Testimony of Austan Goolsbee to the Joint Economic Committee

February 28, 2013

Thank you, Chairman Brady and Vice-Chair Klobuchar for inviting me today to discuss the nature of the recovery in the United States.

The central question we have confronted in the economy in recent years is this: why has the economy not grown faster after such a deep recession?

I believe there are three basic reasons for that but before laying those out, I would like to first fix the facts on the nature of our current economic recovery. I have heard the statement that this is the weakest recovery ever. That is factually incorrect. This recovery is not the weakest recovery in recent memory. It is not even the weakest recovery of the last two recoveries. Measured from the trough, the 2001 recovery was substantially weaker. On the employment side, the jobs picture continued deteriorating for, literally, two and a half years after the 2001 recession's declared end date. This time it was 8 months.

Measured by the speed of decline in the unemployment rate, the rise of GDP or the percentage increase in the number of jobs, this recovery has been below average compared to past recoveries but substantially better than in 2001. It has not been fast enough, certainly. But there is not any question at all that conditions have improved.

The important question, though, is: why there was not a 'V-shaped' recovery following such a deep recession? Certainly compared to 1982-1984 and older episodes of big recessions when deep recessions led to rapid rebounds, this time, the recovery has looked more like the last two recoveries which followed much shallower recessions than it has looked like 1984.

In my opinion there are three basic reasons the recovery is not faster right now:

1) Recessions from Popping Bubbles Are Much Harder To Recover From

When my dear friend and mentor, former Fed chair Paul Volcker, raised interest rates above 20% in the early 1980s, economic activity slowed dramatically. When rates came down, people went right back to doing what they were doing before the recession began. The key component to a V-shaped recovery is not requiring a lot of structural transformation.

This recession resulted from the popping of a bubble so we were not able to return to business as it was before the recession. As we documented in the Economic Report of the President in 2011 when I was serving on the Council of Economic Advisers, the expansion of the 2000s in the United States was heavily driven by residential investment and consumer spending—much more so than past expansions in the U.S. and much more so than other advanced economies during the 2000s.

There was a joke headline in The Onion you may have seen: "Furious Nation Demands New Bubble to Invest in to Restore Prosperity." Shifting the main drivers of growth away from housing construction and spending growing faster than income and toward exports, business investment and more sustainable forms of expansion entails retraining, labor mobility and time. There really isn't a get-rich-quick-scheme to do it, and that's a big reason the recovery hasn't been faster.

Add to the problem that the necessary shift to exports has been complicated by the stagnation and shrinkage in some of our traditionally largest export markets and you can understand why recovery hasn't been faster. Our modest growth of 2-2.5% per year has been among the best in the advanced world. It's been a very rough patch for the world economy.

With regard to jobs and unemployment, I don't think there is any secret to how things go. Over time, productivity grows about 2% per year. If output grows faster than that, then companies must hire or get more hours from their existing workers. The periods of relatively rapid decline in the unemployment rate in the last two and a half years have corresponded to periods when the growth rate got up above 2%. When output grows less than 2%, companies really don't need to hire additional workers to grow that fast and the unemployment rate stagnates or gets worse.

The good news is that exports and investment have rebounded, firm profitability has, literally, never been higher as a share of GDP and interest rates and the cost of capital are epically low. Once companies feel that the overcapacity problem has ended and they can expect a sustainable increase in demand, the stage is definitely set for an investment increase. You have seen this already in some sectors. Congress should be doing everything it can to encourage export growth and investment at home. I can go into more detail on these steps if you like but suffice to say that there are many policies that have garnered bipartisan support in past years which could help.

2) Overcoming the Worst Housing Market in History Has Undermined Growth

There has never been a housing collapse like the one we just experienced. Housing is normally the most important cyclical sector in the economy, accounting for about one-third of the growth in the typical expansion. Economist Ed Leamer has documented quite clearly the outsized importance of housing and construction for the short-run business cycle.

So I think it's pretty understandable why the V-shaped recovery model doesn't work when your recession comes from a popping bubble in real estate. Prices grew so far above construction costs in this country that new housing construction exploded to absolutely record levels. Since prices fell, we have had to work through an astonishingly large inventory of vacant homes. At one point there were more than 6 million vacant properties in the country. Normally construction and housing might account for as much as a third of an expansion, but in this kind of environment, they contribute nothing. Who needs to build new houses when there are millions of vacant ones? That major hit on the growth rate also helps explain why there has been no V-shaped recovery.

In the immediate term, the positive side is that in many if not most housing markets around the country, prices seem to have begun rising and we have seen the first vestiges of a return to a normal contribution of the housing sector to growth. This alone would go a fair way to returning growth to a more normal level. Congress could help this process, in my opinion, by facilitating refinancings for people unable to take advantage of low rates because they are underwater and by facilitating the conversion of vacant homes into rental properties. Longer term, most economists would like to see a rational resolution of the country’s housing finance system to get the government out of the business of backing 95+% of the mortgage activity in the nation. But it doesn’t seem to be on Congress’ primary agenda at the moment.

3) Financial Crises and Deleveraging Take a Big Toll on Growth

As our financial system continues its attempts to recover from the crisis, it has complicated the recovery, as it always does whenever there are major financial crisis and forced deleveraging. The Economic Report of the President in 2012 documented that the U.S.'s labor market experience has actually been a fair bit better than the average for countries that have lived through financial crises like the one we just endured.

The good news is that consumer deleveraging may have almost run its course now. Several important measures of consumer and small business credit have begun to expand again, albeit modestly. But the international experience with events like the one we just lived through suggest that years of slower than normal growth result from financial crises. Congress could address this issue by trying to get more principal reduction in underwater mortgages, which is the primary form of consumer debt overhang, but that subject has been a vexing one for some time so I think policy may not make much of a dent in the near term.

Let me take a brief moment to mention two things that I believe the data do NOT suggest are primary shackles on our current recovery.

1) Regulation/Policy Changes Are Not the Main Source of Modest Recovery

Some commentators have argued that the policy decisions and regulatory changes of the past three years have been the primary cause of slow investment and modest growth. Anyone that argues this must explain why the patterns of behavior we see in the U.S., like the accumulation of money on corporate balance sheets without a big increase in investment, are prevalent in virtually every advanced country of the world. Places that did not enact any of the policies of the last four years still had the same experience.

I have noted in the Wall Street Journal and in other venues that economists’ normal methods of detecting the negative economic impact of a policy or a regulation such as comparing places or industries affected and not affected by a particular policy do not, in this case, seem to indicate that policies have been especially important as a primary influence on the recovery. This is true for industries most and least affected by the health plan, energy policy, and so on.

2) The Short-Run Deficit Is Not the Main Source of Modest Recovery

It should be clear to anyone who looks at the CBO projections of the last two decades that the business cycle is an overwhelmingly important driver of the short-run deficit and that the large majority of the increase in the deficit in 2009 to today came directly from the slowdown, not from any explicit change in policy. That is the same reason (in reverse) that government spending and the deficit are now shrinking at the fastest rate in decades. The notion that short-run austerity would increase the U.S. growth rate has not been borne out in the data at all. European countries engaging in austerity have seen their growth rates plunge and their economies shrink.

The idea that fiscal contractions could be expansionary normally relies on austerity improving investor confidence and, in turn, generating lower interest rates which expands output. Interest rates on U.S. debt remain at epically low levels. Central bankers are debating what to do when facing the zero lower bound. Arguing that major immediate cuts to government spending would increase growth requires at least giving a mechanism of how it would work in this kind of environment.

I am a long time advocate of the nation confronting the long-run fiscal imbalance it faces from the aging of our population and the rise of health care costs. I hope Congress will work with the president to sign a so-called grand bargain that will address those issues and think about the level of tax revenue needed to pay for it. But in my opinion, major immediate-term cuts in government spending beyond the unprecedented drops in spending as a share of the economy that are already underway will have the same kind of heavily negative impact on the growth rate that we have seen in other countries of the world and that we saw in the fourth quarter GDP number in the United States.

Conclusion

I think that the difficult experience for the U.S. and for the world over these past several years will soon be coming to an end. It has been a brutal episode in our history and one that we should come together to rise above. The key is promoting growth. I believe Congress and the Administration could have a positive impact on the long-run growth rate of the economy and job market by putting a focus on expanding exports, encouraging private-sector investment at home, upgrading the skills of the workforce and ensuring that the economic infrastructure and intellectual property of the country are secure. Innovation has driven our growth for at least 200 plus years and we should invest in keeping it that way.

Thank you for your time.