

What Is Wrong With the Job Market And How to Fix It

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The Great Recession ended last summer, as the nation's GDP began expanding again, but this growth has not been sufficient to stem the loss of jobs—now more than 8 million and counting—or the rising unemployment rate that now sits in the double digits.¹ The job market is arguably as bad as it has been since the Great Depression, with nearly every industry, occupation, and region of the country suffering from weak labor demand. Layoffs have abated since the financial panic of a year ago, but the number of forced separations remains uncomfortably high. Even worse, hiring and job creation remain dormant.

The struggling job market is the most serious threat to the fledgling economic recovery. In a typical business cycle, recession occurs when consumer and business demand is undermined by a shock such as a surge in oil prices, a stock market crash, or—as in the current cycle—the bursting of a house price bubble. Businesses respond by slashing investment and payrolls to cut costs and stabilize profits. As they do, investors, who had driven down stock prices leading up to the recession, now bid prices up. With better profit margins and higher stock prices, businesses stop cutting and recession gives way to recovery. A self-sustaining expansion takes hold when businesses feel comfortable enough to invest and hire. In the current business cycle, profits and stock prices have risen, businesses have stopped cutting, and recovery has begun. But because employers have yet to resume hiring, expansion remains elusive.

Some firms may have found that they can produce more with fewer employees. Judging by a recent astonishing surge in productivity, businesses may only now be seeing the full benefits of the information technology revolution of a decade

ago. Making the changes needed to fully realize these benefits might have been too difficult in the good times, but in tough times, managers feel unfettered, and even compelled to do so, even (or particularly) if that means slashing payrolls. With so many out of work, managers may also sense they can require their remaining employees to work harder. Corporate profits and stock prices have jumped with the productivity surge, but businesses have yet to respond by expanding or hiring. Unless they do so soon, job and income growth will not be sufficient to support the spending necessary for a self-sustaining expansion.

Another somewhat hopeful explanation for the lack of hiring is simply that it needs more time to rev up. Many businesses suffered near-death experiences a few months ago, and their managers are not yet convinced that conditions are strong enough to justify expanding. Firms lack confidence that demand is strong enough to invest more and hire. It will take more time than in past business cycles for those animal spirits to return.

A lack of credit is also a problem, particularly for small and midsize firms that rely on credit cards and small banks for loans. Credit card companies and small banks remain under pressure and are pulling back. Lending standards have been significantly tightened, contributing to a sharp decline in the number of credit cards and commercial loans outstanding. Smaller businesses account for a surprisingly large share of the nation's job base, and if they are not able to get the credit necessary to expand their operations, the job machine will not start up.

Larger businesses may also be paralyzed by the uncertainty created by Washington's policy debates, over a range of efforts that have the potential to significantly impact the cost of doing business. Healthcare reform, financial regulatory reform, climate change legislation, and the expiring Bush tax cuts quickly come to mind. Businesses are always grappling

with policy uncertainty, but the stakes have arguably never been bigger than now.

To make the leap from recovery to expansion, the Federal Reserve and fiscal policymakers need to remain aggressive in supporting the economy. It is unlikely that the Fed will raise rates until unemployment has clearly peaked; the central bank may even expand its credit easing efforts early this year, rather than allow them to expire on schedule. Congress and the administration should also consider extending some provisions of the current fiscal stimulus package. These most obviously include unemployment insurance benefits to millions of workers who will lose jobs in 2010 and increasing financial aid to hard-pressed state and local governments. Providing more resources to the Small Business Administration and temporarily easing lending terms for small business loans also make sense. There is also a good case for a job creation tax credit, in the form of a payroll tax holiday for firms that add to their payrolls.

These policy efforts would be expensive, costing the federal government approximately \$210 billion over the two-year period 2010-2011. The costs are on top of the \$45 billion for recently passed legislation to extend and expand the homebuyer tax credit, provide more UI benefits to those losing jobs in 2009, and provide tax relief to some money-losing businesses. Yet the costs to taxpayers would be measurably greater if the economy does not turn the corner into expansion but instead retreats back into recession. With the unemployment rate already in double digits, a deflationary cycle of falling wages begetting falling prices, which leads to more wage cuts, could well take hold; at that point, policymakers will have no good response, given the 0% federal funds rate and the federal government's rapidly eroding balance sheet.

The nation has made significant strides in the last year; 12 months ago,

¹ This includes benchmark revisions to the payroll employment data already announced by the Bureau of Labor Statistics.

Chart 1: Lost in Unemployment
% of unemployed out of work for more than 27 wks

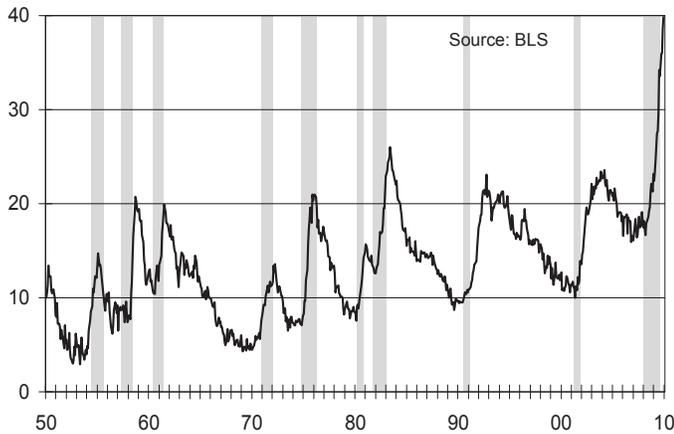
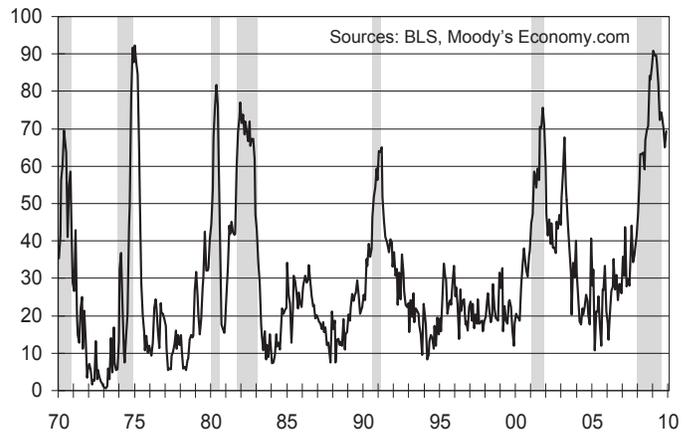


Chart 2: Every Corner of the Country Has Been Hit
% of metro areas suffering employment declines over past 3 mo



major financial firms were disappearing and the economy was in free fall. Yet the proverbial coast is not clear. The Great Recession has given way to recovery, but with firms still unwilling to add to their payrolls, it will take more policy help to ensure a self-sustaining economic expansion takes root.

How bad is it?

The severity and breadth of the job market's problems are clear. The unemployment rate has surged to 10%, despite a very unusual decline in the labor force.² Unemployed workers are likely leaving the job market, feeling there are no jobs to be had. Indeed, there are now almost six unemployed workers for each available position. In normal economic times, there is at most one unemployed worker per open position. If the labor force were growing at closer to the 1% annual pace that prevailed just before the recession, the unemployment rate would be well over 11%.³

For anyone who loses a job, moreover, it is extraordinarily difficult to find another. The average length of unemployment has risen above six months, and well over a third of the unemployed have been out of work for more than the 26 weeks that unemployment insurance normally covers (see Chart 1). Even in the early-1980s' downturn—the last time unemployment hit double digits—only a fourth of the unemployed were out of work that long.

During the worst recession of the 1950s, closer to one-tenth of workers were in this difficult position.

The unemployment statistics are bad, but they still understate the stress in the job market. Including those working part-time because they cannot find full-time work and those who want to work but are not counted as unemployed because they have not looked for jobs in the past month, the so-called underemployment rate jumps to 17.3%. This represents an astounding 27 million Americans. On top of that are those whose hours have been cut back; the average number of hours worked per week is at a record low.

Jobs are tough to get, and unemployment is high in every corner of the market. While the worst job losses have been in manufacturing and construction, unemployment has risen measurably across every occupation and demographic group. The only industry adding to payrolls throughout the recession has been healthcare. The unemployment rate for males between 45 and 54 years old, historically the most stable group in the job market, has surged past 9%. At the worst of the early-1980s' downturn, this group briefly suffered a 7% unemployment rate.

In every corner of the country, job markets are troubled. A year ago, meaningful job losses were occurring in over 90% of the nation's more than 380 metropolitan areas (see Chart 2). Even now, three-fourths of the nation's metro areas are experiencing losses. In most past recessions, a sizable region or two avoided the downturn; this time no area of the country has been spared. This has undermined one of the nation's historical

strengths: workers' willingness and ability to move.⁴ In the past, a laid-off auto worker from Michigan might relocate to Florida, and a displaced aerospace worker in Southern California could move to Las Vegas. That does not work today; the unemployment rates in Florida and Las Vegas are in double digits.

There are some encouraging signs. The rate of job loss is down significantly, from nearly 700,000 per month in the first quarter of 2009 to less than 100,000 in the fourth quarter. The decline in initial claims for unemployment insurance from a peak above 650,000 per week to 450,000 per week is also positive. Claims closer to 400,000 per week would be consistent with stable payrolls. The number of temporary jobs has also risen recently, a positive leading indicator, as businesses hire more temps before they add full-time employees. The hemorrhaging of jobs in manufacturing and construction, which together account for half the total losses to date, should end as soon as activity in these parts of the economy has clearly hit bottom. The Census Bureau will also soon begin hiring a few hundred thousand workers to conduct the 2010 Census. All this is good news, but not nearly good enough.

What is the threat?

Historically, changes in employment and unemployment closely follow changes in GDP. Output rises coming out of recessions

² The last time the labor force declined was nearly 50 years ago in the early 1960s. The statistics cited in this section are from the BLS.

³ The highest unemployment rate since the Great Depression was the 10.8% suffered in late 1982.

⁴ Also curtailing labor mobility is the situation of an estimated 15.6 million homeowners whose equity in their homes is negative. To move, someone whose mortgage debt exceeds a property's value must either raise cash, persuade the lender to accept a short sale, or default.

Chart 3: Without Government Help, Incomes Would Be Falling
Yr-over-yr change in after-tax income, \$ bil

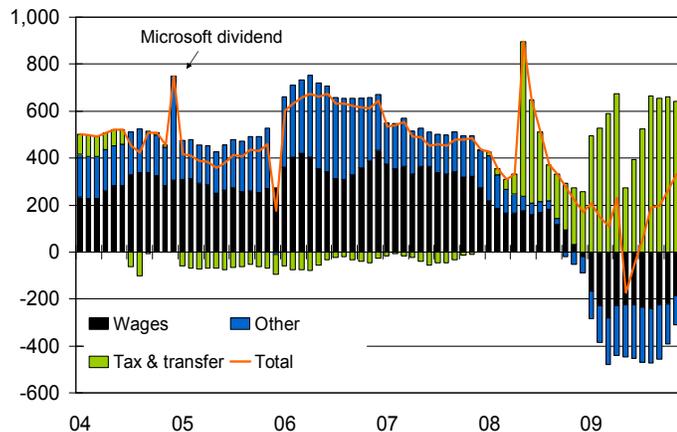
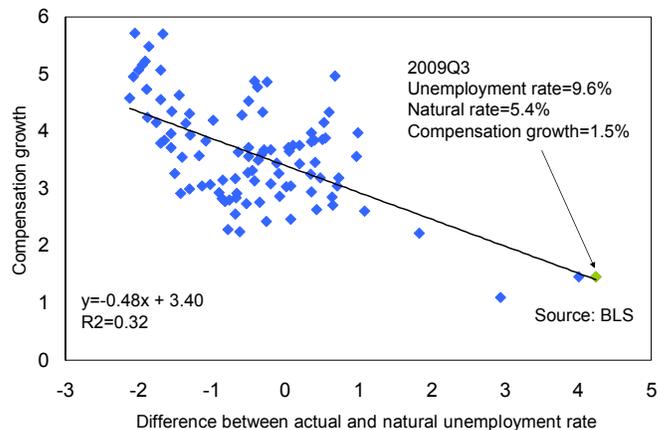


Chart 4: High Unemployment Threatens Compensation
1985Q1-2009Q3



sions; a couple quarters later employment increases, and some months after that, unemployment begins to decline. In the past, businesses could not produce more without hiring more workers. Unemployment took a bit longer to fall, as formerly discouraged workers rejoined the job market. In the time it took for this group to find work, the unemployment rate would increase before beginning to decline.

This dynamic of stronger output leading to hiring leading to lower unemployment has been important in the evolution from recession to recovery to expansion. Without the additional jobs and income, consumers do not have the confidence to spend more aggressively, which is precisely what is required for businesses to continue increasing output.

In more recent business cycles, including the 1990-1991 and 2001 downturns, this dynamic has held less strongly. GDP increased as the recessions ended, but hiring lagged, and unemployment lagged even more. Expansions ultimately took hold, but the jobless recoveries of these periods made the transition difficult. This dynamic seems to have broken down even further in the current cycle. GDP swung from a sharp decline to an increase in the third quarter of 2009, and while job losses have become less severe, they continue.

The only reason the fledgling recovery has not already been short-circuited by the lagging job market is the support to household incomes coming from the federal government. Automatic stabilizers and the fiscal stimulus have sharply lowered tax burdens and increased transfer

payments.⁵ After-tax incomes have risen a bit over the past year, but only because largesse from the federal government has more than offset a decline in wages and other sources of income (see Chart 3).

Concern about the job market would be less acute if unemployment were not already so high. With such a surfeit of labor, already-weak compensation growth threatens to stall or even decline. It is not unusual for real, or inflation-adjusted, compensation growth to fall in recessions, but nominal compensation has not fallen since the Great Depression. Falling compensation would be the catalyst for a pernicious deflationary cycle. The seriousness of this threat is illustrated by examining the relationship between compensation growth and slack in the labor market over the past quarter-century (see Chart 4).⁶ Based on this simplistic but instructive relationship, at a 12% unemployment rate, labor compensation growth will essentially stall. Such a high unemployment rate still seems unlikely, but so too did a 10% unemployment rate just a few months ago.

What ails the job market?

The most straightforward answer to why employment is declining despite rising

GDP is that productivity has increased—indeed, it has soared. During the past two quarters, productivity expanded at an astounding pace of close to 8% annualized. This is the strongest two-quarter gain on record outside of a period in the early 1960s, when productivity bounced back after a protracted decline (see Chart 5). Productivity weakened during the Great Recession, but it never fell.⁷

Businesses will not be able to ratchet up productivity indefinitely, but neither are they likely to give up the gains they have achieved, particularly if the surge is due to information technology investments made since the mid-1990s. Information technology has powered productivity for years, but businesses may not have been able to take full advantage because of the costs associated with significantly cutting payrolls. There is less financial pressure to make such changes when times are good. But in tough times such as those now, firms are more willing and able to change. The result is a measurable and permanent downward shift in the number of workers needed to produce a given level of GDP.

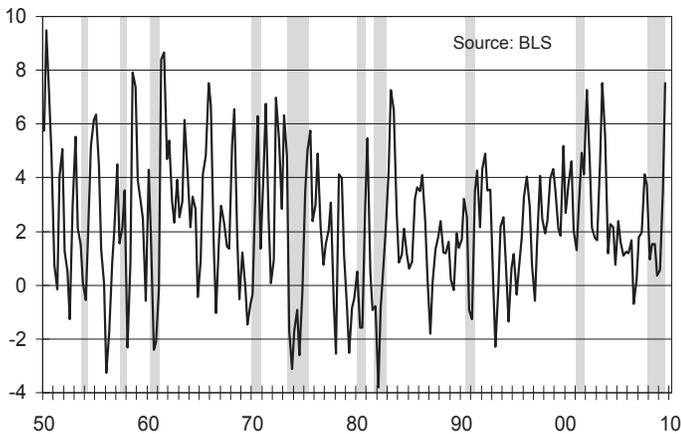
This does not need to be a bad thing for workers, assuming businesses use the profits generated by productivity gains to expand and eventually add to payrolls. Such a process is particularly important now, with demand already fragile. But it has yet to happen. Businesses are scal-

⁵ Automatic stabilizers are federal programs that automatically adjust without explicit action by Congress or the executive branch. The fiscal stimulus includes temporary tax cuts and spending increases legislated and implemented to cope with the downturn.

⁶ Compensation growth in Chart 4 is measured by the annualized percent change in the employment cost index, which includes wages and benefits. Slack in the job market is measured by the difference between the actual and natural rate of unemployment. The natural rate is a Moody's Economy.com estimate. The data points in Chart 4 are the data for each quarter between the first quarter of 1985 and the third quarter of 2009.

⁷ This is on a year-over-year basis; productivity did edge a bit lower on a quarterly basis early in the recession. Note that GDP data have been revised lower for the third quarter of 2009, but this has not yet been incorporated into the productivity estimates. Bigger revisions to GDP, employment, hours and productivity will eventually occur but are still likely to show productivity rising significantly.

Chart 5: Productivity Soars
Annualized % change, 2 qtrs



ing back layoffs—although they remain uncomfortably high—but hiring remains dormant. The number of workers hired each month has slid from nearly 5.5 million before the recession to 4 million in recent months (see Chart 6).⁸

What makes the recent downturn unusual is not the rise in layoffs, but the plunge in hiring. The so-called job destruction rate is lower today than it was during the height of the 2001 recession, but the job creation rate is much lower (see Chart 7).⁹ Judging by the job creation rate, businesses are much less willing to hire than at any time since the BLS began calculating these numbers in the early 1990s. The contrast with the job creation

⁸ This is based on the BLS Job Openings and Labor Turnover survey. Net job growth equals the number of workers hired less the number of layoffs, quits and other separations.

⁹ Job destruction and creation rates, measured as the ratio of layoffs and hires to the labor force, respectively, are from the BLS Business Employment Dynamics survey.

Chart 7: Job Creation Evaporates
Rate of job creation and destruction, %

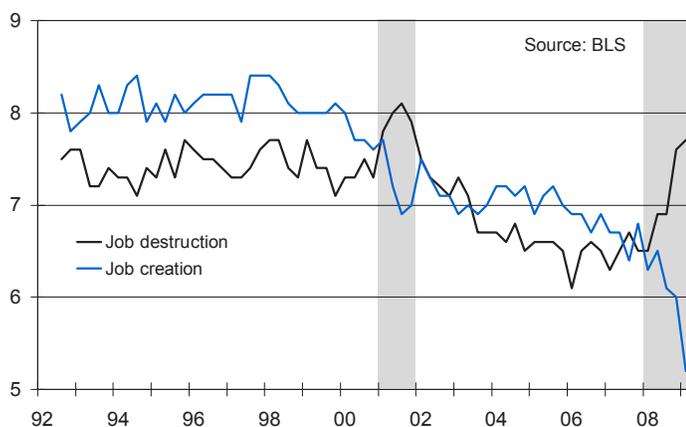
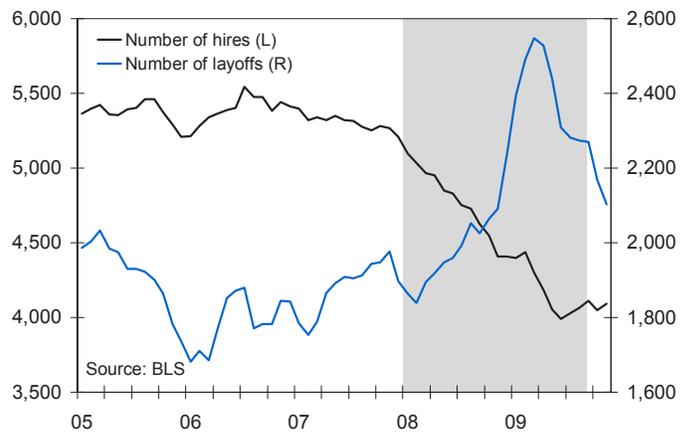


Chart 6: Layoffs Abate, but Hiring Remains Dormant
Ths, 3-mo MA, SA



rate during the tech boom of the 1990s is particularly striking.

Job creation has fallen across all industries, although not surprisingly, it has been most pronounced in construction and manufacturing and related industries such as wholesaling and transportation. The decline is also evident across firms of all sizes but has been disproportionately large among very small businesses (zero to four employees) and very big ones (more than 1,000 employees). Given the large number of workers in small businesses, about half the decline in job creation has been among firms with fewer than 100 employees, about one-fourth has occurred among firms with between 100 and 1,000 employees, and the remaining fourth has happened at firms with more than 1,000 employees (see Table 1).

The principal impediment to hiring at smaller businesses appears to be a lack of credit. The financial crisis has under-

mined the secondary market for small business loans, and bank lenders remain very cautious in their underwriting. According to the Federal Reserve's senior loan officer survey, banks are not tightening as aggressively in their small business lending as they were a year ago, but they remain exceptionally tight (see Chart 8).¹⁰ This is evident in the credit data, as commercial and industrial loans outstanding continue to fall rapidly and the number of bank credit cards has plummeted by nearly 100 million, or 25%, since peaking in mid-2008.¹¹ Most of these loans are

¹⁰ The Fed asks respondents whether they have tightened their underwriting or increased their loan spreads in the last quarter. Recent responses indicate that fewer lenders are tightening further, but there is no indication they have eased after the extreme tightening that occurred this time last year.

¹¹ It is difficult to disentangle the impact of credit standards and weaker credit demand on credit outstanding, but suffice it to say, standards have arguably never been as stringent.

Chart 8: Small Businesses Face Tougher Underwriting
Net % of lenders tightening C&I lending to small businesses

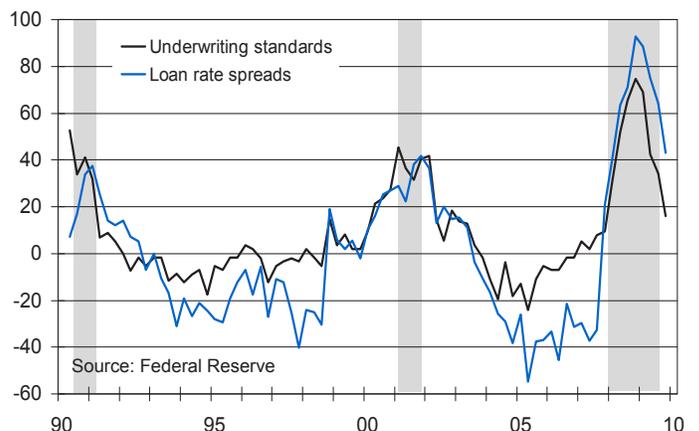


Table 1: Very Small and Very Big Businesses Account for a Disproportionately Large Share of the Problems in the Job Market

Change between 2009Q1 and 2007, ths

	Job Creation	Job Destruction	Job Creation Less Destruction	Share of Jobs 2007	Share of Job Creation	Share of Job Destruction	Share of Job Creation Less Destruction
TOTAL	-1,648	1157	-2805				
0-49 employees	-649	340	-989	41.5	39.4	29.4	35.3
0-4 employees	-146	92	-238	6.0	8.9	8.0	8.5
5-9 employees	-134	39	-173	8.0	8.1	3.4	6.2
10-19 employees	-155	67	-222	10.9	9.4	5.8	7.9
20-49 employees	-214	142	-356	16.6	13.0	12.3	12.7
50-249 employees	-331	318	-649	29.0	20.1	27.5	23.1
50-99 employees	-151	143	-294	12.9	9.2	12.4	10.5
100-249 employees	-180	175	-355	16.0	10.9	15.1	12.7
Over 500 employees	-670	499	-1169	29.5	40.7	43.1	41.7
250-499 employees	-119	116	-235	9.2	7.2	10.0	8.4
500-999 employees	-104	94	-198	6.9	6.3	8.1	7.1
Over 1,000 employees	-447	289	-736	13.4	27.1	24.9	26.2
0-100 employees	-800	483	-1283	54.5	48.5	41.7	45.7
100-1,000 employees	-403	385	-788	32.1	24.5	33.3	28.1
Over 1,000 employees	-447	289	-736	13.4	27.1	24.9	26.2

Sources: BLS Business Employment Dynamics, Moody's Economy.com

to large businesses, and the credit cards are to consumers, but small businesses rely heavily on loans and credit cards to finance their activities.

It is unlikely that credit conditions for small businesses will improve soon. Hundreds of the small banks so important to small business lending, particularly in smaller communities, have failed or will fail in the next couple of years. More than 550 banks are now on the FDIC's troubled list; in many cases, defaulting commercial mortgage loans are overwhelming banks' capital. Credit card lenders also continue to adjust to new legislation and regulation that make it more difficult to engage in risk-based pricing. Without less flexibility to price for risk, they have decided to take less of it.

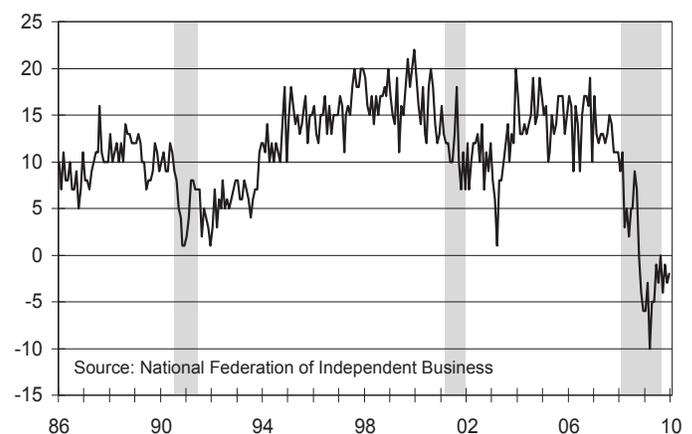
Small business borrowers are also likely being hampered by the collapse in housing and commercial real estate prices. Real estate is often used by small business owners as collateral for borrowing. With the value of that collateral less certain, lenders are less willing to make loans.

The likely impediment to job creation at large businesses is not credit—the corporate bond and commercial paper

markets are functioning well—but rather policy uncertainty. Policy changes now being debated in Washington have arguably not been this sweeping since the Great Depression. The most obvious include reforms of healthcare, energy, financial regulation and tax policy. Except for climate change legislation, all seem likely to result in legislation during the coming year. Each of these policy changes could have enormous implications for businesses; thus, firms are likely holding back on expansion decisions until there is more clarity from Capitol Hill.

The potential of policy to impact job creation is amplified by the ability of large firms to shift activities overseas. Despite big productivity gains and lower labor costs in the U.S., costs and market opportunities in emerging economies are growing in attractiveness.

Chart 9: Near-Death Experiences Undermine Animal Spirits
Net % of small businesses planning to increase total employment



Uncertainty and indecision among business executives cannot be discounted as a reason for the poor job market. Business surveys broadly show sentiment has improved since this time last year, but it remains extraordinarily fragile (see Chart 9).¹² Many businesses suffered near-death experi-

¹² The National Federation of Independent Business survey of small businesses, the Conference Board survey and Business Roundtable surveys of large businesses, and the Moody's Economy.com weekly global business survey all roughly show this.

ences in the past year, and those memories remain fresh. Managers must also wonder whether recent pickups in demand will prove temporary. The massive monetary and fiscal stimulus and an inventory swing have clearly contributed to the turnaround, but these are not long-lasting sources of demand growth. Executives are plagued by the thought of what happens if they build it and no one comes. Until that question fades, many will neither build nor hire.

What can policymakers do?

A reasonable baseline (most likely) near-term outlook is for the job market to stabilize by this spring and for meaningful job growth to resume, with sufficient strength to bring down unemployment, by late in the year. If history is a guide, strong recent gains in productivity and profits will prompt businesses to first end layoffs and then resume hiring in coming months. This script should roughly hold with the monetary and fiscal stimulus already in place, though it assumes policymakers will extend unemployment insurance benefits for workers who lose jobs in 2010.

However, risks to this near-term outlook remain decidedly to the downside. Given the impediments to hiring and other threats, the probability that the recovery will unravel instead of evolving into a self-sustaining economic expansion is uncomfortably high.¹³ Just as important, if the economy were to descend back into recession, it would be very difficult to get out, given the likelihood of a deflationary spiral to which policymakers will not have the resources to respond.

Given the downside risks and the prospects for a very serious downturn if the recovery were to falter, it is important for the government to maintain a very aggressive policy stance. The Federal Reserve appears set to hold the fed funds rate target at zero until unemployment moves decidedly lower. While there is a strong and understandable desire at the Fed to end its credit easing efforts on schedule this March, the central bank will likely remain flexible and increase its commitments if the recovery remains fragile.

Fiscal policymakers should consider also expanding their support of the economy in 2010. This could include

¹³ A discussion of these risks was presented by Mark Zandi in testimony before the Joint Economic Committee at the hearing "The Impact of the Recovery Act on Economic Growth," on October 29, 2009.

Table 2: Fiscal Stimulus Bang for the Buck

Tax Cuts	Bang for the Buck
Nonrefundable lump-sum tax rebate	1.01
Refundable lump-sum tax rebate	1.22
<i>Temporary tax cuts</i>	
Payroll tax holiday	1.24
Job tax credit	1.30
Across-the-board tax cut	1.02
Accelerated depreciation	0.25
Loss carryback	0.22
Housing tax credit	0.90
<i>Permanent tax cuts</i>	
Extend alternative minimum tax patch	0.51
Make Bush income tax cuts permanent	0.32
Make dividend and capital gains tax cuts permanent	0.37
Cut in corporate tax rate	0.32
Spending Increases	Bang for the Buck
Extending unemployment insurance benefits	1.61
Temporary federal financing of work-share programs	1.69
Temporary increase in food stamps	1.74
General aid to state governments	1.41
Increased infrastructure spending	1.57

Note: The bang for the buck is estimated by the one-year dollar change in GDP for a given dollar reduction in federal tax revenue or increase in spending.

Source: Moody's Economy.com

additional steps to bolster final demand, provide credit to smaller businesses, and lower the cost of labor.

More specifically, policy steps that would be most effective in supporting final demand include:

- Extend unemployment insurance for workers who lose jobs through 2010. Given prospects for a double-digit unemployment rate next year, reinforcing the financial safety net is vital to supporting consumer spending and confidence.¹⁴ No other federal program provides a bigger bang for the buck—the most economic activity per federal dollar spent (see Table 2). Without this extra help, laid-off workers and their families will slash their own spending, leading to the loss of even more jobs. The cost to extend the UI benefits through the end of 2010 is estimated at \$100 billion.

¹⁴ Another argument for temporarily providing more UI benefits is the scaling back of welfare and disability benefits in the mid-1990s reform of the nation's welfare programs.

- Provide additional financial help to state and local governments. Fiscal 2011 budgets, which begin next July for most states, are likely to be more troubled than those for the current year. Tax revenues and new borrowing capacity are weakening. Unless municipalities receive more help from the federal government, they will be under intense pressure to cut jobs and programs and to raise taxes and fees. This will be a serious drag on the economy at just the wrong time. To avoid this, more federal aid to states for their FMAP and educational obligations may be necessary. The collective fiscal 2011 budget deficit for states is estimated at close to \$150 billion. The current fiscal stimulus provides only \$40 billion to states in fiscal 2011. To forestall more draconian spending cuts and tax increases, it seems appropriate to provide an additional \$75 billion to state and local governments for fiscal 2011.

To free up credit to smaller businesses, the following policy step would be effective:

- Expand lending by the Small Business Administration. This could help alleviate the impact of tight credit on small businesses, in turn aiding the job market and the broader economy. The federal government could temporarily increase the guarantee on SBA loans from the current 90% to 95%, raise the maximum loan size to \$5 million, and raise the interest rate cap from the current level—the prime rate plus 275 basis points—to prime plus 500 basis points. Lenders are reluctant to extend small-business loans at the current top lending rate of below 6% because of significant credit risks. SBA oversight of lenders would have to be strengthened and penalties on poor lending increased to ensure that the SBA does not take on too much credit risk. The cost of expanding SBA lending through 2010 is estimated at under \$5 billion.

To lower the cost of labor, the following policy steps would be effective:

- Facilitate the expansion of work-share programs. Seventeen states offer some type of work-share program in which employers reduce workers' weekly hours and pay, often by 20% to 40%, and states make up some of the lost wages, usually half, from their unemployment insurance funds. Like the temporary extension of unemployment insurance benefits, work-share has a high bang for the buck, as it provides financial help to distressed workers who are likely to quickly spend any aid. Work-share's bang for the buck is even larger than that of UI benefits, as the reduction in unemployment lowers both the financial and psychological costs of layoffs to workers and their employers. It is particularly helpful for firms that expect workforce reductions to be temporary; work-share allows these firms to avoid the cost of severance, rehiring and training. Providing seed money to establish work share programs in other states and fund the program through 2010 would cost no more than \$1 billion.
- Offer a job tax credit for businesses to expand payrolls in the spring and summer of 2010. The size of the credit

could equal the payroll tax costs of new hires for at least one year and perhaps two. While firms are more focused on the demand for their output and the availability of credit when making hiring decisions, the cost of labor, which this credit targets, is also important. The credit could be made more effective by allocating a set amount—\$30 billion—for those businesses that hire first. This would encourage firms to act quickly and accelerate the benefit of the credit to hiring.

If policymakers adopt each of these measures, the total cost to taxpayers would be approximately \$210 billion over the 2010-2011 period. Combined with the \$45 billion package of tax cuts and spending increases recently signed into law, the impact by the end of 2010 would be to raise payroll employment by 1.2 million jobs and lower unemployment by 0.7 of a percentage point compared with what it would have been otherwise.¹⁵ More importantly, it would significantly increase the odds of the recovery quickly evolving into an expansion.

Other policy considerations

In addition to lowering the risk that the weak and fragile recovery will falter, there are a number of other reasons why fiscal policymakers may want to take additional action to shore up the economy.

Key among these is the difficulty the Federal Reserve will have in responding more aggressively if the economy weakens again. The federal funds rate is near zero and the monetary authorities are reluctant to further expand their credit easing efforts. They have committed to purchasing an additional \$100 billion in Fannie Mae and Freddie Mac insured mortgage securities through this March—this is on top of the \$1.6 trillion in Treasury and Fannie and Freddie securities they have already purchased—but are loath to do more. The Fed has effectively become the nation's predominant residential mortgage lender, a situation it would like to end as soon as possible. If the Fed winds down its purchases as planned, mortgage rates will rise as much as a full percentage point next spring, just when foreclosure sales are expected to increase. The pres-

sure on house prices and the broader economy could be significant.

Purchasing more Treasury securities also seems out of the question given the angst that previous Fed purchases created among investors, who fear policymakers might try to monetize the nation's debt. While this fear is unfounded, investors' concerns were strong enough that long-term interest rates began to rise despite the Fed's bond purchases.

Further supporting aggressive action by fiscal policymakers is evidence that the government's record borrowing has not crowded out private investment. Despite a \$1.4 trillion fiscal 2009 deficit and robust municipal borrowing, total borrowing—including that done by households, nonfinancial businesses and financial institutions—has fallen sharply. As a share of GDP, total borrowing is about as low as it has been since World War II. Households, businesses and financial concerns are rapidly deleveraging, allowing more than enough room for increased government borrowing without driving up interest rates.

This will not continue for long once the recovery gains traction and private credit demands rebound. If budget deficits and government borrowing are not receding at the same time, interest rates will rise sharply. Policymakers thus have the latitude to provide more near-term support to the soft economy through temporary increases in borrowing to finance more tax cuts and spending increases, but they also need to address the increasingly worrisome longer-term fiscal outlook. Healthcare reform and tax increases set to kick in as 2011 starts are important in this regard. Indeed, the more credible these policy efforts are in reducing future projected budget deficits, the more room policymakers will have to help the economy in 2010.

Not taking more aggressive fiscal policy actions now may also cost the economy significantly in the long run. Under the best of circumstances, unemployment is likely to remain uncomfortably high for a long time. Assuming policymakers do take the steps recommended here, payroll employment is expected to fall by 8.75 million jobs from the peak in December 2007 to the trough at the start of 2010 and to not return to its previous peak until well into 2013. The unemployment rate is expected to peak at 10.6% in the fall of 2010

¹⁵ This is based on stimulations of the Moody's Economy.com macroeconomic model system.

and not move back to a rate consistent with full employment until 2013-2014.

The statistical definition of full employment is rising as those losing their jobs stay unemployed longer, undermining their skills and marketability. Workers in their late 40s and 50s will have a particularly difficult time getting back into the workforce. This structural unemployment is also increasing because of the large number of homeowners underwater on their mortgages, a phenomenon that undercuts labor force mobility. Historically, someone who lost a job in one part of the country could readily move for a new one. This is much more difficult if that worker must put up more equity to sell a home before moving. The unemployment rate considered to be consistent with full employment has already risen from below 5% before the Great Recession to an estimated 5.3% currently. Under the best of circumstances, it is expected to reach 6% by early in the next decade.

The longer unemployment remains elevated, the higher the full-employment unemployment rate will increase. This has long plagued European labor markets, whose experience illustrates how

stubborn the problem can become. The more aggressively policymakers act now to ensure the economy can generate jobs, the less likely the U.S. economy will be to suffer these same longer-term ills.

Conclusions

The Great Recession is over, but the recovery will be a difficult slog through much of this year. The risks are also uncomfortably high that the economy will backtrack into recession. This would be an especially dark scenario, almost certainly involving a deflationary spiral of falling wages and prices. The Federal Reserve and fiscal policymakers would also have fewer options and resources with which to respond.

A range of problems suggest that such a scenario cannot be easily dismissed. Most obvious are high and rising unemployment and weak wage growth, the mounting foreclosure crisis, rising commercial mortgage loan defaults and resulting small bank failures, budget problems at state and local governments, and dysfunctional structured-finance markets that restrict credit to consumers and businesses.

Policymakers should provide more help to the economy to ensure the recovery becomes self-sustaining. The Federal Reserve must not raise interest rates too soon or end its credit easing efforts too quickly. Congress must provide more resources to unemployed workers whose benefits are running out, to state governments unable to balance their budgets, and to small businesses looking for credit and all businesses that expand payrolls.

All this help comes at significant cost. While the fiscal stimulus has been vital, it has helped produce a \$1.4 trillion budget deficit this past fiscal year and will lead to another similarly sized deficit in the current one. Yet the cost to taxpayers would have been measurably greater if policymakers had not acted aggressively. The recession would still be in full swing, undermining tax revenues and driving up government spending on Medicaid, welfare, and other income support for distressed families.

It is a tragedy that the nation has been forced to spend so much to tame the financial crisis and end the Great Recession. Yet it has been money well spent.

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