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CONGRESSIONAL TESTIMONY

Testimony of William W. Beach Before the Joint Economic Committee of the House and the Senate of the United States

Congressional Hearing on What Should Congress Do to Avoid a Recession

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Senator Schumer, Congresswoman Maloney, Senator Brownback, Congressman Saxton, and members of the Joint Economic Committee of the U.S. Congress, I am William Beach, Director of the Center for Data Analysis at The Heritage Foundation. It is an exceptional pleasure to testify before you today on the state of the economy and potential efforts by Congress to alleviate financial and economic stresses. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

Overview

There is an increasingly held view that the U.S. economy is slipping into a sustained period of slow economic growth, perhaps even recession. The root of the worsening economic news is believed to be the collapsing housing sector and the financial institutions and practices that surround residential construction and mortgages. Further, it is beginning to look as though declines in housing sales, construction, and the mortgage credit industry will continue in 2008 as the mortgage default rate (principally on adjustable rate mortgages) increase. It is estimated that something above two million sub-prime adjustable rate mortgages will reset to a higher interest rate during the first few months of 2008.

The specter of further declines in home prices, more turmoil in credit markets, and the emergence of secondary, adverse effects in other parts of the economy stemming from these price and credit events has raised concern about the general economy's near-term outlook. Many analysts believe that evidence of widening economic difficulties could be seen in last month's employment report, which contained a much reduced increase in non-farm payrolls from months prior. Others see evidence of emerging macroeconomic difficulties in a relatively poor Christmas retail season and in the increasingly poor revenue results of many major state governments.

As everyone on this Committee must know, comparatively definitive evidence of a recession "near miss" or an actual recession will not be available for a long time, perhaps over a year. This slow accumulation of data renders the policy makers job particularly hard. Do policy makers rally behind an economic stimulus package that aims at avoiding a recession when we may not be heading into one at all, or do we frame a recession stimulus package that assumes we entered a period of negative growth sometime in November? Or, do we operate from the wise counsel of former CBO Director Douglas Holtz-Eakin that economic growth of positive or negative .4 percent is hardly a difference that a struggling family will appreciate.

So, just what should Congress do? As I will argue later in my testimony, Congress obviously should do nothing to harm the economy, it should let the Federal Reserve lead the effort to stabilize economic activity, and it should keep its focus on crafting long-term, pro-growth economic policy. Congress should take this moment of slow growth to do what it does best: set broad economic policy. In this instance, Congress should concentrate on signaling to investors and workers alike that its principal focus will be on improving pro-growth economic policy, mainly in the areas of tax, regulatory and

spending policies. Serious work by the Congress in these areas will create greater predictability for investors and business owners and assure workers that they will have a better chance of improving their wages through increased productivity. Efforts to enhance the long-run may very well have immediate, short-run benefits as economic decision makers reduce the risk premium they place on starting new businesses or expanding existing enterprises.

What do we know about the state of the economy?

While economic data generally is collected well after the fact of economic activity, current, admittedly incomplete data indicate that the economy entered a period of significantly slower growth during the fourth quarter of last year. Indeed, the data may support the argument that problems in the housing sector and related credit markets have now affected a wider array of economic sectors and interests.

The story in the mortgage industry is becoming well known and settled. Most analysts would agree that an excessive inventory of new housing faced declining demand for housing in 2006 as the Fed raised rates to reduce inflation risks. At roughly the same time, the delinquency rates for highly leveraged mortgages, principally sub-prime, began to rise, largely because many borrowers had taken payments they could not afford. Some lenders did not follow traditional underwriting practices that have been crafted to assure that borrowers have enough income to service their mortgage.

The decline in demand produced drops in new and existing home prices, which exacerbated the sub-prime delinquency rates: as home prices fell, the incentive for a sub-prime borrower to stay in a mortgage lost some of the allure that stemmed from the belief that the underlying house would continue to grow in value, thus justifying a loan that might be too great a financial burden otherwise. Further worsening the macroeconomic picture is the seemingly relentless upward trend in petroleum prices, which briefly touched $100 a barrel on futures markets this month.[1]

All of these factors have combined to make a grumpy lot out of economic forecasters. Let me give you my views.

While I continue to believe that the U.S. economy's strength and robustness are its principal characteristics, I, too, have concluded that near-term prospects are poor. For example, the probability of recession has risen in our models from 35 to 40 percent, and I could easily see little or zero growth in GDP when the fourth quarter estimates are published. The decline in residential construction will continue for some time, consumer and investment spending will slow, and growing inventories, principally in the

[1] A host of commentators have given their views on the economic future, but I would direct the reader first to a very recent speech by Ben S. Bernanke, Chairman of the Federal Reserve System, on the economic outlook and recent turmoil in financial markets. See Bernanke, "Financial Markets, the Economic Outlook, and Monetary Policy," speech before Women in Housing and Finance and the Exchequer Club, Washington, D.C., January 10, 2008: www.gederalreserve.gov/newsevents/speech/bernanke2008110a.htm (January 11, 2008).

automotive sector, will become a drag on the economy (where inventory buildup in the third quarter explains some of the large 4.9 percent growth rate).

That said, we expect GDP growth in 2008 of around 2 percent, and monthly employment growth averaging 75,000 jobs. This is slow growth, but not a recession. The reason I believe we avoid recession in 2008 is due in large part to the substantial contributions to GDP from exports. While domestic demand is expected to grow by about .9 of a percent over the next two quarters, exports are forecasted to expand by 10 percent. Recent U.S. export growth is stems from the lengthening, above trend growth in world GDP, largely due to economic strength in Europe and the long-awaited emergence of China and India to the top tier of industrial economies.

Economic policy makers need to focus on the economic trouble spots and the portions of the U.S. economy that are doing quite well. The temptation will be to see the glass as half empty. For example, now would be the wrong time to insulate the U.S. from global economic forces by restricting or regulating international trade. Moreover, now would be the wrong time (and one can't think of a right time) to federalize private mortgage contracts or freeze contracted mortgage interest rates when the vast majority of such contracts are functioning well and when a key institutional factor to our current economic strength is the rule of law in the operation of contracts.

What should Congress do?

These cautions, however, should not discourage Congress from acting to support stronger economic growth. I recommend that Congress address economic policies in three interrelated areas, all of which affect near and long-term economic performance: 1) tax policy, 2) mortgage markets regulation, and 3) long-term spending.

Nearly every significant, general slowdown in economic activity is a good time for congressional policy makers to ask, are we doing everything we can to support long-term economic growth? That is, slowdowns are good times to get back to policy fundamentals and make certain that everything Congress can do to allow the economy to grow has been done.

I am convinced the Congress is not the best policy making body for addressing the short run challenges of the economy. That role is better played by the Federal Reserve System. So much of what Congress does is tied to the budget and appropriation processes, which take time to reach legislative results. Moreover, the Members of Congress frequently do not have the time or background for keeping up with financial markets, the ebb and flow of economic data, and the actions of economic institutions the way the Fed does or even the economic agencies of federal and state governments. These institutional factors explain why congressional action often occurs after the need for action has expired, and why the actions it takes often are not as targeted as they need to be.

However, there are areas of economic policy where congressional action can by timely and targeted, though it may not intend to be short-range in focus at all. Those areas involve the reduction of investment risk.

Investors are driven, in general, by comparative rates of return when making investment decisions between various opportunities. If two business opportunities are possible, but one has a better rate of return than the other; then the investor will go with the superior opportunity…the one with the higher rate of return. Suppose, though, that outside factors intervene (a flood, war, regulatory changes) and this otherwise superior investment now carries more risk than the inferior one. The investor discounts the rates of return for the greater amount of risk and, if the rate of return on the first opportunity is still superior, the investor goes with that same opportunity. If, on the other hand, the risk is too great to go with the otherwise superior opportunity, the investor may take the more cautious approach of avoiding risk and placing funds in the opportunity with the otherwise lower rate of return.

Tax Policy: What can increase risk? Many factors, of course, but public policy commonly looms large. Tax increases, especially if they land on capital, increase the cost of capital and lower investment returns. When investors are uncertain about whether taxes will go up or stay the same, they still can act as though taxes have risen if they judge the risk of an increase to be nearly equal to an actual increase. And, rising uncertainty can have the effect of driving down investments in riskier undertakings.

Thus, among the first things Congress can do to address the current slowdown is to pronounce definitively on the tax increases scheduled for 2009 and 2011. There are projects, new businesses, and expansion of existing businesses that would be undertaken today if Congress signaled that taxes would be lower in three years. Since nearly all major capital undertakings last beyond this three-year period, it is likely that making all or most of the Bush tax reductions permanent would stimulate economic activity today as well as in 2011.

I am probably not the only one here today who knows of businesses that are preparing now for higher taxes in 20ll. They are preparing themselves by reducing their riskier projects and providing for stronger cash flows in 2010. It is altogether possible that there are projects being cancelled today that would otherwise go forward if taxes were not scheduled to rise in 2011. At times like the present, the speech of policymakers is as important as the policy actions they take. The decisions makers in business and investment are watching Washington closely to discern the direction Congress will take in responding to this crisis. If that direction includes tax increases, then investors will find more favorable economies to support and business owners will, as much as they can, locate their expanded activities in places with more favorable tax regimes.

Thus, Congress should signal today what it plans to do on taxes in two or three years. For my part, I urge the Congress to make permanent the key provisions of the 2001 and 2003 tax law changes. Maintaining lower tax rates on labor and capital income will encourage both labor and capital to work harder now when we need that greater activity.

In addition, we know from past experience that accelerating the tax depreciation of capital equipment and buildings or one-year expensing of business purchases that otherwise would be depreciated over a longer period of time for tax purposes can help during periods of slow growth. This was certainly the record in the last slump.[2]

Demand-side stimulus (tax rebates, child tax credit, and the 10 percent tax bracket) did little to change the course of the sluggish economy. The tax rebates of 2001 did little to stimulate the economy or move it from a prolonged sluggish growth trend. Indeed, the contraction in investment and thus job creation did not begin to improve until after the 30 percent partial expensing in the 2002 act and the 50 percent partial expensing in the 2003 act, which also cut the tax rates on dividend and capital gain income. Congress has enacted depreciation and expensing stimulus plans under Republican and Democrat majorities.

Mortgage Market Regulation: Just as working on better, more pro-growth tax policy for the long run can have immediate, short-run benefits; so too can supporting long-term recovery in the mortgage and credit markets. Well functioning financial markets are central to long-term growth in jobs, incomes, and general output. Clearly, the current credit crunch points to the widespread difficulties that flow from extensive violation of traditional lending practices and excessive supplies of credit.[3]

So, what should Congress do? Four principles should be in policymakers minds when framing a policy response to this crisis.

1. <u>Any action should respect private property</u>. When lenders are faced with a high frequency of defaults, they commonly negotiate new terms with borrowers rather than face extensive defaults or delinquencies. We see these negotiations going forward now. Congress should not act in a fashion that arbitrarily abrogates or alters these contracts. It should not empower bankruptcy judges to negotiate new mortgages. It especially should not pass legislation or support administrative actions that freeze interest rates. Such actions would set a dangerous precedent of legislative interference in private contracts that could be more extensively utilized sometime in the future.
2. <u>Congress should not extend new subsidies to the housing sector</u>. An efficient mortgage credit industry is central to the country's economic future. Clearing out poorly run and unethical mortgage companies needs to happen swiftly and thoroughly, and this side of the market correction is visible everyday in the financial news. It also is important that the under- and non-performing loans be refinanced or restructured in a way that serves the long-term interests of

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[2] Matthew Knittel, "Corporate Response to Accelerated Tax Depreciation: Bonus Depreciation for Tax Years 2002-2004," OTA Working Paper 98 (May, 2007), Office of Tax Analysis, US Department of Treasury.

[3] For more on what Congress should do, see David C. John and Alison Acosta Fraser, "HOPE NOW: One Step to Resolve the Subprime Mortgage Crisis", *WebMemo* no. 1742, The Heritage Foundation, December 13, 2007; and Ronal D. Utt, "H.R. 3915 Would Impose New Burdens and Limits on Moderate Income Borrowers," *WebMemo* no. 1703, The Heritage Foundation, November 14, 2007.

borrowers and lenders alike. Federal subsidies to lender or borrowers would only lengthen the correction and distort the costs that the market needs to absorb and discount.

3. Lightly reform mortgage credit regulations. If Congress and the administration encourage the private renegotiation of at-risk, sub-prime mortgages, then the sector with the most to gain (or lose) will be resolving the sub-prime problem. Congress should review existing regulations to determine the contribution of either ambiguity in law or failure of enforcement to the turmoil in mortgage markets. It might also be good to review the administration's proposed regulations of Freddie Mac and Fannie Mae.
4. Congressional actions should be temporary and limited. Whatever Congress does on the regulatory side, those actions should be targeted to the problem, temporary in duration, and supportive of private resolution of the non-performing portion of the nation's mortgage portfolio.

Increase confidence in the U.S. economy by addressing long-term spending challenges. While the attention of most policymakers will be on immediate responses to the current slowdown, everyone should attend to a factor that's increasingly important to confidence in the U.S. economy: the seeming unwillingness of Congress to seriously address the enormous financial challenges from entitlement spending. Many investors and organizations that play key roles in the future of the U.S. economy are worried about long-term growth given the fiscal challenges posed by Social Security's and Medicare's unfunded liabilities. The *Financial Times* recently reported that the lead analyst for the US at Moody's warned that the credit rating agency would downgrade U.S. treasury government debt if action was not soon taken to fix entitlements.

Thus, at a time when the economy is slowing and the speech as well as the actions of Congress can affect economic activity, policymakers should take concrete steps to that will announce their intention to address unfunded liabilities in these important programs. While reforms in these programs may be beyond what this Congress's can do, it is possible to signal change by reforming the budget rules.

Currently, the federal budget functions as a pay-as-you-go system, with a very limited forecast of obligations and supporting revenues. We just do not see in the official budget what may happen over the next 30 years. The five and ten-year budget windows do not permit Members or the general public to sense the obligations that are coming beyond that ten-year time horizon.

A good first step in addressing the long-term entitlement obligations of the United States would be to show these obligations in the annual budget. This could be done by amending the budget process rules to include a present-value measure of long-term entitlements. Such a measure would express in the annual budget the current dollar amount needed today to fund future obligations. Such a measure has been endorsed by a number of accounting professionals, including the Federal Accounting Standards Advisory Board.

A solid second step would be to convert retirement entitlements into 30-year budgeted discretionary programs. Such a move recognizes that mandatory retirement funding programs for millionaires that crowd out discretionary spending programs for homeless war veterans make no sense at all. If we are to contain entitlement spending and reform the programs driving those outlays, then a paradigm shift likely will be required. Recognizing Social Security and Medicare as discretionary programs helps force attention on changes that will assure their survival well into the 21st Century.[4]

[4] See Stuart Butler, "Solutions to Our Long-Term Fiscal Challenges," Testimony before the Committee on the Budget of the United States Senate, January 31, 2007.

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