The Economic Crisis and the Policy Response

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Introduction

- “Our economy is badly weakened, a consequence of greed and irresponsibility on the part of some, but also our collective failure to make hard choices and prepare the nation for a new age.”
  - Barack Obama, January 20, 2009

- The current economic crisis has created almost an “anything goes” mentality with respect to the size and structure of federal policy interventions.

Outline

- Interlocking Problems and Proposed Solutions
  – The Economy
  – The Housing Sector
  – The Financial Sector
  – The Budget

- Where we go from here?

Quick Summary

- The belief that housing prices would rise forever led to risky behavior, fueled by securitization, low interest, saving glut.
- The collapse in housing prices brought down the financial sector, and the two sectors together led the economy down. All three are now in self-reinforcing vicious cycles.
- The budget, already in bad shape, was hurt by the downturn and the stimulus, and faces medium- and long-term problems.
- Proposals to address the economy, housing, finance, and the budget are intertwined and aggressive, but may not work.
- Getting out of the recession won't be enough – medium-term and long-term challenges are significant.

The Economy

The Current Situation

- An economic “vicious circle” that is broad, rapid and deep:
  - Declines in consumer spending and confidence (all-time low), due to uncertainty about jobs.
  - Declines in business investment and hiring (>3 million job losses since September), due to uncertainty about spending.
  - Declines in state and local government spending
    - Balanced budget rules create pro-cyclical spending
  - Net exports not helping
    - “Flight to safety” raises the value of the dollar, hurts net exports
    - Rest of the world in recession, too

The Goal

- Convert the “vicious circle” to a “virtuous cycle.”
- Instill confidence.
- Boost aggregate demand
  - Consumer spending
  - Business hiring and investment
  - Federal, state, and local government purchases
- Stabilize or raise prices
  - Avoid debt/deflation spiral
- Include global dimension
  - Largely overlooked in US

Policy Options

- We don't really know what will work or how much is needed.
  - No good examples of nations pulling themselves out rapidly.
  - We can (maybe) avoid the mistakes of the 1930s and of Japan in the 1990s, but is that enough?
- So, some humility is in order
  - Be wary of solutions from models that did not predict the problem.
  - We will make new mistakes.

Policy Options

- There are no ideal options.
  - Any policy will help some who “don’t deserve it” and hence will create inequities and moral hazard.

- Summers: The risks associated with under-responding are much bigger than the risks associated with over-responding.

The Stimulus Package

- $787 billion in tax cuts and spending
  - – $185 in 2009 (24%)
  - – $399b in 2010 (51%)
  - – $134b in 2011

- Predicted effects on unemployment rate
  - – In 2009, 9.0 with no policy, 7.7-8.5 with stimulus
  - – In 2011, 7.5 with no policy, 6.5-7.2 with stimulus

The Stimulus Package

- Investment
  - Transportation and infrastructure ($117b)
  - Energy ($61b)
  - Education ($48b)
  - Health care ($38b) – Health IT, NIH
  - Science and Technology ($13b)
- Aid
  - To State/Local governments (Medicaid) ($153b)
  - To Individuals (UI, Food stamps, COBRA, etc.) ($99b)
- Tax Relief
  - For Individuals ($247b)
  - Tax incentives for business ($10b)

The Stimulus Package

- The best spending options give big “bang for the buck,” but take time to implement
  - Infrastructure
  - State and local government assistance
  - UI and Food stamps can be implemented sooner
- Tax cuts often can take effect sooner, but seem more likely to be saved in the current environment
  - That will help households and businesses shore up their balance sheets (a little), but won’t be as stimulative.

Assessing the Stimulus

- A big, diversified, somewhat sustained stimulus was the right response, but…
  - We need the stimulus from the housing and financial packages, too.
  - Economic activity now is worse than expected even quite recently.
  - We may need an additional stimulus, or a longer stimulus – expect many provisions to be continued after 2 years.

The Housing Market

Current Situation

- As housing prices rose inexorably for decades,
  - Leverage ratios rose
  - Lending standards fell (especially in 2005 and 2006)
  - Loans were securitized (starting in the 2000s)

- Since peaking in 2006, national housing prices have fallen ~ 30%
  - Even larger declines in certain areas – CA, FL, AZ, NV
  - Foreclosures jumped
  - Now 14 million homeowners are underwater – owe more on their mortgage than the value of their house.

Defaults

- What causes defaults?
  - House value < mortgage balance (e.g., drop in house price)
  - Household income falls (e. g., with job loss)
  - Mortgage payments jump (e.g., with ARMs)

- Defaults and foreclosures destroy economic value (and hence create more defaults and foreclosures)
  - Transaction costs of foreclosures
  - Reduced value of foreclosed houses and neighborhoods
  - Reduced property taxes and increased crime

Defaults

- Why not just write down loan value?

- Securitized loans are hard to restructure
  - Too many parties, complex structures
  - No one has clear, legal authority to negotiate

Housing Package

- Homeowners who are current on payments and have loans between 80% and 105% of house value, held by Fannie or Freddie will be eligible to refinance at favorable terms.

- Homeowners who are behind or struggling on payments, or are underwater, will be eligible for monthly payment reductions, shared by lenders and the government.

Housing Package

- Additional incentive payments to encourage borrowers to stay current and lenders to avoid foreclosure.

- Consistent guidelines and judicial authority for loan modification

- Support for community efforts and FNMA and FHLMC

Will It Work?

- The plan doesn't help people who are underwater get above water (it just reduces their payments). People will still have incentives to walk away if conditions get worse.

- Conditions will get worse:
  – House prices are projected to decline 14% further in 2009 (even after recent record declines)
  – Unemployment will rise further – a lagging indicator
  – Negative equity loans, about to be reset in 2009 and 2010, will boost required payments for many borrowers (especially in CA).

The Financial Sector

A Perfect Storm?

- Over the last decade, increased confidence and regulatory changes led to
  - very high leverage
  - increased dependence on short-term financing

- This system
  - works great when asset prices are rising.
  - is lethal when asset prices fall.

A Perfect Storm?

- Example:
  - For a firm with 30:1 leverage, a 2% drop in assets causes a 60% fall in equity.
  - This makes it harder to borrow (firm has less collateral)
  - But the firm needs short-term financing, so to get cash it has to liquidate illiquid assets and take a loss (especially if all firms are trying to sell assets at the same time).
  - This furthers the decline in equity, and repeats the cycle...
- Note: a 4% drop in assets makes the firm insolvent.
- Now consider a 26% drop in housing values….

A Perfect Storm?

- Rising housing prices also hid a series of other problems that emerged after the collapse
  - Inability to rate complex financial instruments
  - Poor underwriting, risk management, and corporate governance

- Financial markets have crashed
  - Equity markets have declined by 50%.
  - Many credit markets are effectively frozen.

- Without government intervention and the prospect of future intervention, many major firms would have gone under
  - Domino effects would have been even more widespread.

Financial Stability Plan

- Stress tests for major lending institutions
  - Banks who fail will need to raise private or public capital
  - Intended to assure the strength of the financial sector but may have the opposite effect if it reveals large shortfalls and requires massive government intervention.

- Public-private investment fund for “legacy” assets (formerly known as toxic assets)
  - Similar to TARP, but avoids making the gov’t place a value on toxic assets.
  - Not clear if this will work.

Financial Stability Plan

- Consumer and business lending up to $1 trillion (TALF)
  - Effectively, large-scale government loan guarantees backed to some extent by private collateral.
- New recipients of federal funding must
  - Document how assistance increases or preserves lending
  - Restrict dividends, acquisitions and repurchases
  - Restrict executive compensation
- Enormous risk of politicization of bank activities by the Feds.

What about nationalization?

- There is a continuum of actions that qualify as "nationalization"
- It would be quite difficult to literally take over the banks
  - Citigroup is 50 times the size of Continental Illinois.
- Any solution is going to involve some restructuring of banks
  - Good bank/Bad banks
- RTC is not a good example
  - RTC just disposed of the asset of defunct institutions.
  - Completely different from managing a failing institution.

Long-term financial market reforms

- What is the right size and structure of the financial sector?
  - Massive expansion in the 2000s
  - Virtues of many small firms versus fewer, “too big to fail” entities
- Enhanced regulation of systematically important institutions
  - Fund some portion of their assets with long-term subordinated debt

Long-term financial market reforms

- Encourage formation of clearinghouses and regulation for derivatives contracts
  - Start with credit default swaps
- Counter-cyclical capital standards
  - Requiring a higher capital cushion in “good times,” lower ratios in bad times
- Reorganize financial regulatory agencies
  - Jurisdiction by function or objective (solvency, consumer protection) rather than type of regulated financial institution

The Budget

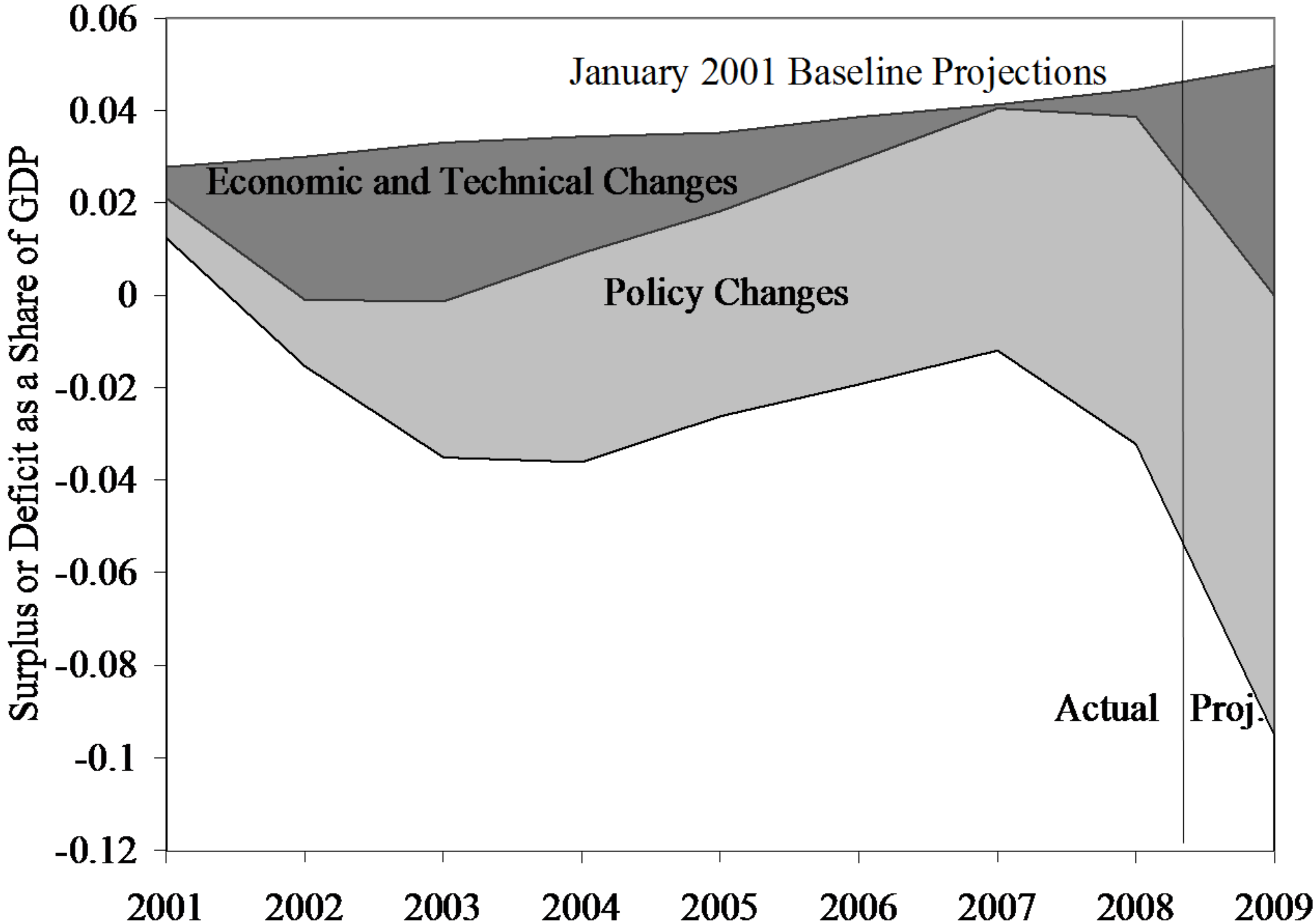
The 2009 Budget

- CBO’s (January) baseline
  - Deficit of $1.2 trillion, 8.3% of GDP
  - With stimulus, deficit of $1.4 trillion, more than 9% of GDP
  - Spending – highest since WWII
  - Revenues – lowest since 1959
  - Deficit – highest since WWII
  - Public Debt – highest since 1956

How Did the Deficit Get So Big?

- In January 2001, CBO projected a baseline surplus for 2009 of $710 billion. How did that turn into a deficit of $1,186 trillion?
  - About 2/3 of difference is due to policy changes – tax cuts and spending increases relative to the January 2001 baseline.
  - About 1/3 due to forecasting errors

Unified Deficit or Surplus as a Share of GDP



10-Year Budget Outlook

- The January CBO baseline
  - Deficits decline sharply through 2012, then gradually through 2019.

- These results are based on a series of rules and accounting conventions that CBO uses that may not be very representative or realistic

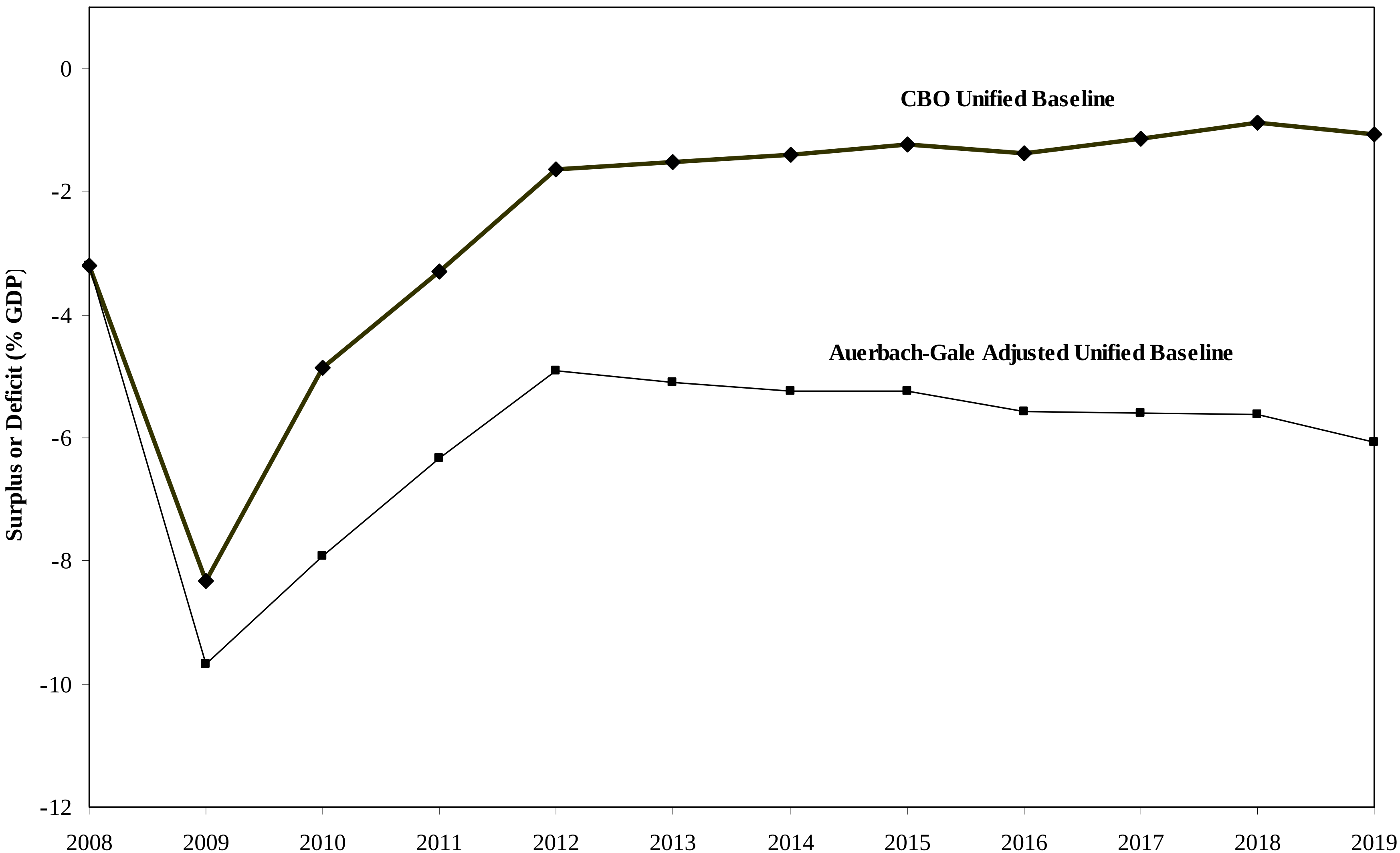
Revenue Assumptions

- The baseline assumes that almost all tax provisions scheduled to expire do expire
  - 2001 and 2003 tax cuts
  - “Regular” expiring tax provisions
  - AMT patches, currently expired at end of 2008
- We extend all of these provisions in the adjusted baseline

Spending Assumptions

- The baseline assumes that discretionary spending will stay constant in real terms
  - This implies a decline in discretionary spending, of 16% relative to GDP by 2019.
- We adjust to assume that real discretionary spending grows with the population

Budget Deficits Under Various Scenarios
Share of GDP, 2008-2019



CBO (2009). Includes economic HR1 stimulus costs.

The Adjusted Baseline

- The adjusted deficit falls through 2012, like the CBO baseline. But the adjusted deficit is 4.9% in 2012, not 1.6%.

- The adjusted deficit rises after 2012, reaching 6.1% of GDP in 2019
  - the CBO baseline deficit shrinks to 1.1% of GDP.

The Administration's Budget

- Starts with expanded baseline similar to above, but with some differences in GDP and other factors.
- New spending
  - Health care
  - Energy
- Tax cuts
  - Families
  - Businesses

Paying for the Administration's Budget

- Revenue raisers
  - Cap and Trade system
  - Eliminate Bush tax cuts for the top 2 percent
  - Restrict itemized deductions for the top 2 percent
  - Close loopholes—international, carried interest
  - No income tax hike for those with Y<250k.

- Spending cutbacks
  - Health care
  - Agriculture
  - Defense (relative to an inflated baseline)

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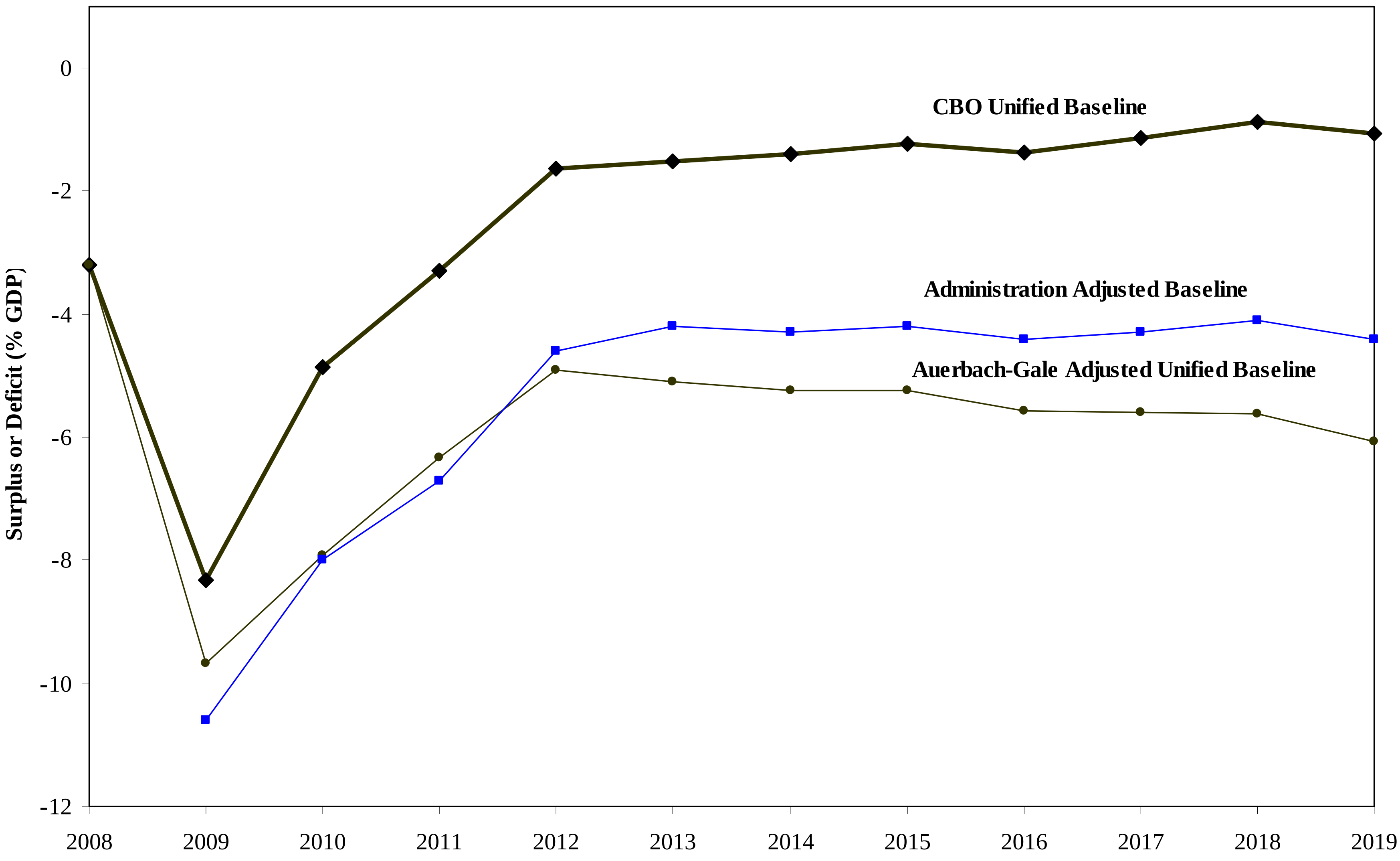

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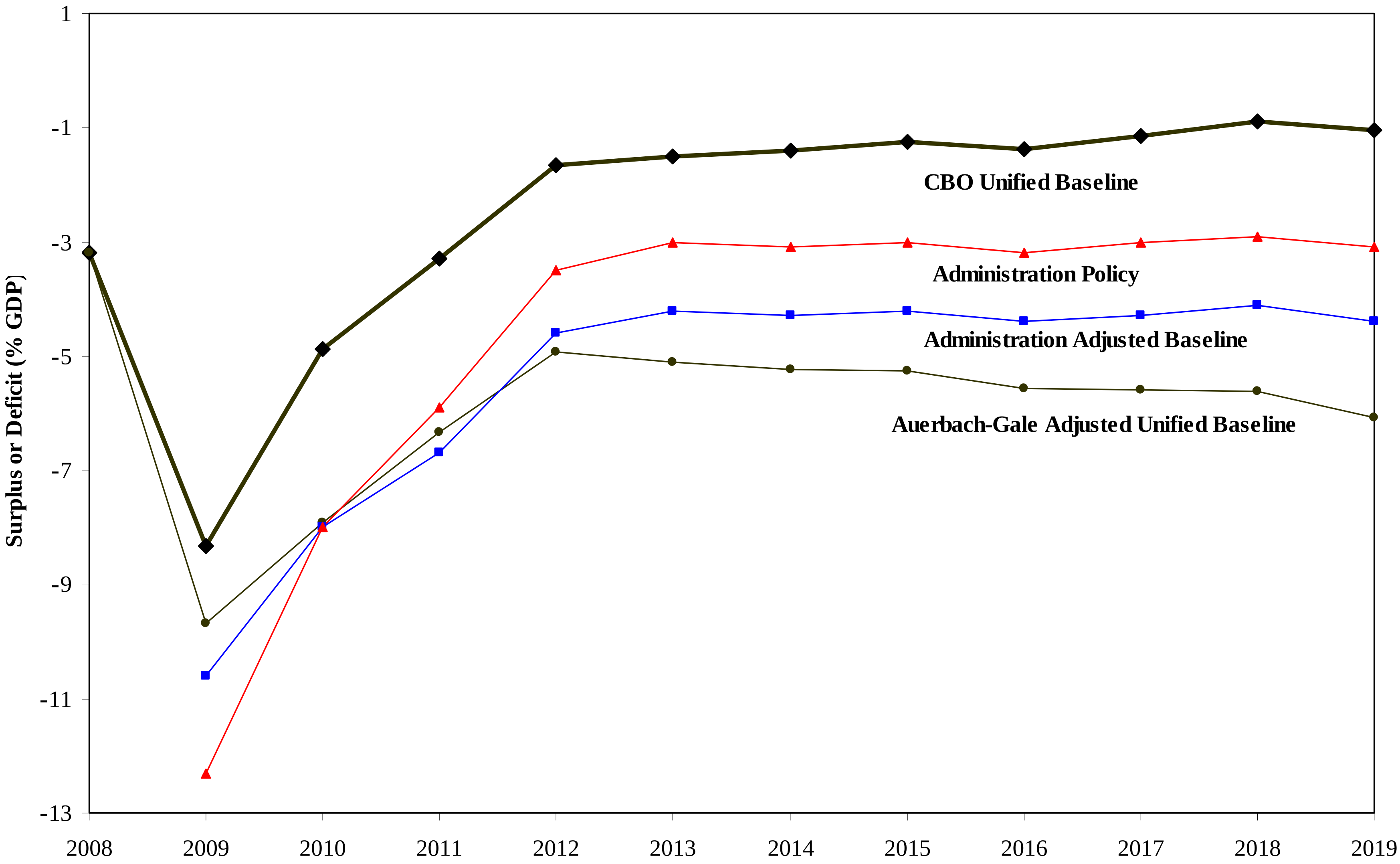

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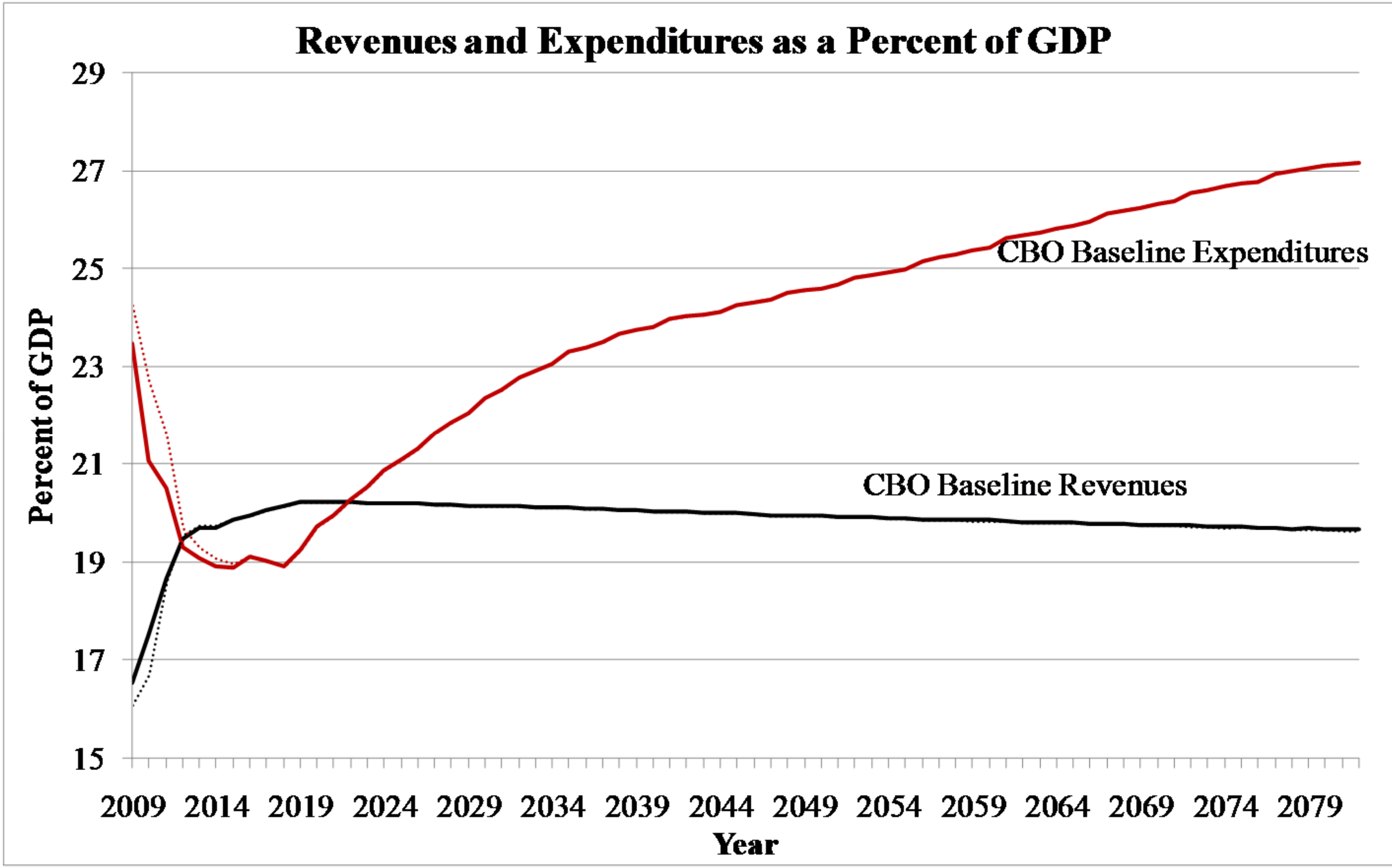
Are the figures too optimistic?

- Economic risk
  - Budget figures depend critically on strong GDP growth.
  - But unwinding in financial and housing sector very uncertain.
  - Global factors also uncertain

- Political risk: Strong assumptions
  - The stimulus package will expire as scheduled
  - Difficult cuts in health care occur
  - A new cap and trade system is enacted
  - PAYGO is installed.


Revenues and Expenditures as a Percent of GDP
CBO Baseline Expenditures
CBO Baseline Revenues
Percent of GDP
29
27
25
23
21
19
17
15
2009
2014
2019
2024
2029
2034
2039
2044
2049
2054
2059
2064
2069
2074
2079
Year

Fiscal Gaps

Baseline:	Official CBO Baseline		Adjusted Baseline	
	Through 2082	**Permanent**	**Through 2082**	**Permanent**
As a Percent of GDP	3.80	5.70	6.65	8.63
In Trillions of Present-Value Dollars	27,844	78,274	48,710	118,514
Including HR1 Stimulus Package:				
As a Percent of GDP	3.92	5.77	6.77	8.70
In Trillions of Present-Value Dollars	28,699	79,229	49,565	119,469

Where do we go from here?

Short-run uncertainties

- The four packages (stimulus, housing, finance, budget) will likely succeed or fail together.

- Global factors
  - Coordinated stimulus could help
  - European financial crisis or Chinese collapse could hurt tremendously

Medium-term uncertainties

- What is the exit strategy?
  - We got into this problem by spending too much and borrowing too much.
  - We are trying to get out of it by spending and borrowing even more

- This may raise GDP, reduce unemployment
  - but it will leave us with higher and more unsustainable levels of spending and debt.

Medium-term uncertainties

- After recovery, we need to transition rapidly to a higher-saving society
  - To pay down international debt, pay for entitlements, finance investments
- This will require
  - Contradictory fiscal policy (lower spending, higher taxes)
  - Reduced private consumption
  - New investment, public and private
  - Trade surpluses
- Structuring fiscal policy to maintain full employment and meet these needs will be a difficult balancing act.

Long-Term Certainty

- Even if the short-run strategy and medium-term transition work, the country faces massive long-run fiscal shortfalls, primarily but not exclusively because of health care.
- Another set of challenges (and, yes, opportunities).