THE ECONOMY: WHERE ARE WE AND WHAT SHOULD WE DO?

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League of Women Voters Annual Community Luncheon
August 18, 2011

Thank you very much for inviting me to join you today. Both my mother and my mother-in-law were very active in the League of Women Voters. So my husband and I both learned from a young age that the League was the place you turned to for sensible, carefully researched information about issues. It is a special honor to be asked to speak at the League community luncheon.

Originally, I was going to talk about some key economic policy decisions during the first two years of the Obama administration. But after the dramatic economic events of the past few weeks—the debt downgrade, the crash of the stock market—that just didn't seem appropriate. It felt a little like reliving some of the battles of World War I the day after the attack on Pearl Harbor.

Instead, I thought I would talk about what is going on in the economy today and what policymakers might do about it. How do we make sense of the roller-coaster ride that stock prices have been taking recently and the flood of worrisome economic news? Is there anything the President and Congress could do to help the situation? In the process, I will try to give you a feel for what working in the White House is like and some sense of the tremendous challenges that policymakers face going forward.

I. WHAT IS GOING ON IN THE ECONOMY?

I won't rehash the whole story of what started the Great Recession and what the government did to try to cure it. I think most people are well aware that the bubble and bust of house prices back in 2008 set off two dangerous developments: a collapse of consumer spending and a loss of confidence in our financial system. This toxic combination caused the American economy to go into freefall following the collapse of Lehman Brothers—and to bring down much of the rest of the world right along with us.

The Federal Reserve and both the Bush and the Obama Administrations took a number of actions to try to contain the crisis. The Fed did everything it could think of to keep credit flowing and banks from collapsing. When they couldn't hold things together, Republicans and Democrats came together and passed the TARP legislation to stabilize the banking system. The Obama Administration spearheaded passage of the Recovery Act, which was the largest countercyclical fiscal stimulus in American history.

For a while, it looked as though that policy response was working pretty well. After plummeting at the end of 2008 and the first quarter of 2009, the U.S. economy stabilized. GDP stopped falling and started to grow again. Employment continued to fall a while longer—but by November 2009, it looked like the tide was turning.

One of the jobs of the Chair of the Council of Economic Advisers is to get all of the economic statistics the night before they are released to the public. I was supposed to let the Fed chairman and the Treasury secretary know if the numbers might cause a meltdown on Wall Street. I also briefed the President on the data. I would often walk over to the Oval Office on the afternoon of an important data release.

Well, when I got the November 2009 employment numbers, they were much better than expected. Rather than falling by about 100,000 as analysts had anticipated, employment had held even that month. When I told the President, he was so relieved that I got four hugs and a kiss. The numbers came out in early December, just after the Christmas decorations had gone up in the White House. My favorite photo is of the two of us standing in front of the Christmas tree in the Oval Office, celebrating this one piece of unexpected good news.

Unfortunately, the recovery never really built up a head of steam. We kept growing, but at a pretty anemic pace. We never had the truly robust growth that an economy needs to bring the unemployment rate down substantially.

Some of this slow recovery is clearly due to the special nature of this recession. The combination of a credit boom followed by a collapse of house and stock prices left consumers in a terrible position. They have too much debt and not enough equity. As a result, consumers have been very slow to start spending again and businesses have been similarly cautious.

We were limping along, but at least things were pretty calm until early this year. Then, a number of things went wrong. Most obviously, Europe continued to have lots of trouble with sovereign debt. Way back in the spring of 2010, investors woke up to the fact that Greece, Ireland, and Portugal had borrowed more than they may be able to repay. Ever since, European leaders have been struggling to figure out a way to deal with this problem and to prevent concern from spreading to the bigger troubled economies of Europe, such as Spain and Italy. It is fair to say that they have not yet figured out a solution.

Fear of what may happen is taking a toll on European growth and causing great financial market volatility. Added to this were a number of smaller shocks to the U.S. and world economy, such as the earthquake in Japan and rising oil prices.

Then, on top of all of this, we just had a bruising fight over raising the debt ceiling. We have a funny system here in the United States. Congress has to vote on any Federal deficit not once, but twice: once when they approve the budget for the year;

then again when they authorize the government to borrow enough to cover any deficit. It is as if they vote first to charge things to the country's credit card, and then they vote on whether to pay the bill.

Congress and the Administration just had a terrible fight about paying the bill. The result of that fight was that the United States came painfully close to defaulting on its government debt for the first time in history. The ultimate agreement had less deficit reduction than experts think will be necessary over time. (I'll talk more about that in a minute.) And the negotiations were obviously very acrimonious.

In response to these developments, one of the big ratings agencies, Standard and Poor's, downgraded U.S. government debt—from triple A to the next lower step. That move didn't have any practical consequences. But when it happened, the stock market went into a tailspin.

So where we are right now is frankly pretty scary. Our GDP numbers show that output has increased by less than 1% (at an annual rate) since the beginning of the year. To put that number in perspective, normal growth is about 2½%. Good growth coming out of a recession this large is closer to 5%. So less than 1% is a pretty wretched number. With growth this low, it wouldn't take much for it to slip into negative territory again.

Likewise, our job creation numbers have been very worrisome. We have been adding less than 100,000 jobs a month—which is the number we need just to keep up with the normal growth of the labor force. The unemployment rate has drifted up again and is back over 9%.

And, a lot of forward-looking indicators are doing poorly. For example, consumer confidence, a key determinant of spending, is now lower than it was following the collapse of Lehman Brothers.

And just to add insult to injury, our financial markets are jumpy as can be. That is exactly the situation where trouble in Europe or another shock of some sort can set off another financial crisis.

II. WHAT SHOULD WE DO ABOUT THE ECONOMIC SITUATION?

That's the gloomy part of my talk this afternoon. I don't want to ruin your lunch, so let me turn to the more positive part. What can we do about our economic mess? Here I can't help but give my own take on things—I have strong views on what policies I think would be desirable. But I will try to give you my reasoning, so you can judge for yourself if you think my proposals make sense.

As I see it, we have two large economic problems. Obviously, we have an immediate jobs crisis. Fourteen million Americans are unemployed. More than six million of them have been out of work for more than six months. The numbers are even more distressing if you take into account all of the people who are working part-time because they can't find a full-time job. Or, the people who are so discouraged about the chance of finding a job that they aren't even looking for work even more. Widespread unemployment is a human and economic crisis that simply has to be faced.

Our other major economic problem is less immediate but also incredibly important—the budget deficit. I say it is a less immediate crisis because the current deficit is really not the problem. The deficit is large today, about 10% of a year's GDP, but that is largely because of high unemployment. When so many people are unemployed, tax revenues are down and deficits are up. Experts expect the deficit to shrink substantially as the economy recovers. And, despite all the uproar over the debt downgrade, the U.S. government is actually still viewed by financial markets as just about the safest place to invest. Interest rates on our 30-year government bonds remain at historic lows.

Our true deficit problem is much more long-term. Our spending is projected to rise substantially over the next two or three decades because of the retirement of the baby-boom generation and rising health care costs. As a result, by 2035, even at full employment, the Federal deficit is projected to be almost 16% of a year's GDP, and on the way to even higher numbers. Now these are truly terrifying projections. No country has ever run deficits like that year after year and remained solvent.

Of course, we have other economic problems besides jobs and the deficit. But my strong belief is that if we can deal with these two fundamental problems, we will be in a good position to face all of the other challenges that come our way.

So how do we deal with them?

The first step is to acknowledge that both are important. For the last couple of years, policymakers seem to be switching from one to the other. After a bad economic report, everyone talks about jobs. Then, all of the discussion switches to the deficit.

We had some very robust arguments when I was in the White House about which problem was more important. Now sometimes the discussions could get so frank and freewheeling that it was easy to forget that one of the participants was the leader of the free world. This led to one of my most embarrassing moments in the White House.

During one of these discussions, the President repeated someone else's argument that given how large the unemployment problem still was and how limited the resources were likely to be, perhaps there was no point in pushing for more stimulus. Without thinking I shot back, "That is oh so wrong!" The president raised an eyebrow and said good-naturedly, "It is not only wrong, it's 'oh so wrong'?" I had clearly crossed a line.

The right answer is that it's not either/or—it's both. We need an integrated strategy that deals with both problems as part of a single package. To continue my World War II analogy from earlier, we need a two-pronged attack.

First, on the jobs front. As I have described our current jobs situation, the main problem we face is too little demand. Families and businesses are not buying enough goods and services to get American companies back to producing at full capacity. If firms aren't operating at full capacity, they aren't going to be rehiring unemployed workers. So, we need to get demand up.

Republicans will say that the key thing is to pass some pending free trade agreements and lower the regulatory burden on businesses. You may be surprised to hear that I don't disagree with either of those moves. Both would be helpful. The free trade agreements, especially the one with South Korea, could help expand our exports and so get demand up that way. And getting rid of unneeded regulations would help businesses trim costs and sell more.

Unfortunately, neither of these measures is likely to be anywhere near big enough to deal with the huge shortfall of demand that we face. That is why I have been encouraging the President and Congress to take substantial additional fiscal actions.

These days, the term "fiscal stimulus" is almost dirty word in Washington. Republicans have portrayed the Recovery Act as $787 billion dollars of pork that didn't do anything. The White House seems to be afraid to suggest more stimulus because they say the American people don't think it worked.

Now I understand why the American people may feel that way: we did a big stimulus and the economy is still very weak. But I think it is incredibly important to explain that it was actually very useful. Let me give you a medical analogy. Suppose a patient has been in a terrible accident and has massive internal bleeding. After life-saving surgery to stop the bleeding, the patient is likely to still feel pretty awful and will have a long way to go before he is fully healed. But that doesn't mean the surgery didn't work. You have to judge the effect of the surgery relative to what otherwise would have happened. Without surgery, the patient would have died.

Well, the same is true of the economy back in 2008 and 2009. We were on a horrible downward trajectory—losing more than ¾ of a million jobs each month. The Recovery Act helped to stop the bleeding. But it wasn't large enough or long-lasting enough to return the economy to full health.

This view that the Recovery Act was helpful has been backed up by a number of recent studies. There is a boom industry of economists testing the effects of fiscal stimulus in general and the Recovery Act in particular. Virtually all of these studies are finding a substantial impact of tax cuts and increases in government spending on employment and output.

To my mind, the right thing to do is to learn from the Recovery Act, and to do more of the things that worked best. For example, aid to state and local governments was one of the most effective components of the Act. The recession has taken a terrible toll on state revenues. The Recovery Act gave about $130 billion to state and local governments. States used this money to continue providing services and to keep teachers, firefighters, and other key state and local workers employed. That money has now run out and we see states laying off tens of thousands of workers. More of this funding would have immediate job creation benefits.

I would be a big fan of a large tax cut for firms that hire unemployed workers. We have all heard that businesses are sitting on lots of cash these days, so I don't see any reason to just give them another tax cut that they might sit on as well. But, suppose we said if you hire an unemployed worker, you don't have to pay your side of the payroll tax for two years. That is a tax cut for businesses that encourages them to do exactly what we want them to do—hire people.

Such a new jobs tax credit is something that I argued for when I was in the White House. That policy debate provides a great window into policymaking in the Obama Administration. The President and Larry Summers, the head of the National Economic Council, were both somewhat skeptical of the idea. To answer their concerns, economists at the Council of Economic Advisers obtained lots of data on the fraction of firms that might be eligible and ran detailed computer simulations. We estimated that such a credit could have a very high bang for the buck.

Economists at the Treasury Department worked with outside experts to survey a representative sample of human resource managers, the people who actually make hiring decisions, to see how many thought their companies would respond to a new jobs tax credit. A surprisingly large fraction said it would affect their hiring behavior.

In the end, because of the evidence, the President endorsed this measure and a version of the tax credit was passed in the HIRE act. Unfortunately, it was quite small and pretty complex. But a simpler, larger version could build on what is there and would increase hiring substantially.

Another useful job creation measure would be a significant infrastructure spending program. We all know that our roads, bridges, and airports need a lot of maintenance. The Recovery Act made a great start in this area—I smile every time I go through the Caldecott Tunnel and see the big Recovery Act sign outside the construction site for the 4th bore.

Actually, I also smile because I remember how one of my young staff members saved the Vice President from making an embarrassing mistake. The CEA staff checks every speech the President or Vice President makes for errors on economic facts. In one draft, the Vice President's speechwriters had said the Caldecott Tunnel went under San Francisco Bay.

But we could do a lot more infrastructure spending. Such spending would not only have immediate job creation benefits, it would also leave us with something enduring. We would be more productive in the future because we would have a 21st century transportation and communication system.

The bottom line is that substantially more short-run fiscal stimulus is the best hope we have of putting a lot of people back to work quickly. Given how many people are unemployed, we need another significant dose of this effective medicine.

But how do we reconcile this prescription with the fact that we have a terrible long-run deficit problem? Well, that is where the second prong of the two-pronged attack comes in. We not only need bold action for dealing with jobs today, we need more serious deficit reduction over the longer term.

As I mentioned, the current deficit is not the big problem. What worries experts are the projected deficits 20 and 30 years out. So we don't have to reduce the deficit immediately. In fact, we can increase it temporarily, as we need to, to help create jobs. But to reassure financial markets (and ourselves) that we will be solvent over the long haul, we need to pass a plan as soon as possible for reducing the deficit gradually over time. We should phase in the necessary spending cuts and revenue increases as the economy recovers.

Now, we made some progress on the long-run deficit during the debate over the debt ceiling. Congress and the President agreed to cut spending by about $2 trillion over the next 10 years. That is certainly a significant amount of deficit reduction. The problem is, it is not enough. Even twice that amount would not be enough to truly solve our long-run problem—but it would make a good dent.

So, how do we make more progress on the deficit reduction front?

A key fact is that we probably can't do much more through further cuts in non-defense discretionary spending. Discretionary spending is the spending that gets decided each year. Non-defense discretionary spending is only about 15% of the total budget. It includes things like education, homeland security, and funding for medical research. We have already agreed to cut this part of the budget very substantially. We might be able to trim it a bit more, but it would be hard to go much further without damaging essential services, like border patrols, air-traffic controllers, and food-safety inspections.

The main spending that is projected to rise substantially is entitlement spending. That is spending on Medicare, Medicaid, and Social Security. This spending increase is due primarily to rising health care spending per person. We just keep coming up with new technologies and new ways of treating diseases. This is adding dramatically to costs every year. Government spending on health care is rising so rapidly that most experts think that it will be nearly impossible to deal with our long-run deficit without slowing it down. That is just another way of saying that entitlement reform has to be part of any realistic package.

How much we have to slow the growth of entitlement spending depends on how much we are willing to raise taxes. If the American people don't want to slow entitlement spending growth very much, we will need to raise revenues substantially. If they are willing to slow spending substantially, we won't have to raise taxes as much. The only thing that isn't an option is to let benefits keep growing rapidly but not pay for them.

Fortunately, a number of bipartisan commissions have come up with sensible plans for raising tax revenues in a way that also simplifies the tax system and improves incentives. The Commission chaired by Alan Simpson and Erskine Bowles, for example, recommended cutting a number of tax deductions and loopholes. They want to use some of the revenue this raises to lower the deficit and some to lower tax rates, so people have stronger incentives to work and start businesses.

Right now neither entitlement reform nor tax increases are seriously on the table. But they both have to be. The long-run deficit is a big problem; and big problems require big solutions.

III. HOW LIKELY ARE WE TO PASS SUCH A BOLD PLAN?

I have just sketched out a battle plan that I think would work. It has more short-run spending and tax cuts to try to get people back to work. And much more aggressive phased-in deficit reduction as the economy recovers. Does such a plan have a prayer of passing?

One thing I know is that it has no chance if nobody proposes it. If we keep saying the right plan will never pass, so we shouldn't fight for it—I guarantee it will never happen.

One of the things I used to love about working in the White House was the way the President always wanted to know what the best policy was, not just what was politically feasible. He'd to say, "Tell me what's right and I'll figure out how to sell it."

I think those words are especially appropriate now. The President should start with the best plan possible, and then see if he can convince the American people this is the right course. Just yesterday there were tantalizing hints coming out of the White House that he may do just that. The President has scheduled a major speech on the economy for early September.

Another thing I learned in Washington is how quickly political calculations can change. Just because something looks hopeless at the moment, doesn't mean it will never happen.

I will give you an example from early in 2010. As the recovery was faltering after the meltdown in Greece, I was urging that we support the economy by giving more money to struggling state and local governments. Rahm Emmanuel, the President's chief of staff at the time, who is highly regarded as a political strategist, told me in no uncertain terms that I must be smoking something. No way was Congress ever going to give more money to state governments.

Well, then in the summer of 2010, towns started having to lay off thousands of teachers for the coming school year. Low and behold, the political calculation changed. Even voters who don't like government spending in general, hate to see their children's dedicated teachers being laid off. Just before I left DC, I attended the signing for a bill that gave another $26 billion to local governments to keep teachers off the unemployment rolls and in the classroom.

So, it may look hopeless now for a grand bargain that creates jobs and really deals with our long-run deficit, but that could change. Another few weeks of stock market gyrations like we have just been through and the cry for a comprehensive plan may become deafening. Or, God forbid, if we start to actually lose jobs again instead of adding a small number each month, partisan wrangling could give way very quickly to a search for meaningful solutions.

The other reason to begin pushing for the big solutions now, is that the American people need to be informed and convinced. We face very big problems and very big choices. The American people have to decide if they want aggressive programs to create jobs now or if think it is best to wait for economy to heal itself. They have to decide how big a government they want and what they are willing to pay for.

Such big decisions should not just be imposed on people—they should be involved every step of the way. They deserve to be treated the way the League of Women Voters treats them: giving them honest information; earning their support with good evidence and forthright discussions.

IV. CONCLUSION

Early on, I got pegged as the optimistic member of the economics team. I still haven't forgiven the *San Francisco Chronicle* for toping and otherwise very nice profile with the headline "Obama's Sunny Economic Forecaster." Personally, I just think anyone looks cheerful next to Larry Summers.

It's not that I don't see the difficulties that lie ahead—of course I do. I have talked about many of them today. It is that I have great faith in the ability of sensible policy to help deal with those difficulties. And great faith that our political leaders, despite their many differences, can find a way to do what needs to be done for the country.

Dealing with both unemployment and the deficit will be an economic and political challenge that tests even my optimism. Policymakers are going to have to sacrifice their short-run political interests for the long-run good of the country.

The only thing that gives me hope is that the stakes are so large. Throughout our history, policymakers have stepped up when they had to. This is another one of those times. Let's pray that our political leaders rise to the challenge once again.