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U.S. Economy in a Global Context

Congress faces difficult challenges in formulating policies to foster economic growth. In the long run, the continuing and growing imbalance between federal spending and revenues would be a major challenge if current policies are continued. This imbalance will lead to unsustainable growth in the federal debt, which crowds out investment. The economy appears to have largely recovered from the 2007-2009 recession. Nevertheless, deficit reduction that is too large in the near term could damage what is still an incomplete recovery. Addressing this tension in policy prescriptions for the short term and the long term is also taking place in an increasingly global environment that interacts with these policies.

Short-Run Challenges

Unemployment

The 2007-2009 recession was severe, and the recovery has been relatively slow. The unemployment rate rose from nearly 4.7% in November 2007 to 10% in 2009, before declining to pre-recession levels over the next seven years. As of November 2016, the unemployment rate stands at 4.6% and has remained equal to 5.0% or lower since October 2015. According to the Congressional Budget Office (CBO), the current unemployment rate is near estimates of the natural rate of unemployment (about 4.8%). Wage growth has also begun to accelerate in recent months, suggesting a tightening labor market.

Although the official measure of unemployment appears to be returning to normal levels, the labor force participation rate fell during the recession and remains depressed. Underemployment (those who could only find or keep part-time employment) also remains elevated. A measure that combines the official unemployment rate, and discouraged or underemployed workers, is at 9.3% compared with 8.4% in November 2007. Long-term unemployed workers as a percentage of the labor force were 0.9% in 2007 and 1.2% in 2016. Thus, although recovery appears to be largely complete, the economy is still fragile. Inflation has remained below the Federal Reserve's target rate of 2%, and CBO estimates an output gap (i.e., the difference between potential and actual gross domestic product [GDP]) of 1.5%.

Fiscal and Monetary Policy

The U.S. recovery has been sluggish in comparison to previous recoveries. Since the end of the recession, real GDP growth has averaged 2.1% per year, compared with an average growth rate of 4.3% during previous post-WWII recoveries.

During a recession or a period of slow economic recovery, reducing the deficit is contractionary. Although a small fiscal stimulus was adopted in 2008 and a larger one in 2009, fiscal policy turned contractionary in 2011. The Budget Control Act of 2011 specified deficit reduction that eventually resulted in spending cuts, largely in discretionary spending. In the beginning of 2013, policy makers faced a major potential contraction (referred to as the *fiscal cliff*) as the 2001 and 2003 tax cuts and other provisions were slated to expire and spending reductions were scheduled to take place. Although most of the 2001 and 2003 tax cuts were made permanent and other changes were made, the fiscal cliff still had a contractionary effect. Thus, addressing the recovery in the past few years has fallen to monetary policy conducted by the Federal Reserve.

The current condition of the economy indicates that a fiscal stimulus (i.e., a deficit increase through higher spending or lower taxes) would likely be ineffective in increasing output. Yet the slow economic recovery and low inflation rate suggest caution in moving too aggressively to reduce deficits to address long-run debt challenges.

The Long-Term Debt Issue

During the recession and recovery, the debt grew from about 40% of GDP to more than 70%. This increase was partly due to an increase in spending (stimulus and automatic increase in transfer payments) and the decline in revenues. As the recovery has progressed, revenues and spending have returned to more normal levels stabilizing the debt in recent years. (The debt can grow without increasing the ratio of debt to GDP as long as it rises at a rate less than or equal to GDP growth.)

Despite the near-term debt stabilization, the debt is projected to grow in the future largely due to long-recognized issues, such as the aging population and increased health care costs. CBO's long-term projections show the debt growing from 77% in 2016 to 86% in 2026 and to 141% in 2049, with accelerating subsequent growth. The debt, in other words, is on an unsustainable path under current policy.

Trends in Government Spending

Recent reductions in the deficit are mostly due to an improving economy. But policy changes to reduce the deficit were also achieved, primarily through caps on discretionary spending (defense and nondefense). Discretionary spending, however, is not the source of the long-run debt problem. Based on current policies and an extended baseline for certain types of spending, CBO projects Social Security, Medicare, and other health transfers (i.e., Medicaid, the Child Health Insurance Program, and payments in the exchanges) each will increase by about 1.6% of GDP, reaching a total of 4.7% of GDP, by 2046. Discretionary spending is already set to decline (due to the caps) by 1.6% of GDP over the next 10 years, leaving defense and nondefense spending at about

2.6% each of GDP in 2026 compared with 3.3% in 2016. (From 2026 on, this spending is assumed to be fixed relative to GDP in the baseline.) Other mandatory spending is also projected to decline by 0.7% of GDP by 2046.

Overall, spending outside of interest is projected to increase by 2.7% of GDP by 2046, with taxes and other receipts rising by 1.2% of GDP (due to real bracket creep in the individual income tax more than offsetting a slight reduction in other revenues). Interest payments are projected to increase by 3.4% of GDP due to rising interest rates and the increased debt. (Interest rates on government debt were very low in FY2016.)

CBO also considers alternative baselines in the long-term projections. Under the path where deficits from 2016 are increased by $2 trillion relative to the current baseline (excluding net interest and macroeconomic feedback effects), debt increases to 193% of GDP by 2046. If deficits from 2016 to 2026 instead decline by $2 trillion, debt is projected to increase to 96% of GDP by 2016.

CBO projects that a permanent reduction in the deficit of 1.7% of GDP would be required to stabilize debt at 75% of GDP under the standard baseline. A 2.9% cut would be required to bring debt to the average of the past 40 years (39%) by 2046. If the reduction is delayed for 5 years, the required decreases will be 2.1% to stabilize debt at 75% and 3.4% to stabilize debt at 39% by 2046. Total discretionary spending is 5.2% of GDP, which is too small for spending cuts limited to this part of the budget to achieve a sustainable debt.

To address the long-term budget pressures, either significant cuts in mandatory spending (such as Social Security and Medicare) or significant tax increases, or both, will likely be necessary. Moreover, if Social Security and Medicare Part A (hospital insurance) are to remain self-financed through payroll taxes, increases in these taxes might be needed through rate increases or, for Social Security, increases in the earnings ceiling.

The Global Economy

The United States is increasingly interconnected with the rest of the world through trade and financial flows. As a result, other countries affect the U.S. economy and U.S. policies affect or are constrained by other countries.

Fiscal Policy in a Global Economy

Recessions and economic slowdowns in other countries, which were worsened in some cases by austerity measures, contracted demand for U.S. exports. Recession and slower growth in other countries continues to affect the U.S. economy. In addition, fiscal stimulus is less effective the more open the economy. Fiscal stimulus pushes up interest rates, which attracts capital inflows and drives up the price of the dollar, discouraging net exports, although the magnitude of this offsetting effect is unclear. In addition, sovereign debt problems in Europe have made European countries' investments relatively less attractive and U.S. government securities' investments more attractive. This inflow keeps U.S. interest rates lower, drives up the value of the dollar, and reduces net exports, which is contractionary.

Foreign Holdings of Debt

Concerns have been raised about the large foreign holdings of U.S. debt, especially by China, and about the effects of a sudden sell-off. However, these concerns may be overstated. China benefits from holding U.S. debt, and an abrupt withdrawal and accompanying fall in security prices would be costly to China. Moreover, any funds withdrawn from the United States would have to be invested elsewhere. The sellers of those securities would in turn invest in U.S. securities (but probably at higher interest rates). In general, the holding of U.S. debt by foreign countries probably makes interest rates and capital flows more stable than privately held debt, which may respond more powerfully to changes in interest rates.

Trade Policy in a Global Economy

International trade (exports and imports) is equivalent to almost 40% of U.S. GDP and will continue to be an important influence on future domestic economic growth. With the growing impact of the global economy on the United States, U.S. trade policy comprises a number of policy tools to increase market access to countries such as China and to address issues such as the protection of intellectual property rights worldwide. Notably, the United States is considering two "mega-regional" trade agreements with 11 Asia-Pacific nations and the European Union to reduce or eliminate trade barriers. The former has been agreed to by the United States but not by Congress. There are indications that the incoming Administration may withdraw from the agreement.

Although free trade is generally mutually beneficial for counties overall, it can affect the distribution of income. It can reduce jobs in import-sensitive industries, although it creates them in export intensive industries. Concerns have been raised about the loss of manufacturing jobs, a trend that has continued for some time. Most economists believe the major reason for this effect is not import competition but automation, as manufacturing output has steadily increased while jobs have declined. In the long run, trade will largely affect the mix of jobs in the United States and not the number.

Other Global Issues

The increasingly interconnected global economy has led to focusing on a variety of other policy issues. The United States continues to negotiate with other countries on the adoption and implementation of financial regulatory standards. Global economy concerns, including base erosion and profit shifting, have given rise to a variety of proposals regarding the corporate income tax, including lowering the corporate tax rate and broadening the base. The effects of these proposed tax changes would likely be small relative to overall economic growth given the small size of the corporate tax, which is about 2% of GDP.

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