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Why Has America's Economic Recovery Stalled?

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CAMBRIDGE – The United States' import bill now exceeds $2.4 trillion a year, more than twice that of China and greater than that of the 27 European Union countries combined. Since the volume of US imports varies with the overall strength of the American economy, so does the volume of other countries' exports.

So it was good news for everyone when the US economy began expanding in the summer of 2009, 19 months after falling into the recession that officially started in December 2007. Unfortunately, the recovery has turned out to be very anemic. Now, 15 months into the expansion, the level of real GDP is still lower than it was when the recession started.

Even more worrying, the rate of GDP growth has been declining almost from the start of the recovery. Real GDP rose by 5% in the fourth quarter of 2009, reflecting the end of the decline in inventories. GDP growth then fell to 3.7% in the first quarter of 2010 and to only 1.7% in the second quarter. The third quarter is shaping up to be much like the second.

This recovery has been much weaker than previous ones because of fundamental differences in the cause of the downturn and in the policies chosen to achieve recovery. Previous downturns were caused by the central bank's efforts to reverse or prevent inflation by hiking short-term interest rates. When the central bank succeeded, it lowered those rates and the economy bounced back.

But this time the downturn was not caused by higher interest rates, and reducing those rates did not produce a strong rebound. This recession was caused by a mispricing of risk, leading to excessive leverage and high prices for a wide range of assets. When those price bubbles burst, households lost substantial wealth and financial markets became dysfunctional.

Because the downturn was not caused by high interest rates, lowering them could not lift the economy out of recession. The Obama administration therefore turned to fiscal policy – tax cuts and a range of spending programs. Unfortunately, the fiscal stimulus was not well enough designed to get the economy onto a strong, self-sustaining growth path. And, now that those stimulus programs are coming to an end, there is a danger that the economy will slide back into slow growth or even recession.

One key to the US economy's future is household demand. Although consumer spending has increased during the past four quarters, helped by substantial government transfer payments, the pace of spending growth by households was less than the overall pace of GDP growth, because households were increasing their rate of saving. Indeed, household saving rose from 2% of after-tax incomes in 2007 to about 6% in recent months.

If the saving rate continues to rise at the same pace in the future as it has over the past three years, the overall GDP growth rate could turn negative after a few quarters. Of course, there is no way to be certain of what will happen to saving. But it is worth remembering that the saving rate averaged 9% in the quarter-century from 1960 to 1985. If the saving rate now rises quickly to that level, it will be hard to keep overall GDP growing. A significantly higher saving rate would help the US economy in the long run, but it would be a barrier to robust growth in the next few years.

A major obstacle to higher consumer spending is the current condition of the housing market. The rapid rise in house prices until 2006 caused households to increase their spending, financed in part by converting home equity into cash. But house prices have since fallen some 40% on average, leaving one-third of homeowners with mortgages owing more than their house is worth.

The resulting fall in wealth has reduced consumer spending, while the decline in homeowners' equity prevents borrowing to finance any increase. And the recent end of a special tax subsidy for first-time homebuyers has caused house prices to start falling again. If that decline continues, it will inevitably reduce the pace of consumer spending.

Earlier this year, economic forecasters were predicting that annual GDP growth would reach 3% or more in the second half of 2010. Now those projections have been cut to less than 2%, which is too slow to make a dent in the very high rate of unemployment. The forecasters have now shifted their predictions of 3%-plus growth to 2011. Let's hope that they are right this time.

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