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How to avoid a lost decade

By Lawrence Summers, Published: June 12

Even with the massive 2008-09 policy effort that prevented financial collapse and depression, the United States is now halfway to a lost economic decade. From the first quarter of 2006 to the first quarter of 2011, the U.S. economy's growth rate averaged less than 1 percent a year, similar to Japan in the period its bubble burst. During that time, the share of the population working has fallen from 63.1 to 58.4 percent, reducing the number of those with jobs by more than 10 million. The fraction of the population working remains almost exactly at its recession trough, and recent reports suggest that growth is slowing.

Beyond the lack of jobs and incomes, an economy producing below its potential for a prolonged interval sacrifices its future. Huge numbers of new college graduates are moving back in with their parents this month because they have no job or means of support. Strapped school districts across the country are cutting out advanced courses in math and science and in some cases opening school only four days a week. Reduced incomes and tax collections are the most important cause of unacceptable budget deficits at present and in the future.

Traditionally, the American economy has recovered robustly from recession as demand has been quickly renewed. Within a couple of years after the only two deep recessions of the post-World War II period — those of 1974-75 and 1980-82 — the economy was growing in the range of 6 percent or more, rates that seem inconceivable today. Why?

Inflation dynamics defined the traditional postwar American business cycle. Recoveries continued and sometimes even accelerated until they were murdered by the Federal Reserve with inflation control as the motive. After inflation slowed, rapid recovery propelled by dramatic reductions in interest rates and a backlog of deferred investment was almost inevitable.

Our current situation is very different. With more prudent monetary policies expansions are no longer cut short by rising inflation and the Fed hitting the brakes. All three U.S. expansions since Paul Volcker brought inflation back under control have run long. They end after a period of overconfidence drives the prices of capital assets too high and the apparent increases in wealth give rise to excessive borrowing, lending and spending.

After bubbles burst there is no pent-up desire to invest. Instead there is a glut of capital caused by overinvestment during the period of confidence — vacant houses, malls without tenants and factories without customers. Meanwhile, consumers discover that they have less wealth than they expected,

less collateral to borrow against and are under more pressure than they expected from their creditors. Pressure on private spending is enhanced by structural changes. The publishing industry provides a vivid example. As local bookstores have given way to megastores, megastores have given way to Internet retailers and Internet retailers have given way to ebooks, two things have happened. The economy's productive potential has increased and its ability to generate demand has been compromised as resources have been transferred from middle-class retail and wholesale workers with a high propensity to spend up the scale to those with a much lower propensity to spend.

What then is to be done? There is no time for fatalism or for traditional political agendas. The central irony of financial crisis is that while it is caused by too much confidence, borrowing and lending, and spending, it is resolved only by increases in confidence, borrowing and lending, and spending.

It is false economy to defer infrastructure maintenance and replacement when 10-year interest rates are below 3 percent and construction unemployment approaches 20 percent.

Policy in other dimensions should be informed by the shortage of demand that is a defining characteristic of our economy. The Obama administration is doing important work by modernizing export controls, promoting U.S. products abroad, and reaching and enforcing trade agreements. Much more could be done through changes in visa policy, for example, to promote tourism as well as education and health services. Recent presidential directives regarding relaxation of inappropriate regulatory burdens should be rigorously implemented to boost confidence.

The greatest threat to the nation's creditworthiness is a sustained period of slow growth that, as in southern Europe, causes debt-to-GDP ratios to soar. Discussions about medium-term measures to restrain spending and raise revenue need to be coupled with a focus on near-term growth. Without the payroll tax cuts and unemployment insurance negotiated by the president and Congress last fall, we might well be looking at the possibility of a double-dip recession. Substantial withdrawal of fiscal support for demand at the end of 2011 would be premature. Fiscal support should, in fact, be expanded by providing the payroll tax cut to employers as well as employees. Raising the share of the payroll tax cut from 2 percent to 3 percent would be desirable as well. At a near-term cost of a little more than $200 billion, these measures offer the prospect of significant improvement in economic performance over the next few years translating into significant increases in the tax base and reductions in necessary government outlays.

We averted Depression by acting decisively in 2008 and 2009. Now we can avert a lost decade by recognizing current economic reality.

The writer, a professor and past president at Harvard, was Treasury secretary in the Clinton administration. He was economic adviser to President Obama from 2009 through 2010.

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