Digging Out:
Economic Prospects for our Country and Region

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Introduction

Thanks very much. It is truly great to be here at Hiram College, one of the nation's oldest liberal arts colleges, where the emphasis is on helping each individual reach his or her potential. And it is especially gratifying to participate once again in a Garfield Center program. I have had the opportunity to meet some of the Garfield Scholars in previous years, and I have to say they are an impressive group of people and a great credit to this school.

My theme tonight is: "Digging Out, Economic Prospects for our Country and Our Region." I'll get right to the point and tell you my primary messages.

- First, the United States, and our region, are still in the process of recovering fully from the devastating effects of the financial crisis and Great Recession. On the surface, US economy today looks to be in decent shape. Nevertheless, I expect the nation's economy to continue expanding only slowly, and I expect Ohio and Northeast Ohio to continue to struggle to keep pace with the nation.
- Second, even after the nation and our region "recover" from the deep recession, you should not expect a return to the status quo ante—the old normal. Even before the financial crisis and the Great Recession, there were several permanent dramas playing out on the world stage —both domestically and internationally— that poses great challenges for us.
- Finally, I will argue that successfully responding to these challenges will require us to think differently about economic growth and development, and especially about the role of education.

Section One

First section is taking stock of where we are as a nation, and a region, after the Great Recession. I will discuss jobs, unemployment, incomes, etc.

Refresh your memory of the Great Recession: Real output declined by 5%; industrial production by 15%; 9 million people out of work, and the fraction of those unemployed who had spells of more that 26 weeks was an all-time record. Mortgage foreclosures, declines in household wealth due to both stock market and housing. Corporate profits, bankruptcies. Toll on small business.

These are some statistics about what did happen. What about the activity that DIDN'T happen? In the absence of the recession, the economy would have kept growing, generating even more income and jobs = Potential GDP. For every year that output and employment run below Potential GDP, we are not fully utilizing the land, labor, and capital stock we have available. Here we are in 2014, some 7 years after the onset of the 2007 recession. Although national production and employment have finally returned to pre-recession levels, there is still a large gap between actual and potential GDP (try to quantify this in lay terms). And from some perspectives Ohio has been faring worse. Show graphs.

Section Two

Why has growth been so slow, and what is my forecast?

Growth has been slow for two categories of reasons;

- The first category pertains to factors specific to this recession, which was induced by over-leveraging and a collapse of the financial system.

- The second category pertains to longer-term forces that have been at work nationally and regionally for quite some time, factors that are associated with economic globalization.

First category—rebounding after the recession. Recessions and recovery episodes each have their own particular dynamics, so it is hard to generalize. There is some evidence that steep recessions generally have sharper recoveries. One reason for this is the simple fact that at the onset of a recession, businesses slow their production and fill orders out of inventory. This process extends through the entire industrial supply chain. When new orders pick up again, the supply chain needs to be restocked, resulting in a surge of industrial production. This time around, things were not that simple.

Critical to the quick snapback process is the degree of confidence within the business sector that setback was temporary, and that the volume of new orders will resume. However, one of the hallmarks of this recession was a seizing up of the entire financial system, a dramatic loss of wealth from the stock market and housing values, and a correspondingly dramatic pullback in risk-taking. Even today, nearly five years after the official end of the recession, households, businesses and financial institutions are still recovering from the scars of the recession.

We know that the last boom was fueled by ever-rising house prices, and the ability of highly leveraged homeowners to take equity out and finance consumption. The world looks different now, on the other side of the recession, than it did before. Investors and homeowners have each changed their mind about the wisdom of being highly leveraged. And in many instances, even if minds have not changed, regulations and financial supervisors have set the bar higher in terms of capital and liquidity standards that financial institutions must adhere to. It's not as easy to be a highly leveraged consumer these days, even if you want to be!

Also critical to the strength of the expansion is the ability of business to obtain financing, especially start-ups, and small and medium enterprises. Many small business owners saw traditional credit sources dry up during the recession, and small business lending has remained problematic. This is especially so for small business owners who are used to relying on their homes or business property as collateral for bank loans.

It takes courage to commit capital in the US when faced with uncertainty about the strength and timing of the recovery. Historically, spending on new plant and equipment is pulled along by strengthening demand and the diminishment of excess capacity, rather than from a "if we build it—it will get used" perspective. This recovery has been so slow, and has been subject to so many "headwinds" that many businesses have decided to just maximize profits with as little incremental capital as possible.

One notable exception to this reluctance is the shale gas boom, which clearly benefits parts of our region. A lot of money is pouring into the region to build the infrastructure necessary to move shale gases from wellheads to refineries. This activity will continue for some years, and be a source of employment and income in the region. Over time the investment profile will taper back down, and the more permanent effects will appear in the form of cheaper energy regionally and nationally.

The performance of the housing sector is also a key factor shaping recessions and recoveries. New residential construction is a highly cyclical activity, and is susceptible to booms and busts as a result of financial—as well as psychological and emotional factors.

Needless to say, the recent recession was a housing bust of extraordinary magnitude. In addition to the massive overbuilding that occurred, house prices were driven well above sustainable levels in many markets. The adjustment process is still taking place. Housing wealth is the most important financial asset for most homeowners, and many small business owners rely on their house as collateral for business loans.

One of my former Federal Reserve colleagues, Joe Haubrich, along with a co-author, examined the importance of housing and financial crises in terms of their association with prolonged economic recoveries.[1] Their research suggests that the US economy has historically been fairly robust in recovering from recessions characterized by credit crunches, but not so well from the few recessions in which housing collapses feature prominently.

Our recent recession was a double whammy, so to speak, leaving borrowers and lenders uncertain abut the true value of residential property, and their willingness to take on debt to obtain it.

Economic problems also persist in Europe, which was similarly afflicted by the global financial crisis, Japan, which is still struggling after decades of weak economic growth, and even China, where economic growth has slowed from the torrid pace we are so used to hearing about. These countries represent good markets for US companies, and their challenges, to some extent, add to our challenges in our global economic system. The

[1] Michael D. Bordo and Joseph G. Haubrich, Deep Recessions, Fast Recoveries, and Financial Crises: Evidence from the American Record," NBER Working Paper No. 18194, Issued in June 2012.

geopolitical situation has changed as well; the fact is that the world is a troubled place, and it takes a lot of courage to commit capital to developing countries in far-flung places.

Before I move on to my second major message—that important changes were taking place in the global economy before the Great Recession, I want to discuss some longer-term changes that may have been set in motion in the US labor market as a result of the Great Recession. According to a recent research study published by several FRB economists[2], there is evidence that the recent financial crisis and ensuing recession have put the productive capacity of the economy on a lower and shallower trajectory than the one that seemed to be in place prior to the recession—about 7 percent below the trajectory it appeared to be on prior to 2007.

They find that the productivity growth trend has declined both because of a steep decline in capital accumulation, as well as just plain being less productive with the capital and labor we have. In addition, they point out that the downward trend in labor force participation appears to have steepened, which raises the possibility that that some structural damage in the labor market occurred during the deep recession. They argue that a significant portion of the recent damage to the supply side of the economy could have actually been caused by the weakness in demand side of the economy.

How? When people remain unemployed for long periods of time, their skills, reputations, and networks could deteriorate, which could cause them to remain unemployed even longer, or to drop out of the labor force.

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[2] Dave Reifschneider, William Wascher, and David Wilcox , "Aggregate Supply in the United States: Recent Developments and Implications for the Conduct of Monetary Policy. FEDS Paper 2013-77.

The second category concerns the longer-term trend rate of growth in mature industrial economies. The continuing slow growth and very low inflation among mature industrialized economies around the world, such as the US, UK, Euro Area and Japan, is prompting serious introspection and debate among macroeconomists.

Some of the economic profession's leading intellectuals have cautioned that the trend rate of economic growth was slowing for decades before the crisis, and for various reason the trajectory is likely to remain very weak for decades to come.

The dire warnings rest on a few basic hypotheses.[3] Some economists, such as Harvard's Larry Summers, suggest that even today's very low interest rates are not low enough to generate the amount of spending that is needed to bring these economies back to full employment. In this view, globally there is still more saving than spending taking place, and economic policies should focus on stimulating demand. If we want spending, production, and economic growth to speed up, real (inflation-adjusted) interest rates need to even further. Monetary policy cannot readily push nominal interest rates below zero. The only hope for monetary policy in this scenario is to try to generate more inflation, which would lower real interest rates.

Unfortunately, the combination of ultra-low interest rates and rising inflation has not been adequately "road tested" and could become, as Summers notes, a source of financial instability. That puts the stimulus ball squarely in the fiscal policy court.

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[3] See Secular Stagnation: Facts, Causes and Cures ,A VoxEU.org Book edited by Coen Teulings and Richard Baldwin, CEPR Press (2014) for a presentation f the views of leading economists on this topic. My discussion draws heavily on the articles written by Lawrence Summers and Robert Gordon.

A second hypothesis, advanced by Northwestern University's Robert Gordon, takes aim at the supply side of the economy, that is, the ability of land, labor, capital, and technical progress to deliver more output. In Gordon's view, the US economy in particular will grow more slowly for decades to come due to four headwinds: demographics, inequality, government debt, and education.

- Population is aging, but in addition, labor force participation rates are falling. Gordon cites recent research (Hall 2014) that has shown that about One estimates (Hall 2014) indicates that half of the post-crisis decline in labor force participation is due to the aging of the population as the baby-boom generation retires (supply side); the other half appears to be explained by declining participation within age groups, due in part to weak economic conditions (demand side).
- The second headwind is income inequality that has concentrated larger fractions of total earnings in the hands of fewer people, stifling overall spending in the economy, as well as income security.
- Gordon's third headwind is the continuing rise in the ratio of federal government debt to GDP. Gordon thinks the official CBO data greatly understate the gravity of the problem, and that the federal debt/GDP ratio could well reach 150% by the late 2030s. A debt to GDP ratio of this magnitude would presumably constrain the government's fiscal flexibility to respond to any number of problems, as well as see interest payments on the debt crowd out other forms of spending. Gordon, like Summers, sees opportunities for the federal government to initiate programs to boost the economy's performance.

- I will hold Gordon's last headwind, education, for a few minutes, since I want to talk about it in more detail.

Of course, the theories of Summers, Gordon, and a host of others who are lamenting the weak performance of many industrial economies might be wrong, but so far it doesn't seem as if the industrialized countries have been able to push their economies forward as fast as they had expected to be able to.

Putting all of these thoughts together, what do I expect to see for the next couple of years, regionally and nationally?

Section Three

The fact that so many countries are still struggling this many years after the global recession indicates that something quite unusual is going on, and that the time has come to think more creatively about spurring economic growth. Countries may face somewhat different barriers and will have to develop their own solutions to their obstacles. Tonight, I'd like to propose one growth strategy for the United States and our region, based on Gordon's fourth headwind: education.

Most economists believe that human capital is a central determinant of economic growth, and that it has played a major role in the economic growth of the United States during the twentieth century.[4] If technology is biased toward requiring workers who have more skills, then ongoing technological progress will favor those with those skills. Rising high-school completion rates during much of the 20th century tremendously boosted the productivity of the US workforce, and did so in a way that generated a certain amount of income equality.

Progress in educational attainment largely stopped 40 years ago, which means that as technological change has continued, less educated people in the labor force have lost the most important means by which they can keep up with their more educated neighbors. It is not surprising that incomes in this country have become less equal.

At the same time, the US is loosing its global advantage. In the latest Program for International Student Assessment, or PISA, assessment (2012) of 15 year-old students in 65 countries systems, the US ranked in the middle of the pack in mathematics, science, and reading literacy. US students did not make it into the top third of developed countries. On another set of measures, Ohio ranks in the middle of the pack of states in terms of high school graduates. While Ohio ranks above the national average for those having an college degree beyond the bachelor's level, our state is still near the bottom of the pack in total for those having a bachelors degree or higher.

We don't have to tolerate this situation. We don't have to stand by and watch the gap widen between the most and least educated among us. The time has come for the United States,

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[4] Claudia Goldin and Lawrence F. Katz's account for the role of human capital formation in the United States in their book The Race between Education and Technology, Belknap Press (2010). My brief comments on human capital draw from a review of their book by Daron Acemoglu and David Autor: "What Does Human Capital Do? A Review of Goldin and Katz's The Race between Education and Technology," Journal of Economic Literature, Journal of Economic Literature 2012, 50:2, 426–463.

and Ohio, to seriously recommit to the goal of building labor force skills through educational attainment, on a scale as widespread and meaningful as we did 100 years ago.

Nationally, we must redouble our efforts to reduce high-school dropout rates and dramatically boost the fraction of those graduates who attain specialized training in skills that match the needs of the marketplace. Not everyone wants to or ought to go to college, at least not immediately after high school, but for those who do, we need to see significantly higher graduation rates. Considering the amount of public and private funds spent on higher education, and the student loan debt being accumulated in the process, low and slow completion rates represent resources we cannot afford to waste.

According to the National Center for Education Statistics, only about 60 percent of first-time, full-time students seeking a bachelor's degree graduate within 6 years of enrollment—only 40 percent in 4 years. Not surprisingly, the graduation rates are markedly lower for minority students, and for students who attend the least selective colleges and universities. At two-year schools, where graduation rates might be less meaningful since many students transfer to four-year institutions, we can look at retention rates between the first and second year. In this case, we see that retention rates are on the order of 40 to 50 percent.

These numbers surely understate the numbers of people who actually graduate within the specified time period due to transfers, but we know, separately, from US Census data that the fraction of the population with a bachelor's degree or greater is about 30 percent.

Before I go on with my plea to elevate our focus on educational attainment, I want to acknowledge two accomplishments. First, many people and organizations in Northeast Ohio are already engaged in many fantastic efforts to increase the educational attainment of our residents, including our most disadvantaged. Second, many people and organizations in Northeast Ohio are similarly engaged in many non-educationally related activities that are designed to strengthen our economic base and improve the quality of life. And yet,…and yet,…I believe that unless we dramatically elevate our game, we will continue to lag the nation in economic growth. There is just so much more that can be done, and must be done, if we are to secure our county's and region's future. I don't have time to cover all of the opportunities this afternoon, but I do have time to talk about one pathway for human capital development that I regard as the *sine qua non* —the one that I regard as the most essential.

Specifically, I want to tell you —if you don't know, and remind you, if you do know, that public returns to investment in high-quality, targeted pre-kindergarten programs are as high as—if not higher than—almost all other public investments. Yet public funding for pre-K has proven much more difficult to obtain than funding for roads, bus lanes, stadiums, bicycle lanes, and hiking trails. High quality pre-K programs are not day care, and they are not just schoolwork for three and four year olds. High quality pre-kindergarten programs foster development of critical social and emotional skills, such as attention, creativity, and perseverance, that are necessary for children and adolescents to become learning individuals. Research shows that the payoff to society for investing in children—especially children in economically deprived households, is very significant.

In regard to higher education, parents, students, taxpayers, and colleges themselves ought to expect better results fem the resources being devoted to higher education. Too much money is spent on classes, books, room and board, and commuting time that does not lead to college completion or to a meaningful enhancement of lifetime earnings. Students and their families need to be smarter consumers, and college officials need to be more accountable for the success of their students. If students are not being adequately prepared at the high school level, then colleges have opportunities to provide valuable feedback to their high school partners. And yet, how much dialogue and partnership actually occurs?

The business community stands to be a big winner from a higher skilled labor force, but I don't think it has figured out how to participate consistently on a broad scale. I think that business leaders are focused on the wrong goal when they seek to influence the course work of today's high school and college students because the students lack skills they need at their companies. By then it is almost too late—the greatest leverage points are at earlier ages, when young people are forming their characters, internalizing their self-worth, allowed to be creative, and can most naturally be inspired to learn. If we send more people like that to high school, we will see more academic and workplace success.

I am confident that the all of you here at Hiram College "get it." Hiram is a member of the Colleges that Change Lives organization, which highlights colleges that promote lifelong love of learning and provide the foundation for successful and fulfilling lives beyond college. In its curriculum, Hiram College stresses the kinds of higher-order critical thinking, analysis and communication skills that employers should want in their employees.

In closing, I want to acknowledge that there really are a large number of organizations and initiatives responding to the challenges I have outlined, and many of them are doing truly great work. But the fact remains that our region still lags the nation in many important human capital measures. If we want to be a more prosperous and thriving region, there simply is no alternative. Thank you.