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The Black Hole in America's GDP

by Martin Feldstein

CAMBRIDGE – The massive downturn in American's economy will last longer and be more damaging than previous recessions, because it is driven by an unprecedented loss of household wealth. Although the fiscal stimulus package that President Obama recently signed will give a temporary boost to activity sometime this summer, the common forecast that a sustained recovery will begin in the second half of 2009 will almost certainly prove to be overly optimistic.

Previous recessions were often characterized by excess inventory accumulation and overinvestment in business equipment. The economy could bounce back as those excesses were absorbed over time, making room for new investment. Those recoveries were also helped by interest rate reductions by the central bank.

This time, however, the fall in share prices and in home values has destroyed more than $12 trillion of household wealth in the United States, an amount equal to more than 75% of GDP. Previous reactions to declines in household wealth indicate that such a fall will cut consumer spending by about $500 billion every year until wealth is restored. While a higher household saving rate will help to rebuild wealth, it would take more than a decade of relatively high saving rates to restore what was lost.

The decline in housing construction has added to the current shortfall in aggregate demand. The annual number of housing starts has fallen by 1.2 million units, cutting annual GDP by an additional $250 billion. While this will eventually turn around as the inventory of unsold homes shrinks, the recovery will be slow.

So the US economy faces a $750 billion shortfall of demand. Moreover, the usual automatic stabilizers of unemployment benefits and reduced income tax collections will do nothing to offset this fall in demand, because it is not caused by lower earnings or increased unemployment.

Although the recently enacted two-year stimulus package includes a total of $800 billion of tax reductions and increased government spending, it would be wrong to think that this will add anything close to $400 billion a year to GDP in each of the next two years. Most of the tax reductions will be saved by households rather than used to finance additional spending.

Moreover, a substantial part of the spending will be spread over the following decade. And some of the government spending in the stimulus package will replace other outlays that would have occurred anyway. An optimistic estimate of the direct increase in annual demand from the stimulus package is about $300 billion in each of the next two years.

The stimulus package would thus fill less than half of the hole in GDP caused by the decline in household wealth and housing construction, with the remaining demand shortfall of $450 billion in each of the next two years causing serious second-round effects. As demand falls, businesses will reduce production, leading to lower employment and incomes, which in turn will lead to further cuts in consumer spending.

To be sure, an improvement in the currently dysfunctional financial system will allow banks and other financial institutions to start lending to borrowers who want to spend but cannot get credit today. This

will help, but it is unlikely to be enough to achieve positive GDP growth.

A second fiscal stimulus package is therefore likely. However, it will need to be much better targeted at increasing demand in order to avoid adding more to the national debt than the rise in domestic spending. Similarly, the tax changes in such a stimulus package should provide incentives to increase spending by households and businesses.

Although long-term government interest rates are now very low, they are beginning to rise in response to the outlook for a sharply rising national debt. The national debt held by US and foreign investors totaled about 40% of GDP at the end of 2008. It is likely to rise to more than 60% of GDP by the end of 2010, with the debt-to-GDP ratio continuing to increase. The resulting increase in real long-term interest rates will reduce all forms of interest-sensitive spending, adding further to the economy's weakness.

So it is not clear what will occur to reverse the decline in GDP and end the economic downturn. Will a sharp dollar depreciation cause exports to rise and imports to fall? Will a rapid rise in the inflation rate reduce the real value of government, household, and commercial debt, leading to lower saving and more spending? Or will something else come along to turn the economy around. Only time will tell.

Martin Feldstein, a professor of economics at Harvard, was formerly Chairman of President Ronald Reagan's Council of Economic Advisors and President of the National Bureau for Economic Research.