

Recession and Recovery¹

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"We are facing an economic crisis of historic proportions." – President Obama

The U.S. economy has been in recession since December 2007. This recession is showing signs of a demand-side downturn, with weak consumer spending, declining business investment and rising unemployment. In 2008, the economy grew at a sluggish rate of 1.2 percent, consumer spending rose about 0.3 percent, investment demand plummeted 5.9 percent, and the unemployment rate climbed to 5.8 from 4.6 percent. In particular, the recession deepened last quarter as the economy plunged at an annual rate of 3.8 percent and unemployment rate soared to 6.9 percent.

In light of a negative growth rate in the fourth quarter of 2008, economists have revised their forecasts for 2009. They expect negative growth, rising unemployment, and tapering investment. This forecast is based on several factors. Consumer confidence is at a record low and business layoff is at a record high. The housing market is in recession. In addition to falling prices, loan defaults and foreclosure rates are extremely high. Even though banks have greater liquidity and charge lower interest rates, the credit market is still tight for both consumer and business loans. With an unprecedented number of workers losing jobs, consumer spending is not showing any signs of recovery. In addition, the recession spreading globally has reduced the demand for American-made goods, resulting in a larger trade deficit. Moreover, low saving rates have provoked greater capital outflow from the United States.

There is a good chance, however, for the U.S. economy to begin a slow recovery late 2009 or early 2010 due to expansionary monetary and fiscal policies. The Federal Reserve Board has taken extraordinary actions to drop the short-term interest rate to a historically low level. Additionally, the Federal Reserve Board has pumped much liquidity into the banking system in order to restore confidence to the financial market and to support consumer and business lending.

Furthermore, the Bush administration's \$750 billion-plus "bail-out" package would substantially support financial institutions, which have issued risky mortgage loans, to remain solvent and gradually stabilize. Spending the remaining \$350 billion of these rescue funds in the first half of 2009 would support investment and consumption. Short-term loans to the domestic automakers would also help the industry to restructure and become more competitive.

The "stimulus" package proposed by the Obama administration is a textbook response to recover from a demand-side recession. The proposed policy is comprised of substantial spending increases and middle-class tax cuts. The package includes as much as \$850

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billion of spending on infrastructure, health care, education, energy, and subsidies for states. Other measures are weatherizing one million homes, saving energy costs at federal government agencies, modernizing schools, and doubling renewable energy production. The goal of the “stimulus” package is to create 3 million jobs over a period of two years and to *“lay a foundation for a stronger economy in the future.”* With proper revision of proposed spending and tax cut components of the “stimulus” package, the Congress is expected to approve the plan and send it to the White House for the president to sign.

The combination of these monetary and fiscal stimuli is expected to trigger a lasting recovery. However, consumer spending and employment would require more time to recuperate. For the entire 2009, the economy would experience negative growth, reduced consumer spending, high unemployment, falling prices, and low interest rates.

The cost of this recovery is a mounting federal budget deficit and an accumulating national debt. Eventually, it could cost the government several trillions of dollars in loans, loan guarantees, and investments to rescue the economy. In the absence of additional tax revenues, the federal government will have to borrow all that money from domestic and foreign investors to pay for its massive spending increase. The prospect of ending military conflict in Iraq and Afghanistan should help alleviate the heavy financial burden of war on the federal budget.