What Happened to the Recovery?
Part II: Government Policy and Why the Recovery Has Been So Slow

BY GERALD FRIEDMAN

The recovery from the Great Recession has been so slow because government policy has not addressed the underlying problem: the weakness of demand that restrained growth before the recession and that ultimately brought on a crisis. Focused on the dramatic events of fall 2008, including the collapse of Lehman Brothers, policymakers approached the Great Recession as a financial crisis and sought to minimize the effects of the meltdown on the real economy, mainly by providing liquidity to the banking sector. While monetary policy has focused on protecting the financial system, including protecting financial firms from the consequences of their own actions, government has done less to address the real causes of economic malaise: declining domestic investment and the lack of effective demand. Monetary policy has been unable to spark recovery because low interest rates have not been enough to encourage businesses and consumers to invest. Instead, we need a much more robust fiscal policy to stimulate a stronger recovery.

GERALD FRIEDMAN is a professor of economics at the University of Massachusetts-Amherst.

Determined not to repeat what orthodox economists saw as the main cause of the Great Depression—a “tight” money supply—the Federal Reserve responded very aggressively to the crisis in 2007 and 2008. The Fed drove its main target short-term interest rate, the federal funds rate, down to an unprecedented near-zero level. Even at interest rates below zero in real (inflation-adjusted) terms, however, effective demand has been so depressed and so much unused productive capacity has remained that banks have found few borrowers.
The lack of demand for borrowing, and banks’ concerns about the reliability of corporate borrowers, have undermined the ability of the Federal Reserve to spark economic recovery by increasing the money supply. Aggressive monetary policy has done little to promote increased investment as banks have stockpiled cash, hoarding almost $2 trillion in “excess reserves”—money they have deposited at the Fed over and above what is required by law. This is unprecedented; the only other time in the last 50 years when excess reserves were more than $10 billion was after the September 11, 2001, attacks. (Note: $2 trillion is equal to $2,000 billion.)

The recovery from the 2001 recession was fueled by consumer spending—based on increasing debt and rising asset values. On the eve of the Great Recession, household debt payments were an unprecedented 18% of disposable personal income. As the crisis hit, household net worth plunged by over $13 trillion, led by falling home prices, and consumer spending fell accordingly. Since the recession, households have increased saving to bring down their debt levels. While this is good for individual balance sheets, it has meant reduced spending, lowering economy-wide demand and income. Average household wealth has since recovered, but the effect on consumer spending has been muted because most of the recovery has been in stocks, assets which are owned primarily by a small (and rich) portion of the U.S. population.

As in past recessions, the federal government responded to higher levels of unemployment through deficit spending. Large increases in deficit spending in 2008 and 2009 helped to halt the economic collapse at the beginning of the Great Recession. From there, however, the all-government deficit (including state and local governments, which traditionally run surpluses) swung heavily toward surplus. Despite persistently high levels of unemployment, government fiscal policy has been contractionary every year since 2010, with rising surpluses slowing an already anemic economic recovery.