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Forget the debt: its jobs that will define Obama's future

By MARTIN FELDSTEIN

The US unemployment rate reached 9.2 per cent in June, up from 8.8 per cent in March of this year and double the 4.6 per cent rate in 2007 just before the recession began. Even if a short-term deal is done on the US debt ceiling, this high and rising unemployment hurts consumer confidence and weakens President Barack Obama's chances for re-election. To bring the unemployment rate down to 8 per cent by the time of the November 2012 election would require employment to rise by more than 200,000 jobs a month, more than four times the rate of job growth in the most recent two months.

Labour market conditions are even worse than the unemployment rate implies. Against the backdrop of uncertainty created by the debt talks in Washington, about 3m Americans who would like to work but cannot find jobs are not officially counted as unemployed because they have not looked for work in the past month. And there are another 9m employees who would like to work full-time but are only able to get part-time work. Add together all of this and we find 29m Americans who cannot find the full-time work they want, a number equal to almost 20 per cent of the labour force.

The high unemployment reflects the lack of demand rather than any fundamental problems with the US labour market. The bursting of the house price bubble caused a collapse of residential construction and a sharp fall in household wealth that led to a decline in consumer spending. Nominal house prices are still falling, continuing to depress construction and household spending. The reduced spending by consumers has caused companies to cut back on production. With little prospect for an upturn of demand for their products, businesses have laid off large numbers of workers, reducing incomes and raising the unemployment rate.

These problems were exacerbated by the dysfunctional credit markets in 2008 and 2009. Since the central bank had not caused the downturn by raising interest rates, it could not cure the downturn by lowering rates. It focused successfully on fixing the credit markets but that was not enough to turn the economy around.

The policies of the Obama administration did not reverse the large initial fall in demand and have actually made the recession longer and deeper than it should have been. Although the "stimulus" package enacted in 2009 was too badly designed to add much to national spending, it did add more than $800bn to budget deficits, causing households and businesses to worry about the consequences of the exploding national debt. The health plan that Mr Obama forced through Congress will add an additional trillion dollars of spending to the national debt in the coming

decade. And the president's February budget plan would, if enacted, raise the national debt by another $3,800bn in the coming decade.

President Obama's relentless call for higher taxes discourages spending by businesses and households. The administration's policies to fix the problems of housing and small businesses have failed. And, despite talking about increasing exports, the president has not achieved any free trade agreements because he made that legislation conditional on increases in government transfer payments that are not acceptable to the Congress.

Reducing the unemployment rate requires increased spending by households and businesses. The American economy has achieved recovery from a deep recession before and can do it again. The unemployment rate reached 9.7 per cent in 1982 but was back down to 5.5 per cent by 1988. That fall in unemployment reflected a 30 per cent rise in real gross domestic product during those six years.

Even when demand does increase, the fall in the unemployment rate will probably be slower this time than in previous recoveries. Almost half of all those officially classified as unemployed have been out of work for six months or more, making a return to employment more difficult. In contrast, the median duration of unemployment is typically less than three months and in 1983, during the worst of that deep recession, it was only 10 weeks. In addition, fewer of the unemployed are now on temporary lay-off with the expectation of being recalled to their old jobs. And companies will shift many part-time workers to full-time before they hire new employees.

But, despite all of these problems, there is good reason for Americans to be optimistic that the unemployment rate will eventually get back to the traditional US "full employment" rate of about 5.5 per cent. Unlike the situation in the major European countries where the unemployment rate rose from less than 3 per cent in the 1960s to more than 9 percent in the 1990s, the US unemployment rate has shown no long-term upward trend.

The key to this stable long-term employment condition and to the future full recovery of employment is the flexibility of the US labour market. Real wages are flexible and are currently falling. Employees are mobile both geographically and among industries. Unionisation is low, with only 7 per cent of the private sector labour force being union members. The minimum wage is also relatively low and acts as a barrier to employment only for the young and very low skilled.

A good indication of the flexibility of the American labour market is the fact that manufacturing employment fell from 27 per cent of all jobs in 1965 to just 17 per cent in 1990 with no increase in the overall unemployment rate because employees shifted from manufacturing to other industries. Another indicator is that the labour force participation rate of adult women rose from 42 per cent in 1970 to 60 per cent in 1990 with no increase in the national unemployment rate. And the US has absorbed some 8m additional immigrant workers between 1994 and 2004 - equivalent to about 8 per cent of the labour force - without any rise in the unemployment rate until the recession began in 2007.

The US unemployment rate will come down when the government in Washington develops policies that encourage business investment, housing construction, small business hiring, stronger exports and other increases in demand. Unfortunately, it does not look like the Obama administration has a strategy for achieving any of that.

The writer is professor of economics at Harvard University and former chairman of the Council of Economic Advisers and President Ronald Reagan's chief economic adviser.