Shaping the Next Economic Expansion

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When I last spoke here, as Treasury Secretary, in September of 1999, I remarked that history was "important for the understanding that it affords but equally for the humility that it imposes." And I suggested that just as the world in 1999 looked very different from the world in 1989, I had no doubt that the world in 2009 would look very different from the world in 1999.

In discussing the appropriate way to think about the economy at that time, I went on to distinguish between the Keynesian theory that was appropriate for situations of low private sector demand, substantial excess capacity, and limits on the scope of monetary policy, which I suggested was not the right one for that time, from the alternative paradigms that were relevant to a moment of surging borrowing and investing and fully employed resources.

That same distinction appears very relevant today, after the reminders about humility that the last two years have provided.

This morning, we learned that GDP growth in the third quarter of this year was 3.5 percent – the highest level of GDP growth in two years and a stark contrast to the decline of 6.4 percent that the economy suffered just two quarters ago. After four quarters of negative growth, this is welcome news and a testament to the efficacy of policy efforts to promote recovery and stimulate demand.

Today's news underscores the tremendous progress we have made this year. The acceleration in economic output over the past six months is the largest recorded in more than a quarter century and confirms that the American economy is turning a corner.

Consider how far we have come:

- Nine months ago, the debate was about whether the recession would turn into a depression. Today, the debate is about the timing of the end of the recession and the shape of the expansion going forward.
- Nine months ago, financial markets priced in what might be called a substantial Armageddon tail. Today, people worry about whether there are some bubble elements in credit spreads or in a stock market that has risen by more than 50 percent.
- Nine months ago, the economy was in freefall. It had lost more jobs in a single month, quarter, or year than at any point in American history. Today, the question is at just what date job growth will resume.
  I would suggest to you that events did not have to work out this way. There was no assurance that the contraction that followed the Lehman collapse would be contained.

What happened? How to think about the economic events of the previous year and the mechanisms of their unwinding in recovery?

One of the most important lessons you learn in an introductory economics course involves the self-stabilizing properties of markets.

We teach our students that when there is an excess supply of wheat, prices fall, people grow less, people consume more, and the market equilibrates. We tell similar stories about the supply of credit and investment. That's what Adam Smith had in mind when he talked about the invisible hand.

We use as a metaphor the self-equilibrating character of the thermostat, in which things return to their normal level. The vast majority of the time, that is the right way to think about how markets work.

But it was Keynes's central insight that perhaps several times a century the self-equilibrating properties of markets break down, and stabilizing mechanisms are overwhelmed by mutually reinforcing vicious cycles. The right metaphor ceases to be a thermostat and instead becomes an avalanche.

When President Obama was preparing to take office last winter, he faced an avalanche unlike any we have seen in our lifetimes. A combination of irresponsible borrowing and lending decisions on a massive scale, regulatory failures, unsustainable bubbles in key asset markets, and a massive erosion of confidence created an extraordinarily dangerous economic and financial situation.

Vicious cycles associated with deleveraging took hold:

- A liquidation cycle – where financial assets fell in value, forcing their sale by those on margin, pushing the prices even lower.
- A capital losses cycle – where lower prices on assets reduced institutions' capital, leading to less lending and lower asset values, continuing the downward spiral.
- A credit-accelerator cycle – where a weakening economy led to a weaker financial system, which led to less lending, which led to a weaker economy.
- A Keynesian vicious cycle – where lower spending led to lower employment, which led to lower incomes, which led to lower spending, continuing the cycle.
- And, at the worst of it, a panic vicious cycle – where individuals saw financial institutions in trouble and rushed to withdraw their funds, creating self-fulfilling prophecies that institutions were in fact in trouble.
  Starting in the summer of 2007, but accelerating last fall, these five mutually reinforcing vicious cycles created an extraordinarily dangerous situation. They created a situation in which one could not rely on the self-stabilizing properties of markets.

Toward this end, the President moved vigorously to attack the vicious cycles I have just described at each of their key nodes. The key steps are familiar:

- Substantial, direct support for income, spending, and job creation through the fiscal policies embedded in the Recovery Act.
- Support for financial confidence through the activities of the central bank, transparent stress tests, and encouraging of capital raising by major financial institutions.
- A global effort to support demand and avert financial panic, and in particular to ensure a continuing, strong flow of capital to emerging markets.
- And steps to support the flow of credit directly to homeowners and small businesses and to contain the potential vicious cycle associated with foreclosures.
  The result of these measures has been the partial reversal of the vicious cycles that were pulling the economy downward.

Panic selling has been replaced by anxiety about missed opportunities. Anxiety about capital levels has given way to eagerness to pay back government funds.

A stronger economy has strengthened financial confidence, which then has fed back into the economy.

To borrow from Churchill: We are not at the end or even the beginning of the end of our efforts to promote economic recovery. But we are perhaps at the end of the beginning as the economy turns a corner. To be sure, crucial problems remain. Unemployment continues to increase. While businesses are doing surprisingly well given the seriousness of the recession, much progress comes to the bottom line from reduced costs rather than the top line of increased sales. And flows of credit are certainly not yet wholly normalized, even as pricing has improved.

Today, in an economy facing overhangs of excess debt, we continue to confront the challenge of spurring demand in an environment in which borrowing and spending have been sharply reduced. At this point, a lack of demand is the major constraint on output and employment in the American economy. The pace of economic growth will depend importantly on the extent to which policy is able to support demand directly or indirectly.

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.

Through the Recovery Act, government has taken up slack in the economy and made important public investments. Yet even with the dramatic action of the Treasury and the Federal Reserve, the total level of borrowing in our economy is actually lower than in normal times, not higher. Accordingly, the volume of securities that have to be absorbed by market participants is lower, not greater, than normal.

This is, however, a profoundly temporary state of affairs. As economic recovery takes hold, it will be essential to ensure that expansionary policies appropriate to a downturn be withdrawn. This is why President Obama has consistently emphasized the importance of fiscal discipline and why the process of reversing extraordinary interventions in the financial system has already begun.

This is not only a matter affecting the economy over time. Even in the near term, expectations of future policies have direct impact on both capital costs and confidence, so policy signals will be very important. I should say in this regard that while legislative discussions continue, we are confident that health care reform will have an important positive impact on the long-run health of the Federal Budget.

To encourage businesses, consumers, and investors to spend and invest, we must foster an atmosphere in which they feel both that recovery can be sustained and that the economy is returning to a long-run sustainable path. No actions to combat short-run output gaps must ever be allowed to call into question our fundamental national commitments to sound money, noninflationary growth, and sustainable devolution of government debt.

An atmosphere of confidence is central to our efforts to raise demand and, in turn, to enhance our economic growth. This will depend on appropriate fiscal discipline.

How, then, to think about economic recovery that is not driven by unsustainable consumer borrowing and spending or by the public sector?

By the logic of national income accounting, it depends on three things. It depends on private sector investment, it depends on exports, and it depends on income growth that can support consumer spending increases. Let me say a little bit about each of those three things.

Given that capacity utilization is at very low levels, it is inevitable that private investment will lag for some time to come in some parts of the economy. But in a variety of other spheres, private investment will be profoundly important for the next economic expansion. That is why the President has emphasized measures that support the availability of credit for small businesses. That is why the public sector is playing a crucial role during this period in the financing of new houses.

But experience with U.S. economic growth suggests the importance of strong actions in key sectors. Think of the information technology boom of the 1990s, or the successful and rapid growth of the 1950s and 1960s, or even the 1920s

Two cutting-edge sectors for the American economy at this juncture are, first, energy and the environment and, second, information technology.

We are currently working with Congress on major cap-and-trade and energy legislation to build on the substantial steps contained in the Recovery Act to support both energy efficiency and renewable energy as well as more efficient and effective exploitation of our traditional energy resources.

Turning over the capital stock more rapidly to meet environmental and energy independence objectives can be a significant contributor to aggregate demand in the short and medium term, even in the presence of significant unused capacity.

Certainty as to the likely price tag for energy can also be a spur to investment. It has been demonstrated again and again that the greatest barrier to long-term investment decisions is residual uncertainty. If we are able to resolve uncertainties in the investment area, there is substantial scope for increased demand in this key sector.

We are also working to support what is predominantly a private sector undertaking: the improvement of our information technology infrastructure investment in this country. Our broadband program is a complement to continuing efforts to knit the country together in very important ways.

With respect to the health care system, these issues are important as well. It cannot be right that the average 7-Eleven uses more information technology than the average doctor's office, at a time when the lack of recordkeeping is thought to be associated with tens of thousands of deaths each year in the United States. Investments in the Recovery Act directed at stimulating private investment in this sphere can contribute both to our economy's long-run potential and to increasing demand and creating jobs in the short run.

Promotion of investment is one key component of any economic strategy.

A second key component is support for increased exports.

During my time in government in the 1990s, I was fond of warning that the world economy could not fly indefinitely on a single American engine and expressing concern about the then-magnitude of our current account deficit. In fact, the world economy flew rather longer and rather stronger than I would have imagined at that time. But even stopped clocks are right twice a day, and ultimately, after 2007, we saw the undoing of the world's unbalanced growth strategy.

If our economy is to enjoy the growth it needs, and if the world economy is to be safe, a reorientation toward a more balanced global growth strategy will be essential. That is why I believe the decisions taken this year to establish the G20 as a central global economic forum, including all of the major emerging market countries, will prove to be of historic importance. That is why the framework agreed to in Pittsburgh for rebalancing global growth has great potential.

Rebalancing has to be reality rather than rhetoric. At a time when we cannot afford to have a consumption share of GDP rising from starting levels above 70 percent, the world economy will underperform. China continues to have a consumption share of GDP that declines from initial levels below 40 percent. Rebalancing is an additional component of a sound long-run, private sector-led growth strategy.

We are also working to support U.S. exports by again putting the weight of the U.S. government behind U.S. producers in international competition. In that vein, we are working to relax export controls that no longer serve valid national security purposes and to make sure that our trade laws are fully enforced for the benefit of U.S. producers.

Those are the first two components: stronger exports and stronger private investment.

Ultimately, of course, what happens to the economy will depend crucially on what the consumer does. Consumption is by far the largest component of our GDP.

Here, it is important to recognize, in thinking about the medium term, just how depressed certain consumer-related expenditures are relative to long-run norms. Allowance for normal scrappage plus a rise in population requires the sale of some 15 million automobiles each year. Automobile sales are currently running between 10 and 11 million. New family formation results in the demand for somewhere between 1.5 and 2 million new housing units each year. Housing starts are currently running close to half a million.

At just what point these figures will normalize is difficult to judge, but that moment will come and will come with significant impetus to the economy.

So too, we can promote growth in consumption while not encouraging unsustainable borrowing if we are able to raise levels of consumer income. Health care reform has an important role in that effort. If reform succeeds in containing the growth rate of costs, it will accomplish some combination of reducing businesses’ hiring costs and increasing households’ take-home income. Similarly, over the longer term, the ultimate determinant of what workers earn is their productivity, which depends crucially on the education that they have received.

By supporting investment and by supporting exports, we lay the foundation for private sector-led growth.

Keynes, in talking about Britain’s economic problems during the 1930s, referred to them as a “magneto” problem. “Magneto” was a British term during that period of history for the alternator of a car. What he meant was that a cyclical downturn like the one that Britain was suffering at that time did not reflect a profound inability of the economy to produce, but instead reflected a breakdown of the economic mechanisms that manifested itself in a lack of demand.

That is true in our country today. For that reason, so much of the focus of our policy for the very short term has been on encouraging demand and expanding the flow of credit.

Ultimately, though, if we do this in the right way, we will also succeed in increasing our economy’s productive potential and increasing the character of our economy’s ability to include everyone in its prosperity. That is why financial reform is such an important part of the President’s economic strategy.

Over the last generation, we have seen the Latin American debt crisis, the 1987 stock market crash, the S&L debacle, the Mexican financial crisis, the Asian financial crisis, LTCM, Enron and the NASDAQ bubble, and now the events of the last two years. Almost every three years for a generation, there has been a substantial crisis in which a financial system that has as its fundamental purpose the dissemination and diversification of risk has misfired. It has proved to be a source of risk, leading to the loss of jobs for hundreds of thousands, if not millions, of people.

In addition to spurring demand and raising the economy's productive potential, establishing a sound foundation for recovery requires a serious and collective effort by all of those involved in the financial system in the private and the public sector to strengthen its stability, to increase regulation, and to make the kind of risks that we have seen in the past less likely.

So I conclude where I began. We have come a long way over the last year. We are in many ways in a better and stronger position than appeared likely at that time. But we still have a long way to go – in moving the economy forward, in increasing its ultimate potential, and in ensuring its more stable and steady growth in the future.