and fiscal integration, which is necessary to fully quell the debt crisis.

Most important, President Obama and Congress must conclude the debt-ceiling deal in a reasonably graceful way in the next few months. Another round of political vitriol will be too much for the collective psyche to bear. As part of this process, policymakers must also agree to scale back the significant fiscal restraint that is fast approaching and provide more support to the beleaguered housing market. Given the economy's current difficulties, it is hard to see how it will be able to manage through these headwinds. Tax reform is not immediately necessary, but it is key to achieving fiscal sustainability in the long term.

Another recession would be debilitating. The unemployment rate would quickly rise back into double digits and could remain there for years. Our daunting fiscal problems would become overwhelming as tax revenues fell and demands rose on government programs to help the economically hard-hit. This dark scenario can be avoided, but only if policymakers act definitively and deftly.

Recession threat

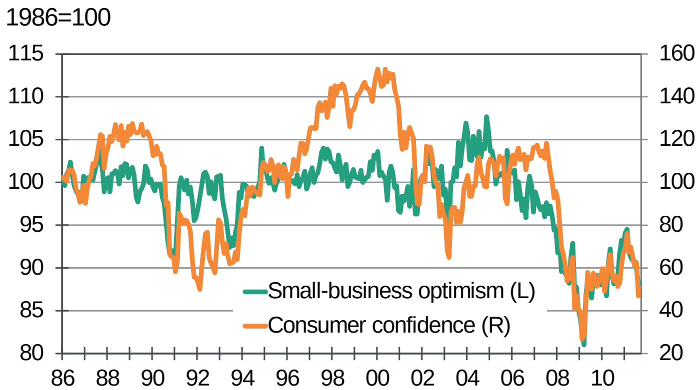
Recession risks are uncomfortably high, largely because confidence is so low. The economy continues to grapple with a number of fundamental problems, most notably the foreclosure crisis, a surfeit of homes and commercial space, and yawning government deficits. But even more serious is that investors, consumers and businesses appear shell-shocked by recent events.

Confidence normally reflects economic conditions; it does not shape them. Consumer sentiment falls when unemployment, gasoline prices or inflation rises, but this has little impact on consumer spending. Yet at times, particularly during economic turning points, cause and effect can shift. Sentiment can be so harmed that businesses, consumers and investors freeze up, turning a gloomy outlook into a self-fulfilling prophecy. This is one of those times.

The collective psyche was already very fragile coming out of the Great Recession. The loss of 8.75 million jobs and a double-digit unemployment rate have been extraordinarily difficult to bear. Businesses have also struggled with a flood of major policy initiatives from Washington, led by healthcare and financial regulatory reform. Other major policy debates, over issues such as immigration, energy and unionization, produced no legislation but still left businesses nervous.

The drama over raising the nation’s debt ceiling, and especially S&P’s downgrade of U.S. debt, eviscerated what confidence remained. While losing the AAA rating has little actual significance—Treasury yields have fallen since the downgrade—it apparently unnerved investors, judging by the plunge in stock prices. Consumer and small-business confidence gauges are as low as they have been outside the Great Recession (see Chart 1).[i]

Chart 1: A Very Fragile Collective Psyche



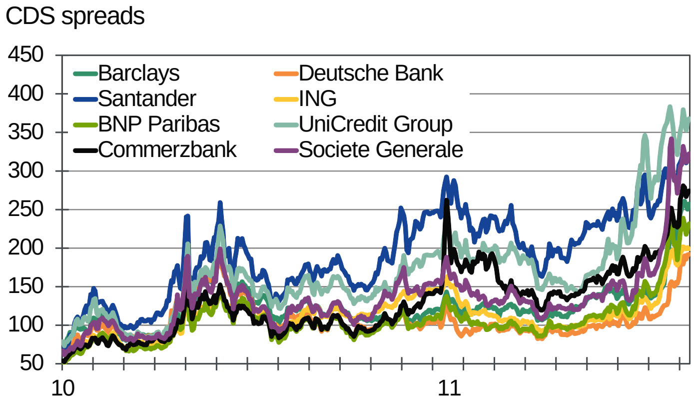
Sources: National Federation of Independent Business, Conference Board

A loss of faith in the economy can quickly become self-fulfilling. A key conduit is the stock market. Since equity prices peaked in late April, some $3 trillion in wealth has evaporated. Since every $1 decline in stock wealth is estimated to reduce consumer spending by 3 cents, the loss to date means spending will take a $100 billion hit over the coming year. This in turn will reduce real GDP growth by about two-thirds of a percentage point.

Stock prices also serve as signals to businesses, letting firms know when it is time to expand as well as providing the means to do so. Rising stock prices embolden managers to take risks and seek growth opportunities, and a rising market allows firms to issue more equity to fund investment, hire, or acquire other businesses. Conversely, falling stock prices weigh heavily on those animal spirits so vital to a well-functioning economy.

A crisis of confidence can also impair the financial system. Banks and other financial institutions borrow heavily from one another to fund their activities. Much of this is overnight or short-term borrowing; thus even a brief disruption in money flows can trigger a financial crisis. While such a scenario seems unlikely at the moment, serious stress lines are developing, particularly in Europe. The Euribor interbank lending rate—the rate that European banks pay to borrow for brief periods—has more than doubled over the past several weeks. European banks also appear to be turning to the European Central Bank to maintain liquidity, and CDS spreads—a measure of the cost of insuring against defaults on bonds issued by banks—have risen sharply (see Chart 2). The same stresses are not as evident in the U.S., although the Libor-Treasury and CDS spreads have risen in recent weeks.

Chart 2: Stress Mounts in Europe's Banking System



Source: Bloomberg

Whether the current crisis of confidence becomes self-fulfilling and ignites a double-dip recession critically depends on how effectively policymakers respond. Policymakers must act aggressively to stabilize sentiment and lift flagging expectations.

Fiscal policy two-step

The Obama administration and Congress must accomplish two seemingly contradictory things at the same time in the next several months: Follow through on the debt-ceiling deal and agree to additional long-term deficit reduction while scaling back the near-term fiscal restraint that is already intensifying.

The debt-ceiling deal achieved in early August is a substantive step; it does not solve the nation's fiscal problems, but it goes more than halfway to the $4 trillion over 10 years in deficit reduction necessary to achieve a stable debt-to-GDP ratio. The deal cuts as much as $2.4 trillion in government spending over the next decade, of which $900 billion has already been identified and the remaining $1.5 trillion is to be determined by a super-committee of legislators by the end of November (see Table 1). If the super-committee process fails, there will be $1.2 trillion in automatic spending cuts over the next 10 years beginning in 2013, distributed evenly between defense and nondefense (mostly nonentitlement) outlays.

Table 1: Deficit Reduction Under the Debt-Ceiling Deal
Fiscal yrs, $ bil

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012-2021
Discretionary spending	-25	-46	-58	-66	-73	-79	-87	-95	-103	-111	-741
Mandatory spending	3	5	2	-3	-4	-4	-4	-5	-5	-5	-20
Debt service costs	0	-1	-3	-6	-10	-15	-20	-26	-33	-40	-156
Total excluding committee/triggers	**-21**	**-42**	**-59**	**-75**	**-87**	**-99**	**-112**	**-126**	**-141**	**-156**	**-917**
Committee/triggers											-1,500
Total											**-2,417**

Sources: CBO, Moody's Analytics

Policymakers have been able to circumvent budget rules in the past, beginning with Gramm-Rudman in the late 1980s, but this budget mechanism appears much more durable. Judging by the loud protests from those in Congress opposed to such cuts, they think so too.

The spending cuts will not be enough to achieve fiscal sustainability; policymakers will also likely need to raise tax revenues. However, this is unlikely to occur until the lead-up to the expiration of the Bush tax cuts, scheduled for the start of 2013. Since there is little political appetite for letting tax rates rise for everyone, policymakers could instead agree to tax reform that reduces the more than $1 trillion in annual deductions and credit (loopholes) in the corporate and personal tax code.

These so-called tax expenditures—because from an economic perspective they act no differently than government spending—are costly, add significantly to the complexity of the tax code, and generally benefit higher-income households. Limiting these loopholes and broadening the tax base could potentially raise a substantial amount of tax revenue and thus achieve fiscal sustainability, make the Bush tax cuts permanent and even lower marginal rates for corporations to improve the nation’s global competitiveness.

Of course, tax reform will be politically difficult to pull off given that each loophole has a strident advocate willing to go to the mat for it. A plausible fallback would be to simply allow marginal personal tax rates to rise for those making more than $250,000 annually, the top income bracket. This would generate enough revenue to get close to fiscal sustainability. Many Republican legislators who have signed a no-tax pledge will not be happy with this, but they may have no choice, given the alternative of higher tax rates for everyone.

Policymakers have two very different paths immediately before them. If they take the current opportunity to make substantive and enduring reforms to entitlement spending and the tax code, the nation will achieve long-term fiscal sustainability, producing stronger long-term economic growth. If lawmakers fail to successfully execute on the debt-ceiling agreement, confidence will unravel and the economy will descend back into recession. The other major ratings agencies will downgrade U.S. Treasury debt; the nation's fiscal problems will be overwhelming; and our long-term growth prospects will be meaningfully diminished.

Near-term fiscal drag

While policymakers must act to return the nation to long-term fiscal sustainability, they must also scale back the fiscal restraint that will hit in 2012. If no changes are made to current federal fiscal policy, it will shift from acting as a small drag on the economy this year to subtracting 1.7 percentage points from real GDP growth in 2012 (see Table 2).

Table 2: Fiscal Restraint in 2012 Under Current Policy

	Cost		GDP Impact	
	$ bil	% of GDP	$ bil	% of GDP
Change in deficit, 2011 vs. 2012	-371	-2.5	-261	-1.7
Cyclical deficit	-65	-0.4	0	0.0
Structural deficit	-306	-2.0	-261	-1.7
2% payroll tax holiday	-110	-0.7	-68	-0.5
Emergency UI	-50	-0.3	-58	-0.4
Accelerated depreciation	-22	-0.1	-5	0.0
State and local government aid	-50	-0.3	-56	-0.4
Infrastructure spending and other	-43	-0.3	-46	-0.3
Debt-ceiling deal	-31	-0.2	-28	-0.2

Source: Moody's Analytics

For context, at the peak of the federal fiscal stimulus in 2009, federal policy added 2.6 percentage points to real GDP growth. Yet as federal policy shifts from a stimulus to a restraint, the private sector must grow faster for the economy to simply grow at its potential–that rate of growth consistent with stable unemployment. In 2012 that potential is estimated at 2.7%; to reach it, private sector GDP would need to grow well above 4%. That seems unlikely given that growth has all but stopped recently.

The biggest drag next year under current federal policy comes from the scheduled expiration of two stimulus measures at the end of 2011: the current 2% employee payroll tax holiday and the emergency unemployment insurance program. Not extending the programs will shave 0.9 percentage point off 2012 real GDP growth and cost the economy some 750,000 jobs. The end of other fiscal stimulus measures enacted in 2009 will further reduce economic growth.

State and local government actions are already producing serious drags on the economy. Spending cuts and tax increases will shave an estimated 0.5 percentage point from real GDP growth this year and almost as much in 2012. The impact can be seen clearly in the job market. State and local governments have cut close to 700,000 jobs since their employment peaked three years ago and are continuing to shed workers at a stunning rate, averaging nearly 40,000 per month. Many of those losing their jobs are middle-income teachers, police, and other first responders.

Also adding to the need to reduce the near-term fiscal drag in current policy is the Federal Reserve's diminishing ability to respond to the weak economy. The Fed recently took a bold step, stating its intention to keep short-term interest rates near zero until mid-2013. This has brought long-term interest rates down and provided some support to stock prices. The Fed can provide even more help by extending the maturity of its current portfolio of Treasury bonds and by purchasing more long-term bonds in another round of quantitative easing. But even these policies are likely to be less effective at stimulating the economy than they might have been earlier.

Acknowledging this in his recent Jackson Hole speech, Fed Chairman Ben Bernanke essentially passed the ball to fiscal policymakers. Bernanke said Congress and the Obama administration must follow through on plans for long-term deficit reduction, but also must provide additional near-term support to the economy. Monetary policy alone may not be able to prevent another recession.

Additional fiscal help for the economy would not be desirable or even possible if the federal government's debt costs were rising or if government borrowing were tightening credit for households and businesses. But there is no evidence that such crowding out is occurring. Ten-year Treasury yields have fallen below 2%, a near record. This is in part because of the Fed's actions, but the U.S. also remains the global economy's safe haven. Whenever there is a problem anywhere, the investment of choice is a Treasury bond—witness the current flight to Treasuries sparked by financial turmoil in Europe. Borrowing costs for households and businesses also remain extraordinarily low, with fixed mortgage rates closing in on a record low of 4% and Baa corporate bonds (the lowest investment grade) yielding near a 50-year low of below 5.5%.

American Jobs Act

President Obama's much-anticipated jobs plan is a laudable effort to reduce this near-term fiscal restraint. If fully implemented, the Obama jobs plan would increase real GDP growth in 2012 by 2 percentage points, add 1.9 million jobs, and reduce the unemployment rate by a full percentage point, compared with current fiscal policy (see Table 3). That is, passage of the Obama jobs plan would mean that fiscal policy would be neutral with respect to the economy in 2012–neither a drag nor a spur to economic growth.

Table 3: President Obama's Jobs Plan
Budgetary cost, $ bil, calendar year

	2012	2013	10-Yr Cost
Total tax cuts and spending increases	421	63	447
Total tax cuts	293	-1	260
Payroll tax holiday for employees	175	0	175
Payroll tax holiday for employers	65	0	65
Accelerated depreciation	45	-1	5
Long-term unemployed hiring tax credit	8	0	8
Veterans hiring tax credit	0.1	0	0.1
Total spending increases	128	64	192
Unemployment insurance reforms	40	9	49
Infrastructure spending	25	25	50
Infrastructure bank	10	0	10
School renovations	20	10	30
Aid to state and local govts for teachers and first responders	20	15	35
Neighborhood stabilization	10	5	15
TANF work subsidies, summer job programs, other spending	3	0	3

Source: Moody's Analytics

The president's plan includes a wide range of temporary tax cuts and spending increases. Among its provisions are one-year extensions of this year's employee payroll tax holiday and the full expensing of business investment. Surprisingly, the plan would also increase the size of the temporary payroll tax cut and creatively expand it to employers. The president would also help state and local governments pay teacher and first-responder salaries, boost funding for unemployment insurance while meaningfully reforming the UI system, and launch several infrastructure initiatives.

The plan would cost close to $450 billion over 10 years, with slightly more than $250 billion coming from tax cuts and $200 billion from spending increases (see Table 4). For context, the plan's cost is equal to about 3% of current GDP and just over half the $825 billion ultimate price tag of the 2009 Recovery Act.

Table 4: Economic Impact of Obama Jobs Plan

	2011	2012	2013
Real GDP			
Obama jobs plan			
2005$ bil	13,295	13,850	14,234
% change	*1.6*	*4.2*	*2.8*
Current fiscal policy			
2005$ bil	13,295	13,586	14,105
% change	*1.6*	*2.2*	*3.8*
Moody's Analytics current baseline			
2005$ bil	13,295	13,652	14,118
% change	*1.6*	*2.7*	*3.4*
Payroll employment			
Obama jobs plan			
Mil	131.0	133.4	135.4
Change, mil	*1.2*	*2.4*	*2.0*
Current fiscal policy			
Millions	131.0	131.5	134.7
Change, mil	*1.2*	*0.5*	*3.2*
Moody's Analytics current baseline			
Mil	131.0	132.0	134.9
Change, mil	*1.2*	*1.0*	*2.9*
Unemployment rate			
Obama jobs plan	9.1	8.3	7.7
Current fiscal policy	9.1	9.3	8.1
Moody's Analytics current baseline	9.1	9.0	8.1
Federal budget deficit, FY			
Obama jobs plan			
$ bil	(1,320)	(1,386)	(886)
% of GDP	*-8.8*	*-8.7*	*-5.3*
Current fiscal policy			
$ bil	(1,320)	(1,079)	(880)
% of GDP	*-8.8*	*-6.9*	*-5.3*
Moody's Analytics current baseline			
$ bil	(1,320)	(1,164)	(874)
% of GDP	*-8.8*	*-7.4*	*-5.3*

Note: Current policy assumes that the Bush tax cuts are extended, the AMT is indexed to inflation, and the scheduled 30% reduction in Medicare payment rates for physician services does not occur. Moody's Analytics baseline differs from current policy in a number of ways, but most important in the near term is that it assumes an extension of the current payroll tax holiday for employees.

Note: These results are derived from simulations of the Moody's Analytics macromodel of the U.S. economy.

Sources: BEA, BLS, Treasury Department, Moody's Analytics

The largest tax cuts include an extension and expansion of the payroll tax holiday for employees and a creative new payroll tax holiday for employers. Employers would be permitted to reduce their payroll taxes by half on taxable wages up to $5 million annually. Businesses would also pay no additional taxes on any wages that rise from the year before, up to $50 million. This would give firms a substantial incentive to increase hiring and should result in a larger economic bang for the buck—additional GDP per tax dollar—than previous job tax credits such as last year's HIRE Act.

The president has also proposed a tax credit for businesses that hire people who have been unemployed longer than six months—a group that, astonishingly, includes half the jobless. The longer these workers remain unemployed, the harder finding work becomes as their skills and marketability erode. Structural unemployment thus rises as a long-term threat; it appears to have already risen from around 5% before the Great Recession to closer to 5.5% currently.

The Obama plan's most significant spending increases, totaling more than $100 billion, are for infrastructure. Such development has a large bang for the buck, particularly now, when there are so many unemployed construction workers. It can also help remote and hard-pressed regional economies and produce long-lasting economic benefits. Such projects are difficult to start quickly—"shovel ready" is in most cases a misnomer—but since unemployment is sure to be a problem for years, this does not seem a significant drawback in the current context.

More serious concerns are the expense of infrastructure projects and their often political rather than economic motivation. A creative way to address these concerns is through an infrastructure bank—a government entity with a federal endowment, able to provide loans and guarantees to jump-start private projects. These might include toll roads or user-supported energy facilities or airports. Private investors and developers would determine which projects to pursue based on what works financially rather than politically. The infrastructure bank would take time to launch, however, and thus would not produce quick benefits.

The president also proposes more funding for unemployment insurance, but in combination with some much-needed reforms to the UI system. One idea involves scaling up a Georgia program that places unemployed workers at companies voluntarily for up to eight weeks at no charge to the businesses. Along with their unemployment benefits, workers receive a small stipend for transportation and other expenses, training, and a tryout with the employer that could lead to a permanent job. Employers can potentially abuse the program by recycling unemployed workers, but the program seems to have had some success since it began in 2003.

Another idea to reform UI is to more broadly adopt "work share" as an alternative to temporary layoffs and furloughs. Instead of laying off workers in response to a temporary slowdown in demand, employers reduce workers' hours and wages across a department, business unit, or the entire company. The government then provides partial unemployment insurance benefits to make up for a portion of the lost wages. Work share exists in 17 states and several countries overseas, including Germany, where it is credited for contributing to a relatively strong recovery.

Like the temporary extension of unemployment insurance benefits, work share has a large bang for the buck, since distressed workers are likely to quickly spend any aid they receive. Work share's economic effectiveness even exceeds that of straight UI benefits, because it reduces both the financial and psychological cost of layoffs. Work share can particularly help firms that expect reductions to be temporary, by reducing their costs for severance, rehiring and training.

Hard-pressed state and local governments would also receive additional relief under the president's plan. While state governments appear to be working through their near-term budget problems, local governments are still struggling with flagging property tax revenues. The biggest casualties are teachers and first responders, and Obama's plan would help with their salaries through the end of the 2013 school year.

Of the 1.9 million jobs added in 2012 under the president's plan, the largest contributor would be the extended payroll tax holiday for employees, which adds approximately 750,000 jobs. The payroll tax holiday for employers is responsible for adding 300,000 jobs, although this may be understated; quantifying the impact of this proposal is difficult. Infrastructure spending adds 400,000 jobs, 275,000 jobs are due to additional unemployment insurance funding, and 135,000 jobs result from more aid to state and local governments.

Drawbacks

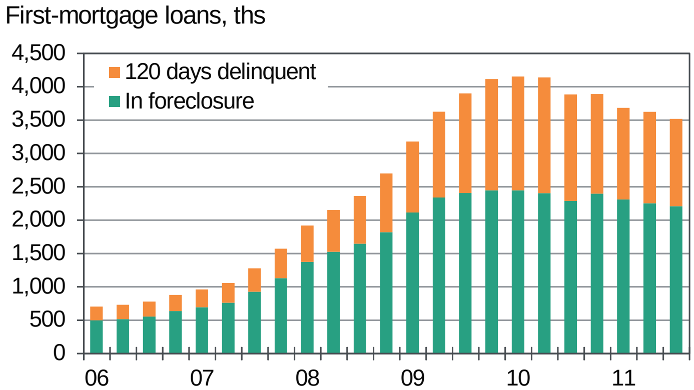
The president's jobs plan has its drawbacks. At an estimated $450 billion, it is not cheap. Given that it must be paid for over the long run, this cost will only add to the burden of achieving fiscal sustainability. The president has proposed that the congressional super-committee consider reductions in various tax expenditures to pay for the plan. More likely, the committee will need to make even deeper spending cuts.

Another potential pitfall of the president's plan is that the boost to growth and jobs fades quickly in 2013. Additional infrastructure spending and aid to state and local governments will continue to support growth, but the benefits of the tax cuts will peter out. The hopeful assumption is that the private sector will be able to hold up as government support fades. While this is a reasonable hope, it is important to acknowledge that policymakers hoped for the same thing last year when they passed the one-year payroll tax holiday and extended emergency unemployment insurance through 2011.

The president's plan is large, but in some key respects, it is not complete. Most notably, it does not directly address the foreclosure crisis and housing slump, save for some added funding for neighborhood stabilization. In his speech, the president did say he would work with the FHFA (Fannie Mae's and Freddie Mac's regulator) to facilitate more mortgage refinancing; this would be a significant plus for housing and the broader economy if he is able to break the logjam in refinancing.[ii]

With some 3.5 million first-mortgage loans in or near foreclosure and more house price declines likely, housing remains a major impediment to the recovery. (see Chart 3). A house is most Americans' most important asset; many small-business owners use their homes as collateral for business credit, and local governments rely on property tax revenues tied to housing values.

Chart 3: The Foreclosure Crisis Is Not Over



Sources: Equifax, Moody's Analytics

Most worrisome is the risk that housing will resume the vicious cycle seen at the depths of the last recession, when falling prices pushed more homeowners underwater—their loans exceeded their homes' market values—causing more defaults, more distress sales, and even lower prices. That cycle was broken only by unprecedented monetary and fiscal policy support.

The president's plan will be criticized for other reasons. Some will argue that he should have proposed massive public works, like the Depression-era WPA. Others will say the plan should have included broader reforms to corporate taxes or even immigration. Although these suggestions may have merit as policies, they seem like steps too far given what lawmakers need to do and how quickly they need to do it.

Policymakers need to work fast

The risk of a new economic downturn is as high as it has been since the Great Recession ended more than two years ago. A string of unfortunate shocks and a crisis of confidence are to blame. Surging prices for gasoline and food and fallout from the Japanese earthquake hurt badly in the spring; more recently, the debt-ceiling drama, a revived European debt crisis, and the S&P downgrade have been especially disconcerting. Confidence, already fragile after the nightmare of the Great Recession and Washington's heated policy debates, was severely undermined.

Whether the loss of faith in our economy results in another recession critically depends on how policymakers respond. Whether they will succeed in shoring up confidence is a difficult call. The odds of a renewed recession over the next 12 months are 40%, and they could go higher given the current turmoil in financial markets. The old adage that the stock market has predicted nine of the last five recessions is apt, but the recent free fall is disconcerting. Markets and the economy seem one shock away from dangerously unraveling. Policymakers must work quickly and decisively.

[i] The Moody's Analytics weekly business survey has held up better, but it also has weakened significantly in recent weeks, with expectations regarding the outlook into next year and hiring intentions turning notably softer.

[ii] For a discussion of this and other ideas to help the beleaguered housing market, see "New Ideas for Refinancing and Restructuring Mortgage Loans," testimony before the Senate Banking Committee, Mark Zandi, September 14, 2011.