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Econ 101

No Growth, No Jobs, No Wonder

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With the debt ceiling fight behind us and the supercommittee debate ahead, Washington has refocused, at least for a moment, on what it should have been focusing on all along—jobs. Everyone seems to wonder why we are not creating any new jobs. I would suggest a simple answer—insufficient economic growth. Thus, focusing on job growth, rather than on the underlying economic growth, may be the wrong target.

The economic recoveries up until 1991 were characterized by very strong economic growth in the first year or two and equally rapid job growth. Hence, the economy was generally able to put people laid off during the downturn back to work in a very short time. However, beginning with the 1991 recovery and extending through the current recovery, economic growth in the early years of each recovery has been relatively weak, barely equaling our long-run potential rate of growth. The resulting job growth has been weak as well.

Linking Economic and Job Growth

In the early 1960s, Arthur Okun, President Kennedy's chief economist, examined the phenomena of economic growth and job growth. His analysis led to the development of what has since been called Okun's Law. Roughly speaking, the current version of this law states that the economy must grow at about 2 percentage points above its long-run potential for a year to drive the unemployment rate down 1 percentage point.

While Okun's Law is more like a rule of thumb, it does provide a ballpark figure for what kind of growth we need to reemploy the displaced workers from the recession. With our current potential rate of growth about 2.5%, the economy must grow at about 4.5% to 5.0% in real terms for a year to lower the unemployment rate by 1 percentage point. To drive the unemployment rate from its current level of about 9.0% down to 6.0%, the economy must grow at 4.5% or more for about three years.

Okun's Law can also help explain our lack of job growth. Our economic growth rate since the start of the recovery has averaged 2.4% annually, but growth over the last year was only 1.6%. So our lack of jobs can be explained primarily by lack of growth.

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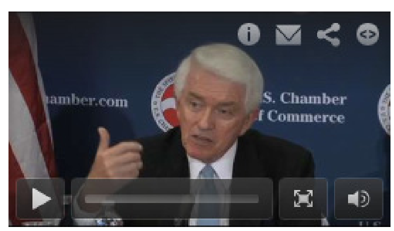

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At 2.4%, we are barely reaching our potential; at 1.6%, we are likely well below our potential. Therefore, the key to job growth is getting more economic growth.

Spurring Economic Growth

How can we get the economy growing faster? If we are to institute effective policies and programs, we must first understand how the economy grows in both the short run and long run. The economy's long-run potential is determined by its factors of production, namely labor and capital, as well as the productivity of those factors. Most current estimates place the long-run potential growth rate at about 2.5% to 3.0%.

Moreover, most economists believe that there is a limited ability to affect this long-run potential with current policies. Policies that foster capital broadening and deepening, promote savings and investment, and improve education and human capital appreciation all help encourage higher productivity growth. The relationships, however, are not direct and often require a long period of time to show results. Thus, while increased education and enhanced human capital may be prudent long-term policies, they are not likely to get us out of our current malaise.

In the short run, the economy oscillates around this long-run potential growth in a series of expansions and contractions. When the cycle results in a severe contraction, where growth actually turns negative, we call the downturn a recession. When we emerge from a contraction, the economy usually grows for a time at a pace faster than its long-run potential. This growth spurt allows the economy to reengage resources and reemploy workers who were idled during the downturn.

We are now emerging from a steep, long-lasting recession. However, almost two years after the recovery began, we have yet to climb above our long-term potential rate of growth. As a result, we have not created enough jobs to reemploy laid-off workers. Unlike policies aimed at improving our long-run potential rate of growth, which can take generations to show results, countercyclical policies are aimed at improving the economy in a hurry. Normally, countercyclical policies fall into two basic categories—monetary policy and fiscal policy.

We have tried a wide array of both fiscal and monetary policies, with mixed results. So here at the U.S. Chamber of Commerce we have suggested some alternative strategies to free up the market economy and get it working again, which are presented here (http://www.uschamber.com/sites/default/files/110905_jobs_letter.pdf) . We urge both Congress and the administration to adopt this pragmatic approach.

Looking Ahead

Now that we have laid out what we should do and why, it may help to take a brief look at the present situation to see just how far we must go. Current data show that over the first half of the year the economy has grown at a 0.7% annual rate. We expect the pace to pick up slightly in the third quarter to a little over 1.0% and hit about 2.0% by the end of the year. This subdued growth path is the result of weakness in the primary components of GDP, especially consumption.

Consumption dropped off considerably in the second quarter, growing at only a 0.4% annual rate. In contrast, consumption increased at a 2.1% annual rate in the first quarter. Part of the slowdown is the result of limited gains in income and wealth. In the first half of the year, real per capita disposable income increased 0.4% at an annual rate, and household net worth remains off by more than $6 trillion since the start of the recession.

Furthermore, household net worth is driven by financial and housing wealth. With the stock market hovering around its level at the start of the year and the housing market weak and volatile, we do not expect much growth in consumption this year.
Business investment remains strong and was a significant driver of second quarter

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GDP growth. However, because it makes up a relatively small share of the economy, the impact from business investment is currently insufficient to raise GDP above its potential rate of growth.

Another positive contribution has come from our net exports. But, again, this makes up a relatively small share of our economy and with the global outlook rapidly deteriorating, we cannot rely on growth in this sector to dramatically improve our outlook.

With weak economic growth in the first half of the year, we have experienced commensurately little job growth. Since the start of the year, the economy has added an average of only 109,000 jobs per month, and the trend has been slowing. In August, the economy did not produce any net new jobs, and the private sector added only 17,000. The unemployment rate was unchanged at 9.1% in August and is little changed from the start of this year. At the current pace, our economy is barely adding enough jobs to meet the demand from new entrants to the labor force.

If there's a bright spot in our outlook it's that the weak economic growth has produced little in the way of inflationary pressure. As a result, the Fed has plenty of leeway to continue its accommodative stance. This will help, but it's time to consider other strategies.

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