**Written Testimony of Mark Zandi**
**Chief Economist and Co-Founder**
**Moody's Economy.com**
**Before the Senate Budget Committee**
**Hearing on "Economic Stimulus: Budget Policy for a Strong Economy Over the Short and Long-Term"**
**Wednesday, January 30, 2008**

---

Mr. Chairman and members of the Committee, my name is Mark Zandi; I am the Chief Economist and Co-founder of Moody's Economy.com.

Moody's Economy.com is an independent subsidiary of the Moody's Corporation. My remarks represent my personal views and do not represent those held or endorsed by Moody's. Moody's Economy.com provides economic and financial data and research to over 500 clients in 50 countries, including the largest commercial and investment banks, insurance companies, financial services firms, mutual funds, manufacturers, utilities, industrial and technology clients, and government at all levels.

I will make four points in my remarks.

First, the economy is on the edge of recession if not already in one. Real GDP growth slowed sharply during the last quarter of 2007, and the economy appears to be contracting in early 2008. The job market has stalled, retailers are struggling, and manufacturing activity is declining.

The substantial threat of recession is evident in the recent increase in unemployment. The unemployment rate has risen 0.6% between its 4.4% cyclical low last March to 5%

in December. Recessions are always preceded by such a rise, and such a rise has never occurred and a recession not ensued. The economic reasoning behind why higher unemployment is the catalyst that sets off the vicious cycle that characterizes recession is that increased joblessness undermines consumer confidence and thus consumer spending. Businesses respond to flagging sales by cutting back their investment and payrolls, and unemployment rises further. A negative self reinforcing cycle begins.

A number of large state economies are already in recession, including Arizona, California, Florida, Michigan and Nevada.[1] These states account for one-fourth of national GDP. Alaska, Arkansas, Connecticut, Minnesota, Missouri, Ohio, Rhode Island, Vermont and Virginia are on the edge of recession. These states account for an additional over 15% of national GDP. The large metro area economies of the Northeast, extending from Boston to Washington DC are still expanding, but growth is sharply slowing, particularly around New York City which is being hurt by Wall Street's travails. If these economies devolve into recession, then a national recession will occur.

My second point is that the most fundamental source of the economy's problems is the unprecedented housing downturn and resulting surge in mortgage loan defaults and foreclosures. Housing activity peaked two and half years ago, and since then home sales have fallen by approximately 35%, housing starts by nearly 50%, and house prices by 8%. Some two-thirds of the nation's housing markets are currently experiencing substantial price declines, with double-digit price declines occurring throughout Arizona, California, Florida, Nevada, the Northeast Corridor and the industrial Midwest.

[1] Regional economies are determined to be in recession using a similar methodology as employed by the National Bureau of Economic Research in determining national recessions. Payroll employment and industrial production are the two principal economic indicators used for the basis of whether a regional economy is experiencing a persistent broad-based decline in economic activity.

Further significant declines in housing construction and prices are likely through the end of the decade as a record amount of unsold housing inventory continues to mount given the ongoing turmoil in global financial markets and its impact on the mortgage securities market and thus mortgage lenders and the recent weakening in the broader economy and job market. There is now a broad consensus that national house prices will fall by no less than 15% from their peak to their eventual trough.[2] Even this disconcerting outlook assumes that the broader economy will avoid a full-blown recession and that the Federal Reserve will continue to ease monetary policy.

Residential mortgage loan defaults and foreclosures are surging. Falling housing values, resetting adjustable mortgages for recent subprime and Alt-A borrowers, tighter underwriting standards, and the weakening job market are conspiring to create the current unprecedented mortgage credit problems. According to very accurate data based on consumer credit files, there were 450,000 first mortgage loans in default (the first step in the foreclosure process) as of year-end 2007.[3] This equates to some 1.8 million defaults at an annualized pace. Even if mortgage loan modification efforts increase measurably in coming months, I expect almost 3 million mortgage loan defaults this year and next. Of these, 2 million homeowners will go through the entire foreclosure process and ultimately lose their homes. The impact on these households, their communities, and the broader economy will be substantial.

[2] See "Aftershock: Housing in the Wake of the Mortgage Meltdown," Moody's Economy.com, December 2007.
[3] The source of this data is a 5% random sample of all the nation's consumer credit files maintained by credit bureau Equifax. The sample is drawn at the end of every month.

The unraveling of the housing and mortgage markets continues to undermine the fragile global financial system. Estimates of the mortgage losses global investors will eventually have to bear range as high as $500 billion.[4] The losses publicly recognized by financial institutions to date amount to no more than $150 billion. Losses on construction and land development loans made by the banking system to homebuilders are sure to increase measurably in coming quarters and the credit problems on other consumer loans are rising rapidly, particularly in those parts of the country in recession due to the housing downturn. These stresses are also exposing other weak spots in the financial system, including the monoline insurance industry and the credit default swap market. Given the opacity of the global financial system, it is unclear who are at most risk, and as such players in credit and equity markets remain on edge; unwilling to extend credit to each other. The availability of credit has been impaired and the cost of capital has risen for nearly everyone, good credits and bad, and the negative economic repercussions are mounting.

The housing downturn is also undermining consumer spending. Even a modest pull-back by consumers will push the economy into recession, as such spending accounts for 70% of the nation's GDP. The odds of such a retrenchment are high given that the saving rate of the one-third of households who are homeowners and have borrowed against their homes in recent years is an estimated negative 10%.[5] If this group, which also accounts for about one-third of all consumer spending, simply matches its' spending to its income

[4] See "Leveraged Losses: Why Mortgage Defaults Matter," Jan Hatzius, Goldman Sachs US Economic Research, November 15, 2007. "A Macro Look at Subprime Losses, ARMs and Convexity Hedging," Alec Crawford, RBS Greenwich Capital, November 2007.

[5] The personal saving rates for difference groups within the population is derived based on data from the Federal Reserve's Survey of Consumer Finance and Flow of Funds. Renters and homeowners who have not cashed-out homeowners' equity, each accounting for about one-third of the population, have close to zero saving rates.

over the next several quarters, the negative impact on overall consumer spending will be substantial.

My third point is that while a recession may be unavoidable in coming months, it will take deft and aggressive monetary and fiscal policymaking to ensure that if the economy suffers a downturn it will be short and modest.

Indeed, the last two recessions in 2001 and 1990-91 were short and mild by post World War II standards, but only because of the aggressive monetary and fiscal stimulus provided to shore up the economy. In the early 1990s downturn, the real federal funds rate fell from 5% to 0% and the federal budge deficit increase from 3% to 5% of GDP. Early in this decade, the real funds rate fell from 4% to -1% and the deficit from 2% to -4%. So far in the current period the real funds rate has fallen from 3% to 1.25% and there has been no fiscal policy response.

Policymakers should act quickly to provide more stimulus to the unraveling economy. The Federal Reserve has become much more aggressive, slashing the federal funds rate target quickly from last summer when it stood at 5.25%. Even more rate cutting will likely be needed given that monetary policy has seemingly become less effective in stimulating growth in the current environment.[6] The most immediate conduit between monetary policy and the economy runs through the housing market. Housing is the most interest-rate sensitive sector of the economy, and historically it would receive a quick boost from monetary easing. This boost will be much more muted today given the

[6] This point is well articulated in "Housing, Housing Finance, and Monetary Policy," Martin Feldstein, presented at the Jackson Hole conference of the Federal Reserve Bank of Kansas City, September 2007 http://www.kansascityfed.org/publicat/sympos/2007/PDF/2007.09.05.Feldstein.pdf

ongoing problems in the mortgage securities market. Issuance of bonds backed by subprime, alternative-A, and jumbo mortgage loans has collapsed. Save for conforming fixed-rate loans which are only loosely tied to Fed actions, lenders are unable and unwilling to extend mortgage credit at any interest rate.

Various fiscal automatic stabilizers are also now beginning to kick-in as the economy falters. Tax revenue growth is already measurably slowing and spending on various transfer programs will soon ramp up. Even if policymakers do nothing in response to the eroding economy, the budget deficit will increase substantially.

Doing nothing would be a mistake, however. Fiscal policymakers currently have a window of opportunity to provide a substantial amount of additional stimulus in a timely and targeted way. A well-designed tax rebate issued this summer and additional spending for financially-pressed households reliant on unemployment insurance and food stamps would be very helpful in shoring up the flagging economy.[7] This stimulus should be temporary so that while it will result in a larger deficit this fiscal year and next it will not weaken the nation's already daunting long-term fiscal prospects. Indeed, a well-timed, targeted, and temporary stimulus could ultimately be less costly to the Treasury as a debilitating recession will severely undermine tax revenues and induce more government spending for longer.

---

[7] A very good review of the various potential tax and spending elements of a fiscal stimulus plan are provided in "Options for Responding to Short-Term Economic Weakness," Congressional Budget Office, January 2008. http://www.cbo.gov/ftpdocs/89xx/doc8916/01-15-Econ_Stimulus.pdf
For an analysis of the economic efficacy of various fiscal stimulus proposals, see "Assessing the Macro Economic Impact of Fiscal Stimulus 2008," Mark Zandi, January 2008.

My final point is that in addition to more monetary and fiscal stimulus, policymakers should continue to consider potential policy responses to the ongoing difficulties in the housing and mortgage markets. Expanding FHA lending authority, temporarily lifting the mortgage loan caps on Fannie Mae and Freddie Mac, and the Hope Now initiative are all laudable efforts, but may very well prove inadequate to reviving the moribund mortgage securities market, mortgage lending and the housing market. Until this occurs, the broader economy will continue to struggle regardless of the monetary and fiscal stimulus provided.

What policymakers decide to do or not do in the next few weeks will determine whether millions of Americans lose their job this year and will have a significant bearing on the economic well-being of everyone else.