Double-Dip Recession: Previous Experience and Current Prospect

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December 9, 2011

Congressional Research Service
7-5700
www.crs.gov
R41444

CRS Report for Congress
Prepared for Members and Committees of Congress

c11173008

Summary

Concerns have been expressed that the United States may be about to experience a "double-dip" recession. A double-dip or W-shaped recession occurs when the economy emerges from a recession, has a short period of growth, but then, still well short of a full recovery, falls back into recession. This prospect raises policy questions about the current level of economic stimulus and whether added stimulus may be needed. The pace of the recovery has been relatively slow and growth has recently decelerated. For the first year of the recovery, real GDP grew at an average rate of 3.3%, slow by the standard of earlier post-war recoveries, but fast enough to stop the rise of the unemployment rate at 10.1% in October 2010 and to cause it to fall to 9.5% by mid-2010. However, in the recovery's second year, the rate of GDP growth slowed to an average rate of 1.6% and the unemployment rate was only slightly lower at 8.6% in November 2011. Other indicators, such as weak consumer spending, falling house prices, reduced flows of credit, and the prospect of fading fiscal stimulus, are also worrisome.

Double-dip recessions are rare. There are only two modern examples of a double-dip recession for the United States: the recession of 1937-1938 and the recession of 1981-1982. They both had the common attribute of resulting from a change in economic policy. In the first case, recession was an *unintended* consequence of the policy change; in the second case, recession was an *intended* consequence.

Historically, there has been what is termed a "snap back" relationship between the severity of the recession and the strength of the subsequent recovery. In other words, a sharp contraction followed by a robust recovery traces out a V-shaped pattern of growth. However, unlike earlier post-war recessions, the recent recession occurred with a financial crisis. Research suggests that a slow recovery with sustained high unemployment is the norm in the aftermath of a deep financial crisis.

The prelude to the economic crisis in the United States was characterized by excessive leverage (the use of debt to support spending) in households and financial institutions, generating an asset price bubble that eventually collapsed and left balance sheets severely damaged. The aftermath is likely to be a period of resetting asset values, deleveraging, and repairing balance sheets. This correction results in higher saving, weakened domestic demand, a slower than normal recovery, and persistent high unemployment, but not necessarily a double-dip recession.

Slower growth in the first half of 2011 was, in part, attributable to temporary factors, such as supply chain disruptions caused by the earthquake in Japan, recent floods and tornadoes in the South and Midwest, and the spike in many commodity prices, particularly oil. Nevertheless, recent economic indicators suggest that the recovery's underlying momentum has also weakened. While not leading to projections of a double-dip recession, this weakening has prompted many economic forecasters to substantially reduce their near-term growth projections from those made earlier in 2011.

This report discusses factors suggesting an increased risk of a double-dip recession. It also discusses other factors that suggest economic recovery will continue. It presents the U.S. historical experience with double-dip recessions. It examines the role of deleveraging by households and businesses in the aftermath of the recent financial crisis in shaping the likely pace of economic recovery. The report concludes with a look at current economic projections.

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Background

There is recurring concern that the United States may be about to experience a "double-dip" recession. A double-dip or W-shaped recession occurs when the economy emerges from a recession, has a period of growth, but then falls back into recession, well short of a full economic recovery. This prospect raises policy questions about the current level of economic stimulus and whether added stimulus may be needed.

The 2007-2009 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.[1]

When the fall of economic activity finally bottomed out in the second half of 2009, real (i.e., inflation adjusted) gross domestic product (GDP) had contracted by approximately 5.1%, or by about $680 billion.[2] At this point the output gap—the difference between what the economy could produce and what it actually produced—widened to 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%.

Economic recovery as measured by growth of real GDP has been underway for nearly 2½ years, however, the pace of growth has been slow and uneven. Real GDP increased at an annualized rate of 2.2% and 5.6% in the third and fourth quarters of 2009; it increased 3.7%, 1.7%, 2.5%, and 3.1% over the four quarters of 2010. For most of 2010, much of this upward momentum was sustained by the transitory factors of inventory increases and fiscal stimulus.

Concern about the recovery's sustainability increased during the second and third quarters of 2010, due to growth slowing to around a 2% annual rate, a pace that may not be fast enough to keep the unemployment rate from rising. Moreover, beyond the temporary contributions of inventory adjustments and federal stimulus spending, the real economy grew only 0.5% in the third quarter of 2010. In the fourth quarter of 2010, the recovery's prospects looked more promising as stronger consumer spending and export sales helped to boost the pace of growth to 3.1%.

However, in the first quarter of 2011, growth slowed to a weak 0.4% because of a deceleration of consumer and government spending. Propelled by stronger business investment spending and a positive contribution from net exports, the pace of growth quickened during the second and third quarters of 2011, with real GDP increasing at annual rates of 1.3% and 2.0% respectively, but the advance continues to be substantially weaker than in previous post-war recessions.[3]

[1] See CRS Report R40007, *Financial Market Turmoil and U.S. Macroeconomic Performance*, by Craig K. Elwell.

[2] Real GDP is the total output, adjusted for inflation, of goods and services produced in the United States in a given year.

[3] Department of Commerce, Bureau of Economic Analysis, http://www.bea.gov/national/index.htm#gdp.

This deceleration, particularly the sharp slowing through three quarters of 2011, along with the winding down of government economic stimulus, the persistence of substantial areas of economic weakness, and significant downside risks, raises concern about the sustainability of the recovery and about the possibility that a second dip into recession is imminent. Larry Summers, the former head of President Obama's Economic Council, reportedly says there is a 1-in-3 chance of a double-dip; ex-Reagan Economic Advisor Martin Feldstein reportedly puts the chances at 1-in-2; and a recent report by the Federal Reserve Bank of San Francisco has also paced the changes of a second recession during the first half of 2013 at 1-in-2.[4]

This report discusses factors suggesting an increased risk of double-dip recession. It also discusses other factors that suggest economic recovery will continue. The U.S. historical experience with double-dip recessions is also presented. Also examined is the role of deleveraging by households and businesses in the aftermath of the recent financial crisis in shaping the likely pace of economic recovery. The report concludes with a look at current economic projections.

Factors That Suggest Increased Risk of Double-Dip Recession

A double-dip recession in the United States is likely to be the consequence of a substantial negative economic shock to an already weak economy.

Indicators of Continued Economic Weakness

- Consumer spending, the usual engine of a strong economic recovery remains tepid, spending has been slowed by households' need to rebuild substantial net worth lost during the recession, high unemployment and underemployment, and the surge in energy prices in the first half of 2011.[5] In general, consumers are not optimistic about their economic prospects, as consumer confidence measures are still well below pre-recession levels.[6]
- Housing prices continued to decline, down 4.7% for the year ending October 2011.[7] Moreover, in the third quarter of 2011, the incidence of negative equity increased with an estimated 28.6% of mortgage holders currently "underwater."[8]

[4] Jim Puzzanghera, "Economist Lawrence Summers Warns of Double-dip Recession," *Los Angeles Times*, August 4, 2011, at http://articles.latimes.com/2011/aug/04/business/la-fi-summers-20110804; Bloomberg TV, "U.S. Recession Risk Own Words," *Bloomberg News*, August 4, 2011, at http://www.bloomberg.com/video/73493014/; and Federal Reserve Bank of San Francisco, *Economic Letter,* "Future Recession Risks: An Update," November 14, 2011, http://www.frbsf.org/publications/economics/letter/2011/el2011-35.html.

[5] U.S. Department of Commerce, Bureau of Economic Analysis, "National Income and Product Accounts," news release, November 2011, at http://www.bea.gov/newsreleases/national/gdp/2011/pdf/gdp2q10_3rd.pdf.

[6] University of Michigan, Index of Consumer Sentiment, FRED Economic Data, http://research.stlouisfed.org/fred2/series/UMCSENT.

[7] National Association of Realtors, *Median Sales Price of Existing Single-Family Homes for Metropolitan Areas*, 2nd Quarter 2011, at http://www.realtor.org/research/research/metroprice.

[8] Zillow Real Estate Research, *No Respite from Housing Recession in First Quarter*, May 2011, http://www.zillow.com/blog/research/2011/05/08/no-respite-from-housing-recession-in-first-quarter/.

In addition to dampening direct expenditures on housing, these are factors that weaken household balance sheets and dampen household spending generally.

- After steadily climbing over the previous two years, the stock market weakened in the second quarter of 2011 and has fallen more than 7% through November 2011. Falling stock prices tend to reduce household wealth and dampen current spending.
- Employment conditions remain weak. The unemployment rate, which had peaked at 10.1% in October of 2009, had only fallen to 8.6% in November 2011. Most of this improvement occurred during 2010 with essentially no net improvement through the first 10 months of 2011. Economic growth in most of 2011 has only been 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.[9]
- The level of consumer revolving credit continues to fall, down 3.2% in the third quarter of 2011. This weakened flow of credit to households reflects a mixture of demand and supply forces at work, with cautious behavior by both lenders and consumers playing a role.[10]

Possible Negative Economic Shocks

- The sovereign debt crisis in the euro area remains unresolved and economic growth in the region has slowed substantially, increasing the risk of a second recession occurring there. Slower growth in Europe would decrease the demand for U.S. goods. In addition, a major European sovereign debt default or bank failure would likely reverberate in U.S. credit markets and add to the dampening effect on real economic activity in the United States.
- The amount of federal fiscal stimulus, under current law, has begun to fall rapidly, providing decreasing support for economic activity. The Congressional Budget Office (CBO) projects that between FY2010 and FY2013, the federal budget deficit will decline from 8.9% to 3.2% of GDP. Several factors contribute to the reduced fiscal stimulus. Temporary relief from the alternative minimum tax (AMT) enacted under the American Recovery and Reinvestment Act of 2009 (ARRA; P.L. 111-5) expired in 2009, but the economic effects are felt for several quarters after that. The stimulative effect of the spending increases enacted under ARRA peaked in the first half of 2010 and fall off substantially by late 2011.[11] In addition, the simulative impact of the tax reductions, first enacted in the Economic Growth Tax Relief Reconciliation Act of 2001 and the Jobs and Growth and Tax Relief and Reconciliation Act of 2003, that were extended at the end of 2010 by the Tax Relief, Unemployment Insurance Reauthorization, and

[9] Bureau of Labor Statistics, *Labor Force Statistics from the Current Population Survey*, October 2011, http://www.bls.gov/cps/. For more detail, please see CRS Report R41434, *Job Growth During the Recovery*, by Linda Levine.

[10] Federal Reserve Statistical Release G. 19, November 7, 2011, http://www.federalreserve.gov/releases/g19/current/g19.htm.

[11] Congressional Budget Office, *The Budget and Economic Outlook: An Update*, August 2011, at http://www.cbo.gov/ftpdocs/123xx/doc12316/08-24-BudgetEconUpdate.pdf.

Job Creation Act of 2010 (2010 Tax Act; P.L. 111-312) has been greatly dissipated by continued sizable decreases in spending by state and local governments in the first half of 2011. Also, the temporary payroll tax cut and extended unemployment benefits enacted under the 2010 Tax Act are due to expire at the end of 2011. Fiscal consolidation over the near term, not offset by increased spending in other sectors of the economy, is likely to slow economic growth.

- A 32% increase in the price of oil from January through April of 2011 likely adversely affected household budgets and contributed to the slowing of economic growth during the remainder of 2011.[12] 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, much of which is imported, they tend to spend less on domestic output, slowing economic growth. After stabilizing during most of the second half of 2011, the price of oil has begun to inch up again. Another major spike in oil prices could tip the balance between economic expansion or contraction. [13]
- China's economy slowed in the second quarter of 2011 as the Chinese government stepped up its efforts to dampen inflation by raising interest rates for the third time this year. Slower growth could translate into decreased demand for U.S. exports, which have been one of the few sources boosting economic activity during the economic recovery.[14]

Historical Experiences with Double–Dip Recession

Double-dip recessions are rare. There are only two modern examples of a double-dip recession for the United States: the recession of 1937-1938 and the recession of 1981-1982. They both have the common attribute of resulting from a change in economic policy. However, in the first case, recession was an *unintended* consequence of the policy change; in the second case, recession was an *intended* consequence of the policy change. Both point to the importance of policy persistence in overcoming difficult economic circumstances.

The 1937-1938 Recession: A Premature Removal of Economic Stimulus

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

[12] U.S. Energy Information Administration, *Petroleum; Weekly Spot Price*, June 2011, http://www.eia.gov/dnav/pet/hist/LeafHandler.ashx?n=PET&s=WTOTUSA&f=W.

[13] 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 baseline 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.

[14] Conference Board, *Global Business Cycle Indicators*, August 15, 2011, http://www.conference-board.org/data/bcicountry.cfm?cid=11.

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 (the Fed) 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 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 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 where 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%.[15]

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 wartime spending in 1941.

The 1981-1982 Recession: A Policy of Disinflation

By the end of the 1970s, inflation had become a major economic problem for the United States. Since the mid-1960s, as measured by the consumer price index (CPI), inflation had steadily ratcheted up from an annual rate of less than 2% to more than 13% by the end of 1979. In the fall of 1979, Paul Volcker, recently appointed to the Fed chairmanship, initiated a policy of *disinflation*—a reduction of the rate of inflation. Applying an aggressive contractionary monetary policy, the Fed progressively increased the federal funds rate from about 11% in the summer of 1979 to nearly 18% by the spring of 1980.

Economic growth had been sluggish in 1979 because of the effects of the second OPEC-induced petroleum price shock, but with the added negative impact of a contractionary monetary policy, the economy tipped into a short recession that lasted from January through July of 1980.

[15] 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.

However, despite the recession the rate of inflation hardly budged. It fell from an annual rate of 14.6% in the spring of 1980 to an only slightly lower rate of 13% in the fall of that year.

The economic recovery that commenced in the second half of 1980 would be short lived, lasting only through the first quarter of 1981. Because the Fed was determined to wring inflation out of the economy, it applied a second, stronger dose of contractionary monetary policy beginning in the fourth quarter of 1980. The federal funds rate, which had fallen to around 9% during the 1980 contraction, would be steadily increased by the Fed to more than 19% by mid-1981. The sharp increase of interest rates again tipped the economy into what would this time be a longer recession, lasting through the third quarter of 1982.

During this second dip, the rate of inflation did fall sharply, decreasing to below 3.5% by early 1983. Successful disinflation came at a significant cost: a 2.7% contraction of real GDP and an unemployment rate that would be pushed to a peak of 10.8% in November of 1982 and remain above 10% through the first half of 1983.

The Pattern of Past and Present Economic Recoveries

For the U.S. economy, the annual rate of growth of real GDP in the early years of recovery from a recession has typically been above its long-term trend rate of growth (real GDP advancing at a 2.5% to 3.0% annual rate).

Historically, there has been what is termed a "snap back" relationship between the severity of the recession and the strength of the subsequent recovery. In other words, a sharp contraction is followed by a robust recovery tracing out a V-shaped pattern of growth. Having deferred spending during the contraction, households and businesses have typically increased purchases quickly as economic conditions improved.

Excess capacity and high unemployment generated during the recession typically means that for the near term the normal supply constraints do not apply, allowing the economy to grow faster than its long-term trend. The more slack, the greater the possibility for above normal growth. As the recovery matures and the economy approaches full employment and high rates of capacity utilization, growth slows to the economy's trend rate of growth that is governed by growth of the labor force and productivity.

Prior to the recent recession, the three sharpest contractions, as measured by the cumulative fall of real GDP, occurred in the recessions of 1981-1982, 1973-1975, and 1957-1958. In 1981-1982, the cumulative decline of real GDP was 2.7% and the increase in the first year of recovery was 7.7%; in 1973-1975, the cumulative decline was 2.8% and the subsequent increase was 6.1%; in 1957-1958, the cumulative decline was 3.7% and subsequent increase was 9.5%.

The current recovery has not followed this pattern, however. The contraction was sharp, but recovery has been slow and uneven. Over an 18-month contraction, real GDP fell 5.1%, a post-war record. In the recovery's first year, real GDP growth averaged 3.3%, slow in comparison to other post-war recoveries, but fast enough to slowly reduce the unemployment rate. In the recovery's second year, growth decelerated to a much slower 1.6% average rate, a pace too slow

to prevent the unemployment rate from rising. As the recovery entered its third year in the third quarter of 2011, growth of real GDP occurred at a relatively weak 2.0% annual rate. [16]

The Impact of a Financial Crisis on the Pace of the Subsequent Recovery

Unlike earlier post-war recessions, the recent recession occurred with a financial crisis. Carmen Reinhart and Kenneth Rogoff say in a recent book that a slow protracted recovery with sustained unemployment is the norm in the aftermath of a deep financial crisis.[17] 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 substantially above normal growth to quickly return the economy to its pre-crisis potential output and growth path and, in turn, quickly reduce unemployment. Protracted underutilization of resources, including long-term unemployment, results in a deterioration of the economy's potential output. This failure to return to the pre-crisis potential output path means that the economy bears the burden of a permanent output loss.

Recent analysis by the International Monetary Fund (IMF) examines the question of whether output will return to its pre-crisis trend after the crisis.[18] 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.

The Drag of Deleveraging on U.S. Economic Growth

The prelude to the economic crisis in the United States was characterized by excessive leverage (the use of debt to support spending) in households and financial institutions, generating an asset bubble that eventually collapsed and left balance sheets severely damaged. The aftermath is likely to be a period of resetting asset values, deleveraging, and repairing balance sheets. This correction results in higher saving, weakened domestic demand, a slower than normal recovery, and persistent high unemployment, but not necessarily in a double-dip recession.

Counter-cyclical policy (fiscal and monetary stimulus) can moderate these negative effects but it cannot fully or quickly undue the underlying economic damage. That rebuilding will take time,

[16] U.S. Department of Commerce, Bureau of Economic Analysis, *National Income Accounts*, Table 1.6.1, http://www.bea.gov/national/nipaweb/SelectTable.asp?Popular=Y.

[17] Carmen Reinhart and Kenneth Rogoff, *This Time is Different: Eight Centuries of Financial Folly* (Princeton, NJ: Princeton University Press, 2009).

[18] P. Kannan, A. Scott, and M. Terrones, "From Recession to Recovery: How Soon and How Strong?," in *World Economic Outlook* (Washington: International Monetary Fund, 2009), pp. 103-138. Also see Davide Furceri, and Annabelle Mourougane, *The Effect of Financial Crisis on Potential Output: New Empirical Evidence from OECD Countries*, Organisation for Economic Co-operation and Development, Economics Department Working Papers No. 699, May 2009.

and as it occurs economic growth is likely to remain moderate, even with the support of fiscal and monetary stimulus.[19]

The collapse of the housing and stock markets in 2008 and 2009 substantially decreased household net worth, which by the end of the contraction in mid-2009 had fallen $15 trillion below its level in 2007.[20] This large fall in net worth pushed the household debt burden 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 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 a drag on the pace of economic recovery.[21]

The household saving rate has risen sharply since the beginning of 2010, averaging near 6% of disposable income, suggesting households could be making some progress at repairing their balance sheets.

Investment and employment typically follow demand once the inventory cycle has run its course. Until consumer demand returns, business investment is likely to be weaker than normal.

Many banks and financial institutions are also deleveraging and rebuilding their balance sheets, a process that tends to dampen the flow of credit to the wider economy. Lending standards to consumers and businesses remain tight, as banks are inclined to hold a larger cushion of reserves to maintain liquidity and are more reluctant to lend long term. Large firms in good financial condition have access to credit on favorable terms. Reluctance to expand operations and employment depends on increased final demand for their products, not financing costs. However, smaller firms that are more dependent on bank lending may be having greater difficulty obtaining credit.

More Support from the Foreign Sector?

Strong net exports (exports minus imports) could take up some of the slack from weak consumer spending. Strong growth in many emerging economies provides an external stimulus to economic activity in the United States. Also, the dollar is very competitive from a historical perspective, adding support to U.S exports. Over the last year, exports have consistently accounted for about 50% of the growth of real GDP. But it is uncertain that recovery in the foreign economies that are typically large markets for U.S. exports will be strong enough to generate above normal demand for U.S. exports.

Increasing U.S. net exports to any degree requires that the trade deficit continue to decrease. For that to happen, trade surpluses in the rest of the world must simultaneously decrease. To achieve this adjustment of trade flows, a sizable rebalancing of domestic and external demand on the part

[19] See CRS Report R41332, *Economic Recovery: Sustaining U.S. Economic Growth in a Post-Crisis Economy* , by Craig K. Elwell.

[20] Board of Governors of the Federal Reserve System, *Flow of Funds Accounts*, Table B.100, December 2011, http://www.federalreserve.gov/releases/z1/Current/z1r-5.pdf.

[21] See Evan Tanner and Yassar Abdih, *Rebuilding U.S. Wealth*, Finance & Development, IMF, December 2009. See also CRS Report R41623, *Household Deleveraging: Why Is Consumer Debt Falling?*, by Mark Jickling and Darryl E. Getter.

of the deficit and surplus economies must occur.[22] 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.

Effective global rebalancing arguably also involves sizable adjustments by the largest surplus economies—Germany, Japan, and China. However, there are potential constraints on how substantially each of these economies can "save less and spend more," perhaps limiting any sizable appreciation of their currencies relative to the dollar, and any near-term prospect of a large boost from net exports to U.S. economic growth.[23]

Economic Policy Response

Mainstream macroeconomics' standard prescription for combating recession is to use monetary and fiscal policy to increase aggregate spending and stimulate economic activity. A stimulative monetary policy is initiated with the Fed entering the federal funds market, making open-market purchases of Treasury securities from banks in exchange for cash. The infusion of cash increases the reserves (liquidity) of the banking system, exerting downward pressure on interest rates. A stimulative fiscal policy supports economic growth through an increase in the budget deficit via lower taxes and increased government spending. Both fiscal and monetary policy were used to counter the 2008-2009 recession and support the ongoing recovery. If the pace of private spending proves insufficient to assure a sustained recovery, is further stimulus by monetary and fiscal policy warranted?

The case for stimulative monetary and fiscal policy has not been without its critics. However, a full discussion of this issue is beyond the scope of this report. Other CRS reports deal more extensively with possible policy responses to recession and a faltering economic recovery.[24]

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.

Slower growth in the first half of 2011 was, in part, attributable to temporary factors such as supply chain disruptions caused by the earthquake in Japan, floods and tornadoes in the U.S.

[22] On global rebalancing, see for example Olivier Blanchard, *Sustaining Global Recovery*, IMF, September 2009, at http://www.imf.org/external/pubs/ft/fandd/2009/09/index.htm; "Rebalancing," *The Economist*, March 31, 2010; and Board of Governors of the Federal Reserve System, Vice-chairman Donald L. Kohn, speech "Global Imbalances," May 11, 2010, at http://www.federalreserve.gov/newsevents/speech/kohn20100511a.htm.

[23] For further discussion, see CRS Report R41332, *Economic Recovery: Sustaining U.S. Economic Growth in a Post-Crisis Economy* , by Craig K. Elwell.

[24] See the following: CRS Report R41332, *Economic Recovery: Sustaining U.S. Economic Growth in a Post-Crisis Economy* , by Craig K. Elwell; CRS Report R40770, *The Sustainability of the Federal Budget Deficit: Market Confidence and Economic Effects*, by Marc Labonte; CRS Report RL30354, *Monetary Policy and the Federal Reserve: Current Policy and Conditions*, by Marc Labonte; and CRS Report R41849, *Can Contractionary Fiscal Policy Be Expansionary?*, by Jane G. Gravelle and Thomas L. Hungerford.

South and Midwest, and the spike in many commodity prices, particularly oil. Nevertheless, recent economic indicators suggest that the recovery's underlying momentum has also weakened. While not leading to projections of a double dip recession, this weakening has prompted many economic forecasters to trim their near-term growth projections from those made earlier in 2011.

- CBO projects the economic recovery continuing albeit at a slow pace. Real GDP is expected to advance 2.3% in 2011 and 2.7% in 2012 (measured on a fourth quarter to fourth quarter basis). Weak economy-wide demand will result in relatively slow improvement in job growth. The unemployment rate is projected to fall from 9.1% in the second quarter of 2011 to 8.5% in the fourth quarter of 2012.[25]
- The Fed's Open Market Committee projects real GDP in 2011 to advance in a range between 2.7% to 2.9% and in 2012 in a range between 3.3% to 3.7% (the growth projections for both years are down 0.4 percentage points from the previous projection). The unemployment rate is projected to be in a range between 8.6% to 8.9% in 2011 and 7.8% to 8.25% in 2012 (about 0.2 percentage points above the previous projection in both years).[26]
- The IMF projects real GDP in the United States to increase 1.5% in 2011 (down 1.0 percentage points from its June 2011 projection) and 1.8% in 2012 (down 1.1% from the June 2011 projection). Globally, the IMF expects an unbalanced expansion, with weak recovery in most advanced economies and strong growth in many emerging and developing economies. World output is projected to increase 4.0% in 2011 and 4.0% in 2012.[27]
- Global Insight, an economic forecasting company, is currently projecting real GDP will advance 1.7% in 2011 (down 1.0 percentage points from its June projection) and 1.4% in 2012 (down 1.3 percentage points from its June projection). The unemployment rate is projected to be 9.1% in 2011 and 9.3% in 2012.[28]

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., sharp financial crisis, greatly weakened balance sheets of households and businesses, and unusual and strong policy responses).

[25] The Congressional Budget Office, *the Budget and Economic Outlook: An Update,* August 2011, http://www.cbo.gov/ftpdocs/123xx/doc12316/08-24-BudgetEconUpdate.pdf.

[26] Board of Governors of the Federal Reserve System, Minutes of June 21-22 Meeting, *Projection Materials*, released July 12, 2011, http://www.federalreserve.gov/monetarypolicy/fomccalendars.htm.

[27] International Monetary Fund, *World Economic Outlook: An Update*, September 2011, http://www.imf.org/external/pubs/ft/weo/2011/update/02/index.htm.

[28] Global Insight, *U.S. Economic Outlook*, October 2011.

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