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Economic Outlook

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Keys to Sustainable Recovery

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With economic growth lower than expected, policymakers should undertake measures with a higher probability of stimulating the economy. Plenty of options have not yet been tried. To start down the path of sustainable economic recovery, the economy needs shock therapy: preventing deflation, reforming the tax system, and moving away from regulation. The zero growth looming in the second half of 2010 should prompt Congress to lower marginal tax rates for all taxpayers and use unspent stimulus money to finance a one-year payroll tax holiday.

The extensive monetary and fiscal stimulus efforts detailed in last month's *Economic Outlook* ("We Do Not Have Liftoff") have failed, and the economy has deteriorated even more rapidly over the summer than pessimists had anticipated. The dubious report of 2.4 percent annualized growth for the second quarter has already been revised down to 1.6 percent, and after accounting for a one-off inventory boost and increased government spending, second-quarter growth was probably more like an underlying negative 1 percent. Headline growth in the third quarter is likely to be near zero and underlying growth even weaker. Fourth-quarter growth will probably be negative.

Having wasted substantial resources on a poorly designed fiscal stimulus while endangering recovery with a hesitant monetary policy, our economic policy leaders need to start undertaking measures that have a higher probability of success as economic stimulants. I hasten to add that any program for sustained recovery, especially on the fiscal policy side, will not bring instant relief from our economic malaise. Nothing magical and new will be suggested here. Plenty of options have not yet been tried and—based on what we know about creating the preconditions for sustainable growth—some of those options would likely arrest the economic deterioration we are now witnessing.

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The biggest problem facing America's economy today is not bewilderment about what to do to fix it, but rather getting a sensible program enacted promptly and coherently. The many voices that will be raised to claim that the measures suggested here are not politically viable are voices advocating continued economic stagnation. We have reached a point where the need to move to a sustainable growth path in the aftermath of a serious financial crisis is intense. Having undertaken a barrage of ill-conceived and halfhearted measures, we are faced with the truism that the only thing left to do is the right thing.

A program for sustainable recovery of the U.S. economy includes three major components. First, the Federal Reserve needs to prevent deflation and restart the flow of money and credit to households

Key points in this *Outlook*:

- The need to move to a sustainable growth path in the aftermath of a serious financial crisis is intense.
- The Federal Reserve needs to prevent deflation and restart the flow of money and credit to households and businesses.
- Congress should reform the tax system along the lines pursued in the 1986 bipartisan tax reform.

and businesses. Second, Congress needs to reform the tax system along the lines pursued in the 1986 bipartisan tax reform, which sharply lowered marginal tax rates while broadening the tax base by removing tax preferences that were costly in terms of lost revenue. Third, Congress needs to move away from the aggressive steps toward regulation that have emerged in the financial and health care sectors, among others, over the last year. Rescinding the recently passed reform of the health care system would be a good start, as would sound financial reform separating the institutions offering insured deposits from those undertaking riskier investments while currently relying on taxpayer underwriting of deposit insurance.

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I will focus primarily on the first two measures: new monetary and fiscal policy measures to arrest the drift back into recession and toward deflation. Rolling back the ill-advised health care and financial reform bills is a substantial legislative task better left for a time when the economy is not threatening to drop either into negative growth or deflation.

Monetary Policy

At the outset of any current discussion of monetary policy, it is important to recognize that, by analogy to medical research, we have reached the "experimental-drug phase" of monetary measures. Monetary policy, so far, has failed to boost economic activity despite zero interest rates and $1.2 trillion worth of quantitative easing. Money growth (specifically, growth of M2, or currency and demand deposits) has been stagnant, while a sharp drop in velocity (the rate of money turnover) has sapped spending, as households—those that are able—add to liquid balances in the face of rising economic uncertainty and the approach of deflation. If the disinflation resulting from these moves turns into outright falling prices—deflation—the move into cash will accelerate further and the economy—robbed of demand growth—will slow further.

The Federal Reserve faces a formidable task. After its August 10 Federal Open Market Committee meeting, the Fed meekly admitted it needed to stop allowing shrinkage in its balance sheet. More specifically, it indicated that as its mortgage holdings mature, rather than let the balance sheet shrink (in effect, causing a slight reduction of quantitative easing), it would instead use the proceeds to purchase longer-term Treasury securities in the five-to-ten-year maturity range. These measures amounted to an announcement that the Fed had abandoned its ill-advised exit strategy and was contemplating further quantitative easing in the event that either the economy deteriorates further or disinflation appears ready to turn into deflation.

The Fed's performance so far in 2010 has constituted almost a textbook case of ill-advised overcaution following a financial crisis. The combination of zero percent interest rates and a substantial increase in the size of the Fed's balance sheet leads the less imaginative members of the Federal Open Market Committee to have nightmares about looming inflation, even though the data suggest that deflation is a bigger risk. It may be that the misguided idea "if inflation is bad, deflation is good" lurks somewhere in the minds of many central bankers. Perhaps that thinking accounts for the persistent tendency of central banks to exit an accommodative stance far too soon after a severe financial crisis. The Fed did so during the Great Depression, and the Bank of Japan made several efforts to exit its highly accommodative stance during the 1990s and the early years of the new millennium, only to be forced by a sudden deterioration of economic conditions to reverse course.

Premature tightening must be acknowledged and abandoned—decisively. Once again, the Fed's timid steps on August 10, taken merely to reverse its creep toward an exit strategy, are insufficient. A necessary condition for monetary stimulus to succeed is for the Fed to announce aggressive quantitative easing by promising a substantial addition to its balance sheet—say, up to another trillion dollars achieved through large-scale purchases of longer-term Treasuries, including thirty-year bonds. The Fed's focus has to be on achieving a sharp increase in the quantity of money sufficient to remove the threat of deflation. In a speech on July 29, James Bullard, president of the Federal Reserve Bank of St. Louis, emphasized this and the disquieting parallels with the situation that the Bank of Japan had confronted.

To underscore its commitment to avoiding deflation, the Fed should, along with sharp quantitative easing, announce a price-growth target (say 2 percent) and make it clear that if inflation runs persistently below the target then it will take measures to overshoot the target for a while, so that inflation over some finite time interval (say,

five years) will average roughly the targeted level. The dirty little secret of monetary policy after financial crises is that the central bank has to promise more inflation in order to preempt deflation. Those worried about runaway inflation can take heart from the fact that the medicine for curing a rising inflation rate is far better known and more easily implemented than the antidote for deflation.

Fiscal Policy

It is no surprise that the highly touted $862 billion stimulus package enacted early in 2009 has produced neither a sustained increase in output growth nor sustained employment growth. The stimulus package consisted largely of transfers to states and municipalities that are being hoarded, in part, to make up for huge revenue shortfalls tied to collapsing real estate values and incomes. Emblematic of the package's absurdity is the disposition, to date, of the $22 million in stimulus funds for Washington, D.C. The *Washington Post* reported on August 14 that, as of June 30, our nation's capital had spent $373,000, out of the $22 million, for television advertisements and billboards promoting its new tax on plastic bags. Using "stimulus" funds to promote a five-cent-per-bag tax on plastic bags—a highly regressive, contractionary tax—is the height of absurdity. It is therefore no surprise that the stimulus is not stimulating in a hypocritical city where refuse collectors leave recycled cans and bottles lying uncollected in their city-designated bins for weeks at a time, while the city's leaders congratulate themselves for imposing a five-cent-per-bag tax on plastic bags with ads financed out of funds meant to stimulate the economy.

Of course, the problem of poorly designed, counterproductive fiscal measures exists on a far larger scale. At a time when a weakened U.S. economy needs the benefits of increased allocative efficiency, the Obama administration is promising to move in the other direction. The higher marginal tax rates due to take effect in January 2011, along with announcements implying that more efforts are needed to use the tax system to achieve goals of social policy, constitute the exact reverse of sound fiscal policy. Any economist trained in public finance—Larry Summers, please take note—knows that the lowest possible marginal tax rates levied on a broad tax base constitute the best way to collect the revenues needed to finance government activities. Taxes distort and reduce economic efficiency, and higher marginal tax rates—along with tax expenditures to favor parts of the economy, such as owner-occupied real estate—all reduce allocative efficiency, thereby reducing the steady-state growth rate of the economy. Investigations conducted in the lead-up to the 1986 tax reform bill suggested that a substantial reduction in marginal tax rates financed by the reduction of tax expenditures that favor some parts of the economy over others could add up to a half of a percentage point to the basic growth trend of the economy.

Unfettered, widely respected specialists in public finance such as Martin Feldstein have advocated a gradual phasing-out of numerous tax expenditures by reducing the rate at which their beneficiaries can write them off. The enhanced revenue that results should finance lower marginal tax rates for all taxpayers.[1]

To jumpstart the impact of the fiscal stimulus, the one-year payroll tax holiday is still a good idea. At a cost of $650 billion, a payroll tax levied on employers and employees alike, were it eliminated, would provide a nearly 7 percent boost to after-tax incomes for households and a nearly 7 percent reduction in the marginal cost of new hiring for employers. It is remarkable that an administration that touts the need for job creation and help for working Americans has persistently resisted the elimination, for one year, of a regressive tax on employing labor. Once again, one is forced to ask: what are the administration economists thinking?

The funds for a one-year rescission of the payroll tax would come from three sources. About $260 billion of unspent stimulus money could be redirected to this effort in a way that would substantially increase job creation over the coming year. Also, efforts to extend unemployment benefits should cease. Rather than undertaking measures like extended unemployment benefits that pay people not to work, why not have a payroll tax holiday that pays employers to increase hiring or reduce layoffs? Finally, the remaining $300 to $400 billion needed to pay for a one-year payroll tax holiday could be funded through outright purchases of longer-term Treasury bonds by the Federal Reserve as it pursues quantitative easing. Yes, this would amount to printing money to fund budget deficits. But printing money to fund an effort to reduce the payroll tax that increases the take-home pay of

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workers and increases the incentive for employers to hire more workers seems like a particularly good investment at this time.

"It Can't Be Done"

The "realists" in Washington, D.C., continue to argue that such aggressive measures cannot be undertaken. They are sure that Congress is not prepared to reduce tax preferences for homeownership and myriad other favorite projects and that the administration certainly is not prepared to lead in that direction. Meanwhile, the Fed is not prepared (we are told) to risk higher inflation by pursuing aggressive quantitative easing that finances larger budget deficits.

The answer to these criticisms is straightforward. The virtual zero growth appearing during the second half of 2010 as deflation threatens ought to be, along with history manifest in the Great Depression and Japan's disastrous experience of the last two decades, ample evidence that the policies currently being followed are ineffective at best and counterproductive at worst. If the political process and the Fed's policymaking machinery cannot generate new policies now, when can they? While trite, the familiar words of the philosopher George Santayana sound the appropriate warning: "Those who cannot remember the past are condemned to repeat it."

Notes

1. See Martin Feldstein's excellent July 20 op-ed in the *Wall Street Journal*, "The 'Tax Expenditure' Solution for Our National Debt."