Growth STRATEGIES

LA JOLLA INSTITUTE

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IN THIS ISSUE: WHY I'M SHORT-TERM PESSIMISTIC, LONG-RANGE OPTIMISTIC

1 – WHAT ECONOMIC RECOVERY?

The great recession supposedly ended four years ago, but the subsequent recovery has been pitiful. Income, production and job growth are meager. Why is the current recovery so weak? According to Lee Ohanian and John Taylor, poorly designed and implemented government policies have impeded capital and technological investments and hiring. In other words, bad government policies – not underlying problems with the US market economy – are the primary reason why the economy has not recovered.

Since the fall of 2008, the US government has adopted dozens of policies that were advertised as being necessary to restore prosperity. These policies impacted many key economic channels, including monetary and fiscal policies, commercial and investment banking, manufacturing, housing, and the environment. But many of these policies have depressed growth by distorting the normal forces of supply and demand that are critical for a market economy to function well and create new jobs. Many of the policies that were implemented were based on old Keynesian models that advocate temporary spending increases and one-time tax rebates, while others created new regulations of economic activity in key sectors. But both of these policy responses misdiagnosed the problems facing the American economy, write the authors. The spending policies had little impact on the economy other than to increase government debt, and regulatory policies raised business costs and depressed growth.

The centerpiece of the old Keynesian stimulus policies was the 2009 $821 billion American Recovery and Reinvestment Act (ARRA), which combined temporary tax cuts with federal funds for national, state, and local government spending. President Obama's economic advisors stated that the ARRA would keep unemployment from rising above 7.9%, and would restore employment to its pre-recession trend around 2013. But the US labor market remains severely depressed today, and is nowhere near its pre-recession trend. There are two important reasons why the ARRA failed to restore jobs, write the authors. One is that attempts to stimulate spending likely had a much smaller impact than was advertised. The second is that the type of spending that was supposed to be undertaken – including investment in government infrastructure – simply did not materialize in any significant way. State and local governments did not use these federal funds to significantly expand infrastructure spending. Instead, these governments increased transfer payments and reduced debt, and the nation's employment rate continued to decline.

Other spending policies were aimed at propping up the hard-hit auto and residential construction industries. These policies included "Cash for Clunkers," which provided some new car buyers with payments between $3,500 and $4,500 by turning in an old car that was scrapped, and the Homebuyer Tax Credit, which provided some buyers of houses a tax credit of $7,500. These policies did little to strengthen either industry. Sales of autos and homes temporarily increased while these policies were in place, but then sales declined sharply once the policies ended. These policies were pure subsidies to some auto and home buyers, with little if any impact on the industries that were supposed to be helped.

Other policies imposed new regulations on key sectors of the economy, including the Dodd-Frank financial regulation legislation that regulates many aspects of banking and financial intermediation. Dodd-Frank was intended to solve the nation's "too big to fail" problem, in which very large and complex banks would be bailed out should they face insolvency. But Dodd-Frank codifes the too big to fail problem. It allows regulators to identify banks deemed to be too big to fail, thus giving them certain advantages over small banks, and at the same time the legislation substantially raises the costs of doing business, particularly to smaller banks and particularly in the area of making home mortgage loans.

What will it take to get the US economy back on track? According to the authors that requires restoring transparency and simplicity to the tax code, including reducing the US corporate income tax rate, and reducing marginal income tax rates, which now exceed 50% in some states. In addition, growth will be enhanced by labor, energy, and environmental policy changes that make it less costly to hire workers and reduce the cost of becoming energy independent. When these changes are made, say authors, the US economy will recover strongly. But without these changes, the US economy will continue to significantly underperform, just as it has for the last four years.

2 — ADVANTAGE AMERICA

A. Gary Shilling writes there are six reasons the US will dominate the future.

1. DEMOGRAPHICS

The US fertility rate of 2.06 is close to the 2.1 births per child-bearing woman needed to sustain the population in the long run.

In contrast, the fertility rates in all European countries and even Canada and Australia are below the reproduction level. Japan's, the lowest at 1.39, is compounded by the total lack of any immigration. China's fertility rate is just 1.55 because of the one-child-per-couple policy, which the government is reconsidering.

By 2040, the US working-age population ratio, 60.3%, is projected to be the highest of any developed country. China's ratio falls rapidly from 72.4% in 2010 to 63.1% in 2040 due to its one-child policy; new labor force entrants age 15-24 are already declining in number.

Even if the 2 million people who left the labor force in the last two decades for non-demographic reasons never re-enter because their skills are rusty or they prefer disability benefits and food stamps, it won't impede robust real GDP annual growth of about 3.5% after our "Age of Deleveraging" is completed.

2. ENTREPRENEURIAL SPIRIT

Another big advantage for the US is the American entrepreneurial spirit, observed by de Tocqueville in the 1830s and still going strong today. Despite perceptions of an erosion of US economic vigor, America still seems way ahead of whoever is in second place. It starts with the education system, which has many faults but does encourage free inquiry and the challenging of accepted doctrine.

3. LABOR FLEXIBILITY

An added long-term advantage for the US in international competition is her flexible labor markets. Labor unions are becoming a thing of the past, especially in the private sector and now increasingly among state and local employees.

The auto industry is a case in point. After the Great Recession drove GM and Chrysler into bankruptcy, US automakers introduced $14 per hour wages for new employees, half the level of veterans. So in 2011, the average pay of US autoworkers including benefits was $38 per hour compared to $66 in Germany and $37 in Japan. US pay has increased $3 per hour since 2007, but $12 in Japan and $14 in Germany. As a result, vehicles from US auto plants are beginning to be shipped abroad in numbers.

4. DECLINING NEED FOR FOREIGN FINANCING

An additional major advantage for the US in future years is the likely decline in dependence on foreign financing.

Americans have little choice but to save more. They no longer trust their stock portfolios as they did in the 1980s and 1990s to substitute for saving out of current income to educate their kids and finance early retirement. The nosedive in house prices after heavy cash-out refinancing of mortgages and home equity loans has removed much of the home equity they earlier used to finance oversized spending. The postwar babies have been notoriously poor savers and desperately need to keep working and save much more for their old age.

As the saving rate rises, the US will meet more of its financing needs internally.

5. STRONG DOLLAR

A rising dollar is another long-run advantage for the US in the global arena, reflecting the economic, political and financial strength of America as well as the buck's continuing status as the world's primary reserve and trading currency.

6. ENERGY INDEPENDENCE

America is on her way to self-sufficiency in energy. To the dismay of Peak Oil devotees, horizontal drilling and fracking technology have unlocked from shale oceans of natural gas and petroleum. Combined with the oil sands in Canada and other nonconventional sources of energy as well as higher auto fuel-efficiency and other conservation measures, there are predictions that the US could be relatively free from foreign oil dependence by 2020. Cheap natural gas is a competitive advantage for US producers, especially of petrochemicals and nitrogen fertilizers.

Leaping American oil and gas production has created a global energy supply cushion that allows the US to deal with Iran and other trouble spots without debilitating spikes in oil prices.

3 — LUCKIEST GENERATION IN HISTORY

Millennials face an uphill climb, reports the [Wall Street Journal]. More demanding job requirements, coupled with the pressures of the recession, have delayed the transition to adulthood for young people in the past decade and earned them the title of "the new lost generation," according to a report from the Georgetown University Center on Education and the Workforce.

But [Mark Perry writes] that today's young Americans are the luckiest generation in history.

To demonstrate how free market capitalism and "the miracle of the marketplace" generate increased prosperity over time for average (and especially low-income) Americans, economist W. Michael Cox has compared the purchases at different points in time from the income earned by college-bound teenagers working at a full-time, minimum-wage job for 12 weeks during the summer (ignoring taxes). Here's a summary and update:

In 1973, the minimum wage was $1.60 per hour and a full-time summer job at 40 hours per week for 12 weeks would have generated $768 in total summer earnings for a college-bound teenager (ignoring taxes). Using retail prices from a 1973 Sears Spring and Summer Catalog, a college-bound student in that year would have been able to purchase the following five items for his or her college dormitory room using their entire pre-tax summer earnings of $768 from a minimum wage job: an electric typewriter, pocket calculator, portable TV, tape player and compact refrigerator.

Now compare that pretty pathetic group of five items in 1973 to the cornucopia of 19 electronic and household items that could be purchased by a teenager or college-bound student heading off to a dormitory this year with summer earnings of $3,480 (ignoring taxes) from working at the current minimum wage of $7.25 per hour, based on prices from the Best Buy and Amazon websites: laptop computer, iPod, iPhone, iPad, GPS, digital camera, printer, HDTV, Blu-Ray Player, home theater system, compact refrigerator, PlayStation, Kindle, sonic toothbrush, iPhone and iPod dock, DVR, satellite radio receiver, espresso maker, financial calculator.

Pretty amazing contrast, isn't it? And keep in mind that today's inflation-adjusted minimum wage is actually 14% below the minimum wage in 1973, so today's teenagers would actually have more than $4,000 to spend on today's electronic gadgets if the minimum wage was adjusted to $8.43 per hour to make it equal to the 1973 minimum wage on an inflation-adjusted basis. Further, according to BLS data, 79% of workers ages 16-19 years old earned *more than the federal minimum wage last year* of $7.25 per hour, so a large majority of teenagers working full-time over the summer would have actually earned more than the $3,480 amount used in the analysis above.

According to Cox, the summer-job at the minimum wage comparison above tells us that "When it comes to their economic prospects, today's young Americans are the 'luckiest generation' in history – at least until their children grow up and forge an even luckier one. And even if real wages are flat, the explosion of new products over time at lower and lower prices translates into a rising standard of living for all income groups, even minimum wage workers."

Cox makes a key point that even when real wages or real household incomes are stagnant over time, we are still most often experiencing increases in our real standard of living, due to the explosion of new consumer products that become available at ever-cheaper real prices. The 1973 vs. 2013 summer-job at the minimum wage comparison above illustrates that we've made a lot of economic progress over the last 40 years that has increased our national prosperity – and that march of progress has happened in spite of six recessions during that period, the stagflation of the 1970s with 18.5% mortgage rates and a 20% prime rate, the savings and loan crisis with almost 3,000 bank failures in the 1980s and 1990s, several major stock market corrections, and the Great Recession.

Today, even though the US economy is still struggling to fully recover from the Great Recession, and we've had sub-par economic growth and sluggish job creation for several years, our economic progress and a rising standard of living will continue unabated. The economic challenges facing past generations didn't stop innovation and prosperity in the long run, and neither will the current challenges stop prosperity from rising over time. Just like today's teenagers are exponentially more prosperous than their counterparts in 1973 and can afford items not available to billionaires of past eras, the teenagers 40 years from now in 2053 will likely be exponentially more prosperous than today's teens and will be able to afford products that today's billionaires can't even imagine, much less afford.