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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***			Jobless Rate		
Peak	Trough	Recession Peak to Trough	Expansion Trough to Peak	Real GDP	Industrial Production	Nonfarm 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.

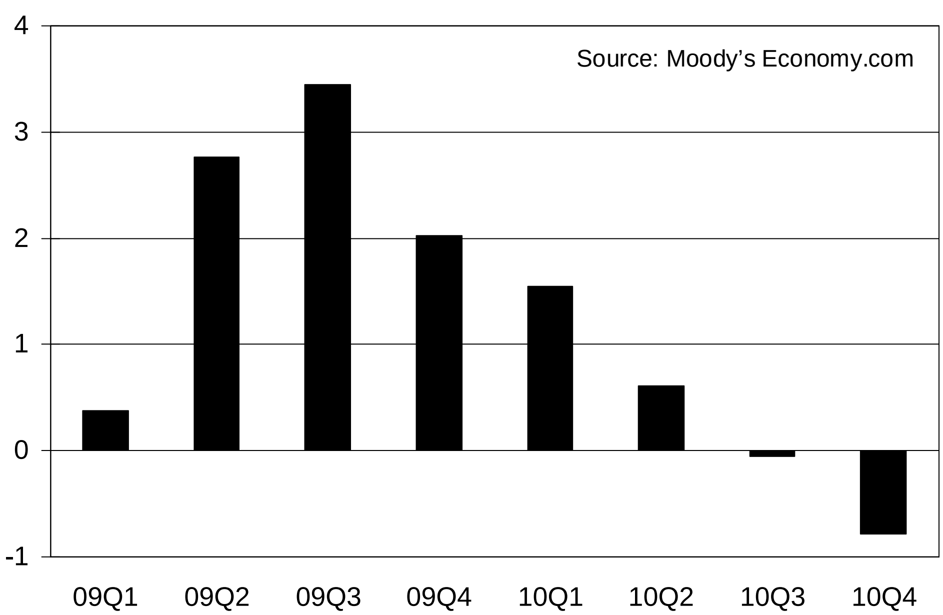
Retailers and manufacturers have also worked hard to reduce bloated inventories. The plunge in inventories in the second quarter was the largest on record and came after a year of steady destocking. Inventories are now so thin that manufacturing production is picking up quickly, as otherwise stores will 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.

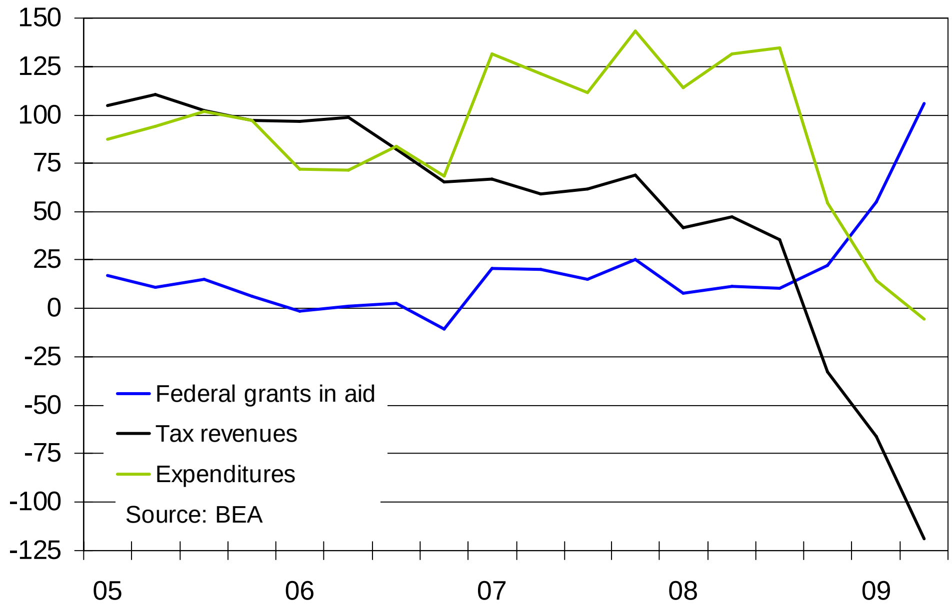
Table 3: Fiscal Stimulus Bang for the Buck

	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

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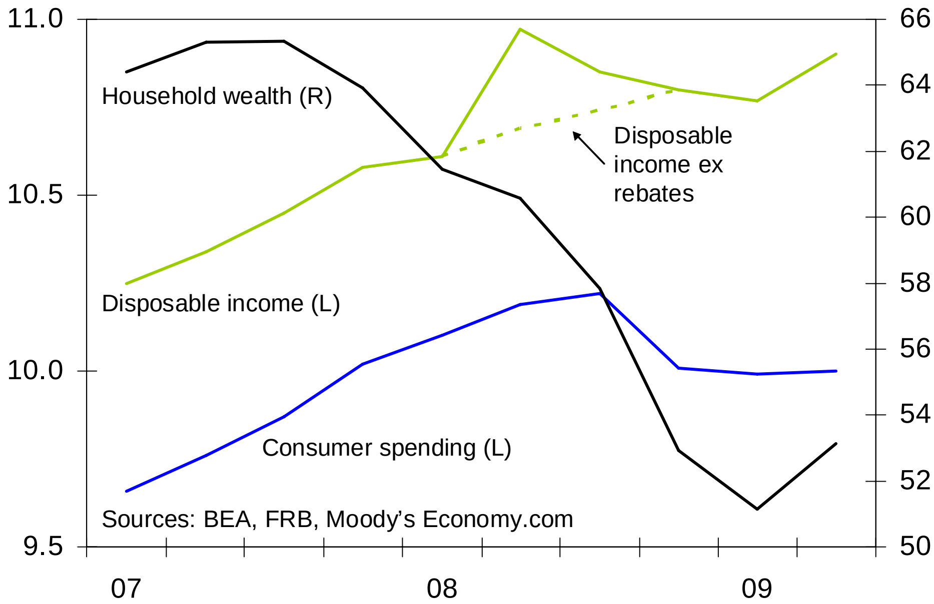


Criticism that infrastructure spending funded by the stimulus has been slow to get started is valid. But this is partly because safeguards against funding unproductive or politically driven projects have slowed things down. Infrastructure projects are now gearing up, however, and this will be particularly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

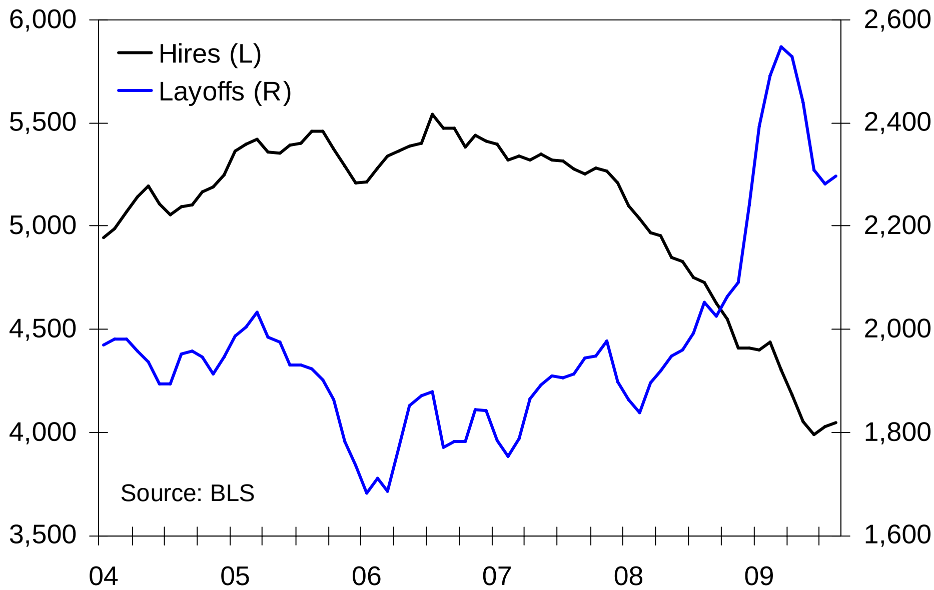
Whether the recovery becomes self-sustaining or recedes back into recession depends first on how businesses respond to recent improvements in sales and profitability. As the benefit of the stimulus fades, businesses must fill the void by hiring and investing more actively. To date, there is not much 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

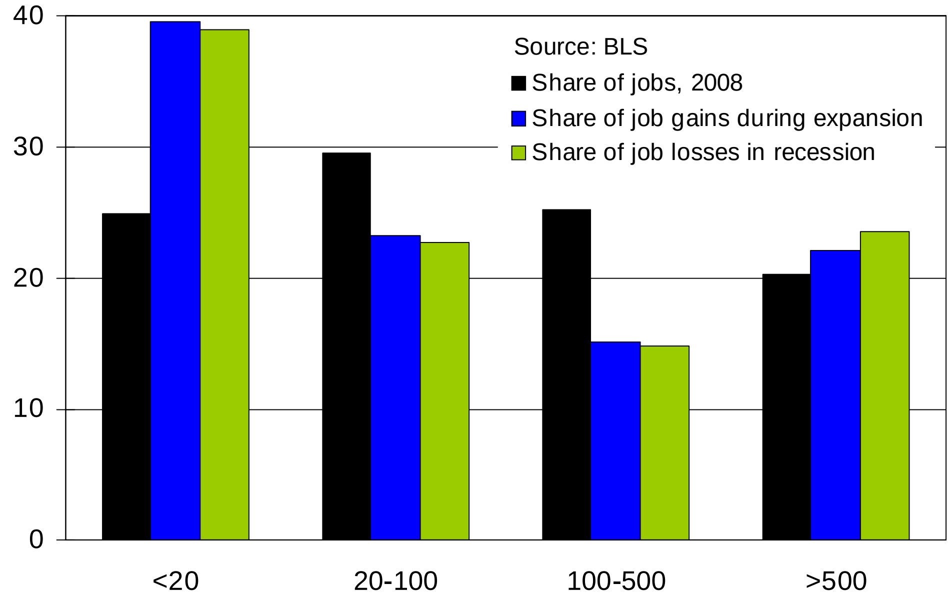
Ths, 3-mo MA



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.

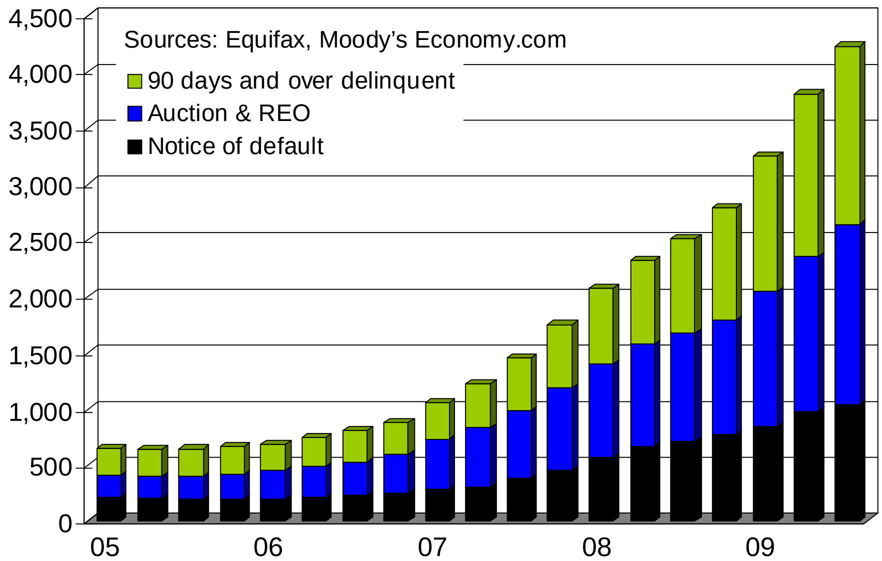
Whatever the reason, unless hiring resumes soon, the severe stress in the job market will not abate. With nearly 26 million workers—17% of the workforce—unemployed or underemployed, and those with jobs working a record-low number of hours, workers' nominal compensation threatens to decline. It is not 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.

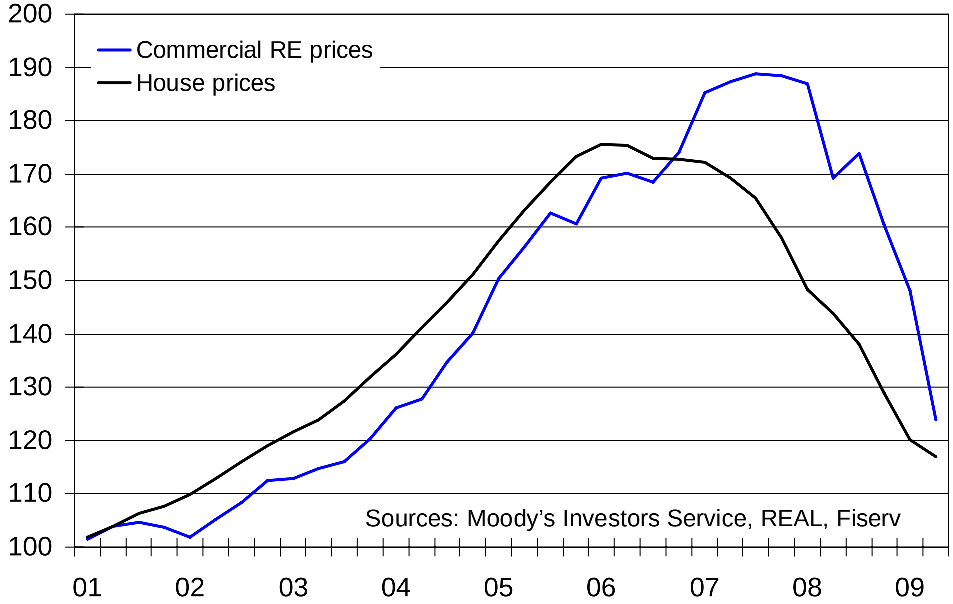
House prices are likely to fall further as foreclosure sales pick up. Nothing works well in the economy when house prices are falling; as household wealth erodes, consumers lose the ability and willingness to spend, and the financial system loses the ability and willingness to extend credit. The recovery 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.

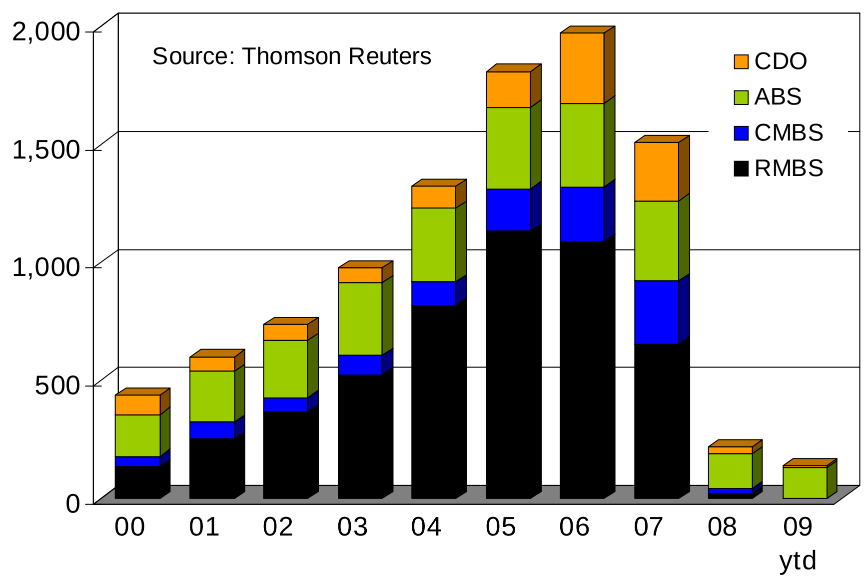
Falling prices, combined with reluctant lenders, will lead to hundreds of billions of dollars in commercial mortgage defaults over the next two to three years. This threatens to upend hundreds of banks whose portfolios of commercial real estate loans are large relative to their capital bases. As of June, 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

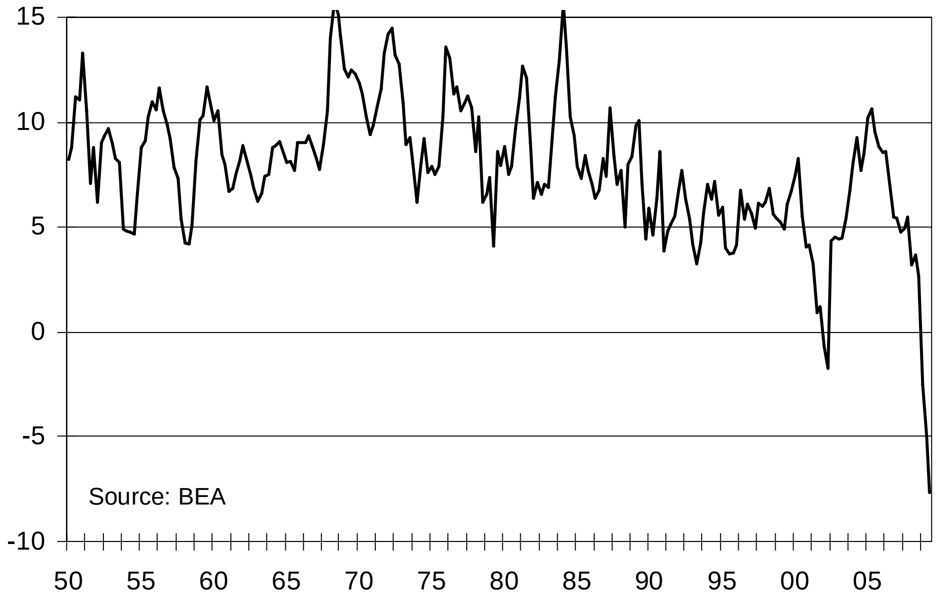


The credit crunch is not getting worse, as the federal government has aggressively stepped up its direct lending to consumers and businesses, but credit remains severely impaired. According to credit file data, household debt outstanding has declined by close to $450 billion—a stunning 4%—since peaking 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

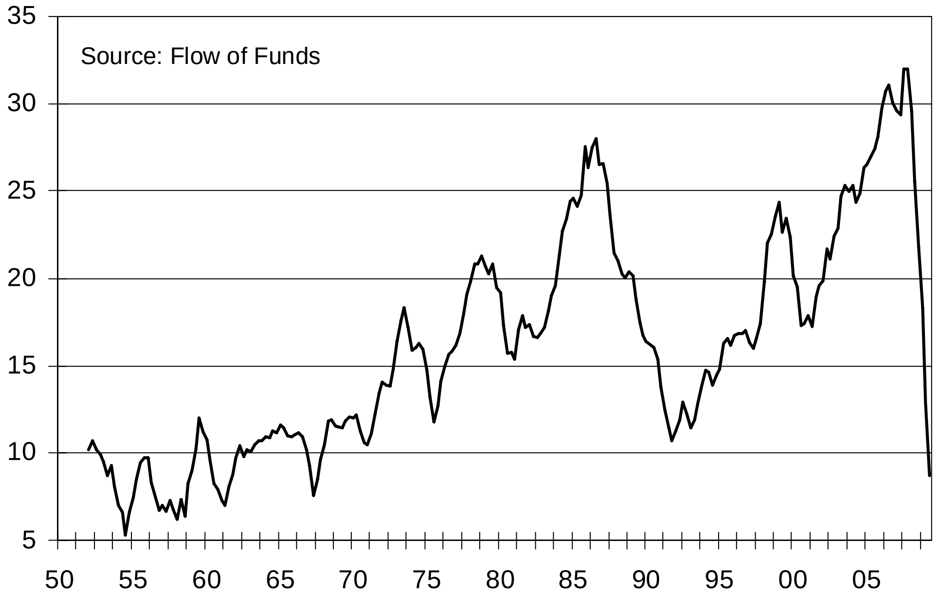
In addition to the prospects for a weak and fragile recovery that is at an uncomfortably high risk of faltering, there are a number of other reasons why fiscal policymakers may want to take additional actions to shore up the economy.

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.

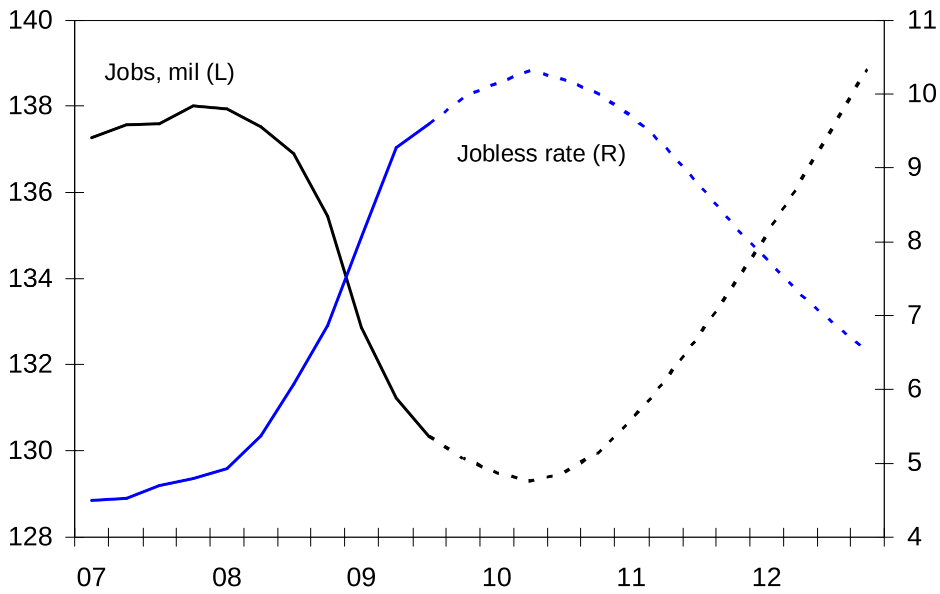
Chart 10: No Crowding Out
Total borrowing as a share of GDP



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.