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CBO Projects More Severe Downturn

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CBO Projects Long and Costly Recession

The new economic projections from the Congressional Budget Office[1] show the economy remaining well below its potential level of output until 2014. The projections show the unemployment rate averaging 10.2 percent in 2010 and gradually edging down to the long-term sustainable rate of 4.8 percent by 2014. Over this 4 year period, the workforce will face a substantially higher risk of unemployment or underemployment due to insufficient demand in the economy. This paper highlights some of the main implications of CBO's new economic projections.

Excess Unemployment

CBO substantially increased their projections of unemployment from their January Economic Outlook. It is now projecting that unemployment in 2010 will average 10.2 percent. The unemployment rate is projected to decline gradually towards the 4.8 percent level that CBO considers the long-term sustainable rate. The unemployment rate for 2012, when President Obama will presumably be running for re-election, is projected to be 7.7 percent. CBO does not project that the unemployment rate will return to its long-term level until 2014, as shown in **Figure 1** below.

The Unemployed and Under-Employed

CBO's projection of a long period of high unemployment implies that millions of people who want to work will be unable to find jobs. In addition to the number of people who are unemployed, there will also be a large number of people who want full-time work but who can only find part-time jobs.

Figure 2 below shows the additional number of workers that CBO projects will be unemployed in the years 2009-2014 due to the recession. It also shows the number of additional people who desire full-time work but who will only be able to find part-time employment.[2] The CBO projections imply that, due to the recession, nearly 8 million additional people will be unemployed and 4 million underemployed in 2010. Many of the unemployed workers will have exhausted their unemployment benefits, which in some states do not go beyond 52 weeks, even with the recent extension of benefits.

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FIGURE 1
CBO Projections of Unemployment and the Sustainable Unemployment Rate 2009-2014

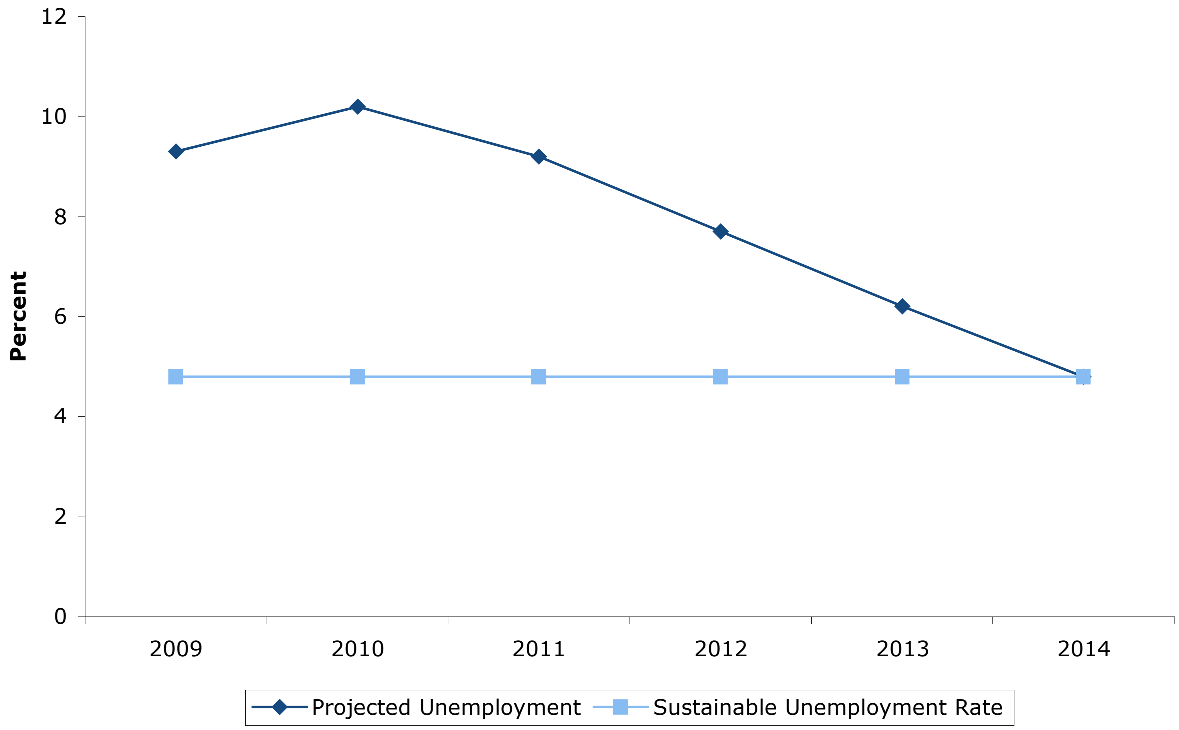
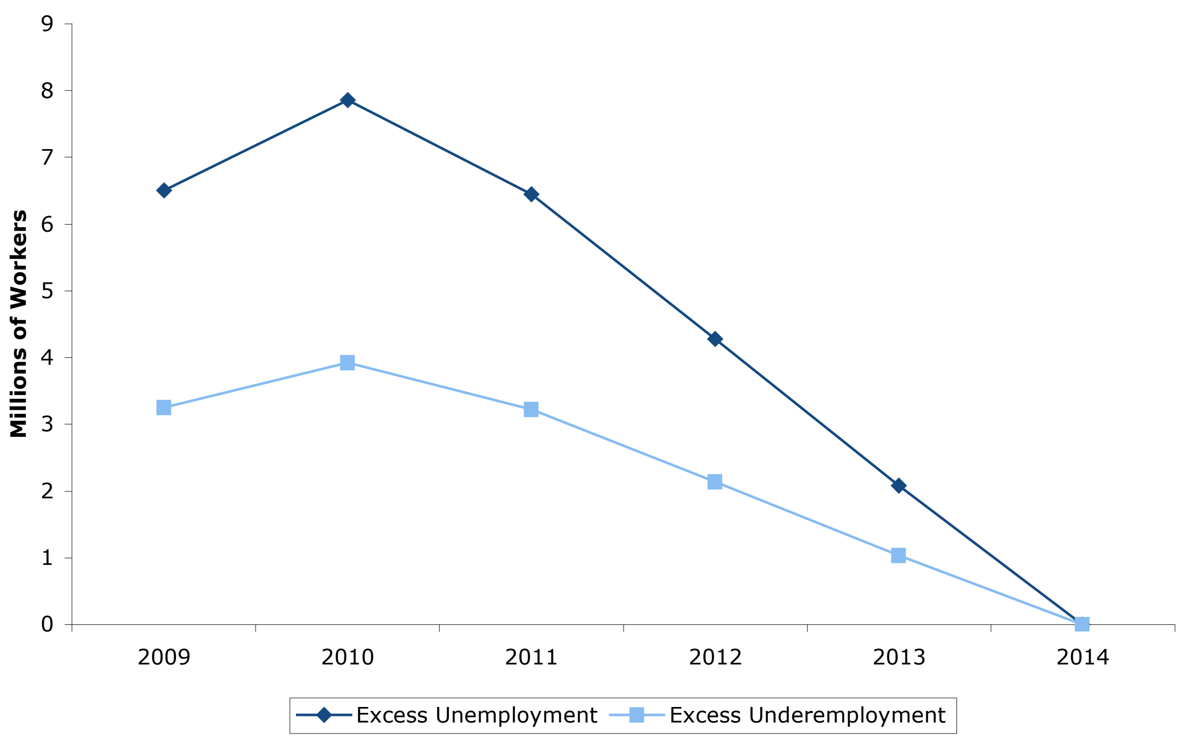


FIGURE 2
Number of Additional Workers Unemployed or Underemployed Due to Recession

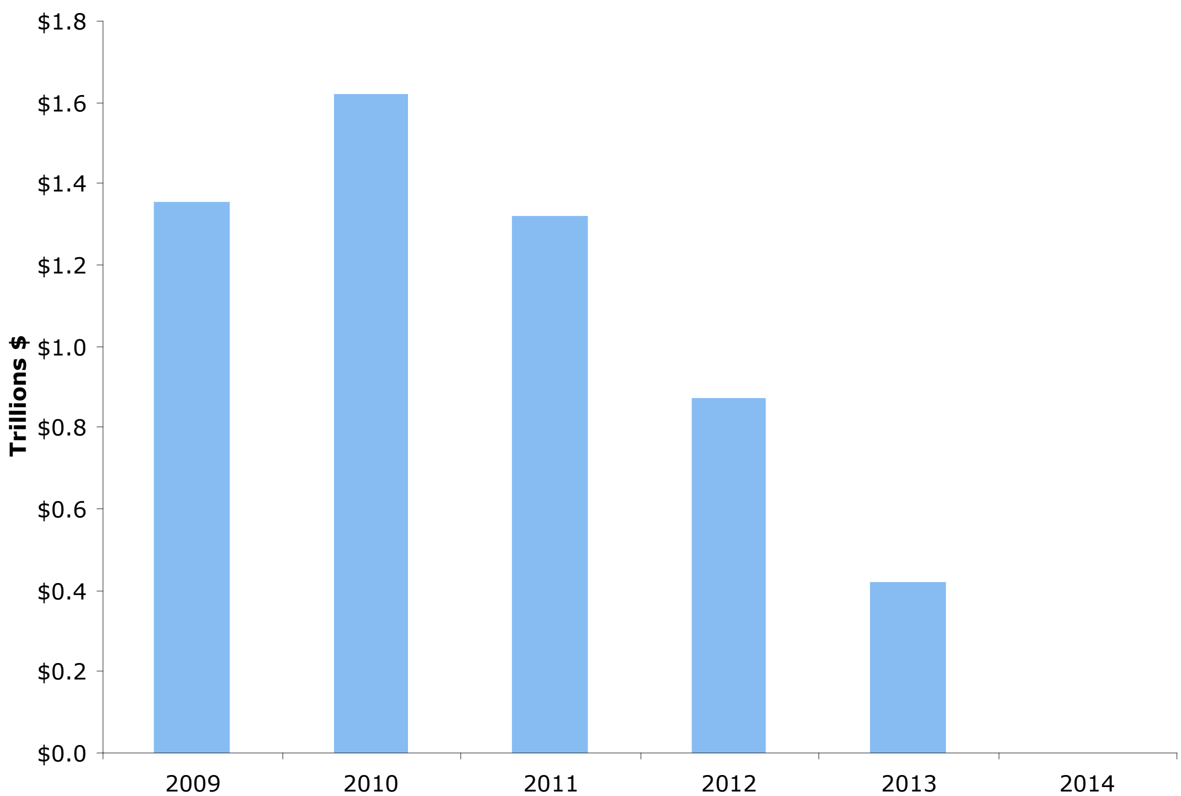


The Loss in Output Due to the Recession

Okun's law, a rule of thumb relating changes in unemployment and GDP, holds that a 1 percentage point increase in unemployment implies a 2 percentage point reduction in GDP. Using this ratio, it is possible to calculate the annual loss of output implied by the CBO unemployment numbers.

Figure 3 shows the annual loss in output associated with the unemployment rate projected by CBO. The loss peaks at more than $1.6 trillion in 2010.

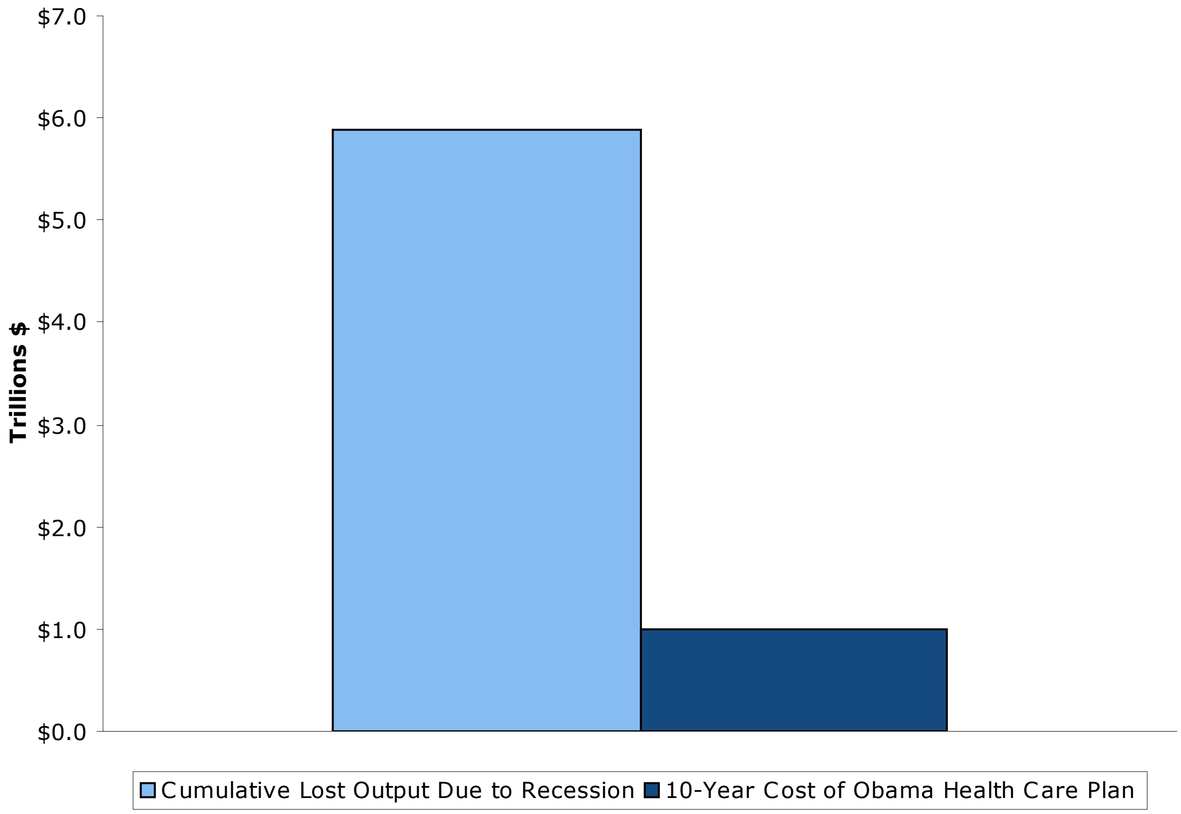
FIGURE 3
Lost Output Due to the Recession 2008-2014



The Loss in Output and the Cost of President Obama's Health Care Plan

It is useful to put the loss of output implied by CBO's projections in some context in order to better assess its importance. **Figure 4** shows the cumulative loss of output from the recession based on CBO's projected unemployment rates, including the output lost in 2008. The projected cumulative loss is $5.9 trillion. By comparison, President Obama's health care plan is projected to cost $1 trillion over the next decade.

FIGURE 4
Comparison of Lost Output Due to the Recession and the Cost of the Obama Health Care Plan

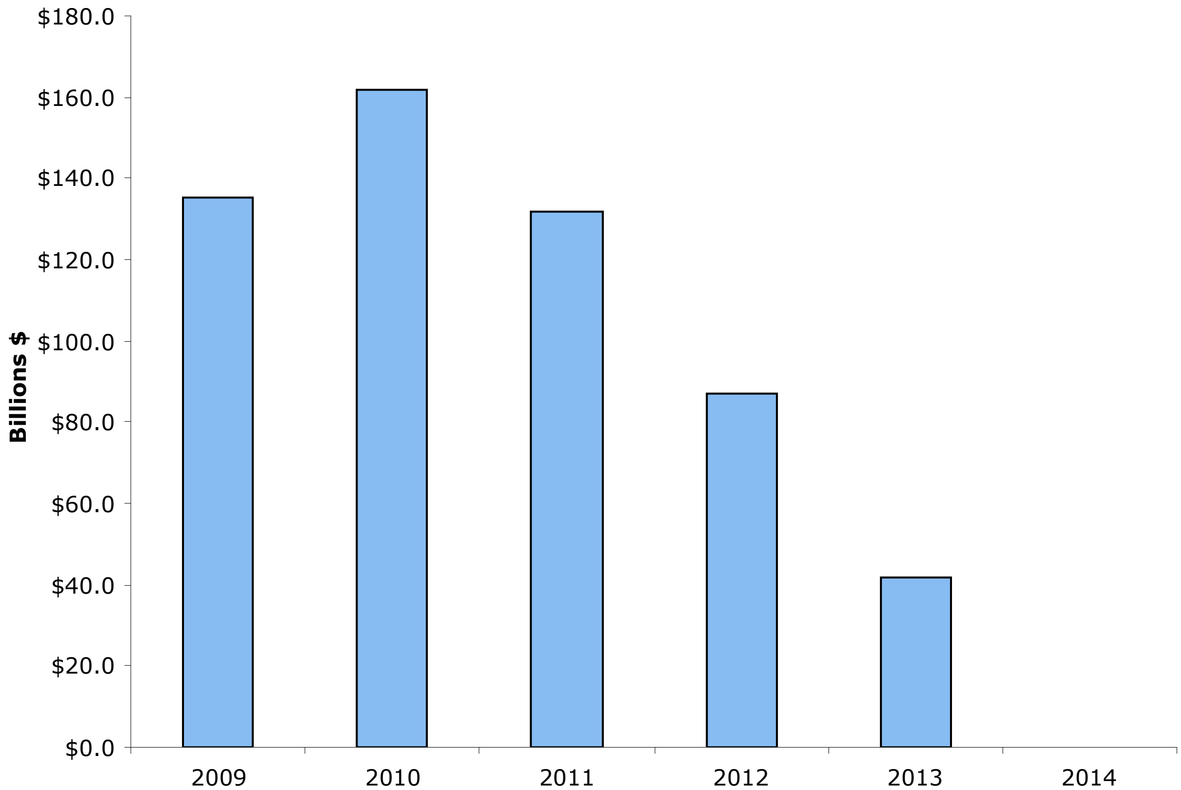


The Investment Lost Due to the Recession

Most of the loss of output will take the form of reduced consumption. However, investment has also fallen sharply in this downturn, even more so than in most recessions. By the second quarter of 2009, real non-residential investment was down by 19.6 percent from its peak in the second quarter of 2008. An important determinant of investment is the rate of growth of sales as well as current profits. If the economy remains depressed, then investment will be lower than it would be if the economy were at full employment due to the fact that both sales growth and profits will be much lower. This lost investment means that we will have a smaller capital stock. A smaller capital stock will make workers less productive in the future and the economy will be poorer as a result.

Figure 5 shows the lost investment from 2009 through 2014, under the assumption that the falloff in investment is equal to 10 percent of the falloff in GDP. This assumption implies that the loss of annual investment will peak in 2010 at more than $160 billion. The cumulative loss of investment as a result of the downturn will be almost $600 billion. This means that the country will have $600 billion less in plant, equipment, and software as a result of this downturn compared with a situation in which the economy had sustained a high level of employment.

FIGURE 5
Lost Investment Due to the Recession 2009-2014



These new projections from CBO suggest that the downturn will be far more severe and prolonged than in its projections from January. The projection of a more severe downturn should draw considerable attention from the Obama administration and Congress. It implies a much more dire situation than the one envisioned when the stimulus package was crafted in February. Presumably, the President and Congress will want to adjust their policy in light of the new information in this report.

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[1] Congressional Budget Office, The Budget and Economic Outlook: An Update, August 2009. All data in this issue brief refers to this report, available at http://cbo.gov/doc.cfm?index=10521.

[2] The calculation shown in Figure 2 assumes that the number of involuntary part-time workers is equal to half of the number of unemployed workers. The growth in involuntary part-time employment has been a bit more than half of the increase in unemployment during the downturn.