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**Research Report**

## Will the recovery continue? Four fragile markets, four years later

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Levy Economics Institute of Bard College

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# ***Public Policy Brief***

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No. 118, 2011

## **WILL THE RECOVERY CONTINUE? FOUR FRAGILE MARKETS, FOUR YEARS LATER**

GREG HANNSGEN and DIMITRI B. PAPADIMITRIOU

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## Preface

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In this brief, Research Scholar Greg Hannsgen and I focus on the risks and possibilities ahead for the US economy. Using a Keynesian approach and drawing from the commentary of other observers, we analyze publicly available data in order to assess the strength and durability of the expansion that probably began in 2009. We focus on four broad groups of markets that have shown signs of stress for the last several years: financial markets, markets for household goods and services, commodity markets, and labor markets. This kind of analysis does not yield numerical forecasts of economic variables but may unearth important clues about the short-term outlook for the country's economic well-being, in the narrow sense of output and income.

Like Milton Friedman before them, most modern-day academic opponents of fiscal stimulus have argued that monetary policy easing will fail to keep real interest rates low as long as governments are putting great demands on capital markets. This theory has not been borne out in practice following the expansionary policy response to the Great Recession, which has reduced the yields of low-risk, short-term securities and resulted in lower rates for other types of issues and loans crucial to corporate bottom lines. Interest rates are at historical lows—one of many signs that monetarist scenarios leading to high inflation are not being played out—and both monetary easing and fiscal stimulus have had some impact on demand by the US sector that is financially weakest: the household sector. Inflation-adjusted measures of the volume of household expenditures, including retail sales and personal consumption expenditures, sustained positive growth rates from midsummer of 2010 to year's end. Unfortunately, the growth rate of personal consumption expenditures turned slightly negative in January, and retail sales have not been strong in the first two months of this year.

In addition, seasonally adjusted industrial production was flat in February, and real earnings growth has been meager at best since the recovery began. In the aftermath of a severe recession, a modest-to-severe financial retrenchment, marked by tightened lending standards, an increased aversion to indebtedness, and more conservative investment tactics, tends to occur almost by necessity—as Hyman Minsky observed. Overall, consumer credit has yet to expand after stagnating in 2007–09,

though the bleak picture painted by recent data on credit-card debt levels was offset by the attainment of a new record for non-credit card consumer debt—approximately \$1.6 trillion.

In Europe, the banking system has been threatened by the sovereign debt crisis, and numerous institutions with large holdings of government bonds are not yet out of the woods. The banking industries in Greece, Ireland, Portugal, and Spain are surviving only by depositing securities worth hundreds of billions of euros at the European Central Bank, in return for cash. The long-run presence of financial fragility looms large in our view, compared to the supposedly excessive demands for capital generated by high government deficits.

Although the dollar's value against the major foreign currencies still seems to be trending downward, recent data show that the trade deficit widened by about \$6 billion in January, to \$46 billion, largely due to increases in the cost of imported oil. In the broader commodities market, the prices for corn, soybeans, cotton, and cattle have made double-digit and triple-digit gains over the past year. If commodity prices climb broadly and sharply, the Fed could face the prospect of a serious episode of cost-push inflation similar to the one that occurred during much of the 1970s and early 1980s.

Unfortunately, the labor market is ill positioned to deal with a double whammy of rising commodity prices and a monetary-policy tightening. The seasonally adjusted unemployment rate stood at 8.9 percent in February, reflecting only a tiny drop from the January level of 9.0 percent, and labor market data show every sign of a widespread and severe weakness in aggregate demand. Unless there is new resolve for effective government action on the jobs front, drastic cuts in much-needed federal, state, and local programs will be the order of the day in the United States as in much of Europe. The bottom line: markets cannot be counted on to solve a long-lasting macroeconomic crisis like ours in the absence of firm monetary stimulus, jobs programs, and other public sector initiatives.

As always, I welcome your comments.

Dimitri B. Papadimitriou, *President*  
April 2011

## **An Approach to Analyzing Current Economic Problems**

To begin with the conventional wisdom, most government and private sector forecasters foresee solid but moderate growth over the next two years or so. For example, the Fed reported in January that most of its regional bank presidents and board members expect GDP to grow 3.4 percent this year and 3.9 percent in 2012 (Federal Reserve 2011b). On the other hand, it has become almost a cliché to point out that improvement in the labor market is lagging behind the recovery in output growth. The Fed's forecasts of the unemployment rate range from 8.8 to 9.0 percent for this year and from 7.6 to 8.1 percent for 2012. These forecasts do not differ greatly from other widely reported forecasts and projections, and the "beige book" reports on individual geographic regions did not seem to be greatly at odds with these earlier forecasts.

This analysis focuses on the risks and possibilities ahead for the US economy.<sup>1</sup> We use a Keynesian framework, in which the strength of demand for goods and services matters a great deal more than most observers seem to realize, even after years of high unemployment. We consider the strength and durability of the weak expansion that appears to have begun in 2009 and consider various diagnoses for the weak US labor market using publicly available data and commentary, as well as the perspective offered by the work of Keynes and his followers. We focus on data related to four markets that have shown signs of stress for most of the last several years: financial markets, markets for household goods and services, commodity markets, and labor markets. This approach does not yield numerical forecasts of economic variables but it will help us to obtain some clues about the short-term outlook for the country's economic well-being, in the narrow sense of output and income. It will also cast light on some longer-run threats that will be important over the next five years or so and indeed have the potential to wreak economic havoc during that time. In particular, dangers and stresses in the financial and banking systems are presently very serious, though they are difficult to measure and forecast in precise terms. The paper ends with some ideas about macroeconomic policies appropriate to our time.

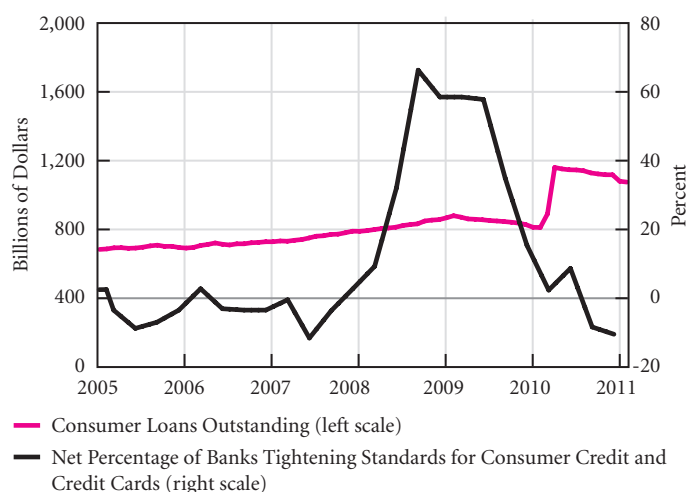
## **Market No. 1, Finance and Banking: Minskyan Instability Is the Real Threat**

There are still many observable but scattered stresses in important European financial markets, where rising and sometimes unstable yields draw the attention of regulators and central bankers. Some observers seem to assume that large budget deficits and loose monetary policy are causing things to get out of hand in these markets, but the recent financial crisis seems to have led to less restrictive policy, rather than vice versa. The inflationary scenarios envisioned for years by monetarist and "new classical" economists have not materialized in a convincing way, though important problems involving money and deficits are evident.

More to the point, many observers worry about stresses that are building in some credit markets and financial institutions, with little help from the public sector. They worry that if left unchecked, these problems could lead to a moment of truth similar to but more profound than the "Minsky moment" of 2008–09. As in that crisis, current threats to the financial system mostly involve loans, derivatives, and securities that were created and sold by private financial companies and permitted rather than demanded by the Fed, the Securities and Exchange Commission, and other regulators.

The main concern of deficit skeptics is a possible drain on capital markets that would sap resources that could be used more productively by the private sector. Anti-Keynesian commentators see deficits leading to higher interest rates and taxes over some unspecified long run, a development that would in their view greatly hinder growth within a year or two after fiscal stimulus. As we will see below, however, interest rates are low by historical standards. This is one of many signs that monetarist scenarios leading to high inflation or hyperinflation are not being played out. These observations must be kept in mind when isolated data points or events in a few sectors are taken as empirical support for critiques of policy activism that rely upon the quantity theory of money and other traditional economic doctrines.

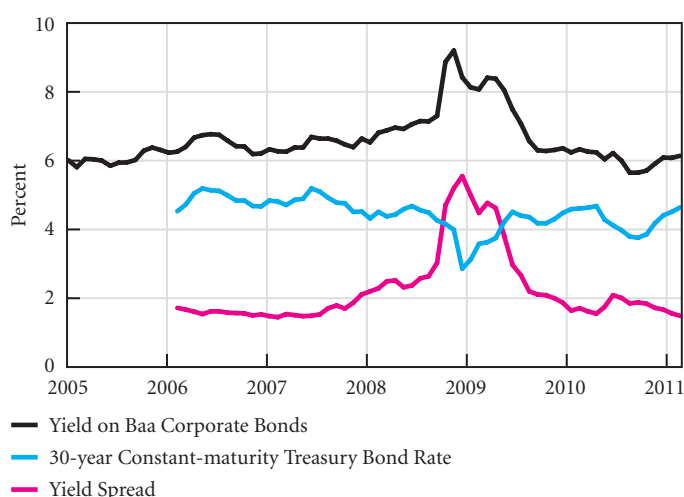
Consumer spending, it is often noted, accounts for more than one-half of GDP. Standards for loans to the private sector tightened greatly during the financial crisis but have since loosened a great deal, according to data from the Fed's survey of senior loan officers (see Figure 1). Now, in sharp contrast to the situation that has prevailed for most of the last three years, less than half of surveyed banks are tightening credit standards.

**Figure 1 Consumer Credit Indicators**

Source: St. Louis Federal Reserve Bank, FRED database

Overall, consumer credit has yet to expand after stagnating during the Great Recession (again, see Figure 1), though the bleak picture painted by recent data on credit-card debt levels as of February was offset somewhat by the attainment of a new record for the total amount of non-credit card consumer debt—approximately \$1.6 trillion (Norris 2011a).<sup>2</sup> While the data reflect large numbers of loan write-offs, it is likely that weak credit card lending arises mostly from low demand among people with adequate credit scores who wish to make major household purchases. Similarly, credit is rarely of great help to businesses in conditions that typify the aftermath of a severe recession: widespread bankruptcies, weak household balance sheets, and reduced real earnings. Also, in such circumstances, a modest-to-severe financial retrenchment, marked by tightened lending standards, an increased aversion to indebtedness, and more conservative investment tactics, tends to occur almost by necessity (Minsky 2008 [1986]). It goes without saying that these sometimes useful repercussions of financial overextension on the part of households help explain our bias in favor of macroeconomic policies that do not depend on the encouragement of a new private sector credit boom. At the Levy Institute, we began emphasizing this in the 1990s with warnings about the credit-fueled and imbalanced domestic economy of the era, which had developed in concert with insufficient government spending and high levels of foreign borrowing (Godley and Wray 1999).

And not only that, bull markets have developed around the world, making cheap credit available to borrowers who have

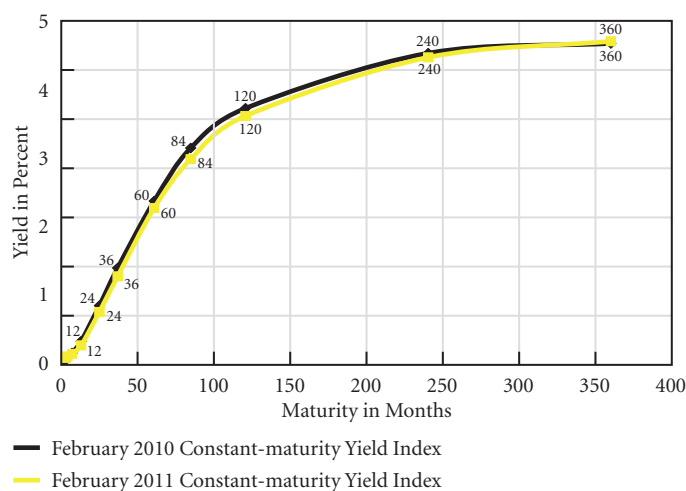
**Figure 2 Corporate Bond Yield and Yield Spread**

Source: St. Louis Federal Reserve Bank, FRED database

access to the “hottest” but perhaps most volatile sources of funding. In domestic bond markets, some have noted a boom in the issuance of “junk” bonds, investments that had again become unpopular because of the recession and the resulting increase in default rates for firms that may not have been very sound to begin with (*Financial Times* 2011a; Van Duyn 2011). Yields for securities with ratings somewhat below “investment grade” remain low despite continuing concern and uncertainty over the state of the economy (Figure 2). The red line in the figure approximates the difference, or spread, between the yield to maturity of a typical 30-year corporate bond with a Baa rating and the yield for a Treasury bond of a similar maturity. This spread is not unusually wide and has continued a long-lived downward trend in recent months, making it easier for companies without investment-grade bond ratings to raise funds in capital markets, should they have business in need of financing. A similar yield spread for true junk bonds—corporate securities of the lowest quality—stood at approximately 2.69 percent in early March, not far above its 2007 low of 2.41 percent (Van Duyn 2011).

Some observers and critics of current monetary policy worry that inflation will soon take off, leading to a run on long-term, fixed-income investments such as bonds issued by the federal government. Figure 3 shows the “yield curve” for Treasury securities of various maturities in February 2011 as well as the same curve as it appeared exactly one year earlier. Monetary stimulus has been effective in reducing rates at most maturities,

**Figure 3** Yield Curve for Treasury Securities, February 2010 and February 2011

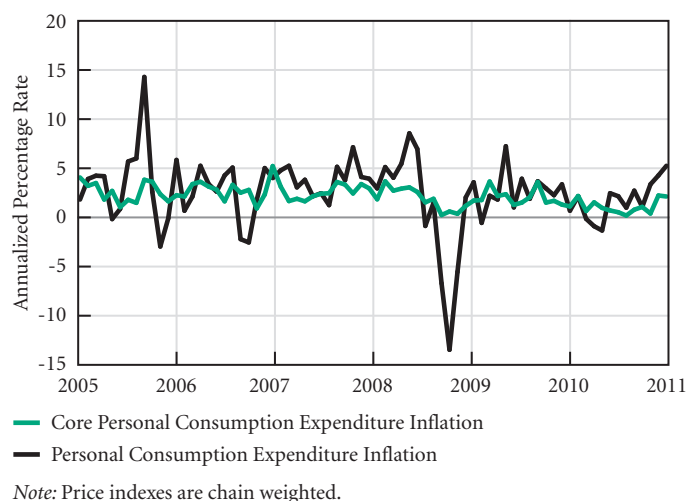


Source: St. Louis Federal Reserve Bank, FRED database

partly as a result of the “unconventional” but almost surefire Fed policy of purchasing long-maturity bonds. Some careful studies suggest that recent policy actions have had only a small effect on long-term rates, but the Fed now holds a portfolio worth over \$2.5 trillion, compared to around \$870 billion at the beginning of March 2008 (Federal Reserve 2011a). The newer holdings include some assets acquired from failing financial corporations, when few potential buyers for their assets could be found, as well as mortgage bonds and Treasury securities of short and long maturity. Of course, a sudden sale of all of these securities would destabilize some important financial markets and lead to significantly higher yields.

On the other hand, many central banks, regulators, and accounting firms find themselves in the position of at least temporarily overlooking serious problems with asset quality and capital adequacy at financial institutions around the world (*Financial Times* 2010, 2011b; Weil 2011). Worldwide regulatory changes about to go into effect may change the profitability of many large banks for the worse (*Financial Times* 2010, 2011b). In Europe, the banking system has been threatened by the sovereign debt crisis, and numerous institutions with large holdings of government bonds are not yet out of the woods. The banking industries in Greece, Ireland, Portugal, and Spain are surviving only by depositing securities worth hundreds of billions of euros at the European Central Bank (ECB), in return for cash. As of

**Figure 4** Monthly Inflation in Consumption Good Prices, with and without Food and Energy



Source: St. Louis Federal Reserve Bank, FRED database

December 2010, these loans were equivalent in value to 37 percent of GDP in Greece, 68 percent in Ireland, 24 percent in Portugal, and 4 percent in Spain. The long-run presence of financial fragility looms large in our view, compared to the supposedly excessive demands for capital generated by high government deficits. The case for this perspective on risks to the economy goes beyond data showing that nominal yields on US government debt are relatively low and stable.

Inflation is often regarded as the chief enemy of bondholders, one of many links that connect controversies about macroeconomic policy to concerns about the cost and availability of finance and capital. To wit, critics of Keynesian policies argue that recent deficits and monetary policy actions will inevitably lead to an increase in inflation that not only angers consumers, but also ultimately raises nominal interest rates for mortgages and business loans. Defying recent arguments to this effect, the data in Figure 4 show that inflation at the level of the consumer remains very much in check, with no upward trend after the passage of three fiscal stimulus packages and more than two years of near-zero short-term interest rates. In January, headline personal consumption expenditure inflation was 3.5 percent, while the annual rate of inflation in consumer prices excluding food and energy items was only 1.5 percent. These inflation rates rose in February data, but other key data released in March suggest that the economy is stagnating or weakening further. Moreover,

month-on-month inflation data tend to be rather volatile, as shown in the figure.

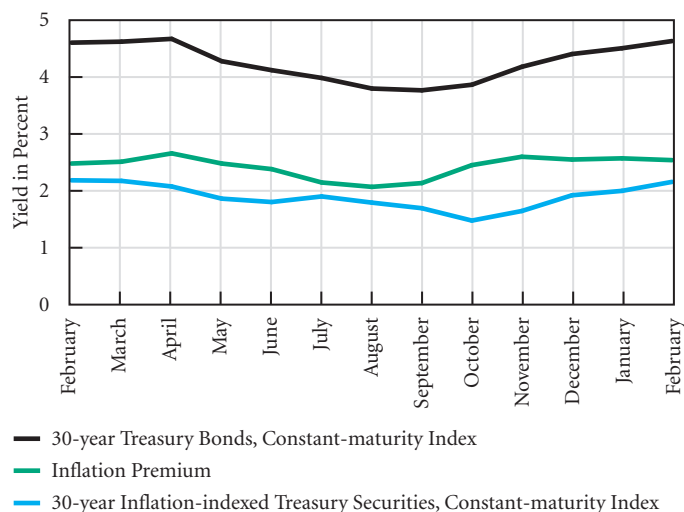
Moreover, despite the Fed's seemingly lax stance against inflation, the yield spread separating yields on inflation-indexed Treasury securities from those available on nonindexed Treasury securities of the same maturity has remained almost constant (Figure 5). In other words, people who wish to obtain securities whose returns are insulated from the effects of inflation are paying only slightly more for inflation protection than they were about one year ago. This flatness in inflation premiums indicates that there has not been a sharp increase in investor demand for such insurance for government bonds. Those who purchase securities for long-term investment purposes evidently have not greatly revised their forecasts of inflation following recent policy actions. This is reassuring, because in those countries where inflation is quite high, inflation premiums are closely watched and volatile, and almost all investors prefer inflation-protected investments to ordinary fixed-income assets. Hence, evidence on inflation premiums paid in bond markets indicates that fears of inflation are not putting upward pressure on yields. This chart and other evidence in this brief indicate that many of the widespread concerns of the past few years about President Obama's policies were grossly misplaced.

Another insight into the weakness of policy critiques that condemn government borrowing can be gained by studying

bond markets in countries that have strongly expanding economies and relatively high interest rates. Far from suggesting that "saving is in short supply," the performance of some financial markets in rapidly growing economies has raised concerns about the possible emergence of new and dangerous financial bubbles. Such worries have led some governments in Asia and Latin America to impose restrictions on capital movement, designed to stem appreciation of their currencies. High returns and growing economies have been sufficient to attract more than enough capital in the eyes of local authorities.

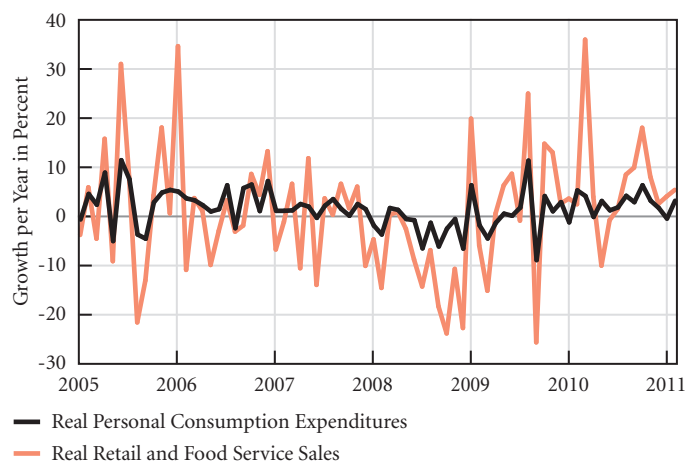
Since the financial crisis, central banks have managed to ease conditions in many developed-country credit markets. Like Milton Friedman (1968) before them, most modern-day academic opponents of fiscal stimulus have argued that monetary policy aggressiveness will fail to keep real interest rates low as long as governments are putting great demands on the capital markets. By the lights of conventional theory, short-term nominal interest rates can be changed at will by either the government or the central bank, but real rates gravitate toward equilibria that are independent of the veil of money and prices (Woodford 2003, 248). Moreover, demands on capital markets by the public sector increase these "natural" interest rates. Hence, once the Fed lowers interest rates, it sets in motion a process whereby accelerating inflation eventually brings real rates back to their original levels in the absence of changes to the equilibrium.

**Figure 5 Yields on 30-year Treasury Securities, with and without Inflation Indexing**



Source: St. Louis Federal Reserve Bank, FRED database

**Figure 6 Monthly Indicators of Household Expenditures**



Source: St. Louis Federal Reserve Bank, FRED database



This theory has not been borne out in practice following the policy response to the Great Recession. As we saw before, rounds 1 and 2 of quantitative easing (QE) and recent reductions in the federal funds rate have not generated unintended impacts on inflation sufficient to reverse the effects of monetary policy easing on real yields. More generally, expansionary policy has not only reduced the yields of low-risk, short-term securities, but it has also resulted in lower rates for other types of issues and loans crucial to corporate bottom lines. Hence, it is not surprising that Fed Chairman Bernanke's public statements still give no hint that he plans to call off the Fed's recent "unconventional" policy actions before their scheduled end date in June (Hilsenrath and Crittenden 2011). This increases our confidence in the stability of the financial system.

### The Market for Goods and Services: Stronger, but Not Strong Enough

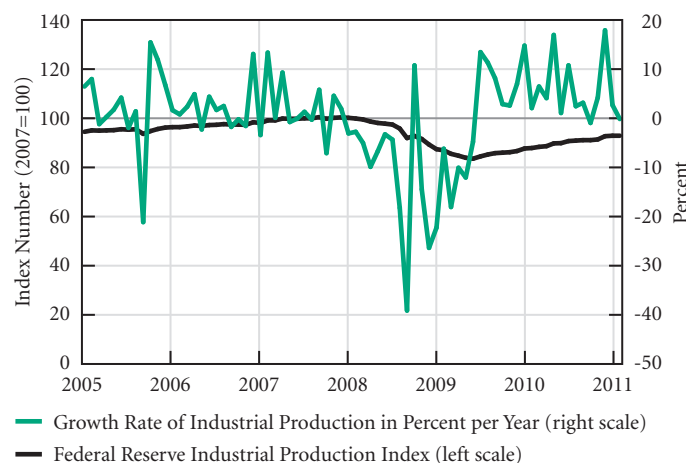
Perhaps indicating that recent policy has been somewhat successful, many signs have appeared of an ongoing expansion in the demand for goods and services produced in the United States. In particular, both monetary easing and fiscal stimulus have had some impact on demand by the US sector that is financially weakest: the household sector. We saw above that credit

standards for this sector appear to have eased significantly following Fed intervention in a number of financial markets, including those for some types of securities backed by consumer loans. Evidence of a modest recovery is readily available: inflation-adjusted measures of the volume of household expenditures, including retail sales and personal consumption expenditures, sustained positive growth rates from midsummer of 2010 until the end of last year (Figure 6). In particular, an easing of credit terms and standards for auto loans may have helped drive an 11 percent increase in new car sales in 2010 (Dash 2011). Unfortunately, the growth rate of personal consumption expenditures turned slightly negative in January, and retail sales have not been strong in the first two months of this year.

This leads us to the Fed's index of industrial production, which has mostly been growing smartly after sustaining a fall of 17 percent in the months between September 2007 and June 2009. Figure 7 shows that seasonally adjusted industrial production was flat in February and has still not attained its earlier peak. This disappointing announcement follows hard on the heels of January's encouraging 2.9 percent annual growth rate for industrial production.

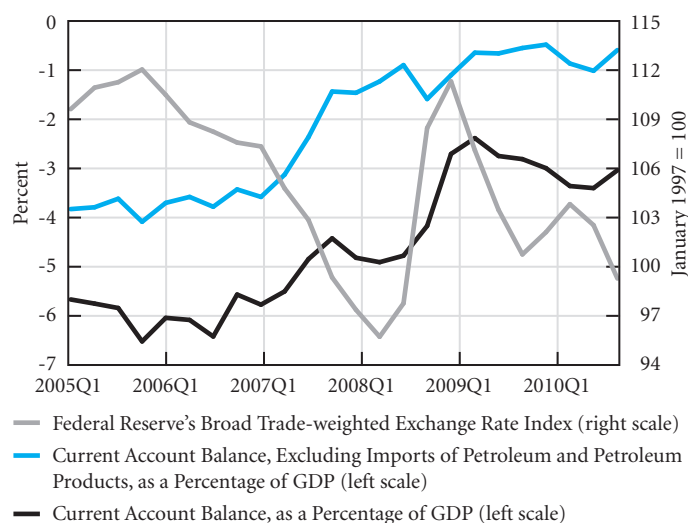
In light of the constraints on US consumers discussed in the section on financial markets, much hope resides in the export sector of American commerce, where, unfortunately, the signs

**Figure 7 Industrial Sector Production Recovery**



Source: St. Louis Federal Reserve Bank, FRED database

**Figure 8 Narrowing of the Current Account Deficit, 2005Q1–2010Q4**



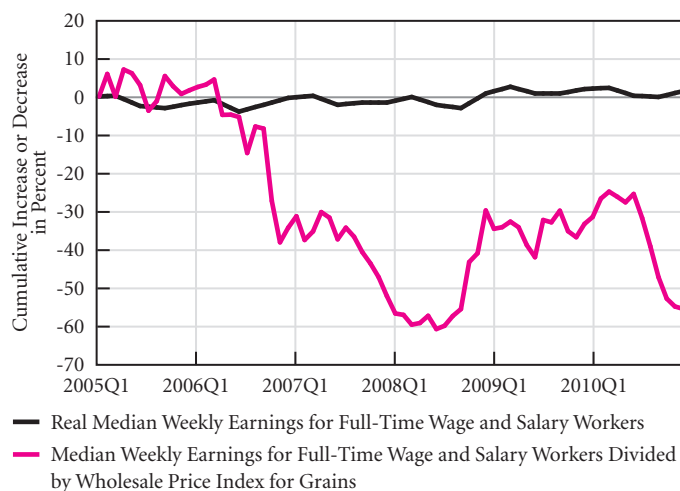
Sources: Bureau of Economic Analysis, International Transactions Accounts; St. Louis Federal Reserve Bank, FRED database; authors' calculations

have not been strongly and consistently positive. Of course, there has been some progress since pundits began to warn seriously that trade deficits might soon surpass 10 percent of GDP. The current account includes not only goods and services that are traded across international borders, but also income payments, such as interest and dividends on foreign investments. The balance in these transactions has improved from a deficit of about minus 6.5 percent of GDP in the last quarter of 2005 to levels consistently above minus 4 percent of GDP since the beginning of 2009 (Figure 8). However, the deficit has been gradually deteriorating over most of the past two years or so and stood at minus 3.0 percent of GDP as of the fourth quarter of 2010. Imbalances of this magnitude have contributed to rapid, unwanted capital inflows in many emerging-market economies, as mentioned above.

Nonetheless, there are still signs of hope in this regard. As shown in the same figure, the Fed's trade-weighted exchange-rate index for the dollar's value against major foreign currencies still seems to be on a downward trajectory, a trend that was reinforced by rising interest rates overseas following the ECB's intimation that it would begin tightening its policy stance. The dollar has also depreciated somewhat vis-à-vis the Chinese currency, a development that will be helpful to US GDP economic growth, especially when its effect is combined with increased inflationary pressures in much of Asia. Such trends, which depreciate the dollar in real terms, tend to make US exports less expensive for foreign buyers and raise the price of imports sold in the United States.

Recent monthly data show that the trade deficit widened by about \$6 billion in January, to \$46 billion, a disappointing result that was largely due to increases in the cost of imported petroleum. One should keep in mind a rule of thumb asserting that each \$1 billion reduction in the US trade deficit leads to a 0.1 percent increase in GDP (Chinn 2011). President Obama's annual State of the Union address focused largely on national competitiveness in technology, a somewhat helpful nod toward the obvious importance of trade and other key economic issues affected by the quality of the educational system and the state of science and technology in this country.

**Figure 9 The Purchasing Power of a Week's Earnings, 2005Q1–2010Q4**



*Notes:* Approximations used to compute monthly observations from quarterly data for real weekly earnings and nominal weekly earnings; earnings data not seasonally adjusted.

*Sources:* BLS; authors' calculations

## **An Old Nemesis: The Markets for Raw Materials, Energy, and Other Commodities**

The topic of recent oil-price increases, and their effects on output, brings to mind the broader market for commodities such as corn, soybeans, cotton, and cattle, where prices have been climbing rapidly. There has been a general rise in recent months in the spot and forward prices of many agricultural and other commodities. For example, cotton futures have risen 162 percent over the past year, reaching an all-time high in February, while many other commodity prices have made double-digit and triple-digit gains in that timespan (Farchy 2011). Such volatility has been known to pose a threat to financial stability, as there is an enormous volume of trading each day on the commodity markets and related financial derivatives markets.

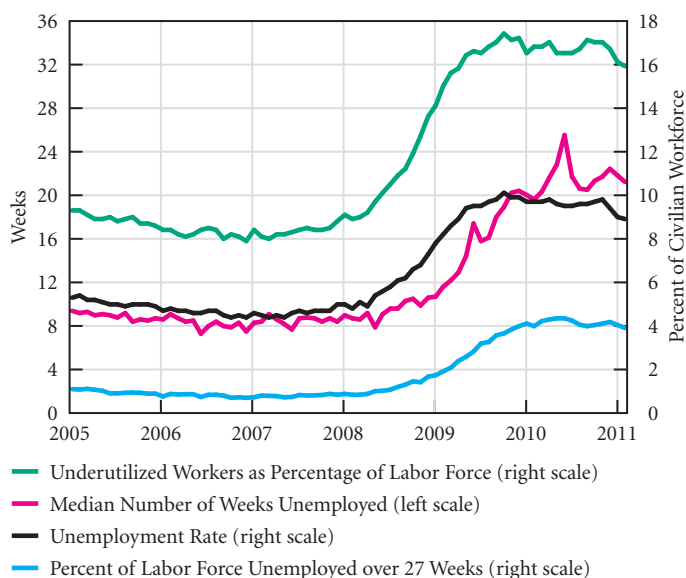
This run-up in commodity prices has already had an unfortunate impact on levels of extreme poverty and hunger in many countries (World Bank 2011). Even in the developed world, increases in the prices of food, energy, and materials can crowd out other kinds of expenditures from consumers' budgets before serious headline inflation appears. For now, real weekly earnings for full-time employees, as estimated by the Bureau of Labor Statistics (BLS), have remained very stable over the past five years, lending support to the notion that commodity price inflation

has not been making a big dent in US standards of living during that time (Figure 9). However, one can see a dramatic effect on the amount of agricultural commodities that can be purchased with the median weekly paycheck. Illustrating this trend, Figure 9 shows nominal earnings divided by the producer price subindex for grains. This “grain earnings” series gives one the sense that consumers are likely to be feeling a strain at the supermarket checkout lane when they buy items made from wheat, corn, and other cereal grains. Increases in commodity prices also adversely affect firms’ production costs, which is one reason commodity inflations like the current one have tended to promote overall inflation and hinder growth at the same time.

Many economists dismiss popular concerns that recent rises in raw materials prices could spur an increase in inflation, on the grounds that in high-income countries, these commodities account for only a small share of GDP. And not only that, most mainstream academic macroeconomists and policy officials believe that increases in these prices will not start an ongoing consumer-price inflation as long as the Fed maintains a credible monetary policy strategy, one that commits policymakers in one way or another to a fight against core inflation that could come at great cost to output and employment (Barro and Gordon 1983; Calvo 1978; Kydland and Prescott 1977; Rogoff 1985). It is not always appreciated in the political discourse that this high-level confidence that inflation is contained arises from a modern economic theory, and certainly not from an extreme fealty to the Keynesian school of macroeconomics or from long and successful experience with the current Fed’s monetary policy doctrine.

The aforementioned “modern” view on inflation containment, which rests on the importance of “time consistent” policy, may prove incorrect if challenged by one or more severe supply shocks. In fact, Alan Blinder and Jeremy Rudd (2008) deny that the supposedly permanent taming of inflation and moderation of the business cycle that was touted in the mid-1980s can be attributed mostly to improved policymaking. Instead, they argue that improved US economic performance during much of the 1980s and 1990s was largely the result of good luck in avoiding shocks to the price of oil and other commodities. A run-up in commodity prices in the 2000s proved less damaging to the economy than the oil and food price shocks of the 1970s for a variety of reasons, especially the adaptation of the economy to higher resource costs. In case these mitigating circumstances do not prevail in this decade, and commodity prices climb broadly and sharply, one might gather that the Fed could face the prospect of

**Figure 10 BLS Unemployment Indicators**



*Note:* All series seasonally adjusted by BLS.

*Sources:* St. Louis Federal Reserve Bank, FRED database; authors’ calculations

a serious episode of cost-push inflation, similar to the one that occurred during much of the 1970s and early 1980s. Chairman Bernanke might then find himself in the position of a new-era Paul Volcker, committed to raising interest rates drastically, until inflation abated to some unhelpfully low target range. Such a policy response might be far more injurious to output and job creation than an isolated commodity-price inflation with no subsequent monetary policy response. Unfortunately, the labor market is ill positioned to deal with a double whammy from rising commodity prices and a monetary-policy tightening, as employers are only just beginning to get back to form in the wake of the 2007–09 recession.

### The Vexed Labor Market and Stubborn Unemployment Rate

We now turn to this issue, which continues to vex the US economy. As shown in Figure 10, BLS household survey data show that the seasonally adjusted unemployment rate stood at 8.9 percent in February, reflecting only a tiny drop from the previous month’s level of 9.0 percent. According to the BLS’s separate survey of businesses, payrolls rose by 192,000 workers in February. Figure 10 puts these data in perspective, demonstrating that the

economy has not even begun to reverse the steep rise that occurred from 2008 to 2009 in four gauges of the extent and severity of the US unemployment problem. Along with the traditional measure of unemployment, the figure shows large and enduring increases in the median length of time people have been unemployed, in the percentage of workers who have been unemployed for more than 27 weeks, and in the BLS's U-6 labor underutilization measure, which adds to the standard unemployment rate the percentage of the labor force that is either out of work but not searching for a job or involuntarily working less than full time. The most recent data point in this latter gauge was 15.9 percent, representing more than one in seven civilian workers wishing that they could find more work in the labor market.

February's survey data followed a more ambiguous and somewhat confusing set of data that was summarized in the previous month's BLS employment report. Offering some hope that the job market was recovering more quickly than expected, January household survey data indicated a sharp decline from the previous month's figure in the traditional version of the unemployment rate, but this apparent improvement was largely the product of seasonal adjustment procedures that are routinely applied to results from BLS surveys. In fact, January's reported fall in the unemployment rate to 9.0 percent from 9.4 percent last December could be accounted for almost entirely by seasonal adjustment; in other words, many lost their jobs between December 2010 and January 2011, but these losses were omitted from headline BLS figures because large numbers of layoffs, et cetera, are normal for that time of year.

Following the release of the report, many economic commentators focused on what seemed to be a puzzling discrepancy between data obtained via the household survey and data from the same month's survey of business establishments (Economix Editors 2011). When seasonal adjustments are removed, it becomes clear that these two data sources were actually in agreement that many fewer people were employed in January than in December, though the two estimates were very different. Non-seasonally adjusted data from the household survey showed a loss of 1.56 million jobs in January, of which 472,000 could be accounted for by a change in the methods used by the BLS to estimate the total population. This means that well over one million fewer people were employed in January than in December on a seasonally unadjusted basis, according to the household survey. Meanwhile, the BLS's survey of employers found a net employment increase of 36,000 jobs after seasonal adjustment.

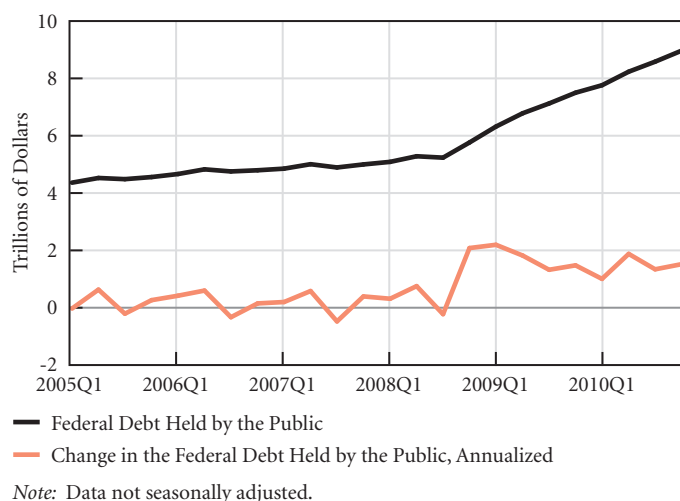
Before seasonal adjustment, there was a loss of 2.9 million jobs, a staggering figure that was not widely reported or commented on following the release of the BLS data in early February. Revised January figures that were released in March showed a much higher payroll increase of 63,000 jobs for the month, but the unadjusted results were still abysmal after the revision.

Some may doubt that seasonal adjustment does anything but obscure actual trends in data series such as those reported by the BLS. In theory, seasonal adjustment makes data series more useful as gauges of the economic performance. For example, because of the US holiday season, even a mediocre December for the economy is far better than a good month most other times of year. Seasonal adjustment can help us see if changes in unemployment in January reflect an incipient recovery of the labor market or merely a seasonal blip. Also, there are many possible explanations of the business cycle, and it is important to avoid confounding them with seasonal variations that also affect many economic variables somewhat predictably. Hence, a good measure of the economy's health must take into account the fact that much of the fluctuation in economic data that takes place over the course of a year results from these changes, and not from movements in the forces that underpin economic growth. However, in examining the January employment report, there is another way of looking at the choice of seasonally adjusted versus non-seasonally adjusted data. Whether or not reported job losses were normal for this time of year, we must keep in mind that with many fewer jobs and more unemployed people than at the end of last year, there is an increased need to create job opportunities.

### **How Will the Job Market Slump Come to an End?**

Can such a goal be realistic? Our colleagues at the Levy Institute have done extensive work on various proposals for jobs programs and on the recent stimulus bills (e.g., Antonopoulos et al. 2010). From the other side of the debate, there has been much work criticizing public sector efforts to alleviate job losses in the last few months. The invective is strong. "New Keynesian" macroeconomist John Taylor (2011) opines, "Why the extraordinarily high and prolonged unemployment? . . . Discretionary government interventions . . . have been largely responsible." What is often missed by commentators of all types is the absence of any reasonable alternative set of policies to create jobs within the "free market" paradigm that dominates so much of the national

**Figure 11 Federal Deficit and Debt, 2005Q1–2010Q4**



Source: St. Louis Federal Reserve Bank, FRED database

policy discussion. Some economists suggest structural reforms to allow unemployed workers to enter industries and occupations where workers are in high demand. They attribute problems in the labor market to structural forces such as a mismatch between the skills needed to qualify for new positions and those possessed by most of the unemployed. A dubious Paul Krugman recently looked at the ratio of 2010 unemployment rates to 2007 unemployment rates for various groups of workers. He points out that “unemployment doubled for every industry, every occupation, every state. Where are the sectors/occupations/regions gaining jobs? Nowhere to be found” (Krugman 2011). Hence, in his words, “there is nothing structural” about the run-up in the unemployment rate that began in 2008. One might also point out that such a rapid rise in unemployment is rarely the result of structural shifts in the economy, which usually occur more gradually. Labor market data show every sign of a widespread and severe weakness in aggregate demand that began to appear only three to four years ago. In recessions since the 1930s, no remedy other than macroeconomic policy stimulus has proven to be an effective means of dealing with weakness in the job market at the bottom of the business cycle.

The federal budget situation (shown in Figure 11) has mostly been a focus of antigovernment rhetoric in recent months. On the other hand, better training and education of the workforce for available jobs is certainly a relevant and important issue, if not a likely solution to a rapid doubling of the unem-

ployment rate. Also, with educational funding lacking in so many areas, it is important to point out that part of the remedy for any mismatches between workers and jobs lies in more and better public efforts, and certainly not fewer or worse efforts of any kind. This makes it particularly unfortunate that cuts to education are most likely in prospect once a new budget agreement is hammered out. Recent budget proposals by the Obama Administration and congressional Republicans have called for cuts in Pell Grants and other programs to make training and education more affordable (Leonhardt 2011). Various other spending reductions, such as cuts in Medicaid programs, that are now being considered in most states will also adversely affect public health, making the unemployed and underemployed less work ready.

Drastic cuts in much-needed federal, state, and local programs will be the order of the day in the United States, as in much of Europe, unless there is new resolve for effective government action. Unfortunately, such austerity measures are likely to cause problems out of proportion to the amount of money saved. There is no reason to pay such a large price in lost productivity and human well-being at a time when large deficits are still needed anyway. Since state and local governments do not have their own “state monies” and are often constitutionally bound to balance their budgets, they lack the ability to spend the amounts of money required to save some of the essential programs that lie mostly within their bailiwick, rather than that of the federal government (Hannsgen and Papadimitriou 2010). Some examples are education, law enforcement, sanitation, public transit, public hospitals, and medical programs for the poor. During the bubble of the 2000s, many state and local governments grew reliant on the abundant property and sales tax revenues generated by the decade’s hot real estate markets. Over the last few years, weak tax revenues and increased demand for services have resulted in an average budget gap of \$140 billion for the states, and they have managed to cover only about 15 percent of this shortfall by raising taxes and fees on residents (Pollin and Thompson 2011). Meanwhile, 450,000 jobs in state and local governments have vanished since 2008, when those levels of government began to fall into fiscal crisis (Norris 2011b). Now the states will have difficulty replacing the \$150 billion in extra funding that was sent by Washington as part of the 2009 stimulus package (Lowenstein 2011, 28). Further state tax increases would hinder the effort to restore full employment and have their greatest impact on residents of the most economically depressed areas



and regions of the country. Additional “revenue sharing” for states and localities would be a worthwhile and cost-effective form of new federal spending to aid workers and labor markets, as James Galbraith (2008) and others point out.

Such commonsense responses to high unemployment are resisted by many informed and sophisticated commentators. The greater part of mainstream economic scholarship suggests that whenever there is an overall lack of job openings, higher though perhaps meager levels of employment will eventually be restored by a natural and orderly decline in real wages and salaries that encourages employers to increase hiring. Perhaps that is what is hoped for by observers who oppose QE2 and judicious increases in government spending. So far, though, there is no strong evidence that the relentless decline in real wages and salaries for male workers that began perhaps decades ago has accelerated significantly since the Great Recession began. It hardly seems likely that a further decline in real compensation would help even workers who currently cannot find a job, though wage and salary reductions are described by many economics textbooks and some commentators as an inexpensive free-market cure for involuntary, nonstructural unemployment (Miron 2010). Few justifications of any kind have even been proposed lately in blogs, op-ed pieces, and the like for the idea that markets can be counted on to solve a long-lasting macroeconomic crisis like ours in the absence of firm monetary stimulus, jobs programs, and other public sector initiatives. As James Tobin forcefully pointed out in a 1978 lecture series,

The view that the market system possesses, for unchanging settings of government policy instruments, strong self-adjusting mechanisms that assure stability of its full employment equilibrium is supported neither by theory nor by capitalism’s long history of economic fluctuations. (Tobin 1980, 46)

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We wish to thank Research Scholar Gennaro Zezza for his comments on an earlier draft of this brief.

## Notes

1. Economic projections from the Levy Institute macro model are featured in Papadimitriou, Hannsgen, and Zezza (2011).
2. The early-2010 jump in consumer credit shown in the figure reflects a change in accounting standards that brought numerous off-balance-sheet items onto the books of US financial institutions (Federal Reserve 2010).

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