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'Stimulus' Snake Oil

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A year after the US economy stopped falling, we are still mired in "the worst labor-market crisis since the Great Depression," writes Laura Tyson in The New York Times. Voicing the consensus of the left-liberal economic establishment -- she's reportedly a leading candidate to head up President Obama's Council of Economic Advisers -- Tyson argues that the US unemployment rate, still stuck at 9.6 percent, is reason to try "a second fiscal stimulus" to raise "aggregate demand." She's wrong in a number of illuminating ways.

First, the highest unemployment rates are highly concentrated in relatively few states -- largely the ones with the highest home-foreclosure rates. That suggests that the root problems are *localized,* lingering debt woes -- so a *nationwide* quick fix designed to entice people to borrow more and save less is doubly off-base.

Two-thirds of the states have jobless rates lower than the national average, which is an amalgamation of 3.6 percent unemployment in North Dakota and 13.1 percent in Michigan.

For most of America, this has *not* been the worst postwar labor-market crisis. True, the unemployment rate did reach a postwar high this year in three states hit hardest by the boom-bust cycle in housing -- California, Nevada and Florida. Unemployment also hit postwar peaks in Georgia, North and South Carolina and Rhode Island in 2010 and in Kansas last year. For all other 42 states, however, unemployment reached higher peaks during the recessions of 1976 or 1982.

Tyson's second problem: This stubbornly high unemployment is *not* simply the result of sluggish growth.

Industrial production has been rising steadily for 13 months -- the same 13 months in which the unemployment rate has been above 9 percent. Manufacturing, consumption and business investment have all been recovering -- yet the unemployment rate has been *higher* than it was when the whole economy was collapsing.

The president's Council of Economic Advisers agrees that unemployment is about "1.7 percentage points higher than would have been expected given the behavior of real GDP." But the reason is clear: The US has for the first time extended jobless benefits beyond one year, to nearly two.

In "The Stimulus for Unemployment" on this page last November, I explained how extended jobless benefits have had the predictable effect of raising the duration and rate of unemployment. Citing academic studies, some by economists in the Obama administration, I estimated that extending benefits to 99 weeks had raised the unemployment rate by about two points. (The CEA's 1.7 percentage point estimate invokes the same math, but without explanation.)

The long duration of benefits alleviates the pressure to accept a less-desirable job too quickly; as a result many people spend longer between jobs. That boosts unemployment rates because more people wind up being recounted, time and again, in monthly surveys.

This does *not* tell us that extending benefits was wrong (or right). But it does mean the unemployment rate has become a *less reliable measure* of the economy's performance. We can't compare today's rate with that of past recoveries, because the government has never before underwritten a multi-year job search. While that policy is in effect, we must *expect* unemployment rates to be higher.

Of course, the recovery has been weak, compared to America's exit from past nasty recessions. But "fiscal stimulus" isn't the solution; it's likely been the problem.

Unlike the rapid recoveries from other nasty recessions in 1975-76 and 1981-82, this anemic recovery happens to be the first time the US has ever experimented with "fiscal stimulus" on a cast scale. People think FDR used this magic, but that's untrue. The budget deficit peaked at 5.9 percent of GDP in 1934, falling to 4 percent in 1935. Today, the Congressional Budget Office adjusts such deficits for the impact of recession, which would convert the deficits of 1934-35 into cyclically adjusted *surpluses*. That is, the US economy grew by 10.9 percent in 1934 and 8.9 percent in 1935 without *any* "fiscal stimulus."

After the stagflationary recession of 1974-75, federal spending was cut from 21.4 percent of GDP in 1976 to 20.7 percent in 1977 -- and economic growth averaged 5 percent in those years.

In 2009, by contrast, spending jumped to 24.7 percent of GDP from 20.7 percent in 2008 -- up four points in a single year. Nothing like that ever happened before. Even the CBO's *cyclically adjusted* budget deficit was 7.5 percent of potential GDP -- nearly 3 percentage points above the previous all-time high.

Yet Tyson and congressional Democrats now want even more "fiscal stimulus" in order to boost *domestic demand* -- that is, total spending by US consumers, business and governments. For proof that we need more snake oil, they point to the the second quarter's weak 1.6 percent growth in real GDP. But that's just wrong: GDP -- gross domestic *product* -- doesn't *measure* domestic demand.

As the second-quarter GDP report clearly stated, "Real gross domestic purchases -- purchases by US residents of goods and services wherever produced -- increased 4.9 percent in the second quarter, compared with an increase of 3.9 percent in the first." Whatever the problems of the US economy, slowing growth of demand is not one of them.

In short, Democrats and allies like Tyson are offering voters more fiscal nostrums that never worked in past recoveries to address a statistical embarrassment that is largely of their own making (extended unemployment) because of a GDP statistic they evidently misunderstand.

Tyson's article was titled, "Why We Need a Second Stimulus." Why, indeed. Because the first one didn't work?

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