Unemployment and Debt

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Stagflation of the 1970s

Collapse of communism

Global Financial Crisis

If there is one common theme to the vast range of crises we consider in this book, it is that excessive debt accumulation, … by the government, banks, corporations, or consumers, often poses greater systemic risks than it seems during a boom.

...

Most of these booms end badly. Of course, debt instruments are crucial to all economies, ancient and modern, but balancing the risk and opportunities of debt is always a challenge.

Source: This Time is Different, Carmen Reinhart and Kenneth Rogoff, 2009, page xxv.

Financial stability reflects the ability of the financial system to consistently supply the credit intermediation and payment services that are needed in the real economy if it is to continue on its growth path.

Financial instability occurs when problems (or concerns about potential problems) within institutions, markets, payments systems, or the financial system in general significantly impair the supply of credit intermediation services – so as to substantially impact the expected path of real economic activity.

Eric S. Rosengren, Keynote Remarks at the Stanford Finance Forum, June 3, 2011, p. 2.

There would be very large negative externalities associated with the disorderly failure of any SIFI [systemically important financial institution], distinct from the costs incurred by the firm and its stakeholders.

Tarullo, Daniel K., “Regulating Systemically Important Financial Firms”, Board of Governors of the Federal Reserve System Speech, June 3, 2011, page 2.)

The rationale underlying the expected impact approach is that the expected impact of failure of SIBs [Systemically Important Banks] and non-SIBs should be the same. Given that the failure of a SIB will have a greater economic impact than a non-SIB, the probability of failure of a SIB will need to be lower than a non-SIB in order for the expected impact to be equal across the two groups.

Basel Committee on Banking Supervision, Consultative Document, Global systemically important banks: Assessment methodology and the additional loss absorbency requirement, July 2011, page 23.

The main reason why our economy behaves in different ways at different times is that financial practices and the structure of financial commitments change. Financing practices result in payment commitments that are embodied in contracts that reflect market conditions and expectations that ruled when they were negotiated and signed. The payment commitments come due and are discharged as the economy moves through time, and the behavior and particularly the stability of the economy change as the relation of payment commitments to the funds available for payments changes and the complexity of financial arrangements evolves.

Hyman P. Minsky, Stabilizing an Unstable Economy, 1986, p. 197.

Fluctuations in risk premiums

- Differences in risk aversion
  - Hyun Song Shin, Risk and Liquidity (Clarendon Lectures in Finance), Oxford University Press, 2010.
- Differences in expectations
  - John Geanakoplos, The Leverage Cycle, Cowles Foundation Discussion Paper, 2009

The impact of any macroeconomic shock can be divided into two components.

One component is the effect of the natural demand and supply adjustments that would occur if prices and their expectations were to adjust continuously. Monetary policy cannot be used to offset this natural consequence of the shock without the risk of inflation being too high or too low.

The other component is the consequence of what economists call nominal rigidities. Monetary policy can be used to offset this latter component without creating undue pressures on inflation.

The challenge for monetary policymakers is to figure out how to divide the observed movements in the unemployment rate into these two components.

Source: "Labor Markets and Monetary Policy", Narayana Kocherlakota, pg 10.

For the Classical Theory has been accustomed to rest the supposedly self-adjusting character of the economic system on an assumed fluidity of money-wages; and, when there is rigidity, to lay on this rigidity the blame of maladjustment.

John Maynard Keynes, 1936, The General Theory of Employment Interest and Money, p. 257.

If trade is brisk all energies are strained to their utmost, overtime is worked, and then the limit to production is given by want of power rather than by want of will to go further or faster. But if trade is slack every producer has to make up his mind how near to prime cost it is worth his while to take fresh orders. And here there is no definite law, the chief operative force is the fear of spoiling the market; and that acts in different ways and with different strengths on different individuals and different industrial groups.

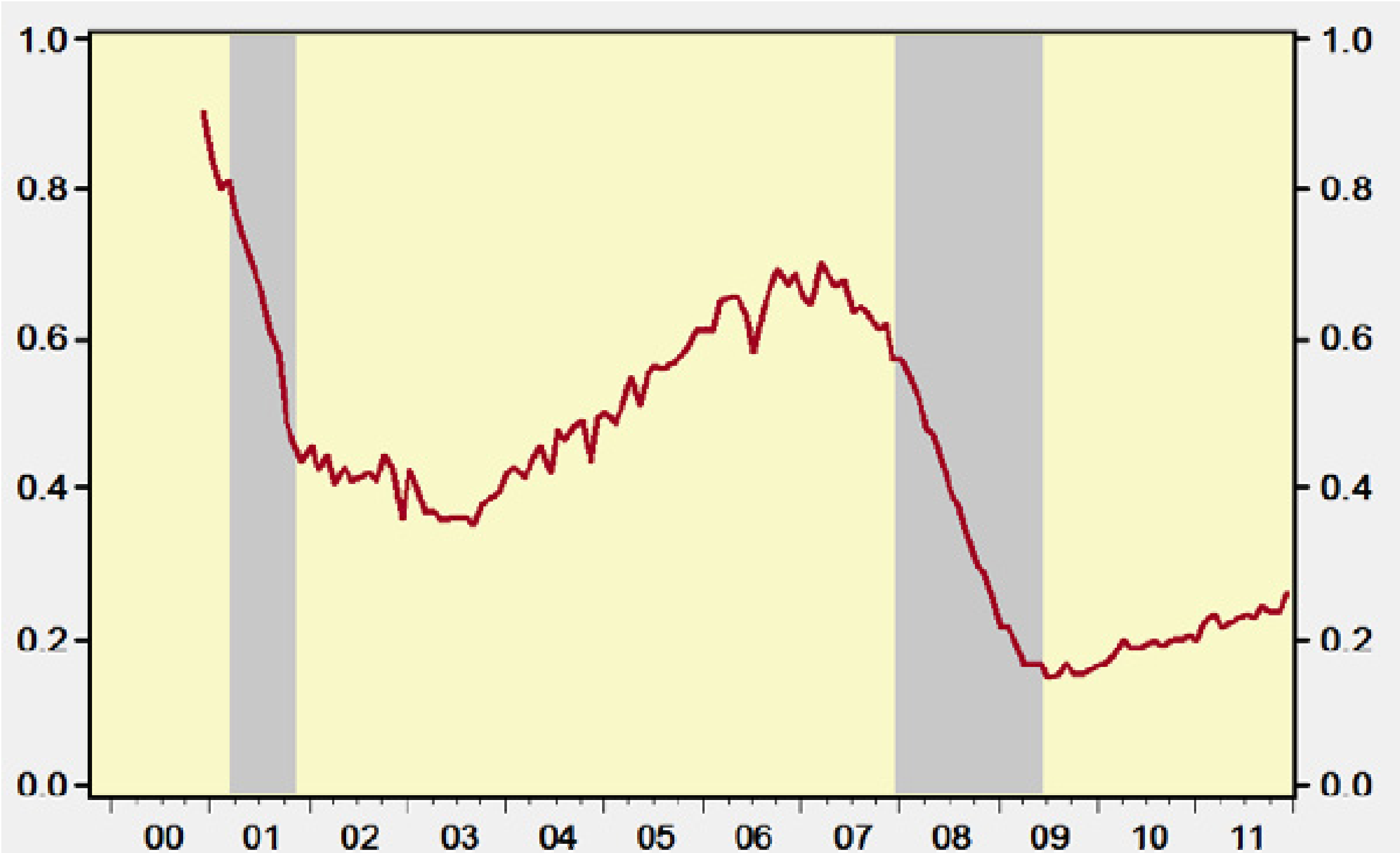
Alfred Marshall, 1920, 1948 edition, Principles of Economics, 8th ed., p. 498.

[On a] streetcorner outside Fenway Park … [t]here are buyers and sellers, neither of whom is willing to budge. The scene is something of a capitalist staring contest, an exercise in supply and demand. … The game has started but his price remains fixed. …

To a casual onlooker, the solution seems simple. Drop the price. But when the idea is brought up, the man in the gray cotton T-shirt quickly shoots it down. … “If you owned a store, and you sold milk, and all your milk was about to go bad, and everyone held out until the last minute to buy your milk, and you dropped the price, what would happen?’’ … He explains that no one would be willing to buy milk at full price. The integrity of the product would be compromised.

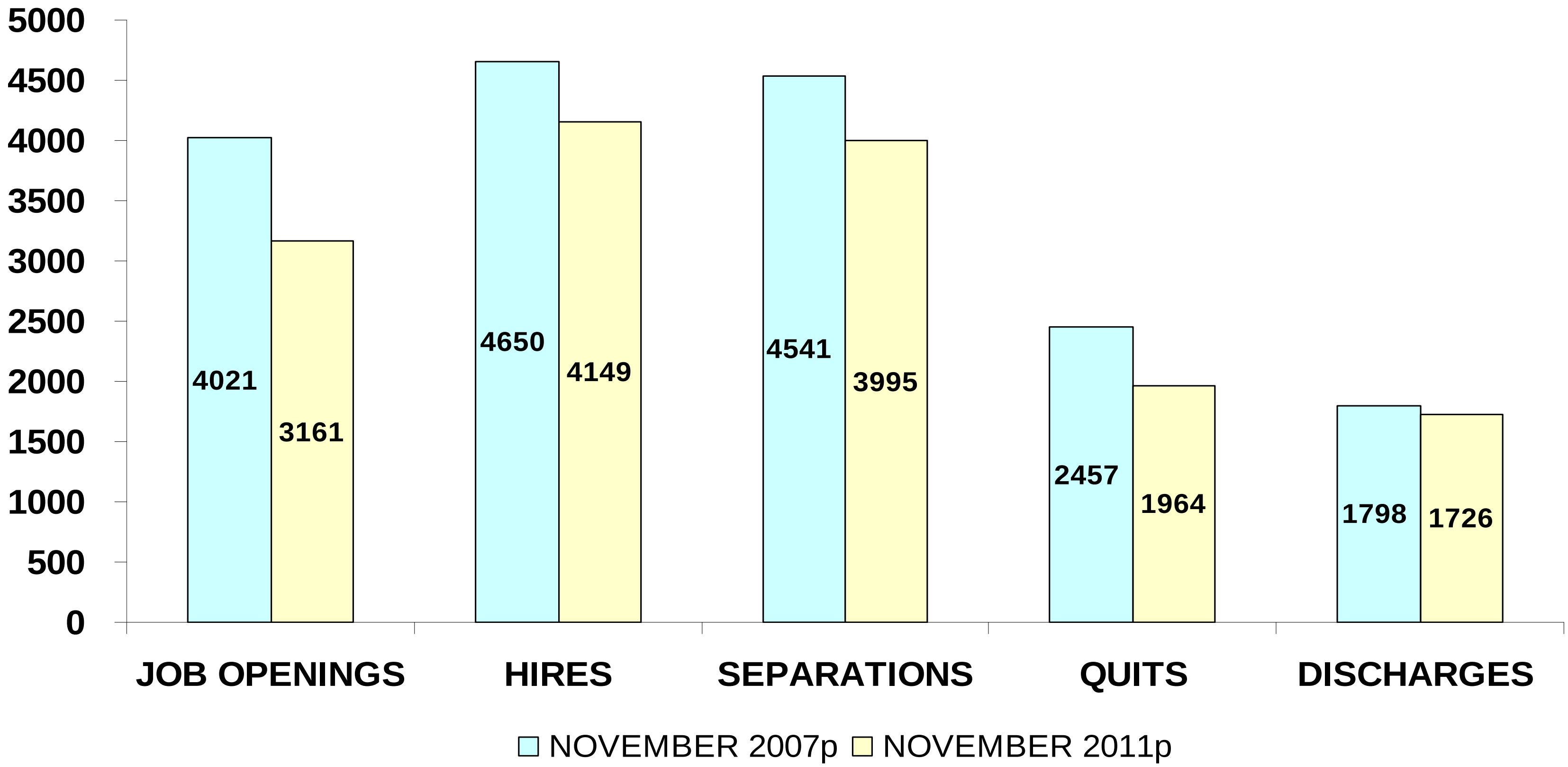
Robert Mays, Globe Correspondent, Losses are piling up for scalpers, August 17, 2010

Ratio of Job Openings (JOLTS) to Unemployed (CPS)



Source: Haver Analytics

Job Openings and Labor Turnover
November 2007 and November 2011
Nonfarm Sector, Seasonally Adjusted



Notes: All Numbers are Preliminary and in Thousands
Figures for “Discharges” are NOT seasonally adjusted

Source: BLS News Release, JOLTS, January 10, 2012
BLS News Release, JOLTS, January 8, 2008

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37 states are providing less funding per student to local school districts in the new school year than they provided last year

30 states are providing less than they did four years ago

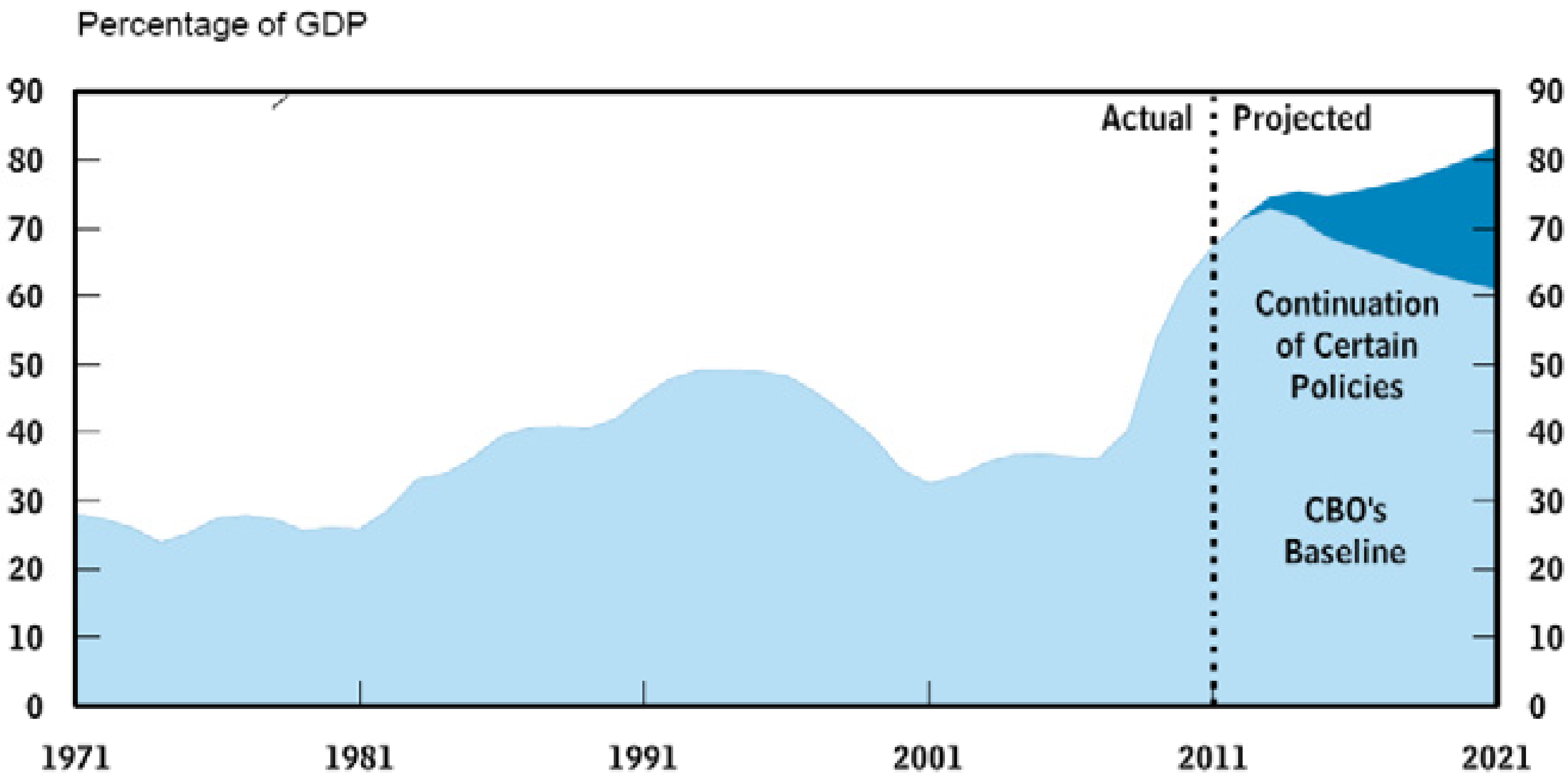
17 states have cut per-student funding by more than 10 percent from pre-recession levels.

4 states— South Carolina, Arizona, California, and Hawaii — each have reduced per student funding to K-12 schools by more than 20 percent.

These figures are in inflation-adjusted dollars and focus on the primary form of state aid to local schools.

Source: CBPP, New School Year Brings Steep Cuts in State Funding for Schools, October 7, 2011.

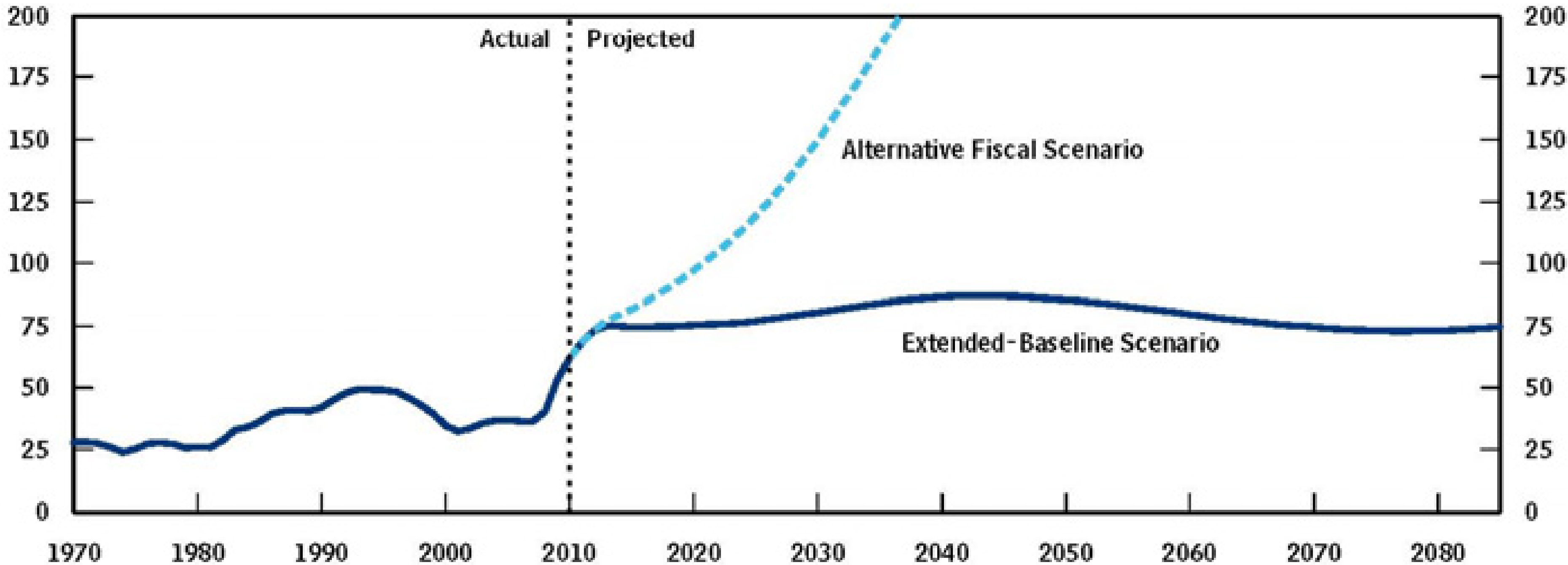
Federal Debt Held by the Public



Source: "Confronting the Nation's Fiscal Policy Challenges", Douglas Elmendorf, Congressional Budget Office, September 13, 2011.

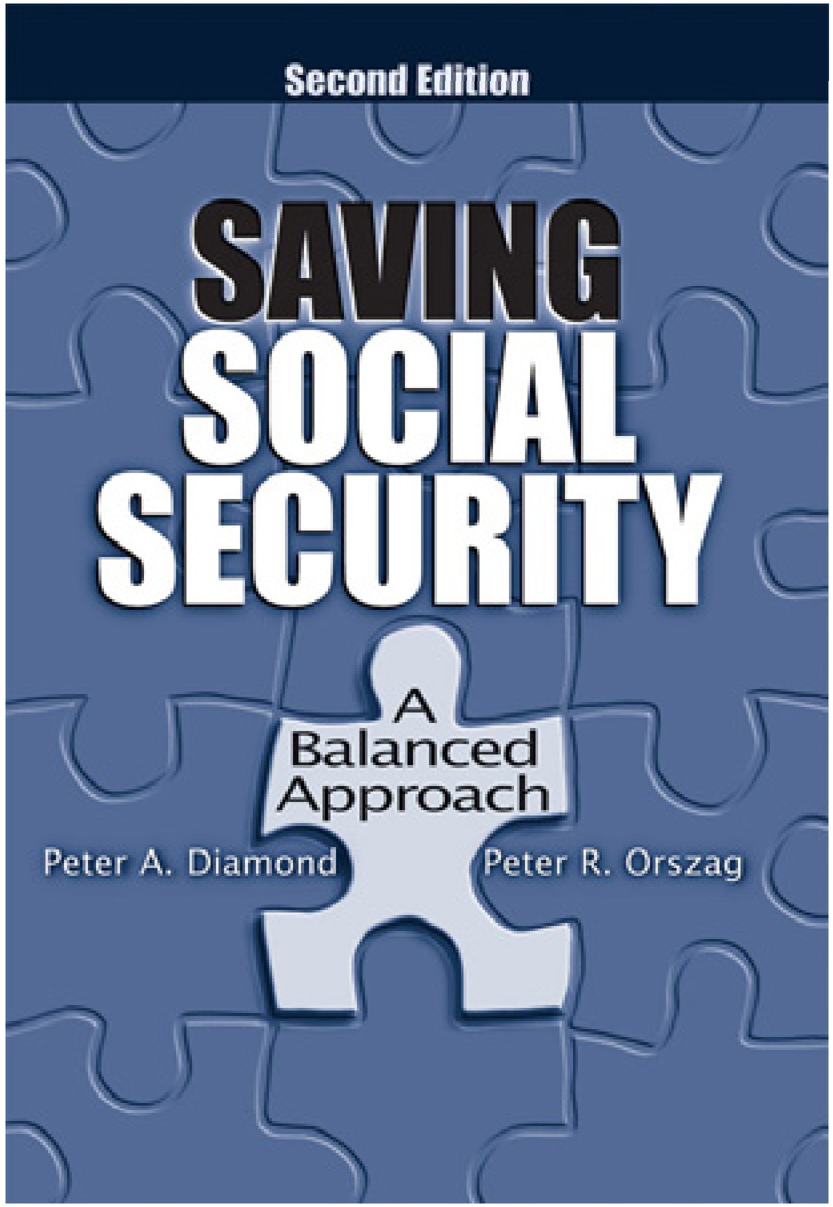
Federal Debt Held by the Public Under CBO's Long-Term Budget Scenarios Through 2085

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Note: The extended-baseline scenario adheres closely to current law, following CBO's 10-year baseline budget projections through 2021 and then extending the baseline concept for the rest of the long-term projection period. The alternative fiscal scenario incorporates several changes to current law that are widely expected to occur or that would modify some provisions that might be difficult to sustain for a long period. (For details, see Table 1-1 on page 4.)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Peter A. Diamond
Peter R. Orszag

the social costs of debt financing are significantly higher than the private costs.

Statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation on FDIC Oversight: Examining and Evaluating the Role of the Regulator during the Financial Crisis and Today before the House Subcommittee on Financial Institutions and Consumer Credit; May 26, 2011.