

Obama Administration's Fiscal Stimulus Package

Objective of the stimulus

- Increase Real GDP to promote **full employment**.

How is full employment defined?

- Most economists agree that full employment occurs at an unemployment rate of 4%.
- Some unemployment can not be eliminated because every month there are workers entering the labor force for the first time as well as workers reentering the labor force.
- Workers entering and reentering the labor force do not find jobs immediately.

Age: 16 years and over
 Unemployed entrant status: New entrants

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Annual
1999	535	523	435	473	409	440	465	459	507	511	463	429	
2000	394	420	429	406	466	427	433	499	415	402	419	490	
2001	444	396	378	457	468	467	448	485	473	481	495	515	
2002	484	507	538	527	497	549	545	612	536	479	591	535	
2003	599	584	630	635	630	661	669	652	686	636	593	693	
2004	676	666	631	652	718	649	702	704	695	734	700	702	
2005	620	752	710	761	719	648	629	624	608	640	678	633	
2006	614	709	632	586	533	641	634	646	615	574	592	589	
2007	620	598	608	616	550	629	594	590	674	699	677	693	
2008	672	660	695	625	832	761	818	829	822	825	760	829	
2009	780	1005	868	900	956	947	967	1085	1112	1090	1266		

Age: 16 years and over

Unemployed entrant status: Reentrants

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Annual
1999	1997	2096	1999	2006	2010	2015	2021	1959	1992	2001	1932	2036	
2000	2046	1991	1982	1919	2050	2046	1986	1953	1812	1880	1960	1879	
2001	1972	1937	1896	1948	1805	1899	1950	2197	2136	2123	2208	2387	
2002	2275	2314	2460	2396	2398	2383	2371	2295	2320	2351	2382	2465	
2003	2389	2411	2416	2547	2504	2713	2525	2489	2414	2497	2396	2352	
2004	2550	2402	2447	2327	2469	2565	2280	2398	2375	2397	2306	2314	
2005	2324	2402	2403	2378	2406	2377	2380	2423	2371	2337	2445	2352	
2006	2256	2305	2180	2184	2149	2183	2342	2283	2285	2257	2235	2143	
2007	2187	2063	2163	2181	2175	2145	2025	2062	2164	2099	2147	2302	
2008	2183	2096	2126	2145	2522	2562	2668	2678	2587	2650	2655	2777	
2009	2751	2834	2974	3087	3180	3335	3312	3307	3255	3433	3214		

Real GDP

1. Real GDP is defined as the value of all final goods and services produced. It is a measure of the productive activity for a country.

Real GDP

- GDP consists of four categories of spending: consumption by households; spending on structures and equipment by business; government purchases; and exports.
- If spending falls (for whatever reason—reasons are called demand shocks), firms begin to cut output (GDP) and unemployment rises.

Real GDP – recent data

Year (quarter)	Real GDP (2005 prices)
2007q4	\$13,391 billion
2008q1	\$13,366
2008q2	\$13,415
2008q3	\$13,324
2008q4	\$13,141
2009q1	\$12,925
2009q2	\$12,901
2009q3	\$12,973

Okun's Law

- Evidence shows that every 2% decline in real GDP is associated with a 1% increase in the unemployment rate (that's Okun's Law).
- Okun's Law is a simple technique for identifying the size of the fiscal stimulus required to restore [attempt to restore is more accurate] full employment.

Using Okun's Law

- We know that the actual unemployment rate is 10%.
- If we accept that full employment occurs at an unemployment rate of 4%, then the **unemployment rate is 6% above the full employment rate.**

Full Employment GDP

- Using Okun's Law, Real GDP is 12% below its potential (full employment level) .
- At the end of the third quarter 2009, Real GDP was at \$12,973 billion—again this level is 12% below our full employment level.
- **At full employment, Real GDP would be \$14,742 billion = $12,973 / .88$**

GDP Gap

- GDP gap: the difference between Full Employment GDP and Actual GDP.
- **GDP gap =**
\$14,742-12973=\$1769 billion.

Obama's fiscal stimulus

- **\$787 billion package**
- Approximately 67% of this package consisted of increases in government spending or \$527 billion = $(.67)(787)$. If the multiplier for government spending is 1.5, **this part of the package** will create an **increase in total spending of \$790 billion** = $(1.5)(527)$.

Obama's Fiscal Stimulus

- 33% of the stimulus was in the form of tax cuts or \$260 billion = $(.33)(787)$.
- Since part of the tax cut is saved and not spent, the tax cut multiplier is smaller: approximately 1.2.
- The total increase in spending from the tax cuts is **312 billion** = $(1.2)(260)$.

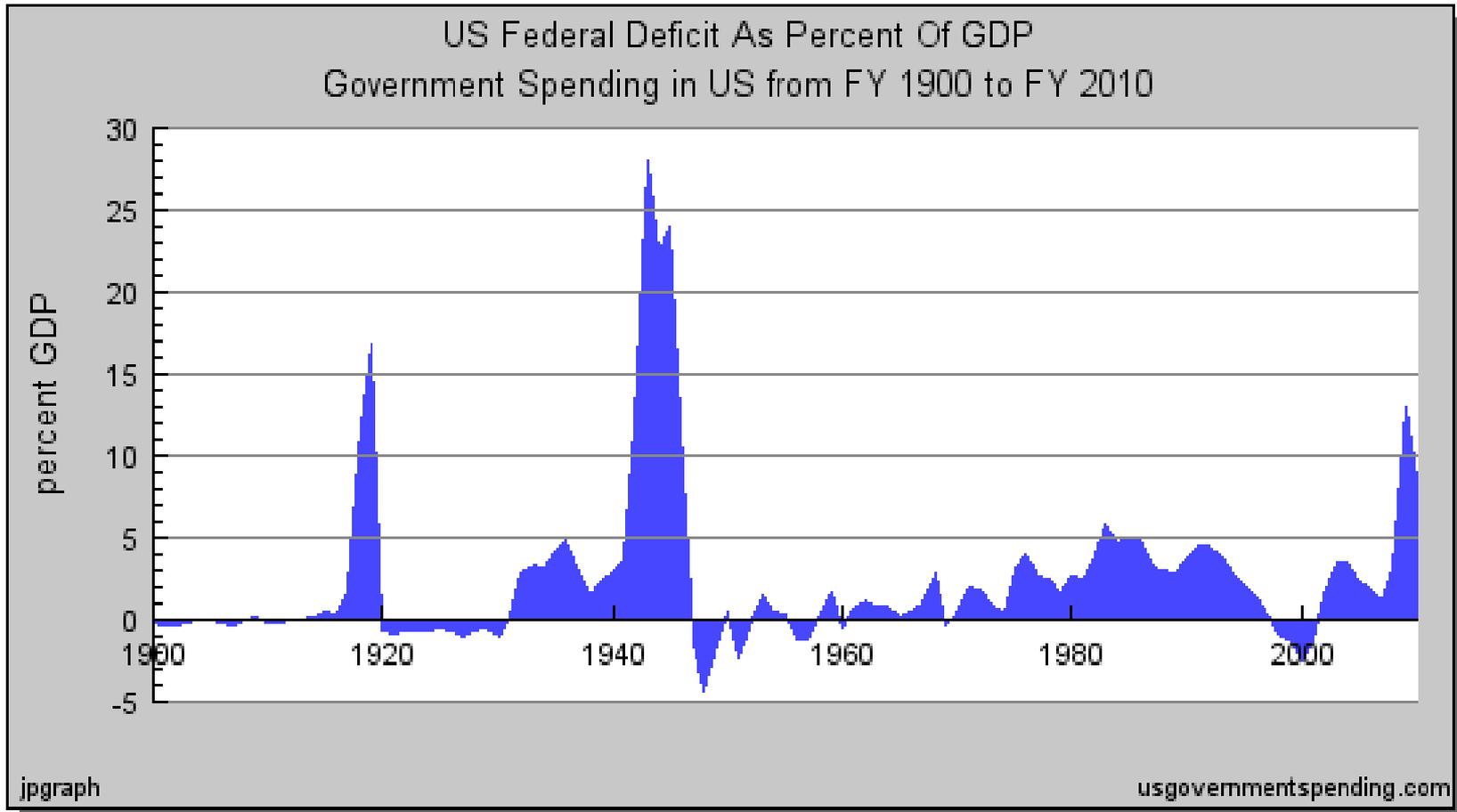
Fiscal Stimulus

- Estimate that total spending ultimately increases by \$1 102 billion as a result of the stimulus package (790+312).
- The GDP gap is estimated at \$1769 billion.
- The stimulus alone will not restore full employment (unemployment rate 6-7% if nothing else changes).

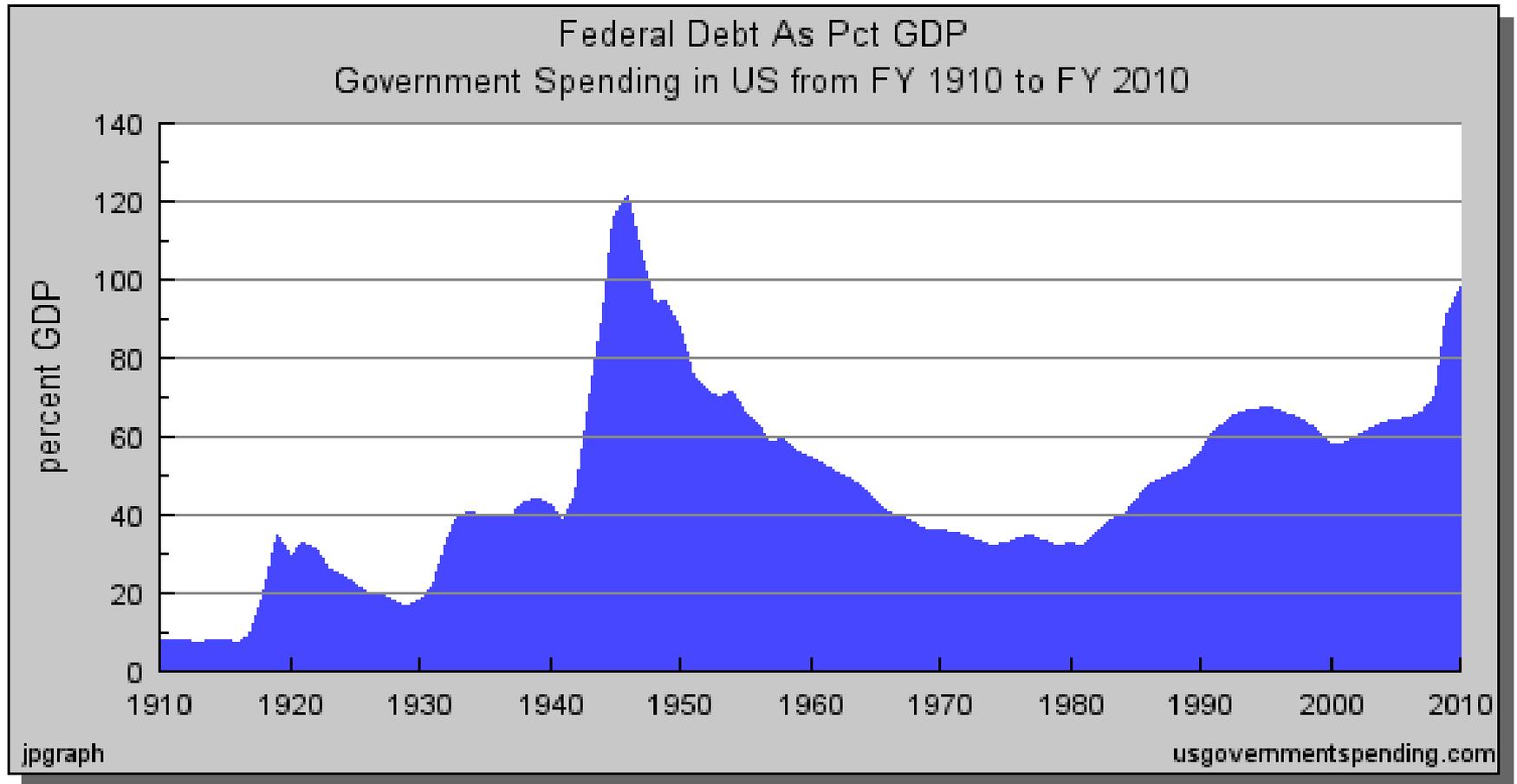
Other Factors

- We may or may not need more government stimulus.
- Interest rates are low.
- The increase in the stock market suggests that people are increasingly optimistic (deluded?). It also increases wealth.
- There are many other factors that can influence productive activity, either positively or negatively (nobody knows).

Federal Budget Deficit percentage of GDP



Federal Debt percentage of GDP



Financial System

- Why did we bail out the financial system?
- In terms of the economy, a collapse of the financial system would initially impact **investment spending**.
- Investment spending refers primarily to spending on plant and equipment by business.
- Production of plant and equipment accounts for 15-20% of GDP.

Investment and the Financial System

- Most investment spending is financed through borrowing. A collapse of the financial system, among other things, eliminates the ability of firms to borrow to finance investment spending.

Depression – Lesson Learned

- In 1929 investment spending was \$16.7 billion, which represented 16% of Real GDP.
- Banking system fails in early 1930's.
- By 1933 investment spending was \$1 billion, which represented 1.7% of Real GDP.
- Letting the banking system collapse is one way to turn a recession into a depression.

Why did the Financial System Fail?

If banks lend other people's money to people who don't pay their debts, then the people whose money they're lending are going to want it back. Can you say **bank run**?

- Corruption, greed, and reckless, risky, unregulated behavior may have possibly played a teeny, tiny role.