Research Notes

You Will Be Stimulated

May 27, 2008

As of May 23, 2008 the US government has sent a cumulative total of $45.72 billion in 51.675 million payments as part of the fiscal stimulus package. The press release for that week notes that they are sending them as fast as they can but those darn regular tax rebates are slowing the fiscal stimulus machine down a little for now.

"Treasury facilities are still also working on completing the mailing of regular tax refund checks, and thus are not at full capacity for printing and mailing stimulus checks. In June, once the regular tax refund mailings are complete, Treasury will print and mail stimulus checks at full capacity and weekly volumes will increase." [1]

The stimulus package will dole out a total of about $160 billion. With $45.7 billion sent already, there is still $114.3 billion to come (mainly in June it sounds like) by mid-July or so.

Will It Spend?

What will happen in the next few months as a result of these payments being sent out just as fast as Washington can print 'em? Many analysts think there will be a modest increase in spending. They argue that most people won't spend the stimulus money, but instead they will use it to pay off debt or save most of it. I disagree, and so does the most recent evidence.

A May 2 *Freakonomics* blog posting by Justin Wolfers provided a nice summary of three recent studies on the effect of the 2001 tax rebates.[2] Shapiro and Slemrod (2003) asked people how people planned on spending their 2001 rebate check and found that only 1/4 were going to spend it, all the rest planned to save or pay off debt. But what did people actually do? Two recent papers by Johnson, Parker and Souleles (2006) and Agarwal, Liu and Soules (2007) tracked actual behaviour. The first paper found that about 2/3 of the rebate was spent in the first 3 months. The second paper found that spending increases were equivalent to about 40% of the average rebate check. A simple average of these two estimates is 53%, much higher than the survey response of 25%.

These findings seem plausible for this time around as well. The best intentions to do the responsible thing and save or pay off debt, often don't occur when the time comes and the money is in hand. Retail therapy beckons. However, I doubt we will see a lot of frivolous purchases.

Consistent with the research findings above, we assume people will spend about 50% the stimulus check within the same quarter that they receive it. In general, this won't help the automakers, of course since the individual payments are relatively small. Most of the additional spending will go to services and nondurables, especially food, clothing, gasoline. For instance, rising prices may also lead some households to stock up at Costco now rather than spreading those purchases over several months. A California radio phone-in show I

[1] U.S. Treasury Department Press Release, May 23, 2008. "Week 4 Wrap-Up: Treasury Sent 6.211 Million Stimulus Payments This Week http://www.ustreas.gov/press/releases/hp995.htm

[2] Available via the *New York Times* at: http://freakonomics.blogs.nytimes.com/2008/05/02/likely-effects-of-the-tax-rebate-checks/

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heard recently asked consumers what they would do with their refund check. Callers said that they would stock up on necessities, make small to medium sized purchases, including energy-saving appliances, take a college course, pay off some debt, pay something on the mortgage, and go out to dinner. There were mixed opinions on the policy, and no real excitement about the refunds. It seemed to be viewed almost as a way to help batten down the hatches for the potentially worse times ahead. Call it spending for a rainy day. What could be more American than that?

Timely, Targeted and Temporary

Legislators tried hard to make the package fit economists' criteria that the fiscal stimulus be "timely, targeted and temporary." They were certainly quick off the mark. We weren't even in a recession and the spending was approved! The package is also temporary rather than permanent. It looks like the package may well be targeted to those who are most likely to spend it, namely households who don't have high incomes.

Timing, however, is still the most difficult criteria. An important criticism of fiscal stimulus and even monetary stimulus is that, in the words of Milton Friedman, they affect the economy with "long and variable lags". Usually the problem has been that the legislators acted to late, and effectively added to a nascent recovery, rather than countering the recession.

But this stimulus package could simply be too early. Have legislators overreacted to some weak data? What ammunition do fiscal policy makers have left if bad times really do come? More deficit spending, of course is an option. However, multiple stimulus packages are likely to face waning effectiveness. If the government provides rebates too often, they may come to be seen as semi-permanent, (i.e. not temporary), so consumers react less to the windfall they provide. Of course there is also the Ricardian view which tells us that consumers will also understand that higher deficits today mean higher taxes or less spending in the future. Such realizations would seem more likely to more often households receive stimulus payments. This would have a further dampening effect on the spending response of additional stimulus packages. So hopefully this one package is all legislators deem necessary to maintain some stability and growth in the economy.

Implications for the Outlook

Looking over the post war data, it seems that consumer led recessions/slowdowns tend to be more long and shallow compared to periods that follow investment booms. (This will likely be explored more in a future research note.) As discussed in earlier notes, I think that the housing bust will last a long time (up to a decade before real house prices rise again).

At the time of writing, we are finalizing our current forecast update, but the themes are clear. The fiscal and monetary stimulus should do enough to avoid recession this year. Most likely, "stimulus" spending will be pulled forward from the upcoming six months or year, as people buy now what they would otherwise delay. This inevitably means some payback (i.e. decreases in consumption growth) in the following quarters. Specifically, the fiscal stimulus will have a significant positive effect on consumption in Q2 and into Q3. The fourth quarter will see a drop off in consumer spending which slows overall growth and may involve a contraction of GDP. While we don't expect stagflation, inflation is a persistent variable and we expect it to remain broadly similar to current trends, with some easing in mid to late 2009. As the credit and housing problems unwind, a protracted period of below trend growth for 2008 and 2009, and possibly longer seems most likely, despite the early and large policy interventions.

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