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How to Avert Recession

By MARTIN FELDSTEIN

The American economy is now very weak and could get substantially weaker. Current economic conditions call for lowering interest rates and for enacting a tax cut now that is conditioned on economic developments in 2008. More generally, fiscal policy should be considered in the future whenever there is a risk that an excessively easy monetary policy could cause an asset-price bubble.

After a surge of above-trend growth in the summer, there is likely to be virtually no rise in real GDP in the current quarter. Almost every economic indicator -- including credit conditions, housing and consumer sentiment -- has deteriorated significantly since the Federal Reserve's October meeting. In my judgment, the probability of a recession in 2008 has now reached 50%. If it occurs, it could be deeper and longer than the recessions of the recent past.

Further interest-rate cuts can reduce the risk of recession and increase output and employment in 2008 and 2009. The current 4.5% fed-funds rate is essentially neutral -- not low enough to stimulate growth and not high enough to reduce inflation. Although there are risks that the rise in oil prices and the falling dollar will raise the inflation rate, the greater potential damage of an economic downturn calls for a more stimulative policy. The Fed should reduce the fed-funds rate at its December meeting and continue cutting toward 3% in 2008, unless there is a clear sign of an economic improvement.

Because of current credit market conditions, there is a risk that interest rate cuts will not be as effective in stimulating the economy as they were in the past. The current credit crunch reflects not only a lack of liquidity, but also a lack of confidence in the creditworthiness of counterparties and in the accuracy of asset prices. This problem is now being compounded by the banks' loss of capital as they recognize past losses, and by their need to use large amounts of the remaining capital to support existing off-balance-sheet credits that have to be shifted to their balance sheets. All of this implies that lower interest rates may not raise lending and economic activity to the same extent that they did in the past.

But rate cuts can still help. Lower interest rates will still reduce monthly interest payments for the one-third of homeowners who have adjustable rate mortgages, thus freeing up cash to spend on other things. When banks make new loans, they will do so at lower interest rates, encouraging more business and household borrowing.

Yet more than lower interest rates is needed. Fed Chairman Ben Bernanke signaled a desire for additional policies to reinforce monetary easing when he called for a dramatic temporary rise in the maximum size of eligible Fannie Mae and Freddie Mac mortgages -- to $1 million from the current $417,000. While this would help to stimulate the market for high-priced homes, it would cause these government-sponsored lenders to assume an even greater share of the U.S. housing market when there is a strong fundamental case for reducing their role. And why should American taxpayers provide an implicit guarantee to mortgages of up to $1 million when the average sale price of a home is now less than $250,000?

In a similar attempt to go beyond Fed easing, the head of the FDIC recently proposed that the government impose an across-the-board limit on the mortgage interest increases that are now scheduled to occur. With more than $350 billion of mortgages scheduled to adjust up in 2008, such an imposed limit could no doubt avoid many personal defaults. But arbitrarily changing the terms of mortgages now held by investors around the world would also destroy the credibility of American private debt. Who would invest in U.S. bonds or mortgages if the government could arbitrarily reduce the contracted interest payments?

What's really needed is a fiscal stimulus, enacted now and triggered to take effect if the economy deteriorates substantially in 2008. There are many possible forms of stimulus, including a uniform tax rebate per taxpayer or a percentage reduction in each taxpayer's liability. There are also a variety of possible triggering events. The most suitable of these would be a three-month cumulative decline in payroll employment. The fiscal stimulus would automatically end when employment began to rise or when it reached its pre-downturn level.

Enacting such a conditional stimulus would have two desirable effects. First, it would immediately boost the confidence of households and businesses since they would know that a significant slowdown would be met immediately by a substantial fiscal stimulus. Second, if there is a decline of employment (and therefore of output and incomes), a fiscal stimulus would begin without the usual delays of the legislative process.

Even if the Fed decides that it should not cut rates further at the present time, it would not raise rates to offset the stimulus effect of the fiscal change. From the Fed's point of view, the tax cuts can provide a desirable short-run stimulus without the inflationary impact that would result from a lower interest rate and an increase in the stock of money.

Some reliance now on a fiscal stimulus rather than easier money would also take pressure off the exchange-rate adjustment. While further declines of the dollar are necessary to shrink the massive U.S. trade deficit, continued rapid declines might lead to counterproductive retaliatory actions by some of our trading partners.

The excessive asset-price increases caused by some past monetary expansions -- especially the induced rise in the prices of real estate -- provide a further reason to use fiscal as well as monetary policy. By cutting the fed-funds rate to just 1% in 2003 and promising that it would be raised only slowly, the Fed contributed to the sharp rise in house prices and the market's current weakness. A mixed strategy that included a prospective fiscal stimulus would have reduced the Fed's perceived need for a sustained negative real fed-funds rate, and would therefore have produced a more balanced expansion of demand.

Now is surely a time for such a two-part strategy of expansion.

Mr. Feldstein, chairman of the Council of Economic Advisers under President Reagan, is a professor at Harvard and a member of The Wall Street Journal's board of contributors.