STEMMING THE CURRENT ECONOMIC DOWNTURN WILL REQUIRE MORE STIMULUS

A Report By The Joint Economic Committee
Senator Charles E. Schumer, Chairman
Congresswoman Carolyn B. Maloney, Vice Chair
October 29, 2008

The Joint Economic Committee, established under the Employment Act of 1946, was created by Congress to review economic conditions and to analyze the effectiveness of economic policy.

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Executive Summary

The current economic downturn follows the weakest recovery on record, making prospects for a consumer-led recovery unlikely. Families are more financially constrained than at the beginning of any prior downturn as they face rising unemployment, high prices, dwindling assets, historically high debt, and real incomes that are lower than they were over eight years ago. The weakness of household finances means that absent aggressive government action, the current downturn could be particularly long-lasting and severe.

Consumer spending is already declining sharply. Falling household spending – which makes up nearly three-quarters of Gross Domestic Product – means businesses have limited incentives to invest. Declining consumer spending and business investment, combined with the decline in housing prices, will continue to drag down domestic demand for goods and services, leading to further job losses and still greater declines in family income and spending.

Families have not yet recovered from the previous recession and now the country faces a severe financial crisis that is spreading throughout the broader economy. The 10 indicators below demonstrate the weakness in the household sector:

1. Measured by wage gains and job growth, the 2000s economic recovery was the weakest in generations.
2. The 2000s economic recovery was the first since World War II where the typical family saw net income losses.
3. In the face of income losses, families sustained consumption through borrowing and the ratio of household debt to disposable income soared.
4. Families are now spending a historically high share of their income on debt payments.
5. As home prices fall, family net worth is plunging to its lowest levels in two decades.
6. Families have little or no savings "cushion" to maintain living standards in the face of unemployment or falling real income.
7. Families own a smaller share of their home than at any time since World War II, cutting off the opportunity to use home equity loans as a source of "income".
8. Women's earnings will not be able to cushion families as they have in prior recessions, because women's unemployment is already at recessionary levels.
9. Falling real wages and limited savings have already combined to drag down consumer spending.
10. Investment in residential housing usually boosts consumption after a recession, but given the record-high backlog of homes for sale and the continued credit squeeze, this is not likely to happen soon.

These indicators show that the combination of high debt loads, declining income, and rising unemployment will make it difficult for households to sustain consumer spending

at current levels, let alone increase their spending enough to spur economic growth. This cycle, in which lower spending leads to business cutbacks and job losses, which then lowers spending further, is the textbook process, which drives prolonged economic recessions.

Increased business investment in response to export demand is also unlikely to spur economic growth in the near term. Export demand was high in recent quarters, but has still not been sufficient to avert slowing growth. As the economic slowdown spreads globally, such export demand may not continue. In addition, export success depends on a continued low valuation of the dollar.

In order to shorten the duration of a downturn and reduce its magnitude, it is important that government step in and break the current cycle with a temporary fiscal stimulus designed to support economic activity and household well-being while also laying the groundwork for further economic growth.

In January 2008, Congress passed and the President signed the Economic Stimulus Act, which injected over $150 billion dollars into the economy. In the spring of 2008, Congress extended benefits for the long-term unemployed. These policy actions have had their intended effect by temporarily boosting spending, but employment declines have continued and the financial crisis has spilled over into the broader economy.

Given current economic circumstances, infrastructure investment, aid to the states or other direct spending is likely to deliver far more effective stimulus than alternatives such as cuts in business taxes.[1] Over half of the states are projecting budget shortfalls for fiscal year 2009 and this will lead not only to cutbacks in necessary services, but likely higher unemployment as well. Rebuilding and modernizing America's aging infrastructure will strengthen our economy and help create good jobs at good wages.

Families are in a weak economic position and businesses can see clearly that consumers will not be able to increase their spending until their incomes recover. Lowering corporate taxes will not address the fundamental problem: businesses will not have an incentive to invest in products for the U.S. market until family economic circumstances improve. Lowering capital gains taxes will likely have no effect on investment since very few are seeing any gains right now.

The combination of pre-existing economic weakness and the current problems in the financial sector makes additional fiscal stimulus through government investment and support for families vital to keep the economy moving. As economic growth and business hiring slows due to the credit crunch, families have fewer financial resources than ever before to weather a downturn. This means prospects for a consumer-led recovery are bleak, and government stimulus will be important both in promoting economic recovery and sustaining living standards for the middle class.

Introduction

While the nation's attention has been focused on the growing financial crisis, the broader economy has been showing signs of recession.[2] U.S. consumers largely make the economy grow, but families are responding to the current economic difficulties by curtailing their spending. Preliminary data show that real consumer spending declined or stagnated over the summer months: personal consumption fell by ¼ percent in June, ½ percent in July and no growth in August. Retail sales have also fallen sharply over the past few months, as export growth has stalled. Since consumer spending makes up over 71 percent of U.S. Gross Domestic Product, these data indicate that the third quarter GDP will likely will show faltering overall economic performance.

The combination of sustained job losses, falling home prices, and record levels of household debt mean that consumer spending – the largest single source of demand – is unlikely to sustain robust economic growth in the foreseeable future. In addition, state and local governments are feeling pressures to cut spending and businesses are unlikely to make major investments in the face of declining consumer demand and difficulty obtaining credit.

If consumption cannot rise because of the constraints faced by households, then there are three places to look to increase economic growth: increased business investment, increased exports, or more government spending. It appears unlikely that businesses will take up the slack. Demand drives business investment; so long as it remains weak, investment in housing, durable goods, or equipment is unlikely to respond strongly to lower interest rate or to business tax cuts -- unless government takes up the slack by ordering more goods directly. In addition, the combined impact of the financial crisis and associated equity losses are likely to reduce the ability of businesses to raise investment capital – stock market declines have created over 6.2 trillion dollars in equity losses over the last year.

Exports have been the one recent bright spot in the economy, but they are also not likely to solve our growth problem in the months to come. While exports were up sharply in the second quarter of 2008, further export growth depends on a continued low valuation for the dollar and strong consumer demand in other nations. There is no guarantee that the dollar will remain low and, since other advanced economies are beginning to suffer economic slowdowns, export-led growth may not continue.

Economic research demonstrates that downturns coinciding with sharp house price declines or with problems in the banking sector tend to be significantly longer and deeper than other types of recessions.[3] During serious downturns, private sector investment and household consumption decline, leaving government spending as a crucial support for the economy. In addition, lengthy downturns greatly reduce the chance that government fiscal stimulus will be "mistimed", taking effect after the economy has begun to recover on its own.[4] There is a growing consensus that additional economic stimulus is necessary and many prominent economists have recently announced their support for a sizeable package.[5]

Consumption Drives the U.S. Economy

Consumption is by far the largest element of the U.S. economy, which is why the lack of resources available to U.S. households poses significant problems. U.S. consumer spending (consumption) makes up 71 percent of GDP. There are three other elements of GDP: U.S. businesses investment (14 percent), net U.S. government spending (20 percent), and the net difference between how much we export abroad compared to how much we import (-5 percent – meaning that we import more than we export).[6] If U.S. consumers are highly constrained – and especially if they are not willing or able to buy a new home, as they are now – then businesses, other countries (through buying our exports), or government must increase their spending to keep the economy moving. However, because these three elements make up a smaller share of the overall economy, they have to grow much more than usual to make up for weak consumer spending. For example, if, as was the case in July, U.S. consumers buy 0.4 percent less than they did the prior month, then to prevent GDP from falling, the three other components would have to rise by more than twice as much (at least 1 percent) just to make up for the decline in consumption.

Concerns have been voiced that the Bush administration's $700 billion financial rescue plan will constrain the government's ability to boost spending, but the rescue package should not constrain fiscal policy at this time. The rescue package Congress passed in September is aimed at unfreezing credit markets while insulating America's working families from the financial crisis by making investments that may eventually generate positive returns. For example, the Treasury now plans to invest $250 billion in U.S. banks in exchange for equity shares, so that taxpayers will see at least some return on their investment. As former Treasury Secretary Lawrence Summers wrote recently, "for the near term, government should do more, not less …. The case for fiscal stimulus – policy actions that increase short-term deficits – is stronger that any time in my professional lifetime."[7]

Today's economic difficulties are happening after the weakest economic recovery in the post-World War II period. Indeed, real family incomes are still lower than they were 8 years ago. As this economic downturn deepens, families have a limited ability to maintain their living standards in the face of falling wages or job losses because the weak recovery of the 2000s has left them with little to fall back on. Household incomes never recovered to their pre-recession peak, so families took on more debt to maintain their standard of living.

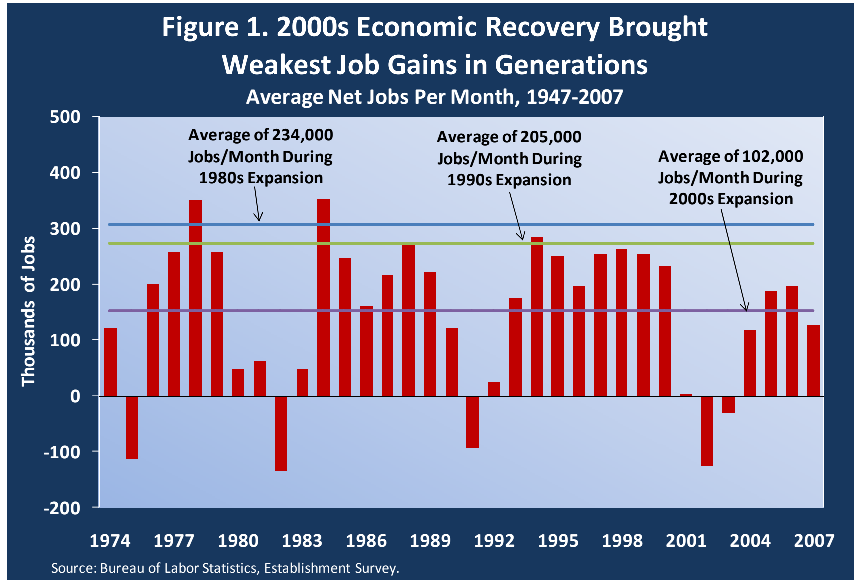
In the recession of the early 2000s, home prices were rising and households had easy access to credit so they responded to falling real incomes by taking out billions of dollars in home equity and credit card debt. This borrowing helped to keep the economy moving (although at a relatively low rate) and helped pull the economy out of recession. Falling home values and rising debt have driven family balance sheets to their worst condition in decades, and banks are now curtailing access to credit.

As the ten charts in this paper show, the deterioration of family economic circumstances makes a consumer-led recovery unlikely.

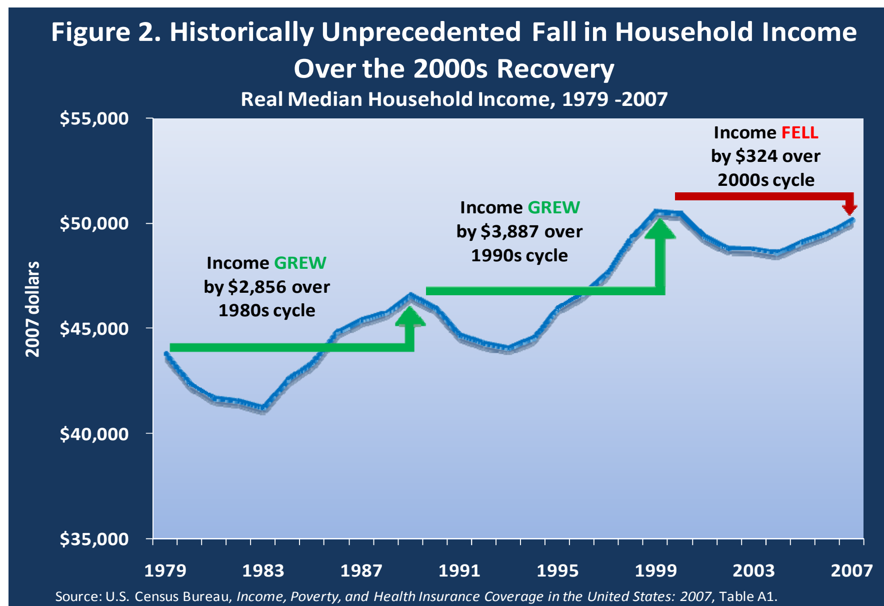
10 Reasons Why U.S. Households Will Not Be Able to Revive the Economy

1. **Measured by wage gains and job growth, the 2000s economic recovery was the weakest in generations** (Figure 1). The 2000s economic recovery created an average of 102,000 jobs each month, less than half as many as during the 1990s expansion, when the economy generated an average of 205,000 jobs each month, or the 1980s expansion, when the economy generated an average of 234,000 jobs each month.

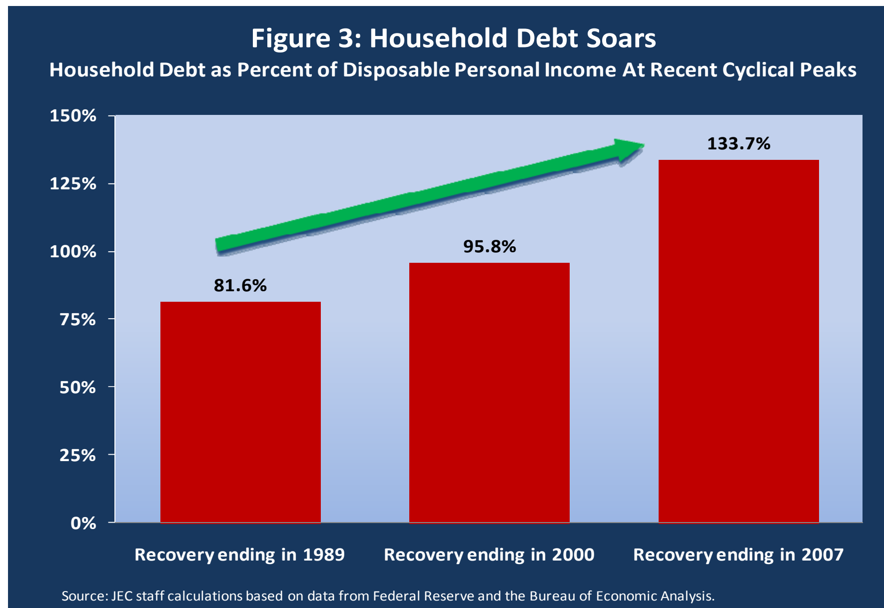
   Lackluster wage growth accompanied these limited employment gains. For women, the 2000s recovery brought weaker wage gains than the 1990s or 1980s economic recovery, while men experienced declining real wages over the 2000s recovery. Wage growth has been slow over the past seven years despite the fact that productivity—which should rise in tandem with wages—rose by over eight times as much as real wages, 2.5 percent per year.[8] The benefits from productivity growth were not shared with workers.



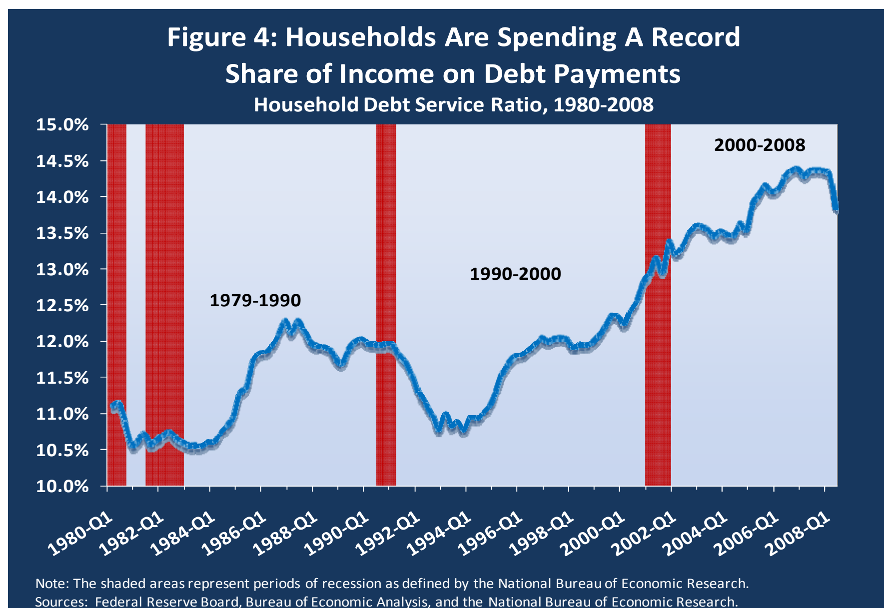
2. **The 2000s economic recovery was the first since World War II where the typical household saw a net loss of income** (Figure 2). Families are starting this downturn with less income than they would have if the 2000s recovery had provided them with real income gains. Real household incomes were $324 lower in 2007 (the last year for which we have data) than they were in 2000. For "working age" households (those headed by someone under 65), real household incomes fell by $2,178 between 2000 and 2007.[9] Given that wages have fallen sharply in 2008 and hours have stagnated, there is little indication that the data for 2008 will show any improvement in incomes. If the 2000s recovery ended in late 2007, this is the first recovery in decades where household income does not recover to its pre-recession peak.



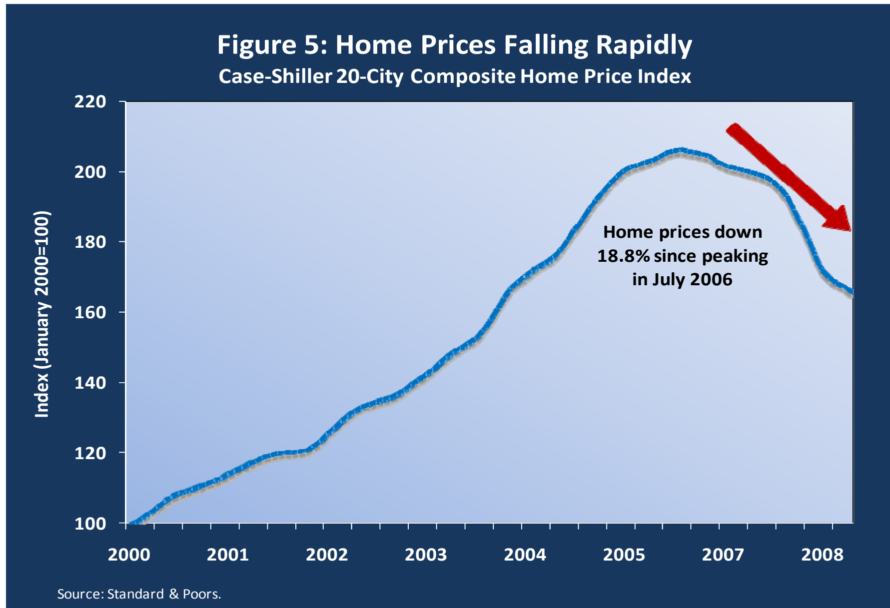
3. **In the face of income losses, families maintained their living standards by borrowing and the ratio of household debt to disposable income soared** (Figure 3). The 2000s economic recovery saw significantly greater growth in household borrowing than previous economic cycles and this growth has accelerated in recent years. There are many theories on the causes of this growth;[10] however, the desire to maintain living standards in the face of declining income likely played a key role. The increase in borrowing has left households with considerably larger debt loads than in the past.[11] Today, U.S. household debt is over 1.3 times the total amount of disposable income households receive in a year.



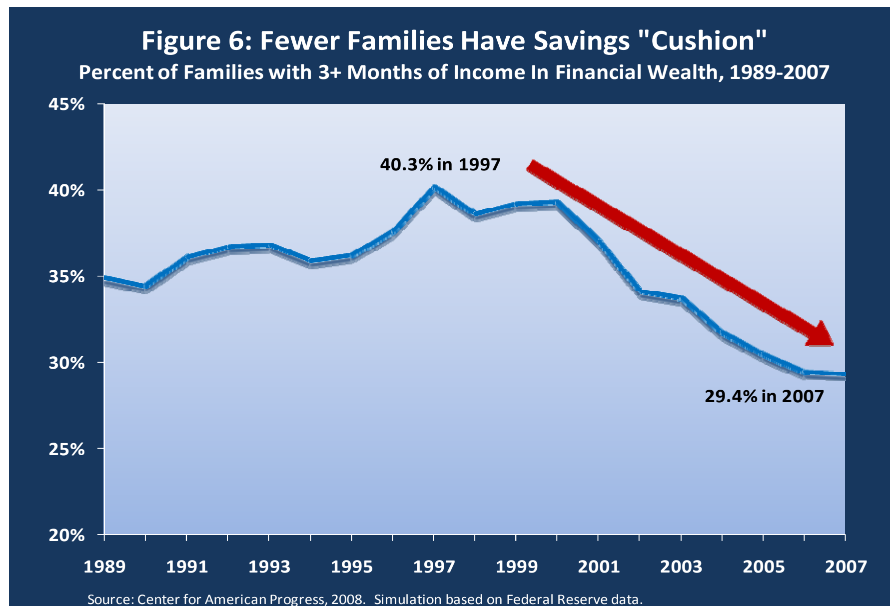
4. **Families are now spending a historically high share of their income on debt payments** (Figure 4). Household debt service ratios have reached historic highs as a percentage of personal income, even though real interest rates reached record lows during the early part of this decade. The Federal Reserve estimates that a typical household pays over 2 percent more of its income in interest payments today than it did ten years ago. That increase represents $1,100 a year in additional interest payments for the typical U.S. household.[12]



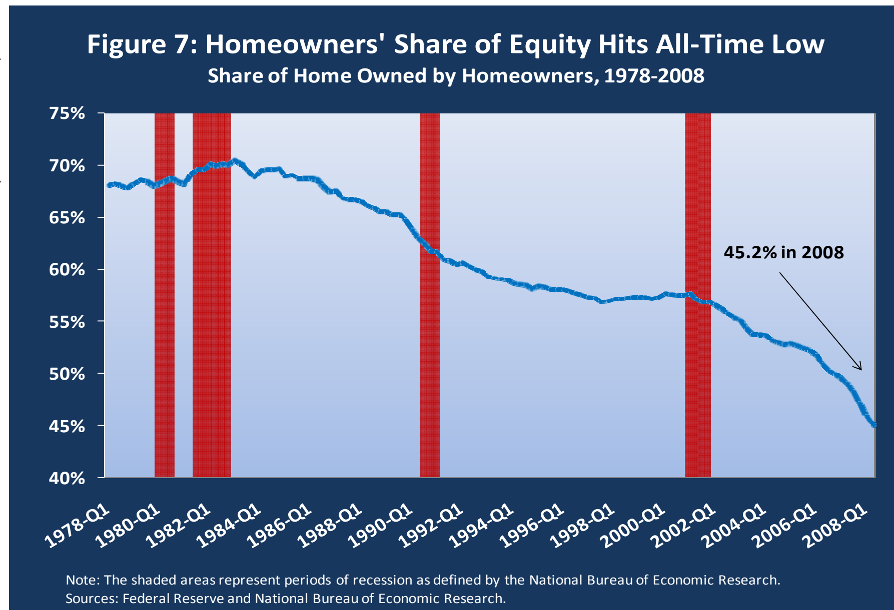
5. **As home prices fall, household net worth is plunging** (Figure 5). Rising real estate prices peaked in July 2006. Since that time, housing prices have declined almost 20 percent and economists forecast them to fall further.[13] This house price decline has already caused a decline in household net worth and this is likely to fall even further as home values continue to decline. The Center for Economic and Policy Research has estimated household net worth for 2009 based on the declines in home values that have already happened and the conservative assumption is that housing prices fall by only an additional 10 percent between mid-2008 and mid 2009. Based on this conservative estimate of housing price declines, the study finds that by 2009, real median household net worth will drop to its lowest levels in twenty years.[14]



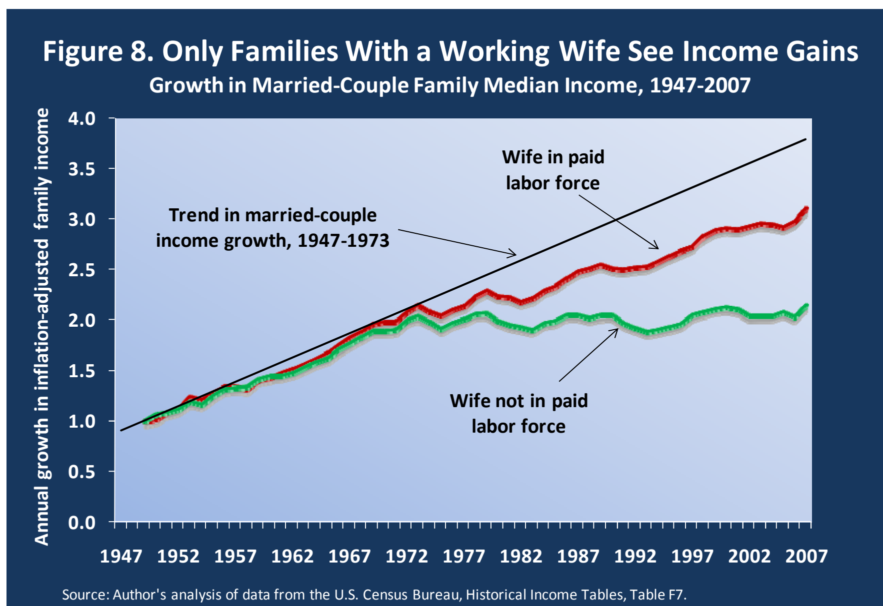
6. **Families have little or no savings "cushion" to maintain living standards in the face of unemployment or falling real income** (Figure 6). The national savings rate was near historic lows in 2007, at one-half of one percent.[15] Low savings means that many families will be unable to dip into reserve funds as incomes fall or they lose a job. The Center for American Progress has recently used Federal Reserve data to estimate the number of households who have a three-month "cushion" of savings to cover an unemployment spell or a medical emergency. They find that in 2007, less than 30 percent of families have such a reserve fund available, down from over 40 percent a decade ago.[16]



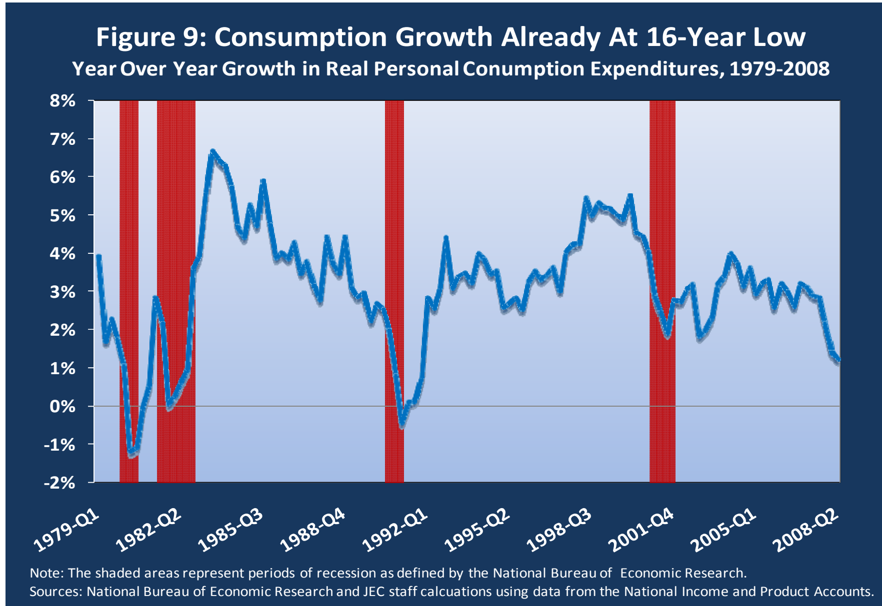
7. **Families own a smaller share of their home than at any time since World War II** (Figure 7). Current levels of homeowner's share of equity are the lowest ever recorded: the average homeowner owns less than half of his or her home. The decline in home equity is due to two factors: first, record levels of home equity loans taken out by families in the mid-2000s, and second, recent declines in housing values. The growth in housing prices during the early 2000s allowed families to significantly increase home equity withdrawals. The Federal Reserve estimates that by 2005 there were over $900 billion in home equity loans outstanding – a 124 percent increase since 2000. The same study found that the average annual level of home equity extraction increased by 350 percent in 2001-2005 as compared to the previous decade of 1991-2000, pumping an extra $160 billion annually into the economy.[17] As home values have fallen over the past two years, the share of their homes that homeowners actually own has plummeted. Many recent purchasers have no equity in their homes, or even negative equity – homes that are now worth less than the mortgage borrowed to purchase them.



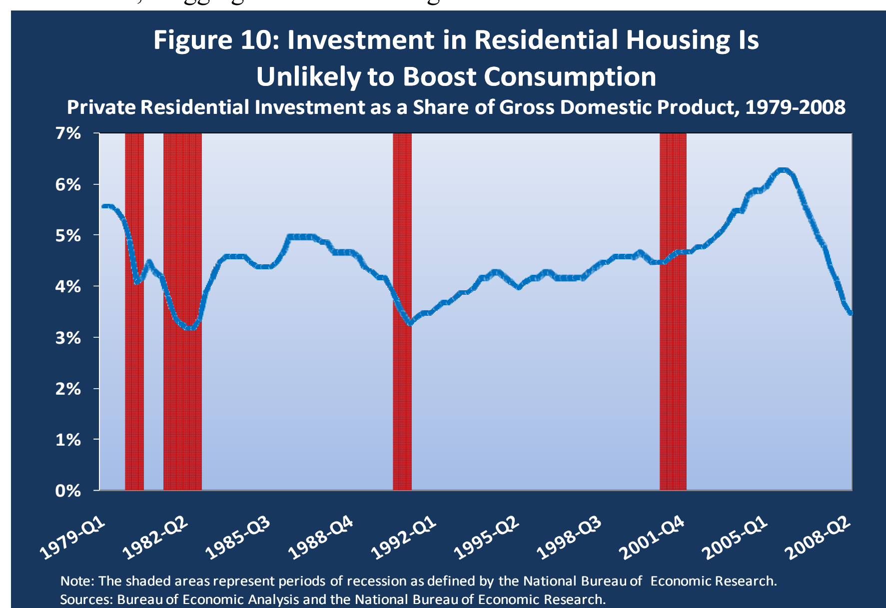
8. **Women's earnings will not be able to cushion families as they have in prior recessions** (Figure 8). In the 1970s, 1980s, and 1990s, family income growth was due in large part to the increase in women's labor force participation. Only families who have had a working wife have seen income growth since the early 1970s; families with a stay-at-home wife have seen no growth in their inflation-adjusted family income. However, in the 2000s, the share of women working stopped rising first, due to particularly devastating job losses suffered during the 2001 recession and then compounded by slow employment growth during the economic recovery thereafter.[18] Since women did not recover to their pre-recession employment levels, families may no longer be able to rely on women to help maintain their living standards in a downturn. This is looking more likely: in recent months, women's unemployment has hovered near its peak during the 2000s recession. This underscores that families are not going to be able to rely on women's employment to help buffer incomes during this downturn, as they had in prior downturns.



9. **Falling real wages, little or no savings, and the inability to borrow have already dragged down consumption** (Figure 9). Rising unemployment and falling real wages, combined with little savings to dip into and increased constraints on borrowing have pushed down consumption. Year over year growth in real personal consumption has fallen sharply in recent quarters and is already below where it was during the early 2000s recession. The trend is worsening, as preliminary data from the last two months shows actual declines in real consumption expenditures. Expenditures on durable goods such as cars and furniture – the easiest item for consumers to cut back on – have been particularly hard hit. In the second quarter of 2008, durable goods consumption dropped to 7.4 percent of GDP, the lowest level in 26 years.



10. **Investment in residential housing is unlikely to boost consumption, given record home inventory** (Figure 10). Looking back on prior recessions, the cycle has typically been that home purchases fall during the recession, but that they help lead consumption as the economy moves out of the recession.[19] Typically, this has been because as the Federal Reserve lowers interest rates, mortgage rates fall so the price that consumers pay to buy a home falls. This, in turn, spurs businesses to invest in new homes and durable goods, since people tend to buy new appliances and furniture when they move into a new home. However, this is not likely to be the case this time around. The third quarter of 2008 saw a record-high backlog of new homes for sale –10.7 months – and it will be quite some time before that backlog is sold and there are incentives to invest in home construction. Already, residential investment is at lows typically only seen during recessions: in August 2008, residential construction hit a 17-year low.[20] Given the record-high backlog of homes for sale, it is likely to fall further before it recovers, dragging down economic growth.



Stemming the Current Downturn Will Require More Economic Stimulus

The combination of sustained job losses, falling home prices, and record levels of household debt mean that consumer spending – the largest single source of demand – is unlikely to sustain robust economic growth in the foreseeable future. To the contrary, consumption weakness is likely to contribute to economic deterioration. In short, the prospects for a consumer-led recovery are not encouraging, making it crucial that Congress and the President take additional measures to shore up the economy.

As employers continue to shed jobs and real wages fall to a seven-year low[21], families are increasingly limited in their ability to draw down assets or rely on debt because of the credit squeeze and falling home values. During the early 1990s and early 2000s recessions, families who saw falling incomes or lost their jobs were able to borrow to maintain their consumption or dip into their savings. However, because family balance sheets are in their weakest position in decades, this will not be possible for millions of families this time around.

If unemployment continues to rise, family's resources are likely to continue to decline as higher unemployment leads to declining real wages and incomes. Researchers estimate that in a mild-to-moderate downturn, families could lose just over $2,000 per year by 2010, but in the case of a more severe recession, families could see income losses of $3,750 per year by 2011.[22] However, unlike during most downturns, this income hit will occur when family balance sheets are already in their weakest position in decades.

The weakness of household finances means that this recession could be particularly long lasting and severe, without swift government action to keep the economy moving: it is the fastest way to increase economic growth, promote job creation and support families in the short- to near-term.

Congress has already considered a new stimulus package. On September 26th, the House passed an economic stimulus package that included infrastructure investment, extended unemployment benefits for the long-term unemployed in high unemployment states, Food Stamp assistance, and funding for states to continue their Medicaid programs. On October 3, the House voted to extend unemployment benefits to unemployed workers in high unemployment states. These efforts have stalled because the President has threatened a veto and Senate Republicans have blocked them.

A temporary fiscal stimulus designed to support economic activity and household well-being, will lessen the severity of the downturn and shorten its duration, while laying the groundwork for future economic growth.

Endnotes

[1] See p. 7, p. 20 of Congressional Budget Office, "Options for Responding To Short-Term Economic Weakness", January, 2008, available at http://www.cbo.gov/ftpdocs/89xx/doc8916/01-15-Econ_Stimulus.pdf.

[2] In a speech given October 14, 2008, Janet Yellen, President of the Federal Reserve Bank of San Francisco said, "Indeed, the U.S. economy appears to be in a recession. This is not a controversial view, since the latest Blue Chip consensus projects that there will be three consecutive quarters of contraction in real GDP starting last quarter." http://www.frbsf.org/news/speeches/2008/1014.html. On October 15, 2008, the Federal Reserve's *Beige Book* begins with the statement, "Reports indicated that economic activity weakened in September across all twelve Federal Reserve Districts." http://www.federalreserve.gov/FOMC/BeigeBook/2008/20081015/default.htm.

[3] Claessens, Stijn, Ayhan Kose, and Marco Terrones, "What Happens During Recessions, Crunches, and Busts?" International Monetary Fund, 2008, available at http://www.aei.org/docLib/20080805_ClaessensKoseTerrones(2008).pdf.

[4] Congressional Budget Office, "Options for Responding to Short-Term Economic Weakness", January, 2008, available at http://www.cbo.gov/ftpdocs/89xx/doc8916/01-15-Econ_Stimulus.pdf.

[5] On October 15, 2008, Nobel Laureate Paul Krugman said on his blog, Conscience of a Liberal, "In addition to financial rescues, we need major stimulus programs."

[6] All percents are from the first quarter of 2008.

[7] Lawrence Summers, "Taxpayers Can Still Benefits From a Bail-Out," *Financial Times*, September 29, 2008.

[8] U.S. Department of Labor, Bureau of Labor Statistics, *Productivity and Costs*, available at www.bls.gov/lpc.

[9] JEC Analysis of U.S. Census Bureau data on median household income for households headed by someone under 65 from the Census Bureau's Current Population Survey, adjusted for inflation by the CPI-U-RS, as reported by the U.S. Department of Labor's Bureau of Labor Statistics.

[10] These theories range from low growth in household income, to lower interest rates, to changes in the willingness of financial institutions to lend to consumers, to changes in for borrowing preferences. See Karen E. Dynan and Donald L. Kohn, "The Rise in U.S. Household Indebtedness: Causes and Consequences," Washington, DC: Federal Reserve Board, 2007. Available at http://www.federalreserve.gov/pubs/feds/2007/200737/200737pap.pdf.

[11] Normally, recessionary periods cause a decline in debt, as the economic shakeout results in less lending by financial institutions and less willingness to take on risk by households. However, during the recession of the early 2000s household debt loads grew at unprecedented levels.

[12] Family income from Census Bureau, http://www.census.gov/prod/2007pubs/p60-233.pdf. Household debt service ratio from Federal Reserve Board, available at http://www.federalreserve.gov/releases/housedebt/.

[13] Case/Shiller 20-city composite index, available at http://www2.standardandpoors.com/portal/site/sp/en/us/page.topic/indices_csmahp/0,0,0,0,0,0,0,0,0,2,1,0,0,0,0,0.html.

[14] Baker, Dean and David Rosnick, "The Impact of the Housing Crash on Family Wealth", Center For Economic and Policy Research, July, 2008. The cited figures use Scenario 2 in the paper, which assumes a ten percent drop in housing prices from March 2008 through 2009. This is the level forecast by housing futures markets, based on CME group September futures contracts for the Case and Fair Composite-20 index for mid-2009, as compared to historical index data for March, 2008. See http://www.cme.com/trading/prd/re/housing_FCS.html.

[15] The annual average savings rate for 2007 was 0.5 percent in 2007. The personal savings rate was 1.2 percent in July 2008, the most recent data available. U.S. Department of Commerce, Bureau of Economic Analysis, National Income and Product Accounts. See BEA's most recent release at http://www.bea.gov/newsreleases/national/pi/pinewsrelease.htm.

[16] Christian E. Weller and Amanda Logan, "America's Middle Class Still Losing Ground," Washington, DC: Center for American Progress, July 2008. Available at http://www.americanprogress.org/issues/2008/07/pdf/middleclasssqueeze.pdf. For methodology, see Christian E. Weller and Eli Staub, "Middle Class in Turmoil: Description of Methodology and Discussion of Findings", Washington, DC: Center for American Progress, September 2006. Available at http://www.americanprogress.org/issues/2006/09/MidClassMethReport.pdf.

[17] See http://www.federalreserve.gov/Pubs/feds/2007/200720/200720pap.pdf. Data on home equity loans outstanding in Table 2, line 45, data on average annual home equity extractions in Table 2, line 3.

[18] Joint Economic Committee, *Equality in Job Loss: Women Are Increasingly Vulnerable to Layoffs During Recessions*, July 22, 2008.

[19] Edward Leamer, Housing Is The Business Cycle, NBER Working Paper 13428, available at http://www.nber.org/papers/w13428.pdf.

[20] The Associated Press, "Housing Starts at 17-Year Low in August," *New York Times*, September 17, 2008.

[21] Except for 2005 Q3 immediately following Hurricane Katrina.
[22] John Schmitt and Dean Baker, "What We're In For: Projected Economic Impact of the Next Recession", Washington, DC: Center for Economic and Policy Research, January 2008. Available at: http://www.cepr.net/documents/publications/JSDB_08recession.pdf.