



## U.S. Fiscal Stimulus Essential

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There is no denying that the U.S. economy has stumbled and the recovery is at risk. The problem is that this time, it really is different, at least different than any other postwar economic recovery. This time the recession was not caused by the Fed's efforts to dampen inflation. Real interest rates did not climb much, and thus, did not crush housing and other interest-sensitive spending. Housing and spending were crushed by the credit crisis, which began in the inflated housing sector while interest rates were still relatively low. The job losses have been cyclical, to be sure, but there is a large component of structural job loss as well, and these jobs will not be coming back.

In normal recessions, the Fed eases monetary policy, lowering interest rates and steepening the yield curve. This reboots housing and other interest-sensitive spending, which leads the economy out of recession. Pent-up demand surges and the economy grows at a 4%-to-5% annual rate in the early recovery period.

This time, given that the Fed did not cause the recession, the Fed cannot end the recession just by lowering interest rates and steepening the yield curve, even through quantitative easing. The Fed's policy actions, along with the fiscal stimulus and bailouts, did end the financial crisis, but the housing sector—the usual engine of economic rebound—remains deeply depressed as does consumer confidence. **U.S. household net worth relative to disposable income has plunged. Indeed, according to this measurement, Canadians are wealthier than Americans for the first time since at least 1990.** American household wealth has been clobbered by the combined effect of plunging house prices and lower stock prices. And while household debt in the U.S. is falling sharply, some of it reflects mortgage foreclosures—hardly the way to improve household balance sheets.

So consumption, which accounts for 70% of the U.S. economy, remains weak and prospects are not encouraging until more unemployed Americans find jobs. Certainly construction jobs will not lead the way, and even sectors that are enjoying strong earnings and record cash levels have been reticent to hire. To date, the recovery has been led by business investment in capital expenditures, inventory rebuilding, and federal fiscal stimulus, which is now running out. Longer work schedules and robust productivity growth can sustain the economic recovery for a while but at some point, we are going to need to get a pick-up in jobs.

Business capex accounted for 15% of the growth in the past year, punching above its weight of only 7% of the overall economy. But business confidence is falling and

businesses are reluctant to rehire workers until their order books fill up, which requires a rebound in consumption. So we are in the midst of a negative feedback loop.

There is no alternative but for the Fed to become even more accommodative through additional quantitative easing and for the federal government to engage in another round of fiscal stimulus. Politically, the battles will continue, but this latest jobs report will likely push the Republicans into agreeing to federal measures to assist further the suffering state and local governments. Since the start of this year alone, state and local governments have reduced their workforces by 169,000, or nearly 1%. Further layoffs can be expected, even with the \$26 billion in extra state aid passed by the Senate yesterday.

**No tax increases should be considered even on the rich and especially not on capital gains and dividends.**

Budget deficits are a second-order problem, exacerbated by the continued long-duration joblessness. Longer-term, it is my view that the U.S. will be forced to: introduce a value-added tax (VAT, similar to the GST), increase the retirement age for maximum Social Security benefits, increase the income-threshold upon which Social Security premiums are paid, and address the excesses of Medicare for the terminally ill. In the short-term, however, the Congress and the White House have no choice but to take actions that will boost employment and mitigate the burden of the unemployed.

The situation is truly dire, with a record number of Americans receiving food stamp benefits. **The Senate voted earlier this month to cut \$12 billion from the food stamp budget in order to help fund the \$26 billion package to help states avoid teacher layoffs.** As of May, a record 40.8 million Americans received federal aid through the Supplemental Nutrition Assistance Program (commonly known as food stamps). According to U.S. Department of Agriculture figures, the number of people on the food stamp rolls has been growing to record levels for 18 straight months. Nearly \$5.5 billion in aid went out to beneficiaries in May alone. The number of May recipients marked a 19% increase from a year ago. Reductions in enrollment typically lag behind changes in the unemployment rate. Many of the new recipients are unemployed and have never relied on food stamps before. Cuts in the program are devastating to the millions of now-indigent family recipients.

Given this very sad situation, this is no time for the Congress to be cutting government social spending, especially because the hiring drought might last an extended period.

**Emergency actions will be taken in Washington, expect fiscal stimulus.**

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