

The Recession and Recovery: Implications for Labor Markets and Macro Doctrine

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Two Aspects of “Lessons for Economics”

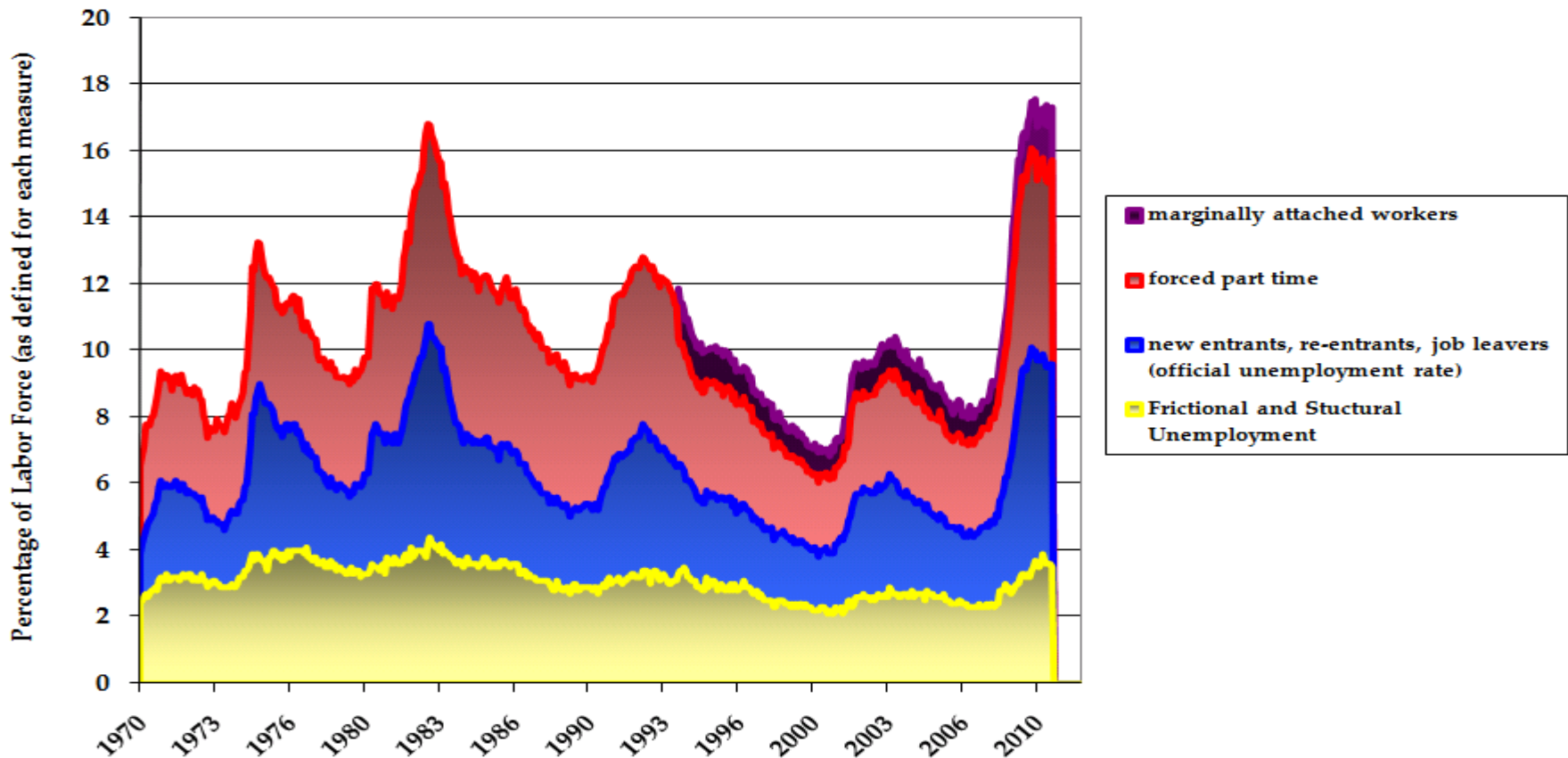
- The macroeconomic implications of the grim reality of today’s U. S. labor market
 - How much employment and GDP growth are needed to return to “normal”?
 - What does “normal” mean? Is there a “new normal”?
 - Media commentary has not yet absorbed how poor is the performance of the U.S. economy in creating jobs compared to the number required to return to “normal” by December 2016 (9 years after NBER peak)
- Macro doctrine: the Great Divide between intermediate undergrad and grad macro teaching

Three Charts on Dimensions of the Current Labor Market

- #1 Official vs. comprehensive unemployment Rates
- #2 Long-term unemployment
- #3 Changes in the historical “Okun’s Law” relationship between the output gap and the hours gap
(“gap” = $100 * \text{LN ratio of actual to trend}$)

U-6 was 16.7 in Dec 2010

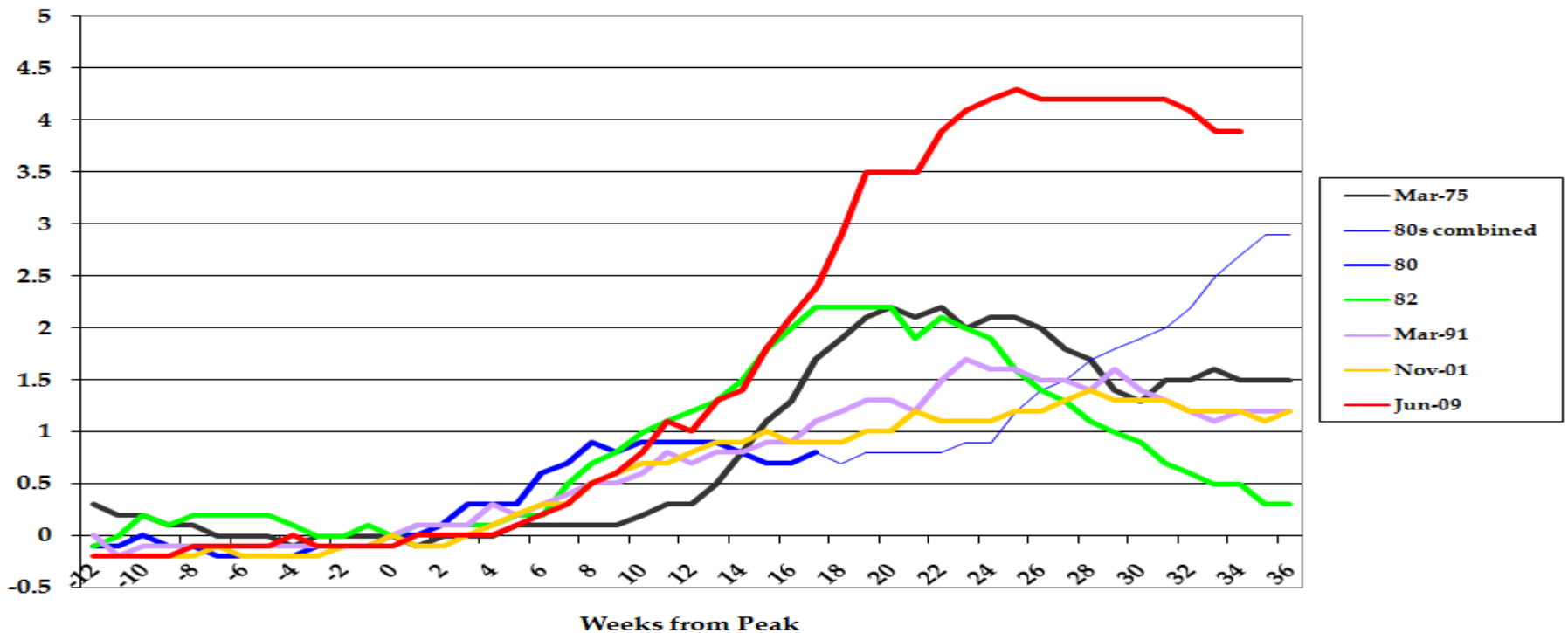
Various Measures of Unemployment Rates from the BLS



U Rate >15 Weeks Dec 2010

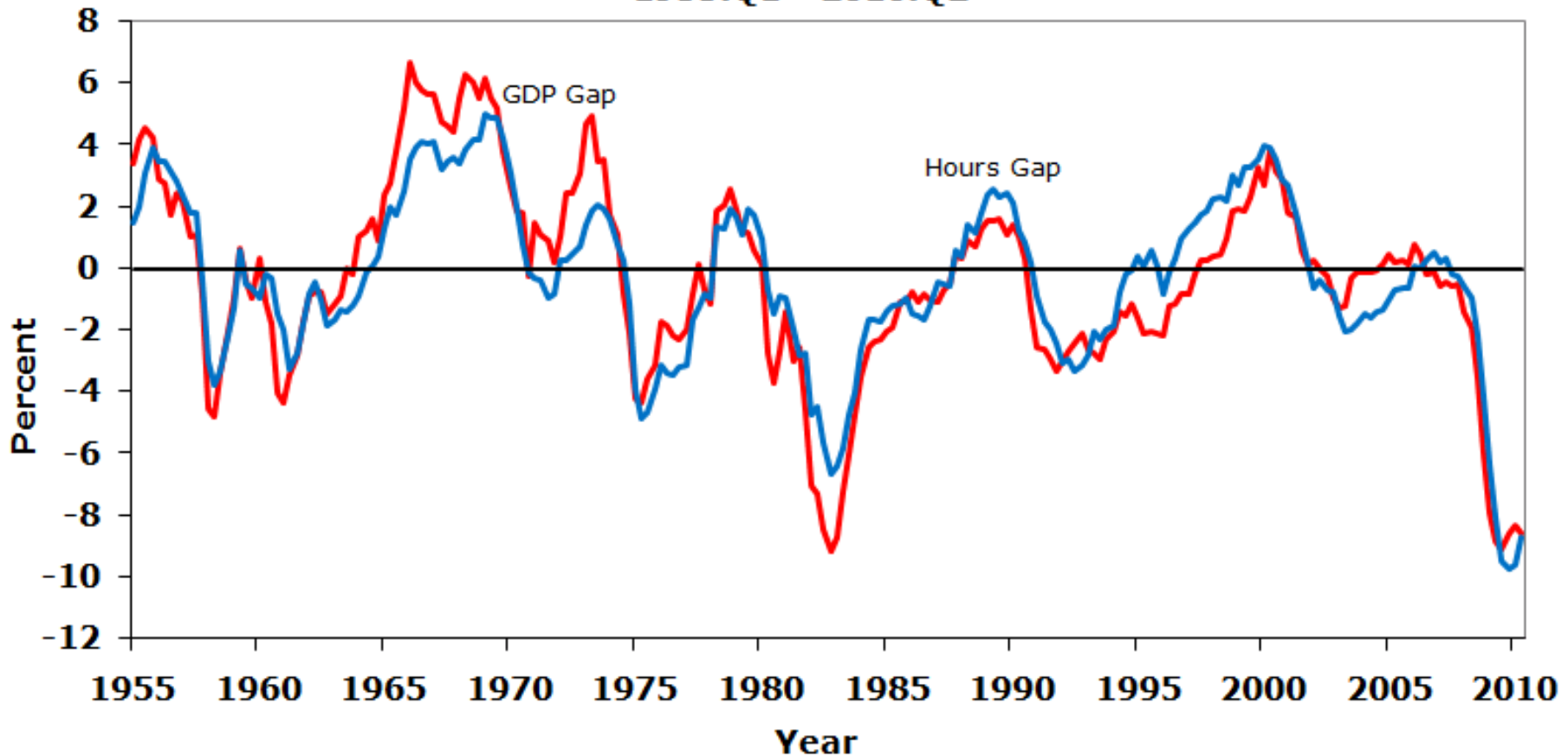
5.6% vs. 1.5% in Dec 2007

Unemployment Over 15 Weeks Rate as Difference from NBER Peak



Output Gap vs. Gap in Aggregate Hours of Work

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



Long-Run Elasticities from Regressions: Old and New 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



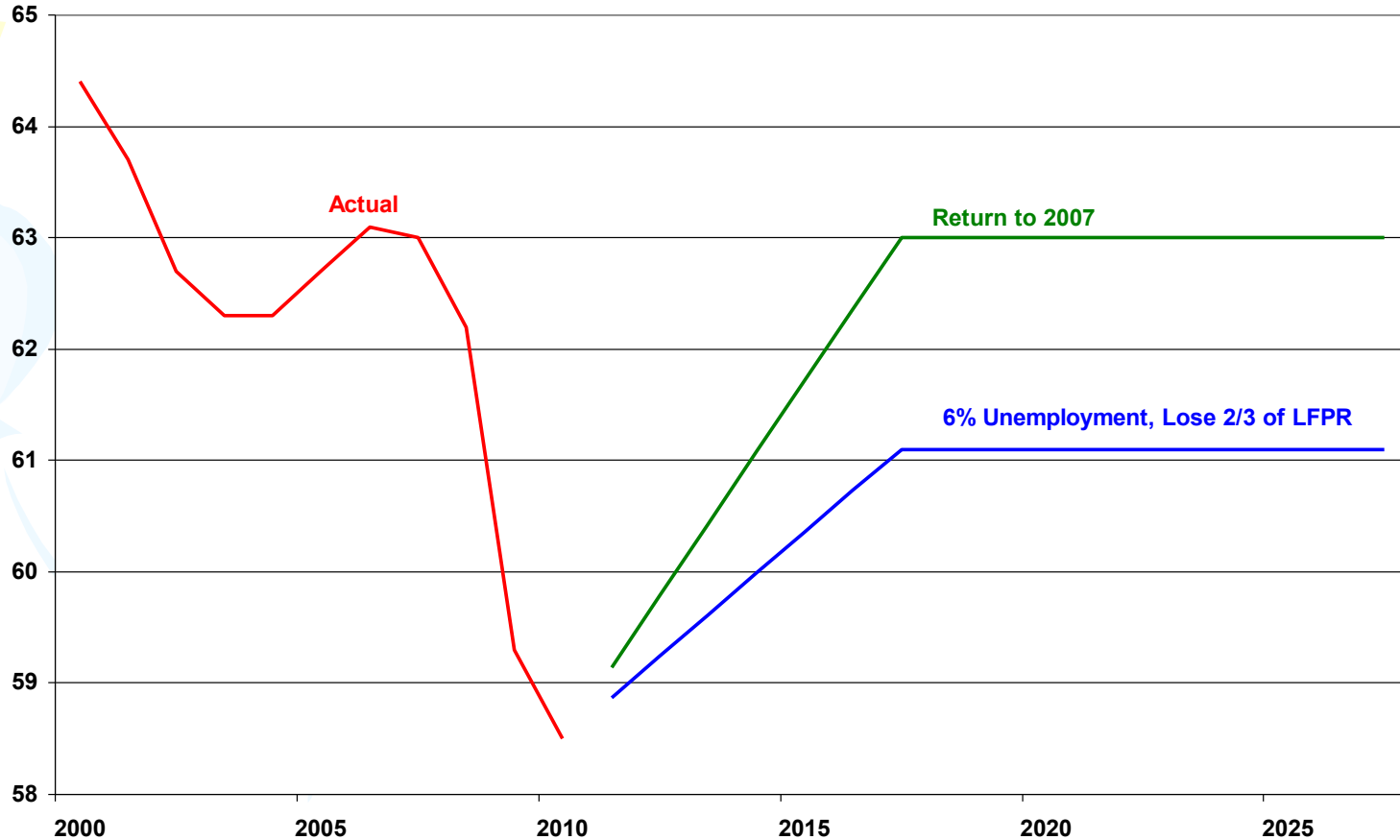
Explanations Offered in My Research

- Short version in *AER Proceedings* May 2010
- The “Disposable Worker” Hypothesis
- Similar sources as rising US inequality
- Increased market power of managers and highly paid professionals
- Reduced market power of workers due to:
 - Declining unions, declining real minimum wage, low-skilled immigration, and imports

Implications for Required Employment Growth

- One possible definition of “normal”: return to employment/population ratio of 2007
- E/P Must Then Climb from Current 58.3% to 63.0%
- Jobs needed with today’s population: 11.5 million
- Extra jobs needed for population of December 2016: 9.3 million
- Total jobs to be created by Dec 2016: 20.8 million = 288,000 per month
- By comparison over past 12 months payroll employment growth 103,000 per month, HH employment growth 96,000 per month

Alternative: A Less Ambitious E/P Target



Arguments for the “New Normal” $E/P = 61.1$

- Definition of “new normal”
 - U rate returns to 6.0 not 4.5
 - LFPR rises from 64.5 to 65.0, not to 66.0
- Hysteresis argument as applied to Europe in mid-1980s: the NAIRU drifts up in response to prolonged high actual unemployment
- Forecasts made in 2007 already forecast a decline in the LFPR due to baby-boom retirement
- Reduces “jobs needed” from 20.8 to 15.9 million
- Required monthly job growth reduced from 288,000 to 222,000

Implied Loss of point-years of E/P

- Loss of 1 point-year with today's population means losing 2.4 million jobs for a year
- How big an event is the projected loss of employment in 2008-16 compared with 1980-86?
 - 1980-86, ~14 point-years of reduced E/P
 - 2008-16, ~22.5 for tough 63% E/P “normal”
 - 2008-16, ~19.6 for less ambitious 61.1% E/P “new normal”
- “New normal” lost job-years 48 million
- And that number requires that all of a sudden, monthly job growth must be 222,000 practically forever

The Crisis, Recovery, and Macro Doctrine

- Too much has been written about the alleged failings of “modern macro”
- Too little has been written about the great macro dichotomy:
 - what we teach to undergraduates is a great success in explaining the crisis and slow recovery
 - But our graduate students are not taught traditional macro
 - The “light bulb glows” for graduate student TAs in intermediate undergrad economics
- This is the same dichotomy as Mankiw’s “Economists as Scientists vs. Engineers”

What is Traditional Macro?

- It is all there, in the 1978 first editions of the intermediate undergrad texts published simultaneously by Dornbusch-Fischer and Gordon
- Basic business cycle macro in 2011 retains all the 1978 elements, with a few new applications
 - These elements are in almost all intermediate texts
 - The main difference is whether the books treat long-run growth first or business cycles first

What Are the Core Elements of Traditional Macro?

- Dynamic AD-AS model as a second-order difference equation. It combines
 - Natural rate hypothesis and adaptive expectations
 - Demand shocks that change output and inflation in the same direction in the short-run, no change in output in the medium to long-run
 - Explicit supply shocks (oil, food, exchange rate, productivity trend) that change output and inflation in the opposite direction in the short run
- This model explains the late 1960s inflation, the twin peaks of unemployment and inflation in the 1970s, the “valley” of low unemployment and inflation in the late 1990s

Where Do the Demand Shocks Come From?

- Their causes are sorted via the IS-LM model (Unwritten law, IS-LM intermediate not principles)
- Consumption: current and permanent income, interest rates, real net wealth (assets – liabilities), quantitative credit conditions
- Investment: accelerator, cost of capital, overbuilding
- Government (tax vs. spending multipliers)
- Net exports (exchange rate, domestic vs. foreign income)

Monetary and Fiscal Policy in Traditional Macro

- Impediments to monetary policy
 - Vertical IS, horizontal LM, liquidity trap, zero lower bound (Japan example)
 - Application to Japan in 1990s, to U.S. today
- Impediments to fiscal policy
 - Vertical LM, interest rate crowding out, capacity constraint crowding out (WWII, Korea, Vietnam)
- Impediments to any policy: adverse supply shocks

Application: 1927-33 vs. 2002-10

- Bubbles
 - 1927-29, stock market bubble on top of overbuilding 1924-28
 - 2002-06 housing bubble
- Overleveraging
 - 1927-29 (construction debt, stock market 10% margin)
 - 2002-06 (leverage, securitization)
- Why wasn't the 1996-2000 stock market bubble as harmful? Lack of leverage (50% margin, much buying with 100% equity through mutual funds)

Policy: Differences and Similarities

■ Monetary policy

- 1930-32: Bank failures, no deposit insurance
 - Fed allowed declining GDP and bank failures to drag down money supply
- 2008-10: Bail-outs, QE1 and QE2
- Similarity: ZLB 1935-40 and 2009+

■ Fiscal Policy

- 1933-39 Stimulus too small to raise share of govt spending in potential GDP
- 2008-10 Obama stimulus failed to raise govt spending share or offset ongoing decline in total government employment

Conclusion about Doctrine

- In a short 9 weeks ending on 11/24/10, Northwestern undergraduate students in intermediate macro knew:
 - How to use the tools of traditional macro to explain causes of the 2008-09 crisis and the differences/similarities with 1927-40 and 1981-85
 - How to explain why the recovery to date was so weak and likely to remain so
- I' ll leave it to others to report on what students in *graduate* macro courses learned in the fall of 2010