

## Economic Growth: Two Possible Paths

While the recession of 2007-2009 has been officially over for roughly two years, the American economy has yet to achieve robust economic growth. By historical standards, this is relatively uncommon. Typically following a recession, the economy rebounds strongly, growing more rapidly than the long-run trend for a few years, and then settles back to its more traditional growth path. As a result, on average, living standards return to, or at least near, the level they would have had no recession occurred. Occasionally this process has taken a bit longer than one might have expected. For instance, following the recessions of 1990-1991 and 2001, it was a while before growth exceeded its long-run average of 3 percent. But it did eventually happen. And we may see a similar growth curve this time as well.

Many forecasters believe this will happen, and there are a number of reasons to suggest they may be right. Business investment, for instance, has been strong and is likely to stay that way. This could improve productivity, especially in the manufacture of capital goods, which are among our key exports to emerging economies such as China, India, and Brazil. Persistent export demand from those countries could aid the U.S. economy for many years.

In addition, one of the weakest areas of the recovery, consumer spending, has room for improvement. Households took a significant hit in net wealth — about \$15 trillion — during the recession. Not surprisingly, people tightened their belts and reined in their expenditures. But recently, households, on average, have been able to increase their savings, pay down debt, and repair their balance sheets. Had energy prices not risen sharply earlier this year, I believe that households would have gradually increased their spending. It appears that those prices may have peaked. If that is the case — and the energy sector remains stable — we could see people feel more comfortable making purchases. This would be significant since consumer spending accounts for 70 percent of GDP.

That said, there is another possible path the economy might take. It may be less likely than the one I just outlined, but it does seem plausible. We may not see that faster, catch-up level of growth that has followed most recessions. Instead, we may simply settle into a growth rate of 3 percent. In short, we may not gain back the ground we lost during the recession.

There are many reasons why this scenario might occur, among them changes in public policy. New tax and regulatory policies — including both the recent health care and financial reform bills — could have significant persistent effects on output and consumption. Moreover, there remains considerable policy uncertainty surrounding such

issues — for instance, how fiscal balance will be achieved over the long run.

Nobel Prize-winning economist Robert Lucas, among others, has argued that the United States may be headed toward an overall policy regime similar to that of many other developed countries, especially those of continental Europe. On balance, these countries



have more regulated labor markets, higher tax rates, and larger social safety net programs. While they tend to have roughly the same average rate of growth as the United States, they generally employ less labor and produce less output per capita. Although these countries are rich by global standards, they typically have been less economically dynamic and are poorer than the United States.

Given that we can't be sure which recovery path the U.S. economy will take, what should the Federal Reserve do? My colleagues and I will have to pay careful attention to events, which may call for a relatively nuanced approach. But overall I think the direction we should take is roughly the same in either case. Monetary policy is highly accommodative right now. While inflation trends are currently well-contained at around 2 percent, we need to be alert to the risk that the monetary stimulus now in place might set off an inflationary surge. More broadly, it is important that people recognize that, as Chairman Bernanke recently noted, monetary policy is not a panacea. Monetary policy determines the inflation rate over time, and has only a transitory effect on real economic growth. Further monetary stimulus is unlikely to alleviate the impediments to more rapid growth, but could raise inflation to undesirably high levels.

The U.S. economy is remarkably resilient. But as we recover from the most significant recession since the Great Depression, we must face the possibility that we may never fully regain what was lost during the downturn, especially if policymakers do not squarely address those issues that have long loomed over the U.S. economy but can no longer be ignored.

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