Overcoming Obstacles—New and Old—to Economic Growth and Opportunity

Remarks at Hoover Overseers Dinner
Washington DC
February 24, 2013

Tonight I want to focus on the obstacles to achieving good economic policy and thus to the goals of policy, which are higher growth and a better life for all Americans—including those who are disadvantaged or in struggling middle income groups. I have called the talk "Overcoming Obstacles" to get a little alliteration, of course, but I was also thinking of the Maurice Sendak children's book about the alphabet "Alligators All Around." In fact that would be a good title too. And Sendak is also wrote "Where the Wild Things Are" which would be an even better title.

I'll start with general points about overcoming obstacles and then illustrate them with issues that are currently on the agenda in Washington including fiscal and monetary policy.

There have always been obstacles to good pro-growth economic policies. The biggest obstacle in the past century has been totalitarianism as exemplified by Stalin and Mao regimes. Fortunately, throughout the history in the United States, the obstacles have been much lower. To me good economic policies are best characterized by the principles of economic freedom: people decide what to buy, what to sell, where to work, how to help others within a framework of (1) predictable government policies, based on (2) the rule of law, with an emphasis on (3) the market, which provides (4) incentives and with a (5) limited role for government. America has prospered over the years because it has adhered to these principles.

But we have had big swings back and forth in the adherence to these principles. From the late 1960s through the 1970s, policy deviated from the principles with unpredictable go-stop monetary policy, interventionist fiscal stimulus packages, and even wage and price controls. Performance was terrible with rising unemployment and inflation and falling growth. Policy adhered to the principles in the 1980s and 1990s and until recently with a much more rule-like monetary policy, an abandonment of short-term oriented fiscal policy, and limits on the federal government's role from price determination to welfare. And the economic performance improved dramatically. Now we have deviated from the principles, and performance is again poor.

This historical experience tells us that the American economy will prosper again if it returns to good economic policy, as I describe in more detail in my book *First Principles*. But the obstacles to doing so are now greater than ever due to powerful countervailing forces emanating from both those on the left of center, who frequently do not agree with the principles, and from those on the right, who may agree but do not always implement them effectively.

Those left of center are making the case that all America has to do is increase taxes on the rich or regulations on entrepreneurs or fiscal and monetary interventions and the economy will do better. While an appeal to class warfare and even revenge may persuade some, many young people and minorities appear to be buying into the arguments that incentives and the rule of law do not matter or that well-intentioned government activism can always do better than the market. But that is not what history or economics tells us.

Another obstacle to good policy is the tactic of making the poor results of deviating from the principles of economic freedom sound better than they are. Consider the current slow economic recovery and the unemployment problem. Yes we have had a recovery from the recession. The problem is that it is a recovery in name only. It's one of the weakest recoveries from a deep recession in American history. Growth has been about 2 percent since the recovery began and median household income has declined. That compares to an average of about 6 percent growth following previous recessions with serious financial crises in American history.

This slow recovery has left unemployment tragically high in most parts of the country. Those in the San Francisco Bay Area may seem lucky. The unemployment rate is 6.7% in San Francisco. But the rate is 7.9 % in the country as a whole, and 9.8 % in the state of California as a whole. In the nearby central valley of California—Yuba City, Modesto, Merced, Fresno—its about 16%, and down south in El Centro California it's 26%. Some parts of the country are doing better, but it is not just the west where unemployment is high. In New Jersey it's 9.6%

But you know, even 6.7% is pretty terrible. I like to tell the story about what Hubert Humphrey said when President Ford's Council of Economic Advisers, where I worked with Alan Greenspan, reported it was raising the definition of the normal unemployment rate from 4% to 4.9%. Humphrey was outraged. He told us in a Joint Economic Committee hearing where the results were reported that if the economy was suffering a plague, and economists were doctors, their solution would be to raise the definition of normal body temperature." So I am worried when typically-concerned people stop talking about such high unemployment rates as if they were normal.

The numbers would all be worse if they included the millions of people who have dropped out of the labor force and are no longer counted as unemployed. If those people counted, the rate would be 9.1 percent.

There are many other problems with slow growth. Real income per capita does not rise, children are worse off than their parents, and revenues for government programs stagnate. And because a slow growth America can't lead the world, America must step back from global leadership, which is a detriment to both the world and to America.

Why the slow recovery? There are several explanations. Some say weak recoveries always follow deep recessions and financial crises. But that's not true. As I said, over American history, the average growth rate in recoveries from deep recessions from financial crises has averaged about 6 percent. In this recovery it has been about 2 percent. Is the problem deleveraging as people must save to draw down their debt? This is a factor, of course, but saving is very low compared to earlier strong recoveries such as the 1980s. Until recently housing has been weak, but all recoveries have weak sectors. In the 1980s it was weak exports. So I come to the conclusion that the answer to the problem has been economic policy itself. Poor economic policy is a main reason for the slow growth and high unemployment.

But the silence about the unemployment problem makes changing policy more difficult. It's an obstacle that must be broken. Though the situation is entirely different, the silence reminds me of the terrible silences of earlier times, such as when no one talked about the economic policy tragedy that lead to great famine in China in the 1959-60 period, as recently described in the book *Tombstone* by Yeng Jisheng. And then there were the tragedies in Russia which Hoover Institution Fellow Robert Conquest wrote about, but was ignored or criticized for doing so. I think people do a great dis-service by spinning or downplaying the economic problems. We should not be making excuses for high unemployment.

Yet another obstacle is avoiding serious open debate about policy reforms. Washington has become obsessed with short-run political maneuvers that suppress debate over the economic policy. For some on the left such tactics—including scare-mongering over sequesters or debt ceilings—seem to be a means to hide the agenda of an expanded role for the federal government and other deviations from economic freedom, which might not survive an open and transparent debate. For others the tactics may reflect a stand against bigger deviations from economic freedom, but with the tradeoff that the they distract from more fundamental debate which is needed for more effective economic policy.

This is why it is important to get back to the regular order of the budget process which has worked well in the past. Under this process the president of the United States submits a budget with a plan to bring the spending into balance with revenues over time. The House and Senate then pass a budget resolution for expenditure and revenue goals after open debate. And then the appropriate committees pass the legislation required to achieve these goals.

Another obstacle is that many of those who are sympathetic to the principles of economic freedom are forgetting or not trying hard enough to demonstrate its benefits, not only for the middle class but especially for the poor and disadvantaged. Highly taxed or excessively regulated firms scared off by unpredictable government controls on their prices and products, are not going to expand or create jobs and thus unemployment will remain high. Children in poor neighborhoods prevented by government from going to good schools and learning needed skills will be trapped into high unemployment or low wages, and income inequality will persist across generations.

Ironically, reformers in China and other emerging markets in recent years have not been reluctant to tell stories of the benefits of economic freedom as they moved away from central planning and their economies grew rapidly bringing hundreds of millions of people out of poverty. While China has a long way to go, it is has been very successful at bringing people out of poverty, while in recent years America has been putting more people into poverty. And now as the Chinese try to fix their income distribution problem, they are looking to move more toward the principles of economic freedom: lifting controls on paying dividends, fighting crony capitalism and corruption, and relaxing restrictions on emigration from rural to urban areas.

Let me now focus more specifically on current issues of fiscal and monetary policy. I have provided a handout with some charts (see attached below), which I hope will be helpful. I recently used these charts in presentations before members of the Senate and House, and they thus represent specific efforts to overcome the kind of obstacles I have been talking about here.

In the first chart I try to put the debate over the sequester in fiscal year 2013 into some perspective. It shows federal spending relative to the size of the economy as measured by GDP. There are four lines: history since the year 2000, the current CBO forecast through 2023 under current policy, the CBO forecast without the sequester, and a reform path (I call it the pro-growth policy) which will balance the budget by 2023 when revenues are expected to be between 19% and 20% of GDP. The pro-growth line is smooth, gradual, and doable and would increase real GDP growth overtime according to my estimates. In fact, the US budget underwent comparable consolidation in the 1990s. From 1991 to 2000, spending share fell from 22.4% to 18.2% or by 4.2% of GDP. Growth was strong in the 1990s. From 2012 to 2023 under the pro-growth proposal we would go from 22.8% to 19.1% or a difference of 3.7% of GDP.

Now, note that size of sequester is very small on an absolute basis (.26% of GDP) and also both in comparison to the increase we have seen since the financial crisis and in comparison to where we ought to go under the reform plan. But scare tactics over the possible damage from the sequester are now being put out as an obstacle to the needed budget reform. To overcome this obstacle the Congress should hold firm on spending totals in the sequester. It would be better for the president to give the agencies the ability to prevent the meat-axe approach of the sequester, but the worst idea would be to cave in on the totals and lose all the credibility the government needs to address the deficit and debt problem.

In fact, as shown in the second chart, there is no absolute reduction in total federal government spending for any of these plans. Letting this fact absorb into people's understanding helps overcome this obstacle to reform.

The third chart illustrates the current monetary policy problem. It shows the impact of the Fed's recent actions on the amount of short term liquidity in the economy as measured by the deposits that banks hold at the Fed. The blue line shows recent history and the red line shows a possible scenario that I will describe. When the Fed engages in its current policy of quantitative easing (also called QE1, QE2, QE-infinity) it finances its purchase of mortgage-backed securities or federal debt by crediting the banks with these deposits. The deposits—also called bank reserves—normally are increased during times of financial stress, as on 9/11/2001 shown in the chart, or during the panic in the fall of 2008, also shown in the chart.

But the huge increases since the end of the panic in early 2009 are completely unprecedented interventions. The recent Fed decision to buy $85 billion per month until the labor market improves is illustrated by the red line.

In my view it is very risky to continue along this red line. The policy is a drag on the economy in part because people do not know how the bank reserves will be unwound, as they must be eventually. Moreover, the policy also has potential international ramifications because central banks tend to follow each other (whether they like it or not) as they try to counter sharp appreciations of their currencies. This leads to unprecedented policy interventions in other countries, and causes what people are now referring to as currency wars. That is what we are seeing as Japan changes monetary policy partly in response to the Fed policy. Recent reports are that these risks are becoming a worry to a number of policy makers at the Fed.

Let me conclude, as I stared, with a literary reference—but to Charles Dickens rather than Maurice Sendack. The last chart—it's actually a cartoon figure—is an illustration of ways to overcome obstacles to reform, not unlike those I have discussed here. It's the ghost of the future from the Dickens story of Scrooge. That ghostly figure is pointing to a worrisome future—like the red lines in the charts—and Scrooge asks, "Are these the shadows of the things that Will be. . . or are they the shadows of things that May be, only?" Let's overcome the obstacles to good economic policy and make sure the answer is "May be" not "Will be."

Thank you.

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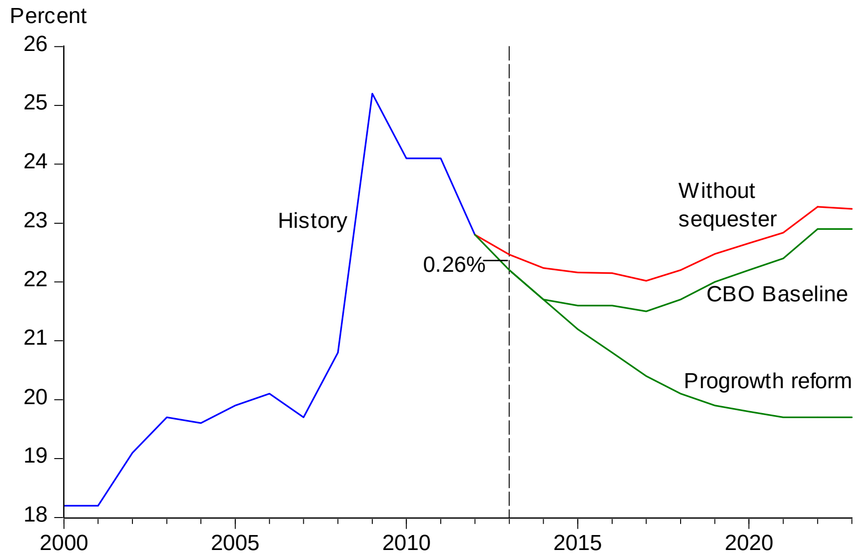
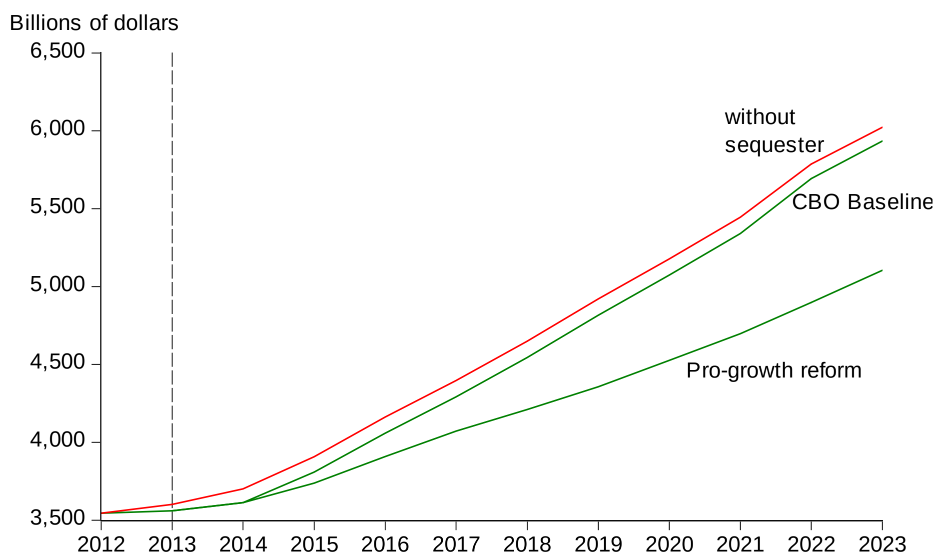
John B. Taylor, February 24, 2013

The Sequester in Perspective…



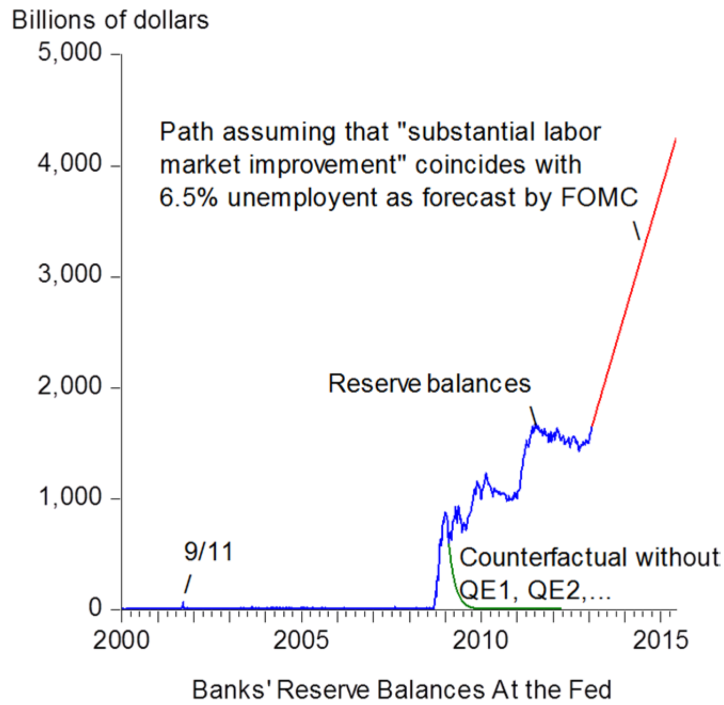
Federal Outlays as a Percent of GDP

And the Federal Government Still Grows…



Federal Outlays

And Look at Monetary Policy: Unprecedented and Risky…



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