Principles for Economic Recovery and Renewal

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When I last spoke at the National Association for Business Economics in 2008, I sought to survey the economic landscape in which the United States found itself. Our country faced profound challenges: the recession, financial repair, health care, energy, globalization, and inequality. Little did we know at that time how serious our problems would become. And little did I know of the opportunity I would have to work by President Obama's side as he sought to take on all those challenges during the momentous first year of his Presidency.

My topic here is more focused than the range of issues I addressed a year ago. It is the topic of economic recovery and the prospects for job creation. That assessment begins from an evaluation of our current situation.

From a financial perspective, the evidence that we have made very substantial progress is clear. Consider, for instance, the trajectories of 15 or 20 major credit spreads during the past two years. If we take as ''normal'' some level prior to the most extreme bubble valuations, and then look at the peak after the collapse of Lehman Brothers, and then ask where we stand today, it turns out that we have normalized between 50 and 100 percent with most credit spreads.

The stock market shows strong signs of recovery, too. Whether we measure stock market volatility on a flow basis or on an ex ante basis as inferred from options, the extent of volatility—a proxy for uncertainty in the stock market—has fallen very substantially. The stock market has rallied in a way that would have seemed quite remarkable if forecast in the first months of 2009. The major indices have risen 50 percent from their lows.

We are even witnessing early signs of stabilization in the housing market in many parts of the country. Moreover, while the quantity of credit flows remains very low by historic standards in a number of key sectors, the pricing of credit flows has substantially normalized.

Our experience so far has not called into question the tendency that I stressed in my 2008 remarks: recessions associated with financial overleveraging and with the bursting of bubbles have tended to entail longer and slower recovery paths than recessions associated with actions by the Federal Reserve that slammed on the brakes and produced a spike in interest rates. It is not hard to understand why the empirical reality should be this way. If a recession were caused by hitting the brakes hard, it could be uncaused by taking the foot off the brakes. If it were caused by something other than policy, it is less readily within the purview of policy to bring about a rapid turnaround. Nonetheless, whereas nine months ago we were debating whether the recession would become a depression, today we are debating what the end date of the recession was and what our path to recovery will be. Most observers expect growth in the second half of 2009 at rates in excess of the economy's long-run potential, fueled by the inventory cycle and by the stimulus provided through the American Recovery and Reinvestment Act of 2009 (ARRA).

Yet it is also essential to recognize that major slack in the economy remains in any reasonable forecast for the foreseeable future. The unemployment gap is approaching 5 percent. The gap between actual and potential GDP by Okun's law—the empirically observed relationship between output and unemployment—now approaches 10 percent. And the extra budget deficit resulting from the recession is in excess of $500 billion. There can be no question that the dominant cause of joblessness is a weak economy, but this explanation does not fully explain our current situation. There is reasonably clear,

though debatable, evidence that unemployment is higher and employment is lower than would be predicted on the basis of historical relationships between output and employment. Or, in technical terms familiar to economic readers, the Okun's law relationship has a positive residual when unemployment is on the left-hand side of the equation.

This fact comes in tandem with a second observation: the expansion of the 2000s created only one-third as many jobs as the expansion of the 1990s did. Together, these findings suggest grounds for structural as well as cyclical concerns about employment creation.

To be sure, for all the problems in the current outlook, it is better than most expected six or nine months ago. We are no longer discussing panics. We are no longer using metaphors about balls falling off tables or freefall. But it is also an unsatisfactory state of affairs.

It is an unsatisfactory state of affairs above all for middle-class Americans and their families. Every day, they must bear the tremendous anguish that comes with a 10 percent unemployment rate. It is also an unsatisfactory state of affairs for our collective future. Each percentage point of unemployment substantially adds to the debt that the government accumulates, greatly reduces the capital stock for future business endeavors, and limits our human potential.

For all these reasons, we have no higher economic priority for the period ahead than maximizing America's rate of economic growth and, associated with that rate of economic growth, the rate of job creation in our economy. It is not for me to lay down hard-and-fast rules for what is obviously a fluid and changing situation. But I would suggest three guiding principles to bear in mind in the formulation of economic policy during months ahead.

1. Confidence

First, confidence is essential. Franklin Roosevelt caught a very substantial truth, even if he exaggerated slightly, when he said that the only thing we had to fear was fear itself. Americans may have had other things to fear, but panic and fear figured as significant obstacles to recovery. We have seen repeatedly that confidence can be a self-fulfilling prophecy. Indeed, I would go so far as to assert that there is a Heisenberg element in economics, where the measurement and observation of the performance of an economy has a direct effect on how that economy performs.

Businesses, consumers, and investors need to feel both that recovery can be sustained and that the economy is returning to a long-run sustainable path. That is indispensable to maximizing our growth potential. No actions to combat short-run output gaps must be allowed to call into question our national commitment to sound money, noninflationary growth, and sustainable devolution of government debt. Equally, policy measures to spur growth or achieve other objectives should, wherever possible, go with rather than against the grain of the market. Think, for example, of reliance on pricing rather than on heavy-handed regulation to discourage the excessive production of goods that pollute.

Wherever possible, we should seek to resolve policy debates as rapidly as possible so as to minimize uncertainty. I first met Ben Bernanke in the late 1970s, when he presented one of the key papers from his thesis at a seminar at Harvard. It was, as you would expect, a rather elaborate and quantitative analysis; but it also made a very fundamental point. If you were considering buying a new boiler, and you knew the price of energy was going to be high, you would buy one kind of boiler. If you knew the price of energy was going to be low, you would buy another kind of boiler. If you did not know what the price of energy was going to be, but you thought you would know a year from now, you would not buy any boiler at all. In exactly that way, it is illustrative that the reduction of uncertainty through the resolution of disputes is central to maintaining confidence. I cannot overstate the importance of confidence. Although broad comfort with the long-run path and reduction in uncertainty are not sufficient to establish a return to rapid growth, I would suggest that they are absolutely necessary.

2. Demand

The second principle is that we need to recognize the continual need for increasing demand in order to maintain economic growth. For the foreseeable future, lack of demand will be the major constraint on output and employment in the American economy. In our present circumstances—with unemployment approaching 10 percent, with capacity utilization near record lows, with credit flows diminished, with substantial remaining inventory of unsold houses, and with interest rates at extraordinarily low levels—this proposition should not be in doubt. The combination of low capacity utilization facing businesses and substantial leveraging of household balance sheets raises questions about the sustainability of demand growth as we proceed into the future. Measures that raise demand carry benefits in a number of forms: the direct impact of that spending and investment, the indirect effect as those who have benefited from the first round of spending and investment increase their spending and investment, and the increase in the economy's long-run potential that prudent investment can bring about.

What are some such measures? I will briefly suggest seven different areas in which the government is making substantial efforts to increase demand and reap the vital benefits that spring from those commitments.

Direct public investment

First, direct public investment plays a pivotal role at a time like this. By maintaining levels of investment and supporting state and local governments, the Obama Administration has avoided substantial layoffs that would have otherwise taken place. With bond rates, unemployment, and the slack in the construction sector at their current levels, there could be no better time to improve America's infrastructure than the present. Accordingly, we are now in the midst of an important period for infrastructure investment.

Support for private investment

Second, it is a crucial moment for measures to support private investment. That is why the ARRA contains significant stimulus in this direction, particularly for small business. That is why we are working with the Small Business Administration and in other ways to increase the flow of credit to small businesses— which have in many ways suffered disproportionately during this difficult period. That is also why we believe that the right health insurance legislation that encourages pooling among small business employers and promotes cost control can increase incentives for investment by reducing private costs.

Support for exports

A third measure intended to increase demand is support for U.S. exports. When I was Secretary of the Treasury a decade ago, I was fond of warning that the world economy could not fly indefinitely on a single American engine. It flew somewhat longer and stronger than I would have guessed at that time. But if you wait long enough, almost any economic prediction is right, and the events of 2007 bore out my prediction.

We are facing reduced consumption demand because of deleveraging. We are also facing reduced investment demand because of low capacity utilization and substantial inventories of housing. In those circumstances, spurring growth means encouraging export growth. That is why the agreements reached at the G20 meeting in Pittsburgh— commitment to a global growth strategy and increased International Monetary Fund scrutiny of surplus countries—are so important. That is why the Administration is focused on the promotion of U.S. exports through appropriate commercial diplomacy, appropriate reductions in export controls, maximization of the activities of the Export-Import Bank, and enforcement of U.S. trade laws. And that is why the issue of global growth will be a subject of continuing conversation between President Obama and his international colleagues.

Support for U.S. consumers

A fourth measure is appropriate support for U.S. consumers. No one wishes to see a return to some of the excesses of the past, but there is also an evident danger from insufficient credit flows that prevent the expression of normal demand by consumers. For that reason, the government's Term Asset-Backed Securities Loan Facility, better known as the TALF program, is tremendously important. Similarly, measures such as the Cashfor- Clunkers program—which was so successful in stimulating demand this summer and which many estimates suggest will produce a net stimulus over a significant period of time and not simply move consumption from one month to the next—are also critical to this broader endeavor. In addition, we are continuing our efforts to ensure the availability of mortgage finance at reasonable prices and, where possible, to mitigate foreclosures. We are gratified that the Administration's foreclosure program, announced last March, is the first such program that has actually achieved its objective, 500,000 modified mortgages, ahead of its target date on November 1.

Leverage private long-term investment

A fifth way to raise demand is to use government funds to leverage private resources toward long-run investments. That is why we have committed very substantial lending resources in the range of $100 billion to support renewable energy projects and the development of a renewable energy sector in the United States. From the point of view of stimulus, the most productive investments of government resources do not involve the provision of good credit where the cost to the government, in a present value sense, is very small. Rather, the most productive government investments are those where the incremental aggregate demand corresponds to the amount of money lent. Invest in community colleges Sixth, and similarly, consider the fact that many of the Americans who could benefit from a community college education are currently unemployed, and the resources of students and community colleges alike are sorely stretched. Can there be a better time than now to invest in our nation's community colleges?

Financial repair

Finally, a focus on financial repair is vital to all of these efforts to stimulate demand. To an extent that I think few would have anticipated six or nine months ago, the process of replacing temporary government capital with permanent private capital is well underway. This represents a fundamental improvement in the quality of capital in U.S. financial institutions. For whatever its formal processes or formal properties, businesses have a strong incentive to repay government capital as rapidly as possible; therefore, it does not provide a basis for a substantial balance sheet expansion. The same is not true of private sector capital. For that reason, the progress made by the stress tests and the ongoing regulatory process—boosting confidence, promoting transparency, and driving growth in private sector capital and labor—should prove effective over time in improving the flow of credit. At the same time, this increase in transparency has generated significant improvement in financial confidence. That trend in turn has reduced pressures from reporting of funds, and it has operated in the direction of promoting the flow of credit.

In all of these ways, and no doubt in other ways that will be discovered over time, the public sector and the private sector have a strong incentive to collaborate in the promotion of demand at this juncture.

3. Education

The third guiding principle operates over a much longer period than most efforts traditionally grouped under the umbrella of economic policy. It is easy at a moment like this to lose sight of the structural dimension of our employment issues. But as I mentioned when I referred to the residual in Okun's law, as I emphasized when I contrasted the recovery of the last decade with the recovery of the 1990s, and as one can observe in a longer-term sense in what is happening to the relative wages of those with less skill and those with more skill—in a world in which technology is expanding its capacity and Americans

workers are facing more competition from abroad than ever before—we have a central national economic and security challenge of improving our educational system.

At the time when I went to college, American students were far more likely to earn a college degree than students in any other country. That is not true today. We no longer rank in the top 10 for the fraction of a given cohort who earn at least an associate's degree. The gap between the access to higher education for those with high family incomes and those with low family incomes has substantially increased over the last generation. And measures of the economic prospects of those whose education ends in high school, much less of those whose educational achievement is short of a high school degree, do not give cause for encouragement.

And that is why I suspect that when the history is written, one of the most important features in the ARRA will prove to have been the money it directed at spurring educational excellence and a ''race to the top'' across American schools. The same is true of the ARRA funding geared toward starting a process of repair for inadequate financial aid.

It is tempting at a moment like this to suppose that all problems are on the demand side. To be sure, those are the salient problems of this moment. But we would make a great mistake as a country if we did not recognize that once even those problems are solved, we will confront substantial employment difficulties. It is therefore imperative that we focus on education as we move forward and work to revitalize the American economy.

4. Looking Ahead

We face real and serious challenges. Our problems were not made in a day or a month or a year, and they will not be solved quickly.

And yet, having spent substantial time in other parts of the world, I would argue that one would prefer to face the challenges that the United States faces rather than the challenges that almost any other country faces. Our capacity for innovation and its application, our capacity for flexibility and entrepreneurship, our capacity for hard work, our capacity to insist on staying at the cutting edge, and our capacity to define what constitutes progress are unmatched around the world. We should not and we will not settle for an economy that does not perform at its full potential. As a gateway to our future, it will be essential in the months and years ahead that we do everything we can to ensure long-run confidence; that we work to create the demand that will drive job creation; and, at the same time, that we give all of our fellow citizens the opportunity to prepare themselves for an increasingly competitive global economy. Those principles form the core of the Obama Administration's agenda for economic recovery and renewal.