

Forefront

New Ideas on Economic Policy from the FEDERAL RESERVE BANK
of CLEVELAND

The Future of Financial Market Regulation

INSIDE:

Slowing Speculation in Housing

Introducing the
Cleveland Financial Stress Index

A Bad Bank, for the Greater Good

PLUS:

Interview with Charles Calomiris

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CONTENTS

-
- 1 President's Message
-
- 2 Reader Comments
-
- 4 Upfront
Unemployment Benefits: Help or Hindrance?
-
- 6 Rules and Regulations
How the Details Take Shape
-
- 10 Early Warning
Introducing the Cleveland Financial Stress Index
-
- 12 How to Build a Bad Bank
For the Greater Good
-
- 16 Keeping Banks Strong
Conference on Countercyclical Capital Requirements
-
- 20 Slowing Speculation
A Proposal to Lessen Undesirable Housing Transactions
-
- 26 Interview with Charles Calomiris
Columbia University banking scholar appraises regulatory reform
-
- 32 Book Review
All the Devils Are Here
-

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Unemployment Benefits: Help or Hindrance?



Amy Koehnen,
Associate Editor

Almost 15 million Americans were jobless as of the end of 2010, a strikingly high 9.4 percent of the would-be working population. Although the mass layoffs that marked the beginning of the recession have tapered off, people who are out of work are having a hard time finding new jobs. A full 6.2 million of the unemployed have been that way for at least half a year. On average today, the unemployed stay out of work for a record-high 34 weeks, about 50 percent longer than in previous cycles.

As a consequence, more unemployed Americans than ever are tapping federal unemployment insurance (UI) benefits after exhausting state benefits. This situation has reignited a policy debate: Are overly generous benefits at least partly responsible for the rising unemployment rate?

The debate centers on two main arguments. One is that UI increases the nation's unemployment rate and lengthens unemployment spells because job seekers put less effort into the search, a form of what economists term "moral hazard." The other is that UI is not a significant factor in unemployment duration or rate, and something else is mainly responsible for the high numbers of both.

A New Deal

Signed into law by President Franklin Roosevelt in 1935 in response to the Great Depression, the Social Security Act provided the original framework of the unemployment insurance system. UI provides benefits for eligible workers who have lost their jobs involuntarily. Regular benefits are based on a percentage of an individual's earnings over a recent 52-week period and are paid for a maximum of 26 weeks in most states.

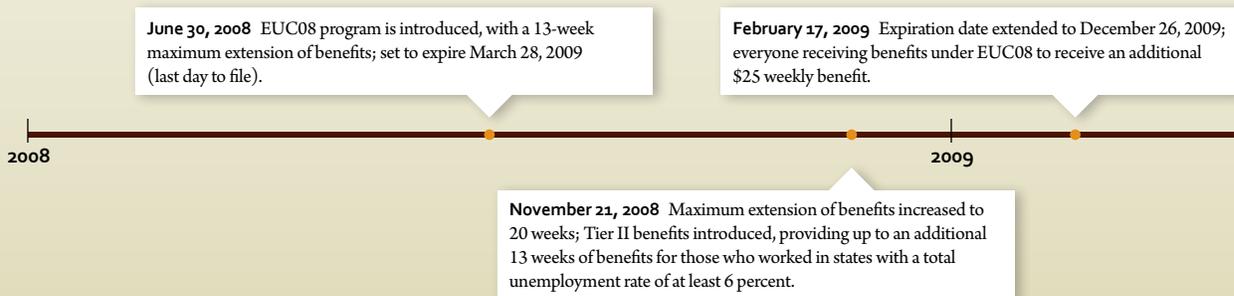
Unemployment Benefits: A Disincentive to Job Seeking?

Harvard economist Robert Barro is one of the highest-profile critics of unemployment benefits. In a recent *Wall Street Journal* op-ed, he argued that in trying economic times, it is reasonable to adopt a more generous UI program—but not one that lasts almost two years. Unemployment benefits decrease efficiency, Barro and others argue, because the program subsidizes unemployment and can cause insufficient job search, job acceptance, and levels of employment. An unemployed person drawing benefits, for example, might search less vigorously for a job or be more selective about accepting offers than he would be in the absence of benefits.

Unemployment Benefits: An Economic Booster?

Some people may indeed take longer to find a new job because of unemployment insurance extensions, but many economists think that UI is not a large contributing factor in driving up the rate of unemployment or in lengthening its average duration.

Timeline of the Emergency Unemployment Compensation Program (EUC08)



Economists at the Federal Reserve Bank of San Francisco compared the duration of unemployment in four categories: involuntary job losers, voluntary job leavers, new labor market entrants, and re-entrants. Their goal was to find out whether there was a difference in length of unemployment between involuntary job losers (who are usually eligible for UI) and job leavers, new labor market entrants, and re-entrants (who usually are not). The results showed that involuntary job losers remain unemployed slightly longer than unemployed workers who are not eligible for benefits, indicating that extended UI benefits have a modest impact on unemployment duration.

The economists concluded that the impact of extended insurance benefits on the unemployment rate for all of 2009 and the first half of 2010 was about 0.8 percentage point. So, at the end of June 2010, the unemployment rate would have been 8.7 percent (compared with 9.5 percent if no UI program had been in place).

Another analysis looks at the broad economic effects of unemployment insurance. Federal Reserve Bank of Philadelphia senior economist Shigeru Fujita contends that the

positive relationship between the level of benefits and the duration of unemployment is socially desirable. The benefits can improve unemployed people's well-being, he says, by helping them avoid large drops in consumption in the face of job losses.

Since UI benefits increase the amount of cash the unemployed have, their consumption is supported, Fujita says, which improves the economy's welfare. And when these workers continue to receive benefits, the pressure to accept a low-paying job is reduced. While this pattern initially seems counterproductive, it also may serve as motivation for creating higher-paying jobs in order to attract workers—another boost to the economy.

Moreover, UI cannot explain the doubling of the unemployment rate during the recession, even when an estimate of UI's effect is on the high end. "I do believe that the effect on the unemployment rate is not more than 1 percentage point, probably less," says Murat Tasci, an economist at the Federal Reserve Bank of Cleveland who specializes in business cycles and labor markets. "My conclusion is based on my observation that, for most of the

period when extended unemployment insurance was in effect, job openings in the U.S. economy were at very depressed levels." In other words, the unemployed couldn't have gone off the rolls if they had wanted to—there was no work for them.

It's logical that it would take some time for the unemployment rate to come down after a large shock like the one our nation recently experienced. Tasci's view is in keeping with that of many other economists: that a large part of the unemployment rate increase results from the severe recession and the accompanying decline in output, not from extended benefits. ■

Recommended readings



Fujita, Shigeru. 2010. "Economic Effects of the Unemployment Insurance Benefit." Federal Reserve Bank of Philadelphia, *The Business Review* (Q4): 20–7.

Valletta, Rob, and Katherine Kuang. 2010a. "Extended Unemployment and UI Benefits." Federal Reserve Bank of San Francisco, *Economic Letter* 12 (April 19).

Valletta, Rob, and Katherine Kuang. 2010b. "Is Structural Unemployment on the Rise?" Federal Reserve Bank of San Francisco, *Economic Letter* 34 (November 8).

November 6, 2009 Tier II benefits extended to 14 weeks and no longer dependent on a state's unemployment rate; Tier III (providing up to 13 more weeks to those in states with an average unemployment rate of 6 percent or higher) and Tier IV (providing up to an additional six weeks if the state unemployment rate is at least 8.5 percent) introduced.

December 6, 2010 Federal unemployment benefits extended and will remain in effect through the end of 2011 for workers who have been laid off for more than 26 and less than 99 weeks.

December 19, 2009 Expiration date extended to February 28, 2010.

April 15, 2010 Expiration date extended to June 2, 2010.

March 2, 2010 Expiration date extended to April 5, 2010.

July 22, 2010 Expiration date extended to November 30, 2010.