
Obama: fiscal stimulus

- Obama's top economists publish estimates claiming his fiscal program will lift real GDP by 3.7% and payrolls by 3.7mn by Q4 2010
- Congressional critics want to tilt the final legislation either toward more spending (many Democrats) or bigger tax cuts (most Republicans). But Obama's centrist approach will prevail.
- Where trouble may be brewing is in the use of the second USD 350 bn tranche of TARP money. Obama and his Congressional allies want it to mitigate foreclosures, while Bernanke wants it to be used to buy toxic assets.
- Bernanke may be simply giving his own views. But he may have a broader agenda of leaning on the incoming administration to defer to Fed preferences on supporting the financial sector at a time when more big losses and hectic restructuring efforts are again roiling the stock markets here and in Europe.

Obama chief economist calculates solid payoff from fiscal stimulus plan

The Obama transition has mostly gone more smoothly than in the past. The president-elect has been careful to avoid interfering with normal decision-making that rightfully belongs to the outgoing Bush administration until the inauguration next Tuesday, January 20 (case in point: articulating US policy toward the Israeli-Palestinian conflict in Gaza). For his part, President Bush has responded favorably to an appeal from the transition team to formally request Congressional approval of the second half of the Troubled Assets Relief Program, TARP, funds. President-elect Obama has chosen not to spell out in detail his plans for a massive fiscal policy stimulus program, beyond reciting the broad outlines of how big it is likely to be and how it may be split between higher government spending and lower taxes.

However, last weekend his choice for head of the Council of Economic Advisers, Christine Romer, working with Vice-President-elect Biden's economic adviser Jared Bernstein, has published a model-based analysis of a fiscal policy stimulus package that presumably is very close to the final version that the incoming administration will be submitting to Congress in just a few days. [Christine Romer and Jared Bernstein, "The Job Impact of the American Recovery and Reinvestment Plan"] The main purpose of the analysis was to estimate the prospective impact of the assumed package on economic growth and, especially, job creation, as compared to a baseline forecast for 2009-2010 without a fiscal stimulus. But its assumptions give the public a detailed look at the magnitude and composition of the main components of the stimulus plan, both tax cuts and spending injections. Na-

turally, last minute changes will be made before the package goes to Congress, and even more revisions are likely as the formal proposal works its way through the various Congressional committees. The main contours of Obama's plan are as follows:

Total size: USD 775 or a little higher, much as advertised in Obama's speech of January 8, 2009. This amounts to 2.7% of GDP of "fiscal thrust" or net boost to income generation during 2009-2010.

Tax cuts: about one-third of total, including USD 135 bn (Make Work Pay) middle class income tax reductions and USD 125 bn business cuts.

Spending injections: two-thirds of total or USD 521 bn, including aid to state and local governments; aid to unemployed workers and low income people through expanded unemployment benefits and larger food stamp program; renewable energy projects; infrastructure investments; education; and health care.

ESTIMATES OF OBAMA STIMULUS IMPACT IN Q4 2010

	Real GDP USD bn	Payroll employ- ment, mn
Without stimulus	11,270	133,9
With Stimulus	12,203	137,6
Effect of package	Up 3.7%	Up 3.7 mn

Source: Christine Romer & Jared Bernstein, UniCredit Research

The methodology of the statistical experiment is standard in the field of macro-economic research. The economists use an econometric model to project the path of the US economy in the absence of any fiscal policy changes from current law. Then they introduce the fiscal plan by lowering tax payments for families and businesses and raising spending levels for consumers, business investment, and state & local government spending. Romer-Bernstein calculate direct effects of spending programs and the various indirect effects that take place through so-called "multiplier effects". They calculate the impact of tax cuts through the indirect effects reduced tax payments by assuming a portion of the lower tax liabilities are saved. To go from impacts on real GDP to effects on net new jobs created (or preserved) they use the familiar rule of thumb that Federal Reserve economists have estimated that a one percentage point increase in real economic growth is consistent with about a one million increase in payroll employment.

The results are shown in the following table:

JOBS IMPACT OF FISCAL PACKAGE COMPONENTS, Q4 2010

Component	Total Effect	Direct Effect	Indirect Effect
<i>Spending measures:</i>			
State relief	821,000	442,000	379,000
Protecting the vulnerable	549,000	140,000	409,000
Energy	459,000	305,000	153,000
Education	250,000	166,000	83,000
Health care	244,000	166,000	78,000
<i>Tax measures:</i>			
Middle class tax cuts	505,000	0	505,000
Business tax incentives	470,000	0	470,000

Source: Romer & Bernstein, UniCredit Research

What the critics are saying

Not surprisingly, the fiscal plan Romer & Bernstein analyzed has been criticized from several sides. Left of center Democrats, led by Nobel Prize winner and New York Times columnist Paul Krugman, attack it for being too timid. They believe a much larger program is needed to offset the drag from the credit crunch and the need for millions of American families and businesses to rebuild depleted savings, wracked by lower real estate and stock market valuations. They prefer spending programs, which have a much larger multiplier effect on the economy, over tax cuts, which are intended by Obama to promote Republican support for his plan. Senior Congressional leaders, (such as powerful House of Representatives' Ways and Means Committee chairman Charles Rangel, whose committee oversees tax-related legislation) have pledged this week to keep the tax cut portion below USD 300 bn. It appears that the Romer-Bernstein analysis already anticipated such a reaction and did, in fact, make a conservative assumption for tax cuts.

By contrast, a number of Democratic members of Congress, mainly from the southern states, are concerned that the federal government's budget deficit is already too big and that a further enlargement of the deficit could be damaging to the economy and the government's creditworthiness over the long term. Put another way, not all Democrats are swayed by Krugman-type arguments.

As for Republicans, now in the minority in both houses, there are also fairly deep splits among their greatly reduced numbers. One faction, who supported President Bush's tax rebate program early last year as well as September's TARP authorization, is supportive of the Obama approach. But the members would prefer larger tax cuts, and smaller increases in government spending programs. On the other extreme are those who oppose activist fiscal policy (and bail-outs of banks or other companies) in almost all circumstances – and who opposed Bush's policy decisions all last year.

In the end, we predict that Obama will involve Congress in the development of specific spending totals, while coming out with a total tax cut close to the assumptions in the Romer-Bernstein analysis. The US economy is shrinking fast, as evidenced by the latest retail sales, employment, and industry data. Failure to quickly legislate an economic recovery program would severely undermine the credibility of the new administration and the newly elected Congress. They, not the Bush administration, would soon be blamed for the coming rise in unemployment. Perhaps recognizing this, Obama in his January 8 speech warned of a double-digit unemployment rate in the absence of timely government action. Curiously, in the Romer-Bernstein analysis the unemployment rate is estimated to peak at just 9% in the absence of their assumed fiscal package. Only in a footnote do they cite private sector estimates as high as 11%.

Bernanke's goal: more help for banks

In a far-reaching speech this week at the London School of Economics (a safe distance from the intense discussions going on in Washington), Fed Chairman Bernanke recounted the various actions the central bank has taken to deal with the US financial crisis of the past two years. But he also presented his own views on what will be needed to shore up the economy. He warned: "fiscal actions are unlikely to promote a lasting recovery unless they are accompanied by strong measures to further stabilize and strengthen the financial system. History demonstrates conclusively that a modern economy cannot grow if its financial system is not operating effectively." The implicit message is that boosting aggregate demand will not be enough. The USD 250 bn injection of new capital into banking organizations plus FDIC support and the Fed's various liquidity programs need to be augmented with additional funding because of "continued credit losses and asset markdowns" that strain capital and balance sheet capacities of financial institutions.

Bernanke strongly suggests that the incoming Obama Treasury (to be headed by his former colleague Tim Geithner) use a sizable portion of the second USD 350 bn of TARP funding to "remove troubled assets from institutions' balance sheets, as was initially proposed for the U.S. financial rescue plan." Congress balked, however, when it was made clear (by Bernanke himself in Senate testimony) that the intention was to buy frozen CDOs or other illiquid assets at prices substantially above then-prevailing market prices. That would amount to a huge transfer from taxpayers to the CEOs and shareholders of financial institutions that had taken inordinate risks. Treasury Secretary Paulson soon ditched the idea, shifting to the less controversial approach of injecting capital into troubled banks.

This time Bernanke softens the pitch by offering the Treasury three possibilities: public purchases of illiquid assets; provid-

ing asset guarantees, in which the government would assume some downside risk, “presumably in exchange for warrants or some other form of compensation;” or the establishment of “so-called bad banks, which would purchase assets from financial institutions in exchange for cash and equity in the bad bank.” Almost as an after-thought, Bernanke also conceded that TARP funding could be used to mitigate “preventable foreclosures” which, “among other benefits, could strengthen the housing market and reduce mortgage losses, thereby increasing financial stability.” That, of course, is the approach that the leadership of the Congress, much of the incoming administration, and President-elect Obama himself have long favored.

By issuing his warning and recommendation for how to spend the remaining TARP money, is Bernanke speaking just for the Fed? Or does he have allies within the Obama team who also judge that the higher priority is to rid the financial system of frozen assets rather than to directly help troubled homeowners? No one knows quite yet, but we will find out in a matter of days. If Obama administration officials reject Bernanke's recommendation, what will that mean for the ongoing relationship between the Fed and the new administration? The answer to that more difficult question will have profound consequences for economic policy formulation and coordination in the difficult months ahead.

Roger Kubarych (HVB)
+212 672 5668
roger.kubarych@us.unicreditgroup.eu