



January 13, 2012, 13:00-14:30

Venue: CIGS Meeting Room 3

CIGS Seminar :

"The Ailing U.S. Economy in 2012: Rehab or Relapse"

by Professor Jay Rosengard

<Discussion after His Speech>

Question 1:

I agree with your opinion (which is illustrated in the slides between 11 and 14) that the most important policy at the moment in the United States is the fiscal stimulus that would reduce unemployment and produce real demand. Monetary relaxation by the Fed would not increase real demand. My question is: Although we know this is the action that the US should take, why don't the US Congressmen understand it and why then don't the American mass media advocate it?

Mr. Rosengard

It's a good question. I agree with you that there is nothing else that the Fed can do. Interest rates are nearly zero. The Fed tripled its balance sheet. It is not a liquidity question anymore. The markets are functioning, but they are not lending. I can say that we had a very innovative and activist Governor of the Fed. But it is really on the fiscal side now.

There are two points to think about the Congress.

We had the midterm elections where the Democrats lost control of the House of Representatives. Before the midterm elections, people are very frustrated with the economy, particularly high unemployment rate. We had the Tea Party movement. And the Democrats lost the House.

It is the Republicans' strategy that serves their short-run interests in the upcoming Presidential election but is bad for the national interest. The idea is if the economy recovers more quickly, Obama will be reelected. If the economy is still very weak and struggling, Obama will be blamed for it and his

chances to be reelected are poor. That is the bottom political line. It is not that these people are stupid, but very sophisticated. It is what they think a calculated risk that if they make Obama look bad in the short run, they can retake the White House and may be get a majority in the Senate. That is a part of it.

A part of it is ideology. The Tea Party movement is saying that the government is too big. It has been a political stream in the US. But they do not acknowledge the figures I put up about who increased the size of government. It was mainly through defense spending for two new wars under Republican Presidents. So, there is a kind of a blind ideology without looking at timing, sequencing or impact. That is very difficult to deal with. And, the Republican mainstream has lost control of the party. They need the Tea Party element to have a majority. In general when we have coalition governments, the small part of the coalition, i.e. the extremist, controls the agenda. This is pretty much what we have now in the US. We have an extreme wing of the opposition party taking over the party which paralyses the legislature.

So a part of it is political calculation and a part of it is ideology. That is my interpretation. Obama believed that he could negotiate and find a middle ground. Now we are in reelection mode. Republicans do not negotiate and Obama is doing everything he can without the Congress (through executive decrees). Instead of trying to find a middle ground now, Obama says that it is up to voters to blame these people for obstructing. His strategy is much more activist and partisan. Republicans have also remained partisan. So we have a very confusing political situation that will probably continue through the election. It is not very encouraging for people who know what has to be done.

Mass media has blamed both sides. They say that there is no compromise, and therefore both sides are wrong. Democrats have not been very good at making their case for the impact of their interventions and the difference in perspective. I do not think that the media has any evil intention. I would blame the policy people for not communicating very well with the mass media.

Question 2:

What are academics saying about this situation?

Mr. Rosengard

Academics have a diversity of views. The problem is that the academics' points are often taken out of context or not completely reported but usually communicated more in nuance.

I think that the only way to deal with a sustainable debt is to increase the denominator, i.e. to stimulate growth. The legitimate fear in stimulating growth is that, if you look at Japan, a temporary stimulus becomes a chronic stimulus and a temporary deficit becomes a chronic deficit. It is very difficult to dig your way out. It is a legitimate concern how you phase out of the growth strategy. Same question applies to the Fed; how do they shrink their balance sheet back to normal size?

Question 3:

Two years ago when we discussed the economic stimulus, everybody referred to the so-called green stimulus as one of the major components of the measures. It seems to me very symbolic that the latest discussion at Capitol Hill is mainly focusing on Keystone XL Pipeline, which will emit more carbon dioxide. How do you evaluate the so-called green stimulus? Is it generating slowly but steadily the positive outcome or is it failure in substance or implementation? Or, even at the beginning, is it just the political facade for the unrelated lot of measures?

Mr. Rosengard

Putting in perspective, the green stimulus was a part of the Obama package of US\$ 787 billion. From that package, approximately 500 billion was spending, from which 224 billion was for infrastructure. And out of that we have some of the green technology and green infrastructure to stimulate new-age industries. So, out of roughly 800 billion, you are talking about a relatively small part of stimulus package. It takes time to see the results. And, there was a big failure that a manufacturer of solar panels supported by the government went bankrupt. For those who argued that it was really bad policy, this vindicated their argument. The other side said that this was an exception mainly due to a collapse in global prices of solar panels that was mainly caused by competition from China.

You can take either side. I would say that it is a relatively small number and that it is supposed to be a catalyst to stimulate private investment. The end

result is too soon to say. You do have the counterargument that there is still a lot of fossil fuel to exploit which meets national security interests.

The pipeline you mentioned has nothing to do with fiscal policy. Approving a pipeline for Canada, it is said to be a job creator. That is why it is in the bill. But, it does not create a great number of jobs, but capital intensive.

You have got all sorts of local politics, local agendas and special interest groups competing. I think philosophically, and we are actually talking about this in Japan too, that the challenge is a new generation of technology that nobody else has. That is where high-income countries should excel. I think Obama is right and as the price of fuel goes up, this will become more valuable. But again, it is a hard argument to make and it is looking at a long-term impact.

Question 4:

Referring to the slide number 10, this is somewhat alarming to me because the level of the fiscal deficit of the US is very high reaching to the post-WW II level. Should we worry about it? Can the United States have more fiscal deficit? Is there any limit? Or, is there no limit by the country like the United States as a too big country to fail? Japan now has the world largest deficit in terms of the percentage of GDP, which is larger than that of the US. That is the reason why I am asking this question.

Mr. Rosengard

The only problem with the debt is its impact on the deficit and on the spending. You are worried that repaying the debt will be a burden in your budget and crowd out other priorities, especially social spending or investments in public infrastructure. We are really looking at two numbers, the annual deficit as a share of GDP and the accumulated deficits in the debt.

If we look at debt to GDP, we are worried about the numerator and the denominator. In the long run, the key is the denominator which is a size of the economy. The way to make it more sustainable is to have a bigger economy. It generates more revenue and more tax revenue that help you to reduce your deficits and service the debt. Is there any magic number? People have asked about Japan for a long time. Is it sustainable by reaching 100%, 120%, 150% or 200%. Japan will face a problem when it cannot sell any more bonds. There

are some protections since almost all buyers are domestic at the current savings rate. If I were Japanese, I would worry about that market.

The US is a little different. It is an international reserve currency. We have a tremendous increase in debt. It would be a worrisome issue. But the cost of that has gone down because we are paying almost nothing for it. Eventually and hopefully, however, interest rates go up, and that debt becomes very expensive. That is the worry. It is a legitimate worry. In the long run it is not sustainable.

If you are looking for fiscal consolidation, you have to obtain more revenue and cut expenditures. The question really is timing; whether you do it now or you do it once the economy is more robust. I think everybody agrees in the long run that trend cannot be sustained. And it is not looking for a magic number, but the trend or the pattern.

I would agree with those who would say not to choke the beast right now, not to starve it, to get a healthy growth rate and to recover lost jobs. I believe that since Obama took over, maybe 3 million jobs have been lost, most of which were caused in the first 6 months. At the current rate, he would actually be a net job creator by the election, but still have a high unemployment rate. The question is when people think the unemployment rate has gone down enough or the growth rate is high enough where you start having expenditure cuts in social security, Medicare, Medicaid and defense. I think everything is the matter of timing not only looking at a long term strategy but also a short-term versus a long-term strategy, and how you transition from one strategy to another.

Question 5:

In this Christmas season (2011), the consumer purchase was very good in the US. The car sales have started very well this year (2012). I just want to know whether the US economy will grow in the short term, and if so what is pushing the US economy today?

Mr. Rosengard

I think it is a good point. All of the indicators we watch are moving in the right direction. Consumer confidence is growing. Sales were pretty robust in the period between Thanksgiving and Christmas seasons, both regular and

internet sales, and for durables. Unemployment is going down slowly. Growth rate despite all disturbances in Europe is going along.

All of these different indicators seem to be going in the same direction. Many projections are for modest but sustained growth over the next year although they may not create enough jobs to regain the lost jobs and to absorb all new people coming on to the market. But if you look at the different projections from different sources, they all are positive but modest.

Everything looks positive but slow and painful. In our two scenarios between rehab and relapse, it seems to be more rehab. Any of you may have gone to physical rehab therapy to recover from sickness or a wound. It is slow and painful, and difficult to see the progress. But everything seems to be moving in the right direction much to the chagrin of the Republicans.

The hope is that it continues and accelerates, which would vindicate Obama administration strategy and help in November election. If it starts to backslide (relapse), it becomes more difficult for him to be reelected.

Question 6:

In the early 90s, we had the so-called jobless recovery or job-loss recovery, and then we had productivity tax. Finally, it ended up with IT-oriented strong recovery. You said that the US economy is recovering slowly. This time, current very modest or slow recovery is being supported by something temporary factors or something new dynamics?

Mr. Rosengard

Your point relates to my earlier comment on the green technology. I would say that we do not have any great revolution, rethinking or restructuring of the economy. But, current situation is more sort of temporary interventions and pent-up demand. For example, if you do not buy things for 3 years, you have this pent-up demand for durables. That is one of the reasons for the current situation.

Luckily, this is not jobless growth. Last month the most jobs were created in 3 years. So, it is generating jobs with some growth, but in the long run you really need a rethinking of comparative advantage of the US where they can be most competitive. It would be green technology, energy conservation or

rebuilding basic infrastructure (such as roads, power, public transport) that makes the private sector more competitive. What we have now is a part of the stimulus package going to the basic enabling infrastructure which will have a longer-run impact in attracting private sector investors. But in the short run, I think that as you say it is probably more temporary factors and catching up.

Question 7:

I would like to present my counterargument against the rosy figures you mentioned. First, the real estate market was expected to stabilize in summer of 2010, which never happened. Second, the unemployment rate figure might be overstated by the smaller denominator which excludes those who gave up finding jobs. If you include them, actual rate could be something like 13.5%. In addition, the absolute increase in hiring might be overstated by the number of people who were hired on a part-time basis for holiday season sales. Third, the figures of consumption might be overstated by the volume of consumption supported by the so-called subprime commercial loans, which may turn out to be a success or a disaster after 2 years. What views do you have on these points?

Mr. Rosengard

What I did not mention in my speech was that absolutely critical to long-term structural adjustment is the housing market, which has not been resolved. That is a big hangover and it is going to be a drag on the economy. We have so many mortgages now that we caught underwater where the debt is greater than the value of house. Until the banks agree to take a loss, that is not going to clear. Housing market is a big cloud over the economy.

As for unemployment rate, the rule of thumb is that if you include the underemployed, the part-time workers and those who have given up, the rate almost doubles. When it was at 10%, it was really around 18% or 19%, and for 8.5% it may be 14% or 15%. But that is true for all these figures. It is fine as long as you are consistent in how you measure. And you have to read the trend rather than the absolute number.

On the consumption figure, actually household debt is going down in general. People were told to save more and borrow less, and they are doing so, which is really good for the long run but really bad for the short run. In general,

people are being more careful or conservative, which is good for sustainability but bad to stimulate consumption.

I would agree with you on the housing and unemployment numbers. Consumption is not much credit driven. In fact, it is very hard for anybody to get a loan now. Housing loans become too conservative, consumer finance is very difficult, and business loans are almost impossible. It is probably been an overreaction in the market on the debt side.

Question 8:

With respect to the mortgages and housing issue, one fiscal policy seemingly under discussion in the administration and the Fed is how to address debt forgiveness of over-borrow of more than half of households. Of course that is a bad news for bankers or other members. What kind of specific policies do you expect to come out maybe at the time of State of Union address or a little later?

Mr. Rosengard

The real concern is not on household debt overhung from consumption. If the debt is consumption debt like credit card debt, you can declare bankruptcy and take other measures. The problem is the debt overhang from the mortgages, which is not easy to deal with. The basis of the problem is that we have a lot of stock of house and no demand. Houses are so overbuilt that will take a long time to clear. Some local governments have taken very drastic action. For example, in Detroit, houses are actually tore down to reduce stock. Banks do not want to maintain the houses and do not want to put any money into them. If you get a few empty houses, they drag down the values of the neighborhood as they become centers of crime. If the banks do not want to take responsibility for these houses and the city is trying to save neighborhoods, one of possible solutions is to physically tear down houses. It is a very sad and dramatic, but it makes certain economic sense to reduce stock and supply.

The painful news is that we have just overbuilt and it is going to take a long time for supply and demand to balance. The question is if there is any way to facilitate or mitigate the impact and maybe accelerate the process. The administrations tried many things. Most of them have not worked because they have been too selective or too complicated, most of families do not

qualify, or the banks do not want to participate. I think that from now to the election we cannot see much development. Maybe after the election depending on who is elected you might see something less voluntary and more imposed on the banks.

If nothing is done, it will be a very long painful process to find new market with a lot of people very unhappy. In America, like in many other countries, the largest household investment is the home. When the value of house goes down and people continue to pay their mortgages, their behavioral economics is irrational. Even though they want to honor the contract, what they are paying is very different from the market value. It is against their own financial interest.

For this real estate issue, there are a lot of ideas. The one I like the most is that banks are forced to take a loss now with an opportunity to benefit on the upside if values goes up again. It is a kind of risk-sharing. Banks share the losses with homeowners. But should the markets recover and the home regain value, banks can share the gains with homeowners. I think in the end, it is a win-win situation for banks and homeowners. But that proposal has not obtained much traction so far.

Question 9:

It is said that export is important to create jobs. Currently, GDP gap is very wide. Do you think that exports will be promoted near future to create jobs?

Mr. Rosengard

Please look at slide 14. In the bottom there is a little circle that says FTA; Free Trade Agreement. I did not mention it in my speech, but one of the strategies that have been pursued is promotion of exports through free trade agreements. For the US, the most important one so far is the one with South Korea. Signing it opens a whole markets that were closed before to products that the US excels in. Two other free trade agreements with Latin American countries have been signed. I agree with you that export is another outlet for creating jobs and income. These agreements passed after many years of negotiation. They have significant value to both countries. They will take effect immediately and can have a dramatic impact. Indeed, FTAs are one of the few things that Obama and the Republicans agreed on.

Exports and exchange rates relate each other, and affect the country's competitiveness. So, a combination of the monetary policy as it relates to exchange rates and the FTAs is important.

If you look at the slide 13, one of the colors is net exports of goods and services. It shows negative trade deficit. You can also see that exports' share of GDP is very small. But at the margin it becomes expensive. The US has a huge domestic market, which is most of the economy, but the trade at the margin can make the difference. So, one of the important strategies is to make trade deficit smaller. It should certainly be a part of the entire strategy.