The Case for Fiscal Stimulus

By Martin Feldstein

Cambridge – Governments around the world are now developing massive fiscal stimulus packages that will cause unprecedented peacetime budget deficits. The fiscal deficit in the United States this year is likely to exceed 10% of GDP. A substantial part of the increased deficit will be due to a wide range of new government spending.

Under normal circumstances, I would oppose this rise in the budget deficit and the higher level of government spending. When an economy is closer to full employment, government borrowing to finance budget deficits can crowd out private investment that would raise productivity and the standard of living. Budget deficits automatically increase government debt, requiring higher future taxes to pay the interest on that debt. The resulting higher tax rates distort economic incentives and thus weaken future economic performance.

Of course, some government spending is desirable or necessary. But an increase in government outlays often means wasteful spending that produces less value than consumers would get from those same dollars.

Now, however, increased government spending and the resulting rise in the fiscal deficit are being justified as necessary to deal with the economic downturn – a sharp change from the reliance on monetary policy that was used to deal with previous recessions. Countercyclical fiscal policy had been largely discredited because of the delays involved in implementing fiscal changes and households' weak response to temporary tax cuts. By contrast, the central bank could lower interest rates rapidly, which worked to raise household and business spending through a variety of channels.

Nevertheless, I support the use of fiscal stimulus in the US, because the current recession is much deeper than and different from previous downturns. Even with successful countercyclical policy, this recession is likely to last longer and be more damaging than any since the depression of the 1930's.

The 40% decline in the US stock market and the dramatic fall in house prices have reduced American households' wealth by more than $10 trillion, which is likely to reduce annual consumer spending by more than $400 billion. And the collapse of housing starts has lowered construction spending by another $200 billion. This $600 billion fall in demand is more than 3% of GDP. If not reversed, it will cause further cuts in production, employment, and earnings, leading to further reductions in consumer spending.

The usual monetary-policy response of lowering interest rates is unable to reverse this sharp drop in demand. The dysfunctional credit markets caused by the uncertain value of asset-backed securities means that banks and other financial institutions are unable to raise funds and are unwilling to lend. As a result, the central bank's lower interest rates

do not translate into increased spending on interest-sensitive investment and consumption.

So there is no alternative to fiscal policy if we want to reverse the current downturn. The resulting increase in the national debt is the price that we and future generations will pay for the mistakes that created the current economic situation. Those mistakes led to an underpricing of risk and the resulting increase in excessive leverage.

There are many reasons for the underpricing of risk and the rise in leverage. The exceptionally easy monetary policy at the start of the decade contributed to financial investors' willingness to buy low-quality financial assets in order to get higher yield and to an explosive rise in house prices. The rating agencies miscalculated the value of asset-backed securities.

The increase in leverage was driven in part by government policies aimed at expanding home ownership among lower-income groups that have proven unable to afford that life style. Banking supervisors did not deal with many institutions' low levels of capital and poor asset quality. A major challenge for the future is to fix the institutional policies that led to these problems.

The new Obama administration and the Congress are still working out the structure of the fiscal stimulus for the US. Although I support the need for a large fiscal package, I disagree with many of the specific features of the plans now under consideration.

Regardless of what is done to provide a fiscal stimulus, governments around the world must act to fix dysfunctional credit markets. Otherwise, credit will not flow and growth will not resume. In the US, reviving the credit markets requires stopping the mortgage defaults driven by negative equity. The US Treasury Department wasted valuable time in 2008 by not using the funds provided by Congress to deal with those housing-market problems. There is hope that the Congress and the new administration will now address that issue.

When the recession is over, the US and virtually every other country will have substantially higher debt-to-GDP ratios. At that point, it will be important to develop policies to reduce gradually the relative level of government spending in order to shift to fiscal surpluses and reduce the debt burden.