Levy Economics Institute of Bard College

Strategic Analysis

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WILL THE US DEBT CEILING DEAL DERAIL THE PANDEMIC RECOVERY?

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Introduction

The US economic recovery that followed the pandemic has been an impressive one. As Figure 1 shows, three years after the beginning of the recovery, real GDP is more than 5 percent above its pre-pandemic (end of 2019) peak. In Figure 2 we can also see that the employment-to-population ratio for the group ages 25–54 has now fully recovered and is also above its February 2020 pre-pandemic peak.

The recovery is even more impressive if we compare it with the previous cycles in the 1990s, the 2000s, and the years post-2009. As we have mentioned elsewhere (e.g., Nikiforos and Zezza 2017, 2018) those recoveries were by far the slowest recoveries of the postwar period in the United States, with the recovery that followed the crisis of 2007–9 being the slowest of them all. The contrast in Figures 1 and 2 is remarkable. Figure 1 shows that the aforementioned 5 percent gain of real GDP that has been recorded between the last quarter of 2019 and the first quarter of 2023 took more than six years to achieve in the previous cycles. In the case of the employment–population ratio (E–P), the full recovery that is now recorded took more than 12 years: the December 2007 E–P ratio (the pre-crisis peak) for people ages 25–54 was not reached until January 2019!

The contrast between the current and the previous recoveries is obviously related to the nature of the respective crises. The pandemic shock was different from the systemic financial crisis of 2007–9, which was also followed by a significant debt overhang for the household sector. At the same time, the dramatic differences in performance are also a testament to the importance of macroeconomic policy. One thing that distinguished the previous cycle was the prolonged austerity that started with the Budget Control Act of 2011. By contrast, the pandemic was followed by aggressive fiscal stimulus. This stark difference in the fiscal stance of the federal government played a crucial role for the different trajectories of output and employment. The rapid employment gains that the US economy has been recording over the last years show that the low employment rates

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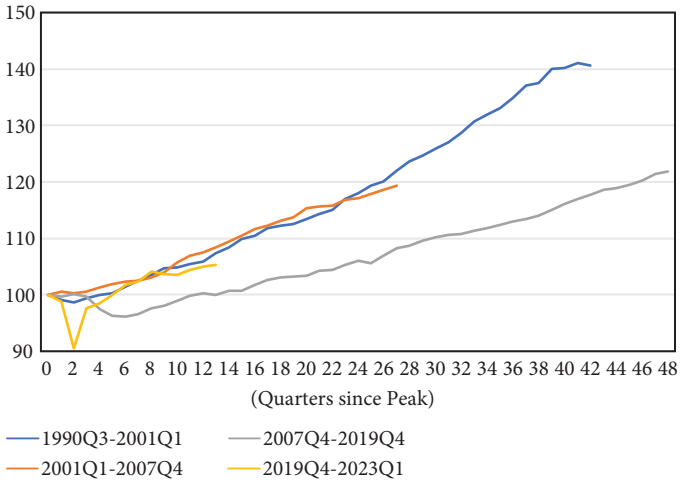
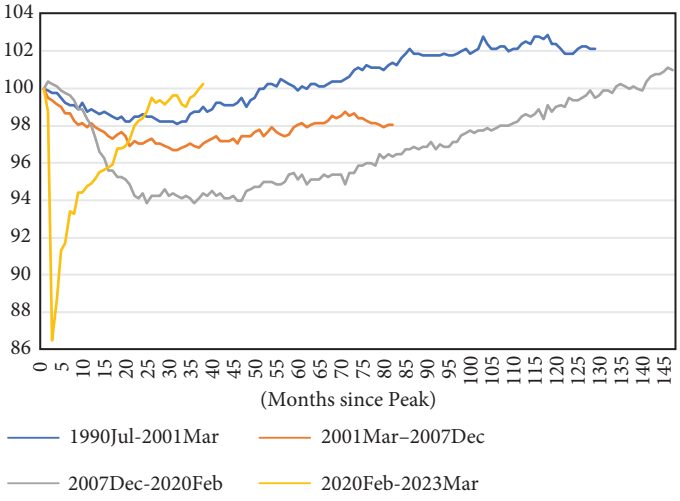
Figure 1 Recoveries of Real GDP in the Previous Four Cycles (peak=100)



Source: BEA; authors' calculations

Figure 2 Recoveries of the Employment-to-Population Ratio in the Previous Four Cycles (peak=100)



Source: BLS; authors' calculations

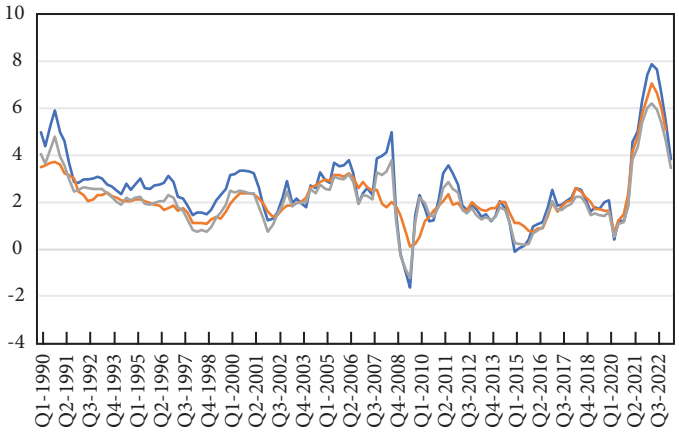
of the previous decade were an unnecessary burden the US economy—and society—was made to bear.

It is also worth mentioning that the recent debt ceiling deal should be examined in this context. The magnitude of the cuts of the recent deal might appear small but there is the danger of repeating the mistakes of the past and adopting policies that are, as Figures 1 and 2 show, demonstrably harmful for output and employment.

At the same time, the recovery from the pandemic was accompanied by a sharp increase in the rate of inflation. Figure 3 shows the inflation rate peaked in the second quarter of 2022, and has since eased to below 5 percent. The latest numbers released by the Bureau of Labor Statistics estimate that in May 2023 the Consumer Price Index was 4.1 percent above its level from one year prior. As we mentioned in previous reports (Papadimitriou et al. 2021, 2022), we believe that the rise in the inflation rate was mostly due to the disturbances caused by the pandemic, as well as the effect of the war in Ukraine on commodity and oil prices. The decrease in inflation over the last three quarters seems to be in line with this explanation.

The conventional diagnosis of inflation is different, in that it emphasizes excess demand as its main source. This has been the guiding theory for Federal Reserve policy, which started increasing its effective rate in March 2022. As we can see in Figure 4, the aggressiveness of the increase is unparalleled in the last three decades. One has to go back to the 1970s to find something similar.

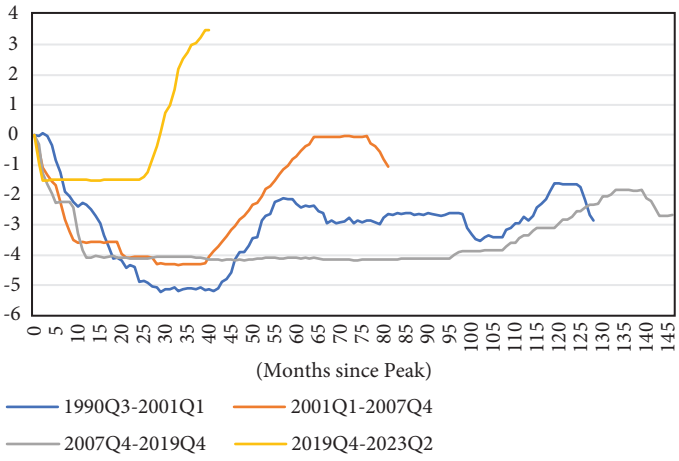
Figure 3 Different Measures of Inflation (percent)



Source: BLS; BEA; authors' calculations

An interesting question is to what extent the recent drop in inflation has been due to the increase in the effective rate by the Fed. The increase in interest rates is supposed to weaken the labor market, increase unemployment, and decrease first wage- and then price-inflation. As we discussed above, the labor market has not weakened over the last year. On the contrary, the employment-to-population ratio and the employment rate are at historically high levels. For that reason, the explanation seems more convincing that the easing of inflation is mostly due to

Figure 4 Fed Interest Rate during Recoveries



Source: FRED; authors' calculations

the normalization of conditions in global value chains and the stabilization of commodity and oil prices.

At the same time, the increase in interest rates poses risks for the financial stability of the US economy. There are several potential transmission channels. An obvious one is that the increase in the interest rate raises the cost of servicing debt for some businesses and households. In an environment of high indebtedness, this can be destabilizing. Second, the increase in interest rates can lead to a decrease in asset prices; the prices of Treasury bonds are the most obvious case, but the prices of securities and bonds more generally can be affected as well. A fall in asset prices can affect financial stability by decreasing the value of the assets of economic units such as households, firms, or banks. Finally, to the extent that the increase in interest rates does cause a slowdown in economic activity, it can lead to a decrease in revenues for economic units, which, in the context of a highly indebted economy, can also be destabilizing.

The collapses of Silicon Valley Bank (SVB) and Signature Bank in March, as well as First Republic Bank more recently, were related to this. As is well established by now, the problems with these banks originated with the decline in the prices of Treasury bonds on their balance sheets. Besides the risks of contagion due to the uncertainty caused by the collapse of these banks, similar problems could arise in other banks as well. This seems to have been the reason behind the decision to declare SVB and Signature systemic risks to the financial system—after years of lobbying on the part of regional banks on the basis that they did not pose a systemic risk; a position that was finally accepted by lawmakers in 2018. Besides that, the rescue of the two banks was accompanied by a reversal of the tentative quantitative tightening that accompanied the increase in interest rates in the months prior. Essentially, the decision of the Federal Reserve to accept collateral valued at par is a new round of quantitative easing.

As a result, the US economy finds itself in a strange situation with two contradictory monetary policy directions: on the one hand, interest rates remain elevated, while on the other hand, monetary authorities have agreed to buy securities from banks at the price levels that held before the increase in those interest rates. In other words, the Federal Reserve is hedging banks from a big part of the effects that the interest rate increases would have on their balance sheets.

In what follows we provide further discussion of the state and prospects of the US economy. The following three sections highlight three issues we consider important. First, we discuss the position of the trade and current account balances of the US economy. The position of the foreign sector is important because a high current account deficit makes growth of an economy dependent on the private sector spending more than it earns (especially when government borrowing is limited by deals such as the recent debt limit deal). Second, we have a look at the balance sheets of households and firms, as well as asset prices. Household indebtedness is at relatively low levels. This is not the case with firms, whose indebtedness is at historically high levels. Firms' indebtedness, together with asset prices that continue to be overvalued, poses a significant risk for the US economy. Finally, we provide a discussion of the recent debt limit deal—its details and how it can pose a risk for the US economy in the near term.

After this discussion, we simulate three scenarios. A baseline scenario follows the fiscal and macroeconomic projections of the Congressional Budget Office (CBO), adjusted for the debt ceiling deal. The baseline scenario lays out the macroeconomic requirements for these fiscal and macroeconomic projections to materialize in the context of our model. One finding that comes out of this exercise is that, given the fiscal adjustment of the federal government and the increase in the current account deficit, the private sector will have to start running deficits and increase its indebtedness in order for the CBO's GDP projection to materialize, a situation that cannot be sustainable for very long.

Scenario 1 simulates a situation where the increase in interest rates by the Fed, the high indebtedness of firms, and

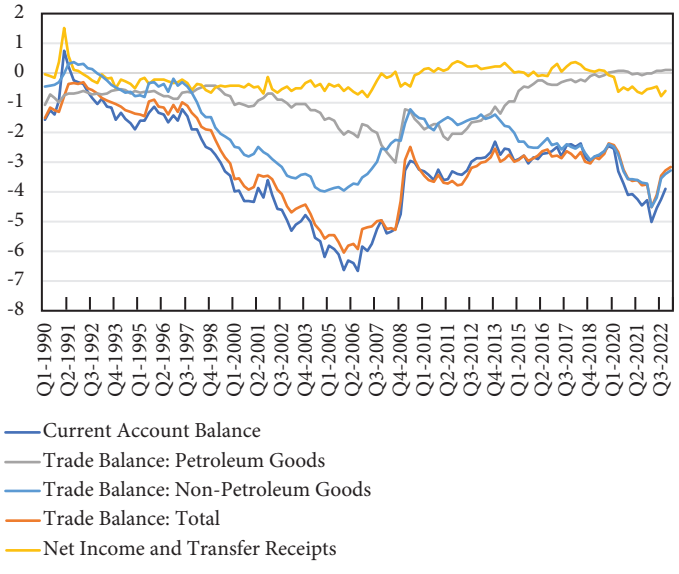
overvalued financial assets lead to a crisis. In particular, we simulate the consequences of a decrease in both stock prices and spending by households and firms. The result is a significant drop in the growth rate of the US economy, which becomes negative in 2024 and 2025.

Finally, in Scenario 2 we argue that, instead of the debt ceiling deal, the US government should pursue expansionary fiscal policy oriented toward two related goals: (1) modernizing aging infrastructure, especially surface transportation such as bridges, roads, and public transit, and (2) investing in a green economy. Besides the long-term benefits of these policies, we show that they will also have positive short-run macroeconomic effects in the form of higher output and employment and lower private sector indebtedness.

External Balance

A basic macroeconomic accounting identity that has been at the core of our analysis is that the current account balance of an economy is equal to the financial balance of the private sector plus the financial balance of the government sector. For example, in a hypothetical case of a balanced government budget, the current account surplus/deficit is equal to the private sector surplus/deficit. Or, if the government balance does not change, any increase in the current account surplus/deficit is reflected by an equal increase in the private sector surplus/deficit.

Figure 5 Trade Balance, 1990Q1–2022Q4 (percent of GDP)



Source: BEA; authors' calculations

Given that the financial positions of each unit or sector lead to changes in their balance sheets, this identity emphasizes the interlinkages among the financial positions and the balance sheets of the different sectors.

As Figure 5 shows, the US economy saw a large increase in its current account and trade deficit starting in the early 1990s, up until the eve of the Great Recession when it approached 7 percent of GDP. To a certain extent, the increase in the private sector deficit and debt over this period reflects this development, given that over the same period (especially in the 1990s) the government was following contractionary fiscal policies.

The current account and trade deficits decreased during the Great Recession and started to increase as the economy began to recover after 2009. An important break in these series takes place around 2011, when the trade deficit in petroleum goods started decreasing because of the shale gas extraction methods that were implemented. Figure 5 shows that the decrease in the trade deficit of petroleum products, which converged toward zero by 2019 (the balance is now slightly positive), contributed to the overall stability of the trade and current account balance, despite the increase in the trade deficit of non-petroleum goods.

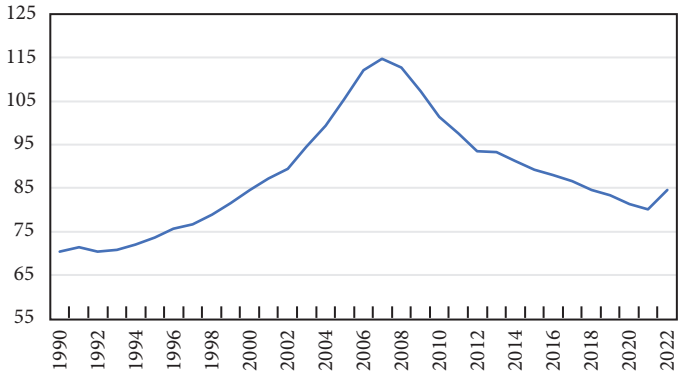
The post-pandemic recovery saw a significant increase in the trade and current account deficits. The latter reached 5 percent in 2021, its highest level since before the Great Recession. Although there has been a decrease in the current account deficit over the last year, it is still around 4 percent, which is elevated by historical standards.

It remains to be seen how the current account deficit will move over the coming period and to what extent the increase in the post-pandemic period reflected the special circumstances that prevailed at the time, such as the increase in consumption of durable goods and the very fast recovery of the US economy vis-à-vis its trading partners. However, if the current account deficit persists at these levels, and given the fiscal limits imposed by the debt ceiling deal, the growth of the US economy will have to rely again on the private sector running deficits and accumulating debt.

Financial Conditions

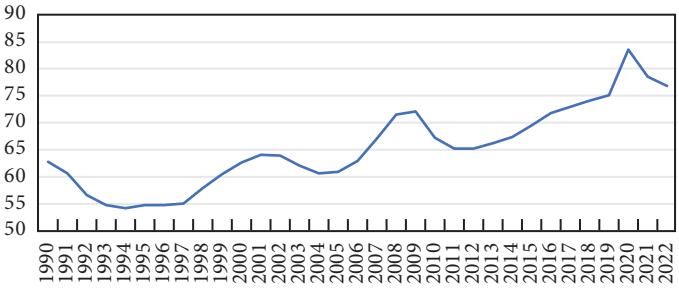
Another important aspect of the US macroeconomy is related to the conditions of private-sector balance sheets (households and firms) and asset prices (mainly financial assets and real estate prices).

Figure 6 Household Debt, 1990–2022 (percent of GDP)



Source: BEA; authors' calculations

Figure 7 Nonfinancial Business Debt, 1990–2022 (percent of GDP)



Source: BEA; authors' calculations

Starting with the household sector, its debt-to-income ratio has decreased significantly over the last 15 years, after it peaked at the beginning of the financial crisis in 2008 (Figure 6). Total household debt is now around 85 percent of disposable income, down from 115 percent in 2008. It is remarkable that the post-pandemic period saw the first increase in indebtedness, mostly due to an increase in mortgages. Given the high rate of inflation of the last years, this increase—small as it may be—implies a significant accumulation of debt.

When it comes to the business sector, the situation is more worrisome. Figure 7 shows that the liabilities of noncorporate business have increased to historically high levels, despite high inflation. The high indebtedness of firms is a source of vulnerability for the US economy, especially given the now-high interest rates and the prospect of a slowdown in the economy.

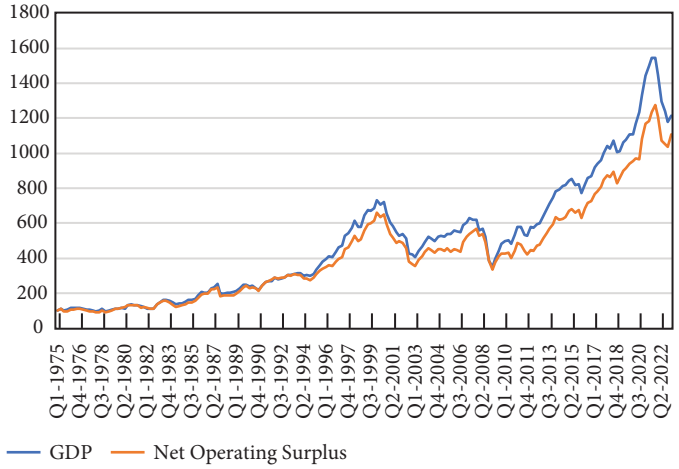
Stock market valuation is another source of vulnerability. Figure 8a shows that despite the drop in the stock market prices of the last year-and-a-half, as of June 8 the Shiller cyclically adjusted price–earnings ratio stands at 30.5, slightly above its level in the early fall of 1929, and lagging only its level of the late 1990s. Looking at another measure of the stock market valuation—the Wilshire market-capitalization-to-nominal-GDP ratio (Figure 8b)—we can see that it is above its late-1990s levels. If one then accepts that the stock market was overvalued in 1929 and the late 1990s, it is not clear why this is not the case now, especially in an environment with high interest rates and without the very accommodating monetary policy of the last 15 years.

Finally, Figure 9 presents two measures of real estate prices. Figure 9a shows the ratio of the "Median Sales Price of Houses

Figure 8a Price–Earnings Ratio P/E10 or CAPE (1950M1–2023M4)

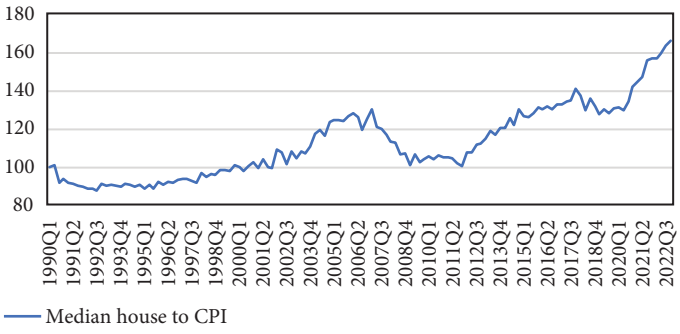
Source: BEA; Wilshire Associates; authors' calculations

Figure 8b Ratio of Market Capitalization to GDP and Net Operating Surplus (1975Q1–2023Q1)



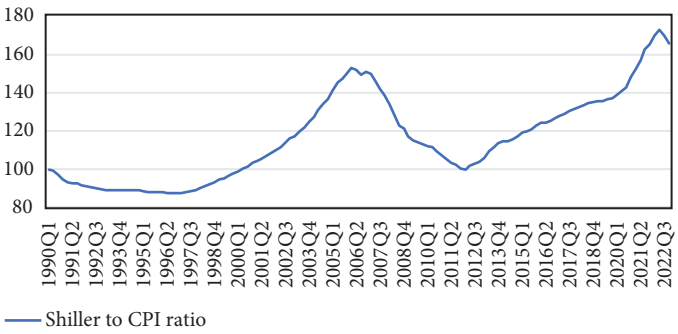
Source: BEA; Wilshire Associates; authors' calculations

Figure 9a Median Sales Price of Houses Sold/CPI (1990Q1-2022Q4)



Source: FRED; authors' calculations

Figure 9b S&P/Case-Shiller US National Home Price Index/CPI(1990Q1–2022Q4)



Source: http://www.econ.yale.edu/~shiller/data.htm; authors' calculations

Sold for the United States" over the Consumer Price Index, while Figure 9b shows the ratio of the "S&P/Case-Shiller U.S. National Home Price Index" over the Consumer Price Index. Both measures show that over the last three years there was a rapid increase in real estate prices. Adjusted for the Consumer Price Index (which also rapidly increased recently), real estate prices are now higher than before the 2007–9 recession and the real estate boom of the time. Again, if one accepts that the real estate market was overvalued then, it is not clear how it is not overvalued now.

Overall, this discussion reveals three sources of vulnerability for the US economy: high indebtedness of the business sector, overvalued stock, and overvalued real estate prices. We will discuss their implications below, after our baseline scenario. However, before turning to the scenarios, a few words are in order regarding the recent debt ceiling deal.

Debt Ceiling Deal

On June 3rd, after a long period of negotiations, President Biden signed into law the so-called "Fiscal Responsibility Act of 2023" (FRA) marking the end of the stand-off over the US debt ceiling. The approved bill suspends the $31.4 trillion ceiling until January 2025, which will then be raised to accommodate any debt issuance that will take place during this suspension.

The FRA also sets a cap on discretionary government expenditure, whose annual nominal growth is limited to 1 percent—a condition that essentially implies a reduction of these outlays in real terms (as the rate of inflation will be above 1 percent). Among other things, the agreement will decrease funding for the Internal Revenue Service (IRS) as well as the Supplemental Nutrition Assistance Program (SNAP) and the Temporary Assistance for Needy Families (TANF) program. Other relevant measures in the bill include the end of the federal suspension on student loan payments, the rescission of some unspent COVID-related benefits, and the relaxation of the current law on the financing of energy-related projects.

A recent report by the CBO estimates that these measures will bring about a deficit reduction of $1.5 trillion over the 2023–33 decade, with a decrease in federal spending by $70 billion and $112 billion in 2024 and 2025, respectively (CBO 2023c). However, these estimates are still preliminary. Some recent estimates published in *The New York Times* suggest that actual cuts may be closer to $1 trillion over the decade, with federal spending shrinking by $55 billion and $81 billion in 2024 and 2025, respectively (Tankersley and Rappeport 2023).

At any rate, in nominal terms, this target would be far more ambitious than the one set by the Budget Control Act of 2011, whose predicted cuts were on the order of $840 billion for the 2011–21 period (CBO 2011). There were further notable differences—for instance the 2011 bill effectively raised the debt ceiling alongside establishing a super committee to enforce these cuts. Nevertheless, the current legislation marks a decisive turn in the fiscal stance of the federal government, which if enacted in its entirety will trigger a decade of fiscal austerity by containing real government expenditure growth.

As we have explained in several previous reports (e.g., Papadimitriou et al. 2016, Nikiforos and Zezza 2017, 2018), the 2011 Budget Control Act had a very negative effect on the US economy, as it paved the way for the fiscal austerity that

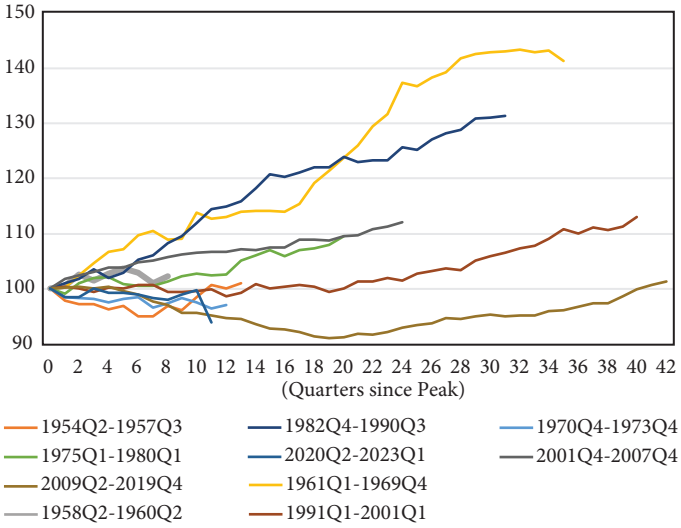
Table 1 CBO Projections (percent of GDP)

	Government Deficit	Outlays	Revenues	GDP Growth (percent)	Outlays (before Debt Ceiling)	Cuts as % GDP
2022	4.666	24.238	19.572	1.911		
2023	4.896	23.235	18.339	0.267	23.250	0.015
2024	5.681	23.426	17.745	1.456	23.680	0.254
2025	5.474	22.833	17.359	2.644	23.220	0.387
2026	4.914	22.654	17.740	2.334	23.090	0.436

Source: CBO; authors' calculations

prevailed in the following years. In Figure 10, which presents the trajectory of real government expenditure in all the postwar recoveries (from trough to peak), the 2009–19 recovery stands out. As we can see, real government expenditure did not return to its 2009Q2 level until more than 10 years later, in 2019Q3. This fiscal austerity was one of the main reasons for the very slow recovery of that period (Figures 1 and 2). The recent FRA risks putting the federal budget on a similar trajectory, which, as before, would have very severe macroeconomic effects.

Figure 10 Government Expenditure in Recoveries (trough=100)



Source: BEA; authors' calculations

Baseline Scenario

As is common in our reports, we build our baseline scenario around the 10-year *Budget and Economic Outlook* that is published by the CBO every year. The aim of our simulations is to examine the necessary conditions for the CBO projections to materialize within our model. For this purpose, we make assumptions that are as neutral as possible. For instance, we assume that the growth rate of US trading partners in real terms follows the projections of the International Monetary Fund's *World Economic Outlook*. We also assume that interest rate hikes will follow the FOMC median projections.

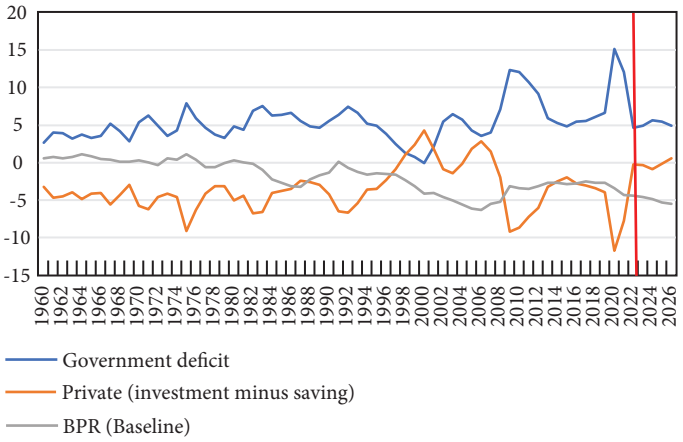
Table 1 provides a summary of the CBO projections from the recent *Budget and Economic Outlook 2023-2033* (CBO 2023a) and an update to it that was published in May (CBO 2023b). As we can see, the CBO projects a low growth rate for this year, which will subsequently pick up at 1.4 percent in 2024 and then to 2.6 percent and 2.2 percent in 2025 and 2026, respectively. The government deficit will remain the same this year, but then it will slightly increase by 0.6 percent next year. Based on our projections, it is then expected to remain at 5.4 percent over 2025 and shrink below 5 percent only in 2026.

The table also contains the CBO estimates for the changes in federal government outlays due to the FRA. The latter implies expenditure cuts of $4 billion, $70 billion, $112 billion, and $132 billion in the years 2023–26, respectively. In terms of percentage of GDP, these cuts increase from 0.01 percent in 2023 to 0.25 percent in 2024 and around 0.4 percent in 2025 and 2026.

To produce our baseline, we first simulate a scenario based on the *Budget and Economic Outlook* and we then impose the outlay cuts in the FRA. In that sense, the assumed fiscal outlays and the growth rates of our baseline are below the growth rates of the CBO *Outlook*, due to the FRA's fiscal cuts.

The results of our simulations are presented in Table 2. The trajectory of the government deficit follows the projections of the CBO. At the same time, given the growth rate of the US economy and its trading partners, the current account balance will slightly deteriorate and will converge to 5.5 percent of GDP by 2026 (around 1 percent below its current level). These two

Figure 11 US Sectoral Balances: Baseline, Historical, and Projected, 1960–2026 (percent of GDP)



Source: BEA; authors' calculations

findings then imply that the private sector balance, which is now around zero, will become slightly negative by the end of the projection period in 2026.

To put this in historical context, this is an unusual position for the US private sector. Figure 11 presents the financial balances of the three sectors going back to the 1960s. We can see that most of the time, the private sector has been running surpluses. The only period when the private sector was a net borrower was in the late 1990s and the first years of the 2000s. It was the deficits of this period that led to the accumulation of debt that eventually led to the crisis of 2007–9.

From the standpoint of the debt-to-income ratios implied in our baseline simulations in Table 2, we see that this ratio for the household sector does increase significantly in our projection period (Figure 12a). However, we find that a prerequisite for the CBO projections to materialize is that there will be a significant increase in the debt-to-income ratio of the business sector at a faster pace than its recent trend (Figure 12b). This increase in the indebtedness of the business sector is worrisome, and it is not clear for how much longer it can continue increasing.

Scenario 1

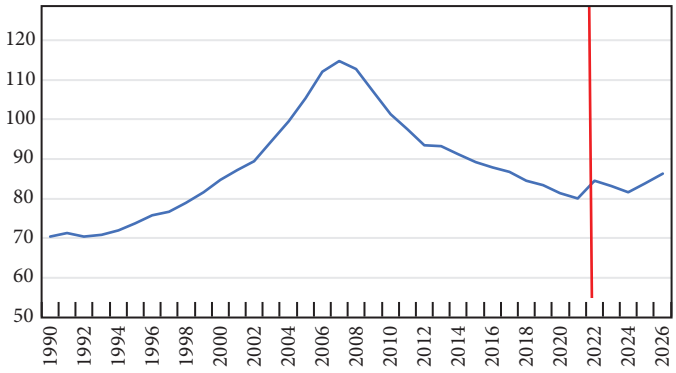
The discussion of the previous sections suggests that the US economy is facing a situation with: (1) historically high business indebtedness; (2) overvalued financial asset prices; (3) high interest rates; (4) credit contraction; and (5) economic

Table 2 Baseline and Alternative Scenarios (percent)

	GDP Growth (Baseline)	GDP Growth (Scenario 1)	GDP Growth (Scenario 2)
2023	0.3	-0.1	0.3
2024	1.5	-1.9	2.7
2025	2.6	-0.9	3.0
2026	2.3	1.2	2.5

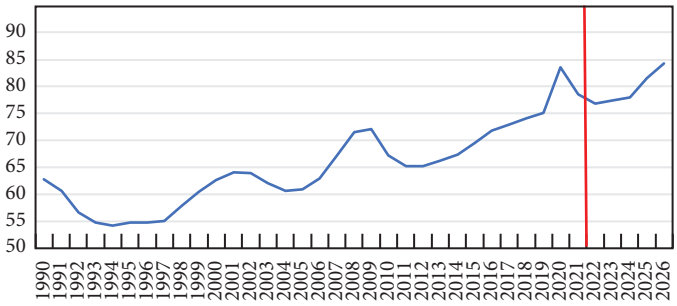
Source: BEA; authors' calculations

Figure 12a Households Debt: Actual and Projected, 1990Q1–2026Q4 (percent of disposable income)



Source: BEA; authors' calculations

Figure 12b Nonfinancial Business Debt: Actual and Projected, 1990Q1–2026Q4 (percent of GDP)



Source: BEA; authors' calculations

slowdown. This is an unfavorable combination of factors that can lead to a decrease in expenditure of the private sector reinforced by a decrease in asset prices, which can in turn lead to a crisis.

In order to evaluate this situation, we simulate a scenario that assumes the stock market index will fall in the last two quarters of 2023, and the S&P index will converge to 3,000 basis points by the first quarter of 2024. In addition, we assume a decrease in spending by households and firms over the last quarter of 2023 and within the 2024–25 period.

Figure 13 shows that, in such a scenario, the growth rate slides to -1.9 percent in 2024 and remains negative at -0.8 percent in 2025. This is a very significant fall compared to the baseline growth rate—also presented in the graph.

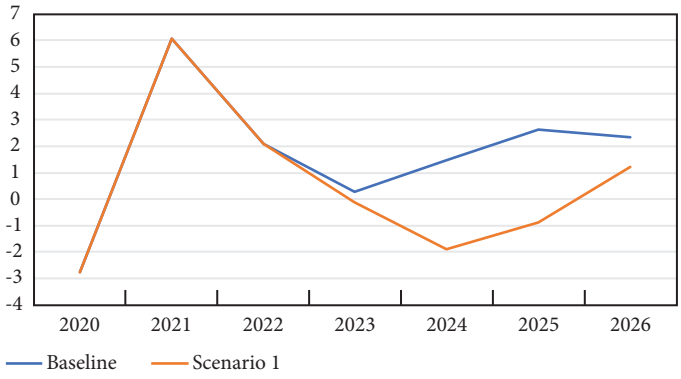
Figure 14 shows that the decrease in private expenditure leads to a sharp increase in the private sector surplus. At the same time, the decrease in the growth rate leads to a decrease in the current account deficit to -3.5 percent of GDP in 2024 and then to around -2.5 percent in 2025 and 2026. On the other hand, due to automatic stabilizers, the government deficit will rise by two percentage points with respect to 2023, averaging 7 percent of GDP over the 2024–26 period.

Three points are worth mentioning here. First, our results show that, given the structural characteristics of the US economy, a crisis like this is the only way for the current account balance to return to its pre-pandemic levels, i.e., a deficit below 3 percent. Second, the difference between the government deficit in this scenario, with respect to our baseline, will average 2 percent for the 2024–26 period, thereby canceling out the (marginal) effect of the FRA. As pointed out elsewhere (Nikiforos et al. 2015), from a sectoral balance perspective, public sector borrowing requirements are, to a certain extent, endogenous with respect to the evolution of the private and external sector balances. Thus, an approach to controlling the government budget based solely on nominal aggregates, such as the one laid out in the current debt legislation, may turn out to be self-defeating. Finally, and related to that, the recent debt ceiling deal undermines the capacity of the US government to react to such a crisis—during which an increase in discretionary spending would be necessary.

Scenario 2

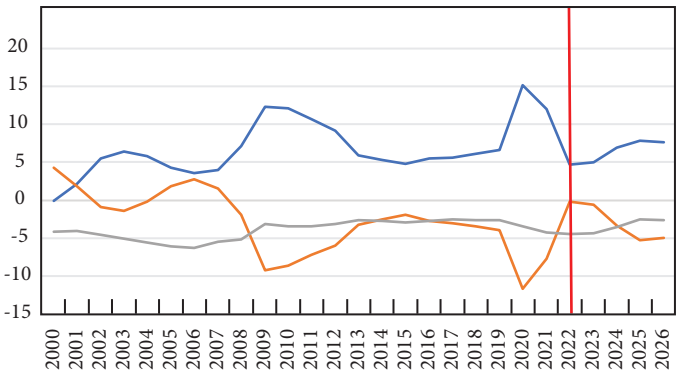
The austerity envisaged in the debt ceiling agreement puts the US economy on the wrong path. There are several reasons that justify a fiscal expansion that would promote structural transformation of the US economy. Firstly, it is well known that the infrastructure of the US economy is aged and needs restoration and upgrade. According to American Civil Society of Engineers (ASCE 2023), in order to close the investment gap and upgrade the US infrastructure system, $2.59 trillion over 10 years will be needed, mostly in surface transportation. Secondly, there has been a revival of interest around an industrial policy plan that could reinforce the manufacturing sector. The recent Inflation Reduction Act and the CHIPS Act move in that direction.

Figure 13 US GDP Growth: Baseline vs Scenario 1, 2020–26 (percent)



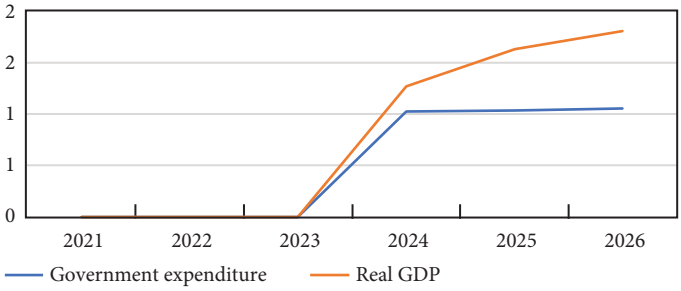
Source: BEA; authors' calculations

Figure 14 US Sectoral Balances: Scenario 1, Actual and Projected, 2000–26 (percent of GDP)



Source: BEA; authors' calculations

Figure 15 Government Expenditure and Real GDP: Scenario 2, Actual and Projected, 2021–26 (percent of real GDP)



Source: BEA; authors' calculations

Finally, but perhaps most importantly, there is the need to reduce CO_2 emissions in accordance with the Paris Agreement of 2015 and transition toward a green economy, not just at the national level but worldwide. Again, the Inflation Reduction Act has recently paved the way for the implementation of green subsidies to production, but more remains to be done if the US is to stick to its commitment to reduce greenhouse gas emissions by 50–52 percent below 2005 levels in 2030, announced at COP27 early this year (US Department of State 2023).

An important part of these structural change policies involves an increase in government outlays. To assess the effects on the US economy, we simulate a 1 percent of GDP increase in government expenditure. We find that this stimulus could have an important multiplier effect. Figure 15 shows that there will be an increase in real GDP by 1.8 percent by the end of our projection period. It is worth mentioning that this result simulates only the demand effect of this policy. Obviously, structural change policies can also lead to other important medium-run effects, such as increases in labor productivity, which could then negatively impact export prices and thereby lead to a decrease in the trade and current account deficits.

Conclusion

This report discusses the current state and the structural features of the US economy and how these might affect its future trajectory. We explained that the recent recovery after the pandemic has been remarkable—especially when compared to the previous cycles. This is evidence of the efficacy of fiscal policy to promote growth and employment. At the same time, the inflation rate has been finally decelerating as the problems in global value chains that emerged after the pandemic are resolving and the price of commodities and oil, which spiked after the pandemic and the war in Ukraine, are stabilizing.

A structural weakness of the US economy is the high level of its current account deficit. As shown in our baseline scenario, if this deficit persists, the private sector will need to become a net borrower in order to achieve the CBO's (modest) growth predictions, given the projected fiscal stance of the government.

Another problem is related to the high level of indebtedness of firms and overvalued stock and real estate prices. Taken together with high interest rates and a potential slowdown of the economy, it is likely that these structural problems can lead to a significant slowdown of the US economy. In Scenario 1, we show that even a relatively moderate decrease in private-sector spending—as a result of these factors—might lead to negative growth rates of real output.

Moreover, despite the success of fiscal policy in promoting output and employment growth, the recent FRA risks putting the US economy on the austerity path of the previous decade, with its very serious consequences in terms of employment and welfare.

Instead, the US economy is in need of a structural transformation toward modernizing its infrastructure, promoting industrial policy, and investing in the greening of its economy and environmental sustainability. A necessary condition for achieving these goals is an increase in government expenditure. In Scenario 2, we showed that such an increase could also have positive demand effects on output and employment.

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