

What Do We Do Now?

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The recession has ended according to the statistical record. But unemployment remains high at between 9 and 10% with long-term unemployment at the highest level since the series began in 1948. Much of the public does not see improvement. Many will not believe the recession is over until they and others are back at work.

Why is this recovery slow, and what can be done to increase growth and employment? Let's start with some of the problems.

The fiscal stimulus helped very little. Economists have known for decades that temporary tax cuts have little effect. The Carter and the first Bush administrations provided additional evidence. Transferring large sums to state governments gave temporary relief to the states but shifted deficits from states to the federal government. Keeping teachers employed for a year helped some teachers for a year, but it does not do much for the unemployed production or service worker. And the teachers spend the year worrying about next year. That's not an outcome that leads to much new spending. Net effect on the economy is close to zero. And the states' problems remain. Most of the stimulus spending went to these programs and did very little for the mass of unemployed.

At issue is not whether the stimulus did some good. It is whether the government's policy and actions were well designed to restore stable growth with low inflation. Pressure for more stimulus makes clear that previous actions have not done what is needed.

Since the end of the Eisenhower presidency in 1961, the federal budget has been in deficit almost every year. The deficits have gotten larger and larger. And the reported deficits are dwarfed by the present value of promises for healthcare and retirement. Most everyone now agrees that our fiscal position is unsustainable. Unlike Japan, we do not finance the deficits with domestic saving; we borrow massively abroad. To service that debt to foreigners we must export more and import less. Americans have enjoyed a high consumption growth rate for many years. They must learn to live with a smaller consumption growth rate. Production must be used for exports, and imports must shrink. This can have a major effect on countries that grew by selling to us.

Uncertainty is the enemy of business investment and expansion. The future is always uncertain, but the administration has added greatly to the costly and unforeseeable future. Here is a short list, admittedly incomplete.

- 1) What tax rate will apply in future to income from investments made now?
- 2) What new regulations will be imposed on businesses?
- 3) How will existing and new regulations for pollution, financial services, and healthcare be implemented and what will they cost?
- 4) What will employee health care cost?
- 5) Will rules governing labor unions be changed to make unionization easier? How much will that add to production costs or increased outsourcing?

If employers have no idea about future costs, they are reluctant to hire additional workers. They satisfy increases in demand by asking current employees to work overtime.

What can be done?

Our current situation can be improved by reducing uncertainty and stimulating business investment. I emphasize investment because the United States must invest more to produce exports. Past experience suggests that reducing the corporate tax rate is an effective stimulus to investment. Arthur Okun, Chairman of President Lyndon Johnson's Council of Economic Advisers and a main architect of the Kennedy-Johnson tax program, analyzed the components after he left office. He concluded that the corporate tax cut was the most effective part of the program. Later work confirmed his conclusion.

Declare a three to five year moratorium on new regulations, including labor market rules and the new financial restraints, unless each new rule is approved by a super majority in Congress.

Develop and announce a precise, credible program of deficit reduction that specifies planned spending reductions and tax increases. Eliminate uncertainty about future tax rates and where the tax burden will increase by announcing the program now.

Announce correct, believable costs of providing health care under the recently approved legislation. Recognize that many states are unable to pay for additions to Medicaid. How much more will the federal government commit to this program? How will these costs be paid?

Use the remaining, unspent funds in the January 2009 stimulus program to reduce the corporate tax rate.

Reduce the risk of future inflation by implementing a gradual program to reduce the excess reserves in the banking system. Some economists argue that the risk does not exist. They point to the interest rate on longer-term Treasury bonds as evidence of diminished inflationary expectations. I believe this interpretation is wrong. Low interest rates on Treasury bonds indicate the uncertainty and fear that exists currently. Investors pay for safety by holding Treasuries and gold.

I recognize that my proposed program is not about to be implemented. You should recognize that high uncertainty about the future will continue and that sooner or later you must act on many of these issues. Growth will be slow and unemployment will remain far outside the range considered full employment if you delay.

Some economists actively urge more government spending and larger deficits. They neglect or denigrate concerns about the debt, the interest cost of servicing the debt, and the negative effect that large deficits and growing debt have on decisions to invest. Their arguments ignore the most important development in macroeconomics for the past 40 years—the careful integration of expectations about the future in dynamic economic models. A program that begins to lift uncertainty and reduce debt and deficits has a positive effect on private spending.

Recent efforts in Britain and in the euro area to reduce spending and deficits have been followed by currency appreciation there and other evidence of relief and more favorable expectations knowing that many governments are willing to act against future calamity. The United States must do the same. The longer we wait, the harder it will be to make an orderly transition. Start by curtailing new regulation and by implementing a program of current and future spending cuts and corporate tax reduction to increase current investment. Everyone knows that current deficits are unsustainable. A credible multi-year program that starts to reduce deficits will remove a major uncertainty.

Deflation

Deflation is a sustained decline in a broad-based price index. We do not suffer from deflation, and it is essential to separate a decline in some commodity price that has a large weight in the consumer price index, such as oil or gasoline, from a general decline in prices. Gasoline prices fell 39 % at an annual rate in the most recent three months. That drags down the increase in the consumer price index, but that's not deflation. A first lesson in elementary economics distinguishes between inflation or deflation and large changes in individual prices. We should not base policy on that error. We have in the past when the Federal Reserve in the 1970s attempted to offset large increase in the oil price. The result was deep recession.

Mention of deflation arouses memories of the Great Depression. That's another mistake. There have been 7 periods of deflation in the 97 years under the Federal Reserve Act. Some were large, 30% decline; some were small, 1 or 2% decline. Only one, 1929-33 brought the country close to disaster. Recovery from the others, most recently 1960-61, looks like any other recovery.

We know now that the 1929-33 disaster was caused by inappropriate monetary policy. That policy reduced money growth by 50%. By 1933, prices had fallen much less than 50%, so the correct expectation was a further deflation. Devaluing the dollar in 1934 brought an end to deflation by inducing sustained massive increases in gold that restored growth in the monetary aggregates and revived the economy.

Current monetary policy is very different from 1929-33. Businesses hold large cash balances. The banking system has over \$ 1 trillion of excess reserves. We do not need more monetary stimulus.

We need programs that get the banks to increase lending and businesses and consumers to increase spending. Reducing uncertainty and restoring confidence is the place to start.

The banks that report their forecasts to the Economist magazine do not predict deflation, except in Japan, for any of the developed countries that they monitor. Their current forecast for the United States in 2011 is 1.5 percent.

Congress gave the Federal Reserve a dual mandate. It is inefficient and costly to concentrate on one objective at a time. That's what caused the Great Inflation of the 1970s. The Federal Reserve should not repeat that mistake. A small increase in interest rates would maintain negative real rates.