Rescuing and Rebuilding the U.S. Economy: A Progress Report

"Rescuing and Rebuilding the U.S. Economy: A Progress Report"
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Today, I want to provide a progress report on the Obama administration's efforts to rescue and rebuild the U.S. economy. I'll begin by talking about where we were, what we've done, and where we are today. I will conclude with some observations on where we are going.

Where We Were

Let me begin in January. Though only a half a year ago, the distance we have traveled these past six months is remarkable. As many have observed, when President Obama assumed office, he faced the most serious economic and financial crisis of any President since Franklin Roosevelt. Typical of the prevailing sentiment was Paul Krugman's warning in January of 2009, "Let's not mince words: This looks an awful lot like the beginning of a second Great Depression."

The economy was in free-fall at the start of the year with no apparent limit on how much worse things could get:

- Over the three months ending in February, the economy lost 2.1 million jobs. This was the largest three-month decline since 1945. In comparison, the second-largest three-month decline in employment prior to this recession, which occurred in 1975, was only half as large.
- GDP fell at an average annual rate of 5.9 percent in the fourth and first quarters—the fastest six-month rate of decline since 1958.
- Even before any policy changes, CBO was projecting a budget deficit for 2009 well in excess of a trillion dollars because of the weak economy.
  Financial markets suggested significant risks of implosion:

- In March, options implied a better than one in six chance of the Dow falling below 5,000 within a year.
- Markets were expecting 38 percent of investment grade corporate bonds to default within 10 years.
- Municipalities faced tremendous difficulty issuing new bonds and Muni interest rates, which were normally below 10-year Treasury rates, soared to nearly double Treasury rates.
  Fear was widespread and confidence was scarce. Traditional measures of consumer and business confidence fell to low levels not seen in decades. The anxiety stretched well into the mainstream. Take one example as an indicator: Google searches for the term "economic depression" were up fourfold from their pre-crisis levels.

What We Have Done

To address the deep and severe crisis he inherited, President Obama started from two main premises. First, the most immediate priority was to rescue the economy by restoring confidence and breaking the vicious cycle of economic contraction and financial failure. Second, the recovery from this crisis would be built not on the flimsy foundation of asset bubbles but on the firm foundation of productive investment and long-term growth.

The President was clear from the beginning that these two tasks needed to be dovetailed—that confidence in our ability to rescue the economy depended on a sense of our commitment to reform and a vision for rebuilding.

The economic problems confronting the United States as President Obama took office were of a unique character. This was not the standard post-World War II recession in which rising inflation had led to monetary contraction which led to economic contraction. Nor was it a crisis of the kind frequently experienced in emerging markets in which the country had experienced a sudden loss of external confidence. Indeed, the dollar strengthened over the second half of 2008.

Rather, the crisis was qualitatively similar to the crisis in Japan after its asset bubble collapse, the early stages of the Great Depression, or other major domestic financial crises in which asset bubbles burst, credit flow contracted and de-leveraging reduced spending.

We were very much aware that there were few, if any, examples of success in rapidly restoring economic growth and stability after broad-based financial crises. We concluded that this was a reflection of insufficiently aggressive action taken too slowly and decided that our policy response would be neither too little nor too late. The Administration decided to pursue a policy approach of seeking to reverse the vicious cycle connecting income declines and financial instability by directly supporting incomes and restoring stability to the financial system.

Our policy approach started with a major commitment to fiscal stimulus. Economists in recent years have become skeptical about discretionary fiscal policy and have regarded monetary policy as a better tool for short-term stabilization. Our judgment, however, was that in a liquidity trap-type scenario of zero interest rates, a dysfunctional financial system, and expectations of protracted contraction, the results of monetary policy were highly uncertain whereas fiscal policy was likely to be potent. We also concluded that we should confront the major contractionary forces in the economy by using all available tools.

While I had once advocated for stimulus that was timely, targeted, and temporary, our analysis of the situation the economy was facing indicated that stimulus needed to be speedy, substantial, and sustained.

Ultimately, the President proposed and the Congress adopted the largest program of fiscal stimulus in the nation's history, with a total cost of about 5% of GDP.

The size of the stimulus reflected a balance of several considerations: the size of the likely output gap that the economy was facing, the difficulties of ramping up spending and then ramping it back down after recovery in a high budget-deficit environment, the question of how much could be spent both quickly and productively, and the recognition that the Recovery Act was just one of several initiatives by the Administration that would have a dynamic impact on the state of the economy.

As to composition, we quickly concluded that in a world of substantial uncertainty and one in which it was important to get stimulus started quickly, a diversified approach was appropriate. That is why we settled on a program that emphasized support for household consumption through tax cuts and expansions in unemployment insurance and food stamps; support for small businesses through lending and expanded access to capital; support for state and local governments; and investment in priority areas like health care, infrastructure, clean energy, and education.

We pledged at the time the Recovery Act became law that some of the spending and tax effects would begin almost immediately. We also noted that the impact of the Recovery Act would build up over time, peaking during 2010 with about 70 percent of the total stimulus provided in the first 18 months. Now, five months after the passage, we are on track to meet that timeline.

More than $43 billion in immediate tax relief has reached households and businesses. Another $64 billion has been channeled into the economy through aid to state and local governments, expansions in social programs, and spending on education, housing, and transportation projects. In addition to the amount that has already been paid out, another $120 billion in spending has been obligated by the federal government and is on track to begin working its way into the economy.

As of May, the tax cuts, fiscal support for state and local government, and family assistance programs in the Recovery Act have boosted disposable income by nearly two percent. This has supported household spending as families have begun the necessary repairing of their household balance sheets.

In addition to providing fiscal stimulus, the Administration also set to work on addressing the origins of this crisis: a financial system in severe distress. There were many—from across the political spectrum—who proposed precipitous action to universalize guarantees or nationalize major financial institutions. There was an even larger group who believed that policy needed to start from the premise that the financial system, as a whole, was substantially insolvent. Even Alan Greenspan asserted that “it may be necessary to temporarily nationalize some banks in order to facilitate a swift and orderly restructuring.”

After considering all options, Secretary Geithner led the Administration in a different approach. We recognized the irreversibility of such actions as nationalization. We recognized that there was a very substantial risk that government could be a source of fear, rather than a source of confidence, and that strong actions taken towards one institution could have major implications for other institutions. We also recognized that a substantial part of the flow of credit in the American economy did not depend on banks, but depended on the “shadow banking” system, including the securitization of consumer financial assets such as mortgages.

Our approach sought to go as much as possible with the grain of the market. It sought to move away from earlier approaches that treated the financial system as a monolith and instead provide a basis for differentiation among financial institutions. For these reasons, the Administration committed itself to a financial stability plan intended to restore the flow of credit to consumers and businesses, tackle the foreclosure crisis in order to help millions of Americans stay in their homes, and comprehensively reform the nation’s financial regulatory system so that a crisis like this one never happens again.

Central elements of the plan included the stress tests process and the Capital Assistance Program, which sought to increase capital in the banking system by supplementing private sources of capital as needed. The transparency of the stress tests contributed to confidence in the financial system. Since the release of the stress test results, banks have been able to generate over $80 billion in equity and issue over $30 billion in unguaranteed debt.

Another element was a range of measures is designed to improve price discovery in the securities markets and jumpstart the securitization markets, which in turn will increase lending throughout the economy.

We sought to stabilize the housing market by providing significant tax credits for first-time homeowners in the stimulus bill, putting in place a series of measures designed to offer assistance to millions of homeowners by reducing mortgage payments, preventing avoidable foreclosures, and supporting refinancing efforts by helping to bring interest rates to historic lows. Although we still have a long way to go, there has been a significant number of mortgage modifications under the Treasury plan—approximately 160,000 trial modifications have begun so far.

We also recognized that the restoration of economic accountability required more confidence in the financial system than could be justified on the basis of government regulatory actions of the last several years. That is why we unveiled a sweeping set of regulatory reforms to lay the foundation for a safer, more stable financial system: one that can deliver the benefits of market-driven efficiency even as it guards against the dangers of market-driven excess.

Finally, the Administration recognized that the risk of collapse was not limited to financial institutions. The prospect of uncontrolled bankruptcy in the automobile industry meant thousands of potential job losses in manufacturing and ripple effects throughout the economy. We took a similar approach with the auto companies as we did with banks, keeping out of day-to-day operations but demanding fundamental restructuring, overhaul of management and business practices, and sacrifices from all members of the auto community.

The President also recognized the important global dimension of the economic crisis. As of last winter, essentially all of the world's major economies were contracting at once, for the first time since the Second World War. The combination of the chronic U.S. current account deficit and the reality that net export growth is usually a key part of the recovery from financial crisis underscored the importance of global growth for the United States.

The President insisted that restoring global growth be added to the London G-20 agenda and sought with considerable success to encourage other countries to stimulate their economies as we were doing. He also worked with British Prime Minister Gordon Brown to lead the effort to more than triple the resources available to the IMF with the objective of maintaining the flow of capital to emerging markets at a tense time.

Where We Are

We were at the brink of catastrophe at the beginning of the year but we have walked some substantial distance back from the abyss.

Consider the following indicators:

- A majority of businesses now report that they expect improved market conditions, the opposite of six months ago. Consumer sentiment has also begun to improve.
- Options are now pointing to less than a one percent chance of the Dow falling below 5,000 this year, when they were once better than one in six.
- The implied 10-year default rate on investment grade corporate bonds has fallen by a third.
- Municipalities can again issue bonds and their borrowing costs have fallen to Treasury rates or below.
- And the pace of GDP contraction is slowing and many private forecasters expect to see positive growth in the second half of this year.
- And…because I know you're all eager to know about Google searches…hits for economic depression have returned to baseline levels.
  It is true that unemployment is substantially higher and job loss has been greater than most observers predicted last winter and unemployment is likely to rise in the coming months. This is obviously a major area of concern. But contrary to a significant amount of commentary, this does not provide a basis for concluding that the Recovery Act is falling short of its goals. Both Administration and independent forecasts predicted that only a very small part of the total job creation expected from the stimulus would take place by the end of the second quarter. Indeed, a CEA study projected that only about 10 percent of the total job impact over the life of the Recovery Act would occur in 2009. Given lags in spending and hiring, the peak impact of the stimulus on jobs was expected to be achieved at the end of 2010.

The economic contraction has caused significant job loss. It is noteworthy, however, that the higher than forecasted job losses do not appear to be primarily the result of weaker-than- expected GDP. Rather, it appears that a given level of output is being produced with fewer people working than historical relationships would have led one to predict. In economists' language, there is a significant residual in the Okun's law relationship: the unemployment rate over the recession has risen about 1-to-1.5 percentage points more than would normally be attributable to the contraction in GDP.

To put the point a different way, normally in economic downturns, productivity decreases as firms keep workers employed even as the amount of work declines. This pattern of deteriorating productivity has not been a feature of the current recession. In fact, productivity has increased in this recession, as it did in the last.

One potential explanation for this phenomenon, though by no means a dispositive one, is that the greater financial pressure on firms in this recession has led them to shed cash flow commitments at an unusually rapid rate by laying off workers and leaving jobs vacant. Perhaps an expectation that the recession would be lengthy has also contributed to this behavior.

I emphasize these points because they suggest the importance of the structural dimensions of economic policy. If unemployment reflects more than just weak aggregate demand, the case for measures to increase the flow of credit and get banks lending again, as the Obama Administration has pursued, is reinforced. It also speaks to the importance of structural policy changes that restore long-term confidence, including job-creating investments in education, infrastructure, renewable energy and energy efficiency that are key components of the Recovery Act.

Where We Are Going

Substantial progress has been made in rescuing the economy from the risk of economic collapse that looked all too real 6 months ago. While employment continues to contract, the available indicators suggest that GDP is on close to a level path with prospects for positive growth to commence during this year. Factors supporting growth include the growing impact of both fiscal stimulus and measures to support the financial system, the wealth effects of stronger asset markets, inventory replenishment, and the replacement cycle for automobiles and other consumer durables.

A critical question for the next year will be whether or not GDP growth accelerates to the point where employment growth kicks in, leading to a mutually reinforcing positive cycle of spending and income increases. Towards this end, it will be essential to continue vigorous implementation of the Recovery program and measures to support the housing and financial markets. Experience during the U.S. Depression and in Japan during the 1990s teaches the danger of premature declarations of victory and withdrawals of stimulative policy.

For quite some time, the United States will be living with the consequences of an over-leveraged economy. The common desire of households, businesses and financial institutions to reduce their borrowing and improve their balance sheets will act as drag on spending and growth. While painful, these balance adjustments are essential to laying a sound foundation for future growth. It is appropriate that while the private sector deleverages, government through fiscal policies and through central bank lending policies must cushion the adjustment process by providing public support for spending.

It is essential that stimulative policies be sustained for as long as necessary but also that they be sustained no longer than necessary. That is why the President has repeatedly emphasized his commitment to containing the long run Federal budget deficit and reining in the nation's debt/GDP ratio once the economy has recovered. The President's budget contains numerous proposals on both the revenue and spending sides directed at long run fiscal discipline. Containing growth in debt is a central objective of the Administration's health care reform proposals. And the Administration has supported the Federal Reserve's desire to assure that it has the monetary policy tools necessary to manage an eventual decrease in the size of its balance sheet.

A sound macroeconomic policy framework is necessary for the confidence on which economic recovery depends. It is not sufficient.

The rebuilt American economy must be more export-oriented and less consumption-oriented, more environmentally oriented and less fossil-energy-oriented, more bio- and software-engineering-oriented and less financial-engineering-oriented, more middle-class-oriented and less oriented to income growth that disproportionately favors a very small share of the population.

The President articulated his philosophy at Georgetown two months ago:

Just as a cash-strapped family may cut back on luxuries but will insist on spending money to get their children through college, so we as a country have to make current choices with an eye on the future. If we don't invest now in renewable energy or a skilled workforce or a more affordable health care system, this economy simply won't grow at the pace it needs to in two or five or ten years down the road. If we don't lay this new foundation, it won't be long before we are right back where we are today.

Yes, the President has an ambitious agenda. But it is an agenda comprised of measures that lay a foundation for future prosperity and for the confidence on which the current recovery depends.

- Without comprehensive health reform, there is little prospect of convincing markets that the long term growth in Federal debt is under control or of convincing businesses that the United States is the most competitive place for them to invest.
- Without financial regulatory reform, we run the risk that that the next recovery will be distorted by asset market bubbles just as were the last several.
- Without an expanded and improved infrastructure, we risk having growth constrained by lack of capacity and of bottlenecks that exacerbate inflationary pressures.
- Without comprehensive energy policies, we increase our vulnerability to the energy price gyrations that have caused so much economic pain in the past.

Our economic challenges were not made in a month or a year or a Presidential term. Recovery will take time and history suggests that there will be setbacks along the way. Yet the pervasive sense of fear of 6 months ago has receded as strong rescue measures have taken hold. And confidence and hope are returning as a program of rebuilding the economy moves forward. The American economy progresses.