POLICY RESPONSES TO THE GREAT RECESSION:
THE INTERACTION OF LEADERSHIP AND ECONOMIC IDEAS

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It is very nice to be here at Iowa State as the Mary Louise Smith Chair, and to be speaking to you this evening. It is especially nice on the Thursday night before the first Friday of the month to be the Smith Chair and not the CEA chair.

The first Friday of the month is a big day for the Council of Economic Advisers. That's the day the monthly employment and unemployment numbers come out. We will get the jobs numbers for November tomorrow morning.

One of the jobs of the CEA chair is the get all of the numbers on the economy the night before they are released to the public. My job was to let the Secretary of the Treasury and the Federal Reserve Chairman know if there was anything that might cause a market reaction—and, of course, to brief the President. So, we were inevitably working late on a night like tonight.

As you might imagine, when the economy is in the grip of a terrible recession, the employment report is of particular interest. This gave rise to a few awkward situations.

One time, I got an email from the President's body man, Reggie Love, saying that the President wanted me to call him in his limo to tell him the report. So, I dialed the number and I heard a very familiar "Hello." But I couldn't say, "Are you really the President?" I proceeded to give him the numbers. After I hung up, I suddenly had this terrible fear that I had just played into a wonderful scam. I quickly emailed Reggie, who assured me that it was indeed the President I had been talking to.

The bottom line is that I would be happy to be at Iowa State any night—but I am especially happy to be here on this particular evening.

The Smith Chair's focus is on women and leadership. This lecture is a chance for me to reflect on the role of leadership in successful economic policy.

Many people tend to think of leadership in narrow terms: the ability to get people to follow you; to get people to do what you want. And that is certainly a part of leadership.

But a much more fundamental issue is not whether you get people to follow you, but where you lead them. Do you convince people to do good and sensible things? For this, what matters is much less the leader's dynamism or powers of persuasion, but rather, the quality of his or her ideas. In the case of economic policy, the key questions are whether the leader has a good understanding of how the economy works, and whether he or she offers policy prescriptions based on strong economic evidence.

Let me give you an example of the central importance of ideas in economic leadership. I think almost everyone would agree Herbert Hoover was not a very successful leader on the economy in the early 1930s. It is tempting to think that this is because he lacked personal dynamism and the ability to rally people to his policies. But, the truth is, President Hoover was quite effective in this narrow form of leadership. He got Congress to pass a number of significant pieces of legislation in response to the Great Depression.

The problem is that Hoover's *ideas* just weren't very good. In the midst of the worst depression in American history, he believed that the two most important things to do were to remain on the gold standard and to balance the budget. Now modern economic research identifies the gold standard as one of the key sources of the

worldwide Depression of the 1930s, and shows that countries that abandoned it sooner, like Great Britain, recovered much more quickly.[1] And, almost any macroeconomics textbook will tell you that balancing the budget when unemployment is 25%, as it was in the early 1930s, is virtually impossible, and almost surely counterproductive. Yet one of Hoover's signature accomplishments was the Revenue Act of 1932—which was the largest peacetime tax increase in U.S. history up to that point. In short, his failure of economic leadership was fundamentally a failure of his economic ideas.

Tonight, I want to talk about the policies taken in response to the Great Recession. The United States, and indeed the entire world economy, has been through a simply horrific downturn. The financial panic surrounding the collapse of Lehman Brothers in the fall of 2008 sent the American economy into freefall. We now know that real GDP fell at an annual rate of almost 9% in the fourth quarter of 2008—a number that makes other postwar recessions pale in comparison.

The unemployment rate rose dramatically: from less than 5% before the recession to over 10% at its highest. This rise in unemployment has hit every demographic group, including the college-educated—a segment of the population that has traditionally weathered recessions more easily. But some parts of our society have been particularly devastated. Young people, for example, have been severely affected, with their unemployment reaching more than 25%. And African Americans have seen their unemployment rise to above 16%.

Perhaps even more distressing than the severity of the downturn has been the weakness of the recovery. Though we started to grow in the fall of 2009, growth has been painfully anemic. As a result, unemployment has barely budged and is still 9%—almost four years since the recession began.

The United States and other countries have instituted numerous policy responses to try to stop the freefall and accelerate the recovery: monetary policy, housing policy, and fiscal policy.

I want to look at the role of ideas behind these various policy responses. I will argue that the key determinant of the actions was not the politics or personal dynamism of our leaders—but rather their ideas about how the economy worked. And, perhaps even more important, I will suggest that whether the policies were successful or not depended on the quality of the ideas behind them. Sensible, empirically accurate ideas have generally led to useful policies, while less accurate ideas have led to policy shortfalls.

In many ways, this analysis of recent policy echoes what I found in my earlier academic research. In a series of papers that I co-authored with my husband, David Romer, who is also an economics professor at Berkeley, we looked at the determinants of macroeconomic policy in the postwar period.[2] We concluded that the main thing that drove monetary and fiscal policy decisions were beliefs about how the economy functioned and what policy could accomplish.

In decades like the 1950s and 1990s, when policymakers had sensible beliefs, policy was successful in generating relatively steady growth and low inflation. But in decades like the 1960s and 1970s, when policymakers were embracing ideas that have since been discredited, such as the notion that there is a permanent tradeoff between inflation and unemployment, policy was much less successful.

I. MONETARY POLICY

Let me start this discussion of economic policy and leadership during the Great

Recession with monetary policy. This is an area where there were some of the earliest and most important actions. And, it is an area where I think economic ideas have played a fundamental role in determining what has and what *hasn't* been done.

Actions. First, what has the Federal Reserve done and how well has it worked? As the economy started to slow over late 2007 and early 2008, the Fed responded by lowering interest rates. By December 2008, the federal funds rate, the main interest rate the Fed controls, was effectively down to zero.

In addition to lowering interest rates, the Fed took extraordinary actions to keep credit flowing. For example, when no one was willing to buy commercial paper—short-term corporate debt often used to cover payroll and other near-term borrowing needs—the Federal Reserve set up a special facility where *they* bought commercial paper until the regular market came back.

By all accounts, these early monetary policy actions were incredibly important and effective. There is a good reason Ben Bernanke was named *Time Magazine*'s Person of the Year in December 2009. Lowering interest rates and flooding the financial system with liquidity helped to stop the panic, which could have been far worse than it actually was. And, the many special lending facilities kept credit flowing at least somewhat, which mitigated some of the impact of the financial crisis on businesses and families.

Since the extraordinary actions of late 2008 and early 2009, the Fed has been much less aggressive. They have taken another round of quantitative easing. Quantitative easing just means the Fed buys a large amount of unusual types of securities to try to push down some interest rates that are not yet zero, such as mortgage rates and long-term bond rates. And the evidence is that this action has been somewhat

helpful.[3] The Fed has also tried to signal that the federal funds rate will stay near zero through 2013, and lengthened the maturity of its debt holdings through Operation Twist.

But *in terms of the Fed's own guideposts*, monetary policy today is not succeeding. The Federal Reserve Act says the Fed is supposed to care about both inflation and unemployment. This is the Fed's so-called dual mandate. The Fed has for many years said it feels inflation should be at 2% or a little less, and unemployment should be at its normal sustainable level, which Fed members currently estimate to be around 5½%.[4]

By those criteria, the Fed is clearly not doing very well. On inflation, the measure they look at, the price index for personal consumption expenditures excluding food and energy, is slightly below their target and expected to remain there. And unemployment is currently almost twice what they think it should be, and likely to stay severely elevated for several more years.

Ideas. What explains the Fed's behavior? Why was the Fed much more aggressive and successful early in the crisis than it has been for the past year and a half or so?

Let me tell you what I *don't* think it is. It's not that the members of the Federal Reserve care more about banks than ordinary people—so they took extraordinary action when the financial system was on the line and not when unemployment was high. Chairman Bernanke and other members have spoken passionately about the need to get unemployment down. I believe they are deeply concerned about the failure to meet their dual mandate.

Likewise, I don't think the answer has to do with a failure of that narrow type of

leadership I talked about earlier—the ability to get people to follow you. I don't believe that the problem is that Chairman Bernanke was a forceful leader in 2008, but then somehow lost his leadership mojo. The truth is he has always had an understated leadership style that emphasized consensus, and valued transparency and substantive debate. He is no less in control today than he was in 2008.

The key difference, I think, has to do with the quality of ideas guiding policy. Early in the crisis, two ideas were paramount: financial crises were destructive and preventable; and credit availability was essential to economic activity. These ideas are fundamental tenets of economics. And the research behind them is well-regarded and rigorous.

Milton Friedman and Anna Schwartz's classic book, *A Monetary History of the United States*, showed that unchecked banking panics in the 1930s were a central cause of the Great Depression, and that better monetary policy could have stemmed the panics and prevented the worst of the economic crisis of the 1930s.[5] And a large modern literature, started by Bernanke's own research on the Depression, showed that credit was essential to the normal spending of households and the operation of businesses.[6]

If you read speeches of Fed officials or descriptions of their policy deliberations, it is clear these basic ideas drove their response to the crisis. In my view, the policies were largely successful because the ideas behind them were strong and sensible.

More recently, ideas are still determining Fed policy, but the ideas are less sound. Some Fed members appear to believe that much of the unemployment we are facing is due to a mismatch between workers' skills and the jobs available. That is, the unemployment is largely structural. Federal Reserve Bank of Philadelphia President Charles Plosser said not too long ago: "You can't change the carpenter into a nurse

easily, and you can't change the mortgage broker into a computer expert in a manufacturing plant very easily.... Monetary policy can't fix those problems."[7] This reasoning has been repeated by other members.[8]

This view is appears to be leading some Fed policymakers to oppose additional actions. But it is also not well-founded in economic research. There is always some skills mismatch in a dynamic economy. But the evidence does not suggest that there is substantially more mismatch today than there was back when unemployment was 5% or lower.

A large number of studies have shown that skills mismatch and other structural factors explain only about 1 percentage point of the severely elevated unemployment we are experiencing.[9] Most of the unemployment we are currently experiencing is due to cyclical factors, particularly a profound lack of demand, which monetary policy absolutely can help to fix.

Even Fed members who don't agree that the current unemployment is due to structural factors have expressed concern about the usefulness of additional action. At his recent press conference, Chairman Bernanke said of additional actions: "Are those tools likely to be sufficiently effective? Or do they bear costs and risks that would make them less effective or not worth using?"[10] Reading between the lines, he seems to be saying that more aggressive monetary expansion might not do much to stimulate consumer and business spending.

From my tone, you can probably sense that I don't feel that this economic idea is correct. It goes against what I learned from Chairman Bernanke in a classic article he wrote on Japan back in 2000.[11] In it, he argued persuasively that there is much the central bank can do to stimulate demand when interest rates are already close to zero.

It also goes against what scholars have learned from studying the Great Depression. In that episode, aggressive monetary action most definitely made people more optimistic about the future. They started buying cars and industrial machinery again, and this helped to foster recovery.[12]

The Fed's tools may not be powerful enough to return the economy quickly to full employment while keeping inflation close to 2%. But I believe the evidence from economic history and economic theory is clear that the Fed could be doing much better at achieving its stated goals.

The bottom line from this discussion of monetary policy is that economic ideas are the key determinant of policy actions. And that the success of the policies depends on the quality of the ideas.

II. HOUSING POLICY

The second policy response to the Great Recession that I want to discuss is housing policy.

House price movements have obviously played a key role in this recession. The rapid rise of house prices led to an incredible boom in homebuilding, and a large increase in household debt. When house prices began to fall in 2007, this put pressure on both homeowners and lenders who were holding lots of mortgage debt. Defaults rose and homebuilding ground to a halt. Eventually, all those defaults led to a loss of confidence in banks—resulting in the first full-fledged financial crisis we have had in the United States in more than two generations.

But the story doesn't end there. Since the beginning of 2008, there have been well over 3 million foreclosures completed, and many more are in process. This has

devastated the families involved, harmed neighborhoods, and further depressed home prices. Today, another 11 million homeowners are underwater on their mortgages, meaning they owe more than their homes are worth.[13] Such underwater homeowners are at risk of default, and they are hesitant to spend until they dig out of their mountain of debt.

Moreover, we built so darn many houses during the boom that we still have a significant oversupply. So we are not going to be needing to build houses in many areas for quite some time.

The bottom line is that housing has been and continues to be a major source of our economic troubles.

Actions. What policies have we pursued and how have they worked? The Administration has implemented a number of programs. It is fair to say they have worked less well than people had hoped.

The main program was the Home Affordable Modification Program (or HAMP). (One thing we can all agree on is that the names of these programs could not have been worse.) What this program did was to encourage the servicer of a mortgage to modify it to make the payments lower for a troubled homeowner. The Treasury Department helped servicers do this by giving them an incentive payment and covering part of the cost.

Of the 3 to 4 million homeowners at risk of foreclosure that the Administration estimated might be helped by this program, about 2 million have received a trial modification. But fewer than 1 million have received a permanent modification.[14] So, the HAMP program has helped some, but not as many as one would have hoped.

In 2010, the program was expanded to help unemployed homeowners. If you are

in this program and unemployed, you qualified for twelve months of forbearance, when payments are reduced or suspended. The cost is added on to the end of the mortgage. But so far, about only about 15,000 homeowners have participated in this program.[15]

The other main housing program is one that allows underwater homeowners to refinance at lower rates. This way, they can at least get a lower payment, even if they owe more than their home is worth. Applications for this refinancing have been very high. But so far only about a million homeowners have managed to actually get a permanent refinancing through this program.[16] The hope had been that 4 or 5 million people might be helped.

Finally, none of the existing programs do much to get rid of negative equity. There have been only small moves in that direction.[17] As a result, as I discussed earlier, there remains a huge amount of negative equity in the housing market. The latest estimate I could find is that homeowners collectively owe about $750 billion more than their homes are worth.[18]

Ideas. What accounts for the housing programs pursued and their limited success? Why was this path taken and not others? Here, too, I can tell you from first-hand experience that ideas were incredibly important. My colleague at the Council of Economic Advisers, Austan Goolsbee, played a key role during the transition in formulating our housing policy.

At that time, what the best academic evidence showed was that most underwater homeowners didn't default. What tended to push people over the edge was something that temporarily lowered their income: unemployment, illness, or some other adverse life event.[19] This analysis suggested that if we wanted to reduce foreclosures, the important thing was reducing mortgage payments for troubled homeowners—to help

them get through these rough patches. The logic was very strong, and the economic ideas and evidence absolutely drove the policy.

One place where we ran into trouble was in the implementation. We had very few carrots or sticks to use to get banks to do the needed modifications. It also turned out to be hard for homeowners to jump through all the hoops.

A more fundamental limitation is that we designed a program that focused on only part of the problem. We were focused on preventing foreclosures, which was clearly very important. But new research shows that negative equity matters, even separate from the risk of foreclosure.

Negative equity is obviously highly correlated with a drop in wealth, which tends to depress consumer spending. It is also highly correlated with high household indebtedness, which may also have its own negative impact on consumer spending.

My Berkeley colleague Atif Mian and his coauthor, Amir Sufi, have important new research looking at household debt and household spending across American counties.[20] What they find is that consumers in counties with higher growth in debt before the crisis, cut spending much more during the downturn, particularly on big-ticket items like cars. And, that spending has been slower to recover.

Thus, negative equity appears to be a bigger problem than economists had realized. And it suggests that policy may need to be more focused on reducing principal on troubled mortgages, and less on just reducing payments.

Now I don't think the government should absorb the negative equity. It would be very expensive. And I would be nervous about using lots of government money to help people well off enough to own houses.

But, there are sensible ways we could encourage or even force financial

institutions to do the write-downs on their own dime. For example, we could modify the bankruptcy law to allow judges to modify mortgages. Right now, they can write down principal for other loans in a bankruptcy proceeding, but not for mortgages.

Housing is a case where policy was driven by sensible ideas, but implementation problems reduced its effectiveness. And, new research suggests that the driving ideas may have been too limited. I very much hope that policy responds to the new research and the emerging consensus that principal write-downs are greatly needed.

III. FISCAL POLICY

I have saved the biggest policy issue for last: fiscal policy. Fiscal policy refers to anything having to do with the government budget: tax changes or spending changes. It includes tax and spending measures to help reduce unemployment during a recession—so-called fiscal stimulus. But it also covers changes in spending and taxes to help deal with our long-run budget problems.

Actions. Let's start with what we have done with fiscal policy since the Great Recession started and how it has worked. And here I want to branch out a bit and talk not just about the United States, but also some other countries. Fiscal policy is a big issue, not just in this country, but also in Europe, and even in many emerging economies.

Fiscal stimulus was an essential part of the policy response to the Great Recession. Here in the U.S., it actually started in the Bush Administration. The Economic Stimulus Act of 2008 was signed in February 2008, just two months after what we now date as the start of the recession. It provided a tax cut of up to $1200 for a family. Much of it came in the form of a rebate check mailed to families between April

and June of 2008.

President Obama continued the fiscal response. The American Recovery and Reinvestment Act of 2009 was passed just one month after his inauguration. At $787 billion, it was the largest countercyclical fiscal stimulus in American history. It took the form of roughly one-third tax cuts, one-third increases in government spending on things like infrastructure and renewable energy, and one-third aid to states and people directly hurt by the recession (including program like unemployment insurance and nutritional assistance).

Many other countries also took aggressive fiscal actions. Germany, for example, had an aggressive program of paying employers to keep workers on through the slump. China spent close to $600 billion on infrastructure and social welfare programs—which is pretty amazing considering their economy is only about a third as large as ours.

The best available research points strongly to the conclusion that all this rapid fiscal stimulus played an important role in stopping the freefall. A study that we did at the Council of Economic Advisers looked at the outcomes in different countries.[21] Countries that did more fiscal stimulus, like China, Korea, and Japan, did substantially better relative to predictions from before the stimulus, than countries that did less, like Italy and Switzerland. The U.S. was in the middle: we did a moderate amount of stimulus (relative to our size) and we were about average in performance relative to expectations.

The notion that the Economic Stimulus Act of 2008 and the Recovery Act of 2009 were helpful in the U.S. has been backed up by a number of recent studies. There has been a blossoming of new research on the effects of fiscal stimulus, almost all of which finds that expansionary fiscal policy does raise demand and increase

employment.[22] For example, a very nice new study shows that families quickly spent a large part of their 2008 rebate checks.[23] Indeed, many of them behaved like my father, who went straight to the Honda dealer and bought a new car when his check came in the spring of 2008.

Likewise several studies show that the Recovery Act had an impact. One by Daniel Wilson at the Federal Reserve Bank of San Francisco looked carefully at the variation in spending across states.[24] He concluded that the Recovery Act spending provisions alone raised employment relative to what it otherwise would have been by 3.4 million as of March 2010. Including the likely impact of the tax cut provisions, which accounted for about one-third of the total cost of the Act, would likely raise that estimate substantially.

Since the Recovery Act, the United States has taken a handful of additional actions. Most of these have involved continuing some of the Recovery Act provisions, such as the aid to unemployed workers and the tax cut for working families. But so far the President's proposal for a second big round of job creation measures has not gotten very far in Congress.

Instead, both here in the U.S. and especially in Europe, much of the focus of fiscal policy has switched from stimulus to concern about the deficit. The Greek debt crisis—which began in the spring of 2010—helped wake everyone up to the fact that many countries, including the United States, were not on a sustainable fiscal path. Many advanced countries are looking at looming budget deficits as the baby-boom generation retires and health care costs continue to rise.

The response in many European countries was to move immediately from fighting the recession to fighting the deficit. Country after country cut government

spending and raised taxes. Some countries, like Greece, Spain, and Portugal, were forced to do this to get help with their debt crises. But others, like the United Kingdom and Germany, chose to do this because they thought it was the best policy.

The outcome in countries adopting strong fiscal austerity—that is, immediate aggressive deficit reduction—has not been positive. The true problem children of Europe find themselves caught in a terrible circle. Fiscal austerity increases unemployment. High unemployment lowers tax revenue and so the budget deficit doesn't decrease. This leads to pressure for more austerity.

We see this in Spain—a country with a pretty good deficit record before the crisis. Their unemployment is now 22.6%, and their deficit is proving difficult to reduce because of it. The United Kingdom is another case where austerity is taking a toll on growth. They have seen a fairly strong recovery give way to rising unemployment and falling output.

Here in the United States, we are talking a lot about the deficit (and fighting about it *a lot*), but not actually doing all that much. This summer the President and Congress eventually agreed to reduce the deficit by about $2 trillion over the next decade. This sounds like a big deal, but unfortunately is well short of what almost every expert says we will need to do to remain solvent over the long haul.

And then we learned just before Thanksgiving that the super committee set up by that legislation to actually come up with the specific plan couldn't come to an agreement. So our long-run fiscal future is still very unsettled.

Ideas. Once again, we can talk about where these various fiscal policies came from. And once again, the evidence points to a central role for ideas.

Take the two main early fiscal stimulus actions—the tax rebate under President

Bush and the Recovery Act under President Obama. In both cases, the president's leadership was important. Having watched the process close up, I know it takes a lot to shepherd even a fairly popular bill to completion. So I don't want to sell short the persuasion and personal leadership both presidents provided.

In the case of the Recovery Act, the two senators from Maine, Susan Collins and Olympia Snowe, also showed extraordinary personal leadership. They made the very tough decision to support the Recovery Act, despite the opposition from their party's leaders—because they thought it was the right thing to do.

But the far more important source of these actions were the prevailing economic ideas. Though it may feel hard to believe this now, given how acrimonious the discussion of stimulus has become, one of the most widely accepted principles of economics is that tax cuts and increases in government spending can help heal a troubled economy.

Indeed, one of the things that the economics team did during the transition in December 2008 was to call a large number of respected macroeconomists of both parties and ask them what we should do to help the economy. We figured we needed all the advice we could get. Republicans and Democrats differed some in their preferred form of fiscal stimulus—with Republican economists preferring more tax cuts and Democratic economists preferring more spending increases. But, there was widespread support for aggressive fiscal expansion.

Likewise, ideas played a key role in why the rest of the world adopted aggressive fiscal stimulus measures as well. The International Monetary Fund encouraged countries to take fiscal expansion in December 2008, citing the theory and evidence that it would be effective.[25]

But ideas also played a big role in why stimulus was stopped. Here in the United Sates, many policymakers have become convinced that fiscal stimulus doesn't work to create jobs.

Now, I understand the temptation to say, "We spent $787 billion and the economy is still weak, so obviously stimulus doesn't work." But that reasoning fails to take into account the fact that the economy was headed into a tailspin when the Act was passed. So it can still have been very helpful, even if we have a long way to go before we are fully recovered. And, as I described, a number of careful studies have concluded that stimulus does work.

In Europe, the ideas changed even more radically. A key idea that took hold was the notion that a fiscal contraction could actually be expansionary. That is, that getting the budget deficit down could raise output. The mechanism is supposed to be a confidence effect. People would be so reassured by the improvement in the deficit that the private sector would take off.

You can see why this idea would be very appealing to policymakers. They could deal with both their problems—high unemployment and the budget deficit—with one move. And it caught on very strongly—particularly in the U.K. and in Germany.

To an economic historian, this is an idea that sounds a little *too* familiar. It is almost exactly what Herbert Hoover claimed in pushing for the 1932 tax increase. He said: "The reduction in governmental expenditures and the stability of Government finance … can contribute greatly to employment and the recovery of prosperity."[26]

The main problem with the idea is that it just isn't true. One study thought it had found this in the data.[27] But a much more careful study done by the International Monetary Fund in 2010 showed convincingly that fiscal contractions were in fact

contractionary.[28] The IMF researchers used budget documents to identify every time governments in 15 countries undertook a fiscal austerity program over the past 30 years. They found that output typically fell and unemployment rose after such fiscal contractions. And that is certainly consistent with the experience of the countries moving immediately to deficit reduction.

In May 2010, the Administration was concerned about the widespread move to fiscal austerity in Europe. We thought it could derail the recovery. On a trip to the Organization for Economic Co-operation and Development in Paris, I tried to convey the message that a more varied approach would be better.[29] Fiscal austerity might be necessary in some countries—particularly those with the largest deficits. But other countries, such as the United Kingdom, France, and Germany, could wait until the recovery was more firmly established. But austerity has continued to be the main policy prescription in Europe. And it is frankly not working.

What is desperately needed in both Europe and the U.S.today is a comprehensive fiscal policy based on ideas better supported by the evidence. Because fiscal stimulus does help an economy grow in the near term, I think there is a strong case for doing another significant round. We should learn from all the new research and design a fiscal expansion that is more cost-effective, and that leaves us a more productive economy after we recover.

At the same time, we can't ignore the deficit. The budgets for the United States and other countries are on a terrible long-run path. The deficits are projected to grow astronomically 20 to 30 years from now. What we should do is pass a plan right now for what spending we will cut and whose taxes we will raise. But we should phase in the actual fiscal contraction gradually—as the economy recovers. That will reassure all of us

that we will be solvent over the long haul, but it won't make the unemployment problem worse in the near term.

IV. CONCLUSION

The key message of my talk this evening is that, when it comes to economic policy, ideas about how the economy works are a key determinant of policy actions. And the success of the policy depends on the soundness of the ideas.

This has certainly been true of the policy response to the Great Recession. Monetary policy, housing policy, and fiscal policy actions have all had their roots in economic ideas. And the policy responses have been most successful when the ideas behind them are based on strong empirical evidence and careful economic theory.

What does the key link between ideas and policy tell us about leadership? To my mind, it suggests that true leadership is much less about personal dynamism and the ability to motivate others. It is about the strength of one's ideas. It's about where you lead people, not just whether you can get them to follow you.

This view of leadership has implications for universities, such as Iowa State or Berkeley, that train so many of our future leaders. We need to instill in our students a passion for ideas and a deep respect for evidence. We can do the most to train them to lead by training them to think and to never stop learning. The ability to critically evaluate ideas and empirical evidence is the skill a future leader most needs to acquire.

This view of leadership also has implications for voters. Each one of us needs to learn to look past superficial attributes such as charm and charisma. We need to focus on a candidate's ideas. In the realm of economic policy, we need to demand that our potential leaders explain their views of how the economy works, and ask them to defend

the soundness of those ideas.

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

It's not that I don't see the difficulties facing our country. Of course I do. Our economic challenges are larger today than they have been since our parents and grandparents were born.

My optimism comes from a firm belief that sensible policies can help solve our economic problems. As long as they are based on sound ideas and rigorous evidence.

More fundamentally, my optimism is born of a deep respect for American voters, who I think are hungry for a serious discussion of our economic challenges and an honest debate about economic ideas. For all our sakes, I hope that candidates from both parties will give voters the straight talk and substantive discussion of economic ideas they so desperately need and deserve.

NOTES

[1] See, Barry Eichengreen and Jeffrey Sachs, "Exchange Rates and Economic Recovery in the 1930s," *Journal of Economic History*, 45 (December 1985): 925-946.

[2] Christina D. Romer and David H. Romer, "The Evolution of Economic Understanding and Postwar Stabilization Policy," in *Rethinking Stabilization Policy* (Kansas City: Federal Reserve Bank of Kansas City, 2002): 11-78; and "Choosing the Federal Reserve Chair: Lessons from History," *Journal of Economic Perspectives* 18 (Winter 2004): 129-162.

[3] Arvind Krishnamurthy and Annette Vissing-Jorgensen, "The Effects of Quantitative Easing on Interest Rates," *Brookings Papers on Economic Activity* (Fall 2011), forthcoming. Earlier papers showed that the first round of quantitative easing (in late 2008 and early 2009) was also effective. See Joseph Gagnon, Matthew Raskin, Julie Remache, and Brian Sack, "The Financial Market Effects of the Federal Reserve's Large-Scale Asset Purchases." *International Journal of Central Banking* 7 (March 2011): 3-43; and Andreas Fuster and Paul S. Willen, "$1.25 Trillion is Still Real Money: Some Facts about the Effects of the Federal Reserve's Mortgage Market Investments," Federal Reserve Bank of Boston Public Policy Discussion Papers, No. 10-14, November 2010.

[4] See the economic projections of the Federal Reserve Board Members and Federal Reserve Bank Presidents, November 2011, http://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20111102.pdf.

[5] Milton Friedman and Anna Jacobson Schwartz, *A Monetary History of the United States, 1867-1960* (Princeton: Princeton University Press for NBER, 1963).

[6] Ben S. Bernanke, "Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression." *American Economic Review* 73 (June 1983): 257-276; Ben S. Bernanke and Mark Gertler, "Agency Costs, Net Worth, and Business Fluctuations." *American Economic Review* 79 (March 1989): 14-31; and Mark Gertler and Simon Gilchrist, "Monetary Policy, Business Cycles, and the Behavior of Small Manufacturing Firms," *Quarterly Journal of Economics* 109 (May 1994): 309-340.

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