Financial Fragility in the Consumer Age: Source of Growth – Seeds of Collapse

Weidenbaum Center Lecture Series
January – February, 2013
Part 1
Setting the Stage: The Great Recession and its Aftermath

- Historic macroeconomic event
  - The “Great” Recession: severe and persistent

- Unanticipated?
  - The “Great Moderation;” presumed ascendance of wise monetary policy
  - Reflected in recently released Fed transcripts
Voices in the Wilderness

- Ned Gramlich – Fed Governor
- Economist, October 2007:
  - Consumer spending (70% of the economy) “is threatened by its evil twin – the explosion of household debt … The U.S. may have exhausted an unprecedented consumption-driven boom and may sit on the brink of the most severe downturn in economic activity since the early 1980s, and possibly since the Great Depression.”
- Juneau, AL newspaper (early 2008): “the views of Fazarri [who is that guy?] and Cynamon, we should hasten to say, are not widely shared.”
- Others who doubted the Great Moderation – Motivation for our book project
The Basic Story

- Mid 1980s – mid 2000s: Consumption boom fueled by debt stimulated US economy
- Rise in debt ultimately unsustainable
- 2006–2008: Lending slows, then freezes; spending collapses
- The Great Recession
- Look at some details …
Employment Relative to Beginning of Recession

- 9/74-2/76
- 4/80-9/83
- 7/90-2/93
Adjusted Profile: Labor force grows at 0.09% per month from December, 2007. (Actual growth from Dec. 2004 to Dec. 2007 0.11% per month.)
Seeds of Collapse – Part 1

- Mid 1980s up to the Great Recession
  - The “Consumer Age”
  - Cynamon and Fazzari (2008 and 2012, chapter 6)
- Importance of consumer demand
  - Always the dominant share (about 62% in 1960s)
- Could be driven by income growth
  - Largely true prior to early 1980s
  - But middle–class incomes stagnant since about 1980
- Paradox: Importance of consumer spending rises ....
Consumption Share in Total Output

Nominal PCE / Nominal GDP

Consumer Age
Seeds of Collapse – Part 2

- How could consumption rise so fast when (most) incomes stagnated?
- Households borrow at unprecedented rates
- Consumer age: debt-financed consumption & home purchases as primary engines of demand
What Motivated the Consumer?

- **The “life-cycle” model**
  - Forward-looking consumption smoothing
  - Use debt to help with periods of low income

- **Problems:**
  - Baby-boomers should be saving; saving rates fell
  - No reason for debt to be excessive

- **Expectations and wealth effects**
  - Did people anticipate faster income growth?
  - Consumption powers through burst of dot-com bubble
Alternative Behavioral Model

- **Uncertainty**: when you don’t know what to do, learn from those around you
  - James Crotty (1994): “because they are fully human, agents have a deep psychological need to create the illusion of order and continuity even where these things may not exist.” People “endeavor to fall back on the judgment of the rest of the world which is perhaps better informed,” (Keynes, 1936).

- **Reference groups**: individual behavior conditioned by social environment
  - The “consumption norm”

- **Forces that raised consumption norms**
  - Technology: cool new stuff
  - Media saturation expands relevant neighborhood
  - Consumption “arms race” (Robert Frank)
  - Rising inequality encourages higher spending
How Was It Paid For?

- Rising access to credit
  - Credit cards, HELOCs, cash-out refinancing
- Nuanced perspective on financial behavior
  - Do not grab every dollar of credit immediately
  - But bias over time toward more spending when credit is available
  - As behaviors change, social norms of finance change $\Rightarrow$ mutually reinforcing trends
Household Demand

- Consumption spending and demand for new homes
- Source of growth – Risk, and then reality, of collapse
Household Demand Stimulus in Consumer Age


NIPA PCE to Disp. Income

Adjusted Household Demand to Spendable Income

Output Before and After the Great Recession

2012 Output Gap: $1.5 trillion (9.2%)
Two Measures of Investment

- Business Investment
- Residential Investment
What Comes Next?

- Conventional wisdom: slow improvement; no significant structural change
  - Recovery should “gain traction”
- But disappointment, quarter after quarter
- To understand, we need a deeper look ...
Lecture 2: Anatomy of a Crisis

- The role of finance
  - Why did they do it? (Borrowers and Lenders)
  - Who pulled the trigger?
  - Can we get (and do we want) a return to “normal” in the financial system?
  - Framework: Minsky’s financial instability theory

- Rising inequality
  - Remarkable trend
  - Controversy about whether it matters
  - Some new research

- For further reading ...
http://muddywatermacro.wustl.edu

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