A new study finds that we fought the Great Recession with much success.

What can we learn about counter-cyclical policy from what we got right and wrong in fighting the Great Recession?

By Jared Bernstein October 16   Washington Post
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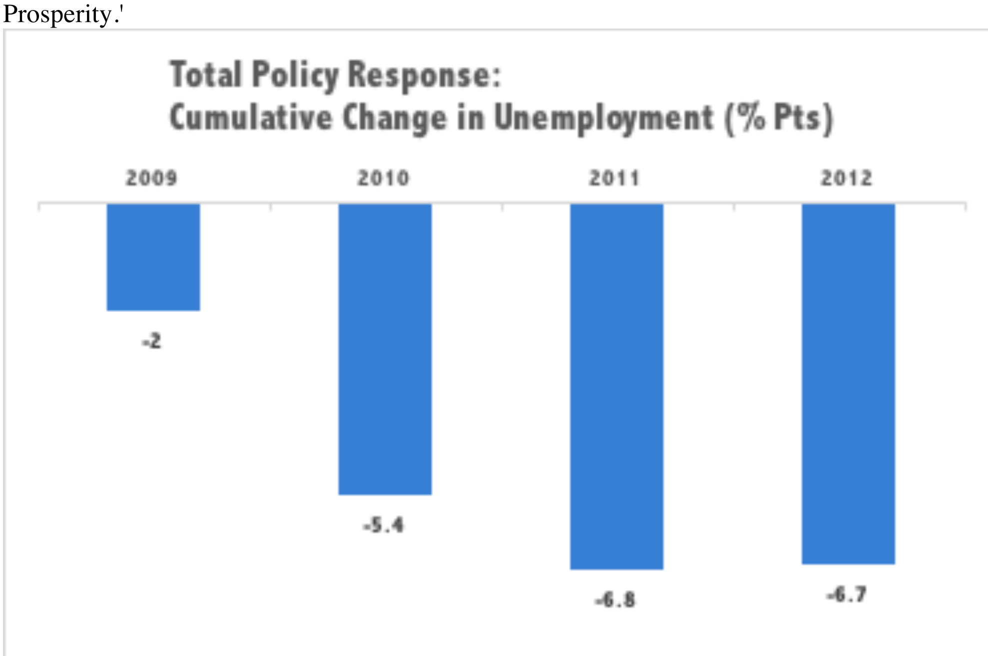

Source: Blinder and Zandi (2015)

When contemplating economic policy, it's just as important to look backward as it is to look forward. What tools did we use the last time we were faced with a particular challenge, and how well did they work? What can we learn that should inform our thinking the next time around?

One of the most important areas of policy in this regard is so-called counter-cyclical policy, meaning actions taken by the government and the Federal Reserve to offset an economic downturn. The Recovery Act — the $800 billion stimulus package implemented in 2009-10 — is a clear example of a temporary, counter-cyclical policy (really, set of policies) designed to inject a significant dose of economic resources into the pockets of those hurt by the deep recession of those years, as well as into their communities and schools, and the infrastructure they use.

The Federal Reserve aggressively applied monetary policies, both conventional — lowering the interest rate they control to make consumer credit and mortgages more affordable — and unconventional — "quantitative easing," or pushing down long-term interest rates by purchasing longer-term bonds.

And finally, key sectors, including finance and the two failing auto companies, got bailouts in order to prevent cascading failures with the potential to turn a recession into a depression.

Did these interventions work? Did they have their intended impact, without much in the way of unintended consequences? Can we quantify their impacts? And particularly importantly, given that there's another recession out there somewhere, what can we learn from them?

These are the questions answered in a new paper by economists Alan Blinder and Mark Zandi, just released by the Center on Budget and Policy Priorities as part of our full employment project. It's easily the most thorough look at the impact of the full spate of counter-cyclical actions taken by the government and the Fed to protect the U.S. economy from the gale forces of the Great Recession.

Here's how they summarize their findings:

The massive and multifaceted policy responses to the financial crisis and Great Recession — ranging from traditional fiscal stimulus to tools that policymakers invented on the fly — *dramatically* reduced the severity and length of the meltdown that began in 2008; its effects on jobs, unemployment, and budget deficits; and its lasting impact on today's economy.

Absent these interventions, according to Blinder and Zandi's analysis:

— Real GDP would have fallen 14 percent from its peak to its trough, instead of its actual decline of 4 percent.

— The downturn, which ended in mid-2009 — that's when GDP began to grow again — would have lasted twice as long.

— More than 17 million jobs would have been lost, about twice the actual number.

— Unemployment rose to 10 percent, which is obviously far too high. But it would have peaked at around under 16 percent, which in today's job market equals 9 million fewer unemployed people (see figure above showing the percentage points that the policy response shaved off the unemployment rate in various years).

— In a particularly notable finding, B & Z find that the federal budget deficit would have peaked at -20 percent of GDP, instead of its actual peak of -10 percent. That may sound counterintuitive, but it's actually just counter-cyclical. By preventing the huge losses in GDP and jobs, the interventions kept the budget deficit from getting a lot bigger.

— Today's economy would be far weaker than it is — with real GDP about $800 billion lower, 3.6 million fewer jobs, and unemployment still at 7.6 percent. That translates to close to 4 million fewer unemployed in today's labor force.

This all may be a bit hard to wrap your head around if you've heard the critics of the Recovery Act talking about the "failed stimulus." But that's just another example of the way ideology is crowding out facts in today's politics.

In reality, the stimulus package provided desperately needed relief to states, extra nutritional support and job opportunities to poor families, extended unemployment benefits to jobless households to tide them over before the engine of job creation finally turned over in 2010, jobs to production workers repairing public infrastructure, investments in clean energy, tax breaks to struggling families, low-cost loans to small businesses, and much more.

The Fed, as noted, took interest rates down as far as they could go, while it and the Treasury helped to reflate the credit system, an essential part of the financial rescue efforts. GM and Chrysler might well have faced Chapter 7 bankruptcy and liquidation as their failures coincided with the collapse of private credit markets. Instead, their bailouts saved 800,000 jobs, according to B & Z.

Here's another important reminder from this study: Stimulus measures like these are temporary, and as such they're nothing like the budget busters their critics claim. They get into the system when they're needed and leave the system when their work is done. As noted above, the deficit would have been higher, not lower, had we pursued the Hooveresque liquidation strategy that many conservatives urged at the time. Today's budget deficit of about $440 billion, 2.5 percent of GDP, is at its lowest level since 2007.

In fact, I'd argue (as do B & Z) that if anything, the counter-cyclical measures were too temporary. They ended too soon, as the pivot toward deficit reduction got underway well before the private side of the economy was ready to grow on its own.

This shift to "austerity" — premature fiscal consolidation while private demand is still weak — is one of the serious economic policy mistakes that should inform economic policy going forward. B & Z show that the U.S. pivot to austerity, while not as damaging as that of some European countries, put downward pressure on growth and jobs, 2011-13. Other lessons highlighted by B & Z include:

— The Great Recession was the result of a massive housing bubble juiced by "innovative" finance. It is thus essential that policymakers provide much better oversight of financial markets, particularly watching out for asset bubbles. In this regard, it was encouraging to hear the Democratic presidential candidates lean heavily into this point in their debate earlier this week.

— Fiscal and monetary policy must work together, as their interactions are large and positive. Low interest rates from the Fed set the table, as it were, but greater demand from stimulative fiscal policy leads more people to sit down and eat, i.e., to take advantage of low rates. As B & Z put it, "policymakers should use a 'two-handed' approach (monetary *and* fiscal) to fight recessions."

— *Discretionary* fiscal policy, where Congress appropriates temporary funds of the types that went into the Recovery Act, has been a standard way to fight recessions since the Great Depression, and despite unfounded claims to the contrary, it remains so. And as B & Z say, "the size of the stimulus should be proportionate to the magnitude of the expected decline in economic activity."

I understand that facts aren't exactly welcomed in debates over matters such as these in today's dysfunctional politics. That's hurting our economy today, as six years into an expansion — one hastened along by the measures implemented in the face of a deep recession — there's still too much slack in the job market, while incomes of many middle- and low-income families are still climbing out of the hole.

But at least we're growing, adding jobs and moving in the direction of full employment. Our economy appears to be resilient enough to withstand dysfunction in expansion. But I assure you, that will not be the case in a recession. For that, we need to absorb the lessons B & Z offer, both regarding what we got right and what we got wrong. Counter-cyclical economic policy clearly works, and unless we want to engender needless suffering the next time a recession hits, that's a fact that every policymaker needs to learn.

[Correction: an earlier version of this post said the budget deficit would have grown to 18 percent of GDP. The correct number is 20 percent, as the post now reflects.]