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HPS**insight**

THE PATH FORWARD
Policy Options

Executive Summary

In the context of the deleveraging challenge we described in our last report, there are a few high-level policy options that have been tried or could be enacted in some combination to help short circuit this economic vicious circle:

- Monetary policy designed to elevate inflation above the Fed's traditional target would devalue debt (and savings) and deleverage households faster.

- Fiscal stimulus in different forms (e.g., tax cuts, transfer payments, public works projects) could raise incomes either directly or indirectly helping the deleveraging process.

- Fiscal support for workouts for debtors in the form of things like mortgage adjustments could likewise speed the deleveraging process.

- Policy shifts could incrementally improve growth prospects through such changes as regulatory reform, tax reform or free trade agreements.

- If policy-makers believe the medicine is worse than the disease, it makes sense to simply wait for the current deleveraging process to run its course.

Without being directly prescriptive, we have tried to lay out in the following pages an overview of these options and the pros and cons that come with each.

Introduction

We are three years into an historic economic slump and no policy out of Washington during that time has successfully addressed the full extent of the problem. Whatever the impact has been (positive or negative) from the extraordinary efforts of the Federal Reserve, the President's stimulus, and various other actions, it is undeniable to say that despite all the good-faith efforts, our economic challenges continue.

This report is the second in a series of three intended to jumpstart a discussion of the economic policy path forward in conjunction with the return of Congress from summer recess, the President's joint address to Congress on the economy and the first meeting of the Joint Select Committee on Deficit Reduction.

In the first report, we worked to outline in a digestible form a view of the major cause of our extended economic slump. In this report, we look at the major policy choices that exist to address our current problems. In the final report, we will outline a potential political path toward real action on the economy.

This report has been prepared independently by Hamilton Place Strategies with the invaluable efforts of Ashley Smith and Russell Grote. No third party funded this work and our conclusions are our own. The analysis here has been conducted simply to further a public dialogue on the political and economic choices facing the country.

Hamilton Place Strategies

Matt McDonald
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Policy responses

Policymakers have three basic tools at their disposal to potentially spark stronger growth: monetary expansion, fiscal stimulus, and policy changes, which can be adopted in isolation or in concert. All three options address elements of the crisis; however, each policy targets the economy in different ways and carries different risks and uncertainties. Given these risks and uncertainties, policymakers also have a fourth option. They can create policy certainty by waiting for the slump and the deleveraging process to run its course. (See Exhibit 1)

Exhibit 1

POLICYMAKERS HAVE FOUR POTENTIAL COURSES OF ACTION TO TAKE

Levers	Policy Tools	Pros and Cons
Monetary Policy	Allow inflation through traditional or unconventional monetary policy measures (e.g., price target)	• Reduces debt burden through increase in nominal incomes and devaluation of debt • Lowers real interest rates, spurring investment • Risks run-away inflation
Fiscal Policy	Direct spending (e.g., public works project) Tax cuts to increase personal income Subsidized workouts for debtors (e.g., home, student and/or auto loans)	• Can have direct impact on incomes • Increases short-term deficits • Potential for spending to be wasteful, delayed or distortionary
Regulatory Policy	Approval of free trade deals Regulatory reform Other	• Often positive and commonsense, but incremental changes • Will have little short-term impact
Wait	Freeze new policy – wait for the market to deleverage	• Avoids market distortions, inflation, large deficits • Increases likelihood that extended cyclical unemployment will become structural and reduce future growth • Risks deflation

Monetary policy

The Federal Reserve can take both conventional and unconventional steps to increase the money supply and inflation to aid the deleveraging process. The Federal Reserve has already adopted traditional steps as the Fed Funds rate has been close to zero since late 2008 and will remain low for two more years. While these steps have reduced the concern for deflation, core inflation (excluding energy and food) remains low. To raise inflation the Fed could adopt more unconventional policies such as another round of quantitative easing, a nominal gross domestic product target, a price level target, and a negative rate of interest on reserves.

These policies could boost inflation, which would directly address the issues of household debt levels and reduced spending. Since debts are owed in fixed nominal dollars, inflation could increase incomes relative to debt, easing debt burdens for households. This process is often called "inflating away the debt." Moreover, inflation increases the cost of holding money. Consequently, an extended period of increased inflation would incent cash holding institutions and individuals to spend and invest. More specifically, negative interest on reserves would encourage banks to convert excess balances into loans or other productive assets. An extended period of inflation would require no federal deficit spending and could reduce the real federal debt burden. However, there are downsides and uncertainties.

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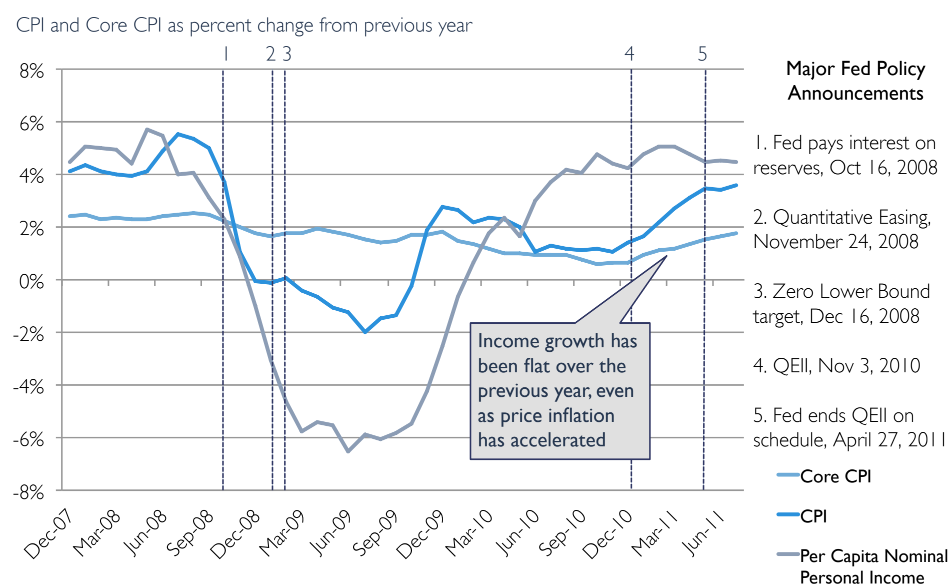
Inflation eases debt burdens, but also erodes savings punishing financially responsible individuals. Moreover, by raising all consumer prices, inflation erodes the value of retirement savings. Beyond these downsides, there are considerable uncertainties that make such policy difficult to enact.

Exhibit 2

INFLATION AND PERSONAL INCOME



Source: BEA, BLS data

The Fed may not actually be able to control the level of inflation or even raise inflation much at all without extraordinary measures, as the experience of the Bank of Japan attests. Moreover, 3% inflation may seem innocuous, but price increases could be concentrated in certain sectors, or trigger commodity hoarding. Over the past year, the growth rate of per capita personal income has been flat. At the same time, we have seen spikes in inflation in places like energy (price increase of 13% since QEII), which has been outpacing the rate of income growth. Depending on where inflation appears, it can be detrimental to the deleveraging process and recovery, as households have to commit more disposable income to things like gas and have less free cash flow to reduce debts.

The final and perhaps greatest danger is that the Fed risks losing its credibility if inflation does take off. And in the long-run, a Fed without credibility will be less able to stabilize the macro economy without a dramatic increase in interest rates.

Fiscal policy

Policymakers can also enact fiscal stimulus in several forms: direct spending by the government (e.g., infrastructure projects), tax cuts to increase incomes, and more targeted workouts that directly address debt levels.

Direct fiscal stimulus was passed in 2009 with the American Reinvestment and Recovery Act (the Obama stimulus). The federal government borrowed money to finance tax cuts, transfer payments to households and state governments, and direct spending. Government can provide income support to households and make capital purchases (like a road construction contract) to create jobs, both of which help the deleveraging process.

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There are two challenges with this approach. The first is that especially in the case of direct spending, it is very difficult to spend money in the short time frame it is needed. President Obama observed this himself when he quipped that, "Shovel-ready was not as shovel-ready as we expected." It never is. Think about the early process that would go into proposed construction projects: design, environmental review, public comment period, bidding, etc. It can easily take months or years before a shovel hits the ground, depending on the complexity and sensitivity of the project. The benefit of such projects is that they can theoretically improve economic capacity in the future.

Tax cuts, by contrast, are usually felt more immediately in the economy, and can change consumer or business behavior quickly, depending on the duration of the cuts. One-off rebates, transfer payments, or time-limited tax cuts will have less of an impact on behavior than durable change that fundamentally changes the tax code.

A challenge of fiscal stimulus is the increase in government deficits, causing two distinct problems. First, increased federal debt could cause market concern. Interest rates could increase, stifling investment and increasing the debt burden. This concern has not yet been seen in the current environment. Second, a deficit-financed tax cut may not encourage more investment, spending or borrowing by individuals because any spending in the present will be paid for in future taxes. Consequently, expectations of future tax increases could mute any behavioral change. Again, this effect may be larger with short-term tax cuts that will expire.

Beyond this, both tax cuts and direct spending also fall short in their lack of targeting of those individuals who are actually severely overleveraged. Some of the spending here will benefit people who do not need the help. More targeted workouts for debtors could directly address debt burdens with comparatively less impact on the federal deficit. Examples of this type of program would be allowing those underwater in their homes to refinance, creating payment plans for those who fall behind on mortgage payments or allowing student loan debt to be refinanced.

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The Obama administration already established the Home Affordable Modification Program (HAMP). HAMP provided creditors financial incentives to reduce debt burdens on homeowners to avoid foreclosure. Similar workouts for debtors could boost the housing market, which has remained stagnant. Unfortunately, experience with HAMP shows the difficulties in designing a successful mortgage debt workout.

The design of these types of programs can be difficult as many factors affect creditors' decision to foreclose or offer modifications. HAMP 'nudged' creditors by offering them financial incentives to cut interest rates, extend loan periods, and possibly reduce the principal of debt. However, the incentives provided were simply not adequate to alter the overall decision of creditors. In some circumstances, the reduction in payments was not enough to avoid default. Unfortunately, HAMP was not the only program to fail. Since 2007, Congress, the FDIC, the Federal Reserve and the GSE's have all attempted loan modification schemes. All efforts have been seen as unsuccessful. More aggressively structured workouts could theoretically succeed but the design of these programs is quite difficult, especially in light of concerns over "moral hazard" and rewarding bad behavior.

In general, housing programs to date have focused on cash flow difficulties without addressing the balance sheet problems. For example, the problem facing a homeowner with a $300,000 mortgage on a home with a market value of $150,000 – not an uncommon situation in the hardest hit metro areas – is not the interest rate. It's the fact that the debt burden is worth twice as much as the house. A preferred option to refinancing in this case may simply be a debt forgiveness program.

As we look at the fiscal policy options available and the recent stimulus proposal by the President, we see a comparative dependence on direct spending and tax cuts. (See Exhibit 3) Of the three major policy tools that we outlined above, major components of the package are simply an extension or adjustment of current policy (i.e., the payroll tax cut, unemployment insurance), rather than actual new stimulus. Additionally, the specific language on housing debt workouts simply advocates making the current program work and figures as a limited part of the package.

Exhibit 3

THE SECOND OBAMA STIMULUS RELIES ON DIRECT SPENDING AND TAX CUTS

	Cost	Proposals	Challenges
Direct spending	$140B	• State subsidies for teachers and first responders ($65B) • Infrastructure spending ($60B) • School renovation ($30B) • Vacant property rehab ($15B)	• It is unclear what states would otherwise do, absent these federal funds • Infrastructure spending comes with project planning processes that will likely delay the impact
Tax cuts	$245B	• Extend the current employee payroll tax cut another year ($175B) • Cut employer payroll and other taxes ($70B)	• The payroll tax cut is actually a continuation of current policy, rather than "new" stimulus • Employers make hiring decisions based on demand and cost of labor; a small one year drop in labor cost will have incremental impact on jobs
Subsidized workouts	$0	• The proposal contained no new initiatives to address housing or indebtedness specifically	• This second stimulus largely ignores the most troubled sector of the economy, and poorly targets the current high levels of debt
Other	$62B	• Unemployment insurance ($49B) • Tax incentives for hiring unemployed ($8B) • Worker training ($5B)	• Unemployment insurance can have the unintended consequence of lengthening the period of unemployment by making people more selective in work

The result is a package that may incrementally benefit the economy over the coming year, but is not really targeted at the core problems that have made the current economic slump so enduring. Like the previous stimulus, this one, if passed, will likely help keep the economy afloat while the deleveraging process runs its course. It does little to speed the deleveraging process itself.

Policy changes

Structural reforms such as loosening of unnecessary regulation, free trade agreements and revenue-neutral tax reform can also help combat our current slump at the margins, and can help lay the basis for long term growth. Regulatory reform could help cut needless red tape to improve the general business environment. The completion of the free trade deals with South Korea, Panama and Colombia could spur efficiencies and economic growth. Tax reform could help reduce the compliance burden for both businesses and individuals and eliminate economic distortions that slow long-run growth..

These three would all have a positive impact on the economy, as would hundreds of other incremental reforms like them. While these three measures would increase growth in the long run, they have little immediate effect compared to the scope of the problem we face.

Waiting

The three options discussed above are levers policymakers have to combat the crisis. However, given the risks and uncertainties of the policies we have outlined, waiting is also an option. Waiting for the stagnation to run its course has a number of advantages. On the monetary side, inflation would be avoided. Fiscally, the federal government would be less in debt. And on both sides, market distortions would be avoided allowing for the market to reallocate resources with less government involvement.

However, without policy action, the slump could extend for several years causing significant suffering for American families. While economists differentiate between structural and cyclical unemployment, long-term cyclical unemployment can become structural unemployment as workers lose skills, lose motivation and grow old. A higher level of structural unemployment would require increased government spending and would reduce capacity for economic growth in the future. Deflationary effects could return as well, aggravating the deleveraging process as individuals wait for prices to fall to spend and invest.

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Political challenges to policy

In sum, given the unprecedented nature of the stagnation, all policy options carry uncertainty and risk. However, possible action or even discussion over what should be done to combat our economic malaise has been rendered politically irrelevant in the face of gridlock over future expenditures and tax revenues. Most near-term solutions to help the economy will cost money, and given historically high levels of debt, there is little political appetite to increase spending. Washington must find a long-term solution to the debt crisis in order to open political space to act (or not act) in the short-run to address the economic crisis. We will look at a potential political path forward in our last report in this series.

About Hamilton Place Strategies

Hamilton Place Strategies is a policy and communications consulting firm based in Washington. As a firm, our focus and expertise lie at the intersection of government, business and media. Our deep experiences on all of these dimensions allow us to serve industry leaders seeking to navigate the paths between Washington and the private sector.

HPS works with clients on a host of challenges, from crisis management and reputation building to policy analysis and business strategy. Our support includes outside advisory, as well as transformational work to directly improve client capabilities.

Our collective prior work entails decades of experience at the highest levels of government, business and communications, including work in Congress, the White House, the Office of Management and Budget, the Treasury Department, the Financial Crisis Inquiry Commission, Presidential campaigns as well as management consulting.

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