Budget deficit, weak spending, politics making it hard to get economy going

August 16 2011, By Lloyd B. Thomas Jr.

A Kansas State University economist says the government is running out of options when it comes to stimulating the weak economy and holding off a second double-dip recession since the 2007-2009 financial crisis.

"The federal government normally has two tools to use in an effort to ameliorate a very weak economy: fiscal policy and monetary policy. Unfortunately, neither of these tools appear likely to resolve our situation," said Lloyd B. Thomas Jr., K-State professor of economics and the author of the book "The Financial Crisis and Federal Reserve Policy," recently published by Palgrave Macmillan.

Thomas said the economy has still not recovered from the severity of the 2007-2009 recession, and he added that the outlook for recovery isn't promising right now because of low consumption spending, investment spending and government purchases -- or aggregate spending, a main driver in economic activity.

"Consumer spending is weak right now because household wealth has been hammered by the decline in home prices -- with one-third of households with mortgages now having negative equity in their homes; by the decline in the stock market and retirement accounts; by the decline in consumer confidence; and by very high unemployment," Thomas said.

Investment spending is weak since firms are reluctant to expand operations because people aren't buying their goods and services. New construction, also considered investment spending, is extremely weak, largely because of the glut of repossessed homes on the market. And government purchases are weak as state and local governments are forced to retrench because of the decline in their revenues, Thomas said.

"Spending by the federal government is inhibited by political considerations stemming from the huge federal budget deficit, which is largely the result of the enormous financial crisis that began in 2007," he said.

According to Thomas, conventional fiscal policy would involve large tax cuts and expansion of government expenditures to boost aggregate spending. However, fear that the United States could follow European countries into a sovereign debt crisis, coupled with political forces in Washington, have taken a needed additional fiscal stimulus off the table, he said.

When it comes to monetary policy, Thomas said the Federal Reserve has essentially exhausted its ammunition. The Fed announced Aug. 9 that it would continue to keep interest rates as low as possible.

"The Fed has maintained its short-term interest rate near zero since December 2008, and has taken several measures to try to push the long-term interest rate as low as possible," Thomas said. "Today, the 10-year Treasury bond yield is near 2 percent -- the lowest rate in 60 years. In short, the Fed is out of bullets."

Thomas said the fear that we may be in for a lengthy period of economic stagnation, coupled with the gridlock in government, is driving the volatility in the stock market.

"Investors are contemplating the possibility of a lengthy period of economic stagnation: slow or negative growth and very high unemployment," he said. "Because both monetary and fiscal policy are essentially immobilized today, the economic outlook is precarious and indeed frightening."

Thomas' research interests include monetary economics, macroeconomic policy and international monetary economics. His work has appeared in leading journals, including *The Economic Record, Business Economics, Southern Economic Journal, Journal of Economic Perspectives* and more.

Provided by Kansas State University

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