We economists make all kinds of assumptions, many of which are unwarranted, but I’m going to climb out on a limb here and assume you’re with me all the way out to the end of the branch on the importance of full employment to the reconnection agenda. I mean, unless you’re someone who’s either just downright mean-spirited or who benefits from a bunch of surplus labor, or both, you’d probably like to see everyone who wants a job get a job, and a decent one at that. Which again, means we need to have tight enough labor markets to give workers the bargaining power they need to claim a fairer share of the growth they’re helping to generate.

In modern, advanced economies, the two biggest tools to achieve full employment are fiscal and monetary policy. And since what we’re up to here is putting the right tools in the reconnection agenda toolbox, then these two are the biggest and most essential,
the veritable hammer and drill, the tools without which we will be unable to reconnect growth and more broadly shared prosperity.

Fiscal policy is taxing and spending, something with which we’re all pretty familiar. It occurs at all three levels of government; in 2013, government receipts were around $3.1 trillion at the federal level and $1.5 and $1.2 trillion at the state and local level, respectively (that’s 19, 9, and 5 percent of GDP). So yeah, there’s some real money in play here that we use for social insurance programs like Medicare and Social Security, defense, our public infrastructure, public education, and the one we’re going to be diving into pretty deeply here: temporarily stabilizing the economy when markets fail.

Monetary policy may seem a bit more mysterious, though that will no longer be the case after a few painless and entertaining minutes of your time (OK, “entertaining” may be a bit of a stretch, but I’ll try). But it’s really nothing more than the actions of the nation’s central bank—that’s our Federal Reserve, or the Fed—to try to control two opposing forces: unemployment and inflation. Though the negative correlation between these two variables has lessened in recent years (meaning they’ve become somewhat less likely to move in opposite directions), it is still generally the case that slack in an economy—weak demand, lots of people out of work—leads to lower price pressures, or less inflation.

Of course, other factors can and do come into play. As I write this, the price of a barrel of oil is down by more than half over the
past six months, largely due to increased supply. In a country like the US that’s still a net oil importer, lower energy costs will tend to boost growth, leading to a situation of lower prices (due to the positive oil shock) and lower unemployment. But interestingly, as I’ll show later on, when Fed economists measure inflation, they leave out oil prices, not because such prices are immaterial to the Fed’s mandate of balancing inflation and employment, but because they’re both volatile and more of a function of global forces. Our central bank is more interested in the underlying trend in inflation and its connection to the movements of other domestic variables, like wages.

The Fed’s main tool in its efforts to manage its dual mandate—maintaining both full employment and stable prices—is the interest rate it controls, called the federal funds rate, which I’ll just call the Fed rate. Based on its extensive analysis of the economy—the Fed employs over 300 economists! . . . What could go wrong?—it adjusts that rate up to slow growth and inflation and down to try to speed it up.¹

OK, enough with the niceties. I’ve obviously got an angle here and it’s this. You’ll note I mentioned “market failure” up there and

¹ The Fed moves the interest rate up and down mostly through its “open market operations,” printing money to finance its purchase of government bonds from commercial banks or conversely, selling securities back to banks to reduce the money supply. Instead of printing or burning cash, the Fed just credits or debits bank X’s account, showing that they’ve either increased or decreased their holdings (or “reserves” in Fed-speak) at the Fed. In expansion mode, the increase in loanable funds, as well as the Fed-induced increase demand for government bonds, lowers the interest rate (because bond rates move inversely to their prices). And vice versa when the Fed wants to “tighten.”
regarding the role of fiscal policy. It’s the same with monetary policy—the business cycle (booms and busts) used to be much more volatile before central banks came on line. It is my not-at-all-humble-opinion that Figure 1 in the previous chapter, the one showing how we’ve been at full employment only 30 percent of the time in recent years, is representative of a persistent and deeply damaging market failure, one that looms behind the negative trends documented in Chapter 2 that have been tremendously costly to working families. And I’m here to argue that better—much better—monetary and fiscal policy can help a lot here.

So let’s dive in. I’ll start with an overview of how the two policies can and should work together, provide evidence of their effectiveness, and suggest a variety ways they can be more complementary to the reconnection agenda.

**Fiscal, Monetary, or Both?**

As a “listy” kind of guy, I’m tempted in this sort of exposition to give each of these two policy areas their own section. But in this case, even while they’re pretty different, there’s an important substantive reason to at least begin the discussion in unison: there are times, and the last few years in the US and Europe serve as exhibits A and B, when growth-oriented fiscal and monetary

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2 It may be sort of obnoxious, but I’ve found when you say to someone, e.g., “there are three reasons why X is true,” they just pay closer attention to your argument. Of course, you have to remember your three reasons, as I, a la Rick Perry, decidedly did not do the other night on national TV (well, cable . . . but still). In that case, your argument will be somewhat less effective.
policy must work together. At such times, they are not substitutes but essential complements, each boosting the other’s effectiveness.

See the box in Table 2. Before we get to its relevance re the one-two punch of fiscal and monetary policies working together, let me explain the hydraulics in terms of growth and contraction. Again, fiscal is simple because it’s so direct: government spending, by definition, adds to economic growth.

To those skeptical of that claim, stay calm! That is far from saying “all government spending is well spent” or asserting that we can get whatever growth rate we want through fiscal policy (and, in fact, I pursue in some detail in Chapter 8 this question of what “well spent” means in this context). Spending more than you take in (deficit spending), while essential in recessions and a few other specific times, is misguided at others and, if you do too much of it, unsustainable in the long run. But the fact that at first blush government spending unquestionably adds to growth is what you need to know to understand the box.³

Monetary policy, as alluded to above, is less direct but can also be a powerful growth inducer (or dampener). The fact that the Fed can lower or raise borrowing costs is of course a big potential growth factor, whether a household is borrowing to redo the kitchen (you’ll see that analogy again in these pages; it’s because I’m living that particular dream) or a business is planning to open

³ Since GDP = consumption + investment + net exports + government spending, this assertion is definitional.
a new branch. And many other influential interest rates in the economy, from car loans to student loans to home loans (mortgages), key off of the Fed rate.

The takeaway, then, is that both fiscal and monetary policy can be in either growth, contraction, or neutral mode (the latter wherein they’re neither nudging nor suppressing the underlying growth rate). Now, turn to Table 2 below. When we’re in box 1, both government spending and Fed interest rate policies are trying to raise the growth rate, goose investment and job creation, and lower unemployment. Both fiscal policy and monetary policy are in expansionary mode.

<table>
<thead>
<tr>
<th>Fiscal Policy</th>
<th>Monetary Policy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Growth</td>
<td>1 2 3</td>
</tr>
<tr>
<td>Neutral</td>
<td>4 5 6</td>
</tr>
<tr>
<td>Contraction</td>
<td>7 8 9</td>
</tr>
</tbody>
</table>

The last time that happened was back in 2009-10, in the throes of the Great Recession, when the deficit rose to between 9 and 10 percent of GDP and the Fed rate was headed for about zero. But, unfortunately, we didn’t stay there for long.

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4 Fed aficionados will recognize that I’m talking about the federal funds rate (the rate set by the Fed that banks charge each other for overnight loans of balances parked at
The Fed kept rates low, enabled in no small measure by their political independence, an absolutely critical advantage afforded to our central bank. But fiscal policy went all “austere,” by which I mean it shifted into contraction/deficit-reducing mode, as in the third row of Table 2. Instead of employing government spending in the business of temporarily offsetting the private-side market failures in countries across the globe, governments turned to “consolidating their fiscal accounts,” i.e., lowering their budget deficits. Thus, by 2012-13, we were in box 7, with monetary policy in growth mode but fiscal policy pushing the other way. And many of the victims of the Great Recession, still trying to claw their way back, paid a steep price in terms of weaker job and wage growth than would otherwise have prevailed. For example, European policy makers went in for fiscal austerity measures far more than here in the US and unemployment there in early 2015 was north of 11 percent.

In fact, US fiscal policy went neutral in 2014, so with the Fed still in growth mode, the economy moved to box 4. The result was a considerably more robust year for growth.

A Bit of Context Involving Meatless Meatballs

I’ll get to the evidence in a moment, but it’s hard to really absorb, or even believe, such evidence without a common sense context within which to place it. Moreover, I find such common sense to be particularly elusive in this area of fiscal and monetary policy,

the Fed), not the discount rate, the latter being the rate the Fed charges commercial banks for short term loans.
because fiscal in particular is so politicized and monetary is so obscure. The famed chair of the Fed for many years, Alan Greenspan, famously quipped, “If I seem unduly clear to you, you must have misunderstood what I said.”

The Fed’s gotten much better in this regard since G-span left in 2006, as his successors, Ben Bernanke and Janet Yellen, have made more of an effort to explain their actions in ways that normal humans can comprehend, should they care to do so. Still, readers less ensconced in this material might benefit from some context as to why we’d want to be in one of the other boxes.

Think of the economy as a restaurant. Things have been really slow of late, but the owners of the restaurant have a great idea for a new menu featuring meatless meatballs. Yet they lack the resources to get the new tofu/tempeh combo required to realize their dream (I chose this example because I figured it wouldn’t make you hungry). Luckily, there’s a bank willing to lend them the money to give it a shot, and because the bank is tasked not with making a profit but with stimulating economic activity when times are tough, they make the loan at a near zero rate of interest.

Our vegetarian chefs blissfully get down to work, and in a matter of days they’re ready for the grand opening, featuring every enticing meatless meatball dish you can imagine. The owners invite the lending officer from the bank to opening day, they cut the ribbon, and . . . nothing happens. To their surprise, there’s no line waiting around the block, and, frankly, that’s what they might have expected if they’d thought about the key phrase above about
how “things have been really slow of late.” The problem is not solely one of expensive credit. It’s also a problem of weak demand (I guess it could also be that nobody likes meatless meatballs, but suspend disbelief on that point for now).

*When the Fed is Double-teamed, You Dish to Fiscal*

That’s where fiscal policy comes in. When the economy is weak—growth is too slow, unemployment too high, real paychecks stagnant—consumers reel in their spending. This is an especially tough problem in the US economy, where consumer spending is 70 percent of GDP, compared to about 55 percent in Europe and 35 percent in China. So you can make the absolute best can’t-possibly-tell-the-difference meatless meatballs you want, but if people don’t have discretionary money jingling around in their pockets, they will not partake.

Not to put too fine a point on it, in a down economy, the Fed can set the table, but it takes fiscal policy—a temporary boost in stimulative government spending—to get people in the restaurant. That’s box 1 in Table 2 and it’s the only one that reliably works when consumers are just crawling up off the mat after a knockout recession.

This insight regarding box 1 is both an old and a new one. It is obviously one associated with British economist John Maynard Keynes from back in the 1930s, but it is one that most economists put aside in recent years for two reasons. First, it was believed that the Fed was all you needed. Back in 1997, no less than economist Paul Krugman, someone who understands Keynes’
contributions better than most, wrote the following: “if you want a simple model for predicting the unemployment rate in the United States over the next few years, here it is: It will be what [then Fed chair] Greenspan wants it to be, plus or minus a random error reflecting the fact that he is not quite God.”

Second—and unlike the “Fed-is-all-you-need” rap, this one has some validity—it was and is believed that fiscal policy takes too long to launch and is hamstrung by formulas that don’t always funnel resources to the places where they’re most needed. Even when the nation is in recession, there are of course some places feeling the brunt of the downturn more than others. Yet discretionary fiscal spending in recessions doesn’t always account for such variance, though that’s not a hard problem to fix and I suggest solutions later in the chapter.

On the other hand, the too-long-to-launch problem certainly wasn’t the case in America’s most recent adventure with fiscal stimulus targeted at a market failure: the Recovery Act. As noted in Chapter 1, I was there at the time as a member of President Obama’s economics team, and my boss VP Biden was implementer-in-chief. While no one’s saying the Recovery Act

\[5 \text{http://web.mit.edu/krugman/www/vulgar.html} \]
\[6 \text{Let me be specific about “where they’re most needed” because I think this provides a bit of insight into the economics of why this sort of fiscal policy is so important to have in the toolbox. I’m not so much worrying here about the problem of a boondoggle member of Congress seeking resources to build a “bridge to nowhere.” If that member’s district is facing high joblessness then, while I’d much rather see them build something they need, the fiscal stimulus will still be valued. Instead, I’m saying we want to avoid spending resources in places where the economy is doing okay.} \]
worked perfectly, the measure passed less than a month after the President took office, and some of the most important funding streams get out the door in weeks. Others, including some infrastructure spending and energy projects, took a lot longer, but even there the fiscal boost was still timely, given the length and depth of the downturn.

Leave-it-to-the-Fed was also motivated by the belief among too many economists and policy makers (certainly not Krugman) that the best thing fiscal policy can do is make sure deficits stay very low, if not disappear. While this may sound like a detail or political arguing point, it has in fact served as a critical barrier to a reconnection agenda and to achieving full employment. The drive to reduce deficits regardless of the need for continued fiscal support played, and continues to play, a large role in keeping the US and much more so the nations of Europe out of box 1 and in boxes 7 (Europe) and 4 (US). Or to get out of the box(es) and talk about what actually matters, such fiscal austerity consigned millions of households to unnecessary economic pain.

Summarizing the importance of relearning old lessons, economists Larry Ball, Brad DeLong, and Larry Summers recently pointed to three old-but-new-again insights germane to our economic era: “Keynes’s view that the liquidity trap, or zero lower bound on short-term nominal interest rates, can sharply limit the efficacy of monetary stabilization policy; President Kennedy’s ‘Economics 101’ view of the desirability of fiscal stimulus during a slump; and the possibility that a prolonged
episode of weak demand and high unemployment in an economy may have destructive consequences for aggregate supply.”

I’d argue that if we hope to elevate monetary and especially fiscal policy to their proper position in the reconnection agenda, these insights must be well understood by economists and policy makers. They also fit nicely into this theme about how fiscal and monetary policy must work together if we are to get back to full employment.

We’ve already discussed the second insight, the econ 101 part about stimulus in a slump. But it’s essential that we relearn insights one and three. The “liquidity trap,” which sounds like some sort of economic water torture, can be a serious problem indeed, and it’s one where fiscal policy is not merely complementary; it’s a big part of the solution.

Again, for all the obscure-sounding terms about zero lower bounds and nominal rates, the liquidity trap is simple to describe. It’s what happens when, in order to further incentivize lending and the ensuing economic activity that engenders, the Fed needs to further lower interest rates but cannot. Since interest rates don’t go below zero—if they did, lenders would be paying you for the

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privilege of lending you money, which doesn’t make much sense—the Fed is trapped by zero.\(^8\)

By early 2015, the Fed rate had been about zero for about five years. Though the recovery was finally strengthening, many economists believed that given investor sentiment, even at a zero Fed rate, borrowing was too expensive. The Fed pulled a few other tools out of their bag of tricks over the course of the recovery (quantitative easing—the purchasing of longer-term bonds to lower longer-term interest rates), but there’s just no getting around the fact that when the main interest rate the Fed controls is stuck at its lower bound of zero, the central bank’s impact on the economy is severely constrained.\(^9\)

Luckily, there’s a way out. When Fed policy is neutralized by the zero lower bound, fiscal policy must step up. It’s no more complicated than the old basketball move: when your top player is double-teamed by the D, you dish to the open man (of course, if your open man is covered by anti-Keynesian conservatives, 

\(^8\) We’re talking about nominal interest rates, before accounting for inflation. Since the real interest rate is the nominal rate minus the rate of inflation, it is possible—and when trapped by zero, desirable—to have negative real interest rates.

\(^9\) The problem of chronically weak demand even in the face of zero interest rates is often referenced as evidence of “secular stagnation,” a concept reintroduced by Larry Summers (see [http://www.voxeu.org/sites/default/files/Vox_secular_stagnation.pdf](http://www.voxeu.org/sites/default/files/Vox_secular_stagnation.pdf) for an extensive discussion of these issues). As stressed throughout, I strongly concur with the idea that demand, particularly for labor, has been weak for decades in the US, but argue that the “zero lower bound” is but one dimension of the problem. Large, persistent trade deficits, high inequality, inadequate financial market oversight, unresponsive fiscal policy, misconceptions about the full employment unemployment rate, and the other topics covered throughout this book are equally important aspects of the deficient demand diagnosis.
you’ve got a whole other problem, one we’ll return to in the last chapter).

In fact, as Ball et al. argue, this stuck-at-zero problem actually magnifies the positive impact of fiscal policy. The impact of fiscal policies that boost consumer or investor demand can be particularly effective (in econo-mese, fiscal spending has a “large multiplier” at the zero lower bound) because the economy is flush with underutilized resources and borrowing is and will remain cheap.

Think back to the restaurant example above. It’s not that people don’t want to eat out; it’s that they can’t afford it. Give them some resources from a fiscal stimulus—say, an unemployment construction worker gets a job fixing a highway—and they’ll eat all the meatless meatballs you can throw at them. And as long as so much slack persists in the economy, the Fed won’t step in and bust up the meal by raising rates.

The point is, once again, that fiscal and monetary policies are essential complements in weak economies, and we’ve seen an awful lot of weak economies in recent years.

**Permanent, or At Least Long Term, Damage**

The other old/new insight by Ball et al. in favor of aggressive use of fiscal policy in pursuit of full employment is “the possibility that a prolonged episode of weak demand and high unemployment in an economy may have destructive consequences for aggregate supply.” Let’s unpack that one.
Again, for all the econ rhetoric, all they’re saying is that if policy makers put us in the wrong box, the damage will be lasting. Too many of the unemployed, after being jobless for too long, will leave the labor market for good. Productive investments in equipment, structures, R&D, and so on will get short shrift, with negative consequences for future productivity growth. And the combination of a diminished and less productive workforce means slower growth in living standards, not for the top 1 percent—they’ve been doing swell in times good and bad—but for the middle class and poor.

If that sounds at all theoretical or fanciful, I assure you it’s not. It’s an accurate depiction of the reality of what’s happened in the US and many other economies in recent years as a result of protracted recessions, themselves a function of getting these policies wrong. Moreover, the importance of recognizing these dynamics reappears later in the chapter when we ponder ways to make fiscal and monetary policies more effective from the perspective of those hurt most by weak labor markets.

Figure 3, for example, shows the number of long-term unemployed (people who have been jobless for at least six months) as a percentage of the total unemployed population. This percentage reached heights in recent years heretofore unseen in the history of the data, including the early 1980s double dip recessions. Just a few years ago, 45 percent of the unemployed had sought work for at least half a year, almost double the percentage during the previous peak. Moreover, as I discuss further in Chapter 6, there’s evidence that simply being
unemployed for this long leads employers to discriminate against you.⁴⁰

FIGURE 3

The Long-Term Unemployed
Of total unemployed, percent unemployed 27 weeks and over

Too many of these long-termers ultimately left the job market, and the share of the working-age population participating in the labor force fell more sharply in recent years than in any other period on record, as Figure 4 shows. Study the end of the figure carefully and compare the trend in the labor force with past recessions. Not only was there a sharper decline in this downturn, but it also kept going, only stabilizing in 2014, the fifth year of the recovery (hard to see in the figure, but that’s what happened). There’s an important caveat to this point: a part of the decline,

perhaps as much as half, is due to the aging of the labor force—i.e., people leaving for retirement—as opposed to weak labor demand and the inadequate availability of jobs. But that still leaves more than two million weak-demand-led dropouts.

FIGURE 4

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Civilian Labor Force Participation Rate

The share of the working-age population employed or actively looking for a job fell more sharply in recent years than in any other period on record.

We’ve also skimped on capital investment, which grew about half as fast since 2010 as in the previous decade.11 Put these supply-side losses together—fewer workers and less productive investment—and you end up with precisely what Ball et al. warn of: a “permanent” scarring of the growth rate (the reason for the quotes is a very important point to which I’ll return below: it’s as necessarily permanent as people think it is).

The reluctance to use fiscal policy to try to generate more demand for workers and investment is at fault here and it is responsible for literally millions of hours of unemployment by people who could have been contributing to the economy and getting themselves and their families ahead. Central banks, both here and to a lesser extent in Europe, have been doing their best but, as noted, they were stuck at zero. The government officials who refused to apply temporary fiscal stimulus are responsible for economic scarring effects that have reduced the long-term growth rates of economies in countries across the globe. According to follow-up work by Larry Ball, if you sum up the costs of this policy neglect across most of the advanced economies, it comes to over 8 percent of their cumulative GDP, or $4 trillion. That’s one measure of the cost of being in box 8 (i.e., the Fed rate is constrained at zero and austere fiscal policy is pushing the wrong way) when we should have been in box 1.

*Evidence for the Effectiveness of Fiscal Policy*

That last bit of analysis shows you the costs of getting fiscal and monetary policies wrong, but before you’re convinced these tools deserve the privileged position in the reconnection agenda that I say they do, you might want to see more evidence of their efficacy. Let’s start with the largest infusion of fiscal policy into the economy in recent years, the American Recovery and Reinvestment Act of 2009, an $800 billion Keynesian stimulus

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unleashed in late February of that year in order to repair some of the damage done by the Great Recession.

ARRA had three basic parts about equally endowed: tax cuts, fiscal relief to states, and investments in various public goods (e.g., infrastructure), energy projects, and people (Chapter 6, for example, features an unheralded employment program for low-income workers that I argue should be scaled up). There are a number of ways to evaluate its effectiveness, and here are a few, from the most simple to the more statistical. None are anywhere near perfect—this is economics, not science—but together they paint what I think objective observers would agree is convincing re ARRA’s positive impact.

The easiest way to see if and how ARRA worked is to just take three key variables—GDP growth, job growth, and unemployment—and plot them over this period, drawing a vertical line in late February 2009, when the bill was signed by the new President. As you see in the next three figures, real GDP stopped falling and soon began to grow, employment losses diminished and then turned positive, and unemployment at least stopped rising.

This is, admittedly, not a strong test, as there are no controls for what would have happened absent the Recovery Act. But for those, like myself, who like a clean shave with Occam’s razor, it’s at least the first thing you want to see. All else not equal, ARRA clearly had its intended effect.
FIGURE 5

Real GDP Growth Since 2007
Annualized quarterly changes


FIGURE 6

Monthly Job Changes Since 2007
Thousands of Net Hires

The next level of analysis is to try to guessimate an alternative reality using statistical methods and compare actual reality to your alternative one. This was the practice of a wide variety of analysts, including the White House Council of Economic Advisors, who made Table 3. Based on their estimates of how GDP and jobs would have evolved absent the stimulus, what actually happened was that by early 2010, GDP was more than two percent higher than it would have been otherwise and there were over two million more jobs compared to their estimate for no-ARRA world.

13 http://www.whitehouse.gov/sites/default/files/microsites/CEA-3rd-arra-report.pdf
TABLE 3

Estimates of the Effect of the ARRA Using CEA Multiplier Model

<table>
<thead>
<tr>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP Level (%)</td>
<td>+0.7</td>
<td>+1.7</td>
<td>+2.1</td>
<td>+2.5</td>
</tr>
<tr>
<td>Employment Level</td>
<td>+380k</td>
<td>+1,095k</td>
<td>+1,742k</td>
<td>+2,230k</td>
</tr>
</tbody>
</table>

Source: Council of Economic Advisors calculations.

You might fairly argue that White House economists had a thumb on the scale, and it’s not hard to find opposition research that finds the whole thing to have been a big waste. But non-partisans found results similar to those of the White House economists. The Congressional Budget Office, the well-established non-partisan arbiter of all things economic in DC, undertook the same type of exercise described above and came up with a range of results, which actually makes sense in this context, since it’s statistical guesswork.14 Many of their average estimates look much like that of the White House economists. For example, their GDP impacts in the first quarter of 2010 were between 0.9 percent and 4.3 percent, for an average impact of 2.6 percent, almost exactly the same as the White House economists’ estimate. CBO’s job estimates were lower than the above table for that quarter—1.6 million on average—but for the next quarter they were up to over two million, so part of the difference there appears to be how the

models handle the timing with which ARRA's various programs made it into the field.

One study from back then struck me as particularly convincing, in a methodological sense. A useful way to get the variation you need to more closely evaluate the impact of the Recovery Act is to compare what happened across states. While all states got hit by the downturn, some got hit harder than others. However, there's a statistical problem here: as you'd expect, the states that got hit the hardest often took the longest to recover, so if you just compare them to the less-hard-hit states, you'd mistakenly conclude that ARRA didn't work that well. That is, you'd find that the states that got the most fiscal relief took the longest to recover when, in fact, the results were biased down by the depth of the downturn in those states.

Economists Chodorow-Reich et al. adjusted for this bias in an interesting way. They recognized that one big ARRA component—FMAP, or Federal Medical Assistance Percentages, which is just a confusing name for extra federal help to states to finance their Medicaid programs during the downturn—were partially a factor of the size of state Medicaid programs before the recession. Thus, this ARRA component would be uninfluenced by the impact of the downturn on the state's economy. It's also important to note that a) unlike the federal government, states have to balance their budgets every year, and b) FMAP funds, which amounted to almost $90 billion, were completely fungible.

States used them to patch holes in Medicaid, but that wasn’t all they did with the fiscal aid. The authors report that “ARRA funds were at least partially used to avoid program cuts, since a concentration of the employment effects appears to have occurred in sectors (government, health, and education) which are reliant on state funds.”

At any rate, their punchline finding was that for every $100,000 in FMAP fiscal relief, states created just under four jobs per year, at the cost of $26,000 per job per year. In this business, that’s a very high bang-for-the-buck, which I raise in part to underscore the point made above in all that theorizing about the potency of fiscal policy when the Fed’s interest rate mechanism is jammed by the zero lower bound.

_Doesn’t All this Fiscal Policy Raise the Budget Deficit?_

But what about the budget deficit? As noted, the federal budget deficit went to almost 10 percent of GDP in 2009, though of course not all of that was discretionary (i.e., newly legislated) fiscal stimulus; revenues also decline in downturns and there’s automatic safety net spending kicking in that isn’t counted as part of ARRA. But in the spirit of all of that discussion about why we want to be in box 1, that’s a good thing. One of the central points about fiscal policy as part of the reconnection agenda is that you want budget deficits to temporarily expand in recessions due to both higher spending on stabilization programs and lower tax receipts. And the deeper the downturn, the bigger the necessary
deficit. This rule holds even more when the Fed is at least partially sidelined by the zero lower bound.

Given the economic amnesia around this simple point, I and others have written extensively about it, and you’re welcome to read up on it, but let me cut to the chase.\(^\text{16}\) The policy we want in the reconnection toolbox vis-à-vis fiscal deficits is **CDSH**: cyclical dove, structural hawk. Again, very simple: when the private sector economy is malfunctioning to a significant degree, meaning large enough to move big quantities like GDP, job growth, and unemployment in the wrong direction, then we want to turn dovish on the deficit—make ourselves perfectly comfortable with its expansion. When the private sector is back and all the gaps that developed are closed, or at least solidly moving towards closure, then we want deficits to come down.

Moreover, as economist Dean Baker and I stress in joint work we’ve done on full employment, if you actually follow the movements of deficits and surpluses over time, you’ll see that they’re often driven more by expansions and contractions in the real economy than by the taxing and spending policies that partisans freak out over.\(^\text{17}\) Most notably, we show that in the last time we had a budget surplus, the late 1990s, the biggest driver

\(^\text{16}\) See, for example, chapter 7 here: [http://www.boeckler.de/pdf/p_restoring_shared_prosperity.pdf](http://www.boeckler.de/pdf/p_restoring_shared_prosperity.pdf)

was clearly economic growth, not legislated changes in fiscal policies.\(^\text{18}\)

Those examples all show the benefits of fiscal policy against market failures, but here’s one that shows something equally important: the costs of austerity. Figure 8 shows the impact of fiscal contraction on real GDP growth for three recent years.\(^\text{19}\)

The middle bar for 2013 is particularly notable, both for its magnitude and the factors that drove it. At 1.6 percent of lost GDP, that’s over a million jobs lost based on historical relationships and about three-quarters of a point added to unemployment, at a time when the US economy was still trying to recover from the residual pull of the Great Recession. The negative fiscal impact was caused largely by the pre-emptive sunset of a temporary paycheck booster (the “payroll tax holiday”) and a bunch of mindless and unnecessary spending cuts—that’s not just my opinion; it’s the opinion of politicians on both sides of the aisle—called “sequestration.”

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\(^{18}\) Confusion around this point was what famously got economists Rogoff and Reinhart into trouble a few years ago, when they asserted that when the debt-to-GDP ratio gets too high (above 90 percent), it slows growth (that and a spreadsheet error, though I’m afraid we all make spreadsheet errors—this causal confusion is the much bigger deal). As the text in this section suggests and my work with Dean corroborates, this is backwards. Economist Arin Dube provides statistical evidence for the correct causal flow: [http://www.nextnewdeal.net/rortybomb/guest-post-reinhartrogoff-and-growth-time-debt](http://www.nextnewdeal.net/rortybomb/guest-post-reinhartrogoff-and-growth-time-debt).

\(^{19}\) Technically, the fiscal factor in play here is “fiscal impulse,” which is the change in fiscal policy from one year to the next.
Related work by the IMF is interesting because it shows that, far from an American obsession, destructive fiscal policy was and is much more common in Europe. Economists Blanchard and Leigh show that European economists consistently and systematically underestimated the damage done by austerity measures, even once the results were in. That is, Blanchard and Leigh’s research showed the difference between the economists’ forecasts—what they thought would happen to GDP growth and unemployment if they reduced their deficits—and what actually happened. The economists were off by a factor of between two and three, meaning that’s how much they underestimated the positive impacts of fiscal stimulus on growth and unemployment.

(they thought the fiscal multiplier—the bang-for-fiscal-buck—was 0.5 when it was actually between 1 and 1.5).

**OK, that’s Fiscal. I Suppose You’re Going to Tell Me that Monetary Policy Also Works.**

What about monetary policy? What’s the evidence of its effectiveness? That’s actually a more complicated question. First, monetary policy has been a constant factor in advanced and emerging economies for many decades (our own Fed was born about a century ago) and thus doesn’t often provide the discrete policy interventions you get in fiscal policy, as with ARRA. Second, the Fed’s main tool is a “price,” an interest rate that affects the price of borrowing throughout the economy, so we broadly assume it must have an impact, much like we correctly assume that the rise and fall in gas prices must have an impact.

There’s empirical evidence to back up such assumptions. People my age remember the Volcker recession of the early 1980s when Fed Chair Paul Volcker took the Fed rate up to 20 percent to break an inflation rate that was in double digits. When the big man (some macroeconomists, like my friend Dean Baker, are actually kinda small; Volcker really is a big guy) took his foot off of the brake and lowered rates aggressively, the 1980s recovery took off. Note also how by dint of raising the Fed rate so high, the 1980s Fed had a highly elevated perch from which to lower rates. From interest-rate mountain tops of 20 percent, the “zero lower bound” simply couldn’t be seen with the naked eye.
And then there’s the full employment period of the 1990s, widely understood to have been facilitated in no small part by Alan Greenspan. As Baker and I observed:

... in the summer of 1995 then-Federal Reserve Board Chairman Alan Greenspan made a remarkable break with the orthodoxy within the profession. He insisted that he saw no evidence of inflation in spite of the fact that the unemployment rate, at 5.7 percent, was below the conventional range of estimates for the structural rate of unemployment. As a result, he pushed through a cut in interest rates that opened the door for a speedup of the economy and further declines in the unemployment rate. By the summer of 1997 the unemployment rate had fallen below 5.0 percent. It fell below 4.5 percent the following summer and finally stabilized near 4.0 percent, the year-round average for 2000.21

And that was the last time we were at full employment.

Finally, economists Blinder and Zandi, in an exhaustive review of the full spate of measures that the government and the Fed took throughout the Great Recession, found that in the years during and after the Great Recession, interventions by the Fed (and related actions in financial markets) lowered unemployment by two to three percentage points and raised GDP by as much as 2.7 percent.22 Historically speaking, those are large effects.

**OK, They Work. But Can We Make Fiscal and Monetary Policies Work Better?**

No question, the Fed can be an important part of a reconnection agenda, as can fiscal policy. In fact, to be most effective they must work in tandem, especially in periods of economic weakness. But beyond making the case as I’ve tried to do above with both theory and evidence, what specifically is the “ask” here? What needs to change to make sure these two behemoths of economic policy are prominent and useful components of the reconnection agenda?

In both cases, there are technical fixes with the potential to lift the effectiveness of both fiscal and monetary interventions. Let’s start with fiscal, where it’s all about getting the triggers in place, and move to monetary, where the key improvements involve asymmetric risk and getting the natural rate—the lowest unemployment rate consistent with stable prices—right. Or . . . if not “right,” then less wrong.

*The fiscal ask:* “Countercyclical” fiscal policy—deficit-financed, temporary government spending designed to offset demand contractions—should a) turn on and off in a timely manner, and b) use its resources for high bang-for-the-buck projects where they’re most needed.

The first part—turning on and off—must be a function of measurable triggers and not of political whims. We already have programs that automatically respond to need. Think of the way Unemployment Insurance automatically responds to increasing
joblessness or nutritional support (food stamps) to income losses among the least well-off. Right now, other programs like subsidized jobs or state fiscal help are discretionary (i.e., left up to Congress to legislate), which leads to considerable waste. There’s no reason why these other fiscal interventions shouldn’t be similarly keyed off of state or even sub-state economic indicators. In fact, to not do so is to risk sending the fire trucks to the wrong house, or almost as bad, to risk having the fire trucks leave before the fire is out.

I happen to disdain the hyper-partisan congressional gridlock that has dominated politics for years now and shows no sign of letting up. But if they insist on feckless squabbling when the economy’s doing fine, that’s one thing. When they engage in that sort of thing when we’re in crisis, it’s obviously quite another. The political system in general, then, and the countercyclical system in particular, needs a mechanism to prevent congressional gridlock from keeping the fire trucks in the station when someone’s house is burning down. In fact, such a mechanism would be an important tool in the reconnection agenda toolbox.

In addition, you want the trucks to head for the right house—the one with the fire—and, if you’ll allow me to stretch the analogy to the breaking point, the fire department has the added problem that everybody wants the trucks to come to their house, even if they’ve barely got a spark ablaze. That is, members of Congress have obvious and understandable incentives to want fiscal relief to flow to their constituents, regardless of need.
Triggers can help avoid this, and, as budget expert David Kamin has pointed out, can do so in a way that’s fair and maybe even politically acceptable. He notes that “if the triggers are enacted before we actually enter recession, policy makers are essentially behind the veil of ignorance. They don’t know which states will most benefit from the future relief. Thus, no one will feel cut out and all could potentially benefit—it’s an insurance policy for the country as a whole.”

As noted, the alternative to triggers in this case is discretionary fiscal policy, which is what we do now (except, of course, for the automatic stabilizers, like UI or food stamps). That is, you wait until it’s clear that recession is on the land, squabble with Congress for fiscal policies to help, and end up having to buy off members with goodies for their districts.

So far, I’ve largely focused on how and where fiscal help should trigger on, but such triggers can also help on the other side of the downturn, when the fire is reliably out. I saw close-up the importance of this function—rather, the damage done by the lack of it—in the slow recovery out of the deep recession that began in late 2007 and was officially declared to be over by mid-2009. Officials in the Obama administration were anxious to turn to deficit reduction, motivated more by politics than economics. So they convinced themselves—ourselves, as I was a member of the econ team at the time—that “green shoots” of recovery were

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23 The quote is from personal correspondence with Kamin. See also: http://www.brookings.edu/research/papers/2014/12/15-legislation-responds-fiscal-uncertainty-kamin
breaking out all over (I recall a call-in show I did at the time where a listener said that if we thought the economy was really improving, we must be “smoking green shoots”).

To be fair, we on the economics team did try to go back to the fiscal well, but the political doors were to some degree closed (though not as much as you might have thought). The use of fiscal triggers thus has the potential to avoid this problem by providing real time indicators of when fiscal help is needed and when it isn’t; in other words, triggers can help distinguish when green shoots are real and when they’re imaginary.

Thus far, this exposition has assumed timely and reliable indicators off of which the triggers get pulled. Are such statistical indicators available? If not, could we create them?

The obvious trigger is unemployment, a consummate cyclical variable. It’s very timely on a national level: on the first Friday of each month, we learn the jobless rate (and many related labor market indicators, like job growth, labor force participation, and under-employment) for the previous month. Towards the end of the month, we get state level unemployment, and a few weeks later, metro-level estimates. So, for example, in early January 2015, we learned the national unemployment rate for December 2014 (which happened to be 5.6 percent, since you asked), on

24 That “to some degree” is important and underappreciated, as I explain in this post: [http://jaredbernsteinblog.com/there-was-more-to-the-stimulus-than-the-stimulus/](http://jaredbernsteinblog.com/there-was-more-to-the-stimulus-than-the-stimulus/). In fact, we were able to go to the fiscal well more than people in this debate generally realize or acknowledge. But still, as I note in the post, not enough to avoid “negative fiscal impulse.”
January 27 we got state rates for December, and on February 4 we got December’s city rates.

That’s not bad, and the historical record shows that an unemployment trigger\textsuperscript{25} would fairly quickly signal to policymakers that a downturn was underway. In fact, certain extended unemployment benefits are already keyed to increases in the jobless rate. The timing record also shows that recent recoveries have begun as “jobless” (GDP growth arrives well before job growth). Some folks who think about this sort of thing worry that an unemployment rate trigger would not trigger off soon enough. That is, it might risk keeping fiscal relief flowing after an official recovery has begun.

I’d argue that this is a feature, not a bug. If anything, my concern would be that the unemployment rate would fall too quickly, signaling the fire was out when live sparks were still burning. That’s because of a measurement problem inherent in the way we measure unemployment, the one I discussed above in some detail. To remind you, if unemployed persons give up the job search because they can’t find work, the jobless rate goes down, making it look like the job market is tightening up when in fact the opposite is occurring.

In 2010, for example, the decline in the unemployment rate from 9.8 percent to 9.2 percent occurred because of a fall of the same magnitude in the labor force. Imagine a fiscal trigger that shut off

\textsuperscript{25} Specifically, an unemployment trigger would be an increase above some recent average so as to distinguish a cyclical rise from a structural one.
a subsidized jobs program for the long-term unemployed based on that trend, when in actuality it was telling the opposite story: unemployed job seekers giving up and leaving the labor market.

So we need other triggers, and a recent study by economists at the Chicago Federal Reserve provides one set of possibilities.26 These economists recommend the use of composite indexes of state business cycle indicators tracked by the Philadelphia Fed, which include “nonfarm payroll employment, average hours worked in manufacturing, the unemployment rate, and wage and salary disbursements deflated by the consumer price index.” They show that these State Coincident Indexes may hold promise in terms of reliably catching cyclical turning points. For example, as shown in Figure 9, the indexes captured some of the differences between states that did relatively well during the recession (like Wyoming and North Dakota) and states that did poorly (like Nevada).

At the same time, the results were counterintuitive for California, a state that saw a comparatively large 5.4 percentage point rise in unemployment over the course of the recession to a rate of 11.3 percent in June 2009, the sixth highest rate in the nation. California also had one of the highest foreclosure rates in the nation27 and, according to the Economic Security Index developed by Yale professor Jacob Hacker and colleagues, only five states saw a larger share of their citizens lose at least 25 percent of their

available household income each year between 2008 and 2010. In other words, by just about any metric, the state was whacked hard by the Great Recession. Yet the State Coincident Indexes showed similar results for California and states that were less affected by the recession (like Maryland and New Mexico), meaning this metric alone would likely be an inadequate trigger.

FIGURE 9

<table>
<thead>
<tr>
<th>State Coincident Indexes During the Recession</th>
</tr>
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<tbody>
<tr>
<td>Re-indexed to 100 in November of 2007, these numbers track four state-level business cycle indicators</td>
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</table>

![Graph showing State Coincident Indexes](source: Federal Reserve Bank of Philadelphia)

SNAP, or food stamps, caseloads offer another data source that conveys information about need quickly, and are thus a good trigger candidate. SNAP has been consistently found to be responsive to nutritional needs during recessions and, unlike the unemployment rate, it doesn’t turn off too soon. Also, SNAP data are available with quite short lags (about a month) at the state level.

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28 [http://www.economicsecurityindex.org/assets/state_reports/CA_dated.pdf](http://www.economicsecurityindex.org/assets/state_reports/CA_dated.pdf)
level, so they can provide some of the geo-variance we need in a targeted trigger.

It would be smart trigger policy to tie together some of the lessons discussed above regarding the importance of fiscal policy when the Fed rate is stuck at zero. An effective fiscal trigger might include this macro-constraint, in tandem with others noted above. If policy makers were on the fence regarding the utility of stimulative fiscal policy based on unemployment, the SNAP rolls, etc., factoring in the problem of the Fed rate stuck at zero might be enough to push them towards doing more and vice versa.

Once we get fiscal relief to the right places and at the right time, we’d like to get the biggest bang for the buck from it. My own experience, corroborated above by the research I cited about multipliers (that stuff about FMAP), suggests that state fiscal relief is a strong candidate. The key observation here is that unlike the federal government, states must balance their annual budgets. Thus, when job and income losses begin to weigh on state budgets, they must raise taxes or cut services, a surefire recipe for making a bad situation worse.

Think of the nation’s economy as fifty states and Uncle Sam, all in a boat taking on water. Sam’s the only guy with a bucket. By dint of his essential ability to run budget deficits, Sam’s states’ best hope against sinking. More concretely, I vividly recall a trip

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29 By the way, that right there is one of the main reasons you want to very strongly oppose the push that flares up every now and again for a balanced budget amendment for the federal budget. That would ensure that no one, not even Uncle Sam, had a bucket.
with VP Biden to tout our fiscal relief efforts. We attended a ceremony wherein the mayor of the town we were visiting showed the audience a bunch of pink slips for teachers in one hand and a new Recovery Act check in the other. He (the mayor) then dramatically ripped up the pink slips. That’s state fiscal relief at work.

Later, in Chapter 6, I feature another Recovery Act program I’d significantly scale up and not just in the next downturn, but in any part of the country where pockets of joblessness exist even in the midst of expansion: a direct job creation program through subsidized work. It’s a simple and effective way to apply fiscal policy to job creation, but you’ll have to wait a few pages to learn more about it.

The monetary ask: Because of its political independence and limited tools, the monetary ask—policy changes that would make monetary policy more effective in getting to full employment—is simpler than the fiscal one. It’s all about getting the weights right.

As discussed, the mandate at the Fed is to balance the dual goals of full employment and stable prices. Sounds pretty straightforward until you consider the following: first, as stressed in the full employment chapter, no one knows with the requisite precision what number corresponds to the “natural rate” of unemployment. Second, though the tradeoff between unemployment and inflation is real, we don’t know the magnitude of that correlation. In part, our ignorance is due to the fact that both of these quantities move around with economic conditions,
Fed actions, productivity growth, global supply issues, and who knows what else. End of the day, these constraints make it very tricky indeed to find the right balance for Fed policy in the interest of meeting the dual mandate.

That’s all technical stuff of the sort that economists work on and argue about all the time. We actually travel to conference centers and squabble about what’s the natural rate and the slope of the Phillips Curve (the relationship between unemployment and inflation). I’m sure you’re jealous. But even were we to resolve these gnarly technical questions, there’s still another factor in play, one that’s actually been huge in breaking the connection between growth and broadly shared prosperity: the power to influence the Fed’s actions in ways that favor one side or the other.

I said the Fed was politically independent. I didn’t say they exist in a vacuum. In the real world, there’s tremendous pressure on the central bankers from heavily moneyed interests to settle that balancing act in favor of low inflation, not full employment. This dynamic stems from the difference between people who depend on paychecks and thus on tight labor markets, and a smaller but more powerful group of people who depend on asset portfolios, which get eroded by inflation. What matters here is who benefits from higher labor costs—again, paycheck earners—and whose profits are squeezed by those costs.

At any rate, when the Fed is engaged in stimulus through low rates and the expansion of its balance sheet, meaning the Fed’s
governors are injecting money into the economy, there’s often great pressure on them to cut it out and get back to the business of fighting inflation, even if inflation’s nowhere to be seen.

For the record, both the Yellen and Bernanke-led Feds have resisted much of this pressure, but as I write in early 2015, the pressure to raise rates and the uncertainty around key parameters are coming together. Let me show you what I mean.

Figure 10 plots three recent trends and a constant: unemployment, inflation, wage growth, and the Fed’s most recent estimate of the lowest unemployment rate consistent with stable inflation (I call this the full employment unemployment rate, or FEUR). As unemployment rose sharply in the Great Recession, you can kind of see inflation and wage growth slow a bit, but they clearly don’t budge at all as unemployment falls, even—and here’s the punchline—as it approaches the Fed’s own full employment rate.

Now consider this for a moment. If the Fed’s 5.1 percent is an accurate benchmark signaling to monetary policy makers that they’d better start raising rates to slow the economy in advance of inflationary pressures, then surely we should see some, any, a hint, of such pressures as we near that benchmark. Instead, we’re seeing nothing.

And yet, not only does one typically hear at such times the usual caterwauling from the outside to preempt this phantom menace of forthcoming inflation, we often hear some Fed officials

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That’s the “core” personal consumer deflator, the Fed’s benchmark inflation rate. “Core” means it leaves out volatile food and energy prices.
themselves making sounds like they’re buying such admonitions. At the time the data story you see above was unfolding, one of the Fed’s regional bank presidents, a voting member on interest rate policy, said this:

We are going to conceivably have to make a judgment that the outlook, even in the absence of realtime inflation readings that are rising, that inflation is nonetheless converging to target.  

FIGURE 10

It’s convoluted Fedspeak, so let me interpret, at least the way I understand it: “Even if inflation isn’t going up, we’re going to have to act as if it is.” I wish I’d had that one back in grade

school: “even though my homework assignment is not ready, I’d like you to proceed as if it is.” And this guy’s not alone. Another member of the Fed board has predicted five of the last zero inflationary outbreaks.\(^{32}\)

In order to be a more effective tool in the reconnection agenda toolbox, the Fed needs to be able to assess not just the risks of both sides of the mandate, but their relative weights. As I write this passage, even five-and-a-half years into an economic expansion, those risks are highly imbalanced, or asymmetric, as Fed wonks like to say. The risk of not actually getting to and staying at full employment is much greater than the risk of inflationary pressures.

And yet, other than the stalwart determination of our pretty awesome Fed chair, Janet Yellen, who seems to get pretty much everything I’m laying out here, there’s nothing other than hot air like my own pushing the institution to assign the correct asymmetric weights. Given the critical importance of their independence, I of course want to tread lightly here. I’m not suggesting that some outside body tell them what to do and not do re macro-management. That route may sound appealing to those of you who share the reconnection agenda I’m building here, but I guarantee you there are others out there with their own agendas for the Fed that look very different than the one described in these pages.

So what would help the Fed resist pressure to not nip full employment in the bud? Four things: a more realistic view of the natural rate, wage targeting, “reverse hysteresis” (sounds mysterious, but we’ve actually already discussed it without naming it), and a people’s campaign.

On the first three, I must invoke help from my fellow economists. The Fed must remain immune from political pressure but it must be, and it is, an evolving institution when it comes to absorbing the work of academic economists. A quick look at Figure 10, along with much more careful statistical research, suggests that we don’t have a good bead on the natural rate, which is an extremely important limitation to implementing the optimal monetary policy.\(^33\)

If we as economists are invested in having monetary policy achieve its intended effects of maximizing employment in the context of stable prices—and don’t get me wrong, that latter goal is also essential—then we need to stop writing down numbers that don’t make much sense, like the Fed’s natural rate of unemployment (and this isn’t meant to pick on them; the Congressional Budget Office’s natural rate is even more out of touch). A concerted effort by researchers challenging the conventional wisdom around the natural rate is warranted and my bet would be that eventually such research would rub off on the Fed.

Another very important part of the economic research agenda, one that links quite directly to the reconnection agenda, should be looking into the utility of wage targeting by the Fed. That is, instead of keying an increase in interest rates to price growth, the Fed keys off of wage growth. Especially in a global economy with large and growing inequalities in many advanced economies, it should not be assumed by default that economic expansions lead to pervasive wage pressures, or even price pressures. In fact, that’s a poignant message from Figure 10: even with unemployment close to the “natural rate” by early 2015, neither wages nor prices had yet accelerated at all. Thus, targeting not just earnings, but the extent to which wage growth feeds into price growth, would be a reliable way to connect Fed policy to workers’ paychecks.

Look at it this way. As Figure 10 reveals, and as economic history of the past few decades confirms, real wage growth, particularly for middle and low-wage workers, has been a key missing ingredient from recent recoveries (see also Table A1). In this recovery, which if history is any guide is at least middle-aged if not older, wages have been uniquely flat. In the 2000s the story was similar, as real compensation for the typical worker grew about half-a-percent per year. Working families simply cannot keep losing decades of wage growth like this, at least not without

34 See this chapter on the history of US wage developments by Mishel et al.: http://www.stateofworkingamerica.org/subjects/wages/?reader
35 The average postwar expansion lasted about five years. As of the first quarter of 2015, we’re on year six. http://www.nber.org/cycles/cyclesmain.html
36 Data underlying Figure A4.
a strong and persistent policy response. I recommend wage targeting by the Fed in that spirit.

I’m not alone. No less than the researchers at Goldman Sachs, who do high-level analysis of monetary policy (believe me, GS has the bucks to hire some serious economists), recently wrote the following in a piece on Fed policy:

. . . we find that the benefits of focusing on wage inflation are substantial when slack is difficult to measure and wage growth acts as a reliable cross check for the true amount of spare capacity . . . Although our analysis is subject to a number of caveats, we conclude that increased emphasis on wage developments would likely be beneficial for Fed policy. This would be a strong argument for a continued accommodative stance as current wage growth [in 2014] remains stuck at only 2 percent.37

Now, let’s relate this back to this sickly sounding condition introduced above: “hysteresis.” It’s the problem that occurs when persistent slack in the economy in general and the job market in particular leads to “permanent” damage. It’s when cyclical problems last long enough that they become structural problems. You encountered the idea above first in the discussion of the three old/new fiscal insights by Ball et al., and then again in the

discussion of how labor force dropouts distort the unemployment rate by making the job market look tighter than it is.

Since the growth of the labor force is a key factor in the economy’s potential growth rate, a slower growing labor force maps onto slower real GDP growth. But if running a sagging economy for too long leads to long-term damage, can running a hot economy reverse some of the damage? Is there such a thing as “reverse hysteresis?”

I believe so and there’s at least some evidence to support my hunch. For example, in the same analysis from which Figure 10 is drawn, I show that if you assume the existence of reverse hysteresis, you can explain the behavior of recent wage trends much better than if you deny that possibility.38

But far more important than my own musing and number crunching, check out this quote from a speech by a VIP in 2014:

Some ‘retirements’ are not voluntary, and some of these workers may rejoin the labor force in a stronger economy . . . a significant amount of the decline in participation during the recovery is due to slack.39

That’s another way to say that reverse hysteresis is a real possibility, and this is the opinion of one Janet Yellen, our own Fed Chair. A Fed that considers this dynamic to be a real

possibility should be one that is willing to keep its feet off of the economic brakes long enough for hysteresis to shift into reverse, thus undoing some damage that other, less re-connective agendas would simply write off.

Finally, there’s the need for a people’s campaign targeted at the Fed. Even though I think we often overestimate the power of the Fed to shape economic outcomes, by dint of its control over a critical variable in our economy (the Fed rate) as well as its role as bank regulator (a topic I return to in Chapter 7) it holds tremendous sway. As such, its actions have considerable impact on the lives of working people, and yet few know much about it, especially compared to bankers and those in finance. And yet, there is absolutely no question—in fact, both Yellen and Bernanke were explicit on this point—that working households are a key Fed constituency.

But while more enlightened central bankers may recognize that obligation, for it to become something they feel more acutely, they need to interact with those at the receiving end of their policies. To be fair, there’s some of that going on already, but more recently, a group of activists organized by the racial and economic justice group Center for Popular Democracy took this pursuit to another level. Their mission statement in this space echoes some of the same ideas and concerns I expressed above:

The Federal Reserve has tremendous influence over our economy. Although our communities continue to suffer through a weak recovery and economic inequality keeps growing, corporate and financial interests are demanding that the Fed put the brakes on growth so wages don’t rise. There is a real danger that in early 2015, the Fed will cut the legs out from the recovery before the economy reaches full acceleration, costing our communities millions of jobs and workers tens of billions in wages.

But for the first time in 20 years, community organizations, unions, and consumer advocates are mobilizing around the Federal Reserve for a national economic policy that prioritizes full employment and rising wages.41

The organization is also pushing the Fed to devote some of its economic research staff’s considerable firepower to more work on reconnection-style ideas; though again, while the Fed banks don’t say a lot about it, more of that already goes on than you might think. The Boston Fed, for example, is working on a project called the Working Cities Challenge, where Fed research and expertise combines with stakeholders in troubled communities to build human and investment capital targeted at low-income households.42

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41 http://populardemocracy.org/campaign/fed-national-campaign-strong-economy
But the CPD group has an even more ambitious idea:

Under its quantitative easing program, the Fed supported the economy by purchasing bonds and financial securities . . . Now that that program is over, it should explore the possibility of using its legal authority to purchase state and municipal bonds. Zero interest rate lending to cities and states would help them reduce their debts and invest in public works projects – like renewable energy generation, public transit, climate change adaptation, and affordable housing – that will create good jobs and strengthen our communities.

Wait up . . . can the Fed do that, i.e., buy state and local bonds? I asked a Fed president, one sympathetic to CPD’s cause, that very question. He said no—their charter forbids it. But when I relayed that answer to a CPD official, he assured me that this wasn’t their lawyers’ interpretation of the charter. So, who knows? I see a fight worth having coming soon.

The point is that like any other institution that hopes to survive and flourish, the Fed must evolve. I’ve offered what I hope are a number of ideas, both in research and advocacy, that can move that evolution in the direction of reconnecting growth and prosperity.

**Conclusion**

In sum, fiscal and monetary policy are absolutely essential tools in the reconnection toolbox. In fact, they have to work together,
especially when monetary policy—specifically the Fed’s key interest rate—is jammed up against zero. The evidence reveals solid potential for both types of interventions, and there are a variety of ways to ratchet up their effectiveness when it comes to getting to full employment, boosting wage growth, offsetting cyclical downturns, avoiding permanent damage to the economy and the people in it, and providing states with budget relief in recessions.

Those ideas include fiscal triggers based on not just the unemployment rate but broader indicators of state economic conditions, wage targeting at the Fed, running a tight enough job market to pull sideliners back in, and a people’s campaign such that folks from all walks of life can interact with an institution that has real sway over their economic lives.

OK, glad that’s over and we now have some kick-butt macroeconomic tools in the reconnection toolbox. Let’s turn to another area where policy can help to generate not just more jobs, but more good jobs: revitalizing the manufacturing sector through going after our persistent trade imbalances.