CHAPTER 1

TO RESCUE, REBALANCE, AND REBUILD

President Obama took office at a time of economic crisis. The recession that began in December 2007 had accelerated following the financial crisis in September 2008. By January 2009, 11.9 million people were unemployed and real gross domestic product (GDP) was falling at a breakneck pace. The possibility of a second Great Depression was frighteningly real.

In the first months of the Administration, the President and Congress took unprecedented actions to restore demand, stabilize financial markets, and put people back to work. Just 28 days after his inauguration, the President signed the American Recovery and Reinvestment Act of 2009, the boldest countercyclical fiscal stimulus in American history. The Financial Stability Plan, announced in February, included wide-ranging measures to strengthen the banking system, increase consumer and business lending, and stem foreclosures and support the housing market. These and a host of other actions stabilized the financial system, supported those most directly affected by the recession, and walked the economy back from the brink.

But the Administration always knew that stabilizing the economy would not be enough. The problems that led to the crisis were years in the making. Continued action will be necessary to return the economy to full employment. In the process, an important rebalancing will need to occur. For too many years, America's growth and prosperity were fed by a boom in consumer spending stemming from rising asset prices and easy credit. The Federal Government had likewise been living beyond its means, resulting in large and growing budget deficits. And our regulatory system had failed to keep up with financial innovation, allowing risky practices to endanger the system and the economy. For this reason, the Administration has sought to help restore the economy to health on a foundation of greater investment, fiscal responsibility, and a well-functioning and secure financial system.

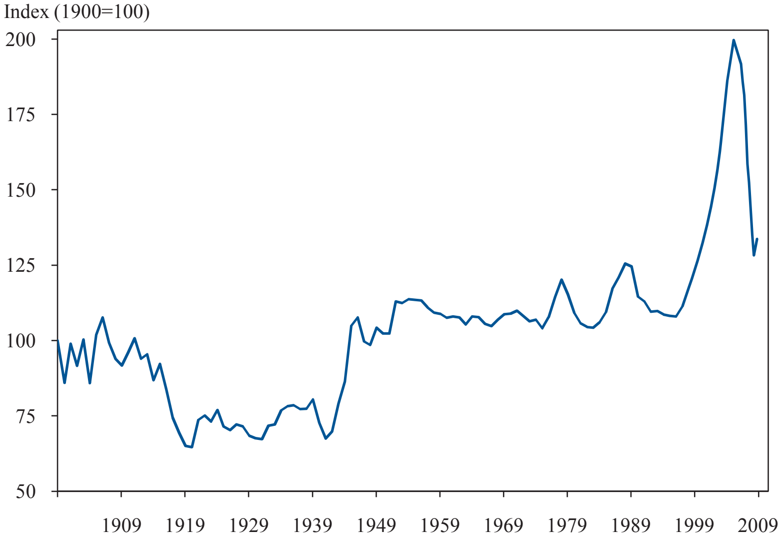
Even this important rebalancing would not be sufficient. In addition to the problems that had set the stage for the crisis, long-term challenges had been ignored and the U.S. economy was failing at some of its central tasks. Our health care system was beset by steadily rising costs, and millions of Americans either had no health insurance at all or were unsure whether their coverage would be there when they needed it. Middle-class families had seen their real incomes stagnate during the previous eight years, while those at the top of the income distribution had seen their incomes soar. A failure to slow the consumption of fossil fuels had contributed to global warming and continued dependence on foreign oil. And a country built on its record of innovation was failing to invest enough in research and development.

The President has dedicated his Administration to dealing with these long-run problems as well. As the new decade opens, Congress has come closer than ever before to passing landmark legislation reforming the health insurance system. This legislation would make health insurance more secure for those who have it and affordable for those who do not, and it would slow the growth rate of health care costs. Over the past year, the Administration has also worked with Congress to make important new investments to sustain and improve K-12 education and community colleges, jump-start the transition to a clean energy economy, and spur innovation through increased research and development. These and numerous other initiatives will help to rebuild the American economy stronger than before and put us on the path to sustained growth and prosperity. Enacting these policies will help to ensure that our children and grandchildren inherit a country as full of promise and as economically secure as ever in our history.

Rescuing an Economy in Freefall

In December 2007, the American economy entered what at first seemed likely to be a mild recession. As Figure 1-1 shows, real house prices (that is, house prices adjusted for inflation) had risen to unprecedented levels, almost doubling between 1997 and 2006. The rapid run-up in prices was accompanied by a residential construction boom and the proliferation of complex mortgages and mortgage-related financial assets. The fall of national house prices starting in early 2007, and the associated declines in the values of mortgage-backed and other related assets, led to a slowdown in the growth of consumer spending, increases in mortgage defaults and home foreclosures, significant strains on financial institutions, and reduced credit availability.

Figure 1-1
House Prices Adjusted for Inflation

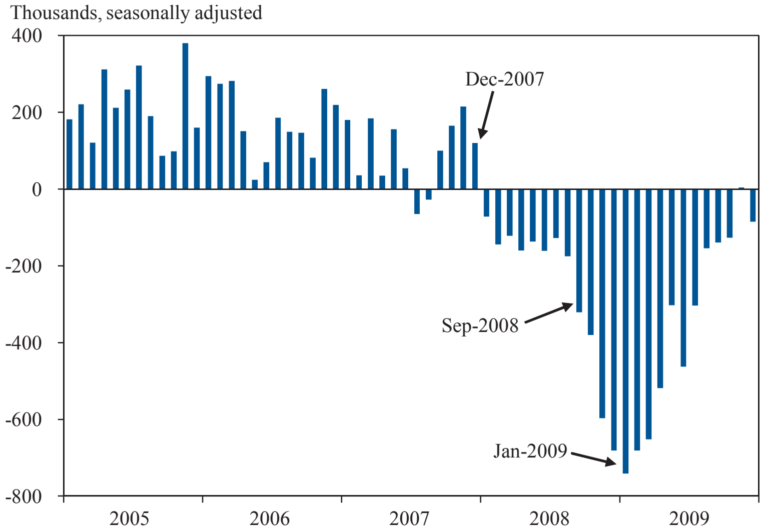


Sources: Shiller (2005); recent data from http://www.econ.yale.edu/~shiller/data/Fig2-1.xls.

By early 2008, the economy was contracting. Employment fell by an average of 137,000 jobs per month over the first eight months of 2008. Real GDP rose only anemically from the third quarter of 2007 to the second quarter of 2008.

Then in September 2008, the character of the downturn worsened dramatically. The collapse of Lehman Brothers and the near-collapse of American International Group (AIG) led to a seizing up of financial markets and plummeting consumer and business confidence. Parts of the financial system froze, and assets once assumed to be completely safe, such as money-market mutual funds, became unstable and subject to runs. Credit spreads, a common indicator of credit market stress, spiked to unprecedented levels in the fall of 2008. The value of the stock market plunged 24 percent in September and October, and another 15 percent by the end of January. As Figure 1-2 shows, over the final four months of 2008 and the first month of 2009, the economy lost, on average, a staggering 544,000 jobs per month, the highest level of job loss since the demobilization at the end of World War II. Real GDP fell at an increasingly rapid pace: an annual rate of 2.7 percent in the third quarter of 2008, 5.4 percent in the fourth quarter of 2008, and 6.4 percent in the first quarter of 2009.

Figure 1-2
Monthly Change in Payroll Employment



Source: Department of Labor (Bureau of Labor Statistics), Current Employment Statistics survey Series CES0000000001.

Rescuing the Economy from the Great Recession

Thus, the first imperative of the new Administration upon taking office had to be to turn around an economy in freefall. Chapter 2 describes the unprecedented policy actions the Administration has taken, together with Congress and the Federal Reserve, to address the immediate crisis. The large fiscal stimulus in the American Recovery and Reinvestment Act, the programs to stabilize financial markets and restart lending, and the policies to assist small businesses and distressed homeowners have all played a role in generating one of the sharpest economic turnarounds in post–World War II history. Real GDP is growing again, job loss has moderated greatly, house prices appear to have stabilized, and credit spreads have almost returned to normal levels. A wide range of evidence indicates that in the absence of the aggressive policy actions, the recession and the attendant suffering of ordinary Americans would have been far more severe and could have led to catastrophe.

Yet, because the economy's downward momentum was so great and the barriers to robust growth from the weakened financial conditions of households and financial institutions are so strong, the economy remains distressed and many families continue to struggle. A change from freefall to growing GDP and moderating job losses is a dramatic improvement, but it is not nearly enough. Chapter 2 therefore also examines the challenges that remain in achieving a full recovery. It discusses some possible additional measures to spur private sector job creation.

Crisis and Recovery in the World Economy

In the early fall of 2008, there was hope that the impact of the crisis on the rest of the world would be limited. Those hopes were dashed during the months that followed. In the fourth quarter of 2008 and the first quarter of 2009, real GDP fell sharply—often at double-digit rates—in the United Kingdom, Germany, Japan, Taiwan, and elsewhere. The surprisingly rapid spread of the downturn to the rest of the world reduced the demand for U.S. exports sharply, and so magnified our economic contraction.

The worldwide crisis required a worldwide response. Chapter 3 describes both the actions taken by individual countries and those taken through international institutions and cooperation. As described in the leaders' statement from the September summit of the Group of Twenty (G-20) nations, the result was "the largest and most coordinated fiscal and monetary stimulus ever undertaken" (Group of Twenty 2009). Just as the actions in the United States have begun to turn the domestic economy around, these international actions appear to have put the worst of the global crisis behind us. But the firmness of the budding recovery varies considerably across countries, and significant challenges still remain.

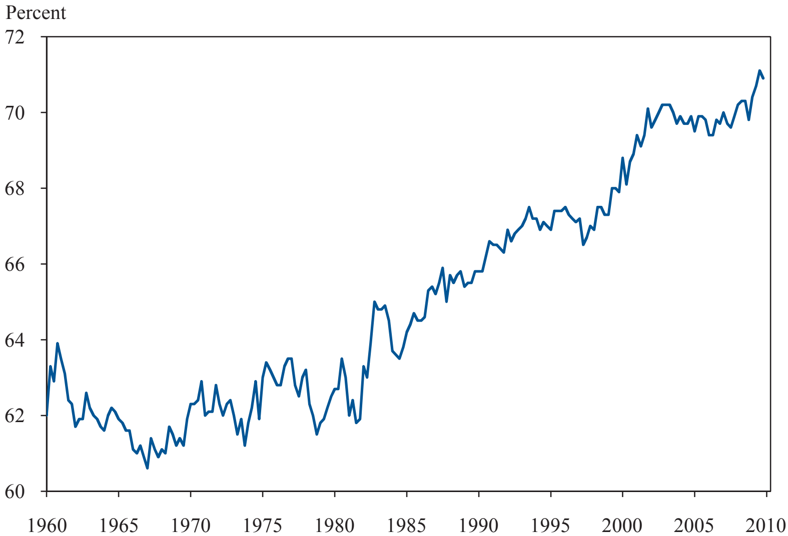
Rebalancing the Economy on the Path to Full Employment

The path from budding recovery to full employment will surely be a difficult one. The problems that sowed the seeds of the financial crisis need to be dealt with so that the economy emerges from the recession with a stronger, more durable prosperity. There needs to be a rebalancing of the economy away from low personal saving and large government budget deficits and toward investment. Our financial system must be strengthened both to provide the lending needed to support the recovery and to reduce the risk of future crises.

Saving and Investment

The expansion of the 2000s was fueled in part by high consumption. As Figure 1-3 shows, the share of GDP that takes the form of consumption has been on a generally upward trend for decades and reached unprecedented heights in the 2000s. The personal saving rate fell to exceptionally low levels, and trade deficits were large and persistent. A substantial amount of the remainder of GDP took the form of housing construction, which may have crowded out other kinds of investment. Such an expansion is not just unstable, as we have learned painfully over the past two years. It also contributes too little to increases in standards of living. Low investment in equipment and factories slows the growth of productivity and wages.

Figure 1-3
Personal Consumption Expenditures as a Share of GDP



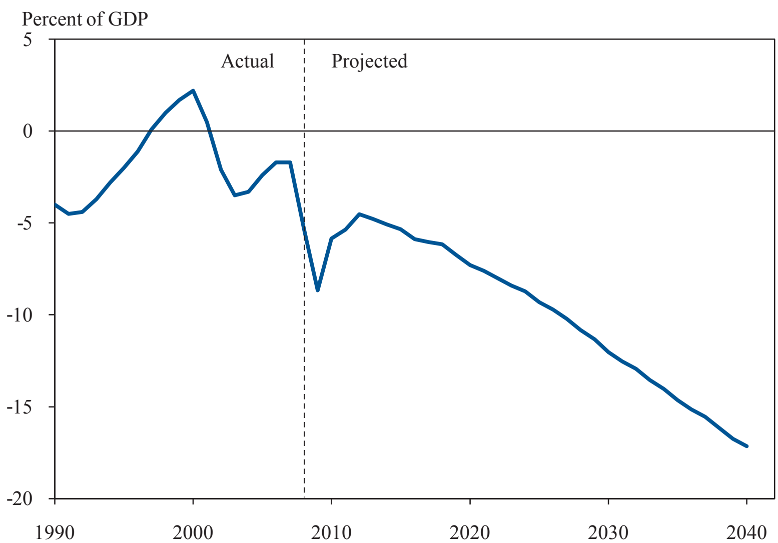
Source: Department of Commerce (Bureau of Economic Analysis), National Income and Product Accounts Table 1.1.10.

Chapter 4 examines the transition from consumption-driven growth to a greater emphasis on investment and exports. It discusses the likelihood that consumers will return to saving rates closer to the postwar average than to the very low rates of the early 2000s. It also describes the Administration's initiatives to encourage household saving. Greater personal saving will tend to encourage investment by helping to maintain low real interest rates. The increased investment will help to fill some of the gap in demand left by reduced consumption. Chapter 4 discusses additional Administration policies, such as investment tax incentives, designed to promote private investment. Higher saving relative to investment will reduce net international capital flows to the United States. Because net foreign borrowing must equal the current account deficit, lower net capital inflows imply a closer balance of exports and imports, which will help create further demand for American products. The Administration also supports aggressive export promotion measures to further increase demand for our exports. The end result of this rebalancing will be an economy that is more stable, more investment-oriented, and more export-oriented, and thus better for our future standards of living.

Addressing the Long-Run Fiscal Challenge

A key part of the rebalancing that must occur as the economy returns to full employment and beyond involves taming the Federal budget deficit. Figure 1-4 shows the actual and projected path of the budget surplus based on estimates released by the Congressional Budget Office (CBO) in January 2009, just before President Obama took office. As the figure makes clear, the budget surpluses of the late 1990s turned to substantial deficits in the 2000s, and the deficits were projected to grow even more sharply over the next three decades. As discussed in Chapter 5, the change to deficits in the 2000s largely reflects policy actions that were not paid for, such as the 2001 and 2003 tax cuts and the introduction of the Medicare prescription drug benefit. The projection of steadily increasing future deficits is largely due to the continuation of the decades-long trend of rising health care costs.

Figure 1-4
Actual and Projected Budget Surpluses in January 2009 under Previous Policy



Note: CBO baseline surplus projection adjusted for CBO's estimates of costs of continued war spending, continuation of the 2001 and 2003 tax cuts, preventing scheduled cuts in Medicare's physician payment rates, and holding other discretionary outlays constant as a share of GDP.
Sources: Congressional Budget Office (2009a, 2009b).

Chapter 5 describes the likely consequences of these projected deficits over time and the importance of restoring fiscal discipline. It also discusses the President's plan for facing this challenge. A period of severe economic weakness is no time for a large fiscal contraction. Instead, the Nation must tackle the long-run deficit problem through actions that address the underlying sources of the problem over time. The single most important step that can be taken to reduce future deficits is to adopt health care reform that slows the growth rate of costs without compromising the quality of care. In addition, the President's fiscal 2011 budget includes other significant measures, such as allowing President Bush's tax cuts for the highest-income earners to expire, reforming international tax rules to discourage tax avoidance and encourage investment in the United States, and imposing a three-year freeze in nonsecurity discretionary spending; alongside a proposal for a bipartisan commission process to address the long-run gap between revenues and expenditures.

Building a Safer Financial System

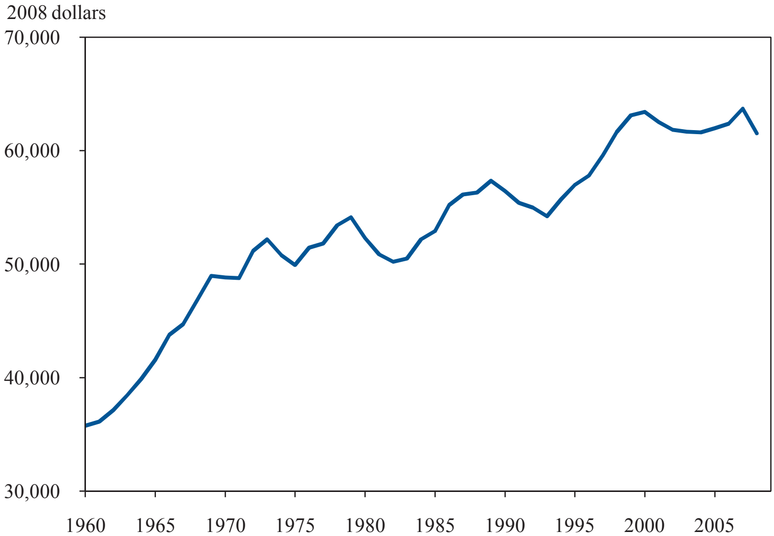
Risky credit practices both encouraged some of the imprudent rise in consumption and homebuilding in the previous decade and set the stage for the financial crisis. Chapter 6 analyzes the role that financial intermediaries play in the economy and diagnoses what went wrong during the meltdown of financial markets. The crisis showed that the Nation's financial regulatory structure, much of which had not been fundamentally changed since the 1930s, failed to keep up with the evolution of financial markets. The current system provided too little protection for the economy from actions that could threaten financial stability and too little protection for ordinary Americans in their dealings with sophisticated and powerful financial institutions and other providers of credit. Strengthening our financial system is thus a key element of the rebalancing needed to assure stable, robust growth.

Chapter 6 discusses financial regulatory modernization. What is needed is a system where capital requirements and sensible rules are set in a way to control excessive risk-taking; where regulators can consider risks to the system as a whole and not just to individual institutions; where institutions cannot choose their regulators; where regulators no longer face the unacceptable choice between the disorganized, catastrophic failure of a financial institution and a taxpayer-funded bailout; and where a dedicated agency has consumer protection as its central mandate. For this reason, the President put forward a comprehensive plan for financial regulatory reform last June and is working with Congress to ensure passage of these critical reforms this year.

Rebuilding a Stronger Economy

Even before the crisis, the economy faced significant long-term challenges. As a result, it was doing poorly at providing rising standards of living for the vast majority of Americans. Figure 1-5 shows the evolution of before-tax real median family income since 1960. Beginning around 1970, slower productivity growth and rising income inequality caused incomes for most families to grow only slowly. After a half-decade of higher growth in the 1990s, the real income of the typical American family actually fell between 2000 and 2006.

Figure 1-5
Real Median Family Income



Notes: Income measure is total money income excluding capital gains and before taxes. Annual income deflated using CPI-U-RS.
Source: Department of Commerce (Census Bureau), Current Population Survey, Annual Social and Economic Supplement, Historical Income Table F-12.

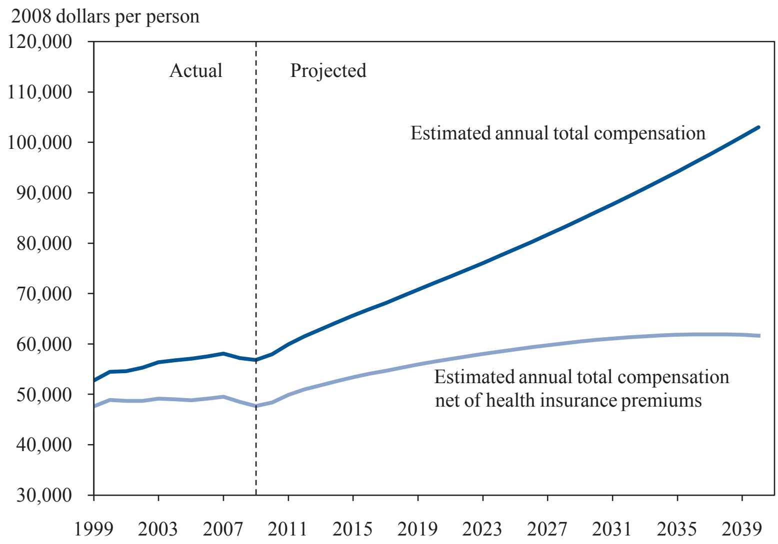
A central focus of Administration policy both over the past year and for the years to come is to build a firmer foundation for the economy. The President is committed to policies that will raise living standards for all Americans.

Reforming Health Care

Health care is a key challenge that long predates the current economic crisis. The existing system has left many Americans who have health insurance inadequately covered, poorly protected against insurance industry abuses, and fearful of losing the insurance they have. And it has left tens of millions of Americans with no insurance coverage at all. The system also delivers too little benefit at too high a cost. Comparisons across countries and, especially, across regions of the United States reveal large differences in health care spending that are not associated with differences in health outcomes and that cannot be fully explained by factors such as differences in demographics, health status, income, or medical care prices. These large differences in spending suggest that up to nearly 30 percent of health care spending could be saved without adverse health consequences. The unnecessary growth of health care costs is eroding the growth of take-home pay and is central to our long-run fiscal challenges. These adverse effects will only become more severe if cost growth is not slowed.

To illustrate what could happen to workers' earnings in the absence of reform, Figure 1-6 shows the historical and projected paths of real total compensation per worker (which includes nonwage benefits such as health insurance) and total compensation net of health insurance premiums. As health insurance premiums absorb a growing fraction of workers' compensation, the remaining portion of compensation levels off and then starts to decline.

Figure 1-6
Total Compensation Including and Excluding Health Insurance



Note: Health insurance premiums include the employee- and employer-paid portions.
Sources: Actual data from Department of Labor (Bureau of Labor Statistics); Kaiser Family Foundation and Health Research and Educational Trust (2009); Department of Health and Human Services (Agency for Healthcare Research and Quality, Center for Financing, Access, and Cost Trends), 2008 Medical Expenditure Panel Survey-Insurance Component. Projections based on CEA calculations.

Chapter 7 describes the actions the Administration and Congress took in 2009 to begin the process of improvement, including an expansion of the Children's Health Insurance Program to provide access to health care for millions of children and important investments in the modernization of the health care system through the Recovery Act. It also describes the key elements of successful health insurance reform and discusses the progress that has been made on reform legislation. Successful reform involves making insurance more secure for those who have it and expanding coverage to those who lack it. It must include delivery system reforms, reductions in waste and improper payments in the Medicare system, and changes in consumer and firm incentives that will slow the growth rate of costs substantially, while maintaining and even improving quality. Slowing the growth rate of health care costs will have benefits throughout the economy: it will raise standards of living for families, help reduce the Federal budget deficit relative to what it otherwise would be, benefit state and local governments, and encourage job growth and improved macroeconomic performance.

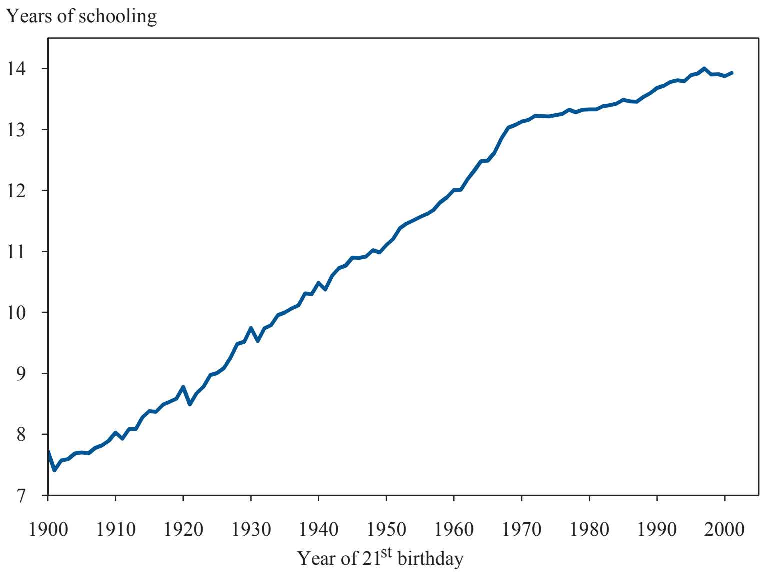
Strengthening the American Labor Force

American workers have suffered greatly in the current recession. As described in Chapter 8, long-term unemployment is at record levels. The unemployment rate, which was 10 percent for the country as a whole in December, is far higher for blacks, Hispanics, and other demographic groups. The decline in house prices has eroded the nest eggs that many Americans had been counting on for their retirement. The Administration has initiated many actions to help support workers and their families through the recession and beyond. These actions range from extended and expanded unemployment insurance, to measures to make health insurance more affordable, to initiatives to promote retirement saving.

American workers also face the persistent problem of stagnating incomes. A key determinant of growth in standards of living is the rate of increase in the education and skills of our workforce. More and more jobs require education and training beyond the high school level, along with the ability to complete tasks that are open-ended and interactive. But, as Figure 1-7 shows, the years of education U.S. workers have brought to the labor market have risen little in the past four decades. And, as is well known, U.S. students lag behind those from many other countries in their performance on standardized tests.

Chapter 8 describes the Administration's initiatives to improve the skills of our workers. The Administration is pursuing reform to eliminate wasteful subsidies to student loan providers, the savings from which will fund new investments in education. The Administration has proposed a major initiative to support and improve community colleges, which are a neglected but critical link in our education system. It has also proposed increasing Pell Grants, and is taking steps to simplify the student aid application process so that eligible students are no longer discouraged by a complicated process from even applying for aid. All of these actions will help to achieve one of the President's key educational goals for the country—that the proportion of adults with a college degree be the largest in the world by 2020.

Figure 1-7
Mean Years of Schooling by Birth Cohort



Notes: Years of schooling at 30 years of age. Methodology described in Goldin and Katz (2007).
Sources: Department of Commerce (Bureau of the Census), 1940-2000 Census IPUMS, 2005 CPS MORG; Goldin and Katz (2007).

Transforming the Energy Sector and Addressing Climate Change

Climate change and energy independence present a very different long-run challenge. Continued reliance on fossil fuels is leading to the buildup of greenhouse gases in the atmosphere and is changing our climate. Left unaddressed, these trends will have increasingly severe consequences over time. What is more, the United States imports the majority of the oil it uses, much of it from sources that are potentially subject to disruption.

Chapter 9 analyzes how economic policy can play a critical role in moving the United States toward a clean energy economy that is less dependent on fossil fuels and fossil fuel imports. Slowing climate change requires slowing the emission of greenhouse gases. A market-based approach, such as that supported by the Administration and currently working its way through Congress, can provide the signals needed to accomplish this slowing of emissions efficiently and with minimal disruptions.

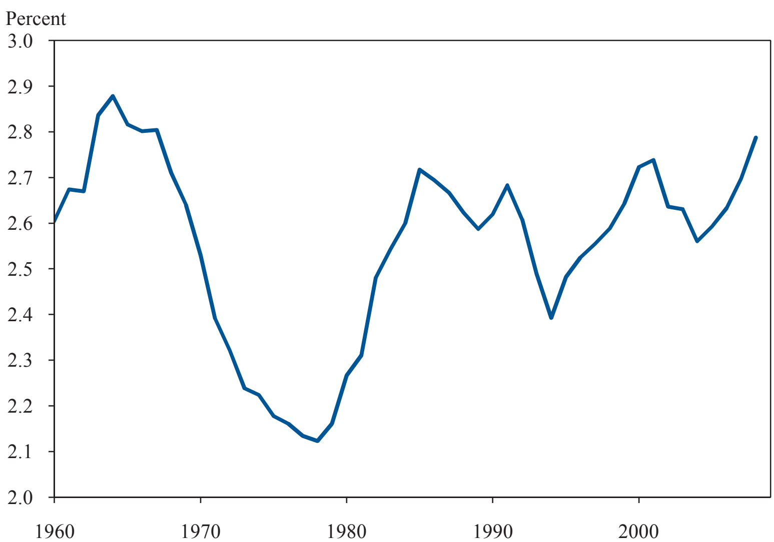
The support for research and development (R&D) and incentives for investment in clean energy technologies and energy efficiency in the Recovery Act and the President's budget, as well as in the energy and climate legislation, can help foster the transition to a clean energy economy and spur growth in vital new industries. These new industries have the potential to reinvigorate the American manufacturing sector and generate secure, high-quality jobs.

Fostering Productivity Growth Through Innovation and Trade

The ultimate driver of growth in average standards of living is productivity growth. Increased investment in capital and in the skills of our workforce are two important sources of that growth. Chapter 10 examines two other sources of productivity gains: innovation and international trade.

Innovation comes from many sources. But a central one is investment in R&D. Figure 1-8 shows the share of GDP devoted to R&D over the past 50 years. In the mid-1960s, R&D constituted a larger share of total spending

Figure 1-8
R&D Spending as a Percent of GDP



Note: Data for 2008 are preliminary.
Sources: National Science Foundation, Science and Engineering Indicators 2010 Tables 4-1 and 4-7.

than it has in the past decade. And in some other countries, such as Korea, Sweden, and Japan, R&D spending is a larger fraction of GDP than in the United States. The President is committed to raising the share of output devoted to R&D to 3 percent, so that America can continue to be a leader in new technologies and American workers and businesses can benefit from more rapid economic growth.

Through the Recovery Act and other measures, the Administration is investing both directly in basic scientific research and development and in the infrastructure to support that research. Most innovation, however, comes from the private sector. Here, the Administration is providing critical incentives for R&D both in general and in such vital areas as clean energy technologies. The Administration is also pursuing a wide range of policies to support the small businesses that contribute so much to technological progress—policies ranging from programs to maintain the flow of credit to small businesses to health insurance reform that will help level the playing field between small and large businesses.

Finally, international trade can be an important source of productivity growth and incentives for innovation. Trade has the potential to allow the U.S. economy to expand output in areas where it is more productive and to enable higher-productivity firms to expand. Access to a world market encourages American firms to invest in the research needed to become technological leaders. Through these routes, a free and fair trade regime can play an important part in lifting living standards in the long run. But for trade to play this role, it is essential to enforce existing trade rules and pursue policies that ensure that the benefits of trade are widely shared.

Conclusion

The past year has been one of great challenge for all Americans. Nearly every family has been touched in some way by the fallout from the crisis in financial markets, the drying up of credit, and the rise in unemployment. These challenges, moreover, have come after a decade in which ordinary Americans have seen their living standards stagnate, their health insurance become less secure, and their environment deteriorate.

The rest of this *Report* describes in more detail the actions the President has taken to end the recession, foster stable growth by rebalancing production and demand, and rebuild the foundation of the American economy. More fundamentally, it describes the work that remains to be done to create the prosperous, dynamic economy the American people need and deserve.

References

Congressional Budget Office. 2009a. *The Budget and Economic Outlook: Fiscal Years 2009 to 2019*.

———. 2009b. *The Long-Term Budget Outlook*.

Goldin, Claudia, and Lawrence F. Katz. 2007. "Long-Run Changes in the Wage Structure: Narrowing, Widening, Polarizing." *Brookings Papers on Economic Activity*, no. 2: 135–67.

Group of Twenty. 2009. "Leaders' Statement: The Pittsburgh Summit." September 24–25 (www.g20.org/Documents/pittsburgh_summit_leaders_statement_250909.pdf).

Kaiser Family Foundation and Health Research and Educational Trust. 2009. *Employer Health Benefits: 2009 Annual Survey*. Menlo Park, CA, and Chicago, IL: Henry J. Kaiser Family Foundation and Health Research and Educational Trust.

Shiller, Robert J. 2005. *Irrational Exuberance*. 2nd ed. Princeton University Press.