INSIDE:
How the Recession May Change America

Unemployment and the Great Recession

Interview with Economic Historian Price Fishback
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More than two years after it officially ended, the Great Recession still casts a long shadow. Although the economy has been growing, the pace of the recovery has been painfully slow, and reaching a full recovery is going to take far longer than most people had expected. The country is just now returning to the output levels we reached before the recession began in late 2007—and that has not been enough growth to put Americans back to work at the levels we desire. Many of us have family members or friends who are still contending with the impact of a job loss or a financial hardship. However, despite this discouraging pace, I firmly believe that eventually we will make a full economic recovery. American businesses and their employees have a long track record of adapting to meet the evolving needs of the economy.

Against that backdrop, a question that we at the Federal Reserve Bank of Cleveland have been thinking about is whether this experience has changed us—and what it might mean for the country going forward. More specifically, we are wondering whether this recession will induce any long-lasting adjustments in economic behavior, such as the spending, saving, and work decisions for an entire generation of people. Most people alive today have no memory of the Great Depression, and the latest recession has no recent comparison.

Mainstream media has already dubbed those Americans who are living through the Great Recession as “Generation Recession.” In this special issue of Forefront, we examine the most critical trends that—if enduring—will have great significance to that generation and to our economy going forward. For example, people have been spending less and saving more: How long will that dynamic persist, and will it hinder the recovery or help long-term growth? Participation in the labor force is shrinking: How many people over the age of 50 who lose a job will decide it is futile to search for new work, and if so, what further strain will those decisions put on our nation’s already fragile social safety net? Newly minted college graduates can’t find work matching their training: Will that alter how people view the value of a college education, to the detriment of the long-run path of skill building and innovation in this country?

It is too soon to make the call on whether the behaviors currently being exhibited will be a lasting fixture of the American economy, but in culling out the critical issues, we hope to better evaluate the economic implications.

A useful perspective on these issues comes from economic historian Price Fishback, whom we interviewed for this issue of Forefront. As a scholar of the Great Depression, Fishback reminds us that America has been through much worse than the recent recession and bounced back considerably stronger than before.

As an economic policymaker, I can assure you that the Federal Reserve will do all it can to move us past the Great Recession once and for all. Most recently, we have indicated that economic conditions are likely to warrant keeping the federal funds rate—our short-term policy interest rate—low until at least mid-2013. We have also announced plans to alter the composition of our asset holdings to put even more downward pressure on longer-term interest rates. Low interest rates can help persuade businesses to invest and consumers to spend. In turn, those activities should lead firms to pick up the pace of their hiring. It is my strong belief that these and accompanying policy efforts are playing an important role in promoting a full economic recovery, in a context of price stability.

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Toward Mobile Payments

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Pop quiz: Where are consumers more likely to use their smartphones for making payments at the checkout aisle—the United States or Kenya?

Surprise! It’s Kenya, but that may change as U.S. financial services providers catch up with the rest of the world.

The concept of mobile payments is new enough to require some explanation. First, there’s a difference between mobile payments and mobile banking.

Mobile banking services allow you to do things like monitor account balances, transfer funds, and receive alerts—pretty much anything you can do with a web browser from your computer. Mobile payments, on the other hand, let your smartphone double as a debit or credit card.

Although they still sound like the stuff of science fiction to many Americans, mobile payments may be commonplace sooner than most people think. Just as ATMs took off and paper checks all but vanished, mobile payments could spread like wildfire. It’s partly a matter of getting the infrastructure and operating agreements in place. For its part, the Federal Reserve is working to ensure that when mobile payments do arrive en masse, they will operate in an environment as safe and secure as other payment channels.

Just two years ago, the Federal Reserve—led by the Atlanta and Boston Reserve Banks—convened a working group to share knowledge about mobile payments and banking developments in the United States. The idea was to organize a meeting of industry stakeholders in the emerging mobile financial services industry and discuss some of the barriers to U.S. adoption of the mobile channel.

Clearly, U.S. mobile banking services were gaining traction. Banks large and small quickly recognized the need to add value and convenience to their products and compete with banks already offering mobile services.

But U.S. mobile payments services weren’t yet catching on. For example, one form, the mobile proximity payment, remains a rare transaction in the U.S. It enables you to use a mobile handset at the merchant’s point-of-sale terminal to purchase goods and services. In effect, the mobile phone substitutes for swiping a credit or debit card through the card slot on the terminal. The buyer simply waves the phone in front of a device at the pay station. Once the payment information from the phone enters the device, it rides the same payment rails as a debit or credit card.

A few developing countries have been the real hotbed of mobile payments. In those nations where people tend to rely on basic mechanisms of exchange, such as cash, mobile telephony has enabled consumers to leapfrog a generation of payment instruments like checks and credit cards. They use their mobile phones as a substitute for
bank branches and ATMs, which don’t exist in most rural areas. By doing so, they achieve a more secure, accessible banking and payments environment than was possible before. Kenya and South Africa are among the countries where mobile payments are drawing previously unbanked people into the modern banking system.

But why not here in America? We already have advanced payments systems, which are safe and secure and complicate the business case for mobile payments. Moreover, so many players are involved here that coordination is difficult. That’s not true in many emerging countries, where a single telecom provider may serve the entire nation, and there may be only a handful of banks.

A Change in the Landscape
Still, a number of new payment service rollouts and trials are emerging in the United States. Telecom carriers, banks, and technology service providers are partnering in new ventures to offer mobile wallet applications by Google, PayPal, and Isis. On the person-to-person payments front—in which parents, for example, can pay babysitters through their mobile phones—three of the nation’s largest banks have announced a payment transfer service that will enable customers to move money from their checking accounts by using either an email address or a phone number.

In August, Visa announced its intention to encourage chip technology for credit card payments. That means cards will be equipped with microchips that can be read by point-of-sale devices, replacing the magnetic stripe technology now used by most merchants. The next generation of point-of-sale devices will accommodate chip-embedded cards as well as mobile phone payments.

So where does the Federal Reserve fit in? Broadly speaking, the Fed’s role is to help ensure that the U.S. mobile payments system is safe and secure. With consumers adopting mobile payments, the Fed has an interest in keeping the system as efficient and orderly as before while providing access to as many users as possible.

What Next?
Ubiquitous mobile payments are not only possible but almost inevitable. As the landscape changes, the industry is moving to create a secure, interoperable, and universal channel for mobile payments. Many questions remain as handset and chip manufacturers, telecom companies, card networks, financial institutions, and software providers all try to get a foothold in mobile payments. Some of the questions are smaller—how will consumers know who to call when they encounter a problem? Some are larger—how exactly will the different players come together to smoothly handle mobile payments through electronic channels? The Federal Reserve’s Mobile Payments Industry Workgroup continues to sort through challenges like these.

Although mobile banking services are widely offered by the largest financial institutions in the United States, the percent offering mobile payments services remains low. Sources: Javelin Strategy and Research; Federal Reserve Bank of Boston.
Many people commonly use the term “Great Recession” to describe the 18-month downturn that ended two years ago, as if it is somehow equivalent to the Great Depression era. In fact, the Great Depression consisted of two separate recessions, punctuated by an expansion from 1934 to 1936. The cumulative loss of output during the decade between 1929 and 1939 was on the order of 20 percent, a far cry from anything we have experienced since.

The recession officially dated from December 2007 to June 2009 was neither as long nor as steep as the recession of 1929–33, let alone the entire Great Depression. Nevertheless, the analogy between the Great Depression and current experience continues to resonate. Perhaps it is because the severity of unemployment already surpasses any episode our country has experienced since the Great Depression. Or perhaps it is because the collapse of housing prices and the magnitude of home foreclosures exceed all records since the Great Depression. Or perhaps it is because nothing else has shaken the public’s confidence in the economy since the Great Depression.
There are many differences between today’s economy and that of the 1930s, some of which are the direct legacy of that tragedy. We have a much stronger social safety net in place now than when the Great Depression started. And today’s economic policymakers responded quickly and forcefully to counteract the recent downturn.

Yet, the evolution of the Great Depression should serve as a grim reminder that much remains unknown about the ultimate footprint that the Great Recession will have on the nation. At this point, we simply don’t know what choices people will make in response. Among the many aspects of economic life that could be affected are labor force participation, housing choices, personal saving, the financial system, the scale of government, and monetary policy. What we do know is that these choices are important to monitor. How they develop could determine just how “great” this most recent recession really turns out to be.

The Variables
Labor force participation has declined considerably since the onset of the financial crisis, led by 25- to 54-year-olds. Clearly, many have become discouraged about their ability to find an acceptable job. Many of those who remain in the labor force but are unemployed have had to contend with extremely long spells of joblessness or underemployment.

During the Great Depression, many breadwinners suffered several years of unemployment, and families endured considerable hardships. In response, many states and the federal government expanded their social safety nets: Unemployment insurance, social security, and aid to families with children received increased public support and funding. The federal government directly created jobs through several large-scale programs such as the Works Progress Administration. Labor union membership grew steadily for decades.

From a personal perspective, how will the Great Recession shape our perspective of what constitutes “a good job”? What strategies will individuals adopt to better prepare themselves for the unpredictability of working life? From society’s perspective, what happens to the skills of those who endure the hardship of long-term unemployment or underemployment—are there cost-effective ways to reduce the deterioration in knowledge and skills that could result? What strategies could be adopted to smooth the transition back into productive work and to reduce dependence on the social safety net?

It goes without saying that the housing market was the epicenter of the financial crisis, and its malfunctioning remains one of the key obstacles to a sustainable recovery. During the Great Depression, depressed housing values and “underwater” homeowners were also barriers. One significant difference between then and now is that our modern financial system turned ordinary home mortgages into highly complex and securitized financial instruments, making it much more difficult to coordinate a solution with all of the affected parties. Add to that the poor underwriting standards underlying some of these mortgages, and it is easy to see why it has been a challenge to “put Humpty Dumpty together again.”
The housing market suffers from a lack of confidence on the parts of sellers, buyers, and lenders as to the “true value” of properties. Lenders have retreated from their very expansive view of what constitutes a “creditworthy borrower” and are rethinking how to price for the risk of a loan. Many foreclosed homeowners have been forced into becoming renters, and many potential homeowners are becoming renters either by choice or by necessity.

From a personal perspective, how will the Great Recession affect the way in which people view a home as the “best investment they can make?” What other vehicles might rise to take the place of housing as an important household asset? From society’s perspective, should we continue to provide an allowance for home mortgage interest expenses in the tax code? Should we continue to support the owner-occupied mortgage market through government-sponsored enterprises? How might a permanent rise in demand for rental housing affect the development of neighborhoods and communities? What are the implications for the construction, real estate, and home-furnishing industries?

Saving and financial literacy in a post-recession world also deserve consideration. Although there is plenty of blame to go around, one of the contributing factors to the housing boom was the willingness of people to live beyond their means. Too many households saved too little, and they often borrowed against their homes to finance current consumption. Many American consumers did not understand the financial products they were dealing with, either as mortgage borrowers or as investors.

What does it mean to be financially literate? From a personal perspective, will the financial crisis convince people to save more? How many people will develop the habit of “paying themselves first” before spending the rest of their paychecks? Will people become more careful in their use of financial products, and more demanding of the financial institutions with which they do business? From society’s perspective, how much caveat emptor will we expect, and how much caveat venditor will we demand? The mortgage foreclosure crisis provides a powerful example of how society at large can benefit from better individual financial decision-making.

For example, research at our Bank and by others shows that foreclosed homes depress the prices of neighboring homes that are not in foreclosure. We can gain a lot by finding more effective ways to educate people in their use of financial products, to incent saving, and to engage in even rudimentary financial planning.

Government policy also bears scrutiny. Let’s start with fiscal policy. Deciding to put the federal budget on a sustainable path is not the same thing as deciding on the scale and scope of government. Arithmetically, there are many ways to make spending and taxes add up to the same number. Should we approach budget balance through more tax revenue, or through less spending? Which taxes and which spending? And don’t forget regulatory policies, which can also significantly affect resource allocation decisions made in the private sector.

One significant difference between the Great Depression and now is that our modern financial system turned ordinary home mortgages into highly complex and securitized financial instruments.
The size and scope of the federal government expanded considerably during and after the Great Depression. Although many economic historians have come to view this expansion as broadly supportive of both longer-term economic growth and stability, most economists recognize that there are limits to that process. The question is, have we reached or crossed that limit, or do we need to rely on the federal government once again for stability and growth? The debate rages on in our current political discourse.

Another debate is under way about the role and conduct of monetary policy. The Federal Reserve (along with the central banks of several other countries) has taken many unusual steps to supply liquidity to financial markets, facilitate credit availability, and spur economic growth. These unusual steps have greatly increased the amount, nature, and maturity structure of the Federal Reserve’s assets, and they have also led to innovations in direct lending programs to financial institutions. Both the Federal Reserve’s ability to respond to the financial crisis in unusual ways, and its choice to do so, have been profoundly affected by the Great Depression. Consequently, there is an irony — one that parallels the questioning of expansionary fiscal policy — to the discord that has arisen over the use of the unusual policy tools.

Both the Federal Reserve’s ability to respond to the financial crisis in unusual ways, and its choice to do so, have been profoundly affected by the Great Depression.

Uncertain Future
During the Great Depression, people did not know it was the Great Depression. The Great Depression evolved and was characterized by episodes of expansion and subsequent relapse. How today’s economy progresses from this point is unclear. Confidence is low, and it’s susceptible to bouts of self-perpetuation. At the same time, we have the benefit of knowing that as a nation we not only recovered from a somewhat similar painful period, we prospered.

What seems increasingly clear is that we are living through a historically fascinating period. The generation of people who are coping with economic problems today may well change the ways in which they think, and those changes may well change our economy. That could be something to worry about. But then again, it could also be something to look forward to.

More on financial literacy
Check out the Cleveland Fed’s Learning Center for resources on financial education at www.clevelandfed.org/learning_center
Survey Says:
Consumer Attitudes May Hold the Key to a Sustained Recovery

By almost any measure, American families are worse off today than they were before the recession. And they know it.

Back in the golden days of 2006, many U.S. households—43 percent—said they were better off than the year before, and 31 percent said they were worse off.

By 2010, a year after the Great Recession’s official end, those sentiments were flipped: Just 25 percent said they felt better off and 41 percent said worse.
These figures come from the Ohio State University’s (OSU) Consumer Finance Monthly survey. A team of surveyors, sponsored by the school’s Center for Human Resource Research, collects thousands of observations each year using a nationally representative sample. The results provide one of the best sources of information available on Americans’ attitudes about their financial situations.

Those attitudes are particularly relevant right now. If this really was a “balance sheet recession,” as many have called it, then recovering from it will first and foremost require time, as consumers pay off their debts and build up their savings. But it may also require a shift in attitudes before consumer demand, not to mention expectations of future income growth, rebounds.

That’s because spending behaviors are likely to depend on how quickly households can rebuild their balance sheets and then feel confident about their future income prospects. Households that describe themselves as worse off financially are more likely to need some time before stepping up their spending.

We know that U.S. families in general experienced pretty rough times during the recession, and even after. Some people saw the values of their homes plummet. Some lost their jobs. Others lost wealth in the stock market. A look at the OSU survey data helps put into perspective the pervasiveness of household discontent, shedding light on which groups suffered the most and which made it through relatively unscathed.

In summary, the survey tells us that household sentiments are tracking pretty closely with other economic data. For example, the decline in household attitudes recorded by the OSU survey seems to correlate strongly with the increase in the unemployment rate during the same period. That rate was 4.4 percent at the end of 2006; by the end of 2010, it was 9.4 percent.

These sentiments also help explain some of that same economic data, because depressed economic sentiments translate into depressed economic behavior.

Let’s take a closer look at our question—how are households doing compared with a year earlier—with a little more precision. Does the malaise extend to all households or just to some of them?

### Would you say that you and your family are better or worse off financially than you were a year ago?

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Sources: Center for Human Resource Research at the Ohio State University; Federal Reserve Bank of Cleveland.
In 2010, Americans across different income categories generally expressed more pessimism about their situations than they did before the recession.

First consider the attitudes of those with very low incomes:

The percentage of those feeling better off fell by 5 percentage points; the percentage of those feeling worse off stayed about the same. For perspective, almost 20 percent of U.S. households have incomes of less than $20,000. So the 45 percent who were feeling worse off in 2010 represents about 8.5 percent of the total U.S. population—about one in 12 families.

The shift is even more evident among those with higher incomes:

The portion of those with incomes higher than $60,000 (representing about 40 percent of the U.S. population) feeling better off fell by almost half, and the fraction of those feeling worse off increased by a third.

What this may be telling us is the relatively wealthy felt their losses more keenly than the less wealthy. People in the higher-income categories were more likely to be homeowners and felt the plummet in property values more acutely. Or it may be saying that people with low-to-moderate incomes have it tough all around—the recession hurt, but did not markedly change their already bleak outlook. Overall, the impact on household outlook would certainly be enough to blunt spending, which in turn serves as a damper to the recovery.
The attitudes of the top 20 percent of the income distribution (those earning more than $100,000 a year) show that the pain of the recession was widespread. The fraction of top earners who said they were better off in 2010 fell by 24 percentage points compared with 2006, and the portion of those who said they were worse off grew by 9 percentage points. While those were dramatic changes, it’s worth noting that they still leave the highest-earning households feeling better than their lower-earning counterparts who make less than $20,000 a year.

Sources: Center for Human Resource Research at the Ohio State University; Federal Reserve Bank of Cleveland.
Finally, we can break down household outlook by age group:

The most pronounced shifts are clearest among younger households—those who probably didn’t have much in the way of assets to begin with, but might have been given expanded access to credit during the prior few years.

Younger people have really lowered their sights: The percentage of those feeling better off is almost a third lower than it was before the recession, and the ranks of “worse off” are up almost 50 percent. What’s really remarkable here is how many 18- to 34-year-olds used to be full of youthful optimism; the recession really took the wind out of their sails.

Job prospects continue to be dim for this cohort, college education or not (though it’s certainly better to have a college degree). The consequences of debt buildup might now be more evident.

The middle-aged, meanwhile, weren’t as optimistic as young Americans to begin with. But by 2010, their pessimism actually exceeded the younger group’s.

Those older than 60 didn’t alter their assessments quite as much as their younger cohorts, though more did say they were worse off and fewer said they were better. Given that the stock market had mostly rebounded by the end of 2010, retirees as a group probably were feeling about the same as they did before the recession.
By the end of 2010, the recession had already been officially over for 18 months. After any other recession, you would’ve expected that to be reflected in surveys like OSU’s Consumer Finance Monthly. But maybe the surveys tell us everything we need to know: This was no ordinary recession.

Related Link
For more on the Ohio State University’s Consumer Finance Monthly survey, visit www.chrr.ohio-state.edu/content/surveys/cfm/cfm.html

Presentation
Watch a presentation based on the survey at www.clevelandfed.org/forefront/surveysays
If unemployment is the single most important indicator of the job market’s health, the patient is unquestionably sick. According to the most recent data from the Bureau of Economic Analysis, total economic activity contracted by 5.1 percent during the recession; as a result, unemployment jumped from 5 percent in December 2007 to 10.1 percent by October 2009. Since then, unemployment has stabilized at around 9 percent, still an uncomfortably high rate.

Typically, the unemployment rate increases whenever the overall economy undergoes a recession. The rate peaks about 15 months after the recession begins, or four months after it ends, then drops gradually as the economy recovers (see the first figure on page 15). Our current experience has been unusual on two counts. First, unemployment has risen much more than in other recent recessions; second, the unemployment rate has remained high for an exceptionally long time.

So the main labor market-related questions facing Generation Recession are these: Is high unemployment here to stay? If so, what does it mean for the millions of Americans who are out of work—not to mention the rest of American society?
Why Unemployment Is Still High

Our work at the Federal Reserve Bank of Cleveland shows that most of the increases in the unemployment rate results from cyclical factors; that is, factors that ordinarily would have only a temporary effect and should gradually fade as the economy recovers. That’s the good news.

The bad news is that we also have found at least two reasons why the unemployment rate could stay high for some time: the weakness of the recovery in real economic output and the slow rate at which workers find new jobs. To understand these reasons, we need to take a closer look at how workers move into—and out of—unemployment.

The unemployment rate reports the number of jobless workers as a fraction of the labor force. But in any given month, some employed workers lose their jobs and some unemployed workers find new ones; in this way, they flow into and out of the unemployment pool. Thus, the overall number provides scant information about the actual extent of churning in the labor market. Worker flows largely determine the unemployment rate, but the rate says nothing about them.

Typically, the start of a recession is marked by an increase in layoffs and a decrease in hiring. As the economy begins to recover, layoffs usually stabilize just before the unemployment rate peaks. Most of the subsequent rise in unemployment results not from layoffs but from a low hiring rate.

In some ways, the recent recession was no exception; toward its end, layoffs stabilized. However, even two years into the recovery, unemployed Americans still have trouble finding work. To better understand when we might expect this situation to improve, my colleague Saeed Zaman and I developed a new measurement of the long-run unemployment rate that incorporates worker flows into the analysis. This helps us distinguish between two potentially different reasons for a high unemployment rate: long periods of unemployment for laid-off workers and the very high number of layoffs overall. Underlying trends in these flow rates determine where the unemployment rate will settle in the long run.

When measured in this new way, the unemployment rate trend—commonly called the “natural rate”—has been relatively stable in the last decade, even after the most recent recession. This natural rate has hovered around 6 percent for a few decades, and there it remains (see the second figure above).

How could the trend have changed so little when unemployment was so high? There are two reasons behind this outcome: First, the recent recession was a terrible recession, in terms of both duration and depth.
Second, the two flow-rate trends have both been declining; the job-finding rate started to decline over the past decade, and separations have been declining since the 1980s. Whatever impact these trends would have had on the natural rate, therefore, have been offset. What emerges is a portrait of a job market where workers change employment status much less frequently than before.

This is not a welcome development. In theory, the more labor market churning there is within an economy, the faster unemployment returns to its natural rate. Intuitively, we would expect that as more unemployed workers start finding jobs, unemployment would decline more quickly toward that rate.

Our model generates an unambiguous conclusion: The low rate at which unemployed workers are finding jobs predicts a slower decline in the unemployment rate. In other words, it will take a long time, longer than it normally did, for unemployment to move back to around 6 percent.

Whether the labor market situation becomes better or worse depends primarily on the growth rate in the aggregate economy. Our research provides a stark example of this potentially important factor. For instance, if real GDP growth had been 4.9 percent annually during the first two years of the recovery (as was the case after the 1982 recession), the unemployment rate would have come down to around 7 percent by now. Instead, growth was only 2.5 percent annually, leaving unemployment around 9 percent.

Long-run unemployment trends are important for understanding an economy’s productive potential. The longer we exceed the natural rate, the longer we waste our resources—in this case, human capital. For instance, almost half of the unemployed remain jobless for 27 weeks or longer; their odds of finding a job become further reduced as their skills decline and they lose professional contacts.

Potentially, a large pool of long-term unemployed might start losing their skills to the point of being a bad match for new jobs when the economy finally starts to recover robustly. This is one particular danger the Great Recession poses for the U.S. labor markets.

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**Recommended reading**

The Labor Force: To Work or Not to Work

Daniel Hartley
Research Economist

When we talk about the U.S. labor force, it’s important to know exactly what the term means. From a statistician’s standpoint, any civilian over the age of 16 who does not live in an institution can be counted as part of the labor force population. Of course, not everybody who can participate does. Some parents might decide to stay at home to raise children. Some 20-somethings might decide to enroll in graduate school. Here is a simple calculation:

\[
\text{Labor force participation rate} = \frac{\text{Labor force population} - \text{Nonparticipants}}{\text{Labor force population}}
\]

Since the last recession began in December 2007, the participation rate has fallen about 2 percentage points. Interestingly, more than three-quarters of that drop has occurred since the recession officially ended in June 2009. In fact, an alternative measure of unemployment is as high as 16 percent right now when accounting for discouraged and marginally attached workers, plus those working part-time for economic reasons.

Will participation eventually recover, or did the recession permanently lower the fraction of Americans who will try to find work? We don’t know yet, but the importance of the answer underlines the reason economists pay attention to the labor force participation rate.

If capital and technology are held constant, an economy with fewer workers will generally produce less. However, capital and technology are not constant; they change over time. Furthermore, large numbers of people who do not participate in the labor force engage in other productive activities such as raising children, pursuing education, or taking time for leisure such as retirement.

Percentage of labor force population

Note: Shaded bars indicate periods of recession.


Percentage of labor force population by age

Note: Shaded bars indicate periods of recession.

So how should we think about nonparticipants in the labor force? Economists seeking a useful barometer of economic well-being tend to focus on the people who would like to work but have given up looking. These “discouraged workers” are defined by the Bureau of Labor Statistics as those “not currently looking for work specifically because they believed no jobs were available for them or there were none for which they would qualify.” The fraction of the labor force composed of self-defined discouraged workers has risen from about 0.2 percent at the beginning of 2008 to about 0.45 percent now.

They account for about an eighth of the overall drop of 2 percentage points in the labor force participation rate—significant, to be sure, but not enough to fully explain the drop.

Structural Changes

In the longer view, the history of labor force participation may tell us something about the path ahead. One of the most striking long-run changes in the workforce has been the dramatic increase in the number of women who work for pay outside the home. Women’s share of the labor force moved from just above 40 percent in 1970 to a bit below 60 percent in 1990. In fact, it was largely because of women that the overall labor force participation rate climbed to historically high rates until about 2000. Since then, however, both men and women have been leaving the labor force with greater frequency.

As the bottom figure on the left shows, labor force participation paths for different age groups have diverged in recent years. Since 2000, the participation rate for people ages 16 to 24 has fallen from 66 percent to about 55 percent. One explanation for this large drop is that more young people are enrolled in school: Between 2000 and 2005, the fraction of 16- to 24-year-olds pursuing an education grew from 53 percent to 57 percent. Observers are not sure whether this increase is a cause or an effect of the lower labor force participation rate. But over the long term, increased enrollment of young people could produce a more highly skilled workforce, which would boost future economic growth.

We have also seen a drop in labor force participation among the prime-age population (ages 25 to 54), from about 84 percent in mid-2000 to about 82 percent in mid-2011. About half of that decline has occurred since mid-2007. One contributing factor may be the relaxation of eligibility criteria for disability benefits: The net number of people added to the disability rolls from 2007 through 2010 averaged about 350,000 per year. This could account for a drop of about 0.5 percentage point in the labor force participation rate from 2007 through 2010 — again, a significant amount, but not enough to explain the entire decline.

While the young and middle-aged have been hopping out of the labor pool, older Americans have been hopping in. The participation rate of people 55 and up has been increasing since the mid-1990s (although it has pretty much flattened out since 2007). Some attribute this change to seniors’ improving health, which allows them to continue working later into life. Others maintain that the financial crisis may have adversely affected retirement accounts, causing older workers to delay retirement in order to rebuild their savings.

Older workers’ increased participation has not been enough to offset the falling participation rate of younger workers. Although the U.S. population is aging on average, the young and prime-age populations still make up almost 70 percent of civilians over 16.

### A Scarring Effect?

No matter how we try to explain the longer-run structural trends, a key question remains: Will the labor force participation rate return to its pre-recession path? Or will the recession and slow economic recovery leave a lasting scar on participation?

It’s conceivable that workers who are discouraged now will find jobs when times are better. Or finding jobs could remain hard for them for a long time because their skills have deteriorated.

Whether economic policy can make a difference depends on the diagnosis of the problem. The Congressional Budget Office estimates that in the long run, the expiration of the Bush-era tax cuts would cause a drop of almost a full percentage point in the labor force participation rate, but it is unclear how much this would affect discouraged workers. If the currently high level of discouraged workers results simply from low aggregate demand, then there is a role for monetary policy; however, if workers are leaving the labor force because their skills don’t meet employers’ long-run needs, then the appropriate policy response could be to provide education or re-training opportunities.

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### Americans Skeptical about Finding Good Jobs

The recent rise in the number of “discouraged workers” in the country is reflected in public surveys about the employment situation.

A July 2011 Gallup survey included a question about the current job market: Thinking about the job situation in America today, would you say that it is now a good time or bad time to find a quality job?

![Graph showing percentage of Americans thinking it's a good time vs. bad time to find a job from 2002 to 2011.](source: Gallup)

Nine out of 10 respondents said that now is a bad time to look for work.

It is important to monitor the number of discouraged workers among us. As a society that prides itself on providing economic opportunity, we may have to ask ourselves how we would deal with a large, stable population of people who want to work but have given up hope of finding a job.

Bottom line: If you want to know whether the economy is getting better, a good place to start is the number of discouraged workers. When it starts going down, the economy should really be moving up.

— Doug Campbell, Editor

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**Recommended reading**

Once upon a time, Americans saved more than 10 percent of their incomes. Then the saving rate went south — fast. By 2005, it had dipped to nearly zero. Borrowing followed the opposite path: Total U.S. consumer credit outstanding clocked in at around $60 billion in 1960, jumped to $400 billion by 1980, then soared beyond $2.5 trillion by the early 2000s.¹

Now, in the wake of the recession, the saving rate has ticked up again to around 5 percent. Debt levels, by contrast, have edged lower. The question of whether this is the “new normal” has large implications for the economy.

According to what’s known as the Solow economic growth model — and depending on the saving rates of other economic sectors, such as business — just bumping the personal saving rate from 5 percent to 6 percent could increase income levels by 2 to 3 percent in the long run. “A difference in the saving rate of one or two percentage points is very important,” says Filippo Occhino, a senior research economist with the Federal Reserve Bank of Cleveland.

But the recession was so deep, and climbing out of it is taking so long, that there are more questions than answers about where Americans’ saving behaviors will go from here. The variables abound.

People don’t save because it’s fun; they do it to ensure their ability to consume later. At root, the amount that people save or borrow is nothing more than a manifestation of countless other factors: Do they feel wealthy or poor? How confident are they about their future income? How sanguine about the economy?

An example: During this season of debt-ceiling discontent, Americans may be quite skeptical about government’s ability to provide safety nets in the future. Social Security,
Medicare, unemployment insurance—the viability of each has been cast into serious doubt. This factor—how people view government—may impel them to sock away more than they otherwise would have.

So if people mistrust the government safety net, our saving rate could rise. Great, right? Yes, though in the short run, when people save more and borrow less, they consume less, which theoretically shrinks aggregate demand and slows growth. That’s one of the paradoxes of the recession’s aftermath. People’s balance sheet decisions seem to work at cross-purposes with the recovery.

The Fundamentals of Saving and Borrowing
But beyond the short run, high saving rates tend to promote growth and improve standards of living. Savings usually get turned into investments—not so much in stocks and bonds, but in durables like factories and equipment. Higher investment levels lead to higher productivity levels (think computers). Standard economic models will tell you that higher productivity means higher incomes. In the medium term (between five and 20 years), higher saving rates encourage investment and growth. Over the longer term, they boost productivity and per capita income.

How much Generation Recession will save or borrow going forward boils down to the basics of consumer finance. Fundamentally, individuals save so they can consume more in the future, such as in retirement.

Likewise, they may go into debt early in their careers in anticipation of higher future wealth. In each case, the amount depends on a wide range of factors, touching on everything from government policy to personal preferences to demographics.

Occhino zeroes in on several factors that are most closely tied to saving rates:

**Expected income growth** is important; a medical school graduate may save less early on, knowing that he will be earning more in the future. For him, taking on some debt is a useful and rational way to smooth consumption.

Recession Adds to Debt Stress
Americans—especially those under 60—have amped up their stress levels about debt since the recession began.

The Ohio State University’s *Consumer Finance Monthly* survey neatly encapsulates the nation’s rising anxiety over debt.

For starters, the fraction of young people who believed debt was “no problem” shrank by 8 percentage points between 2006 and 2010. Meanwhile, the combined percentage of those who felt debt was some sort of problem rose 8 percentage points.

That trend was similar among middle-aged households, whose debt stress (those who said debt was a small, medium, large, or extreme problem) grew by 6 percentage points.
Wealth is essential; when people have less of it, they are likely to build it up by saving more. Of course, lack of wealth can also constrain borrowing. Alternatively, if people feel richer, they are liable to save less. As home values rise, for example, people see their newfound paper wealth as a substitute for savings. And when people pull money out of their homes instead of the bank, it drives down the saving rate.

Also important is uncertainty. In volatile economic times, it’s natural for people to set aside money against the possibility of job loss, medical emergencies, and so forth.

To these evergreen drivers of saving rates, two more must be added to explain what happened in the United States starting in the late 1990s. The first is what Federal Reserve Chairman Ben Bernanke termed the global “savings glut.” Foreign countries, especially China, amassed large amounts of U.S. Treasury bills. Part of the effect was downward pressure on U.S. interest rates, which discouraged saving by lowering its payoff.

Yet investment was actually encouraged, because investors could borrow at low rates to finance their projects. Thus, traditional saving went down but credit went up. All the houses that were sold during this period—which buyers confused with saving because they were confident that they could sell their homes at a profit come retirement—are a case in point (though regulatory gaps certainly played a role as well). One might argue that the construction boom proved that investment is not always good for the economy, since overbuilding contributed to the housing bubble. Investment is good—until it isn’t.

A final factor, which is particularly relevant to any discussion about the cause of the financial crisis, is credit availability. Not coincidentally, the U.S. personal saving rate began to decline in 1980, just as consumer credit took off. With new information technology and innovation, financial institutions developed programs that expanded the amount of credit available to wider swaths of people. The evidence strongly suggests that credit availability leading up to 2007 had become exceptionally easy.

What her research may suggest is that the reduction in overall debt levels hasn’t been driven from the supply side—that is, from creditors burned by reckless lending habits leading up to the financial crisis. The real driver appears to be a pulling back from the demand side, or in other words, from the increasingly debt-averse American consumer. Of course, what we don’t know is whether this change in behavior is temporary or generational.

One piece of early evidence that sheds light on Americans’ reduced appetite for taking on debt comes from an analysis of recent figures from Equifax, one of the three main consumer credit reporting agencies. The Cleveland Fed’s Yuliya Demyanyk, a senior research economist, has pored over millions of credit bureau files.
Both high-and low-quality borrowers have consolidated debt and shrunk their numbers of credit cards. Since the end of the recession, the average consumer has closed one credit card account.

Notes: Primary borrowers only, excludes bankruptcies; score is Equifax Risk Score; both consumers and lenders have contributed to the decline in open bankcard accounts, but the simultaneous decline in credit inquiries suggests that it’s consumers who have driven it.

Sources: Equifax; New York Consumer Credit Panel.

Apart from technology, credit may have been expanded for basically bad reasons. Banks didn’t maintain solid underwriting standards. Some products grew so complicated that it became difficult to judge their risk.

These exceptional factors — the savings glut and slipshod lending that led to things like the housing bubble — help explain why saving rates plunged in the 2000s. It is not surprising that since the financial crisis, saving rates have risen again: Creditors have tightened lending standards and shored up their risk management practices, and households have been rebuilding their balance sheets.

Adding up these factors, it’s unlikely that we will soon see the 10 percent saving rates that prevailed decades ago. That’s largely because the technology that widened credit availability in the first place still exists and, indeed, is getting smarter. With more credit permanently accessible, savings may be naturally lower.

Perhaps the saving rate is stabilizing around 5 percent. It’s difficult to know whether this is a good number, but it is probably reasonable to say that the rate is currently driven by sounder fundamentals than before. For example, credit card borrowing is moving lower as consumers tighten their belts. Yet nonrevolving credit, for items like student loans and cars, is holding firm. This suggests that consumers have shifted away from using debt to finance consumption in nondurables and services and are now investing in education and longer-lived consumption goods — a positive trend.

A fairy tale ending? We simply don’t know yet. While it’s categorically true that a zero percent saving rate is unsustainable, an occasional dip is not necessarily cause for alarm. It may just mean that people are more certain about their future prospects, or that they believe government backstops won’t go away. In the end, Americans will save or borrow at levels that depend on outside events. And those events may only be at the first stages of shaking out.

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Recommended reading


Wealth Building for Low-Income Families

Saving is important for all households, but especially for those with low incomes.

In fact, if low-income families can find a way to keep consumption steady during economic downswings, the benefits can be significant. One study found that low-income families with $500 in emergency savings had better financial outcomes than moderate-income families with lower savings. Households that are "liquid-asset poor" are twice as likely to experience material hardship after a job loss, health emergency, or other adverse event.

The personal saving rate—which now stands around 5 percent—provides a broad picture of Americans’ saving habits. What it doesn’t do is highlight the significant differences in saving rates among people with different incomes. Those in the lowest income brackets consistently save smaller fractions of their earnings than high-income households, research shows. After the latest recession, low-income families are finding themselves in an even more perilous financial position than before.

In this time of stretched public resources, policymakers and financial institutions face new challenges in building safe, responsible credit products for people with low incomes. The Federal Reserve Bank of Cleveland and the University of North Carolina’s Assets Building Research Group co-hosted a conference on this very topic in late 2010. The conference brought together top policymakers, researchers, and community development specialists, including Ray Boshara, senior advisor with the St. Louis Fed.

The virtues of saving extend beyond straight-forward financial stability; they also encompass less tangible indicators of well-being.

This is not surprising—if you are wealthy, then you are more likely to feel comfortable about your financial situation than you would be if you were poor. In fact, this intuition is validated in the Ohio State University’s Consumer Finance Monthly survey.

The survey asks respondents how much better off they are, compared with a year earlier. When the results are broken down by average liquid assets per household (which includes savings, checking, and money market accounts), it’s clear that, in any given year, those who say they feel better off have considerably higher average assets than those of the respondents saying they feel "worse off.”

So while it’s intuitively clear, it has also been shown empirically that stress and a lack of savings go hand-in-hand. To improve the well-being of people on low incomes, addressing the saving problem would be a good first step.

Sources: Center for Human Resource Research at the Ohio State University; Federal Reserve Bank of Cleveland.
The Next Generation of Credit Products for People with Low Incomes

One of the keys challenges, Boshara says, will be to provide low-income people with saving tools that don’t shield them from broader market forces. In the wake of the financial crisis, the knee-jerk reaction might otherwise be to avoid looping low-income people into saving programs for fear that they would lose everything in the event of another crisis. According to Boshara, that’s precisely the wrong conclusion.

“If you’re not subject to the losses, then you don’t win from the gains, either,” he explains. “Before the crisis, we extended credit and homeownership opportunities to people who weren’t ready for them. The problem was not enough access to mainstream financial services. We can do wealth-building more responsibly for low-income people.”

As many as half of all Americans — most of them in the bottom half of the income distribution — do not save at all, largely because they lack access to saving instruments. Employers who pay low wages are less likely to offer 401(k) plans, for example, let alone direct deposit of wages into employees’ bank accounts. This disconnect between low-wage earners and the formal financial services industry forms a significant part of the problem.

The question is why people with low incomes don’t engage in formal saving plans. Is it because of their lack of interest — or the financial industry’s failure to provide targeted services?

“Industry folks say the demand isn’t there,” maintains David Newville, senior policy analyst with the Center for Financial Services Innovation. “There is sometimes not a lot of interest in delivering a new savings project” by the private industry.

Nonetheless, Newville says, a number of saving programs aimed at people with low incomes are being developed. Some of the more familiar ones are listed in the box above.

### Asset-building strategies


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<tr>
<th>Product/Provider</th>
<th>How It Works</th>
<th>Benefits</th>
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<tr>
<td>Individual development accounts (IDAs)</td>
<td>A nonprofit association sponsors a saver, who opens an IDA at a financial institution and participates in financial education classes. The sponsor matches every dollar the saver deposits in the IDA.</td>
<td>Research shows that IDAs help connect disadvantaged populations to mainstream financial services and have a positive effect on their saving.</td>
</tr>
<tr>
<td>Piggymojo</td>
<td>When tempted to buy something non-essential, the consumer texts or tweets piggymojo instead, which notifies the consumer’s partner about the money not spent.</td>
<td>Piggymojo provides a concrete way to save in the moment and reinforces the saver’s decisions with positive feedback.</td>
</tr>
<tr>
<td>AutoSave</td>
<td>Employers set up a channel for workers to deposit a portion of each paycheck directly into a dedicated, flexible savings account.</td>
<td>Because it is integrated with the regular paycheck, AutoSave removes inconvenient barriers to saving and makes the process seamless and habitual.</td>
</tr>
<tr>
<td>BankOn USA</td>
<td>Participating financial institutions charge low-income customers reduced or no fees to open accounts, waive monthly minimum balance requirements, eliminate certain overdraft charges, and accept government identification cards from other countries.</td>
<td>BankOn helps low-income people avoid predatory lenders and expensive check-cashing services.</td>
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Renting: The New American Dream

Homeownership has long been the American Dream. It’s a status symbol and has been regarded as one of the best long-term investments a family can make. In fact, buying a house can make a lot of sense for communities, too: Much research suggests that the stability that comes with homeownership promotes good citizenship, improves the quality of neighborhoods, and is linked with the academic success of homeowners’ children.

But have lessons from the Great Recession changed the way Americans — both borrowers and lenders — think about owning a home? Given the fallout in the housing market, maybe renting will be the new American Dream. And that’s something policymakers will have to weigh very carefully.

The Recession’s Impact on Housing

From 1997 to 2006, U.S. home prices rose nearly 10 percent a year on average, according to the S&P/Case-Shiller National Home Price Index. A decade was long enough, says economist Robert Shiller in a recent *New York Times* article, “for many people to become accustomed to the pace and to view it as normal…. People who owned a home over that period had reason to feel pretty well off and proud of their investment acumen.”

Then came the financial crisis. Home values crashed from their peak of almost $23 trillion in 2006 to just over $16 trillion in the first quarter of 2011. And since the crisis, lenders have been tightening underwriting standards, making it tougher for would-be homeowners to get loans. It can also be tough to get government financing, including Federal Housing Administration and Veterans Administration loans, especially for those with credit scores below 600 or without enough money for a 3.5 percent down payment. And those with a foreclosure in their past can’t get any type of financing for seven years.
As a result of the housing market fallout, the latest Case-Shiller annual survey of homebuyer attitudes showed people’s median expectation for annual home price appreciation over the next decade down sharply, to just 3 percent (versus 7 percent in 2005).

Meanwhile, U.S. homeownership rates have been heading down and rental rates going up. Since the end of 2006, the number of renters has grown faster than the number of owners has declined. This means, says Senior Research Economist Emre Ergungor of the Cleveland Fed, that most new households are renting, whether by choice or by necessity.

When the housing bubble burst in 2007, 31.6 percent of households rented their homes. Now, it’s 33.6 percent. Since the crisis, nearly 3 million households have become renters, and at least 3 million more are expected by 2015, according to census data analyzed by Harvard’s Joint Center for Housing Studies and the Associated Press. It’s hard to know what exactly is behind those numbers — anybody who went through a foreclosure, for example, would probably have to become a renter — but the trend is clear enough.

**Stubborn Attitudes**

Yet the American Dream endures. Homeowners and renters continue to believe that homeownership is a smart decision over the long term. Surveys by Fannie Mae, the National Association of Home Builders, and Pew Research find that a great majority still believe homeownership is a sound investment.

Meanwhile, as Americans cling to their beliefs, economists have been debating some of the ways that the housing market crash has been hurting the economic recovery.

With the glut of empty homes brought on by foreclosure, there’s hardly any market for new construction. And many owners are discovering that their homes have proven to be an unreliable form of savings. Unfortunately, this is particularly true in regions where the housing bust has contributed directly to high rates of unemployment through construction job losses.

A new study conducted by faculty at Florida International University and East Carolina University uses data from 1979 to 2009 to propose that renting has been a better investment strategy than buying a home for the past 30 years. The authors reason that it’s not actual homeownership that creates wealth but rather the forced savings that come from having an amortizing mortgage. And creating wealth can be done — and done better by more people — through other means.

**The Best Investment? Americans Weigh in on Homeownership**

- **37 percent** of Americans “strongly agree” that homeownership is the best long-term investment one can make.
- **41 percent** of homeowners “strongly agree.”
- **31 percent** of current renters “strongly agree.”
- **85 percent** of American homeowners at least “somewhat agree” that buying a home is the best long-term investment one can make.
- **85 percent** of current renters want to buy a house at some point.
- **17 percent** want to continue to rent.

Source: Pew Research Center.
Balancing Act

The question for policymakers is how to square two potentially competing forces: a housing market with less-than-certain investment returns and higher barriers to entry for low-income borrowers; and the persistent aspirations of many Americans to own their own home. The ultimate goal is to make sure individual households’ needs are met while keeping neighborhoods stable and vibrant.

The collapse of the housing market and subprime crisis remind us that policies to promote homeownership can harm households if those policies encourage unaffordable mortgage commitments. At the same time, we know from experience that American neighborhoods are more likely to thrive when their occupants are owners, probably because of the stability ownership brings. A balance must be struck, and it won’t be easy. The next generation may cling to ambitions of homeownership for good reasons, but economic reality may dictate otherwise.

Survey data


Watching and Waiting
Pinning Hopes on Small Businesses to Reignite Economy May Not Be the Best Idea

Anne M. DiTeodoro
Communications Coordinator

Small business is actually quite big in America. In fact, according to the Small Business Administration’s (SBA) definition of small businesses — firms with fewer than 500 employees — they comprise 99.7 percent of all U.S. companies. They employ about half of the country’s private-sector workforce and are an important source of new job generation in the early phases of business-cycle expansions.

No wonder Americans are watching and waiting for the resurgence of small businesses to reignite the hiring process and get the economy back on track after the Great Recession.

But here are two things to consider about that premise. First, small businesses are not exactly the mass creators of jobs and wealth that they’re often cracked up to be.

Second, small businesses really took it on the chin during the recession. Between 2007 and 2009, self-employment fell, thousands of small firms vanished, and the pace of new business formation slowed. That’s a pretty significant blow to recover from, and it’s not clear how resilient today’s entrepreneurs will prove to be.

These two factors could potentially slow the pace of small business growth in the years ahead. That’s a problem because small businesses really do foster the sort of innovation the country desperately needs after the Great Recession. Nobody wants an environment where entrepreneurs are inhibited in their efforts to get started. Economic research, including studies by the Cleveland Fed, suggests that some government programs could be helpful in this regard.

Shocks Still Strong for Small Firms
As the recession deepened in 2009, especially in the first quarter, small firms accounted for almost 60 percent of job losses, according to the SBA. A mid-August 2011 survey by the National Federation of Independent Business reports that small-business owners are still stuck in recession-level growth trends, and the Bureau of Labor Statistics reports the growth in new business startups is the weakest it has been since the early 1990s, when the data were first tracked.
Also notable is research by the Ewing Marion Kauffman Foundation, which finds that today’s businesses start out smaller — and stay smaller — than their predecessors, rarely growing past their start-up employment levels. In fact, this research suggests that companies established in 2009 might now employ a million fewer people than the historic norm.

The Risks and Rewards of Launching a Business

Despite this evidence to the contrary, the myth of the entrepreneur endures. Small-business owners believe that running their own shop is best. High risk, high reward. Consider Mark Zuckerberg, co-founder of Facebook, billionaire, and entrepreneur: a resounding success story.

But Zuckerberg is far from the norm. Think of a plumber, for example, who leaves a larger company to run his own business. He struggles — getting clients, setting up a billing system, juggling the workload, deciding whether to hire others — and ultimately, he may not make any money.

“For every Mark Zuckerberg, there are a million guys like the struggling plumber,” says Scott Shane, visiting scholar at the Federal Reserve Bank of Cleveland and the A. Malachi Mixon III professor of entrepreneurial studies at the Weatherhead School of Management at Case Western Reserve University. “Americans pay more attention to the success stories, but it’s the statistics that don’t follow suit. And the media tend to overstate the probability of good outcomes.”

Truth is, the vast majority of people who start a business go back to wage employment or working for others. “If they spend four years getting a business off the ground, when they return to the workforce, it will take them longer to recoup the wages they were making four years prior. In addition, many of them have also pumped much of their savings into their business, and those funds are now gone,” Shane says.

Policy Challenges

But Facebook stories do exist. Most big businesses started small. Even though their contribution is sometimes oversold, small businesses are indeed integral to economic growth.
That’s why it’s important that they still have an environment in which they can flourish. Usually, innovation blooms anew after recessions, as laid-off workers start their own firms and work on ideas that were ignored by corporate bureaucracies. We should all be concerned about an economy in which people shy away—or are discouraged—from innovating.

As Shane puts it: “We don’t want to discourage innovation and the extreme high-growth companies.”

The challenge is to develop policies that address the specific needs of small businesses. For example, small firms spend more per employee than larger firms to comply with federal regulations such as healthcare, taxes, and environmental rules, and these costs may increase under new restrictions. “Even if the post-crisis regulations aren’t heavier, there is a perception that they are, and if small-business owners believe it’s going to be a burden to comply, then they’re going to hold back,” Shane says.

Access to credit is another sticking point. The decade leading up to 2007 was part of the housing boom. Small-business owners relied heavily on their personal property as collateral to obtain capital for their enterprises. In the wake of the recession, though, these owners are dealing with declining property values that limit their ability to obtain credit for financing their businesses.

Policymakers have intervened in the past, helping to buoy small-business owners. For example, the American Recovery and Reinvestment Act, enacted in February 2009, included several provisions targeted specifically at small businesses, such as tax incentives, reduced fees on certain SBA loans, and monetary support to help programs that promote economic development and entrepreneurship.

A working paper from the Cleveland Fed notes that “small businesses are likely to remain a sacred cow of public policy,” and will probably enjoy continued government support. There is evidence that some government interventions are effective. The researchers found that government interventions in small-enterprise credit markets, such as SBA loan guarantees, produce a positive impact on economic outcomes, especially when an intervention is designed to correct a market failure.

Because they serve as a substitute for collateral or relationships with loan officers, SBA loan guarantees are meant to increase the credit extended to small businesses. They allow lenders to charge a lower interest rate on the loan while mitigating their own risk on the longer-term loans that are the most useful for small businesses’ capital investment.

But the plight of small businesses puts policymakers in a bind—there is no such thing as a “model” small business. “It’s not easy to design a policy for small businesses, because it’s also a policy for consumers,” says Shane, who points out that many small-business owners run their companies as extensions of their households, often mixing business and personal funds.

Also, small businesses are quite diverse; their issues differ widely, depending on whether the owner has five or 100 or 500 employees. As with so many other sectors, the future of small businesses remains uncertain in the wake of the Great Recession. Shane cautions, “I’m not sure we want policymakers to get us back to 2007. Many people believe we were experiencing a small-business bubble, driven by rising housing prices and the use of home equity to finance businesses. If we had a base point to compare to where we want to be, then we would be able to state if today’s levels are above or below where we should be.

“But,” he observes, “we don’t know what is normal.”

**Recommended reading**


Conventional wisdom holds that nothing beats the value of higher education. But tell that to the growing numbers of college graduates who find themselves serving coffee and stocking shelves. You might call them overqualified; economists dub them “mismatched.”

Mismatches occur when workers accept jobs for which they are overqualified because none are available in their field or when workers who want to work full time accept part-time jobs because that’s all they can find. Some mismatch, however, is part of a healthy, dynamic economy. If every firm with a job opening waited for the perfect match or if every unemployed worker waited for the perfect job, the economy would stagnate. In fact, a mismatch can be ideal for the firm, which may get a worker with more education for the same price as a less-educated one.

What’s not clear, though, is how much mismatch is either ideal or healthy for an economy. In the wake of the last recession, more college grads are getting hit by the mismatch phenomenon, according to data from the Current Population Survey (CPS). This trend predates the recession, but it has accelerated since 2007.

Looking at data from the CPS, which contains information for hundreds of different occupations, we found a small increase in the percent of bachelor’s degree holders in occupations that do not require a degree. It’s unclear whether the increase observed during the recession is significant, so we narrowed our focus to 33 occupations that don’t require bachelor’s or associate’s degrees—such as bartenders, waiters, retail salespersons, and hotel desk clerks—and seem most likely to draw underemployed degree holders. In 2004, 14.7 percent of employees in these occupations had bachelor’s degrees. In 2007, that number had edged up to 15.3 percent (a 0.6 percentage point gain). By 2010, it was 17 percent (a 1.7 percentage point increase). The difference in pre- and post-recession rates of change corresponds to 356,000 people, or 2.6 percent of the unemployed. The result, unfortunately, does not resolve the question of how significantly job mismatches feature in the post-recession economy.

College graduates invest in their education with time and money (or parents’ money); societies invest in education with taxpayer subsidies to universities and with subsidized and guaranteed debt. If grads take a low-skilled job after college, they may not be producing a high-value product or service, not getting a high return on their human capital, and probably not earning enough to pay off their debts and stimulate the economy as consumers.

It is also worrisome that while grads are employed in low-skilled jobs, their human capital is depreciating. “They forget things they learned in school. They probably won’t keep up with advancements in their once-chosen field,” says Stephan Whitaker, research economist at the Federal...
The Enduring Appeal of Higher Education

Big events can spawn big changes. It’s not obvious yet how much of an impact the recession had on young people’s attitudes toward higher education. But some early evidence is encouraging because it shows the value of higher education for people’s economic situations. Consider the recent drop in the rate of labor force participation: It has coincided with an increase in college enrollment, suggesting that young people may be beefing up their skills before entering the work force.

It’s worth noting that women are now enrolling in college in greater numbers than men. Another lingering question in the wake of the Great Recession is whether men—who traditionally held lower-skilled but relatively well-paying manufacturing and construction jobs—will find new niches in the new economy.

Compared with 2009, respondent’s family is...

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<tr>
<th>Education Level</th>
<th>Better off</th>
<th>Same</th>
<th>Worse off</th>
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<tr>
<td>Some or Completed High School</td>
<td>47%</td>
<td>25%</td>
<td>28%</td>
</tr>
<tr>
<td>Five to Eight Years Education beyond High School</td>
<td>37%</td>
<td>26%</td>
<td>37%</td>
</tr>
</tbody>
</table>

Sources: Center for Human Resource Research at the Ohio State University; Federal Reserve Bank of Cleveland.

One piece of subjective evidence on the long-term importance of higher education comes from the Ohio State University’s Consumer Finance Monthly survey. It found that 47 percent of families whose members’ highest education levels topped out at “some or completed high school” rated themselves as worse off financially in 2010 than in 2009. By comparison, 37 percent of respondents with between five and eight years of education after high school said they were worse off.

While this doesn’t necessarily suggest changes in future behavior with regard to college enrollment, it’s at least noteworthy that the survey results seem to confirm that people with multiple years of education beyond high school have weathered the recession better than those with less education.

Reserve Bank of Cleveland. “They won’t gain career-related work experience to make themselves more productive. And if they do get back on their chosen career path, their earnings growth will start later, so their lifetime earnings will be lower.”

Less-skilled workers without degrees can also be hurt by the growing underemployment trend. Economic theory tells us that when there are more workers in the low-skilled market, wages are depressed for everyone in that market. When grads are hired in place of less-skilled workers, it decreases the chances that those workers will be able to find jobs and build their work histories.

So while some mismatches are part of a healthy economy, too many can be a waste of human capital. The ability to make a good match once a student has earned a degree is certainly part of the motivation for pursuing higher education. And conventional wisdom actually still holds: High education levels are critical for economic growth. Research, including studies by the Federal Reserve Bank of Cleveland, shows that states with higher percentages of college graduates also have the fastest economic growth.

How much the most recent recession changed young people’s (or taxpayers’) attitudes about the value of an education is therefore of critical interest to economists—and anyone else interested in America’s economic future.

Recommended reading

www.clevelandfed.org/research/trends/2011/0711/01labmar.cfm
The term “uncharted territory” is getting a workout these days. The recent recession was so deep that many have found themselves at a loss trying to predict the way forward. In thinking about the future, it’s often useful to recall lessons from the past.

Economist Price Fishback has made a career of that practice. He has become one of the nation’s go-to experts for explaining the differences and similarities between the Great Depression and the Great Recession. He’s blogged about it for the *New York Times* and been quoted by many other news outlets on the same topic. His latest research delves into the microeconomics of the New Deal, examining the myriad programs introduced in the 1930s and ferreting out which ones worked, and which didn’t.

For all the doubts about the nation’s ability to recover from this recession, Fishback is firmly in the optimists’ camp. If history is any guide—and Fishback certainly believes it is—then the evidence points in favor of a healthy economy for generations to come.

Fishback is the Thomas R. Brown Professor of Economics at the University of Arizona. He serves as a research associate with the National Bureau of Economic Research and as co-editor of the *Journal of Economic History*. Mark Sniderman, chief policy officer at the Federal Reserve Bank of Cleveland, interviewed Fishback at the Bank on August 26, 2011. An edited transcript follows.
The Depression just destroyed people’s confidence in what was going to happen. In the United States in most time periods, people have been very optimistic about what is going to happen in the future. There are always some people who are in trouble, but generally we’ve had an average growth rate in per capita income of 1.6 percent per year since 1840. That includes all the depressions.

Given that kind of growth, the Great Depression is very unusual in American history. People kept expecting that things would get better because income typically has doubled about every generation or so. But 10 years of depression with millions of people who thought they had done everything right finding themselves unemployed will shake anybody’s confidence.

Sniderman: At the time the Great Depression set in, was there much expectation about the federal government playing a role?

Fishback: Before the Depression, welfare policy and labor policies were all the responsibilities of the local and state governments. What was so unusual about the 1930s was the idea that the federal government would get involved in providing relief to the poor and unemployed. It was the first time that federal officials thought of the economy as being more than a group of local economies. They argued that the federal government should get involved because this was a national emergency.

The federal government’s primary role up to that time had been to provide national defense. We created a central bank in 1913 with the Federal Reserve. There was some federal regulation for interstate commerce like railroads and various foods and drugs traded across state lines. But there wasn’t really a sense that the federal government was going to come in and use spending to stimulate the economy. Those were Keynesian notions that developed with John Maynard Keynes’ writings in the early and mid-1930s. The typical person’s attitude toward government was quite different in 1900 than it is today.

The federal government was probably spending about 4 percent of GDP in 1929. State and local governments were probably spending another 10 percent of GDP. It was a whole different time.

If you could hold onto your job, you actually did reasonably well during the Depression because of the tremendous deflation.

Bob Higgs, my thesis adviser, wrote a great book, Crisis and Leviathan. He argues that there was a real change in attitudes toward government associated with three major crises. World War I was the first big crisis, followed by the Great Depression of the 1930s, and then World War II. In each case people wanted [the government] to respond quickly. They did not want to trust the markets to help them move quickly because it is really expensive to try to produce things quickly.

Armen Alchian [emeritus professor of economics at the University of California, Los Angeles] pointed out that every time you do something fast, it raises the costs. To avoid imposing these costs on taxpayers, they imposed a draft where they put young men in the army but paid them poorly. During the wars, the federal government and the military took over the economy, chose how to allocate all of the key war materials, and established wage and price controls. Meanwhile, they rationed all sorts of goods to the general public.

The government was very active in each crisis. Then after the crisis was over, the federal influence dropped back down. When people first started dealing with the crisis in World War I, they thought, “We don’t know if we can do this.” But over the course of a two- to-three-year period, they developed all sorts of techniques for solving the problems that came up. They were learning by doing. As a result, they concluded that trying to run a command economy was not quite as bad as they thought it would be — even though they still were not very good at running it.
Between 1933 and 1935, the federal government spent a tremendous amount of money providing direct relief to people who were not readily able to work.

So when the next crisis hit, they brought back a lot of the same programs, and the government ratcheted up again, often to new heights. In fact, there really was not much time for the government to ratchet down between the Great Depression and World War II. During World War II the federal government’s control of the economy really escalated. Basically, the military was running half the economy. They eliminated unemployment by drafting roughly 10 percent of the work force. There were wage and price controls and rationing—meat once a week and limited access to sugar. Forty-five percent of income was being spent on munitions and hardware that was eventually going to be blown up.

After the war, the federal government dropped back down but not to anywhere near what had been before.

Sniderman: *So it’s a ratchet effect.*

Fishback: Yes, like those ratchet wrenches. It never came back down to the old level. You can see this dynamic later on. The crises have been smaller, but we had the Great Society in the 1960s, and you can actually see it today. With the problems we saw in 2007 and 2008, those problems led to a huge increase in activity with the stimulus packages.

Sniderman: *Let’s go back to the 1930s a bit. The federal government isn’t all that practiced in interventions to deal with the Great Depression. Is it fair to characterize all of the various programs and efforts to deal with it as experimentation of one sort or another?*

Fishback: To some extent it is. What happened is the federal government built upon what the states had been doing. For example, the welfare system went through one of its major long-term changes during the 1930s. The first response was a short-run response. We need to get people back to work! Between 1933 and 1935, the federal government spent a tremendous amount of money providing direct relief to people who were not readily able to work. They then provided relief with a work requirement for people who were able.

In 1935, Harry Hopkins, who had been running the Federal Emergency Relief Administration (FERA), was not satisfied with how that administration had been running. The FERA was giving money to the states, which then largely determined how it would be spent. The administration had very little control because the only way they could change state internal distributions they didn’t like was to threaten to take all of the money away. Hopkins actually made that threat to some states, but having to use such a big threat was not very effective.

In 1935, the federal government rearranged the relief programs. They passed responsibility for direct relief back to the states for people who could not be employed very easily. The FERA was replaced with the Works Progress Administration (WPA). When Hopkins ran the WPA, the federal government had much more control over each project. The states just told them who was eligible to obtain work on the projects.

There was another side to relief. The Social Security Act was passed in 1935. It included the old-age pensions we all know as Social Security, and that program was, and still is, run at the national level. The Act also added three public-assistance programs, in which the federal government provides matching grants to the states.

Another big change with the Social Security Act was the introduction of unemployment insurance. Wisconsin had actually started a program before 1935 but had not paid benefits yet. The federal government provided about 3 percent of the cost for administration and each state set its own benefits. The unemployment insurance funds were run like an insurance fund where all the employers paid into it. When someone became unemployed, he was paid out of the fund collected from employers.
did not take a “haircut.” Basically, the lenders thought that the program was a good deal for them. As a result, the HAMP was projected to refinance about 3 to 4 million loans. But a year after the program started, they were well short of a million.

Sniderman: Could you talk a little about the Progressive Era and compare it to the period leading up to the 2007 recession?

Fishback: Sure. I’m involved in writing a book with University of Arizona PhD student Carl Kitchens about booms and busts in American history. And really the story of American history is far more boom than bust. Seventy percent of the time the U.S. economy has been in booms. Then the other times we have had these short recessions. Then there is the occasional big bust, like during the 1890s and the Great Depression. As I said before, per capita income has risen 1.6 percent per year on average over the long haul, even while including bad times like the Great Depression.

As a result, in most periods of American history, people have pretty optimistic views because things have been going well for quite some time.

The 1920s were very prosperous. Radio arrives, people are buying automobiles and new appliances. There are flappers out there doing the Charleston dance, great new jazz music is flowing out of the speakeasies. Babe Ruth is hitting home runs, and Jack Dempsey is punching people out. It’s a fast-paced era. Even when things started going down halfway through 1929, people think it’s just going to be a short recession, not a big deal.

Sniderman: What do you think are some major misperceptions about the New Deal period?

Fishback: For the last 10 years I’ve been working with a number of co-authors on the microeconomics of the New Deal. Almost all the work had been on the macroeconomic side, the money supply and government spending. During the 1930s, the federal government did not really run big deficits. It’s not a Keynesian period at all. They increased government spending — Hoover raised it quite a bit, by 58 percent in nominal terms over a three-year period. Given the deflation, it rose 88 percent in real terms, which was a faster pace than anything Roosevelt did — but both groups believed in balanced budgets. So they raised tax rates and tax revenues just as fast.
There were enormous variations in how much the federal government spent in state and local areas. We’ve been collecting information at the individual level, at the county level, and at the city level, and using that variation in how much they spent over time and across place to try to see the local effect of these programs. It’s not the same thing as the macro effect; it’s the local effect.

The speed with which Bernanke and [then-Treasury Secretary Hank] Paulson responded during this period was drastically different than the Fed’s response during the Depression.

The most successful programs as far as we could tell were the relief programs and the public works programs. The relief programs included the Federal Emergency Relief Administration and the Works Progress Administration (WPA). They also had a series of programs like the Public Roads Administration and the Public Works Administration that built public works. The public works programs were more generous than the relief programs because they actually hired people at full wages. These programs combined seemed to do some really positive things. They put people back to work.

Sniderman: In the 1930s, it seemed like the Federal Reserve was a teenager relative to the current era. What do you think of that characterization?

Fishback: The Fed was formed in 1913. The founding legislation stated that the Fed was supposed to provide an “elastic currency.” Many people thought what this meant was the Fed was supposed to provide liquidity to stop banking panics. But it wasn’t necessarily clear how they were supposed to do that. When you get to the late 1920s, the Federal Reserve has a notion of what’s known as the “real bills doctrine.” The focus was to provide more credit at a time when businesses were seeking more credit while they were expanding.

But that left the Fed as a passive responder to what was going on with the economy. So, many leaders in the Federal Reserve were following this passive model of the real bills doctrine. They were saying that unless they see demand for liquidity that’s going along with businesses, then they won’t do that much in terms of buying bonds and trying to expand the money supply and stimulate the economy.

By 1931 the economy was in serious trouble. There were three waves of bank failures between 1930 and 1932. The Fed policymakers were thinking that they were providing good liquidity to the system. They had cut the discount rate, at which the Fed lent to banks, to as low as 1 percent. That’s really low, historically. Therefore, they concluded that they had done what they needed to do. But they were not taking into account the enormous deflation of the time period.

Carnegie Mellon University Professor Allan Meltzer, who has written a multi-volume history of the Federal Reserve, could not find any evidence that they were looking at “real” interest rates in the way we think of them today. The discount rate might have been 1 or 2 percent, but the deflation rate in the early 1930s was about 8 to 12 percent. So if I’m a borrower and I see a 1 percent interest rate and a 12 percent deflation rate, that means when I pay back the money, I’m paying back much more valuable money. In purchasing power my interest rate would have been 13 percent instead of the 1 percent nominal rate. That 13 percent rate was twice as high as any real interest rate we’ve seen since the 1930s.

The first time the Fed made a big purchase of bonds through open market operations was in the spring of 1932, when they bought about $1 billion over several months. That’s like $1 trillion today. But the problem was that they had already been through a series of bank failures before. In their book, A Monetary History of the United States, Milton Friedman and Anna Schwartz described it as acting “too little, too late.” The Fed’s leaders were in this position where they thought they were doing the right thing, but the economy was falling apart and the money supply was falling and banks were failing.

One of the key problems the Federal Reserve leaders faced was that they were trying to meet two sets of goals that often did not align well. The policymakers wanted to focus on the U.S. economic problems, but they also wanted to help the world maintain the gold standard. For example, in September and October of 1932, the Fed had to worry about a series of bank failures at the same time that Great Britain left the gold standard and all this gold was flowing out of the United States. The Fed leaders were then between a rock and a hard place. They could either buy a bunch of bonds to help out the banks in the United States, or sell a bunch of bonds and prevent the gold from going overseas. They decided to focus on the international side and prevent the gold from going overseas, but this did not help the U.S. banks at all.

Essentially, the Fed from 1930 to 1933 was like a teenager born in 1913. The policymakers were learning on the job. They were still trying to figure out what to do, then the Depression hit. Few of the policymakers had seen anything like this set of problems.

But the Fed finally did change its policy. Barry Eichengreen of Cal Berkeley and Peter Temin of MIT have both written about the change in policy. When Roosevelt stepped into office, the U.S. went off the gold standard. The Roosevelt Administration started announcing that its goal was to raise prices, and the Fed started to follow a more expansionary monetary policy. These policies helped shift people’s expectations toward inflation rather than the extreme deflation that they had been experiencing. That helped turn the tide.
Sniderman: You referred to Milton Friedman’s research on the Fed’s failure to shift policy in the Great Depression. On Milton Friedman’s 90th birthday, in 2005, Federal Reserve Chairman Ben Bernanke in so many words said to Milton, sorry about the Great Depression, but we won’t do it again.

Fishback: And thank goodness. Because when the Fed finally made that big open market purchase in the 1930s, annual real income had dropped by 20 percent, there was a nasty deflation, and the unemployment rate was over 20 percent. That’s when they finally made that move.

Think about the difference: There we were in the Depression, and the Federal Reserve waited three years to make a bold move. Not until the unemployment rate was 20 percent and annual output had dropped by 20 percent did they really make a big move to purchase bonds. In the recent crisis, the unemployment rate at the time Bernanke and the Fed started the expansion in liquidity hadn’t even gotten past 7 percent yet. And real output had only been dropping for about three quarters. That’s a huge difference in responses.

It’s clear that Bernanke thought that’s what needed to be done. And actually I believe he was right. In the end, it didn’t cost us that much because we were backstopping situations and didn’t have to pay out that much, although we still don’t know the story about Fannie Mae and Freddie Mac. The speed with which Bernanke responded during this period was drastically different than the Fed’s response during the Depression.

Sniderman: Perhaps it’s not surprising during periods such as we have now when times are tougher, and when we see a number of other countries around the world emerging and growing at very fast rates, that a number of people have said that it’s time for the U.S. economy to realize that it’s not going to be as preeminent. What would you say to people who think we should be scaling back our aspirations?

Fishback: I think we should not be disheartened. As a matter of fact, I’m pretty optimistic. I would bet that over the next 50 years, per capita income is going to continue to grow about 1.6 percent per year; that’s just my expectation.

Here’s why I say that: It’s really easy to look around at what you’re seeing and problems—and we’ve had plenty of problems in the last three years, they just seem to keep coming— and be discouraged. Almost anyone you can talk to has a litany of things they can point to as being a terrible problem that is going to prevent the economy from growing. But we’ve seen that over, and over, and over again in the last 200 years. The Club of Rome [a global think tank] was talking about how the world was going to fall apart and run out of all sorts of commodities in the 1960s, and then we had a big boom in commodities. The reason I think this is going on is that we don’t know what’s going to come next, because there are all sorts of entrepreneurs out there who are coming up with new ideas that you and I and most people don’t know about. It’s hard to tell which ones will be the winners, but there will be winners.

Look at the growth in incomes in many developing countries. I am betting that there will be a huge increase in technology change in developing countries. As more people have higher incomes and better educations in those countries, they will be willing to buy from us. Not only that, they will be developing new products and services that we will benefit from. I am very optimistic even though I study the Great Depression. Well actually, it’s probably because I study the Great Depression, because it was so bad that everything else looks good.

Sniderman: It’s clear from the conversation that you’re quite passionate about economic history.

Fishback: To say the least!

Sniderman: Who were some of your mentors in that realm?

Fishback: I was really lucky that I got to go to graduate school at the University of Washington, where they had five economic historians, which is pretty unusual. Bob Higgs, Douglass North, and Morris D. Morris all shaped the way I think about economic history in very diverse ways. They created a wonderful and challenging environment. Bob was my thesis advisor and a group of us wrote the book Government and the American Economy: A New History in his honor.

Milton Friedman certainly had a big impact on me. He was just a great economist in all sorts of dimensions. Certainly a number of colleagues in economic history—Claudia Goldin at Harvard, she’s just an amazing labor historian. John Wallis at Maryland was in graduate school with me, and he has done great work on the New Deal, federalism, and studies of long-term changes in the role of government.

The great thing is, when you’re doing research and teaching and reading the work of my colleagues in the profession, there are hundreds of economists and economic historians that have had influence on what I think. I’m the co-editor of the Journal of Economic History right now, and every time I get a new paper, I get to learn something new and it adds to my understanding of what’s going on.

Watch video clips and read the full interview
www.clevelandfed.org/forefront

Recommended reading
The summer of 2011 did not inspire much confidence about the immediate future:

- Stagnant job growth and lowered GDP numbers,
- U.S. debt downgraded after a nasty debt-ceiling battle,
- Several eurozone countries in crisis and world financial markets roiling,
- London burning after deep UK budget cuts that point to a growing wealth divide, and
- Back at home, raging tropical storms in the east and catastrophic wildfires in the west.

The once-common assumption that living conditions and economic opportunities will improve for each new generation now seems dubious. It’s depressing stuff with no easy solutions. Where to find some inspiration for how to move beyond current challenges and plan for a better future? British economist Diane Coyle offers some ideas on how to get started in her new book, *The Economics of Enough: How to Run the Economy as if the Future Matters.*

Despite what the title might suggest, this book is no “eco-screed” that trashes traditional economic thought in favor of some rosy, utopian worldview. Far from it: the analysis is rigorous and the arguments well informed by prior research. In fact, the first half of the book feels like a lengthy literature review, and it’s a bit of a slog for a non-economist.

But the broad themes the book goes on to explore — addressing the challenges of climate change, high debt levels, income inequality, and deteriorating social capital, all while the economy undergoes technological transformation — are well worth your while. They provide a rich context to assess our present troubles and speak to realistic ideals for how to face the future.

The critical question posed in this book is what legacy we intend to leave behind — what is “enough” for us to consume today so that we don’t leave an unsustainable burden of environmental, social, and economic debt to future generations. Coyle notes that “current and recent generations in the rich economies have been living beyond their means and will need to correct that by saving more and consuming less.” That reality is complicated by what she sees as a breakdown of collective trust and a lack of effective governance in today’s society.

**Book Review**

*The Economics of Enough: How to Run the Economy as if the Future Matters*

by Diane Coyle
Princeton University Press 2011

Reviewed by Robin Ratliff
Executive Editor
A first step in making needed changes involves measurement. Coyle dismisses the notion that a conventional focus on economic growth should be tossed aside in pursuit of a new “happiness” measure, as others have proposed. Indeed, research shows that economic growth contributes greatly to happiness. “What’s more,” she adds, “poor countries in particular need to continue growing to reduce poverty and satisfy natural aspirations to reach the living standards of the leading economies.” As a result, Coyle insists that GDP growth should remain a policy target.

The critical difference in the twenty-first century is how to adequately capture the vast changes in economic growth brought by improved productivity and technological advances. Coyle proposes a wider array of statistics beyond GDP and the existing national accounts. These new, longer-term measures would track social and economic progress, including generational accounting (to capture the burden of future pension and welfare obligations), comprehensive wealth (to bring the future impacts of current policies into decision-making), and productivity in services and other intangibles (to better capture their true economic value). She acknowledges that these measurement changes would take time to gain traction and could be especially difficult to develop in poor economies.

Institutions matter as well, as reflected in what Coyle defines as the currently dysfunctional U.S. political system. She advocates a major restructuring of the public sector in line with changes that have already been integrated into the private sector.

International economic institutions could also bear some major reforming to “embrace a public service mission, openness, and greater direct engagement with the members of the public whose lives they will ultimately affect.” Of course, putting the necessary resources and political will behind these sweeping changes would be a mammoth task.

Another daunting challenge is the current extremes of income inequality, which have destabilized large swaths of the globe and are undermining the foundations of future economic dynamism. Coyle advocates attacking this problem through legal and regulatory structures. She suggests using the tax system to drive out excessive bonuses and performance pay, and she takes a pretty hard stab at what she sees as paltry reforms in the banking industry following the financial crisis, calling for the breakup of big banks.

What her analysis lacks, though, is the obvious need for lower-skilled workers to increase their levels of education and training to compete in today’s high-tech workplace.

Coyle also calls for savings incentives to spur economic growth. Some of these are happening already—such as making people opt out of, rather than opt into, retirement savings plans. Replacing the progressive income tax with a consumption tax would discourage excessive spending, she says, and could also discourage the use of high-carbon products and services. Interestingly, where the consumption tax was once championed mostly by commentators on the right side of the political spectrum, it is now being considered by the left as a way to halt over-consumption of scarce resources. Businesses, too, would need to change their perspectives, adopting a longer time horizon than the traditional two-year investment cycle.

Cuts in entitlement spending are inevitable to halt insurmountable debt burdens, and they are bound to be painful. Coyle suggests engaging citizens more directly in public policy through the internet to improve “transparency and legitimacy in decision-making and offer a defense of policy decisions against lobbying and legal gaming.”

Still, tough changes that include longer work horizons, less time off, and reduced pensions will become a reality. Those changes are made even tougher by what Coyle perceives as a lack of collective trust that we can actually harness the measures, values, and institutions we need to avoid ripping apart the social capital that holds society together.

If market capitalism is to deliver social well-being that speaks to the welfare of future generations, the most important ingredient will be the attitudes of individuals. I am reminded of President John F. Kennedy’s remarks to the students at American University in June 1963, just a few months before his death: “Our most basic common link is that we all inhabit this small planet. We all breathe the same air. We all cherish our children’s future. And we are all mortal.”

While idealistic in its scope, Diane Coyle’s book helps us think about some specific ways to make “the economics of enough” work for both today and tomorrow.
Next in *Forefront*:

**The Muni Market**  
State and local government finances under stress

**Cash**  
No longer king, but not going away yet

**A View from the FOMC**  
Federal Reserve Bank of Cleveland  
President Sandra Pianalto explains her perspective on monetary policy