

Discussant's comments of William R. Emmons, Federal Reserve Bank of St. Louis, on  
**"The Continuing Unemployment Crisis: Causes, Cures, and Questions for Further Study",**  
**by Christina D. Romer**

A Forum on Unemployment, Underemployment and Public Policy, Co-sponsored by the Center for Social Development, the Center for New Institutional Social Sciences, the Weidenbaum Center, and the George Warren Brown School of Social Work's Youngdahl Lecture Series

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Thank you for inviting me to participate in this very important forum. These are, indeed, critical issues we are discussing, with no easy answers.

My role on the panel may be to throw some cold water on Prof. Romer's enthusiasm for more short-term stimulus for the economy. In my remarks, I'll address only the first and third categories of policy measures Prof. Romer discussed—namely, monetary policy and some policy measures that may increase longer-term economic growth. Please remember that these are my own views, and not necessarily those of the Federal Reserve Bank of St. Louis.

My main comments on Prof. Romer's address will be that: 1) I think we should not expect too much from monetary policy as we move beyond the crisis, and, 2) conversely, that she—and perhaps the Administration and Congress—may be focusing too little on structural issues like education, international trade, innovation, and health care. These are the engines that will drive our economy forward and create jobs or, in the case of health care, may be an anchor dragging down our potential to create jobs. I think a central bank's power to moderate unemployment is significant during a financial crisis, but should be seen as quite limited in the long run. I think we should be focusing more attention on fundamental long-term determinants of growth and employment—even, or especially, in the aftermath of a severe financial crisis and recession. Good structural policies can create jobs in the short run, too.

First, I'd like to address the role of monetary policy in fighting unemployment. Prof. Romer believes strongly that the causes of our current high unemployment rate are primarily

cyclical in nature, not structural. Therefore, she suggests that aggressive monetary and fiscal policies were appropriate during the crisis and remain so today due to the unsatisfactory nature of the recovery. Moreover, while fiscal-policy changes can have “substantial effects on output and employment” (p. 10), she identifies monetary policy as the “frontline tool for macroeconomic stabilization” (p. 10).

I would like to draw a distinction here between classical central banking and monetary policy focused on the business cycle. This distinction parallels a difference pointed out by Prof. Romer between stabilization and growth as monetary-policy objectives. It also may line up with what she has labeled (in a February 26 *New York Times* op-ed) a debate about monetary policy between “theorists” and “empiricists”. Prof. Romer calls herself a “confirmed empiricist” and what I’m about to say probably makes me a “theorist”—although I think there are important differences even among theorists. For example, I’m not an “inflation-nutter”—a monetary-policy hawk who fears inflation even when the economy is deeply depressed—; but I may be a “bubble-nutter”—that is, someone who fears that we may sow the seeds of the next financial crisis if we misdiagnose the previous one.

As you know, the Federal Reserve and other central banks around the world acted in their traditional role as the economy’s lender of last resort during the financial crisis; this is what I term the classical function of central banking, which is focused on stabilizing the financial system. During 2008 and 2009, we not only lent on a large scale to our traditional counterparties, the commercial banks, but we also provided liquidity to a wide array of non-bank financial institutions and even entire financial-market sectors, like commercial paper and private securitization. The Fed’s emergency actions during the crisis no doubt hastened the end of the panic and helped restore the normal functioning of financial markets. Hence, we indirectly contributed to lower unemployment because the financial system again was able to perform its vital role.

As we move beyond the acute phase of the financial crisis and recession into an economic recovery, Prof. Romer and others have called for continuing, if not redoubled, efforts

by monetary- and fiscal-policy authorities to spur a stronger upswing. She goes so far as to castigate these authorities for their “shameful” lack of aggressiveness (p. 15).

My perspective on a central bank’s attempts to speed up an expanding economy will not be surprising to anyone who is familiar with the views expressed by several recent presidents of the Federal Reserve Bank of St. Louis, such as Tom Melzer, Bill Poole, and Jim Bullard. Using interest-rate policy to manage the business cycle has not been an entirely successful experience during our own history or that of most other central banks. There are even some who think the Fed’s interest-rate policies during the years leading up to the financial crisis may have helped to cause it—although you didn’t hear that from me.

We all can agree as a general principle that the Fed plays a critical role in anchoring the public’s expectations for medium- and long-term price stability, but there are differences of opinion within the Fed itself about the benefits, costs, and risks associated with our current, so-called “quantitative-easing” program. Just like our traditional short-term interest-rate tool, large-scale purchasing of long-term bonds is a very blunt instrument. I agree that the Fed appears to have been able to nudge long-term interest rates and the dollar lower, while apparently reversing a decline last year in inflation expectations. Still, I don’t think we will be able to judge the success of this policy until we have returned to our normal operating procedures. Only then can we assess what unintended consequences, if any, may have accompanied QE1 and QE2.

At this early stage, I would offer this prediction: To the extent that quantitative easing is seen in retrospect to have been a crisis-fighting tool—including a crisis in the form of an undesirable decline in the public’s medium-term inflation expectations—, it would fit into the category of classical central banking and has a high chance of success. If, on the other hand, quantitative easing becomes a means of turbo-charging economic growth, I think the outcome will be less favorable, both for the Fed’s reputation and for the economy.

Next, I’d like to respond in a very general way to a few comments Prof. Romer made about policies designed to enhance the economy’s long-term growth potential. My view is that

structural issues are critical in understanding why the recovery is so weak and what we might do about it.

As I understand her thinking, Prof. Romer believes the economy was basically OK before the Great Recession hit—it was producing enough employment and output and the mix across sectors was about right. It's not doing well now; but, when aggregate demand recovers sufficiently, it will be OK again. Following this diagnosis, her prescription is for aggressive monetary- and fiscal-policy measures to restore higher levels of employment as soon as possible.

Like Prof. Romer, I find implausible the idea that the structural unemployment rate suddenly has jumped several percentage points as a result of the housing-market crash. Nevertheless, I think the financial crisis and Great Recession have revealed a somewhat different structural problem in our economy, albeit one of long standing.

In short, I think the economy was *not* OK before the Great Recession hit, even though unemployment averaged a mere 4.6 percent during 2007. In my view, the US economy in 2007 was unhealthily dependent on giant housing and credit bubbles for much of its apparent strength. Moreover, this had been true for years, and we had become truly addicted to cheap capital flows from overseas. When those giant bubbles began to burst in 2006 and 2007, we were left with a severely over-indebted household sector and, if everything were to be marked to realistic market prices, an undercapitalized financial sector even today.

These are the principal problems facing us in 2011, in my view, not long-term interest rates that are too high or businesses irrationally afraid to hire or invest. Small businesses report that financial constraints are not what's holding them back; it's lack of sales and, I would guess, the expectation that household demand will remain feeble for the indefinite future. It's a household-solvency problem, not a liquidity problem. And the Fed cannot fix household balance-sheet problems.

I spoke earlier of Prof. Romer's division of economists into monetary-policy "empiricists" and "theorists". I would like to propose another division of economists into two

camps: Those who did not see anything particularly wrong or unsustainable in the US economy of 2007—I'll call them "aggregate-demanders"; and those who thought something was seriously amiss with the composition or mix of of US economic growth—a group I'll call "demand-mixers". The first group is more concerned with the total amount of output and employment in an economy—that is, aggregate demand; while the second group believes the composition of output and employment matters and can be out of whack, even over long periods of time—albeit not forever and not without cost.

I do not place Prof. Romer in the aggregate-demand camp. She clearly has been focused on the micro-economic features of the economy in her voluminous academic research, her policy advice to Pres. Obama, and in her address to us today. But I do disagree with Prof. Romer's apparent preference for monetary-policy measures to address our economic predicament over structural policies and initiatives. Of course, this may reflect the wisdom of a recent Washington insider on the political difficulties of implementing long-term growth-enhancing measures directed at areas such as education, international trade, innovation, and health care that also stimulate job creation today.

My fear is that we are in danger of failing the challenge presented by the crisis to make needed structural adjustments in our economy. It's not easy to increase the share of business investment and exports in GDP, or to raise education and skill levels, or to bring the health-care sector under control. But I think these, and not a move toward QE-three, -four, or -five, are the right policy choices right now.