

Macroeconomic Overview

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2 for 8

- I thought subprime was too small to take down the U.S. economy, even if the housing bubble did crash hard
- I thought, after Bear-Stearns, that we were in liquidation-quasinationalization mode rather than uncontrolled bankruptcy
 - I thought the TBTF institutions knew they had a government backstop, and would use it aggressively
- I thought higher inflation would follow rather than precede strong recovery
 - I thought no run on Treasuries possible until higher inflation appeared
- I thought that the Federal Reserve would make stabilizing nominal GDP growth in order to avoid prolonged high unemployment its principal priority
- I thought the Obama administration would apply the lessons of the RTC and the S&L crisis
- I thought the Obama administration would husband its resources to act--via Reconciliation, FHFA, TARP, infrastructure banks--if needed, even if Congress proved dysfunctional

Global Challenges

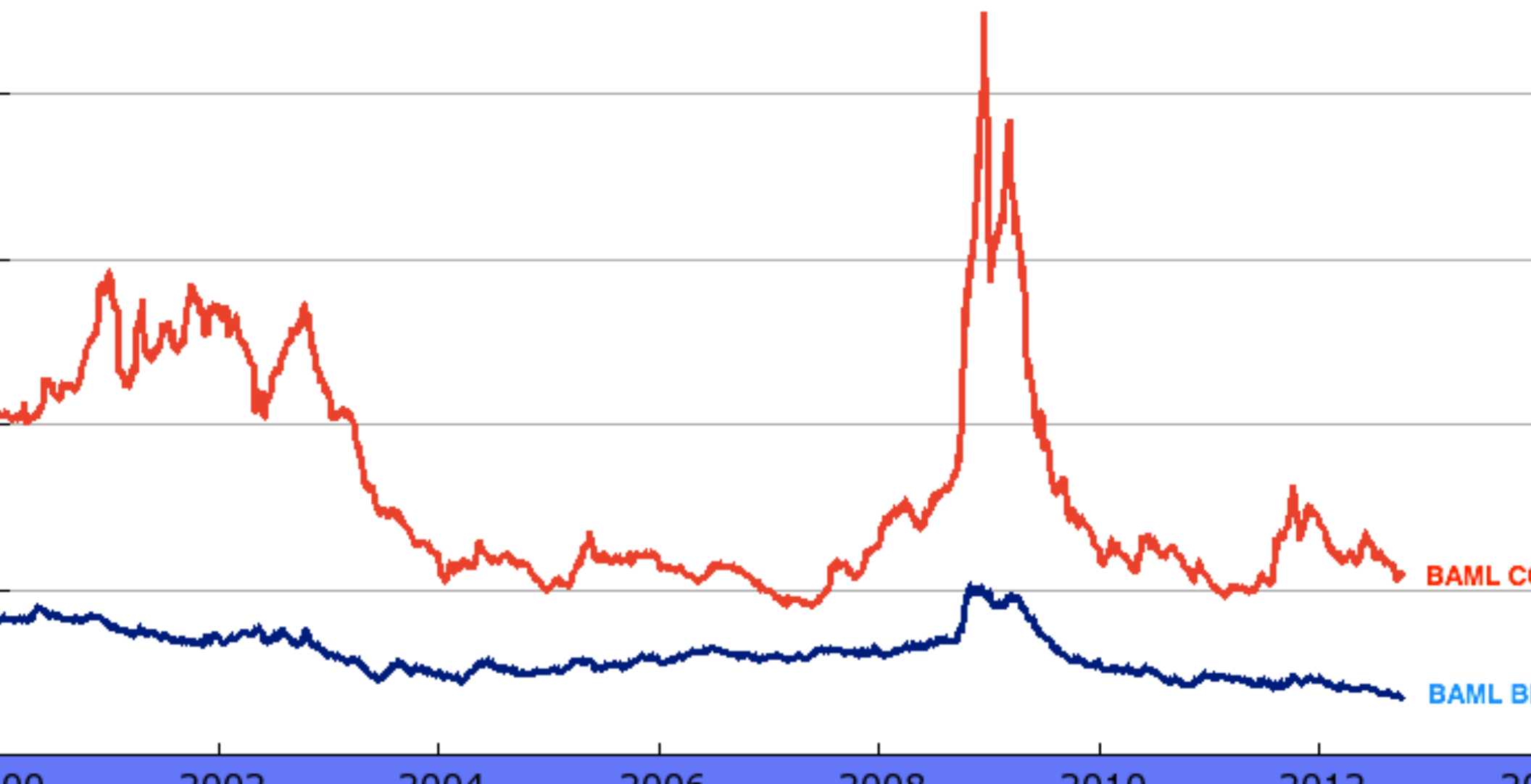
- How to rebalance U.S. Housing market?
- How to avoid transformation of U.S. unemployment from cyclical to structural?
- How to rebalance costs between southern and northern Europe?
- How to allow foreigners to invest on a large scale without deranging domestic capital markets?
- How to deal with a possible major China growth slowdown?
- Can expansionary monetary policy alone cure a balance-sheet recession?
- This last, at least, we are about to find out...

Let's Back Up to Early 19th Century

- Say (1803): Merchants know how to create means of payment
- Malthus (1819): But if excess supply in one sector is balanced by excess demand in another, where is the other?
- Mill (1829) (and Say): What if everybody wants to hold more cash—or something else—and people don't trust private credit?
 - Then pressure for spending to fall below income
 - But, for the economy as a whole, spending is income

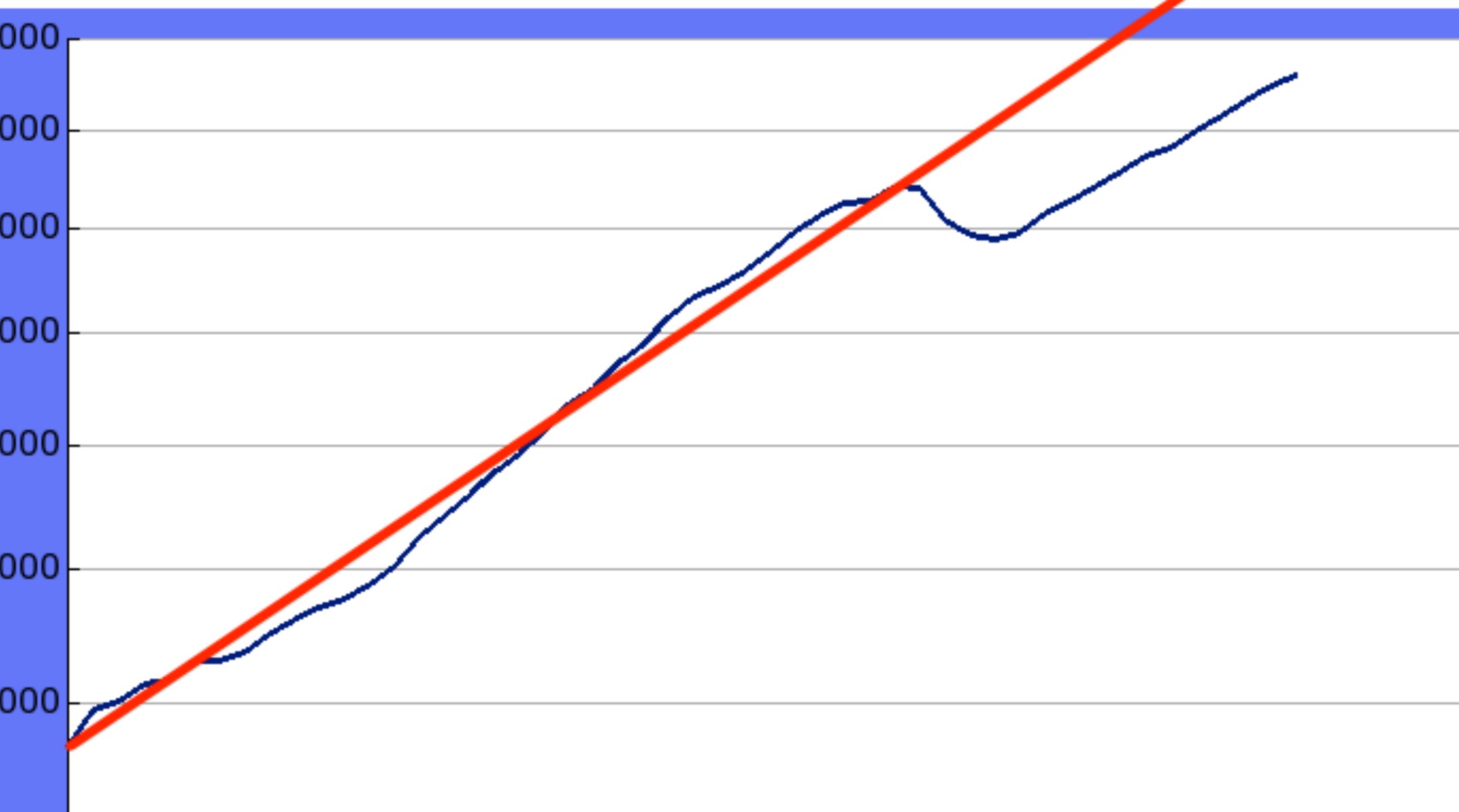
Crisis

Nominal Risky Bond Yields

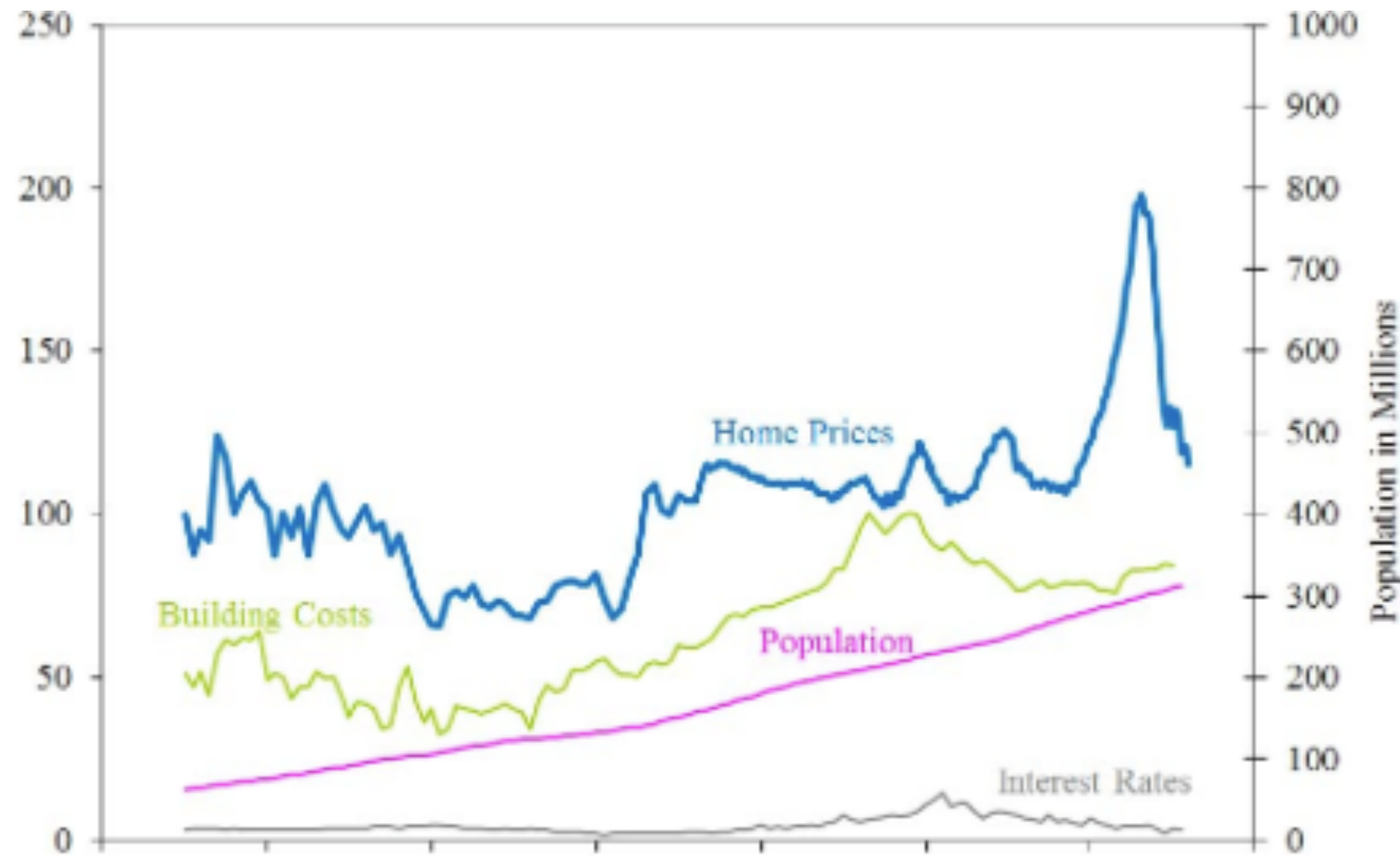


Slowdown

The Slowdown in Spending Growth

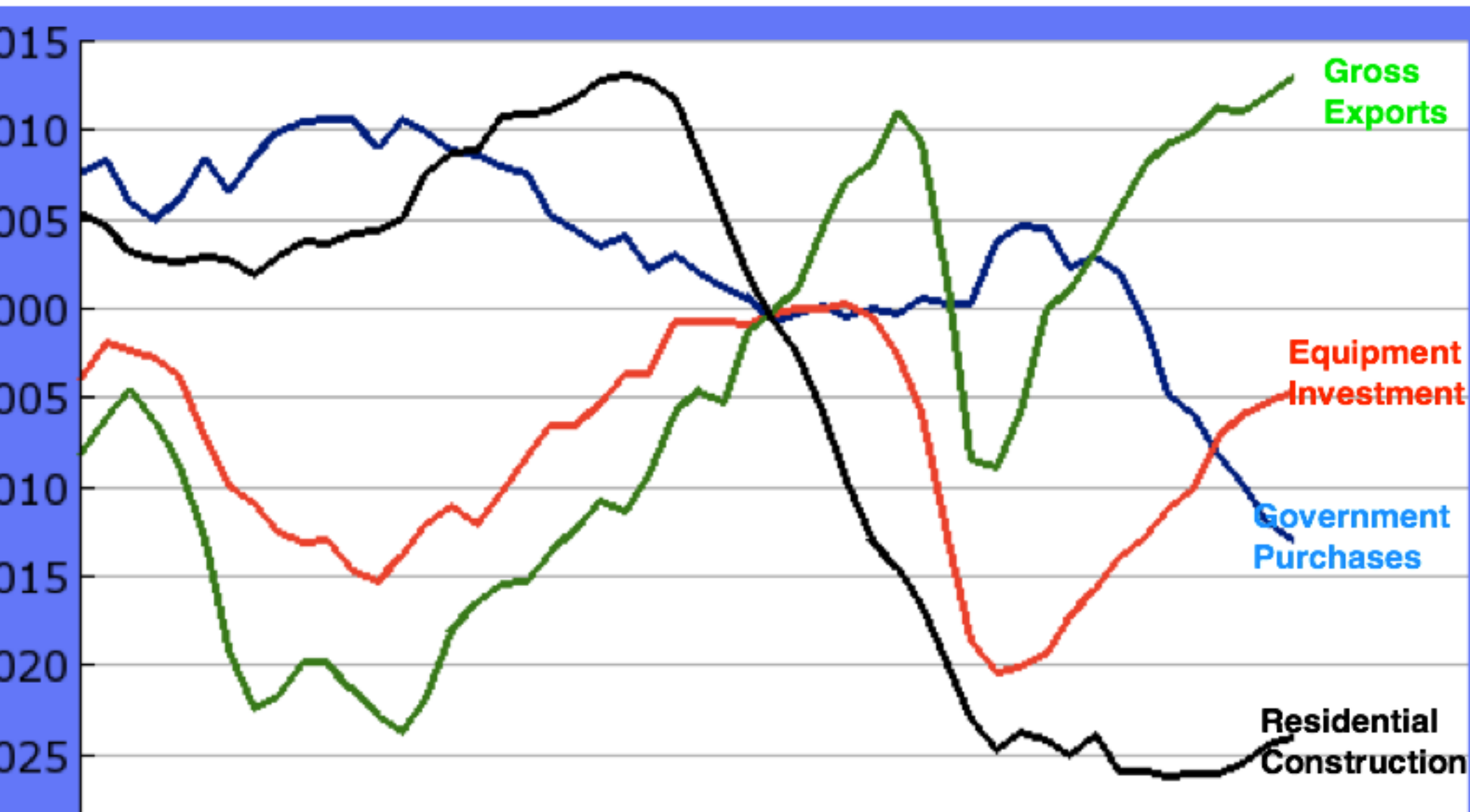


Bubble



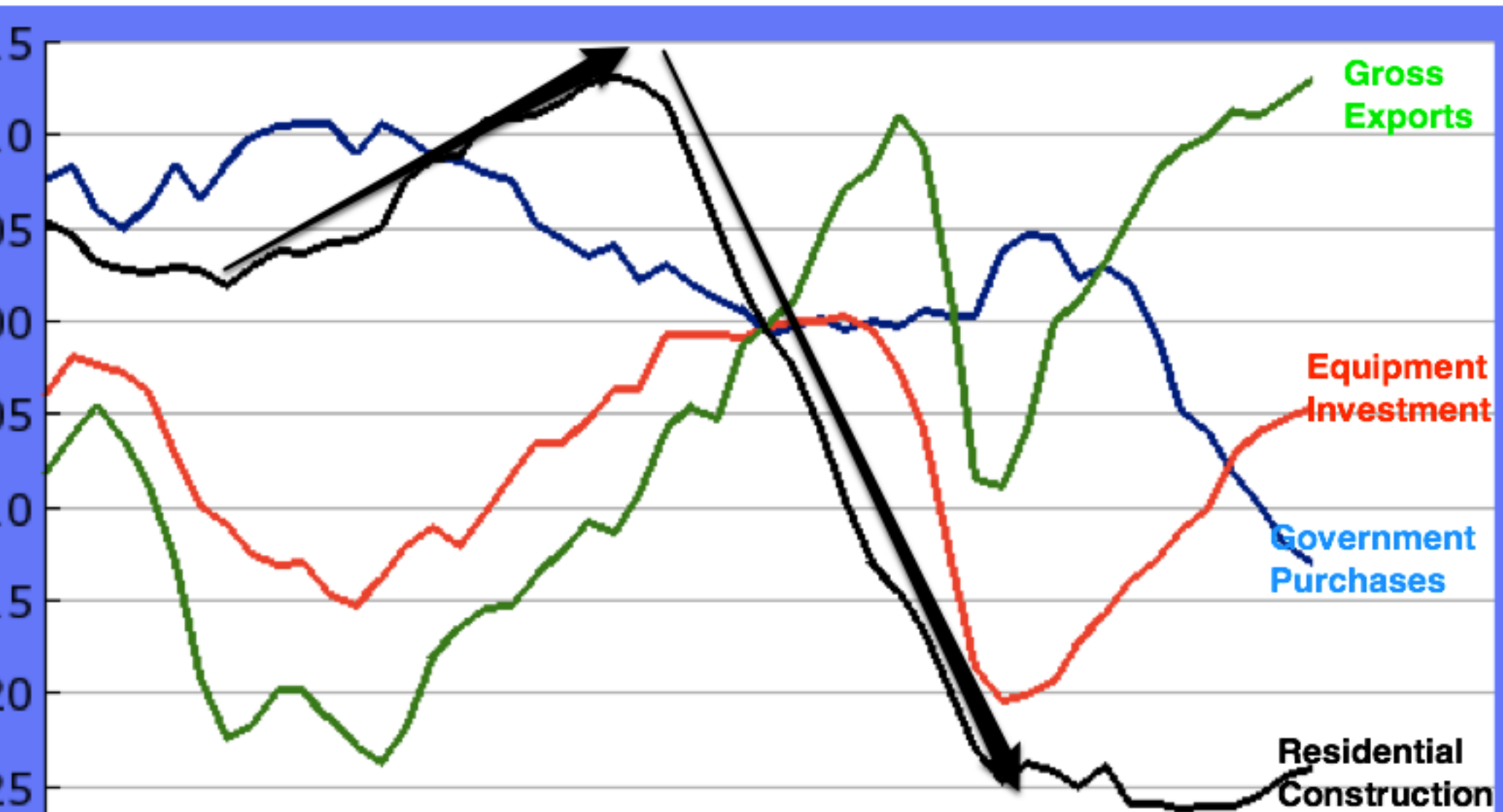
Spending

Deviation from 2007:I Shares of Potential GDP



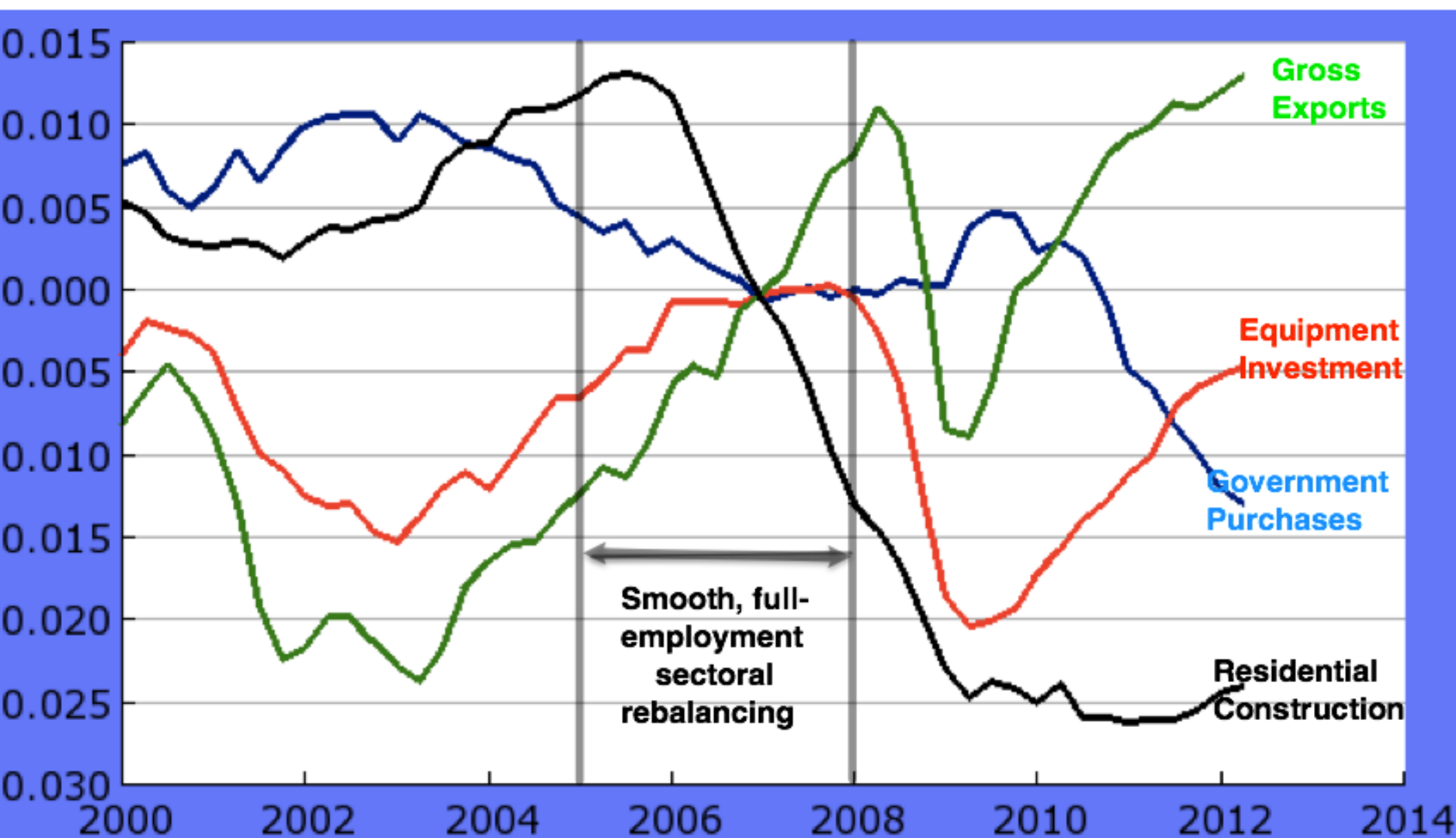
and Its Collapse

Deviation from 2007:1 Shares of Potential GDP



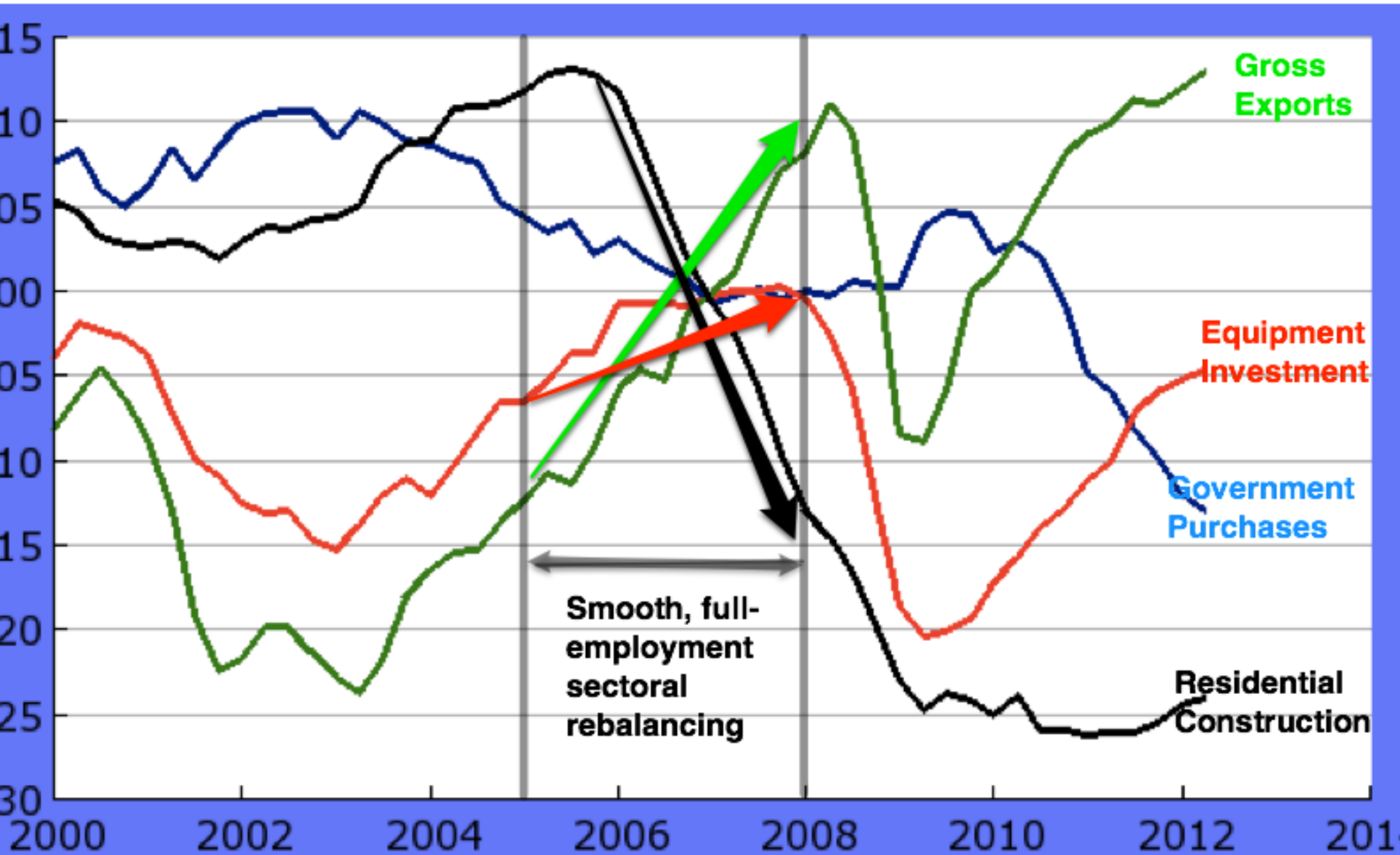
Long-Run: 2003-00

Deviation from 2007:I Shares of Potential GDP



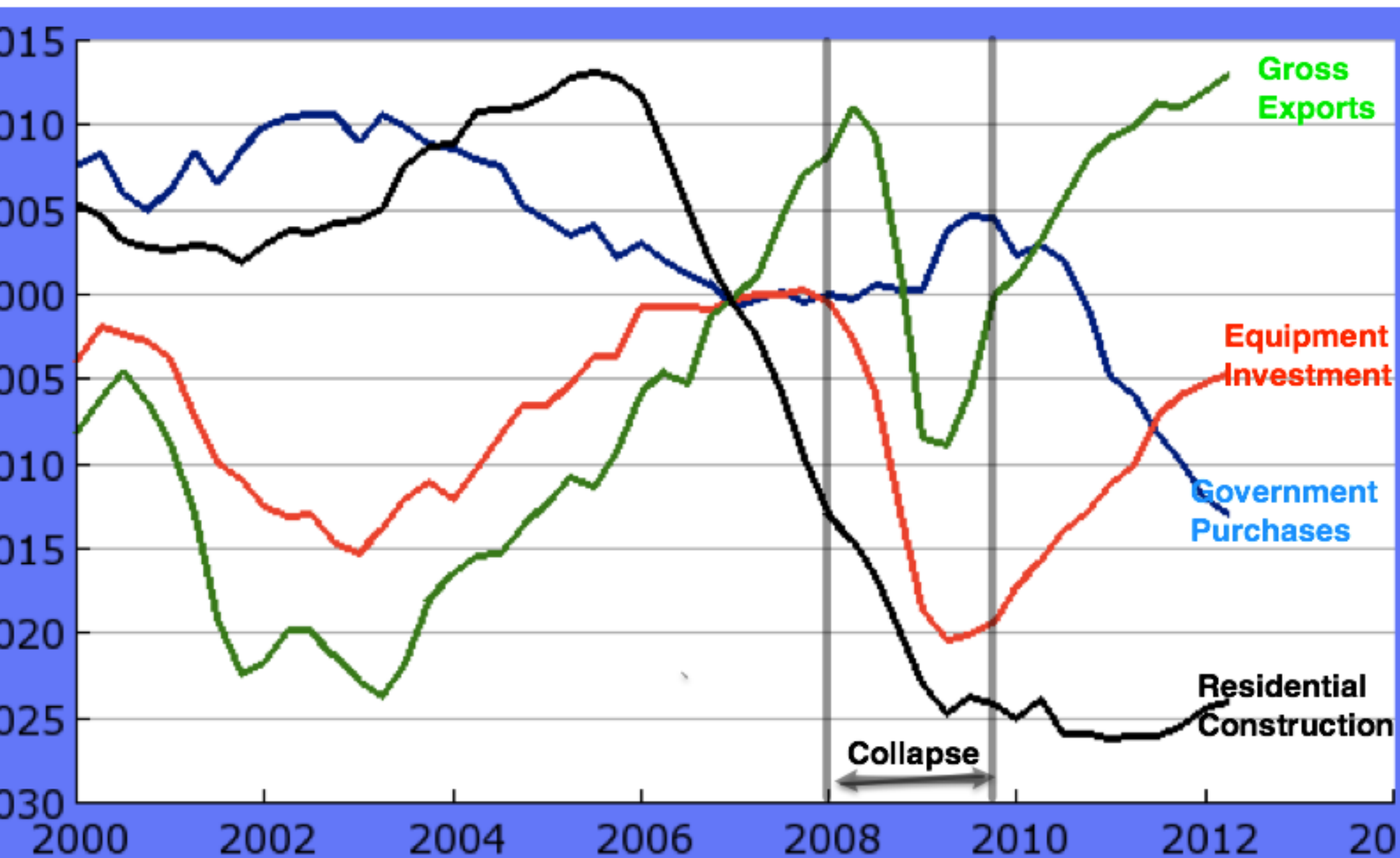
Smooth sectoral rebalancing: full-employment

Deviation from 2007:I Shares of Potential GDP



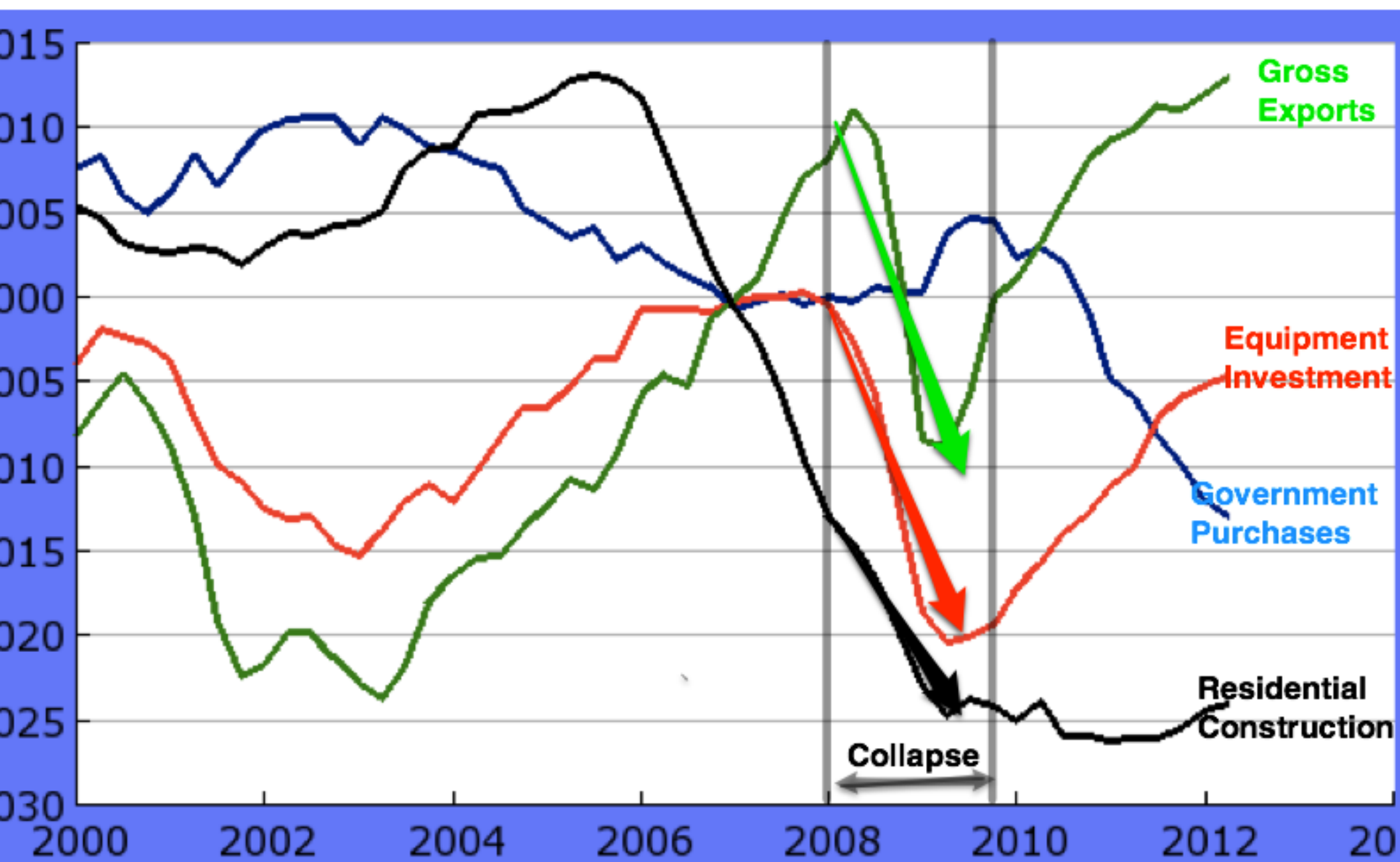
Housing down: exports, equipment

Deviation from 2007:I Shares of Potential GDP



• The collapse of exports and equipment

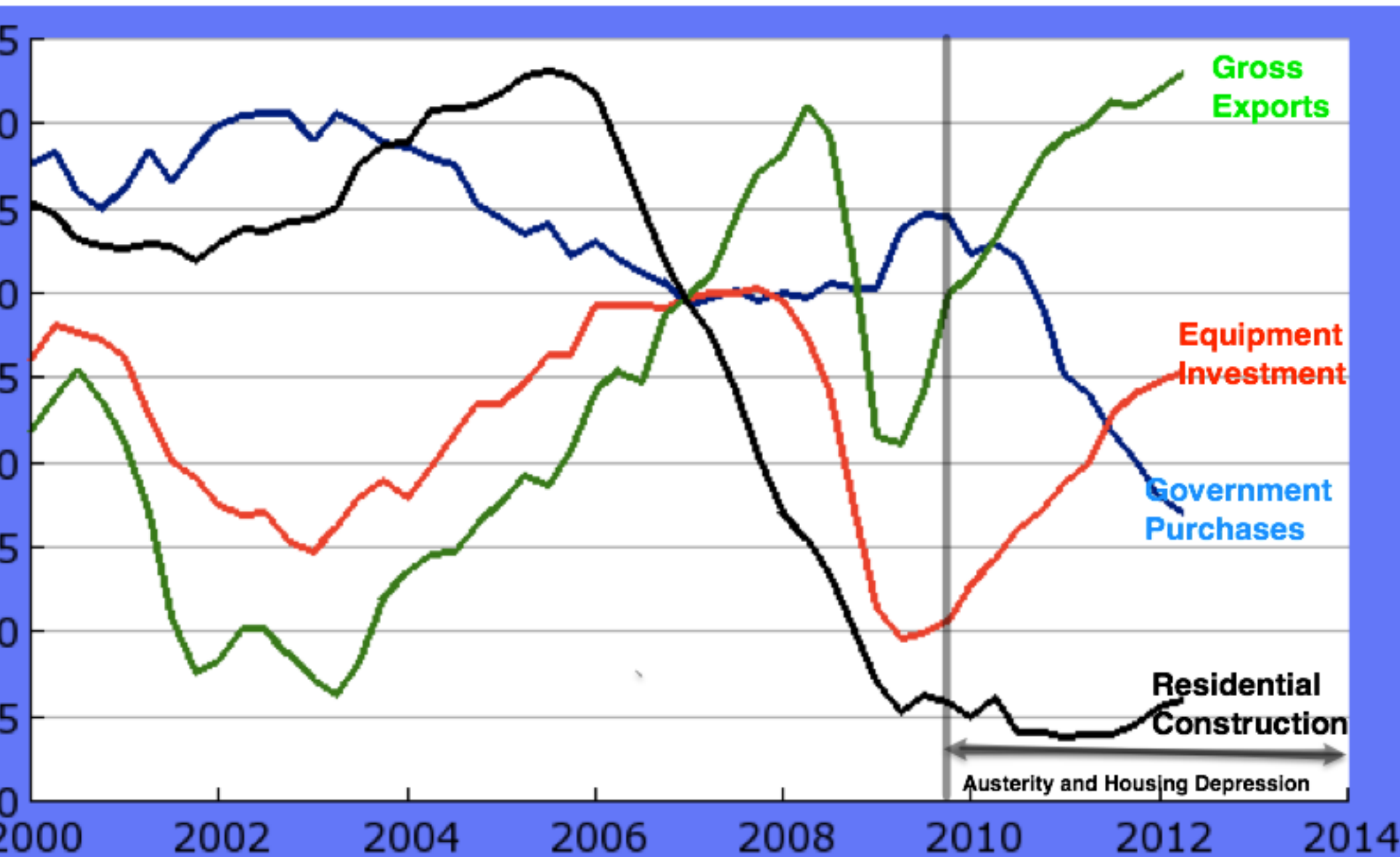
Deviation from 2007:I Shares of Potential GDP



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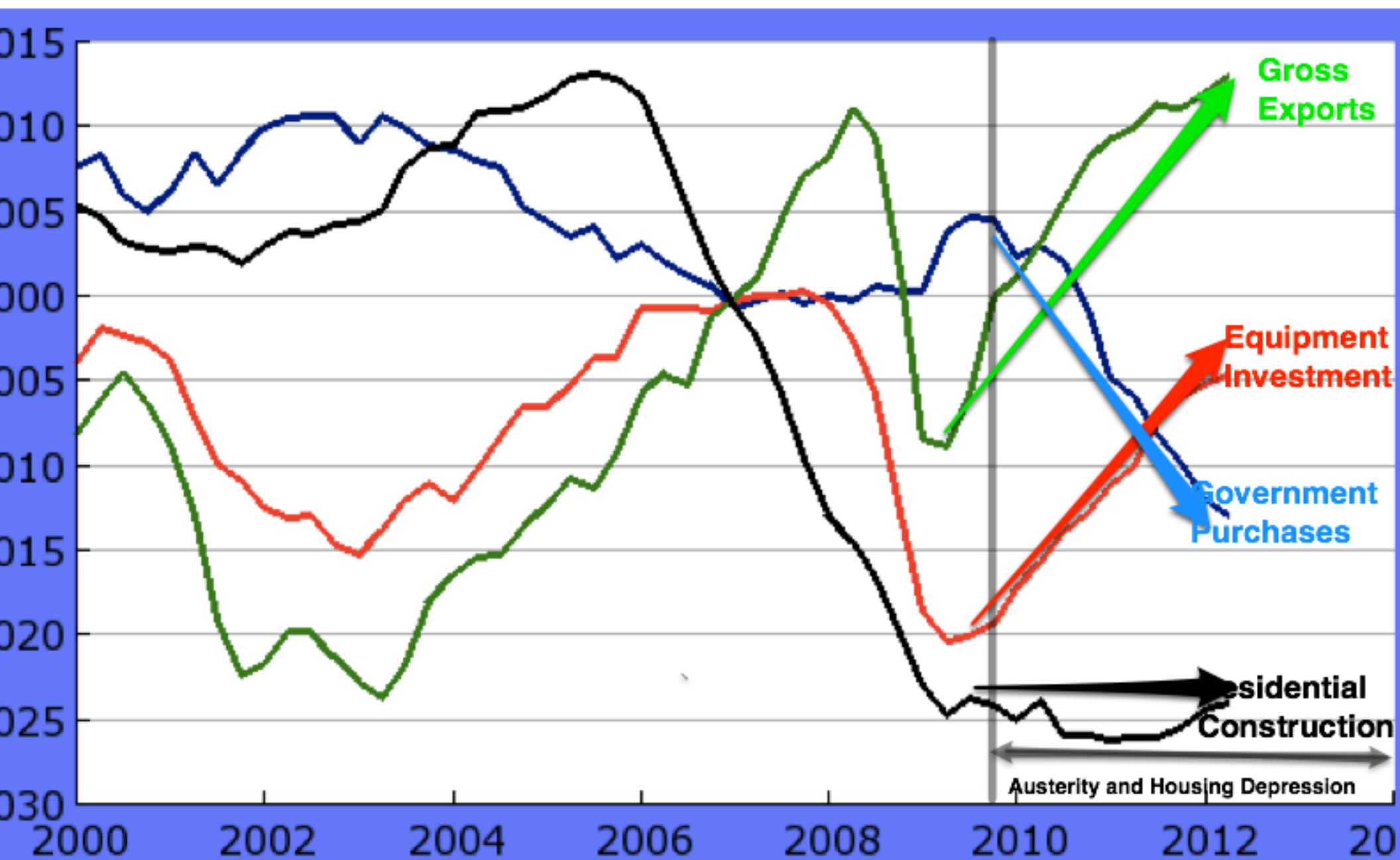
The Long Short Run: 2007

Deviation from 2007:I Shares of Potential GDP



Depressed housing and fiscal austerity

Deviation from 2007:I Shares of Potential GDP



Depressed housing and fiscal austerity

And the Fed Acts...

St. Louis Adjusted Monetary Base



Now: open-ended quantitative easing

Is OE QE Important?

- Yes

- Portfolio-balance effects: at some point the risk-bearing capacity freed-up is put to use
- Expected-inflation effects: cash is expensive to hold when its purchasing power declines

- No

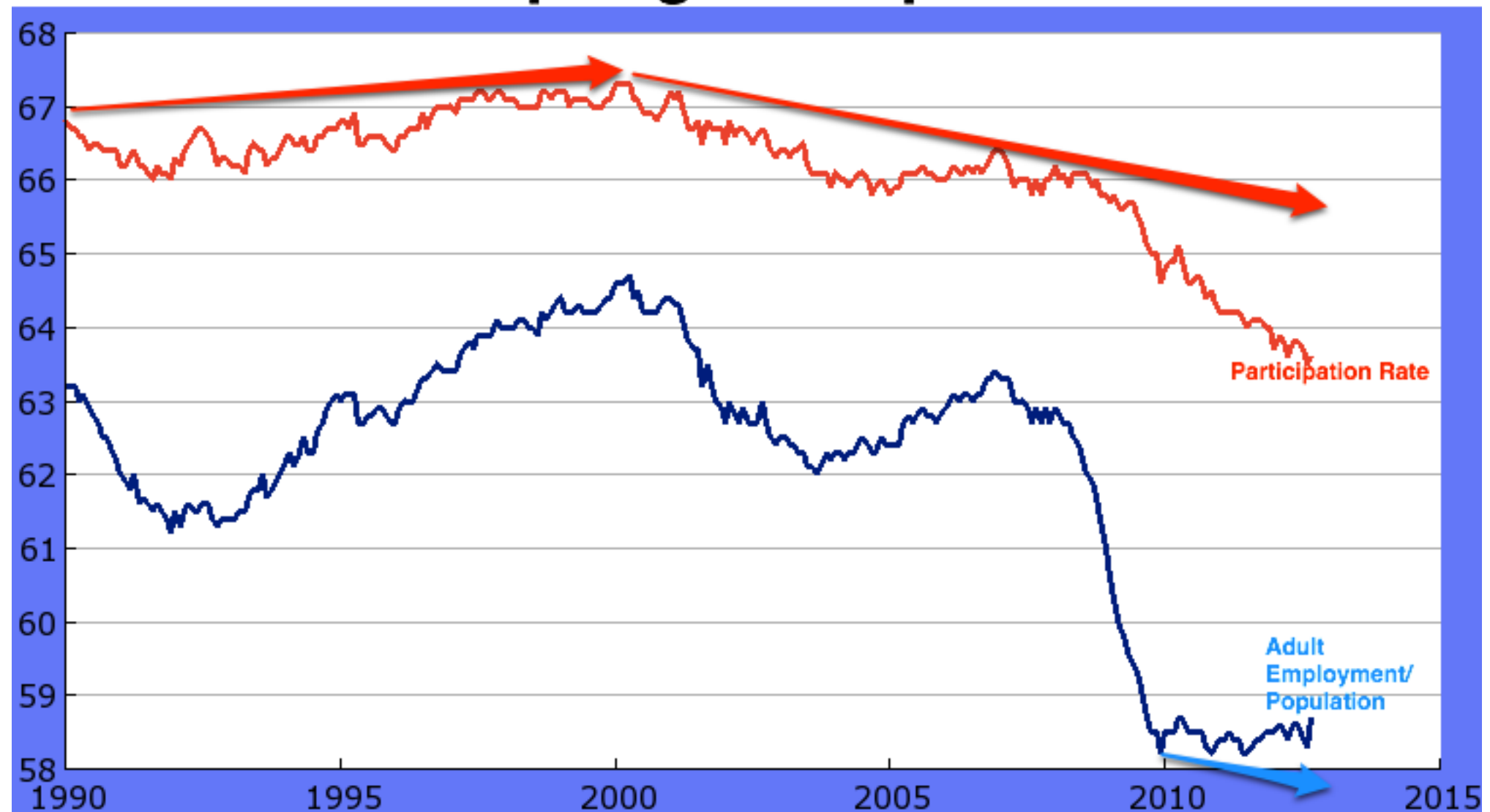
- OE QE is just a continuation of the policy of the past four years
- Rises in expected inflation do not trigger but follow recovery
- Operating businesses focus on cash flow and capacity
- Housing is broken

Risks

- Confidence?
 - The Confidence Fairy and the Inflation-Expectations Imp
- Inflation?
 - No signs of inflation
 - And it would be a boon
 - Exports
 - Incentives to spend
 - Creates an unwinding problem
- Fiscal cliff?
- International: Europe and China?
- Transformation of cyclical unemployment into structural?

Structural Unemployment

Stagnant Employment/Population and Collapsing Participation



10-Year Treasury Constant Maturity Rate (DGS10)
3-Month Treasury Bill: Secondary Market Rate (TB3MS)

