

WHEN GROWTH IS NOT ENOUGH

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I'd like to thank Mario and the European Central Bank for inviting me to participate in the conference here in Sintra. I'm a civilian now of course, but it's good once again to see friends and acquaintances from my days as a member of the community of central bankers.

The theme of the conference, investment and growth in advanced economies, has about it a feeling of transition, which I suspect was intended. With policy interest rates at or close to zero in most advanced economies, and with inflation still very low, there is much more work to be done before a full recovery from the global financial crisis can be claimed. Still, with cyclical expansions apparently entrenched, financial conditions looking stable, and the major central banks at least contemplating their exits from extraordinary policies, it's natural that the focus is beginning to shift to the longer-term challenges of growth, investment, and structural change.

In my remarks this evening I'll discuss some of these longer-term challenges from the perspective of my own country, the United States. My talk is entitled "When Growth Is Not Enough" and is strongly influenced by recent political developments, which have cast a bright light on some disturbing economic and social trends in the United States. Unfortunately, policymakers in recent decades have been slow to address or even to recognize those trends, an error of omission that has helped fuel the voters' backlash. If the populist surge we are seeing today has an upside, it is to refocus attention on both the moral necessity and practical benefits of helping people cope with the economic disruptions that accompany growth. Of course, Europe also faces the problems of managing change as it pursues an agenda of reform and growth. In

the last portion of my remarks I will offer a few thoughts on the implications of the U.S. experience for Europe.

Regarding the United States, let me start with the positive. The nation's cyclical recovery is entering its ninth year this month and appears to have room to run. Although the Great Recession was exceptionally deep and the recovery was slower than we would have liked, real GDP is now up about 12.5 percent from its pre-crisis peak, and real disposable income is up more than 13 percent. Importantly, the Federal Reserve is close to meeting its congressionally mandated goals of maximum employment and price stability: Since the trough in employment in early 2010, more than 16 million net new jobs have been created—compared to a civilian labor force of about 160 million—bringing the unemployment rate down from 10 percent to well below 5 percent. Indeed, the latest reading on unemployment, 4.3 percent, is the lowest since 2001. At between 1.5 and 2 percent, inflation is below but relatively close to the Fed's 2 percent target. The Federal Open Market Committee has expressed confidence that recent softness in inflation is transitory and that wage and price inflation will continue to strengthen; on this, of course, the data will be dispositive.

As is often the case in the United States, the household sector is a major driver of the expansion. Real wages and labor income have lagged the improvement in labor market conditions but appear to be moving in the right direction. Households have very substantially de-leveraged since the crisis and household wealth, reflecting the recoveries in house prices and equity values, exceeds the pre-crisis peak by about 20 percent in real terms. Consumer sentiment has rebounded to pre-crisis levels, with high proportions of respondents expressing confidence in their own financial prospects.

Beyond the cyclical recovery, optimists can also point to some strong longer-term fundamentals for the American economy. It remains, of course, a highly-integrated continental economy with a large domestic market and free internal movement of goods, capital, and labor. The federal government provides a national fiscal policy, including substantial risk-sharing across geographic regions, and (mostly) unified regulation, including of the financial sector. Despite recent controversies and talk of border walls, immigrants are generally well-assimilated, and their presence contributes to an overall demographic outlook in the United States that is somewhat better than in most other advanced economies. The country remains a technological leader, with vibrant high-tech clusters like Silicon Valley and a large share of the world's leading research universities within its borders. The markets for capital and labor are generally flexible, and the financial system looks healthy. Energy production has soared as the result of the application of new technologies. These are substantial advantages.

And yet, despite the sustained cyclical upswing and the country's fundamental strengths, Americans seem exceptionally dissatisfied with the economy, and indeed have been for some time. For example, those who tell pollsters that the country is "on the wrong track" consistently outnumber those who believe that America is moving "in the right direction" by about two to one.¹ And, of course, last November Americans elected president a candidate with a dystopian view of the economy, who claimed that the "true" U.S. unemployment rate was 42 percent, (inaccurately) described the United States as the most highly taxed nation in the world, and promised to restore lost American greatness. Nor, it should be noted, did the anger come exclusively from the right, as a left-wing populist made a serious bid for his party's nomination as well.

So why, despite the undoubted positives, are Americans so dissatisfied? The reasons are complex and not entirely economic. Without trying to be comprehensive, I'll highlight here four worrying trends that help to explain the sour mood.

First, stagnant earnings for the median worker. Since 1979, real output per capita in the United States has expanded by a cumulative 80 percent, and yet during that time, median weekly earnings of full-time workers have grown by only about 7 percent in real terms. Moreover, what gains have occurred are attributable to higher wages and working hours for women. For male workers, real median weekly earnings have actually declined since 1979.² In short, despite economic growth, the middle class is struggling to maintain its standard of living.

Second, declining economic and social mobility. One of the pillars of America's self-image is the idea of the American Dream, that anyone can rise to the top based on determination and hard work. However, upward economic mobility in the United States appears to have declined notably over the postwar period. For example, in a paper aptly entitled "The Fading American Dream," Raj Chetty and coauthors studied one metric of upward mobility, the probability that a child would grow up to earn more than his or her parents. Using Census data, they found that 90 percent of Americans born in the 1940s would go on to earn more as adults than their parents did, but that only about 50 percent of those born in the 1980s would do so.³ Other research finds that the United States now has one of the lowest rates of intergenerational mobility among advanced economies, measured for example by the correlation between the earnings of parents and their children.⁴ For a supposedly classless society, the U.S. is doing a good job of rigidifying its class structure through means that include residential and educational segregation, social networking, and assortative mating.⁵

Stagnant median wages and declining mobility are of course related to the overall trend toward increased income and wealth inequality, which is already more pronounced in the United States than in other advanced economies.⁶ In particular, high inequality tends to impede economic mobility, by increasing the relative educational and social advantages of those in the upper percentiles. (My former Princeton colleague Alan Krueger has dubbed the close cross-country relationship between inequality and lack of social mobility the Great Gatsby curve.⁷) I think though that the frustrations of stagnant earnings and limited upward mobility are more salient to most Americans than inequality per se. Americans tend to be more tolerant of inequality than citizens of other countries, putting greater stress on equality of opportunity rather than equality of outcome.⁸

The third adverse trend is the increasing social dysfunction associated with economically distressed areas and demographic groups. For example, other former Princeton colleagues of mine, Anne Case and Angus Deaton, have done important work on morbidity and mortality among white working-class Americans (more precisely, people with only a high school degree). They find that midlife mortality rates among white working-class Americans have sharply worsened, relative to other U.S. demographic groups and working-class Europeans. Case and Deaton refer to the excess mortality among the white working class as “deaths of despair,” because of the associated declines in indicators of economic and social well-being and the important role played by factors like opioid addiction, alcoholism, and suicide.⁹ Indeed, in 2015, more Americans died of drug overdoses—about 60 percent of which involved opioids—than died from auto accidents and firearms-related accidents and crimes combined.¹⁰

Because the white working class was pivotal in the recent election, its problems have received much attention recently. However, the problem of social dysfunction among the

economically stressed population is much broader. For example, among the most worrying economic trends is the decline in labor force participation among prime-age (25-54) men, which has occurred across demographic groups. In 1960, about 97 percent of American prime-age men were in the labor force; today, only about 88 percent are. Studies find that many of the men not working in the formal sector are substantially idle—not involved in caring for children or the elderly, for example.¹¹ Participation rates of prime-age men are lower in the United States than in many European countries, despite the weakness of labor markets in much of Europe.¹² One possible explanation for the trans-Atlantic divergence is differences in criminal justice policies. America's high incarceration rate leaves many men, particularly African-American men, with prison records, which hurts their employment opportunities for many years after release.

The fourth and final factor I'll highlight, closely tied to the others, is political alienation and distrust of institutions, both public and private. In particular, Americans generally have little confidence in the ability of government, especially the federal government, to fairly represent their interests, let alone solve their problems. In a recent poll, only 20 percent of Americans said they trusted the government in Washington to do what is right “just about always” or “most of the time”.¹³ The failure to prevent the global financial crisis did not help this situation of course, but these attitudes are long-standing, going back at least to the 1970s. A recent book by the sociologist Arlie Russell Hochschild, *Strangers in Their Own Land*, recounts her experience living for several years in a politically conservative community in Louisiana. One of her most striking findings is the reluctance of Louisianans to support federal efforts to protect the local environment, despite the substantial health risks they face as the result of pollution by oil refineries and other industries.¹⁴ This opposition appears to be partly a product of traditional values of self-reliance and independence but also reflects deep-seated skepticism about the

sincerity of government officials and their ability to achieve improvements at a reasonable economic cost.

Stagnant median wages, limited upward mobility, social dysfunction, and political alienation are a toxic mix indeed. How did it happen? The sources of these adverse trends are complex and interrelated. But at a fifty-thousand-foot level, they appear to be the product of some broad global developments of the postwar era, together with the U.S. policy response (or lack thereof) to those developments.

The immediate postwar era, say 1945-1970, was an extraordinary period, economically speaking. Following fifteen years of depression and war, Americans were once again able to enjoy peace and prosperity. A substantial backlog of technological and commercial innovations was available to be exploited, and producers faced enormous pent-up demand for consumer goods and housing. The federal government provided expansive support for education, through the GI Bill for example, and undertook major infrastructure projects like the interstate highway system. Importantly, for a time the U.S. economy had no effective competition, either from war-ravaged Europe and Japan or from not-yet-emerging markets. There was plenty of economic change and what we would now call disruption, but strong catch-up growth, active economic policies, and America's monopoly position resulted in widely shared economic gains. It's not really surprising that the period evokes nostalgia as a time of national greatness.

However, as Robert J. Gordon has documented, the pace of technological and economic change in the middle of the past century was historically quite unusual and unlikely to be sustained.¹⁵ By 1970 or so, the backlog of commercial and technical opportunities available at the end of the war had been used up, and the conversion to a civilian, consumer-driven economy was complete. Outside of a brief productivity spurt associated with the IT revolution, the past

forty-five years or so have been historically more ‘normal’ in terms of economic growth and productivity gains. Productivity growth has been particularly anemic over the past decade. Equally important, American economic dominance faded, as Europe and Japan recovered and as what we now call emerging-market economies accounted for increasingly larger shares of global output and trade. The emergence of China as a global trading power was particularly disruptive, with adverse effects on the wages and employment opportunities of many American workers of moderate or lower skills.¹⁶ In contrast, high-skilled workers tended to be favored by global economic integration, particularly those whose talents were scalable to the size of the market, such as managers of internationally active firms or of global hedge funds.

Of course, similar forces were playing out in Europe and elsewhere, with effects that depended on the policy response. In the United States, in the immediate postwar era, feelings of social solidarity and economic optimism had helped to generate political support for significant expansions in government spending on education, health, and infrastructure. The introduction of Medicare and expanded Social Security benefits provided economic security for the elderly in particular. However, the postwar glow faded as America divided over a variety of big issues in the 1960s and 1970s, including the Vietnam War and the civil rights movement, and as economic growth began to slow. The Reagan revolution heralded a more constrained approach to economic policy, aimed primarily at fostering aggregate economic growth by empowering the private sector. Examples of such policies include tax cuts and tax reform under Reagan, a number of consequential trade agreements under Reagan’s immediate successors, financial deregulation and welfare reform under Clinton, and more tax cuts and trade opening under the second President Bush.

Missing from the mix, however, was a comprehensive set of policies aimed at helping individuals and localities adjust to the difficult combination of slower growth and rapid economic change. Why policy was not more proactive in this area is an interesting question: Perhaps the failures of Lyndon Johnson's Great Society and the inflationary monetary and fiscal policies of the 1960s and 1970s hurt the reputation of activist policies and helped revive American's *laissez-faire* inclinations. Perhaps the stresses in the heartland were not sufficiently understood until it was too late. Perhaps the politics didn't align. Whatever the reason, it's clear in retrospect that a great deal more could have been done, for example, to expand job training and re-training opportunities, especially for the less educated; to provide transition assistance for displaced workers, including support for internal migration; to mitigate residential and educational segregation and increase the access of those left behind to employment and educational opportunities; to promote community redevelopment, through grants, infrastructure construction, and other means; and to address serious social ills through addiction programs, criminal justice reform, and the like. Greater efforts along these lines could not have reversed the adverse trends I described at the outset—notably, Europe, which was more active in these areas than the United States, has not avoided populist anger—but they would have helped. They might also have muted the disaffection and alienation which our political systems are currently grappling.

Which brings us to the present. Whatever one's views of Donald Trump, he deserves credit, as a presidential candidate, for recognizing and tapping into the deep frustrations of the American forgotten man, twenty-first-century version. That frustration helped bring Trump to the White House. Whether the new president will follow through in terms of policy, however, is not yet clear. Trump's economic views, which mirror the odd combinations of factions that

make up his coalition, are a somewhat unpredictable mixture of right-wing populism and traditional supply-side Republicanism. The policies that his administration has actually proposed or endorsed so far lean toward the latter, including health care bills that would significantly reduce insurance coverage among lower-income people, tax cuts for both individuals and corporations, and a relaxation of financial, environmental, and other regulations. Policies that would more directly address the needs of the people who elected Trump, such as community redevelopment, infrastructure spending, job training, and addiction programs have recently received a good bit of rhetorical attention from the White House, but it remains to be seen whether that attention will be translated into programs and budgets. Ironically, it may be that the most rhetorically populist president since Andrew Jackson will, in practice, not be populist enough.

I'm hardly the first to observe that Trump's election sends an important message, which I've summarized this evening as: sometimes, growth is not enough. Healthy aggregate figures can disguise unhealthy underlying trends. Indeed, the dynamism of growing economies can involve the destruction of human and social capital as well as the creation of new markets, products, and processes. Unaided, well-functioning markets can of course play a crucial role in facilitating economic adjustment and redeploying resources, but in a world of imperfect capital markets and public goods problems there is no guarantee that investment in skills acquisition, immigration, or regional redevelopment will be optimal or equitable. Tax and transfer policies can help support those who are displaced, but the limits on such policies include not only traditional concerns like the disincentive effects of income-based transfers but also conflicts with social norms. Notably, people can accept temporary help but transfers that look like "handouts"

are often viewed with extreme suspicion or resentment. Some active interventions thus seem a necessary part of a responsive policy mix.

Providing effective help to people and communities that have been displaced by economic change is essential, but, on the other hand, we should not understate how difficult it will be. Addressing problems like the declining prime-age participation rate or the opioid epidemic will require the careful and persistent application of evidence-based policies which populist politicians, with their impatience and distrust of experts, may have little ability to carry through. Moreover, to be both effective and politically legitimate, such policies need to involve considerable local input and cooperation across different levels of government as well as cooperation of the public and private sectors. The credibility of economists has been damaged by our insufficient attention, over the years, to the problems of economic adjustment and by our proclivity toward top-down, rather than bottom-up, policies. Nevertheless, as a profession we have expertise that can help make the policy response more effective, and I think we have a responsibility to contribute wherever we can.

I've been speaking about the United States, but of course Europe has shared some of the same problems, including populist reactions. The European Central Bank, as one of the most respected European-wide institutions, has been an outspoken proponent of pro-growth reforms. I think the ECB's efforts have generally been constructive, and reforms have taken place and appear to have had some success, including here in Portugal. I'd like to conclude my remarks with a few comments about the European reform process, in light of the American experience.

First, I have made the case this evening for more intervention in labor markets by American policymakers, for example, through active workforce policies like the promotion of job training and apprenticeships. In Europe, however, the message has been that governments

should intervene less in labor markets. I'd emphasize that there is no real contradiction here; rather, the contrast reflects differences in starting points. It's useful to divide labor market interventions into what I will call, somewhat tendentiously, forward-looking and backward-looking policies. Forward-looking policies, like job training and other types of workforce development, aim to help workers adjust to change, endowing them with the skills and training they need to take advantage of new opportunities. To invoke another theme of this conference, forward-looking policies generally involve investment in human, social, or physical capital. Backward-looking policies, in contrast, aim to preserve the status quo, and in particular to protect incumbent firms and workers. Examples are rules that excessively restrict employers' ability to fire workers or to set pay and hours, impose restrictive licensing or certification requirements, or create large fixed costs of hiring or market entry. Backward-looking policies inhibit productive growth and change, which is why they are ultimately not sustainable. Relative to the United States, and reflecting differences in political traditions among other factors, postwar Europe has employed many more of both the forward-looking and backward-looking types of labor market policies. Calls for reform in Europe today largely focus, appropriately, on the elimination of backward-looking policies. But the distinction between the two types of policies should be in front of mind, including the recognition that a reduction in rules that protect incumbent workers, for example, may need to be balanced with an increase, not a decrease, in active policies to support necessary adjustments in the labor market.

Second, the cyclical recovery in the United States is sufficiently far advanced that issues of longer-term growth and reform can be debated largely independently of short-term cyclical considerations. In Europe, labor market slack remains, interest rates are still at zero, and macroeconomic adjustment is incomplete, all of which implies that reform plans cannot ignore

macroeconomic conditions. A small literature has argued that structural reforms can be counterproductive when interest rates are at the zero lower bound, because of disinflationary effects.¹⁷ I tend to agree that those ZLB effects are probably quantitatively modest.¹⁸ However, whether rates are at zero or not, it seems quite likely that policies that have the effect of releasing redundant labor resources could have adverse short-run effects if insufficient aggregate demand exists to re-employ those resources in a reasonable time. It's consequently important for the content and sequencing of reforms to take into account the macroeconomic situation, as has been pointed out by the International Monetary Fund and others.¹⁹ Likewise, reforms can complement, but should not be viewed as a substitute for, appropriate macroeconomic policies. In particular, labor market reforms should not by themselves be expected to solve national competitiveness problems, at least not in the short term. Also needed are appropriate macroeconomic policies, especially fiscal policies, to help ensure adequate demand and remedy the underlying source of trade imbalances.

Finally, on both sides of the Atlantic we have to grapple with the issue of political legitimacy. As I've noted, in the United States, many voters have gone beyond disagreement about specific policy proposals to question both the federal government's motives and its capacity to improve their lives. Winning back that trust will require a better policy process as well as better policies. In particular, we need more two-way communication between the grass roots and the center, to try to adapt policy initiatives to local conditions. America's federal system, in which much economic policy is made at the state and local level, is well adapted to help that happen.

In Europe, again, the starting point for policy is different. While the United States is already an integrated continental economy, Europe is still working toward that goal. Achieving

uniformity across the euro zone in areas such as banking and capital market regulation inevitably requires decisions to be made at the center, even if after wide consultation. However, there may be less of a need for top-down uniformity in other areas, such as in the regulation of labor markets or small businesses. Accommodation of national and sub-national differences in rules and institutions that mostly affect local conditions could foster more responsive and more effective policies, which could also be perceived as politically more legitimate.

To sum up: Generally speaking, economic growth is a good thing, positively associated with many indicators of citizens' well-being. More-rapid growth also improves fiscal balances, giving governments greater capacity and flexibility. But, as recent political developments have brought home, growth is not always enough. Economic growth almost always involves significant change and the possibly rapid depreciation of some human and social capital. The resulting dislocations can be very difficult to address, likely requiring a mix of top-down, bottom-up, public, and private interventions. But if the resources released by economic change are to be effectively redeployed; if the benefits of growth are to be widely shared; and if economic policy is to be widely perceived as both successful in its own terms and politically legitimate, then making those interventions effective should be a top priority for policymakers.

¹ A Reuters/IPSOS poll conducted in early June asked survey respondents: 'Generally speaking, would you say things in this country are heading in the right direction, or are they off on the wrong track?' 57% answered that that the country is 'on the wrong track', while only 28% said that the country was moving 'in the right direction'.

² Data are from the Bureau of Labor Statistics' Current Population Survey (CPS) through the first quarter of 2017, tracking median usual weekly real earnings for wage and salary workers employed full-time, 16 years and older (seasonally-adjusted). Real earnings for men fell by 2% over the period, while real earnings for women rose by almost 25%.

³ See Chetty, Raj, David Grusky, Maximilian Hell, Nathaniel Hendren, Robert Manduca, and Jimmy Narang, "The Fading American Dream: Trends in Absolute Income Mobility Since 1940", NBER Working Paper 22910, December 2016.

⁴ See Corak, Miles, "Income Inequality, Equality of Opportunity, and Intergenerational Mobility", *Journal of Economic Perspectives*, Volume 27, Number 3, Summer 2013, 79-102.

⁵ See Reeves, Richard V., "Dream Hoarders: How the American Upper Middle Class Is Leaving Everyone Else in the Dust, Why That Is a Problem, and What to Do About It", Brookings Institution Press, 2017.

⁶ According to the World Bank, the United States has the highest Gini coefficient of the G7 industrial countries.

⁷ See Krueger, Alan B., “The great utility of the Great Gatsby Curve”, Brookings Social Mobility Memos, May 19, 2015.

⁸ See Isaacs, Julia B., “International Comparisons of Economic Mobility,” Brookings Institution Economic Mobility Project, July 2016.

⁹ See Case, Anne and Angus Deaton, “Mortality and Morbidity in the 21st Century,” Brookings Papers on Economic Activity, Spring 2017 (in press).

¹⁰ According to the Center for Disease Control, in 2015 52,404 people died from drug overdoses in the United States. 33,091 of those deaths involved opioids. In comparison, 35,092 people died in auto accidents in 2015 (Department of Transportation), and 12,195 people died from non-suicide firearm-related injuries in 2014 (CDC, 2015 data not yet available).

¹¹ See Black, Sandra, Jason Furman, Emma Rackstraw, and Nirupama Rao, “The Long-Term Decline in U.S. Prime-Age Male Labour Force Participation,” VoxEU, July 6, 2016.

¹² According to the OECD, in 2016 the prime-age (25-54) male labor force participation rate was 88.5% in the United States. For the United Kingdom, Germany, France, Spain and Italy, the participation rates for this demographic were 92.3%, 92.0%, 92.7%, 92.5%, and 88.2% respectively.

¹³ See “Public Trust in Government Remains Near Historic Lows as Partisan Attitudes Shift”, Pew Research Center, May 3, 2017.

¹⁴ See Hochschild, Arlie Russell, “Strangers in Their Own Land: Anger and Mourning on the American Right”, The New Press, September 2016.

¹⁵ See Gordon, Robert J., “The Rise and Fall of American Growth”, Princeton University Press, 2016.

¹⁶ See Autor, David, David Dorn, Gordon Hanson, “The China Shock: Learning from Labor Market Adjustment to Large Changes in Trade,” NBER working paper 21906, January 2016.

¹⁷ See Eggertsson, Gauti, Andrea Ferrero, Andrea Raffo, “Can Structural Reforms Help Europe?”, Journal of Monetary Economics, 2014, vol. 61, 2-22.

¹⁸ See Vogel, Lukas, “Structural Reforms at the Zero Bound,” European Economy Economic Papers 537, 2014.

¹⁹ See International Monetary Fund, “Time for a Supply-Side Boost? Macroeconomic Effects of Labor and Product Market Reforms in Advanced Economies,” World Economic Outlook, April 2016, chapter 3.