ECONOMIC CRISIS AND HIGHER EDUCATION

Forum for the Future of Higher Education

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Panelists

Brookings Panel on the Domestic and Global Economy

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Abridged Transcript

MR. BOSWORTH: My name is Barry Bosworth. I would like to welcome you to this meeting. This is not the best of times, and it does, again, reinforce the dismal science of economics, but it has made economists popular again, so for that, in some respects, we're grateful.

This morning the major objective is to have a discussion, but to start if off, I have some colleagues who can stir your interests on specific aspects of what's going on with the economy.

We're going to do this just alphabetically, so we're going to start with Martin Baily, then we'll hear from Becky Blank, and Gary Burtless, and Charlie Schultze.

Current macroeconomic situation and outlook

MR. BAILY: Thank you, Barry. I think the crisis has made economists in demand, but "popular" is not necessarily the way I would have described it. I'm going to talk about the current macroeconomic situation and the outlook for the macro economy.

The number that came in for GDP the fourth quarter of 2008 was minus 3.8. That was a smaller number in absolute number, a smaller decline than had been expected, but nobody took very great comfort from that since most of the difference came from a bigger import slump than I think the forecasters had expected to see in the numbers, and the bigger inventory accumulation, which does not, if it’s correct, does not bode well for future production.

Another thing that’s particularly worrisome appears to be the collapse of world trade. Trade numbers tend to be a bit lagged relative to other numbers. But such numbers as we have show very substantial declines of exports and imports for the U.S., exports from countries like China that are big exporters, and anecdotal evidence from folks who are in the shipping, packaging kinds of business suggests things in world trade are very gloomy.

What often happens in business cycles is, you get inventories piling up and then production drops below demand, so things can look very bleak for a while stuff piles up on the docks, cars are kind of piling up on the docks unsold coming into the U.S., and so production cuts tend to be very severe. But it does create that very sharp decline in production, and correspondingly, often in employment.

Now, I knew we were going into hard times, I didn’t realize how bad it was going to be, so saying exactly how this is going to play out in the future, I don’t feel confident, I know that. I feel pretty sure we’re going to get a nasty quarter in the first quarter of ’09, and probably a fairly nasty quarter in the second quarter.

I’m somewhat hopeful that the economy will begin to level out after that so that maybe the economy is still falling, but it’s not falling as fast as it was, and I think we can maybe look for some consolation there, but I don’t think we’re going to see much of a turnaround before the end of 2009, and maybe into 2010.

Typically, I think from prior U.S. experience and from other countries’ experiences, when you have this kind of financial crisis, it’s hard to get sustained growth coming in quickly even after the recession, the decline itself, is completed. So if we get any growth at all in the second half of the year, I think it would be pretty sluggish, and I would expect sluggish growth at best in the early part of 2010.

The housing market still, well, there was a little glimmer of light in pending sales of houses, but basically I don’t yet see a bottom in the housing market. You sort of feel if construction keeps falling at the current rate, they won’t be building any houses at all, and at that point, I guess it can’t go any further, but overall, the housing market and construction are still very weak.

And, of course, job loss is substantial. We’ve been running at about a 500,000 decline a month.

The other thing that's pulling us downward is the loss of wealth. Between 2000 and 2007, household net wealth increased by $19 trillion, and that includes financial assets, housing, consumer durable goods. Housing was probably the biggest single driver. Based on an estimate forecast from the fourth quarter of '08, that has declined by $12.6 trillion, so we've seen a $12.6 trillion decline in wealth since the peak sometime in '07. The usual rule of thumb that the Fed has used is that every dollar of decline in wealth translates into about five cents of decline in consumption, and that would mean about a $600 to $700 billion a year decline in consumption. And if you add onto that households' concern about job security and so on, it's not surprising that consumers, American consumers, are cutting back quite substantially.

Again, one bright spot there is the decline in gasoline prices, which I have pegged at about a $250 billion increase in household income as a result of not paying $4 a gallon, but instead paying around $2 a gallon. It's not enough to offset the decline in consumption that you're going to see from the wealth decline.

Let me talk about the financial sector. I thought we were getting a handle on how large the losses were globally, now I'm not so sure. Goldman Sachs number is $2.06 trillion for all bank losses. Globally, Nouriel Roubini is up around three trillion, and I've seen some other analyses that have something like that.

Well, that's a pretty good range, a trillion here, a trillion there, but unfortunately, I don't think we know where these losses are exactly. But if it's two trillion, I would view it as being somewhat manageable in light of where we stand. Banks have raised about $500 billion in private capital. Governments, including the U.S. government, are putting in about 800, again, this is a Goldman number, $823 billion. So that means it's sort of within range if you get the second tranche of the TARP and increase bank capital by that amount, and then you maybe either guarantee or buy some of the troubled assets.

Now, I know there's a lot of political opposition in the country to doing this kind of thing, bailing out the banks and all of that. I understand that, I have a lot of sympathy with that, but I think we have to do it, because otherwise, the effect on the U.S. economy is going to be severe.

There's a lot of uncertainty around the value of a lot of the banks' assets. The only agent within our economy that seems willing to take high amounts of risk is the U.S. government, and so the U.S. government has sort of been forced to take on those risks. It might turn out tax payers will do well, it might turn out tax payers will do very badly, but it appears that, from my judgment, we have to do that in order to get some of the uncertainty out of the banks so they can raise capital, and then as the economy recovers, they can make additional lending.

I would not expect them to make much additional lending while the economy is still in free fall. But we want to set them up so that they can make additional lending once things begin to recover. Let me stop there.

Labor market and family incomes

MS. BLANK: I want to say a little bit about the labor market and family incomes, and then talk a little bit about the prospects for future growth. Up until a little over a year ago I was actually being a higher education administrator over at the University of Michigan, and I have, upon a number of occasions in the last few months, reflected on the fact I think I'd much rather be an economist in Washington right now than a higher ed administrator given all the problems that I know you folks are all facing.

So just to pile onto the bad news here, this recession is both deep and broad. In the last four months, more than two million jobs were lost in the economy, which is a very large job loss in a very short period of time. Those job losses are spread across all sectors of the economy. One of the things that makes it very clear that this is a serious recession is, when you look across industries, there's only one exception to the job loss. I mean every other industry is posting losses, and that one exception is the health care industry. So those of you with medical schools will still have a set of graduates who have jobs out there.

But everyone else has lost, and particularly, of course, construction and manufacturing have had huge losses posted over this past year.

The unemployment rate currently sits at 7.2 percent. That means there are 11 million unemployed persons in the country right now. If you add onto that unemployment rate the number of people who say they're working part-time but want full-time jobs, they're involuntarily employed part-time, and if you also add on the number of people who say they really need and want to work, but they've become discouraged so they're not looking as hard, then you have 20 million people who say that they're actively looking for work of one sort of another and not quite finding it That's a big number. Almost surely it's going to go up. I think the probability is that we're going to see unemployment rates over ten percent unless this stimulus package works better than it might; I could be wrong about that.

And, in fact, one of the benchmarks that I have the sense the administration has at least internally put out for itself is, they'd like to keep unemployment under ten percent and they'd like to have a package that tries to create jobs so that they don't hit that ten percent mark. Whether or not they achieve that, we will see.

The labor market is a lagging indicator of the economy. So even if you start seeing good signs in some other parts of the economy and things start to be turning up, usually the labor market continues to deteriorate because companies are often quite cautious about hiring, and so the last thing to turn up is jobs, and you sort of want to ask, are we really coming out of the recession? Once employment starts turning up and unemployment starts falling, you're almost surely really coming out of the recession because of the lagging nature of the labor market. Finally, in terms of discussing the labor market, it is worth saying, of course, that there are big differences in the employment challenges facing different groups in the labor market. If you're a high school dropout, your unemployment rate currently is pretty close to 11 percent. If you're a college graduate, good news for those of you who create college graduates, the unemployment rate is 3.7 percent.

Now, historically, that's quite a high unemployment rate for college graduates. They usually perk along around two percent. So the percentage increases in unemployment among college graduates have been quite high, but it remains at a relatively low level.

Now, to put this in perspective, the highest unemployment rates among college graduates were posted in the early '80's, and then it went up to 4.3 percent. So my expectation is in the next few months, we're going to reach those same highs and we're going to see unemployment rates among the college educated over four percent.

That's nothing like the problem some other skill groups are facing, but it's very high for that group. It'll be particularly high, bad news for you folks, among the new entrants, because they are the group who are going to have the biggest trouble finding jobs. And, you know, one of the things that I would sure think hard about if I were still in higher education is what my career service group should be doing in a world where job finding is just a lot harder, and I think you have to coach students a little bit differently about persistence and expectations and what they're going to find.

The last comment I'd make about all of these things in the labor market is that all of this suggests that there is going to be a pretty steady increase and demand for higher education. Unlike other sectors of the economy, demand for the things that you provide is not going down, it's going to go up; demand for higher education is counter cyclical.

The opportunity cost of going back for further schooling is as low as it has ever been, particularly if you're unemployed and having difficulty finding jobs. That's going to hit the community colleges first, and some of the state universities second, and it might hit some of your institutions by a little less, but it will hit you. And, you know, that's sort of good in terms of being able to select more among applicants, but particularly among older students, those of you who have continuing education type programs, my guess is you will see some increasing demands. The problem is that will be offset a little bit by very tight incomes, and how that plays out, we'll see.

Not surprising out of all of this, family income is going to be pretty badly hit, as well, is my expectation. The income statistics really lag. We aren't going to know anything about 2008 income until the end of August, early September of 2009. So, we're sort of guessing at what's happening to the income out here. But almost surely we're going to see some pretty big income declines when those numbers come out.

There's both good news and bad news on family income. Married couples are more buffered against this type of an economy than 20 years or certainly 40 years ago, because it's much more likely there's two working adults in those families. And that does mean if one of them loses their job, it's still likely there's going to be some earnings coming in, that's the good news. The bad news is, there are fewer married couples out there. There are many more single adult families, and, of course, if they lose their job, all of the income goes. So how that trades off in terms of overall income is an open question.

What's different about this recession? What's really different about this recession, to no one's surprise, is the whole financial collapse. The only comparison we have post-World World II for depth and breadth really is the early 1980's. Between 1980 and 1982, we had a very bad series of years for families' income, labor markets. But it was different in the sense that that was driven by external shocks and prices as opposed to a complete collapse of financial markets. And, of course, that's one reason why we're trying to do much greater fiscal stimulus as opposed to monetary policy.

Financial collapse does mean that in some sense you've got to get the banks stabilized before you can fix the other parts of the economy and worry about job creation. And my own sense is, as long as there's instability in the financial market, nothing else is really going to get a lot better. And it's not until you believe that the financial market has stabilized and you start seeing lending coming back, and start seeing people having some trust in the whole banking and financial sector, then you can say, okay, now we're just in a good old fashioned recession and we'll come out of that, we've been there before. But you do have to get the financial market stabilized, and Charlie will tell you exactly how to do that in a minute.

Finally, the last comment, as you're coming out of this recession, I want to say something about the change in demographics in this country, because I think the expectations for future economic growth ought to be different than they have been in the relatively recent past.

So the 1990's, the years of golden growth, we were thinking, gosh, four – four and a half percent of GDP growth, you should expect this on a regular basis. That is an unrealistic expectation for the years ahead, even as we come out of this recession, and that's because of the changing demographics.

There's two things that are going to shade points off economic growth. One is that there's essentially no expectation of future increases in labor force participation in the near term. Some of this is because female labor participation, which has been going up steadily for the last 30 to 40 years, has actually flattened out, and it's not likely to rise a lot more. The second issue is the aging population. We're going to be hitting a number of years where a higher share of the population is reaching retirement age than is entering the labor force.

And labor force participation growth is responsible for about ten percent of economic growth over the last 30 to 40 years, so you're shaving ten percent off if you don't have labor force participation growth.

Secondly, I don't think you can expect as high earnings growth as you come out of the recession, and again, this is also due to aging. In the 1980's, you had the bulk of this baby boom population moving from the 20's to their 30's, years of very high earnings increase. In the 1990's, you had this population moving from their 30's to their 40's, also years of high earning increases.

As that population moves into their 50's and 60's, the so called age earnings profile, as economists call it, slows down; the rate of earnings increase for people who go from their 40's to their 50's, much less their 50's to the 60's, not only slows down, but even becomes negative in many cases, and the result is, you're just not going to see the same earnings growth, and earnings growth has been the main driver of GDP growth. So I think even once you get past the recession, we're in a slower growth economy, and that has all sorts of implications for how you think about the future and how you monitor what's success and what's not success. I'll stop there.

MR. BOSWORTH: Thank you. The next speaker is Gary Burtless.

Higher education funding

MR. BURTLESS: I'm a labor economist and public finance economist, and I once worked in the Department of Labor. My past association with the Labor Department means that I sometimes receive calls from reporters who ask, "Well, what can we do in a recovery package to retrain workers who are currently unemployed?" I have to sadly inform them that actually the Department of Labor is not a very big source of funds for training or retraining workers.

I would be surprised if the total amount of training money spent by the Labor Department per year would keep the U.S. higher education system going for a week and a half. It's true that Congress intends to increase DOL spending for that budget item, but the amount is going to be very small.

It's natural for reporters to think about retraining in a recession. It can serve two kinds of functions. The first is that it can prepare workers for some future economy in which jobs are more plentiful. In that future economy, having a better credential would represent a real advantage. But the second thing it can do is to take people who otherwise would be standing in line for an unemployment insurance benefit to do something useful, either in a college classroom or a training center. Adults who are devoting their time to upgrading their skills are not going to be fighting with the newly laid off to find whatever small number of jobs are available.

The two biggest sources of funds for training and retraining in the United States are, first, federal grants and loan subsidies for higher ed and for training. These are financed through the Department of Education. The second main source of funds are state and local grants to public colleges, universities, and local community colleges.

As Becky just said, the demand for post-secondary schooling places, especially in community colleges, tends to be countercyclical. A high unemployment rate drives up the demand for college places.

Now, as most of you know, neither the federal portion of public funding nor the state and local portion of funding is countercyclical. Funds from these two sources do not automatically increase whenever there's a recession. In fact, the state and local funding stream tends to be strongly cyclical; it tends to *decline* when there's a recession.

But here's some good news. Based on my reading of the stimulus bills, this recession promises to be different. My reading is that both the Senate and the House bills will contain somewhere between $36 and $40 billion in direct and indirect federal assistance to higher education.

That amount is more than is earmarked, I think, for the highly publicized spending on bridges and roads. And to me, it's a dazzling surprise, because it has not been my experience in past recessions that there's very much in the way of countercyclical aid. As I said before, at the state and local government, it works the opposite way: Public spending tends to *decline* in a recession.

The House bill has $15.5 billion in higher Pell Grants, an increase I think of $500 per student per year who qualify for those kinds of grants. It has half a billion dollars in work study; $12.5 billion in refundable tax credits, an increase over and above whatever the HOPE education credit provides currently. Six billion dollars is earmarked for renovation and improvement of college facilities, and a billion and a half for biomedical research facilities at the nation's universities. There's hundreds of millions of dollars extra through the NSF for graduate fellowships and science.

At any rate, it is really quite surprising, I think, and this does promise to be a different government response to the recession.

MR. BOSWORTH: The last speaker is Charlie Schultze.

Banking Crisis Effects

MR. SCHULTZE: Thank you. What I am going to do is expand on what Martin Baily ended with, which was the effect of the current financial and banking crisis on the overall economy over the next three to four years. But let me just quickly start with the losses that either have been experienced or are likely to be experienced by the financial community, banks in particular, because of U.S. mortgages, mortgage backed securities, or other investments by banks all over the world.

What size are those losses? And as we speak, they continue to grow.

Last October, the IMF said there would be about $1.4 trillion worth of losses to world banks, about half – a little over a half U.S. and the rest mainly in Europe. The latest estimate is, that I put a lot of stock in, is from Goldman Sachs, which says something like not 1.4, but 50 percent larger, like $2.1 trillion in losses, again, a little over half of the U.S. banks and less elsewhere.

Now, each dollar of losses from their assets that banks take wipes out a dollar of bank capital. Now, bank capital fundamentally is the back-up or reserves that fly behind their investments and their loans. And on the average in the U.S., for every $1 million in capital, banks borrow $9 million, and all together make loans of $10.

Conversely, that means that with every $1 million in bank losses, banks either have to find new capital to replace it or they've got to cut their loans and investment portfolios by $10 million, ten times as much, round numbers.

Well, it's very difficult for banks to get additional private capital now, because they're in a precarious position, who wants to invest in that, and secondly, because of the incredible complexity of these derivative related securities they've got, who in the hell knows what the quality of assets in any bank really is.

There's a lot of uncertainty about that, so they're just not getting much new capital, which means, in turn, that given the latest loss estimates, and I don't dare think of what would happen if the $3 trillion estimate that Martin talked about came about. But given that $2 trillion, and for the U.S., something a little over $1 trillion set of losses, U.S. banks would have to cut back their portfolios of loans and investments over the next five years by 20 percent, and that's no small number.

It would mean a large contraction in the supply of credit to business and consumers with, not dollar for dollar by any means, but substantially bad effects on the economic outlook. Now, in the United States, it would take about, let's say it's 1.4, but I'll say one and a half, not to be accused of being too precise, trillion dollars in federal funds to offset that necessity to cut those loans, either by injecting new capital into the banks or buy buying up some of their worse assets.

That would mean that $1.5 – $1.4 trillion, a doubling of the $700 billion in the TARP, the fund for injecting capital or buying up loans that the Treasury now runs.

Well, the Congress is very sour on this existing program, the $700 billion, of which only about probably $400 billion has been spent by now. They're demanding that, out of all of this, the banks ought to be made to make new loans. And as I say, they're very sour because they haven't seen any progress on that.

But unfortunately, the Treasury now can't satisfy those demands. The whole objective of the bailout - at this stage, initially, not forever, but initially - is to slow and halt the threatened contraction in lending. So you're not talking about this money principally going to make a lot of new loans, it's to stop having to cut way back on them, and they can't satisfy the Congress. And so as a consequence, I'm very pessimistic about the prospects for turning around the credit crunch very soon.

Now, at the moment, we're in a recession, and the demand for credit is also falling, along with the supply of credit, so the impact of the credit crunch right now is a little muted. It's making a bad thing worse, but not as bad as you would have thought, because the fall in demand.

However, what it does mean is if we don't get something like that $1 and a half trillion and spend it well, the impact is going to be on stretching out the recession and slowing down the subsequent recovery, not necessarily cutting off any recovery, but significantly slowing the pace of recovery.

In a very small way, that happened after the recession in 1990, when there was a real estate credit crunch, financial crunch, particularly in New England, and that did give us a recovery from the 1990 recession that was noticeably slower than what we had been used to. Two things on that: Number one, just to kind of offset a little bit the pessimism that I'm pushing, it's not catastrophe. What we're really talking about is, will this recession be something like or maybe even a little worse than the worst we've had in the post-war period. We're not talking about Depression or anything like that, but that's still a very serious matter, but it is not catastrophe.

The second point, given the Congress' very sour attitude about the current funding that Treasury is getting and what it's doing with it: From a political standpoint, it might be useful in getting a second tranche out of this, instead of injecting all of the money into new capital for the bank, to instead guarantee some of their bad assets and give them the assistance that way.

Now, what that really means, it's a little bit of which shell is the pea under. It doesn't reduce the total amount of money you're going to put in, because some of those loans, when you guarantee them, are going to go bad. What it really means is, you don't have the upfront money to go to Congress for. You don't have to go right now for a big increase in the TARP if some of the money could be used that way. Now, there are a lot of problems in doing that, it sounds easy, but it isn't. But for political reasons, maybe that's what they ought to go for. In short, what I am saying is that the size of the credit crunch is still very substantial, that doing something to stop it, moderate it, and then stop its downward effect on the economy is key.

If we do that, it's going to make a very big difference, but particularly it's going to make a difference in how long the recession lasts and how fast the recovery is, and that's the big issue.

Takeaway Points

MR. BOSWORTH: Thank you. As I listened to this, I was trying to think about what some takeaways might be. I think one is, compared to the past, don't think this is going to be over in the short run. Usually we are so used to thinking of what we economists call V-shaped recessions, you go down very fast and you come back very fast, this looks more like a long, drawn out L. We're going to go down, and there's a very real risk that we actually just sit there year after year.

There's been several studies recently done. Financial crisis just last a lot longer than normal economic business cycles. Around the world we've had this happen again and again. We continue to make the same mistakes that we made. But remember, like in Japan, it lasted for over a decade. And what initiated the crisis in Japan is very similar to what initiated the crisis here in the United States: wild real estate speculation and a collapse of the banking system.

The second one I think is, get used to the fact that the public sector budget deficit is going to run between $1 and $2 trillion for years to come. Just a few months ago we were arguing that a $500 billion budget deficit was unacceptable and a long run budget crisis was coming from the aging of the baby boomers. Now that looks like peanuts, and that's been the experience of every single country that's had a major financial crisis, because you have to replace all this financial capital that got destroyed, and the only people that could potentially do it are the central bank or the government itself. The only issue is going to be how much we do through the central bank and how much we do through the budget. And so these public budget deficits are going to persist for years.

Another one I think that Becky mentioned and is important, because it reminded me of a few months ago when Gary and I went to a conference, there was arguing about the preparation of the baby boomers for retirement. Someone made the fundamental point, and I think it was right at the time, the baby boomers are actually in good shape for retirement, their wealth was never higher. They had a 401K plan, it was in great shape, and their homes had appreciated in value, and they hoped to sell them and move to Florida. All that has gone away.

The baby boomers now are in extremely poor financial condition, in fact, and they really don't have enough time to rebuild their financial portfolio.

But what's going to drive a lot of American households over the next decade, is rebuilding their financial structure, not consuming. I think you walk away from this thinking, this is going to last a long time, it's going to have a very high cost, and it's going to run through a lot of what we're used to thinking of as sort of the middle income groups of American families.

With that, I think the easiest way to do this is to see if we can't generate some discussion and comments or questions from other people around the table.

BEGIN Q&A/DISCUSSION

Higher Education Funding

SPEAKER: I agree with Gary, that there's a remarkable injection of funds from the federal government into higher education. What I'm a little worried about is, it's really all on the demand side. It's subsidizing the consumers of higher education, and traditionally the recession problem is that states squeeze the budgets of the institutions, and then there's a reduction in the supply of places.

So, for example, right now you have the California State University campuses advancing their normal application dates precisely so they can turn kids down who would otherwise go to the CSU campuses.

The only way that demand side money gets into the institutions' budgets en masse is if they raise tuition. And the political pressures on them not to raise tuition are strong. So it's a lot of money, but it may not help directly with this problem on the supply side, which in the past I think has been the main source of recession related problems.

Some of these places are very cheap. The problem is, they're not supplying the classes that you need in order to get your degree. But it is a ton of money, I agree with that.

MR. SCHULTZE: Unlike the proposed salary limits that the President wants to put on banks accepting federal funds, I don't think that I've heard that Congress wants to put limits on what public colleges or private colleges can charge for tuition and other fees in order for their students to take advantage of the more generous tax credits.

And, look, historically we know that the reaction of the higher education system to more generous support for students was to let that be reflected in the higher charges they make. And I would also say, Barry knows more about Michigan, as does Becky, than I do, but I believe that with severe financial crisis, some states have been pushed to giving greater authority to their higher educational institutions to have independence in where they set their tuitions.

Now, this varies from state to state, but certainly some states have allowed, the University of Michigan, for example, to charge lot higher tuitions, because they're getting so much less state support and the state doesn't feel as though it can put as many constraints when they're not providing as much direct aid.

MS. BLANK: I just want to say that, to the extent that there is a substantial amount of dollars in the stimulus package that go to state and local governments, money is fungible, and the more that those dollars go to cover the huge gap, for instance, in Medicaid programs on the state side, the more that it's going to give states the ability to not cut higher education.

But on the other hand, the Center for Budget and Policy Priorities has noted that something like 29 or 30 states have already announced cuts in their higher education budget for the next year, and my guess is that's going to go awful close to 50 before it's over.

Consumption

SPEAKER: Is there another aspect of this, that there's another shoe to drop, which is, we come out of this with a major structural change in our economy? I mean how many shopping malls and how many Starbucks and all that other stuff are going to disappear? We can't have a sustainable economy at 70 percent consumption. Is there an evolution of that, we'd lose even more manufacturing jobs? Has anybody thought about there being another shoe that drops that makes this even more prolonged and difficult?

MR. BOSWORTH: I think the big issue that I would address on that is, if you think that the consumption binge in the United States over the last 20 years, and the rise in consumption as a share of GDP, was fundamentally driven by peoples' perception that they were rich - in other words, by the rise in the wealth to income ratio - then that's going to be a fundamental shift.

And we thought we had to do it in the long run because we had become a country that consumed too much, ran huge current account deficits with the rest of the world, and relied on them to support our consumption. That could not go on indefinitely. It's just that you couldn't name a worse time than trying to make that correction right now in the midst of a global recession. But what has happened so far is, one part of the adjustment is occurring, people have quit consuming, households are now saving. They decided to do what people urged them to do for the last 20 years at a terrible time, but it appears that their saving is going to be offset by government sector dissaving. Is the external balance of the United States going to improve in these sort of circumstances? Well, we have to learn to export more. But isn't that what every country in the world thinks they should do right now to get out of this crisis? Everybody wants to export more.

So we're trying to do all the corrections that ultimately had to occur at a very bad time, because we wouldn't address the problem in the prior decade, we just put it off and put it off.

But now I would say the perverse thing is, the world needs us to do this again for a few more years yet. It's a very complicated story for the President to try to tell people. In the short run, we've got to emphasize domestic consumption to try to get recovery, and in the long run, we've got to have the fiscal restraint that he is talking about, and households have got to save more.

But you can't keep the economy going in that circumstance unless we can learn to export more. I mean what else is going to increase if all these other things are going to go down? That's going to be very hard to do.

MR. BAILEY: Let me add one very quick note. This was a preliminary number that was developed, but I saw a number that said since 2000, about 13 percent of world GDP growth was accounted for by U.S. consumption. So that's a big number in the sense that the U.S. is a big country, we're doing a lot of the consumption, but it's not so big that it's impossible to make the adjustment if the rest of the world is able to do it. I think Barry has got it exactly right that it's a very bad time to be doing this. But if we can get out of this global recession, I think the adjustment for the rest of the world is not so great. They need to spend a little bit more as we spend a little bit less.

Construction Prices/Psychology of Recession

SPEAKER: I'd like to ask a real practical question. Construction prices for us are down 20 – 25 percent, the question is, is the stimulus package alone going to turn that around? That is, if I can buy a building now at a 25 percent discount and low interest rates, it might be a good time to do it, but if it's going to take a long time for the stimulus package to actually affect construction prices, then I'm better off waiting. Do you have any insight about that?

MR. BOSWORTH: Most recessions occur because people think, as you did, prices are down 25 percent, but they're going to be down 30 percent tomorrow. And as long as people have the expectation that the situation is going to get worse, they're going to hold off. And I think, and what most people think right now in the construction industry, as a stimulus measure for this area, it seems to me the program has been a failure, it's just too slow.

It's going to be very effective in the year 2010 and 2011 on the expenditure side of the public works and things like that, but it's not going to do anything in the next six months to a year.

The idea of trying to stop the decline got lost on Capitol Hill. I think the problem on Capitol Hill started out with, this is terrible, and then after a little bit of thought, what a great opportunity, I can get every program I ever dreamed of, but they lost sight of the urgency of trying to get money out to the economy quickly.

Inflation/Deflation

SPEAKER: A question, what do you think about inflation, or for that matter, deflation, given all of these things that you've been discussing earlier?

MR. BAILY: I think right now we're probably in a deflationary period with commodity prices falling. There are people who worry about deflation and think that's going to push us further into recession as it did in the Great Depression when prices were falling. I'm not so worried about that. I think we're seeing, obviously, wage incomes falling, but not wage rates falling. The rate of growth has slowed down, which you'd expect, but I don't think we're seeing declines on that side, and I wouldn't expect to see them.

And falls in commodity prices, particularly the fall in oil prices, is actually helping us on the recovery. So then the question is, okay, are we then going to run into inflation once the economy begins to recover. Well, I was on a panel like this with a colleague, Alice Rivlin, who was the Vice Chairman of the Fed, and I said, well, once the economy starts recovering, the Fed is going to have to get out a big vacuum cleaner and suck up all this liquidity that it's put out there, otherwise, we may get inflation and possibly we'll have to also do something to retrench on the fiscal side again. And Alice said, at least on the monetary side, well, we know how to do that. So I'm glad to hear that Alice feels we know how to do that.

I think it is a little bit tricky; if you do it too early, then you push the economy back into a downturn; if you do it too late, then you may end up with an inflationary impulse. It's a risk I think we have to take right now, and I'm reasonably confident we can do it okay, but there may be some inflation along the way.

Housing

MR. BOSWORTH: I guess I agree with all that. I would only add one thing, I think there's one sector we haven't talked about that much about where that's not true, and it's housing. I think we came close to it on the question about construction. As long as you think the price of something is going to be lower tomorrow than it is today, you're going to hold off.

And the situation in housing and the mortgage market is just going to keep right on deteriorating until we can find a way to stabilize home prices, because the more they go down, the more people are going to say they're upside down, they're going to walk away, the bank is going to take the home, dump it on the market in a foreclosure proceeding, and the price is going to go down further. And so one of the big, crucial things that's been missing from this whole program is, how do you go about stabilizing housing.

So the question is, how can government do that, and I think the fundamental thing that's holding us back at present is, we can't figure out a mechanism for sorting out the deserving from the undeserving. And no politician or government official wants to bail out some household that then somebody else points to and say those bastards deserved it. And I think that's a grave difficulty. Maybe we're at the point where the crisis is so severe, forget about what's fair and what's not fair. You've just got to hold your nose and figure out some way to pump a lot of money into the housing market and stabilize it.

But that, it still seems to me, is a big problem area for us before we can expect a turnaround. I think the economy will keep on deteriorating as long as we continue to hear about declines in home prices.

Interest Rates

SPEAKER: A question about interest rates. If the federal government is financing enormous deficits, there must be an enormous supply of government instruments. What will be the effect on interest rates and what will be the effect on international willingness to purchase our debt?

SPEAKER: That depends on what the fed does. The fed can always pump enough reserves in to, at least in the short term, keep rates down. Of course, if we overdid the stimulus and the economy really recovered well, and if you kept trying to do this, you got a problem. But I think as long as the fed is willing to pump the money in, you'd do it.

Now, that's kind of Alice Rivlin's point, that when things get good, we'll come back out of that, we'll no longer be doing it. That's some question. But as long as we've got slack in the economy and the fed is pumping money in, I don't think that's a problem.

MR. BAILY: Well, I mildly disagree with that in the sense that if we don't have some kind of plan on what we're going to do with the budget over the long run, then I think we might get into a situation down the road of seeing upward pressure on longer term interest rates and maybe some downward pressure on the dollar. Now, to some extent, downward pressure on the dollar, as Charlie already said, might be a good thing. But Nouriel Roubini, you know, he's the doctor doom that predicted this catastrophe, but he didn't exactly predict the catastrophe we have. He thought what was going to happen was that there was going to be a run on the dollar and that U.S. longer term interest rates were going to go way high, and that's not exactly what we seen.

But I think if we look five years ahead and we see the baby boomers and Medicare, unless we do something about that, I don't think there will be a huge run on the dollar, but I think that's something we should worry about. And the Fed just pumping in money, Charlie, I'm not sure is the solution to that.

Higher Education and the Stimulus Package

SPEAKER: I want to bring us back to higher education and the stimulus package. My read on the House bill is that more than $40 billion will go to American higher education, the largest increase since World War II. How much over $40 billion depends upon the fiscal stabilization provision, where something like $54 billion will go to the governors, $39 billion of which must go to education.

The increase in the Pell Grant will, in two years, double the total amount that we are spending for Pell, but it still won't bring us up to the percentage of the cost of the attendance that we had in the 1970's, right after the Pell bill was implemented. And I think we're approaching a point of inflection. If the American dream is that every generation will be better educated than the previous generation, we now, for the first time, are seeing that the youngest adult cohort has a lower level of educational attainment than the oldest adult cohort in the U.S.

So in the world, we rank number one with the level of education of people over 55. By the time you get down to people under 30, our ranking is tenth. We're seeing a flattening of the slope that links lifetime earnings with the level of education for the baccalaureate degree.

In "Chindia" there are ten times as many kids in school as there are in the United States, and their college-going rates are increasing dramatically. So in the global context, these are potential points of inflection that make investment in higher education ever more important.

Higher Education's Role in Economic Recovery

MS. BLANK: I think you're absolutely right. And if you're looking out in the long term and asking how the United States is going to maintain its economic dominance over this next century, there's basically two things that are going to drive long term economic growth. One is skills, and the other is technology, and that's going to lead you to human capital development or entrepreneurialship, and both of those are closely related to higher education. We have been falling steadily behind our major competitors over the last two decades on that front.

It's one of the real concerns that I have around this recession. This would be the time to try, because the opportunity costs of going to school is so low, to try to actually increase skills in the whole population so that we can come out of this recession with a more skilled work force. But we're largely not doing that.

Instead, you've got states that are cutting back their slots. I understand why that's happening, but it's really eating seed corn for the future. And higher education is obviously not the only sector that has to speak to this, but there needs to be a much better appreciation throughout the economy that our long term economic growth is fundamentally tied to the skill level of the U.S. work force, and that we're not where we should be on that front.

Long-Term Effects of Stimulus Spending

SPEAKER: Barry described a circumstance for the next several years where the feds will either print or borrow an extra trillion dollars or so. Martin reminded us that we intend to print or borrow dollars for the entitlements for the baby boomers. It feels like the stimulus is sort of a bridge to the next problem. To the extent that printing or borrowing sums of that magnitude are going to be out there, I'd ask the panelists if you can describe a circumstance where we ever get back to business as usual, because it doesn't sound like there's going to be any capital.

MR. SCHULTZE: One of the problems with the stimulus, is that intellectually you can say, well, look, why not for the stimulus put in the beginning stages of some of our longer range programs that we want to do anyway, and that sounds like a good idea.

Why dig holes in the ground when you can do something useful? The problem with putting those longer range programs into your stimulus program is that, for example, all the energy stuff they're putting in, or a lot of it, is that you don't do those well if you don't do them a little slowly.

Once you dump them into the stimulus program, then you don't have to pay for them because we're in a recession and we don't want to pay for them. We don't want to tax for them. And the danger is that once you stick them into the stimulus program, they never get paid for. One thing that would help a little bit, I won't say a lot, because paying for it is very difficult and we haven't been able to do it yet, is at least to put in that, starting with 2011, any money you're still spending for this program, you've got to pay for, kind of a pay-go rule.

Now, the Congress doesn’t have to really abide by that in the future, they get around it. But at least it would put a signal in that we’re serious about the fact that this idea of not having to worry about printing the money or not paying for it is something we can just let go with anything we dump into the stimulus program. Now, that at least sends a signal that we understand we’ve got to get at this later. But I don’t want to say it’s worth too much.

END OF PANEL