Challenges to Recovery: Why Is It So Slow? What Can Policy Do?

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Part 3
The Recovery Is Slow

- Job growth fairly steady (Chris Waller talk); just not fast enough to restore full employment
- Review employment profiles
  - As reported
  - Adjusted for labor force growth
Great Recession: Actual and Adjusted for Potential Labor Force Growth

Adjusted Profile: Labor force grows at 0.09% per month from December, 2007. 130,000 to 140,000 per month. (Actual growth from Dec. 2004 to Dec. 2007 0.11% per month.)
Why So Slow?

- Financial crisis (Reinhart & Rogoff)
- Minsky: Long “Consumer Age” boom with contained downside
  - Encourages more aggressive financing
  - Crash, when it comes, is worse
  - Moral hazard and “Minsky Paradox” (Robert Pollin)
- Consumer spending hit hard this time
  - Arithmetic of demand (consumption = 71.2%)
  - Deleveraging & reduced credit in huge sector
  - Financial weakness: kills firms, disables households
  - Historical comparisons
Challenge from Rising Inequality

- Another drag on demand—source of slow recovery
  - Propensities to spend across income groups and the income recycling problem
  - Evidence hard to come by, but research supports this conclusion

- Historic rise of inequality (data)
Income Share of U.S. Top 5% (Pre-Tax)

Excluding Capital Gains

12.5%
A Paradox

- Rising inequality => “demand drag”
- But strong demand growth in Consumer Age
- Why? New Cynamon and Fazzari research
  - Bottom 95% spent a higher share of their slow-growing income
  - Top 5% spending share volatile, but no trend
- Consumer Age dynamic: “Rich” recycle rising income to demand by lending to middle class
- New data
  - Integrate new housing with consumer spending
Disaggregated Demand Rates

Bottom 95% spending rate greater than 100% 1999 – 2007

Unsustainable Trend

Debt to Income Ratio - Survey of Consumer Finance

Middle Class: up 95%
Beyond Minsky …

- Higher household debt in bottom 95%
- More nuanced perspective: unsustainable spending and borrowing in the group getting lower share of income
  - Unsustainable spending about 8% of GDP by 2006
- Postponed demand drag from inequality
- Minsky’s “cleansing” may not fix this problem
The Challenge

- Lost big piece of demand from bottom 95% in Great Recession
  - Also lost about 0.5% of demand growth
  - No obvious replacement
- A structural problem => “just waiting” not enough
- What to do?
  - Traditional macro monetary and fiscal policy
  - Institutional reform and inequality
Monetary Policy

- “Lender of last resort” (bail outs)
  - Contain financial vicious circle; prevent catastrophic collapse
  - Problems with structure; but time and experience was limited

- Interest rates and quantitative easing
  - Definitions
  - Stimulate by encouraging borrowing: “rewinding the clock springs of financial instability”
  - Constrained by chastised lender behavior
  - Distributional concern with low rates

- Important, but further effects limited
Fiscal Policy

- Government spending: direct channel to demand; could help fill demand gap
  - Counterexample: sequester chops 1% from 2013 growth
- Tax cuts for those who will spend
  - Recent news on payroll tax increase
- Possibly effective, but can we “afford” it?
  - Contrast views with political rhetoric
Why Worry about Federal Debt/Deficits Today?

- Interest rates and “crowding out”
  - Rates at historic lows (if credit available)
- Interest burden on taxpayers (data)
- Inefficient government (how big?)
Inflation–Adjusted Federal Interest as Share of Potential GDP

Why Big Decline?
1) Low interest rates
2) Depressed Actual GDP

Percent of Potential GDP
Percentage of "All Other" in Total Federal Spending

Excludes: Defense, VA, Health, Social Security, Income Security
($354 billion in 2011; 27% of 2011 federal deficit)
U.S. Fiscal Situation in 2013

- **No crisis!** Deficits and debt manageable
  - Current debt ratio close to sustainable at full employment

- **Spending cuts exacerbate slow recovery**
  - Sequester: $90 billion cut destroys ~$144 billion of income (multiplier of 1.6); less than ~$60 billion of deficit reduction
  - Benefit / Cost ratio at least 2.5

- **Manageable for 5+ years to come**
  - Weak economy => low rates
  - Faster growth => smaller deficits “automatically”
  - Interest cost offset by effect on potential output
The Long Term

- People live longer and want state-of-the-art health care => health share will increase
- Access to decent retirement and medical care not determined entirely by ability to pay
  - Government transfers create access
  - Policies have wide support: TAPS results
    - Medicare: same 43%; increase 44% (54% & 25%)
    - Social Security: same 45%; increase 48% (51% & 37%)
- Cost and tax trends => unsustainable long-term rise in debt to GDP
What to Do?

- Improve efficiency: “Bend the curve”
  - Realistically, health care share will rise anyway
- Shift costs off government budget
  - Raise eligibility age; increase personal premium
  - Does not eliminate cost but affects distribution
- Link revenues to cost
  - Higher “taxes” (or “premiums”)
  - Issue of distribution (per capita health cost ~$9,000; median household income ~$51,000)
- No benefit from hurting the economy now
A Broad Policy Agenda

- Increase public infrastructure investment
  - Low interest rates; unemployed resources
- Middle-class income growth to support “organic” consumption growth
  - Health and retirement security
  - Tax cuts for those who spend them (personal allocation vs. bureaucratic allocation)
  - The American Dream and faster wage growth linked to productivity gains
More Specific Policy Thoughts

- Infrastructure and entitlement tax reform
- Role of quality education
  - Raising “skills” not sufficient, but provides options and raises prospects for worker upward mobility
  - Education improves quality of life and citizenship
- Higher wage growth in the collective interest
  - Strive for consensus, not conflict
- Rising living standards abroad
  - Development of China, et al. is win–win
- A different kind of monetary policy