



## Testimony

**Statement of  
Douglas W. Elmendorf  
Director**

### **The State of the Economy**

**before the  
Committee on the Budget  
U.S. House of Representatives**

**May 21, 2009**

*This document is embargoed until it is delivered at 10:00 a.m. (EDT) on Thursday, May 21, 2009. The contents may not be published, transmitted, or otherwise communicated by any print, broadcast, or electronic media before that time.*

---

## Note

Figures use shaded vertical bars to indicate periods of recession. (A recession extends from the peak of a business cycle to its trough.)

---

In the Congressional Budget Office's (CBO's) judgment, the economy will stop contracting and resume growing during the second half of this year, but the hardships caused by the recession will persist for some time. The growth in output later this year and next year is likely to be sufficiently weak that the unemployment rate will probably continue to rise into the second half of next year and peak above 10 percent. Economic growth over time will ultimately bring the unemployment rate back down to the neighborhood of 5 percent seen before this downturn began, but that process is likely to take several years.

On the positive side, the fiscal stimulus provided by the federal government is now beginning to boost the economy, and financial markets show clear signs of improvement since the fall and winter. Moreover, the sharp reductions seen in manufacturing production will keep inventories to leaner levels than would have occurred otherwise, so that upturns in sales, when they come, will lead to faster and larger increases in output.

However, many factors will temper the strength of the recovery: the loss of household wealth; the fragility of financial institutions; persistently weak growth in the rest of the world; a surplus of housing units on the market; and low utilization of manufacturing capacity. How much those factors will dampen the recovery is uncertain: They may be overcome relatively quickly by the jump start provided by the stimulus and improvements in consumer and business confidence, or they may cause the economy to slump again next year, as the effects of the stimulus begin to wane.

Recently released data are consistent with CBO's forecast in March that gross domestic product (GDP) will bottom out this year.<sup>1</sup> Indeed, a wide majority of economic forecasters share that view. However, CBO's assessment of developments in the financial system and in the nonfinancial parts of the economy suggests that the initial stages of the economic recovery are likely to be more tepid than the agency had projected earlier. CBO's March forecast of 2.9 percent growth in real (inflation-adjusted) GDP in 2010 is more optimistic than the current consensus, as is the agency's forecast for a peak unemployment rate of about 9½ percent. CBO is now beginning the process of updating its previous forecast and will release a new forecast in August.

The uncertainty surrounding CBO's forecast—and the forecasts of private analysts—deserves emphasis. The future course of the economy is always uncertain, as can be seen in the confidence region around the agency's March forecast of real GDP (see Figure 1). Moreover, uncertainty is especially great around economic turning points and in conditions that have not been seen in the economy for some time, such as the current financial crisis.

Even if the economy returns to positive growth this year, the loss in output, income, and employment during the recession and the next few years will be huge. Under CBO's forecast from March, the difference between the economy's actual and

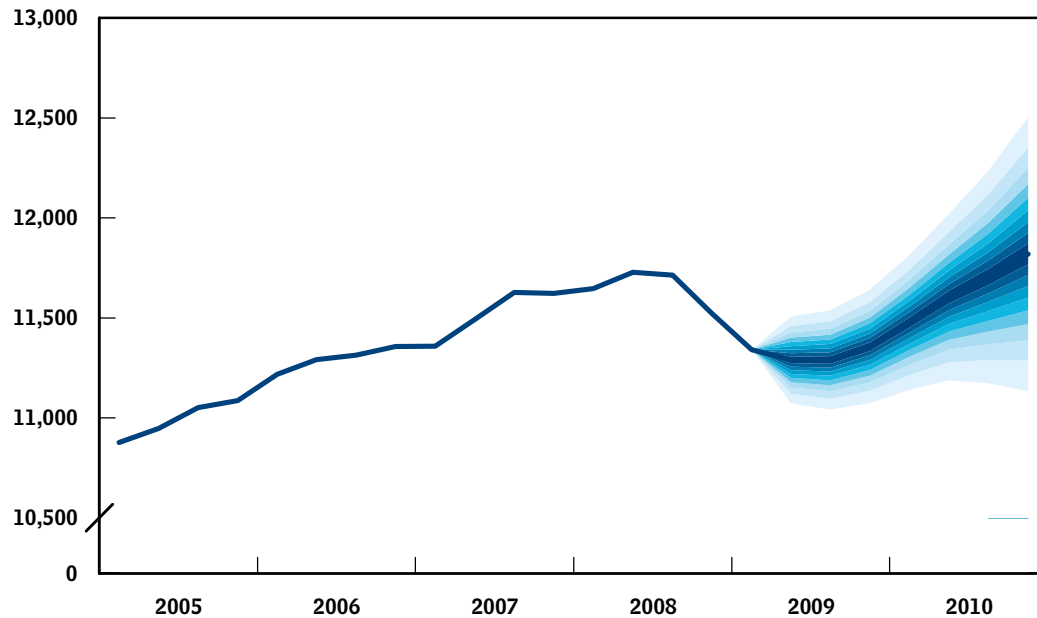
---

1. Congressional Budget Office, *A Preliminary Analysis of the President's Budget and an Update of CBO's Budget and Economic Outlook* (March 2009).

**Figure 1.**

## Uncertainty in Projections of Real GDP

(Billions of 2000 dollars)



Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

Note: This figure, based on CBO's past errors in forecasting real (inflation-adjusted) growth, shows a range of possible outcomes for real gross domestic product (GDP). CBO's March projection falls in the middle of the darkest area of the figure. If the potential errors in the current forecast are similar to the errors in CBO's forecasts published between 1976 and 2006, the probability is 90 percent that real GDP will fall in the shaded area of the graph. In the current circumstances, larger errors are more likely to occur than usual.

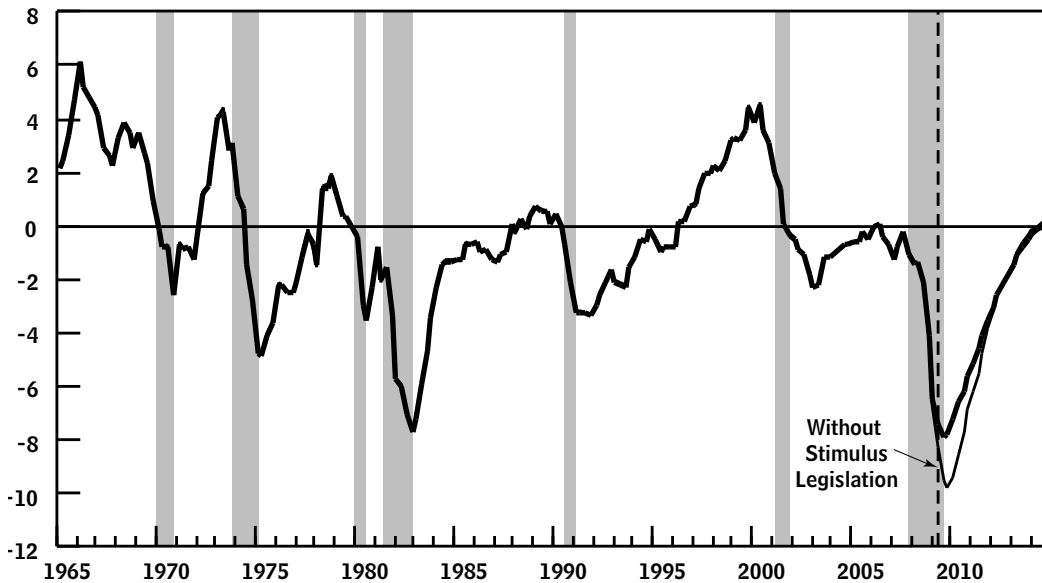
potential output will average 7 percent of GDP (which is equivalent to about a trillion dollars) this year and next, and that gap in output will not close until 2013 (see Figure 2). CBO's forecast in August is likely to show even larger shortfalls in output over the next few years. By this measure, the current recession and its aftermath will be the most severe economic downturn of the postwar period.

Short-term and long-term goals for the federal budget are often in conflict during recessions. Whenever the threat of inflation is low and productive resources are not being fully used—that is, when the unemployment rate is high and many factories are idle—an important goal of fiscal policy is, most experts believe, to stimulate spending in the near term. By increasing the budget deficit through higher spending and lower taxes, the federal government can encourage growth and bring the levels of resource use and output closer to the economy's potential. But the long-run outlook for the federal budget is unsustainable and, if it is not resolved, will undermine economic growth. The sharp increase in debt this year and over the next few years heightens the

**Figure 2.**

## The GDP Gap, 1965 to 2014

(Percent)



Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

Notes: The GDP gap is the difference between real (inflation-adjusted) gross domestic product and its estimated potential level (which corresponds to a high level of use of labor and capital resources).

Data are quarterly and are plotted through the fourth quarter of 2014.

importance of putting the budget on a sustainable path as the economy approaches full employment.

### Is the Contraction Moderating?

Although huge uncertainties about the near-term path of the economy remain, a number of indicators have begun to show improvement of late. Manufacturing output may be stabilizing; consumer spending and confidence are showing some signs of life; initial claims for unemployment insurance may have peaked; a number of measures of financial markets have improved; and there are some signs that the decline in housing construction may be close to bottoming out.

Most forecasters now anticipate that the trough of the recession will occur sometime in the second half of this year. In a survey of about 50 private-sector forecasters released on May 10, the average forecast of GDP indicated a decline of 1.7 percent in the current quarter and weak positive growth during the second half of this year. The average of the 10 most optimistic forecasters indicated mildly positive growth in this quarter, and the average of the 10 most pessimistic indicated that the economy would begin to recover in the fourth quarter (see Table 1).

**Table 1.****Private-Sector Forecasts for 2009 and 2010**

	2009, by Quarter				Annual Average	
	1st	2nd	3rd	4th	2009	2010
Growth of Real GDP <sup>a</sup> (Percentage change)						
Top 10	-6.1	0.3	2.1	3.3	-2.3	2.8
Consensus	-6.1	-1.7	0.5	1.8	-2.8	1.9
Bottom 10	-6.1	-3.6	-1.3	0.4	-3.3	1.0
Unemployment Rate (Percent)						
Top 10	8.1	9.3	9.9	10.3	9.4	10.4
Consensus	8.1	9.0	9.4	9.7	9.1	9.7
Bottom 10	8.1	8.7	9.0	9.2	8.8	9.0

Source: Aspen Publishers, Inc., *Blue Chip Economic Indicators* (May 10, 2009).

Note: Growth rates are expressed as annual rates, and annual averages describe year-over-year growth.

a. Real GDP = inflation-adjusted gross domestic product.

Nevertheless, numerous factors pose the threat of continued weakness, highlighting the uncertainty of even those tentatively optimistic forecasts for the near term. Business fixed investment is likely to be extremely weak for some time, foreign economic activity slumped sharply in recent quarters, and many financial institutions face large further losses in coming years.

### Manufacturing

Over the past few quarters, manufacturing output collapsed as firms reduced their output even more than their sales declined. However, the Institute for Supply Management's index of new orders, which tend to precede changes in manufacturing output, has rebounded over the past four months. That rebound does not yet indicate a corresponding rebound in manufacturing activity but does suggest a lessening in the rate of decline or, perhaps, a leveling out. Regional surveys of manufacturing (compiled for Chicago, New York, and Philadelphia) generally support that signal.

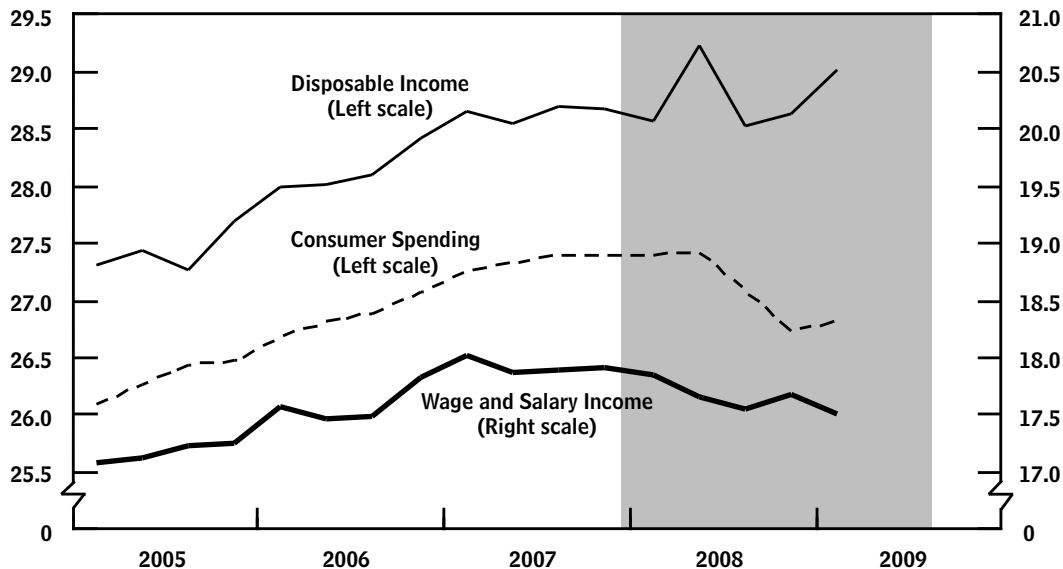
### Consumer Spending

After falling at about a 4 percent annual rate during the second half of 2008, real personal consumption expenditures grew at a 2.2 percent rate in the first quarter. In recent months, measures of consumer confidence have either stopped falling or have ticked up slightly. Although the drop in employment has cut labor income, real disposable personal income actually rose in the first quarter, because of higher transfer payments (including a large cost-of-living adjustment for Social Security recipients), lower tax payments (or larger refunds), and lower energy prices. Real disposable income per capita has not fallen during this recession even though wage and salary income has (see Figure 3).

**Figure 3.**

## Real Income and Consumer Spending per Capita, 2005 to 2009

(Thousands of 2000 dollars per person)



Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

Note: Data are quarterly and are plotted through the first quarter of 2009.

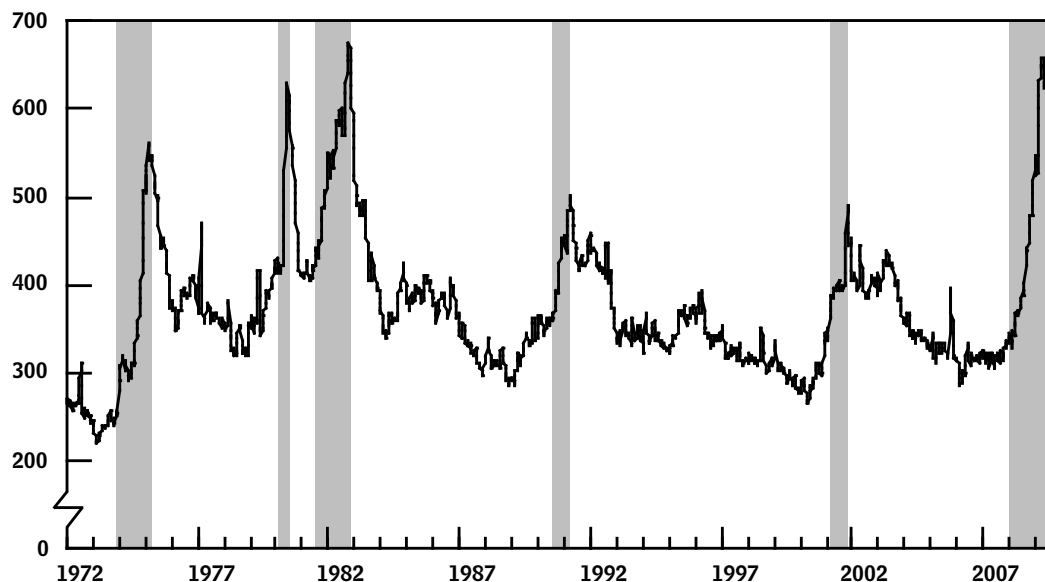
Two influences are supporting households' spending in the near term, but other factors may yet outweigh those effects. The American Recovery and Reinvestment Act of 2009 (ARRA, Public Law 111-5) is currently bolstering disposable income. Specifically, lower payroll tax withholding resulting from that legislation began in March and was fully phased in on April 1, and unemployment insurance benefits have been increased. Spending may also be receiving a boost from a new wave of mortgage refinancing, which in recent months has occurred at the highest rate since early 2003 and which may permit some households to reduce their monthly payments or withdraw equity. Although those effects may be small given recent changes in house prices, they contribute to households' spending.

But despite the effects of the stimulus package and mortgage refinancing, the sustainability of the recent gains in households' spending is unclear. Two factors—households' desire to increase saving in response to their loss of wealth over the past three years and further reductions in employment—may limit any near-term rebound in consumption. Declines in wealth will encourage households to try to raise their saving rate by slowing the growth of their spending. Households' loss of wealth in the past few years is likely to cause the saving rate to be at least 4 percentage points higher this year than it would have been otherwise. Some economists expect even larger increases in saving—perhaps back to the rates of 8 percent to 10 percent that prevailed before 1980. Although greater saving by households is beneficial in the long run—because it

**Figure 4.**

## Initial Claims for Unemployment Insurance, 1972 to 2009

(Thousands)



Sources: Congressional Budget Office; Department of Labor, Employment and Training Administration, Unemployment Insurance Division.

Note: Data are four-week moving averages of weekly data and are plotted through May 8, 2009.

would help provide domestic financing for investment—in the short run, it may prolong the current recession.

Low employment and slow wage growth may also undermine consumer spending. For the recent resilience in households' spending to be sustained, declines in the number of hours worked and in the growth of wages must slow. There are some tentative signs that employment will not deteriorate as rapidly over the next few months as it has over the past eight months, but the growth of households' income from wages is likely to be depressed throughout this year.

### The Labor Market

With the exception of initial claims for unemployment insurance, labor market indicators tend to lag changes in economic activity. The pattern of past recessions suggests that employment will not increase and the unemployment rate will not decline until 6 to 12 months after output begins to increase again. Hiring lags behind the initial stages of a recovery because firms tend to increase output by first increasing the number of hours employees work and their productivity and then later by adding employees. The unemployment rate also lags behind the turning point because the number of people seeking work tends to rebound faster than employment. According to the latest comprehensive information about employment from the Bureau of Labor



Statistics, the rate of deterioration in employment slowed only mildly in April, and the unemployment rate has continued to rise rapidly.

However, small signs of potential improvement in the labor market have emerged. The four-week moving average of initial claims for unemployment insurance has eased slightly, from 659,500 in the week ending April 3 to 630,050 in the week ending May 8 (see Figure 4). Initial claims for unemployment insurance may be useful as a leading indicator because, in the past five recessions, that number has typically started to decline at about the time the recession was ending. The number of claims responds more quickly than other employment indicators to changes in labor market conditions because the data pick up changes in flows into unemployment, rather than increases in employment. Although the data can be erratic, other information on the labor market (such as surveys of hiring plans, layoff announcements, and perceptions of the availability of jobs) also indicate some improvement in employment conditions.

### **Financial Markets**

Some indicators suggest that conditions have improved in a number of financial markets, but those markets nevertheless remain strained. For example, a measure of the risk of default on interbank lending, which had jumped to 365 basis points in October 2008, eased back to 123 basis points by early this year; most recently, on May 8, it stood at 60 basis points, the narrowest spread since March 2008 (see Figure 5).<sup>2</sup> A narrower spread between the yields on corporate bonds and 10-year Treasury notes also indicates some improvement in financial conditions. For high-quality AA-rated corporate debt, the spread peaked at the same time that the spread for interbank lending did and then started to lessen. The improvement has accelerated over the past two weeks, with the yield spread narrowing by 70 basis points. The narrowing of spreads at the low end of the spectrum of investment-grade debt has been more gradual. The spread for BBB-rated debt remained elevated throughout the end of 2008 and the first quarter of 2009, reflecting the greater likelihood that lower-rated companies will have trouble paying their debt, particularly in an economic downturn, compared with higher-rated companies. Nevertheless, that spread has also narrowed by about 70 basis points over the past two weeks.

Another measure of risk, the equity premium—or the compensation that investors require for the risk of holding stock relative to the safety of Treasury notes—indicates less aversion to risk in equity markets. One measure of that premium, the spread between the earnings yield on equities and the interest rate on 10-year Treasury notes, has fallen by half since March—as the broad-based Standard & Poor's 500 index

---

2. The spread referred to is the difference between (1) the three-month Libor (London interbank offered rate, or the interest rate major banks offer to other banks for loans of that duration) and (2) market expectations of the federal funds rate (which can be measured from an overnight index swap contract). A basis point is one one-hundredth of a percentage point.

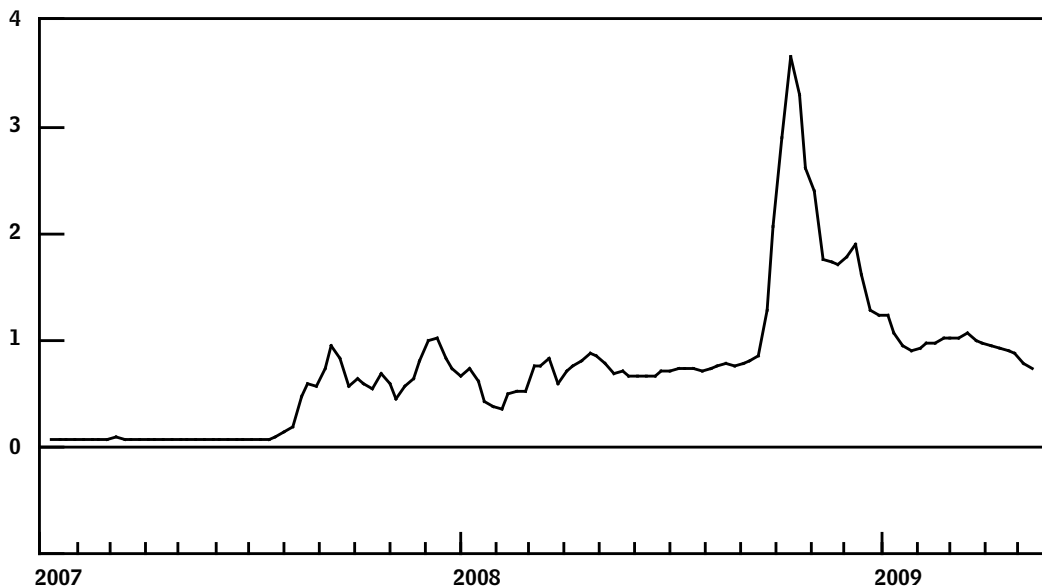
**Figure 5.**

---

**The Risk Spread on Lending Between Banks, 2007 to 2009**

---

(Percentage points)



Sources: Congressional Budget Office; Bloomberg.

Notes: A spread is the difference between two interest rates. One, the three-month Libor (London interbank offered rate), is the interest rate major banks offer to other banks for loans of that duration. The other is the average federal funds rate expected over a three-month period as measured by the overnight index swap contract.

Data are weekly and are plotted through May 8, 2009.

---

gained about 40 percent (correspondingly reducing the earnings yield on equities) and the yield on 10-year Treasury notes increased 60 basis points.<sup>3</sup>

Additionally, interest rates on residential mortgages remain under 5 percent, the lowest level in at least 38 years. The Federal Reserve's purchases of securities backed by residential mortgages have played some role in lowering mortgage rates.

In contrast, the Federal Reserve's survey of lending conditions shows only slight improvement over the past few months. A smaller percentage of banks are tightening their business-lending policies than were doing so earlier in the year, but all in all, banks are still tightening those policies.

### **Housing**

Sales of new homes and the number of single-family housing permits and starts have stopped falling in recent months, but a closely followed house price index, the

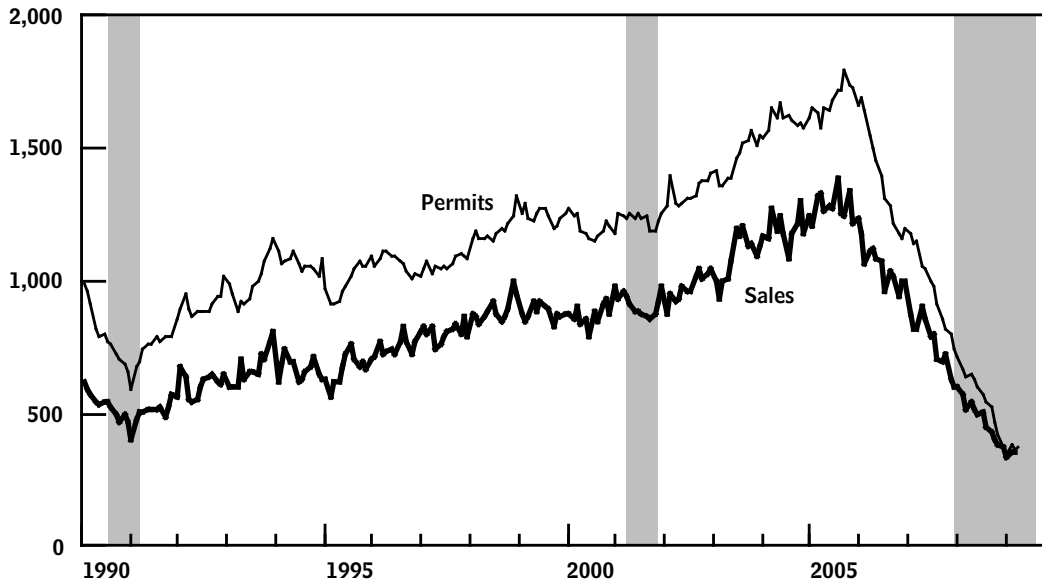
---

3. The earnings yield on equities is calculated by dividing the earnings per share over the preceding year by the current price of a stock.

**Figure 6.**

## Single-Family Housing Permits and New Home Sales, 1990 to 2009

(Thousands)



Sources: Congressional Budget Office; Bureau of the Census and the Department of Housing and Urban Development; National Association of Realtors, Economics and Research Division.

Note: Data are monthly and are plotted through March 2009.

Case-Shiller index, is still declining (see Figures 6 and 7). Even though very low mortgage rates have improved the affordability of homes, concerns about further declines in prices, the difficulty in raising down payments during the recession, and the tightening of credit standards have so far kept sales from rebounding. Until sales pick up, the excess of new homes for sale will remain high, and new housing starts will probably remain moribund. Furthermore, the rate of foreclosures remains high, which may dampen expectations of stabilizing prices, further undercutting sales.

### Foreign Economic Developments

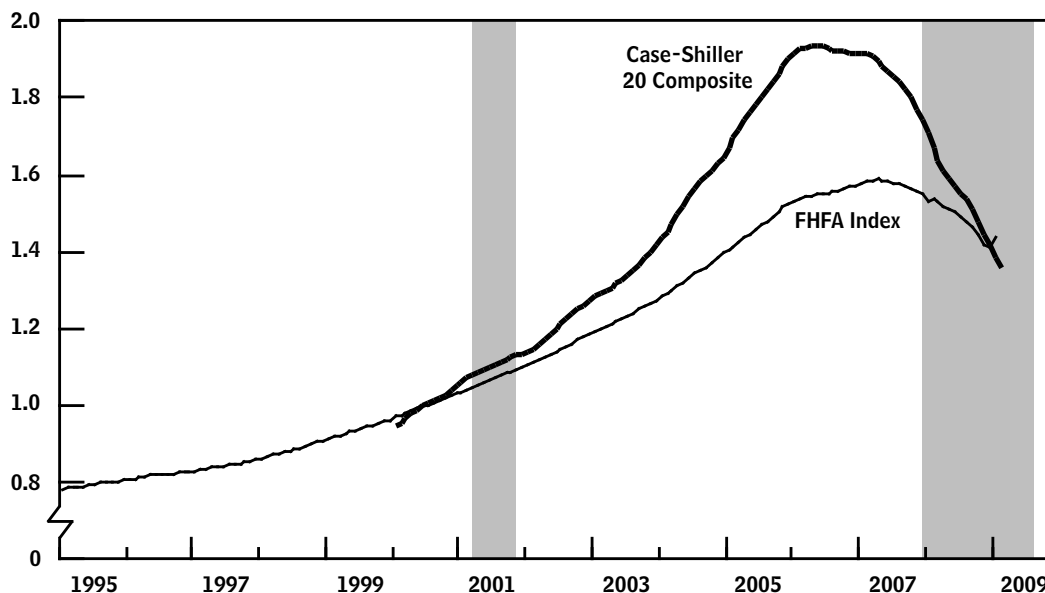
Despite a few uncertain signs of improvement, many countries in the rest of the world are still in a severe recession. Equity markets have improved in most countries; business and consumer confidence has rebounded somewhat; the contraction in manufacturing activity has moderated in some countries; and in China, South Korea, and India, manufacturing activity has expanded in recent months. Furthermore, credit spreads have narrowed overseas, as they have in the United States.

However, the current declines in economic activity in most of the advanced economies—the major trading partners of the United States—now appear to be much worse than anticipated a few months ago. In the first quarter of this year, output in the 16-country Eurozone fell by 10.4 percent at an annual rate, the biggest drop since

**Figure 7.**

## House Price Indexes, 1995 to 2009

(Index: 2000 = 1)



Sources: Congressional Budget Office; Federal Housing Finance Agency; Standard & Poor's; Fiserv; and MacroMarkets LLC.

Notes: The FHFA index is the Federal Housing Finance Agency's monthly measure of house purchases for the nation. The S&P/Case-Shiller index is the monthly measure for 20 metropolitan areas. Both measures track repeat sales of existing single-family houses to avoid distortions resulting from changes in quality attributable to the mix of houses. The FHFA index is generally a broader measure, but it includes only transactions involving conforming conventional mortgages purchased or securitized by Fannie Mae or Freddie Mac, whereas the S&P/Case-Shiller index does not exclude any type of mortgage.

Monthly S&P/Case-Shiller house price indexes are calculated using three-month moving averages and published with a two-month lag.

Data are monthly and are plotted through February 2009.

the data were first collected in 1995. In the United Kingdom, real GDP in that quarter fell by 7.4 percent at an annual rate. Similarly, Japan's economy contracted at an annual rate of 15.2 percent in the first quarter of this year. Canada's economy is stronger, though still in recession; that country's output fell at an annual rate of 3.4 percent in the fourth quarter of last year.

The only major countries with prospects for positive growth this year are China and India. China's economy grew at a rate of 6.1 percent in the first quarter of this year. According to one index, manufacturing activity in China first expanded in March and grew further in April, as the decline in export orders moderated and as investment increased, prompted in part by the government's \$586 billion stimulus package. India

has weathered the international downturn somewhat better than other economies because its export sector is a small share of the economy.

### **Spending by Businesses**

Businesses' spending on fixed investment, especially structures such as offices, oil wells, and retail space, does not appear likely to recover soon. A leading indicator of business investment in structures, the billings index of the American Institute of Architects, implies severe declines in nonresidential construction during the rest of the year. Other investment spending by businesses—that for equipment and software—is also weak, though it may recover if the rest of the economy picks up. Spending on equipment tends to lag in recoveries, as businesses usually wait until demand for their products begins to press their existing capacity before they commit to additional capital spending. Because the utilization rate of manufacturing capacity, at 65.7 percent, is the lowest it has been in the postwar period, business investment spending may be slow to recover. The continued contraction in investment spending threatens to undercut any increase in demand from other sectors of the economy. If households' spending continues to post moderate gains, but businesses' spending on equipment and software fails to respond to the pickup in demand, the recovery could be very weak.

### **Major Determinants of the Outlook Through 2010**

The outlook for the next year and a half is influenced by a number of factors: the effectiveness of the American Recovery and Reinvestment Act; the degree to which excess stocks of housing, business structures, and inventories may dampen the recovery; and, of course, the state of financial markets and the effect that they, along with consumers' need to reduce their debt, will have on the economy.

Although CBO expects that ARRA will provide a significant boost to economic activity the rest of this year and next, uncertainty about the legislation's effects is greater than normal for fiscal stimulus because the stimulus was enacted during a period of unprecedented financial turmoil and was significantly larger than such efforts in the past.

Similarly, there is uncertainty about the degree to which the excessive accumulation of physical stocks (for example, housing units or automobile inventories) and financial imbalances will affect growth for the next year and a half. Stocks of housing and goods have fallen relative to sales, but it is not clear how much further they must fall to encourage a rebound in production.

Last, gauging the effects of the financial turmoil on the near-term outlook is problematic. The improvement in various financial market indicators in the past several months does not prove that the financial system is strong enough to provide sufficient lending to support a robust economic recovery. Indeed, economic recovery may be necessary for the full recovery of the financial system, rather than the other way around.

**Table 2.**


---

## Estimated Macroeconomic Impacts of the American Recovery and Reinvestment Act of 2009, Fourth Quarters of Selected Calendar Years 2009 Through 2019

---

	Fourth Quarters of Calendar Years			
	2009	2010	2011 ...	2019
Real GDP <sup>a</sup> (Percentage change from baseline)				
Low estimate of effect	1.4	1.1	0.4	-0.2
High estimate of effect	3.8	3.4	1.2	0
Unemployment Rate (Percentage-point change from baseline)				
Low estimate of effect	0.5	0.6	0.3	0
High estimate of effect	1.3	1.9	1.0	0
Employment (Millions of jobs change from baseline)				
Low estimate of effect	0.9	1.2	0.6	0
High estimate of effect	2.3	3.6	1.8	0

---

Source: Congressional Budget Office.

a. Real GDP = inflation-adjusted gross domestic product.

---

### The Effects of the American Recovery and Reinvestment Act

Only a small part of the spending authorized by ARRA has occurred so far. It appears that about 5 percent, or about \$19 billion, of the approximately \$380 billion in budget authority for 2009 granted under the law was spent through the end of April. (Reported expenditures of \$29 billion include \$11 billion in federal transfers into the unemployment insurance fund, most of which has not yet been distributed to recipients.) In contrast, reductions in payroll taxes were fully in place by April 1.

That rate of spending is broadly consistent with the assumptions that CBO used to estimate the macroeconomic effects of the legislation. Under those assumptions, ARRA will boost the level of GDP by the end of this year by between 1.4 percent and 3.8 percent, but the positive effects of the law on the level of GDP will taper off during 2010 and subsequent years (see Table 2). Therefore, the recovery will falter in 2010 if private-sector demand for goods and services does not accelerate to offset the diminishing federal stimulus.

### Imbalances in Inventories of Goods and Structures

In spite of the massive slowing in the creation of new housing units, CBO estimates that the excess of unsold homes is still between 2½ and 3 million units. At current rates of construction and sales, that surplus would take about two years to work through. However, it seems likely that housing starts will gradually pick up in 2010, and the elimination of the surplus in housing will occur over many years.

During 2007, just before the onset of the recession, inventories of goods rose relative to sales. The slowdown in sales during 2008 kept the inventory-to-sales ratio high even as manufacturers slowed production. Ultimately, manufacturers slashed production by the end of last year, which finally reduced the overall “overhang” in inventories. Of course, some sectors still have significant surpluses, the motor vehicle sector in particular, but the overhang is not likely to dampen growth now as much as it did during the past 12 months.

The situation for business structures may be the worst. The stock of retail space, warehouses, factories, and the like appears to be far in excess of current needs, and businesses’ investment in structures is likely to fall steadily throughout this year. It could fall further during 2010, even if there is a mild recovery for the rest of the economy.

### **Gauging the Effects of the Financial Turmoil**

Although a number of financial market indicators are encouraging, huge questions remain about the ability of the system to adequately finance an economic recovery. Because of massive losses, banks have been tightening the availability of credit, and now it is primarily the higher-quality borrowers who have ready access to financing from banks. Major sources of uncertainty are the magnitude of additional losses that financial institutions may experience, the effectiveness of the various financial rescue actions, and the extent to which households’ spending will be held back by losses in wealth. In addition, tracking the effect of the financial sector on the real economy is subject to uncertainties of its own.

**Estimates of Losses of U.S. Financial Institutions.** Banks and other financial institutions are in the process of absorbing losses on their bad loans and reducing their leverage—the amount of assets in relation to their capital. However, losses absorb capital and hence slow the deleveraging process. While that deleveraging occurs, financial institutions will be less willing to make risky loans, hurting the ability of businesses and consumers to spend and invest. If losses on loans remain high—as most analysts believe—the deleveraging process and the recovery of the financial sector will take some time to complete.

Recent estimates suggest that U.S. financial institutions will need to absorb a significant amount of losses over the next few years. According to *The Supervisory Capital Assessment Program: Overview of Results*, released by the Federal Reserve Board, losses at the 19 largest U.S. banks will total approximately \$950 billion through 2010 under pessimistic economic conditions. Of that \$950 billion, approximately \$350 billion has already been recognized, leaving nearly \$600 billion in anticipated losses in 2009 and 2010. The International Monetary Fund, in its April 2009 *Global Financial Stability Report*, predicts that the entire banking sector in the United States and Europe combined will have to write down and charge off more than \$1.6 trillion in losses this year and next.

**Financial Rescue Actions.** The losses on financial instruments have created enormous uncertainty about the health of financial institutions, which has led to problems in

other financial markets. The financial rescue actions by the Treasury, the Federal Reserve, and the Federal Deposit Insurance Corporation have played a significant role in stabilizing financial markets and maintaining a flow of credit. Indeed, some lending programs created by the Federal Reserve since the crisis began are already shrinking in size, suggesting that some markets are beginning to return to normal. For example, the size of the Commercial Paper Funding Facility (CPFF) has declined from a high of approximately \$350 billion in January to \$167 billion in the week ending May 13. Dollar funding provided to foreign central banks via liquidity swaps has also fallen from a peak of \$580 billion in December to \$250 billion. With Libor (London inter-bank offered rate) funding becoming more readily available, banks outside the United States have less need to obtain dollars from their central banks.

**Financial Adjustments by Consumers.** Consumers' attempts to reduce spending to better cope with the recession are also prolonging the recession and will probably weaken the recovery. Household wealth increased rapidly between 2001 and 2006, spurred primarily by the appreciation in house prices but also by gains in financial assets. Households borrowed against some of those gains to finance a boost in personal consumption expenditures—in effect, they were able to increase their spending faster than their income was increasing. As a result, the standard measure of the household saving rate declined rapidly during that time. Since the onset of the recession, however, households have reduced their appetite for debt and raised their saving rate. They may want to cut back more on spending, however, to try to further reduce debt and build up savings.

**Assessing the Effects of Financial Markets.** Assessing the role of the financial problems in the current recession is complicated by the presence of other significant recessionary factors and the difficulty of determining how much of the reduction in the growth of credit stems from supply constraints versus the usual drop in demand for credit during recessions. If a significant part of the sharp decline in economic activity over the past six months stemmed from factors other than the financial problems, then the near-term outlook may not depend as heavily as most forecasters believe on assumptions about the state of financial markets and institutions.

A number of factors other than the financial turmoil probably played a large role in the decline in economic activity during 2008 and early 2009:

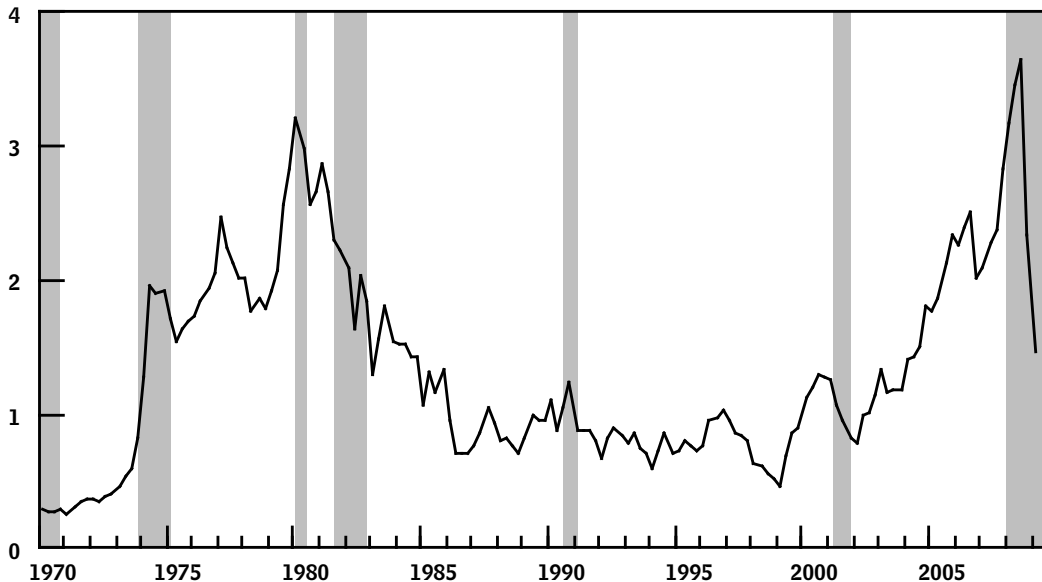
- Most of the debilitating effect of the persistent decline in housing construction and housing-related employment occurred long before the severe phase of the financial crisis in September 2008;
- The decline in housing wealth contributed to the recession by reducing households' spending on goods and services, and much of that decline also predated the financial market turmoil; and
- The sharp rise in oil prices between early 2007 and the third quarter of 2008 had a large negative effect on the economy.



**Figure 8.**

## **Petroleum Imports as a Share of Nominal GDP, 1970 to 2009**

(Percent)



Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

Notes: GDP = gross domestic product.

Data are quarterly and are plotted through the first quarter of 2009.

The rise in oil prices may have been the most significant factor. The value of petroleum imports rose from 1.3 percent of GDP at the end of 2003 to 3.7 percent in the third quarter of 2008 (see Figure 8). The increase was particularly sharp during the last four quarters of that period, and such increases in the past were followed by recessions. The short-run effect of the increase in oil imports on GDP is similar to that of a sharp tax hike, so the rise in oil prices certainly weakened growth in the United States and may have been sufficient to cause at least a mild recession by itself. Since then, however, the implicit tax imposed by oil imports has dropped back down to 1.4 percent of GDP in the first quarter of this year, greatly lessening the drag on the economy.

Another difficulty in assessing the relationship between financial problems and the real economy is determining how much of the credit tightness stems from supply factors. Growth in lending has certainly been weak, but a large part of the contraction probably is due to the effect of the recession on the demand for credit, not to the problems experienced by financial institutions.

## **The Threats of Deflation or Higher Inflation**

The outlook for 2010 is also clouded by uncertainties about prices. The recession has raised two apparently contradictory concerns. In the near term, the weakness of the economy, combined with falling price indexes both here and abroad, seems to pose the threat of deflation. However, in the longer term, the Federal Reserve's actions to try to fight the recession raise concerns that excess liquidity after the economy has recovered could pose the threat of high inflation. Both of those concerns have to do with the constraints on the ability of the Federal Reserve to achieve its goals.

Deflation is the bigger threat, at least for 2010. Deflation is the decline in a broad array of prices of goods and services for a protracted period. It is a concern because deflation and expectations of future deflation discourage investment and spending. Because nominal interest rates cannot go below zero, a decline in prices implies an increase in real interest rates, reducing the desire of both firms and households to borrow for investment or consumption spending. A deflationary spiral—lower prices, growing real debt burdens, lower spending, and subsequently even lower prices and lower spending—contributed to the depth of the Great Depression, and some analysts argue that even the mild deflation experienced by Japan during the 1990s made it more difficult for the country to escape a period of economic stagnation.

Measures of prices have fallen in the United States and in many other countries, but that phenomenon is not by itself an indication of deflation. Price indexes have fallen primarily because of the sharp drop in the prices for oil and many other commodities since July 2008, but prices have not yet fallen for a wide variety of goods and services. However, the huge amount of excess capacity, indicated by the size of the GDP gap, could drive down the prices of more goods and services.

In contrast, the massive amount of monetary stimulus during 2008 and 2009 has raised concerns about rapid inflation in 2010 or subsequent years. The Federal Reserve has engineered a huge increase in liquidity in the financial system to mitigate the contractionary effects of the credit crunch. Because reducing the federal funds rate—its most commonly used policy tool—was clearly insufficient to alleviate the problems in financial markets, the Federal Reserve took actions to ease conditions in credit markets more directly. It reduced the terms for lending to depository institutions; cooperated with foreign central banks through currency swaps; and, for the first time since the 1930s, extended credit and other support to nondepository institutions. That increase in liquidity will need to be drawn down as the economy recovers, in order to avoid the possibility that demand will run ahead of supply and create inflation.

The Federal Reserve can take actions to try to avoid both deflation and high and persistent inflation. The actions that it has already taken, intervening directly in credit markets and buying Treasury securities, could be vastly expanded if deflation started to affect the economy. Conversely, the Federal Reserve has designed some of its programs (such as the CPFF) to be self-liquidating: They charge interest rates that the private market will not be willing to pay in normal times. Any additional excess

liquidity would have to be pulled back quickly by reversing direct intervention programs, reducing reserves, and raising interest rates.

The risks of deflation and high inflation remain, however, because it is by no means easy to determine when further monetary easing or tightening is appropriate. The Federal Reserve must base its policy decisions largely on uncertain measures of the current economic situation and forecasts of the near term. Policy, therefore, may not be able to forestall deflation or high inflation, and if either extreme came to pass, the recovery could be adversely affected. A threat of high inflation might cause the Federal Reserve to raise interest rates and slow growth before the recovery took hold; and deflation would cause buyers to pull back, similarly slowing growth.

## **The Conflict Between Near-Term and Long-Term Fiscal Objectives**

During a recession there is an inherent tension between fiscal policy goals for the near term and for the long term. Efforts to combat the recession, such as ARRA, may have significant short-term benefits, but they also increase the budget deficit for at least the short run. CBO's March baseline implied that deficits would peak at about 12 percent of GDP in fiscal year 2009 and remain at about 2 percent of GDP throughout the 2013–2019 period and that debt held by the public would peak at 62 percent in 2011—even if the economy recovered to its potential level of output and current laws, under which tax rates revert to higher levels, remained in place (see Figures 9 and 10). Beyond the 10-year budget window, pressures arising from spending on health care portend higher deficits.

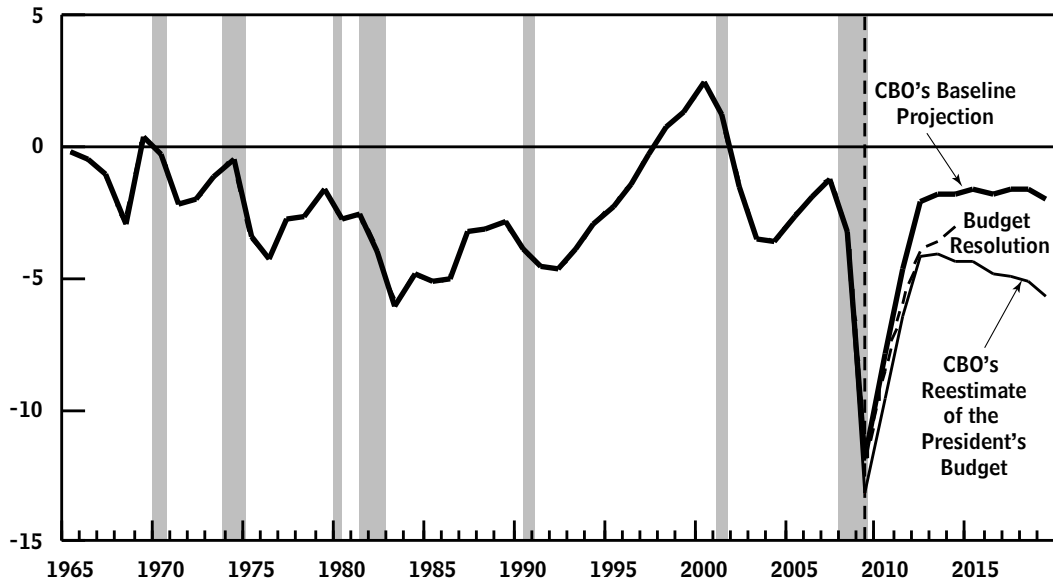
Budget deficits tend to slow economic growth in the long term if they are allowed to persist, because they tend to reduce capital accumulation and the upward trend in the economy's capacity to produce. Given the significant projected shortfall of federal revenues relative to outlays in the medium term, and the larger projected shortfalls in the long term, any policy designed to provide short-term fiscal stimulus will have to contend with long-term consequences. Increases in spending and decreases in taxes that are intended to be temporary may be difficult to reverse later. Moreover, even if taxes and noninterest spending return to their baseline levels, the additional debt service from the period of larger deficits will—unless offset by greater fiscal discipline later—crowd out some amount of future economic growth.

In addition to their negative long-term effects, policies that substantially worsen the fiscal outlook can have negative short-term effects as well. The nation currently benefits greatly from the fact that investors worldwide consider U.S. Treasury securities a safe haven in times of trouble. That tendency provides an important advantage for the United States in times of crisis, helping to increase liquidity and decrease interest rates. If investors lost confidence in the government's debt as a safe haven because of deterioration in the long-term fiscal outlook, the U.S. economy would lose that advantage, perhaps permanently.

**Figure 9.**

## Total Deficit or Surplus, 1965 to 2019

(Percentage of GDP)



Source: Congressional Budget Office.

Notes: GDP = gross domestic product.

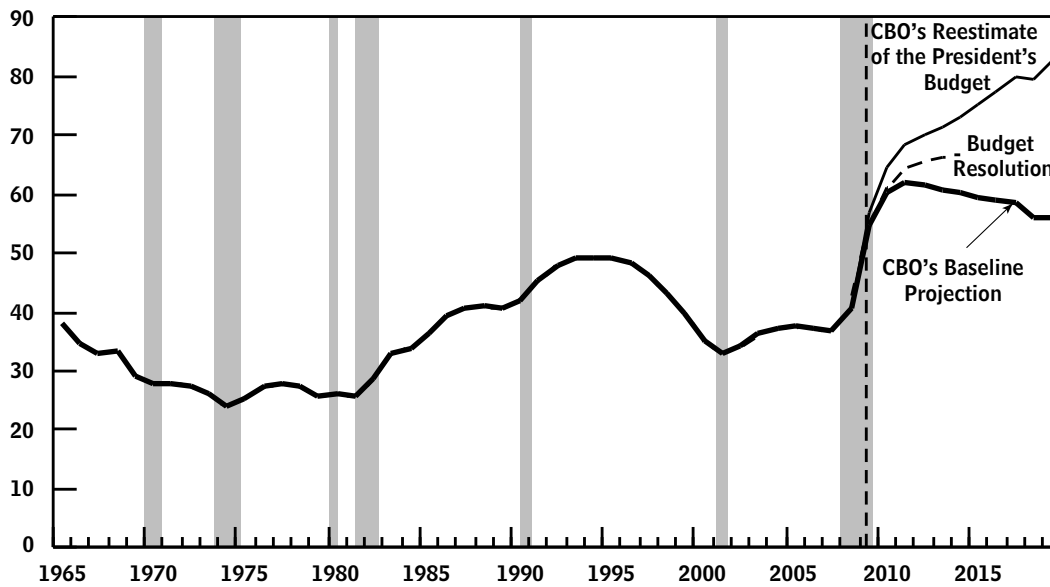
For information on CBO's baseline projection and reestimate of the President's budget, see Congressional Budget Office, *A Preliminary Analysis of the President's Budget and an Update of CBO's Budget and Economic Outlook* (March 2009). The data on the budget resolution are from the conference report *Concurrent Resolution on the Budget for Fiscal Year 2010* (April 27, 2009).

Data are by fiscal year and are plotted through 2019.

**Figure 10.**

## Debt Held by the Public, 1965 to 2019

(Percentage of GDP)



Source: Congressional Budget Office.

Notes: GDP = gross domestic product.

For information on CBO's baseline projection and reestimate of the President's budget, see Congressional Budget Office, *A Preliminary Analysis of the President's Budget and an Update of CBO's Budget and Economic Outlook* (March 2009). The data on the budget resolution are from the conference report *Concurrent Resolution on the Budget for Fiscal Year 2010* (April 27, 2009).

Data are by fiscal year and are plotted through 2019.

