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The Great Unraveli n g

Election 2016 Is Propelled by the American Economy's Failed Promises

U.S. leaders in 2000 anticipated an era of rising prosperity. Much went wrong in ways few foresaw, laying groundwork for Donald Trump and Bernie Sanders

By Jon Hilsenrath* and *Bob Davis

When U.S. economic leaders in April 2000 gathered in the White House to mark a decadelong expansion, the consensus was clear. Trade, technology and a wise central bank had helped fuel an era of rising prosperity.

Stick to that model, Alan Greenspan, then Federal Reserve Chairman, told the assembly, and "I do not believe we can go wrong."

Much did go wrong. The economic stability and robust growth the U.S. enjoyed in the previous decade proved to be in its final throes. After 2000, the economy would experience two recessions, a technology-bubble collapse followed by a housing boom, then the largest financial crisis in 75 years and a prolonged period of weak growth.

The past decade and a half has proved so turbulent and disappointing it has upended basic assumptions about modern economics and our political system. This string of disappointments has resulted in one of the most unpredictable and unconventional political seasons in modern history, with the rise of Donald Trump and Bernie Sanders.

Median household income, accounting for inflation, has dropped 7% since 2000, and the income gap widened between the wealthy and everyone else. Even though official measures of unemployment have receded from postrecession peaks, seven in 10 Americans believe the nation is on the wrong track, the most recent Wall Street Journal/NBC poll found.

The 2016 election is shaping up in large part as a referendum on an economic model that is widely seen as failing. Messrs. Trump and Sanders argue that policies celebrated 16 years ago no longer work for most Americans, a message that is resonating widely among those who have most suffered the consequences. Mr. Trump confounded expectations to win his party's presumptive nomination. Mr. Sanders, though losing his, will take his message to the convention and has yanked his party to the left.

<u>The Promise</u>

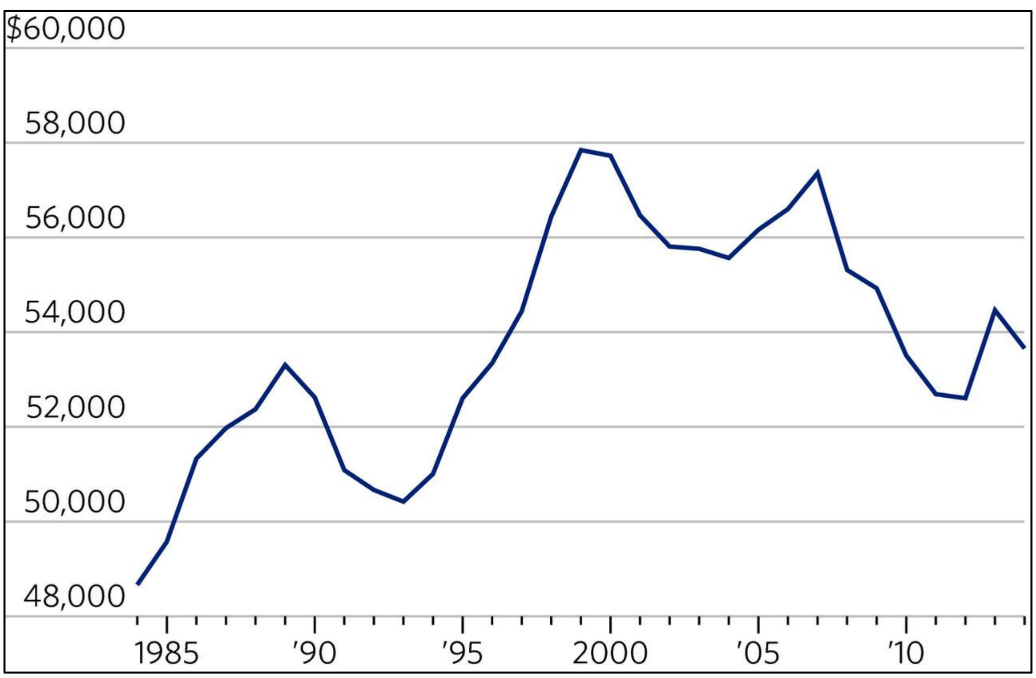
America had an economic model that wouldn't fail.

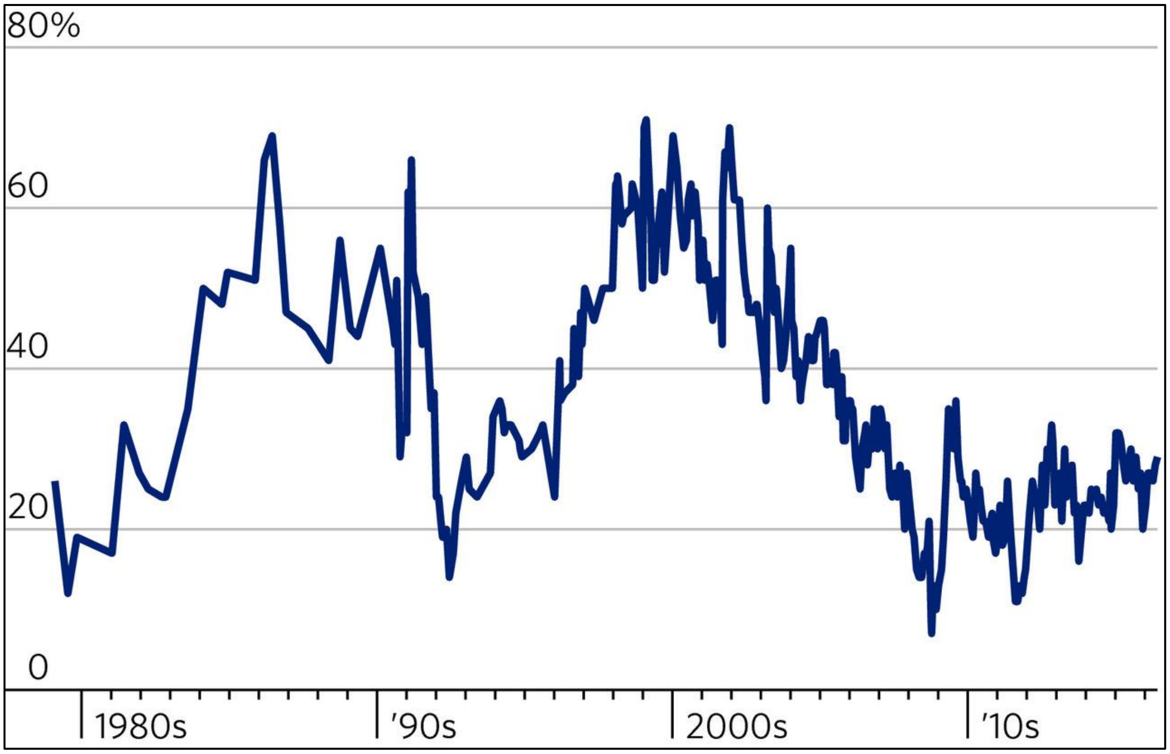
<u>The Reality</u>

American median household incomes, adjusted for inflation, have fallen 7% since 2000. In the process, a persistent majority of individuals have come to believe the country is on the wrong track.

Median household income, adjusted for inflation

Percentage satisfied with where things are going in the U.S.





Sources: Labor Department (income); Gallup (satisfaction)

This article begins a series examining the economic roots of that disillusionment and its social and political consequences.

The disappointments are many and deep seated. China, whose vast market seemed to promise prosperity for U.S. exporters, itself became a giant exporter, dealing blows to U.S. communities far more damaging than earlier import waves from Japan and Mexico.

Technology delivered gadgets and software but didn't produce the anticipated economic growth or jobs, especially for those without advanced education. Central bankers, once deified globally, couldn't foresee or manage the financial storms that eventually leveled the global economy. Economic maelstroms deepened social problems, as working-class communities especially were challenged by drugs, out-of-wedlock births, a dearth of employment opportunities, suicides and fraying social institutions. The problems are scrambling Democrats and Republicans, sending them to new populist frontiers and forcing party leaders to grapple with their purpose and values.

Contributing to the rethink is a sense that Washington, because of gridlock, venality or incompetence, is itself broken and can't fix what ails America.

Workers have come out short-handed. In 2000, they collected 66% of national income through wages, salaries and benefits. That dropped to 61% after the recession and has only recently partially recovered. Profits have risen to 12% of income from 8%.

I do not believe we can go far wrong if we maintain a consistent, vigilant, noninflationary monetary policy…a trade policy that fosters international competition…and an education policy that ensures all Americans can acquire the skills needed to participate in what may well be the most productive economy ever.

—Alan Greenspan, April 2000

In the process, 30 years of established wisdom about how to manage capitalism has been upended by events and challenged by Mr. Trump and Mr. Sanders—the most serious challenge thus far to the post-Cold War economic consensus. Red states and blue states are being redefined along new lines: haves and have-nots.

A recent Pew Research Center poll found 61% of Trump supporters and 91% of Sanders supporters see the economic system as tilted toward powerful interests. Both embrace a new nationalism that rejects global integration and the influence of what they describe as moneyed interests.

It isn't just the public rethinking the old model. Among policy makers and leading economists themselves, the desultory results of the past decade and a half have prompted soul-searching and a re-evaluation of some central tenets of what drives prosperity.

Alan Greenspan, then Federal Reserve Chairman, and President Bill Clinton entered a White House meeting of economic leaders in 2000, where the consensus was that trade, technology and a wise central bank had helped fuel an era of rising prosperity. *PHOTO: PAUL J. RICHARDS/AGENCE FRANCE-PRESSE/GETTY IMAGES*

"I went back to square one and asked, 'Where did I miss it and why?' " Mr. Greenspan says. He was wrong about his faith that markets on balance acted rationally, he says. "I had presumed that irrational behavior on the whole was essentially random and produced nothing of value."

Instead, he says, bouts of fear and greed are systematic, leading markets to overshoot and undershoot.

"We've all had to get a dose of humility," says Martin Baily, chairman of President Bill Clinton's Council of Economic Advisers in 2000 and an attendee at that celebratory White House reception.

The Promise

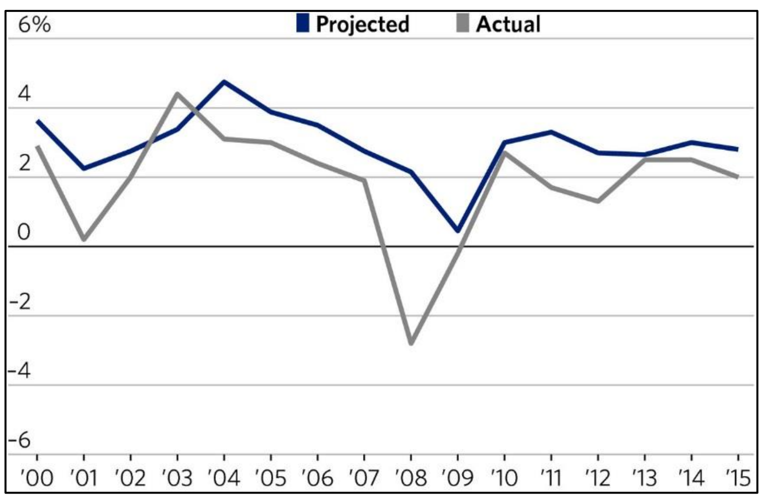
Central banks can manage the balance between growth and inflation and the fallout from financial bubbles.

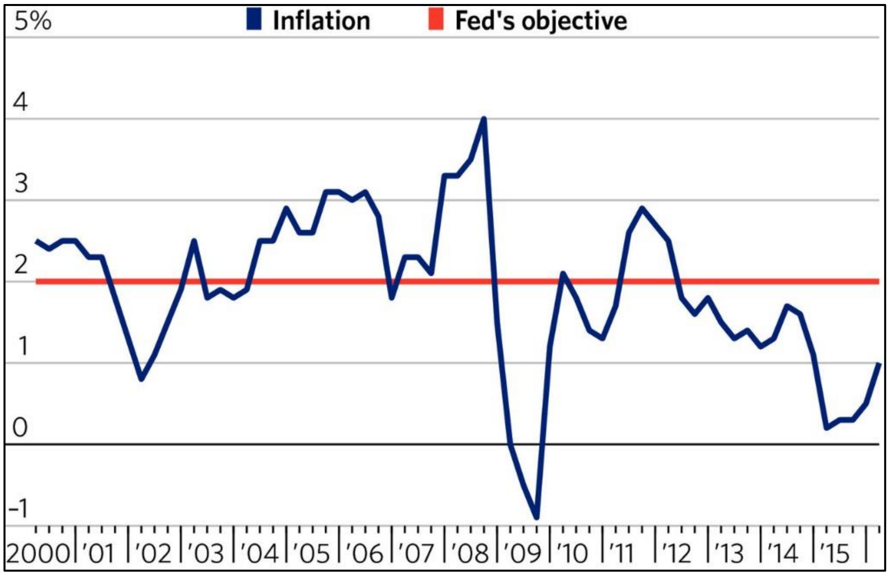
The Reality

The Fed didn't deliver the growth it expected, consistently undershot its own inflation objective, and missed the buildup of financial excesses which caused the 2007-2009 financial crisis.

GDP growth

Inflation





Source: Federal Reserve, Commerce Department

The economic rethinking under way is far from complete and echoes the re-examination that occurred after the Great Depression. A new army of economists is investigating what went wrong. Their work will shape how the U.S. deals with trade, monetary policy, technology, the workforce and fiscal policy for decades, though their conclusions aren't always in line with the populism embraced in the political arena.

Mark Gertler, a New York University economics professor, is rewriting models for central banking and the macroeconomy, filling gaps in how economists thought financial markets and monetary policy affected the economy.

For Fed officials in the early 2000s, an article of faith was that manipulating a single interest rate—an overnight-lending bank rate called the federal-funds rate—could keep the economy on an even keel. Mr. Gertler's research partner, Princeton professor and future Fed chairman Ben Bernanke, argued central banks helped create a "Great Moderation" of stable growth and low inflation.

We have had a Federal Reserve that has focused on elongating this economic expansion and has also emphasized appropriate regulation of our banking institutions.

—Abby Joseph Cohen, Goldman Sachs analyst, April 2000

The moderation turned out to be a mirage.

"There certainly was a lot of hubris about the ability to stabilize the economy," says Mr. Gertler.

Mr. Gertler is seeking new ways to account for the risks of financial crises, collapsing banks and other unstable financial institutions. Yet many central-banking dilemmas the last crisis uncovered remain unresolved. Among them: Central bankers aren't at all sure better regulation, the preferred tool of Mr. Gertler and Mr. Bernanke, can prevent another crisis.

Perhaps most vexing, central banks themselves might spark crises by pushing rates down in a quest for growth. "We're stuck," says Raghuram Rajan, the Reserve Bank of India's governor. "We cannot admit the tools we have are less and less powerful than we predicted and may have perverse effects."

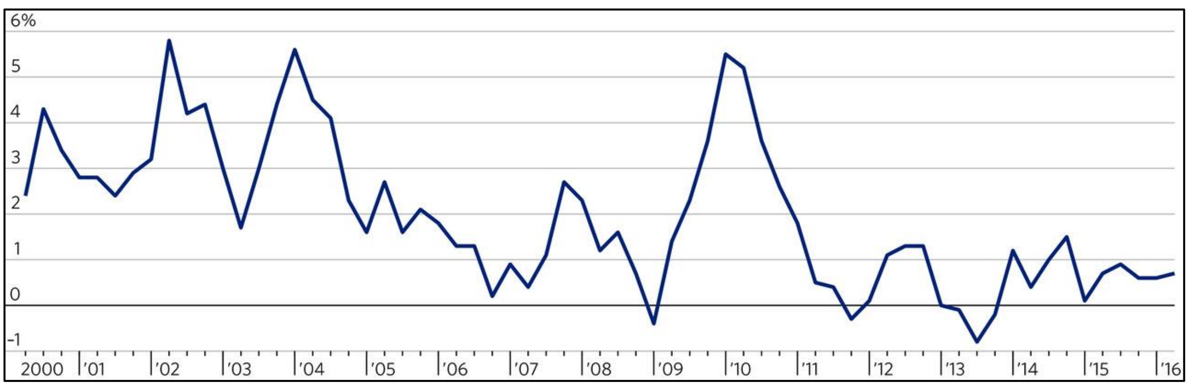
<u>The Promise</u>

Technology would lead to rising incomes and broadly shared prosperity.

<u>The Reality</u>

Productivity and output growth have slowed and technology has been polarizing the workforce.

Nonfarm labor output per hour, change from a year earlier



Source: Bureau of Labor Statistics

At the Massachusetts Institute of Technology, Erik Brynjolfsson is looking at unexpected ways technology has reshaped the economy by sharply reducing jobs and adding to the pool of disillusioned workers. In the 1990s, he was among the first economists to show computer technology was finally boosting worker productivity, a crucial ingredient in economic growth.

His view about workers' gains from technology has turned gloomier. Measured productivity growth has slowed dramatically. He and co-author Andrew McAfee, an MIT business-technology specialist, found that as computing power transforms society, it swallows more jobs—a development they say is accelerating.

Software investment doubled to 1.6% of GDP in the 1990s, as factories and offices added computers that helped firms manage with fewer workers. The shift started hurting workers whose skills computers could replace.

Information technology today represents only 10% of American jobs, but is responsible for 30% of our economic growth…rifling through every sector of our economy, increasing the power of American firms and individuals to share broadly in its prosperity.

—Bill Clinton, April 2000

For a time, those with bachelors' degrees in science seemed safe from automation-prompted layoffs—their knowledge was tough for computers to duplicate—as did less-educated workers in personal service, such as home health aides. Economists argued more education was crucial to future success.

That advice, says Mr. McAfee, turned out to be "way too narrow."

Between 2000 and 2012, estimates Harvard economist David Deming, the hollowing-out of work spread to professions including librarians and engineers. Those with the right skills came out ahead, a big reason the income gap widened. The top 20% of American families accounted for 48.9% of total income in 2014, Census figures show, versus 44.3% in 1990.

The U.S. is on the cusp of a new innovation wave, Mr. Brynjolfsson says, represented by Google's self-driving car. Look for demand for Uber and taxi drivers to expand, he says, then crash, eliminating another job with a middle-class salary—adding still more workers to the ranks feeling betrayed by old economic models.

Most presidential elections turn on voter perceptions of the economy, from Ronald Reagan's 1980 invocation of a "misery index," which combined readings of inflation and unemployment, to Barack Obama's call for a powerful government response to the 2008 financial-sector collapse.

Something similar is happening today, only more dramatically. Until Mr. Trump's successful primary run, Republicans cast themselves as the champions of free markets and low marginal-tax rates. Democrats have been the party of activist government that tries to tweak the economy so it shifts in a desired direction.

The economy's long underperformance has scrambled the debate. Old prescriptions, such as tax cuts by Republicans in the early 2000s and government spending by Democrats, haven't delivered prosperity, leading voters to cast about for alternatives.

Those alternatives narrowed to Mr. Trump, who promised to rip up trade deals and deport millions of illegal immigrants, and Mr. Sanders, who would break up big banks, tax stock trading and match Mr. Trump as an opponent of free-trade deals.

China, more than any other issue, shows the disillusionment with globalization.

At the 2000 White House conference, President Clinton said expanded trade with China would "open their markets to our goods and services."

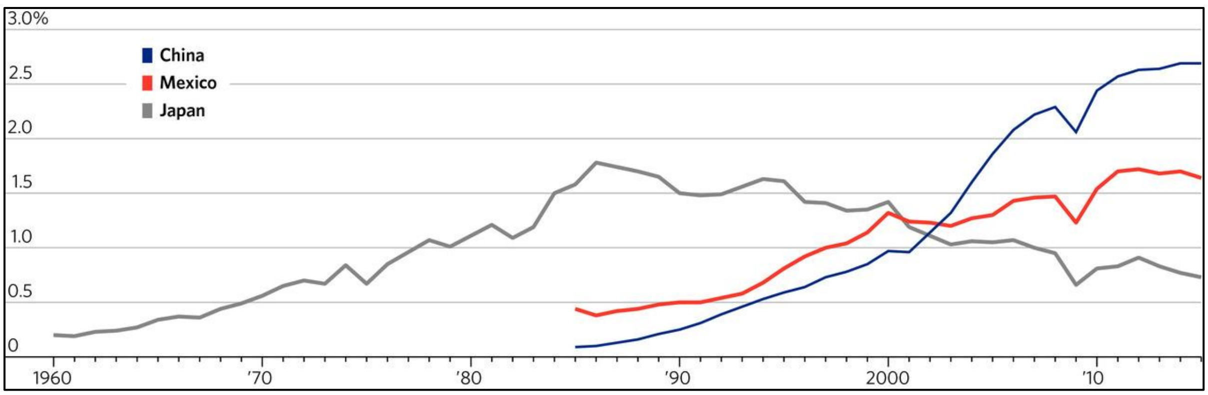
The Promise

Trade with China and other nations would have a net positive impact on the economy as it would expose the world's largest population to U.S. goods and services, while those hurt by trade in America would adapt and be supported.

The Reality

Trade with China turned out to be a bigger shock to the economy than anybody expected, and the adjustment of the workforce slower.

U.S. imports as a percentage of GDP



Sources: Census Bureau; Commerce Department; OECD; Moody's Analytics

Reality has been rougher on American workers. Hillary Clinton, who pushed a Pacific Rim trade deal as secretary of state, now positions herself as tough on China and opposes that same trade deal.

Mr. Trump has made China-bashing a campaign centerpiece. Of America's 100 counties with industries most exposed to Chinese imports, 89 voted for him in Republican primaries. Of the 100 least-exposed counties, before all of his competitors dropped out, 28 gave him the nod. Mr. Sanders takes a tough line on China.

The economy's failure to bring broad prosperity has prompted a growing anger that contributed to the rise of Donald Trump and Bernie Sanders.*PHOTOS: L-R: CARLO ALLEGRI/REUTERS; PBG//STARMAX/ZUMA PRESS*

Economists long recognized import competition hurt some workers but generally dismissed the costs as small relative to benefits such as cheaper goods. Research from widening trade with countries such as Japan and Mexico confirmed that theory, despite activists' targeting the North American Free Trade Agreement as a job-killer.

Economists were blinded, though, to the scale of potential downsides, says Gordon Hanson, a University of California at San Diego economist. His work shows how soaring Chinese imports, which picked up after Beijing joined the World Trade Organization in 2001, magnified technology's impact on jobs. "We were the high priests protecting free trade," he says. "There was a little bit of intellectual insularity."

We in this country have to worry about those who have been left behind in this country, and we have to worry about our role in the world and the vote in China in the next several months will be a crucial test of our country's international sentiment.

—Lawrence Summers, Treasury Secretary, April 2000

Chinese competition, goosed partly by a currency China kept cheap, had far greater effects on U.S. manufacturing than any country since World War II—a finding MIT labor economist David Autor has helped make mainstream with Mr. Hanson and David Dorn of the University of Zurich. The trio studied 722 communities around the country and how they responded to import competition.

Their conclusion overturned conventional wisdom. China was simply different, they found in a 2013 paper. Its workforce was so vast, wages so low and productivity rising so fast, it caused greater disruptions in the American labor market than any country before.

"Washington and we in the establishment spent too much time celebrating the efficiency gains of trade," says Timothy Adams, U.S. Treasury undersecretary under President George W. Bush, "and not enough time thinking about the people who were impacted."

Between 2000 and 2007, import competition from China accounted for 982,000 manufacturing jobs lost, about one-fourth of all manufacturing job losses. Between 1999 and 2011, work published this year found, China accounted for 2.4 million jobs lost, including manufacturing and service jobs.

That loss might have been less damaging if U.S. workers were shifting from declining industries and towns and into growing ones, as they once did. However, fewer workers are willing to move, Mr. Autor and his co-authors wrote. Moreover, America is producing fewer fast-growing startups.

Surveying U.S. economic prospects, former Clinton Treasury Secretary Lawrence Summers invokes a Depression-era idea, "secular stagnation," to argue a dearth of investment opportunities is holding back spending and growth while the income gap has created an overabundance of savings pushing down interest rates.

In the slow-growth world he foresees, global trade becomes more fraught as competitors grab for pieces of a pie that isn't growing rapidly. Tensions over currency policies mount. Central banks have limited tools to cushion blows, putting pressure on fiscal policy—taxes and spending to boost investment—to spur demand.

That wasn't what Mr. Summers argued at the 2000 White House conference, where he said the private sector was so abundant "with staggering high quality investment opportunities" it was the government's job to get out of the way.

Today he says the government must help. "The world has changed," he says. "So my views have changed."