Why the Recovery is Slow: What Should Be Done?

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Senate Budget Committee

September 24, 2013

Mr. Chairman, Mr. Ranking Member, Members: I appreciate the opportunity to respond to the questions, Why Is the Recovery Slow; What Would Speed Recovery?

In the fifth year of recovery from a serious recession, the unemployment rate remains distressingly high at 7.3 percent. Much of the decline from the peak is at least as discouraging as the many discouraged workers who have left the labor force. An unusually large part of the slow job increase is for part-time work, not permanent employment. Despite the administration's expressed concern for the widening spread is the distribution of income, the spread has widened. And the recently released data on poverty shows that 46.5 million people are impoverished, 15 percent of the population. In sum, a miserable set of failed policies.

Private forecasts remain more optimistic than outcomes. Less optimistic, indeed downright pessimistic, are forecasts for government budget deficits and debt. The latest CBO estimate show budget deficits rising from 3.3 percent in 2023 to over 6 percent in 2035 and higher still in later years. Government debt reaches 100 percent of GDP in 2038 and 200 percent in 2075. Long before these numbers are reached, we will be in crisis. Unsustainable policies end that way.

I believe current and recent policies bear most of the blame for slow recovery. The administration and the Federal Reserve rely too heavily on short-term palliatives that have little long-term benefit for the economy. The Fed's major error is refusal to recognize that our problems are not monetary. The Fed's past actions assure that there is no shortage of money or liquidity; banks hold $2 trillion of excess reserves, so they can make loans to any qualified borrower at the lowest interest rates in our history, if only more would borrow.

Much of the Fed's stimulus helped banks rebuild their capital and repay the loans that helped many banks survive. Now large banks pay dividends and bonuses from the earnings the Fed's interest rate policies allow them to earn. The effect on unemployment is modest at best.

We need stable, pro-growth policies, not more of the same. Our economic problems are mainly real, not monetary. The Federal Reserve's huge expansion has had only a small effect.

Some console themselves by forecasting improved recovery. Maybe, but users should know that forecasters have been consistently too optimistic. This recovery has remained persistently weaker than forecast.

It is not unusual for forecasts to be wrong. Economics is not the science that gives high quality quarterly forecasts with low errors. There is no such science.

But a string of persistent errors always overestimating the rate of recovery calls for an explanation. I believe the principal explanation is the mistaken, often perverse government policies that discourage investment and employment. We saw this outcome once before. The administration is repeating the error last seen in 1938-1940.

Good policy is based on the best validated theory representing the accumulated professional knowledge. At the start of the Obama presidency, his chief adviser said that policy actions should be "timely, targeted, and temporary." That is a strange mixture that lacks any analytic foundation. Modern economic theory teaches us to make permanent, not temporary, changes and to encourage not discourage investment incentives. What analytic basis do we have for the administration's targeted actions? None. Do we know how to manipulate relative responses to increase the size of the response? I believe not.

We have two overriding problems. First, unsustainable structural budget deficits, especially unfunded spending for entitlements creates uncertainty that clouds the future. Second, greatly increased regulation of business also heightens uncertainty and raises current and future costs.

Uncertainty is the enemy of investment. Uncertainty about future tax rates, spending, and regulation is the main reason that investment is low and that much investment goes to robotics, programs and other labor-saving investments.

John Maynard Keynes is frequently cited as the intellectual father of short-term policies to restore growth by increasing government spending to stimulate private consumption. The 2009 stimulus implemented that policy by offering sizeable temporary tax reduction to middle income taxpayers and temporary payments to state and local governments. (As recipients of social security, my wife and I received checks.)

To write my book on Keynes's work, I read most of his books and papers. Keynes believed that the 19th century problem of raising living standards was too little saving. The 20th century problem, he said, was too little investment, in part a result of uncertainty. In his *General Theory*, he gave an economist's explanation.

No one who has read Keynes's work carefully can find him favoring policies to boost consumer spending. He opposed them throughout his life. As late as 1943, he wrote to his Cambridge colleague, James Meade, disagreeing with Meade's proposals to encourage consumer spending by giving temporary tax relief. A return of taxes on which people could only rely for an indefinitely short period, he said, would have very limited effects in stimulating consumption. Milton Friedman and Franco Modigliani later earned Nobel prizes in part for independently developing this theme.

In his 1921 *Treatise on Probability*, Keynes highlighted uncertainty, the "unknown unknowns" long before Secretary Rumsfeld used the term. He never changed his mind about uncertainty as a reason for changes in investment spending and economic activity. As early as the 1928 election in Britain, Keynes argued that in periods of recession and slow growth, policy should encourage capital spending. In his words, "Generally speaking, the indirect employment which schemes of capital expenditure would entail is far larger than the direct employment…the greater part of the employment they provide would be spread far and wide over the industries of the country…[T]he greater trade activity would make for further trade activity; for the forces of prosperity like those of trade depression work with a cumulative effect…In the economic world, 'coming events case their shadow before'." He never said the same about consumer spending.

Keynes would have eagerly endorsed the Kennedy-Johnson tax cuts or the Reagan tax cuts that permanently reduced corporate and high marginal personal rates. They changed incentives and reduced uncertainty about future tax rates and thereby increased business investment. And he warned the proponents of large, persistent budget deficits not to favor persistent deficits. His student, protégé and later colleague, Richard Kahn, wrote that Keynes's *General Theory* advocates deficit finance in only one place and only if other means fail. Keynes favored temporary deficits to replace private investment, but he opposed permanent deficits.

Uncertainty is always with us, but Obama administration policies and statements heighten the problems that businesses see. The president used anti-business rhetoric in his election campaign, campaigns for higher tax rates usually without mentioning specific rates, and raised health care, energy and other costs without limiting the increases. Generations of managers learned to choose investments by estimating the value of future costs and revenues have no idea what the costs will be. They wait, holding on to cash. Uncertainty reduces investment, as Keynes believed. And much of the U.S. private sector investment in this recovery adds labor-saving equipment and computer programs to increase output by increasing worker productivity without much new hiring. High unemployment continues.

I do not claim that the stimulus policies were useless. But it must be obvious that they are inadequate. My main criticism is that we have long-term problems that require implementing the kind of consistently stable, expansive policies that reduce uncertainty about spending, taxes and regulations. I am sure from what they say that some see benefits in higher tax rates and increased regulation. They should not ignore the heavy costs of prolonged high unemployment and growing despair that uncertainty about taxes and regulation engender.

An Earlier Sluggish Recovery

Historical comparisons are never precisely accurate descriptions. Yet the current recovery has several similarities to the very sluggish recovery from the deep pre-war 1937-38 recession. Like President Obama, President Roosevelt chastised businessmen, in his case, he called them “economic royalists.” He tried to pack the Supreme Court. He began anti-trust proceedings against several industries and companies and introduced an unpopular excess profits tax and a minimum wage among other programs that many businesses regarded as hostile or counter-productive. Reported unemployment rates rose. By 1940, at 14.6 percent, they were still slightly above the rate in 1937, when the recession began. Now as in 1938-40 investments and unemployment lagged and recovery was slow.

See Table 1

President Roosevelt’s anti-business rhetoric and action ended with the war. War brought an overriding goal and an end to political infighting that united the country.

Business men are not always right, of course, but we have learned that attitudes and expectations matter greatly. Short-term policy actions that heighten uncertainty will not restore output to its long-term growth path. It is past time for a bi-partisan policy to increase business investment spending and a long-term program to reduce future deficits. The slow recovery and inept policies reinforce rampant pessimism and prolong high unemployment. A better future depends on leadership on both sides that looks well beyond the election. To service our large foreign debt, we must export more of our output and import less. To increase exports, future consumer spending must grow more slowly than in the past.

Table 1

Investment and Employment in Two Slow Recoveries

Year	1937-41		Year	2008-12	
	Gross Private Domestic Investment[a]	Total Wage and Salary Workers[b]		Private Fixed Investment[c]	Total Private Employment[d]
1937	11.8	31,026	2008	2128.7	114,342
1938	6.5	29,209	2009	1703.5	108,321
1939	9.3	30,618	2010	1679.0	107,427
1940	13.1	32,376	2011	1818.3	109,411
1941	17.9	36,554	2012	2000.9	111,826

a/in billions. Economic Report, Jan. 1967, p. 225
b/in thousands. Economic Report, Jan. 1967, p. 242
c/in billions. Economic Report, March 2013, p. 346
d/in thousands. Economic Report, March 2013, p. 378

Almost every current CEO, CFO, or business manager learned as part of his or her MBA to base investment decisions on discounted future cash flows. Current uncertainty about tax rates, healthcare costs, labor regulations, energy costs and finance preclude correct calculation of future costs and cash flows. Most firms hold extraordinary amounts of cash waiting for reduced uncertainty. We cannot eliminate all uncertainty about the future, but we can and should reduce the additional uncertainty created by tax and regulatory policies.

Conclusion

The United States has long-standing real problems that require policy procedures very different from the policies we have. Current policies aim at near-term change. Little if any thought is given to the longer-term consequences. The accumulation of neglect of those consequences and uncertainty about current and future policies is the main reason the recovery is slow.

Economic analysis shows us how to work out of our problems over time. I argue that there is no analytic basis for the policies we have. It is a misreading or probably non-reading of Keynes to claim his work as the model for short-run problems.

Our policies are driven by hope and political pressures, not economic analysis. Some claim that economics has failed. A more correct statement is that policy has been politicized so much that it has lost sight of the economic principles that made America great. Those policies would work well again if applied as part of a constant long-term plan for growth.