A Structural Agenda for the United States

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The global economy is struggling to generate sufficient growth to re-employ capital and labor resources idled in the recent recession in the advanced economies, despite extremely low or even negative real interest rates resulting from highly accommodative monetary policies. The natural resilience of market economies has been restrained by a variety of forces, including the need to work through the overhang of debt and of houses, and consumer durables purchased with that debt in the previous sharp upswing in the credit cycle. Relieving these restraints and overcoming these forces will require a variety of structural as well as cyclical policy initiatives. Businesses and households need to have the incentives, as well as the means, to invest in physical and human capital and to expand their operations and spending. Pessimism about future employment and demand has been the major damper on the expansion, but both the feasibility and effectiveness of countercyclical policies are being impeded by deep structural problems and uncertainties that our political systems seem unable to deal with effectively.

In this essay, I will concentrate on a structural agenda for the United States, but a globally integrated U.S. economy is being held back by two notable structural issues that must be addressed by policymakers in other jurisdictions. The first is the necessity of shifting current account surplus countries toward more domestic demand and less reliance on exports, especially in those countries that have artificially held down exchange rate appreciation. We have seen the destabilizing effects of a reliance on U.S. consumers to drive global growth through much of the 2000s. A more sustainable configuration for global growth will have less consumption and residential housing, more exports and investment in the U.S., stronger domestic demand and fewer exports in current account surplus countries. To a considerable extent, the reorientation toward higher private domestic saving has already been underway in the United States and a number of other advanced economies. To support global growth, the complementary adjustment must also occur in the surplus countries. That shift in turn requires changes in relative prices in deficit and surplus countries, as well as in policies that directly affect the structure of demand; the necessary real appreciation of surplus countries will be much less disruptive if it occurs through exchange rate appreciation than if it is the result of higher inflation.

The second critical area requiring policy action abroad is in the euro area. Concerns about developments there—fiscal sustainability, bank resilience and persistent current account imbalances—have weighed on global financial markets, causing increasing volatility, reductions in the valuation of business capital in equity markets, and a decline in credit availability everywhere. Tighter financial conditions in turn threaten recovery broadly and the euro area governments must take actions to get the required fiscal and competitive adjustments, and to sustain the provision of banking and other financial services while that is going on. These actions must be of sufficient scale and targeted well enough to be credible in financial markets.

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At the same time, U.S. authorities have a long list of structural issues they should deal with to foster near-term recovery and longer-term growth. The problems the U.S. economy is facing are multifaceted and a broad range of policies will be required to restore its vitality. Some necessary changes are underway, but many are not. In addition, the

lack of attention to a number of structural issues is reducing the feasibility and effectiveness of countercyclical policies.

1. Devise and commit to a medium-term path for fiscal policy that results in a sustainable level and path for government debt.

   The current inability or unwillingness of U.S. politicians to tackle the very tough medium-term issues for debt sustainability is harming the recovery in several ways: First, it is adding to uncertainty about the structure and level of taxation, and the structure and level of government support for retirement and for meeting health care costs as the population ages. A number of temporary fiscal actions have been taken to boost demand; whether they will be extended adds to uncertainty. A natural response to this policy uncertainty is to do more saving as a household, and for households and businesses to hold back on investment until future government policies become clearer. Planning and investing will be easier when the parameters of government action are clearer. Second, the inability of elected officials to make substantive progress on these issues, and the tendency to play them for short-term political gain, is undermining confidence. It likely is no coincidence that the sharp drop in consumer and business confidence in August coincided with the spectacle of the debt-ceiling negotiations. Third, while the combination of longer-term cutbacks with short-term stimulus probably decreases the effects of short-term stimulus, it is also the case that in the absence of a medium or longer-term credible commitment to fiscal sustainability, the only way politicians have to signal that they take the longer-term problem seriously is to engage in fiscal austerity in the short run. A credible, committed medium-term plan would enable much more flexibility for shorter-term fiscal policy to avoid ill-timed austerity.

2. Reform the tax system to reduce marginal rates, raise more revenue and encourage saving.

   Since the last major overhaul of the federal tax structure in 1986, the U.S. system has become much more complex and inefficient. The bi-partisan Simpson-Bowles commission pointed to a way to raise revenue while lowering marginal tax rates—tackling "tax expenditures", the tax credits that encourage certain types of spending. These include the deduction for mortgage interest costs and the tax-free character of business spending for health care insurance for their employees. Moreover, these types of tax deductions are more valuable for higher income individuals and families facing higher marginal tax rates. Marginal tax rates could be lowered, revenue raised and income redistributed to lower income taxpayers if these deductions were reduced and changed to tax credits in those cases in which the Congress decided certain types of spending still should be encouraged. In addition, consideration should be given to moving toward a more consumption-based tax system over time with a national sales tax or value-added tax. As the U.S. returns to full employment, it should do so with less consumption and more domestically financed investment and less reliance on foreign capital flows. Encouraging domestic saving would contribute to the necessary rebalancing.

3. Clean up the system of housing finance in the United States.

   The U.S. is facing difficult structural problems in housing finance in both the short and long term. In the short run, the inability to make good progress on cleaning up the debt mess left by the housing price bubble burst is hobbling the recovery. Housing usually is one of the sectors to lead the economy out of recession. It is not surprising that it is not filling this role in the current circumstances—we entered the recession with an overhang of debt and houses. But it is disappointing how weak housing remains five years after the peak in house prices, and a good part of the continuing weakness owes to the slowness of the process of dealing with loans that are underwater or are in arrears because borrowers are facing difficulties or sim-

ply chose to default. We seem unable to move forward on either refinancing into more sustainable affordable loans or foreclosing where that is not possible. The resulting overhang of "shadow inventory" of homes that are likely to come onto the market at some point is putting downward pressure on home prices and creating uncertainty about future movements in prices. The concern about further depreciation of houses quite naturally is making lenders very cautious and is constraining the availability of credit for refinancing or the purchase of new and existing homes. Devising workable plans for restructuring loans with principle write-downs without encouraging further defaults is very difficult and new efforts seem always to be under consideration. If there is a plan, it should be announced soon or the effort abandoned. In addition, banks need to fix their foreclosure procedures to enable them to move forward quickly when restructuring does not work. State attorneys general, others suing the banks, and the banks themselves should settle expeditiously or figure out a way for foreclosures to proceed while the lawsuits are underway.

The second structural issue with housing finance is the role of the government or government agencies over the longer term. The behavior of Fannie Mae and Freddie Mac likely contributed to the housing bubble and the erosion of lending standards. All agree that these types of institutions in which gains are private but losses are picked up by taxpayers should not be revived. In addition, goals and financing for affordable housing need to be considered separately by the Congress and not piggy backed onto government or government-like agencies in ways that obscure the costs. The revival of the housing market as the detritus of the bubble is dealt with will be facilitated by much greater clarity on the extent of government involvement in housing finance. Such clarity would enable the private sector to get a better fix on the problem and design its role.

4. Build a more stable financial sector.

The transition from the highly leveraged and risk-prone financial system of five years ago to a more robust and resilient system that can absorb major shocks without greatly restricting the availability of credit is inherently difficult and time consuming. Under present circumstances when bank credit is still tight, it could well be slowing the pace of credit easing, thereby reducing the effectiveness of countercyclical monetary policy. Nonetheless, financial institutions and lenders must build capital and liquidity along with better systems to understand and monitor risks if we are to avoid another systemic event. Regulators must put more constraints on risk taking and work to have more transparent and less complex financial instruments that can be evaluated by market participants. Credit needs to be rechanneled—some that was inappropriately priced and distributed in the "shadow banking system" will find its way back into banks. Some credit that was in banks will no longer be profitable once banks hold higher capital and liquidity, and will be intermediated in markets.

The needed structural and regulatory adjustments are underway. The challenge is to have them made with as little negative effect on bank lending as possible. One way to contribute to this objective is to get the regulations promulgated as quickly as possible so as to give market participants more certainty about the rules of the road. A second, and potentially contradictory imperative, however, is to subject those regulations to as rigorous a cost-benefit calculation as is possible within the parameters given by the law. A third is to encourage the buildup of capital buffers and the increase in capital ratios through restraint on payouts of earnings—share repurchase, dividends and compensation—rather than through the reduction of risk assets. Finally, institutions should be allowed long transition periods to the higher requirements—provided that is consistent with the stability of the financial system—as the authorities are already doing in their plan for implementation.

5. Educate our young people for better jobs.

Perhaps the most important longer-term structural reform the United States is already undertaking is the improvement of its primary and secondary education systems. Legitimate concern has been focused on the effects of long-term unemployment and on the stagnation of median incomes even before the current economic cycle. As jobs return, it will be critical that the unemployed have the skills necessary to meet the demands for an increasingly technical and high-skilled labor force. Investment in training beyond the high school level has continued to pay off over recent decades, but that type of training is predicated on a strong foundation and the U.S. is just getting started on the necessary reforms to make that happen. Future increases in living standards will depend on how well the education system provides the right learning opportunities and prepares its students to take advantage of them.

6. Carefully weigh costs and benefits for regulations; rely on market-based solutions where possible.

Externalities and systemic effects justify government intervention in many areas of economic life. But regulations should be subject to rigorous and objective cost-benefit analysis. They should be changed only when absolutely necessary so households and businesses can plan. And to the extent possible, they should rely on adjustments to market-based prices to take account of externalities, rather than potentially arbitrary decisions by regulators so as to minimize the costs of regulatory interventions. Although the administration has moved in these directions, there is a widespread perception that regulatory changes have become considerably more numerous and less subject to rigorous analysis. A sustained effort to improve processes will help reduce uncertainty and concerns about unnecessary and intrusive regulation that may be adding to the uncertainty that is holding back investment and hiring.

7. Preserve free markets internationally.

Free and open markets in capital, goods and services, and foreign exchange can be volatile and prone to overshooting. But in general they are less distortive to resource allocation and more supportive of growth over long periods of time than markets subject to heavy government intervention. Moreover, free and open markets are a powerful signal to households and businesses that they will be able to reap the rewards for their saving and investments, for the risks they might take. To date, a protectionist response to the recession in the forms of tariffs or other restraints on trade or on capital flows have been relatively muted. But pressures are building as weak growth persists and in response to capital inflows, some emerging market economies trying to protect export industries have moved toward capital controls rather than adjustments to exchange rates or to monetary policy. In addition, as already noted, some surplus countries are resisting the natural and needed appreciation of their exchange rates. The response of spending to the incentive effects of countercyclical policies and allowing the adjustments needed to promote global growth will be enhanced by adhering—in the United States and elsewhere—to the principles of minimally intrusive interventions into free and open global markets.

This is a formidable structural agenda for the United States. Progress has been made in some dimensions, but not in many others. As is already evident, even very aggressive countercyclical fiscal and monetary policies have not proven sufficient by themselves to pull the United States or the global economy out of the slump that followed the systemic financial crisis of 2008 and its aftermath. That crisis and period of economic weakness also have highlighted the cost of neglecting critically important structural issues for many years. Breaking out of the current economic morass will require action on many fronts at the same time.