Controversial Issues About the Recession and Recovery

Robert J. Gordon
Northwestern University and NBER
Sandhouse Gang, Chicago
December 9, 2010
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 of Labor Productivity, Two Intervals

Output/Hour
Capital Deepening
Labor Quality
MFP

Percent per Year
0
0.5
1
1.5
2
2.5

1987-2007
2007-2027
From Y/H to Y/N, the Role of Falling LFPR as Baby-Boomers Retire
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
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”
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
- \( E/P = E/L \times L/P \)
  - 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 unemployment rate fixed: 127K.
- Monthly increase in employment needed to get back to 2007 E/P by 2015: 316K.
- 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
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 Economic Analysis NIPA Tables. Details in Appendix C-4.
Summary of the Restraints on Consumption Expenditures

- High unemployment and fear of unemployment
  - Many people going beyond 99 weeks of unemployment
- 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
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

Month-Year

- Total Government
- Federal Government
- State and Local Government
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

- Corporate bond rate
- 10-year Treasury bond rate
- Federal funds rate
- Risk Premium

Graphs showing trends in interest rates and risk premium from 1987 to 2009.
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?

![Graph showing spending/GDP ratios for various categories over time.]

- **Federal Spending/GDP**
- **Transfer Payments/GDP**
- **State and Local Spending/GDP**
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!