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Will the Recovery Continue?

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With quantitative easing winding down and the latest payroll tax-cut measures set to expire at the end of this year, pressing questions loom about the current state of the US economic recovery and its ability to sustain itself in the absence of support from monetary and fiscal policy. While these are the questions we ought to be addressing, public debate in recent months has instead been dominated by the notion that government spending must be cut and monetary policy tightened in order to curtail budget deficits and forestall a perceived threat of inflation. A look at trends and recent economic signals in four key markets—financial markets, markets for household goods and services, commodity markets, and labor markets—suggests that this (premature) abandonment of fiscal and monetary stimulus would be both damaging and unnecessary.

According to a critique that is at risk of coalescing into conventional wisdom, stimulative policies of the sort that have been pursued in the last couple of years have unintended consequences that ultimately render such policies self-defeating. Loose monetary policy combined with fiscal stimulus, so the argument goes, will not only lead to runaway inflation but also place enough pressure on capital markets to crowd out private investment.

These predictions, however, have not come to pass. Interest rates remain low by historical standards. Even after three rounds of fiscal stimulus and expanding budget deficits, businesses have access (at low rates) to short-term securities, loans, and other financial instruments that are crucial to operations. Nor is there compelling evidence that US government policy is contributing to rampant inflation. Core inflation, which excludes volatile food and energy prices, stood at a meager and historically low 1.5 percent in May. Moreover, the yield spread between inflation-indexed and nonindexed Treasury securities—the premium investors are willing to pay to insure themselves against future inflation—has barely budged, suggesting that investors are not expecting substantial inflationary increases down the road.

The critical threat in financial markets is not government borrowing spurring inflation or sapping private investment, but rather the continued fragility of the global financial system. Underlying instability in European financial markets, as well as stresses that are building in financial institutions, present the risk of another—potentially deeper—crisis breaking out. In the household sector, demand for US goods and services has been undergoing a steady expansion, with both retail sales and consumer spending growing at moderate levels; yet recent data suggest that growth in this sector may be stalling. Industrial production, steadily rising since its collapse in 2007–09, also flattened out in February—below its prerecession peak. Export numbers provide only small comfort that additional demand for American goods might be sought outside of the United States. Although a continuing depreciation of the dollar tends to make US exports more attractive to foreign buyers, this positive effect has been dampened by a rise in the price of imported oil—resulting in only a modest improvement of the trade deficit in April.

The recent jump in oil and agricultural commodity prices (which is not a result of US fiscal or monetary policy) poses a potential risk to the already lackluster recovery in other ways. Although they are not feeding into core inflation, these price increases may still bite into households' budgets, crowding out other purchases even in the developed economies.

Monetary easing and fiscal policy have contributed to a modest improvement in demand for household goods and services, but this has not translated into a sustained improvement in labor markets. Alongside May's 9.1 percent unemployment rate, taking a full measure of the labor market situation requires looking at additional indicators—none of which provide much solace. Long-term unemployment rates remain high, and underemployment (measuring the unemployed, those who have given up looking for work, and those who would prefer to be working more hours) remains at intolerable levels, and it is not trending downward in any marked way.

Despite protestations to the contrary, there is little evidence that this crisis of unemployment and underemployment is a result of a "structural" mismatch between skills and jobs. Instead, what we are experiencing is a lack of sufficient demand in the economy. In the face of potentially sputtering consumer spending and industrial production, uneven help from exports, and the absence of an overall expansion in consumer credit, additional fiscal stimulus is crucial to alleviating this crisis.

With all of the oxygen in our public debates being sucked up by discussions about debt, deficits, and inflation, one might be forgiven for assuming that there is little additional need or room for more stimulative policy. But that assumption would be wrong. The economy may be in the midst of a modest recovery, but it is a recovery marked by anemic job growth and a series of potential dangers and pitfalls. Markets alone, unsupported by additional monetary or fiscal policy, should not be expected to bring us the improvements in economic well-being that we need.

For a more detailed discussion of this topic, go to www.levyinstitute.org/pubs/ppb_118.pdf.

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