**The Aftermath of the Great Recession: A Guide for the Perplexed**

*Introduction*[1]

In just a decade the United States has moved from an expansive "New Economy" based on technological advance to the "Great Recession", the longest recession in post-World War II experience. Ben Bernanke's "Great Moderation" came almost exactly between. Many had opined that recent affairs were going to be even worse, projecting a "Great Depression II." Few past US economic transformations have been as dramatic, or as politically conflictive.

In 1999, the economy had already established an historical record for 40 quarters of continuing prosperity since 1991; unemployment had fallen to 4 percent by the end of the year; and the federal government enjoyed a surplus on fiscal account. A key issue became what to do with this excess. Alan Greenspan had no doubts: "I believe that the growth potential of our economy is best served by maintaining the unified budget surpluses presently in train and thereby reducing Treasury debt held by the public. … The resulting boost in the pool of domestic saving will help sustain the current boom in productivity-generating investment in the private sector."[2] In the presidential election in 2000, Gore and Bush differed in their proposals about how to use the surplus, but both agreed about its continuing availability as a basis for subsequent economic advance.

Fast forward to September, 2010. The US economy was moving only slowly upward in apparent recovery from the sharp downturn in output that had begun, according to the NBER's formal dating, in December 2007. There is wide agreement that the cycle had bottomed in the summer of 2009, but the NBER has only pronounced the official June terminal date this month. That delay has fed the renewed discussion of a potential double dip recession that somehow always makes the news. Analysts as different as Nouriel Roubini and Martin Feldstein, not to mention others, seem to give high probabilities to another decline in the near future. Double dip has now become a common expression. There is a high fiscal deficit, amounting to almost 10 percent of GDP, formal unemployment has approximated to almost 10 percent of the labor force, with underemployment still higher, and economic growth –despite massive intervention of the Federal Reserve- had unexpectedly slowed to 1.6 percent, revised downward from 2.4 percent, in the second quarter of 2010.

What has happened? While differences persist, there is agreement, at least, that two primary factors were at the root of this transformation: the rise in prices of residential property and the sudden breakdown of financial intermediation.

[1] This brief essay, in honor of Dionisio Carneiro, takes up several points we had a chance to discuss at the Casa das Garças in early June of 2010. His many contributions will be sorely missed.
[2] Testimony Before the Senate Special Committee on Aging, March 27, 2000.

As Robert Shiller puts it, "The housing bubble was a major cause, if not *the* cause, of the subprime crisis and of the broader economic crisis…"[3] Housing prices rose in continuing, and record, proportion from the latter 1990s until 2006, enabling homeowners to consume, and borrow, without cease, driving the economy onward from the collapse of Nasdaq stock prices in 2000/01 and the Al Queda attack upon the Twin Towers in 2001. Real estate construction, and employment, became the leading sector of the economy. That persisted until the beginning of 2006, when residential investment began to fall off. Over the previous 3 years, such investment –reaching 6 percent of total product- was a source of 15 percent of the growth in GDP. By November 2006, when new home permits had fallen by 28 percent relative to the previous year, it was clearer, at least to some, that a serious problem was brewing.

On the other side, securitization of mortgage debt became a major source of financial sector expansion. These were sold on by an expanding number of mortgage bankers to banks and other institutions, who in turn repackaged them and sold them off to other investors. Commercial and investment banks utilized structured investment vehicles (SIV), off balance sheet assets, to increase their profitability by increasing their leverage. Progressively more complicated financial instruments were created, collateral debt obligations (CDO), and novel financial assets progressively moved beyond their physical counterparts and were rapidly sold off to others. Mortgages increasingly became sub-prime, requiring little evidence of ability of purchasers to service them. Derivatives, unregulated, became widely used as a means to augment financial leverage. Credit default swaps (CDS), an insurance device guaranteeing asset values in the event of failure, proliferated as well.

By September 2007, responsive to sudden increase in the LIBOR rates as banks became hesitant to place their excess reserves on deposit with other banks, the Federal Reserve Bank reacted to slowing real growth by lowering interest rates from 5.25% to 4.75%. That was just the belated start of a process that, by the end of 2008, had accelerated to a Federal Reserve rate of close to zero. In between came a massive financial collapse in September 2008, and major government fiscal intervention (TARP) of $700 billion to try to offset the increasing evidence that this decline went beyond a typical business cycle. Indeed, right after the inauguration of Obama in January, 2009, came another fiscal program, the American Recovery and Reinvestment Act (ARRA), involving $787 billion of expenditure increases and tax reductions to seek to counter a decline.

This measure is now running down. Many on the left are hoping for an immediate supplement, emphasizing the need for greater direct expenditures, with its greater multiplier effect than tax reductions, to revive a sagging economy. On the right, the need is seen differently: to sustain the Bush tax reductions for the indefinite future, allowing private, rather than public, demand to serve as the basis for future expansion. President Obama has just sought to launch a new expenditure program, joint with permanent tax reductions for investments and continuing lower tax rates for couples below

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[3] Robert J. Shiller, *The Subprime Solution: How Today's Global Financial Crisis Happened, and What to Do about It*, (Princeton University Press, 2008), p. 29. Author's italics.

an income of $250,000. Election in November will determine whether either view elicits a majority over the next two years and enables any coherent policy to emerge.[4]

Initially, there were hopes that the crisis might be limited to the US, and then just to the developed nations. Within the globalized structure of trade and capital flows that had grown up, the possibility of delinking the expanding developing world from the rest had been surging within a number of countries. Latin America was prominent in such a view, given the historic importance of import substitution as well as the current predilections of Hugo Chavez and others to boycott globalization. Despite the many structures that had arisen, from IBSA, involving India, Brazil and South Africa, to UNASUL in South America, that independence was fictional. By the last quarter of 2008, that became crystal clear. All countries were involved. Further, the active response of the leading developing countries made a difference in the speed of subsequent recovery.

International trade began to go up as 2009 proceeded, continuing into 2010. Product growth has resumed on a global scale. The world economy has increasingly become dependent upon the performance of the developing countries. China, India –and Brazil- have become responsible for something like 40 percent of increasing income in 2010 and are projected to continue in that lead role in the future. Indeed, one reason for recent slower US expansion in the second quarter of 2010 has been the resumption of expanding imports: the current account deficit, instead of continuing downward as earlier, has moved up, thereby diminishing the effect of increased exports.

In this brief essay, rather than pursuing this recent history in greater detail, I want to focus on three questions of current interest. First, I discuss double dip recessions in the US and argue that earlier historical experience in the 1980s has only modest similarity to what is now occurring. The cycle of 1937, eight years after 1929, can not even be classified as a double dip recession, although some seem to try. Second, I take up a true differentiating characteristic of this Great Recession, the high rate of unemployment experienced in the US, and its slow adjustment to improving income. Third, I consider the further adjustments required for any US recovery to serve as a permanent basis for renewed global economic expansion. Here is where all of the preoccupation about the increased level of US, and EU and Japanese, public debt enters. Equally, there is a widening division between the US and EU as emerged in the Toronto G-20 meeting at the end of May.

*Double-Dipping*

Talk of double dip recessions is now very much *au courant*. A Google visit to the internet offers 1.5 million options within 0.26 seconds. Economists, academic as well as those employed within the financial sector, as well as numerous amateurs, have been recalculating the probabilities of renewed decline frequently as recovery has faltered. Newspaper headlines regularly appear, dependant on regular publication of new data, and predictable changes in the stock market occur.

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[4] On the left, Paul Krugman has emerged as a preeminent proponent of increased spending in his regular columns in the *New York Times*. On the right, the selection is less obvious, although there is Sarah Palin. The editorial pages of the *Wall Street Journal* provide a more resonable alternative.

In point of fact, double dip recessions, defined as another downturn within a year of exit from a past decline, are quite rare. Deutsche Bank only discovered three within the US, going back to the 1850s and 33 historical cycles. Two occurred in the immediate vicinity of the First World War, beginning and end, in 1913 and 1920. Both examples seemed to be associated with a mild initial decline followed by a more severe subsequent fall. Thus an industrial production index declines, from peak to trough, by -9.1 percent in 1910, and by -12.1 percent in 1913. After the war, circumstances are more dramatic: -6.2 percent in 1918, and -32.5 percent in 1920. The latter is one of the most severe cases on record, exceeded only by 1929, 1937 and 1945.[5]

The third is identified in 1980 and 1981-2, and serves as a frequent reference for current discussion. An initial decline was brief in 1980, associated with rise and subsequent rapid decline in interest rates. While industrial production dropped by 6.6 percent, the trough occurred after only 6 months. The Federal Reserve, after Volcker's appointment, responded to high and mounting inflation rates in the 1970s by adopting a different strategy. Increased OPEC prices and a deteriorating exchange rate created problems. Inflation reached 11.3 percent in 1979. The Federal Reserve in October 1979 switched to controlling the quantity of free reserves in the banking system rather than focusing on the interest rate. As a consequence of such controls, interest rates rose rapidly, peaking close to 20 percent by March 1980. Then the government placed, direct controls on expansion of consumer credit, reducing consumption considerably. Output fell rapidly enough to cause their removal by July, when interest rates had gone down to 9 percent. That did not much help recovery, and inflation still mounted to 13.5 percent during 1980.

One should note, however, that the calculated annual rate of real growth between 1974 and 1979 comes out to 3.6 percent, almost equal to previous trend growth. While inflation was certainly high at the very end of the decade, the oil price enters as a principal factor. Stagflation is a term Reagan made popular during the election campaign of 1980 by emphasizing a misery index, adding together the inflation rate and the rate of unemployment that Carter himself had used to win in 1976. Sometimes one loses sight of actual performance.

Reagan, not surprisingly, given economic conditions, defeated Carter and became president in January. The Federal Reserve sustained its restriction on reserves and monetary growth, setting off the next, longer and deeper, cycle in July 1981 lasting until November 1982. Interest rates went back up sharply, this time affecting bank failures and sharply cutting back on housing construction. Unemployment increased to more than 10 percent. Over the period as a whole, GDP growth was minimal: something of the order of .5 percent a year from the third quarter of 1978 to the second quarter of 1982. That compares to post-war growth from the beginning of 1947 to the third quarter of 1978 at an annual rate of 3.8 percent.[6] In Chart I, measuring quarterly annualized changes in GDP, this W pattern of the early 1980s is quite clear.

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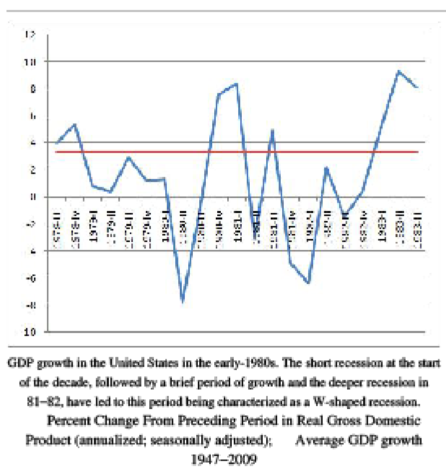
[5] Christina D. Romer, "Business Cycles," *The Concise Encyclopedia of Economics,* www.econlib.org, Table 2.

[6] See Steven Gjerstad and Vernon L. Smith, "Household expenditure cycles and economic cycles, 1920-2010," June 2010, p. 11.



GDP growth in the United States in the early-1980s. The short recession at the start of the decade, followed by a brief period of growth and the deeper recession in 81–82, have led to this period being characterized as a W-shaped recession. Percent Change From Preceding Period in Real Gross Domestic Product (annualized; seasonally adjusted); Average GDP growth 1947–2009

What makes this episode comparable to the present period? It surely is not inflation. Recent price increases rates have remained low, and while the rise in oil prices in 2008 to a peak of $150 a barrel had some influence, that circumstance was subsidiary to the downturn already underway. The implicit GDP deflator comes out to an annual change of 7.1 percent in the years 1974 to 1979, versus 2.8 percent in the years 2002 to 2007. Nor is it the preceding rates of growth. Here the comparison works the other way round: the annual rate of growth over the period 2003 to 2007 is a lesser 2.8 percent compared to the 3.6 percent in the earlier years.

Nor is it the details of the policy adopted. The Federal Reserve in the earlier period had actively to restrain the economy to combat inflation, at the expense of unemployment, whereas this time around the task was quite different. Real demand fell dramatically in 2008 after only moderate previous growth, very much driven by housing investment. This time, expansion of Federal Reserve assets was quick and massive in 2008, by more than a trillion dollars, as was the decline in interest rates. The concern, now, is the need for additional invigorating policies as the economy appears to be flagging. Ben Bernanke has made clear the intent of the Federal Reserve is to continue making credit available.[7] Moreover, because the current situation remains in doubt, more attempts at a fiscal stimulus have already emerged in Obama's recent speeches.

[7] Ben Bernanke, in his August 27 2010 speech in Jackson Hole, Wyoming, made clear that the repayment of some of the mortgage-backed securities would not lead the Federal Reserve to reduce its outstanding credit at just the time when concerns about a continuing expansion were beginning to seethe. Equally, however, he made clear his doubts about further fiscal impetus, emphasizing private sector recovery.

In only one dimension does the comparison between the 1980s and the present make sense. That is the equivalence of residential investment as a dominating element in the downturns, as well as the temporary recovery in 1980. Earlier, in the 1980s, there had been bank failures and difficulties with savings and loan intermediaries, but the extent of the problem was limited.

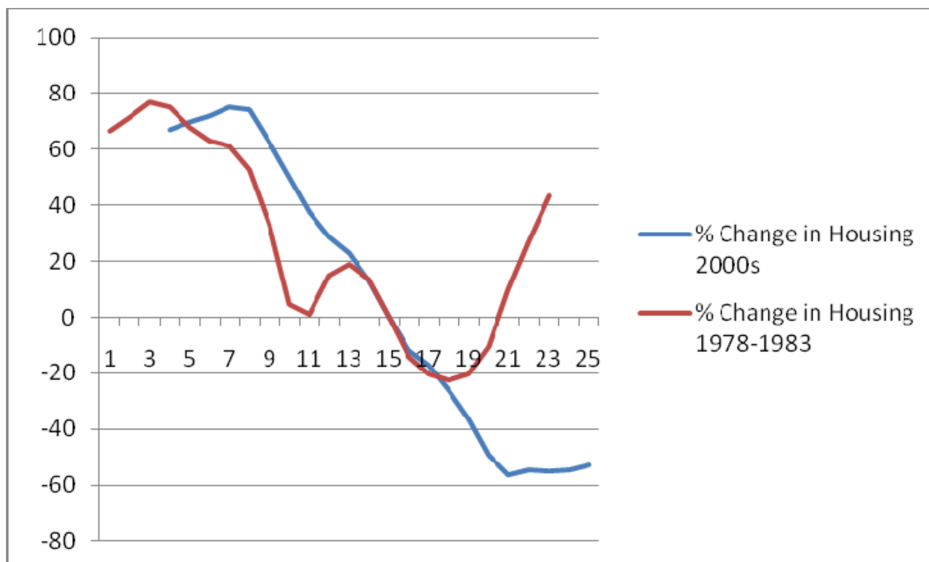



Chart II presents a graph of quarterly real investment expenditures in new housing.[8] The x-axis measures quarters over time; the first quarter of 1978 is the beginning for one line, and the second quarter of 2004 for the other line. The y-axis measures percentage changes relative to the base quarter for each of the series: these are 1981Q3 and 2007Q4, the NBER beginning points of the respective recessions.

One can clearly see the brief reversal in 1980, followed by renewed decline in 1981 that set off the second, and more serious, downturn. But that came to an end in early 1983, leading the recovery that took place. There was no such reversal the second time, until the very, very small rebound in 2009. One reason for that was the special Federal tax rebate encouraging home owners. That now has ended, and new efforts are afoot to deal with the problem. Some do not see a bottom until 2013, and thereafter only slow improvement.

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[8] These data come from the Census Bureau, and refer to investment in new housing. Note that total private housing investment includes renovations, and is therefore larger, and slightly less cyclical. This chart is far different from the one presented on the Bloomberg Businessweek site, which somehow shows the expansion in housing starts from April 2009 to April 2010 as equivalent to the first 1980 cycle from June 1980 to May 1981. That is part of the double dip frenzy going on.

Housing starts are presently at the lowest level recorded, a fraction of what they had earlier been despite the increased size of population. This decline has a double effect. For one, the level of investment has so fallen that any further fall will have minimal effect upon the subsequent economic activity. For another, given the very large number of vacancies, and of continuing foreclosures, one cannot expect an early housing recovery to serve as a basis for a subsequent large expansion as housing investment has frequently done in the past.

The geographic dimension of the present problem is greater than earlier. There is higher geographic concentration of foreclosures in the recent years, as compared with the 1980s. Four states, Arizona, California, Florida and Nevada were the leaders in the subprime mortgage boom. This housing crisis occurred within the states whose population was expanding and where the service sector dominated, rather than within the old industrial states. Migration, and immigration, played a role in this new regional distribution of population.

Finally, a significant difference in the two residential cycles was the role of housing price increases in the recent bubble, as compared to the previous experience. There was no real gain until the 1980s, then coming to an end. In the recent period, large and continuing capital gains by home owners translated into reduced personal savings and increased demand for consumer durables. This afforded abundant opportunity for imports, and underwrote reduced domestic manufacturing activity. Tax reduction, and the wars in Iraq and Afghanistan, translated into fiscal deficits increasingly financed abroad.

*Unemployment*

What differentiates the current downturn from earlier post-war declines is the much higher continuing level of US unemployment. The early 1980s briefly saw a comparable absolute level of 10 percent, but that started from a higher natural rate of unemployment, then supposedly close to 6 percent. In the early 2000s, in the midst of the gains in construction and the service sector, the rate had fallen to about 4 percent. In the 1980s, the percentage unemployed began to decline continuously shortly after the cycle had bottomed out, whereas now, despite a comparable output fall, the high level has barely budged. The *New York Times* headlined its story on the end of the recession, "Recession May Be Over, but Joblessness Remains."[9]

This experience is clearly different. The Okun rule that had fit so well since the late 1960s, whereby changes in the unemployment rate are a function of half the difference between the potential and actual rates of growth, no longer seems to apply.[10] That is the reason why the initial Obama administration projections of peak unemployment in early 2009 of less than 8 percent were so far off. Large corporations reduced the size of their labor forces in 2008 and 2009, contributing to high productivity gains. Whereas in the 1980s, part of the high unemployment rate was explained by

[9] Tuesday, September 21, 2010, p. B1.
[10] See the treatment in the Council of Economic Advisors, *Economic Report of the President, 2010*, pp. 73ff. where this point is explicitly made.

temporary lay-offs –contributing to the subsequent rapid decline of those out of work- that percentage currently has been only half as great.

This anomaly, different from much of the European experience despite their smaller fiscal deficits relative to GDP, has become a central part of the current political debate in the US.[11] Concern with unemployment reflects itself in the rising antagonism toward illegal –and even legal- immigration. Repeated extension of unemployment benefits beyond their original expiration date has occurred. Programs encouraging small business formation and infrastructure investment have been favored by the Obama administration by virtue of their higher labor intensity. But poverty increases, and an increasingly dual labor force showing increased returns to advanced education and a much larger portion of long-term unemployed, those beyond 26 weeks, help to explain the present public unhappiness, and apparent unwillingness to return to the previous high consumption that had driven previous growth over the last decades.

Federal spending for extending unemployment benefits has been necessary. Originally limited to 26 weeks in individual states, aid for longer periods has now been provided by Washington, bringing the total to a maximum of 99 weeks. In 2010, it is estimated that something closer to $175 billion will be expended for this purpose, more than twice the sum in previous years. Overall, this has been the most costly Federal stimulus addition from 2008 to the present, with a total price tag approximating $300 billion.[12] About 75% of the unemployed receive compensating benefits. Others, self-employed, temporary workers and those who quit, do not.

This has led the Obama administration and its supporters to use counterfactual techniques to assess the significance of the fiscal measures actually undertaken. A recent example is the paper prepared by Alan Blinder and Mark Zandi, using the Moody's Analytics model of the US economy. There they come to the conclusion that the downturn would have continued through the end of 2010, contributing to a peak-to-trough decline in GDP close to 12% instead of the 4% actually occurring. In particular, "the unemployment rate peaks at 16.5%, and although not determined in this analysis, it would not be surprising if the *under*employment rate approached one-fourth of the labor force." [13]

Such an estimate of the employment consequences goes well beyond the assessment of the Council of Economic Advisors or the Congressional Budget Office. The latter calculates an effect –also using macroeconomic models-that suggests, as a maximum, a reduction of unemployment from about a 12% percent level as a result of ARRA. Similarly, they show the positive effects on GDP to vary from 1.7% to 4.5%, at most, half as much as the Blinder and Zandi study. On the other hand, the CBO analysis shows

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[11] High rates of unemployment in the EU in Spain, Ireland and elsewhere, have also been especially associated with large previous increases in construction activity.

[12] Congressional Budget Office, "Losing a Job During a Recession," April 22, 2010, pp. 5ff. Alan Blinder and Mark Zandi, "How the Great Recession Was Brought to an End," July 27, 2010, p. 16.

[13] "How the Great Recession Was Brought to an End," p. 4.

that the benefit-cost ratio from a policy of unemployment benefits exceeds virtually all others that have been suggested. [14]

Analysts on the right are critical of these results. They suggest that fiscal multipliers are much exaggerated.[15] Indeed, as a consequence of rational expectations, effects of increased outlays could turn out to be less than one by virtue of crowding out effects. The preference on this side is policies that enhance private sector decisions through tax cuts. Some commentators take advantage of the extensive academic literature on the subject, by picking and choosing among papers until they find one offering a conclusion supporting their political predilections, and then they cite it, but not the others, to justify their position.[16]

Current estimates, on virtually all sides, suggest that the unemployment rate will stay quite high until 2012, and will descend to a full employment level of 5 percent only by 2015. Moreover, there is a correspondingly greater level of unemployment among ethnic minorities; the rate among blacks is 16.3% and 12% for Hispanics, compared to a rate of 8.9% for whites. Such disparity is not unusual. It has been characteristic of past cycles as well. What is different is the extent of unemployment among the young, less than 25 years old, and among those with lesser education. That is one of the reasons that educational reform has become an important component of policy.

Numbers in poverty in 2009, just published, have risen to more than 14 percent of the population. Some expect the level to continue upward to exceed 16 percent and to remain high. Children are disproportionally included: one in five currently; for blacks, the proportion rises to one-third. On the other side, the income distribution has become progressively more unequal. The degree of inequality as measured by the Gini coefficient has been regularly climbing since the 1980s and currently approaches the level of the 1920s. Returns to higher education have gone up. Much of the gain in income in the last decade has found its way to the richest 10% of the population, although the stock market decline and the fall in real estate prices may check that tendency, at least temporarily. That is the reason why the Obama administration has emphasized an increase in taxes for the rich while maintaining current lower levels for others. The middle class, a bulwark of the United States, has been eroding in its average relative income.[17]

The Republicans have opposed extension of additional unemployment benefits to cope with this substantial problem. Their campaign for the mid-term November election was based upon public unhappiness with unemployment and the increasing size of the national debt. That occurred despite the strong Democratic advantage over Republicans in all the polls asking about policies dealing with

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[14] CBO, "Estimated Impact of the ARRA on Employment and Economic Output, April 2010-June 2010," Table 1. For the comparison of benefit-cost ratios see CBO Director Douglas Elmendorf, "Fiscal Policy Choices in Uncertain Times," September 16, 2010, p. 11.

[15] There has been a flourishing of academic research on this topic over the last two years. References can be found at the end of the regular CBO reports estimating the effects of ARRA, as well as new contributions available on the voxeu internet site.

[16] One can find examples in the extensive production of the Heritage Foundation and the Cato Foundation, among other groups. A recent paper supporting the view that job growth was modest in response to stimulus is Daniel Wilson, "Fiscal Spending Jobs Multipliers: Evidence from the American Recovery and Reinvestment Act," *FRBSF Working Paper Series*, 2010-17, September 2010.

[17] The discussion in the *Economic Report of the President, 2010*, Chapter 8, goes into these matters much more extensively.

unemployment. Most people believe the Democrats will be better in resolving this matter. But as Charles Boustany of Louisiana said, for the Republicans in the House of Representatives, there is need "to pay for the unemployment extension from already appropriated funds."[18]

The Republican preference is to highlight the size of the current fiscal deficit –in excess of 9 percent- and to emphasize a need for reduction in expenditures –but not increases in taxes- to compensate. A ballooning national debt has clearly emerged. But whereas the EU, equally faced with an increasing debt, has indicated its immediate commitment to reduce fiscal deficits at the Toronto G20 meeting, the Democrats want to use continuing short-term fiscal stimulus –not enough for the left- postponing treatment of the debt problem until recovery is more self-sustaining.

*National Debt*

At the recent ILO conference on unemployment, Olivier Blanchard, Chief Economist of the IMF, faced the issue directly: "On the fiscal side, one of the issues in the United States is that there are uncertainties about the medium and the long term. There are some uncertainties that the government at this stage has yet a fully clear plan to stabilize debt. That makes markets nervous, so this is probably something that should be done. When that occurs, the American government would have more room to consider programs like subsidies for the unemployed."[19]

The question comes down to policy sequence.

European countries, very mindful of the evolving problem of Greece, with its great fiscal deficit and accumulated national debt, have had little alternative but to emphasize that as the principal policy focus they have committed to tackle. They clearly did so at the Toronto meeting of the G-20 at the end of June. There was a joint commitment to halve fiscal deficits by the end of 2013, and to begin reducing the debt to GDP ratios by 2016. An evaluation of EU financial institutions, similar to the US review from late February to April 2009, was undertaken, with a strong positive finding. In July, only 7 of 91 banks were found to be deficient, involving E3.5 billion. In the US, 15 months earlier, the total was $74.5 billion.[20] Still, the credit default swap rates remained high in late September, not only for Greece at almost 900 basis points, but Ireland and Portugal are not too far behind at 442 and 362 points.

The Basel Committee has now recommended a substantial increase in equity capital to 4.5% from 2%, as well as a rise in Tier 1 reserves. A countercyclical buffer, plus additional capital for systemically important banks also has been put in place. These requirements are to take effect beginning in 2013.[21] They represent a response to the financial crisis roiling the international economy in 2008 and 2009. New legislation in the US goes beyond, and sooner, and the EU is undertaking its own efforts.

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[18] www.ibtimes.com, July 22, 2010.
[19] *New York Times*, September 14, 2010, p. B3.
[20] www.businessweek.com, July 27, 2010. Part of the reason required capital was so small was that losses on government securities were registered only on those traded rather than held. Another reason was the low Tier 1 Basel target at that time of 6%.
[21] www.basel.org, September 12, 2010.

In the US, while supporting the Basel action and reluctantly agreeing to the G20 target for fiscal deficit reduction, efforts have been oriented to sustaining public sector demand, especially as recovery has slowed. Indeed, new monthly GDP estimates show declines in output in May and June, the most recent available, and non-farm payrolls are still lower than their level fifteen months ago. This is where popular attention is focused. The report of the bipartisan Fiscal Commission appointed earlier in the year comes after the election.

On the debt issue there is also disagreement about whether the gross debt, including intra-governmental holdings, dominantly social security funds, or debt held by the public is the relevant magnitude. The former, now above 90% of GDP, contrasts with the lesser 60% of the latter. Needless to say, administration opponents prefer the higher number, while the Council of Economic Advisors has focused exclusively on debt held by the public, and the size of the primary deficit. Interest costs are now quite low, but that special circumstance will end. With the need to redeem accumulated social security bond holdings in future years, moreover, the difference between the measures will narrow and move toward the gross debt.

There is the related subject of whether the US is close to a debt threshold. Kenneth Rogoff and Carmen Reinhart believe so. They have used a gross debt/GDP cutoff of 90 percent as a predictor of lower future growth (and higher inflation). "Dismissing debt concerns at this time is tantamount to ignoring the proverbial elephant in the room."[22] But, possibly by reforming medium-term entitlements now, and assuring public confidence, one can allow scope for shorter-term deficits, and rising debt, to deal with unemployment and faster recovery.

There is a third factor entering as well, an increasing dependence upon external purchasers of debt. Today, foreigners hold more than 40% of the public debt, with China and Japan responsible for a bit more than half of that. Will such creditors demand higher real interest rates, thus leading on to a disequilibrating sequence of larger deficits and accelerating inflation? That is an undesirable exit route that some advertise as an inevitable consequence of refusal to restrain deficit spending now.

The Congressional Budget Office projections are sobering.[23] Their realistic scenario shows the debt held by the public rising to 87 percent by 2020 and 185 percent by 2035. Interest charges mount from 1.4% of GDP in 2010 to 8.7% of GDP in 2035. When additional indirect consequences such as crowding out of private investment are taken into account, the situation further worsens. This is not all the product of inadequate macroeconomic policies. An aging population over 65, from 13% in 2010 to 20% in 2035, much contributes to the need for higher future tax revenues by virtue of greater social security and health outlays.

These prospects indicate a need for remedial action soon, but not necessarily immediately. Government revenues will have to rise and expenditures will have to be reduced in order to achieve consistency. The longer one waits, the greater is the consequent burden that will have to be borne: an adjustment of 4.8% of GDP in 2010 translates into an adjustment going forward of 12.3% in 2025. Postponement has real costs to compensate for its current political advantage.

[22] VoxEU.org, August 11, 2010.
[23] CBO, "The Long-term Budget Outlook," rev., August, 2010.

*Conclusion*

The difficult circumstances confronting the US economy will not lead to the double dip many observers have predicted. That is about the only good news. Unemployment will not soon diminish from its current high level and the labor force return to full employment. Public indebtedness will not reach its long term equilibrium over the next few years, but will continue to rise as fiscal deficits accumulate.

This is not a very positive outlook. The present recovery does not recapitulate post-World War II cyclical US experience. Moreover, the external world is rapidly changing with the emergence of China and India, and potentially Brazil. Yet global imbalance in current accounts is apparent and threatens continuity. Even while the G-20 has become a permanent institution, there is a limited degree of international economic cooperation among the member countries, even within the EU.

In these changing times, economic policy becomes ever more an art rather than a science, and ever more subject to national political pressures. At a time when international coordination is ever more necessary, we seem to be moving in the opposite direction.