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UNEMPLOYMENT WILL REMAIN VERY HIGH WITHOUT CONTINUED STRONG FISCAL STIMULUS POLICIES, NEW LEVY STUDY SAYS

ANNANDALE-ON-HUDSON, N.Y.—Though recent market activity and housing reports give some warrant for optimism, U.S. economic growth was only 2.8 percent last quarter and unemployment is still very high. A new study from The Levy Economics Institute of Bard College projects that high unemployment will continue to be a problem if fiscal stimulus policies expire and deficit reduction efforts become the policy focus. In their latest Strategic Analysis, Sustaining Recovery: Medium-term Prospects and Policies for the U.S. Economy, the Levy Institute’s Macro-Modeling Team—President Dimitri B. Papadimitriou and Research Scholars Greg Hannsgen and Gennaro Zezza—argues that continued fiscal stimulus policies are necessary to reduce unemployment. The resulting federal deficits are sustainable, the authors say, as long as they are accompanied by a coordinated and gradual devaluation of the dollar, especially against undervalued Asian currencies—a step necessary to prevent an increase in the current account deficit and ward off the risk of a currency crash.

In their analysis, Papadimitriou, Hannsgen, and Zezza explore three scenarios for the U.S. economy in the medium term, through 2015. In their baseline, they assume April 2009 IMF GDP projections for American trading partners, showing output growth returning to trend in 2011. Further, they assume that net household borrowing will remain negative but increase as a percentage of GDP until 2013, and that the federal government will curtail its fiscal stimulus, with the government deficit dropping gradually to around 3 percent by the end of the simulation period. In this scenario, which the authors assert will lead to a “growth recession,” real GDP growth resumes but remains sluggish, staying well below the rate required to drive unemployment significantly below 10 percent. All financial balances converge to zero by the end of the simulation period, and government deficits

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increase the stock of government debt from 61 to 91 percent of GDP, a rise the authors determine is sustainable provided interest rates remain at current levels. In a second scenario, the authors assume the baseline assumptions but with a continuation of fiscal stimulus policies, including the Bush tax cuts. This scenario shows unemployment falling below 7 percent by the end of 2015 and GDP growth rates averaging above 3 percent but with rising government debt and an expansion of the current account deficit from 2.6 to 4.1 percent of GDP. Their next scenario takes on the assumptions of the last, except that the federal government tightens fiscal policy more slowly and manages to achieve a gradual dollar devaluation. Here, the authors find unemployment falling in line with the previous scenario, government deficits declining faster, and the adverse effects of faster domestic growth on the current account deficit now countered by growth in net exports.

The Levy team asserts that “a modest dollar devaluation could prove to be a very effective pro-employment policy, while at the same time directly addressing the medium-term threat posed by large imbalances.” However, they warn that the devaluation should be controlled and brought about by a multilateral agreement with the central banks of major surplus countries, particularly in East Asia. “Failure to deal with the overvaluation of the dollar could lead to adverse consequences beyond those mentioned in the … scenarios above,” they write. “In one plausible scenario that we have not formally modeled, investors might sell U.S. Treasury securities en masse, leading to a sudden collapse of the dollar. In turn, a flight from the dollar might bring a large increase in U.S. interest rates, reverse the economy's path toward sustainable sectoral balances, and bring back financial fragility.”

The authors therefore conclude that federal deficits are not only sustainable, provided current low interest rates continue, but also necessary to create growth significant enough to reduce unemployment. Furthermore, a controlled dollar devaluation is necessary to achieve sustainable growth—an effort the authors admit comes with considerable political challenges. “President Obama’s recent public disagreement with President Hu Jintao of China over a possible revaluation of the renminbi underscores the challenge of a multilateral approach to currency adjustments and shows that much work remains to be done at an international level to achieve sustainable growth.”

### Strategic Analysis: Sustaining Recovery: Medium-term Prospects and Policies for the U.S. Economy

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