

# Testimony to the Senate Budget Committee on the U.S. Economic Outlook

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I wish to thank Chairman Conrad and Ranking Member Sessions as well as the other members of the Committee for inviting me to talk about the U.S. Economic Outlook. I want to make clear that my opinions today are solely my own and should not be construed as reflecting the position of my employer, the American Action Forum.

I would like to state at the outset that I am not an economic forecaster, and have successfully avoided doing such activities for all but a small portion of my career. However, I have had reason to use economic forecasts throughout my career as an economist in the Treasury, the Office of Management and Budget, and for the U.S. Congress, among other positions, and have given copious consideration to the strengths and weaknesses of forecasts in general as well as in how they are used by politicians.

## **The Problem with Economic Forecasts**

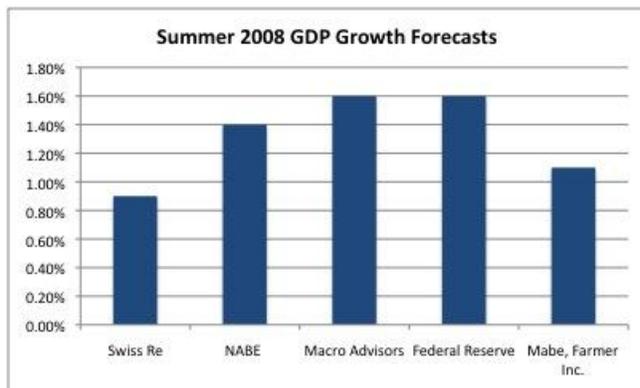
Before I opine on the U.S. economic outlook I'd like to begin by suggesting that most people put too much stock in the forecasts of economists. While some have compared the predictions of economic forecasters to those of meteorologists, to do so does the science of climatology a great disservice. Weather forecasts have improved considerably in the last three decades, thanks to improvements in data, advances in the understanding of their science, and the seismic increases in computing power available today. One meteorologist observed that today's forecast five days out is as reliable today as their two day forecast was just a generation ago.

There has been no such improvement in economic forecasts, despite improvements in data and in computing power available in our profession. I'll leave unexplained but implied the weak link that has hindered progress in economic forecasting. In general, economists are good at forecasting what the economy will be like in the future when there is no reason to think that any significant economic change will impact the economy: in such an absence forecasters generally conclude that the next quarter will be much like this quarter, and the quarter after that will trend towards our long-run equilibrium growth rate, and the quarter after that will probably be *at* the equilibrium growth rate, which is the same thing as saying "we have no idea what will happen that far in the future but if you have to guess, we'll guess the long-run average and be, on average, correct." This isn't science: it is mere extrapolation.

Figure 1 shows how poor the profession is at forecasting future growth when the economy is at a turning point. In the first and second quarter of 2008, at the precipice of the biggest post-war recession to befall the U.S. economy, none of the major entities that model the U.S. economy anticipated a

recession. By pointing out their amazing lack of perspicacity I do not mean to denigrate the competence of the Fed, Macro advisors, NABE, or anyone else, only to suggest that asking economists to come up with an accurate picture of the economy more than a few months into the future is a fool's errand, and we should take such forecasts with a grain of salt.

**Figure 1:**



And just as it is beyond the ability of mere economists to forecast the ups and downs of the economy past the immediate future, it is also beyond the ken to forecast how any government stimulus might affect the economy as well. In part it is because stimulus always comes at a turning point in the economy, where the usual formula of forecasting (doing a convex combination of last quarter's growth and long run trend) makes little sense.

The other problem is that I believe that fiscal stimulus is rarely effective at stimulating the economy. Keynesian economists who place credence in the ability of government to manage a business cycle insist that stimulus spending must be targeted and timely, and I submit that this does not in any way describe the 2009 stimulus program. I won't bore the Committee with a litany of examples where stimulus spending prescribed in the stimulus took years to get off the ground—but they are legion, from the home weatherization programs that waited over 18 months for the government to determine the appropriate prevailing wages<sup>1</sup> to a remodeling of a government building that began by evicting every ground floor retail tenant and nearly two years later has yet to begin remodeling.<sup>2</sup> Even this president has acknowledged that the definition of "shovel-ready" in the government does not, in fact, mean shovel-ready.

Even if the government were able to produce targeted and timely fiscal stimulus, I do not believe it would, in fact, have much of an impact on our macro economy. As I have explained elsewhere, most macroeconomists dismiss its impact, based on a perception of the world and the macroeconomy that is at odds with reality. In 2009 I wrote that:

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<sup>1</sup> Jonathan Karl: "Stimulus Weatherization Program Bogged down by Red Tape." [ABC News](#), February 17<sup>th</sup>, 2010.

<sup>2</sup> Ike Brannon: "What Happened to Loeb's Deli?" [Weekly Standard](#), March 14<sup>th</sup> 2011.

*It is difficult to find a macroeconomics textbook these days that discusses Keynesian fiscal stimulus as a policy tool without serious flaws, which is why the current \$800-billion proposal has taken many macroeconomists by surprise. John Cochrane of the University of Chicago recently noted that the idea of fiscal stimulus is "taught only for its fallacies" in university courses these days. Thomas Sargent of New York University noted that "the calculations that I have seen supporting the stimulus package are back-of-the-envelope ones that ignore what we have learned in the last 60 years of macroeconomic research."<sup>3</sup>*

The problem, in short, is that responsible economic actors observing an endless string of trillion dollar deficits should rationally expect future tax increases as necessary to reduce these deficits. Putting more money in people's hands via government borrowing will result in much of that money being set aside to pay for future tax increases without any concomitant increase in aggregate demand, a concept economists call Ricardian Equivalence.

I think that harm has been done to our economy via the urgency to propagate some sort of massive stimulus program in 2009 and the multiple attempts to add stimulus of various sorts since then. Ryan Lizza documents in his recent article in the *New Yorker* that even the Administration recognized how difficult it was to effectively spend the amount of money they allocated in a way that would actually achieve anything useful—but political expediency and the desire for a nice, round number to sell won out over efficacy and frugality.<sup>4</sup> As a result, much of the policy focus has ignored the factors that can contribute to long-run economic growth, which is something that our government *can* do something about—but hasn't, at least over the past few years.

## **My Prognostication**

I would like to offer a few thoughts on where the U.S. economy might be expected to go in 2012 but more importantly I would like to lay out the pitfalls that might slow or stop this disappointingly slow economic expansion.

First, while the topic *du jour* of the economic press seems to be that the U.S. economy may go through a further deterioration of the Euro crisis unscathed, the result of a more tightly integrated global economy is not decoupling. In fact, the opposite is occurring: As financial markets (and major players) become more global in scope, it means that we should expect a greater synchronicity between the various economies of the world.

As a result, to some degree it doesn't matter whether the banks and financial institutions of the United States have labored to insulate themselves from any fallout from a possible collapse of

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<sup>3</sup> Ike Brannon and Chris Edwards: "The Troubling Return of Keynesianism." *Cato Tax and Budget Bulletin*, January 2009.

<sup>4</sup> Ryan Lizza: "The Obama Memos: The Making of a Post-Partisan Presidency." *The New Yorker*, January 30 2012.

Greece, Italy, Spain, or the overall Euro-zone economy. Some of them have—despite pretences to the contrary--significant exposure to Europe and will take a hit if the Euro crisis deteriorates, but the fact that the market fears that there is significant U.S. exposure means that such an event will impact our economy regardless of the balance sheet of banks. We too have unsustainable deficits and a lack of political will to address them: It is hard to see why investors frightened of sovereign default risk would leave Euroland for the U.S.

An unraveling of the Greek debt crisis that leads to a contraction of the Euro would more likely trigger a contagion effect, dampening U.S. investment and consumption, as U.S. households hunker down in fear of another round of job losses, absence of raises, and general economic malaise.

There are other downside short-term risks to the U.S. economy: Middle East unrest from either a belligerent Iran or a destabilized Iraq could shoot up global energy prices, as would further instability in Nigeria or a messy aftermath of the Chavez reign, should he perish and descend to Hell.

And I am not sure the U.S. economy is in a spot where it can easily absorb a series of external shocks and continue unscathed. The overhang from the housing crisis continues to be a serious drag on the economy and I do not see that changing in the near future. To have nearly one in four homeowners underwater on their mortgages has created a problem not just for those homeowners but for their communities and the banks. Unemployed workers are more reluctant to move to where there are jobs, banks are more hesitant to lend, and few new homes are being built. I've advocated a fairly radical solution of allowing for a mortgage cramdown in the context of a chapter 13 bankruptcy elsewhere,<sup>5</sup> and I believe that without some sort of radical solution, our economy will at best muddle along at something close to our long-run average, which is not enough to make a dent in our inventory of unemployed workers.

The biggest problem with economic policy in the last few years is that the government has become too involved in the game. Businesses fear the flood of new regulations that the current administration has unleashed; there has been no serious effort to reform a seriously broken tax system, one in which a plethora of important provisions need to be renewed each year, leading to incredible uncertainty; and the one positive economic boon for our economy of late—the dramatic rise in domestic production of oil and gas—has been occurring in spite of opposition from a Democratic Congress and EPA, not because of it.

## **We Need a Better Umpire**

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<sup>5</sup> "A Cure for the Housing Blues," [The Weekly Standard](#), November 7<sup>th</sup>, 2011.

Brett Butler was an all-star outfielder for the Braves and Dodgers in the 1990s and had a successful career that stretched over fifteen years. On the eve of his last game he was asked by reporters how the league had changed since he had first been promoted to the Major Leagues. He said—with not a bit of frustration—that earlier in his career he spent most of his preparation time studying the tendencies and abilities of the pitchers he was to face in the next game. However, the last few years in the league he felt the need to devote more and more time studying the predilections of the home plate umpire assigned to the game that night. The complete lack of standardization in the strike zone across leagues—and umpires—made the job of a hitter all the more difficult, and it took complaints from respected players like Brett Butler and others for MLB officials to finally do something about it.

Today, I submit that our economy has reached the same precipice as Major League Baseball did fifteen years ago. The legion of businesses who need to plan for the future find themselves more preoccupied with trying to discern what the government might do in tax and regulatory policy rather than focus on how to attract new business or provide their products more efficiently. Questions as to whether the aggressive regulatory agenda will continue through the election, the resolution of the expiration of the various tax cuts come 2013, or whether EPA will succeed in its efforts to rein in hydraulic fracturing and the construction of future coal plants weigh heavily not just on how forecasters view the economy but on how millions of businesses make future plans. And the uncertainty the government has injected into the economy makes that task all the more difficult.