Economics Group

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Special Commentary

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Decision-Makers' Guide to Stimulus Part Deux

"You cannot step twice into the same river…"

Heraclitus, as quoted by Plato in *Cratylus*

In the *Blue Chip Survey* published just after the first Obama administration stimulus passed, the consensus estimate for the unemployment rate in the fourth quarter of this year was 9.2 percent.[1] Moreover, the top 10 most pessimistic forecasts had unemployment hitting nine percent as soon as the second quarter. Congratulations to them. Our March forecast had unemployment hitting 9.6 percent during the second half of this year.[2] Therefore, when Vice President Biden says, "The truth is, we and everyone else misread the economy," we know that he is taking political liberties with the economic facts.[3] Everyone did not misread the economy. Contrary to political rhetoric, economic analysis outside the beltway clearly anticipated a nine percent plus unemployment rate even with the stimulus package.

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As we begin the third quarter of this year, there have been renewed proposals for another stimulus, Part Deux, to get this economy going. For decision-makers outside the political beltway, there are several principles that underlie the risks to such a strategy and the outlook for growth, inflation, interest rates and the dollar. Each of these core economic drivers of institutional success will be affected by any attempt at stimulus Part Deux.

Recovery in Growth: Patience not Politics

First, the initial Obama administration stimulus needs time to work. Politicians are quick to overpromise and this was certainly again true in this case. The American voter was eager for solutions, but the economy is not instant oatmeal. In a society accustomed to microwaved leftovers, the economy is a slow cooker. Washington was simply too optimistic on how fast the economy would react to policy action.

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Setting the political promises aside, estimates by the Congressional Budget Office (CBO) suggested that most of the impact of the stimulus would begin to appear in the third (now the current) quarter, and then continue into the fourth quarter and the first quarter of next year.[4] The major thrust of the stimulus would be felt in the 2010 fiscal year which begins this coming October, according to the CBO (Table 1). Here at Wells Fargo, our assessment was the same, as our March forecast called for a significant rise in federal spending beginning in the third quarter, leading to overall positive growth for the entire economy by the fourth quarter. To credit the CBO again, it indicated that only one-third of government checks would be sent out by the end of September and just 11 percent of infrastructure spending would be started. Shovel ready was nothing of the sort.

[1] *Blue Chip Economic Indicators*, Vol. 34, No. 3, March 10, 2009.
[2] A copy of this forecast is available upon request.
[3] Vice President Biden, ABC "This Week" July 5, 2009.
[4] CBO, Letter to Speaker of the House Nancy Pelosi, Feb. 13, 2009.

Together we'll go far

Table 1

CBO Estimates of Stimulus Impact

(Millions of $)

Fiscal Year	Defecit/Surplus Impact	Fiscal Year	Defecit/Surplus Impact
2009	$184,924	2012	$36,124
2010	$399,427		
2011	$134,429	2009-19	$787,242

Source: Congressional Budget Office[5]

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During the current quarter, business decision-makers can start to anticipate positive overall economic growth. Unfortunately, a second stimulus could add too much to the growth momentum to be consistent with stability in long-run inflation, interest rates and currency expectations. Inflation/debt concerns, which are already rising, would accelerate quickly and thereby prompt negative interest rate/dollar reactions that would create a boom/bust cycle—especially in the sensitive credit markets. Such a boom/bust cycle would hamper efforts to improve the long-run growth fundamentals in the overall economy that are so necessary to meet entitlement commitments. A second stimulus would, in our opinion, run the risk of steroid-induced, short-run growth increases at the cost of significant long-run losses in economic muscle.

Internal Policy Contradictions

Washington policy-makers are acting at cross purposes to the economy and effective strategic thinking in the private sector. Economic growth may be the aim of the stimulus, but the focus for most households is jobs. For decision-makers, known or feared costs today of proposed policy talk on healthcare, energy and taxes outweigh future uncertain benefits, such that both hiring and investment decisions are frozen in place. Any decision-maker may have the inclination to accept that some proposed domestic policy initiatives may deliver long-run benefits to society some time in the future. However, in the short run, that same decision-maker understands that many policy proposals also generate very high levels of uncertainty and significant transition costs immediately. For example, the proposed increases in taxes on individuals and businesses may produce some expected greater equity in income as a perceived public goal but would also represent an immediate and significant negative incentive to hiring another worker or buying equipment to earn more highly taxed profits.

In another example, cleaner energy initiatives, in the name of reduced future global warming, may appear to be proper policy from an environmental view, but these proposals also suggest significant challenges and transition costs in the short run in an economic review. The movement from the current energy infrastructure to a future, greener structure is characterized by certain immediate costs to the firm and uncertain future benefits to society. Higher transportation costs due to energy, taxes and mandates are immediate and would lead to some combination of higher consumer prices, lower wages, reduced employment or diminished profits.[6]

Cyclical Policy-Structural Change

Washington policymakers have failed to recognize the structural changes in the economy and thereby continue to push pro-cyclical economic policies in a world of structural change. For example, within the labor market, as workers very well know, the gains or losses of jobs are not solely or even primarily temporary—they are permanent. Sectors, such as retail, homebuilding, manufacturing (autos and textiles for example) and, of course, finance, are undergoing fundamental changes. U.S. workers, especially in low-skilled manufacturing, are losing global competitiveness. In addition, political proposals on healthcare, energy and trade all create high

[5] CBO, Letter to Senator Charles Grassley, March 2, 2009.

[6] For further discussion see our recent piece, which is available on our website: "Macro Clouds, Micro Foundation, Realities for Decision-Makers" July 8, 2009.

levels of anxiety among employees and employers with the net effect that firms are reluctant to hire or invest in the short term given the anticipation of much higher tax/energy/healthcare costs over time. Moreover, the first stimulus has emphasized short-run job gains, with temporary federal funding, that are not sustainable over time. The push to increase consumer spending, even at the risk of supporting more credit-driven spending, will only delay the fundamental turnaround in housing and the needed increase in national saving required to meet our future federal deficits.

Moreover, for the current administration to get the stimulus passed through Congress, the usual horse-trading meant that many pet projects, "earmarks," slid by to secure a quick vote. These pet projects were certainly an inefficient utilization of taxpayer funds from an economic point of view, yet these economic losses were the political price of the stimulus.

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Never the Same River

Significantly, the context of a proposed second stimulus would be very different than that of the first stimulus for three reasons. As a scientist would say, the initial conditions are different. First, the economy has already begun to recover as indicated by leading indicators, such as orders, money growth, credit spreads and equity prices. Therefore, any stimulus would not be countercyclical but would amplify the economic cycle and create risks on the upside for interest rates and inflation. Second, there is already significant Federal Reserve and global central bank easing in place so that further fiscal policy ease runs the risk of adding more expansionary fuel to an economy already on the path to recovery. Finally, trends in both the dollar exchange rate and the federal deficit are significantly different than when the first stimulus debate was in motion.

Since the spring, public officials from other nations have increasingly focused on the development of an alternative currency to the dollar.[7] Since the passage of the first stimulus, the dollar has actually declined in value, and this decline would likely be further aggravated by concerns of foreign officials that further deficits would raise the probability of dollar devaluation down the road. Moreover, as we have recently witnessed, there is an escalating concern that federal budget deficit estimates are rising rapidly, and this has led, in part, to a steeper yield curve (10-year Treasury yield less two-year Treasury yield) since the passage of the first stimulus package. Moreover, it is these expectations for future deficits that influence the path of interest rates.[8]

Takeaways

For decision-makers, we can say the following about a second stimulus and its risks:

- A second stimulus would add fuel to the already recovering economy and would create the false impression that all is now back to the "happy days" of an overleveraged consumer and strong growth. Therefore, estimates of top-line revenues are likely to overstate the true sustainable future pace of sales in a deleveraged economy.
- A second stimulus would likely add to inflation/interest rate pressures and, thereby, higher interest rates and the cost of capital down the road.
- A second stimulus would further raise doubts on the ability of our nation to control future spending/deficits and lead to a depreciation of the currency and possible loss of our near-exclusive role as the world's reserve currency.
- A second stimulus would further hide the negative impacts of the numerous micro policy proposals in place and thereby obscure, for a short time, the economic losses from the misallocation of public resources.

[7] Graham, Peter, "China plans global role for renminbi," *Financial Times*, July 14, 2009.
[8] Laubach, Thomas, "New Evidence on the Interest Rate Effects of Budget Deficits and Debt," Federal Reserve Board, Finance and Economics Discussion Series, 2003-12

Economics is a very dynamic system. The impact of a second stimulus, with a significantly different economic background than the first, would likely produce unpredictable and likely counterproductive results to the long-run outlook for the economy. There are serious issues of inflation expectations, currency depreciation and further misallocation of economic resources. There is a time-inconsistency problem between short-run political payoffs and long-run economic losses. Anyone that is tempted to dismiss this contradiction between macro policy and micro impacts on jobs would be well to pay heed to the comments of another public leader who focused on this conflict:

> "Higher public spending, far from curing unemployment, can
> be the very vehicle that losses jobs and causes bankruptcies
> in trade and commerce."[9]

[9] Margaret Thatcher "The lady's not for turning," Speech delivered to the Conservative party conference in Brighton on Oct. 10, 1980.

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