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**Allen Sinai**  
*Chief Global Economist and President*

October 23, 2008

Honorable George Miller  
Chairman  
House Committee on Education and Labor  
House of Representatives  
2175 Rayburn House Office Building  
Washington, DC 20515  
[Jody.Calemine@mail.house.gov](mailto:Jody.Calemine@mail.house.gov)

Dear Chairman Miller,

I am happy to provide some overview comments relating to the Hearings on “Building an Economic Recovery Program: Creating and Preserving Jobs in America,” to take place Friday, October 24, 2008.

You will see from my comments that: 1) the U.S. and Global Economies are in recession, which suggests rising joblessness; 2) a second stimulus program, or perhaps better called an Economic Recovery Program, is absolutely needed, particularly to generate jobs, near- and long-term, given the “Long and Deep Recession” that is expected; and 3) federal government spending should be increased, targeted on extending unemployment benefits as an automatic stabilizer, on increased “infrastructure” spending as part of a longer-run program to Rebuild America’s infrastructure, aid to states and localities increased to help offset high and rising deficits and where cutbacks in jobs are increasingly likely, and tax credits and *permanent* tax reductions instituted for middle- and lower-income families.

Policies to aid homeowners in distress on foreclosures, bankruptcies, or refinancing mortgages also would make a lot of sense.

Hopefully, these comments are of help to you and the House Committee on Education and Labor.

Sincerely,



## **Building an Economic Recovery Program in a Time of Crisis**

**Allen Sinai\***

A second stimulus, or now Economic Recovery Program, is essential given the current state and prospect for the U.S. and global economies, which is recession. The timing should be immediate. Policies, fiscal and monetary, are behind-the-curve given lags in gestation, implementation, and in the response of economic behavior to policy changes. Congress can also weigh-in on the Financial Crisis to the Administration, Federal Reserve, and SEC, with or without legislation in-process.

### **Full-Fledged U.S. Recession; Global Recession a Reality**

*Recent U.S. economic data show a sharp slide and deterioration in the economy, also so for numerous non-U.S. economies and several global regions.*

*The U.S. economy in the third quarter is tracking negative for real GDP with a sharp downturn in inflation-adjusted consumer spending of nearly 3%, at an annual rate, and ripple effects to come, for example in reduced business capital spending. Better foreign trade, that is lower imports, should provide an offset but not big enough to prevent a -0.7% decline for GDP in the third quarter.*

*The Baseline forecast is then for a -3-1/2% to -4% decline of real GDP in Q4; in Q1:2009, -3% to -4%; a small decline in Q2; and second half growth for real GDP flat-to-up a little. The unemployment rate likely will rise to 7-1/2%-or-more by mid-2009. Price inflation should move lower, particularly for commodity prices, but may be sticky downward given the large role of the services economy in the United States.*

The view is a “Long and Deep Recession,” extending through most of 2009. The previous longest U.S. economic downturns were 16 months each in 1973-75 and 1981-82. This one probably will be longer.

### **Why? The Main Causes**

1. A “*hunkering-down*” of consumer spending, with rare outright reductions in consumption spending and an intensification of the downturn because of the financial crisis and credit crunch. *All consumer fundamentals are negative at this time.*
2. *The freezing-up of funds inside the financial system as between bank and nonbank financial intermediaries and a “Credit Crunch” outside the financial system affecting borrowers including consumers, businesses, and government.*

*Historically, when in force, a “Credit Crunch” can produce sharply declining economic activity; therefore, an even more negative pattern could occur with real GDP potentially off by -3% to -7% from Q4 to Q2:2009.*

3. *A housing bust and depression in financial services have been both a catalyst and cause of the downturn. A housing boom, then bust after a long period of excesses in housing activity, mortgage finance and mortgage indebtedness was one reason. A housing price bubble then bursting of that bubble, brought down the values of mortgage debt, credit, derivative*

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mortgage products, structured investment vehicles, and financial businesses structured around housing, and continues now.

The housing downturn is the biggest since the 1930s, with housing starts down 64.1%, peak-to-trough, new home sales off 65%, existing home sales down by 35%, and home prices declining by over 15% year-over-year and near 20% peak-to-trough. This represents a bursting asset price bubble, with falling debt and a worsening of financial businesses tied to mortgages and residential real estate activity.

4. The financial services sector, particularly investment banking/brokerage and commercial, banks, also is in recession now. The sector is around 15% to 20% of the U.S. economy and is consolidating and squeezing down to a much smaller size, with a downturn in the volume of activity and large losses of jobs.

### **Cyclical Processes—About 10 Months Into the Downturn**

*The recession likely started at the turn of the year, as reflected in a number of key monthly economic indicators although not real GDP.* Real GDP is a quarterly statistic and an imperfect, late, summary measure of the state of the economy; the monthly economic indicators do a better job. On this dating, nearly 10 months of the downturn have passed. The cyclical processes to go indicate quite some time left before a recovery can begin.

The role of an Economic Recovery Program would be to cushion the downturn and speed up the onset of economic recovery, hopefully dovetailing with longer-run objectives for the economy.

A housing decline and then bust came first with real estate asset prices tumbling, causing weakening consumption and worsening economic activity from the loss of household wealth and lessened ability of households to borrow.

The declines in housing prices brought down the values of a mountain of housing-derivative mortgage debt, credit, and complicated financial instruments based on the asset values of houses. The Rating Agencies mistakenly rated many of these securities as AAA. Investors willingly bought them, only to find out later that many of the securities lost massive amounts of value and could not be sold at any price.

Financial institutions, both commercial banks and nonbank financial intermediaries such as investment banking/brokerage firms, heavily exposed and involved in the boom of housing-related mortgage debt and finance, saw a shrinking of asset values and balance sheets, a need for capital, and periodic “runs” on financial firms that were capital markets-centric. Considerable capital was required and several large financial institutions—Bear Stearns, Lehman Brothers, AIG, FMNA-Freddy Mac, Washington Mutual, Wachovia, Merrill Lynch—either failed or were absorbed into other relatively strong institutions.

Economic downturn and crunch within the financial system caused distress in financial markets. As a consequence, financial institutions have hoarded funds and refused to lend to one another, fearing default and/or failure. The financial system seized-up and economic and financial activity, as well as equity market prices, suffered. The freezing-up of the financial system still remains, despite huge injections of liquidity, directly and indirectly, by the Federal Reserve and other central banks around-the-world.

A by-product of this has been a significant equity bear market which, in turn, has made IPOs and secondary financing extremely difficult, and the cost-of-capital relatively high. Falling stock

prices also reduce household wealth, consumer confidence, and consumer spending. And, financial institutions earnings have suffered.

The Financial Crisis, worsening stock markets, and worsening credit have fed back to intensify the downturn. The U.S. downturn is hurting non-U.S. exports, with a squeeze on the domestic purchasing power of other countries from high oil, energy and food prices impacting to produce a global recession.

*Policy actions and responses so far have been too late and too little, which is not unusual*—not focused on the places and problems that could alleviate, ease, or cushion the economic downturn and financial crisis, e.g., housing price declines, the consumer downturn, removing bad mortgage-based assets fast enough from financial institutions on current plans to prevent further contraction. Financial markets moving at lightening speed are ahead of policy actions, aggravating the problems.

*The result* has been an incredible series of swift declines in stock prices, with the major U.S. indices now down nearly 40% from the previous peak; total risk aversion and seizing-up of credit in the financial system and a credit crunch outside; flight-to-quality into U.S. Treasuries; a drying-up of funding in the U.S. and increasingly globally; panic and paralysis.

### **Policy Actions and the Role of Congress**

Much of the distress and economic downturn is stemming from a financial crisis and bursting of several long-time bubbles—housing, credit, debt, financial services businesses, and others. This would normally be handled by the Federal Reserve and U.S. Treasury, but their actions up-to-now have been too slow.

Congress can push for measures in this area to help resolve the financial-side of the crisis. The Congress has oversight and leadership and can respond to some of the non-Congressional actions even if not in legislation.

The role of Congress also should be to motivate additional programs to help cushion the downturn, its fallout, and to establish a base for future recovery and expansion.

### **Problems to Deal With**

There are at least four problems to be dealt with by one-or-more branches of government and/or through multiple policy actions perhaps from multiple sources—

1) *Financial Crisis—the tasks.*

- unfreezing credit frozen within the financial system and easing the credit crunch outside the system.
- stopping the contraction of balance sheets and financial institution failure fallout—which now amounts to an implosion of the credit channel in the private sector.
- stabilizing financial markets, especially equity markets, also credit which is impeding flows-of-funds in the financial system and through the economy.

2) *Recession—the task is to cushion or reverse the forces causing the downturn.*

Notable is the important role of U.S. consumption in the recession—now the center of the storm.

- U.S. consumption is declining sharply as consumers cut back.
- Housing activity is still declining with continuing housing price declines.
- The financial and credit crisis is leading to massive losses of wealth and restrictions in the availability of funds.
- Declining non-U.S. economies—at least 20 countries of the 47 countries analyzed and forecasted by DE, including the U.S., are probably in some sort of “recession.” These countries account for about 75% of total global output.

Policies need to be designed to offset, or reverse, the down thrust of consumption, given that its multiplier effects throughout the U.S. and global economies are quite considerable.

- 3) *Financial Markets Disarray*—declines in equity prices and volatility characterize a substantial bear equity market as investors search for appropriate valuations in a situation of declining company earnings, loss of confidence, and a disturbing macroeconomic backdrop. The mechanisms that are intensifying and speeding up the declines of equity prices—including fair value accounting, short selling, and rating agencies ratings—should be impeded.
- 4) *Panic, Loss of Confidence, and Fear*—distress selling of assets to raise cash as well as fear and panic selling are characterizing equity markets. Generally, there has been a growing loss of confidence in the ability of any government to stem the declines.

Not all of these problems lie within Congressional jurisdiction. But Congress can contribute to all of them through the deliberations and debates that go on.

### **A New Stimulus, or Economic Recovery, Package—Size, Diagnosis, Components**

One principal of operation for any Economic Recovery Program would be to “fit” actions into a coherent and thematic long-run vision of what needs to be done, e.g., Rebuilding America’s Infrastructure; Tax Relief for the Middle Class; Rebuilding and Restructuring the Housing of America; Rewriting the Rules of the Financial System.

This way of looking at it ultimately would be cost- and policy-efficient and better than disparate policy actions from different points without coordination.

Size is important—big enough to make a difference but not too big to cause a significant and sustainable increase in the federal budget deficit.

The recommendations would be around \$200 billion, nearly 2% of nominal GDP.

Bush Administration tax reductions over 2001-2005 cumulated to nearly 2% of average GDP per annum over that period. Federal government spending added more to the stimulus. The Reagan tax cuts were approximately 3% of GDP. Federal government spending added to this. The Kennedy-Johnson tax cuts in 1963-64 were 1.6% of GDP. Increased federal government spending also occurred here.

*Any fiscal stimulus can be spread over multiple years.* Fiscal stimulus and monetary ease together set the stage for an economic recovery and upturn.

The components of the Economic Recovery Program should depend on the diagnosis of problems.

## **Tax Reductions**

*The consumer is now the main source of the economic downturn and household financial conditions are the worst since early 1980s.* This favors personal income tax rate reductions for middle- and lower-income families. Social Security tax reductions are another possibility, or tax credits.

More supportive to consumer confidence than temporary tax cuts and lasting in effects, as a source of help for household finance, offset to huge losses in household wealth, and increased tax receipts on growth stimulus, would be permanent tax reductions.

*\$100 billion phased-in over the next three years* but passed immediately post-election is one option. Tax reductions could be retroactive for 2008, showing up in reduced withholding by Jan. 1, 2009. The amounts would be: \$50 billion in Year 1, \$25 billion in Year 2, \$25 billion in Year 3.

*Income tax rate reductions provide more stimulus* than lump-sum tax credits or tax rebates. Cash flow and incentive effects help both consumption and saving.

*Capital gains tax and dividend tax rates should be sustained* at current levels in order to provide stimulus to equity markets and the financing of new enterprise.

## **Federal Government Outlays: \$100 billion**

Federal government outlays of nearly \$100 billion would be appropriate, helping in the following areas.

- *Support for Homeowners and Housing Prices*—this could be through the establishment of a new entity that would deal with foreclosures and homeowner relief. The principal would be to take down the excess supply of mortgages and/or housing to help floor the declines in housing prices; thus, to stop the continuing devaluation of mortgage debt derivative instruments.

A government entity, or agency, as established in the 1930s, or direct purchases of excess supply of housing or mortgages, could be legislated—\$20 billion.

- *Unemployment Relief*—extension to cover the long-term unemployed—\$15 billion.
- *Infrastructure, Including Education*—short- and long-run, with projects on-the-shelf rolled-out that fit longer-run infrastructure needs. Some \$20 billion near-term and \$80 billion more over 10 years are rough approximations.
- *Aid to States and Localities*—to offset budget deficits, \$20 billion to \$30 billion.

The impact of this would be roughly 1-1/2 to 2 percentage points of increased real economic growth in Year I; about half that in additional real growth in Years II and III. The tax revenue feedback from the increased growth would be about \$0.20 per dollar of fiscal stimulus.

## **The Financial Crisis—Potential Actions**

The Congress should support the recapitalization of banks by the federal government through equity shares, partial nationalization, management oversight but not government-controlled, and no wiping-out of equity shareholders.

This would mean a temporary bypassing of the private sector credit channel with public funding.

The creation of a new entity that could enter into the LIBOR market as a direct counterparty, or direct guarantor of loans between financial institutions in the LIBOR markets. Some of these functions are being performed by affiliate executives

There should be more flexible mark-to-market accounting and measures to make short selling more costly. Increased margin requirements, and/or reinstatement of the uptick rule come to mind.

Increase federal insurance of consumer deposits to \$350,000 from \$250,000.

Rating agencies have to be reformed, with supervisory and regulatory actions to clarify their role.

Reform, supervision, regulation to be moved ahead.

Let me note again that in times of stress and extremis, when markets fail and/or move way out-of-line with fundamentals, mark-to-market accounting, while appropriate as a general rule for transparency, can give false readings, add to financial disarray and conditions that can make a solvent financial institution insolvent, encourage short-selling and further declines in stock prices, and intensify an economic downturn.

Short-selling and circuit-breakers to slow down stock market movements need to be considered, perhaps are necessary, even if shutting-down stock markets, in order to give time for responsible and careful public sector decisionmaking and deliberation.