

SELL MORE, BORROW LESS

A LONG-TERM STRATEGY FOR ECONOMIC AND JOB GROWTH

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FEBRUARY 2010

EXECUTIVE SUMMARY

After campaigning in 2008 as a reformer, President Obama found himself hired as a fireman. Taking over as financial markets plunged and unemployment soared, he took admirably to the job. The administration put together — from scratch, and in the face of unanimous Republican opposition — a massive and effective fiscal stimulus which doused the flames, ending the panic in the spring and restarting growth by summer.

But the fireman's job isn't over yet. A year into the president's first term, unemployment may not have peaked, and the economy relies on government spending rather than the business investment and consumer confidence that characterize a normal expansion. And as government debt has risen, the public's enthusiasm for putting more water on the blaze — if that is the right metaphor for fiscal stimulus in crisis — has waned. This year, the fireman needs to begin rebuilding a damaged house, to make it livable again and safer from fire.

In practical terms, as the economy shifts back from reliance on emergency stimulus to the private sector, this means helping make businesses confident that they will have markets for the goods and services they produce. If so, they will begin to invest once again in hiring new workers and adding capital equipment. But this transition will be more difficult in 2010 than it was after earlier recessions. With the job market weak and home values down, families — rightly worried about job security and retirement — now prefer savings to shopping and home-buying. To replace the shoppers, over the next two years the administration has a double task:

- First, find foreign buyers. We need not only a continued commitment to reject protectionism, but a stronger effort to open foreign markets, so foreign demand and rising exports can substitute for the shopping and rising debt that drove the 2002-2007 expansion.
- Second, develop a credible plan to recover control over government finances, to give the private sector confidence in America's long-term growth prospects and encourage lending to small businesses, tech firms, and other likely sources of investment and job growth.

These tasks are as important as the pressure-hose tactics that fitted the 2009 emergency, and in some ways more politically complex. In addressing trade, the president needs — as Presidents Clinton, Carter, and Johnson also needed — to defuse a current of economic isolationism on the party's left. In restoring fiscal discipline, he needs a plan credible in bringing budgets under control, but must be careful to avoid new shocks to the economy through rapid reductions in spending or tax increases. But, complex as they are, these tasks are essential if the administration is to heal the damage it inherited, and leave to the next president an economy restored and a nation confident once again.

EXPORTS AS THE NEXT GREAT AMERICAN JOB ENGINE

As President Obama pointed out in the State of the Union address, the United States needs a powerful contribution from exports for a strong recovery. To reach his goal of doubling exports in five years, the administration will need to launch an ambitious trade policy which transcends the opposition to protectionism which sufficed in 2009, refocused over several years away from the Bush administration's concentration on free trade agreements, and moves towards larger agreements centered on the industries and markets Americans expected to serve as the drivers of growth in the next decade.

The need for exports has grown because American families have sharply and quickly changed their behavior, emphasizing savings over shopping. Healthy in the long run, for now the revival of thrift makes private-sector growth and reduced unemployment more difficult to achieve.

In the last decade America's notorious consumer borrowing habit — sub-prime loans for the poor and McMansions for the rich, trips to auto dealerships for giant sports-utility vehicles and to malls for movie-size plasma TV sets — drove growth. But it left a heavily indebted country reliant on swollen home values and stock accounts for growth and at risk of the financial shock that arrived in 2008. The crisis has made us poorer, but perhaps wiser. Even as the stimulus program begins to restore economic growth, families are putting more of their earnings in the bank. Incomes have not grown, but since 2007 over \$300 billion in personal income — nearly 3 percent of family income and more than 2 percent of GDP — has moved from consumption to savings.

TABLE 1: INCOME AND SAVINGS

	2006	2007	2008	2009
Family Disposable Income	\$9.92 trillion	\$10.40 trillion	\$10.81 trillion	\$10.95 trillion
Household Savings	\$235 billion	\$179 billion	\$286 billion	\$507 billion
Savings as Percent of Income	2.4%	1.7%	2.6%	4.6%

Source: Bureau of Economic Analysis, National Income and Production Accounts. Note - Figures are nominal dollars unadjusted for inflation.

With home values sharply down and stock-market based retirement plans still shrunken, families are right to change in this way. Looking far ahead, they are less secure in retirement and need to put more money in CDs and savings accounts. More immediately, with unemployment above 10 percent, they hope to build up enough savings to avoid financial disaster if a father or mother is laid off.

In the long run, the revival of savings is good. Over the next decade, Americans will be able to finance more investment from domestic savings, and (depending on trends in oil and commodity prices) to run lower trade and current-account deficits.

But for now, thrift will hamper growth and slow hiring. With more money in banks and less going to shopping-mall trips and big purchases, America cannot count on the consumption booms that drove recovery in 1976, 1983, 1992, and 2003. This in turn means that businesses will be skeptical about a durable recovery, and therefore will be slow to hire new workers or invest in new capital equipment. The 9.5 percent jump in worker productivity in the fall of 2009 suggests that though orders are recovering, businesses prefer to push their current workers harder rather than risk hiring new people.

One part of the solution is for exports to drive growth, as businesses tap foreign demand to replace America's vanished shoppers. To some extent this is underway now: export growth accounted for 1.7 of the 2.8 percent growth in the third quarter of 2009 and 1.9 of the fourth quarter's 5.7 percent growth.

In both cases, this contribution is outpacing the rates typical in earlier recoveries. The administration can help to speed this along through a well-focused trade policy, and the State of the Union address set an appropriately ambitious but not impossible goal for that policy in a doubling of exports by 2016.

Consumers, worried about their job security and financial security, are not likely to be the basis of that recovery. Export-based growth is therefore essential and can wait no longer.

The challenge the administration faces, however, is that the trade agenda it has inherited is imperfect — too centered on relatively small FTAs and agricultural reform to meet the goal. Therefore it needs a transition over the next year or two toward goals more focused on the big foreign markets and the industry's most likely to be the foundation of a new expansion. This would proceed as follows:

- In the coming year, act expeditiously to pass the three free trade agreements inherited from the Bush administration with Korea, Panama, and Colombia. Each was renegotiated and rewritten in 2007 to suit Democratic demands for labor and environmental policy. Each has opponents as well. But though there are always reasons to criticize any particular agreement, these are good enough and ought to pass. This decision, however, should mark the end of the FTA program for the time being. FTA partners account for a relatively small share of American trade — the three pending agreements cover 4.5 percent of imports and exports — and while requiring great investment of negotiating time and political capital, cannot contribute enough to be the foundation of growth.
- Over 2010, work to conclude the WTO's Doha Round. Top priorities should include ambitious programs to end tariffs and non-tariff barriers in open markets in the big economies that account for most of America's trade — especially the European Union, China, Japan, India and Brazil — for the industries best suited to serve as engines of growth, innovation, and job creation. These would include goods and services in information and media, the health and medical technology complex, and the clean energy and environmental technology industries.
- Likewise over 2010, begin an ambitious set of talks with other wealthy economies — Israel as the 25th anniversary of the US-Israel Free Trade Agreement approaches, the European Union, Japan, and Canada — on the more complex issues that arise in our rich-country trade relationships dealing with services trade, standards-setting, and non-tariff barriers.

In launching an ambitious, export-focused trade policy, the administration will need to be tactful but also firm. Democrats have been emotionally split over trade since the 1960s. Today, a significant minority of the party worries more about easing competition at home than finding new sources of growth abroad. But with the world economy still shaken and American businesses badly in need of foreign markets — and imports down by 25 percent last year, the sharpest decline since 1938 — protectionism would be especially dangerous.

The administration does have some options for reducing the political stress of trade policy — in particular a strong enforcement agenda and the more vigorous engagement we envision with the European Union, Japan, and other wealthy economies — and should use them. But as the State of the Union address makes clear, a strong recovery depends on finding markets abroad. Consumers, rightly worried about their job security and financial security, are not likely to be the basis of that recovery. Without an alternative source of domestic demand, businesses will be slow to hire. Export-based growth is therefore essential and can wait no longer.

BUDGET DISCIPLINE: A KEY TO LONG-TERM ECONOMIC GROWTH

Just as businesses will need access to foreign markets to recover the confidence they need for new hiring and investment, they also need a recovery of credit at home. Here, the administration's challenge is to provide a credible guarantee that the coming years will be a period of carefully strengthening fiscal discipline, in which the U.S. government does not extend emergency borrowing to the point at which it becomes a burden on credit for businesses.

The past decade has not been a good one for fiscal discipline. The United States has run large budget deficits every year since 2001. The national debt grew by approximately \$4.9 trillion during George W. Bush's presidency. And in his first year in office, President Obama's efforts to stem the Great Recession added another \$1.4 billion by the end of the 2009 fiscal year, the largest shortfall relative to the size of the economy since 1945.

The overall national debt, which is the accumulation of annual deficits, is now nearly \$12 trillion, and projected deficits for the next decade will add an estimated \$9 trillion more. Some of this deficit is due to tax policies and the Medicare drug benefit adopted in 2001, 2003, and 2005 without offsets such as cuts in other programs or new revenues. Other factors include the decline in revenues from the Great Recession, and spending on economic recovery efforts including the Troubled Asset Relief Program (TARP) for financial institutions and the \$787 billion, two-year fiscal stimulus package.

We can fight joblessness now while simultaneously improving our long-term budget picture. In fact, failing to put into place a plan to restore fiscal responsibility could put a fragile recovery at risk.

While no one would agree with how every dollar was allocated in the stimulus and TARP, the high levels of spending to stimulate the economy, save jobs, and staunch the financial crisis were essential. As a recent survey of leading economists noted, without the Obama stimulus, another 1.2 million jobs would have been lost.¹ Higher deficits in the short-term are sometimes necessary for important economic or national purposes including wars and national disasters. However, worries about joblessness this year are not a valid reason to create structural policies that throw the budget out of balance in 2011 and beyond. We can fight joblessness now while simultaneously improving our long-term budget picture. In fact, failing to put into place a plan to restore fiscal responsibility could put a fragile recovery at risk. As the President said last November:

It is important though to recognize if we keep on adding to the debt, even in the midst of this recovery, that at some point, people could lose confidence in the U.S. economy in a way that could actually lead to a double-dip recession.²

¹ Wiseman, Paul and Barbara Hansen, "Experts: Stimulus Reduced Our Pain," *USA Today*, 25 January 2010.

² "Obama: Too much debt could fuel double-dip recession," Reuters November 18, 2009 <<http://www.reuters.com/article/idUSN188108620091118>>

Evidence of potential for a double-dip recession driven by high deficits comes from Japan in the 1990s. Japan experienced a disastrous decade of economic stagnation and deflation from 1991 to 2001 after bubbles in its stock market and land market collapsed. Commonly known as the “lost decade,” Japan’s economy experienced a number of major setbacks, including ten years of declining GDP (CK) and what ultimately became a 70 percent drop in land values by 2001.³

The main reason for Japan’s prolonged recession wasn’t a lack of fiscal or monetary stimulus — the government has run deep deficits to pump up demand, and the central bank lowered Japanese interest rates to nearly zero. Instead, Japan’s stagnation was caused by a lack of confidence, particularly in the ability of that nation’s political system to address structural economic problems. Japanese voters simply didn’t trust their government to make the tough reforms, so they hunkered down and held on to their wallets. Instead, Japan approved a stream of smaller tax cuts and pork-barrel public expenditure projects, which largely failed to reignite the economy and buried the nation under a mountain of public debt.

Confidence in our national leaders to be good economic stewards and make the tough choices is vital to long-term economic growth.

Neglecting confidence is a big mistake. The conventional wisdom that monetary and fiscal stimuli are the only tools policymakers can use to fight recession and prevent deflation overlooks confidence. Confidence in our national leaders to be good economic stewards and make the tough choices is vital to long-term economic growth.

That is why it is vital that American policymakers not follow the same path as Japan and allow mountains of debt to be created by overly generous tax breaks to special interests and deficit spending in the name of stimulating the economy. Borrowing at 12 percent of GDP, necessary as it has been for the past year, surpasses Japan’s largest fiscal stimulus package and needs to be brought down sharply as the economy begins to recover. To show the American consumer that their leaders are serious about creating this condition for long-term economic growth, the Obama Administration and Congress should commit to a real deficit reduction package this year, but whose provisions would not take effect until FY 2011. Such a plan could include the following elements:

- **Put the Lid on Federal Spending:** In addition to balancing the federal checkbook, Congress should set limits on discretionary spending. The Obama Administration’s plan to freeze some types of discretionary spending to save \$250 billion over the next ten years is a good start.
- **Review and Terminate Unnecessary Programs:** Too frequently, Washington establishes a program designed to solve a discreet problem, and then fails to dissolve the accompanying bureaucracy after its mission has been achieved. For that reason, Congress should enact legislation that would grant reform authority to the president to reorganize and eliminate programs. Implemented correctly, this could save up to \$100 billion a year through cuts in the number of federal government contractors, reductions in the government travel budget, and lowering costs by reducing no-bid contracting, among other reforms.

³ American Enterprise Institute, March 2008 <<http://www.aei.org/outlook/27568>>

- **Account for every dollar:** Evaluating every dollar spent on our national defense is not only good fiscal practice; it is a matter of national security. Like all other major federal agencies, the Department of Defense should be subject to annual audits. Senators John McCain and Claire McCaskill have already introduced this measure in the Senate.

By enacting these measures now, but delaying their implementation until FY 2011, Washington can allow the stimulus to take its full effect while providing American consumers and business the confidence to invest in a sound American economic future. If not, and current policies and laws are kept in place, the debt held by the public will continue to accumulate rapidly after 2012 (and net interest payments will roughly triple relative to the size of the economy) and will hamper the ability of private-sector businesses to step in and provide the investment and hiring a durable recovery requires.

Why is this? Higher interest rates. The United States relies on large foreign buyers such as China and Japan to cheaply finance its debt, and these investors may demand higher returns if they begin to doubt that the federal government can control its deficits. Higher rates on Treasuries would force private firms to offer competitive rates of return in order to ensure adequate access to capital. This in turn would raise the cost of doing business and make it more expensive to create new businesses or expand existing ones. Higher rates on Treasuries will also increase the amount of money needed to finance U.S. debt, making the challenge of restoring fiscal balance even greater.

CONCLUSION

As we move into 2010, U.S. policymakers need an economic strategy that will grow jobs, ensure the economy avoids a double dip recession and shift the foundation of growth from one based on emergency government measures to one based on the normal pattern of investment and hiring by private businesses. Metaphorically, the fireman needs to make sure the fire is out, and then stop the water before it begins doing its own damage to the building structure.

The basics of such a strategy are simple: tap foreign demand for growth, and avoid the credit crunch that uncontrolled deficits can create. Both of these policy goals, set out effectively in the State of the Union address, require tough political choices and challenge party orthodoxy. But both are essential, and need to start this year.

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