Why America must have a fiscal stimulus

By Lawrence Summers

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The odds of a 2008 US recession have surely increased after a very poor employment report, growing evidence of weak holiday spending, further increases in oil prices, more dismal housing data and further writedowns in the financial sector. Six weeks ago my judgment in this newspaper that recession was likely seemed extreme; it is now conventional opinion and many fear that there will be a serious recession. Markets now predict the Federal Reserve will provide further stimulus to the economy by cutting rates by an additional 125 basis points on top of the 100 basis points by which they have already been cut so that rates fall to the 3 per cent range.

There is now a compelling case for the president and Congress to create a programme of fiscal stimulus to the US economy that could be signed into law in the next several months.

Given the market's prediction of Fed policy actions, the debate now is not about whether or not to provide macro-economic stimulus. That question appears to be settled. The question is whether it is better for all the stimulus to come from discretionary monetary policy or for some of the stimulus to come from discretionary fiscal policy. A diversified policy approach seems clearly preferable in that (i) in a world where judging the impact of policy measures is difficult, the outcome is less uncertain with a diversified mix of stimulus measures; (ii) the proximate impact of fiscal policies is felt by the families bearing the brunt of recession, in contrast to monetary policies whose immediate impact is on financial institutions; (iii) use of fiscal policy reduces the amount by which interest rates have to be reduced, thereby reducing downward pressure on the dollar, which in turn contributes to upward pressure on US inflation and international instability; (iv) partial reliance on fiscal policy mitigates the various risks of bubble creation associated with excessively low interest rates.

Beyond policy mix considerations there is the desirability of maintaining stable demand by insuring against excessive declines in consumer spending that lead to reduced employment and further declines in incomes and spending. The economy has been more stable in recent years than historically – one reason is that consumer credit markets have allowed households that suffered income declines as the economy turned down to maintain spending by borrowing on credit cards or home equity. These mechanisms, like monetary policy, are less reliable with burdened borrowers and troubled financial institutions. Japan's experience in the early 1990s – when it failed to act decisively to respond to a downturn associated with collapsing financial bubbles and then experienced a disastrous vicious cycle of economic downturns and credit problems – should be highly cautionary regarding the importance of supporting consumption in the wake of financial problems.

Fiscal stimulus is appropriate as insurance because it is the fastest and most reliable way of encouraging short run economic growth at a time when a serious recession downturn would pressure American families, exacerbate financial strains, raise protectionist pressures and hurt the global economy.

Poorly provided fiscal stimulus can have worse side effects than the disease that is to be cured. This suggests close attention to three issues:

First, to be effective, fiscal stimulus must be timely. To be worth undertaking, it must be legislated by the middle of the year and be based on changes in taxes and benefits that can be implemented almost immediately.

Second, fiscal stimulus only works if it is spent so it must be targeted . Targeting should favour those with low incomes and those whose incomes have recently fallen for whom spending is most urgent.

Third, fiscal stimulus, to be maximally effective, must be clearly and credibly temporary – with no significant adverse impact on the deficit for more than a year or so after implementation. Otherwise it risks being counterproductive by raising the spectre of enlarged future deficits pushing up longer-term interest rates and undermining confidence and longer-term growth prospects.

Taken together these criteria suggest the desirability of a programme of equal payments to all those paying either income or payroll taxes combined with increases in unemployment insurance benefits for the long-term unemployed and food stamp benefits. Such a programme could be implemented quickly and would largely benefit those most likely to be cut off from credit markets and with the most urgent need to spend. It could easily be made temporary. Ideally, further stimulus would be provided by measures to reduce future deficits and increase long-run confidence.

How large should a programme of fiscal stimulus be? It depends on what else is done to help the economy – a subject to which I will return soon. But a $50bn-$75bn package implemented over two to three quarters would provide about 1 per cent of gross domestic product in stimulus over the period of its implementation. With some multiplier effects the total impact would be in the range of 1 per cent of GDP over a year. This seems large enough to take some burden off monetary policy and yet unlikely, if properly implemented, to risk substantial damage given flexible monetary policy if the economy proves stronger than expected. After many months of behind-the-curve policy, moving to implement such measures seems more prudent than waiting till the necessity of even greater ones has been unambiguously established by further pain.

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