

The Road to Economic Recovery: Prospects for Jobs and Growth
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Chair Maloney, Ranking Member Brownback, and members of the Committee, my name is Richard Berner. I am Co-Head of Global Economics and Chief US Economist at Morgan Stanley in New York. Thank you for inviting me to this hearing on Prospects for Jobs and Growth.

Following the deepest financial and economic crisis since the Great Depression, the US and global economies are beginning to recover. Thanks to aggressive monetary stimulus, support from strong global growth and from fiscal stimulus, the US economy is now growing again.

In my view, however, the recovery will be moderate and job gains modest. The financial system, while improving, is still burdened by the legacy of bad lending decisions. Imbalances in housing persist. In 2010 and 2011, we expect real GDP to grow by 3¼% and 2½% (Q4/Q4 change), respectively. We expect annual job growth to average 1% (110,000 monthly) over that two-year period, excluding hires for the decennial census. Even those modest gains are not a foregone conclusion. Job losses have abated, and some labor-market indicators have improved, but employment has yet to turn up.

More important, we would need persistently strong economic and job growth over the next few years to regain the 8.4 million payroll jobs lost since December 2007, not to mention the 10.6 million jobs required to restore the employment rate (employment-population ratio) prevailing before the start of the Great Recession.¹

Moreover, as you are aware, our unemployment problem has become increasingly chronic. Two statistics document that fact: The median duration of unemployment has reached 20 weeks, more than twice the peak in the deep 1981-82 recession, and a record 41% of the unemployed have been jobless for six months or longer.

In my testimony today, I will identify four specific obstacles to hiring. Each of these hurdles has a cyclical and a structural dimension. For each, therefore, I will discuss policies that might help foster economic growth and job creation both in the immediate future — the cyclical dimension — and for the longer run — the structural part. But first, I want to identify where job gains are likely to be over the next two years and why.

Where will the jobs be? What sectors of the economy are likely to grow in 2010 and 2011, and by how much? How will employment growth vary in different regions of the

¹ For example, see Lawrence F. Katz, “Unemployment in the Great Recession: Structural Problems and Policy Responses,” February 9, 2010.

country? What will be the likely state of the export market over the next two years, and the resulting impact on employment?

Strong sectors. Advances in export, infrastructure, capital goods, energy, and health-care related industries likely will account for most of the job gains in the next 18-24 months. That forecast echoes my views regarding the sources of growth in our economy. The combination of strong global growth, the lagged effects of fiscal stimulus, and improving financial conditions will promote improvement in many of those industries. And rising demand for healthcare services continues. In contrast, employment in residential and commercial construction, retailing, and financial services likely will remain soft as those industries continue to restructure.

Strong regions. Identifying regional strengths and weaknesses is difficult. For example, industries that likely will benefit from exports and other strong sectors are located in regions hard-hit by regional housing woes. Conversely, some regions that fared relatively well in the downturn, like the Midwest, are now doing less well. In our judgment, the Pacific Northwest, parts of the Rockies and Upper Midwest, parts of the Southeast, and parts of the Southwest seem likely to be the strongest regions.

Export markets and employment. I expect gains in export volumes of around 10% to be sustained over 2010. Paced by their domestic demand, growth in many of our major trading partners in Asia and Latin America likely will average 6-7% this year, and Canada probably will expand at a faster pace than the US. Somewhat slower growth seems likely in 2011 as the US and overseas policymakers exit from stimulus.

In manufacturing, some 20% of employment in 2006 was directly or indirectly associated with exports, and I expect that share to grow over the next two years.² Capital equipment and industrial supplies exports likely will continue to do well, while consumer goods will represent a rising share of overseas demand.

Obstacles to hiring. Worries about the sustainability of recovery are legitimate and probably are holding hiring back. Such concerns are characteristic early in recovery, but this time they are worse because of the lingering fallout from the bursting of the housing and credit bubbles. As a result, it remains essential to pursue policies oriented towards reducing housing imbalances, reducing debt, and improving the functioning of financial markets and financial institutions.

In addition, I think there are four obstacles to hiring that magnify the normal, early-recovery hesitation: Rising benefit costs, mismatches between skills needed and those available, labor immobility resulting from negative equity in housing, and uncertainty around policies here in Washington. Each has both a long-term structural and a shorter-term cyclical element. For each, I'll first discuss the problem and the long-term solutions. Then I will turn to what policymakers can do to help the economy and the labor market improve as quickly as possible.

² Source: International Trade Administration, Department of Commerce

Obstacle 1. Cost of labor resulting from escalation in benefits. The problem: Thanks to the high “fixed” costs of health and other benefits, and of taxes on labor to pay for the social safety net, our labor costs are out of line with other countries when adjusted for living standards. I say “fixed” costs because benefit costs don’t vary with hours worked; they are paid on a per-worker basis. But as employers seek to cut the cost of compensation, these benefit costs drive a growing wedge between total compensation and take-home pay. Unlike in other countries where healthcare benefits are not directly part of compensation, these rising costs likely have intensified employers’ efforts to boost productivity by cutting payrolls.³ The recession made the wedge between compensation and wages bigger, as cost-cutting private-sector employers cut take-home pay while leaving benefits intact. So relative labor costs go up versus other countries and median pay suffers.

Long-term solutions include comprehensive healthcare reform and innovation to boost productivity and labor skills. Healthcare reform to expand access and control costs will reduce the soaring costs of healthcare for employers and employees alike. Policies that boost worker productivity will reduce labor costs in what will be a win-win for employers, employees and overall living standards, because real wages will rise.

Short-run remedies: A refundable payroll tax credit, perhaps for firms that increase their payroll, would be among the most effective short-run remedies. CBO estimates that a well-designed credit could boost employment by about 9 years of full-time equivalent employment per million dollars of budgetary cost.⁴

Obstacle 2. Skills mismatch. The problem: For years, employers have complained that they don’t find the skills they need in today’s workforce. Worker skills have greatly lagged technical change and tectonic shifts in the structure of our economy. Immigration restrictions and massive dislocations in several industries in recession have magnified that mismatch as workers who have been trained for one occupation lose their jobs. And even in healthcare, an oasis of job growth, there is a growing nursing and nursing skills shortage that requires new training facilities.⁵

Long-term solutions include policies that keep students in school and improve access to education, reorientation of our higher educational system towards specialized and vocational training and community colleges, and immigration reform.

Short-term remedies: Our current unemployment situation demands income support through unemployment insurance for those seeking but unable to find a job. Jobless spells degrade worker skills, just when workers need re-training. One remedy would pair training in basic skills that are needed for work with such income support. Two other groups seeking employment — newly minted college students and unemployed teachers

³ See Sarah Reber and Laura Tyson, “Rising Health Insurance Costs Slow Job Growth and Reduce Wages and Job Quality,” Working paper, University of California at Los Angeles, August 2004

⁴ See Congressional Budget Office, “Policies for Increasing Economic Growth and Employment in the Short Term,” February 2010.

⁵ See Bridget M. Kuehn, “No End in Sight to Nursing Shortage: Bottleneck at Nursing Schools a Key Factor,” JAMA 2007; 298:1623-1625.

— could be an ideal nucleus for a Job Training Corps that would empower job seekers with new skills. As is the case with Teach for America, the Job Training Corps would build a pool of training advocates who then go on to work in other occupations with the perspective and conviction that come from helping others to acquire needed skills.⁶

Obstacle 3. Labor immobility resulting from the housing bust. America's workers have always been footloose. Even in the Great Depression, they looked for work wherever it was. Today, however, about one in four homeowners is trapped in their house because they owe more than the house is worth, so they can't move to take another job. Unlike in the Depression, when homeownership was less prevalent, negative equity among a nation of homeowners leads to substantially lower mobility rates. Owners suffering from negative equity are one-third less mobile according to one study.⁷ That is leading to a wave of "strategic defaults," in which borrowers who can otherwise afford to pay decide to walk away. Whether through foreclosure or default, this process is undermining the economic and social fabric of communities and reducing job opportunities.

Long-term solutions: Financial and mortgage regulatory reform are essential to restore the health of housing finance. Significantly improving financial literacy is equally important.⁸

Short-term remedies: Local efforts to stabilize communities plagued by foreclosure are essential, but they are not enough.⁹ It is essential to reduce debt, writing off bad loans while not destabilizing the financial system. Modifying existing mortgages seems appealing, but policies aimed at mitigating foreclosures under the Home Affordable Modification Program (HAMP) have not worked because they attempt to modify mortgage payments and not the amount of debt owed; re-default rates following modification are 50-60%. Efforts to establish a protocol for short sales and/or principal reduction should be a useful tool in avoiding costly foreclosure and strategic default.¹⁰

Obstacle 4. Policy uncertainty is a negative for the economy and markets. America's long-term challenges — healthcare, budget and tax reform, financial regulatory reform, retirement saving, infrastructure, education, energy, and climate change — are not new. Solving them is imperative. But while the debates around major initiatives to address them are an important part of the democratic process, the uncertainty that accompanies major policy change is weighing on business and consumer decisions to hire, expand, buy homes and spend.

⁶ http://www.teachforamerica.org/mission/mission_and_approach.htm

⁷ See Fernando Ferreira, Joseph Gyourko, and Joseph Tracy "Housing Busts and Household Mobility," forthcoming in the *Journal of Urban Economics*.

⁸ Efforts by the Federal Reserve and others are especially encouraging. See <http://www.federalreserve.gov/consumerinfo/foreclosure.htm> and <http://www.mymoney.gov/>

⁹ See <http://www.stablecommunities.org/> for examples

¹⁰ See for example, Larry Cordell, Karen Dynan, Andreas Lehnert, Nellie Liang, and Eileen Mauskopf, "Designing Loan Modifications to Address the Mortgage Crisis and the Making Home Affordable Program," Brookings Institution, October 2009.

Recent work confirms this intuition, underlining how uncertainty produces negative growth shocks. Nicholas Bloom shows how a rise in uncertainty makes it optimal for firms and consumers to hesitate, which results in a decline in spending, hiring and activity. In effect, the rise in uncertainty increases the option value of waiting as volatility rises. Moreover, this line of reasoning suggests that uncertainty reduces the potency of policy stimulus.¹¹ That's because the uncertainty can swamp the effects of lower interest rates, transfers or tax cuts. In effect, uncertainty raises the threshold that must be cleared to make a business choice worthwhile, and as uncertainty declines, the threshold falls with it. This notion squares with our long-held view that policy traction from easier monetary policy, improving financial conditions and fiscal stimulus was lacking through much of last year, but improved as uncertainty fell.

I can tell you as someone who works in financial markets that market participants are used to thinking that political gridlock is good, that it prevents politicians from interfering with the marketplace. The financial crisis clearly exposed the flaws in that reasoning with respect to appropriate financial regulation, whose absence allowed abuses. Indeed, gridlock today is more likely to be bad for markets, as our long-term economic problems are partly the result of past policies and can only be solved with political action.

Long-term solutions involve bipartisan leadership to tackle these complex problems one-by-one, in steps that are fair and call for shared sacrifice and benefits. That means setting priorities, making hard choices, communicating the game plan, and getting buy-in for it in advance. I would encourage you to look to the National Commission on Fiscal Responsibility and Reform — the deficit reduction commission — for leadership.

Short-term remedies: Reducing policy uncertainty now could be a tonic for growth. That won't be easy or come quickly, given the political backdrop in this election year. But even some incremental clarity on policies in any of these areas would offer investors a chance to assess the fundamentals again — fundamentals that we still see as improving.

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¹¹ See Nicholas Bloom, "The Impact of Uncertainty Shocks," *Econometrica*, vol. 77(3), pages 623-685, 05, May 2009