High and Persistent Unemployment: Why It Happened and How Do We Get Out?

Robert J. Gordon
Northwestern University and NBER

BAC Meeting, Transportation Center

October 6, 2010

The Plan for Today: Me and You

- I'll talk about our bad economy and especially why the labor market is so bad
- Then will come comments and questions from you
- The last section of this session will be reserved for your own perspectives from your industry about how the economy is doing, month by month and week by week.

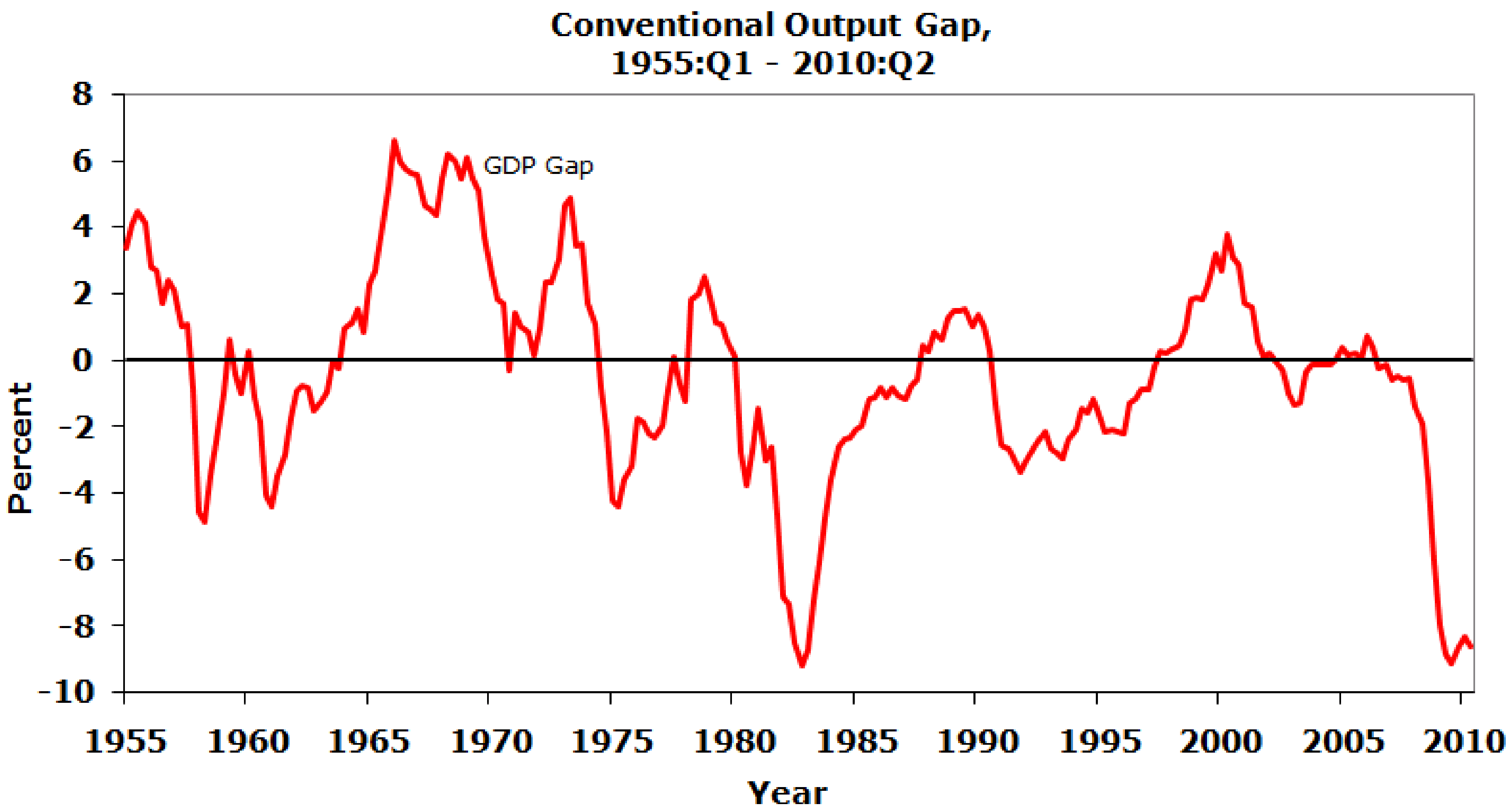
The Recession: What and Why?

- First we examine some descriptive graphs that compare this recession to earlier episodes in the postwar years.
- Next comes the Allocation of blame for the debacle.
  - Distinguish between streets: Wall Street, Main Street, and Pennsylvania/Constitution Avenue
  - Wall Street Meltdown: Fingers of Blame
  - Main Street: Gullible Borrowers and Predatory Mortgage Brokers, Consumers and Small Business as Victims
  - Penn/Constit Ave: A Failure of Monetary Policy and of Holes in the Regulatory Structure through which You Could Drive a Locomotive
  - What about the rest of the world? The saving glut and the gullible foreign banks which bought U. S.-based toxic assets

First Chart: GDP Gap, 1960-2010

- GDP gap compares actual real GDP with "potential" real GDP
  - – YP is the amount the economy can produce without extra pressure for inflation to go up (or down)
- Focus on the "Great Moderation" Starting in 1984 and clearly over in 2008
  - Recessions Less Frequent
  - Recessions Less Severe
- Where will this recession rank compared to previous ones?
- As we will see, by one dimenstion this matches the previous big postwar recession (1981-82) and by others it exceeds it in severity

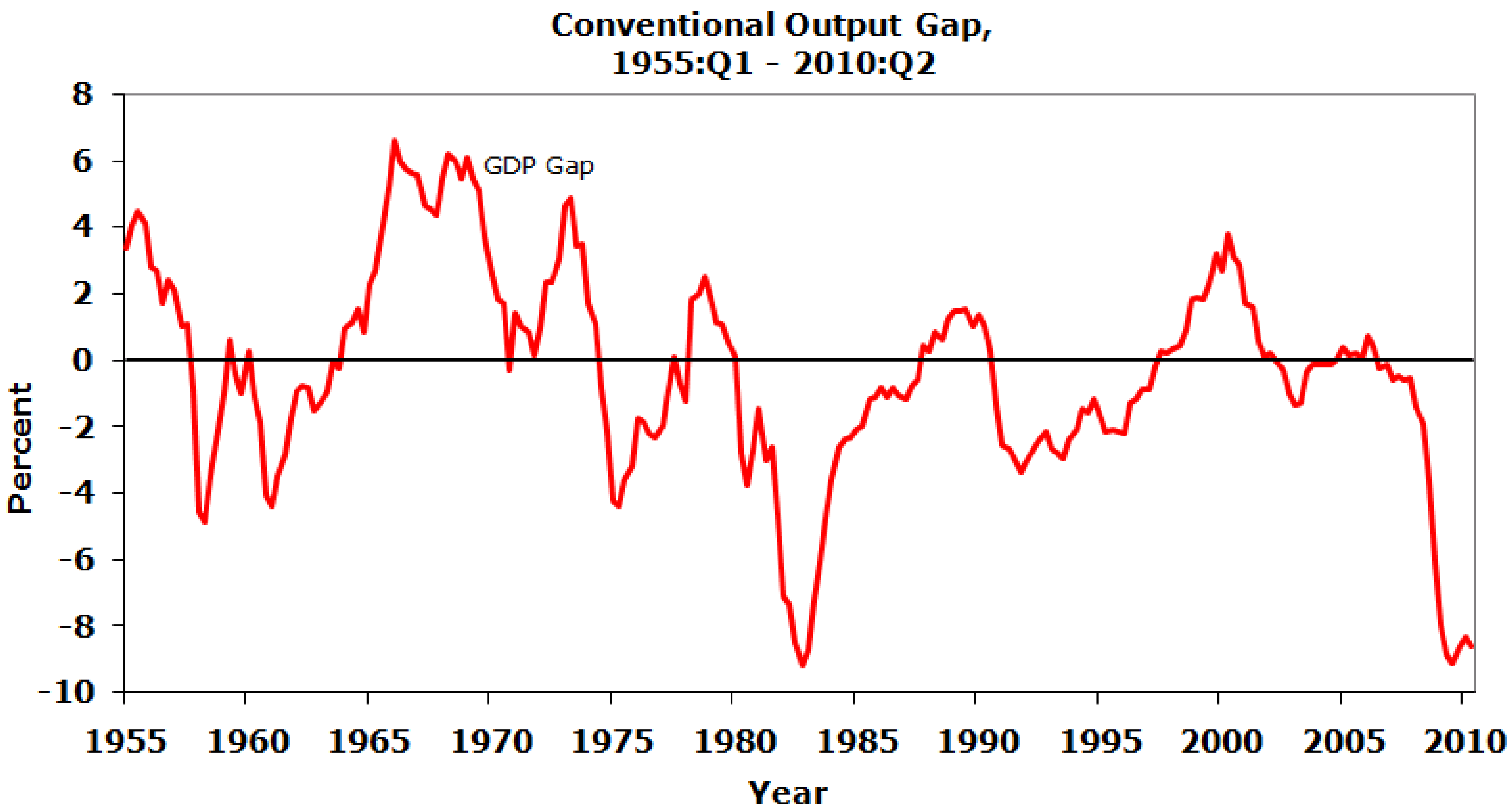
The Output Gap, Percent Relative to Normal ("Potential")



What Are the Big Issues Raised by the Output Gap?

- Compare the deep back-to-back recessions of 1980 and 1981-82 with 2007-2009
- Superficially, they look the same
- But they are radically different:
  - 1981-82 was *caused by tight money and could be fixed by easy money*
  - 2007-09 was not caused by tight money *and has proved unresponsive to easy money.* One of our many tasks is to ask "why?"

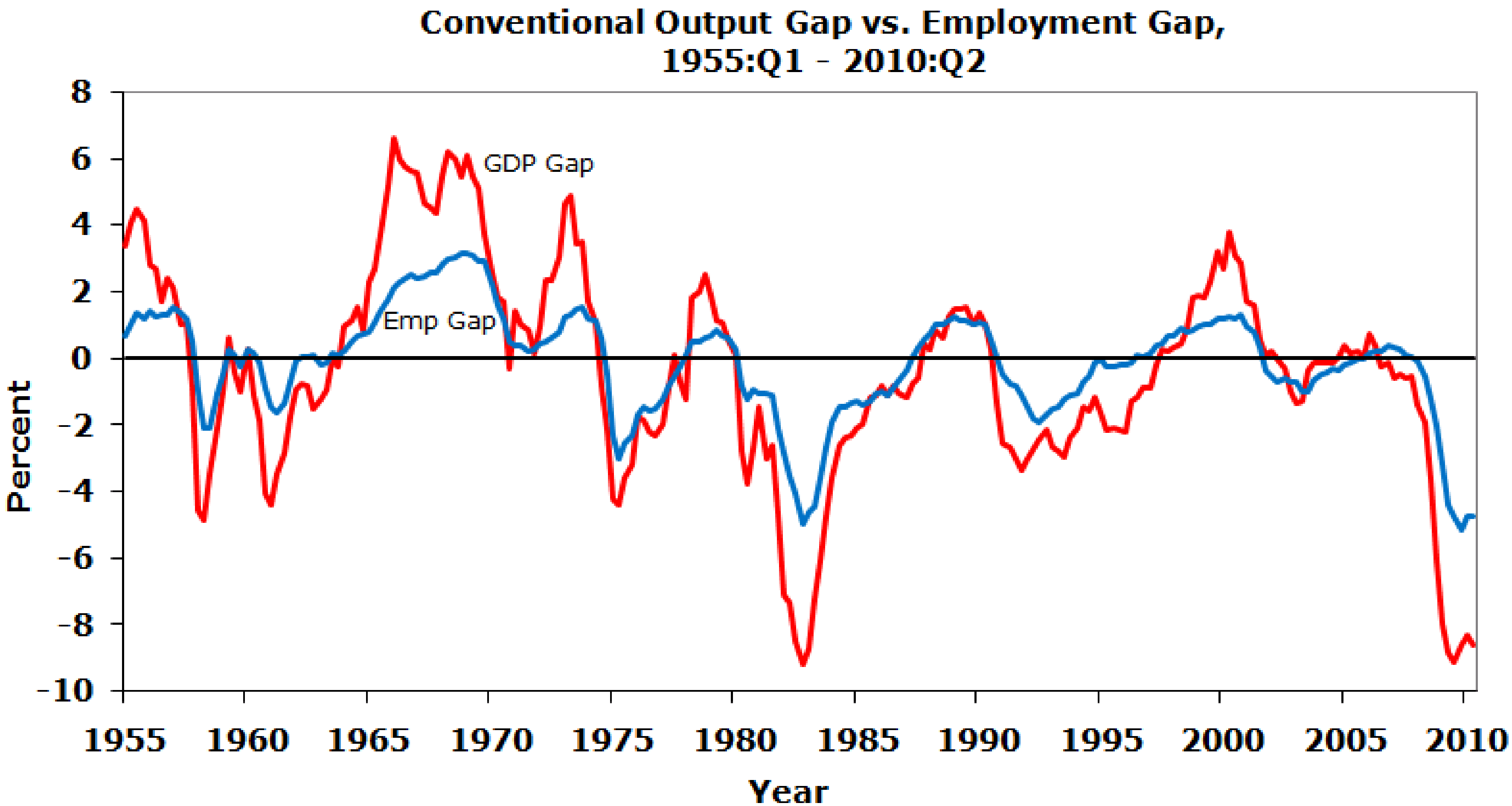
The Output Gap, Percent Relative to Normal ("Potential")



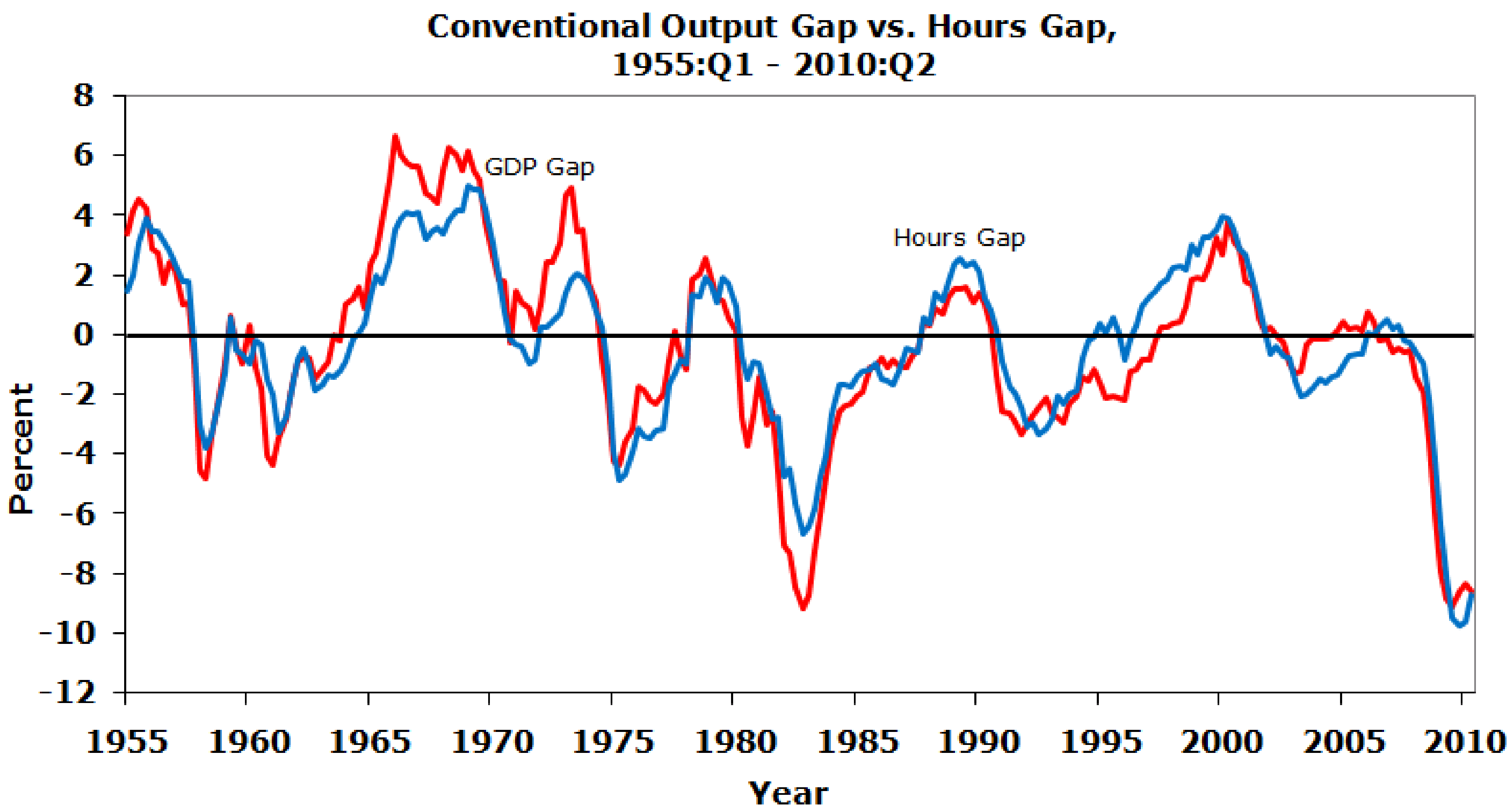
Now We'll See an Array of Measures Showing the Disaster in the Labor Market

- The first few graphs show the "gaps," actual relative to "normal" or "potential" output, employment, aggregate hours, and other measures
- Then we'll look at raw numbers for labor-market measures that are not adjusted for "normal"

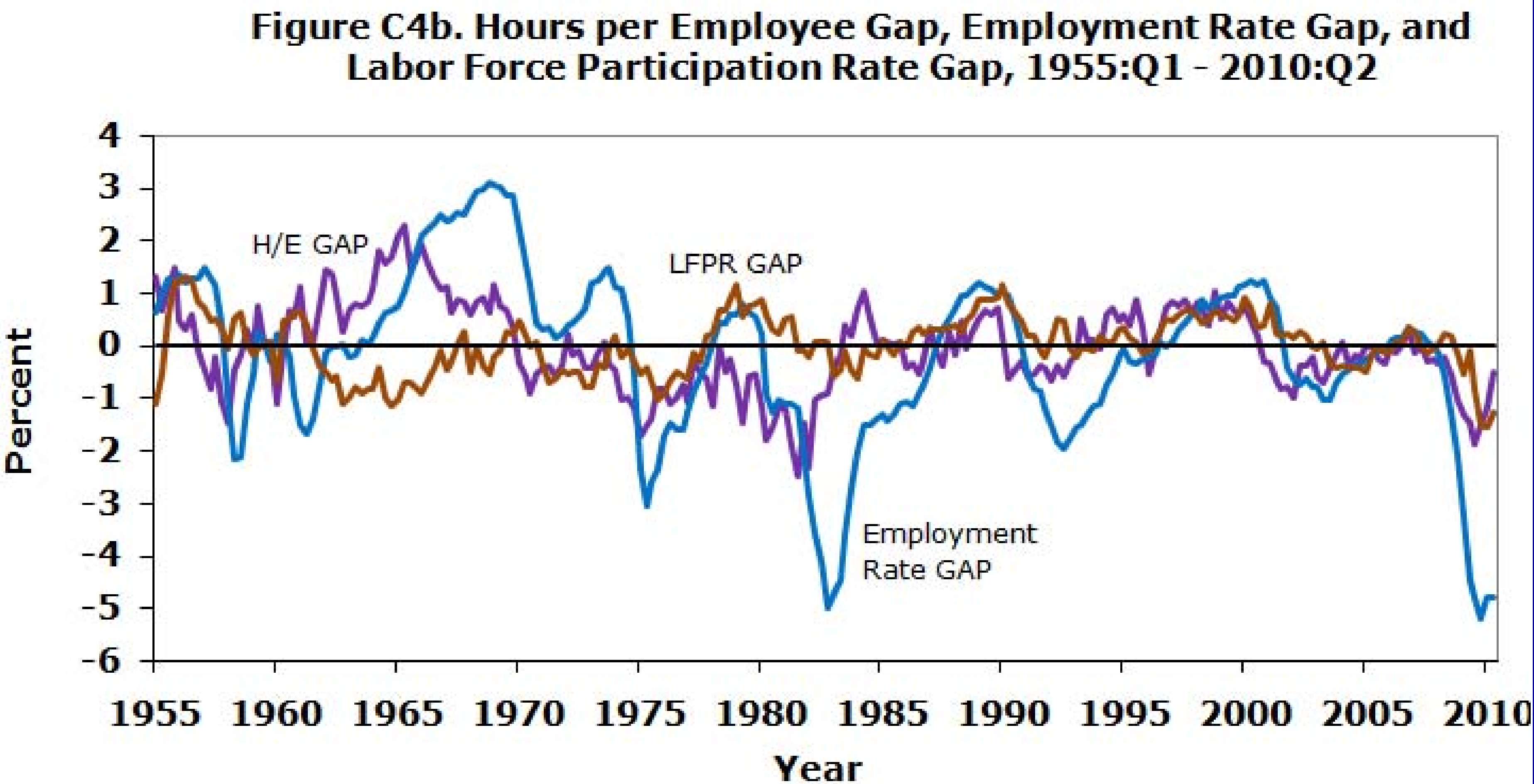
Output Gap vs. Employment Gap



Output Gap vs. Gap in Aggregate Hours of Work

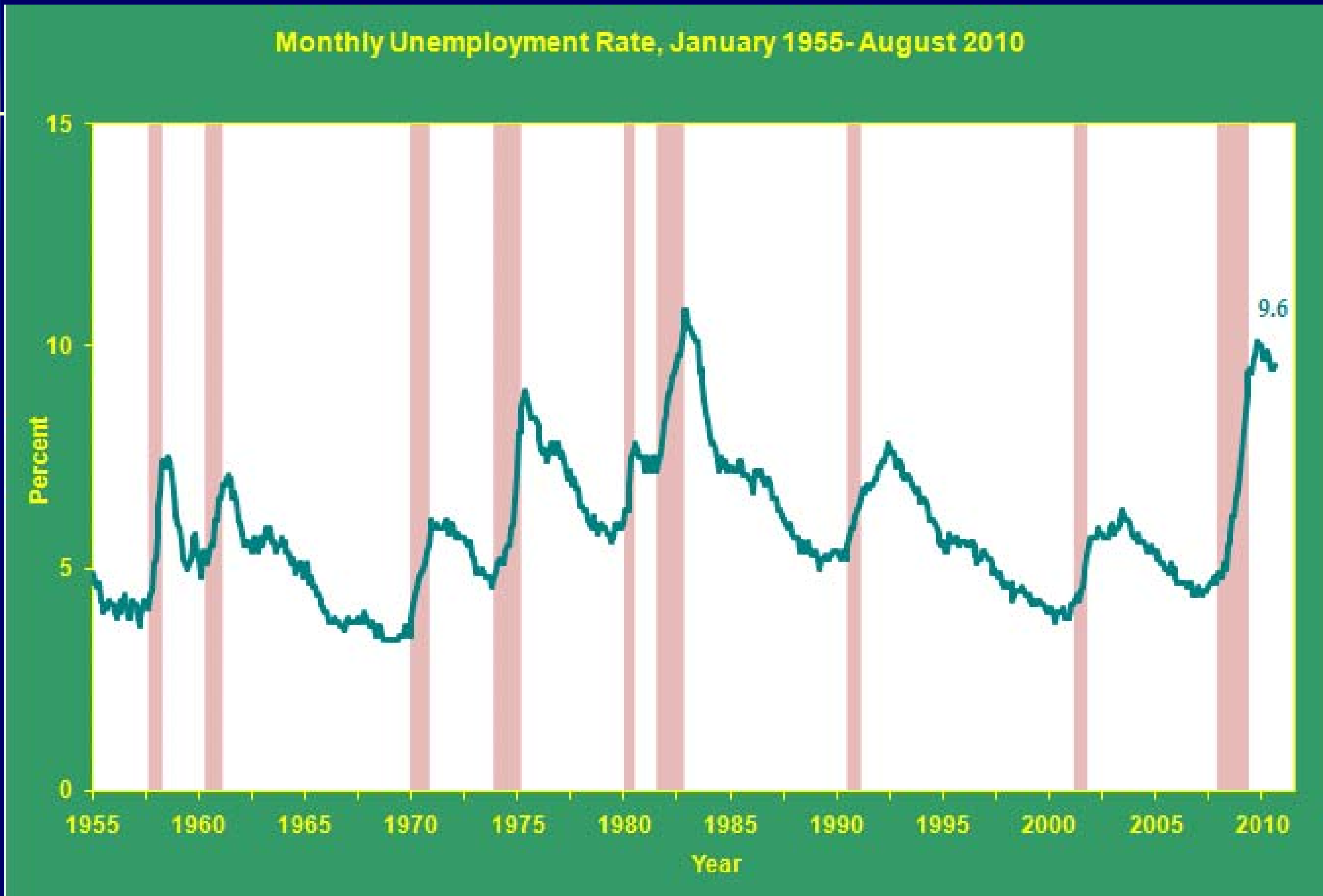


Three Components of Aggregate Hours Gap

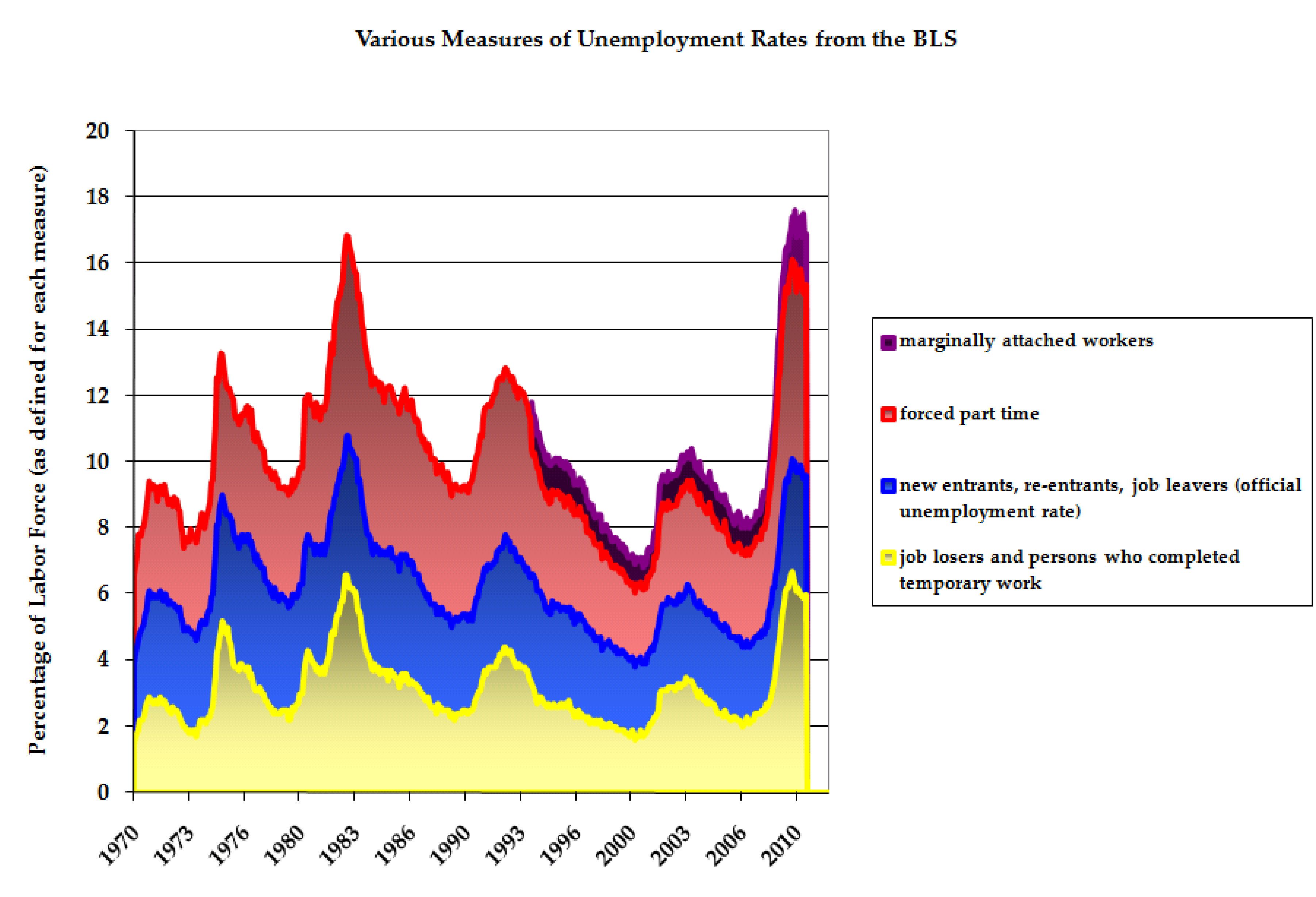


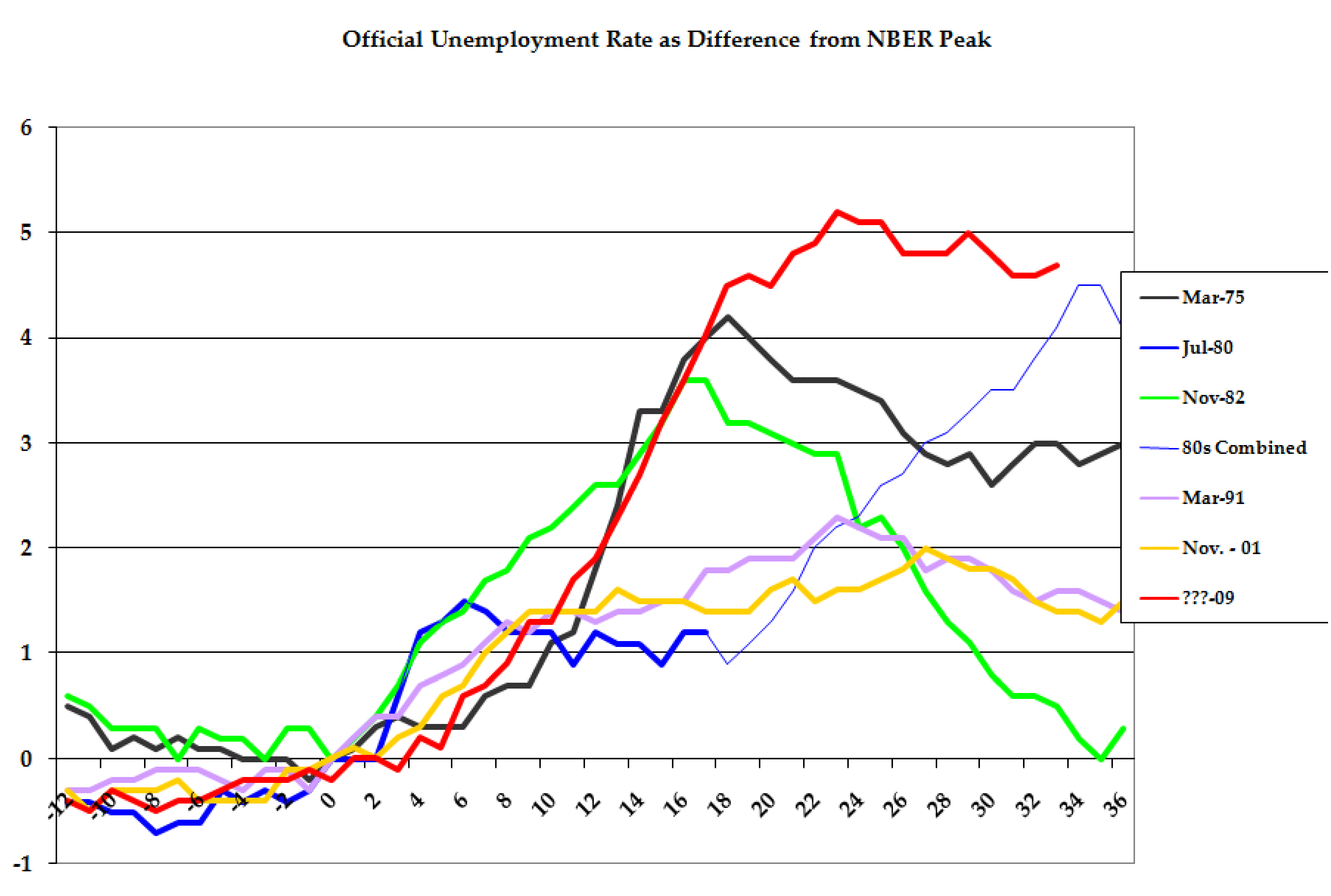
Now We'll Look at Graphs of Raw Numbers

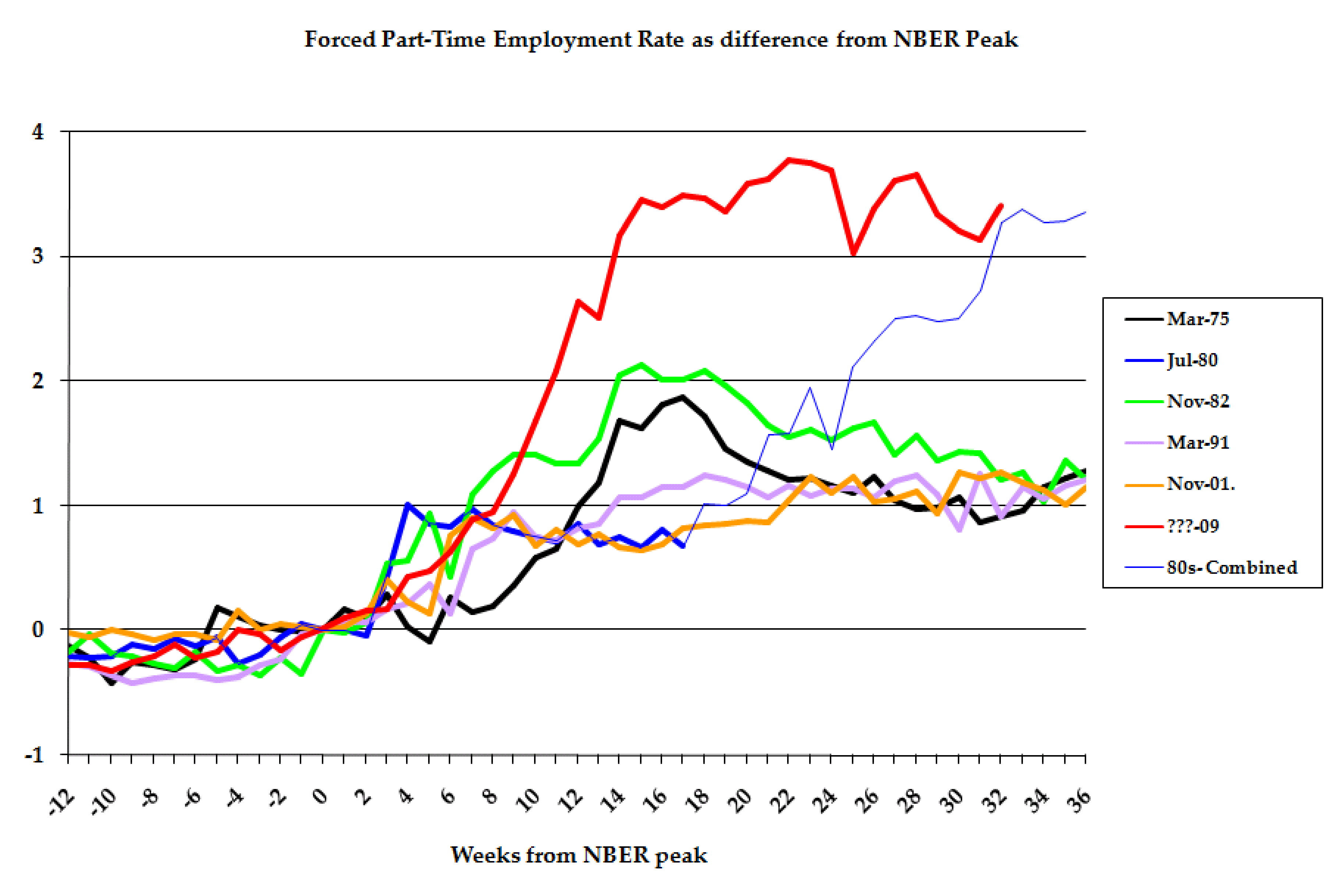
- Now We're Looking at
  - Magnitudes: How Severe Is This Episode?
  - Timing: Do Labor Market Indicators Change at the Same Time as Output (Real GDP)?
  - Which Measures Are the Most Different from 1980-82?
- We Consider 1980-82 as a Single Recession and also as two back-to-back recessions
  - (Jan-July 1980 and Jul 81 to Nov 82)

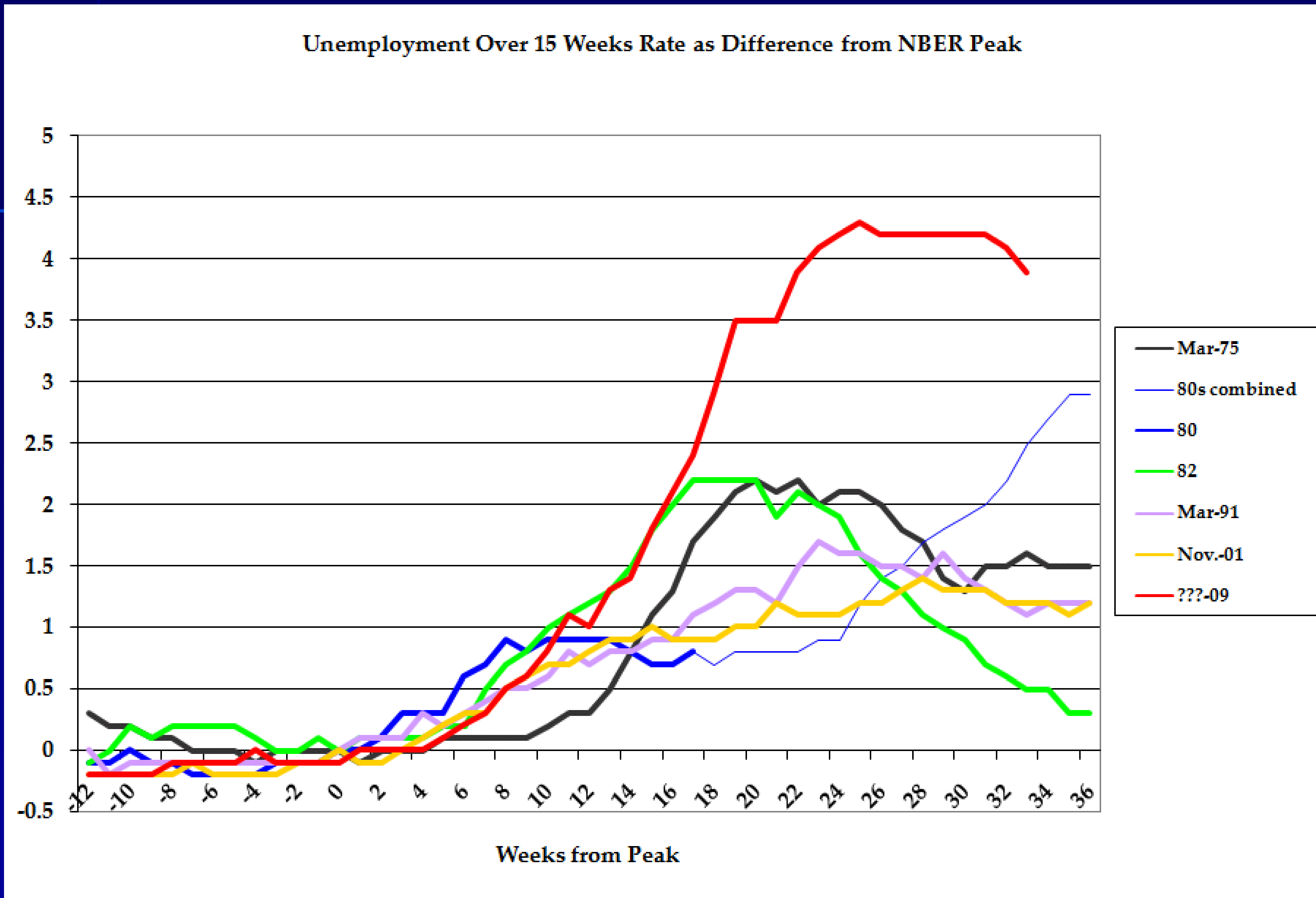


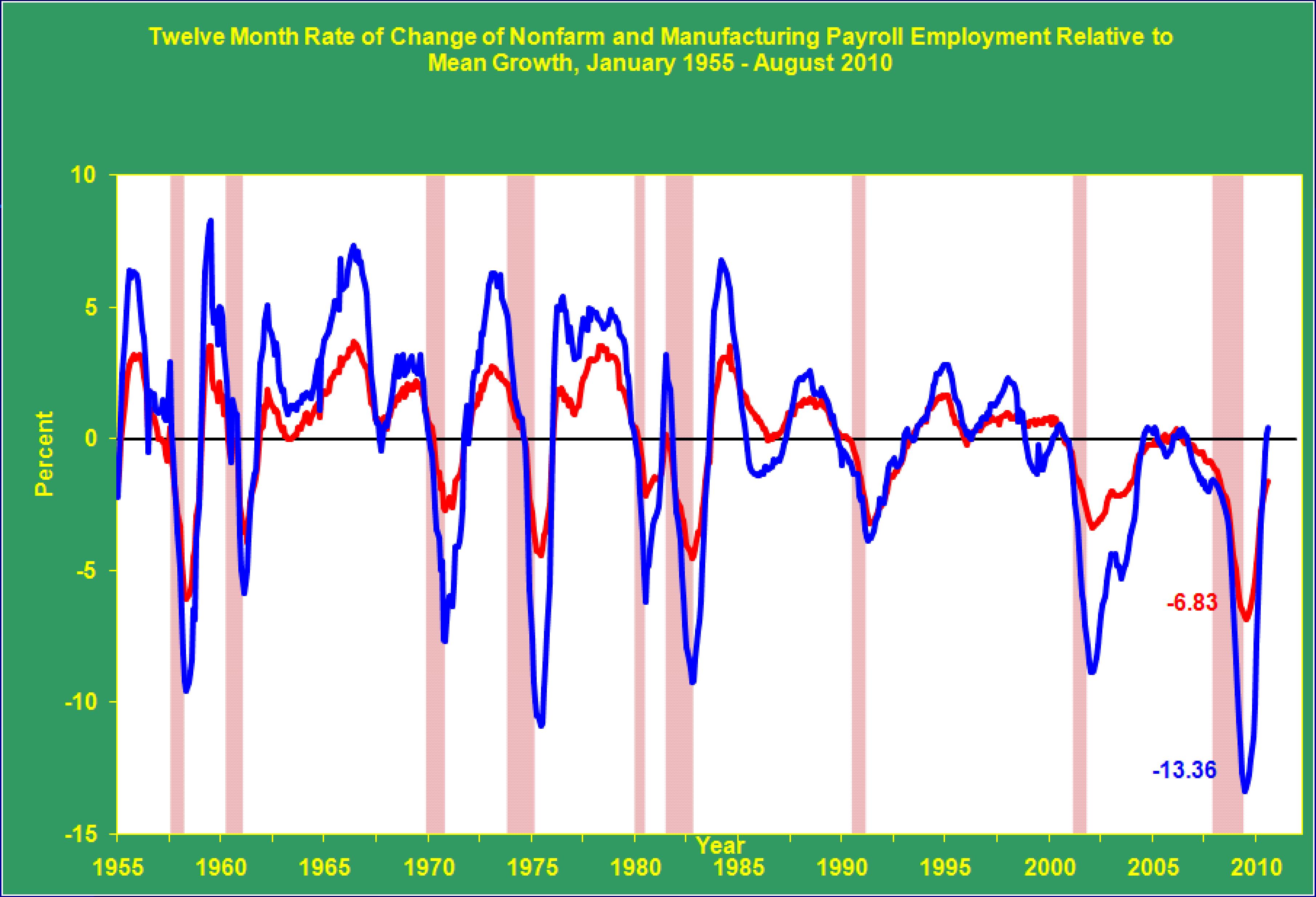
Monthly Unemployment Rate, January 1955- August 2010
15
10
5
0
Percent
9.6
1955
1960
1965
1970
1975
1980
1985
1990
1995
2000
2005
2010
Year


Various Measures of Unemployment Rates from the BLS
Percentage of Labor Force (as defined for each measure)
0
2
4
6
8
10
12
14
16
18
20
1970
1973
1976
1980
1983
1986
1990
1993
1996
2000
2003
2006
2010
marginally attached workers
forced part time
new entrants, re-entrants, job leavers (official unemployment rate)
job losers and persons who completed temporary work

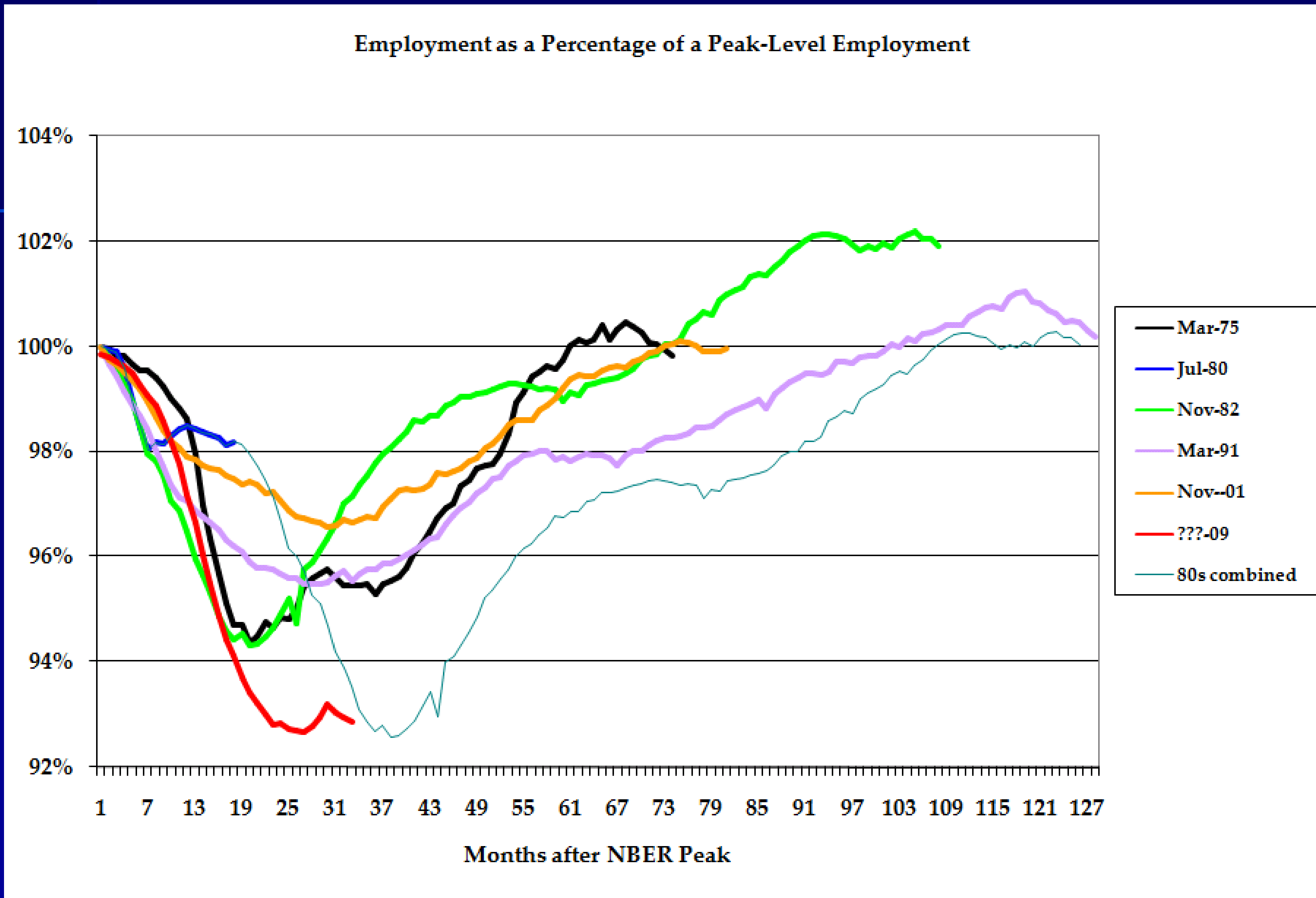

Official Unemployment Rate as Difference from NBER Peak
6
5
4
3
2
1
0
-1
-12
-10
-8
-6
-4
-2
0
2
4
6
8
10
12
14
16
18
20
22
24
26
28
30
32
34
36
Mar-75
Jul-80
Nov-82
80s Combined
Mar-91
Nov. - 01
???-09


Forced Part-Time Employment Rate as difference from NBER Peak
4
3
2
1
0
-1
-12
-10
-8
-6
-4
-2
0
2
4
6
8
10
12
14
16
18
20
22
24
26
28
30
32
34
36
Weeks from NBER peak
Mar-75
Jul-80
Nov-82
Mar-91
Nov-01.
???-09
80s- Combined


Unemployment Over 15 Weeks Rate as Difference from NBER Peak
5
4.5
4
3.5
3
2.5
2
1.5
1
0.5
0
-0.5
-12
-10
-8
-6
-4
-2
0
2
4
6
8
10
12
14
16
18
20
22
24
26
28
30
32
34
36
Weeks from Peak
Mar-75
80s combined
80
82
Mar-91
Nov.-01
???-09



Twelve Month Rate of Change of Nonfarm and Manufacturing Payroll Employment Relative to Mean Growth, January 1955 - August 2010
Percent
Year
10
5
0
-5
-10
-15
1955
1960
1965
1970
1975
1980
1985
1990
1995
2000
2005
2010
-6.83
-13.36



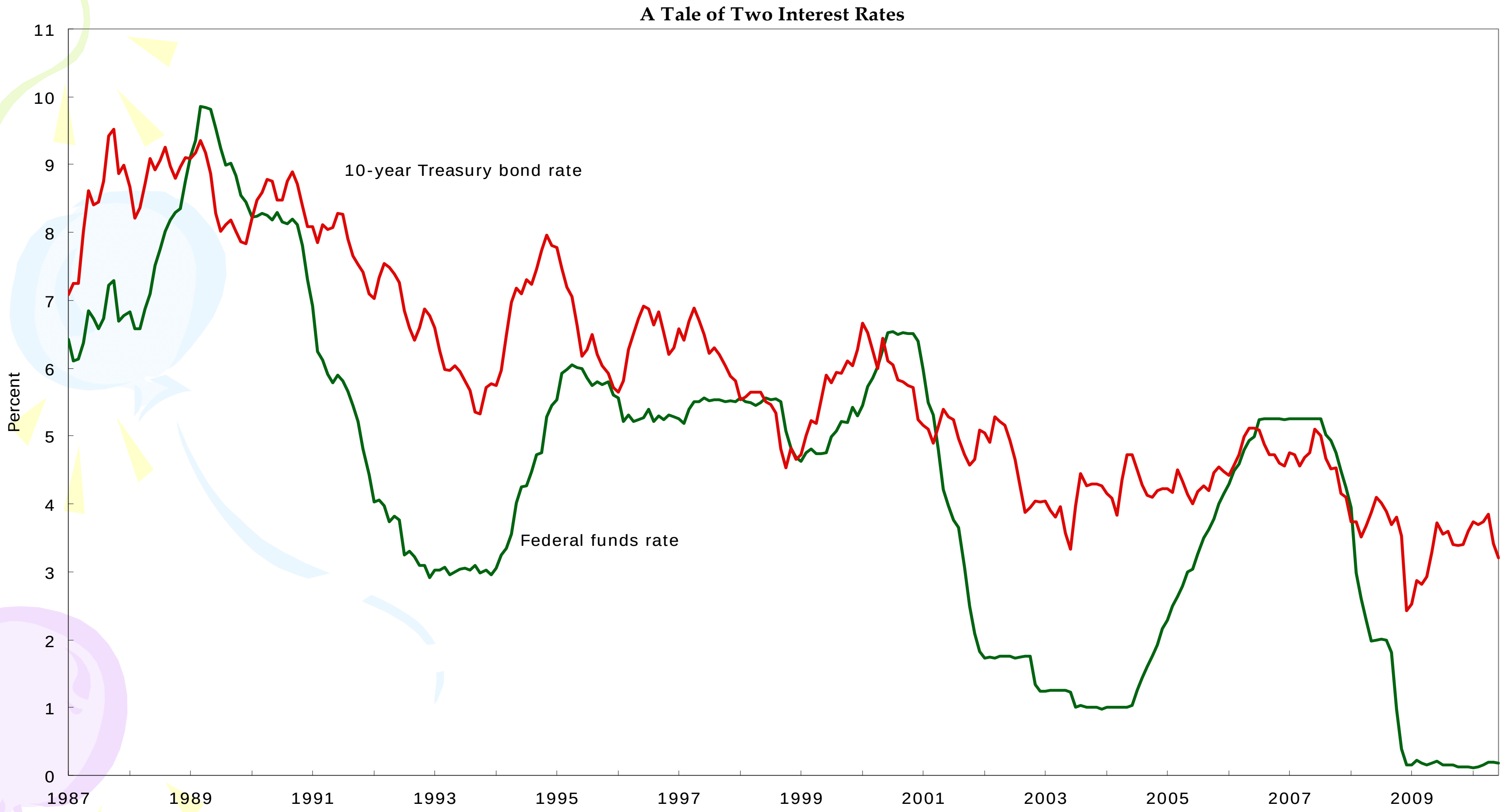
Employment as a Percentage of a Peak-Level Employment
104%
102%
100%
98%
96%
94%
92%
1
7
13
19
25
31
37
43
49
55
61
67
73
79
85
91
97
103
109
115
121
127
Months after NBER Peak
Mar-75
Jul-80
Nov-82
Mar-91
Nov--01
???-09
80s combined

Back to Outline of Talk: What, Why, What Next?

So far we've compared the decline in output and employment, and the rise in unemployment, with previous recessions.

- Trouble started on all four streets (Main, Wall, Pennsylvania, and Constitution)
- A Massive Market Failure that was not Limited in Scope by Government Regulation
- Fire Fueled in 2002-04 by Fed's aggressive cuts of short term interest rates
  - – Distinguish FF rate from 10 year bond rate

Two Key Interest Rates, Only One Controlled by Fed

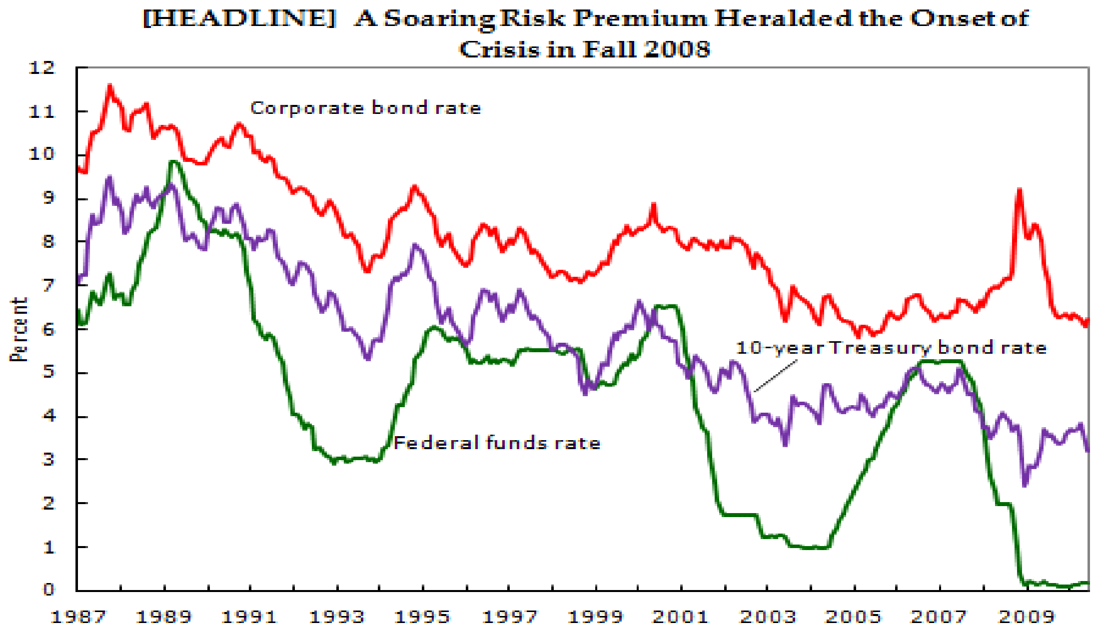


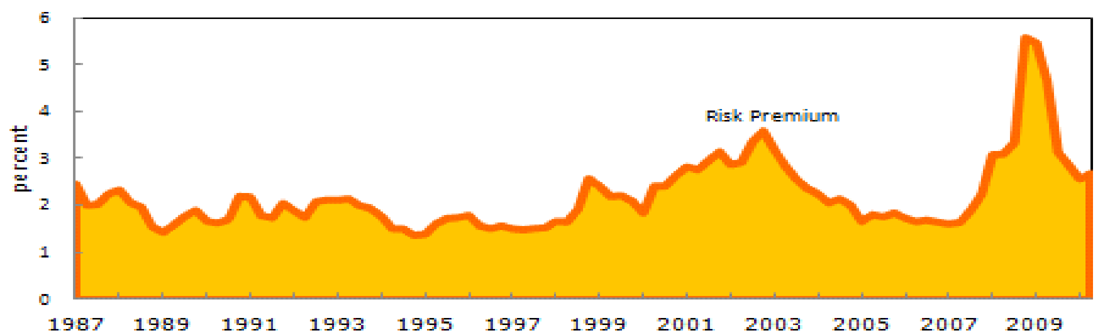
Source : See Appendix C-4

What About that 10-Year Bond Rate?

- Not controlled by Fed, but rather set at the Chicago Board of Trade
- Why so low in 2003-05 when Fed Funds rate came back up?
- Bernanke's hypothesis: worldwide "saving glut"
  - Excess of private saving over investment in China and Japan
  - Deliberate exchange rate manipulation by China and Japan

The Fed Can't Control the Cost of Business Borrowing





Seeds of Disaster Were Planted

- Adjusted for Inflation, Federal Funds Rate *was Negative throughout 2002-04*
  - Auto Sales Exploded with Zero-Rate Loans in late 2001. Throughout 2001-2006 Auto Sales were Borrowed from the Future
  - Housing quickly followed
- Low interest rates create the temptation to financial operators to borrow much more than their own capital equity, add fees at every stage, and make very large profits
- Old world: leverage 10-1. I buy 100, invest 10, borrow 90. If the price of the asset increases to 110, my investment doubles from 10 to 20 and I make 100% profit. If the price decreases to 90, I am wiped out by a 10 percent price decline.
- New World: leverage 20-1. I buy 100, invest 5, borrow 95. If the price of the asset increases to 110, my investment triples from 5 to 15 and I make a 200% profit. If the price decreases to 95, I am wiped out by a 5 percent price decline.

But It Was Worse than That

- Many financial institutions, not to mention ordinary people, became more leveraged (think: lower down payments, no down payments at all on credit cards)
- Leveraged financial institutions lent to other leveraged financial institutions, creating a house of cards that eventually had to fall
- Propped up for a while by rising house prices
  - But house prices were getting out of line with incomes
- Mutual distrust by these institutions resulted in a credit freeze, as significant a financial event for the real economy as bank failures in the 1930s.
- Role for financial regulation: contrast 10% margin requirements in 1929 with 50% requirements in past decade

Interaction of Greed on Wall St and Main St

- Here Main St and Wall St fed on each other's greed
  - Main St greed: mortgage brokers, NINJA loans, gullible borrowers
  - Wall St greed: the more leverage and securitization, the more fees could be tacked on to each step of the process
    - Share finance sector profits in total corporate profits increased from 10 percent 1950-80 to an astonishing 34 percent 2001-06
- The fundamental question is: how much real input into the financial sector does an economy need to function efficiently?
- A regulatory story or a rationality story: why Canada survived without predatory loans or foreclosures

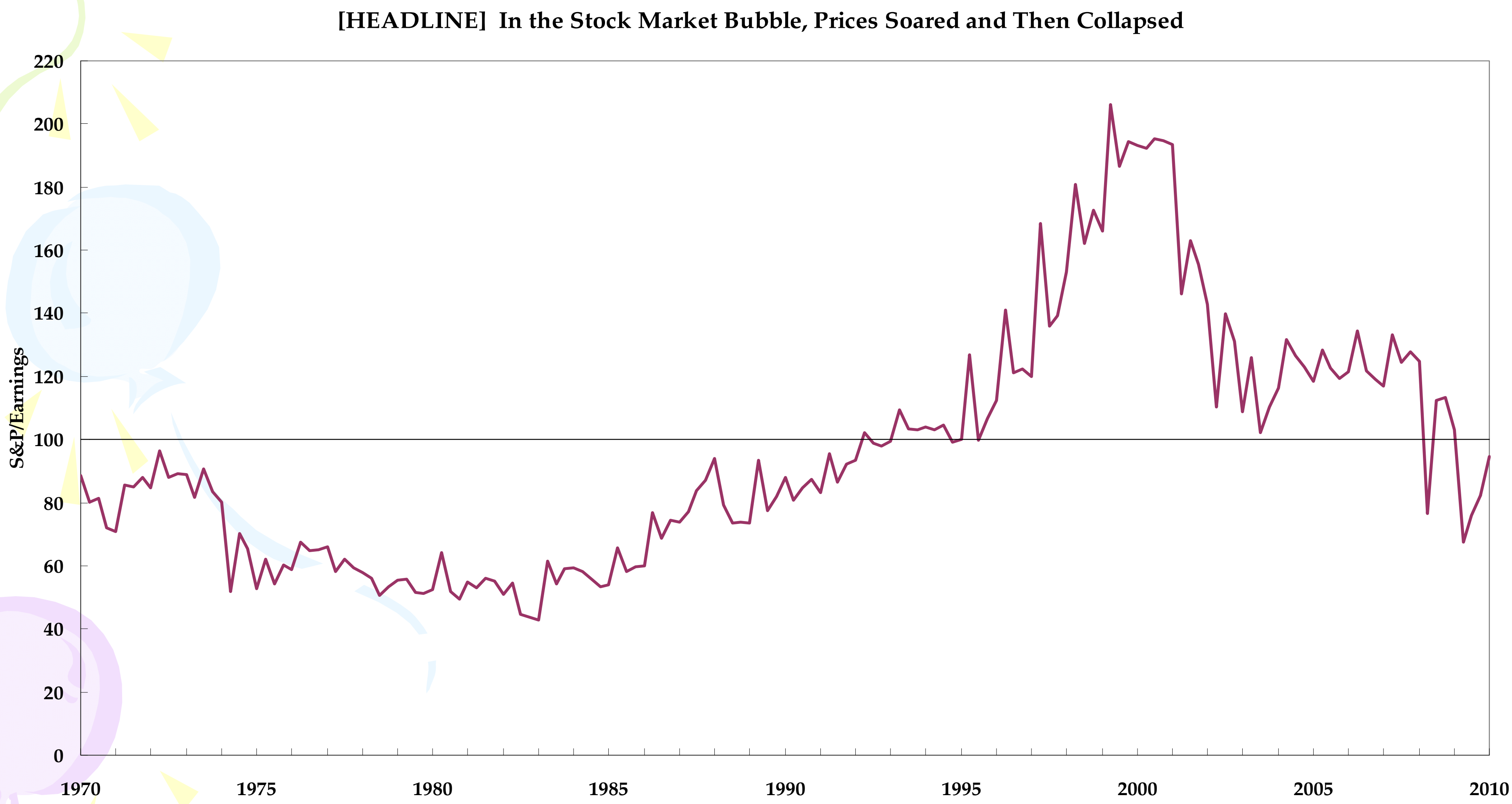
Results: Housing and Consumption were Artificially High

- Housing: Cheap credit pushed up
  - Prices of Existing and New Homes
  - Quantity of New Construction
  - At peak 2.1m housing starts compared to 0.55 now
- Consumer Spending Fueled by
  - Low interest rates on mortgages, consumer credit
  - Housing equity withdrawal
  - At peak 18m annual auto sales compared to 12m now

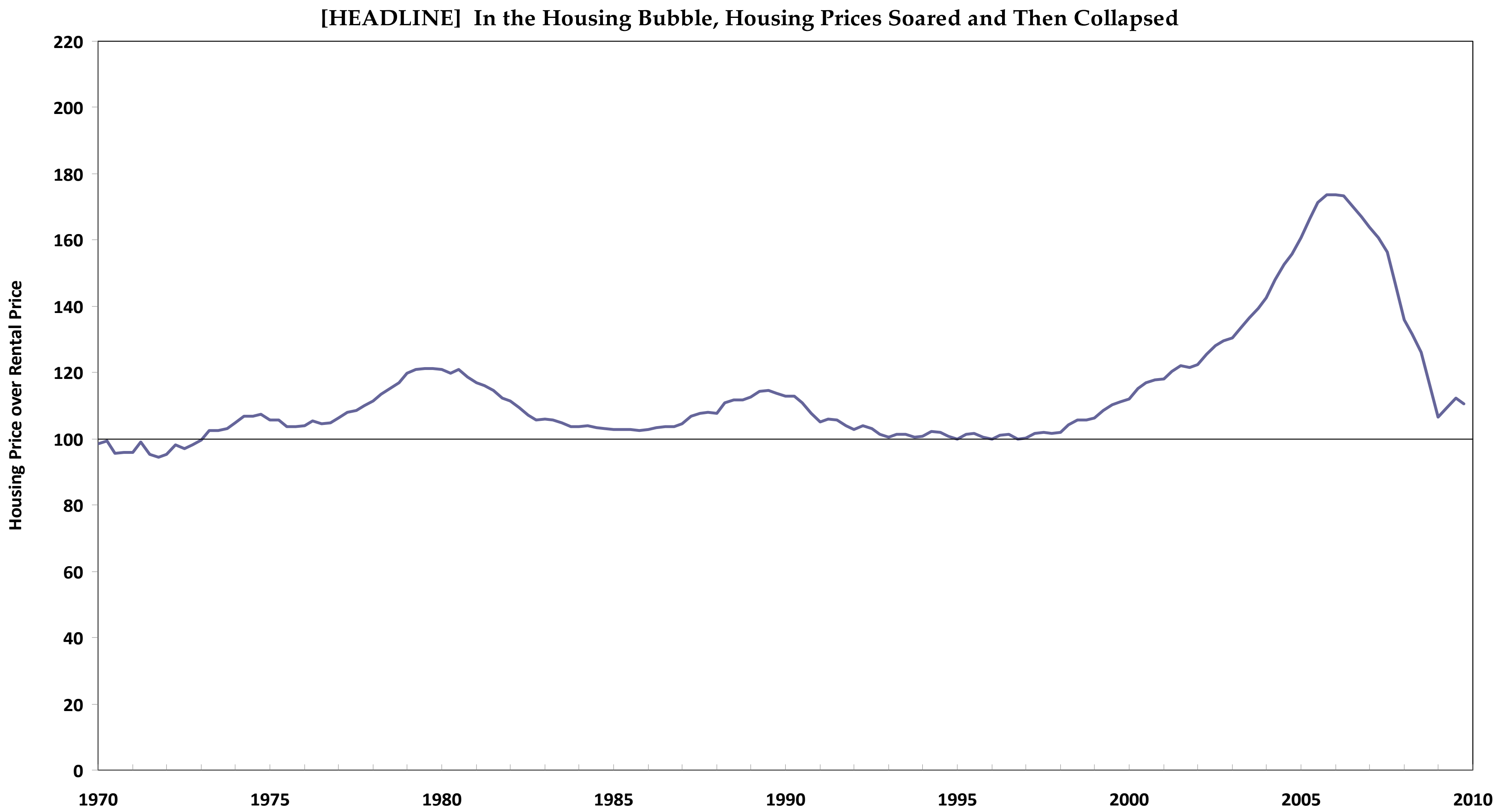
Next Two Slides: Dimensions of Two Bubbles

- The Stock Market Bubble: 1996-2000, not 2003-07
  – S&P peak of 1523 reached in 3/00 and 1568 reached in 10/07. Now 1160 (not adjusted for inflation)
- Housing Bubble: 2000-06
  – Prices went up 60%
    - Out of line with incomes and rents

Stock Market Bubble, 1995-2000



The Housing Bubble Had No Parallel Before 2000



Already by Fall 2006 the Economy was in Trouble

- Household Saving Rate had been Pushed to Zero
  - Wealth Effect on stock prices and housing
  - Newly important mechanism of equity withdrawal further boosted consumption
- Late 2006, house prices peaked and in retrospect appear to have been at least 30 percent overvalued

My Fall 2006 Macro Students Heard Dire Predictions

- House Prices would fall
- End of Equity Withdrawal
- End of Car buying boom
  - Special trouble for Detroit Big-3
- Higher Oil Prices cut Household Buying Power
- Real Wages Declining due to Increases in Oil Prices
- Why Didn't the Government Stop the Housing and Financial Market Meltdown?

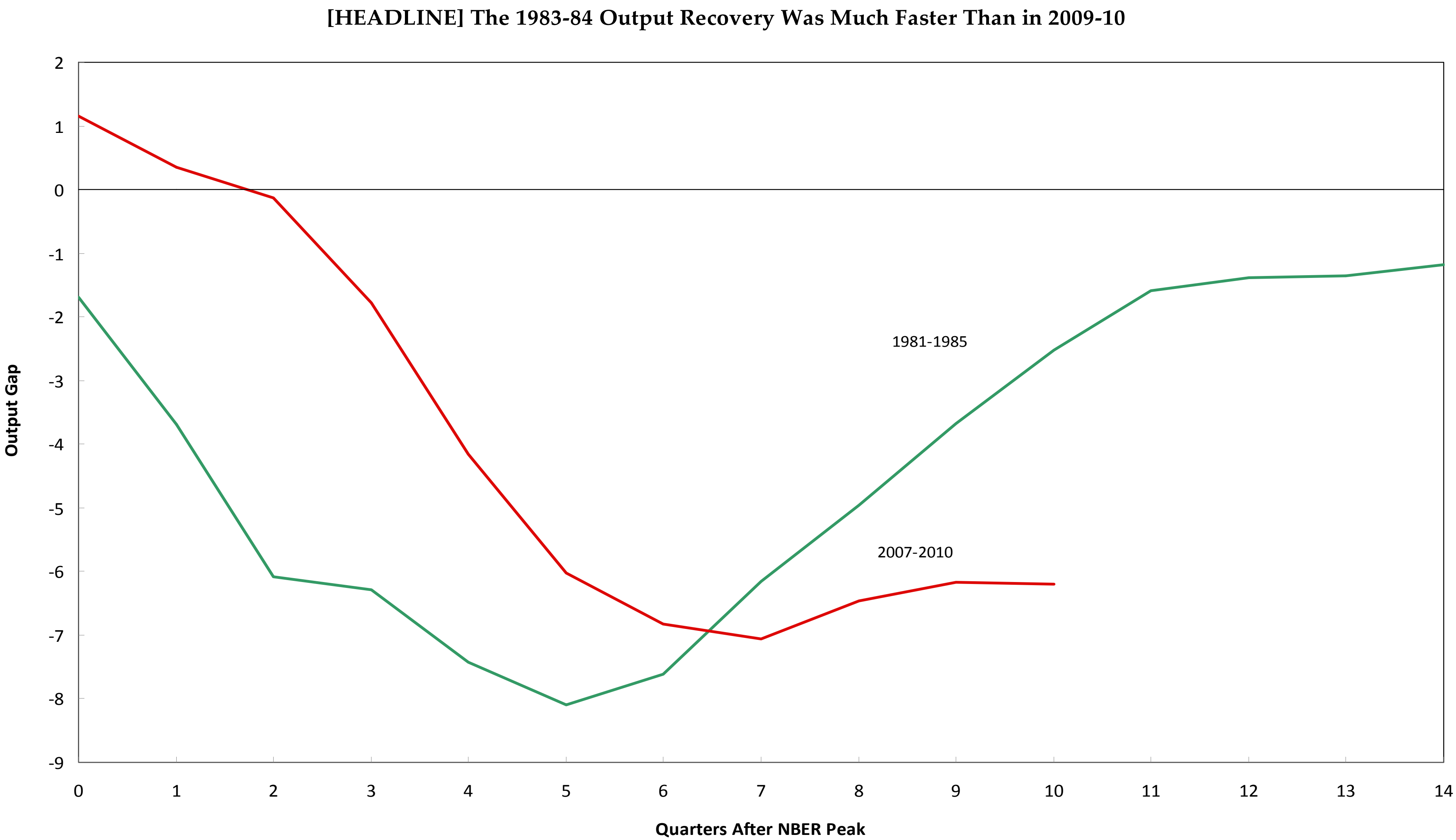
Again Contrast 1981-82 versus 2007-09

- 1981-82 caused by tight money, Fed funds rate of 19%, mortgage rates of 15%
- Fed changed to easy money starting in August 1982. with S&P = 120.
- Economy took off, stock market took off
- But now? Hangover that didn't exist then:
  – Mortgages under water, foreclosures
  – Consumer debt percentage of household income
  – Overbuilt commercial real estate market, not to mention "see-through" condos

Result: Bubble Ended with Foreclosures and Collapse of House Prices

- Foreclosures Ruin Lives and Blight Neighborhoods
- Declining House Prices Lead to
  - Personal Bankruptcy
  - Tainted credit ratings preventing future borrowing and spending
  - Negative equity
  - Inability to move in response to family changes and new jobs

Look Back at post-1982 and post-2009 Recoveries



The Fed Was Asleep at the Regulatory Wheel

- Along with other government agencies
- Failed to Appreciate the Scale of Risks Being Built up by "Shadow Banking System"
  - Credit swaps, derivatives
  - Originator of mortgages sells to Wall Street, repackaged in bundles of securities
- Fed made no attempt to create coordinated Federal regulation of new financial market instruments, from AIG to predatory mortgage brokers
- Why so many foreclosures? Because mortgage firms and brokers toyed with consumer irrationality. A bigger more important example of "payday loan" stores.
- Why Deposit Insurance is Essential to Prevent Bank Runs. But Non-bank financial institutions were subject to runs yet did not have deposit insurance.

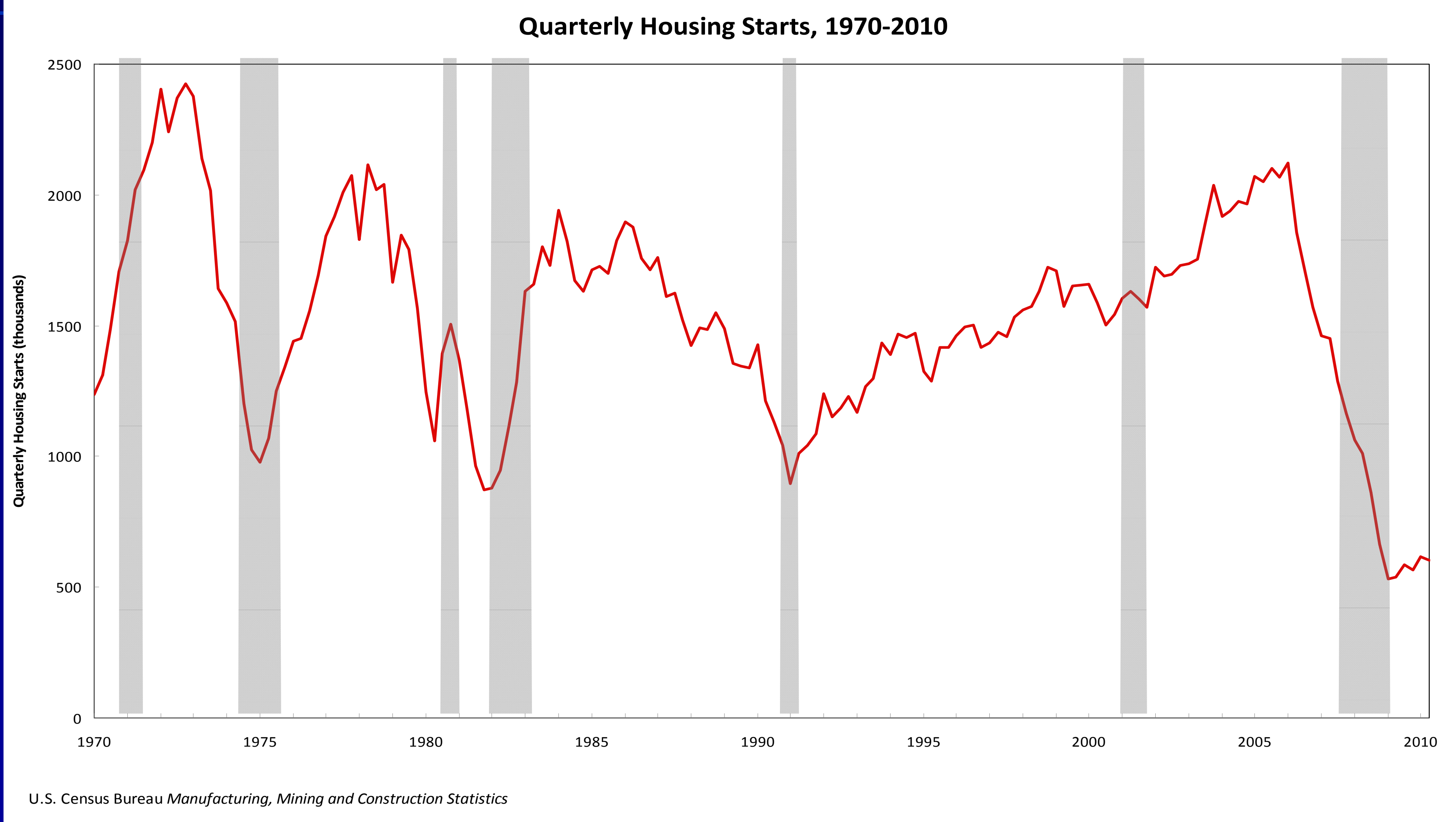
If Leverage Was the Problem, Regulation of Leverage is the Solution

- Regulation must include all financial intermediaries from banks to hedge funds
- This is not pie-in-sky. We've had regulation of stock market margin requirements since the New Deal.
- Why shouldn't the Fed change down payment requirement to lean against housing bubbles?

The Recession: How Deep in Comparison to Past?

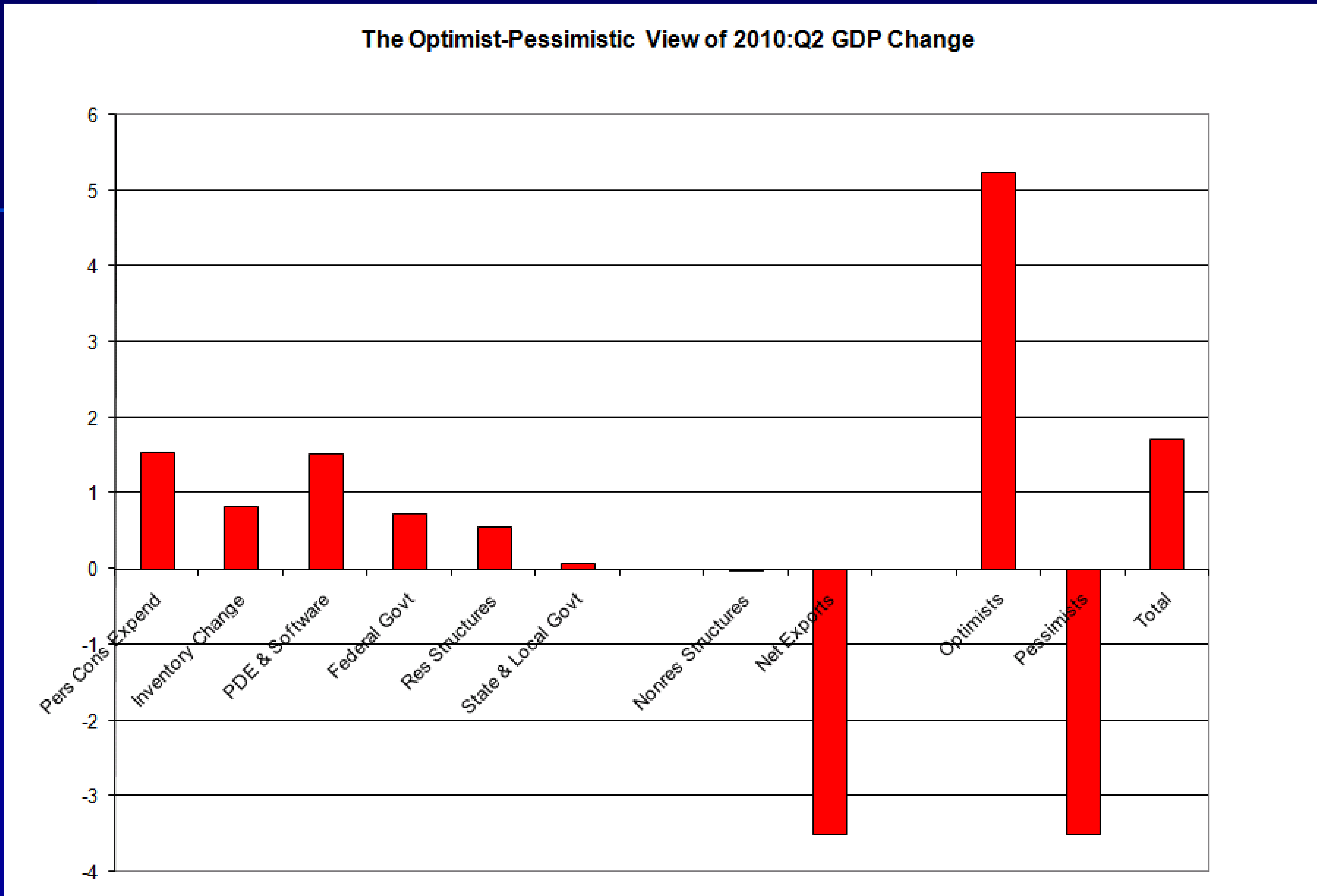
- Housing Starts: Will they recover?
- Business Investment, key driver of economic weakness in 2001-02
  - Nonresidential construction boom: A repeat of the 1920s. Look at downtown Chicago, look at downtown Evanston.
- Consumption: the Perfect Storm
- Our Dependence on Imports Has Almost Cancelled Out the Recovery
  - Why transportation freight carried may be misleading

Instability in Housing Starts is Nothing New



Why Is the Recovery So Slow?

- Needed to Keep Unemployment Rate Constant:
  – Roughly 130,000 jobs per month
  – Roughly 2.5 percent annual growth of real GDP
- In contrast
  – Private job growth has averaged 70K
  – Real GDP growth 1.7 in Q2, 1.5 in Q3


The Optimist-Pessimistic View of 2010:Q2 GDP Change
6
5
4
3
2
1
0
-1
-2
-3
-4
Pers Cons Expend
Inventory Change
PDE & Software
Federal Govt
Res Structures
State & Local Govt
Nonres Structures
Net Exports
Optimists
Pessimists
Total

Fundamental Causes of Weak Recovery

- Consumption
  - Collapse of Household Net Worth
  - Record-high indebtedness
- Residential Construction
  - Foreclosures and Under-water Mortgages
  - People walk away from under-water
  - Their credit is tainted for years
  - Their houses add to supply but not to demand
  - My mortgage broker's story, 3 vs. 80

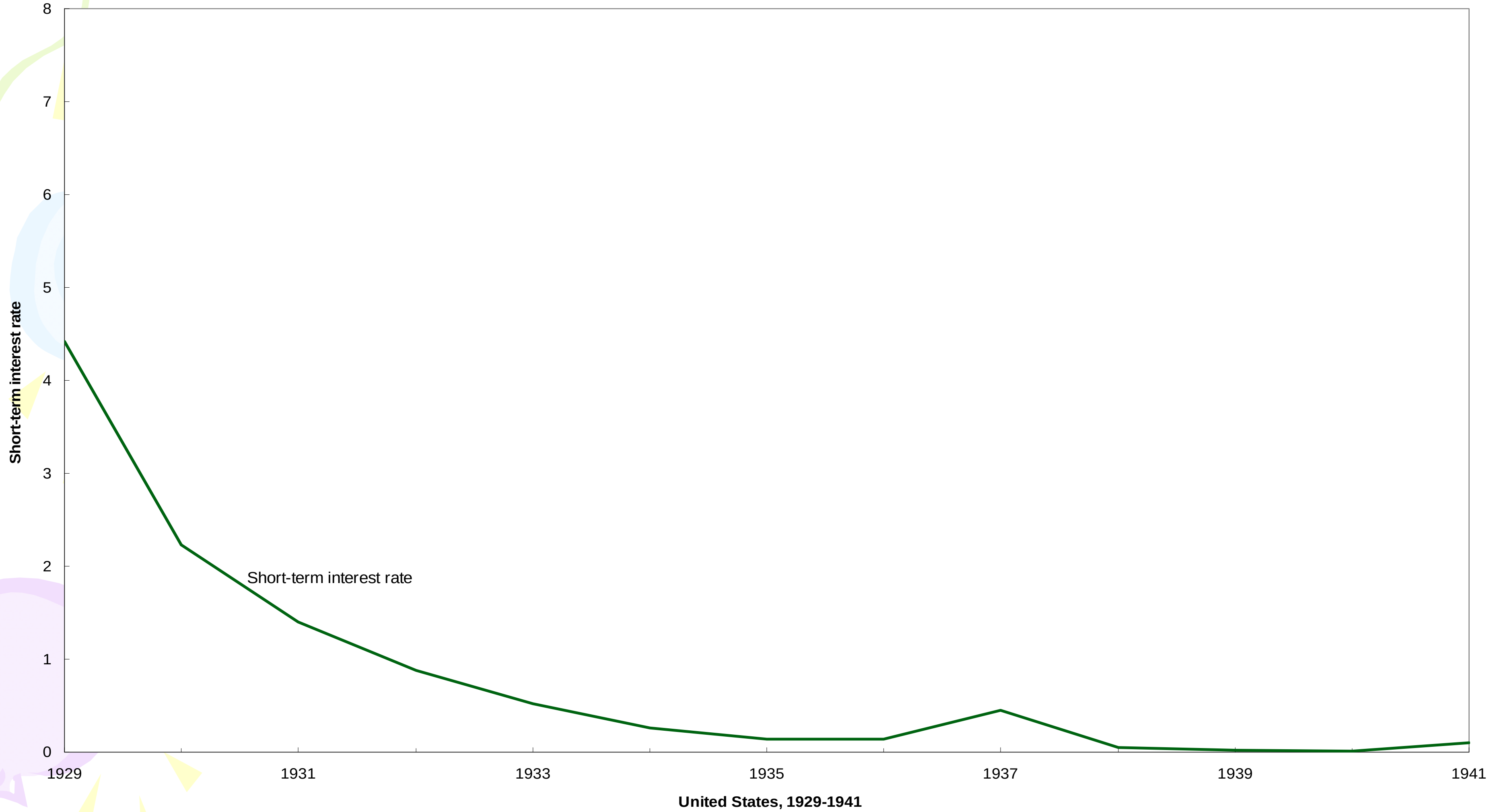
More Causes of Weak Recovery

- Corporations sitting on 1.6 trillion of cash (you tell me why)
- Government has increased transfer payments but not government spending
- Net exports are a disaster, dragging down the economy even if they're good for transportation sector

Why Monetary Policy Is So Weak

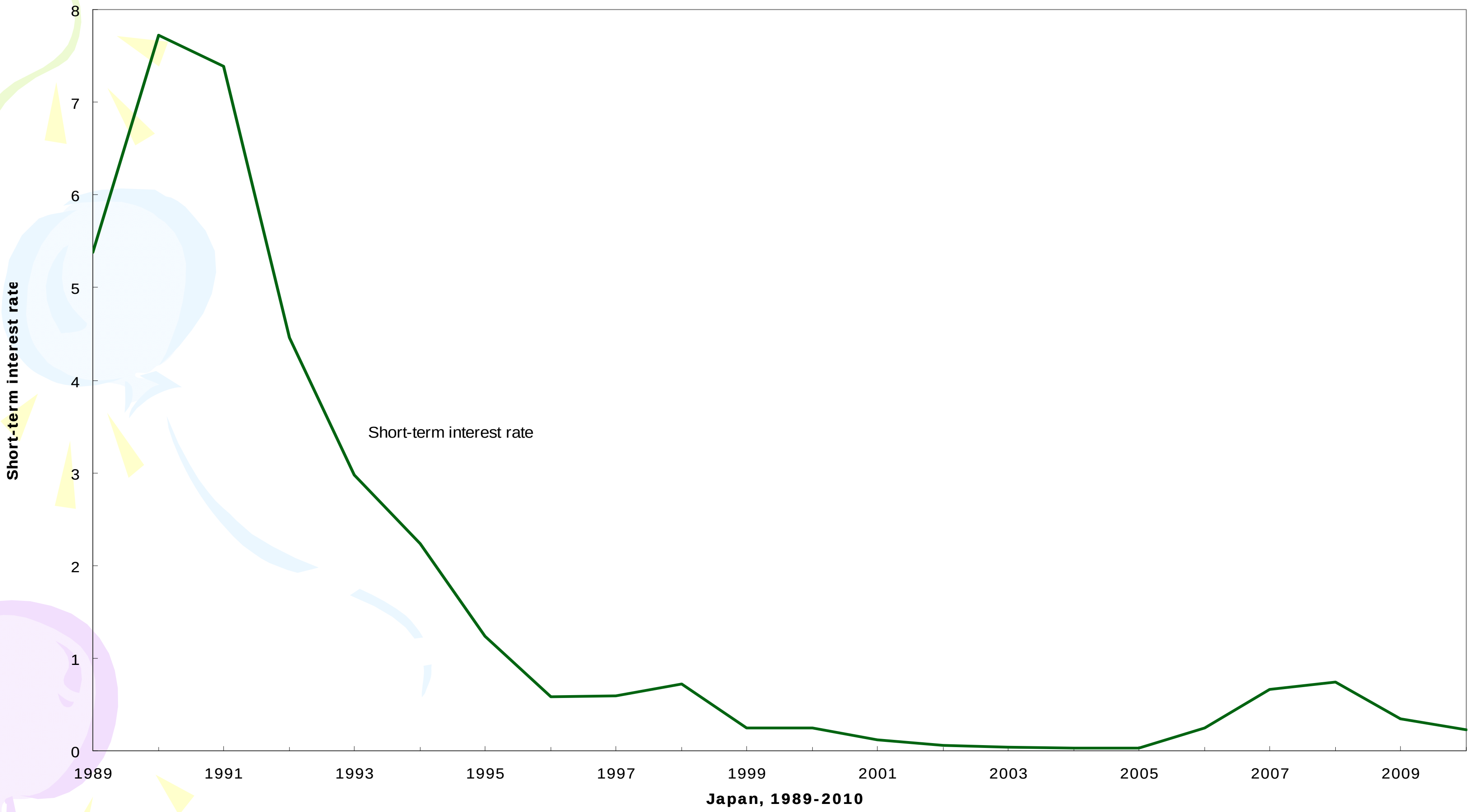
- Zero Lower Bound
  - Compare U. S. in late 1930s
  - Compared Japan in late 15 years
- Quantitative Easing?
  - Must Reduce Corporate Borrowing Rate
  - Can Fed Reduce Risk Premium?
- Even if Baa Rate Reduced, Will Corporations Borrow When They're Sitting on All This Cash?

U. S. Short-term Interest Rate, 1929-41



Source : See Appendix C-4

Japan Short-term Interest Rate, 1989-2010



Source : See Appendix C-4

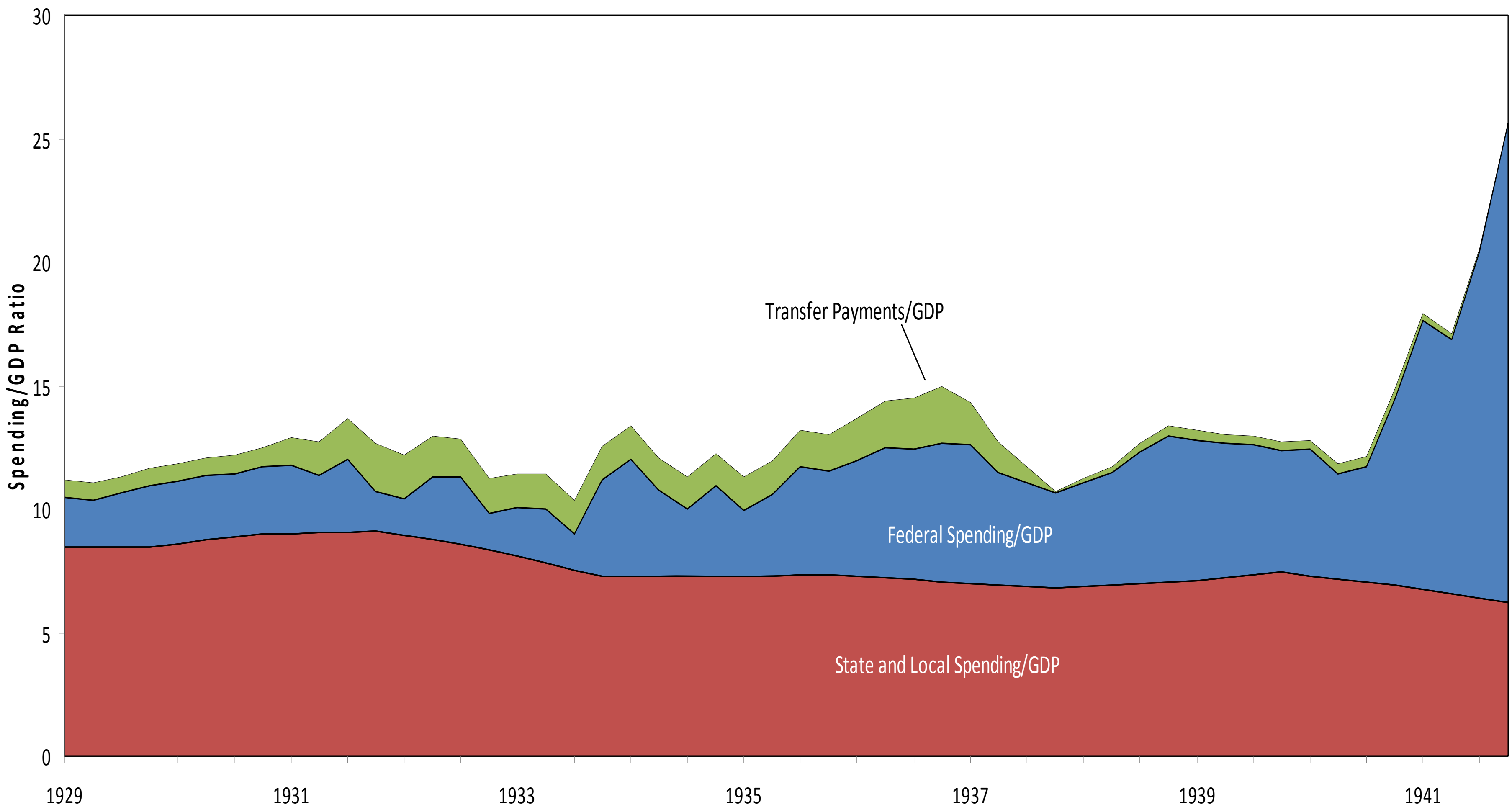
Predictions

- Suddenly Intermediate Macro Textbooks Become Relevant
  - Multiplier effect, the “slow-motion train wreck”
  - No limit to power of monetary and fiscal policy working together
- How Did Great Depression End? Money-fueled Fiscal Deficits

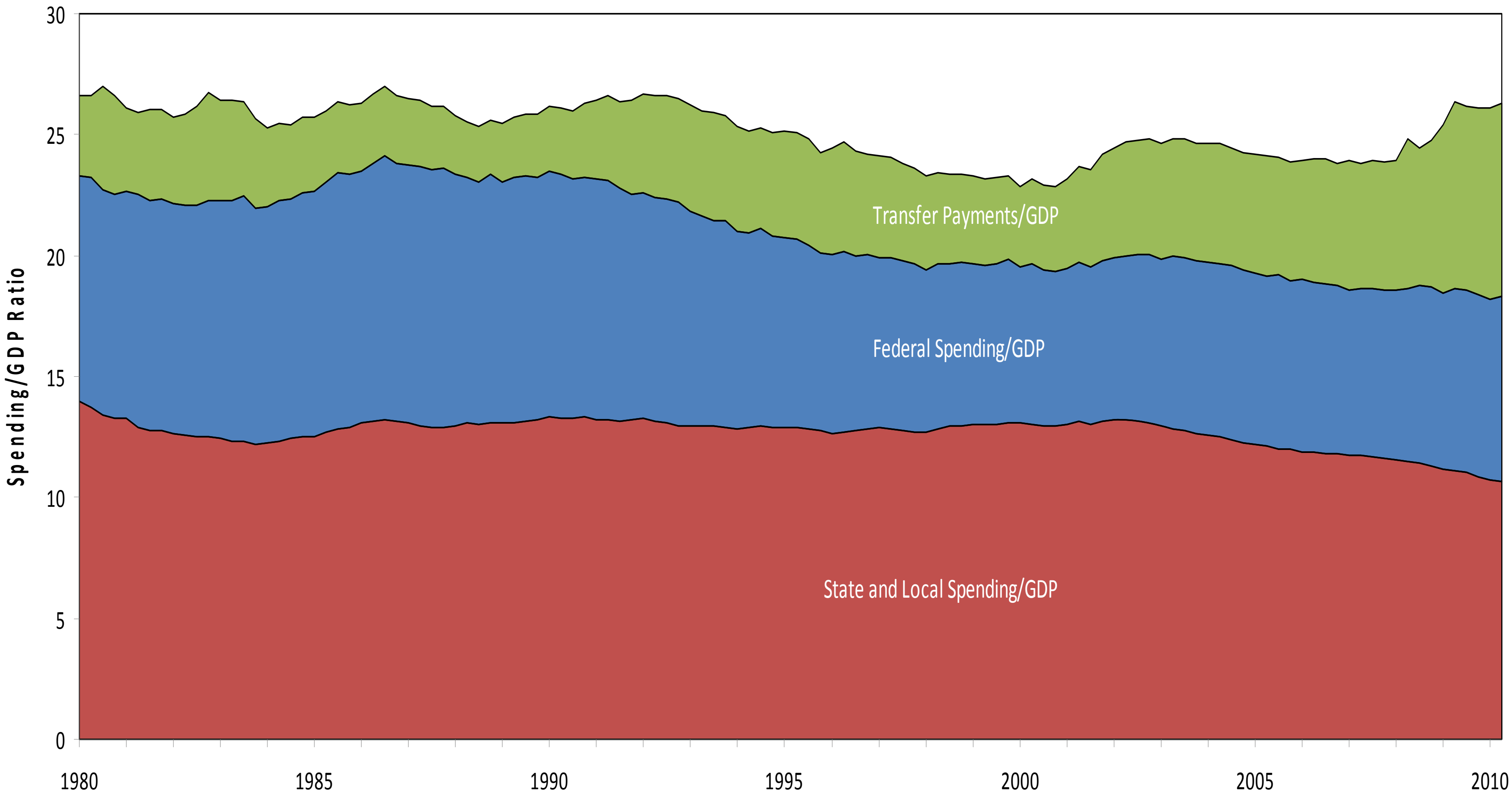
This is Where Obama Stimulus Comes In

- It's not enough to fix financial system
- People who are unemployed cannot borrow when NINJA loans are replaced by normal down payments and credit checks
- Fiscal stimulus is now flowing to consumers and state/local governments, but where do we find it in the data?
- Was it Effectively Designed? Too many dollars were spent per job saved or created

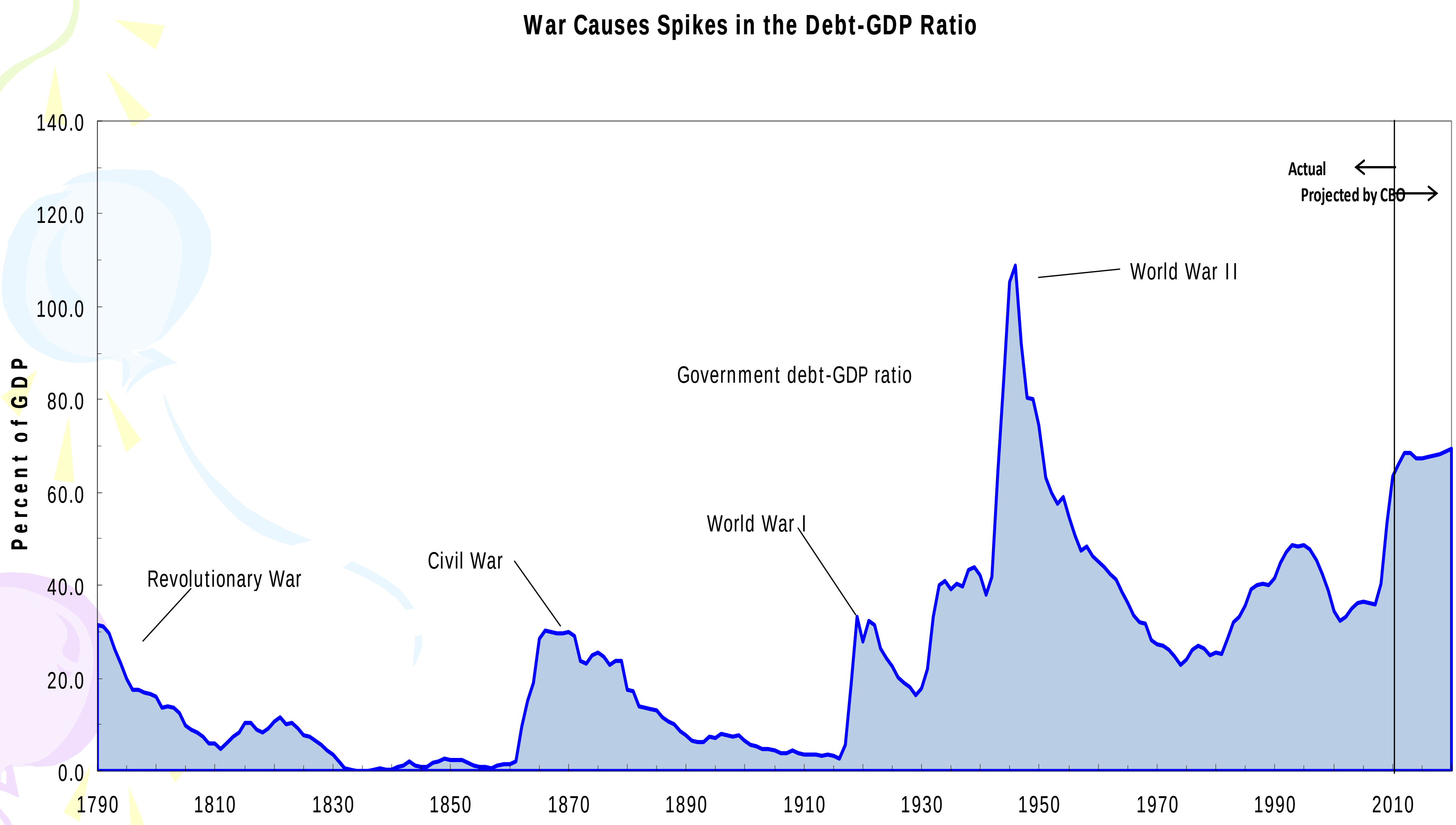
What Ended the Great Depression? Chart Extends 1929-41 Quarterly



How Does the Obama Stimulus Measure Up, 1980-2010



Is the Federal Debt an Obstacle to Fiscal Stimulus?



Are There Long-run Dangers of the Big Federal Deficit?

- Fiscal deficits do not cause inflation if they occur when the GDP gap is negative
- Government dissaving (deficit) makes up from insufficient private spending
- What happens when GDP gap returns from negative to zero or positive?
  - Normally debt/GDP ratio declines as nominal debt drops while nominal GDP rises
  - This time the projected deficits will not go away
- Need tax reform, social security reform, serious attack on medical care costs

Coordinating Monetary and Fiscal Policy

- The Federal Government Runs a Deficit
- The Treasury Issues Bonds that are Bought by the Fed
- There is no addition to the debt held by the public
- This is the classic Milton Friedman "helicopter drop"

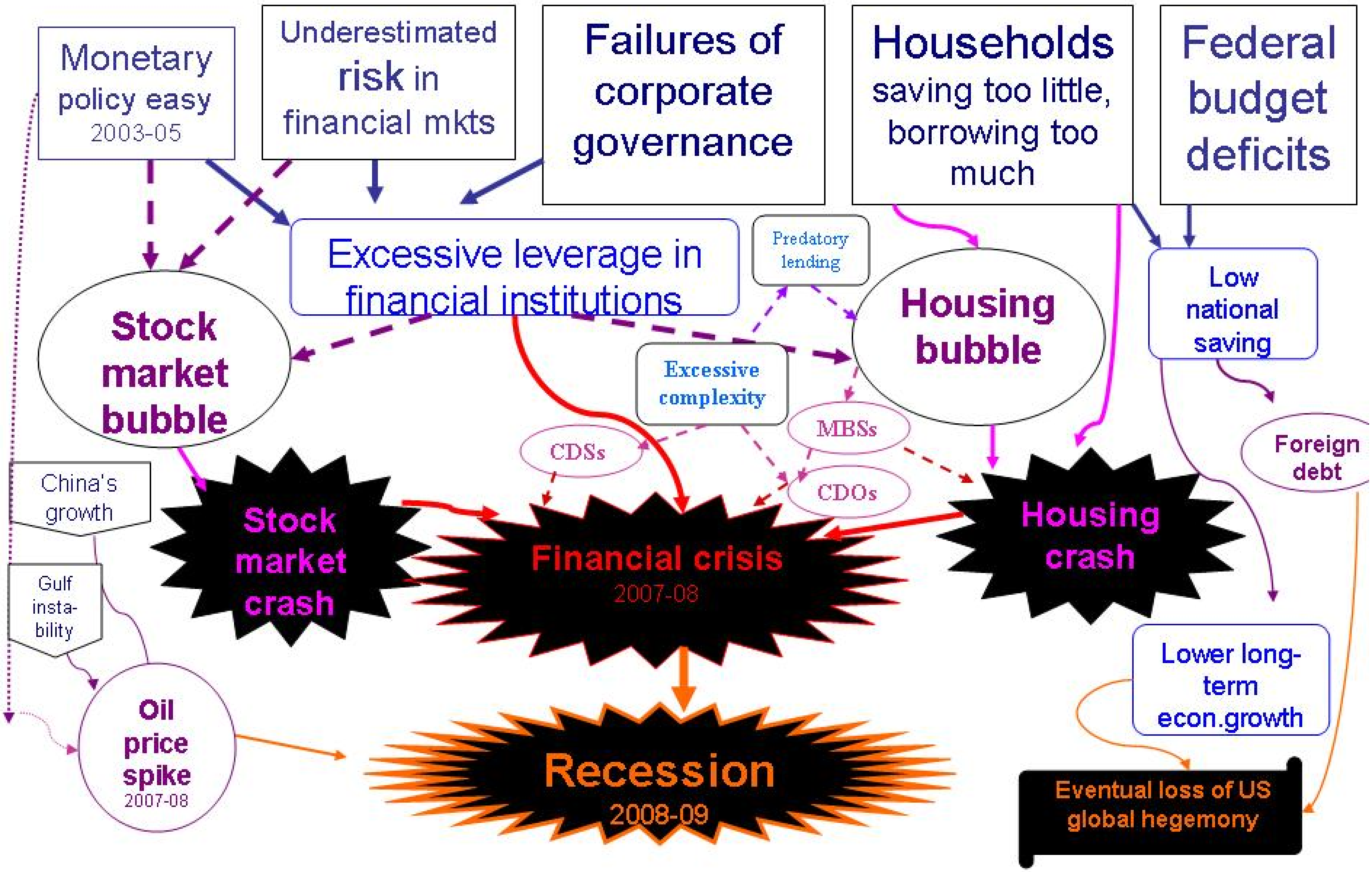
Conclusion: Political Impact of the Crisis

- Glib endorsements that “free markets” should always be the solution led to:
  - Lax regulation or no regulation of the leverage “house of cards”
  - Executive compensation in the financial industries that encouraged risk taking and financial opportunism
- “Free markets” advocates adopt scare tactics by likening financial regulation with socialist central planning
- Guilty parties, not just Greenspan but:
  - Summers and Rubin in Clinton Administration
  - Bernanke who showed no interest in regulation after taking over in early 2006
- Biggest problem: Washington gridlock that works against compromise even on the most important issues that should be noncontroversial, like regulatory reform

This Entire Lecture Reduced to One Slide

- Credit to Jeffrey Frankel of Harvard. . .

we fit the current economy in one account system ?



Now for the Discussion

- Comments/questions about my talk
- Reports from the field about the status of the recovery in transportation
  - Did it slow down this summer as other economic indicators weakened?
  - Do growing imports loosen the tie between transport volumes and real GDP?