The Obama Stimulus Program: Will It Work?

Adam S. Posen says that President-elect Obama's proposals to stimulate the economy may be a hodgepodge, but that is not necessarily a bad thing.

Steve Weisman: Welcome to Peterson Perspectives. This is Steve Weisman at the Peterson Institute for International Economics. We're joined today by Adam Posen, deputy director of the Peterson Institute, who among other things has been traveling the last couple of months in Asia and Europe, but today we're going to talk about stimulus. We are discussing that subject at a moment when President-elect Obama is in the process of unveiling some but not all details of his package. We've heard a general speech from him. What do we know about the size and shape of this package?

Adam S. Posen: We know the minimum size and we know most of the core elements even though Obama's speech the other day was extremely light on the specifics, which was kind of surprising for what was touted as a major speech. We know that the package target range is going to be on the order of $800 billion over two years. It's a little misleading for reasons we can't get into because I think there's other stimulus under way. We know that some of the key components are going to be something called the middle-class tax cut, probably on the order of $100–150 billion; a very big commitment to state and local government in terms of block grants (Medicaid, helping them with their insurance needs); and infrastructure projects, which frankly, I think, is the real heart of the package and actually the most constructive part. Now, it's starting to get freighted with a bunch of stuff on green energy and so forth under the heading of infrastructure, which could potentially be good but it's probably overrated.

Steve Weisman: There are some inherent tensions in this, and maybe any stimulus package, between the need to stimulate the economy quickly and yet have oversight, which implies taking more time. Where have they found the balance there?

Adam S. Posen: I think they've done a reasonable job on the balance, Steve, and in the following sense. They've been very open about the fact that you had to triage: What were the infrastructure projects, what were the ones that were turnkey, or close to being turnkey? And to give credit where credit's due, the National Governors Association actually made a constructive nonpartisan effort. Each state came up with a list of real projects that could move. Even though we don't have all the specifics yet, and there's always the danger of having earmarks or very targeted little expenditures, we do have most of the broad principles at least on this piece of the package—and those are accountable.

The tension you mentioned, I would put it a little differently. Not everything that sounds good for long-term spending has the biggest impact. In a sense, the single biggest thing they could do would be to give checks directly to state and local governments, so they don't furlough people. We've talked about that before. I think it might have been Alan Blinder who suggested that you cut consumption taxes in the United States at the state and local level, and the federal government refunds that to the states. Both of those don't really do anything in terms of public investment but they would be the biggest immediate boost to the economy you can give. So that's the kind of tradeoff you're talking about.

Steve Weisman: And you see the need for a big immediate boost, do you not?

Adam S. Posen: Yes, I do. Paul Krugman, long before he was the columnist at the New York Times, had a very good saying: When you've got a business-cycle headache, you reach for the over-the-counter medicine, which is monetary policy. But if it turns out it's more than just a headache, you go to the prescription drug, which is fiscal policy. He and I both were harping on that in Japan in the late 1990s. In the US case, what we've seen is that monetary policy has reached pretty much its limit. It's gotten close to zero interest rates. The types of things the Fed's doing now are of diminishing effectiveness, and it's a serious matter, so you need fiscal policy.

Then there's the question of size. There's no question: We're talking about peace-time deficits and peace-time spending of a sort we've never, ever seen. But the usual benchmark for how much you want to do is that you're trying to make up for what's called the output gap, the difference between how much you expect the economy to grow and how much the economy's normally capable of growing. If you don't close the output gap, unemployment keeps rising. The US economy normally grows on trend nowadays at about 2.2 percent a year. The CBO (Congressional Budget Office) just released a forecast saying that they think the economy is going to shrink in 2009 by 2.2 percent. I think that's probably a little too gloomy. But anyway, if they're right, that means we've got an output gap potentially of around 4.5 percent of GDP and that gets you to your $700 billion, but that's $700 billion in one year.

Steve Weisman: But the package that you mentioned—$700 billion to $800 billion—is in fact going to be over two years.

Adam S. Posen: Yes. It's going to be over two years, but a lot of it is going to be frontloaded, especially on the expenditure side in the state and local governments. Chronologically if you look at the calendar year, it's probably not going to be two years.

Steve Weisman: You mentioned a moment ago that in fact that's not all of the spending that is being contemplated.

Adam S. Posen: Yes, that was my B to my A, thank you. You've got to look at the whole picture. There are automatic stabilizers in the United States. We're going to extend unemployment insurance, which we should, and Obama has various proposals to get out maybe more health insurance to people. There's almost certainly going to be something—although now it seems to have receded a bit—called mortgage relief coming out of the Congress. That could be hundreds of billions of dollars. We don't know how much it's going to be. The Fed is buying mortgage-backed securities but I don't think it's going to stop there.

There's going to be the release of the TARP funds. Based on the things Congress is saying and what's reported in today's paper, it looks like a lot of those are going to be used for things that look more like stimulus and less like asset purchases. We're going to probably add in a GI bill of some sort for returning veterans. You start adding in a lot. The Obama administration, for understandable political reasons, doesn't want to put it all under the cover of one title called stimulus, in part because these things have their individual merits, but in part because they don't want to have a bill of $1.5 trillion. But I think in practice, we're going to get a much greater stimulus than is being said.

Steve Weisman: That is very startling. What about the tax cut portion of it? The tax cut of last year, of a year ago, was not a great success in terms of stimulating the economy, I think it's generally now agreed. Yet partly because of Obama's promise and also because of a desire to be bipartisan and work with the Republicans, it looks like it's going to be a big part of this package. What do you think about that?

Adam S. Posen: Well, I think you've got it exactly right: The tax cuts are about fulfilling a promise Obama made with reference to the campaign and middle-class tax cut. It's about making sure the Republicans are on board, who want tax cuts to be part of the stimulus package. And I think that's how you have to view Obama's speech. It was all about the urgency of doing all this and this was all really a gesture to Congress: "Pass the package. This is all you're going to get." On the tax cut itself, it depends what tax cuts you make. If you make household tax cuts, individual and middle-class tax cuts, which is what we're talking about—remember the poorest people don't usually pay taxes; people who don't have jobs don't pay taxes—they're going to save most of it.

A year ago, in April–May 2008, when we did the tax cuts then, it was expected that they were going to save over half, close to two-thirds of it. But that was OK because we didn't think it was going to be that big of a recession. Now, if you give $150 billion in household tax cuts, consumer tax cuts, and they save two-thirds of it, you're essentially wasting the money for purposes of stimulus. If you give business tax cuts, particularly ones targeted to investment tax credits, that might be much more effective, I mean, by definition, right? We're in a period now where there are lots of businesses that can't get funding for their investment projects so that would be a better kind of tax cut. But politically, I don't think that's what you're going to get.

Steve Weisman: I thought that even some Democrats were supporting the investment tax credit.

Adam S. Posen: I didn't get the sense that was at the top of the agenda. If it is, fine, so much the better.

Steve Weisman: But it does seem like a hodgepodge.

Adam S. Posen: It's going to be a hodgepodge. There are a couple reasons for that. First, as we've been kind of discussing, it's the natural political process. But second, this is an unprecedentedly large stimulus. And people go back and forth about what happened in Japan in the 1990s or what happened in the United States in the 1930s, but the bottom line is it's difficult to get that much money out into the economy that quickly. That's why it ends up being a hodgepodge. Probably realistically, even with the best of intentions from state governments, you can "only" spend $100 to $200 billion on infrastructure in a way that makes sense in the short term. So you've got to figure out other ways to do it.

Steve Weisman: What struck me about Obama's speech was his emphasis on bipartisanship and the process. It almost was like he was viewing the whole process of constructing a stimulus package as a kind of group therapy for Washington to prove that we've entered the new Obama era. I wonder how realistic that is.

Adam S. Posen: Well, I actually think it is realistic in the sense that most incoming presidents get a honeymoon on their first budget and first economic proposals even when their party isn't in the majority and especially during a crisis. But I think it's also a bit disingenuous because here you've got Obama saying, "Well, I want to pass something the day after I get inaugurated," which is essentially a way of saying, "We're going to really take the lead here and not have Congress take the lead here." So I'm not saying there's anything wrong with that, but this idea of group therapy, you've got a pretty aggressive therapist pushing the session.

Steve Weisman: Let me ask one final question. Banks are not lending: Do you see anything in this package that's going to make them lend?

Adam S. Posen: No, and the more the TARP funds get diverted from bank recapitalization or buying bad assets from banks, the less they're going to lend.

Steve Weisman: And doesn't that worry you?

Adam S. Posen: Yes and no. Again, if through the lens of what is the short-term outlook—how bad are things going to get?—it certainly worries me. And to a lesser degree, you want to put conditions on how banks use their money. And if this reflects the fact that we didn't put enough conditions on the previous money, it's a problem. But longer term, the banking system was making too many loans and growing too large. So this idea that we should be expecting the banking system to increase its loans back up to where they were during the bubble years is misguided. What we really need is a shrinking of the banking system.

The point is to use the fiscal stimulus to buy you the time to offset the contractionary effects of the banking system consolidation. If the Obama team, for political reasons or whatever, insists the banks keep lending and doesn't consolidate the banking system—meaning, shut some banks, close them down, shrink the sector—then at the other end of this process, we will have spent all this money and still have to go through that pain. And there won't be fiscal stimulus to offset it.

Steve Weisman: I think you're speaking also from experience with Japan on this, aren't you?

Adam S. Posen: Oh, absolutely. I mean, Japan postponed and postponed its day of reckoning on cleaning up the banks and did various much smaller fiscal packages at various times. But then in the end, they had to bite the bullet. And the banking problem got worse and worse while they put it off.

Steve Weisman: Well, on that note, let's meet again and talk about how they're doing on all of these including on the banking system. Adam Posen, thanks very much for joining us on Peterson Perspectives.

Adam S. Posen: Thank you, Steve.