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Due: 8 March 2019

MONETARY POLICY REPORT

Pressing Issues

Recap

Between 2007 Q4 and 2009 Q3, the United States saw one of the worst recessions in its history. At the start of this period, the real GDP stood at $15.761 trillion; by the end, it had fallen 4.1% to $15.134 trillion (Figure 1.) Household and non-profit net worth, which together reflect the value of private investments and the housing market, fell 14.1%, from $68.156 trillion to $59.733 trillion (Figure 2.) The civilian unemployment (U3) rate skyrocketed from 4.7% in November 2007 to 9.5% in June 2009 (Figure 3.)

FIGURE 1

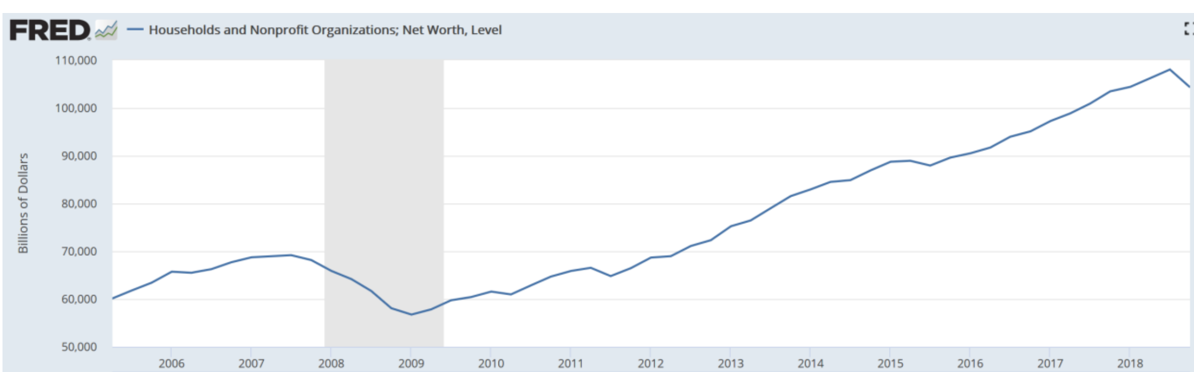

FIGURE 2

FIGURE 3

To guide recovery, the Federal Reserve initiated the standard response of loosening the money supply to lower interest rates. When that failed to stimulate the economy, the Fed began what would become three rounds of quantitative easing, buying up bank debt to get money flowing again. The result was a federal funds rate that stayed near zero for years (Figure 4) and a massively swollen Fed balance sheet (Figure 5.)

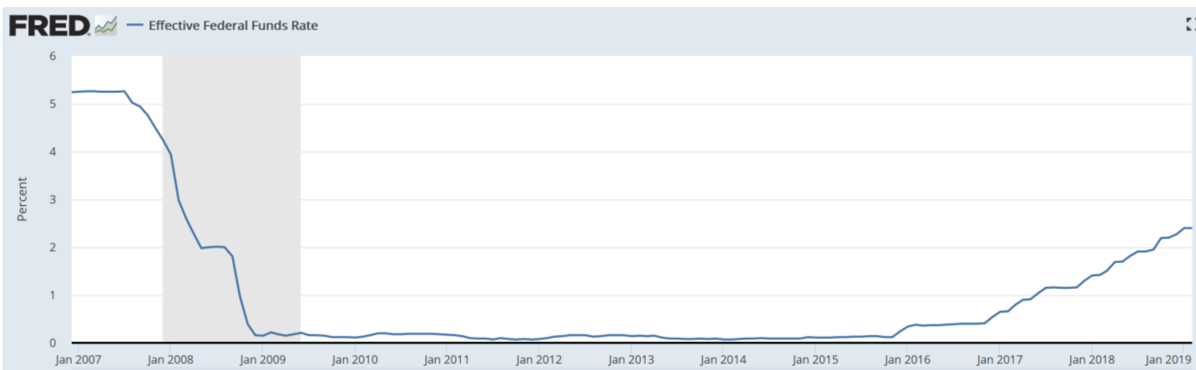

FIGURE 4

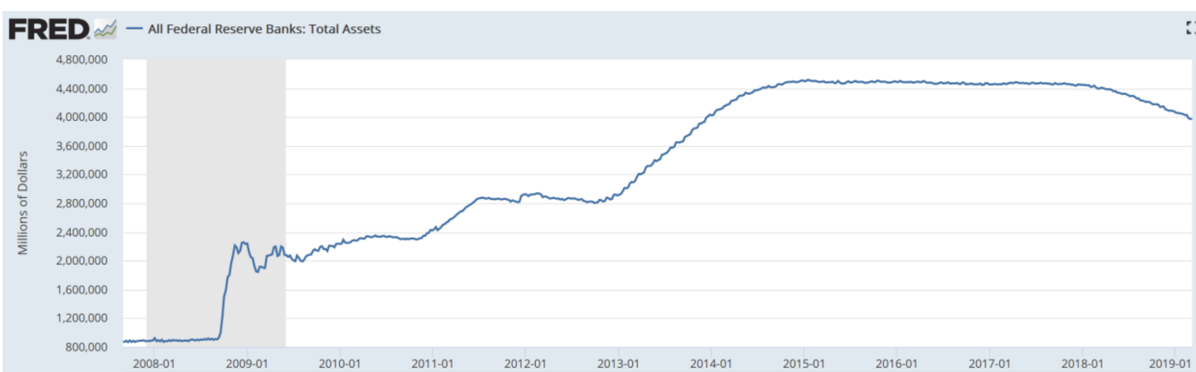

FIGURE 5

For all the Fed's efforts, however, the Great Recession lasted 18 months; the average length of the 10 recessions before it is 10.4 months. Recovery has been much slower than in previous recessions as well. The real GDP resumed a steady upward trend without the surge that has characterized past recoveries, and it took three years before household and non-profit wealth returned to pre-recession levels. It took eight years before the U3 unemployment rate returned to its pre-recession level, and a significant portion of that decline stems from people leaving the labor force entirely (Figure 6.) While retirement is a contributor to this, labor force participation has been lagging in the prime age demographic, workers between the ages of 25 and 54.

FIGURE 6

Deficits

Government Deficits

As illustrated in Figure 7, the United States has been operating on a federal deficit since the beginning of 2002. During the Great Recession, this deficit increased as the government implemented a fiscal policy of increased government expenditures to stimulate the economy. While the deficit has decreased since the end of the recession, it never returned to pre-recession levels and is currently increasing again.

Because the United States has not had a surplus since 2001, the amount of public debt has increased steadily, as shown in Figure 8. This increase remains manageable if the real GDP grows along with it. That is, if the US were a household, we could take on an increased debt load as long as we still had the income to service that debt. Unfortunately, this has not been the case and the ratio of public debt to real GDP has also been steadily increasing as shown in Figure 9. Forecasts indicate that this ratio will reach 100% in 2032 unless changes are made to slow down or reverse the increase in public debt (Gadow, *Econ 426 Project 3.*)

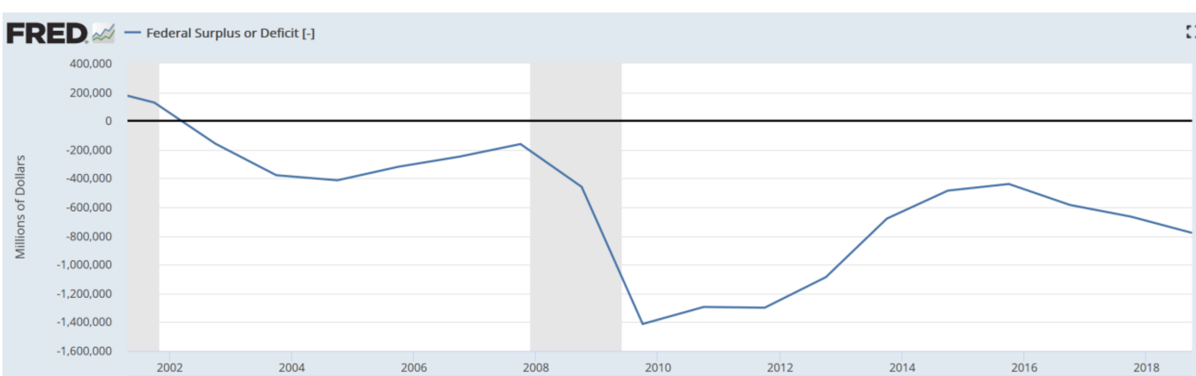

FIGURE 7

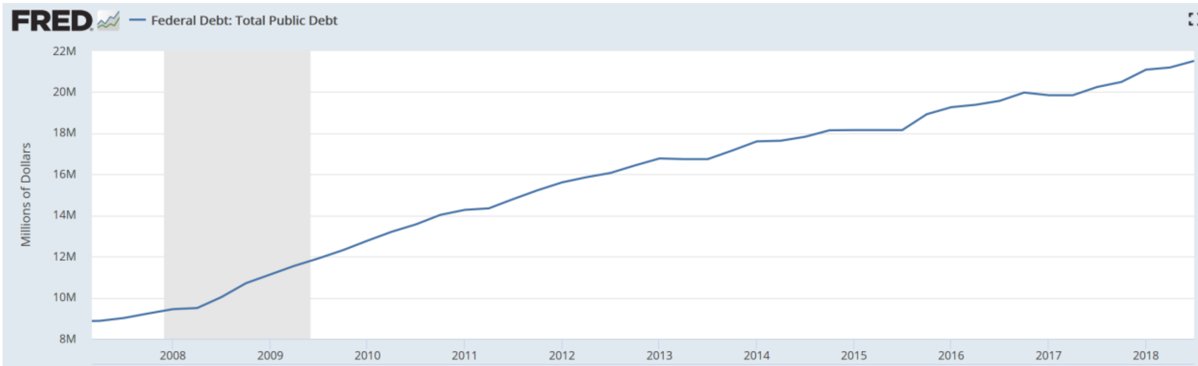

FIGURE 8

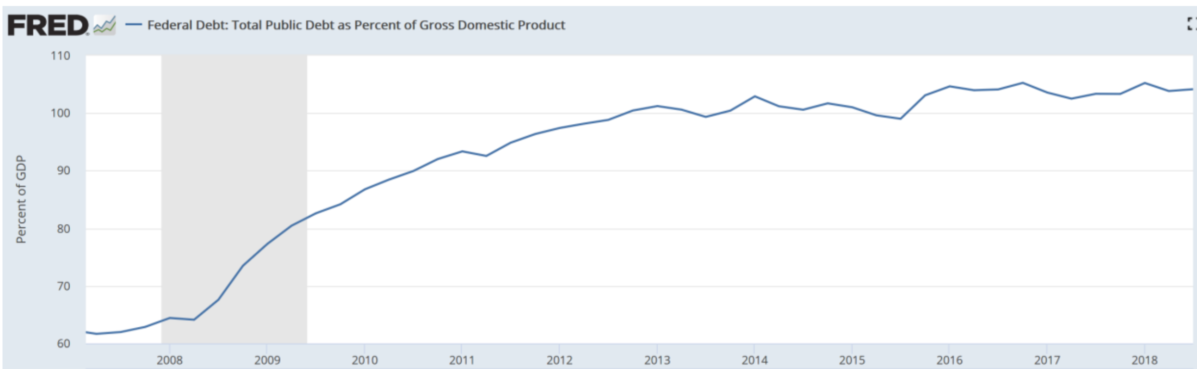

FIGURE 9

There are several reasons for this continually rising debt. A significant part is the fiscal policy undertaken during the recession recovery, when the government both lowered taxes and increased government spending to stimulate the economy. Another significant problem is the federal government's tendency to make government expenditures on credit in order to pay for tax cuts that overwhelmingly benefit the very rich while doing little – and sometimes hurting – the working class and the poor. While tax cuts can help to stimulate the economy, evidence suggests that tax cuts which do not help the least wealthy 90% provide little stimulus.

Trade Deficits

The United States has been running a trade deficit since the third quarter of 1980, meaning that we have been importing more than exporting for almost 40 years (Figure 10.) In the second quarter of 2009, towards the end of the Great Recession, the deficit dropped to $338.6 billion. At this same time, there was a corresponding drop in real GDP (see Figure 1) and civilian unemployment (see Figure 3), indicating that there was decreased income and consequently less demand for imports.

FIGURE 10

Taken together

In macroeconomics, there is what is called the "Twin Deficit Hypothesis" (TDH) which holds that a growing budget deficit drives a widening trade deficit. This is illustrated by taking the national accounting model ***Y = C + I + G + (X – M)***, which says that gross domestic product (Y) is equal to the sum of consumption (C), investment (I), government spending (G), and net exports (exports X less imports M) and the national savings model ***Y = C + S + T***, which says that gross domestic product (Y) is equal to the sum of consumption (C), savings (S) and taxes (T). These two models can be equated and rewritten to get the sectoral balances identity, ***(S – I) + (T – G) = (NX)***, which says that the sum of savings less investment, and taxes less government spending, equal net exports. When taxes less government spending is negative, we have a government deficit. If we assume that GDP is operating at its potential output – meaning that the value Y is fixed – then either investment increases or net exports decreases to maintain equilibrium. When net export decreases, we have a trade deficit.

Having a deficit in government spending or trade is not intrinsically bad and can be necessary in the short run. Doing so chronically, however, is problematic. When the economy is already using its labor and capital at full efficiency, pumping more money into it with increased government spending is not going to make it run with more efficiency. The excess money from that spending can be managed only by increasing imports, which widens the trade deficit.

In theory, the government deficit should be lifting interest rates. This is because the government's need for cash creates a demand, shifting the demand curve in the money market. Supply remains static, creating a new equilibrium at a higher rate of interest. This would increase the value of the dollar, which would attract foreign investment, which would increase foreign demand for US goods and start closing the trade deficit. But while the Fed has allowed the interest rate to rise in the last two years (see Figure 4), the trade deficit has gotten worse, not better, during that time (see Figure 10.)

Pressing issues and proposals

The current growth in the public debt to GDP ratio is unsustainable. As debt rises, it becomes more difficult for the Fed to use fiscal policy to stimulate the economy out of a recession. It also theoretically increases the chance that the US will default on its debt, making us less attractive to the foreign investments that are currently keeping the American economy running; to continue attracting investments, the government will have to agree on paying higher interest to compensate for the increased risk of default, which will further inflate the debt.

Another major issue is the depressed labor participation ratio. Merely creating new jobs will not help the economy, there must be a supply of labor ready and willing to fill those jobs. This would serve the dual purpose of making business and industry more productive, and increasing private consumption, investment, and saving by providing prosperity to more people; both would help increase the GDP, and thus help lower the public debt to GDP ratio.

Improving the labor participation ratio will help, but not by enough. It will also be necessary to bring the deficit under control, at the very least slowing its growth. To increase tax revenues, it may be feasible to close tax loopholes, especially with regards to corporate taxes. It is not unusual for large corporations to pay very little in federal taxes: in 2016, Walmart paid $6.2 billion in taxes on sales of $485 billion, an effective tax rate of 1.28%. Also in 2016, ExxonMobil paid negative $400 million despite sales of $198 billion; that is to say, rather than paying money to the government, the government paid them. Closing these loopholes and having corporations pay their share of taxes would go very far in closing the deficit even if there is no other change.

There is room to cut government spending. In 2017, the United States spent $610 billion on military expenditures, just over 35% of the total military expenditures made by every country on the planet. China, the country with the second highest military expenditures, spend only $228 billion in 2017. We could cut $160 billion from the military budget and still be outspending China 2 to 1. Some of this money could be used to revitalize job training programs that would help discouraged workers return to the labor force, and some could be used to re-establish the Federal Works Agency, creating unskilled and semi-skilled jobs to repair the nation's crumbling bridges, dams, and other vital infrastructure, further increasing labor force participation and creating jobs in lieu of federal handouts. Such programs would help drive the GDP faster than its current path, and thus also decrease the debt to GDP ratio.