

# *If it is over, then what have we learned?*

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*So, a physicist, chemist and  
economist are on a deserted  
island.....*

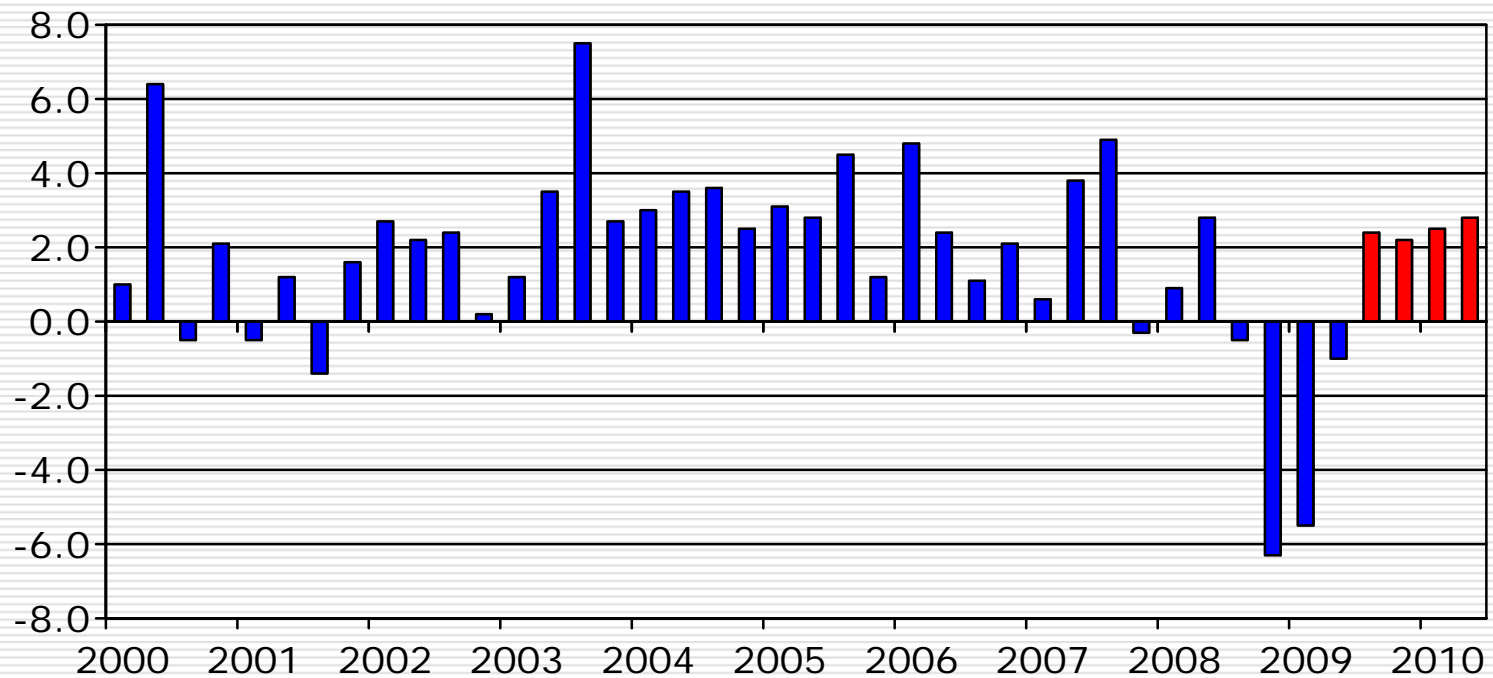
# Agenda

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- National Outlook—*There are signs of spring.*
- Michigan—*Are we looking into a tunnel or a mine?*
- So, what have we learned?
  - *A Minsky's moment.*
  - *Is there anything to Behavioral Economics?*

Good News! We only declined by 1.0% in the second quarter

## Annualized Percent Change in GDP



Source: BEA, Philadelphia Federal Reserve Survey of Professional Forecasters.

# National outlook: Most of the nation's economic indicators are pointing south.

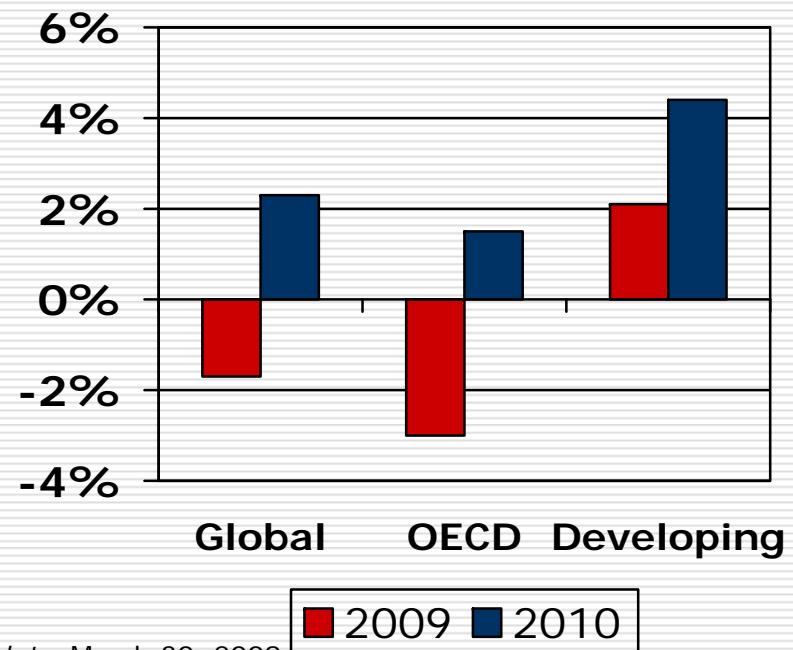
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<input type="checkbox"/> Employment	RED
<input type="checkbox"/> Residential construction	RED
<input type="checkbox"/> Consumer confidence	YELLOW
<input type="checkbox"/> Consumer financial conditions	RED
<input type="checkbox"/> Credit markets	RED
<input type="checkbox"/> ISM Purchasing Mgrs. Index	YELLOW
<input type="checkbox"/> Stock market	GREEN
<input type="checkbox"/> Inflation	GREEN

# It's global!

- The 1.7 percent forecast decline in worldwide GDP would be the first on record!
- GDP in developed OECD countries is expected to fall this year.
- *However, Japan, Canada, France and Germany all reported positive growth in the second quarter.*

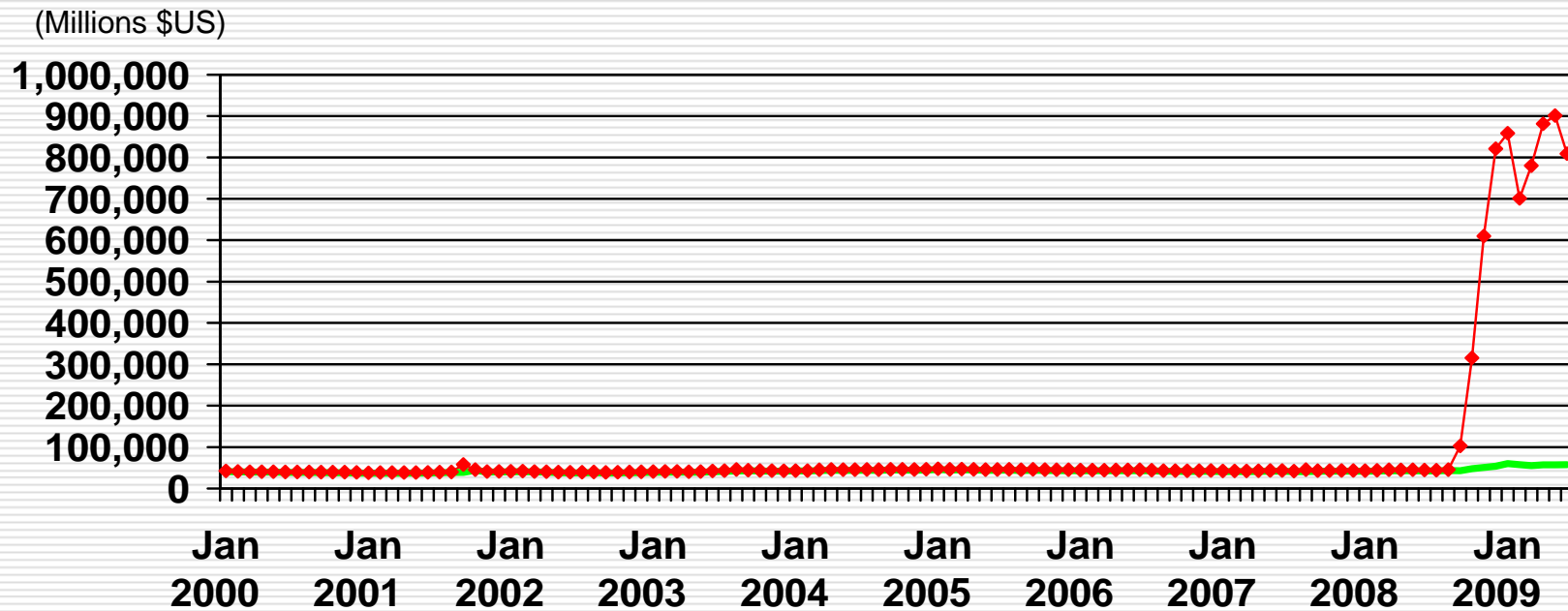
**Forecast 2009 GDP Growth Rates**



Source: World Bank, *Global Economic Prospects 2009: Forecast Update*, March 30, 2009.

# Banks continue to hold on to their reserves.

**Aggregate U.S. Depository Institution Reserves**  
(Adjusted for seasonality and changes in reserve requirements)

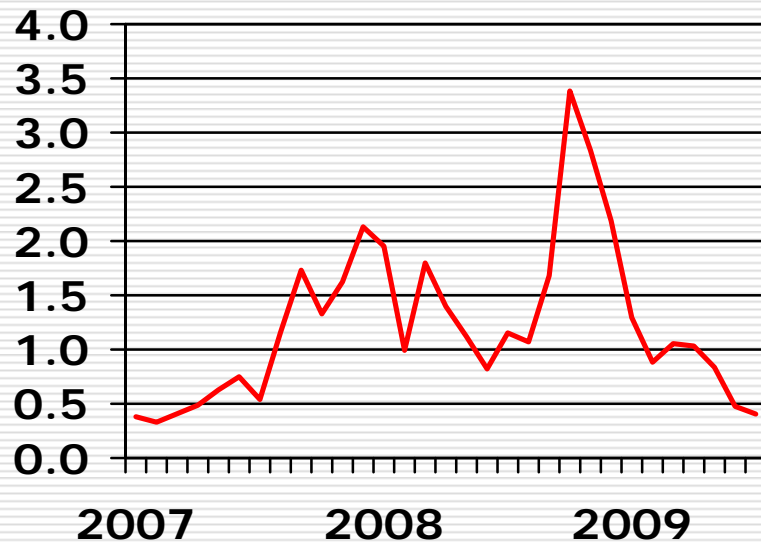


Source: Federal Reserve, Statistical Release H3.

◆ Total reserves — Required

# Risk premium has returned to pre-crisis levels.

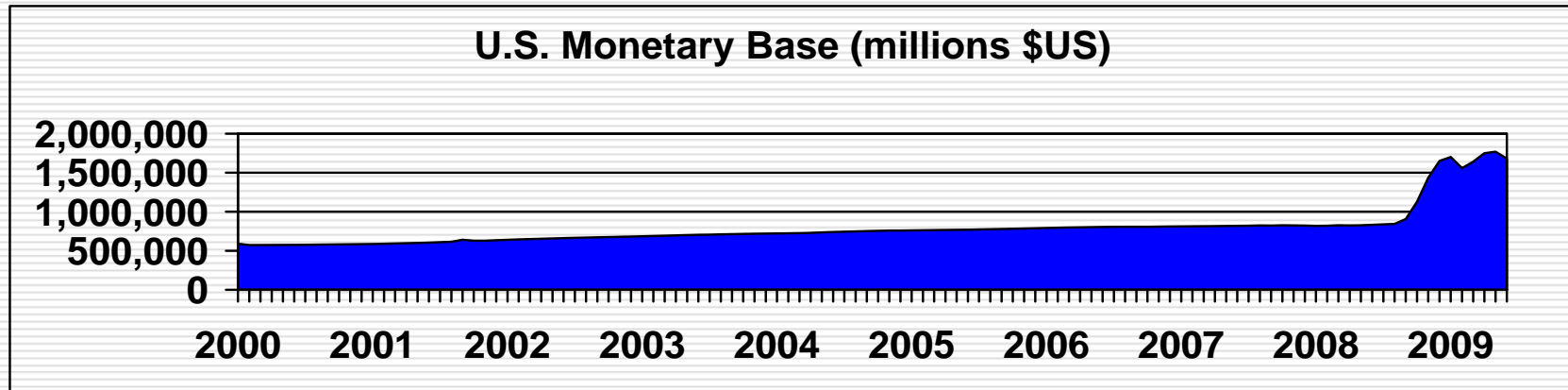
**LIBOR Rate Minus  
Three-Month  
Treasury Rate**



Source: Calculated using data from Federal Reserve and MoneyCafe. All data are for 3-month market rates.

- Difference between LIBOR and risk-free treasury shows risk premium.
- The average rate difference from 2000-2005 was only 0.35 percentage points.

# The nation's money supply has doubled over the past year!



- ❑ Federal stimulus efforts and bank bailouts have led to a substantial increase in the amount of money in the system.
- ❑ However, inflation remains low. Consumers are paying down debts and saving, while banks are hoarding cash reserves.
- ❑ Our international trading partners are also holding a lot of dollars.
- ❑ However, when there is too much money chasing too few goods, inflation is often the result.

Source: Federal Reserve, Statistical Release H3.

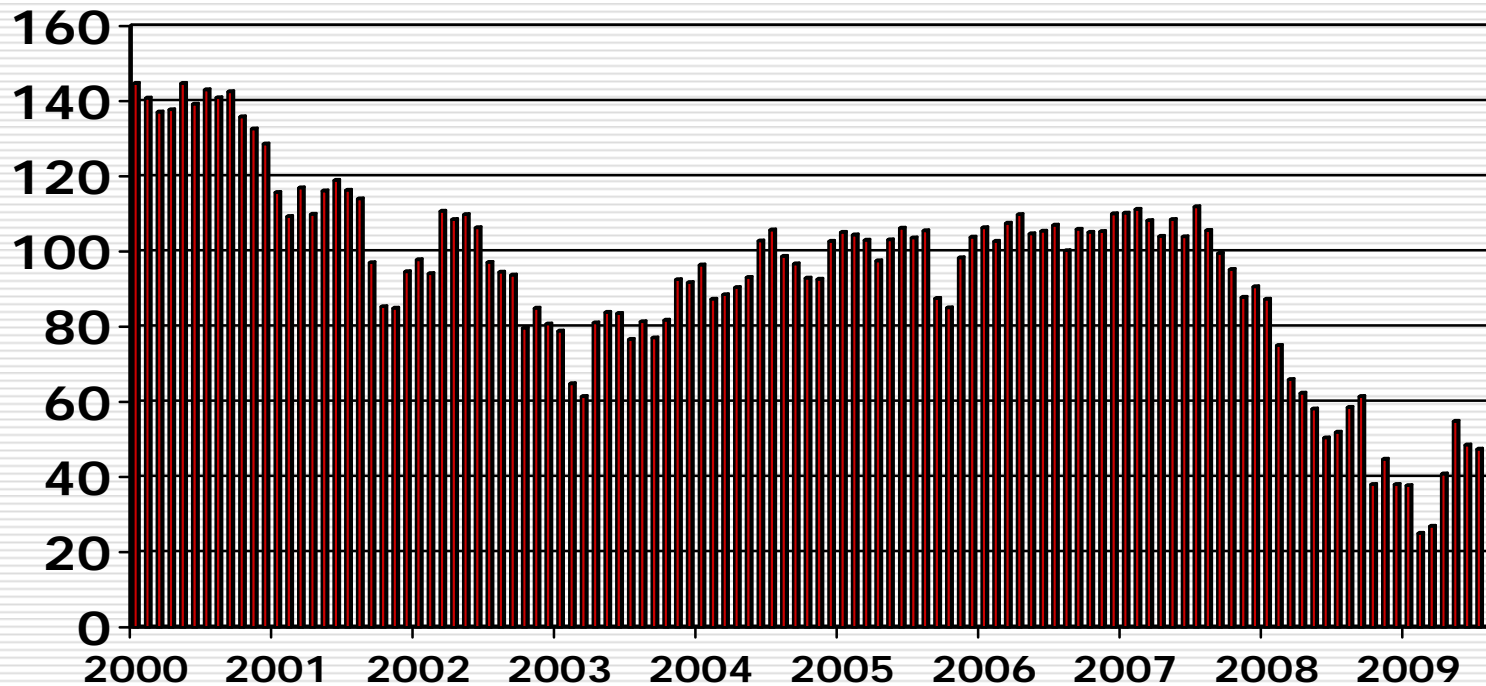
# Consumers

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- ❑ Confidence is slowly returning.
- ❑ The housing market has stabilized.
- ❑ Retirement savings remain troubled, but the savings rate has increased dramatically.
- ❑ Job outlook is not good.

# Consumers' confidence is still low but improving.

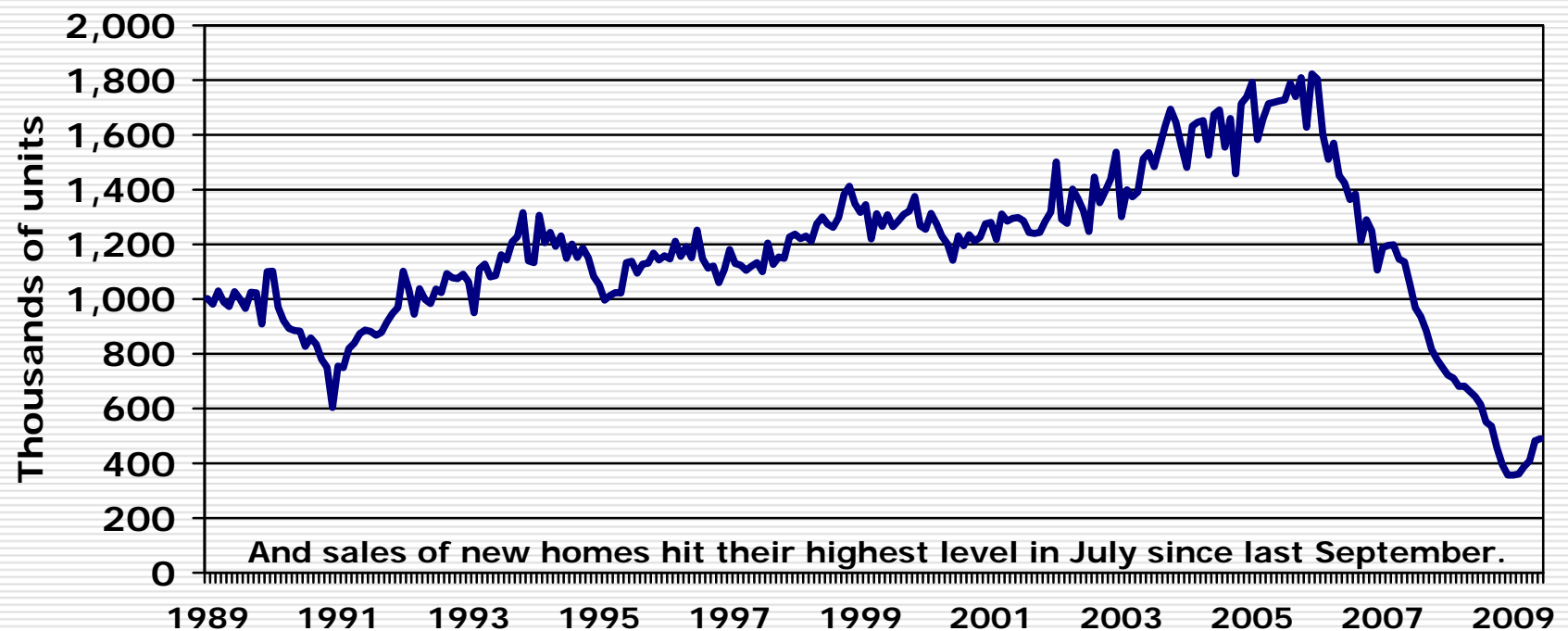
Consumer Confidence (1995=100)



Source: Conference Board.

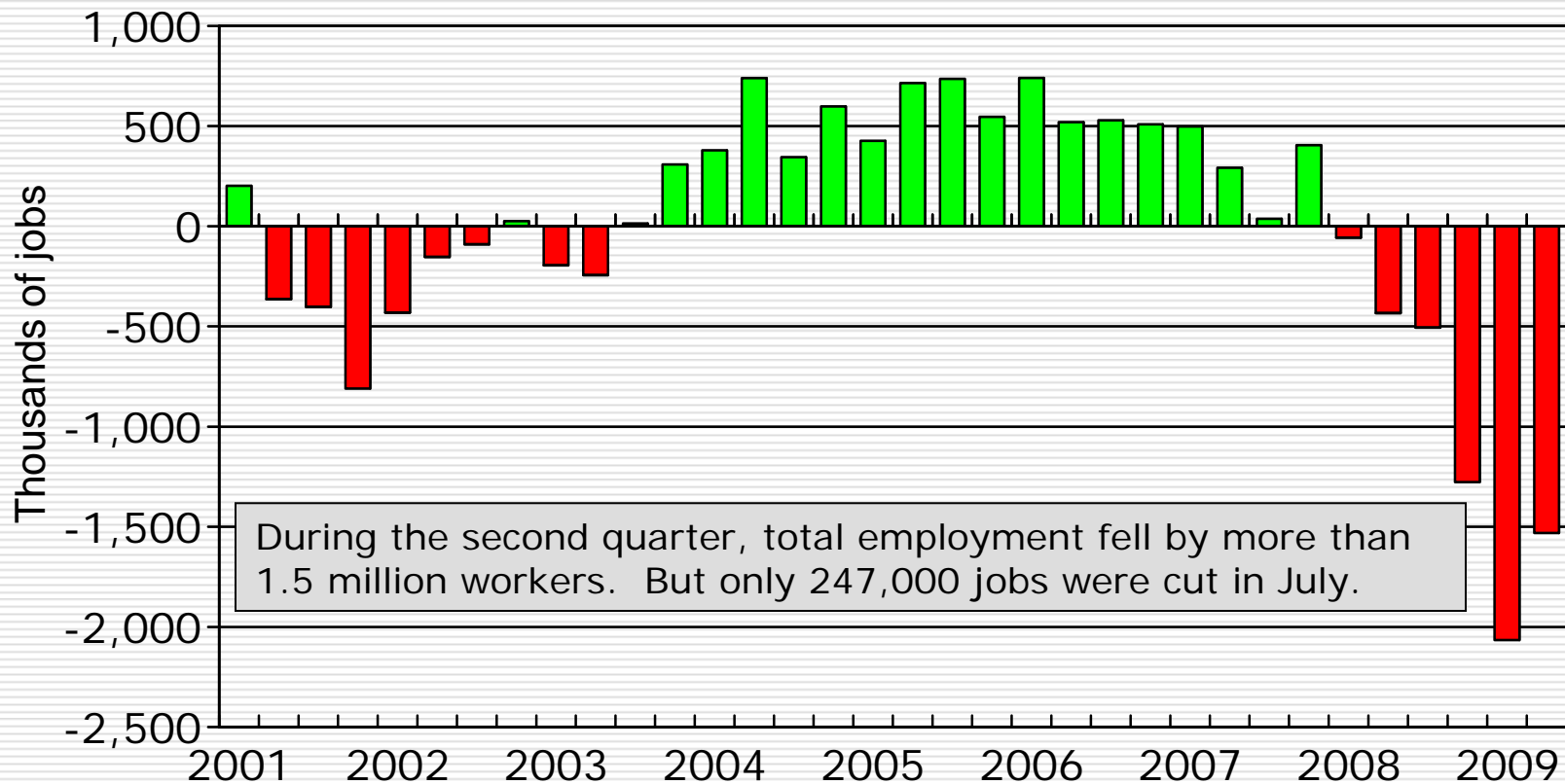
# Single-Family Housing Starts—*Have we found bottom?*

## Seasonally Adjusted Annual Rates



U.S. Census

# Nationwide, employers are cutting way back.



During the second quarter, total employment fell by more than 1.5 million workers. But only 247,000 jobs were cut in July.

Source: BLS.

We must remember that the current recession was rooted in the nation's financial markets.

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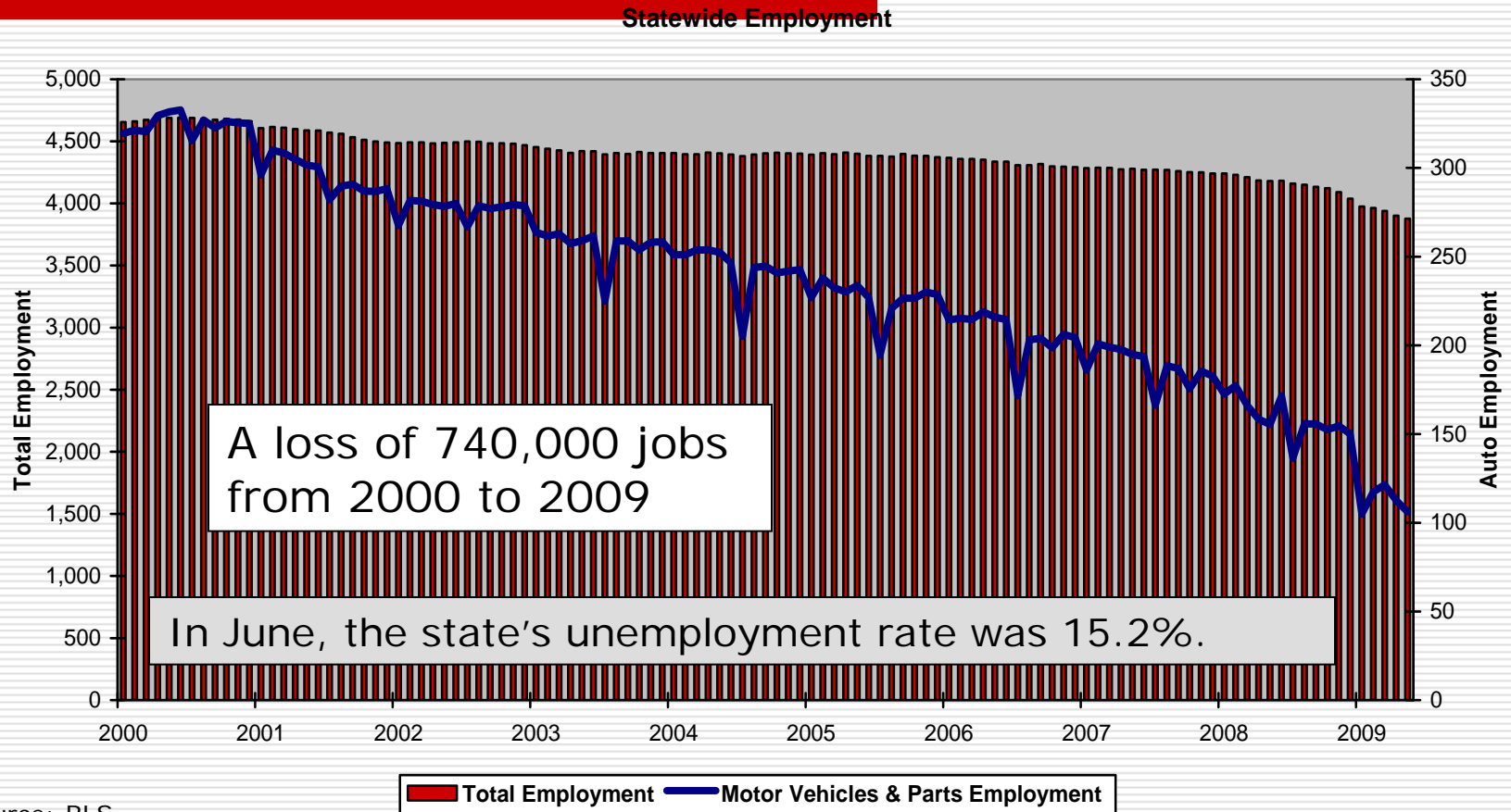
- This suggests that the recession could be more cyclical than structural. In other words, the economy could bounce back looking roughly the same. However,
  - As in any recession, the weaker companies may fail.
  - There are a lot of dollars out there which may cause future inflationary pressures.
  - Employment is a lagging indicator. It may not be until 2012 that employment levels will return to pre-recession levels.

# Michigan remains in crisis.

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- ❑ A one-horse town with one sick horse.
- ❑ State government is facing a structural deficit that will not go away without a substantial change in its tax structure.
- ❑ Perceptions are important and hard to change.

# With the national slowdown, the state's turnaround is further postponed.

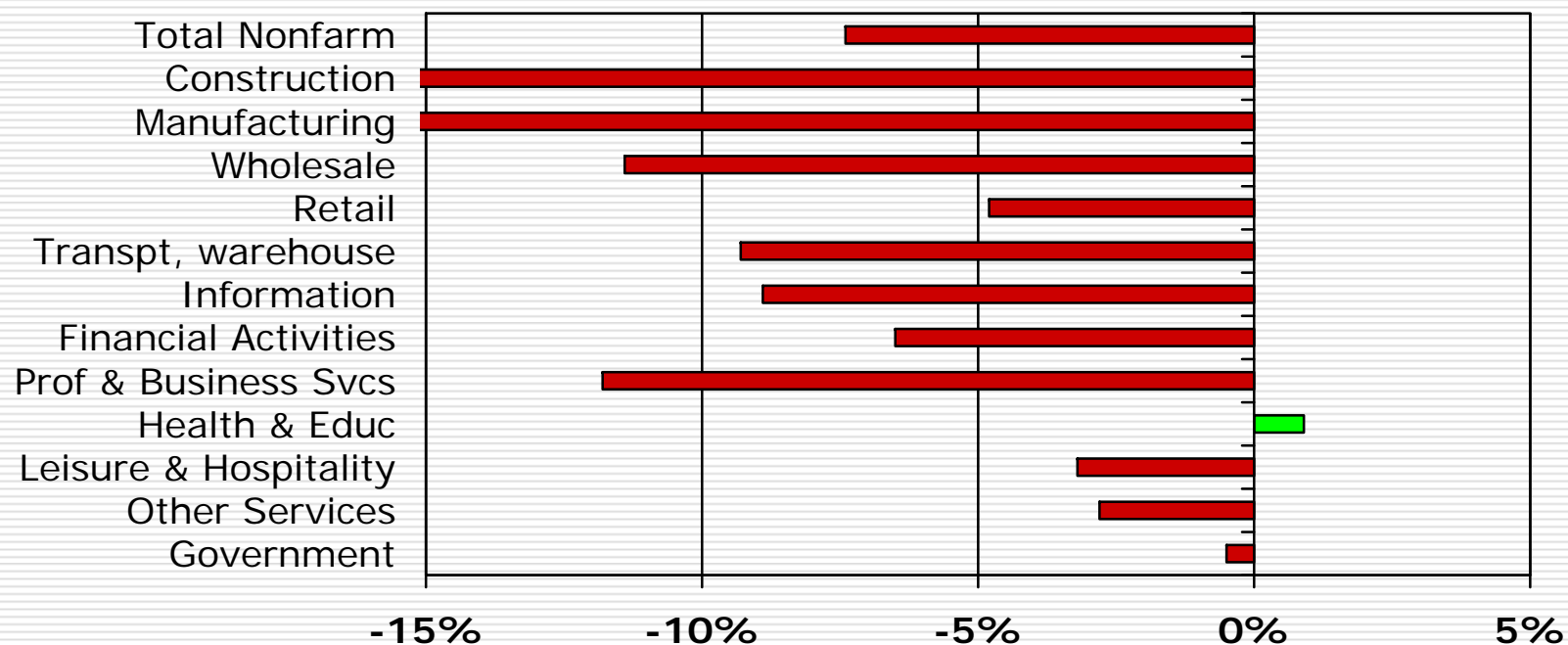


Source: BLS.

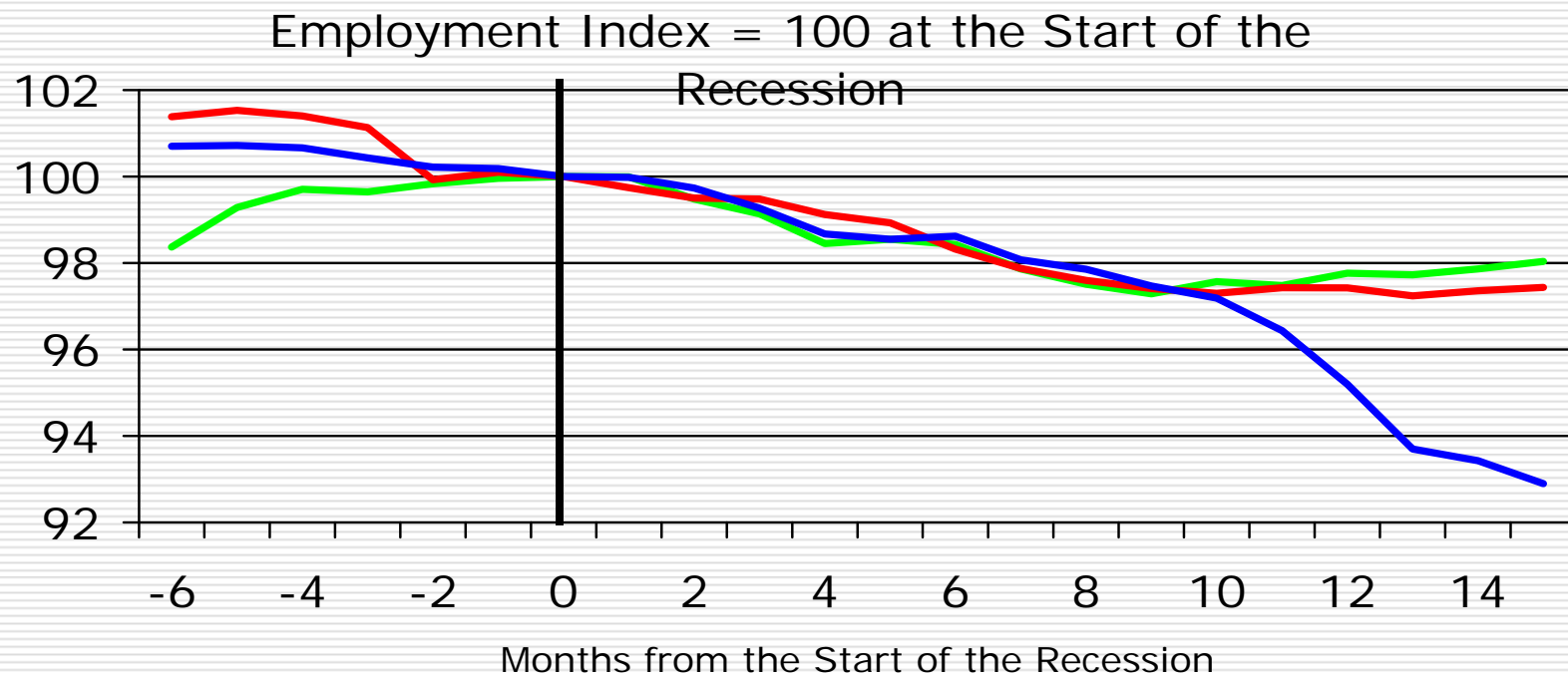
During the past four quarters, employers have cut 308,000 jobs in the state.



Michigan Employment Change  
Second Quarter 2008 - Second Quarter 2009



# This is a tough recession for the state.

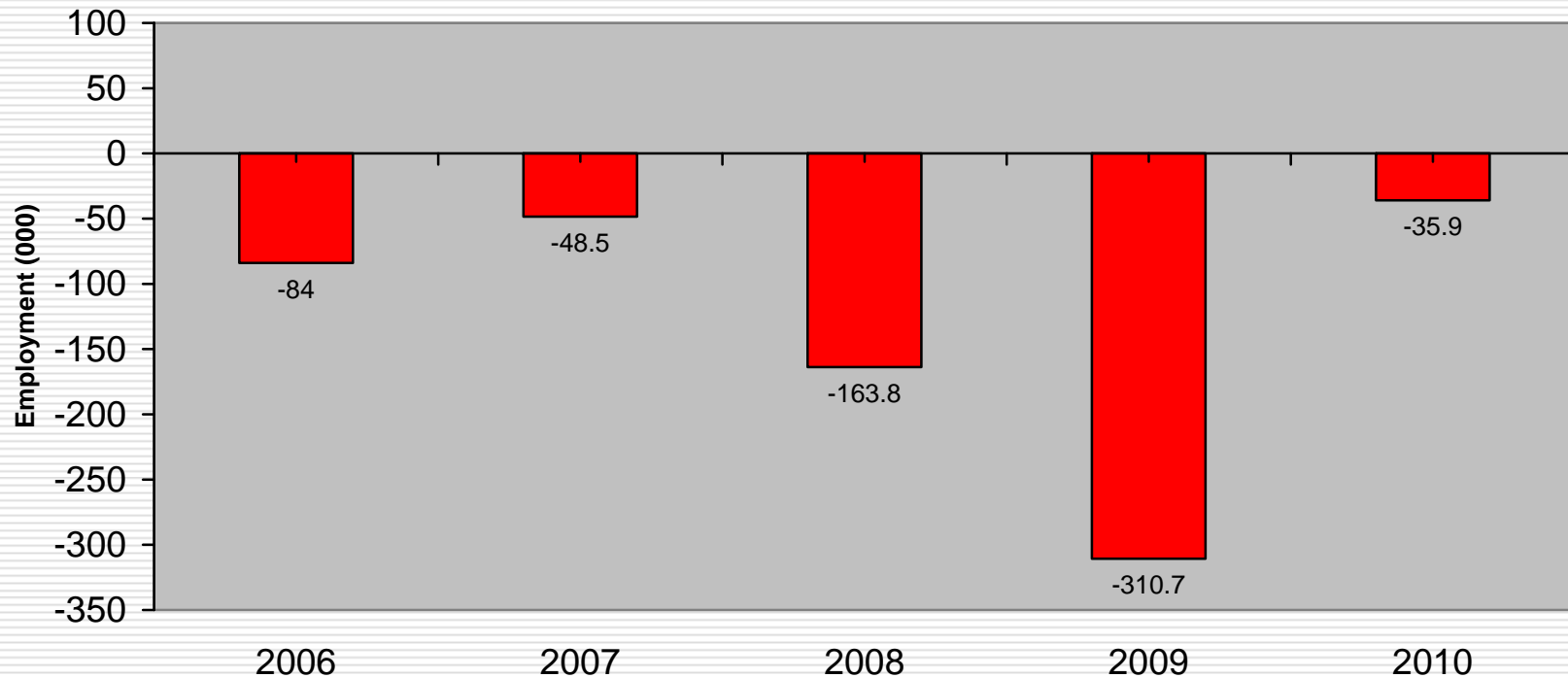


Source: CES, seasonally adjusted.



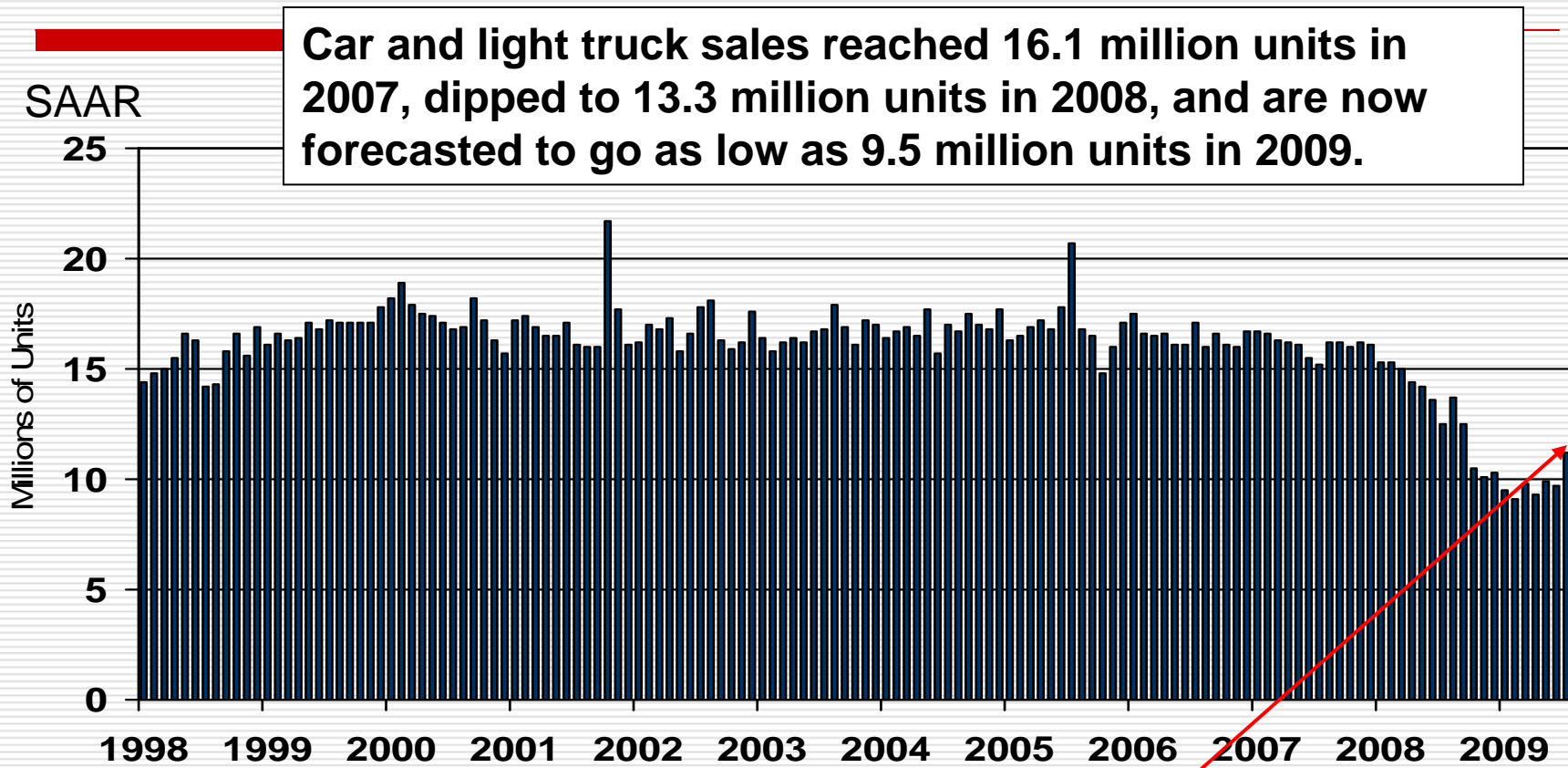
# Employment declined for 10 straight years.

Employment Change, 4th Quarter to 4th Quarter



Source: University of Michigan, July 2009.

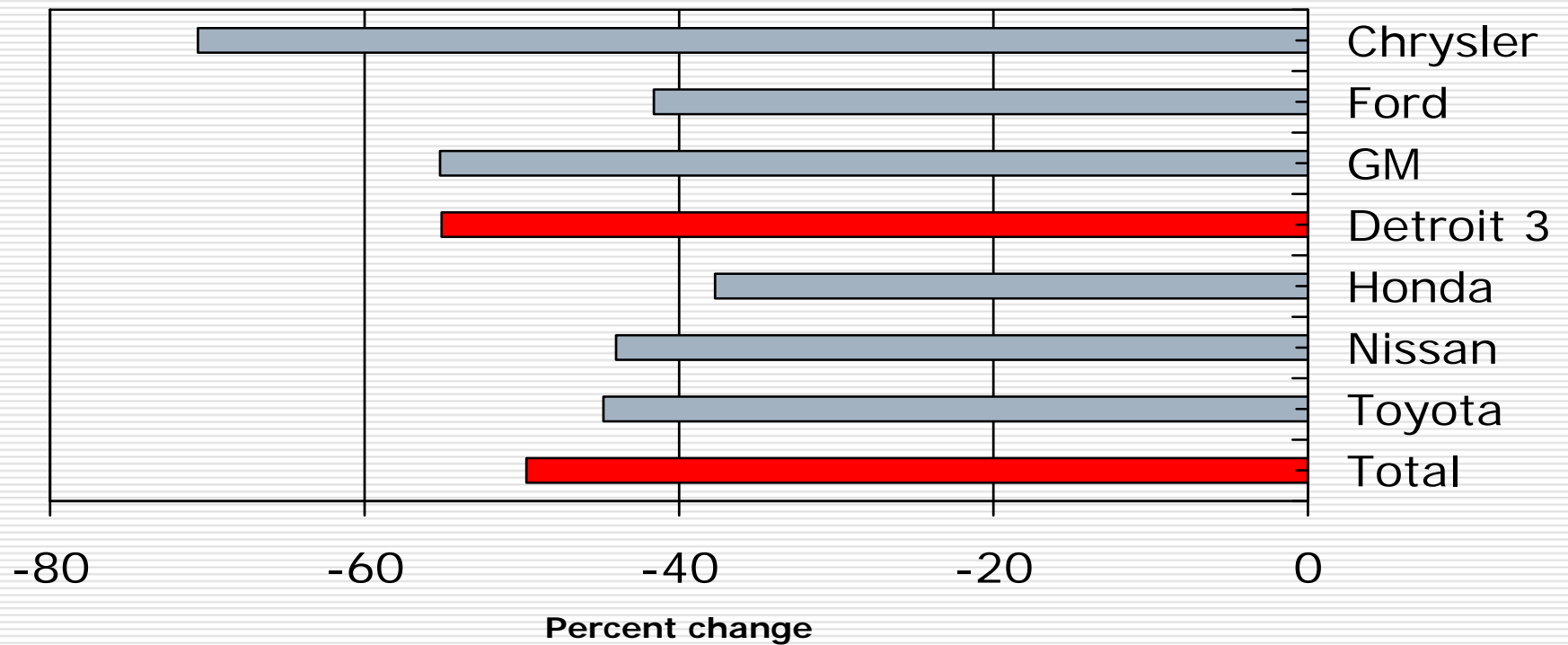
# Now that clunkers are no longer gold, will the showrooms still be busy?



Source: BEA.

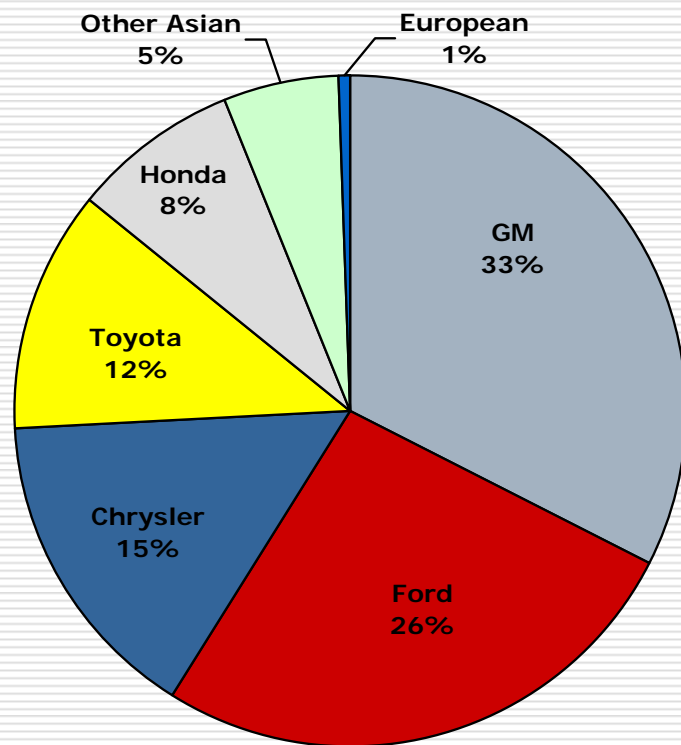
# Production levels have plunged. Jan-June 2008 to Jan-June 2009

North American Car Production



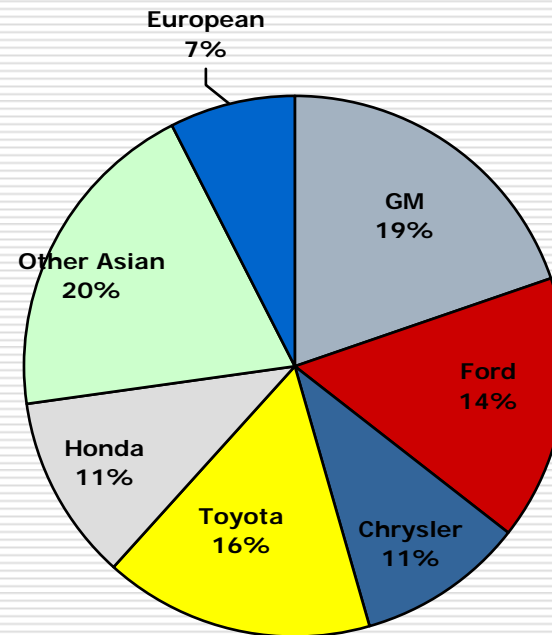
Source: Ward's AutoInfoBank <http://wardsauto.com/keydata/NAProductionSummary0902/>

Loss of market share: In 2001, the Detroit Three controlled 74%; in 2009 it fell to 44%.



Source: *Wards AutoWorld*.

**2001**



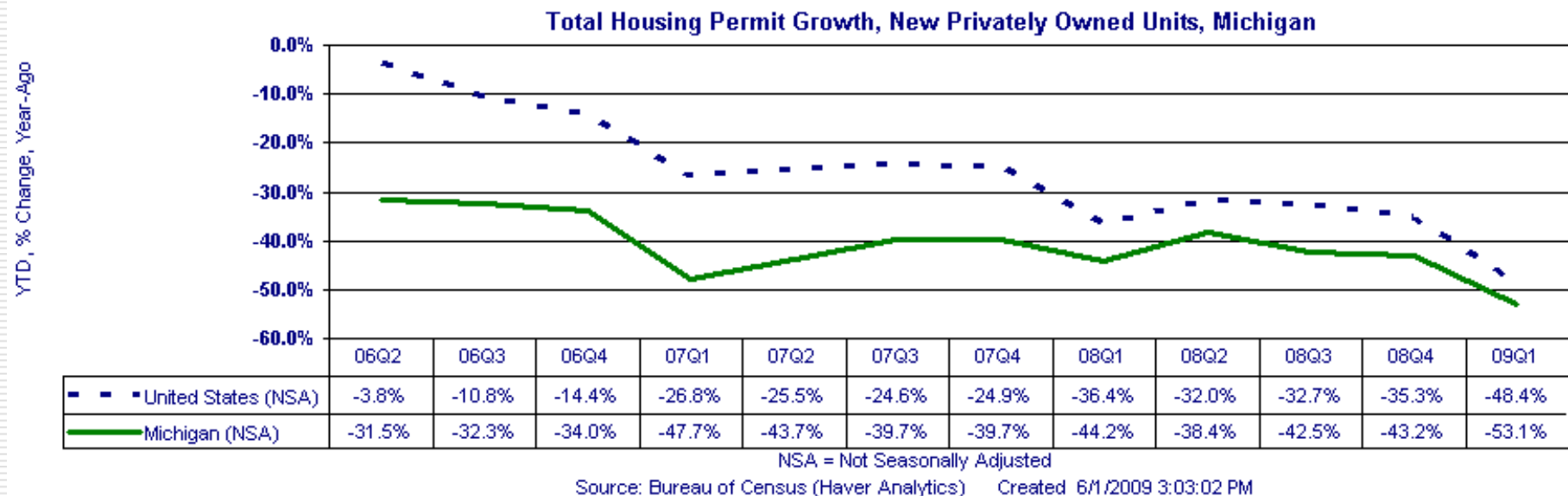
**2<sup>nd</sup> Q 2009**

# So, will GM make it?

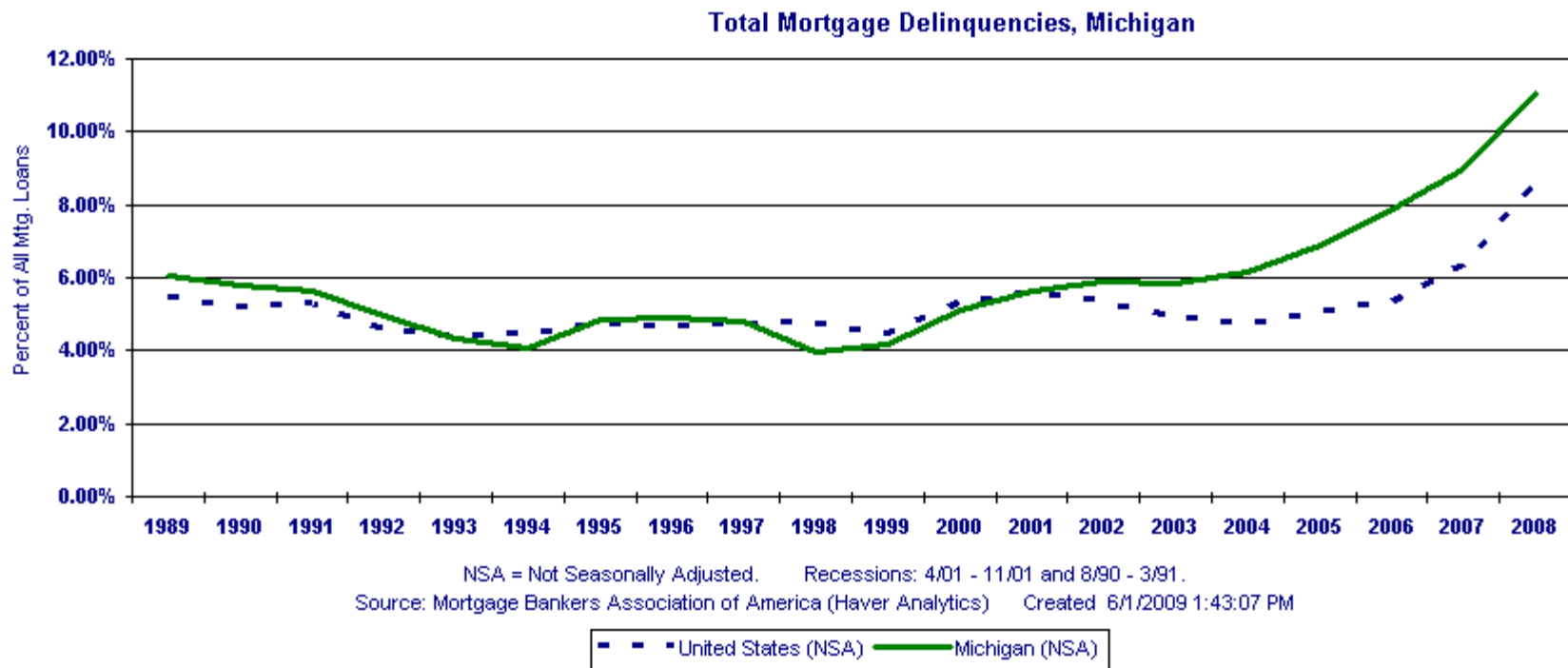
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- The company will reportedly go from 47 factories to 34 by the end of 2010. U.S. employment will go from 91,000 at the end of last year to just 64,000 at the end of this year.
  - Their cars are not known for quality.
  - Their cars are not known for design.
  - Their management structure is a mess.
  - The car market is lousy.
  - The competition is not standing still.
  - Building trucks is different than building fuel-efficient cars.
  - And yet my kid (Dr. Kid to you) just researched, tested, and selected a Chevy Malibu over Honda and Toyota.

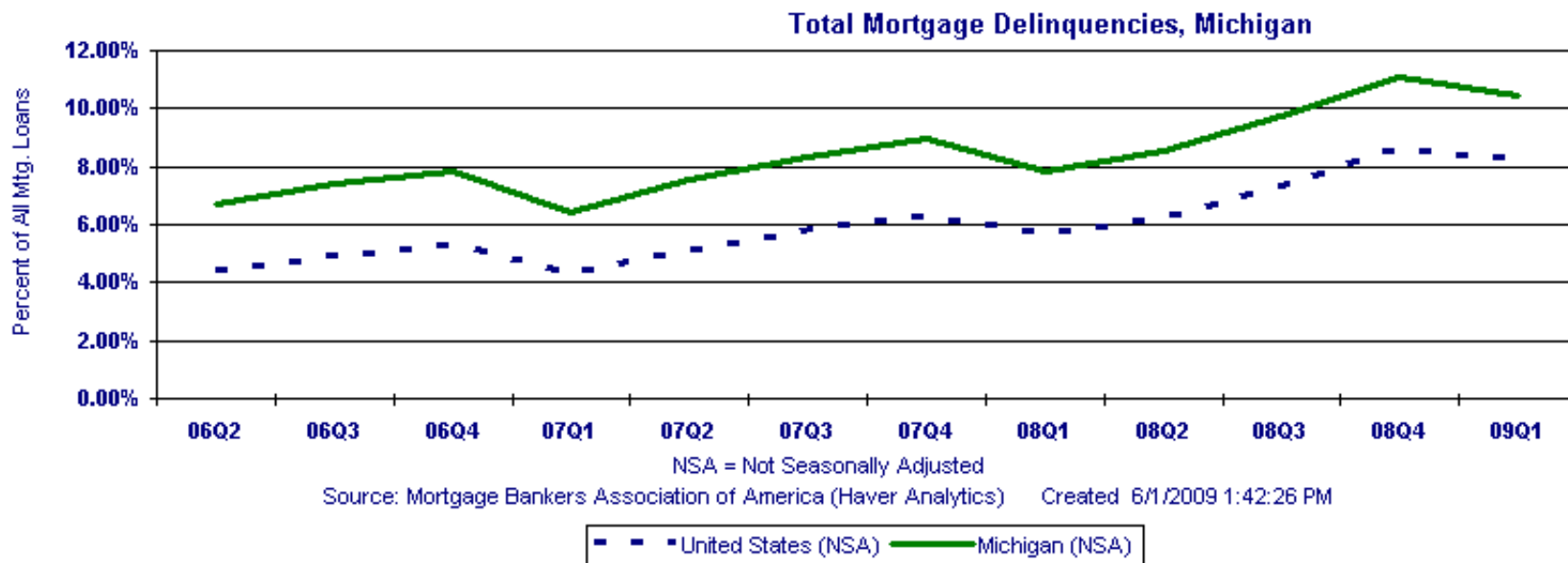
The market for new home construction has fallen even faster in Michigan than in the rest of the nation.



# Mortgage delinquencies have risen to a very high level—especially in Michigan.



# The small delinquency rate decline in Q1 2009 was probably just a seasonal dip.



# Why would rational individuals do the dumb things that were done during the past four years?

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- Answer: They wouldn't, and it is driving economists crazy and their models into a ditch.
  - A Minsky's moment
  - What behavioral economists say

# A Minsky's moment—*Can we learn from our past mistakes?*

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## Warning Signs

1. Change in traditional practices.
2. New willingness to take on debt.
3. New innovations in the market.
4. The promise of higher prices tomorrow.

## □ Financial Examples

1. New mortgage instruments that allowed little money down with low teaser rates.
2. Securitization and the inability to properly account for risk.
3. An environment that encouraged extremely leveraged deals.

### Takeaways:

1. In the middle of a bubble, caution is disregarded.
2. According to Minsky, new regulations and a more conservative culture will keep the banking industry from another bubble for years.
3. But, it is likely that this pattern will repeat itself in another sector

# The irrational things that we do that are predictable.

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- ❑ We are overly optimistic about the timing of benefits and underestimate the timing of costs.
- ❑ Most people's time preference is not linear. We have a very high discount rate in the short time and a low discount in the long term.

# The irrational things that we do that are predictable.

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- ❑ People will cheat but only modestly. But, people will be more dishonest the further their actions are removed from the taking of actual cash.
- ❑ We put too much value on what we own.

# So what?

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- After a period of normal economic growth, we (investors, home buyers and consumers) start making overly optimistic plans where future expected benefits are much greater than possible costs. We buy high because prices will only get higher.

# So what?

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- Because of our high short-term discount rate, we accept high interest rates on our credit cards and do not save. We run up credit card debt but this is ok because it fits with our “plan.”

# So what?

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- ❑ Investors and banks set up questionable instruments that feel on our optimism. And these instruments are “removed” from cash, so it is more acceptable to all.

# So what?

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- ❑ As plans start to fail, those in the position to cheat on nonmonetary assets have strong incentives to do so.
- ❑ Households and investors are trapped
  - by their irrationally optimistic plans and
  - their “ownership” bias that causes them not to adjust to the changing market.

# Wrap up

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- Signs suggest that the national economy is stabilizing, but a slow turnaround is expected
  - Financial markets are still very cautious.
  - Employment will lag and not rebound until possibly 2012.
- We may be older but perhaps no wiser.

## Wrap up (cont'd)

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- ❑ Michigan is not expected to recover until 2012 at best.
  - The future of the Detroit Three is very unclear.
  - Perception is very difficult to change.

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