Roger W Ferguson, Jr: A retrospective on business-cycle recoveries: are "jobless" recoveries the new norm?

Remarks by Mr Roger W Ferguson, Jr, Vice-Chairman of the Board of Governors of the US Federal Reserve System, at the Exchequer Club of Washington luncheon, Washington, DC, 21 July 2004.

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It is an honor for me to address the Exchequer Club of Washington, D.C. Your purpose of providing a frank and open exchange of information and opinion on national policy is indeed laudable.

With business investment bouncing back and consumption continuing to grow, real gross domestic product seems to have been advancing at approximately a 4 percent annual pace over the first half of the year. In addition, both the labor market and the manufacturing sector, two areas that had been lagging through most of the recovery, appear to have finally started to advance. Private payroll employment has risen a little more than 200,000 per month, on average, since the end of last year, and although last month's increase of 117,000 was disappointing, there is little indication that the labor market's progress is stalling. The same may be said of the manufacturing sector, in which employment, before last month's decline, had posted three consecutive months of solid gains, and production advanced strongly again in the second quarter.

Of course, as some recent data remind us, there are always sizable uncertainties regarding both the likely rate of growth of economic activity and the trajectory of inflation. That said, the recovery from the 2001 recession appears to be firmly on track. Accordingly, this seems to be a good time to take stock of what we should learn from recent business-cycle experience. In particular, we have experienced two "jobless" recoveries. Are these the new norm? The question is of more than academic interest. A change in business-cycle dynamics might dictate important changes in the conduct of monetary policy. As usual, the remarks I make today represent my own views, which are not necessarily shared by other members of the Board of Governors or of the Federal Open Market Committee.

Distinctive features of the current recovery

A truism among students of business cycles is that no two cycles are ever exactly the same, and the current recovery has been unusual in several respects. For some time after the recovery began, businesses were reluctant to increase expenditures for fixed capital and to re-stock inventories. Business fixed investment usually jumps shortly after a business-cycle trough, as firms that held back during the recession rush to put new equipment in place to replace aging equipment and to meet the expected surge in demand. For example, in the year-and-a-half after each of the six troughs between 1958 and 1982, business fixed investment rose at an average annual rate of 7-1/2 percent. But in the year-and-a-half after the trough of the 2001 recession, firms actually decreased investment at an annual rate of ¾ percent; this decline occurred in addition to the sharp fall in capital spending (relative to GDP) that took place during the recession. Likewise, investment in business inventories, which had subtracted more than 1 percentage point from real GDP growth, on average, during the six quarters leading up to the trough, failed to snap back in its usual fashion. Instead, the inventory stock was little changed, on balance, in the first two years of the recovery. Some of this unusual behavior probably reflects the ability of modern firms to function with leaner inventories, but firms also appear to have been acting more cautiously.

A second distinctive element of this recovery involved households. The household sector remained a relatively bright spot in the economy in 2001; increases in spending for consumption goods and housing prevented the downturn in investment from generating a deeper recession. Household spending has continued to rise at a solid pace during the recovery. However, because this recession included neither the typical sharp decline in purchases of durable goods nor the usual deceleration in outlays for other types of personal consumption, we have not seen the sharp increases in these areas that often follow a trough. Indeed, real consumer spending actually rose at a greater rate during the recession than it did over the first year of the recovery. Similarly, real residential investment continued to expand during the recession, and although the rate of growth was relatively subdued, it bore no resemblance to the sharp declines that characterized every previous recession in the post-World War II period; the acceleration since the upturn began has been relatively subdued as well.

However, the most noted feature of the current recovery is that employment has been below par - another so-called jobless recovery. Private payroll employment, and the workweek on net, continued to fall for two years from the trough of the recession in late 2001. Private employment last month remained well below its level when the recession began, and only in May had it climbed above its level when the recession ended. This situation contrasts sharply with the beginning of most postwar recoveries (although, as I will discuss later, not with the one in the early 1990s), when employment surged. Similarly, with employment growth until recently having been wanting, the unemployment rate peaked more than a year and a half after the recession ended and has not yet fallen below its level at the time designated by the National Bureau of Economic Research as the economic trough. And quite possibly the unemployment rate has been understating the amount of slack in the labor market because labor-force participation has been unusually weak, perhaps reflecting an assessment on the part of many households that job availability would be poor for those actually in the labor market.

The output growth that largely defines the recovery resulted from impressive growth in labor productivity. During the two years of falling employment, productivity in the nonfarm business sector rose about 5 percent per year. Part of this spectacular performance is typical. One expects productivity to rise quickly during the early stages of a recovery; as utilization rates rise, companies find more for their workers to do. Part of the growth of labor productivity may have to do with unusual, and transitory, hesitation on the part of businesses to hire, a topic to which I will return. Happily, however, the recent increases appear to have an important structural component as well. Whereas most recessions since World War II had no productivity growth or had outright declines, productivity during this past recession rose at a rate of more than 2 percent. And this growth was a continuation of the rapid gains that characterized the latter half of the 1990s.

The favorable performance of productivity likely is related to another unusual feature of this recovery: the behavior of prices. Productivity growth in the years leading up to the business-cycle peak in early 2001 was one factor that contributed to keeping inflation low. Core prices for personal consumption expenditures advanced at an average annual rate of less than 2 percent over the two years preceding the peak - despite unemployment rates down around 4 percent. Moreover, prices decelerated during the recovery. At this time last year we observed core PCE inflation in the vicinity of 1 percent. In fact, inflation was so low, especially once known biases in the price indexes are taken into account, that for several months the FOMC was concerned more about the possibility of “inflation becoming undesirably low” than about the risk of a rise in inflation.

These low rates of inflation coming into the recession and continuing into the recovery were one reason why the Federal Reserve responded so aggressively to the downturn and why we maintained a historically low federal funds rate so long after the trough. Just how aggressive was this response, relative to history? In general, comparing monetary policy responses across cyclical episodes is difficult. The natural indicator to look at, the federal funds rate, is measured in nominal terms, so that large movements in the rate of inflation can mask the underlying stance of policy. Moreover, an easing of a certain size might be considered relatively more or less aggressive depending on the magnitude and nature of the shocks hitting the economy. Still, in the current cycle, the Fed began lowering the federal funds rate two months before the official cyclical peak (as identified by the National Bureau of Economic Research) and lowered rates 450 basis points over the first year of the easing and 100 basis points over the second year. Although this total decline of 550 basis points was not the largest on record, it was large and quite early. And given the relatively small decline in output in 2001, one can easily argue that this monetary policy response was unusually aggressive.

Similarities with the recovery in the early 1990s

In the period since World War II, several of the earlier recoveries had one or two of these features in common with the most recent period. For example, the rebound in residential investment fell short of the typical burst in 1961, the unemployment rate remained stubbornly high in 1971, and inventory investment remained low in 1975. But no previous recovery looked quite like this one.

However, the recovery following the 1990 recession stands out as similar to the current episode in several important respects. First, employment rose at a glacial pace for a year and a half after the trough in early 1991, and the unemployment rate continued to rise. Second, the business sector continued for a full year to reduce spending on fixed investment and to refrain from accumulating significant amounts of inventories. Third, household spending did not accelerate rapidly after the 1990 recession. Instead, both consumption expenditures and residential investment posted among the most-subdued recoveries in the past fifty years. One should note, however, that household expenditures did fall markedly during the 1990 recession, unlike the most recent episode.

Figuring out why these two recoveries were atypically hesitant and jobless is not an easy task. Let me consider several possible explanations. One explanation for the similarity of the two most recent recoveries may be that both of these lukewarm recoveries followed shallow recessions. The shallowness of the downturns is consistent with the general moderation of the volatility of U.S. economic activity in the past twenty years, which many observers have noted. The 2001 decline in total output - only ½ percent spread over the first three quarters of the year - was so small that the level of real GDP exceeded its pre-recession peak by the first quarter of 2002. Similarly, real GDP fell only 1-1/4 percent in the 1990 recession. One could argue that, because little ground was lost during the recessions, little ground was available to be regained in the recovery phase. However, the recession of 1969-70 was not any deeper, yet investment spending and payroll employment growth shot up immediately after the trough. Accordingly, a shallow recession does not appear to guarantee a shallow recovery.

A second possibility is that the labor market has changed in a way that makes jobless recoveries the new norm. For example, perhaps the pace of structural change in the demand for labor has increased over time. One could point, say, to a smaller proportion of temporary layoffs among job losers during the past two episodes as an indication that re-employment is now more likely to require changing employers than it was in earlier times. And the common perception is that workers are now more likely to have to change industries or occupations to remain employed. From a firm’s perspective, hiring new workers for different jobs rather than recalling former workers to their previous jobs is likely to involve greater up-front costs in terms of recruitment and training, and the shifts in demand that created the need for new workers mean that hiring is associated with new capital as well. In this case, firms may require greater confidence in the durability of demand for their products to be willing to incur the costs involved in hiring.

Many analysts argue, however, that the labor market has become more flexible since workers have become less attached to individual firms, jobs have become more project-oriented, wage setting has become less rigid, and the use of temporary help and other “contingent” work arrangements has become more prevalent. These developments reduce the up-front costs and commitments involved in hiring and should make firms more willing to hire as demand for their products revives. Therefore, the case for structural change in the labor market as the cause of the jobless recoveries is far from conclusive.

It is tempting to interpret the two recent recoveries as reflecting a fundamental shift in the behavior of the economy or the labor market over the business cycle. Indeed, the two explanations for slow economic recoveries that I have discussed - shallower recessions and structural change in the labor market - likely contain some elements of the truth. However, the structure of the economy is always in flux to some extent, and I think it probable that experiencing two hesitant recoveries in a row was largely a matter of coincidence. In each case, idiosyncratic factors that were specific to each episode combined in a way that inhibited the economic expansion in important sectors when other fundamentals would have favored a more typical cyclical upturn. I will discuss these factors now.

Idiosyncratic factors inhibiting recoveries

The strength of a recovery may be related to the nature of the shocks that led the economy into recession. In contrast to earlier recessions, which were often sparked by tightening monetary policy, the 1990 recession was triggered by a pullback in aggregate demand not induced by monetary policy. In 1990, oil prices increased and consumer confidence dropped sharply; both occurrences were at least partly related to the Iraqi invasion of Kuwait. In response, consumer spending dropped sharply. Although the Federal Reserve had tightened policy in the late 1980s to restrain price pressures, it was loosening again by mid-1989.

Similarly, before the 2001 downturn, the Federal Reserve was not aggressively tightening. Rather, the 2001 recession seems to have been kicked off by unreasonable expectations about the profitability of investment in technology related to the Internet. One manifestation of these overly optimistic expectations was that the nominal share of high-tech investment in overall equipment and software spending rose from about 35 percent in the mid-1990s to almost 45 percent by the end of 2000. By the time more-sober assessments of the profitability of the high-tech sector came to the fore, huge sums of money had been sunk into capital equipment and software and into new enterprises. A serious reconsideration of these expenditures contributed to a sharp retrenchment of business investment.

Although the causes of these two most recent recessions were clearly different, they were similar along one important dimension: Both were related to changes in the subjective appraisals by persons and businesses of fundamental economic prospects, and to heightened uncertainty about those prospects. In real time, it is extraordinarily difficult to determine the likely severity and duration of these types of shocks. Using monetary policy to counter a shock of this nature is not as straightforward as reversing an earlier tightening. In retrospect, it is clear that during the two most recent recoveries these subjective views improved and uncertainty abated only slowly. Therefore, the first idiosyncratic reason why these recoveries were tepid was likely that the preceding recessions were caused by shocks that proved to have longer-lasting effects and that were more difficult to counteract than expected.

In the wake of the two recent downturns, further idiosyncratic shocks hit the economy, exacerbating the sluggishness of the recoveries. In the early 1990s, the collapse of savings and loan institutions and the need to repair the capital structure of the banking industry led to a period in which the flow of credit to businesses was impaired - the so-called credit crunch. Facing limited access to credit, businesses - especially small businesses - curtailed hiring and capital expenditures.

After the trough in 2001, the banking industry was much sounder. However, the economy was still adjusting to the excess capital spending from the late 1990s. Equipment takes years to depreciate; so when firms realized that they had purchased more than they needed, they did not feel compelled to raise their level of capital expenditures again for quite some time. Indeed, this "overhang" of capital has likely contributed to the impressive growth in productivity over the past few years, as businesses have made more and better use of the high-tech equipment they had previously installed but underexploited.

Besides the boom-bust cycle in capital spending, the U.S. economy confronted the terrorist attacks of 2001, the corporate governance scandals of 2002, and the 2003 war in Iraq. Clearly, such an uncertain and risky environment, which led many firms to question the durability and strength of the recovery, encouraged neither the creation of new jobs nor the expansion of capacity.

This discussion of the post-recession shocks that damped the pace of the most recent two recoveries does not imply that similar obstacles were absent in earlier recoveries. The early stages of previous recoveries also contained events that legitimately raised concerns about the vitality and viability of the upturns. Indeed, at the beginning of each recovery for at least the past fifty years, some observers expressed concern that various factors might result in a tepid recovery. In 1982, for instance, as the United States emerged from recession, growth in the rest of the world was moribund, and the international financial system was considered fragile. Other concerns were that the length of the recession would make consumers and businesses cautious and that changes in the economy would lead to prolonged structural unemployment.

In 1975, concerns were that the recovery would be weak because businesses were still adjusting to higher oil prices and pollution regulations and because several large cities (most famously New York) were having serious financial troubles. In addition, the housing industry was threatened by a large inventory of unsold homes as well as difficulties obtaining financing after the collapse of the market for real estate investment trusts. Even after the relatively mild recession of 1969-70, a speculative crisis in foreign exchange markets and apprehensions on the part of businesses about just-enacted wage and price controls and environmental regulations fueled some pessimism about the prospects for a quick recovery.

Geopolitical tensions, which may seem like a distinctive feature of the past two business cycles, also weighed on analysts' minds following the cyclical troughs in 1961 and 1958. The 1961-62 recovery coincided with the building of the Berlin Wall, the resumption of nuclear weapons testing in the Soviet Union, and other incidents that heightened Cold War tensions in various parts of the world. The 1958-59 recovery coincided with a crisis in the Middle East that involved the entry of U.S. troops into Lebanon as well as a crisis in the market for Treasury securities that kept Fed observers, at least, on the edges of their seats.

Thus, adverse conditions and events were certainly not confined to the two most recent recoveries. In the earlier cases I have just noted, however, these headwinds did not, in the event, result in sluggish recoveries. Given the disparate nature of the shocks across these episodes, one cannot say with certainty why the particular combinations of factors in the most recent cases led to a different outcome. The upshot for policy, unfortunately, is that clearly identifying both the possible obstacles to a recovery and the ramifications of those obstacles is extremely difficult, if not impossible.

Conclusion

In summary, delayed and sluggish improvements in the labor market, business equipment investment, and inventory accumulation mark the two most recent recoveries as different from other recoveries after World War II. Why these most recent two recoveries have been atypically hesitant and jobless is unclear. As I have discussed, the shallowness of the recessions and the possible structural changes in the labor market may have played some role. However, I think that important weight should be given to idiosyncratic features such as the causes of the preceding recessions and the occurrence of additional shocks after the recessions ended that exacerbated the economy's problems. This view implies that monetary policymaking probably does not need to be altered in a systematic way to accommodate a new sort of business-cycle dynamics. On the contrary, the fact that the two most recent recoveries have involved slow job growth in their initial stages may best be attributed to chance rather than a new structure of the economy. Each recovery faces its own obstacles, and understanding the forces acting on the economy at any point requires continual monitoring of a wide range of indicators of economic activity, household and business attitudes, financial market developments, and price pressures. In all cases, however, the touchstone guiding policy should be the mandate given to the Federal Reserve: a foundation of stable prices underpinning maximum sustainable growth.