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How to achieve stronger U.S. growth☆

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1. Introduction

The United States faces two distinct challenges in raising our rate of economic growth. The first is to overcome the tepid pace of cyclical expansion since the current recovery began in the summer of 2009. The second is to raise the long-term potential growth of GDP.

I am convinced that there are a large number of policies that could make important contributions to growth in both the near term and the more distant future.

2. Stimulating short-term demand

The rise in GDP and employment since the recovery began in 2009 never reached the pace that was common in previous economic upturns. Real GDP at the end of each year has been less than two percent higher than a year earlier and employment has grown more slowly than population.

This very sub-par recovery occurred because the 2007 recession was itself very different from earlier downturns. Previous post-war recessions were caused by the Federal Reserve raising interest rates to deal with inflation. When the Fed achieved what it wanted, it lowered the interest rate and the economy bounced back. In contrast, the 2007 downturn was caused by a general mispricing of risks, including grossly overpriced houses supported by very high loan-to-value mortgages.

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House prices started to fall and mortgage borrowers began to default in 2006. Other overpriced assets also lost value. The falling prices of financial assets led to a dysfunctional financial market in which financial institutions were unwilling to lend to each other. Credit dried up.

In this condition, lower Federal Reserve interest rates could not generate a sharp recovery. Housing in particular was declining and not responding to lower interest rates.

The 2009 fiscal stimulus package was less than the GDP gap and so poorly designed that it added more to the national debt than it did to GDP.

The Federal Reserve's unconventional monetary policy lowered long-term rates but house prices continued to fall until 2012 and the stock market did not rise faster than corporate earnings until 2013.

The Federal Reserve's unconventional monetary policy has been the only policy stimulus in recent years but is no longer able to provide a substantial boost to growth. The near-zero interest rate policy and aggressive quantitative easing also create dangerous risks to future stability. The Fed is now cutting back on its bond buying and long-term interest rates are up significantly.

So fiscal policy is the best way to stimulate faster short-term growth. But while the *direct* effect of a large fiscal stimulus would be to raise GDP, the resulting increase in the national debt would be a drag on the economy as businesses and entrepreneurs cut back because they fear higher future tax rates and a sharp rise in future interest rates.

A feasible strategy for raising GDP and employment more rapidly in the remainder of this decade would therefore be to combine substantial reductions in the relative size of the *future* national debt with *immediate* permanent tax-rate cuts and a multiyear program of infrastructure spending.

The size of the five-year infrastructure program would have to exceed $1 trillion to achieve the needed rise in the economic growth rate. The lack of "shovel ready" projects is not an excuse for not pursuing this strategy or for diverting the funds into low-impact spending of the kind that made the 2009 stimulus so ineffective. It would be better to spend a year or two preparing for the right kind of spending.

But the short run fiscal stimulus will only increase GDP if it is combined with policies to reduce future government spending by enough to make the ratio of debt to GDP lower a decade from now than it is today. That can only be achieved by slowing the growth of Social Security and Medicare and limiting the tax deductions and exclusions that are really hidden forms of government spending (Feldstein, 2013a).

That is a politically tough prescription but the combination of the positive and negative tax and spending components could in principle achieve bi-partisan support. Without such a plan, we are likely to continue to have sub-par growth and employment.

3. Raising long-term growth

I turn now from stimulating demand in the current decade to policies that could raise real GDP in the longer term.[1] I divide these potential policies into three groups: increasing the labor force; improving the quality of the labor force; and increasing the rate and quality of capital accumulation. These policies would also accelerate technical progress through a more technically competent labor force and more capital accumulation. If there were more time, I would discuss policies aimed more specifically at increasing technical change.

[1] I discuss these and other ideas in *America's Challenge* (Feldstein, 2011).

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