The Current State of the U.S. Economy and the Role of Fiscal Policy

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Introduction

Chairman Saxton, Vice Chairman Reed, and members of the Joint Economic Committee, thank you for inviting me to testify before you on the economic outlook. My name is Janet Yellen, and I am the Eugene E. and Catherine M. Trefethen Professor of Business and Professor of Economics at the University of California at Berkeley. I served as Chair of the Council of Economic Advisers from 1997 to 1999, and on the Board of Governors of the Federal Reserve System from 1994 to 1997. I am pleased to have the chance to share my thoughts with you today on fiscal policy and the economy because I believe that the U.S. economy is at an important juncture. The decisions this Congress makes about the economic stimulus package currently under consideration matter not only to the short-term outlook but also to our longer-term prospects.

The Economic Outlook

Over the past year, the American economy has been suffering the fallout from a collapse of stock prices and an unwinding of the hi-tech investment boom that had propelled growth at accelerating rates after 1995. Capital spending turned sharply downward this year, and steep cutbacks in inventory accumulation further depressed production. The slowdown has not been confined to the United States. It has been global—with weakness abroad exacerbated by diminished U.S. spending on foreign goods and services. The downturn in IT spending especially impacted countries such as Taiwan, Singapore, Malaysia, and Thailand, which rely on hi-tech exports. I consider Japan's situation bleak: it has again tipped into recession and may be undergoing an intensifying deflationary spiral. European growth has also slowed substantially. Weak global growth, in turn, is depressing American exports.

A major offsetting positive is that consumer spending has kept growing, although it has slowed considerably in the face of a weakening labor market, high debt burdens, rising bankruptcies, and, importantly, declines in equity prices. Housing has also held up well thus far. But both are vulnerable to setbacks. Housing already shows signs of weakening.

Before the attacks, the U.S. economy was in the midst of a growth recession—a period of growth well below the economy's potential. Such sub-par performance results in greater slack in labor markets and lower capacity utilization. Even before the attacks, employment had declined, unemployment had increased substantially, and capacity

utilization had fallen to levels last seen in 1983. The economic pain resulting from the slowdown in economic growth has been widely shared: corporate profits have declined about 20% over the past year; state and local governments have seen surpluses erode, forcing cutbacks in spending on a broad range of public goods and services; and American families have lost work, wages, benefits and the economic security that access to a job provides.

The terrorist attacks dealt a substantial blow to an already weak economy, tipping it into outright recession. Economic growth in the third quarter was slightly negative, at -0.4%, according to the Commerce Department's first estimate of real GDP growth. Economic activity seems likely to decline at a much faster pace during the remainder of this year. Unemployment spiked upward, from 4.9% in September to 5.4% in October; employment shrank by 415,000 jobs in a single month—about 0.75 million over the past six months. Like most observers, I anticipate that unemployment will edge yet higher in the coming months.

The direct and immediate impact of the attacks in the form of loss of life, property destruction, and disruption of production, distribution, and transportation has been substantial. In total, September 11th surely ranks as the most devastating single catastrophe in U.S. history. The most important economic risk now, however, is of further retrenchment in capital and consumer spending. Americans are naturally more uncertain and apprehensive. In the face of uncertainty, deferring significant spending commitments—whether for capital expenditures or consumer outlays—is a rational response. Declines in capital goods orders suggest that just such a response is now in progress. The ripples from reduced spending will cause additional job and income losses, exacerbating the downturn. Heightened uncertainty has also translated into larger risk spreads in borrowing costs and tighter lending standards by banks. Recent signs are not unambiguously negative—for example, October saw a strong rebound in retail sales, a decline in new claims for unemployment insurance, and a slight increase in consumer confidence readings. Still, most indicators remain unsettling: aggregate hours of work continue to decline; unemployment insurance claims, although down from their post-attack highs, stand at recessionary levels. Housing sales and starts have slipped noticeably. And industrial production continues to decline, suggesting that the manufacturing sector has not yet hit bottom.

The track record of economists at predicting turning points is not good. Even so, there are legitimate grounds for optimism that the economy will rebound during the coming year with growth returning to trend or above. This optimism is reflected in a rebound in stock prices since the attacks. What actually happens, though, depends critically on both the progress of the war on terrorism and the decisions that Congress and the Administration make now about the future course of fiscal policy. Without meaningful stimulus, unemployment could remain at unacceptably high levels for an extended time, even if a rebound occurs. With inflation well contained, the case for fiscal stimulus is strong.

The reasons for optimism can be briefly summarized. First, the inventory downturn is arguably nearing its end. During each of the last five quarters, the level of inventory investment has declined, holding growth down. In the third quarter, inventory disinvestment reached a record $50 billion in real terms. Inventory disinvestment could rise yet further this quarter; even so, there is good reason to project a rebound next year to more normal positive levels. The consequence would be a noticeable uptick in production and growth. A second reason for optimism relates to spending on high-tech equipment. Many forecasters predict progress in working off the overhang of excess investment in this sector, which would pave the way for some rebound in equipment spending. A third reason for optimism is that the global downturn is pushing oil prices down. Declines in energy costs give households extra income to spend on a broad array of products and services. Lower energy costs also decrease business costs, raising profits.

The most important reasons for a positive economic outlook, however, relate to policy. Current monetary policy is extremely conducive to recovery. The Fed had cut its key interest rate by 300 basis points before the attacks. In response to September 11th, the Federal Reserve immediately threw open its discount window to counter disruption and inject liquidity. In three separate moves since the attacks, it has lowered the federal funds rate by 150 basis points to 2.0%. In real or inflation-adjusted terms, the federal funds rate is now very low as well (maybe even negative)—so the Fed has its foot on the accelerator. Monetary policy works with a lag but we have already seen some payoffs: low short-term rates helped automakers introduce 0% financing schemes that boosted auto sales last month. Mortgage rates have declined, triggering a great surge in mortgage refinancing during the past month.

Under normal conditions, the Federal Reserve can keep the economy on track without help from fiscal policy. There are reasons for concern, however, that the Fed's medicine is less potent now than normally. Fed policy typically operates through at least four distinct channels: short-term interest rates; longer-term interest rates; equity values; and the value of the dollar. A cut in the federal funds rate typically impacts each of these financial variables, in turn stimulating spending through several distinct mechanisms. Broad indices of "financial conditions," constructed to track the combined movements of these financial variables, reveal that overall financial conditions are not as "loose" as would be suggested by the low federal funds rate—the dollar has remained strong; stock prices have fallen, not risen, on net, over the last year; long-term interest rates have declined much less than is typical, with the yield on 10-year Treasuries down less than 1 percentage point since the Fed's easing cycle began; and credit spreads have risen. Unlike Japan, the U.S. is not now in a liquidity trap; nor is the U.S. experiencing deflation—just disinflation. Still, the scope for additional monetary policy has diminished.

Fiscal policy is already providing meaningful stimulus to the economy as well. In addition to the $38 billion of rebates that went out last summer, around $70 billion of tax cuts are scheduled to take effect in 2002. The emergency package passed by Congress, moreover, authorizes $40 billion for rebuilding and disaster relief. The question is whether additional stimulus beyond these steps is needed. My answer is yes, but only if the package is properly designed. Even if the recession proves short-lived, there is no

guarantee that the recovery will be strong enough to reduce unemployment and eliminate economic slack. The extra boost to demand from a stimulus package could speed the return to "full employment." But to stabilize rather than destabilize the economy, the stimulus must come now, when it is needed—not after the economy has recovered, when it would be counterproductive. The stimulus must also be temporary, to avoid harm to the long-term budget outlook. Actions that undermine the longer-term position of the federal budget jeopardize long-term growth. They also reduce interest-sensitive spending by driving up long-term interest rates, deepening, not shortening, the recession.

The biggest challenge our economy faces in the longer-run remains exactly the same as prior to September 11th: preparation for the tremendous pressures that an aging population will place on the federal budget and national saving. Those pressures have not gone away. They have worsened, since other priorities for the federal budget–associated with recovery and the war against terrorism–have surely increased. With fiscal policy, the potential for *bad* policy is so great that a "stimulus package" could do more harm than good. I would rather see *no* stimulus package at all than a badly designed one that simply wastes crucial federal dollars, provides little or no positive short-run stimulus, erodes national saving, drives up long-term interest rates, and diminishes the ability of the federal budget to meet the needs of an aging population.

Before turning to a more detailed discussion of what more fiscal policy can and should do, I would like to comment briefly about the longer-term outlook for the U.S. economy. Here I agree with the current CEA Chairman, Glenn Hubbard, that the longer-term outlook for the U.S. economy remains favorable. The 1990s, particularly the second half of the decade, was a fabulous period for the United States because productivity growth, which ultimately determines how fast living standards improve, perked up substantially. Productivity growth averaged 1.4% from 1973 to 1995. Over the next five years, it averaged 2.5%. Firms invested heavily in IT. But they innovated in other ways too: they altered relationships with suppliers and customers, changed production methods, and reengineered jobs, hierarchies, and organizations. Faster productivity growth held inflation down in the face of extraordinarily low unemployment. It also improved budget outlooks for federal, state, and local governments. In the near-term, three separate factors are likely to depress productivity growth. First, productivity growth commonly slows in recessions and rebounds in recoveries. Second, the downturn in investment spending will depress productivity growth for a time. And finally, as Chairman Greenspan and others have emphasized, the level of productivity will suffer for a time due to the additional costs associated with increased levels of security: the terrorist attacks constituted a negative supply shock. In a recent op-ed, Chairman Hubbard emphasized that "the attacks did not undermine long-term productivity growth." This assessment accords with calculations by the forecasting firm, Macroadvisers, which suggest that any long-term quantitative impact on productivity growth from the attacks is likely to be "immeasurably small." There are no certainties when it comes to forecasting future productivity growth; but my hunch, based on recent studies and data, is that productivity growth will rebound to a healthy pace during the next expansion. An implication is that the U.S. economy does not currently face any serious "supply-side" or productivity-related problem that necessitates a change in tax policy. The most important

contribution that fiscal policy can make to assure healthy productivity growth is continued fiscal discipline, to provide an adequate level of national saving and low long-term interest rates. Tax cuts in the name of long-term growth are more likely to harm than boost productivity if they erode the budget surplus.

What More Can Fiscal Policy Do?

I was one of 14 economists who recently signed an open letter to Senators Daschle and Lott, urging them to lead the Senate in coming up with a stimulus package that would actually do more *good* than harm. We discussed two principles that a stimulus package should satisfy—principles that have also been endorsed on a bipartisan basis by the leaders of the Senate and House Budget Committees. First, policies should be targeted to increase spending immediately. The purpose of a stimulus package should be to complement monetary policy in raising aggregate demand. The package should not primarily focus on raising supply since a shortfall in demand, not a shortfall in supply, is the problem currently facing the U.S. economy. Second, the stimulus package should be temporary, phasing out when the economy recovers. As I have already emphasized, this second feature is important not only for productivity growth but also to insure that long-term interest rates do not rise now, choking off recovery. Unfortunately, the House Economic Recovery Bill violates both principles.

The House bill is heavily directed toward business tax relief, yet the provisions of the bill would have little or no immediate impact on investment spending. For example, repeal of the corporate AMT and refund of AMT credits provide a pure, and unconscionable, windfall for businesses. The payments are based on past investments, not current investment decisions. Because this provision creates no meaningful incentive for investment, it provides no stimulus. The proposed relaxation of subpart F regulations is a similarly expensive windfall for old capital. Among the various business tax incentives that have been discussed for inclusion in a stimulus package, a temporary provision for partial expensing of investment, or, alternatively, a temporary investment tax credit, deserves serious consideration. Temporary investment incentives are attractive because they are targeted at new, not old investments (although they reward investment that would have occurred even without the incentive); and they create potent incentives due to the "use it or lose it" opportunity they entail. In the current downturn, many firms are suffering from substantial excess capacity and will likely be immune to this incentive. But even in a recession, many firms invest and temporary investment incentives encourage these firms to speed up their purchases. From the standpoint of immediate stimulus, however, the three-year period allowed for partial expensing in H.R. 3090 is far too long. The extra spending is needed now, not two or three years from now. In my view, the time horizon for such a temporary investment incentive should be far shorter, as in the Senate Democratic plan, which makes it available only over the next 12 months.

The House Bill contains provisions for individual as well as business tax relief, but again, with some exceptions, the provisions violate the two main principles enunciated in the economists' letter. The proposal to accelerate implementation of the 25% income tax rate, now scheduled to take effect in 2006, provides very little stimulus

"bang per buck" because its benefits are targeted to the top 25% of households, whom studies show are not heavily "liquidity constrained" and spend a lower fraction of extra income than low-income households.[1] In addition, the provision is extremely costly. Given the new burdens on the government budget resulting from the attacks, the tax cut that passed last spring is now, in my view, unaffordable. It would probably never have become law had we known that September 11th would happen. The attacks are no reason to accelerate the tax cut; instead, they are a good reason to reconsider them.

The capital gains tax cut included in the House Bill is especially problematic. Proponents of such cuts argue that they raise saving, not spending. As Chairman Greenspan has explained to this committee, such policy therefore has almost no short-run stimulus potential: a recession is not the right time to use tax policy to stimulate private saving. Such tax reductions are also expensive for the government budget over the longer term. To consider such a tax change in the current economic climate and in the name of stimulus, at a time when there are more pressing demands on the budget that cannot wait, strikes me as totally irresponsible. It reduces the funds available to help those truly in need while wasting money on windfall gains that do nothing to spur new spending. And it abandons the fiscal discipline that we should be maintaining for the long-run challenges that remain.

The one provision of H.R. 3090 that meets the principles endorsed in the economists' letter and would be highly effective in a stimulus package is the proposed rebate for individuals that did not receive a full rebate last summer. The "bang per buck" of these payments would be substantial because the benefits would go disproportionately to low and moderate-income workers. Such workers are typically liquidity constrained and spend a large share of extra income. Also, a temporary rebate avoids damage to the long-run budget.

In my view, a solid case can be made for several stimulus measures not included in the House bill. For example, Alan Blinder has proposed a temporary cut in state sales taxes, financed from federal government general revenues. This plan, if it can be implemented quickly, has considerable merit as a stimulus measure: it could give a quick boost to consumer spending. Alan Krueger, Wendell Primus and others have argued for

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[1] In a recent *Washington Post* op-ed, Glenn Hubbard ("Tax Cuts Are the Best Stimulus, November 16, 2001, page A47) states that "despite the repeated claim that only poor households will spend additional income, evidence indicates almost all households spend about the same percentage of their tax cuts." In fact, a recent study by Karen Dynan, Jonathan Skinner, and Stephen Zeldes (Do the Rich Save More? NBER Working Paper No. 7906) finds that saving rates rise with income, ranging from less than 5 percent for the bottom quintile of the income distribution to more than 40 percent of income for the top 5 percent. A recent study by Joel Slemrod & Matthew Shapiro ("Consumer Response to Tax Rebates," October 10, 2001) examined questions about this summer's tax rebates included on the Michigan survey of consumer sentiment and found surprising results. When people were asked how they planned to use their rebate, the responses indicated that on average only about 20% of the rebates would be spent and this fraction did not differ much across income groups. The authors note, however, that these results are surprising and anomalous. The rebates did not go to the lowest-income households, and actual behavior may differ from the intentions reported in the survey.

improvements in the unemployment insurance system, and such measures are included in the Senate Democratic bill. Krueger and Primus advocate changing the eligibility rules of the UI program, which mainly exclude part-time workers and have become outdated. Only 40% of the unemployed now receive UI benefits. A case can also be made for a temporary increase in the level of UI benefits and an extension of the duration of benefits should the recession turn out to be long-lasting and should unemployment reach sufficiently high levels. The case on equity grounds for directing benefits to unemployed workers is extremely strong; and from the standpoint of stimulus, such expenditures are highly effective, since they assist individuals who are especially liquidity constrained. Temporary additional allocations for foodstamps, WIC, housing subsidies, and other safety net programs also would provide effective stimulus targeted toward those in need. Increased federal transfers to state and local governments whose budgets have been adversely impacted by the economic downturn are also worthy of inclusion in a stimulus package. These governments are forced, by balanced budget requirements, to react to the downturn with spending cuts or tax increases; but such responses exacerbate the downturn. Additional federal support could alleviate such destabilizing policy shifts and mitigate potential cuts in social services to the needy. One promising possibility would be to temporarily raise the federal matching rate for Medicaid.

In his recent Washington Post op-ed, CEA Chairman Hubbard argued against spending as a means to revive the economy. He wrote that "it is a major fallacy to praise new spending plans as 'stimulus.' This ignores the fact that a dollar spent by the government is one fewer that can be spent by private businesses." Hubbard's argument wrongly contradicts a basic macroeconomic principle, enshrined in textbooks for the last 40 years. When an economy is operating at full tilt, with no slack in the labor market, a tradeoff between government and private spending exists, as Hubbard asserts. Additional spending by the government "crowds out" an equal amount of private spending, through the channel of higher interest rates. But when an economy is operating with slack, as ours is now, the tradeoff not only disappears, it reverses, so that greater spending by the government raises, not lowers, spending by private businesses. In an economy plagued by slack, extra spending means more business orders, more jobs, and less spare capacity. New jobs raise household incomes, further boosting private spending via the "multiplier." When firms see sales rise and excess capacity decline, they have the incentive—likely a more powerful incentive than any business tax incentive now under consideration—to invest more: to satisfy customer orders. A temporary spending boost thus raises both government spending and private business spending. Whereas trickle-down economics boosts employment indirectly by stimulating investment and saving, trickle-up economics spurs investment by boosting government and/or consumer spending. Assuming that long-run fiscal discipline is maintained, there is no reason whatsoever for short or long-term interest rates to rise, choking off the recovery.

Conclusion

The U.S. economy stands at a critical juncture. Fiscal policy has an excellent opportunity to play a supportive role in getting the U.S. economy back on track. But the House "stimulus package" does little to boost spending and severely undermines the long-

term federal budget outlook, an outcome America can ill afford with the retirement of the baby boomers looming just beyond the ten-year budget horizon. Numerous practical and effective options are available to strengthen the stimulus while reducing the long-term budget damage.