

**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**

**< Speech of Professor Jay Rosengard>**

(Slide 1) This is the third session of my series of speeches at the Canon Institute for Global Studies. For today's topic, I will talk about "The Ailing US Economy in 2012." Is the US economy slowly recovering in a process of rehabilitation, or will it have a relapse to a double-dip recession? This is a question we would like to discuss looking into the US economy over the next years.

(Slide 2) Looking back in 2010, we really wanted to understand the causes of the crisis in the US economy and how we might prevent a recurrence. We talked about underlying causes of the crisis; what the short-term triggers were; why the crisis occurred at that time; how it was accelerated; what the magnitude of the crisis was and how much worse it would get in the future; what the public sector did in response to the crisis in terms of injecting liquidity, solvency, and regaining political trust; and then global governance about a new post-Bretton Woods world order.

(Slide 3) Last year we wanted to look at strategies coming out of the crisis around the world and we boiled it down to two different philosophies of public finance; Keynesian or Hoover philosophy; and so countercyclical injection of the economy versus austerity to regain confidence. We talked about fiscal policy; do we run a short-term deficit or try to restore confidence by balancing the budget even when the economy is not doing well. Then, we talked whether the compatible monetary policy should be expansionary or contractionary. We tried to look at whether the US was currently like it was after the Great Depression or like Japan was over the last decade or two, which would inform the policy decision.

(Slide 4) Today, we want to talk about prospects for the US economy. Did the monetary stimulus or Fed's intervention work? Have the fiscal stimulus packages in the US worked or not? Then, discuss the contrary opinion: Does austerity during a crisis foster growth or not? That is a strategy of much of Europe, especially the UK, and the US, especially the Tea Party wing of the Republican Party.

Then, in the context of the upcoming presidential election in November and the Euro crisis, looking ahead the challenge for the US, we will discuss how we balance long-term concerns about fiscal sustainability versus short-term need to get out of the recession and start robust and sustainable growth?

So, the question is: Is the US on the path of a slow and painful recovery (rehab) or will the US end up back with a double-dip recession (relapse).

(Slide 5) The first topic was: The US intervening aggressively in the economy, especially the Fed, and so the question is: Did the monetary stimulus work? The quantitative easing one (QE1) totaled about US \$1.7 trillion. Quantitative easing two (QE2) starting November 2010 was another \$600 billion.

Since the crisis, the Fed has essentially tripled its balance sheet which is now around US \$3 trillion. That is a lot of injection of liquidity into the system. One of the best indicators of restoring confidence, stability and efficiency in the financial market is to look at the difference between the yield on the 3-month Libor rate and the US treasury bills, so what we have here is from 0-5% difference in yield and then over time from the onset of the crisis, the peak of the crisis, and going forward. Traditionally, we are talking about closer to 0.5% difference. At the peak of the crisis, we are looking at almost 5%. This is in the mid-2008.

Starting at about 0.5%, some of the key points are Bear Stearns and so on. Down to the 0 interest-rate policy of the Fed, the bank stress test, it is now actually lower than the crisis level. That is a pretty compelling indicator of the impact of the injection of liquidity by the central bank. These data are from the US Federal Reserve and Moody's Analytics. And other data seems to confirm this.

(Slide 6) In terms of the stimulus, GDP growth and unemployment rate are the two indicators. A very interesting study was done by Alan Blinder and the Head of Economics for Moody's Analytics. The data here is from the US Sphere of Economic Analysis and Moody's Analytics. There are basically four scenarios that they run.

Here, we have the level of US GDP in trillions of dollars. At the onset of the crisis, we are looking at about GDP of \$13.5 trillion. If we have no policy intervention at all (no fiscal stimulus packages and no monetary interventions), their estimate is that the GDP would have contracted to less than 12. Now we are here and would be around 12, maybe over the next year up to 13 in real dollars with no federal government intervention.

Then, there is quantitative easing without any financial intervention. In the graph, fiscal stimulus is in orange, the green is financial but no fiscal, and the blue is the baseline case which is both the monetary easing and the fiscal stimulus packages.

On the fiscal stimulus packages, the first one (QE1) was actually under President Bush in 2008 of US \$168 billion. Then, the Obama American Recovery and Reinvestment Act of 2009 (QE2) was \$787 billion. I would include extending the Bush Tax Cuts and on the benefits in 2010 which is another \$858 billion. All together, the US has spent roughly 1.8 trillion in a combination of direct and tax expenditures, and extended tax cuts and benefits. That is roughly 13% of GDP. That is the stimulus packages I am talking about, which are all the different ways of trying to intervene in a countercyclical way to counteract the contraction of the private sector.

Again, the baseline starts at about 13.5 trillion. Today, we are about 14. Next year, it will get to close to 15. This is a pretty compelling study. The analytics and the data are good, and they are transparent and conservative. The stimulus packages have apparently some impact.

The political problem is that it is hard to make a case for what did not happen or what we prevented. If we look at the data, the growth is still slow and long-term unemployment rate is high. People look at these, and say that the economy should be doing better; it is hard to explain how much worse it could be right now. This is the political challenge now facing President Obama.

(Slide 7) If you look at the same four scenarios for unemployment rate, the shape of graph looks inverted and the numbers are lower. At the beginning, we have unemployment at about 5%. With actually no intervention, we are looking at 14%. With interventions, by end of the year it could go below 8%. We are right now actually at about 8.5%. This predicts 10%. We are actually doing better than we would expect.

But please keep in mind that the unemployment rate includes only those who are actively looking for work. The irony in the US is that when the economy starts to get better, the people get more optimistic, the unemployment rate actually goes up first before it goes down, because more people start looking for jobs again. Right now, the latest figure is about 8.5% which is even better than projections and certainly much better than the 16% projected without any interventions.

If we look two factors - the size of the economy as a proxy for economic growth and unemployment, which is the key in the growth as creating jobs - it seems like there is a compelling case for how much worse the US economy would be without the stimulus packages and the quantitative easing.

(Slide 8) Just to put in perspective, the US has not been the only country that has had stimulus packages. Japan injected roughly ¥27 trillion through two major stimulus packages, about 5.5% of GDP. A lot of Europe was between 1% and 2% of GDP. South Korea was 1.2% of GDP.

The interventions, though probably not big enough, were necessary. Without them the situation would be much worse. Then, the question is if austerity fosters growth? Because the counterargument is that we are creating a lot of long-term debt and that people lose confidence in the financial markets and capital flees. Essentially it is to restore one's fiscal house in order so that the confidence would generate investment, job creation and growth.

An IMF study of 173 fiscal policy changes in high-income countries from 1978 to 2009 found that cutting the budget deficit by 1% of GDP does show a reduction of real output by two-thirds of a percent and increase in the unemployment rate of one-third of a percent. That is contraction. It is not expansion.

If we look at the UK today, the numbers are not very encouraging. There are exceptional cases where there has been expansionary austerity. For example in Denmark, in the mid-80s when they started with a strong economy in their interest rates, it was complementary. If we look at the point of departure for much of Europe, it was all-time low interest rates and very weak economies.

The other big exceptions are Ireland and Italy, which started with an overvalued currency, again not the case in most of the countries following the austerity package. So, 173 changes in two decades is a pretty compelling argument that unless we have very special circumstances, drastically cutting the budget in the short-term probably will lead to the contraction pattern.

The UK cut roughly 5.6% of GDP in 2010 - the biggest cuts in 60 years. The deficit was 10-12% of GDP. The US deficit has been around 10% or slightly less than 10% of GDP. These are some very different approaches to a similar situation. We can talk about this in context of Greece, Ireland, Portugal, Spain, Italy or any other country.

(Slide 9) Coming back to the US and the future, the first part of question is if the interventions have worked and whether the alternatives would have been better? I would say that the strategy was correct. Anything else was not robust enough but prolonged the recovery and made it more difficult. We would say that the alternative approach would have been what Hoover did with similar results during the Great Depression.

For the future, the question is how we balance the long-term concern about a large-budget deficit and growing debt with the need for the short-term interventions in trying to work our way out of the recession. It is a legitimate concern which should be noted. Since 2007, we have a ninefold increase in the federal budget deficit as a share of GDP. It is now a little bit less than 10%, but about a year ago was about 11% of GDP. We had over 60% increase in gross federal debt as a share of GDP. Now, it is around 100%.

When it comes to meeting the Japanese standards, we have a long way to go because we are not near 200. But if we start at a much lower base, it is a huge increase in a very short time. That is the debt. Interest on the federal debt as a share of GDP will also increase, and is projected to reach about 12.5% of expenditures in a few years which could push out other types of spending. So,

there clearly is the need for fiscal consolidation with some combination of revenue enhancement, not necessarily higher tax rates, maybe larger base, and decreased expenditures especially in social security, healthcare and defense.

When we look at the trends, our federal receipts last year were 14.4% of GDP. That is the lowest since 1954 and a 22% decrease in a few years. On the revenue side clearly we need more revenue. It is normally around 18-20% at the federal level and 10% at sub-national level. It outweighs 25% of GDP, the highest since the end of the Second World War, and a 29% increase since 2007, so we have got 10-11% deficit. That is not sustainable. So, when I say we clearly need a way to enhance revenue as well as cut big items expenditures, I do not disagree.

(Slide 10) There is the history. This is running up the US debt. This shows time and percentage of GDP. Prior to President Reagan, we were at about \$1 trillion which is roughly 25% of GDP. At the end of George Herbert Walker Bush, it had quadrupled and was about 60% of GDP. In the Clinton era, the actual percentage of GDP went down and in the last 3 years we had a budget surplus. After George W. Bush, it doubled from 6 trillion to 12 trillion, so a little over 50% of GDP to over 75%. Now, we are around 100%. A lot of the fiscal conservatives in the US do not quite acknowledge that most of the increase in the debt came during Republican administrations preaching fiscal conservative practices.

(Slide 11) So where do we go from here, because today we are at 14.3 trillion. We need more fiscal stimulus. So, these are the things that are being debated in the US.

Should we have more direct expenditure stimulus packages? Should we extend long-term unemployment compensation? Should we provide more assistance to local government or investments in infrastructure?

First two items (extended unemployment compensation and aid to states) are very good for stimulus because they are spent immediately. State governments in the US have to balance their budgets, so they have a choice of cutting or getting assistance from the federal government. So the first two items have a great multiplier and immediate effect in terms of stimulating

consumption. The last item (investments in infrastructure) has a more medium to long-term impact.

When it comes to the US social security payroll tax, 6.4% is paid both by the employee and the employer. So, there is a reduction in the employee share of 2%. The argument was that if we extend that, do we also reduce the employer's share? We cut 2 to make it 4.4%, and do that same for the employer. Obama's argument was to make it even bigger; Obama had said why we don't cut it in half. But the Republicans were against introducing this. Obama's proposal of tax credit to businesses for new employees was also opposed by Republicans.

The Super Budget Committee could agree on long-term deficit reduction plan. Right now in a year, we have mandated expenditure cuts of more than \$1 trillion which is directly opposite to the stimulus and about half of that will be in defense and half in non-defense. At the end of this year, the Bush Tax Cuts are due to expire. If nothing is done, we will have a rather dramatic austerity package. So, doing nothing is actually a policy decision.

(Slide 12) This slide gives a comparison of the last bills proposed by the House of Representatives and the Senate. I would like to give you some details comparing the two bills. The House Bill would have cost 180 billion, the Senate Bill 33 billion. It is the Senate Bill that was passed. The House wanted to extend the 2% payroll cut through the year. The Senate Bill does it for 2 months and then they revisit the issue. The House Bill wanted to extend long-term unemployment, but the Senate Bill makes it shorter and has a lot of restrictions and compromise, and after 2 more months it will revisit the issue. Another item was the 27% cut in Medicare payments to doctors. Both bills prevent that from kicking in. That is a very strange thing. It is a legacy of other bad legislations.

The oil pipeline from Canada, through the middle of America, down to the Gulf is very controversial. The administration wanted to delay a decision until after the elections. Both bills require approval of this pipeline within 60 days after the election. The House Bill also had something about undoing some curbs in industrial boiler pollution. The House Bill would have been paid by lots of budget cuts and social programs. The Senate Bill is paid for by the one-tenth of 1% increase in home loan guarantee fees charged to mortgage lenders by

Fannie Mae and Freddie Mac, Federal Housing Authority, and then passed on to home buyers. So, this is the source of financing of the bill that they passed.

(Slide 13) Why again do I think are the stimulus packages so important? This graph shows the composition of the US economy, i.e. GDP. The blue is total GDP. The brown is personal consumption. Clearly, if we are to have any major impact on the economy, we have to affect household consumption. The problem from the crisis is that normally we have private sector investment that creates jobs, jobs increase disposable income, people buy things, GDP grows, and we get a virtual cycle. We also have trade and government.

(Slide 14) What has happened is that this link between private investments and job creation has stopped. Companies are not investing, so there is no job creation. We have the government expenditures increase through fiscal stimulus packages to try to both increase disposable income and generate jobs, which in turn should get this virtual cycle going again. That is the basic philosophy that a lot of the Congressmen do not seem to understand.

In the end, we have a presidential election. President Obama is running for a re-election. A lot of his success will depend on the state of the economy in November and the strength of his opponent. Right now, the leading contender is former governor Mitt Romney, but there are a whole slew of primaries coming up and it is still an open season.