Challenges for US Economic Policy

Karen Dynan

State of the Economy Address
Juli Plant Grainger Institute for Economic Research
University of Wisconsin—Madison
September 21, 2023

Today's talk

The three great macroeconomic surprises since 2020

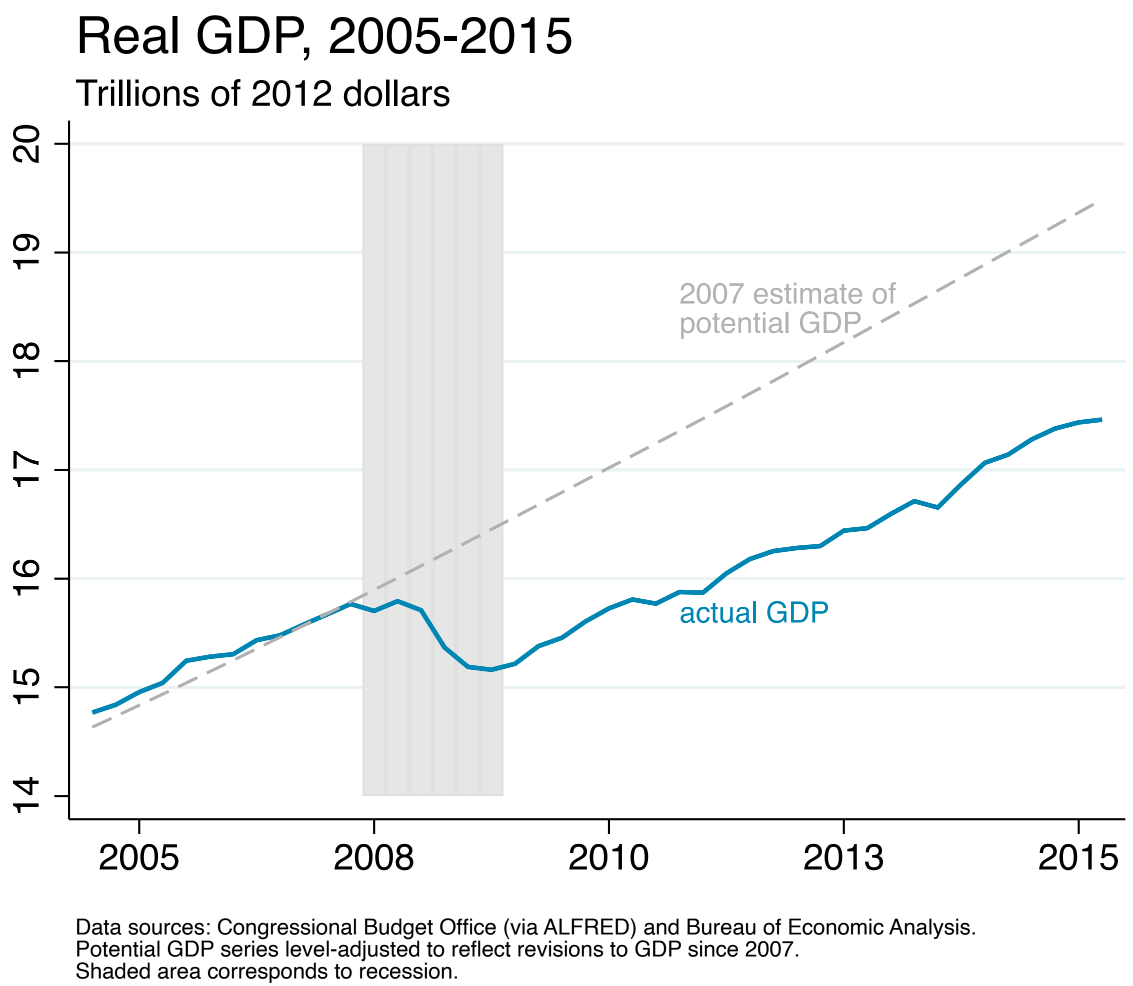
Longer-term issues for economic policy

- High and rising government debt
- The backlash against globalization
- Artificial intelligence

The three great macroeconomic surprises since 2020

1. The limited economic scars left by the COVID recession

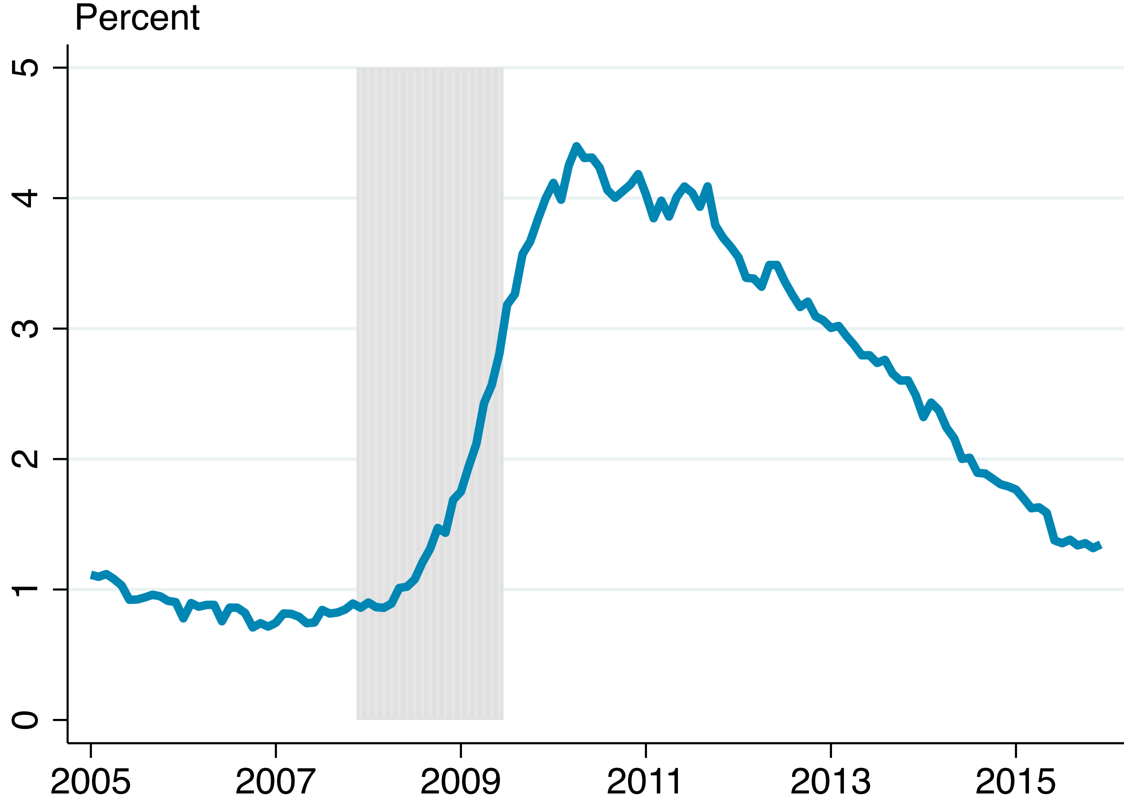
Context: The "Great Recession" left significant scars on the economy and on people



GDP started growing again in mid-2009 but never got back to the path that had been expected before the recession

Context: The "Great Recession" left significant scars on the economy and on people

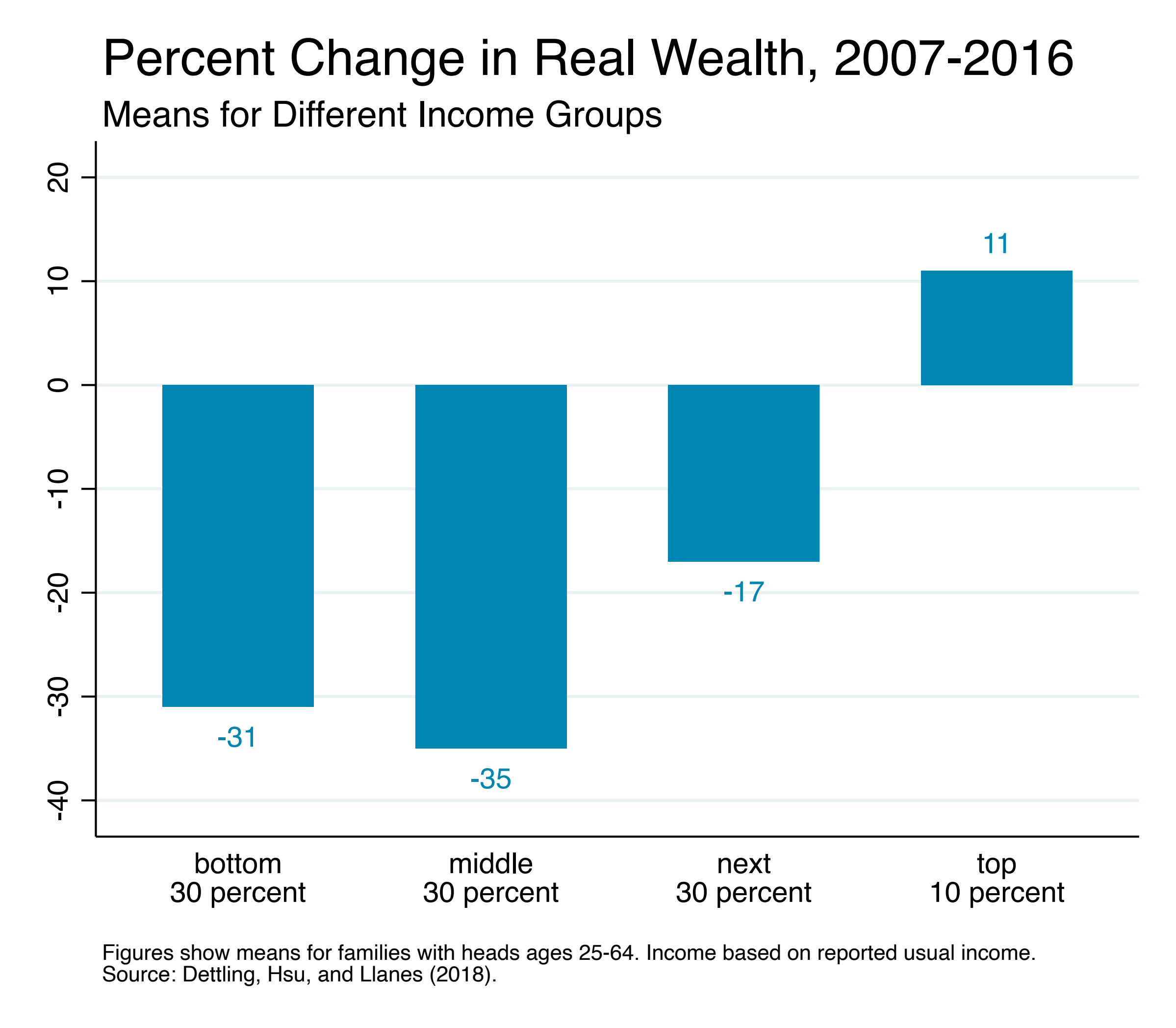
Long-term Unemployment Rate, 2005-2015



Data source: Bureau of Labor Statistics (via FRED). Shaded area corresponds to recession.
Percent of labor force unemployed for 27 or more weeks.
Last data point: December 2015.

It took labor markets almost a decade to return to normal

Context: The "Great Recession" left significant scars on the economy and on people



Even after labor markets recovered, most families had significantly less wealth than before the recession

The COVID shock to the economy was dramatic, with employment plunging 14 percent in April 2020

For comparison, the peak employment loss during the Great Recession period was 7 percent

This raised concerns about both **hardship in the moment** and **the potential for economic scarring** over the longer-term

Below, one economist's estimates of the potential impact on GDP through various "scarring" channels

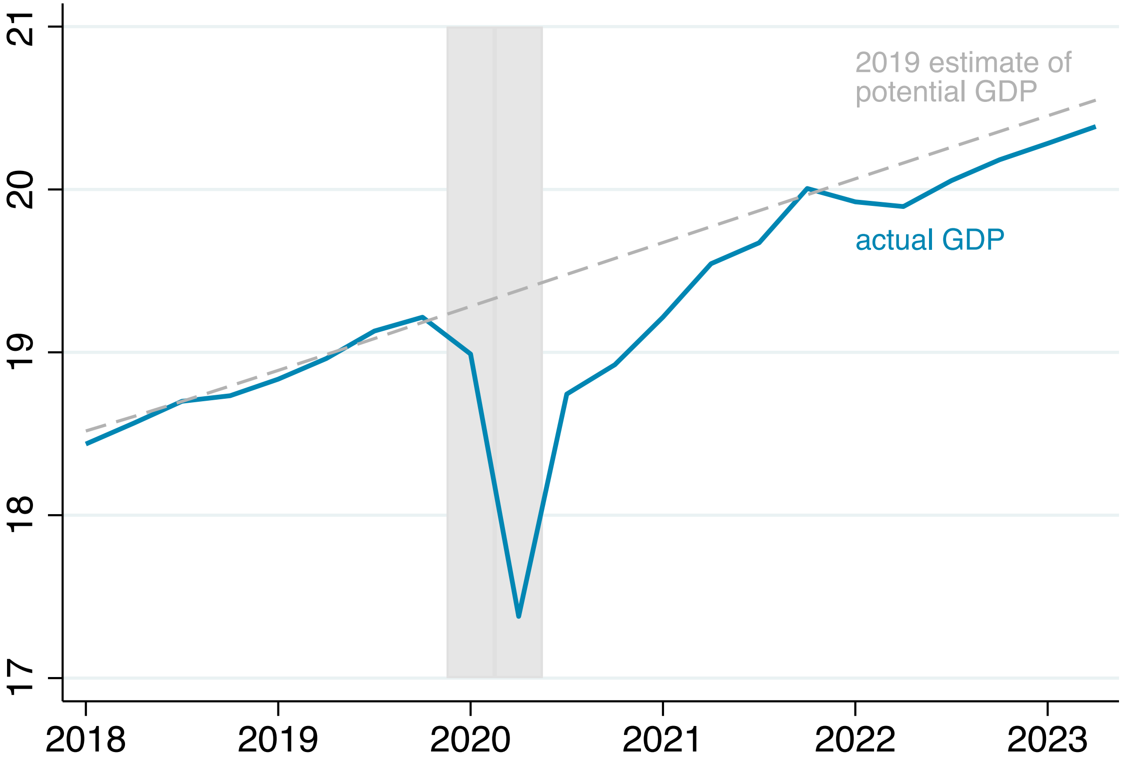
	Short to medium term	Longer term
Unemployment	3-4%	2-3%
Job separation	5%	zero
Organisational capital	2%	zero
Education	zero	2-2.5%
Business investment	1%	1%
Total GDP "at risk"	12%	5-6.5%

Screenshot from Portes (2020)

Yet, economic outcomes post-COVID have been much better than after the Great Recession

Real GDP, 2018-2023

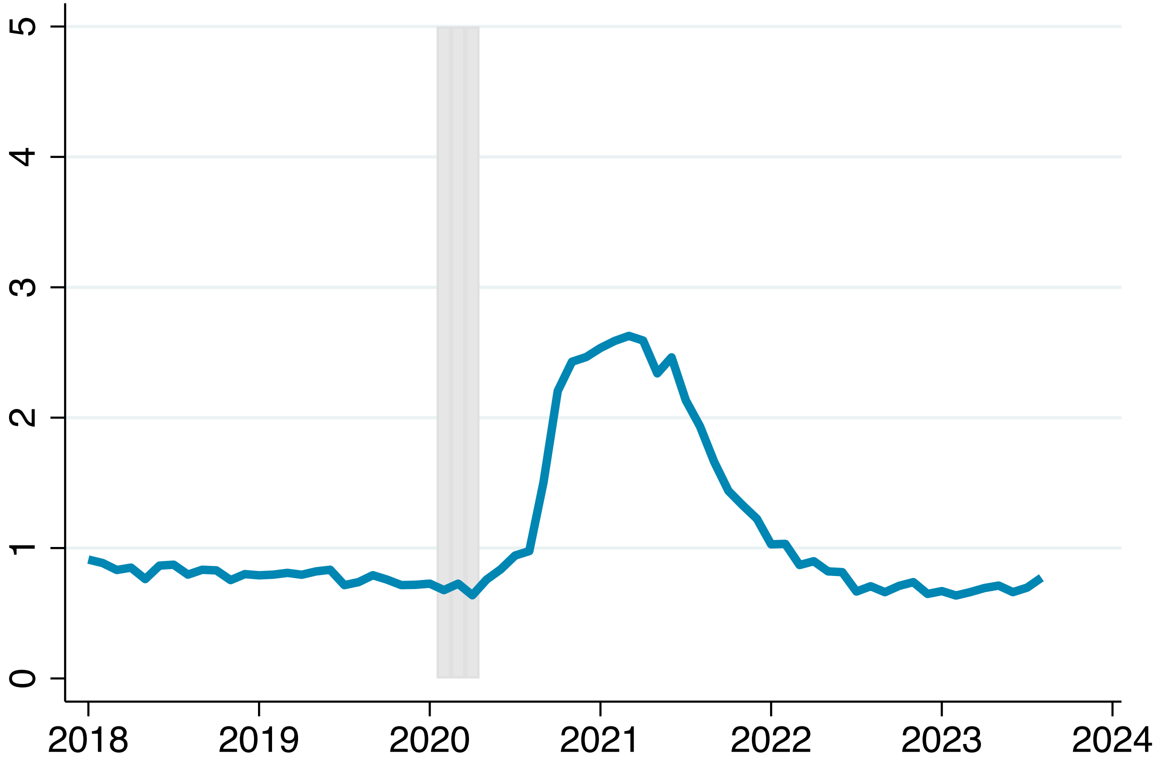
Trillions of 2012 dollars



Data sources: Congressional Budget Office and Bureau of Economic Analysis.
Potential GDP series level-adjusted to reflect revisions to GDP since 2019.
Shaded area corresponds to recession.

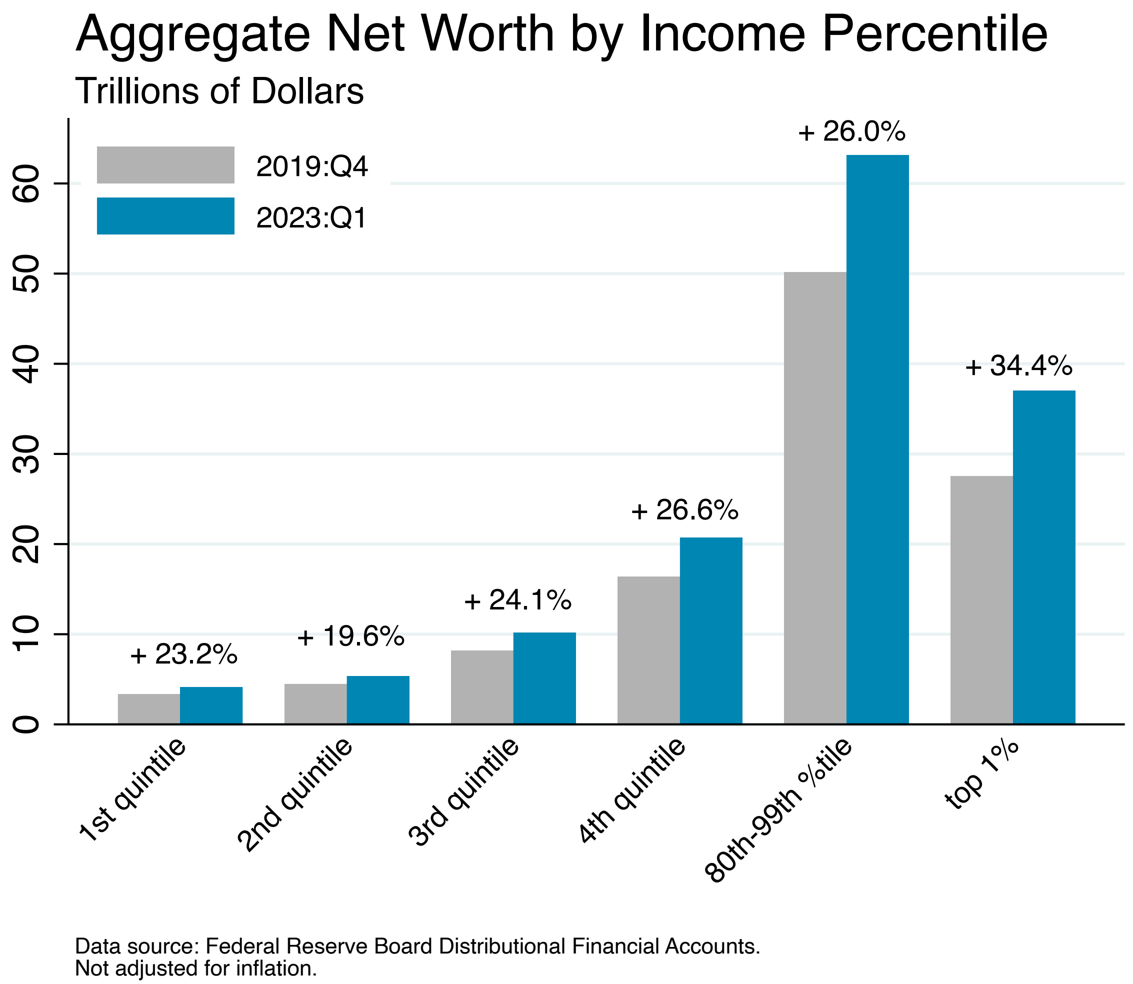
Long-term Unemployment Rate, 2018-2023

Percent



Data source: Bureau of Labor Statistics (via FRED). Shaded area corresponds to recession.
Percent of labor force unemployed for 27 or more weeks.
Last data point: August 2023.

Yet, economic outcomes post-COVID have been much better than after the Great Recession

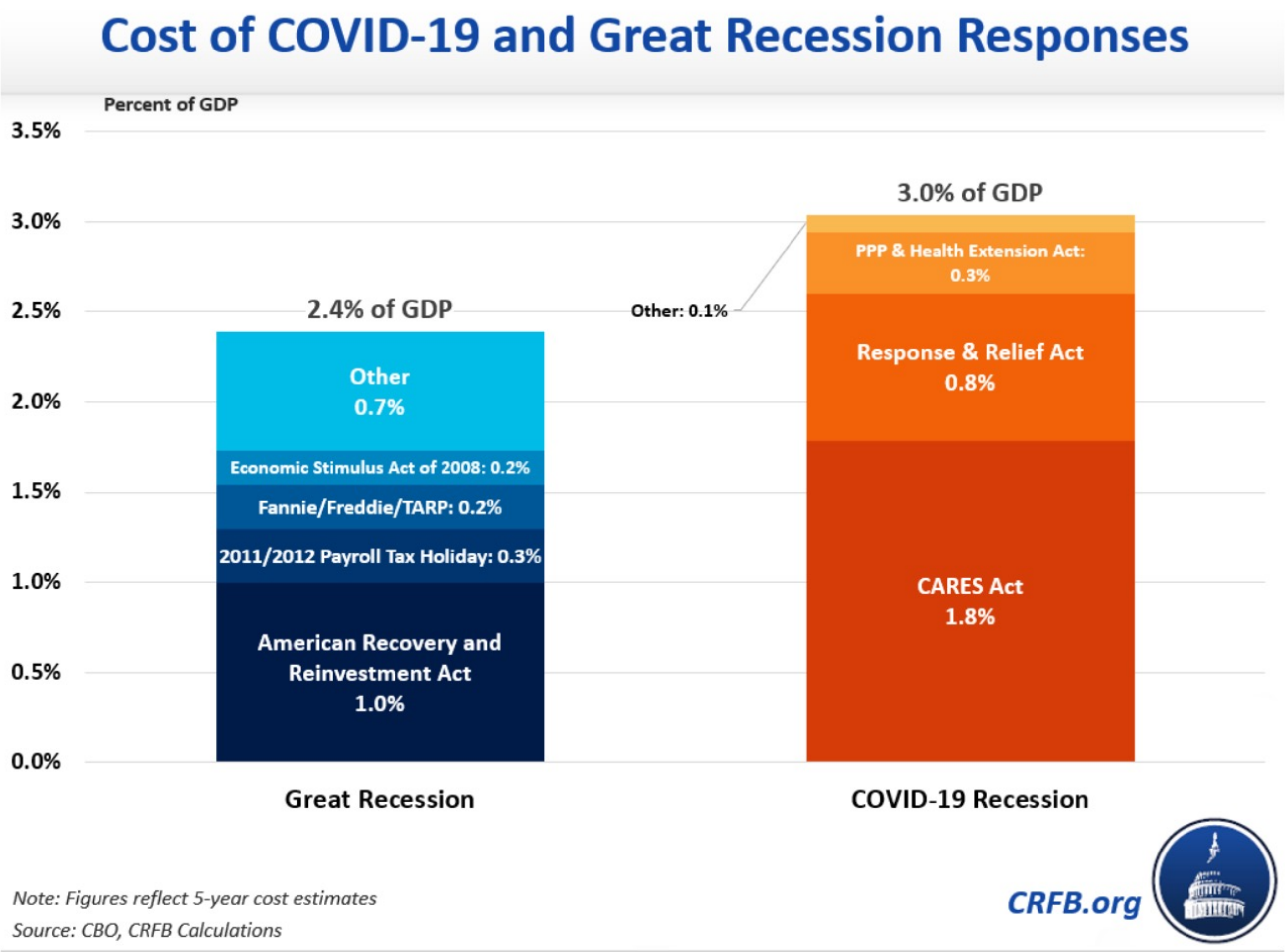


We do not yet have comprehensive micro data on how household balance sheets have fared post-COVID, but estimates based on a parsing of aggregate data suggest that most households have more wealth than they did before the pandemic

The better outcomes reflect at least in part a much more vigorous policy response to the pandemic

US fiscal policy aimed at mitigating the costs of the pandemic was considerably larger and was put in place faster than fiscal support during the Great Recession

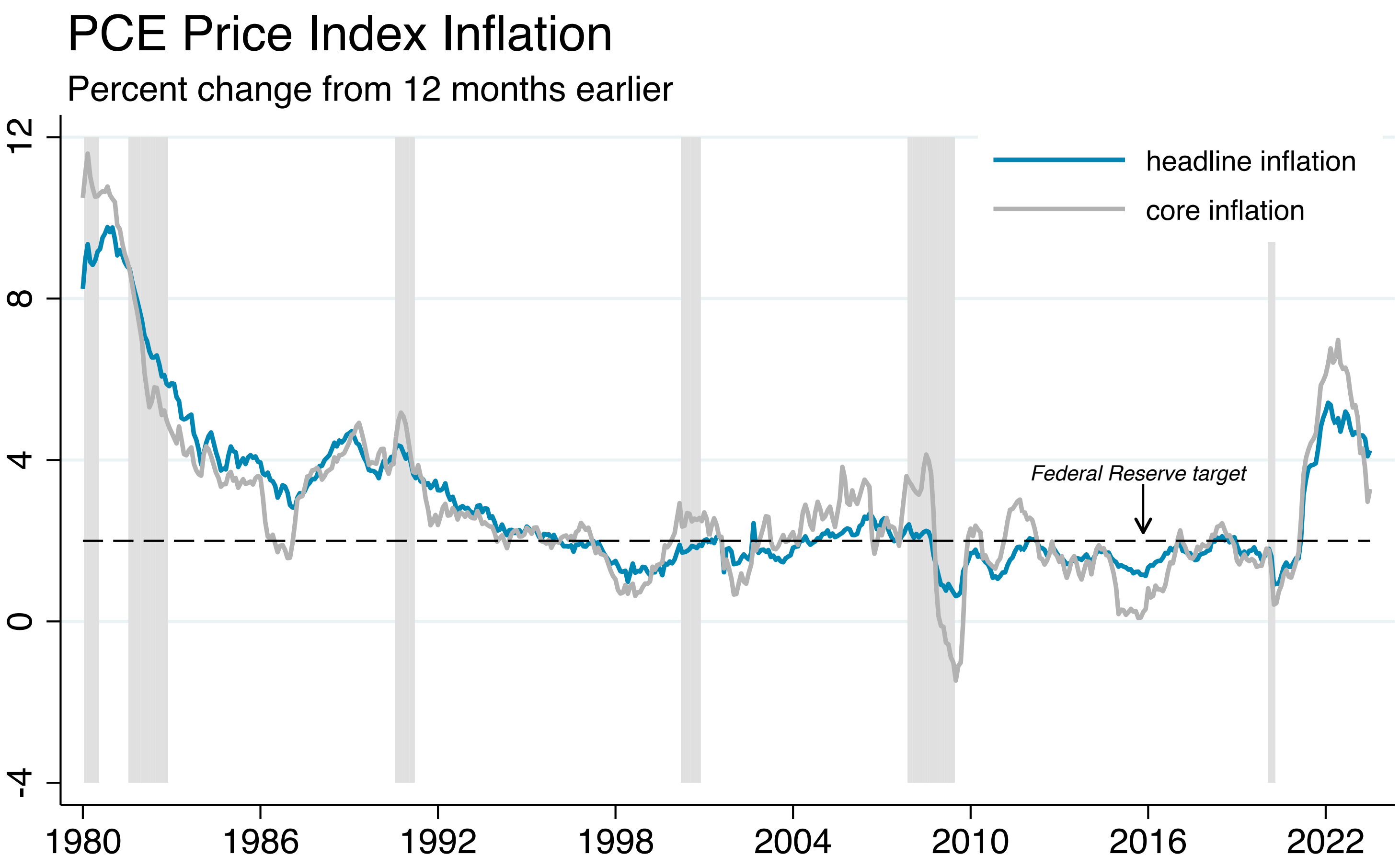
The estimates at right do not include the 2021 American Rescue Plan, [which is estimated to have distributed half again as much as the pandemic legislation shown]



The three great macroeconomic surprises since 2020

1. The limited economic scars left by the COVID recession
2. The post-COVID run-up in inflation

Policymakers in the pre-COVID period thought they had conquered inflation—but they were wrong



Data source: Bureau of Economic Analysis (via FRED). Shaded areas correspond to recessions.
Last data point: July 2023.

Inflation began to pick up in 2021 but was initially misread by many as transitory

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Why Fed's Powell still thinks high inflation is 'temporary'

By Ann Saphir

August 27, 2021 4:33 PM EDT · Updated 2 years ago

Aa

Aug 27 (Reuters) - Federal Reserve Chair Jerome Powell on Friday pushed back against concerns that swiftly rising prices could become an enduring feature of the economy, forcing the U.S. central bank to raise interest rates and cut short the recovery.

The Fed was in good company:

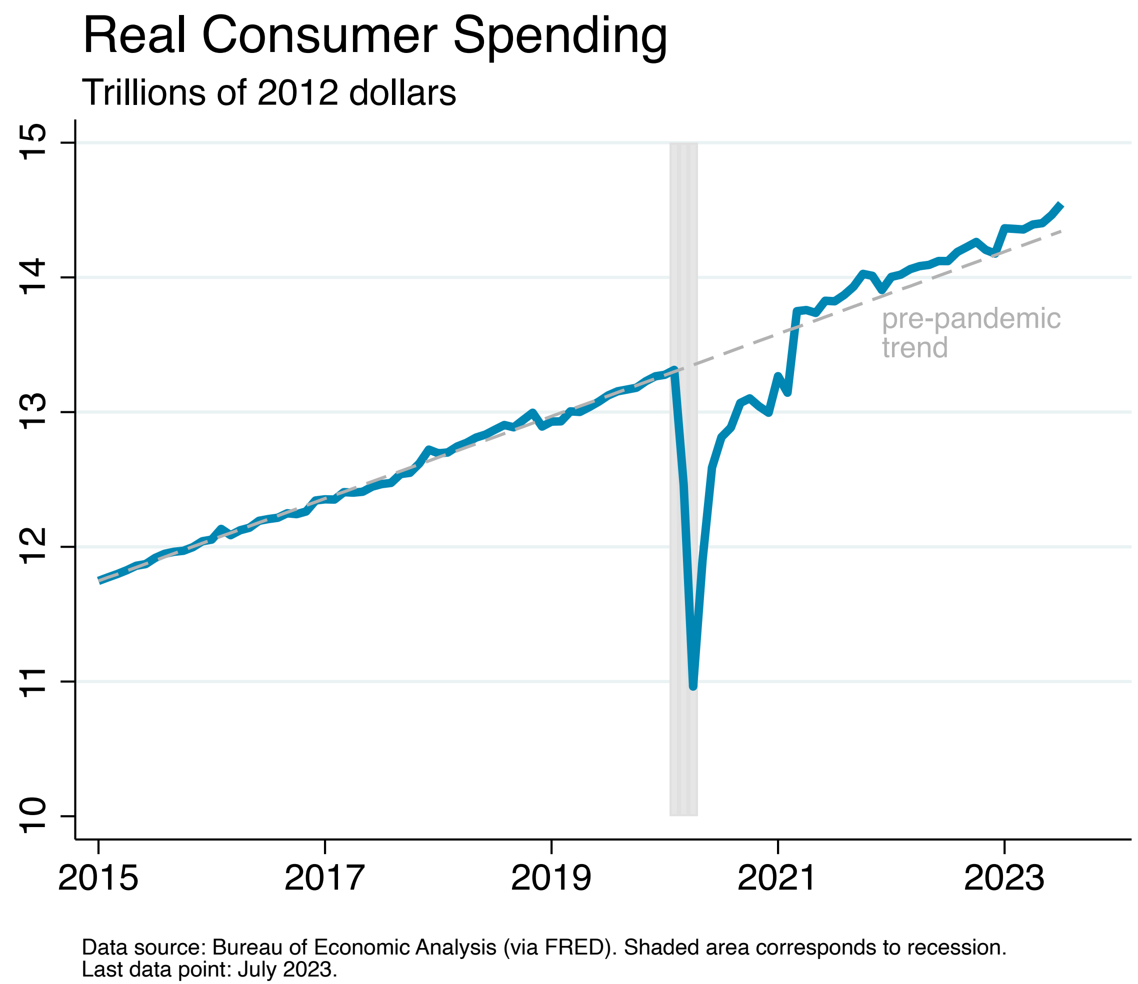
In July 2021, the average forecast of core PCE inflation in a *Wall Street Journal* survey of economists was:

3.2% for 2021 (Q4/Q4)
2.3% for 2022 (Q4/Q4)

(For 2022, the highest forecast out of 60 was 4.0%; core inflation came in at 4.8%)

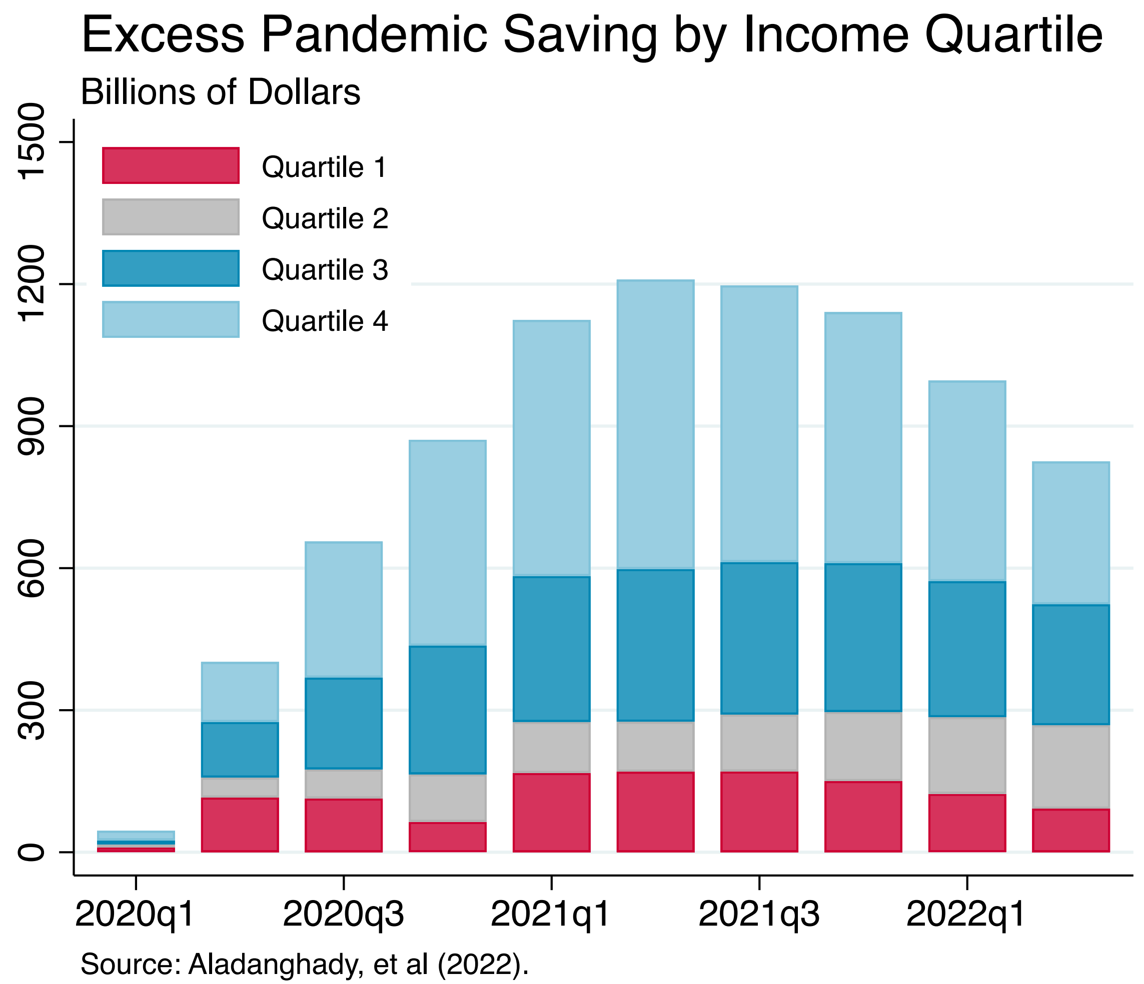
We have a better understanding now of why inflation picked up on a sustained basis

Going into 2021, demand was strong because of **a pent-up desire to spend** after a year of suppressed consumption …



We have a better understanding now of why inflation picked up on a sustained basis

… and, given generous income support during 2020, many people across the income distribution had **the wherewithal to finance this pent-up demand**



We have a better understanding now of why inflation picked up on a sustained basis

But **supply has not been able to ramp up fast enough to meet demand** because of a variety of factors

shutdowns to contain the virus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By HANNA ARHIROVA July 10, 2022

supply chain disruptions

Cargo Ships Continue To Arrive, Just To End Up Waiting To Get Into Ports Of LA, Long Beach

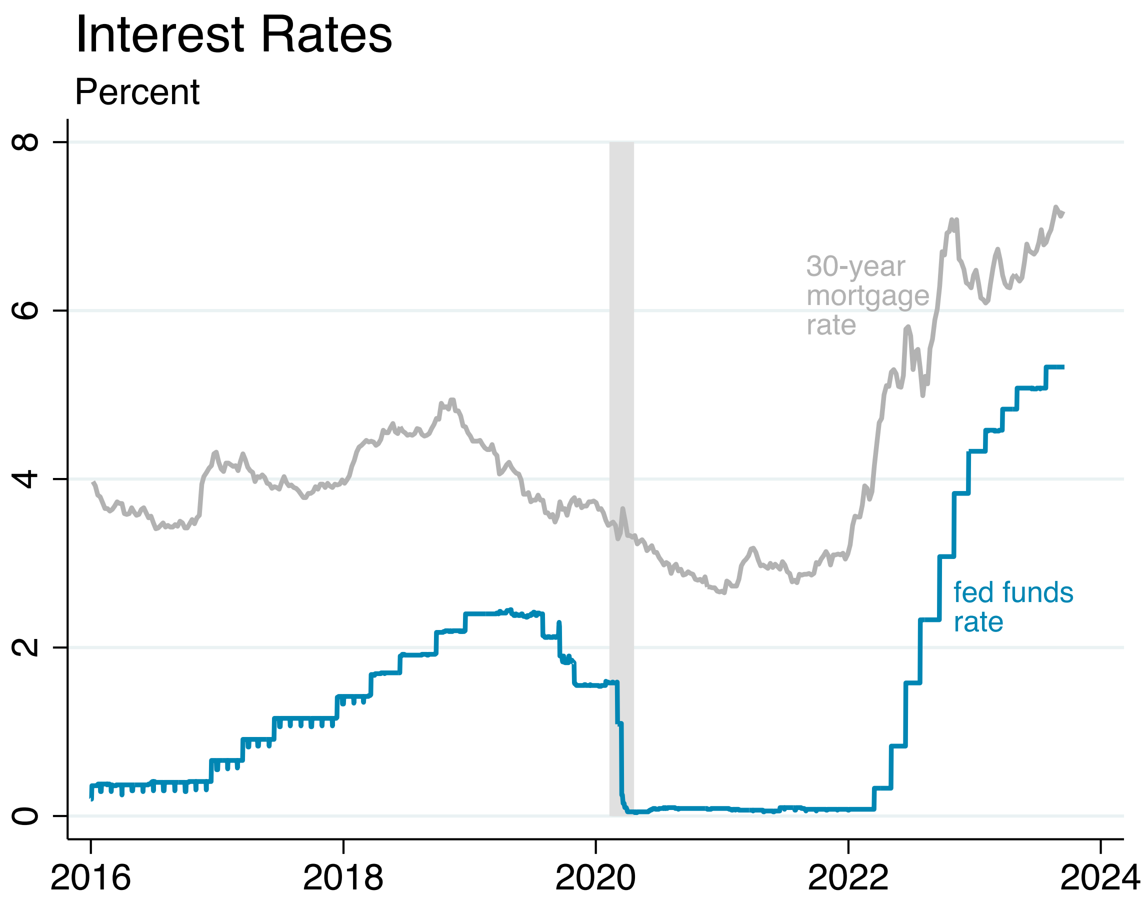
bottlenecks

worker shortages

The three great macroeconomic surprises since 2020

1. The limited economic scars left by the COVID recession
2. The post-COVID run-up in inflation
3. The “soft landing” that seems to be beckoning—though is not assured!

The monetary policy response to higher inflation has been the most aggressive in decades



Data source: Federal Reserve Board (via FRED). Shaded area corresponds to recession.
Last data point: September 18, 2023.

The Fed started tightening policy in March 2022 and has since raised its policy rate by more than 5 percentage points

By design, this has tightened financial conditions broadly and thereby curbed demand and kept inflation expectations in check

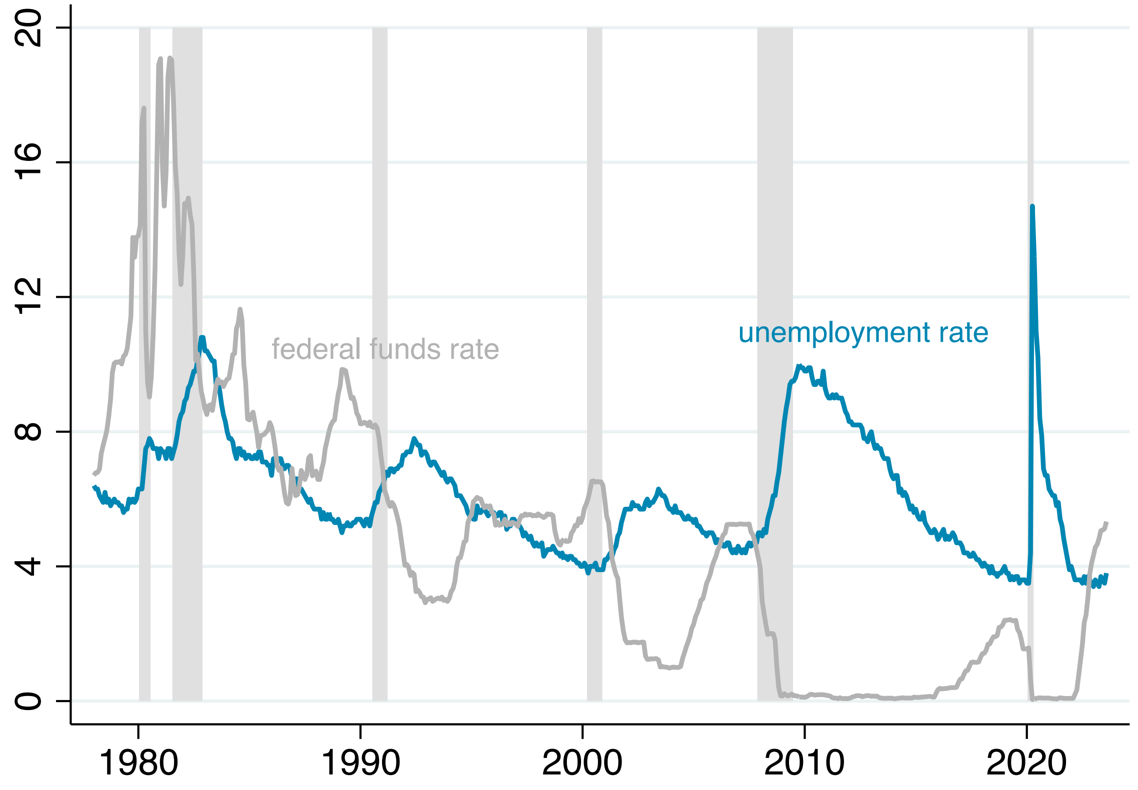
The hope has been for a “soft landing,” but historically that has been hard to achieve

A “soft landing” is when inflation retreats to the Fed’s target with growth that may be softer than trend but not negative

But, as seen at right, Fed tightenings have often preceded economic downturns

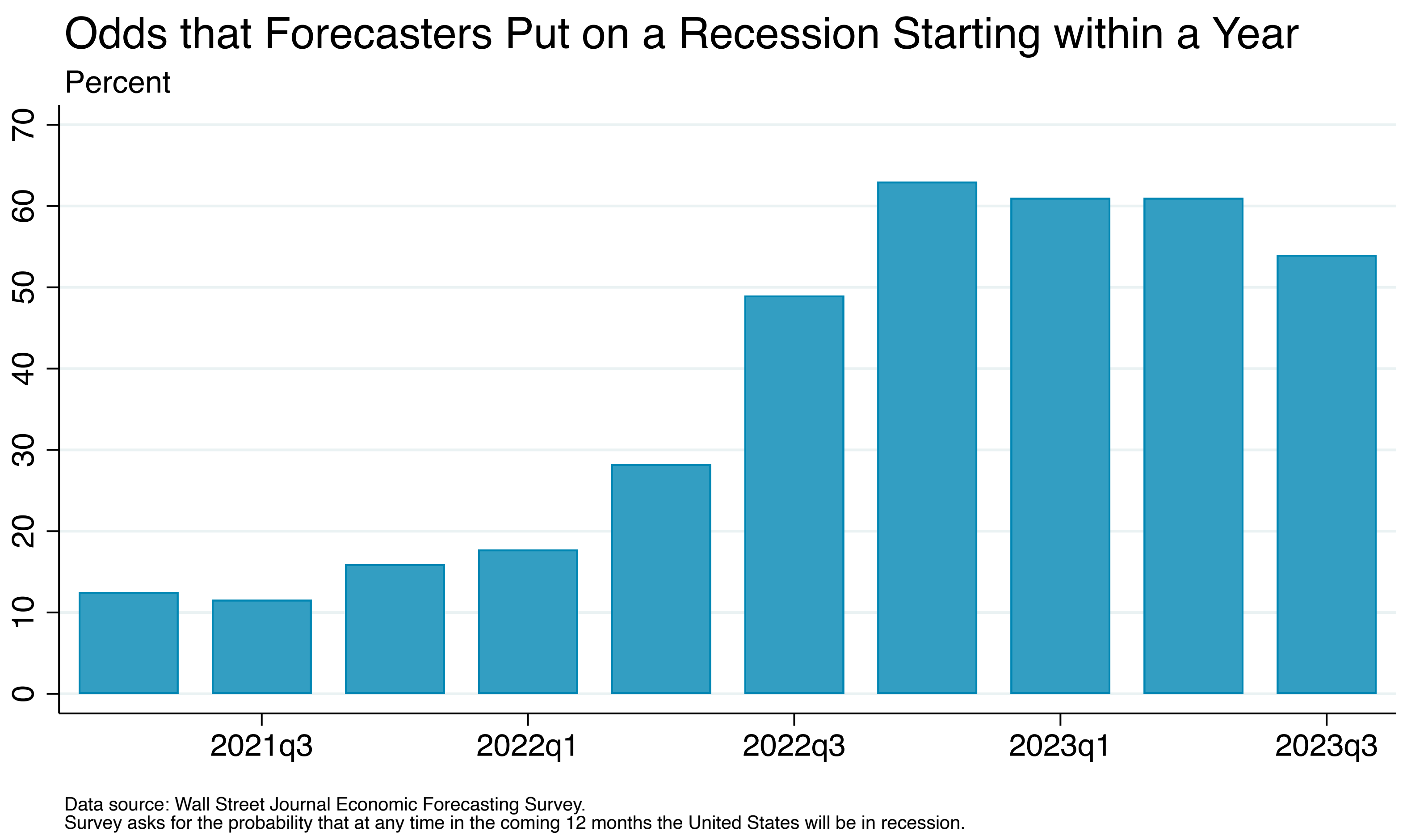
Federal Funds Rate and Unemployment Rate

Percent

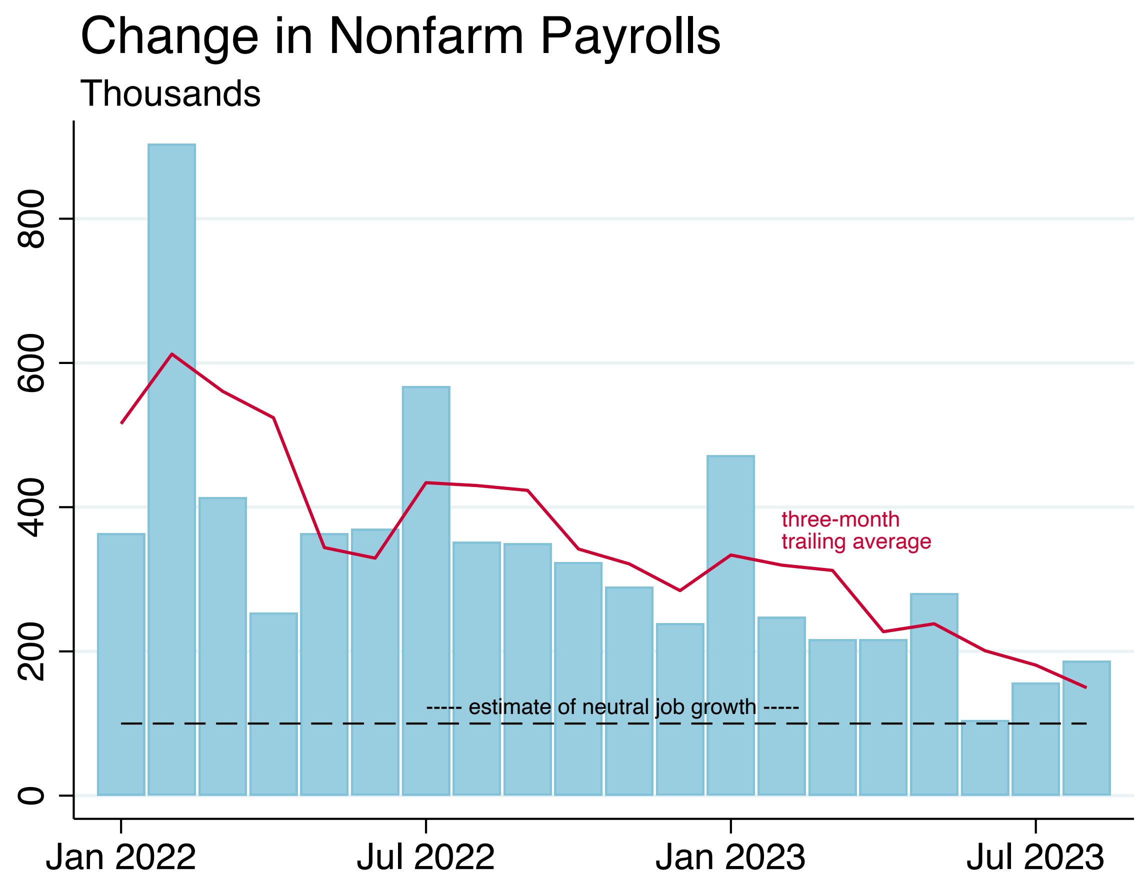


Data source: Federal Reserve Board and Bureau of Labor Statistics (via FRED).
Shaded areas correspond to recessions. Last data point: August 2023.

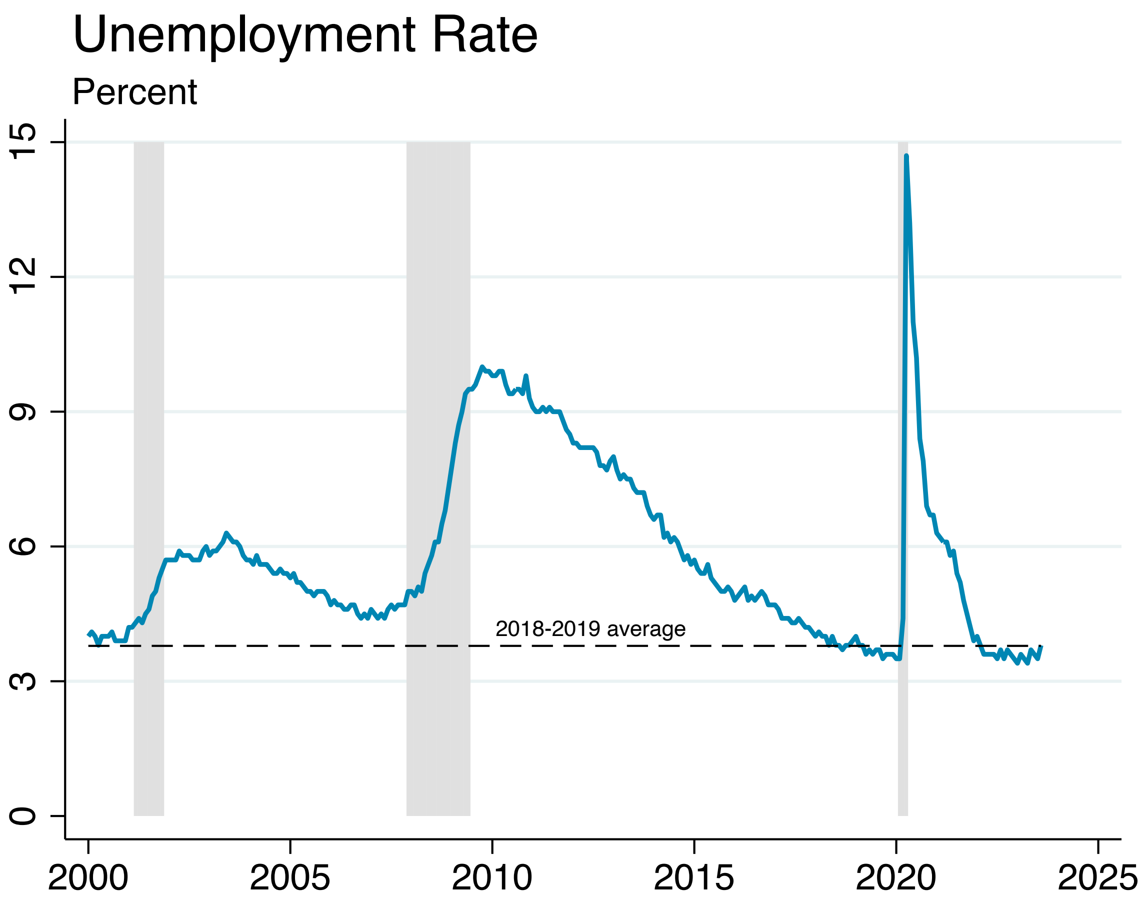
As Fed tightening proceeded, many macroeconomists grew bearish about prospects for the economy



But the news has been good this year! Labor demand has slowed but remained healthy



Data source: Bureau of Labor Statistics (via FRED). Last data point: August 2023.
Black dashed line marks Atlanta Fed estimates of pace at which the unemployment rate would stay constant.
See https://www.atlantafed.org/chcs/labor-market-slider.

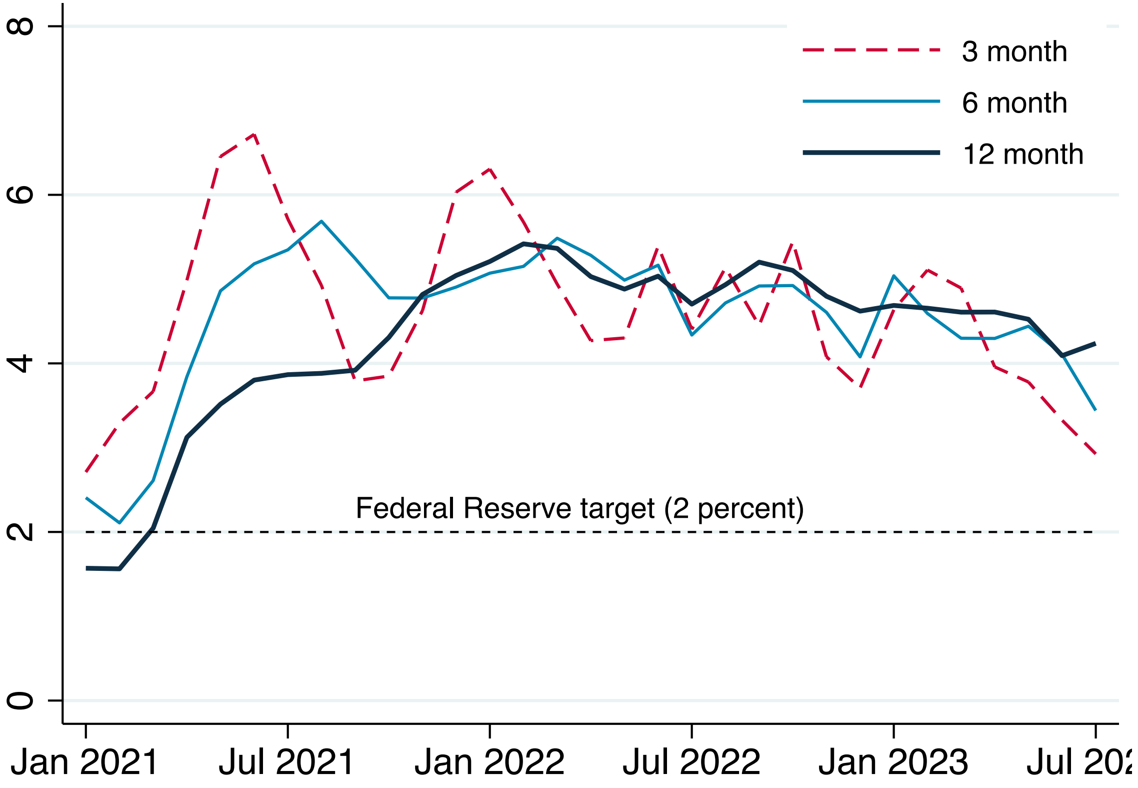


Data source: Bureau of Labor Statistics (via FRED). Shaded areas correspond to recessions.
Last data point: August 2023.

But the news has been good this year! Inflation is retreating and inflation expectations have subsided

Core PCE Price Index Inflation

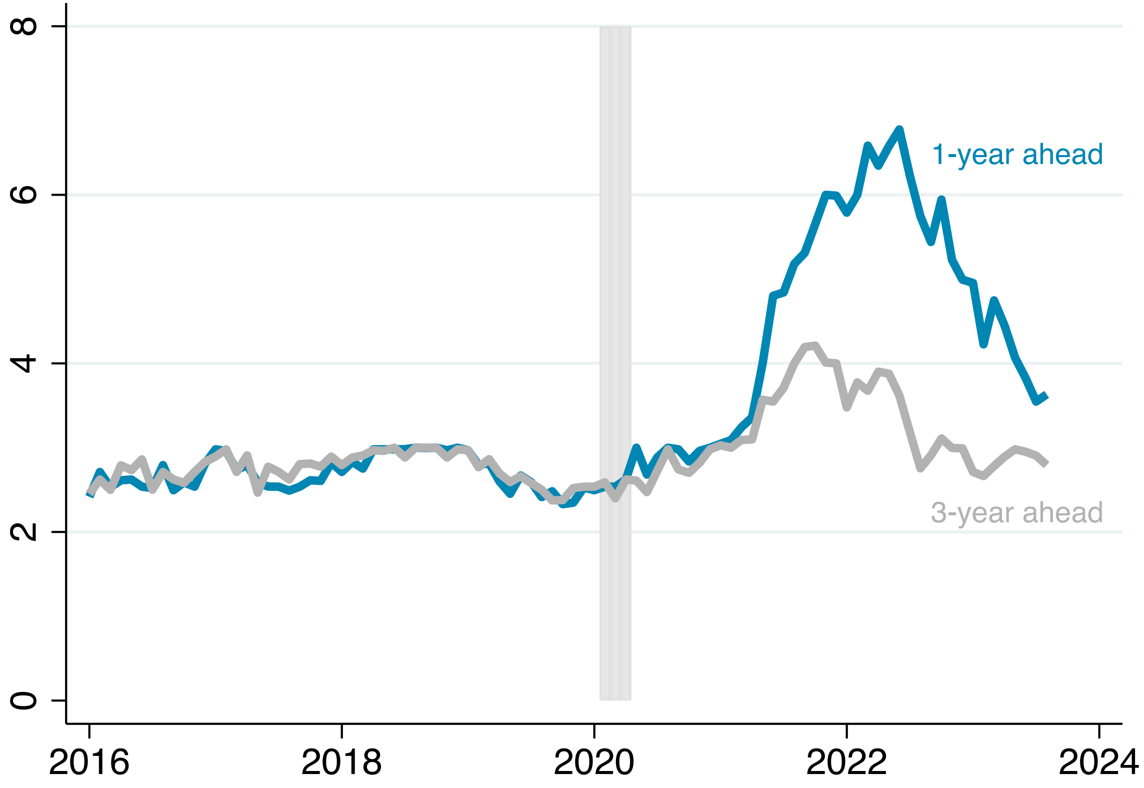
Percent (annualized)



Data source: Bureau of Economic Analysis (via FRED).
Last data point: July 2023.

Median Expected Inflation

Percent



Data source: Survey of Consumer Expectations, © 2013-2023 Federal Reserve Bank of New York.
Last data point: August 2023.

We can be cautiously optimistic about a "soft landing," but there are risks on both sides

Inflation is still at least 1 percentage point above target, and **multiple factors could generate sustained overheating and ongoing inflation pressures**:

- Possibly still-considerable amount of "excess saving"
- Strong labor market supporting incomes
- Potential for another inflationary supply shock

On the other hand, **various factors could weaken the economy more than currently anticipated**:

- Lagged effects of monetary policy tightening
- Commercial real estate troubles creating a "slow burn" in the banking sector
- Weaker Chinese economy

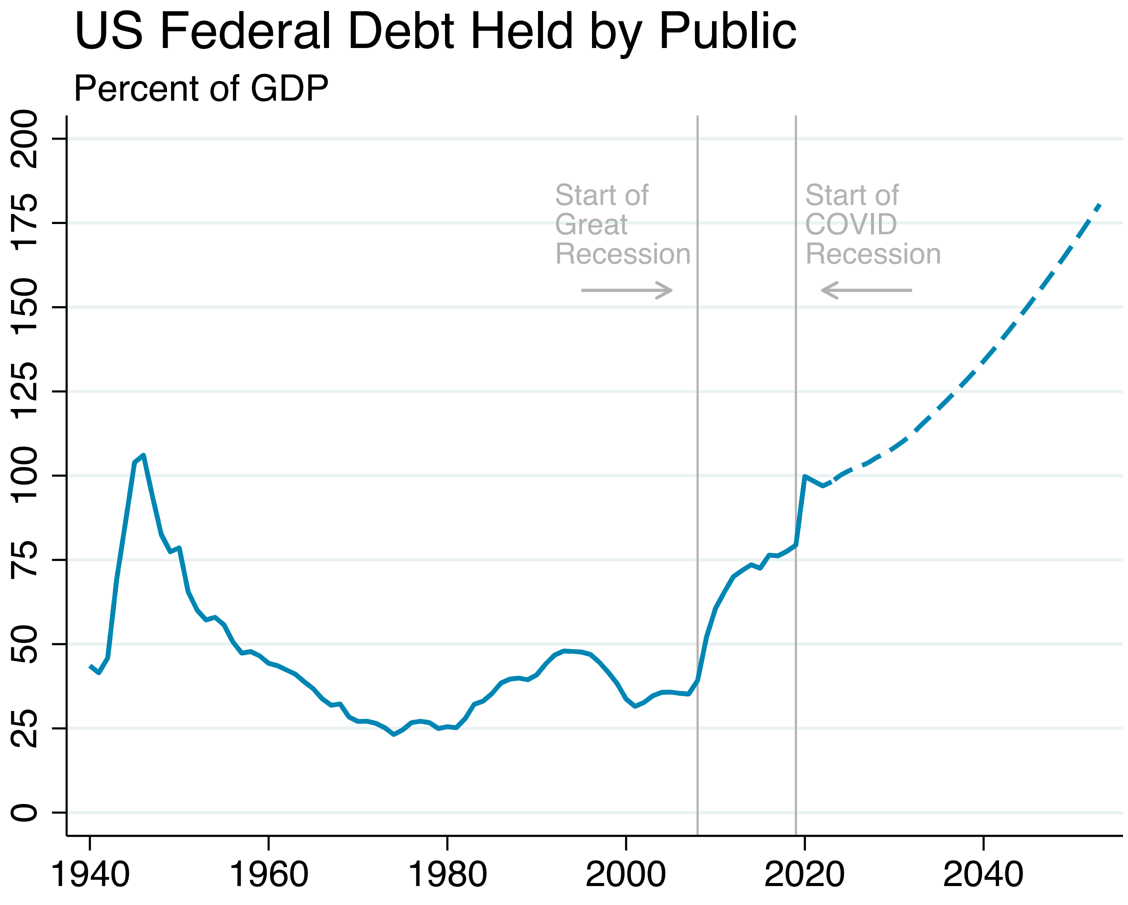
Beyond the soft (or hard) landing—longer-term issues for US economic policy

1. High and rising federal debt

The COVID fiscal response has exacerbated the unsustainable path of federal debt

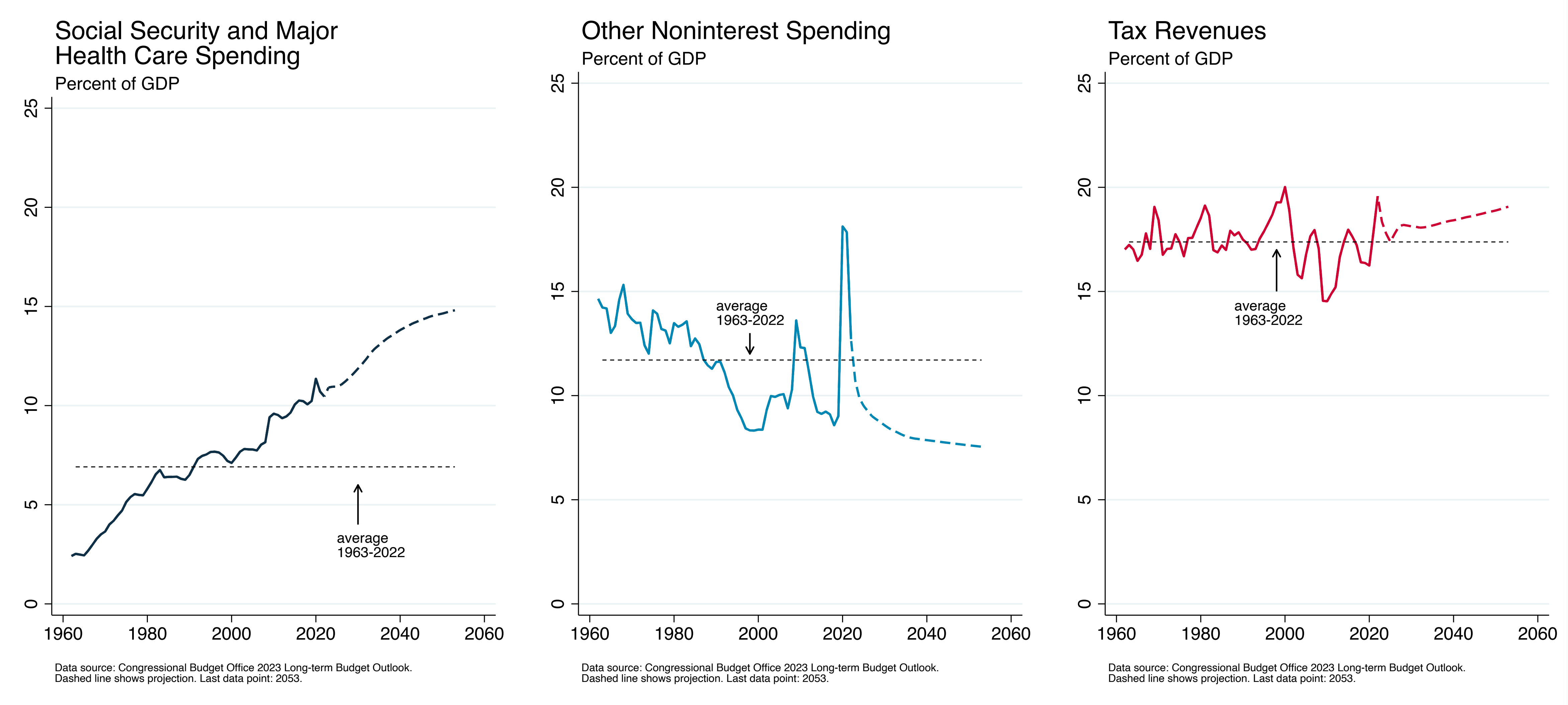
Prior to COVID, we knew US federal debt was on an unsustainable path because of an aging population and rising health care costs

Recessions tend to be hard on the federal budget, so, not surprisingly, federal debt jumped much further with the COVID fiscal response, which means **we will reach unsustainable levels even earlier**



Data source: Congressional Budget Office 2023 Long-term Budget Outlook.
Dashed line shows projection. Last data point: 2053.

Adjusting spending and taxes enough to put debt on a sustainable path will have significant social costs



But the costs and risks of high federal debt are significant, so adjustments will *need* to be made

Budgetary costs—a greater share of government outlays need to go to making interest payments on the larger debt [constraining "fiscal space" for future priorities]

Lower potential output because money that could be funding the expansion of the private capital stock is diverted into government bonds

Maybe: **higher inflation** if people come to believe the government will eventually resort to printing money to finance spending because it's hard to borrow [inflation expectations go up and higher inflation becomes self-fulfilling]

Maybe: **the truly bad outcome of a "debt crisis"** where the country loses the ability to borrow because its ability to pay its debt comes into question

Beyond the soft (or hard) landing—longer-term issues for US economic policy

1. High and rising federal debt
2. The backlash against globalization

Globalization has had many benefits

Comparative advantage—specialization means more goods produced at lower prices

Greater incentives and ability to innovate—because the return is higher when companies can sell into a larger market, because companies face more competition from abroad, because of more global exchange of ideas

Decline in gap between rich and poor globally—trade has helped some poor countries grow, lifting huge numbers of people out of extreme poverty

That said, 21st century experiences have revealed important downsides of globalization

HARVARD Kennedy School

Effects of 'China shock' linger long after imports boom leveled off

POLICY TOPICS

HKS researcher Gordon Hanson and colleagues document long-term damage for U.S. workers and factory towns hurt by Chinese manufacturing competition.

HOME / FACULTY & RESEARCH / POLICY TOPICS / GLOBALIZATION / EFFECTS OF 'CHINA SHOCK' LINGER LONG AFTER IMPORTS BOOM LEVELED OFF

By James F. Smith
January 19, 2022

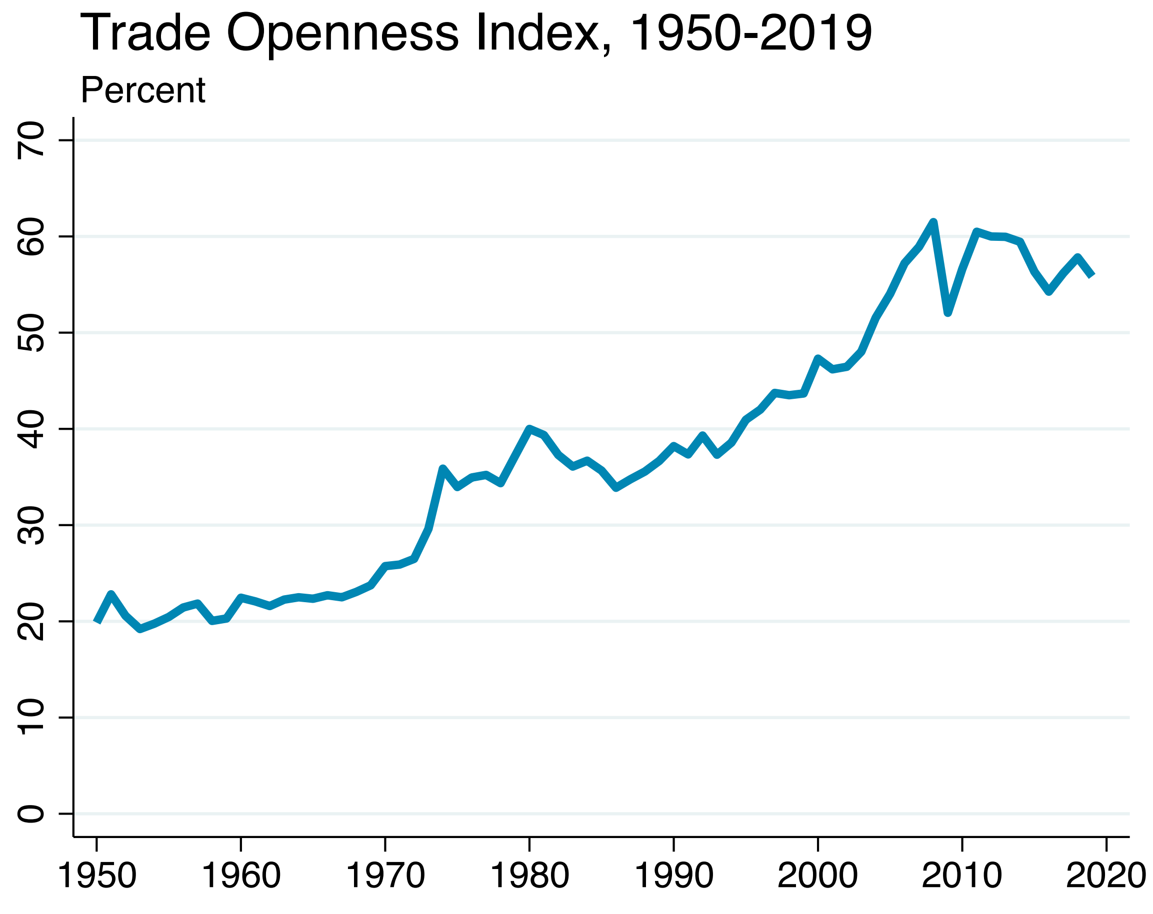
CSIS | CENTER FOR STRATEGIC & INTERNATIONAL STUDIES

Semiconductors and National Defense: What Are the Stakes?

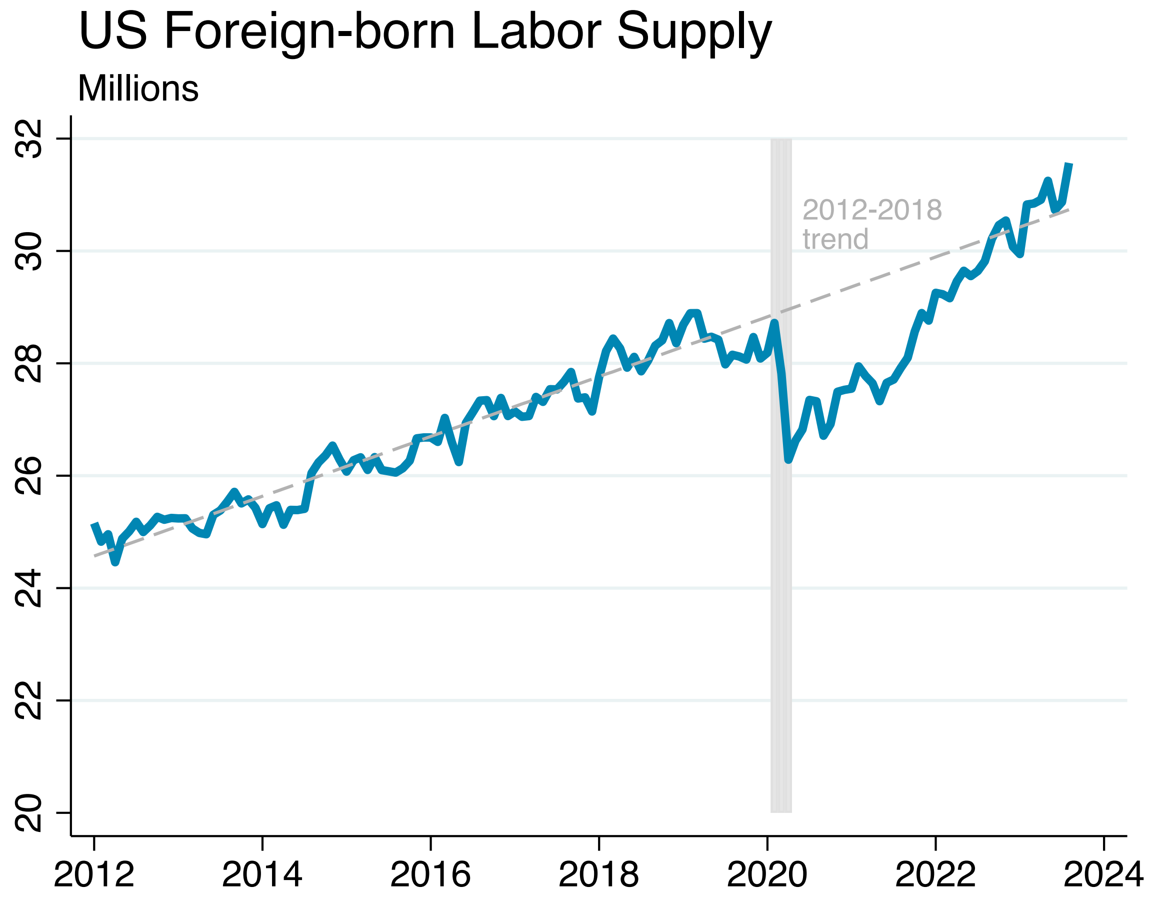
Photo: golibtolibov/Adobe Stock

Commentary by **Sujai Shivakumar** and **Charles Wessner**
Published June 8, 2022

These downsides have generated more backlash to globalization, but as yet the data only hints of a reversal



Data source: Penn World Table (via Our World in Data).
Sum of world exports and imports divided by world GDP.



Data source: Bureau of Labor Statistics (via FRED). Not seasonally adjusted.
Shaded area corresponds to recession. Last data point: August 2023.

Addressing the downsides of globalization is difficult

*We document shifts in the pattern of US participation in global value chains over the last four decades …The available data point to a looming **"great reallocation" in supply chain activity**: Direct US sourcing from China has decreased, with low-wage locations (principally: Vietnam) and nearshoring / friendshoring alternatives (notably: Mexico) gaining in import share.*

Alfaro and Chor (2023)

*In January, TSMC's chief financial officer, Wendell Huang, said certain construction costs in the U.S. were several times the level in Taiwan. **TSMC founder Morris Chang has said it might cost at least 50% more to make chips in Arizona compared with Taiwan.***

Wall Street Journal, 4/19/23


CNBC

Growing talent gap in U.S. chip space emerges as makers spend billions

PUBLISHED WED, AUG 9 2023·10:00 AM EDT | UPDATED WED, AUG 9 2023·6:46 PM EDT

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Beyond the soft (or hard) landing—longer-term issues for US economic policy

1. High and rising federal debt
2. The backlash against globalization
3. Artificial intelligence

Background: multifactory productivity growth has been dropping in the US and that's a concern

Growth in multifactor productivity (output per unit of input) has dropped in the 21st century—from an average of 1.1% per year between 1990 and 2003 to an average of 0.6% per year

Lower growth is bad news for:

- advances in the average standard of living
- economic mobility (listen to [this interview](#) of Robert Solow)
- the sustainability of government debt

American Economic Review 2020, 110(4): 1104–1144
https://doi.org/10.1257/aer.20180338

Are Ideas Getting Harder to Find?†

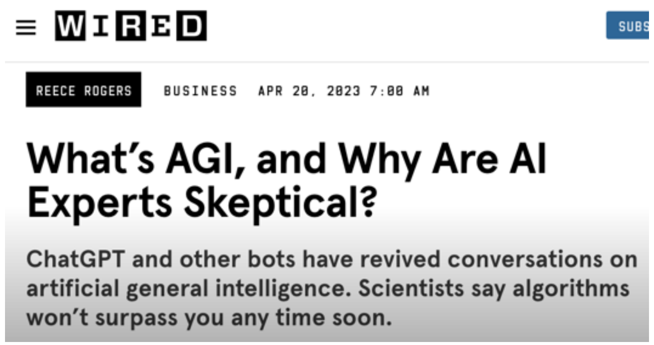
By Nicholas Bloom, Charles I. Jones, John Van Reenen, and Michael Webb*

Long-run growth in many models is the product of two terms: the effective number of researchers and their research productivity. We present evidence from various industries, products, and firms showing that research effort is rising substantially while research productivity is declining sharply. A good example is Moore's Law. The number of researchers required today to achieve the famous doubling of computer chip density is more than 18 times larger than the number required in the early 1970s. More generally, everywhere we look we find that ideas, and the exponential growth they imply, are getting harder to find. (JEL D24, E23, O31, O47)

the above research implies productivity growth may continue to fall

Will AI advances help? Three scenarios

1: The great AI leap forward has mostly played out


WIRED

REECE ROGERS BUSINESS APR 20, 2023 7:00 AM

What's AGI, and Why Are AI Experts Skeptical?

ChatGPT and other bots have revived conversations on artificial general intelligence. Scientists say algorithms won't surpass you any time soon.

2: AI drives big changes that predominantly substitute for large groups of workers

Think of this as entering a world where everyone has a thousand free research assistants. Now,

Tyler Cowen 5/25/23

In addition to direct costs of job loss, potential for social and political dysfunction

Global South particularly vulnerable because rich countries "own the robots"

3: AI drives big changes that predominantly complement workers

AI finds new ideas for us

AI invents new professions for displaced workers

AI dramatically lowers the cost of education and training

Three AI scenarios: policy implications

1: The great AI leap forward has mostly played out

Still stuck with problems of low productivity, low mobility, and high government debt that need to be addressed

2: AI drives big changes that predominantly substitute for large groups of workers

Need to: (1) strengthen the safety net (2) invest in training displaced workers (3) find ways for more people to "own the robots"

3: AI drives big changes that predominantly complement workers

Everything is better (though unlikely to be enough better to avoid hard government budget decisions)

In all scenarios: will have to think about appropriate regulatory response to AI

Summary and final thoughts

There are **risks on both sides in the fight against inflation**—a "hard landing" would be painful, but policymakers should also be mindful that not curbing demand adequately today may lead to a need for a much sharper tightening in the future

Policymakers **need to face up to hard budget decisions** that will put the federal debt on a sustainable path

Policymakers **need to proceed carefully with measures to address the downsides of globalization** and consider evidence about whether they are meeting their goals

Strengthening the safety net and investing in workers' skills are generally a good idea—could help with the backlash against globalization and provide some insurance against the displacement, hardship, and dysfunction that could come with scarier AI scenarios

Thank you