Oral Testimony of Mark Zandi
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"Assessing the Federal Policy Response to the Economic Crisis"

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Thank you Senators Conrad and Gregg for the opportunity to testify today on such an important matter.

I will make 3 points in my remarks.

First, the policy response to the economic crisis was very successful. The merits of any individual aspect of the response, and there were many, is debatable, but the totality of the response forestalled what would have been a 1930s style depression.

Broadly speaking, the policy response had two principal objectives, first to stabilize the financial system and second to jump-start an economic recovery.

Success stabilizing the financial system is evident in movements in the TED spread, a very good measure of the angst in the system. I will quickly focus on 3 policy steps, the CPP or bank bailout (October 3) which was funded by TARP money, the FDIC's TLGF (October 13), and the bank stress tests (May 7, 2009).

Fiscal stimulus was key to jump-starting the recovery. It is no coincidence that the Great Recession ended in June 2009 as the NBER recently determined when the stimulus was providing its maximum economic benefit. The link between stimulus and economic growth is the rate of spendout – the temporary tax cuts and spending increases. That spendout was at its peak in June 2009.

Let me mention 2 other aspects of stimulus; cash for clunkers and housing tax credits. It is clear that the auto industry turned the corner in August 2009 precisely when cash for clunkers was in full swing. The housing tax credits also clearly stemmed the free fall in the housing market. Both were temporary and pushed for sales, but this was vital to stem the collapse of these two vital industries.

My second point is that while the recovery remains intact, it is fragile. Growth has slowed since the spring and is currently insufficient to forestall even a further increase in unemployment. I expect the jobless rate to drift back closer to double-digits late this year or early next.

To a significant degree, it should not be surprising that the recovery was *not* substantially stronger. Well-respected research shows that economies that have experienced similar financial crisis have suffered slow recoveries given the very significant weight on growth generated by the deleveraging process that must occur. Moreover, the benefit of the fiscal stimulus is now fading as the spendout rate slows.

The slowdown in growth in recent months is, however, greater than anticipated. In my view, this is due to the fallout from the European debt crisis on our stock market. The S&P 500 fell 15% during May and June, knocking the wind out of confidence and stalling hiring plans by businesses and spending especially by higher-income households.

Indeed, if the recovery had not been sidetracked by the European debt crisis, the recovery will have very likely evolved into a self-sustaining economic expansion characterized by falling unemployment by now.

Finally, my third point is that given my view that the policy response to the crisis was a success and that the recovery remain fragile, policymakers should remain aggressive in their support for their

economy. At the very least this means that policymakers should not exit out of their current support until an expansion has taken full root – that is, the unemployment rate is moving definitively lower.

To support the recovery in the critical next 6-12 months I suggest policymakers do 3 things. First, quickly decide what to do about the expiring tax cuts. My suggestion would be not to raise taxes on anyone in 2011 given the fragile recovery, but allow the higher tax rates on upper income households to be phased in 2012-13 when the economy is on sounder ground and we will need to address our daunting long-term fiscal problems.

Second, work to facilitate mortgage refinancing via Fannie Mae and Freddie Mac. Current refi activity is disappointing given the currently low mortgage rates. More refinancing can be done if Fannie and Freddie make some small adjustments in their practices which will not be a cost to taxpayers. I can discuss this in more detail if you have an interest.

And third, if economic conditions do not improve by early next year, policymakers should consider a payroll tax holiday targeted a firms that add to their payrolls. The current job tax credit is too small and restrictive to be very effective.

Thank you again for the opportunity to testify again today.