Recovery and Reinvestment 101

What caused the current recession?

The economy was already performing badly by many measures before the recession started in December 2007, but the poor economic performance was partially camouflaged by rising asset values—especially home values. Those rising asset values made many people and businesses feel well off and comfortable going into debt. Rising asset values, consumer overconfidence, and borrowing fueled economic activity and gave the economy a veneer of well-being, even though real family income remained lower than it had been before the recession of 2001.

The immediate cause of the current recession was the collapse of the housing bubble, which took away the camouflage that was hiding an already troubled economy. It also revealed the consequences of the financial sector's irresponsible behavior, as well as failures by that sector's government regulators.

Lenders had made risky loans with escalating interest rates, counting on refinancing to save the day when the inevitable defaults loomed. The scheme was essentially to capture the increased value from rising home prices to cover the lagging payments through refinancing. But this no longer worked once housing values stopped rising. The result has been record levels of mortgage defaults and foreclosures.

Mortgage brokers had packaged many of these risky loans into securities and sold them to a variety of investors. Those investors found that mortgage-backed securities lost their value as the loans went sour. This alone would have been a blow to the financial sector. But the damage has been much greater than simply the decline in value of mortgage-backed securities.

The financial services industry had created a range of products to essentially insure the holders of mortgages and mortgage-backed securities against losses. Yet those offering protection did not actually have the wherewithal to cover anywhere near the losses they were protecting against. Thus, when the losses started to emerge, companies such as AIG who offered this "insurance" were also drawn into the crisis.

Many institutions had financed much of this activity—their mortgage lending, security buying, and insurance—by themselves borrowing, which even further exacerbated the situation by broadening the problem to include their lenders as well.

The financial system is now plagued by doubt regarding the value of many of its assets in addition to the actual recognized losses. Because such a wide range of mortgage loans were sliced into multiple securities, it has been nearly impossible for financial institutions to determine how vulnerable any particular security is to the fall in housing prices, which has cast doubt over the value of all mortgage-related securities.

Doubt has now spread beyond mortgage-related securities. The problem is that many of these securities had been highly rated by financial rating services. When it became clear that the securities weren't nearly as secure as their ratings had indicated, the rating services lost their credibility, which has raised suspicion about all rated securities, not just those connected to mortgages. Virtually all financial institutions are now suspect in the eyes of investors, shareholders, and lenders. This makes it very hard for them to raise capital and has made them very reluctant to take on new risk in the form of loans or investments as they try to regain trust and protect themselves from insolvency.

Thus, a problem that started in the housing sector has eviscerated much of the financial sector. That, in turn, created dire consequences for the rest of the economy as the financial sector's pull back put the brakes on the entire economy and made businesses unable to raise capital or obtain many types of even the most routine loans used in their daily operations.

The even worse news is that the crisis in the financial sector has only just begun to affect the rest of the economy. Unemployment has been rising for over a year, but job losses began accelerating in September 2008 as the financial crisis worsened. Job losses grew initially out of sharp declines in construction and manufacturing jobs, then expanded to layoffs in the financial industry, and most recently, economy-wide cuts as businesses and consumers became unable to access the funds necessary to keep spending. On top of this, budget woes at the state and local level caused by the fall-off in property and income taxes, as well as a greater need for public services, are now threatening hundreds of thousands of government jobs nationwide.

Is recession only a problem in the United States?

No, this is now a global recession. Recent data shows that other industrialized nations are also experiencing sharp declines in economic growth. Trade volumes are falling globally as nations that usually import a high share of goods, such as the United States, cut back. This is leading to unemployment in export-focused economics, such as China. Many other nations are taking aggressive action with economic recovery measures.

What is the most important issue in the current recession?

We are now in a situation where the private sector is unable—or unwilling—to use all of the available productive capacity: able people aren't working, machines sit idle, and cubicles stand empty. Job losses are escalating with no clear source of private sector demand to create the confidence in markets that spurs new economic investment.

Economist John Maynard Keynes termed the current problem as a "lack of effective demand." Let's say your car has broken down and you need a new one—you want to "demand" a new car. But, if you do not have the money to buy a car and you cannot get a loan because credit has dried up, then you cannot "effectively" demand a new car, even though you need one. Multiply this by millions of families who are cutting back due to layoffs, fear of layoffs, lower home values, or reduced retirement savings, and demand for goods and services in the entire economy falls. As demand falls, companies stop making so much stuff, which means they have to layoff more workers, or reduce hours or pay, which further dampens demand. And so the cycle continues. Right now, this is the most important issue in the recession because if nothing is done about it, the downward spiral will continue and accelerate with grave consequences for all. Forceful action is needed by the government to prevent this.

Is this recession different from other recent recessions?

Yes. This recession has the potential to be deeper and more protracted than most other recessions. The Federal Reserve can normally encourage economic activity by lowering the cost of borrowing, but these tools are not as effective as they are in more typical recessions because of the crisis facing the financial sector.

The Federal Reserve has already used up its most common ammunition to boost the economy—the Federal Funds Rate. It lowered the Federal Funds Rate to about zero percent in December 2008 from 5.25 percent in August 2007. Even so, economists are forecasting that economic growth will continue to be negative in 2009, and the end of the economic downturn is nowhere in sight.

What's more, U.S. families began this recession with less to fall back on than in prior recessions because of existing economic weaknesses. Income growth had been weak, and Americans had more debt and fewer assets than at the beginning of prior recessions. Since consumers make up over 70 percent of the U.S. economy, the weakness of family finances will likely hamper the economy's ability to recover quickly.

Why does a stimulus and recovery plan help?

The recovery and reinvestment package is designed to break the cycle of job loss and economic decline. An economy suffering from lack of demand needs a jump-start. The stimulus allows the government to step in and create demand by making purchases itself; it directly puts people back to work and gets money into people's pockets so they can spend again. Businesses begin, in turn, to hire and make investments as they regain confidence that there is a market for what they produce. The downward spiral becomes an upward spiral.

What are the criteria for an effective stimulus?

An economic recovery package should be large enough to address the problem, timely, targeted to cost-effective uses, and use taxpayer dollars responsibly.

Large enough to address the problem

Economists are now generally convinced that the stimulus package must be equal to at least 2 to 4 percent of gross domestic product, which is about $300 to $600 billion annually.

Timely

Head of President Obama's National Economic Council Lawrence Summers suggested in early 2008 that any stimulus package must be "timely, targeted, and temporary." This logic was applied to the stimulus package passed in March 2008, which provided $160 billion of tax rebate checks. Yet economic conditions have continued to worsen and it is clear that it will take more than a few months to solve the problems facing our economy. A "timely" recovery package should therefore be focused on the next 18 to 24 months.

Targeted

Investments should increase demand and generate jobs. If the problem is that firms are not seeing demand for goods and services, the most effective package will create demand. The best demand and job creators are investments in infrastructure and green jobs, as well as aid to the states. Such investments will also indirectly increase demand because every dollar spent is spent again by whomever receives the funds.

The government can only spend so much responsibly in a short period of time, however. Tax cuts are therefore a useful addition to the package—although they would otherwise be a second-best approach—because they put money into people's pockets that, if spent, will spur demand. The most effective tax cuts are those that go to lower- and middle-income families that need the money most and are thus most likely to spend it. (See Krugman, Romer, and Bernstein, and Zandi.)

Responsible

The government is committing trillions of dollars to the economic recovery through a stimulus package and by shoring up the financial sector. It is imperative that the public knows this money is being well spent. This can be accomplished both by having appropriate supervision of the spending and by keeping the public and media well informed about where the money goes.

What is the difference between recovery legislation and policies intended to promote long-term economic growth?

The primary purpose of recovery legislation is to get the economy moving now—to boost economic activity to make full use of the economy's potential. As a result, it will increase economic growth in the short term. Policies that promote long-term growth have less emphasis on their short-term impact and more emphasis on investments that provide long-run returns. But there are policies that can both provide the needed short-term boost and also the foundations for long-term economic growth. Investments in infrastructure and other policies such as education, health care reform, clean and sustainable energy, and wise tax and budget policies will help increase the economy's potential in coming years, as well as help the economy get back on track now.

Are there policies that help short-term recovery and promote long-term economic growth?

Yes. An economic stimulus package should generate short-term economic growth while supporting efforts to establish long-term economic growth. The best example is investments in infrastructure. An economic recovery package that puts money into restoring roads and bridges, or investing in a 21st-century energy grid will boost both short- and long-term economic growth. These investments will generate jobs in the next couple of years and also improve productivity for the entire economy and boost long-term economic competitiveness. Such "twofer" spending is particularly important now as the economy was already languishing prior to the recession in part because of a lack of attention to the nation's long-term economic needs.

What specific recovery and growth policies does CAP recommend?

The time is right for the federal government to implement a set of federal policies that will address these huge problems by providing stabilization, stimulus, recovery, and growth. The economy could further collapse and perpetuate an ever-worsening spiral of job loss and economic decline without government action. Congress should therefore act quickly to pass measures that will stimulate the broad economy and commence the road to recovery in addition to taking action aimed at stabilizing the financial and housing markets that are dragging down the rest of the economy.

CAP proposed in December 2008 a $350 billion package (greater than 2 percent of GDP) of initiatives for a first year for stimulus and recovery. The $350 billion package broadly includes approximately $55 billion to assist those most in need; $70 billion in aid for state and localities; $175 billion for infrastructure investments in stimulus and recovery, including $100 billion in green job creation; and $50 billion for tax cut stimulus.

The main differences between CAP's proposals and whose that have emerged so far from Congress and the Obama administration is that the current federal proposals are for two years and larger, which reflects the changing circumstances in the economy.

What is the Federal Reserve's role and why isn't it doing more?

The Federal Reserve sets the money supply, guarantees the banking sector, and acts as the lender of last resort. The Fed typically lowers interest rates during a recession and the economy begins perking up. But the economy only appears to be worsening even though the Fed has lowered interest rates from 5.25 percent to about zero between August 2007 and December 2008.

The Federal Reserve's other two roles—guaranteeing the banking sector and acting as a lender of last resort—have also been expanded considerably since the financial crisis began in the summer of 2008. This action has been effective in some ways; namely, the financial sector has not experienced a complete meltdown. But the Fed has a limited toolbox, and Federal Reserve Chairman Ben Bernanke is applauding the incoming Obama administration on its fiscal stimulus plans: "The incoming administration and the Congress are currently discussing a substantial fiscal package that, if enacted, could provide a significant boost to economic activity."

Even after a recovery package is put in place, however, the economy will not fully recover until the financial system is functioning normally. The Federal Reserve will play a very important role in stabilizing that sector through its lending authority and its relationship with the banking sector.

Aren't stimulus plans based upon Keynesian theory—a theory that has been repeatedly disproved in practice?

No. The idea that government spending and tax cuts can reduce the length and severity of recessions is widely accepted by economists. The deficit spending required by World War II ultimately ended the Great Depression. That's why economists ranging the ideological spectrum support an economic stimulus, including Reagan advisor Martin Feldstein and McCain advisor Mark Zandi. Nations around the globe are also taking action in recognition of the fact that this is the best path forward.

While Keynesian hasn't been disproven, supply-side economics has. President Bush's economic advisors assured the American public in the early 2000s that the president's massive tax cuts would generate economic growth and create jobs. This classic supply-side policy intervention did no such thing. The 2000s economic recovery was the weakest of all post-World War II recoveries in terms of growth in investment, GDP, and job creation.

Aren't all-time record deficits irresponsible and damaging to the economy?

The economic recovery package will cost money, and it will increase the deficit. But if the policy is effective—which, as outlined above, means it must be large enough to offset the problem—then the economic growth that it will generate will make it affordable to deal with the budget problem in the future.

What's more, doing nothing will be even more costly. This problem is not going to go away on its own. Each week that Congress delays action means that over a 100,000 workers are losing their jobs at the current rate of job loss. Each of those unemployed Americans will spend less in the months to come and further drag down the economy. Stopping the accelerating job losses must be the first priority for everyone's sake. When people are back at work and the economy has stabilized, then we will pay for the recovery package.

The costs are also not as large as they may seem. Let's say, for example, that Congress passes a $900 billion package. That comes out to about $3,000 for every person in the United States. Repaying that bill will not be painless, but paying it over time will be easily manageable if the economy is performing well.

Aren't tax changes more effective at growing the economy if they are permanent?

Permanent tax changes are a very poor choice for spurring an economy during a recession. Layoffs, cut-backs in investments, and the rest of the behavior that must be turned around for a weak economy to recover are not the result of concerns about future tax liabilities. They are the result of an immediate demand shortfall and require an immediate—not permanent—response. In fact, permanent tax cuts could exacerbate the downturn by permanently increasing the deficit and driving up interest rates.

Those who favor permanent tax cuts as the path to economic recovery are those who always favor tax cuts as the path to economic success, whatever the economic conditions.

Their argument is particularly weak in an economic downturn. See "Take a Walk on the Supply Side" for further discussion of tax cuts as path to long-term growth.

Why does it cost $825 billion to create 3 million jobs—more than $275,000 per job?

This critique is a red herring. The primary objective of a recovery and reinvestment package is to get the economy back on track, not create a specific number of jobs in a short period of time. Getting the economy back to normal functioning will create many years of many millions of jobs. It will also increase wages, restore businesses to profitability, and spur investment as demand increases. The package will also help those most hurt by the recession and start building for long-term growth. So, dollars-per-job is the wrong way to look at it.

The arithmetic behind this figure is also incorrect. The actual cost for each year of employment generated by the recovery legislation is closer to $50,000, according to CAP Senior Fellow Scott Lilly.