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Wall Street rollercoaster: Stanford expert tries to make sense of a careening marketplace

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Economist Roger Noll admits that ignoring the wild ups and downs is hard, but "high volatility reveals only that many people are fearful about the nation's economic future."

Wall Street continued to careen wildly today, signaling a great deal of nervousness and uncertainty in the markets. Stanford News Service asked economist Roger Noll, co-director of the Program on Regulatory Policy at the Stanford Institute for Economic Policy Research, to offer some guidance.

The Dow tumbled 635 points Monday, climbed back 430 points on Tuesday, then plummeted 520 points again yesterday. Today it's up about 420 points. Can you make sense of this?

The short-term behavior of the stock market is virtually impossible to explain, especially during a period of extreme volatility. Certainly no underlying economic facts could explain either the overall decline in the past two weeks or these huge day-to-day swings.

Ignoring this volatility is easier said than done. High volatility reveals only that many people are fearful about the nation's economic future. On a day-to-day basis, they can overreact to the latest tidbit of economic news. As a society, we should try to focus on the big picture issues while giving little weight to the latest economic factoid.

Could you give us a little orientation about the "big picture" – starting with the budget deficit?

Looking five to 10 years into the future, the federal budget deficit is not sustainable. However, the current ratio of debt to GDP is not high enough to cause immediate concern, so short-term deficits can still be used safely to stimulate the economy.

So how do we "fix it"?

The single most important factor affecting the federal deficit is the rate of economic growth. If the U.S. could grow at 4 to 5 percent over the next three years, over half of our deficit problem will go away through the additional taxes collected and the reductions in safety net and stimulus spending that will automatically occur when growth returns.

How best to do this depends on one's political ideology, but a good place to start is temporary transfers to state and local governments to prevent layoffs of teachers, police and firefighters. Other attractive stimulus actions are to increase spending on infrastructure, which we need anyway, and to extend the payroll tax cut for another year or two. A good place to cut expenditures is foreign military activity, including bases in Europe, which do little to stimulate our economy.

What's the biggest problem with our budget, in your opinion?

The primary long-term budget problem is growth in health care costs – Medicare, Medicaid and the pre-tax status of payments for employerbased health insurance. The U.S. must adopt substantial health care reforms in the next few years to solve our long-term fiscal problem.

Politically, neither large tax increases nor large cuts in access to medical care are likely to be feasible. The only plausible solution is institutional reform that effectively contains costs.

What about taxes?

Wholesale tax reform is long overdue. The main problem with the U.S. tax system is its complexity, due to a crazy quilt of deductions and credits. The present tax code is expensive to enforce and inequitable in its impact. A system with many fewer deductions and lower rates, on net raising somewhat more revenue, is the final piece to encouraging short-term growth and long-term fiscal stability.

Provided by Stanford University

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