Economic Numbers Looking Up

Michael Mussa says that several factors, including the recently enacted tax package, will push economic growth up next year, probably bringing unemployment below 9 percent.

Steve Weisman: Quantitative easing. A surprise approval in Congress of a new tax package described as a stimulus measure. An uptick in interest rates. These developments suggest that the recovery next year might be stronger than previously anticipated. Who better to address that issue than Michael Mussa, senior fellow at the Peterson Institute for International Economics? This is Steve Weisman. Mike, welcome.

Michael Mussa: Good to be here.

Steve Weisman: What are economic prospects next year?

Michael Mussa: I think that they look a little stronger now than they did a couple of months ago. Partly it's the facts as you mentioned. In addition the data look better. Retail sales in the Christmas season have been doing at least moderately well—not surging, but certainly improving. And other data on the economy, in particular the trade figures for October, are showing a better picture. So the actual data say that the end of this year looks like it's strengthening from where we were in the spring and summer. In addition we are getting some further policy stimulus, uncertainties about where policy would be next year have been removed, and I think that's a positive, over and above the actions actually taken.

Steve Weisman: What are the major contributors among all the factors we've mentioned?

Michael Mussa: It's probably a mix of things getting better on their own to a greater extent than was anticipated. We had this surge in imports in the spring and summer, and that seems now to be at least partially reversing and the consumer is in a better mood. So that's about half of it, or a little more. The other half is on the policy front, where we got some additional monetary policy easing with the quantitative easing. And the fiscal policy also is certainly not tightening next year, whereas there was, I think, at least an important degree of uncertainty that they might get stuck and fail to reach a compromise early enough to avoid a negative impact on the economy.

Steve Weisman: Let's talk about the tax compromise. It was described as a package of $800 billion over two years, though much of it was extension of existing tax rates. How much of a kick do we get that's new?

Michael Mussa: I think it's between $100 and $150 billion in the coming year. We had a lot of continuation of existing policies and since the budget was based on previous law, the assumption on the budget was that the Bush tax cuts would go away in their entirety. Well, now none of them are going away and we know that for certain. They also put in a cut in the payroll tax by two percentage points for individuals, and that replaces, to an extent, the "Make Work Pay" tax policy of Obama, but it's larger than that. There's also the expensing provision for investment in most capital equipment. It should provide an incentive to boost capital investment in 2011. It will probably subtract from the incentives for investment of 2012, so it's not a long-run stimulus.

Steve Weisman: How much is this going to add to the previous growth prediction for next year?

Michael Mussa: I was anticipating, as one must always when making a forecast, that some policy action would be taken. And I thought the Bush tax cuts would most likely be extended in their entirety along with the unemployment benefits and other things, so most of the package was already in the forecast. But the uncertainty about whether and when it would actually happen was a meaningful negative, and it turned out to be bigger than what I or I think anyone else was thinking.

Steve Weisman: You mean the uncertainty was a bigger drag?

Michael Mussa: No, I mean the package itself was a little larger than I anticipated. So I would boost my forecast for growth, which was at the very upper end of other forecasts, by about half a percentage point on a fourth quarter to fourth quarter basis, and by about a quarter of percentage point or a little more, year over year.

Steve Weisman: Taking us to what?

Michael Mussa: Taking us to 3.6 percent growth, something like that, year over year and taking us to about 4.25 percent growth, fourth quarter to fourth quarter.

Steve Weisman: What does this mean for unemployment?

Michael Mussa: It means that the unemployment rate would come down more rapidly during the course of 2011. I think, in my view at least, it provides a high degree of confidence the unemployment rate will by the end of the year fall below 9 percent.

Steve Weisman: What about the effect on the budget deficit? Is that a concern?

Michael Mussa: Again, you need to ask: relative to what? If you say, "The alternative was a continuation of none of these tax cuts," then presumably the budget deficit would have been smaller in that instance. But the economy also would have been weaker, which would have cut into revenues. So my guess is that we're looking at a budget deficit that is going to be a little bit larger next year than it was last year as opposed to a situation where we would have been somewhat smaller in 2011 than in 2010. But there are other factors that play in that, the strength of the economy also. We had big repayments of the TARP [Troubled Asset Relief Program] loans in 2010, and that's not going to be repeated in 2011, not on the same scale. So that tends to make the budget deficit look bigger or the improvement look smaller.

Steve Weisman: There's a debate underway about why interest rates in the medium and somewhat longer term have jumped up a bit. Some say it's in response to quantitative easing and fears of inflation. Others say it's a sign of growing confidence in economic growth next year. What's your view?

Michael Mussa: When quantitative easing was first announced, or indicated as quite likely in the late summer, we saw interest rates drop, I think pretty clearly related to the expectation of the effect of the easing, which had not yet occurred. The subsequent rise in interest rates, which has occurred, especially over the last three weeks, I think would relate more to evidence that the economy is strengthening and increased worries that the budget deficit is going to be bigger rather than smaller going in, which may feed into inflation as well. Inflation expectations have come up some from the summer, but we would expect that would happen if people are expecting that the economy will be a little stronger. I would have to say on balance it does weaken the case for quantitative easing, of which I was not particularly a fan. There's a stronger case for [quantitative easing] if you expect the economy to be weak than if you think the economy's going to strengthen.

Steve Weisman: But in your reservations about the quantitative easing policy, you weren't sure that it was inflationary, just that it was unnecessary.

Michael Mussa: Well, yes, I was worried and I remain worried that this is going to need to be taken out at some point and that may prove to be disruptive.

Steve Weisman: You mean, the policy will stop?

Michael Mussa: The policy will stop and then will need to be reversed. So whatever they put in, in terms of additional quantitative easing, at some point they're going to need to take it out, and they're sort of betting that taking it out will occur at a relatively convenient time.

Steve Weisman: What does that mean, taking it out?

Michael Mussa: They've got a couple of options. One is to sell [Treasury securities] back into the market and then contract the supply of bank reserves. That's not necessarily contractionary from a monetary standpoint if the banks want to lend out more money given the level of reserves. But it can have an effect of slowing the economy depending upon what's happening. We've also got the worry that so long as monetary policy remains so easy, you could get some general inflationary pressure, or you could get what we saw last time—that it translates into asset price increases that will prove unsustainable in the longer term.

Steve Weisman: With a new Congress, President Obama will deliver his State of the Union message. What would be the best thing for the economy that you'd like to hear him say?

Michael Mussa: I think it's fairly clear that the president is going to have something to say about the need to address the budget deficit problem in the medium to longer term; that we've gotten this additional stimulus, basically a continuation of very low tax rates. But as the economy recovers, we're going to need to address the situation of a large budget deficit. I think part of the message from the election was that the electorate is concerned about that issue, and the president doesn't like to be on the opposite side of any major issue from where the electorate is.

Steve Weisman: No president does.

Michael Mussa: In general not. I mean the man who said I'd rather be right than president, he may have been right but he certainly wasn't president.

Steve Weisman: So you'd like to see some action on the deficit in the medium term but not necessarily next year. The Republicans will be saying, "We're cutting the budget big time." Are you saying, "Not so fast"?

Michael Mussa: They're trying now to finalize the spending bills for the current fiscal year, which extends through next September. There will be modest efforts to cut things back a little bit when the new Congress comes in. But as far as spending in 2011 is concerned, or taxes in 2011, that's basically now locked in, so we're really talking about 2012 and beyond. And there will no doubt be a very considerable fight over the spending bills and in the budget for fiscal 2012, where there will be a more substantial effort to cut things back on the part of the Republicans, including I think repealing some of what was in the original stimulus bill, the longer-term investment for high-speed rail and a number of other things that they're going to target. There are going to be a number of arguments. Who knows what the proposals will be? But there'll be some effort certainly to scale back elements of the healthcare reform.

Steve Weisman: Including possibly some of the cost containment elements.

Michael Mussa: That could very well be. I mean, we've seen on the so-called "Doctor Fix" of five or six years ago, they decided they would impose tough limits on compensation to doctors and then they counted the budget savings from that. But they've never been prepared to actually implement it.

Steve Weisman: Mike, thanks very much.

Michael Mussa: Right.