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The Stimulus Plan We Need Now
The President-Elect Won't Have to Wait Till January to Act

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(PDF Version)

Further legislation to deal with the economic crisis should not wait until the new president takes office. Fortunately, the president-elect will be a senator and can propose legislation without waiting to be sworn in as president. Immediately after Nov. 4, the winner could, and should, take the lead in the legislative process.

The economy faces two separate problems: the downward spiral of home prices, which hangs over the financial markets, and the decline in aggregate spending, which could cause a deep and prolonged recession.

Home prices have already fallen about 25 percent from their peak in 2006, and experts say they must fall an additional 10 to 15 percent to get back to pre-bubble levels. But they could fall much further than that as a result of mortgage defaults and foreclosures. Further declines from the current level would increase the number of homeowners whose mortgages exceed the value of their homes, creating a strong incentive to default. Defaults and the resulting foreclosures would put more homes on the market, driving down prices even more.

And this fear of a deep drop in home prices depresses the value of mortgage-backed securities, contributing to the difficulty that banks are having raising funds and to their reluctance to make loans.

Although home prices must get back to pre-bubble levels, Congress should enact policies to reduce defaults that could drive prices down much further. Direct help to the 12 million homeowners who already have negative equity in their homes could help to stop foreclosures. But it is important for Congress to go further and stop declining prices from pushing a large portion of the other 37 million homeowners with mortgages into negative equity, which could tempt them to default. The mortgage replacement loan plan that I suggested on this page in June, essentially a congressionally enacted mortgage "firewall" to prevent prices from dropping too far, is one possible way to do that.

Falling home prices have already reduced homeowner wealth by about $3 trillion; the stock market decline has cut wealth by an additional $8 trillion. This reduced household wealth is causing consumers to cut spending, leading to lower employment, lower incomes and, therefore, further cuts in consumer spending.

Other components of aggregate demand are also falling. The decline in consumer spending will lead to less business investment in plants and equipment. And the recession in Europe and Japan will further reduce our net exports.

With the Fed's benchmark interest rate down to 1 percent, there is no scope for an easier monetary policy to stop the downward spiral in aggregate demand.

Another round of one-time tax rebates won't do the job. The rebates that Congress enacted this spring failed to stimulate consumer spending: More than 80 percent of tax rebate dollars were saved or used to pay down existing debt.

The only way to prevent a deepening recession will be a temporary program of increased government spending. Previous attempts to use government spending to stimulate an economic recovery, particularly spending on infrastructure, have not been successful because of long legislative lags that delayed the spending until a recovery was well underway. But while past recessions lasted an average of only about 12 months, this downturn is likely to last much longer, providing the scope for successful countercyclical spending.

A fiscal package of $100 billion is not likely to be large enough to revive the economy. The fall in household wealth resulting from the collapse of the stock market and the decline of home prices may cut aggregate spending by $300 billion a year or more.

The president-elect should focus on developing a mechanism for identifying and funding spending initiatives that can occur quickly and that would otherwise not be done. While it would be good if some of the increased spending also contributed to long-term productivity, the key is to stimulate demand. Any plan to finance this spending by raising taxes, even if postponed, as Sen. Barack Obama has suggested, would hurt the recovery by causing affected taxpayers to cut their spending now.

The increased government spending should include not only money for infrastructure such as bridges and roads but also for a wide range of equipment. Rebuilding some of the military capacity that has been depleted by the wars in Iraq and Afghanistan could be done relatively quickly and should be part of the overall package.

Although the economy is facing severe challenges, the president-elect can turn the situation around by introducing legislation to deal with the downward spiral in home prices and with the declining level of aggregate demand. It is important that such legislation be enacted as quickly as possible.

The writer, an economics professor at Harvard University and an adviser to the McCain campaign, is president emeritus of the National Bureau of Economic Research.