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U.S. ECONOMY FACES AT LEAST A GROWTH RECESSION OVER THE NEXT TWO YEARS, NEW LEVY ECONOMICS INSTITUTE ANALYSIS SAYS

Similar to 2001, Policymakers Must Loosen Fiscal Stance to Bolster GDP

ANNANDALE-ON-HUDSON, N.Y.—As major banks and other financial institutions report huge losses, world financial markets are reeling and the consensus is growing among leading economists and policymakers that the subprime mortgage crisis and collapse of the housing boom will have serious implications for the U.S. economy. Analyzing the fluctuations of the U.S. economy over the past 10 years, a new study from The Levy Economics Institute of Bard College argues that, without an expansion of fiscal spending, the United States is facing a growth recession over the next two years and could enter into a true recession in 2008 if the current crisis evolves into a prolonged credit crunch in which private spending in excess of income is dramatically undermined.

In their Strategic Analysis, *The U.S. Economy: Is There a Way Out of the Woods?* the Levy Institute's Macro Modeling Team—Distinguished Scholar Wynne Godley, President Dimitri B. Papadimitriou and Research Scholars Greg Hannsgen and Gennaro Zezza—argues that the fate of the U.S. economy hinges on the extent to which private borrowing and spending are affected by the subprime debacle and, furthermore, on the degree to which those impacts on GDP are mitigated by export growth, which has been fueled by the falling dollar. Based on previous credit crunches, the scholars' projection is that private spending in excess of income will fall dramatically over the next two years—with monetary policy providing little relief—before recovering moderately. Their conclusion, assuming the government budget deficit declines as the Congressional Budget Office (CBO) projects and exports continue to grow rapidly (based on a further 5 percent devaluation in the dollar), is that the U.S. economy will enter a recession next year, with

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three successive quarters of negative real GDP growth. Spending in excess of income will return to negative territory and stabilize at about 1.5 percent of GDP, very close to its prebubble historical average. In this scenario, demand is bolstered by an improvement in net exports, such that the balance of payments approaches zero by 2010. Should the credit crunch be less severe, the authors offer a "soft landing" alternative, which implies a less severe growth recession in 2009, with real GDP growth slowing down to less than 1 percent. Under both assumptions, household debt relative to GDP peaks in 2008, and then decreases—more rapidly under the pessimistic scenario.

On the positive side, despite the potential for a relatively large fall in private expenditure over the next two to three years, Godley, Papadimtriou, Hannsgen, and Zezza foresee the potential unraveling of the structural imbalances between the private, public, and foreign sectors of the U.S. economy as private spending (less income), government spending, and the current account balance move toward zero over the next five years. On the negative side, there are serious concerns about economic recovery. "While the rate of growth in GDP may recover to something like its long-term average, all our simulations show that the *level* of GDP in the next two years or more remains well below that of productive capacity," the authors write, arguing that the failure of GDP to recover properly is directly related to the fiscal policy stance. To bolster growth, they conclude that there will have to be a relaxation of fiscal policy large enough to add perhaps 2 percent of GDP to the budget deficit. Moreover, "should the slowdown in the economy during the next two to three years come to seem intolerable we would support a relaxation having the same scale, and perhaps duration, as occurred around 2001," they write.

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Strategic Analysis: *The U.S. Economy: Is There a Way Out of the Woods?*

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