

Finishing the Job: The Policies Needed to Ensure Full Recovery and Fiscal Stability in the United States

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My life as a policymaker began the Monday before Thanksgiving in 2008 when President-Elect Obama announced his economic team. By the following Monday, we were all in Washington formulating the recovery policies. I vividly remember the Friday of that first week in December: the employment report for November was released showing that we had lost more than half a million jobs. It was clear that what might have been an ordinary recession a few months earlier was taking on ominous proportions. As I was briefing the President-Elect by phone, I found myself saying, “I am so sorry, the numbers are horrible.” The President-Elect replied, “It’s not your fault—yet.”

In the next few months, we saw even more terrible numbers. The American economy lost almost 3 million jobs between November 2008 and March 2009. Real GDP fell at an annual rate of 6.4 percent in the first quarter of 2009, and countries around the globe began to report staggering declines.

The policy response was swift and bold. The Federal Reserve had taken dramatic actions when the crisis began, and continued to find creative ways to unfreeze credit markets. The TARP legislation, though deeply unpopular, provided crucial ammunition for dealing with the panic. Less than a month after the inauguration, President Obama

signed the American Recovery and Reinvestment Act of 2009—the largest countercyclical fiscal stimulus in American history. And over the spring, the stress test and other measures taken by the Federal Reserve and the Treasury helped to stabilize and begin to heal our financial markets.

By the second quarter of 2009, GDP had nearly stopped declining. It has now grown steadily for the last three quarters—rising some 2.5 percent since the first quarter of 2009. Job losses gradually slowed over 2009, and in the first quarter of 2010 we averaged job gains of 94,000 per month. By almost every indicator, the U.S. economy is finally on the road to recovery.

It is against this backdrop that policymakers in the United States are trying to navigate the best path forward. While the American economy is clearly improving, our unemployment rate is still painfully high. How do we ensure that we complete the difficult task of full recovery as quickly as possible? At the same time, our budget deficit is currently large and the long-run fiscal outlook is extremely challenging. How do we make progress on the deficit without choking off the recovery? It is these topics that I want to discuss this morning.

The Economic Situation in the United States

Recovering. Let me begin by describing economic conditions in the United States. As I mentioned, GDP is growing solidly. It rose at an annual rate of 3.2 percent in the first quarter of this year, fueled by significant growth in consumer spending and business investment in equipment and software. This growth is also reflected in industrial production, which has risen more in the last 10 months than in any 10-month period since 1997.

Even more important, the growth in output is now leading to sustained growth in employment. Payroll employment has risen for five of the past six months. The U.S. economy added nearly 300,000 jobs in April, the vast majority of them in the private sector. The job gains were spread broadly throughout the economy, with manufacturing adding the most jobs in a month in over a decade and employment in services rising strongly.

Most analysts anticipate that U.S. GDP growth and job gains will continue at a steady pace. In the forecast underlying the 2011 budget, the Administration projected GDP growth of 3 percent over the four quarters of 2010 and employment growth of roughly 100,000 per month. Many private forecasts have edged up slightly from these levels, but few anticipate significantly more rapid growth because of continuing headwinds and the winding down of our fiscal stimulus.

But Not Yet Recovered. The U.S. economy is clearly on the right trajectory. But while we are recovering, we are very far from recovered. The output gap in the U.S. remains very large. The nonpartisan Congressional Budget Office puts the gap at about 6 percent of GDP. Importantly, their estimate is based on a conservative measure of potential GDP growth in the near term. The Administration estimates that potential GDP growth remains at its recent historical norm of 2.5 percent. Using this measure, the output gap is substantially larger.

Independent estimates of capacity utilization in the U.S. confirm a significant output gap. Capacity utilization, though beginning to rise, is still far below its historical average. And, it is only slightly above the low level reached at the trough of previous severe recessions.

Unemployment in the United States recently ticked up to 9.9 percent. Some have

suggested that our high unemployment reflects structural changes or other factors not easily amenable to correction. High unemployment in this view is simply “the new normal.” I disagree. Unemployment is high fundamentally because the economy is producing dramatically below its capacity. That is, far from being “the new normal,” it is “the old cyclical.”

In this regard, I am reminded of a frustration I have felt many times when people write books and organize conferences about the unemployment problem in the Great Depression—as if the high unemployment were somehow separate or distinct from the rest of the Depression. Then, as now, the economy had been through a wrenching crisis that had caused demand and production to plummet. Unemployment was a consequence of the collapse of demand, not a separate, coincident problem.

Some have argued that the fact that long-term unemployment is at record levels is a sign that the high unemployment rate is the result of structural factors. There are now more than 6½ million workers who have been unemployed for more than 26 weeks. Long-term unemployment is cause for serious concern. Long spells of unemployment cause much greater hardship than short spells, and they can be associated with deterioration of skills and long-term falls in earnings.¹

But, this rise in long-term unemployment is readily explained by the prolonged collapse of aggregate demand. When hiring rates are very depressed, workers who lose their jobs are unlikely to find work quickly, and thus face a substantial chance of becoming long-term unemployed. This effect is compounded by the fact that exit rates from unemployment, both in normal times and in recessions, are typically lower the longer a worker has been unemployed.² This makes it even more likely that those who do not find work quickly will have long spells of unemployment. Thus, the rise in long-

term unemployment is the almost-inevitable consequence of the severe recession. We do not need to appeal to any underlying structural changes to understand it, and there is every reason to expect that long-term unemployment will come back down when aggregate demand recovers.

Unemployment Is Not Structural. Other observers point to troubling trends, such as the decline in traditional manufacturing jobs and falling rates of employment among less educated middle-aged men, as signs of the inevitability of permanently high unemployment. These developments have led to terrible distress in some communities and devastation for the workers affected. But, these trends were in full sway in the 1990s and mid-2000s, when the unemployment rate was often below 5 percent and long-term unemployment was very low. They are trends that we absolutely need to work to change, but they are not indications that the United States is doomed to permanently higher unemployment.

Another concern is that certain sectors, notably construction and finance, are likely to remain substantially smaller than they were during the boom even after the economy returns to normal. As a result, some have suggested that the workers who lost their jobs in these sectors may have trouble finding work after the economy recovers—and thus that reallocations across sectors might mean higher unemployment in the long run. In fact, however, we have seen only slight declines in the rate at which workers who have lost their jobs in declining sectors exit unemployment relative to workers who lost jobs in other sectors.³ The dominant pattern is that workers from all sectors have seen their exit rates fall, exactly as one would expect when job creation is low.

In short, in my view the overwhelming weight of the evidence is that the current very high—and very disturbing—levels of overall and long-term unemployment are not a

separate, structural problem, but largely a cyclical one. It reflects the fact that we are still feeling the effects of the collapse of demand caused by the crisis.

The reason that I have been emphasizing that the high unemployment we are experiencing is cyclical rather than structural is not to somehow minimize or downplay it. In fact, just the opposite. It is to shake people out of the complacency that says, “That’s just the way life is.” It may be the way life is right now—but it doesn’t have to be. We have the tools and the knowledge to counteract a shortfall in aggregate demand. We should be continuing to use them aggressively.

What Do We Need to Do to Complete the Recovery?

This discussion naturally raises the question of why we face such a severe and lingering aggregate demand shortfall and what can we do about it.

Headwinds to the Recovery. At the most fundamental level, the source of the deficient demand is the exceptional severity of the recent crisis. Among the effects of the crisis were a dramatic fall in wealth, severe disruptions of credit, devastation of state and local government budgets, much greater caution on the part of consumers and firms, and falls in output around the world. All of these developments reduced spending greatly.

The policy response has greatly mitigated those consequences and, in doing so, has moved us beyond the immediate crisis. Indeed, a recent report by the Council of Economic Advisers estimated that the Recovery Act alone has played a key role in generating the positive GDP and employment growth we have experienced.⁴ But although the challenges have been reduced, they have not been eliminated. Let me highlight four key headwinds that the American economy is facing as it tries to recover.

First, credit availability remains tight. One important indicator of credit conditions is the Federal Reserve's Senior Loan Officer Opinion Survey. This survey shows that although banks have largely stopped tightening their lending standards, they have not yet begun to loosen them. In addition, many small businesses report difficulty in obtaining credit. This is a development that makes it harder for businesses to hire and invest.

Second, state and local governments face continuing budget shortfalls. For example, a recent report estimates that even given the support from the Recovery Act funds, the states face a collective budgetary shortfall of nearly \$300 billion in the next two fiscal years.⁵ And, because almost all states have balanced budget requirements, they have to respond to the shortfalls with a combination of spending cuts and tax increases. As a result, to some extent we are seeing a replay of what happened during the recovery from the Great Depression, when a significant part of the fiscal stimulus by the Federal government was offset by fiscal contraction at the state and local level.⁶

A third headwind is that no one expects consumers, after the searing events of the past few years, to go back to their free-spending ways. Nor, in light of the need to move to a higher-saving economy, should we want them to. But, this means that consumption is unlikely to be the main engine of a strong recovery.

Finally, foreign demand for our goods remains subdued. Recovery has not taken hold as firmly in Europe as in the United States, limiting European demand for American goods. And, low consumption growth and persistent trade surpluses in some countries have contributed to restraining our exports. Exports have grown 22 percent from the depth of the crisis, but they are still 10 percent below the pre-crisis peak.

The other fundamental source of the lingering shortfall of aggregate demand

comes from the limits of monetary policy. The recession we have just been through is different in character from almost every other postwar recession. The usual postwar recession has a fairly simple narrative. The groundwork is laid when for some reason policy is overly expansionary and so generates inflation. The recession occurs when the Federal Reserve realizes that things have gone awry. It raises interest rates, slows the economy, and so brings inflation down—at the cost of a recession.⁷

That type of recession is easy to end: once the Federal Reserve is satisfied with the behavior of inflation, it can slash interest rates and provide the economy with a large jolt of stimulus. The result is that the recoveries from severe recessions caused by tight monetary policy have been very strong. For example, in the year following the trough of the 1981-82 recession, real GDP grew almost 8 percent and the unemployment rate fell 2.3 percentage points.

The recent recession was obviously not caused by tight monetary policy. Interest rates were not especially high when it began, and so the Federal Reserve had only limited room to cut them. It has brought short-term rates down to virtually zero, but it cannot push them below that.

The combined result of the policies that we have taken and the inherent resiliency of the American economy on the one hand, and the headwinds that we face on the other, is that we are growing again, but not booming. GDP is rising at a solid pace, but not as quickly as after other severe recessions and not as quickly as it needs to. As a result, the unemployment rate remains painfully high and is not predicted to reach normal levels for an extended period.

What More Can We Do? Given this situation, the obvious question is: What more can we do? Here, it is important to emphasize that the crucial source of demand

has to be the private sector. Especially at a time of large long-run fiscal challenges, there are limits to the role the government can play. Fortunately, the private sector is starting to show some life. Recent retail sales numbers suggest that consumer spending, while not exuberant, is stronger than anticipated and indicates a move toward replenishing some of the household goods that have not been purchased over the past two years. Likewise, private investment in equipment and software rose 19 percent in the last quarter of 2009 and 13 percent in the first quarter of 2010 (both at an annual rate), showing a willingness on the part of many firms to invest even though capacity utilization remains very low. Our focus as policymakers should be on how we can help the private sector recover faster.

The President and his economic team see a key role for targeted actions. There are fiscally responsible measures we can take that can make an important difference between so-so recovery and strong recovery; between stubbornly high unemployment that falls only very slowly and unemployment that is on a steady downward trend.

We have already taken some additional steps. For example, Congress recently passed the HIRE Act, which provides tax incentives for businesses to hire unemployed workers and retain them over time. The Act also has provisions to spur infrastructure spending.

Beyond these measures, there are new actions aimed at stimulating aggregate demand that would be very valuable. One targeted measure that is likely to be very effective is additional fiscal relief to the states. By preventing tax increases and spending cuts, this relief would raise income and employment relative to what it otherwise would be.⁸

A closely related type of targeted stimulus is extensions of support to those who

have been most directly affected by the recession. An obvious—and important—example here is extensions of emergency unemployment insurance benefits. While there is some evidence from better economic times that unemployment insurance extensions can lead to reduced job search, this not a concern at a time when there is a shortage of jobs, not of willing workers. Additional benefits will greatly mitigate some of the worst direct harms of the recession. And, the difficult financial positions of families suffering from extended periods of unemployment mean that most of any such support will be spent quickly, and so have a rapid impact on the economy.

A third targeted measure that has the potential to be very effective is the provision of capital to small banks to promote small business lending. The President has proposed the creation of a \$30 billion small business lending fund to provide capital to small and community banks, which play a critical role in small business lending. These government investments would include incentives to increase this lending, thus further magnifying their impact. And, because the government will be getting capital stakes that will lead to future repayments, these investments will involve little long-run cost to taxpayers. This program would complement the many other steps the Administration has taken to support creditworthy small businesses seeking to expand and create jobs, such as a proposal to eliminate capital gains taxes for investments in small businesses.

A fourth targeted action is our steady effort to open markets to U.S. goods and move the global economy toward more balanced growth. These measures not only promote economic recovery, they move the world economy toward a more stable and fairer outcome.

These and other targeted policy actions are what the economy needs to ensure a

more rapid return to full employment. By speeding up and strengthening the recovery, policy could help lessen the pain and devastation that prolonged high unemployment would bring to millions of American families.

Furthermore, more rapid recovery is the most important thing that we could do to prevent the currently high rate of cyclical unemployment from becoming structural. The academic literature suggests that there may be a link between prolonged recessions and higher normal unemployment. In a well known paper, Olivier Blanchard and Lawrence Summers found that in Europe in the 1970s, one-time unemployment shocks seemed to have almost permanent effects on the unemployment rate.⁹ In more recent work, Laurence Ball found that in advanced countries in the 1980s, extended recessions driven by changes in aggregate demand were associated with substantial increases in economies' normal rates of unemployment, while similar recessions that were reversed by aggressive stimulus were not.¹⁰ Thus, it is possible that by encouraging more rapid recovery, we can help ensure that unemployment does not remain permanently higher.

Fiscal Challenges

Any further actions to bring the unemployment rate down will need to be taken in the context of a very challenging fiscal situation. Like many other countries, the United State began the recession with a large budget deficit. The economic crisis caused it to grow substantially. We simply must get our fiscal house in order as we return to full employment.

U.S. Fiscal Situation. It is, however, helpful to understand the nature of the U.S. fiscal situation. The budget deficit, which averaged 2½ percent of GDP in the five years before the crisis, grew to over 10 percent as output plummeted. It is expected to

fall substantially over the next few years. By 2013, the Administration projects that the federal deficit will be just over 4 percent of GDP.¹¹ The nonpartisan Congressional Budget Office has a very similar estimate.¹² Some of this projected fall in the deficit is due to growth, but an important part reflects the winding down of the stimulus and policy actions that will improve the fiscal situation.

Over the longer horizon, the U.S. deficit is projected to rise substantially. This is due primarily to the anticipated rising cost of health care. A related, but decidedly smaller, problem is the projected aging of the population. Now, I won't take you through the history of how we got on this terrible path—Chapter 5 of the *Economic Report of the President* does a good job of that—other than to say that the budget problem was years in the making. It is not, as some have suggested, due to actions taken in the past year and a half. The Recovery Act, which was absolutely necessary to turning the economy around, is the source of at most a tiny part of our long-run fiscal challenge.¹³ Before any of the actions our Administration has taken, the Congressional Budget Office estimated that the budget deficit in 2040 under plausible assumptions about the then-prevailing policy path would exceed 15 percent of GDP.¹⁴

Obviously, such large long-term deficits are not sustainable. Once the economy has returned to normal, high budget deficits would raise interest rates and discourage investment. And attempting to embark on a path of exploding deficits would, sooner or later, lead to catastrophe.

The U.S. Fiscal Plan. The sensible way to address the current and projected deficit is with a credible plan. It would be penny-wise but pound-foolish to try to deal with our medium- and long-run problem by significantly tightening fiscal policy immediately or foregoing additional emergency spending to reduce unemployment.

Immediate fiscal contraction would inevitably nip the nascent economic recovery in the bud—just as fiscal and monetary contraction in 1936 and 1937 led to a second severe recession before the recovery from the Great Depression was complete. And nothing would be more damaging to our fiscal future than a protracted recession and permanently higher unemployment. But, a credible, comprehensive plan for deficit reduction would create a favorable climate for investment and ensure that the economy remains strong.

Thus, we should be taking concrete steps now to ensure that as we recover from the recession, we bring our deficit down sharply and curb the growth of entitlement spending. And we are.

Congress has also adopted pay-as-you-go rules that will help ensure that nothing they do will make the deficit worse from this point on. Had such rules been in place during the past eight years, the medium-run and long-run deficits would be far more manageable. The fiscal stimulus will wind down sharply in 2011. The President's policies call for allowing the 2001 and 2003 tax cuts to expire for high-income taxpayers and for a freeze on non-security discretionary spending for three years. These are concrete steps that will help to reduce the medium-run deficit. They will also help restore balance to our tax code and ensure that discretionary spending is shrinking, not rising, as a share of the economy going forward.

The landmark health reform legislation signed into law in February is most well known for expanding health insurance to millions of Americans who are currently uninsured. But, it is also a major fiscal consolidation. The legislation includes savings in the government health care programs of more than \$450 billion over the next decade.¹⁵ More importantly, it contains the key cost control mechanisms that experts

say will slow the growth rate of health care costs over time. The Council of Economic Advisers estimates that the difficult reforms enacted, such as a tax on high-priced insurance plans and the creation of an independent payment advisory board, will slow the growth rate of costs by 1 percentage point per year.¹⁶ Such cost containment will have a substantial impact on the deficit. The Congressional Budget Office estimates that even with the expansion of coverage, health reform will reduce the deficit by more than \$1 trillion over the next two decades.¹⁷

The changes that we have made or proposed will help to bring our deficits under control. But, they will not be enough. Much more will need to be done if we are to put the United States on a genuinely sustainable path. For this reason, the President has established a bipartisan fiscal commission to help forge a consensus around the further actions essential to lasting deficit control. The commission has a mandate to bring the deficit down to 3 percent of GDP in 2015, and by doing so, stabilize the ratio of net debt to GDP at below 70 percent.¹⁸ It is also charged with proposing policies to improve the long-run fiscal outlook, including reform of entitlement programs. The commission is supported by members of both parties. And, the President has refused to take any measures off the table because he wants to give the commission the greatest chance of success.

Reaching consensus and taking the necessary actions to get our deficit under control will not be easy. It will require difficult decisions and unpopular measures. But, we will do it, because the alternative is simply unacceptable. For at least the last 100 years, the United States has been the most creditworthy country in the world—the place everyone invests when the going gets tough. We will do whatever it takes to remain that country.

A Final Thought

During my tenure in Washington, I have gotten typecast as the optimist on the economic team. The headline of a recent profile in my hometown paper was “Obama’s Sunny Economic Forecaster.” But the truth is, I have a very realistic sense of the tremendous challenges we face. Indeed, I set out this morning to deliver the stern message that even though things are better, they are not nearly good enough. We are painfully far from full employment and taming our budget deficit will require difficult choices going forward.

But I can’t help ending on an optimistic note. I have a deep belief in the potential of the American economy and the promise of good economic policy. The extraordinary actions that we have taken have already meant the difference between freefall and the beginnings of economic recovery. The passage of comprehensive health care reform will bring health insurance coverage to millions of Americans and begin the process of slowing the growth rate of health care spending. My plea today is for continued action—both to accelerate the return to normal for the millions of American families who are still suffering and to put the United States firmly on the path to fiscal sustainability.

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ENDNOTES

¹ See Arulampalam, Gregg, and Gregory (2001) and Gregory and Jukes (2001).

² Elsby, Hobijn, and Şahin (2010).

³ Elsby, Hobijn, and Şahin (2010). One limitation of this paper (which reflects a limitation of much of the data that are available) is that the measures of exit from unemployment include not only workers who find jobs, but those who exit the labor force. There is no evidence, however, that departures from the labor force are driving the authors' results.

⁴ Council of Economic Advisers (2010b).

⁵ Center on Budget and Policy Priorities (2010).

⁶ See the classic paper by E. Cary Brown (1956).

⁷ Romer and Romer (1989).

⁸ See Council of Economic Advisers (2009a).

⁹ Blanchard and Summers (1986).

¹⁰ Ball (1999).

¹¹ Office of Management and Budget (2010).

¹² Congressional Budget Office (2010a).

¹³ Council of Economic Advisers (2010a).

¹⁴ Council of Economic Advisers (2010a).

¹⁵ Congressional Budget Office (2010b).

¹⁶ Council of Economic Advisers (2009b).

¹⁷ Congressional Budget Office (2010b).

¹⁸ Council of Economic Advisers (2010).