

Controversial Issues About the Recession and Recovery

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The Plan: From Long-Run to Short-Run to Policy

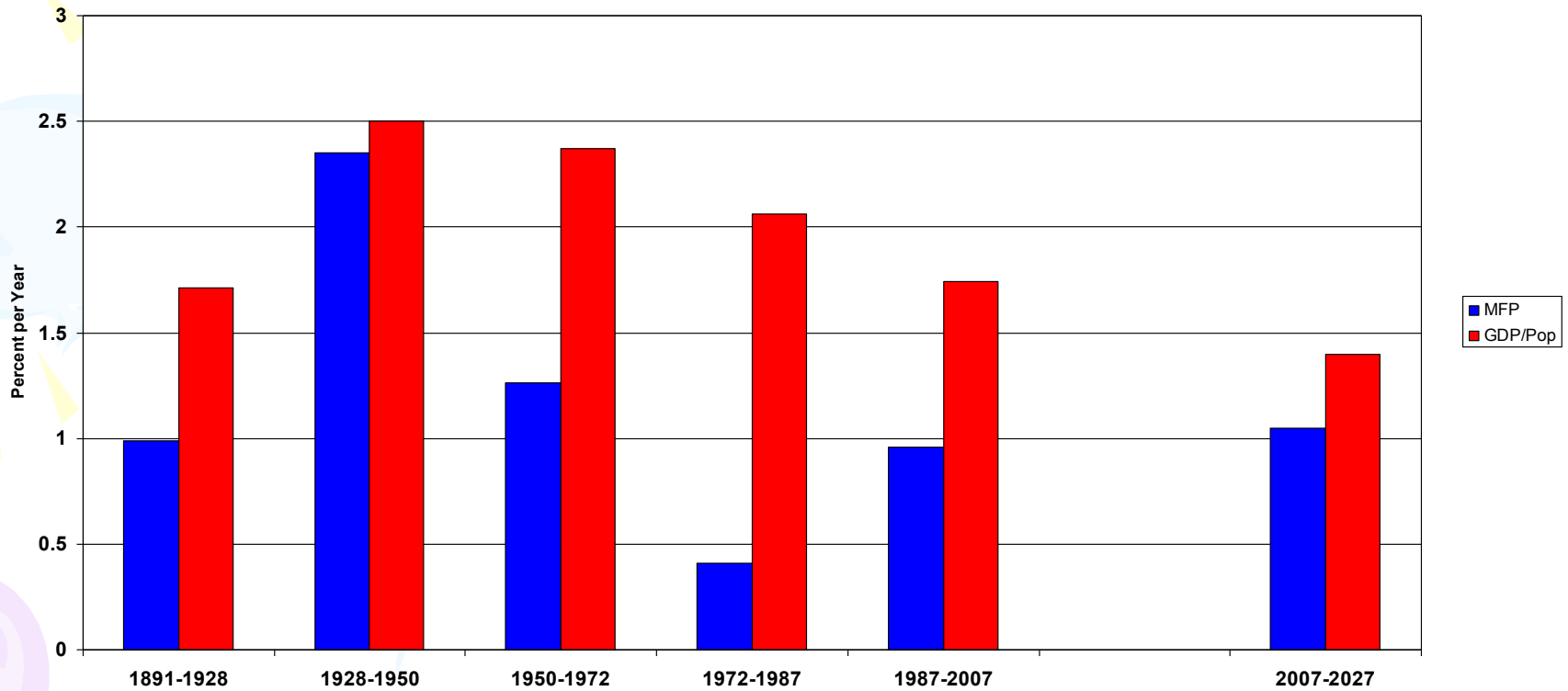
- The reasoning behind my pessimistic long-term US growth forecast, recently summarized in Business Week
- Graphs on dimensions of the weak labor market. The labor market is in worse condition than the product market.
- Why the recovery to date is so weak? Why widespread forecasts of a growth pickup in 2011 may be misleading.
- The policy debate: what more can monetary and fiscal policy do?

Long-term Growth 2007-2027, Should This Be Revised Up or Down?

- Comparing 2007-2027 forecasts with 1987-2007 actual:
- Output growth will slow from 2.9 to 2.4
- Output per capita growth will slow from 1.74 to 1.4
- That is the slowest growth of income per capita “since George Washington”
- Compare to 2.16 1929-2007 or 2.02 1891-2007

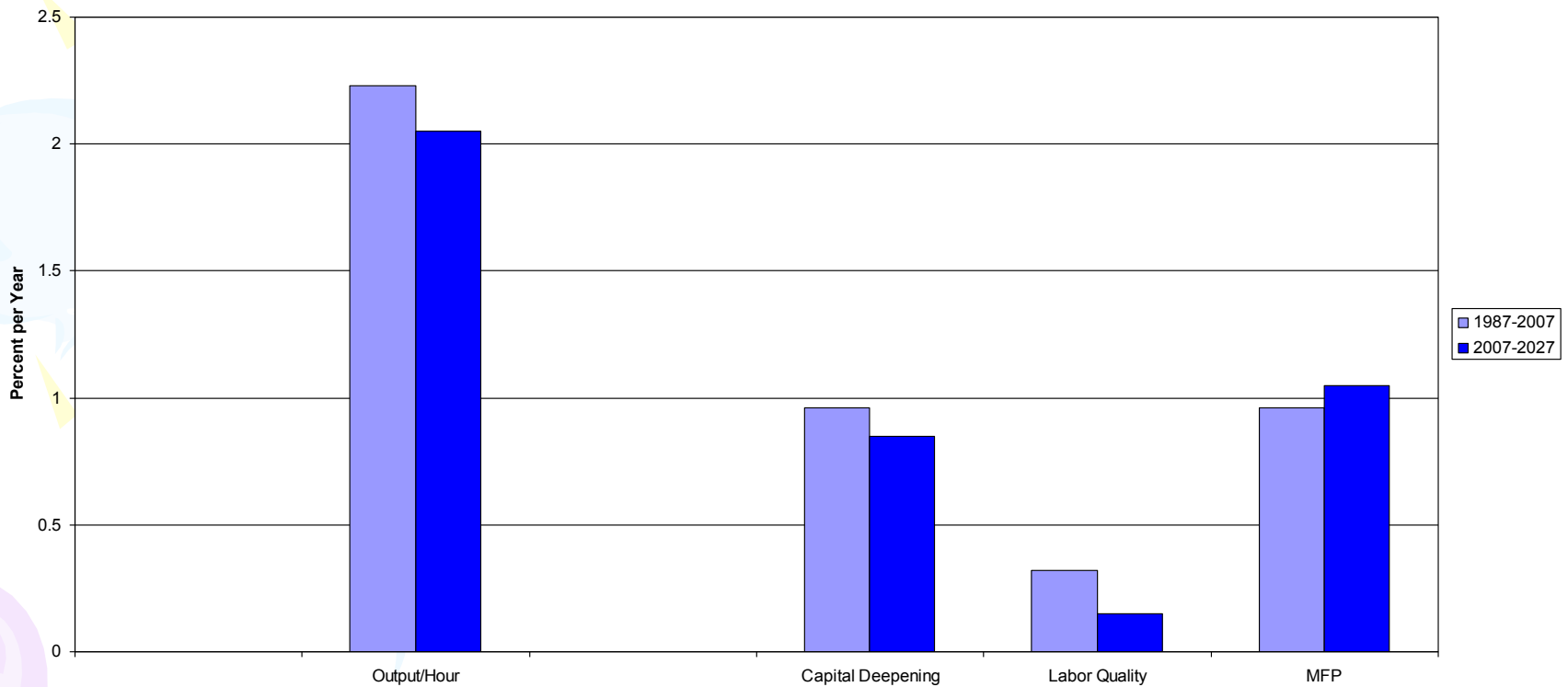
Growth in MFP vs. Ypc by Time Interval, 1891-2027

Growth in MFP and Real GDP per capita, selected intervals, 1891-2027



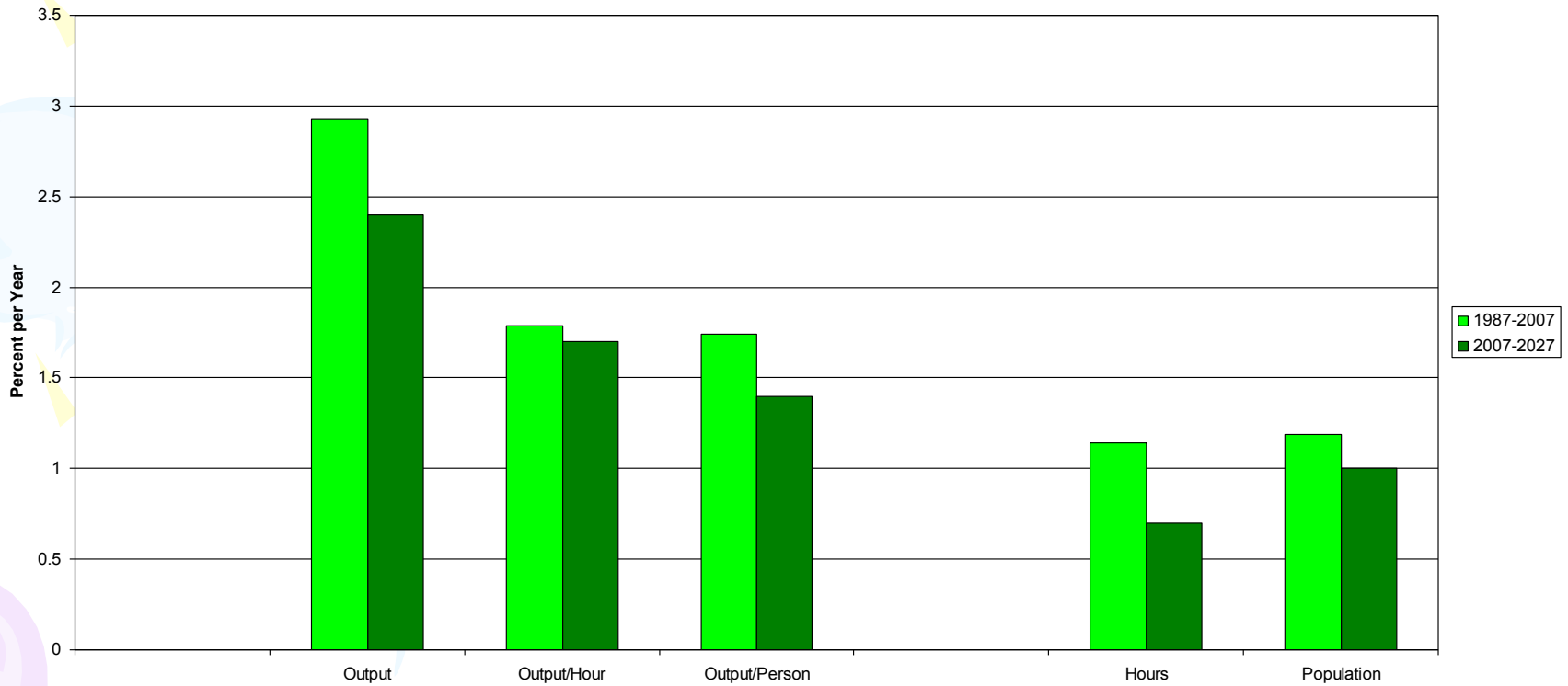
Components of Growth in Y/H, 1987-2007 vs. 2007-27

Components of Growth of Labor Productivity, Two Intervals



From Y/H to Y/N, the Role of Falling LFPR as Baby-Boomers Retire

Components of Output Growth, Two Intervals



Possible Further Room for Pessimism

- These projections are based on the historical record of growth between years of “normal” utilization (1987, 2007)
- No allowance here for long-run “tainting” effects of the current abysmal economy
 - Loss of skills and human capital
 - Years of low investment will increase the age of the capital stock and reduce the growth of both capital quantity and capital quality
- The European analogy from 1985-2005, not enough capital to return to 2007 US E/P ratio

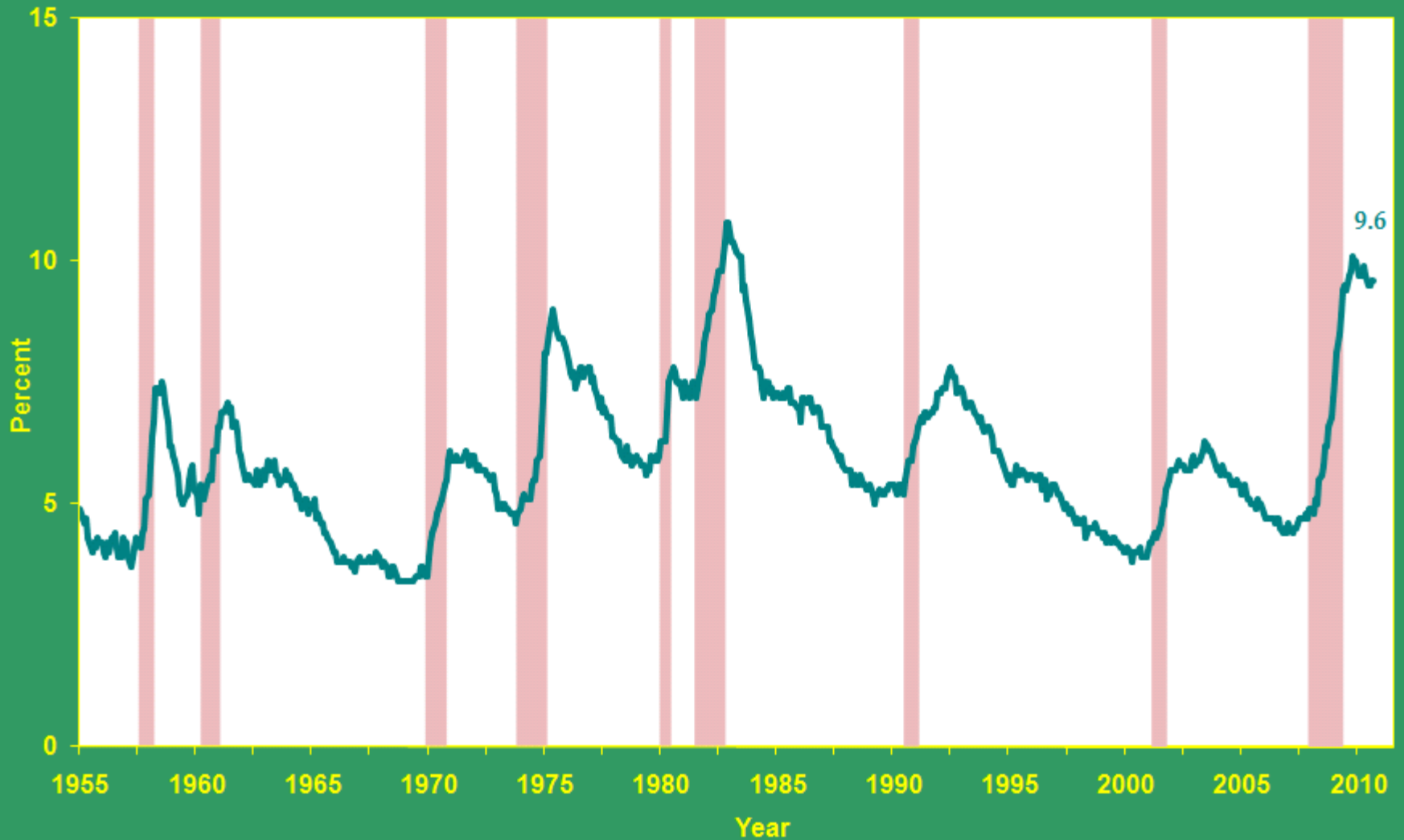
Policy Prescriptions for Long-Run Growth Problem

- Original 2007 prediction of slowdown reflects aging of population and stagnation of educational attainment
- Solve the first by immigration, particularly of high-skilled people
- Work on the second by better government-run student loan programs and direct measures to address the rising relative price of college education (“higher education cost disease”)
- Stimulate demand to avert long-run supply sclerosis

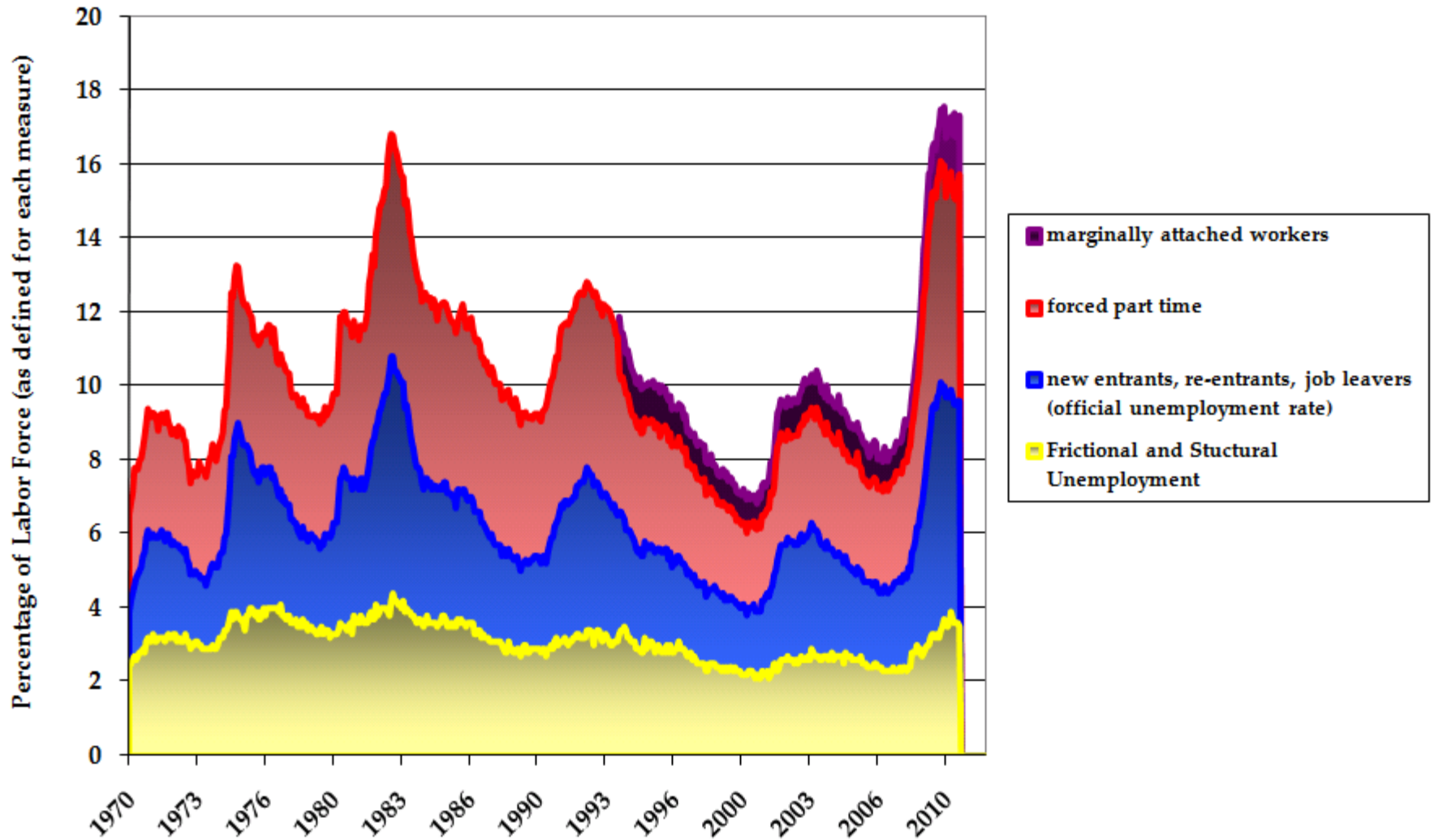
Next We' ll Look at Graphs of Raw Numbers for Current US Labor Market

- 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
 - (Jan-July 1980 and Jul 81 to Nov 82)

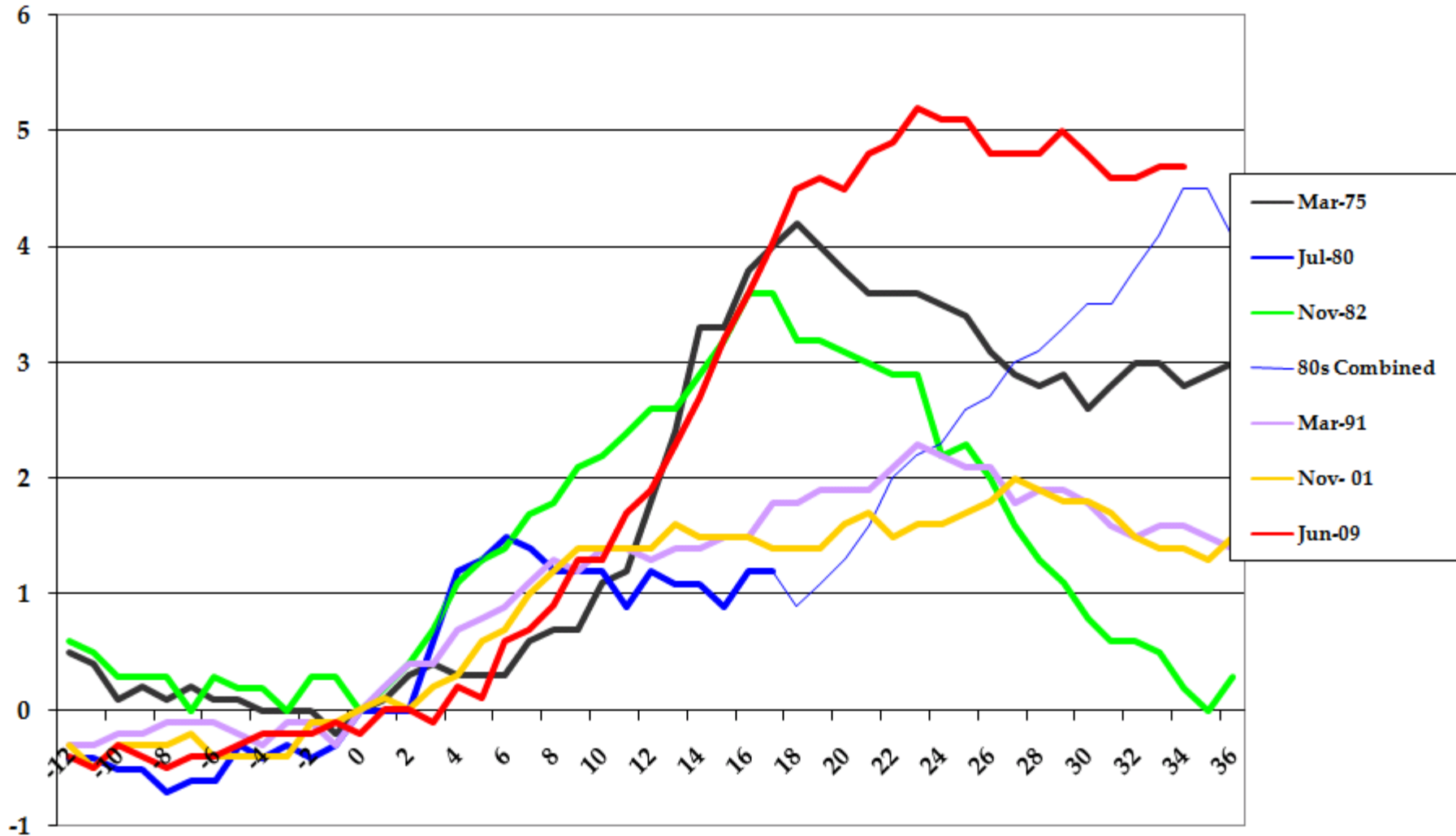
Monthly Unemployment Rate, January 1955-September 2010



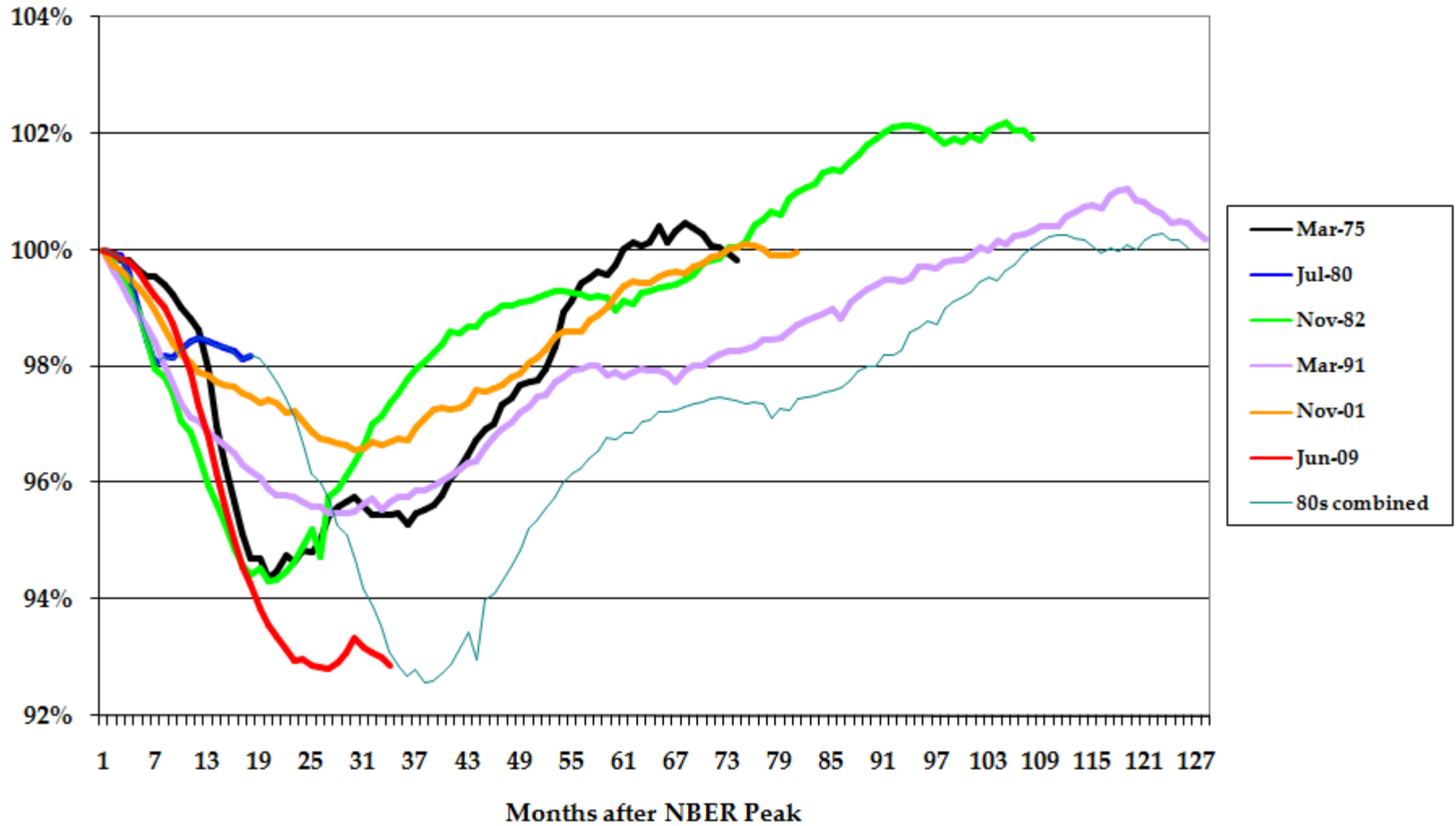
Various Measures of Unemployment Rates from the BLS



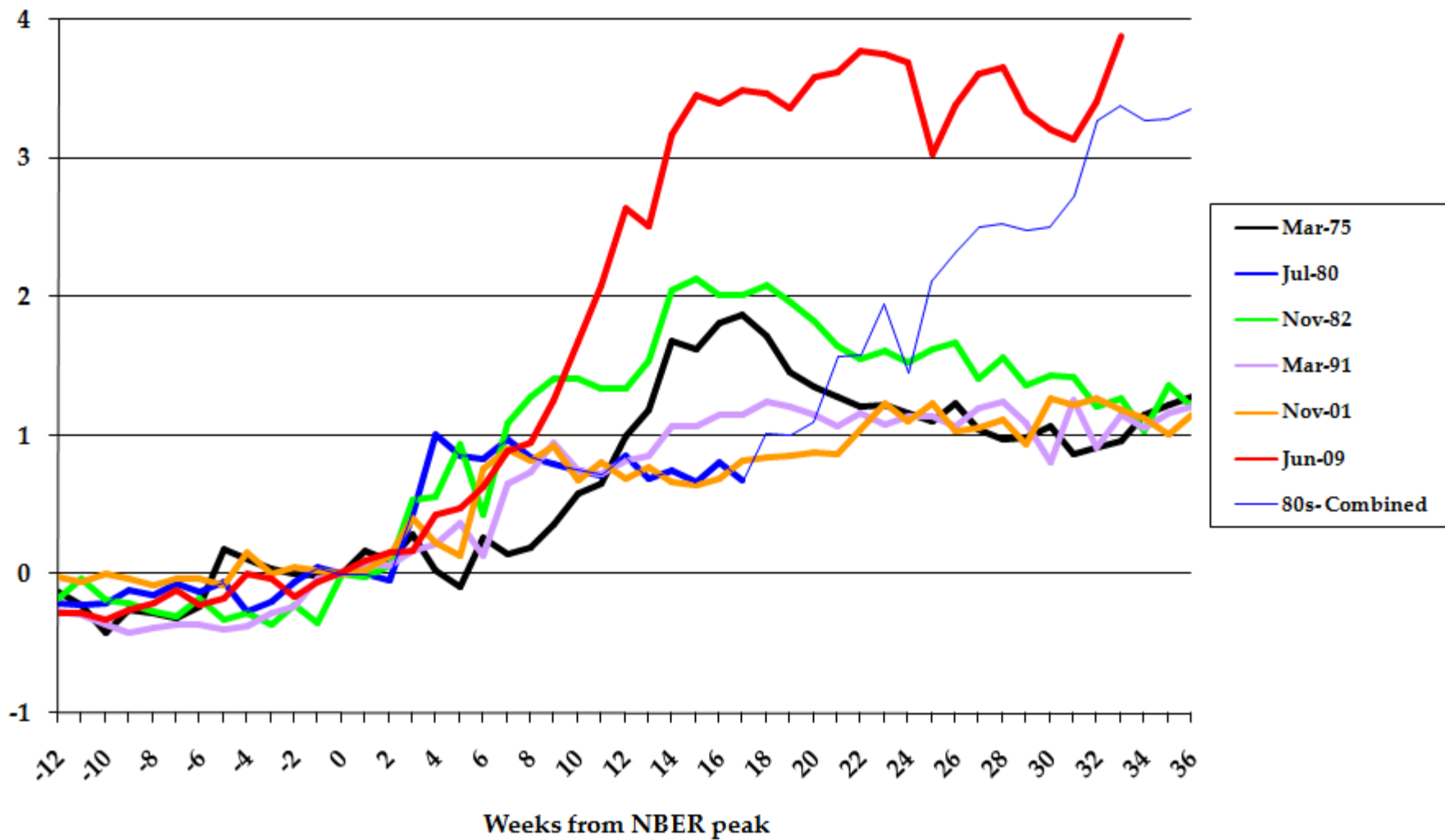
Official Unemployment Rate as Difference from NBER Peak



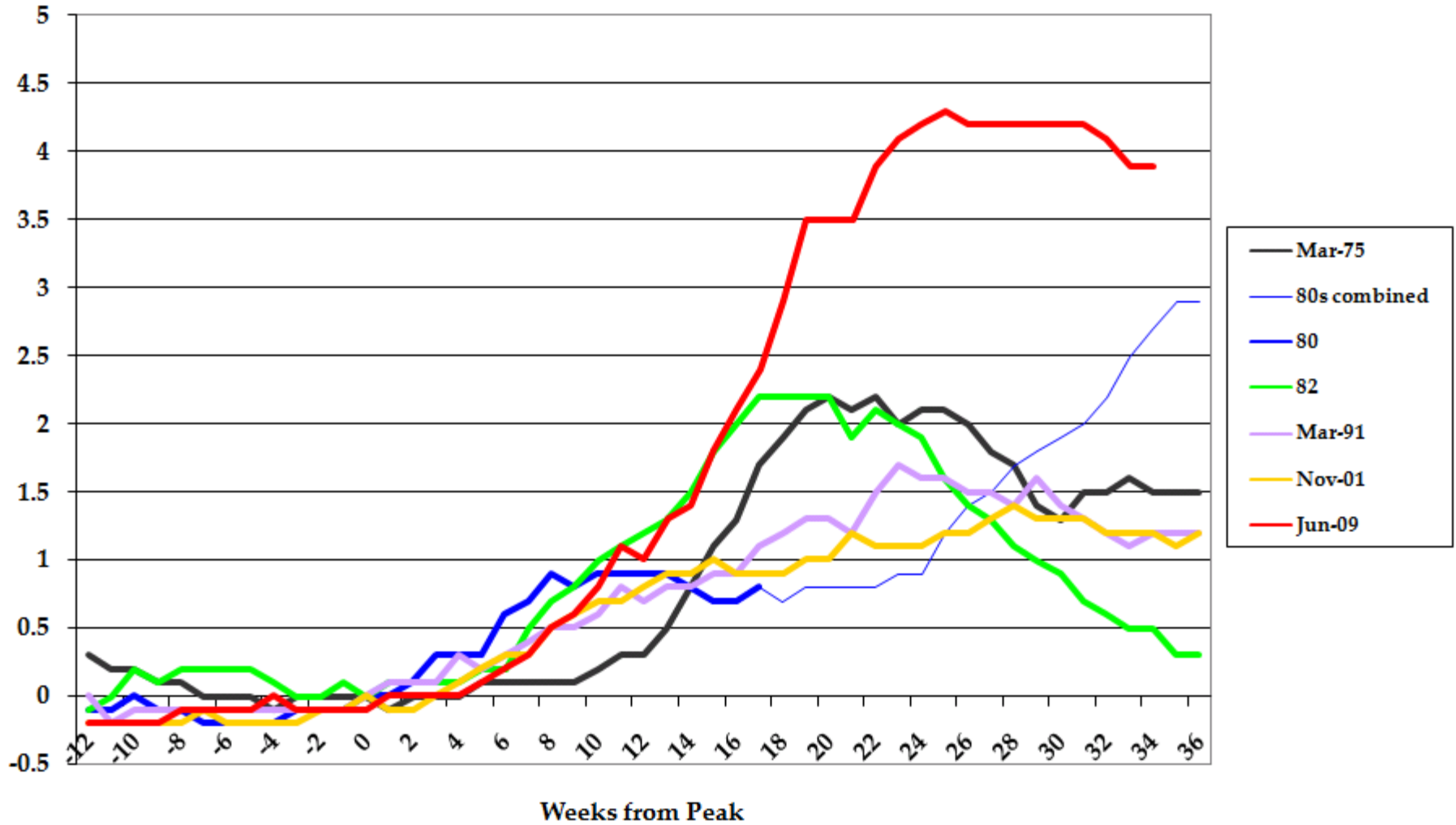
Employment as a Percentage of a Peak-Level Employment



Forced Part-Time Employment Rate as difference from NBER Peak



Unemployment Over 15 Weeks Rate as Difference from NBER Peak

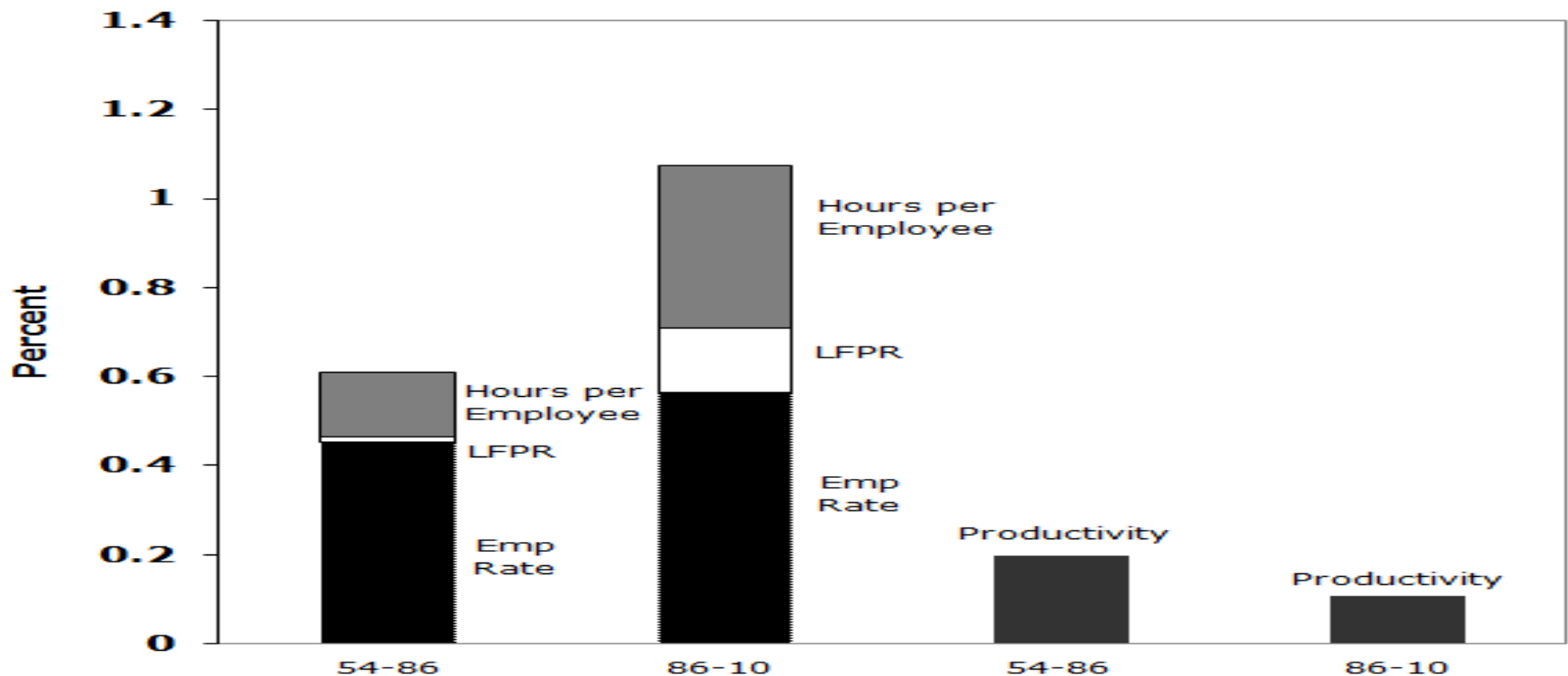


Conclusion to this point

- Comparing the 9.6 level of U rate now to 10.8 in Nov & Dec 1982 is misleading
 - U rate in July 81 or even Jan 80 started higher
 - Overall increase in 2007-09 is greater
 - Much more incidence this time of long-term unemployment and forced part-time
- The emergence of long-term unemployment: is the US becoming more like Europe's two decades 1985-2005?

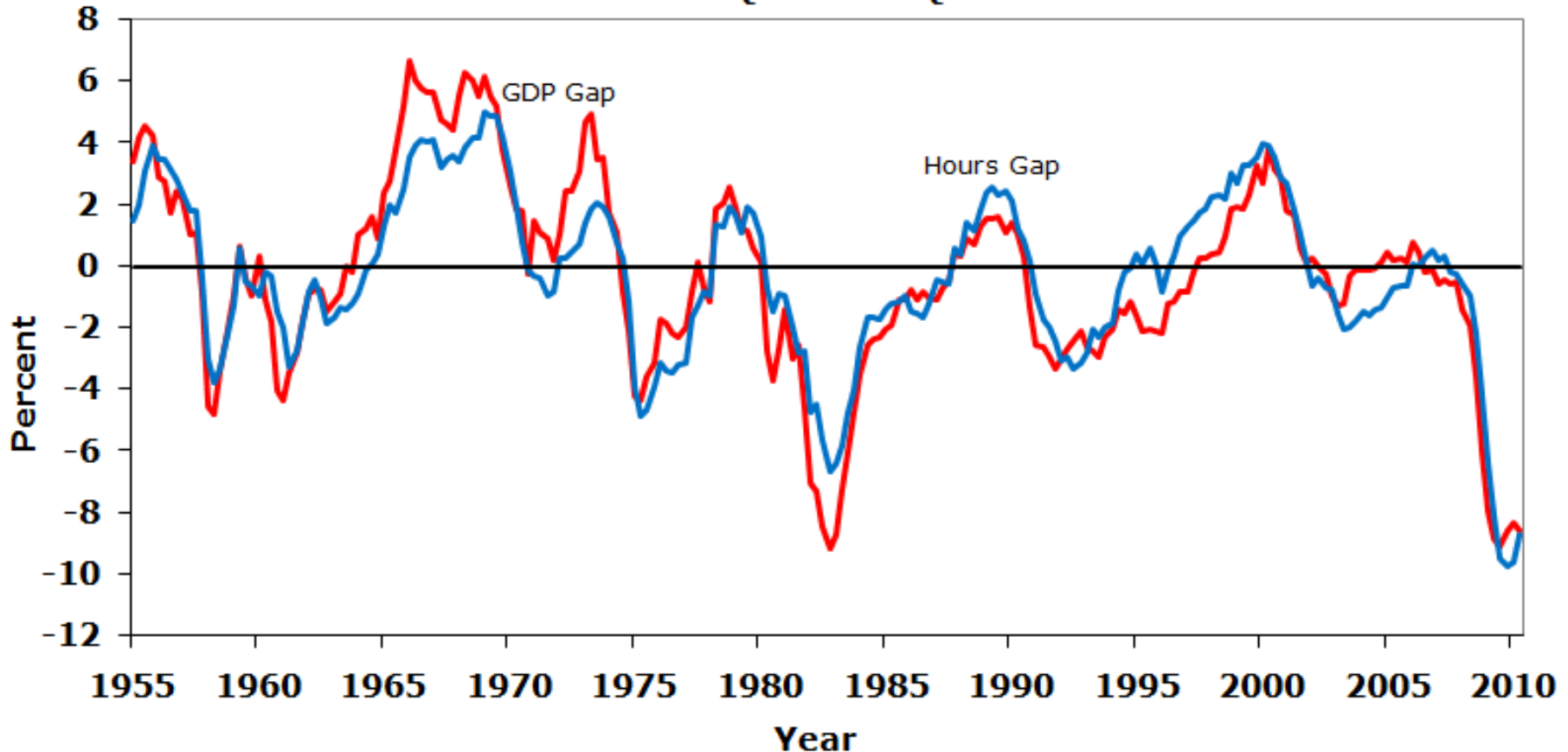
Long-run Coefficients: The “Demise of Okun’s Law”

Figure 6. Long Run Response of Labor Productivity and Aggregate Hours by Conventional Definitions using 1954:Q1 - 1986:Q1 vs 1986:Q1 - 2010:Q2 Coefficients



Output Gap vs. Gap in Aggregate Hours of Work

Conventional Output Gap vs. Hours Gap,
1955:Q1 - 2010:Q2



Explanations Offered in My Research

- The “Disposable Worker” Hypothesis
- Similar sources as rising US inequality
- Increased market power of managers and highly paid professionals
 - Increased share of executive incomes coming from stock options
- Reduced market power of workers due to:
 - Declining unions, declining real minimum wage, low-skilled immigration, and imports

Summary of How Weak is the U. S. Labor Market

- E/P is the ratio of employment to population
- $E/P = E/L * L/P$
 - E/L is 1 minus U/L
 - L/P is “labor force participation rate”
- Our current E/P is 58.2 percent (Nov 2010) compared to 64.3 in 2000 and 63.0 in 2007

The Astonishing Required Growth in Employment

- Compared to 2000 Level of E/P, we are currently short 14.5 million jobs
- Compared to 2007 level of E/P,. We are currently short 11.5 million jobs
- Monthly increase in employment required to keep U rate fixed: 127K
- Monthly increase in employment needed to get back to 2007 E/P by 2015: 316 K
- What was monthly growth in employment in Nov 2010? 39K!

Why Is The Economic Recovery So Weak?

- Unemployment rate has been between 9.5 and 10.0 percent for more than one year
- Real GDP must increase by 2.4 percent to keep U rate constant
- Real GDP growth four quarters of 2010 (including forecasts for Q4): 2.25%

Sources of Slow Real GDP Growth

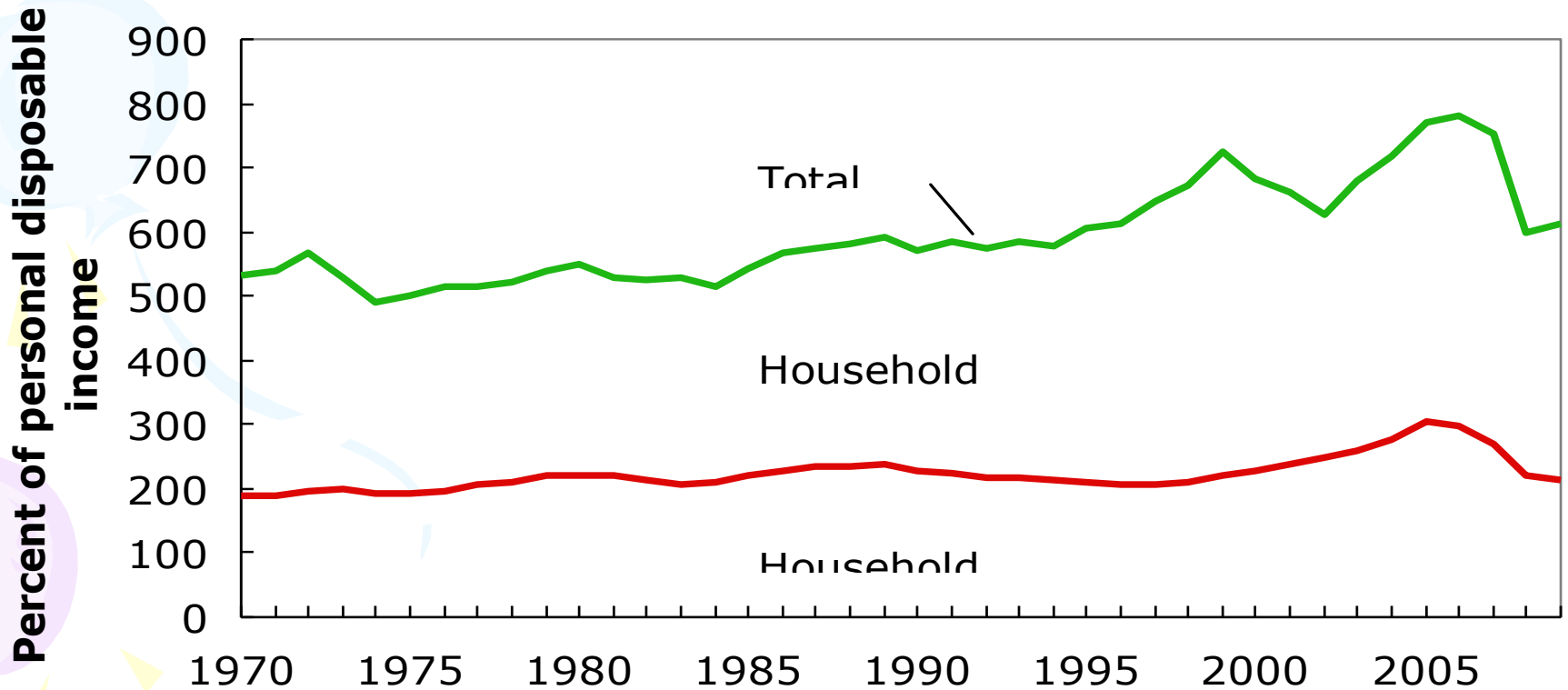
- Decomposition of Real GDP Growth
 - Consumption (durables, nondurables, services)
 - Investment (equipment, structures, inventory change)
 - Government (federal, state and local)
 - Net exports (exports minus imports)
- $Y = C + I + G + NX$

Sources of Slow Growth in Consumer Expenditure

- High Unemployment
 - Many have dropped out of the labor force
 - Many more fear future unemployment
 - This week's extension of unemployment benefits does not help those > 99 weeks
 - Uncertainty restrains traditional spending on cars and appliances and electronic goods
- Wealth and debt effects, see next slide

Household Total, Financial, and Tangible Assets

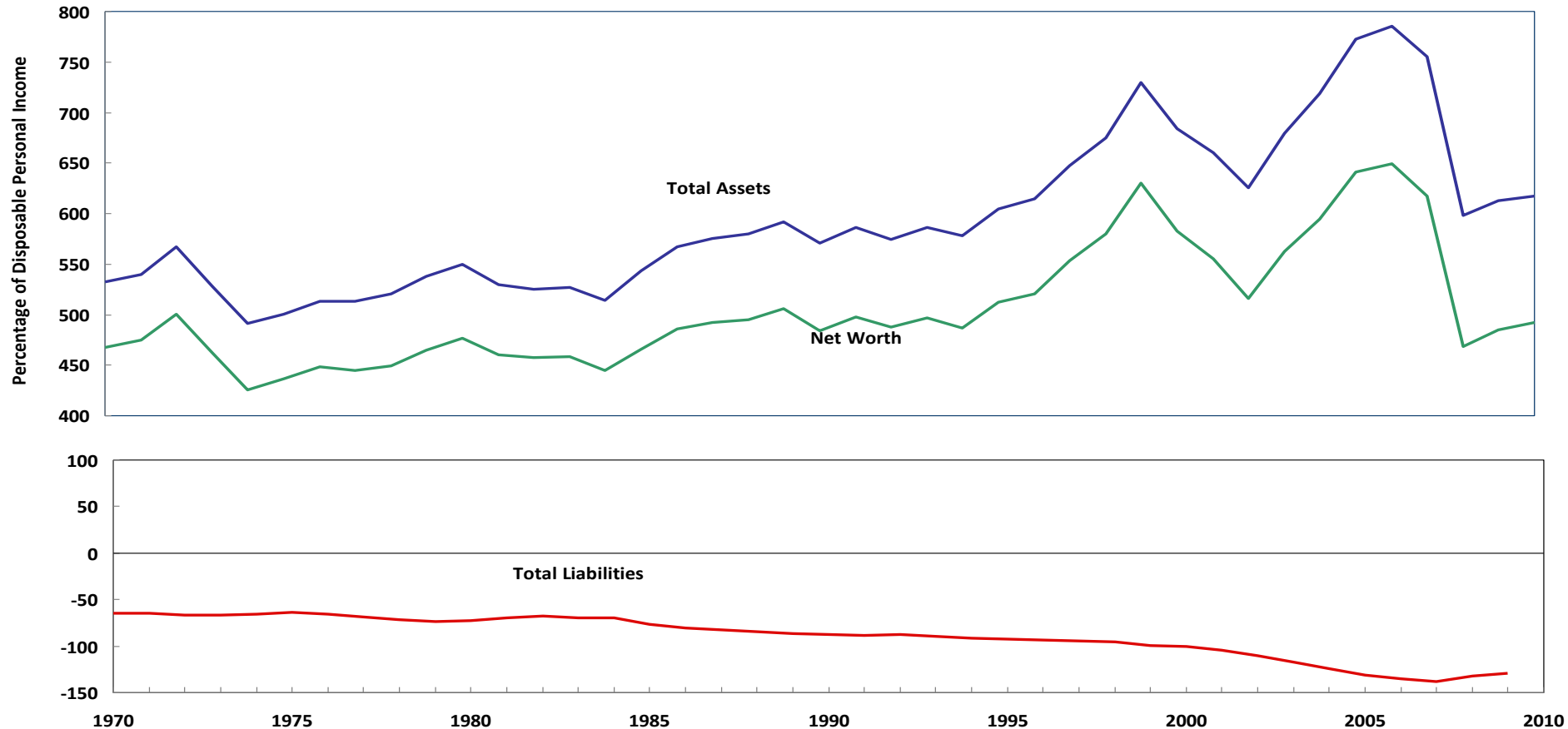
The Roller-Coaster of Household Assets after 1995



Sources : Federal Reserve Board *Flow of Funds Accounts* and Bureau of

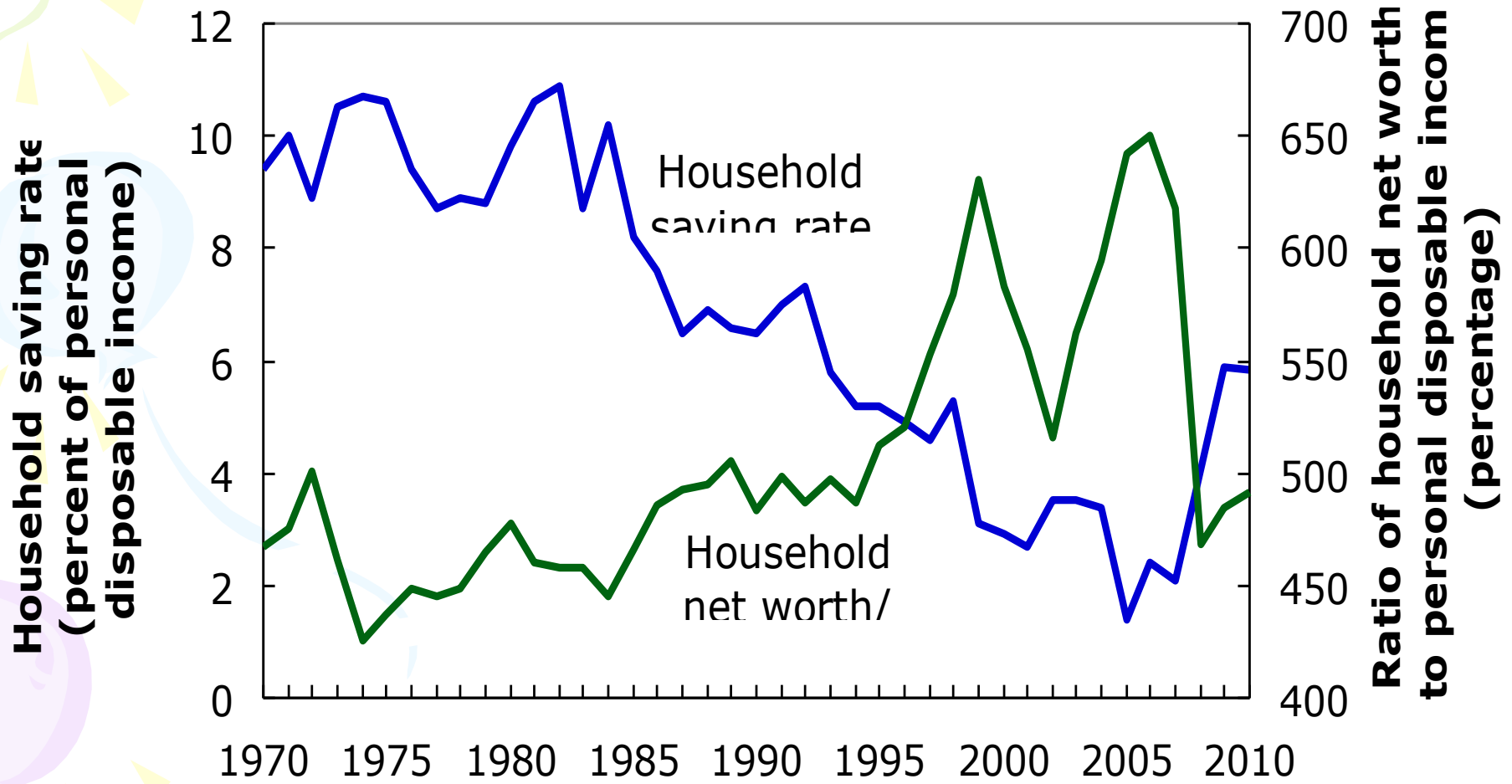
Consumption Problem: Household Balance Sheet

The Twin Peaks of Household Net Worth



Sources : Federal Reserve Board *Flow of Funds Accounts* and Bureau of Economic Analysis *NIPA Tables* . Details in Appendix C-4.

Is the Household Saving Rate a Mirror Image of Household Wealth?



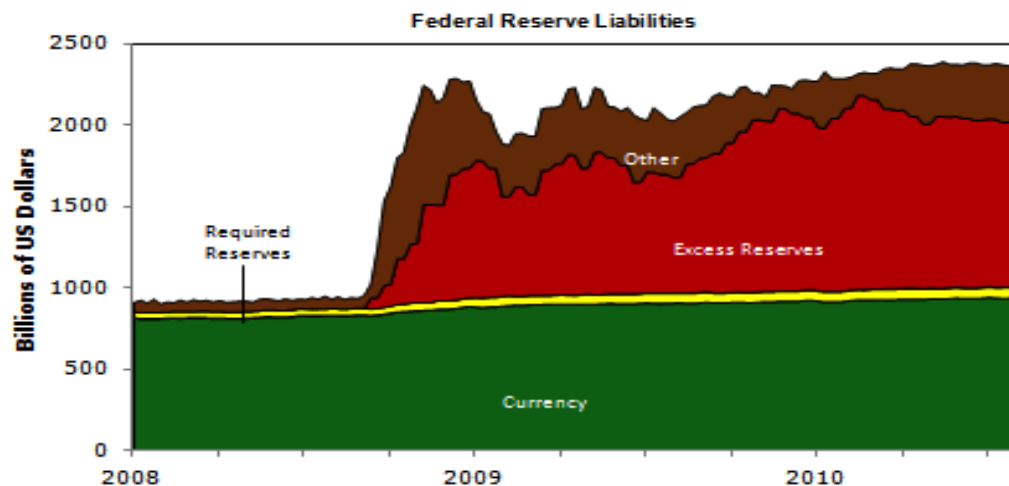
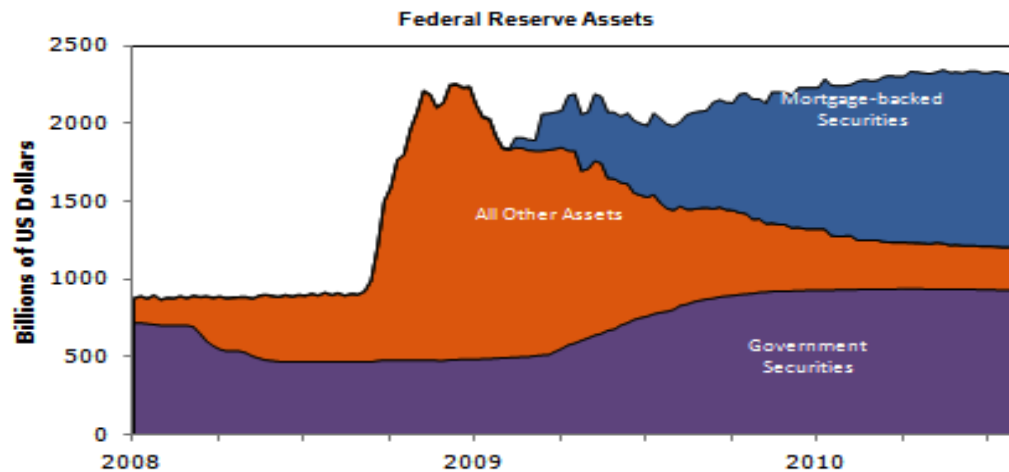
Sources : Federal Reserve Board *Flow of Funds Accounts* and Bureau of

Summary of the Restraints on Consumption Expenditures

- High unemployment and fear of unemployment
 - Many people going beyond 99 weeks of U
- Reduced HH Net worth
 - Decreased assets
 - Increased liabilities
- Credit constraints
 - Tales of my mortgage broker
 - Confirmed (mostly) by chief economist of Wells Fargo

Evidence of Credit Constraint: Excess Reserves

[HEADLINE] The Fed's Assets and Liabilities More than Doubled During the Crisis of Fall 2008



Why Are Banks Sitting on So Much Excess Reserves?

- My mortgage broker's story
 - 2005: 5 percent of applications denied
 - 2010: 80 percent of applications denied
- Discussion with chief economist of Wells Fargo
 - 2010: 50 to 60 percent of applications denied
- Why?
 - Higher FICO required scores
 - Detailed IRS income verification required
 - Tight limits on debt payments / income ratios
- In short, they were burned by NINJA and won't do it again!

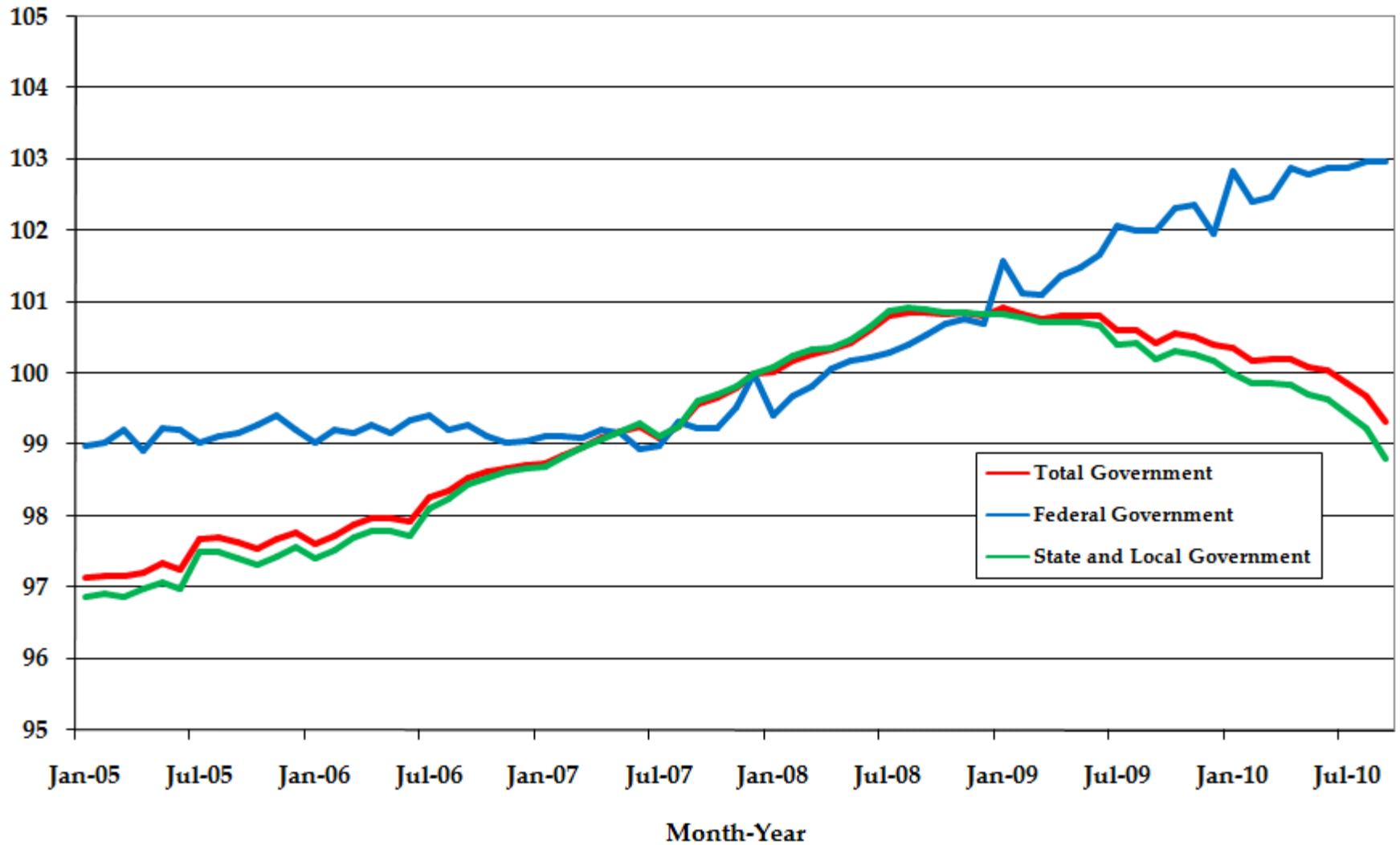
$Y=C+I+G+NX$: Why Total Investment Will Grow Slowly

- Residential Structures
 - Each foreclosure adds one unit to supply and none to demand
 - Credit constraints as detailed before
 - Why no inflation in rents? Moving in with relatives and even “boarding”
- Nonresidential Structures (see-through office buildings)
 - Unfinished Las Vegas casinos
 - Analogy to 1930s
- Equipment: Where is the innovation?

Government Spending: Where is the Stimulus?

- Obama Stimulus 2009-10
 - 1/3 wasted on tax cuts
 - Too little on direct aid to S&L govts
 - Infrastructure? Only \$65 billion slowly spent
 - Sheridan Road at NU: 10 machines and 5 people
- Next slide: government employment
EXCLUDING CENSUS WORKERS

Government, Federal, State and Local Employment, Excluding Census Workers,
January 2005 - September 2010
December 2007 = 100



Net Exports?

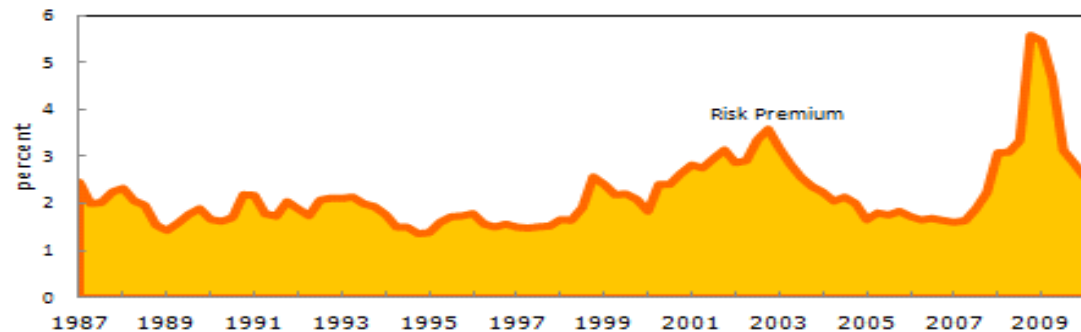
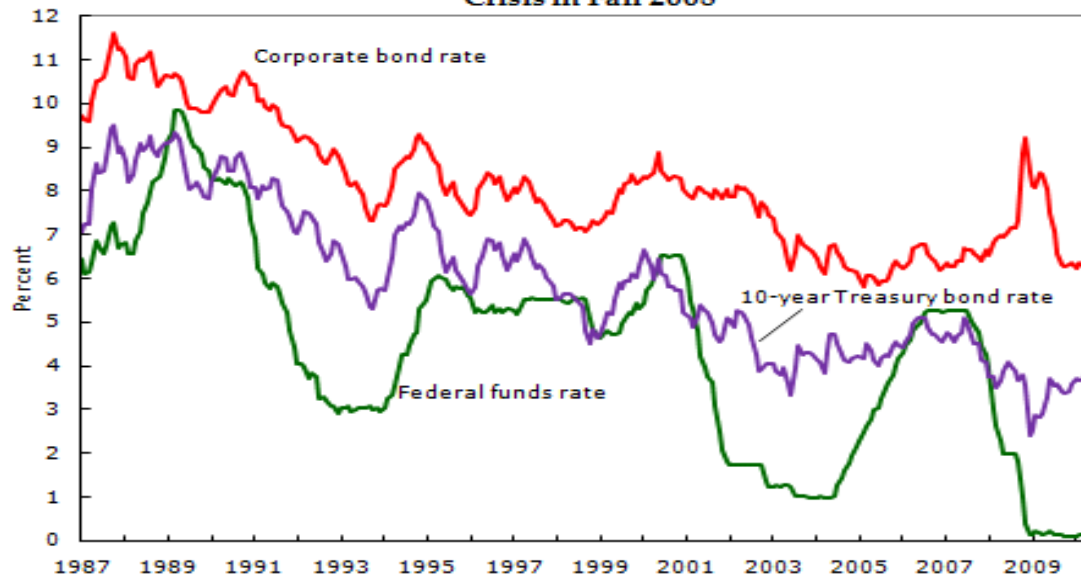
- So far imports have subtracted a big hunk out of growth in domestic demand
- 2010 Q1 Q2 Q3
- As stated growth 3.7 1.7 2.5
- Without net exports 4.0 5.2 4.3

Solutions? The Fed is Out of Ammunition

- Textbook IS-LM model still taught in intermediate undergrad macro
- Monetary policy is ineffective if:
 - Horizontal LM curve
 - Vertical IS curve
- The Fed now is plagued by both
- Why should QE2 work since QE1 didn't?

The Fed Can't Control the Cost of Business Borrowing

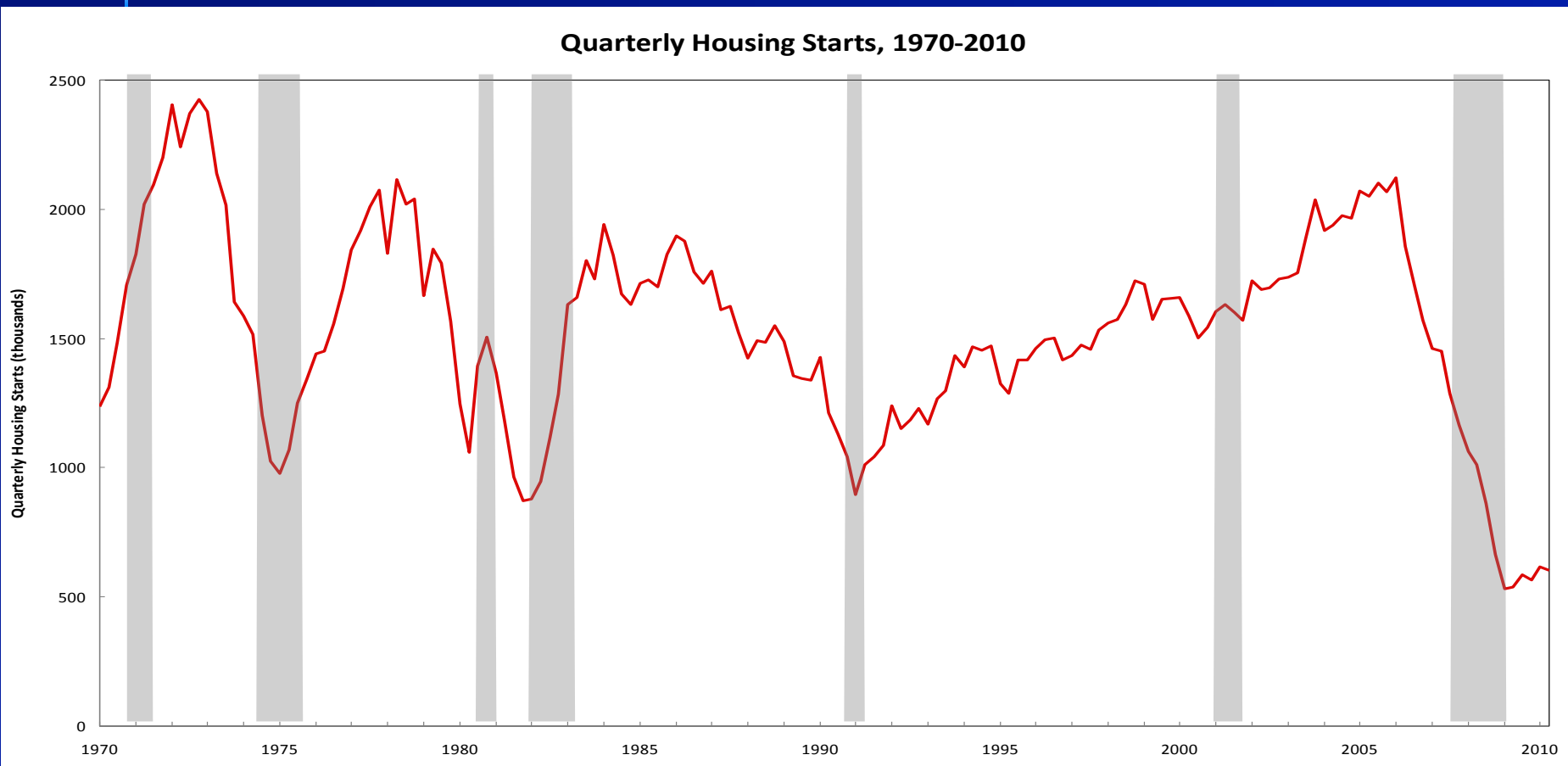
[HEADLINE] A Soaring Risk Premium Heralded the Onset of Crisis in Fall 2008



Summary: Fundamental Causes of Weak Recovery (Vertical IS)

- 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

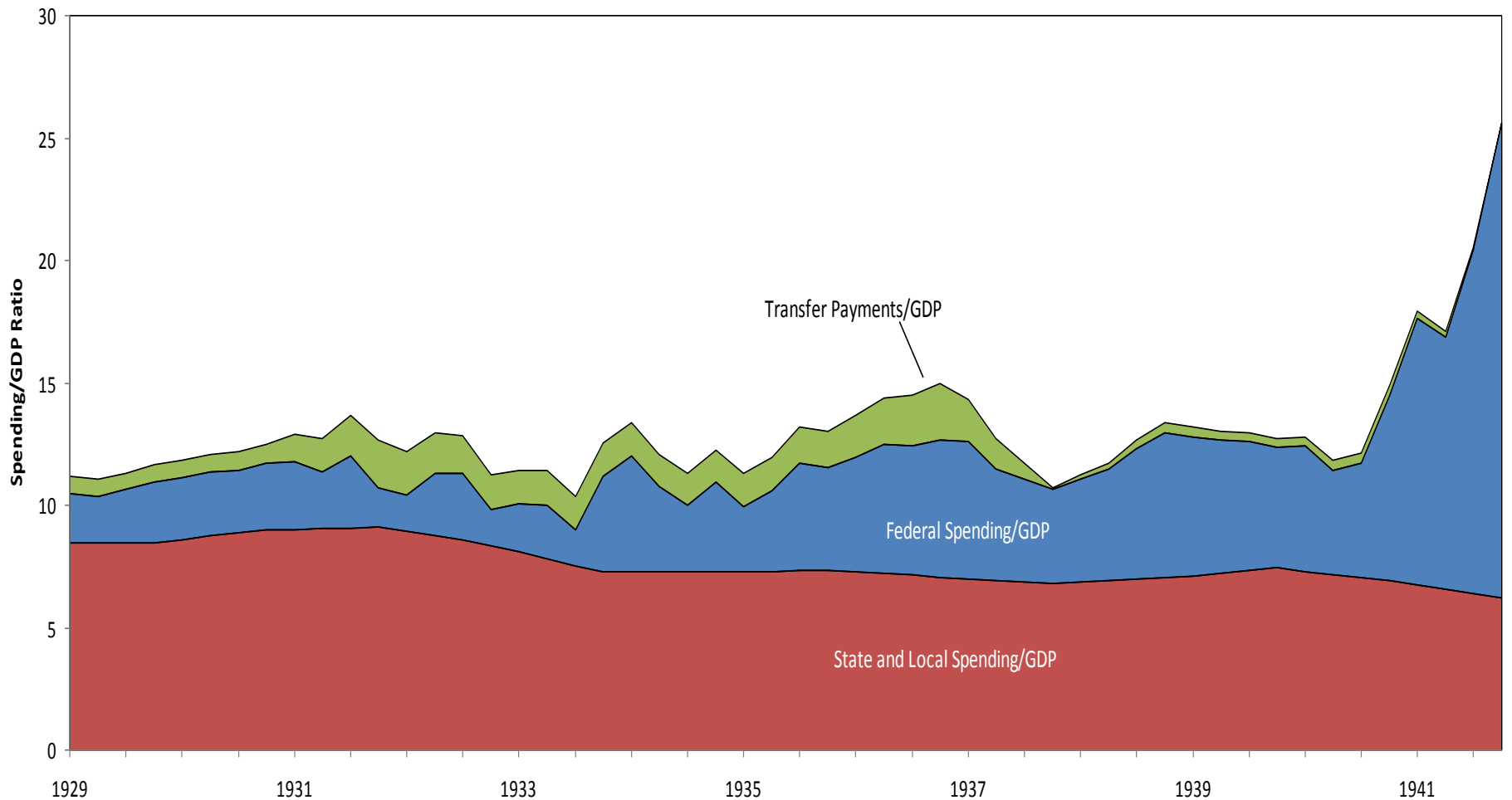
Housing Starts Used to be a Leading Indicator, but Not Any More



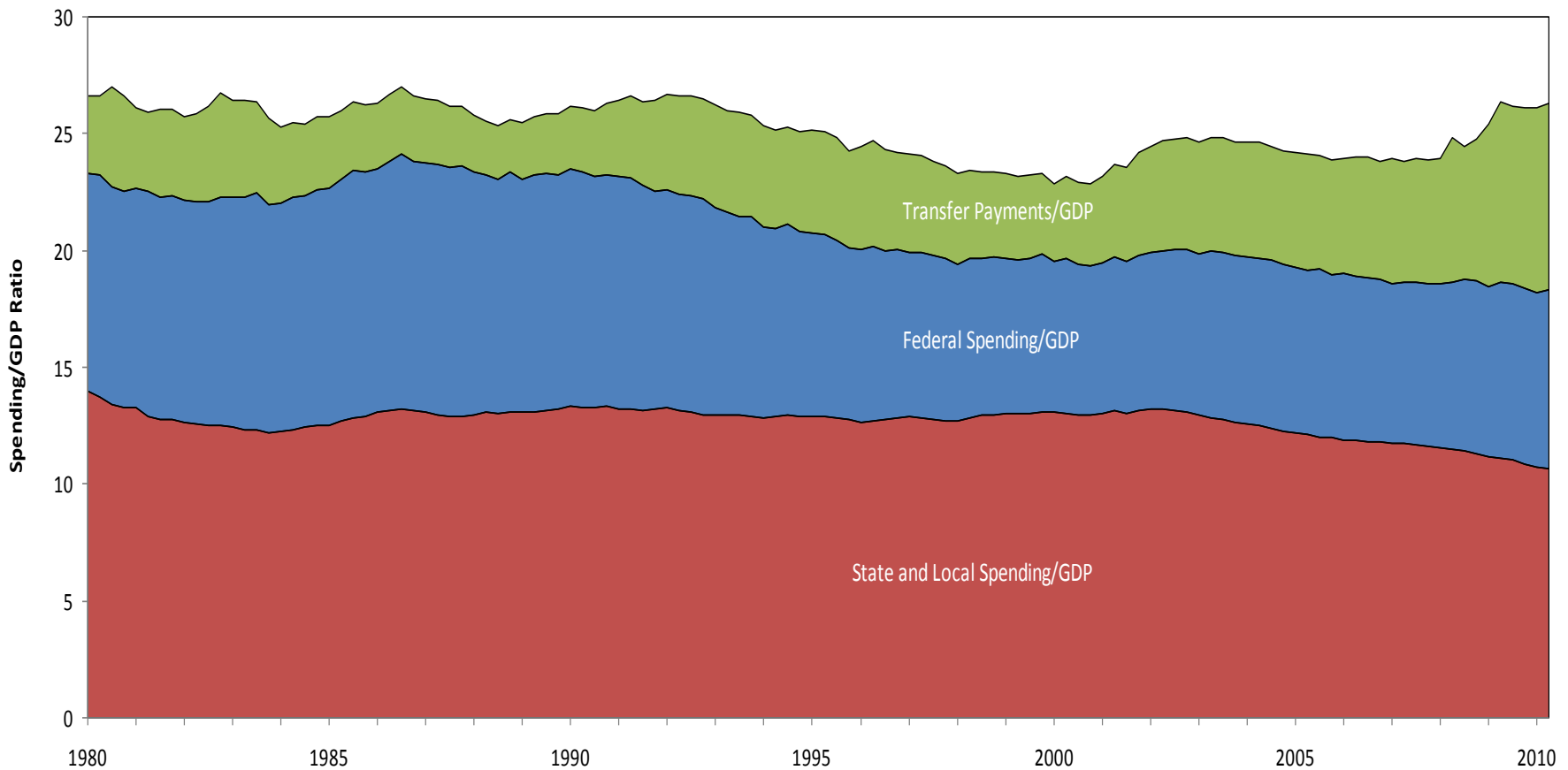
Where is Fiscal Policy?

- Common verdict on two episodes of fiscal stimulus
 - FDR's New Deal: too small
 - Obama's Stimulus: too small
- We've already looked at government employment
- The Obama stimulus was too small and too much was wasted on tax cuts and capital-intensive infrastructure spending

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



How Does the Obama Stimulus Measure Up?



Conclusions #1

- Long run growth in GDP per capita: predicted in 2007 to be slower than any time since George Washington
- But events since 2007 could only make that forecast worse
- 2008-10 slack in labor market: uniquely different than 1980-82, worst since Great Depression

Conclusions #2

- Why Recovery is so weak and likely to remain so
 - Consumption: high unemployment, decline in net worth
 - Tight credit
 - Investment: overbuilding, foreclosures for structures
 - Equipment investment: depends on final demand, slowing pace of fundamental innovation
 - State and local fiscal implosion not yet fully felt
 - Net exports have been chewing up growth in final domestic demand

Conclusions #3

- Why can't monetary policy fix this?
 - ZLB for fed funds rate
 - 10 year treasury rate more controlled by market expectations than by Fed bond purchases
 - Lack of control by Fed on risk premium
- What about fiscal policy?
 - A fundamental conflict between weak tax cut multipliers and capital intensity of infrastructure spending
 - Longing for the Skokie Lagoons!