



# Double-Dip Recession: Previous Experience and Current Prospect

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## Summary

Concerns have been expressed that growth in the United States may falter to the point where the U.S. economy again experiences 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. 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 9.1% by mid-2011. Growth remained weak during the recovery's third year, advancing at an annual rate of 1.9%, and the unemployment rate had only improved to 8.2% by May 2012. Other indicators, such as weak consumer spending, falling house prices, reduced flows of credit, the prospect of fading fiscal stimulus, and the premature return of recession in the euro area 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 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

Recent economic fragility in Europe is again prompting 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.<sup>1</sup>

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.<sup>2</sup> At this point the output gap—the difference between what the economy could produce and what it actually produced—widened to 8.1%.<sup>3</sup> 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 on average to near 4.0%.

The economy, as measured by real GDP growth, began to recover in mid-2009. However, over the next three years, the pace of growth has been slow and uneven. During 2009 and 2010, growth had been largely sustained by transitory factors, such as fiscal stimulus and the rebuilding of inventories by business. In the first half of 2010, economic growth showed signs of beginning to be generated by more sustainable forces such as consumer spending, business investment spending, and exports. But the strength of those forces continued to be uneven, and they weakened by the year’s end. In the first quarter of 2011, growth slowed sharply to a 0.4% annual rate, largely because of a deceleration of consumer and government spending. This pronounced slowing of growth raised concern about the recovery’s sustainability and the prospect of a second “dip” into recession. However, over the remainder of 2011 the pace of economic growth improved. Propelled by stronger business investment spending and a positive contribution from net exports, the pace of growth increased to a 3.0% annual rate in the fourth quarter of 2011, allaying concern about the return of recession.

In the first quarter of 2012 growth slowed again, falling to a 1.9% annual pace. Growth at less than a 2% annual rate may not be fast enough to close the output gap or to keep the unemployment rate from rising.<sup>4</sup> Moreover, the persistence of economic weakness in the United States, the prospect of negative spillovers here from Europe’s return to recession, and a looming

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

<sup>2</sup> Real GDP is the total output, adjusted for inflation, of goods and services produced in the United States in a given year. GDP data are available from the Bureau of Economic Analysis, U.S. Department of Commerce, at <http://www.bea.gov/>.

<sup>3</sup> Computation made from data on GDP and potential GDP available at FRED Economic Data, Federal Reserve Bank of St. Louis, <http://research.stlouisfed.org/fred2/categories/106>.

<sup>4</sup> U.S. Department of Commerce, Bureau of Economic Analysis, *National Income and Product Accounts*, at [http://www.bea.gov/iTable/index\\_nipa.cfm](http://www.bea.gov/iTable/index_nipa.cfm).

large dose of fiscal restraint (under current law) in early 2013 could increase the risk to the United States of an early return of recession. A recent report by the Federal Reserve Bank of San Francisco estimates the chances of a second recession during the first half of 2013 at 1-in-2.<sup>5</sup>

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**

- In the third quarter of 2011, the economy had regained its prerecession level of output. But it took 15 quarters to accomplish this as compared to 5 quarters on average in previous post-war recoveries. However, since potential GDP has also continued to grow, the output gap over this time period has only narrowed from about 8.1% to 6.1%.<sup>6</sup>
- Consumer spending, the usual engine of a strong economic recovery, remains tepid, generally slowed by households' ongoing need to rebuild substantial net worth lost during the housing crisis and the recession. The Federal Reserve estimates that median household net worth decreased by 38.8% during the period 2007-2010.<sup>7</sup> Also constraining consumer spending was continued high unemployment and underemployment and a surge in energy prices in the first half of 2012. While consumer spending was stronger in the first quarter of 2012, this improvement was largely financed by a fall in the household rate of saving. This is unlikely to be a sustainable support for household spending.
- Employment conditions remain weak. The unemployment rate, which had peaked at 10.1% in October of 2009, had fallen to 8.1% in April 2012, but increased to 8.2% in May 2012. Most of the fall in the unemployment rate occurred during 2010, with essentially no net improvement during 2011 and the first quarter of 2012. Relatively weak economic growth in 2011 was only just fast enough to keep the unemployment rate from rising. An 8.2% rate of

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<sup>5</sup> 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>.

<sup>6</sup> Computation made from data on GDP and potential GDP available at FRED Economic Data, Federal Reserve Bank of St. Louis, <http://research.stlouisfed.org/fred2/categories/106>.

<sup>7</sup> Federal Reserve Bulletin, "Changes in U.S. Family Finances from 2007 to 2010: Evidence from the Survey of Consumer Finances," June 2012, at <http://federalreserve.gov/pubs/bulletin/2012/PDF/scf12.pdf>.

unemployment after more than three years of economic recovery is unusual and a source of concern to many. Also, some of the fall of the unemployment rate since 2009 does not reflect people finding jobs, rather it is caused by discouraged workers leaving the labor force. Another measure of labor market conditions, the employment to population ratio, which is not affected by changes in labor force participation, shows a labor market that is essentially “treading water.” During the recession that ratio fell from 63% to 58%, and it has remained near that low through nearly three years of economic recovery.<sup>8</sup>

- The housing market remains depressed. Mortgage loan foreclosures continue to rise, house prices are still falling in many regions, and millions of mortgage holders are “under water,” with the market values of their houses below the amounts of their mortgages. Beyond the direct effect on economic activity through lower rates of new construction, housing market weakness has a strong negative indirect effect on the balance sheets of households and banks. The sharp fall in household net worth caused by the fall of house prices has been an important factor dampening current consumer spending and the pace of overall economic recovery.
- Growth in the Euro area has been weak and fiscal austerity measures to stem the growth of public debt have likely pushed the region back into recession, slowing growth there further. Slower growth in Europe, a major U.S. export market, will likely transmit a contractionary impulse to the United States, which could slow the pace of the U.S. recovery.<sup>9</sup> A recent analysis by Goldman Sachs suggests that over the last year the European crisis might have already erased a cumulative 0.5 to 1.4 percentage points from U.S. GDP.<sup>10</sup>

## **Possible Negative Economic Shocks**

- The unresolved sovereign debt crisis in the Euro area remains a principal near-term risk. Economic growth in Europe has slowed substantially, with several of the regions economies likely experiencing recession. If the recession in Europe intensifies, it raises the risk of a second recession occurring in the U.S. economy. 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 impending “fiscal cliff” would sharply slow U.S. economic growth in 2013. Fed Chairman Ben Bernanke, speaking at an April 2012 press conference, warned about the likely adverse effect on the economic recovery of the “fiscal cliff” the economy could face in January 2013.<sup>11</sup> The fiscal cliff refers to the

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<sup>8</sup> Bureau of Labor Statistics, *Labor Force Statistics from the Current Population Survey*, October 2011, at <http://www.bls.gov/cps/>.

<sup>9</sup> International Monetary Fund (IMF), *World Economic Outlook*, April 2012, at <http://www.imf.org/external/pubs/ft/weo/2012/01/index.htm>.

<sup>10</sup> Goldman Sachs Global ECS Research, *U.S. Economics Analyst*, “U.S. Growth in Low Gear,” June 1, 2012, at <http://360.gs.com>.

<sup>11</sup> Board of Governors of the Federal Reserve System, *Press Conference*, at <http://www.federalreserve.gov/mediacenter/files/FOMCpresconf20120425.pdf>.

confluence of various spending cuts and tax rate increases that are scheduled to occur at the beginning of the new year under current law. The scheduled fiscal events include the end of the extension of the Bush tax cuts, the adjustment of the alternative minimum tax (AMT), the end of the Social Security payroll tax cut, reductions in Medicare reimbursement payments, and spending cuts mandated by the “sequestration” process of the 2011 Budget Control Act (BCA).<sup>12</sup> CBO has estimated that the combined impact of these policy measures would be to reduce the federal budget deficit by 5.1% of GDP between 2012 and 2013.<sup>13</sup> As this fiscal shock reverberates through the wider economy, CBO estimates that in the first half of 2013 real GDP growth could contract at an annual rate of 1.3%. Such a contraction would likely be judged as a recession.<sup>14</sup>

- A 30% increase in the price of oil from October 2011 through April 2012 likely had an adverse affect on household budgets and contributed to the slow rate of increase in consumer spending over the same period.<sup>15</sup> In the short run, the U.S. demand for energy is relatively inelastic, meaning there is little curtailment of energy use in the face of the rising price. As households and businesses spend more for energy, which is largely imported, they tend to spend less on domestic output, slowing economic growth.<sup>16</sup> Since April 2012, the price of oil appears to have stabilized, and if it remains near the current level, the dampening effect on economic growth is likely to fade. Nevertheless, oil prices are volatile, influenced by global political events as well as economic forces. Another major spike in oil prices could tip the balance between economic expansion or contraction.
- China’s economy is expected to slow in 2012 as the Chinese government stepped up its efforts to dampen inflation by raising interest rates for the third time this year.<sup>17</sup> Slower growth in China would add to the “head-winds” generated by recession in Europe, translating into greater dampening of global demand for U.S. exports, which have been one of the few sources boosting economic activity during the economic recovery.

## 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

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<sup>12</sup> For more information, see CRS Report R42362, *The Federal Budget: Issues for FY2013 and Beyond*, by Mindy R. Levit and CRS Report R42485, *An Overview of Tax Provisions Expiring in 2012*, by Margot L. Crandall-Hollick.

<sup>13</sup> CBO, Updated Budget Projections: Fiscal Years 2012 to 2022, March 2012, at <http://www.cbo.gov/publication/43119>.

<sup>14</sup> CBO, *The Budget and Economic Outlook: Fiscal Years 2012 to 2022*, January 2012, [http://www.cbo.gov/sites/default/files/cbofiles/attachments/01-31-2012\\_Outlook.pdf](http://www.cbo.gov/sites/default/files/cbofiles/attachments/01-31-2012_Outlook.pdf).

<sup>15</sup> U.S. Energy Information Administration, *Petroleum: Weekly Spot Price*, May 2010, at <http://www.eia.gov/dnav/pet/hist/LeafHandler.ashx?n=PET&s=RCLC1&f=D>.

<sup>16</sup> Research indicates that a \$10 increase in the per barrel price of oil sustained for two years is likely to reduce real GDP growth relative to base-line by 0.2 percentage points in the first year and 0.5 percentage points in the second year. See U.S. Energy Information Administration, *Economic Effects of High Oil Prices*, 2006, at [http://www.eia.gov/oiaf/aeo/otheranalysis/aeo\\_2006analysispapers/efhop.html](http://www.eia.gov/oiaf/aeo/otheranalysis/aeo_2006analysispapers/efhop.html).

<sup>17</sup> *IMF Survey Magazine*, June 8, 2012, at <http://www.imf.org/external/pubs/ft/survey/so/2012/CAR060812A.htm>.

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 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%.<sup>18</sup>

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

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<sup>18</sup> For further discussion of the recession of 1937, see Christina D. Romer, "The Nation in Depression," *Journal of Economic Perspectives* 7 (spring 1993), pp. 19-39; Milton Friedman and Anna D. Schwartz, *A Monetary History of the United States, 1867-1960* (Princeton, NJ: Princeton University Press, 1963); Francois R. Velde, "The Recession of 1937—A Cautionary Tale," *Economic Perspectives*, Federal Reserve Bank of Chicago, fourth quarter 2009, pp. 16-36.



## **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. 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.<sup>19</sup>

## **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.<sup>20</sup> 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. Such a 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.<sup>21</sup> It examines the medium-term and long-run paths of output after 88 banking crises over the past four decades in a wide range of countries (including both advanced and developing economies). A key conclusion was that seven years after the crisis, output had declined relative to trend by nearly 10% for the average country. But there was considerable variation of outcomes across crisis episodes.

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<sup>19</sup> U.S. Department of Commerce, Bureau of Economic Analysis, *National Income Accounts*, Table 1.6.1, at <http://www.bea.gov/national/nipaweb/SelectTable.asp?Popular=Y>.

<sup>20</sup> Carmen Reinhart and Kenneth Rogoff, *This Time is Different: Eight Centuries of Financial Folly* (Princeton, NJ: Princeton University Press, 2009).

<sup>21</sup> 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.

## **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, and as it occurs economic growth is likely to remain moderate, even with the support of fiscal and monetary stimulus.<sup>22</sup>

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.<sup>23</sup> 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 drag on the pace of economic recovery.<sup>24</sup>

The household saving rate has generally risen since 2008, and remained near 5% of disposable income through late 2011, suggesting households have been making some progress at repairing their balance sheets. However, during the first quarter of 2012 the saving rate has fallen to about 3.5%.<sup>25</sup>

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 largely 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.<sup>26</sup>

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<sup>22</sup> See CRS Report R41332, *Economic Recovery: Sustaining U.S. Economic Growth in a Post-Crisis Economy*, by Craig K. Elwell.

<sup>23</sup> 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>.

<sup>24</sup> See Evan Tanner and Yassar Abdih, *Rebuilding U.S. Wealth*, Finance & Development, IMF, December 2009. See also CRS Report R41623, *U.S. Household Debt Reduction*, by Darryl E. Getter.

<sup>25</sup> Saving rate data available from FRED Economic Data, Federal Reserve Bank of St. Louis, at <http://research.stlouisfed.org/fred2/categories/106>.

<sup>26</sup> Federal Reserve Board, *April 2012 Senior Loan Officer Survey of Bank Lending Practices*, at (continued...)

## 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 of the deficit and surplus economies must occur.<sup>27</sup> 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.<sup>28</sup>

## 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 tax revenue 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?

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(...continued)

<http://www.federalreserve.gov/boarddocs/SnLoanSurvey/201205/default.htm>

<sup>27</sup> 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>.

<sup>28</sup> For further discussion, see CRS Report R41332, *Economic Recovery: Sustaining U.S. Economic Growth in a Post-Crisis Economy*, by Craig K. Elwell.

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.<sup>29</sup>

## Economic Projections

Given the large deterioration of the balance sheets of households and businesses, the possible reduction of the U.S. economy's level of potential output, and the weakened state of the global economy in the aftermath of the recent financial crisis, projections of the U.S. economy's near-term path carry a high degree of uncertainty.

As 2012 began, many economic forecasters, in light of the factors causing a deceleration of economic growth in 2011, trimmed their growth projections. The U.S. economic recovery, despite significant "headwinds" and recession risk, was expected to continue, albeit at a slower pace. That general expectation has not changed in more recent projections.

- The Fed's Open Market Committee projects real (inflation adjusted) GDP in 2012 to advance in a range between 2.1% to 3.0% and in 2013 in a range between 2.4% to 3.8% (the current growth projection for 2012 and 2013 is unchanged from the January 25, 2012, projection). The unemployment rate is projected to be in a range between 7.8% to 8.2% in 2012 and 7.0% to 8.1% in 2013 (the range for the 2012 unemployment rate is 0.4 percentage points narrower than in the January projection).<sup>30</sup>
- The IMF projects real GDP in the United States to increase 2.0% in 2012 (up 0.2 percentage points from its January 2012 projection) and 2.6% in 2013. Globally, the IMF expects an unbalanced expansion. For 2012, growth of the advanced economies is projected to average 1.5% and growth in the emerging developing economies to average 6.3%.<sup>31</sup>
- Global Insight, an economic forecasting company, is currently projecting real GDP will advance 2.1% in 2012 and 2.3% in 2013. The unemployment rate is projected to be 8.0% in 2012 and 7.4% in 2013.<sup>32</sup>

Forecasts are always subject to uncertainty. That uncertainty is likely to be especially high at this time because forecasting the path of the economy near turning points in the business cycle is always difficult and because of the singular characteristics of the current business cycle (i.e., sharp financial crisis, greatly weakened balance sheets of households and businesses, and unusual and strong policy responses).

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<sup>29</sup> 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.

<sup>30</sup> Board of Governors of the Federal Reserve System, *Minutes of March 2012 FOMC Meeting*, Projection Materials, at <http://www.federalreserve.gov/monetarypolicy/fomccalendars.htm>.

<sup>31</sup> International Monetary Fund, *World Economic Outlook*, Table 1.1, April 2012, at <http://www.imf.org/external/pubs/ft/weo/2012/01/pdf/c1.pdf>.

<sup>32</sup> Global Insight, *U.S. Economic Outlook*, March 2012.

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