

Helping Students Understand the Challenges the U.S. Economy is Currently Facing

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Long Live Keynes

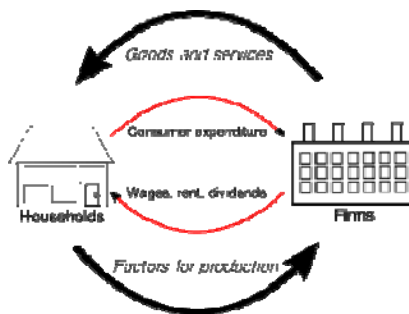


Thinking on the Margin

- The current crisis demonstrates thinking on the margin.
- Marginal benefit of each policy versus its marginal cost.
- We rarely see Congress and the Federal Reserve clearly making short-run decisions knowing that there will/could be negative long-run costs.
- Opportunity cost on display.

Economic Cycle

- Each transaction involves a good/service and money.
- Both sides of the transaction have had problems.
- Don't have the income to buy the product and we don't trust the bank with our money.
- Normally, one industry or part of economy (such as technology during its boom and bust) has a crisis.
- Hard to explain how a car works or how to fix it if it is running smoothly.



Short-term vs. Long-term policy

- Current actions include \$700 billion to stabilize the financial system and \$787 billion to stabilize the economy.
- Both actions increase the deficit.
 - Cumulative debt to GDP is set to rise from about 40% in 2007 to 70% in 2011.
 - Interest rates have been kept at historic lows but how long will that remain?
- Are we just delaying the pain for the future?

Why are we doing this?

- Housing crisis leads to financial crisis lead to downward spiral of economy.
 - Started with the deflationary concerns following September 11th.
- GDP decreases and decreases quickly. Haven't seen this type of drop since 1982.
- Unemployment increases to close to 10%.
- Retail firms going out of business.
- Bankruptcies have moved to manufacturing.
- Financial institutions fail.

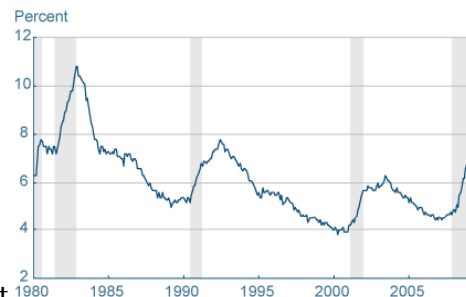
When did we decide to help those on the margin?

- Each wave of the crisis that is hit is “less deserving of the negative consequences.” We feel sorry for them and realize that it could be us.
- First wave of foreclosures are people who put little to nothing down on the mortgage and bought a huge home.
 - We don't feel sorry for them. It is just the market correcting itself. Some of us are even glad to see the correction.
- Second wave are regular people who are closer to the edge. Banks in those areas begin to have problems.
 - At low interest rates and a good economy (steady income) they can survive but when the economy hiccups, they get pneumonia.
- Third wave is the spiral downward as job losses move to people who didn't have the subprime mortgages or weren't in the main industries but instead, working in related industries.
- We didn't see wide-spread desire to help until the second wave. The third wave is the scary wave because it could be any of us.
 - Policies are to try to stop the third wave from happening by slowing the second wave.

Cyclical versus Structural Unemployment

- The recession causes cyclical unemployment.
- The Diffusion Index of Employment Change shows that only 32.7% of industries are hiring.
- Unemployment rate has more than doubled in less than 3 years.
- Unemployment is at a level not seen since early 1980s.

Unemployment Rate



Seasonally adjusted rate for the civilian population, age 16+.
Source: Bureau of Labor Statistics.

Average monthly change (Thousands of employees, NAICS)					
	2006	2007	2008	YTD 2009	May 2009
Payroll employment	178	96	-257	-585	-345
Goods-producing	5	-34	-126	-302	-225
Construction	15	-16	-57	-108	-59
Heavy and civil engineering	3	0	-6	-11	-8.7
Residential ^a	-5	-23	-35	-45	-19.5
Nonresidential ^b	16	6	-16	-52	-31.7
Manufacturing	-14	-22	-73	-183	-156
Durable goods	-4	-16	-54	-146	-131
Nondurable goods	-10	-5	-19	-37	-25
Service-providing	173	130	-131	-282	-120
Retail trade	3	14	-44	-44	-17.5
Financial activities ^c	9	-10	-19	-46	-30
PBS ^d	45	25	-63	-122	-51
Temporary help services	2	-7	-44	-56	-6.5
Education and health services	39	43	43	27	44
Leisure and hospitality	33	21	-21	-127	3
Government	17	24	14	19	-7
Local educational services	6	8	1	5	2
Average for period (percent)					
Civilian unemployment rate	4.6	4.6	5.8	8.5	9.4

a. Includes construction of residential buildings and residential specialty trade contractors.
b. Includes construction of nonresidential buildings and nonresidential specialty trade contractors.
c. Financial activities include the finance, insurance, and real estate sector and the rental and leasing sector.
d. PBS is professional business services (professional, scientific, and technical services, management of companies and enterprises, administrative and support, and waste management and remediation services.
Sources: Bureau of Labor Statistics.

Cyclical unemployment

- Whom do I fire first (marginal employee)? Notice which industries lay off workers first. Which industries have limited job security?
 - Construction, retail, temporary.
 - Unemployment moving to the professionals.
- The unemployment rate has increased faster in this recession than in any prior recession post WWII.
 - Other recessions have had greater GDP decreases –1953-54, 1981-82, 1973-75, and 1957-58.
- Sometimes unemployment peaks after the recession has ended.
 - Firms delay hiring until they are positive that they need the extra workers (marginal thinking).
- Duration of unemployment is a lagging indicator.

Unemployment rate if:

- Currently at 9.4% with 14.5 million people out of work.
- Discouraged workers add about 800,000 and raise rate to 9.8%.
- Marginally attached workers or workers who have stopped looking for work because of barriers to employment such as transportation, health care or child care add 1.4 million and raise rate to 10.6%.
- Involuntary part-time workers who either could only get part-time or had their hours reduced add 9.1 million and raise rate to 16.4%.

Structural unemployment

- People who don't have the skills or are in wrong place.
- Automobile workers in a factory town.
 - Plant is gone.
 - Houses, which is main family asset, worth substantially less.
 - Families need to move – but where and what about selling the old house?
- Tech bubble – the workers tended to be young with no families or at least mobile skills.
 - Technology was added to more industries who could finally afford the workers.
- What do we do with the structurally unemployed workers?
 - Lose retirement benefits and health care.

Immigration considerations

- Dr. Orrenius' presentation.
- Immigrant unemployment higher than native born unemployment.
- Many immigrants on temporary visas so easy to lay off.
- Immigration is not in the news anymore.
- For those industries that have had a shortage and thus, rising salaries, the tide has changed. Firms are now in charge.
 - WTAMU College of Business hired 3 American males this year!
- Fewer foreign students coming to U.S. but this could negatively effect future U.S. growth.
- For firms, it is a short-term gain in hiring but a potential long-term loss on quality.

Fiscal policy to assist with unemployment

- Provide the short-term buffer for workers.
- If deficit is cyclical, expenditures are fine.
- Concern that the stimulus package will create a structural deficit.
- Economy is beginning to show some signs of life but much of the stimulus funds haven't even been used yet.
- Fiscal policy – “targeted, timely, and temporary” – from Dr. Saving's presentation.

Deficit spending

- If it is targeted to people on the margin – those with the highest marginal propensity to consume – the spending creates economic activity.
 - Those on unemployment insurance have highest multiple (1.64).
- If it builds infrastructure such as roads, communications and education – investment for future economic growth, the spending creates economic activity.
- If the spending is spread over many years, the spending becomes permanent and expected which can lead to a structural deficit.
- So where is the marginal stimulus dollar being spent?
 - Investment or consumption?

Deficit spending effects

- Either growth or taxes will be needed to pay off the spending.
- Higher taxes – at least for someone.
 - Potential to have less than 50% of the U.S. population paying income taxes.
 - Considering taxing health benefits, chocolate, soda, etc.
 - Considering national sales tax.
 - Considering taxing transactions on the Internet.
- Of course, if economic growth is high enough, we can grow and pay off the debt.

Growth versus deleveraging

- The recession has forced firms and households to deleverage.
- $\text{Assets} = \text{Liabilities} + \text{Equity}$.
- If liabilities decrease, either equity must increase to compensate or else assets decrease.
- Stock market decline and housing values decreases have lowered equity.
- Assets fall – negative wealth effect.
- Government has picked up the slack by taking on debt for us.

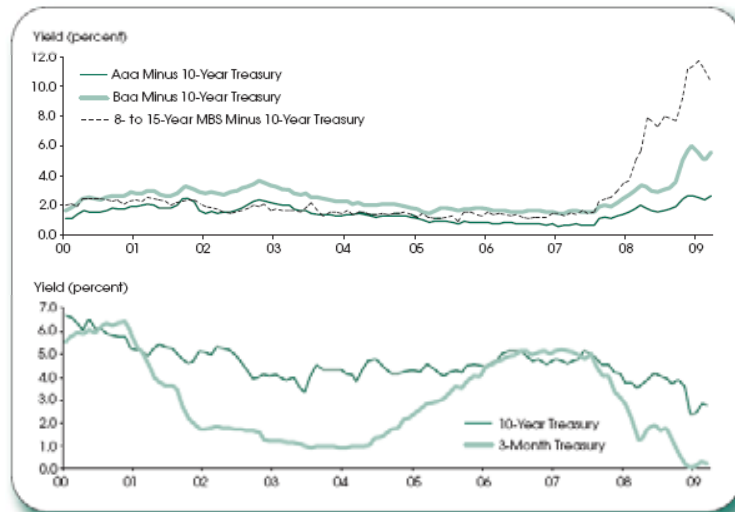
Deleveraging and Productivity

- Traditional way to grow a firm in the short-run: borrow at 8%, invest the funds and grow at 12%. Firm is ahead 4%.
 - But if borrowing costs are higher and borrowing capacity is lower, the equation still works but the growth is smaller and slower.
- How fast will U.S. be able grow with less debt?
- Need to consider productivity which is the long-run growth mechanism.
 - If we are more productive, we will grow whether there is debt or not.
 - Technology firms have little debt and they led the growth in the 1990s.

Interest rates

- Federal Reserve has lowered rates dramatically.
 - Eased credit crunch.
 - Acted as Lender of Last Resort.
 - Provided confidence to the economy.
- But the lower rates have not translated in the same percentage decline of other interest rates.
 - Indicates that there is greater risk still in the economy.
 - Indicates that lenders are unsure of the quality of the borrowers.

Spreads have not fallen as much as expected or as needed



Inflation vs. Excess Capacity

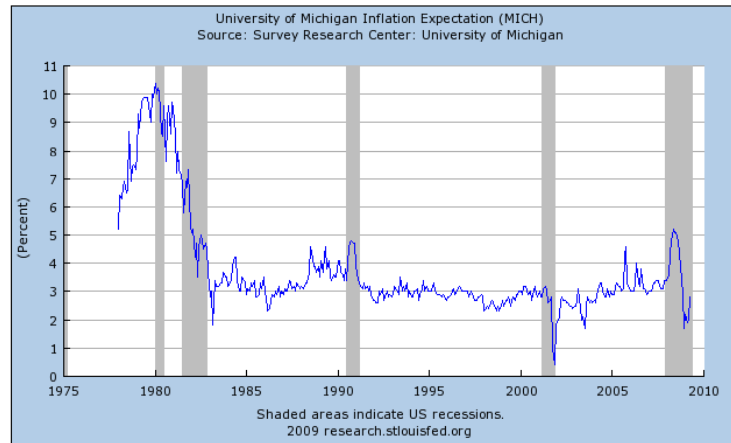
- Concern that the expansionary fiscal policy coupled with the expansionary monetary policy will lead to inflation.
- If the economy has excess capacity, there shouldn't be inflation – just movement of demand curve back to long-run supply curve.
- Excess capacity can lead to deflation.
 - Fed wants to avoid deflation and is willing to risk some inflation to avoid deflation.

PCE - Personal Consumption Expenditures

PCE Inflation

Percent change from year ago





- Short-run deflation concerns versus long-run inflation concerns.
- Could the higher long-term interest rates be reflecting higher inflation expectations?

Deficits and interest rates

- Will the rest of the world continue to buy our debt at low interest rates?
- Deficits put upward pressure on interest rates.
- Interest rates will react to inflation expectations.
- Inflation (from printing money to pay off debt) puts downward pressure on value of dollar.
 - Depreciation makes imports such as oil more expensive.
- Who will pay for our health care and retirement?
- Is there a better place to put your money in another country?

Corporate Governance

- It is a whole new world – who is the new regulator?
- In boom times, firms and financial institutions must accumulate capital for bust.
- Credit default swaps removed the need for financial institutions to monitor debt.
 - Free rider issue for small investors.
- Workers and in particular, the pension plan, moved ahead of bond holders as claimants in Chrysler bankruptcy.
- More regulation but how do you regulate a firm that is too big to fail?

Conclusion

- Who can we blame for the crises?
- People need to work and earn income or entire economy fails.
- Short-run policies will have long-run consequences. But short-run situation requires action.
 - We don't know what will happen to inflation and deficit.
- While we are in a recession, we have not lost our productive capabilities or our comparative advantages.
 - U.S. is still the best place to start a business.
 - U.S. still has the largest group of consumers with money.

Thank you!

