Angell Economics
Telephone 703 528 3686
E-mail: wangell@comcast.net

TESTIMONY BEFORE THE SUBCOMMITTEE ON ECONOMIC POLICY OF THE SENATE BANKING COMMITTEE

By

Wayne D. Angell

May 22, 2003

Mr. Chairman and members of the sub-committee, thank you for the opportunity to testify today on the subject of the use of economic policy to speed up economic growth in an economy that has been mired too long in recession. This is a very welcome opportunity to address the particular difficulties faced by an economy in the throes of a capital goods cycle beset by risks of deflation. Half way measures are handicapped at the outset by a tendency to underestimate the lingering power of previous episodes of restraint. Both monetary policy and fiscal policy are likely to be deemed to be stimulative or accommodative even while policy continues to retard economic growth. If policy had been accommodative then economic performance would not long be regarded as a problem.

We would not be hearing warnings about the risk of deflation if monetary policy had not been less accommodative than reported. We would not be beset by such a rapid and prolonged decline in equilibrium interest rates if fiscal policy had switched from restraint to stimulation. This problem is so severe that at the outset we need to define *fiscal stimulus* as a fiscal policy that would produce a Federal budget deficit even when labor and capital goods resources are fully employed. The current Federal budget deficit is not stimulative as the deficit only exists due to the reduction of tax receipts forthcoming from an economy seriously underutilizing its precious resources.

First, a question arises as to whether or not an economic policy response would be an efficient remedy to the current recession. But, before we get to that question let's take a look at what incoming data are telling us about this downturn

1. This is the longest employment recession since the 1930's. Non-farm payroll employment has declined in 24 of the last 25 months to bring April employment as a percent of peak employment to the lowest level of the recession. Chart 1 compares the slow and persistent decline in employment in this cycle as a percent of the peak employment to the steeper yet shorter decline in the 1981-1982 recession.
2. Labor markets continue to be weak as business managers are able to reduce labor costs by capital investments and restructuring—labor productivity has continued to post sizable gains. Weekly unemployment claims show no sign that this employment recession has ended.
3. Although long in duration the decline in employment has been only 60 percent as deep and the decline in output only 70 percent as deep as in the 1981-1982 recession. See Chart 2.
4. This is a capital goods downturn rather than a typical inventory cycle. As depicted in Chart 3 the total index of industrial production has declined, so far, only 6.7 percent from its April 2003 peak whereas the index of business

equipment production stands 18.5 percent below the peak month—indeed this is a capital goods cycle.

5. Six months after the March 2001 employment peak economic activity was hammered by the September 11 terrorist attacks on the World Trade Center and the Pentagon. Recovery from the terrorist event gave a false impression of economic recovery.
6. Another misleading indicator of economic recovery emerged in 2002 as solid gains in labor productivity enabled output to expand while employment and hours worked declined.

Second, it is important to have a clear understanding as to how the 1991-2000 expansion came to an end. Was it simply that we had an unprecedented coincidence of bad events such as Y2K and an over-exuberant stock market or was there an economic policy failure that was decisive?

1. Sometimes the makers of economic policy become convinced that the best way to avoid an unwelcome event is to engage decisively in a new economic plan. That is exactly what happened in the late 1990s when voices of alarm predicted that a low saving rate in the United States would result in an unsustainable increase in imports in excess of exports until our indebtedness to the rest of the world would produce a global economic collapse. **The chosen remedy was to pursue a large enough Federal budget surplus to offset deficient private sector saving.**

2. In the four quarters to the second quarter of 2000 individual income tax payments to the IRS rose exactly twice as fast as the growth rate of personal income: 11.4 versus 5.7 percent.
3. The engine that had been driving our prosperity was an unprecedented capital goods boom that matched up with an unprecedented surge in capital goods technology. Disposable personal income took such a hit from the 11.4 percent increase in individual income tax payments that there was simply not a sufficient increase in disposable income to enable households to buy what had been produced.
4. In the turning point year 2000 a second, third and fourth quarter slowdown in the growth of personal consumption expenditure coincided with such a high rate of increase in capital goods capacity that the return on capital goods plummeted. While interest rates on real capital were plunging in the second half of 2000, FOMC action in lowering the target Fed funds rate was not begun until January 3, 2001. Even though the January 3rd cut in the target Fed funds rate was followed by an unprecedented volley of rate cuts through the year 2001, it was not sufficient to have avoided an employment recession. But, without the FOMC action results would have been worse.
5. Although a tax rate cut was proposed by President Bush in early 2001, its enactment came in a compromise form that distributed non-incentive tax rebates in the third and fourth quarters of 2001 and implemented a phased in tax rate reduction in fiscal years 2002, 2004 and 2006.

6. Even though the monetary policy and tax rate policy response was far from ideal, it seem appropriate to credit the FOMC and the Congress for alleviating the rate of decline in employment and output. The half scale tax remedy did not prevent a recession, but it cushioned the recession's rate of decline.

Third, let's consider some facts to be learned about deficits and debt from a review of the data from the Federal Reserves Flow of Funds statistical base:

1. Economic growth in current dollars ($GDP) averaged 5.0 percent from 1991 to 2002 matching the growth of total sector borrowing as a percent of total sector debt which averaged 5.2 percent by an arithmetic mean and by 5.1 percent by a median. Total sector borrowing rates during these 12 years is considerably lower than the 7.8 percent average for 37 years from 1965 to 2002—a lower inflation rate reduces the rate of growth of debt necessary to sustain an expansion. Think how much worse this decline would have been if we had entered the recession with a 12 percent rate of inflation.
2. When Federal borrowing as a percent of Federal debt actually declined at a 3 percent annual rate as it did from 1998 to 2001 then borrowing from non-Federal sectors must necessarily have increased enough to make up for negative Federal borrowing contribution. Household borrowing as a percent of household debt increased to a 7.7 percent rate up from the 12 year average of 6.8 percent. And business borrowing surged from its 12 year average as a percent of business debt from 5.1 to 8.8 percent.

3. But, the problem with requiring a surge in household borrowing and business borrowing to offset a decline in Federal borrowing is that households and businesses are not able to sustain such a high increase in borrowing as a percent of debt. The result was not only a 2002 slowdown in business borrowing as a percent of business debt to 2.8 percent, but also a slowdown in total borrowing to a level insufficient to maintain an expansion of output. Give credit to the FOMC for providing sufficient liquidity to enable the price of houses and condominiums to continue to move somewhat higher and thereby provide a sufficient level of equity extraction to enable households to continue a spending pace sufficient to keep output growth positive.

Fourth, is the stimulus of Federal borrowing offset by a crowding out effect on private borrowing? Or, put another way, does an increase in Federal borrowing put upward pressure on interest rates?

1. The answer to the first question is “No.” Crowding out occurs only when government expenditures require resources in competition with the production of private sector goods. A reduction in tax rates increases incentives to invest and to produce by leaving buying power in the private sector. There is no crowding out.
2. The answer to the second question is “Yes.” But, it is a far different matter to push the natural rate of interest up to 1 percent than to push it up to 10 percent. The problem today is that interest rates are too low to provide a meaningful

reward for saving and too low to provide an adequate safe fixed income for people facing retirement or currently retired.

3. There is not likely to be any crowding out effect from tax rate reductions. For example in the 1981-82 recession a tax rate cut worked to create jobs without any crowding out effect as the average monthly employment gain was 367,000 per month in the 22^{nd}, 23^{rd}, and 24^{th} months after the July 1981 peak in employment. In contrast, the average monthly employment **change** was minus 87,000 per month in the 22^{nd}, 23^{rd}, and 24^{th} months after the March 2001 peak in employment. If economic policy should be geared toward an increase in employment then the 1981-82 model warrants emulation.
4. Given that the FOMC has now recognized that the risk of deflation exceeds the risk of inflation, interest rates are more likely to remain too low for several years. It is a time to understand that economies besieged by a disinflation to deflation risk are likely to be in a low interest rate environment for many years to come. The only likely escape is through the incentives of tax rate reduction.

Fifth, is monetary policy likely to work in a deflationary environment?

1. Monetary policy always works as long as the target variable chosen is countercyclical. The FOMC has the choice of selecting one of three target variables: a target Fed funds rate, a target growth of reserve bank credit or a target price level. Any one of these target variables could work to counter deflation.

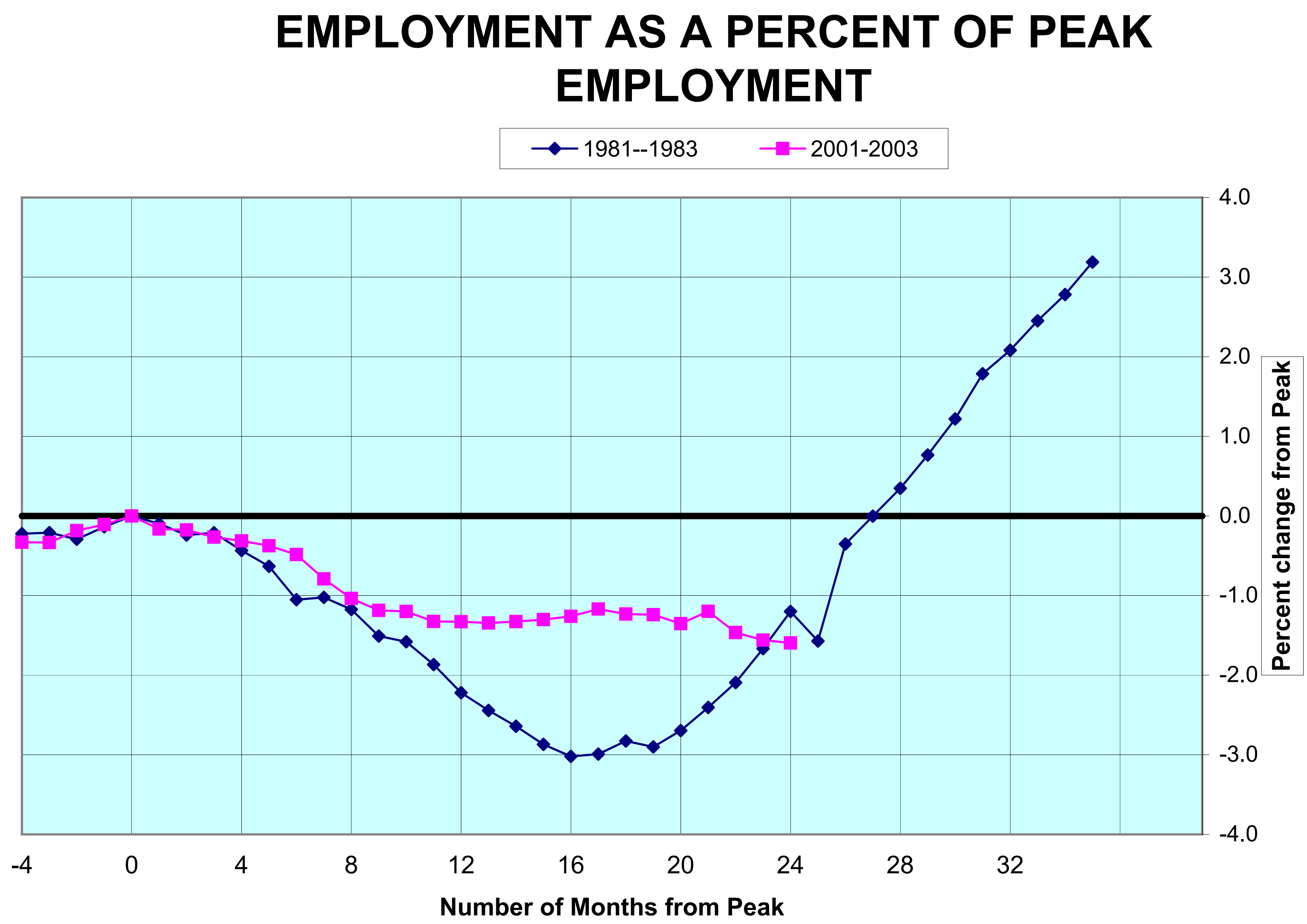
2. The FOMC has chosen to target the Fed funds rate as a way to measure out the amount of monetary liquidity additions and subtractions. Consequently, I will confine my focus to selecting a target Fed funds rate that is likely to increase the growth rate of real economic output to a level sufficient to stimulate employment growth. The problem with monetary policy in long cycle periods is not that monetary policy runs out of ammunition, but that the monetary authority quite often misjudges the degree of economic restraint contained within a chosen target Fed funds rate.
3. Persistent economic growth rates below the growth rate of the labor force and the growth rate of capital goods capacity is a clear indication that the chosen target Fed funds rate has been too high to accommodate the money hoarding preference of households and business. Selecting a lower target Fed funds rate will require an increased injection of monetary liquidity into the banking system.
4. A reduction of the target Fed funds rate from 1.25 to 0.75 percent would require a significant injection of liquidity to bring a supply of liquidity consistent with a 0.75 percent rate. It is monetary nonsense to argue that "quantitative easing" can provide more liquidity at the existing Fed funds rate. Any increase in the supply of reserves would result in a lower Fed funds rate. As long as the Fed funds rate is positive the FOMC is likely to want to measure its quantitative easing by the extent of the change in the Fed funds rate.

Sixth, could monetary policy restore the desired price level and thus the desired economic growth rate without changing tax rates?

1. The pragmatic answer is “not likely” in a capital goods contraction as compared to a recession driven by an inventory correction. A persistent failure of the price level and the growth of output and employment to respond to significant cuts in the target Fed funds rate is evidence of fiscal restraint. Whereas inventory recessions tend to be followed by a motive to increase production more than the increase in sales, in order to reverse previous inventory rundowns, capital goods recessions are not prone to such a predictable end. After a labor market has passed the “soft market” stage to a stage where labor market uncertainty has a cumulative depressing effect on “life time income perceptions” then monetary easing alone is likely to be transmitted only through disruption of global exchange rates.
2. My advice is to choose a tax rate reduction that is likely to increase the expected economic growth rate of the United States sufficient to keep the dollar strong and stable. Monetary policy alone runs a danger of providing “beggar thy neighbor” remedy to domestic deflation. In other words, the more than moderate 2003 decline in the exchange value of the U. S. dollar against the Euro is likely to have simply transferred deflationary pressures from the United States to Europe and Japan. That is less than acceptable economic policy leadership.

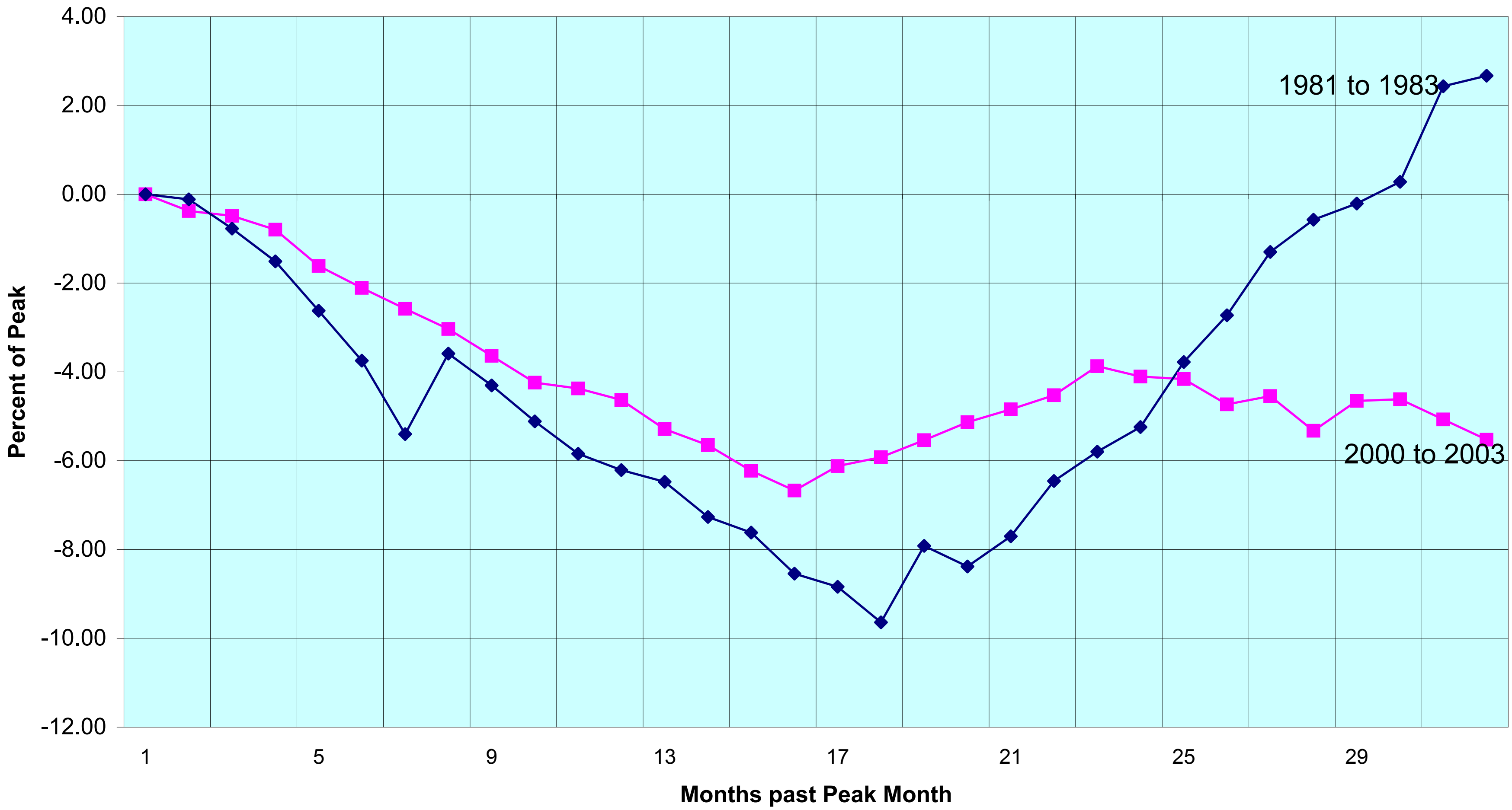
Seventh, what tax rate proposal do I favor?

1. The elimination of the double taxation of corporate income paid out in dividends is far better than any other proposal as it reduces our highest effective tax rates.
2. There is more bang for the buck in eliminating double taxation as no other proposal will make common stock ownership so much more attractive. Not only does it eliminate the pernicious double taxation but it is likely to have the greatest effect in modifying corporate executive branch behavior to perfectly align the CEO's interest with shareholder interest. Why would top management wish to distribute the fruits of their labor in any other way than in paying dividends.
3. The exclusion of qualified income from taxation will first increase the dividend payout ratio then it will alter the choice of employed workers to reduce the amount of income deferred from taxation into company retirement plans in favor of direct stock ownership. And for retired workers it will encourage withdrawing funds from retirement programs, paying the income tax, and then securing tax free income. I am convinced that Federal tax receipts would increase between 2004 and 2010 as a result of the elimination of double taxation.
4. Although it seems the Congress may choose a combination tax rate of 15 percent for both dividends and capital gains, I continue to prefer the original model presented by the President as it is much more likely to provide the surge in common stock values. We have never moved from recession to recovery without first seeing a new bull market in common stocks.
5. Reducing maximum non-corporate business tax rates to the 35 percent corporate rate is essential to provide an optimum increase in jobs for American workers.

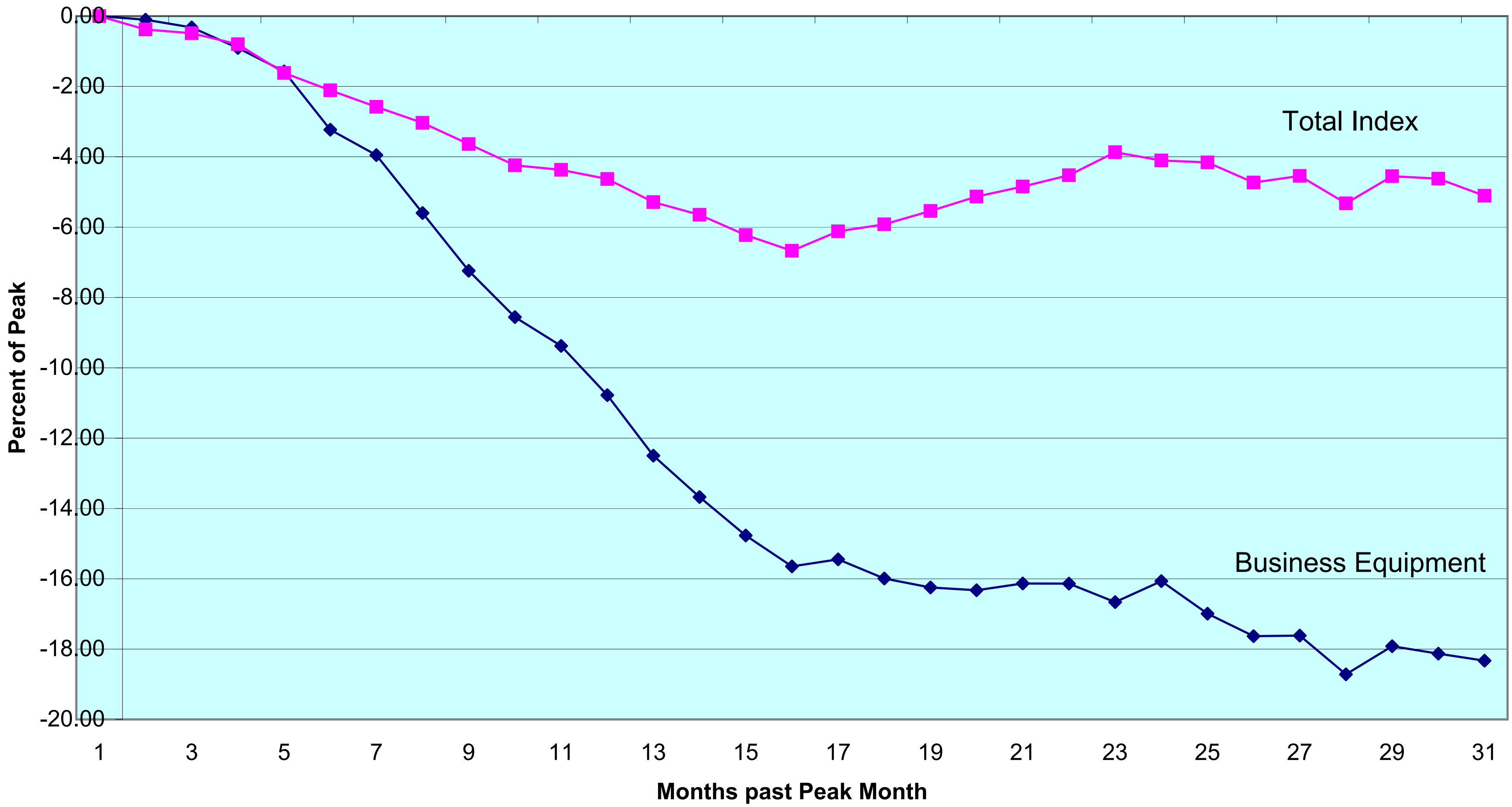


EMPLOYMENT AS A PERCENT OF PEAK EMPLOYMENT
1981--1983
2001-2003
4.0
3.0
2.0
1.0
0.0
-1.0
-2.0
-3.0
-4.0
Percent change from Peak
-4
0
4
8
12
16
20
24
28
32
Number of Months from Peak

INDUSTRIAL PRODUCTION 2000 to 2003 CYCLE COMPARED TO 1981 to 1983 CYCLE



INDUSTRIAL PRODUCTION 2000 to 2003 CYCLE



INDUSTRIAL PRODUCTION 2000 to 2003 CYCLE