

The U.S. Macroeconomy Recent Developments and Policy Challenges

Andrea Bubula

EDF-Alliance Executive Workshop

October 15, 2012

Agenda

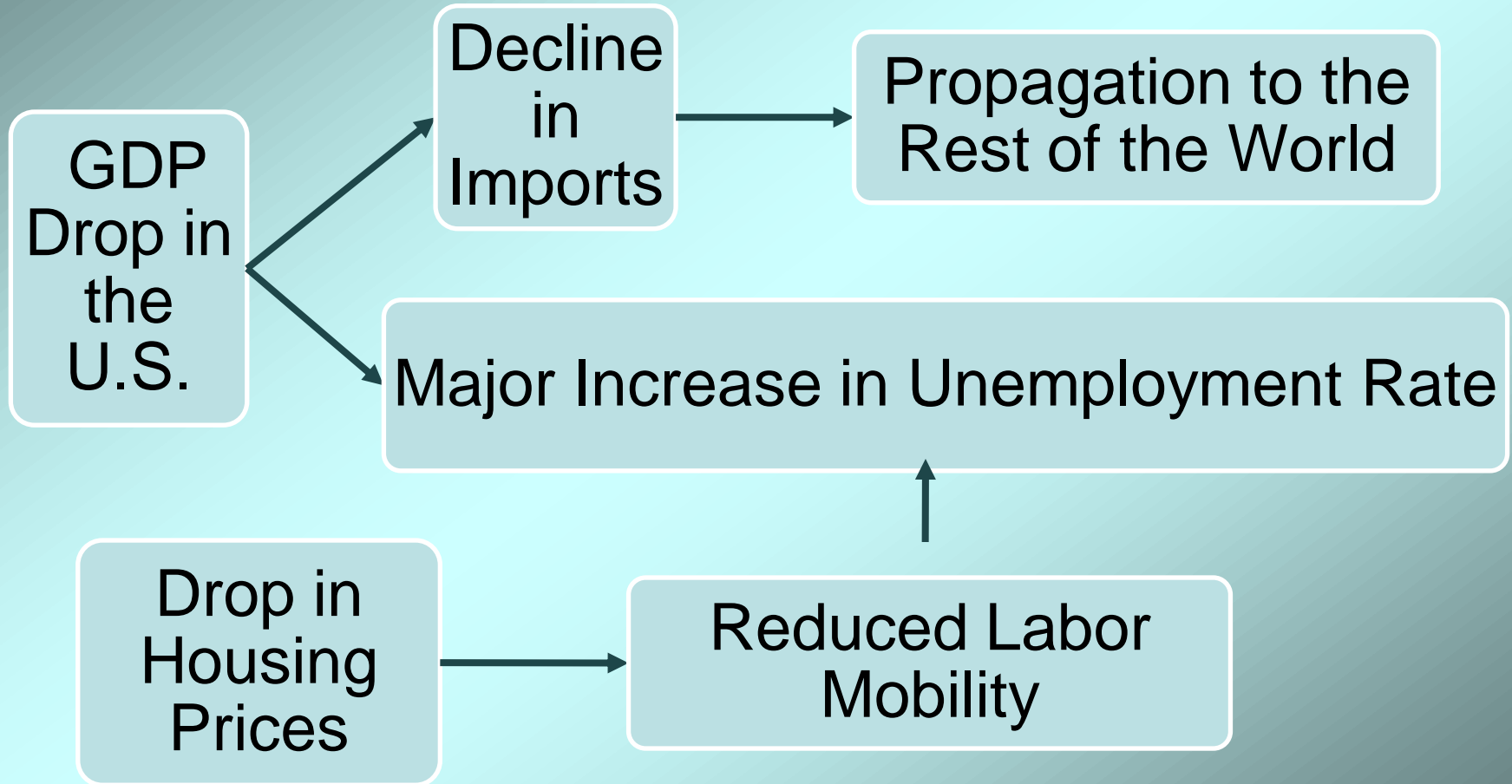
- The Propagation of the Financial Crisis
- Monetary Policy Issues
- Fiscal Policy Challenges
- The Policy Debate Before the Elections

The Financial Crisis

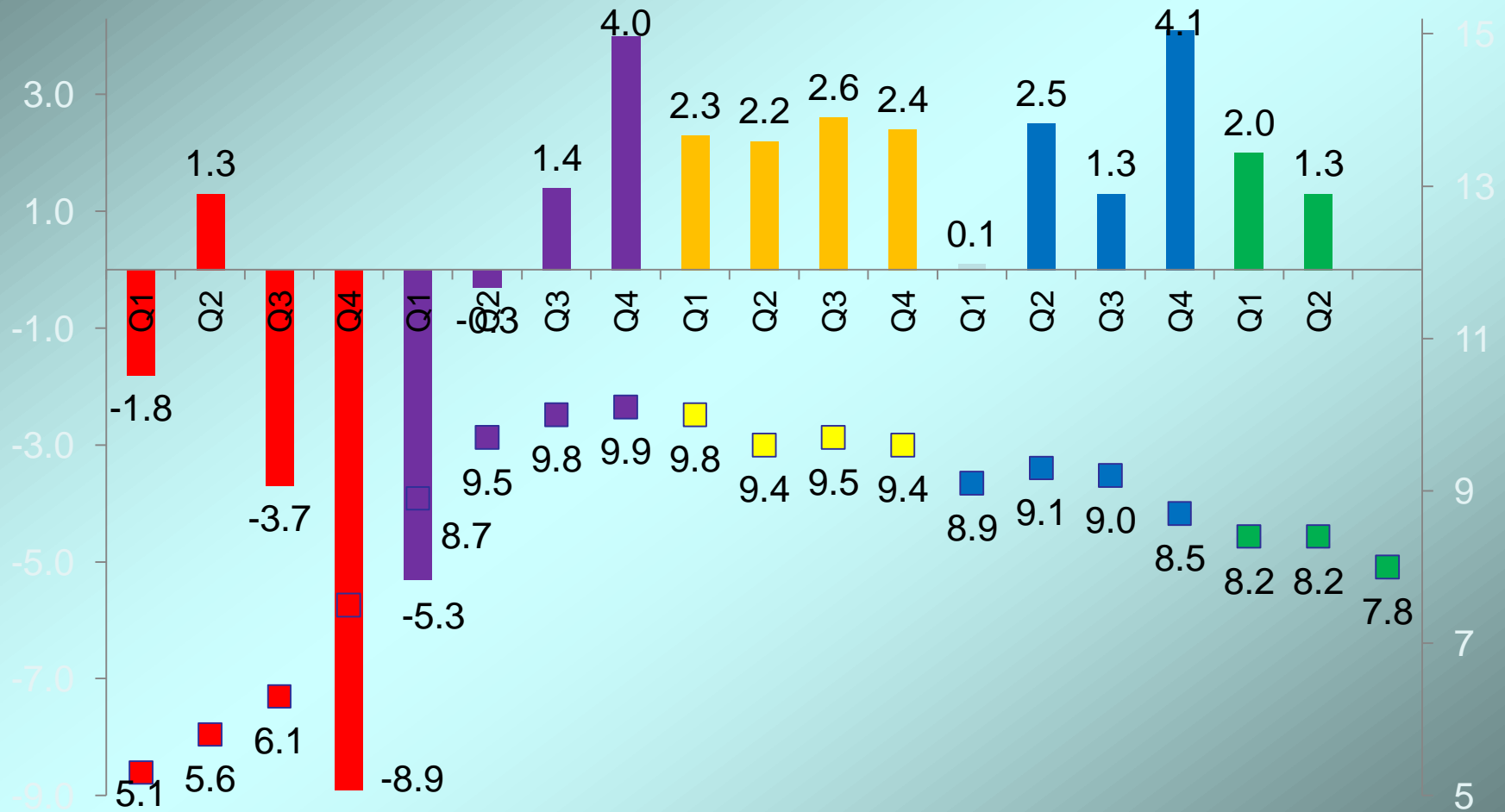
$$\text{GDP} = C + I + G + \text{NX}$$



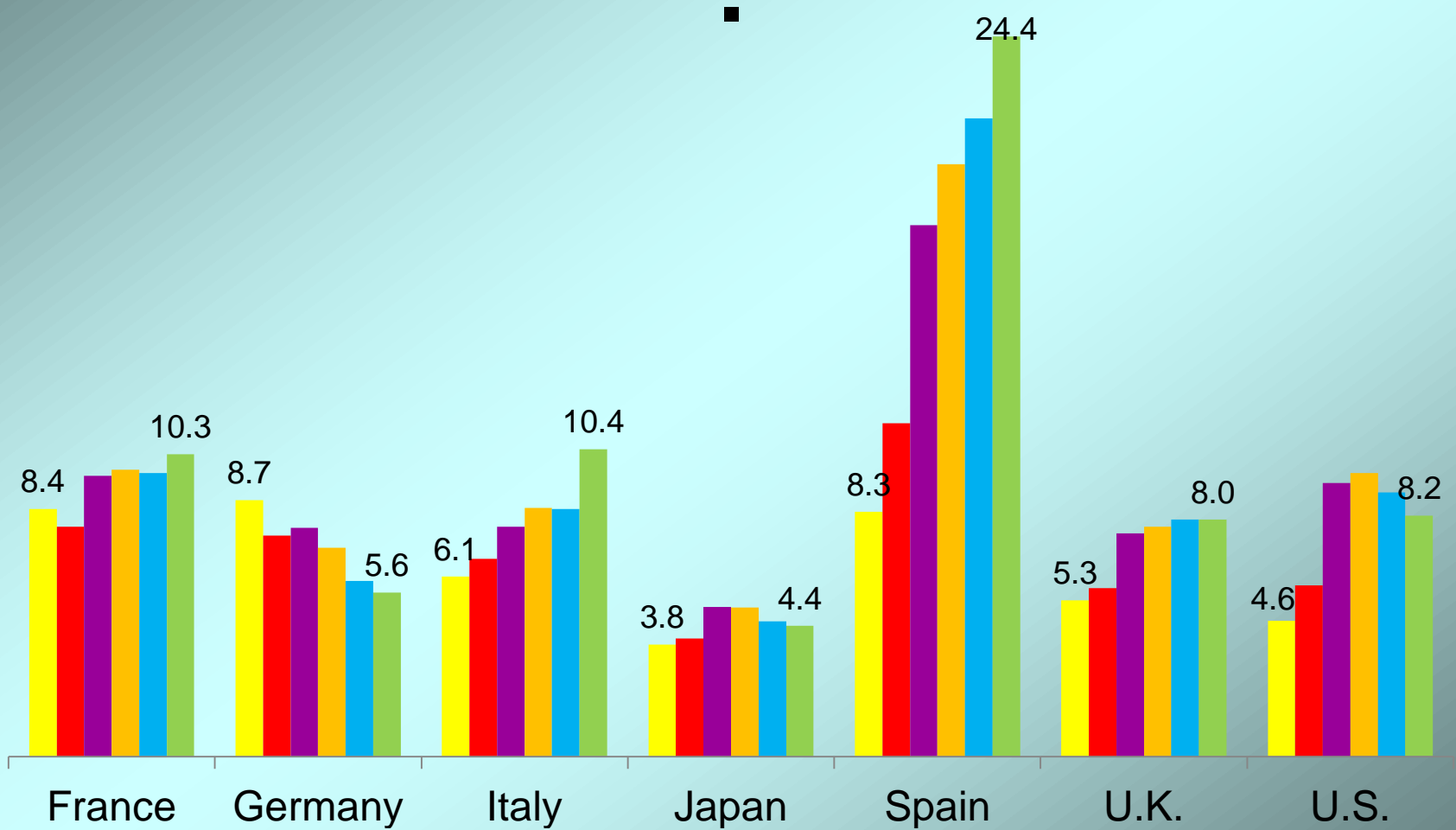
The Propagation of the Financial Crisis



GDP Growth and Unemployment Rate in the U.S.



Unemployment Rate in Selected Countries by Year



Increase in the Unemployment Rate: Policy Implications

Cyclical Factors

Need for a Stimulus

Structural Factors

More Difficult Correction

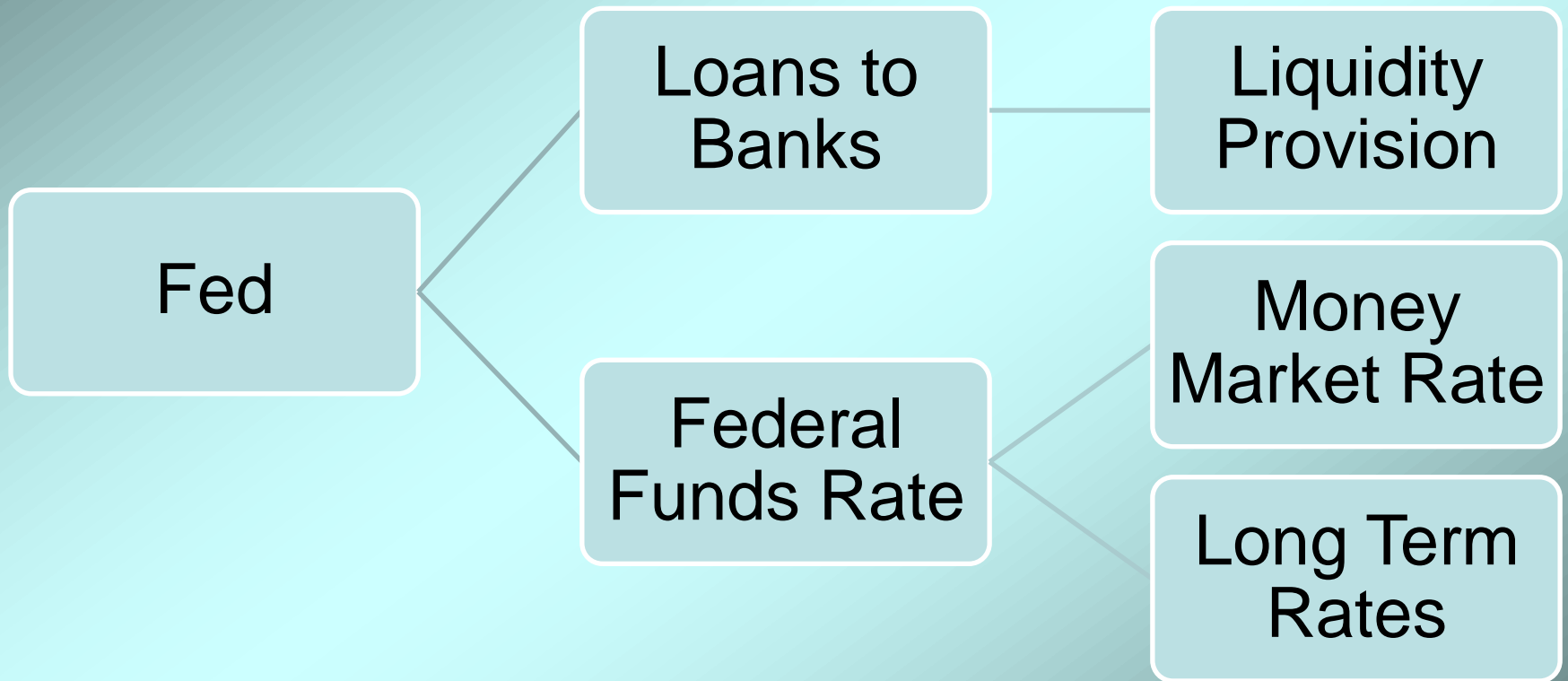
Monetary Policy Goals

**Stabilizing
Credit
Markets**

**Maintaining
The
Economy at
Full
Employment**

**Stabilizing
Output
Prices**

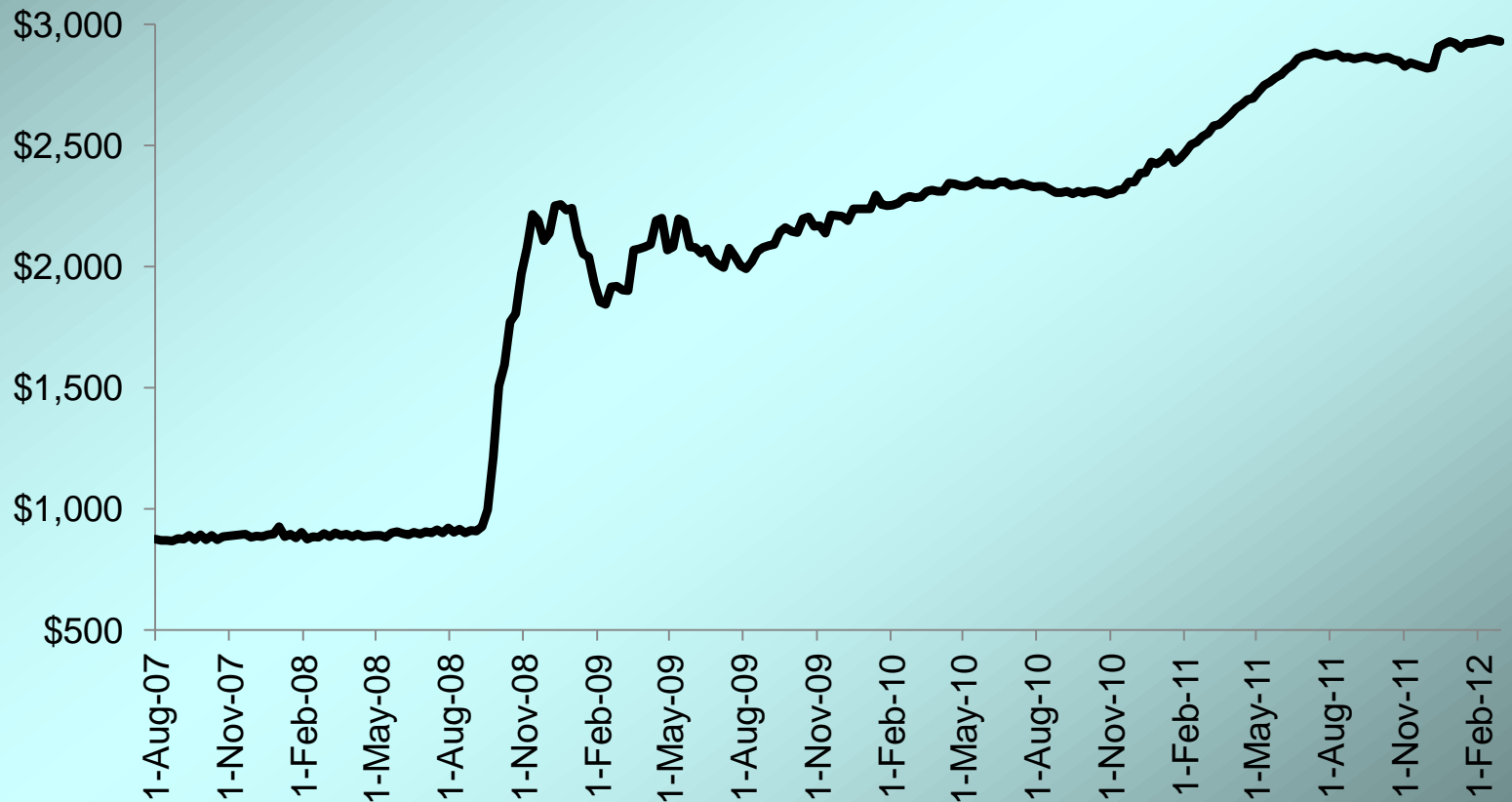
Conventional Monetary Policy Instrument



Monetary Stimulus in the U.S.

Fall 2008	Credit Easing
Fall 2010	Quantitative Easing 2
Summer 2011	Long Term Commitment to Keep Short Interest Rates at 0.25%
Fall 2011	Adjustment in the maturity of assets at the Fed
Summer 2012	Quantitative Easing 3

Assets at the Federal Reserve (billions of \$)



Monetary Policy Issues

Is a monetary stimulus needed?

Central Bank Independence

Selective Asset Purchases

Inflation Risk

Fiscal Policy Response

GOAL:

Stimulate Spending, GDP, and Employment

INSTRUMENTS:

Cut in Taxes and Increase in Government Spending

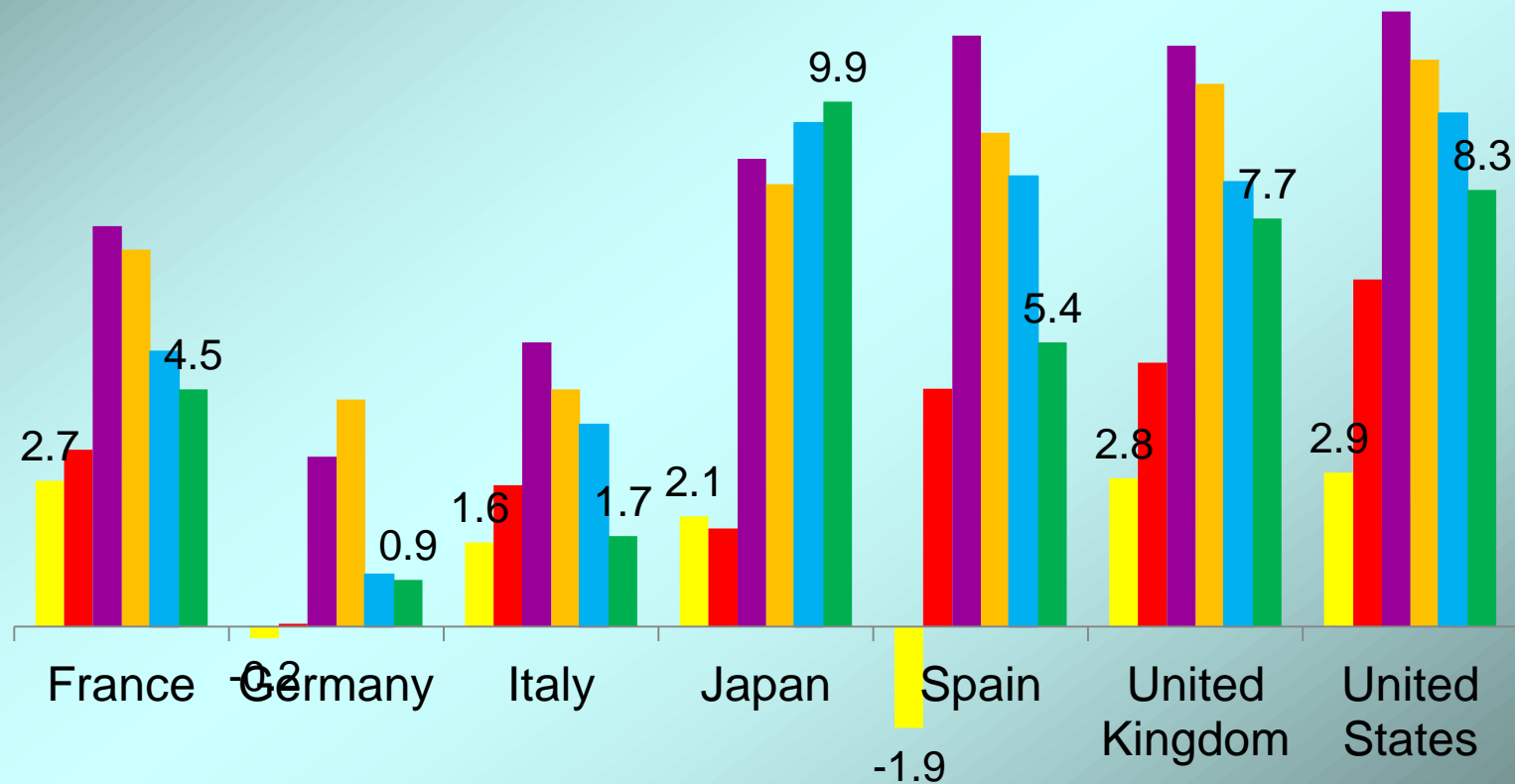
$$C\uparrow + I + G\uparrow + NX \rightarrow GDP\uparrow$$

DEBT CRISIS RISK:

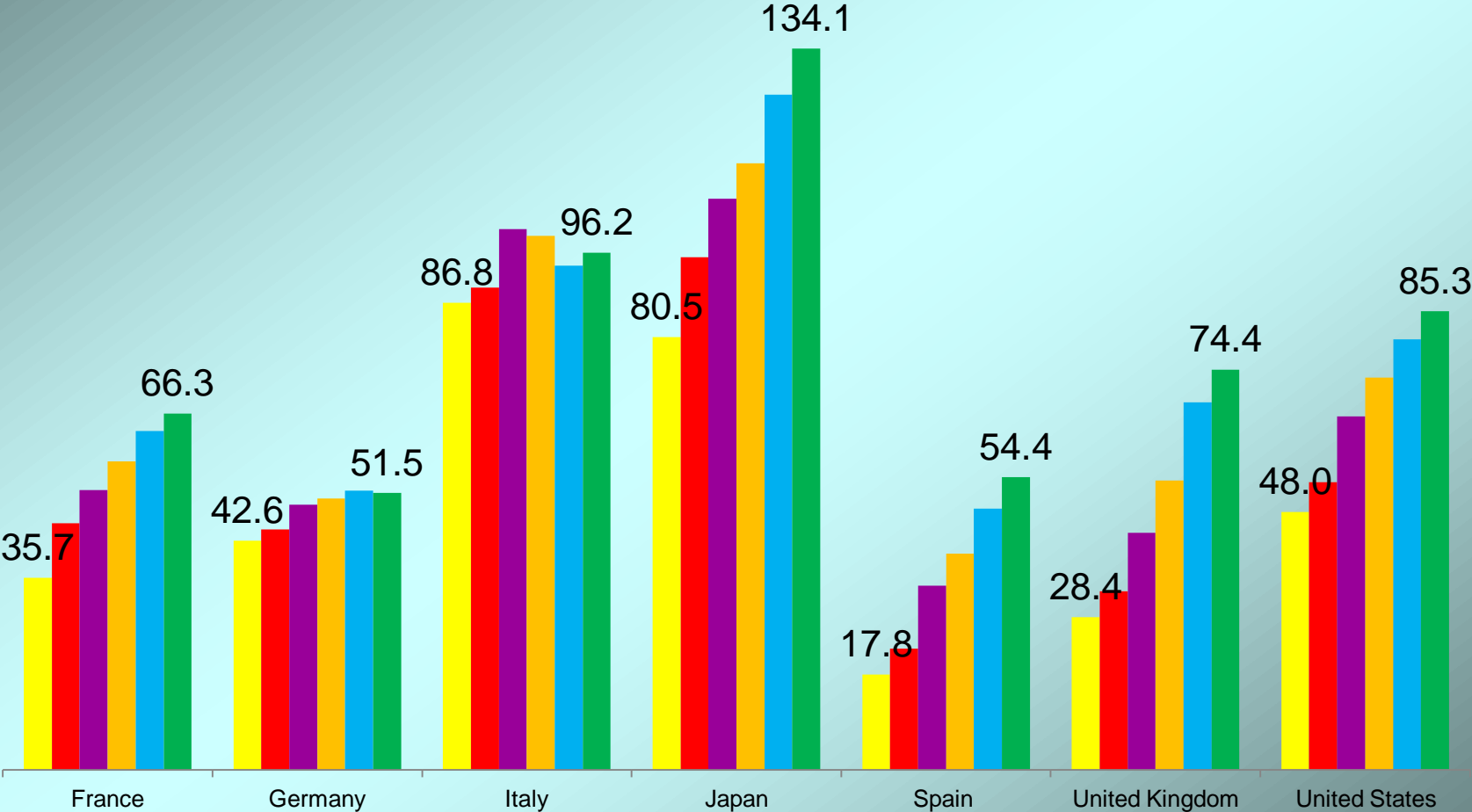
Deterioration of Government Finances: Increase in Government Deficits and in Government Debt
→ Increase in Government Borrowing Rates



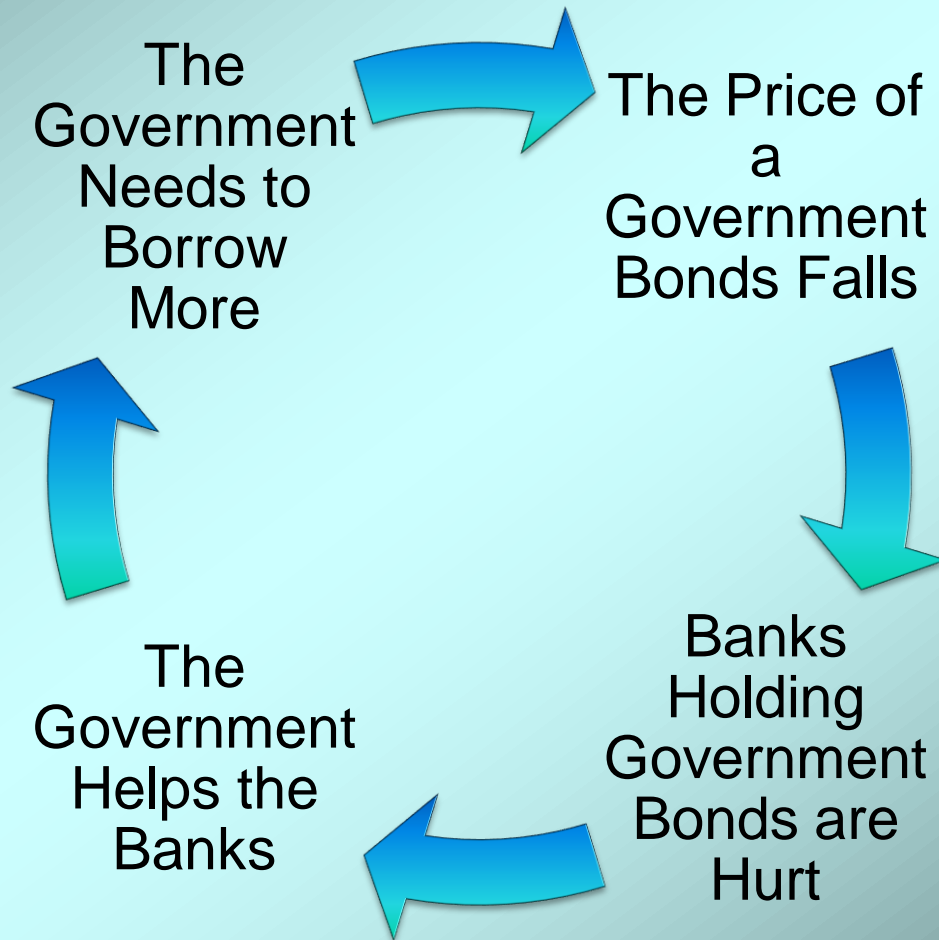
Government Deficit in Selected Countries by Year



Government Debt in Selected Countries by Year



From Government Debt to Banking Crises



The Effects of the Eurozone crisis on the U.S. economy

The contraction in economic activity in the Eurozone and a weaker euro would reduce the net exports in the U.S.

Instability in European financial markets may have a negative effects on all asset markets.

The instability in European asset markets has increased the appetite for U.S. assets, and caused a reduction in the borrowing conditions to Americans.

Fiscal Policy Challenges (1)



A fiscal correction would contract economic activity in the present, worsening the unemployment situation and even increasing the government default risk



The fiscal correction would cause an increase in saving, investment and future income



January 2013: The Fiscal Cliff in the U.S.

Expiration of the Bush tax cut

The Obama Social Security tax cut is bound to end

Several Unemployment benefit programs are expected to expire


Other spending cuts negotiated in the summer on 2011 when the U.S. government debt reached its legal upper bound



Fiscal Policy Challenges (2)

While government finances have to be brought under control, fiscal corrections needs to provide a transparent trajectory –with a contingency plan- for the tax increases and spending cuts over the years.

President Obama's Economic Plan

- 
- Increase in tax revenue from the expiration of Bush tax cut for higher-income households.
 - Gradual reduction in overall government spending
 - Composition of spending: Reduction in military spending and increase in infrastructure spending.
 - Medicare and Medicaid: lower payments to providers and higher premiums on higher income individuals
 - Increase the competitiveness of the U.S. economy

Rationale for President Obama's Proposal

An increase in the tax rate would directly stimulate saving.

The increase in saving would stimulate investment and increase the income available to future generations.

Concentrating the tax increase on higher-income individuals would reduce the extent of the decline in aggregate consumption and contain the contractionary effect of the fiscal correction.

An increase in exports would stimulate consumption, employment and national saving



Mitt Romney's Economic Proposal

- Reduce the Bush tax rates by 20%.
- Rapid reduction in overall government spending
- Composition of spending: reduction in nondefense items
- Medicare: option to buy private insurance
- Medicaid: delegating administration to individual states
- Promote free trade agreements

Rationale for Mitt Romney's Proposal

Cutting taxes would have a significant impact on the incentive to work, save and invest because markets would have fewer inefficiencies.

The lower tax rate would not cause a lower tax revenue because:

- i. There would be fewer tax deductions, and
- ii. The tax cut would stimulate GDP growth

Saving, Investment, Labor Supply and Demand are very responsive to price changes

Conclusion

The U.S. economy is recovering from the effects of the Financial Crisis.

The low interest rates at all maturities may indicate an effective monetary policy and the increase demand for U.S. assets from abroad

The U.S. economy faces important fiscal challenges.

Deficit reduction programs should provide credible trajectory with a predetermines contingency plan.

Export promotion would indeed stimulate growth, but it could also generate some trade frictions.

