



Nearing the Bottom, or Digging a Deeper Hole?

By Kevin L. Kliesen

The recessionary headwinds that began in late 2007 show few signs of abating. In the United States, we have witnessed sizable declines in employment; a multitrillion dollar decline in household net wealth, which has shaken consumer confidence and eroded consumer spending; a record-smashing plunge in the single-family housing construction industry, coupled with historic declines in house prices; a domestic automotive industry fighting through the worst slump in decades; and, not least, spectacular fraud, failure and turmoil in the banking and financial investment sector. Not surprisingly, real GDP contracted at a 6.25 percent annual rate in the fourth quarter of 2008, its largest decline since 1982. Moreover, economic activity is likely to decline and the unemployment rate rise through the first half of 2009.

Otherwise, things are OK.

In response to these events, policymakers worldwide have scrambled to prop up their ailing economies. To begin with, central banks in the United States and most other major countries have significantly reduced their interest rate targets. In the United Kingdom, for example, the Bank of England has lowered its target to its lowest level in more than 300 years. In the United States, the Federal Open Market Committee reduced its federal funds target rate to zero, in effect, and communicated it would keep the target there for an extended period.

Many central banks have also implemented new, unconventional lending facilities designed to stabilize credit and financial markets. In early March, the Federal Reserve unveiled yet another new special lending program: the Term Asset-Backed Securities Loan Facility. As a result of this and previous actions, the Fed engineered a stunning

escalation in the monetary base (the raw material for money creation) from about \$871 billion in August 2008 to more than \$1.7 trillion in January 2009.

Fiscal authorities have also jumped into the fray. In February, Congress passed, and President Barack Obama signed, a \$787 billion package of expenditures and tax cuts designed to boost economic activity over a two-year period. Then, building upon the \$700 billion Troubled Asset Relief Program (TARP), which was implemented in October 2008, the administration unveiled its Financial Stability Plan in February. In addition to offering more financial assistance for banking organizations, the plan seeks to stem the tide of home foreclosures.

Finally, in its budget that was released in late February, the Obama administration proposed to spend \$3.9 trillion in fiscal year 2009, a 32 percent increase from a year earlier. This startling level of spending is projected to be about 28 percent of GDP and to produce a budget deficit of \$1.7 trillion in the fiscal year that ends Sept. 30—easily the largest expansion of government spending since World War II.

Weighing the Costs and Benefits

Does the depth of the current recession justify this level of intervention? In March 2009, the recession was into its 16th month, which is considerably longer than the post-WWII average duration of 10 months. However, it is not yet clear that the recession will be deeper than normal, though that looked increasingly likely as of March. For the 10 recessions that have occurred from 1945 to 2001, the average peak-to-trough decline in real GDP is 2.1 percent, while the unemployment rate increases by an average of

2.9 percentage points. Through the fourth quarter of 2008, real GDP had declined only 1.7 percent from its peak in 2008:Q2, while the unemployment rate had risen by 3.7 percentage points from its trough in the fourth quarter of 2007. These numbers, while likely to worsen further over the first half of 2009, still pale in comparison to the 27 percent decline in real GDP and the nearly 25-percentage-point increase in the unemployment rate that occurred from 1929 to 1933.

When the depth and duration of the current recession are put into a historical context, the economic justification for the massive monetary and fiscal stimulus actions becomes less clear. While these actions may indeed end the recession significantly sooner than if policymakers had adopted a more moderate course of action, this benefit might be more than offset over time by (1) higher future marginal tax rates to pay for the increase in public debt, (2) a more interventionist regulatory structure that diminishes the role of market incentives and (3) the possibility of higher inflation and inflation expectations from excessive money growth.

Policymakers must be exceedingly careful not to put in place policies that begin to erode the nation's growth rate of labor productivity, which is the building block for rising living standards over time. ¹

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