

Wednesday, January 14, 2009

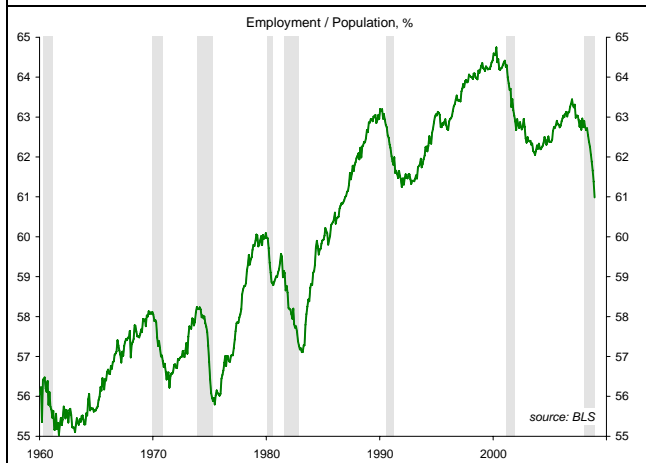
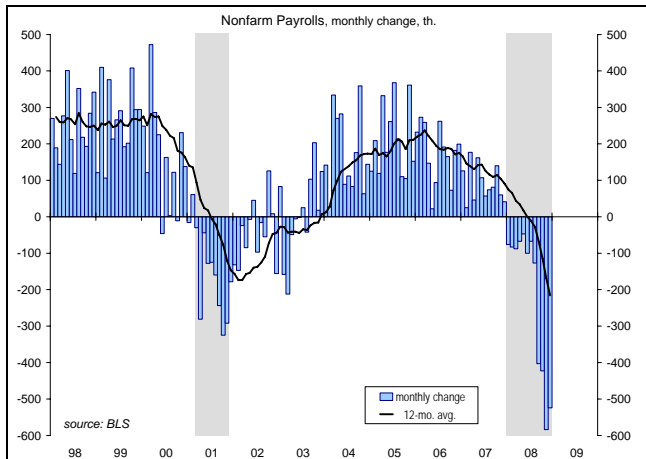
Economic Research – Scott J. Brown, Ph.D.

Fiscal Stimulus Needed

- The U.S. economy continued to weaken broadly through the end of 2008. Job losses have been large.
- The Fed lowered the overnight lending rate target to a range of 0% to 0.25%. With conventional monetary policy exhausted, the Fed will resort to “credit easing.”
- Vicious cycles within the economy can be broken by massive fiscal stimulus. The goal is to keep the output from weakening further and to restore confidence.

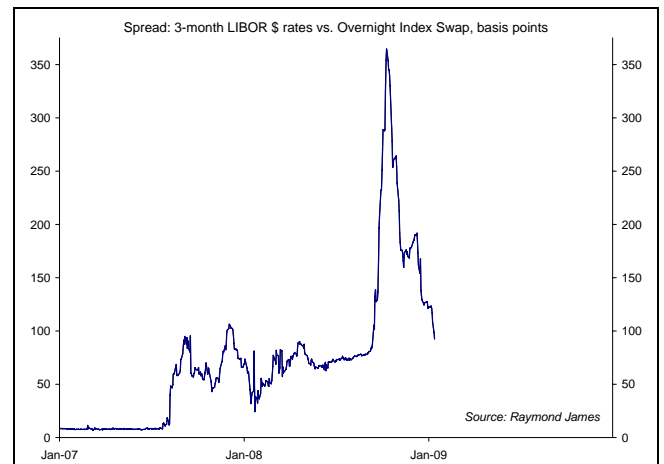
The advance estimate of real GDP growth for the fourth quarter will be reported on January 30. The headline figure will be significantly negative (down at a 4% to 7% annual rate). As with any advance estimate the uncertainty is high. Inventories and foreign trade can swing the numbers a lot. Consumer spending was clearly weak, with a large decline in consumer durables (led by autos). However, the impact of lower gasoline prices may have tempered declines in other areas.

Nonfarm payrolls fell by 2.6 million in 2008, with 1.9% of that in the last four months. The unemployment rate has risen sharply (7.2% in December) and measures of labor underutilization have surged.

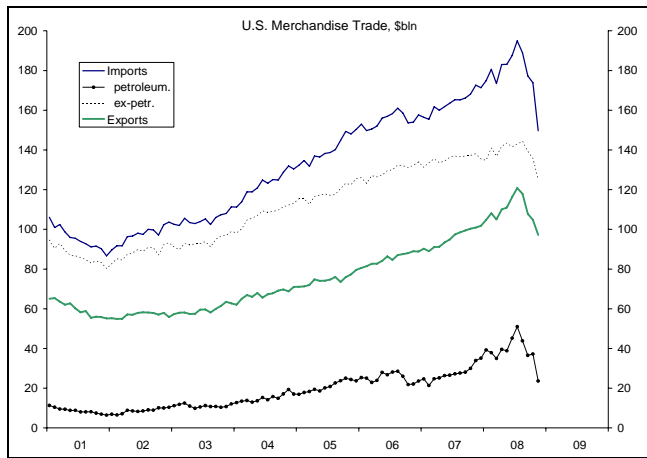


Minutes of the December 15-16 Federal Open Market Committee meeting showed that monetary policymakers were more worried about the economy. The Fed’s lowering of the overnight lending rate target, while unprecedented, was not much of a stretch. The actual Fed funds rate had already been far below the previous target. Officials communicated that interest rates would remain “unusually low for some time” (such a pledge is one tool to head off deflation).

The Fed, having reached the limit on potential reductions to the Fed funds target rate, is not powerless. The Fed has begun buying mortgage-backed securities and agency debt (FHLMC, FNMA, FHLB) and is creating facilities to purchase asset-backed securities. The Fed may, at some point, decide to purchase Treasury securities as well. These asset purchases increase bank reserves and the money supply. Eventually, the Fed will have to back away from these nontraditional moves and that may prove to be challenging. With significant amounts of slack available in the national and global economies, there’s little chance of generating higher inflation in the near term. The Federal Reserve and other central banks remain firmly committed to keeping inflation low over the long term. Fed Chairman Bernanke stated that the timing and pace of the unwinding of the Fed’s special liquidity and lending facilities will depend on “assessments of credit market conditions and the prospects for the economy.” Bernanke said that the Fed’s recent efforts are not “quantitative easing,” per se, and contrasted what the Fed has done with Japan’s efforts a decade ago.



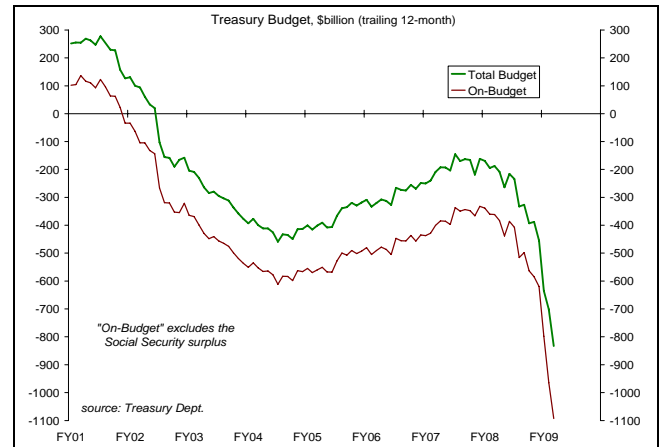
Credit market conditions improved into the new year, but have remained far from normal. The Fed’s decision to buy mortgage-backed securities pushed mortgage rates down. Yields on long-term Treasury securities fell sharply in December as market participants become even more reluctant to take risk. With the new year, there should be a return of risk taking to some extent.



The U.S. trade deficit fell sharply in November (to \$40.4 billion, vs. \$56.7 billion in October). The data reflect the impact of tighter credit on global trade. Exports, which had improved over the first three quarters of 2008, are now falling. Imports are also declining (imports have a negative sign in the GDP calculation and the decline will add to the overall growth estimate).

While the recession is more than a year along, the economic downturn broadened and intensified over the last few months of 2008. We are facing a number of adverse feedback loops (or “vicious cycles”). In housing, lower prices lead to increased foreclosures, and more foreclosures lead to even lower home prices, and so on. In lending, tight credit leads to slower growth, and slower growth leads to even tighter credit. In employment and consumer spending, job losses lead to weaker spending, and weaker spending results in further layoffs. The cycles would eventually play themselves out over time, but that could be years, leading to an incredible amount of lost output. Monetary policy certainly has a role to play in combating these cycles. However, to break them, we need to have a large fiscal stimulus. The goal is to make the stimulus big enough so that it prevents the economy from weakening further and helps restore confidence.

Even before any additional stimulus, the federal government is on its way to a record deficit for the current fiscal year. The deficit for the first three months of FY09 was \$485 billion and the Congressional Budget office is projecting a total of \$1.2 trillion for the full fiscal year (again, this is before any added stimulus).



The fiscal stimulus package will have a number of elements. Obama ran on a platform of middle class tax cuts, although there is relatively little bang for the buck in comparison to increased spending. State budgets are under extreme strain. Many are forced to raise taxes or cut expenditures (both of which are contractionary policies) to reduce deficits. The federal government can give grants to the states to help ease them through the transition. Extending unemployment insurance benefits and boosting food stamps will help many households through these tough times. Infrastructure spending should help create jobs. Many states have projects ready to go, but a lot will have to be planned over time.

As with the Fed’s special liquidity and lending facilities, fiscal policy efforts should not be permanent. Fiscal responsibility should become a priority as the economy recovers. However, there is a risk of not doing enough right now. A stimulus package is a political process. Hopefully, lawmakers will make it big and bold.

	4Q07	1Q08	2Q08	3Q08	4Q08	1Q09	2Q09	3Q09	4Q09	2007	2008	2009	2010
GDP (↓ contributions)	-0.2	0.9	2.8	-0.5	-5.8	-2.4	-1.0	1.1	2.5	2.0	1.1	-1.5	2.3
consumer durables	0.0	-0.3	-0.2	-1.2	-1.5	-0.4	0.1	0.2	0.2	0.4	-0.3	-0.5	0.2
nondurables & services	0.6	0.9	1.1	-1.6	-0.4	-0.2	0.4	1.0	1.4	1.6	0.5	0.0	1.4
bus. fixed investment	0.4	0.3	0.3	-0.2	-1.0	-1.2	-0.8	-0.3	0.1	0.5	0.3	-0.7	0.0
residential investment	-1.3	-1.1	-0.5	-0.6	-0.8	-0.4	-0.2	0.0	0.1	-1.0	-0.9	-0.4	0.2
government	0.2	0.4	0.8	1.1	0.0	0.1	0.3	0.5	0.5	0.4	0.6	0.4	0.4
Domestic Final Sales	-0.1	0.1	1.5	-2.3	-3.8	-2.1	-0.2	1.3	2.2	1.9	0.1	-1.2	2.2
exports	0.5	0.6	1.5	0.4	-2.6	-2.1	-1.6	-0.6	0.1	0.9	0.8	-1.3	0.0
imports	0.4	0.1	1.4	0.7	2.4	1.4	0.5	0.0	-0.4	-0.4	0.6	1.0	-0.3
Final Sales	0.8	0.9	4.8	-1.3	-4.0	-2.8	-1.4	0.7	2.0	2.4	1.5	-1.4	1.7
ch. in bus. inventories	-1.0	0.0	-1.5	0.8	-1.8	0.4	0.4	0.4	0.5	-0.4	-0.4	-0.1	0.4
Unemployment, %	4.8	4.9	5.3	6.0	6.7	7.3	7.6	7.9	8.0	4.6	5.8	8.2	8.9
NF Payrolls, monthly, th.	80	-82	-71	-199	-410	-150	-130	-60	-20	91	-216	-151	43
Cons. Price Index (3 mo)	6.2	3.1	7.9	2.6	-13.4	2.1	2.1	2.2	2.3	4.1	0.1	2.1	2.3
excl. food & energy	2.6	2.0	2.5	2.7	0.0	1.7	2.0	2.0	2.1	2.4	1.8	2.0	2.1
PCE Price Index (q/q)	4.3	3.6	4.3	5.0	-5.7	-1.9	1.8	2.0	2.0	2.6	3.3	0.0	2.0
excl. food & energy	2.5	2.3	2.2	2.4	0.7	1.2	1.8	1.9	1.9	2.2	2.2	1.5	1.9
Fed Funds Rate, %	4.49	3.18	2.09	1.96	0.53	0.12	0.13	0.15	0.20	5.02	1.94	0.15	0.58
3-month T-Bill, (bond-eq.)	3.5	2.1	1.7	1.5	0.3	0.1	0.1	0.1	0.2	4.5	1.4	0.1	0.6
2-year Treasury Note	3.5	2.0	2.4	2.4	1.2	1.0	1.4	2.5	2.7	4.4	2.0	1.9	3.0
10-year Treasury Note	4.3	3.7	3.9	3.9	3.2	2.5	3.3	3.9	4.1	4.6	3.7	3.5	4.4