The Heightened Risks of a US Downturn

Jan 26, 2018 Martin Feldstein

The US economy has experienced nine recessions during the last 50 years. What makes the current situation unusual and more worrying than in the past is the low level of short-term interest rates and the high (and rising) level of federal debt, which will limit policymakers' ability to provide the stimulus needed to counter a recession.

CAMBRIDGE – The United States' economy is roaring ahead, and above-trend GDP growth looks set to continue in 2018 and 2019. Although the expansion is in its ninth year, there is no sign of an imminent slump.

The greatest risk to the economic expansion is the fragility of the financial sector. A decade of excessively low interest rates has pushed asset prices to extreme heights. The real yield on ten-year Treasury bonds is approximately zero. The price-earnings ratio of the S&P 500 share index is about 70% above its historic average. If these and other asset prices reverted to their historic benchmarks, investors would suffer losses in excess of $10 trillion, leading to declines in consumer spending and business investment.

Economic activity could also slow as a result of international conflict in Korea, heightened trade disputes, or domestic political events in the US.

Downturns are a normal feature of the US economy, which has experienced nine recessions during the last 50 years. What makes the current situation unusual and more worrying than in the past is the low level of short-term interest rates, which limits the ability of the US Federal Reserve to bring monetary policy to bear in countering the next recession.

The Fed traditionally responds to a downturn by sharply reducing the short-term federal funds rate. During the most recent downturn, the Fed lowered the benchmark rate from over 5% in July 2007 to just 0.16% in December 2008, a total reduction of more than five percentage points. At only 1.4% now, the Fed has little scope for a significant rate reduction. At its meeting in December, the Federal Open Market Committee's median forecast for the federal funds rate at the end of 2019 was still a very low 2.9%.

To stimulate demand in the last downturn, the Fed also practiced what it called "unconventional monetary policy," promising to keep short rates low for a long time and buying long-term bonds for its own portfolio. This strategy was aimed at keeping long-term interest rates low enough to boost demand for equities and real estate, and thereby increase wealth and spending. It is not clear that this strategy would provide the hoped-for stimulus as long as real interest rates remain low.

The responsibility for stimulating the economy in the next downturn will therefore fall to fiscal policy – changes in taxes and government spending.

A new temporary tax cut would not work. Experience shows that a temporary cut in personal income taxes would provide very little stimulus, because most taxpayers would use the resulting extra net income to pay down debt or increase their savings, rather than spending more.

But the 2017 tax law provides an opportunity for a permanent tax cut by preserving the cuts that are now scheduled to expire in 2025. The Republicans who designed and voted for the 2017 law expected to extend those cuts beyond 2025 in subsequent legislation. An economic downturn in the next few years would be a good time to make the cuts permanent.

The other way to reverse an economic downturn would be to increase government spending. There is now widespread bipartisan support for increased spending on infrastructure of all kinds, just as there was in the 2007 downturn. Although the Obama administration spoke about "shovel ready" projects when promoting its putative stimulus legislation, the reality was that very little of the money was spent on infrastructure, owing to the long delays involved in implementing such projects.

The US Congress and the White House should begin now to develop an inventory of infrastructure projects that could be implemented when the economy slows. If there is no downturn during the next several years, it would still be desirable to start some of those projects.

Another form of spending to stimulate the economy would be increased outlays for defense. Because of the "sequester" rule in the Budget Control Act of 2011, the level of defense outlays is required to decline from 4.3% of GDP in 2012 to just 2.8% of GDP in 2023, the lowest GDP share since World War II. Defense experts agree that this level is far too low for America's defense needs. An increase in outlays to 4% or more of GDP would be a significant source of increased overall demand and a crucial contribution to national security.

The high level of the national debt – about 77% of GDP now and heading to 97% at the end of the next ten years – would create strong resistance to either tax cuts or increased spending. But a significant economic downturn with limited scope for Fed action would leave Congress with little choice.

The need for a future fiscal stimulus makes it clear that the US needs to start now to develop a strategy for slowing the growth of the national debt. That is the only way to create enough room for the expansionary fiscal policy that the economy eventually will need.

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