



# Economic Recovery: Sustaining U.S. Economic Growth in a Post-Crisis Economy

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## Summary

The 2008-2009 recession was long and deep, and according to several indicators was the most severe economic contraction since the 1930s (but still much less severe than the Great Depression). The slowdown of economic activity was moderate through the first half of 2008, but at that point the weakening economy was overtaken by a major financial crisis that would exacerbate the economic weakness and accelerate the decline.

Economic recovery began in mid-2009. Real gross domestic product (GDP) has been on a positive track since then, although the pace has been uneven and slowed significantly in 2011. The stock market has recovered from its lows, and employment has increased moderately. On the other hand, significant economic weakness remains evident, particularly in the balance sheet of households, the labor market, and the housing sector.

Congress was an active participant in the policy responses to this crisis and has an ongoing interest in macroeconomic conditions. Current macroeconomic concerns include whether the economy is in a sustained recovery, rapidly reducing unemployment, speeding a return to normal output and employment growth, and addressing government's long-term debt problem.

In the typical post-war business cycle, lower than normal growth during the recession is quickly followed by a recovery period with above normal growth. This above normal growth serves to speed up the reentry of the unemployed to the workforce. Once the economy reaches potential output (and full employment), growth returns to its normal growth path, where the pace of aggregate spending advances in step with the pace of aggregate supply. There is concern that this time the U.S. economy will either not return to its pre-recession growth path but perhaps remain permanently below it or return to the pre-crisis path but at a slower than normal pace. Problems on the supply side and the demand side of the economy have so far led to a weaker than normal recovery.

If the pace of private spending proves insufficient to assure a sustained recovery, would further stimulus by monetary and fiscal policy be warranted? One of the important lessons from the Great Depression is to guard against a too hasty withdrawal of fiscal and monetary stimulus in an economy recovering from a deep decline. The removal of fiscal and monetary stimulus in 1937 is thought to have stopped a recovery and caused a slump that did not end until WWII. Opponents of further stimulus maintain that the accumulation of additional government debt would lower future economic growth, but supporters argue that additional stimulus is the appropriate near-term policy. There is concern that the "fiscal cliff," the confluence of various spending cuts and tax rate increases that are scheduled to occur at the beginning of 2013 unless policies are changed, could have an adverse effect on the economic recovery.

In regard to the long-term debt problem, in an economy operating close to potential output, government borrowing to finance budget deficits will in theory draw down the pool of national saving, crowding out private capital investment and slowing long-term growth. However, the U.S. economy is currently operating well short of capacity and the risk of such crowding out occurring is therefore low in the near term. Once the cyclical problem of weak demand is resolved and the economy has returned to a normal growth path, mainstream economists' consensus policy response for an economy with a looming debt crisis is fiscal consolidation—cutting deficits. Such a policy would have the benefits of low and stable interest rates, a less fragile financial system, improved investment prospects, and possibly faster long-term growth.

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## Background

### Severity of the 2008-2009 Recession

The 2008-2009 recession was long and deep, and according to several indicators was the most severe economic contraction since the 1930s (but still much less severe than the Great Depression). The slowdown of economic activity was moderate through the first half of 2008, but at that point the weakening economy was overtaken by a major financial crisis that would exacerbate the economic weakness and accelerate the decline.<sup>1</sup>

When the fall of economic activity finally bottomed out in the second half of 2009, real gross domestic product (GDP) had contracted by approximately 5.1%, or by about \$680 billion.<sup>2</sup> At this point the output gap—the difference between what the economy could produce and what it actually produced—widened to an estimated 8.1%. The decline in economic activity was much sharper than in the nine previous post-war recessions, in which the fall of real GDP averaged about 2.0% and the output gap increased to near 4.0%. However, the recent decline falls well short of the experience during the Great Depression, when real GDP decreased by 30% and the output gap probably exceeded 40%.<sup>3</sup>

As output decreased the unemployment rate increased, rising from 4.6% in 2007 to a peak of 10.1% in October 2009, and remaining only slightly below that high into 2011. The U.S. unemployment rate has not been at this level since 1982, when in the aftermath of the 1981 recession it reached 10.8%, the highest rate of the post-war period. (During the Great Depression the unemployment rate reached 25%.) This rise in the unemployment rate translates to about 7 million persons put out of work during the recession. Another 8.5 million workers have been pushed involuntarily into part-time employment.<sup>4</sup>

The recession was intertwined with a major financial crisis that exacerbated the negative effects on the economy. Falling stock and house prices led to a large decline in household wealth (net worth), which plummeted by more than \$12 trillion or about 20% during 2008 and 2009. In addition, the financial panic led to an explosion of risk premiums (i.e., compensation to investors for accepting extra risk over relatively risk-free investments such as U.S. Treasury securities) that froze the flow of credit to the economy, crimping credit-supported spending by consumers, such as for automobiles, as well as business spending on new plant and equipment.<sup>5</sup>

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<sup>1</sup> See CRS Report R40007, *Financial Market Turmoil and U.S. Macroeconomic Performance*, by Craig K. Elwell.

<sup>2</sup> Real GDP is the total output, adjusted for inflation, of goods and services produced in the United States in a given year.

<sup>3</sup> Data on real GDP are available from the Department of Commerce, Bureau of Economic Analysis, <http://www.bea.gov/national/index.htm#gdp>. Size of output gap is based on CRS calculations using Congressional Budget Office estimate of potential GDP, data for which is available at FRED Economic Data, St. Louis Fed, <http://research.stlouisfed.org/fred2/series/GDPPOT>.

<sup>4</sup> Data on unemployment and employment are available from the Department of Labor, Bureau of Labor Statistics, <http://www.bls.gov/>.

<sup>5</sup> Data on wealth and financial flows available at the Board of Governors of the Federal Reserve System, <http://www.federalreserve.gov/releases/z1/Current/z1r-5.pdf>.

The negative shocks the economy received in 2008 and 2009 were, arguably, more severe than what occurred in 1929. However, unlike in 1929, the severe negative impulses did not turn a recession into a depression, arguably because timely and sizable policy responses by the government helped to support aggregate spending and stabilize the financial system.<sup>6</sup> That stimulative economic policies would have this beneficial effect on a collapsing economy is consistent with standard macroeconomic theory, but without the counterfactual of the economy's path in the absence of these policies, it is difficult to establish with precision how effective these policies were.

## **Policy Responses to the Financial Crisis and Recession**

Both monetary and fiscal policies as well as some extraordinary measures were applied to counter the economic decline. This policy response is thought to have forestalled a more severe economic contraction, helping to turn the economy into the incipient economic recovery by mid-2009. These policies are likely continuing to stimulate economic activity into 2012.

### **Monetary Policy Actions**

To bolster the liquidity of the financial system and stimulate the economy, during 2008 and 2009 the Federal Reserve (Fed) aggressively applied conventional monetary stimulus by lowering the federal funds rate to near zero and boldly expanding its "lender of last resort" role, creating new lending programs to better channel needed liquidity to the financial system and induce greater confidence among lenders. Following the worsening of the financial crisis in September 2008, the Fed grew its balance sheet by lending to the financial system. Between September and November 2008, the Fed's balance sheet more than doubled, increasing from under \$1 trillion to more than \$2 trillion.

By the beginning of 2009, demand for loans from the Fed was falling as financial conditions normalized. Had the Fed done nothing to offset the fall in lending, the balance sheet would have shrunk by a commensurate amount, and the stimulus that it had added to the economy would have been withdrawn. In the spring of 2009, the Fed judged that the economy, which remained in a recession, still needed stimulus. On March 18, 2009, the Fed announced a commitment to purchase \$300 billion of Treasury securities, \$200 billion of Agency debt (later revised to \$175 billion), and \$1.25 trillion of Agency mortgage-backed securities.<sup>7</sup> The Fed's planned purchases of Treasury securities were completed by the fall of 2009 and planned Agency purchases were completed by the spring of 2010. At this point, the Fed's balance sheet stood at just above \$2 trillion.<sup>8</sup> (Further monetary policy actions taken to accelerate the pace of economic recovery are discussed later in the report.)

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<sup>6</sup> See IMF, *World Economic Outlook*, October 2009, Chapter 2, <http://www.imf.org/external/pubs/ft/weo/2009/02/pdf/c2.pdf>.

<sup>7</sup> Agency debt and securities are issued by "government sponsored enterprises" (GSEs), such as Fannie Mae and Freddie Mac.

<sup>8</sup> For further discussion of Fed actions in this period, see CRS Report RL34427, *Financial Turmoil: Federal Reserve Policy Responses*, by Marc Labonte.

## **Fiscal Policy Actions**

Congress and the Bush Administration enacted the Economic Stimulus Act of 2008 (P.L. 110-185). This act was a \$120 billion package that provided tax rebates to households and accelerated depreciation rules for business. Congress and the Obama Administration passed the American Recovery and Reinvestment Act of 2009 (ARRA; P.L. 111-5). This was a \$787 billion package with \$286 billion of tax cuts and \$501 billion of spending increases that relative to what would have happened without ARRA is estimated to have raised real GDP between 1.5% and 4.2% in 2010 but will increase real GDP by a smaller amount in 2011 and an even smaller amount in 2012.<sup>9</sup>

In terms of extraordinary measures, Congress and the Bush Administration passed the Emergency Economic Stabilization Act of 2008 (P.L. 110-343), creating the Troubled Asset Relief Program (TARP). TARP authorized the Treasury to use up to \$700 billion to directly bolster the capital position of banks or to remove troubled assets from bank balance sheets.<sup>10</sup>

Congress was an active participant in the emergence of these policy responses and has an ongoing interest in macroeconomic conditions. Current macroeconomic concerns include whether the economy is in a sustained recovery, rapidly reducing unemployment, speeding a return to normal output and employment growth, and addressing government's long-term debt problem.

## **Is Sustained Economic Recovery Underway?**

Evidence indicates that the economy, as measured by real GDP growth, began to recover in mid-2009. However, the pace of growth has been slow and uneven with a pronounced deceleration evident during 2011. During 2009 and 2010, growth had been sustained by transitory factors, such as fiscal stimulus and the rebuilding of inventories by business. Economic growth in 2010 showed signs of being generated by more sustainable forces, but the strength of those forces continues to be uneven, and a slowing of growth during 2011 prompted concern about the recovery's sustainability.

- The economy began to recover in mid-2009. For the remainder of 2009 and through 2010, real GDP (i.e., GDP adjusted for inflation) increased at an annualized rate of 3.0%. However, during 2011 growth slowed to 1.6% and in the first quarter of 2012 that pace improved only slightly to 2.2%. In comparison to previous economic recoveries, growth at 3.0% is relatively weak, but is fast enough to at least make slow progress at reducing the large output gap and at reducing unemployment. However, growth at less than a 2% annual rate may not be fast enough to close the output gap and keep the unemployment rate from rising. Through 2010, much of the economy's upward momentum was sustained by the transitory factors of inventory increases and fiscal stimulus. Sustainable recovery would depend on more enduring sources of demand, such as consumers spending and businesses reviving, and providing momentum to the recovery.

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<sup>9</sup> See CRS Report R40104, *Economic Stimulus: Issues and Policies*, by Jane G. Gravelle, Thomas L. Hungerford, and Marc Labonte.

<sup>10</sup> For more information on TARP, see CRS Report R41427, *Troubled Asset Relief Program (TARP): Implementation and Status*, by Baird Webel.

While business investment spending has been relatively brisk during the recovery, consumer spending was relatively tepid in 2011. Weak consumer spending along with the rapidly fading effects of fiscal stimulus and weaker growth in Europe raises concern about the sustainability of U.S. economic recovery in 2012.<sup>11</sup>

- Credit conditions have improved, making getting loans easier for consumers and businesses, loosening a constraint on many types of credit supported expenditures. The Fed's survey of senior loan officers indicates that, on net, bank lending standards and terms continued to ease during 2011 and that the demand for commercial and industrial loans had increased.<sup>12</sup>
- Manufacturing activity is increasing. Through March 2012, output had increased 3.8% over a year earlier and capacity utilization has risen from a low of 65% in mid-2009 to 77.8%. (A capacity utilization rate of 80% - 85% would be typical for a fully recovered economy.)<sup>13</sup>
- Since mid-2009, non-farm payroll employment has increased by about 3.1 million jobs. Monthly gains have been consistently positive since late 2010, but often not at a scale characteristic of a strong recovery. Recent months have seen employment gains steadily falling, down from 275,000 workers in January 2012 to 115,000 workers in April 2012.<sup>14</sup>
- The stock market has rebounded and interest rate spreads on corporate bonds have narrowed. The Dow Jones stock index had plunged to near 6500 in March 2009 but through April 2012 had regained about 90% of its lost capitalization. Spreads on investment grade corporate bonds, a measure of the lenders' perception of risk and creditworthiness of borrowers, have fallen from a high of 600 basis points in December 2008 to less than 100 basis points in 2012.<sup>15</sup>
- China, Asia's other emerging economies, and Latin America are growing rapidly, which is transmitting a positive growth impulse to the United States by boosting demand for U.S. exports. Also the dollar is very competitive from a historical perspective, adding support to U.S. exports.

On the other hand, significant economic weakness remains evident.

- In the third quarter of 2011, the economy had regained its prerecession level of output. But it took 15 quarters to accomplish this as compared to 5 quarters on average in previous post-war recoveries. However, since potential GDP has also

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<sup>11</sup> U.S. Department of Commerce, Bureau of Economic Analysis, *National Income and Product Accounts*, [http://www.bea.gov/iTable/index\\_nipa.cfm](http://www.bea.gov/iTable/index_nipa.cfm).

<sup>12</sup> Board of Governors of the Federal Reserve System, *Senior Loan Officers Survey on Bank Lending Practices*, April 2012, <http://www.federalreserve.gov/boarddocs/SnLoanSurvey/>.

<sup>13</sup> Board of Governors of the Federal Reserve System, *Statistical Release G.17*, April 2012, <http://www.federalreserve.gov/releases/g17/>.

<sup>14</sup> Bureau of Labor Statistics, *Labor Force Statistics from the Current Population Survey*, April 2012, <http://www.bls.gov/cps/>.

<sup>15</sup> Spread of 600 basis points is 6%. Data on spreads found at <http://www.bloomberg.com/apps/quote?ticker=.TEDSP%3AIND>.

continued to grow, the output gap over this time period has only narrowed from about 8.1% to 6.1%.

- Consumer spending, the usual engine of a strong economic recovery, remains tepid, generally slowed by households' ongoing need to rebuild substantial net worth lost during the housing crisis and the recession, continued high unemployment and underemployment, and a surge in energy prices in the first half of 2012.
- Employment conditions remain weak. The unemployment rate, which had peaked at 10.1% in October of 2009, has only fallen to 8.1% in April 2012. However, much of this improvement occurred during 2010, with essentially no net improvement during 2011, because economic growth in 2011 was only just fast enough to keep the unemployment rate from rising. This high rate of unemployment after more than two years of economic recovery is unusual and a source of concern. Also some of the fall of the unemployment rate does not reflect people finding jobs, rather it is caused by discouraged workers leaving the labor force. Another measure of labor market conditions, the employment to population ratio, which is not affected by changes in labor force participation, shows a labor market that is essentially "treading water." During the recession that ratio fell from 63% to 58%, and it has remained near that low through nearly three years of economic recovery.<sup>16</sup>
- The housing market remains depressed. Mortgage loan foreclosures continue to rise, house prices are still falling in many regions, and millions of mortgage holders are "under-water," with the market value of their house below the amount of their mortgage. Beyond the direct effect on economic activity through lower rates of new construction, housing market weakness has a strong negative indirect effect on the balance sheets of households and banks. The sharp fall in household net worth caused by the fall of house prices has been an important factor dampening current consumer spending and the pace of overall economic recovery.
- Growth in the Euro area has been weak and fiscal austerity measures to stem the growth of public debt have likely pushed the region back into recession, slowing growth there further. Slower growth in Europe, a major U.S. export market, will likely transmit a contractionary impulse to the United States, which could slow the pace of the U.S. recovery.<sup>17</sup>

## The Shape of Economic Recovery

In the typical post-war business cycle, lower than normal growth of aggregate demand during the recession is quickly followed by a recovery period with above normal growth of spending, perhaps spurred by some degree of monetary and fiscal stimulus. The degree of acceleration of growth in the first two to three years of recovery has varied across post-war business cycles, but

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<sup>16</sup> Bureau of Labor Statistics, *Labor Force Statistics from the Current Population Survey*, October 2011, <http://www.bls.gov/cps/>.

<sup>17</sup> International Monetary Fund (IMF), *World Economic Outlook*, April 2012, <http://www.imf.org/external/pubs/ft/weo/2012/01/index.htm>.



has been at an annual pace in a range of 4% to 8%.<sup>18</sup> This above normal growth brings the economy back more quickly to the pre-recession growth path and speeds up the reentry of the unemployed to the workforce.

Once the level of aggregate demand approaches the level of potential GDP (or full employment), the economy returns to its pre-recession growth path, where the growth of aggregate spending is slower because it is constrained by the growth of aggregate supply, which in recent years is estimated to have been at an annual pace of near 3.0%. (A subsequent section of the report looks more closely at aggregate supply.)<sup>19</sup>

There is concern, however, that this time the U.S. economy, without supporting stimulus from policy actions, will either not return to its pre-recession growth path, perhaps remain permanently below it, or return to the pre-crisis path but at a slower than normal pace, or worse, dip into a second recession. Below normal growth would almost certainly translate into below normal recovery of employment, whereas a second round of recession could increase the already high unemployment rate. The next sections of this report discuss problems on the supply side and the demand side of the economy that could lead to a weaker than normal recovery.

## **Demand Side Problems?**

Much of the vigor that has occurred on the demand side of the economy in 2009 and 2010 has largely come from fiscal stimulus and business inventory restocking. Fiscal stimulus and inventory rebuilding are, however, temporary sources of support of aggregate spending. Sooner or later fiscal stimulus will fall away. The Congressional Budget Office (CBO) projects that fiscal stimulus peaked in 2010, provided a smaller boost to demand in 2011, and will continue to diminish in 2012.<sup>20</sup> Inventory building is a self-limiting process that will not go on indefinitely; stock-building was weaker during most of 2011, and despite a stronger turn in late 2011 and early 2012, inventory growth will unlikely continue to have a major positive effect on aggregate demand.

A strong recovery of private-sector demand, including consumer spending, investment spending, and exports, is required to sustain an economic recovery that brings the economy quickly back to its pre-recession growth path and unemployment rate. However, there are major uncertainties about the potential medium-term strength of each of these components that could dampen aggregate spending and constrain the economy's ability to generate a recovery period with above normal growth and quickly falling unemployment.

## **Consumption Spending**

Personal consumption expenditures historically constitute the largest and most stable component of aggregate spending in the U.S. economy. During the first three post-war decades, personal consumption spending averaged a 62% share of GDP. However, that share rose significantly over

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<sup>18</sup> Department of Commerce, Bureau of Economic Analysis, <http://www.bea.gov/national/index.htm#gdp>.

<sup>19</sup> The long-term growth of aggregate supply is determined by the growth in the supplies of capital and labor and on the growth in production technology used to turn capital and labor into goods and services.

<sup>20</sup> The Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2012 to 2020*, January 2012, <http://www.cbo.gov/publication/42905>.

the next three decades, averaging about 65% in the 1980s, 67% during the 1990s, and about 70% between 2001 and 2007. The high level of household spending reached during the 2001-2007 expansion is unlikely to reemerge during the current recovery because it was supported by an unsustainable increase in household debt, decrease in personal savings, ease of access to credit, and rising energy prices.

### ***Household Debt***

In the mid-1980s, after a long period of relative stability at a scale of around 45% to 50% of GDP, the debt level of households began to rise steadily, reaching over 100% of GDP by 2008. Such a substantial rise in the level of household debt was sustainable so long as rising home prices and a rising stock market continued to also rapidly increase the value of household net worth, and interest rates remained low, mitigating any rise in the burden of debt service as a share of GDP.

The collapse of the housing and stock markets in 2008 and 2009 substantially decreased household net worth, which had, by mid-2009, fallen about \$16 trillion below its 2007 peak of nearly \$67 trillion.<sup>21</sup> This near 25% fall in net worth pushed the household debt burden up to what may be an unsustainable level, especially if interest rates rise.

Unlike in earlier post-war recoveries, the current need of households to repair their badly damaged balance sheets is resulting in a large diversion of current income from consumption spending to debt reduction. That above normal diversion could persist for several more years and be a continuing drag on the pace of economic recovery.<sup>22</sup>

Some rebuilding of household net worth has occurred during the recovery. Through the fourth quarter of 2011, household net worth has increased by about \$8 trillion, reaching about \$58.4 trillion and recovering slightly more than half of what was lost during the recession. This improvement has occurred largely on the asset side of the household balance sheet, primarily due to the rise of the stock market from its low point in early 2009.<sup>23</sup> However, this source of improvement slowed in 2011, and household net worth actually declined in the first half of 2011. Traditionally, rising home equity, largely dependent on the path of house prices, has been the major contributor to household wealth. The rapid rise of home prices during the last economic expansion caused an equally rapid rise in home equity. Consumers borrowed against this equity to fund current spending. With the sharp fall of home prices, home equity was reduced substantially, erasing that source of funding. Home prices are still falling and the housing market is expected to remain weak for several more years. That weakness is likely to slow the rebuilding of household wealth and be a drag on consumer spending.<sup>24</sup>

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<sup>21</sup> Board of Governors of the Federal Reserve System, "Flow of Funds Accounts," Table B.100, April 2012, <http://www.federalreserve.gov/releases/z1/Current/z1r-5.pdf>.

<sup>22</sup> See Evan Tanner and Yassar Abdih, "Rebuilding U.S. Wealth," *Finance & Development*, IMF, December 2009.

<sup>23</sup> Board of Governors of the Federal Reserve System, "Flow of Funds Accounts," Table B.100, April 2012, <http://www.federalreserve.gov/releases/z1/Current/z1r-5.pdf>.

<sup>24</sup> The standard model of consumer spending used in economic analysis assumes that consumers seek to avoid large swings in their living standards over the course of their lifetimes. Thus as incomes rise and fall both in the short and long term, individuals are expected to vary their saving rate to minimize the effect on their consumption. If consumers seek to maintain a fairly stable level of consumption over their entire lives, then the level of consumption at any given point in their lives will depend on their current wealth and some expectation about their income over the rest of their lives. See Annamaria Lusardi, Jonathan Skinner, and Steven Venti, "Saving Puzzles and Saving Policies in the United States," National Bureau of Economic Research, Working Paper 8237, April 2001.

In addition to diverting more personal income to saving, a continued weak labor market is likely to dampen income growth and, in turn, slow the recovery of consumer spending.

### ***Credit Conditions***

Easy credit availability in the pre-crisis economy enabled households to readily borrow against their rising home equity to fund added spending. Financial innovations allowed lenders to keep interest rates low and offer liberal terms and conditions to entice households to borrow. Many believe that credit conditions will be tighter during the current expansion. Interest rates are still low, but banks greatly tightened the terms and conditions of consumer loans during the crisis and recession and have only slowly relaxed them as the recovery has proceeded. While not likely as important a driver of higher savings as high household debt, tighter credit conditions will make it less likely that households will exploit any increase in their home equity to fund current spending, further constraining consumer spending relative to what occurred during the 2001-2007 economic expansion.

### ***Personal Saving***

The U.S. personal saving rate had averaged about 10% of GDP consistently through the 1970s, 1980s, and 1990s. Subsequently, the personal saving rate declined sharply, reaching a low of 1.0% by 2005.<sup>25</sup> It is likely that the evaporation of household saving was in large measure a consequence of the sizable increase in household net worth associated with increased house prices and stock prices occurring at that time. As wealth rose rapidly, it was less urgent to divert current income to saving.

The sharp reduction of household net worth during the recent recession dramatically changed the financial circumstances of households, reducing the use of debt-financed spending. The need to repair household balance sheets is likely to induce households to pay down debt. The poor prospect for the appreciation of house prices will sharply limit the ability to use rising equity as a substitute for saving.

In addition, the above normal increase in economic uncertainty in the aftermath of the financial crisis and recession will likely mean that over the medium term, households could be more inclined to save. As the economic decline intensified, the personal saving rate increased, climbing from 3.5% of GDP in 2007 to 6.1% of GDP in 2009.<sup>26</sup> However, since that point, the personal saving rate has fallen, reaching 4.7% in 2011. The passing of the dire financial and economic circumstances that prevailed in 2008 and 2009 has likely led to some of the recent moderation in households' saving behavior. A lower rate of saving enables higher rates of consumption, but it is unlikely that this could be an enduring support for economic recovery.

### ***Energy Prices***

A 30% increase in the price of oil from October 2011 through April 2012 has likely adversely affected household budgets and contributed to the slow rate of increase in consumer spending

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<sup>25</sup> See CRS Report R40647, *The Fall and Rise of Household Saving*, by Brian W. Cashell.

<sup>26</sup> U.S. Department of Commerce, Bureau of Economic Analysis, *National Income and Product Accounts*, Table 5.1, <http://www.bea.gov/national/nipaweb/SelectTable.asp?Selected=N>.

over the same period.<sup>27</sup> In the short run, the U.S. demand for energy is relatively inelastic, with little curtailment of energy use in the face of the rising price. As households and businesses spend more for energy, which is largely imported, they tend to spend less on domestic output, slowing economic growth.<sup>28</sup> Since April 2011, the price of oil appears to have stabilized, and if it remains near the current level, the dampening effect on economic growth is likely to fade.

### ***Slow Recovery of Consumer Spending?***

If consumer spending continues its slow paced recovery, then for the U.S. economy to return to its normal pre-crisis growth path, an improved pace of GDP growth will have to come from other components of aggregate demand: investment spending, net exports, or government spending.

### **Investment Spending**

Investment spending is the third-largest component of aggregate spending, historically averaging 17% to 18% of GDP in years of near normal output growth. (Government spending is second largest at about 20%.) Historically, the largest portion of total investment spending is business fixed investment, its share averaging 11% to 12% of GDP in periods of normal growth. The second component of total investment is residential investment (i.e., new housing), averaging 4% to 5% of GDP.

Investment spending is very sensitive to economic conditions and more volatile than consumer spending. This sensitivity is at least in part because investment projects are often postponable to a time when economic conditions are more favorable. Its volatility makes investment spending an important determinant of the amplitude, down and up, of the typical business cycle.<sup>29</sup>

As aggregate spending fell and credit availability tightened in 2008, investment spending quickly weakened. As a share of real GDP, investment spending fell from about 16% in 2007 to about 11% at the economy's trough in 2009. The sharp fall in real GDP from the second quarter of 2008 through the first quarter of 2009 was nearly fully accounted for by the sharp fall of investment spending over this same period. With economic recovery, investment spending was a leading source of economic growth, elevating its share of real GDP to 13.1% in 2010; it continued to increase strongly over 2011, reaching 13.5% of real GDP. In the first quarter of 2012, investment spending continued its upward trend reaching 14% of real GDP.

In particular, the *equipment and software* component of nonresidential investment has been the principal source of business spending strength and an important contributor to the pace of the economic recovery. Equipment and software spending increased 14.6% in 2010, contributing nearly a full percentage point to the growth of real GDP in that year. This category of business investment spending continued to be an important source of economic growth in 2011, increasing at an annual rate of 10.4% and contributing 0.7 percentage points to real GDP growth. However,

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<sup>27</sup> U.S. Energy Information Administration, *Petroleum: Weekly Spot Price*, May 2010, <http://www.eia.gov/dnav/pet/hist/LeafHandler.ashx?n=PET&s=RCLC1&f=D>.

<sup>28</sup> Research indicates that a \$10 increase in the per barrel price of oil sustained for two years is likely to reduce real GDP growth relative to base-line by 0.2 percentage points in the first year and 0.5 percentage points in the second year. See U.S. Energy Information Administration, *Economic Effects of High Oil Prices*, 2006, [http://www.eia.gov/oiaf/aeo/otheranalysis/aeo\\_2006analysispapers/efhop.html](http://www.eia.gov/oiaf/aeo/otheranalysis/aeo_2006analysispapers/efhop.html).

<sup>29</sup> *Ibid.*, Table 1.1.5.

in the first quarter of 2012 investment spending on equipment and software slowed substantially, increasing at a much slower 1.7% annual rate.<sup>30</sup>

Typically, this same sensitivity also works in the opposite direction. Strongly rising investment spending, responding to improving market demand, reduced uncertainty, and expanding credit availability, often gives above normal contribution to the rebound of aggregate spending during the recovery phase of the business cycle.

Looking forward, however, some significant constraints on both residential and business investment raise uncertainty about whether investment spending will continue to be a strong contributor to economic recovery, and therefore, whether it could be a component of aggregate spending capable of compensating for a weaker than normal recovery of spending by consumers.

The principal constraint on residential investment is likely to be the large inventory of vacant housing, left over from the 2002-2006 housing boom. It is estimated that the number of vacancies could be more than 2 million units above what would normally be expected at this stage of the business cycle. As discussed above, it is still not clear that the housing market has stabilized, and new construction remains weak. The rate of housing starts is likely to remain low for the next two years while the inventory overhang is worked down.

The prospect for nonresidential investment is likely to be better than for residential investment, but it is not clear that with economic recovery nonresidential investment will exceed its pre-crisis level. On the supply side, capacity utilization rates have climbed back from record lows of below 70% reached during the recession, but, at about 75% currently, are still only at the lows reached in the 1990 and the 2001 recessions and well short of the 80% to 85% that would typically correspond to operating near or at capacity.<sup>31</sup> On the demand side, business investment in new plants and equipment is most often a response to the expectation of increased demand for the products they produce. The main driver of that demand is consumer spending and, as discussed above, that spending has been tepid, with the not unlikely prospect that it may continue to be weak over the near term if households have made a lasting commitment to increased savings.

Stronger foreign demand could also stimulate investment spending and in theory compensate for the weaker pull of domestic demand, but as discussed more fully below, foreign demand may also be weak. Also, problems in the financial sector have caused sharply reduced activity in commercial real estate, contributing to persistent weakness in business investment spending on structures.

In general, it seems questionable whether total investment spending would provide the offset to a below normal contribution of consumption spending to economic growth over the near term.

## **Net Exports**

The U.S. trade deficit (real net exports) shrank from about 6% of real GDP in 2006 to below 3% in 2009. Since the beginning of the recession in late 2007 through the end of the contraction in

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<sup>30</sup> Department of Commerce, Bureau of Economic Analysis, *National Income and Product Accounts*, Table 1.1.5, <http://www.bea.gov/national/index.htm#gdp>.

<sup>31</sup> Data for capacity utilization are available at Board of Governors of the Federal Reserve System, *Industrial Production and Capacity Utilization*, Table G17, <http://www.federalreserve.gov/releases/g17/>.

mid-2009, net exports made a significant positive contribution to real GDP in an otherwise declining economy. Even as economic weakness abroad caused U.S. exports to fall, imports fell by more, providing a net positive push to current economic activity.<sup>32</sup>

The 3 percentage point swing in real net exports is, however, largely the consequence of the severe economic weakness in the United States over this period. Since mid-2009, the deficit in net exports has increased slightly, reaching 3.2% of real GDP in 2010, but in 2011 the deficit decreased slightly, falling to 3.1% of real GDP; and in the first quarter of 2012 it fell to 3.0% of GDP. This relatively flat performance means that over the course of the current recovery net exports have had not had either a substantial positive or negative impact on economic growth. This neutral pattern makes it uncertain that net exports can be expected to boost aggregate spending sufficiently to offset weak consumption over the medium term and help assure a sustained recovery at a pace that steadily reduces unemployment.

### ***Boosting U.S. Net Exports Through a Rebalancing of Global Spending***

Increasing U.S. net exports to any degree requires that the trade deficit continue to decrease. For that to happen, trade surpluses of the rest of the world with the United States must simultaneously decrease. To achieve this adjustment of trade flows, a sizable rebalancing of domestic and external demand on the part of the deficit and surplus economies would need to occur.<sup>33</sup>

Because a trade deficit is a consequence of an economy spending more than it produces, rebalancing in this circumstance requires a decrease of domestic spending and increase of domestic saving. In contrast, for overseas trade partners, because a trade surplus is a consequence of an economy spending less than it produces, rebalancing in this circumstance requires an increase of trade partner domestic spending and decrease in trade partner domestic saving.

This rebalancing of spending will put pressure on the dollar to depreciate and foreign currencies to appreciate. A fall in the value of the dollar relative to the currencies of the surplus countries causes the price of foreign goods to rise for U.S. buyers and the price of U.S. goods to fall for foreign buyers. This change in the relative price of foreign versus domestic goods will cause the net exports of the United States to rise, giving the boost in spending needed to potentially offset reduced consumption spending. The change in relative prices would also cause the net exports of surplus countries to fall as more of current output is absorbed by increased domestic spending.

In the United States, as discussed above, some measure of rebalancing seems to be occurring, as evidenced by the increase in the personal saving rate above its pre-recession low. Although there are good reasons to expect this increase to be sustained, there is the possibility that households would eventually revert to their pre-crisis low saving patterns. However, even if household saving remains higher, it is likely that any significant increase in the overall U.S. national saving rate would also require an increase in government saving via smaller federal budget deficits.

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<sup>32</sup> Department of Commerce, Bureau of Economic Analysis, *National Income and Product Accounts*, Table 1.1.6, <http://www.bea.gov/iTable/iTable.cfm?ReqID=9&step=1>.

<sup>33</sup> On global rebalancing, see, for example, Olivier Blanchard, “*Sustaining Global Recovery*,” International Monetary Fund, September 2009, “Rebalancing,” *The Economist*, March 31, 2010, <http://www.imf.org/external/pubs/ft/fandd/2009/09/index.htm>, and Board of Governors of the Federal Reserve System, Vice-chairman Donald L. Kohn, Speech “Global Imbalances,” May 11, 2010, <http://www.federalreserve.gov/newsevents/speech/kohn20100511a.htm>.

Large U.S. budget deficits over the near term are providing a needed boost to weak aggregate spending during the early stages of an economic recovery. With the strengthening of private spending as the recovery matures, large government budget deficits would fade away, causing government saving to rise. What puts this fading away of budget deficits in doubt over the long term is the prospect of having to fund the obligations attached to the rising demand of an aging U.S. population for healthcare, Social Security, and other entitlements. Without policy actions to address these long-term demands, it is not clear how the long-term budget deficits will fall.

Effective global rebalancing arguably also involves sizable adjustments by the largest surplus economies—Germany, Japan, and China. However, there are significant potential constraints on how substantially each of these three economies can “save less and spend more,” perhaps limiting any sizable appreciation of their currencies relative to the dollar, and any associated boost in U.S. net exports.

The inability of Germany to move its exchange rate independently from the other Euro area economies reduces its flexibility of adjustment. In addition, the effects of the 2008-2009 recession have left limited room for further fiscal expansion and small ability to lower the household saving rate. In addition, the ongoing sovereign debt crisis in the euro area has dampened growth prospects in Germany, likely weakening the demand for U.S. exports. While its level of debt is not high, recent German policy actions have stressed fiscal consolidation, tending to increase saving and dampen spending. Japan, which does have a very high level of public debt, has little to no room for fiscal expansion and a poor prospect of boosting household spending. Moreover, both Germany and Japan, faced with substantial near-term economic weakness in the aftermath of the global recession, may take steps to avoid the dampening of their net exports that a sizable appreciation of the exchange rate would cause.

China has the largest bilateral trade surplus with the United States and therefore has the potential to have a large impact on U.S. export sales and through that a significant positive impulse on the pace of the U.S. economic recovery. Also, economic growth has remained relatively strong in China through the recent global financial crisis and recession, and aggregate demand is expected to be strong through the next two to three years. What is uncertain, however, is whether a greater share of this spending will be domestic demand, particularly consumption spending by Chinese households.

The very high rate of saving by Chinese households is thought to be a precautionary measure to compensate for a lack of social insurance. It likely also reflects limited access to consumer credit. The difficulty for the near-term task of sustaining economic recovery is that even if policy actions are taken to remove these constraints on consumer spending, households are likely to only gradually change their pattern of consumption and not provide a sharp near-term boost to domestic spending.

Also, a closer look at the sources of increase in China’s domestic saving over the last decade reveals that the principal contributor to that growth was Chinese companies, not households. Therefore, changing the saving practices of Chinese companies is likely to be an important aspect of any large increase in China’s saving rate. It is argued by some that Chinese companies retain too large a share of their earnings. Better access to credit and changes in the governance rules of Chinese business would likely reduce the business saving rate. But, as with households, even if

such policy initiatives are forthcoming, the change in the business saving rate is likely to emerge only gradually.<sup>34</sup>

Even with a successful rebalancing, it is unlikely that China alone can propel a boost in U.S. net exports sufficient to offset weak domestic demand and pace economic recovery. China's global trade surplus is estimated to be about 10% of GDP. However, China is only about one-third the size of the U.S. economy. Therefore, if China's trade were only with the United States, it would have to reduce its trade surplus by 3% of GDP to affect a 1 percentage point reduction of the U.S. trade deficit. But since, in fact, only about 16% of China's trade is with the United States, it would take a 15 percentage point change in China's trade balance (moving from a surplus equal to 10% of GDP to a deficit equal to 5% of GDP) to reduce the U.S. trade deficit by 1 percentage point. (This assumes that the fall of China's trade surplus is not offset by an increase of other trading partners surpluses.)

Other emerging Asian economies also run trade surpluses, and adding these to the calculation makes the relative scale of rebalancing needed to achieve a given amount of improvement in the U.S. trade deficit more feasible. However, all of emerging Asia is only about half the size of the U.S. economy. Therefore, if the U.S. share of the whole region's trade is similar to China's, emerging Asia would need to accomplish a sizable 7 percentage point change in its trade balance to generate a 1 percentage point change in the U.S. trade balance. As with China, for a reduction of the trade surpluses of other emerging Asian economies to happen quickly, their currencies will need to appreciate against the dollar.

All in all, there are reasons to doubt whether U.S. net exports can increase over the near term at a pace sufficient to fully compensate for the prospect of slower than normal growth of other components of U.S. domestic spending.

## **Supply Side Problems?**

The supply side of the economy governs its capacity for producing goods and services. That capacity is a function of the economy's supplies of labor and capital and the level of technology used to turn labor and capital into the output of goods and services. In the short run, the potential supplies of these productive factors are relatively fixed and will determine the economy's potential output. In periods of economic slack, rising aggregate demand can increase the economy's output and employment up to the level of potential output, which corresponds with full employment.

In the long run, as the supplies of capital and labor and the level of technology increase, the level of potential output also increases. Over time the steady rise of potential output will define the economy's long-term growth path (called the "trend" growth rate). When aggregate demand is below potential output the economy can grow faster than trend growth, but when the level of

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<sup>34</sup> Of course, for these reforms to translate into a shift in China's trade balance, that nation must be willing to allow its' exchange rate to rise relative to the dollar, causing a decrease in the price of foreign goods relative to domestic goods, and exerting downward pressure on China's trade surplus. From July 2005 to February 2009, China abandoned its dollar peg, allowing the yuan to appreciate by 28% (on a real trade-weighted basis). However, faced with weakening export sales due to the global financial crisis China for the last 10 months has re-pegged the yuan to the dollar. China's export-led growth model, relying on a high saving rate (to keep internal demand low) and a low exchange rate pegged to the dollar (to keep external demand high), has been very successful and, despite the possible advantages of reforms to boost domestic demand, it is uncertain whether China would move substantially away from this model.



aggregate demand reaches the level of potential output, further growth of output will be constrained to the trend growth rate.

Typically the long-run growth path is thought to be relatively stable and not greatly affected by recessions and the associated short-term fluctuations in aggregate demand. Over the post-war period, the average annual growth rate of potential output for the United States has been 3.4%; however, since the 1970s it has averaged closer to 3.0%.<sup>35</sup>

An analysis by the International Monetary Fund (IMF) examines the question of whether output will return to its pre-crisis trend.<sup>36</sup> It examines the medium-term and long-run paths of output after 88 banking crises over the past four decades in a wide range of countries (including both advanced and developing economies). A key conclusion was that seven years after the crisis, output had declined relative to trend by nearly 10% for the average country. But there was considerable variation of outcomes across crisis episodes.

In other words, such crises not only reduce actual output, but also may reduce potential output (the economy's structural and institutional capacity to produce output). In this circumstance, the economy could return to its trend growth rate, but there is unlikely to be a rebound period of above normal growth to quickly return the economy to its pre-crisis potential output and growth path and, in turn, quickly reduce unemployment. This failure to return to the pre-crisis potential output means that the economy bears the burden of a permanent output loss and the large initial increase in the unemployment rate caused by the crisis could persist even as the economy is growing at its trend rate.

The reduction of the post-crisis growth path is found to be the consequence of decreases of approximately equal size in the employment rate, the capital-labor ratio, and productivity. The adverse effect of the financial crisis on the employment rate is thought to arise from an increase in the "structural unemployment rate," hampering the post-crisis economy's ability to accomplish the needed reallocation of labor from sectors that have contracted permanently to sectors that are expanding.

Because the aftermath of the crisis will likely involve sizable changes in the composition of the economy, it likely also increases the mismatch between the skills of the unemployed and the skills demanded in the post-crisis labor market—job vacancies go unfilled for lack of a worker with sufficient skills for the job.<sup>37</sup> Also, labor force participation rates may fall if the crisis is severe enough to substantially increase the numbers of the long-term unemployed, some of whom may become discouraged from searching for a new job. A crisis-induced fall of house prices and a rising incidence of mortgages with negative equity will also discourage the geographic mobility of workers who are unable to sell their houses.

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<sup>35</sup> Ibid., CBO, p.39.

<sup>36</sup> P. Kannan, A. Scott, and M. Terrones, "From Recession to Recovery: How Soon and How Strong?," in *World Economic Outlook*, April 2009, pp. 103-138. International Monetary Fund. Also see Furceri, Davide and Annabelle Mourougane, "The Effect of Financial Crisis on Potential Output: New Empirical Evidence from OECD Countries," *Economics Department Working Papers No. 699*, May 2009.

<sup>37</sup> Employment in construction, financial services, and some types of manufacturing may remain depressed for some time, requiring some who lose their jobs in those sectors to seek employment in other sectors. See also CRS Report R41785, *The Increase in Unemployment Since 2007: Is It Cyclical or Structural?*, by Linda Levine.

The adverse impact of a financial crisis on capital accumulation is likely the combined outcome of several factors. Decreased demand for products and heightened uncertainty of potential return dampens the incentive to invest. In addition, the financial crisis could impede the process of financial intermediation for up to several years, as weakened balance sheets, lower collateral values, and elevated risk premiums slow the flow of credit and elevate the real cost of borrowing.

The dampening effect on productivity may occur as higher risk premiums and a generally more cautious approach to spending by businesses diminish the willingness and ability to finance relatively high-risk projects. Expenditures on research and development are typically pro-cyclical and likely to be sharply reduced in times of crisis.

Productivity tends to recover quickly after recessions and thus allows the economy to resume growth at the pre-crisis trend rate. However, the capital and employment losses tend to endure and keep the economy on a lower growth path.

Has the recent financial crisis caused a reduction in the potential output of the U.S. economy and placed it on a lower trend growth path? It is difficult to make a concurrent determination because potential output is not directly observable, and can only be imputed from the economy's actual post-crisis performance. A clear determination of any such permanent output loss is some years in the future.

Although the IMF study gives reasons why the financial crisis possibly could have adversely affected the economy's supply side, the study also finds that there can be some significant mitigating factors that could be particularly relevant for the U.S. economy. First, a high pre-crisis investment share is a good predictor of a large potential output loss. This is a reflection of the high sensitivity of investment to the negative effects of a financial crisis. For the United States there was no sharp increase in investment spending above trend as measured as a share of GDP for the three years prior to the financial crisis, averaging near a typical 16% of GDP.

Second, the IMF study also found that those economies that aggressively apply stimulative fiscal and monetary policies during the crisis tend to have smaller medium-term output losses. As already discussed, the United States has applied quickly and substantially stimulative policies in response to the financial crisis.

Third, countries with fewer labor market rigidities suffered smaller medium-term output losses. U.S. labor markets, as compared to other advanced economies, are relatively free of labor market rigidities, though as mentioned declining house prices may have reduced mobility of some workers who own their own homes.

CBO currently projects U.S. potential output to increase at an annual average rate of 2.2% for the 2011-2016 period, slightly below the 2.4% pace of the 2002-2010 period. CBO's projected rate of growth of potential output is well below the post-war average of 3.3%. Slower growth of potential GDP is largely the consequence of a projection of significantly slower labor force growth than during the post-war period in the coming decades. Most of the slow down in labor force growth is related to long-term demographic changes forced by an aging population, however, a protracted recession with growing numbers of long-term unemployed and discouraged workers has also contributed to this labor force dynamic.<sup>38</sup>

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<sup>38</sup> The Congressional Budget Office, *Budget and Economic Outlook: An Update*, August 2012, Table 2-3, (continued...)

## **Policy Responses to Increase the Pace of Economic Recovery**

The momentum of the current economic recovery has been assisted by injections of fiscal and monetary stimulus. But with substantial economic slack remaining and with unemployment still stubbornly high, would further stimulus by monetary and fiscal policy be warranted to sustain economic recovery?

### **Fiscal Policy Actions Taken During the Recovery**

In 2010, many economists argued that another dose of fiscal stimulus was warranted because the effects of the first stimulus package were beginning to fade, and because of evidence that private spending lacked sufficient vigor to sustain a healthy recovery.<sup>39</sup> In this situation, the risk of not applying further fiscal stimulus could be several years of sub-normal growth, or worse, dipping into a second recession.

In response to concerns that the recovery was faltering, Congress passed and President Obama signed in December 2010 the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312). The essential features of that measure were an extension for two years of the “Bush” tax cuts, a 2 percentage point cut in the payroll tax during 2011, a 13-month extension of unemployment benefits, and allowance for more rapid expensing of business investment in 2011. CBO estimated that the direct simulative effect of these revenue and spending changes as measured by the increase in the federal budget deficit would be approximately \$374 billion in 2011 and \$422 billion in 2012.<sup>40</sup>

A major counterforce to federal stimulus policies has been contraction of spending by state and local governments. Direct expenditures by state and local governments decreased 1.8% in 2010 and 2.2% in 2012, having the effect of subtracting from real GDP growth 0.2 percentage points in 2010 and 0.3 percentage points in 2011.

### ***Evaluating the Case for Fiscal Stimulus***

Fiscal stimulus is not without its critics. The case against more fiscal stimulus comes in three forms, used separately or in combination: one, no further stimulus is needed; two, fiscal stimulus does not work; and three, stimulus increases the budget deficit, makes the U.S. long-term debt problem worse, and dampens economic growth.<sup>41</sup>

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<http://www.cbo.gov/doc.cfm?index=12316>.

<sup>39</sup> Lawrence H. Summers, “*Reflections on Fiscal Policy and Economic Strategy*,” Speech at the Johns Hopkins School of Advanced International Studies, May 24, 2010. Other economists have also concluded that further stimulus is called for. See, for example, Brad DeLong “The Worst -of-Both-Worlds Fiscal Policy,” June 18, 2010, <http://delong.typepad.com/sdj/2010/06/worst-of-both-worlds-fiscal-policy.html>; and “The Case for More Stimulus” Interview with William Gale of the Brookings Institution, June 2010, <http://www.theatlantic.com/business/archive/2010/06/the-case-for-more-stimulus/57776/>.

<sup>40</sup> Congressional Budget Office, CBO Estimate of Changes in Revenue and Direct Spending for the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, <http://www.cbo.gov/ftpdocs/120xx/doc12020/sa4753.pdf>.

<sup>41</sup> See, for example, Derek Thompson, “The Case Against More Stimulus,” *The Atlantic*, June 2010, <http://www.theatlantic.com/business/archive/2010/06/the-case-against-more-stimulus/57774/>, and “Here’s Why Fiscal (continued...)”

In regard to the need for stimulus, the U.S. economy does have strong recuperative powers and it is possible that private spending and economic growth will soon surge without further fiscal stimulus. Events such as improved consumer confidence, lower energy prices, a more normal flow of credit, or faster growth in the rest of the world could separately or in combination induce stronger spending by households and businesses. However, given the severity of the recent recession and, as outlined above, given the current weakness of private spending and the several economic obstacles that households and businesses will probably continue to face over the near term, there remains a significant risk of sub-normal growth for the next several years.

In regard to the ability of fiscal stimulus to boost output and employment, some economists argue that fiscal stimulus only shifts spending, it does not increase spending. In this view, when people see the government running a budget deficit, they anticipate that the government will need to increase taxes in the future to pay off the debt. This anticipation causes households and businesses to increase their current savings to pay for the higher taxes. The increase in saving tends to offset the stimulative effect of the budget deficit.<sup>42</sup> There is little empirical support for this theory, however. Mainstream economic analysis indicates that in circumstances like the present, in which the economy's output is likely constrained by insufficient demand, fiscal stimulus can raise the level of output and employment.<sup>43</sup>

In regard to the long-term debt problem, it is often pointed out that for an economy operating close to potential output, government borrowing to finance budget deficits will draw down the pool of national saving, leaving less available to support private capital investment. Private investment by business and households in education, housing, research and development, and capital equipment that would have otherwise occurred is in theory "crowded out" through higher interest rates bid up by government borrowing. If budget deficits divert national saving from private investment, other things equal, future productivity and income growth may be slowed. However, the U.S. economy is currently operating well short of capacity and market interest rates are generally at or near historical lows, making the risk of such "crowding out" occurring and damaging future economic growth not seem immediate.<sup>44</sup> Another variant of this argument against fiscal stimulus maintains that by increasing public debt, fiscal stimulus undermines household and business confidence and causes them to postpone current spending. In this view,

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Stimulus Won't Work," *The Atlantic*, February 2010, <http://www.theatlantic.com/business/archive/2010/02/heres-why-government-stimulus-does-not-work/36466/>.

<sup>42</sup> This theory is called "Ricardian equivalence." It is named after the nineteenth-century economist David Ricardo who first made the argument. For further discussion see N. Gregory Mankiw, *Principles of Economics* (Ft. Worth, Dryden Press, 1998), p. 556, and Robert J. Barro, "Are Government Bonds Net Wealth?" *Journal of Political Economy*, vol. 82, no. 6. (November-December, 1974), pp. 1095-1117.

<sup>43</sup> See CRS Report RL31235, *The Economics of the Federal Budget Deficit*, by Brian W. Cashell; Alan J. Auerbach and William G. Gale, "Activist Fiscal Policy to Stabilize Economic Activity," working paper, September 29, 2009, available at <http://elsa.berkeley.edu/~auerbach/activistfiscal.pdf>; and Robert E. Hall, "By How Much Does GDP Rise If the Government Buys More Output?" *Brookings Papers on Economic Activity*, fall 2009, pp. 183- 250. On the probable stimulative impact of alternative fiscal measures see CBO, *Policies for Increasing Economic Growth and Employment*, March 2010, [http://www.cbo.gov/ftpdocs/112xx/doc11255/02-23-Employment\\_Testimony.pdf](http://www.cbo.gov/ftpdocs/112xx/doc11255/02-23-Employment_Testimony.pdf), and J. Bradford DeLong and Lawrence H. Summers, "Fiscal Policy in a Depressed Economy," The Brookings Institution, March 2012.

<sup>44</sup> For discussion of the long-term debt issue, see President Obama's *National Commission on Fiscal Responsibility and Reform*, <http://www.fiscalcommission.gov/>.

contrary to mainstream economic thinking, shrinking the deficit would, by improving confidence, actually stimulate current spending by consumers and business.<sup>45</sup>

### *The Short-Term and Long-Term Fiscal Problems*

Because the United States faces two macroeconomic problems, two policy responses are, arguably, appropriate: a short-term policy to sustain a cyclical recovery of economic growth and a long-term policy to trim government debt. Conceptually there is no necessary tradeoff between these two objectives. They can be mutually reinforcing: a credible commitment to dealing with the long-term debt problem allays investor uncertainty and increases the near-term incentive to spend, while effectively dealing with the short-term problem of weak aggregate demand puts the economy on a stronger growth path, which boosts tax revenue and eases the long-term debt problem.

Once the short-term problem of weak demand is solved and the economy has returned to a normal growth path, the appropriate policy response for an economy with a looming debt crisis is fiscal consolidation—cutting deficits. Such a policy would have the benefits of low and stable interest rates, a less fragile financial system, improved investment prospects, and possibly faster long-term growth.

To address the government's long-term fiscal problem, Congress passed on August 2, 2011, the Budget Control Act of 2011 (P.L. 112-25). The Budget Control Act (BCA) sets caps on discretionary spending. It also created the Congressional Joint Select Committee on Deficit Reduction, whose task was to propose further policy changes that would lead to \$1.5 trillion in further deficit reduction over 10 years. The joint committee was unable to reach an agreement on how to achieve further deficit reduction. In the absence of an agreement, the BCA established a process for automatic spending reduction. The CBO estimates that the fiscal restraint caused by the expiration of provisions of the 2010 tax act and from enactment of the BCA will decrease real GDP in 2013 by between 1.5% and 3.5%.<sup>46</sup>

### *The Impending "Fiscal Cliff"*

Fed Chairman Ben Bernanke, speaking at an April 2012 press conference, warned about the likely adverse effect on the economic recovery of the "fiscal cliff" the economy could face in January 2013.<sup>47</sup> The fiscal cliff refers to the confluence of various spending cuts and tax rate increases that are scheduled to occur at the beginning of the new year unless policies are changed. The scheduled fiscal events include the end of the extension of the Bush tax cuts, the need for adjustment of the alternative minimum tax (AMT), the end of the Social Security payroll tax cut, reductions in Medicare reimbursement payments, and spending cuts mandated by the "sequestration" process of the 2011 BCA.<sup>48</sup> CBO has estimated that the combined impact of these

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<sup>45</sup> For further discussion of this issue, see CRS Report R41849, *Can Contractionary Fiscal Policy Be Expansionary?*, by Jane G. Gravelle and Thomas L. Hungerford.

<sup>46</sup> For more information on the BCA, see CRS Report R41965, *The Budget Control Act of 2011*, by Bill Heniff Jr., Elizabeth Rybicki, and Shannon M. Mahan; and the Congressional Budget Office, *Budget and Economic Outlook: An Update*, August 2011, p. 38, <http://www.cbo.gov/doc.cfm?index=12316>.

<sup>47</sup> Board of Governors of the Federal Reserve System, *Press Conference*, <http://www.federalreserve.gov/mediacenter/files/FOMCpresconf20120425.pdf>.

<sup>48</sup> For more information, see CRS Report R42362, *The Federal Budget: Issues for FY2013 and Beyond*, by Mindy R. (continued...)

policy events would be a fiscal contraction of about \$388 billion (or about 2.5% of GDP) in 2013.<sup>49</sup> As this fiscal shock of this size reverberates through the wider economy, CBO in an earlier study had estimated that in 2013 real GDP growth could be slowed by as much as 2.9 percentage points and the unemployment increased by as much as 1.8 percentage points.<sup>50</sup>

## **Monetary Policy Actions Taken During the Recovery**

On November 3, 2010, the Fed announced that it would provide more monetary stimulus by means of the purchase an additional \$600 billion of Treasury securities at a pace of about \$75 billion per month, and continue the practice of replacing maturing securities with Treasury security purchases. When this second round of monetary stimulus (sometimes referred to as “quantitative easing 2” or QE2)<sup>51</sup> was completed in June 2011, the Fed had increased the size of its balance sheet to more than \$2.5 trillion. The maturity lengths of the securities purchased were mostly between 2½ and 10 years.<sup>52</sup>

The Fed argued at that time that a second dose of monetary stimulus was needed because economic growth is decelerating and much of what economic momentum existed was being provided by the transitory factors of inventory adjustment and fiscal stimulus. In the second half of 2010, growth slowed to around 2%, a pace barely fast enough to keep the unemployment rate from rising. Fed Chairman Ben Bernanke indicated that of particular concern was the substantial increase in the share of the long-term unemployed (workers who have been without work for six months or more). Such long-term unemployment tends to convert temporary cyclical unemployment into more intractable structural unemployment. In addition, the lingering economic slack in the economy had added to deflationary pressure. Measures of core inflation had been decelerating during 2010, reaching a low of only slightly above 1%. A continuous decline in the price level is troublesome because in a weak or contracting economy it can lead to a damaging, self-reinforcing, downward spiral of prices and economic activity. Deflation exacerbated the economy’s decline during the Great Depression.<sup>53</sup>

To support a stronger recovery, the Fed announced on September 21, 2011, that it would purchase by the end of June 2013 \$400 billion of Treasury securities with remaining maturities of 6 years to 30 years and to sell an equal amount of Treasury securities with remaining maturities of 3 years or less. By changing the composition of its asset holdings toward longer maturities, the Fed is attempting to put downward pressure on longer-term interest rates and increase monetary policy’s stimulative effect on economic activity.<sup>54</sup>

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Levit and CRS Report R42485, *An Overview of Tax Provisions Expiring in 2012*, by Margot L. Crandall-Hollick.

<sup>49</sup> CBO, *Updated Budget Projections: Fiscal Years 2012 to 2022*, March 2012, <http://www.cbo.gov/publication/43119>.

<sup>50</sup> CBO, *The Budget and Economic Outlook: Fiscal Years 2012 to 2022*, January 2012, [http://www.cbo.gov/sites/default/files/cbofiles/attachments/01-31-2012\\_Outlook.pdf](http://www.cbo.gov/sites/default/files/cbofiles/attachments/01-31-2012_Outlook.pdf).

<sup>51</sup> On the policy of quantitative easing, see CRS Report R41540, *Quantitative Easing and the Growth in the Federal Reserve’s Balance Sheet*, by Marc Labonte.

<sup>52</sup> Board of Governors of the Federal Reserve System, *Federal Open Market Committee*, <http://www.federalreserve.gov/monetarypolicy/fomccalendars.htm>.

<sup>53</sup> For further discussion of deflation, see CRS Report R40512, *Deflation: Economic Significance, Current Risk, and Policy Responses*, by Craig K. Elwell.

<sup>54</sup> Board of Governors of the Federal Reserve System, press release, September 21, 2011, <http://www.federalreserve.gov/newsevents/press/monetary/20110921a.htm>.

### *Evaluating the Case for Monetary Stimulus*

The Fed's recent policy initiative to provide a second round of monetary stimulus has been criticized. One concern is an increased risk of inflation. Such a large increase in bank reserves would also lead to a rapid increase in the overall money supply through the "money multiplier" effect, which in normal times might generate inflation. At present, the sizable degree of slack in the economy and banks' heightened tendency to hold reserves rather than lend them out keeps the risk of inflation low.

As noted above, one of the reasons for initiating a second round of monetary stimulus in late 2010 was to counter an incipient deflation problem, which is accomplished by policies that exert upward pressure on the level of prices, that is, policies that generate some degree of inflation. The Fed's second round of monetary stimulus seems to have reduced the deflation risk.

Also, some of the recent increase in broad measures of inflation, such as the consumer price index (CPI), is due to the sharp rise in oil and other commodity prices in the first half of 2011 and again in early 2012. However, such inflation effects are most often temporary and not a source of persistent inflationary pressure. The "core CPI," a measure of inflation that does not include volatile food and energy prices, has remained low. Other indicators also suggest that inflation is likely to remain subdued. First, wages, which are generally the most important determinant of unit production costs, have been stable. Second, longer-term inflationary expectations, as measured by the yields on long-term securities, have not risen appreciably.

However, when the economy returns to more normal conditions, reserves would likely need to be removed to avoid excessive upward pressure on prices. The likely unprecedented scale of the reserves that might need to be drained from the economy has raised concerns about whether the Fed could effectively provide the degree of restraint needed to keep inflation under control.

A second criticism of the Fed's monetary stimulus during the recovery is that it depreciated the dollar. Although influencing the exchange rate is not a stated goal of the Fed's policy, standard macroeconomic theory would predict, all else equal, that a by-product of monetary stimulus would be a depreciation of the dollar (assuming other countries do not similarly alter their monetary policy in response). A weaker dollar would add to the stimulative effect of monetary stimulus on total spending in the United States by increasing exports and decreasing imports. However, countries such as Germany, Japan, and China that have relied on net exports to propel their economic growth are resistant to a depreciating dollar and have criticized the Fed's actions.

As it turns out, the dollar depreciation that has occurred over the last year is, arguably, not the result of Fed actions, but a correction from the appreciation of the dollar in late 2008 and 2009 that was caused by a flight to safety by foreign investors during the financial crisis. At that time, a strong global demand for relatively safe U.S. Treasury securities bid up the dollar's exchange rate. As financial panic receded, the demand for safety abated, and the dollar depreciated to its pre-crisis level.

A third criticism is that monetary stimulus will have little impact on real economic activity. In the current economic environment, with badly weakened household and business balance sheets placing a premium on improving liquidity, it is difficult for monetary policy to get "traction," stimulating the broader economy by pumping reserves into the banking system. For this reason, the effect of the Fed's recently concluded round of monetary stimulus on real activity in 2011 is expected to be modest. Nevertheless, how effective monetary stimulus has been is difficult to

judge because it is difficult to determine what would have happened if the policy had not been used, and even modest positive effects are helpful in sustaining recovery.

With the recovery continuing to show considerable weakness, is more monetary stimulus needed? At the November 2, 2011, meeting of the Federal Open Market Committee (FOMC), noting evidence of some improvement in economic activity, the Fed did not elect to apply any further monetary stimulus. It stated that economic activity was weaker than it had expected, but this reflected temporary factors, including higher commodity and energy prices and supply chain disruptions from the Japanese earthquake that had begun to reverse themselves. The Fed would continue its program to extend the average maturity of its asset holdings as announced in September. The committee also decided to maintain the current size of its balance sheet and to keep the federal funds rate within its current target range of 0 to ¼%. It also noted that economic activity is anticipated to remain weak over the medium run and warrant exceptionally low levels for the federal funds rate at least through mid-2013. At its most recent meeting, the FOMC reiterated this position, but due to continued evidence of economic weakness extended the time period for an accommodative monetary policy to late 2014.<sup>55</sup>

### **A Lesson from the Great Depression**

One of the important lessons from the Great Depression is to guard against an overly hasty withdrawal of fiscal and monetary stimulus in a fragile economy still recovering from a sharp economic decline. Beginning in 1933, the U.S. economy rebounded from its sharp fall into what has become known as the Great Depression. From 1933 to 1936, supported by expansionary fiscal and monetary policies, the U.S. economy grew briskly at an average rate of 9.0% and unemployment fell from 25% to 14%. Economic output had nearly returned to its level in 1929, but the economy was still well short of full recovery. But in 1937, the recovery halted and the economy tipped into a second recession. Most economists believe that the second dip into recession was caused by an unfortunate premature switch to contractionary monetary and fiscal policies in a still-fragile recovering economy.

On the monetary side, in 1936, the Federal Reserve began to worry about inflation. After several years of relatively loose monetary policy, the U.S. banking system had built up large quantities of reserves in excess of legal reserve requirements. The Fed feared, despite little overt evidence of a problem, that should the banks begin to lend these excess reserves, it could lead to an overexpansion of credit and generate an inflationary surge. In an attempt to sop up those excess reserves, the Fed raised the banks' reserve requirements three times during 1936. However, banks were still nervous about the financial panics of the early 1930s and uncertain about the durability of the economic recovery, and consequently wanted to hold excess reserves as a cushion. In response to the higher reserve requirements erasing that cushion, the banks worked to rebuild it by reducing lending, leading to a contraction of credit-supported spending.

On the fiscal side, by 1936, following several years of large budget deficits, the federal government had a strong urge to declare victory and get back to normal policy—specifically, balancing the government budget. The veterans' bonus that was paid in 1936 was not renewed in

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<sup>55</sup> Board of Governors of the Federal Reserve System, "FOMC statement," press release, November 2, 2011, <http://www.federalreserve.gov/newsevents/press/monetary/20110622a.htm>; and Federal Reserve issues and FOMC statement," press release, April 25, 2012, <http://www.federalreserve.gov/newsevents/press/monetary/20120425a.htm>.



1937; in addition, Social Security taxes were collected for the first time in 1937. The overall effect was a fiscal contraction equal to about 3% of GDP.

The double hit of contractionary monetary and fiscal policy in an economy that had still not reached the point in which private demand was capable of fully sustaining economic growth led to a recession. In 1938, GDP fell 4.5% and the unemployment rate increased to 19%.<sup>56</sup>

Economic policy quickly changed course and recovery resumed in the second half of 1938, but the policy error added about two years to the Great Depression, which ended with the step-up in war-time government spending in 1941.

The euro zone countries appear to be re-learning this policy lesson from the Great Depression, at considerable economic cost. Their attempt to impose austerity measures to combat growing government debt, while still in the mist of economic recovery, has pushed the region back into recession.

## **Economic Projections**

Given the large deterioration of the balance sheets of households and businesses, the possible reduction of the U.S. economy's level of potential output, and the weakened state of the global economy in the aftermath of the recent financial crisis, projections of the U.S. economy's near-term path carry a high degree of uncertainty. As 2012 began, many economic forecasters, in light of the factors causing a deceleration of economic growth in 2011, trimmed their growth projections from those made earlier in 2011. The U.S. economic recovery was expected to continue, albeit at a slower pace. That general expectation has not changed in more recent projections.

- The Fed's Open Market Committee projects real GDP in 2012 to advance in a range between 2.1% to 3.0% and in 2013 in a range between 2.4% to 3.8% (the current growth projection for 2012 and 2013 is unchanged from the January 25, 2012 projection). The unemployment rate is projected to be in a range between 7.8% to 8.2% in 2012 and 7.0% to 8.1% in 2013 (the range for the 2012 unemployment rate is 0.4 percentage points narrower than in the January projection).<sup>57</sup>
- The IMF projects real GDP in the United States to increase 2.0% in 2012 (up 0.2 percentage points from its January 2012 projection) and 2.6% in 2013. Globally, the IMF expects an unbalanced expansion. For 2012, growth of the advanced economies is projected to average 1.5% and growth in the emerging developing economies to average 6.3%.<sup>58</sup>

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<sup>56</sup> For further discussion of the recession of 1937, see Christina D. Romer, "The Nation in Depression," *Journal of Economic Perspectives* 7 (spring 1993), pp. 19-39; Milton Friedman and Anna D. Schwartz, *A Monetary History of the United States, 1867-1960* (Princeton, NJ: Princeton University Press, 1963); Francois R. Velde, "The Recession of 1937—A Cautionary Tale," *Economic Perspectives*, Federal Reserve Bank of Chicago, fourth quarter 2009, pp. 16-36.

<sup>57</sup> Board of Governors of the Federal Reserve System, *Minutes of March 2012 FOMC Meeting*, Projection Materials, <http://www.federalreserve.gov/monetarypolicy/fomccalendars.htm>.

<sup>58</sup> International Monetary Fund, *World Economic Outlook*, Table 1.1, April 2012, <http://www.imf.org/external/pubs/ft/weo/2012/01/pdf/c1.pdf>.

- Global Insight, an economic forecasting company, is currently projecting real GDP will advance 2.1% in 2012 and 2.3% in 2013. The unemployment rate is projected to be 8.0% in 2012 and 7.4% in 2013.<sup>59</sup>

Forecasts are always subject to uncertainty. That uncertainty is likely to be especially high at this time because forecasting the path of the economy near turning points in the business cycle is always difficult and because of the singular characteristics of the current business cycle (i.e., the aftermath of a sharp financial crisis, severely reduced household net worth, increased long-term unemployment, volatile energy prices, and an unresolved long-term fiscal imbalance).

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<sup>59</sup> Global Insight, *U.S. Economic Outlook*, March 2012.