RIGHTING THE UPSIDE-DOWN ECONOMY:
CREATING A SUSTAINABLE RECOVERY
Transcript
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Paul Krugman:
Thanks. I guess I have to make the usual disclaimer: because of the Times I'm not allowed to do political endorsements; my political preferences are as well hidden and obscure as those of Bill Safire's. And I just want to say the Center for American Progress, I was a little skeptical, does Washington need another think tank? But it is spectacular work, I just find it an incredible resource and I'm honored to be asked to speak to a CAP gathering.

Okay, well I'm going to talk about, I'm going to devote about half of this to talking about where we really are in the economy and in that I'm going to be covering ground that was probably covered in the panel, which unfortunately I wasn't able to make it to. But I have the feeling you're going to be hearing some of the same messages so let's just hope that my take is just a little bit different in presentation, though I suspect we have all arrived at the same conclusions. And then I'll talk about what this says about the prospects for recovery. So, let's hope that our technology works here. I'm not usually a PowerPoint person, but as you'll see in a bit, pictures are actually terrifically important for trying to make sense of what's happening here.

The first thing to say is that we are in a period of economic recovery and if you read the papers, certainly if you watch the cable news, you'd have the impression that it's really spectacular and there's this almost whinny note from a number of commentators about "why isn't the public feeling more enthusiastic? Why isn't this leading to a huge surge for Bush?" But, just in general, "why isn't the public saying things are great," with fairly often the implications that people are stupid. Or they just haven't caught on yet, and just you wait.

It's important to have some perspective. So the first thing to say really is "how good are the numbers?" And the answer is "they're good, but they're not something that we've never seen before." And the reference point which drives certain people wild is to look at the Clinton era, at the eight year stretch from January 1993 to January 2001. These last five months have been much better than what went before, which means that the average so far this year is just about exactly the rate of job growth that we had under Bill Clinton for eight years.

We are eagerly awaiting tomorrow's numbers, but for what it's worth, straws in the wind, new claims for unemployment insurance, suggests an improving but not great labor market. If anything, the last few numbers suggest that we might be seeing job growth at roughly the rate of population growth. Real GDP first quarter was good but not great. Again, it was just barely faster than the average over the whole of the Clinton years, and just average for Clinton's second term. So again it is not a spectacular number.

Again, for what it's worth, the straws in the wind suggest that second quarter, if you look at a little piece in this morning's Wall Street Journal, saying that it's probably a number that begins with a three and possibly a number that begins with a two. Again, it's probably not, it doesn't look spectacular, we'll find out. But what you're seeing is good growth, and after all, we do think of the Clinton years, correctly, as a time of enormous prosperity, but there's nothing in recent experience that's better than that.

One question you might ask is "where is the sense that we're having some extraordinary boom come from," and a lot of it comes from the third quarter of 2003, which was in fact more than eight percent growth. But that's getting a little old you know, you can only live off that one spectacular quarter for so long, so it's not really as big a thing as it seems.

But to really have a perspective, of course, you have to have a sense that these pretty good numbers are coming after a long stretch of really pretty bad stuff. And here's my favorite picture. The blue line that goes all the way, there is the actual non-farm payroll employment. And as you see, in early 2001 it turned down, continued to slide down after the recovery formally began, and in the last nine months has finally turned up. And if you just take the last few months, it's a pretty good pace.

How are we? We might end up just with employment in October, which would be the last number that we have, being higher than it was when Bush took office, which will remove a big debating point for the Democrats. But that's really silly – what we really should be asking is how we are doing compared to what we should be doing. And there's a pretty nice simple gage of how we should be doing which is the purple line there. That's actually the forecast from the 2002 Economic Report of the President, which was released in February 2002.

For those who want to know the technicalities, what it actually forecasts is year average employment, which I've assigned to July of each year. It's actually based – the last date that's baked into it is from October of the proceeding year, just for technical stuff. The important thing about that is that this is a report that is post-9/11, it's post-NASDAQ collapse, it's post the recession. So, this is what the White House, or actually the Treasury, OMB, and the Council of Economic Advisors thought was a reasonable projection of what was going to happen over their term. What they were really projecting was that by 2004, the economy would be back on the track of the Clinton years – the slump in employment would be over, that we would have had a recovery, a period of above normal job growth. And, as you see, unless we create about seven million jobs between now and July, we're not there. We're really a long way down.

Another way to look at it is to use the – again technical stuff. There are two surveys. This is a survey that asks employers: "How many people do you have working for you?" The other survey asks people: "Are you working?" And that one has the virtue of telling us what fraction of the adult population is actually employed. So we can look at the employment-population ratio. Actually, last year, when the numbers from that looked a little bit better than the payroll numbers, we heard a lot about it but now we hear a lot less about it because now it's looking a little worse. Basically, that little wiggle at the end is the Bush boom I guess.

The point is that jobs are still very scarce compared to population. People here probably know that the measured unemployment rate fell quite a lot over the last year. But that as you can see, is entirely because of a reduction of the number of people who say they are looking for work, not because of an increase in the employed share of the population. Again, the picture is, compared with the first two and a half years of the Bush administration, recent numbers have been very good and they are a huge relief to people who thought that we were really sliding into the abyss. But compared with previous growth, they are not spectacular and they don't come anywhere close to making up for the long period of very poor job performance.

A word here about "why doesn't the public feel more enthusiastic." It's an interesting thing. What the people who say that the public should be feeling enthusiastic about the economy are really urging – what they believe is right, just – is not that the public should be smart, but that the public should be medium-stupid. That is, if the public is really stupid and has no idea that the job picture has improved, well, that's the story they are telling, and maybe that's the case. But if the public was really smart, they would say, "Well, you give me five months of okay numbers after all of that – I'm still a whole lot worse off than I was when you took office," and the public would be feeling pretty disgruntled despite the recent numbers.

So when the people say what the public ought to be feeling is really good, what they are saying is that the public should be smart enough to notice that the numbers have improved lately, but not have enough storage in their memory to remember what things were like a few years ago. So it's a funny kind of proposition. For what it's worth, it is also the proposition that econometric models of voting tend to suggest – that people really only look at the rate of change in the last few quarters. But I'm less and less convinced that those models are actually right.

The thing that you can't capture by looking at these job numbers is the question of who is getting the benefits from the growth. And here the story is really quite spectacular because we've had, one way or another, a fair bit of growth these last few years, but almost none of it going to the working population.

Here's one picture I've chosen from the last Clinton quarter, which is the most recent one that we have data - you can play with other time periods, it doesn't really make a difference, you come up with a similar story. The economy has growth of more than eight percent since the fourth quarter of 2000. The wage and salary income deflated – adjusted for inflation – has risen only a little over one percent over that period. So basically there has been very, very little shared with the work force.

And then you ask the question: "Things have to add up, where did the growth go?" And the answer, of course, is: This is real GDP growth over that same period and the growth in after-tax corporate profits, adjusted for inflation, but it doesn't really make a difference. Since the fourth quarter of 2000, after-tax corporate profits have risen 96 percent, after inflation, in a period when the GDP only grew eight percent. So it's an extraordinary redistribution – basically all of the growth has gone to profits, none of it to wages. It's pretty spectacular.

Now you might say: "Isn't that what always happens during economic recoveries?" And the answer is: "Yes and no." I don't want to be too extreme here. So here's the picture of after-tax profits as a share of GDP. Now if you do look, the first Clinton term was also a period in which the share of after-tax profits rose. So you don't want to say that this is completely off the tracks. Something like this has happened before. But, the pace at which it has risen, given the fairly modest pace of the economic growth, is very rapid and it has now reached a level, after-tax profits as a share of GDP are at their highest level since quarterly data began being collected in 1947. So this is really dramatic.

Now, it turns out – actually, John Irons at OMB Watch is the one who pointed this out – sending me to the BEA website to do some downloading. And it turns out that it's not quite right to say that we don't have data on this before, we only have quarterly data back to 1947. We do have annual data, God knows how reliable it is, but there is annual data reaching back further than that. It turns out that this share of after-tax profits in national income has been matched before, but only in one year in which we have data, which is 1929. Which raises the question: "How are we doing in terms of sustainability?"

Before I get there, I just wanted to say two things. This is the hourly wage of non-supervisory workers in 1982 dollars. Just to make the point, as you expect, big wage gains, although, in Clinton's second term, not in the first term. Again, you don't want to overstate the differences too much. And stagnation in this administration, with a fall in recent months. One more thing, I just picked this up from an article in this morning's Wall Street Journal. It was an afterthought. I have not gotten back to it.

This really is a lopsided recovery, in which those who have, are getting better off, or think they're getting better off, than those who don't, are not sharing and actually see a deteriorating situation. Which you can see also – straws in the wind, Wal-Mart, Target are issuing warnings that sales are falling short of anticipations. We are seeing something happening.

Okay. So let's talk about what it all means. We're all a little bit at sea here because this is not a typical economic recovery, not a typical post-war economic recovery, anyway. What I have been trying to tell people for some time- this is not your father's business cycle. It's your grandfather's business cycle. For reasons that we do not fully understand, we had a very long boom without inflation. And it's a boom that, unlike previous booms, died a natural death; it was not brought to an end because the Fed slammed on the brakes by raising interest rates because of fear of inflation, rightly or wrongly. It's a boom that came to an end because at a certain point, businesses which had been investing like crazy suddenly discovered that there really wasn't a market for all that they were able to produce. It was an over-investment slump, at least that is my understanding. It is a 1920s or pervious style of economic slump. It's like the panic of 1873, when they built more railroads than they actually had traffic for. It came to an end basically because as long as everybody is investing like crazy, it's kind of self-sustaining, but at some point it just can't go on. It was a Wile E. Coyote moment, you run off the edge of the cliff about five steps, then look down, realize there's nothing and "tshhhhn." And that was the recession.

The recovery, if you go back, the problem is now we're going back to the mists of history. If you go back and ask: "How did the economy recover from recessions of that kind in the past?" And the answer is, "actually, it was sort of time eventually created healing." That as enough time went by between a growing population, technological progress, and just plain depreciation; there came a point where even though the economy was weak, businesses said: "Well, we really need to start replacing some stuff." When the big businesses jockey to do that, enough businesses do it; you get a self sustaining recovery, as investment leads to a growing economy, which leads to more investment and so on. By those historical standards, the recovery we are having now is premature, which doesn't mean that it is a bad idea. I would be doing a lot more to be promoting recovery. But the point is that we have had a recovery that is not the result of businesses saying: "Our stuff is so out of date we really need to replace it and we invest." There is some of that – that is part of the reason why this year is better than last year.

But by and large, the recovery is driven by aggressive, expansionary policies. By aggressive monetary policy which has driven down interest rates that has led to a housing boom, which is very unusual for a housing boom to continue through a recession. But that's how it's happened. And it's the result of an expansionary fiscal policy, which is, I'm sure almost everybody in this room knows is something that any college sophomore could devise a fiscal policy that would have delivered much more stimulus with much less debt increase but none the less, as somebody said, "There's not much bang for the buck, but it's a heck of a lot of buck." So it is at least something to push the economy up.

The question that we now ask is: Okay we've got a recovery, which is certainly gratifying, but falls well short of a full recovery. And it's one that does not seem to be accelerating. At this point, if you had to make a rough guess, a rough judgment from all the scraps of information we have, it's probably getting a little slower – I'm not saying it's about to end, but it's probably getting a little bit slower rather than faster. Meanwhile, the fiscal and monetary policy has pretty much done all that it's going to do. The tax cuts have happened. We're not going to have another wave for a while anyway, and the long term budget concerns are going to crimp any future tax cuts. The war, well, it's not over, but the big surge of military spending is behind us. You go down the list, things are pretty much, policy has shot its wad. The monetary policy, I have to say I am a little baffled at why there is such a strong consensus that interest rates need to go up. Again, you see how the inflation numbers are a bit higher, but every measure that I can think of, of labor force utilization, capacity, suggests that the economy is still way down there. But in any case, the Fed is not going to cut rates any further and the market believes that they are going to go up. So you kind of have an exhaustion of the stimulus.

Does that mean that this is unsustainable? I'm not sure. You have to be a little careful of confusing value judgments with economic analysis. I'd say that the form of this recovery is grossly unfair, is grossly unjust. The workers are not sharing in this thing. But economics is not a morality play. What's fair and right isn't necessarily what works. And there's no reason in principle why you can't have an economy in which jobs are created producing luxury goods even while sales languish at Target and Wal-Mart. So there's no reason in principle.

Although we often talk about the Great Depression and the huge inequities of income that the economy had in 1929 – inequalities that we have now fully replicated today and say that the inequality of income must have been a reason why the economy was structurally weak and had to have a collapse, that's – we're not sure of that. It's a good story, it might be true, but we're not sure of that. The main source of weakness here I think that's pretty obvious, is that wages and salaries of all kinds, including salaries of highly paid people are lagging far behind economic growth. So if you ask me where is the extra income generated by this extra growth showing up, the answer is that it is showing up in corporate profits. And in a world of perfect rationality, everybody would say: "Well look, I own a piece of that corporation so those profits are really part of my income." In the real world, people don't necessarily see through the veil that way.

And so disposal incomes is not rising nearly as fast as the economy, which makes you wonder whether consumer demand will keep on growing fast enough to sustain this rate of growth. I think the answer has to be, (I know the background paper that CAP has produced says this) consumer demand is not going to keep on growing at recent rates. It might even turn down because there is a lot of build up of consumer debt because the home refinance boom is not going to keep delivering cash into people's hands.

Will corporate investment come along and save the day? And the answer is maybe, but it seems kind of weak to count on. As I said, the huge backlog of unexploited technologies, unexploited investment opportunities that traditionally led the economy into a recovery from a pre-WWII style recession has not happened yet. We have moved into a recovery before all the machines had time to wear out, which again is not a bad thing. We are saying that that kind of recovery probably needs more "umph" behind it then we seem to be getting.

Short-term forecasting is a black art. I think everyone has been surprised again and again. But I have to say that the consensus that everybody has had – that this is going to be a banner year for growth – that we've got a firing of all cylinders recovery that is going to be four to five percent growth for years to come, seems to be based pretty much on thin air. The consumer demand is not going to drive it. Businesses are not saying that they're going to invest at rates that would sustain that. So this is all about in effect, patting the heads of CEO's saying, "Yes, yes, we know you're saying that you're cautious, but we don't really believe it." I'm not sure that you want to base your economic forecast on that.

In a different world, we would want to sit down with the leaders of economic policy and talk about: "Let's have some sensible back up plans for economic stimulus that would keep this recovery going if it falters in ways that won't actually lead to massive build up of long-term liabilities for the federal government." In a different world, you could lose weight without dieting and lots of other things.

The point is that this is a recovery that is more fragile than people have been saying. It's not as good as people have been saying. And we may have some unpleasant surprises in the quarters ahead.

Thanks.