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Nagging Questions. The list of big questions is growing much faster than the ability of economists – and politicians – to respond.

First, let me assure you that I will try to be as non-ideological as possible. Furthermore, it is essential to distinguish between the immediate future and the longer term. I recently tore leg muscles during some athletic activity after years of being sedentary. The ultimate cure is for me to work out and strengthen those muscles. However, my physician warned that this is exactly the wrong thing to do in the near-term. Until the tears heal, strenuous exercise would worsen matters. (My face lit up when he said I should refrain from exercise).

Are we facing a double dip? The incoming data are mixed. Retail sales have been weak and so has housing. Job growth has been anemic. But GDP (Gross Domestic Product) is still growing slowly, so we're not yet in recession.

Forecasters are saying that the most likely outcome is for modest U.S. economic growth to continue. However, the odds of another recession have been rising. I put the slow growth odds at around 50 percent and recession at about 35 percent. Academics like to call these "Bayesian probabilities," which is just a fancy name for made up numbers. My real point is not the precise probabilities but the very narrow spread between the two outcomes.

These odds will soon shift – for better or worse – as a number of issues resolve or evolve. By late November, the Congressional "Super Committee" will recommend ways to reduce the deficit. Failure to enact legislation will initiate automatic, broad-based spending cuts. Even before that, the European sovereign debt/banking crisis will be on the path to resolution or start to spin out of control.

Won't reducing those huge deficits help the economy grow? This is generally true in the longer run, but short run deficit reductions will very likely slow an already sputtering economy. With Treasury bond yields already at record lows (2 percent for the 10-year), it is hard to see how smaller deficits can lower interest rates enough to counteract the fiscal drag. There are claims that deficit reduction will raise business confidence, thereby boosting capital spending and hiring. Some Europeans had been saying this a while back, but so far, it looks like the fiscal drag has dampened both business and consumer spirits over there.

However, there is a way around this apparent short vs. long term conflict: pass legislation now that deals with both time horizons. That is, the legislation could provide for near term stimulus from spending programs and tax cuts while, at the same time, specifying deficit reductions that kick in several years from now.

The first stimulus package didn't work, so why talk about another one? Pointing to the 9 percent unemployment rate or the disappointing job growth does not prove that the stimulus enacted in 2009 was ineffective. The real question is: where would unemployment be today if there had been no stimulus program? Studies using carefully constructed models of the U.S. economy conclude that the recession would have been much worse and the recovery even slower. Furthermore, today's unemployment rate would be lower and the job gains larger if the 2009 stimulus had been both bigger and more focused on tax/spending programs with larger near-term multipliers. Finally, failure to renew the extended employment benefits and employee payroll tax cuts that expire on December 31 will cause a major drag on the economy.

Shouldn't Bernanke stop printing all that money? This is a reference to the Fed's program of Quantitative Easing (QE) during 2008-2010. The Fed purchased billions of dollars of Treasury debt and mortgage-backed securities from financial institutions that it paid for with newly created deposits at the Federal Reserve. This really didn't create money because almost all remained on deposit at the Fed where it still sits as "idle reserves" earning a paltry ¼ point interest. As long as they remain idle, there's no impact on the money supply, the economy, or inflation. And there's no school of economic thought that will argue otherwise... maybe.

Musings & Amusings: *A Modest Proposal*

Some years ago, comedian Jackie Mason said we should **put politicians on commission.**

OK, so here we go. A recent survey showed that people in the DC area thought the economy is in pretty good shape. Their economy might be OK, but ours certainly isn't! Maybe its time for them to have more "skin in the game"

So, I'm proposing that for every point the unemployment rate goes up, elected officials and their staffs should have to take a 5% pay cut. With today's 9% jobless rate, they'd be down 25%. And they only get their pay back as the unemployment rate falls...

The purpose of QE was to reduce long-term interest rates because the Fed had already cut short-term rates to zero. And I'm sure that QE is one of the reasons why the Treasury only has to pay 2% on bonds and why mortgage rates are at record lows.

What if these funds start getting lent out? I hope that happens! But what if bank lending grows so fast that it ignites inflation? The Fed has plenty of tools to prevent that from happening. Since October 2008, it had been authorized to pay interest on idle reserves. If loan demand gets out of hand, all the Fed has to do is raise the interest paid on excess reserves to bribe the banks to keep these funds with the Fed. Of course, most other short-term interest rates would rise in tandem.

Can't we get jobs growing again by aiming tax incentives at the firms and industries most likely to create jobs? Governments don't have a great track record in picking winners and identifying losers. Some years ago, I invited Michael Porter of the Harvard Business School to address members of the Connecticut General Assembly. Porter, who is an expert on competitiveness, urged them to forget about trying to pick winners. Instead, they should create a winning overall environment in terms of taxes, regulations, etc. that helps firms to succeed, leaving the marketplace to pick the winners and losers. I don't think they listened very closely.

Can we stimulate job growth by cutting back on regulation and making it more sensible? Sure, but once again this is a longer-term payoff. If we start revamping regulations now, the payoff will be down the road. Meanwhile, we need to do things immediately to take care of today's job problem before we slip back into recession. Furthermore, it is uncertain how large the gains would be.

Why do economists keep harking back to 1937-38? A decent recovery was underway from the deep depression that started in 1929 and bottomed with unemployment hitting 25 percent in 1933. However, a number of policy mistakes caused a major setback that wasn't fully reversed until World War II. The federal budget tightened as, among other things, the newly enacted Social Security Act started collecting taxes but there were almost no beneficiaries! In addition, the Federal Reserve worried that all those idle reserves sitting in banks would eventually be lent and feed speculation. Hence, they moved towards a more restrictive monetary policy by raising reserve requirements. The unemployment rate rose from 14 percent to 19 percent. Could this be *déjà vu all over again?*

Does all this mean that mean it will take years for us to get back to normal? Recent extensive research on the aftermath of financial crises says we have to be patient. It takes a long time for the financial wounds to heal. However, I'm reasonably sure that economic policy decisions can shorten or lengthen the recovery period.

Are there any measures the government can take to move things along now? Housing was at the epicenter of the financial crisis and has shown very few signs of recovering, despite several new programs over the past few years. Normally, residential sales and construction lead the economy out of recession but not this time.

A number of experts are saying much more must be done about the huge number of homes currently "underwater," where the mortgage balance now exceeds the market value of the home. Home prices are off 30 percent from the 2006 peak, leaving millions of families in this situation. For most, this means that they cannot refinance to take advantage of today's record low mortgage interest rates.

Forcing lenders to write down the portion of the loan that is underwater would entail huge losses which could destabilize the financial system. The housing crisis had many contributors: loan originators, government officials, rating agencies, speculators, borrowers, etc. In short, the housing debacle was a national problem that requires a broad-based solution. Using federal money to help write down mortgages would free up household purchasing power and reduce foreclosures. It would even raise home prices for all of us.

There you go again, Perna, wanting to spend our hard earned money and increasing the deficit! Well, I don't see any alternative to spending cuts and/or tax hikes that increase the near-term deficit if you want to create jobs in the near future! If you have a workable plan that will create jobs quickly and not enlarge the budget deficit in the short run, I'm pretty sure I can get you a Nobel Prize. I'll even buy you a pony!

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