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Mitchell’s Musings 3-26-12: Is Pay-as-You-Go a No-No?

Daniel J.B. Mitchell

California has various pension funds operated at the state level. It has local pension funds as well in particular jurisdictions. The largest of the California pension funds by far is CalPERS – which is also the largest state and local defined benefit plan in the country with assets of $225 billion as of last December.¹ It currently covers 1.1 million active public workers and has over 500,000 retirees. Workers covered include state employees with some exceptions – mainly at the University of California which has its own plan – and employees of local jurisdictions that don’t have their own separate plans.²

Various sub-plans are part of CalPERS; there is not a single benefits formula for all covered workers. At the bottom of the global financial crisis, the official all-plans blended funding ratio of CalPERS dropped below 60%. With the recovery in financial markets, the funding ratio has been officially in the mid-70% range. In theory, the funding ratio is the percentage by which plan assets cover the present value of current liabilities for future pension payouts.

CalPERS has been subject to the same criticism as other public pension funds in recent years. It is noted that its assumed long-term earnings rate, until recently 7.75%, may be too high. That rate was cut to 7.5% based on such concerns about two weeks ago, but the lower rate has also been criticized as still overoptimistic. The more you cut the assumed earnings rate, the greater the estimated present value of liabilities and, hence, the lower the estimated funding ratio. However, I will point out below that the funding ratio is not the be-all and end-all of metrics for pension strategy, particularly for significantly underfunded plans. Underfunding may well have occurred because of bad judgments by pension fund policy makers but once bad judgment has occurred, it may be difficult to reverse.

It should be noted that making forecasts about future earnings does not in itself change future rates of return available in the marketplace. That obvious point is important since assumptions and forecasts are sometimes concerned with actual events that will occur. Put another way, the future will be what it will be. Nevertheless, the standard approach to defined benefit pension management is to require contributions (employer and employee) that cover the normal cost of the plan – essentially an estimate of what this year’s pensions promises will cost – plus an amortization of estimated unfunded liabilities. And the estimate is partly dependent on the earnings forecast. In effect, standard practice says pension administrators should cover currently accruing costs and also add enough revenue over time so that, at some target date, it is estimated that the plan will be 100% funded. The target, in short, is always supposed to be 100%.

The media and academic controversies about funding ratios and earnings assumptions often neglect the underlying basis of what we consider to be good pension management. A fundamental question is why we have trust funds for pensions and funding rules at all. The basic reason is for the protection of


² School teachers in California are covered by a state-run plan known as CalSTRS.
employees. In a defined benefit pension, we make promises of future benefits according to a formula typically based on age, length of service, and earnings history. Having a trust fund to back up those promises is meant as a contractual assurance for employees. You will get your pension because we have put the money aside to make that happen.

The degree to which a trust fund, especially a 100% funded trust fund, is important depends on the degree to which employees believe that the promise will be honored regardless of funding. In the public sector, however, such promises have been generally regarded as ironclad legally although this situation may vary from state to state. That is, the public employer is responsible for meeting the pension promise, even if there is insufficient money in the trust to cover the liability.

A secondary reason for maintaining a trust fund is protection of the employer. Having a trust fund with a funding ratio of 100% says that in the future when promises come due, there will be money set aside to meet those promises regardless of the then-existing fiscal condition of the employer. For the public sector, where – as noted - pension promises are typically regarded as ironclad legal contracts, having that financial backup is important. Absent money in a trust fund, the pensions would have to be paid out of current operating income.\(^3\)

Apart from the rationale for having a fully funded trust fund, let’s consider the idea of always paying the normal cost into the trust fund. There is a general rule for state and local finance – not just with regard to pensions - that current services should be paid for currently.\(^4\) For example, the cost of municipal police protection this year should not be charged to the future by borrowing. Residents of the city who received the police service this year should be expected to pay for it this year.

If part of police officers’ compensation is composed of pension promises and if the incremental promises made this year are not funded this year, then future residents - who did not receive those services - will be paying for them, something considered unfair. In addition, there is an economic rationale for paying the full current cost of current services. If part of the cost of police service is effectively charged off to the future, those police administrators and political leaders making decisions on how many police officers to employ may underestimate the true cost of such employment. They may treat police labor as cheaper than it really is and – as a result - hire too many police officers. The normal cost rule thus provides the correct signal to decision makers about the true cost of policing.

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\(^3\) The issue is more complicated for the (rapidly disappearing) private sector defined benefit pensions. Before 1974, a private employer might go bankrupt and pensioners might well be out of luck. In 1974, however, Congress created the Pension Benefit Guaranty Corporation – a public entity which assumes (most of) the liability of private pension plans when such bankruptcy occurs. So rules for establishing and properly maintaining private pension trust funds effectively protect the PBGC and the federal government. Public sector defined benefit plans are not covered by the PBGC. See [http://www.pbgc.gov/](http://www.pbgc.gov/) for information.

\(^4\) Note that at the federal level, macroeconomic policy (fiscal policy) may involve deficit finance. State and local jurisdictions do not have macroeconomic responsibility and are more like households which also are well advised not to pay current expenses by borrowing.
I began this musing with a reference to CalPERS because of an article that appeared in an online service that covers California pensions: Calpensions.com. According to the article, CalPERS has apparently been doing the kind of stress testing that has been applied to other financial institutions after the financial debacle of 2008. Discussion has turned at CalPERS to what could happen if there were a repeat of 2008. What if the funding ratio fell below 40%? Is there some level from which no recovery is possible? The article notes that CalPERS has a health care plan which for retirees is essentially unfunded. So it is essentially a pay-as-you-go system. If 40% funding is viewed as a no-recovery mark, zero funding is clearly well below that level. And that fact – along with the discussion of a stress test – raises an interesting issue.

We know that the retiree health component of CalPERS has been running for years on a pay-as-you-go basis. That may not have been a good policy decision but it is history. The history tells us that in principle, a defined benefit pension plan can also be run on a pay-as-you-go basis, i.e., with no trust fund at all. Or, even if it has a trust fund, it could be run with a target funding ratio of less than 100%. Such less-than-full-funding approaches risk making future benefit promises seem more uncertain to employees. If employees feel that promises might not be honored, even if there are seemingly ironclad legal guarantees, offering a defined benefit pension is a less attractive option for the employer. The pension promise becomes a less attractive recruitment and retention tool if the promise is not fully credible. All of these considerations are important – but they are not absolute guides to policy.

What may be needed for public defined benefit pension plans is a regular discussion of the full set of options, some of which deviate from optimal pension administration, assuming “optimal” means a target of 100% funding. CalPERS currently takes in about $11 billion per annum in employer and employee contributions. Under the most conservative critics’ views, its unfunded liability should be evaluated at the rate it could earn on riskless U.S. Treasuries. If CalPERS put all of its assets into long-term Treasuries, it would earn something like 4% per annum which would be about another $10 billion on its current assets. So the combination of contributions and portfolio earnings would be about $21 billion per annum at present. Its current annual payout for benefits is about $15 billion. That amount has been rising, however, due to an increase in the ratio of retirees to active workers and to some ill-conceived pension formula adjustments during the dot-com boom. Still, even with rising benefit costs, there will be some future limit to the level of benefits relative to the underlying government budgets that ultimately support the system.

My suspicion is that a CalPERS strategy of investing in Treasuries and continuing on with current pension contribution rates would produce a result something like that characterizing Social Security today. It would take decades for CalPERS to draw down its trust fund to zero and after that it would still have

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6 The main rationale for this view seems to be that since the pension promises are ironclad, they should be evaluated at the risk-free Treasury rate. Put another way, if the promises are risk free, then the discount rate should be risk free.
current contributions coming in to pay benefits, although – like Social Security – not enough for full benefits which would then have to be paid out of general revenue. It would be nice if the annual reports of CalPERS produced such examples.

Of course, there are many in-between strategies of somewhat higher contributions and long term target funding ratios of less than 100%. The choice does not have to be either zero funding or 100% funding. Examples in the annual report ranging between zero and 100% would make clear, however, that freezing the pension funds (no new hires paying into the plan or even no continued service as a credit to the plan) would hasten the depletion of the fund. Contributions would decline as new employees were outside the system. Given the legal impediment to cutting public pensions, such freezes might create a public budget crisis sooner rather than later.

As was noted earlier, the future of market returns will be what it turns out to be. So, too, the past is the past as it actually was. The difference is that we have some control over future returns to a pension plan by changing the portfolio mix. But we have none over the past. And if decisions in the past did not produce full funding today for a pension plan, fiddling today with the plan as it goes forward cannot change those prior decisions.

The bottom line here is that for at least some subset of public sector pension plans, not necessarily CalPERS, a goal of reaching 100% funding may not be realistic. Yes, we are in that unfortunate situation because of past mistakes. But sometimes you have to live with your past sins as best you can. Insisting that the only policy option is a choice between 100% funding or freezing existing public pensions can produce perverse results, both for the employees involved and for the employers.
Mitchell’s Musings 3-19-12: Apples and Oranges

Daniel J.B. Mitchell

Many readers will recall headlines, such as the one pictured below, that appeared a little more than a month ago.\(^7\) Labor conditions in Chinese factories manufacturing Apple products became a hot issue after the New York Times published a series of critical articles.\(^8\) The New York Times series, in turn, seemed to be linked, at least in timing, to the activities of Mike Daisey, an activist who had been performing a one-man play at the Public Theater in New York City based on claimed interviews with workers at Apple contract factories in China. The Times published an op ed by Mr. Daisey about those factories that has now been modified.\(^9\) There was added publicity when the public radio program, “This American Life,” broadcast a program based on the Daisey play.

\(^7\) The article shown in the picture is at http://www.latimes.com/business/la-fi-apple-china-labor-20120214.0,5184260.story

\(^8\) For example: http://query.nytimes.com/gst/fullpage.html?res=9C02E2D71438F935A15752C0A9649D8B63&pagewanted=all

As it turned out, Mr. Daisey’s interviews were apparently fabricated and the issue came to light after another public radio program - “Marketplace” - conducted a more thorough fact check than had occurred at “This American Life.”10 “This American Life” has now retracted the broadcast.11

Even before the most recent revelations, the Daisey and New York Times stories produced a predictable reaction. Apple promised to do better at auditing and correcting labor conditions at its Chinese suppliers. While some commentators were critical of Apple, others pointed out that the situation in China is complicated. It is a developing country. What were U.S. factories like in the 19th century when America was a developing country? Conditions at suppliers to big American firms in China may not be great but they tend to be better than in other workplaces. In relative terms, Chinese workers think conditions at the suppliers to American firms are good. Etc., etc., etc.

Of course, now the debate has shifted away from labor conditions at Chinese factories and instead focuses on Mr. Daisey, particularly after he defended his fabrications as a form of theater rather than journalism: (from the “This American Life” retraction statement)

Interviewer: So you lied about that. That wasn’t what you saw.
Mike Daisey: I wouldn’t express it that way.
Interviewer: How would you express it?
Mike Daisey: I would say that I wanted to tell a story that captured the totality of my trip. So when I was building the scene of that meeting, I wanted to have the voice of this thing that had been happening that everyone (has?) been talking about.

But there is another question that was not asked by Mr. Daisey, by the New York Times series, by “This American Life,” or by “Marketplace.” Why are all of these products – Apples and many others - being manufactured in Chinese factories? Is it really true that there is some law of nature (or economics) that says the U.S. should no longer manufacture things and should instead just do “services”? And if there is such a law, how can the U.S. go on buying imported manufactured goods and run up more and more debt in payment for them? Or put another way, how can there be a law of nature (or economics) which cannot be sustained? In short, the questions to be asked about Chinese labor conditions and about assumed natural laws are like apples and oranges. They are different and only distantly related.

10 http://www.marketplace.org/topics/life/ieconomy/acclaimed-apple-critic-made-details
At about the time that the Daisey exposé was released, another item was also circulating in the news media, albeit rather buried in the back pages:

*Foreign demand for U.S. Treasury debt rose to a record high in January. China, the largest buyer of Treasury debt, increased its holdings for the first time in six months. Total foreign holdings rose 0.9 percent in January to $5.05 trillion, the sixth consecutive monthly increase, the Treasury Department reported Thursday. China boosted its holdings 0.7 percent to $1.16 trillion. Japan, the second-largest buyer of Treasury debt, increased its holdings 2 percent to a record $1.08 trillion.*

In short, the two Asian countries that base their economic policy and exchange rate policy on mercantilism – exports are good; imports are bad – continue to drain manufacturing jobs from the U.S. Japan, it might be noted, is boosting its dollar reserves on the anniversary of the earthquake and tsunami that devastated parts of the country. Reserves are supposed to be a “rainy day fund,” prudently held for emergencies. If the earthquake/tsunami was not a rainy day, what would such a day be?

When such questions are raised, the response tends to be along the lines of the *Economist* magazine article pictured above. Chinese wages will go up and it will no longer be so cheap to manufacture there. Presumably, when that happens, trade will somehow balance. But wait! Japanese wages are far above Chinese and we are still awaiting that balance. And no one is writing plays and publishing exposés about labor conditions in Japanese factories.

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13 [http://www.economist.com/node/21549956](http://www.economist.com/node/21549956)
In short, the natural law of eventual adjustment is as artificial as the natural law of manufacturing-is-passé-in-the-U.S. There is no evidence, based on the experience with Japan, that some natural force will remove the trade imbalance problem. The U.S. has an exchange rate problem that will not be addressed by an Adam Smith-style invisible hand. Wishful thinking about natural adjustment will not remove the problem. Only a conscious and visible exchange rate policy on the part of the U.S. can do it.
Mitchell’s Musings 3-12-12: Put Downs

Daniel J.B. Mitchell

For those of us teaching on the quarter system here at UCLA, the end of the quarter is coming soon. As a result, I have a briefcase full of term papers to read so my musing will be limited to one basic observation and its implication.

Michael Hiltzik, a business columnist for the Los Angeles Times, wrote an interesting column about the housing market a couple of weeks ago.¹⁴ As it would be hard for anyone not to know, the Great Recession was triggered by the bursting of a housing bubble that then exposed a variety of flaky mortgage writing practices. The resulting financial fallout from the flaky mortgages is still being felt.

Hiltzik noted in his column that many homeowners now find themselves “under water.” That is, the value of their home is less than their mortgage debt. Some of this deluge is the result of the decline in home prices after 2006-2007. But in bygone days when mortgage standards were higher, it was customary for prospective buyers to have to make a cash down payment of 20% of the purchase price of the house. With the mortgage thus being a maximum of 80% of the price, the house price could fall by 20% before the buyer was under water. And, since paying back the debt was amortized over the life of the loan, the margin between the home price and the remaining debt, other things equal, would generally widen over time.

However, the key point in the Hiltzik column was that those homeowners who found themselves under water and who simply walked away from the house, i.e., turned the home back to the lender, were viewed as moral failures. Bank and federal reluctance to provide debt relief by lowering the face value of the debt seems linked to this notion that national morality would be undermined if lenders had to write down their claims.

State law on mortgages varies and I am no legal expert but I can tell you that walking away from the house by an underwater buyer is the exercise of a “put.” Here is an excerpt from a Forbes magazine website, explaining the financial term “put”:

**Put Options:** A put option gives you the right to sell a stock to the investor who sold you the put option at a specific price, on or before a specified date. For instance, if you bought a 25 October put option on Pfizer, the option would come with terms telling you that you could sell the stock for $25 (the strike price) any time before the third Friday in October (the expiration date). What this means is, if Pfizer falls anywhere below $25 before the third Friday in October, you can sell the stock for more than its market value. And if you don’t want to sell the stock yourself, you can sell your option to someone else for a profit.15

Puts and their opposite number – calls – are standard fare in financial markets. In the example above, if the market price of a share of Pfizer stock falls below the $25 strike price, you can “walk away” from your share, leaving the seller of the put to make up the difference between the strike price and the lower market price. No one views someone exercising a put option in the stock market as doing something immoral. All that happened was that consenting adults entered into an options contract. The seller of the put undertook to carry the risk that the price of the stock might fall below the strike price. If that happens, the seller of the put loses. If it doesn’t happen, the seller gains since the buyer paid a price for the unexercised put. The put therefore is a form of insurance, a stop-loss instrument that shifts the risk of a down market to someone else willing to take the risk.

Mortgages are also contracts negotiated by consenting adults. In effect, the mortgage has a put option built in of which surely the lender as a financial institution was aware when it agreed to the terms of the mortgage. The homeowner has the option to “put” the house to the lender, satisfying the debt. The lender may not want to take the loss or may have thought that the risk that the put would be exercised was negligible because, after all, everyone before 2007 knew that home prices would always go up.

So why is it moral to exercise a put in the stock market but immoral to do the same in the housing market? Why is exercising the home put sometimes termed a “strategic default,” as if there was some fiendish cleverness in calculating that you owe more on a house than it is worth and exercising your put as a result?

Are there any financial advisors who, in the Forbes example above, would advise someone not to exercise a put on Pfizer stock if the stock was below the strike price? So why would an advisor think differently about the put in a mortgage? One reason, you might say, is that someone who puts the house to the lender will ruin his/her credit rating. But wait! Credit rating services would not downgrade the credit of someone exercising a put on Pfizer stock. (Indeed, it would be inadvisable to extend credit to anyone foolish enough not to exercise the put option if the stock fell below the strike price.) So just as we could raise the issue of why it is considered immoral to exercise the mortgage put, so – too – could we ask what justification there is for

rating agencies to downgrade the credit of someone who exercises a house put. Why is a homeowner who makes the rational calculation that it does not pay to hold on to a house and therefore exercises a put a bad credit risk?

Now what, you might ask, has this excursion into finance to do with employment. A great deal, I would answer, since the recent data indicate that home prices are continuing to decline in many major real estate markets. The resistance to house puts is simply a way of trying to keep homeowners from exercising the options built into their mortgages. If homeowners were more willing to exercise their puts, lenders would be more likely to come to the table and write down the amount of the debt still owed to keep those homeowners in their homes. And federal policy would be forced to focus on encouraging such write downs rather than other palliatives.

Bringing the housing market into some kind of equilibrium would end the housing drag on the current slow pace of economic recovery. In the end, such write downs, if they kept people in their homes, would better preserve the housing stock in stricken neighborhoods. Lenders might actually benefit collectively if homes they owned were not abandoned and empty.

If a rose is a rose is a rose, at the end of the day, a put is a put is a put. A job is a job is a job and there would be more jobs if we treated “strategic defaults” as what they are: simple exercises of puts by rational homeowners.
One of the nice things about simple arithmetic is that it can often cut through seemingly complicated issues. In the past few years, there has been much controversy about deferred employee benefits, particularly in the public sector at the state and local levels. By “deferred,” I simply mean benefits that are promised today but are payable in the future. The most obvious example is pensions but other benefits such as retiree health care can also be cited. Promised future benefits can be prefunded or paid for on a pay-as-you-go basis (or some mix of the two). By “prefunded,” I mean that money is put aside in the current period sufficient to pay the future promises that are being made in the current period. By “pay as you go,” I mean that promises are being made but are being not prefunded; they will have to be paid out of future revenue at the time those promises come due (or else the promise will be breached).

The basic facts surrounding deferred benefits are often obscured by technical jargon. My object in this musing is to lift the cloud of obscurity regarding such benefits and make a few basic points. So let’s use some simple examples that capture the basic ideas of prefunding, pay as you go, and deferred benefit. And let’s be clear that the numerical examples are not meant to simulate some actual pension fund or retiree health care program. Indeed, to emphasize that point, I will not characterize the values involved as expressed in dollars ($) or the time frame in years. Instead, let’s have our currency be the Talent (T) – a nice Biblical currency or valuation – and let time be measured in “periods.”

There seems to be a notion embedded in the complaints about public sector benefits that any use of a deferred benefit is inherently an overpayment and abusive. Clearly, that does not follow logically. Pay should be set to some target level, however that target is determined. The composition of that pay, i.e., the mix of current wage and deferred benefit, can vary. For the sake of simplicity, let’s suppose that the objective is to pay an employee in a certain job category at a level he/she would value at T100/period. (Perhaps the employer has determined – based on labor-market surveys - that T100 will meet objectives of recruitment, retention, and turnover.) In all examples below, we will keep the employee’s valuation of pay at the target level of T100 so that there is no overpayment (or underpayment).

Now let’s suppose that initially (period 1) we pay our employee entirely in current cash but in period 2 we move to a partially deferred payment scheme. Part of the pay package starting in period 2 will be a promised bonus to be paid in the next period (in period 3). And we continue thereafter using this mix of current cash and deferred promise, but always with the package valued by the employee at T100 each period.

In period 2 when we adopt the partially deferred payment plan, we have to make a choice: Will we prefund the promise by putting aside enough money in period 2 to pay the bonus when it comes due in period 3? Or will we use a pay-as-you-go system so that there is no cash outlay in period 2? In that case, the bonus will have to be paid in period 3 out of whatever revenue there is in period 3. Let’s acknowledge that the latter pay-as-you-go approach violates the usual rule for public spending that
today's services should be paid out of today’s revenue.\textsuperscript{16} We might agree that pay as you go is not a Good Thing but our objective below is to determine what the consequences are if we nonetheless make that decision.

In order to determine how much we would have to put aside to prefund a future promise if we choose to do so, we need a discount rate, i.e., the rate we can expect to earn from one period to the next. We also need to make some assumption about how employees would value a future benefit promise. Even if they have the same discount rate for riskless future pay, they might be somewhat leery about a future promise that is not prefunded since there is a risk that the promise might not be kept.

**Five Easy Lessons**

Let’s start with the simplest case in which employees and employers discount at the same rate - the rate that one can earn from period to period - and the benefit is prefunded. Let’s assume the discount rate is 10% per period for employer and employee. In period 1, the employee is paid entirely in current cash. In period 2, the payment is partly in the form of a promised bonus of T11 to be paid in period 3 which is prefunded. Thereafter, pay is the mix of cash and promise. The table below shows the shift in policy toward deferred bonuses out to period 5.

<table>
<thead>
<tr>
<th>Period</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wage</td>
<td>100</td>
<td>90</td>
<td>90</td>
<td>90</td>
<td>90</td>
</tr>
<tr>
<td>Value of Prefunded Promised Next-Period Benefit to the Employee</td>
<td>0</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Total Compensation Value to the Employee</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

Note that there is no unfunded liability in this example since the employer is prefunding. The employer puts away T10 each period starting in period 2 which fully prefunds the T11 bonus in the subsequent period. The employee values the next-period T11 promised bonus at T10 in the current period.

Now let’s consider the same policy but carried out on a pay-as-you-go basis. We assume at first that the employee takes the promise of the future T11 bonus as ironclad. That is, he/she has no doubt the promise will be kept.

\textsuperscript{16} Since I want to illuminate issues facing state and local policy makers, I will avoid notions of macroeconomic stimulus that might entail running current deficits. Macroeconomic considerations are relevant at the level of the national government. The notion of current services paid out of current revenue is partly based on equity, i.e., future taxpayers shouldn’t have to pay for past services they didn’t enjoy. And it is partly based on economic efficiency. If labor appears artificially cheap to decision makers in public agencies because the cash required is reduced by paying workers with promises, there may be overuse of labor.
In this case, the cash outlay for pay in period 2 drops temporarily from T100 to T90. But thereafter, the T11 must be paid out of current revenue. So the “saving” in period 2 is balanced by higher costs of T1/period to future taxpayers in subsequent periods. And there is an unfunded liability each period starting in period 2 of T10.

Now let’s assume that without prefunding, employees have some doubts about whether future promises will be kept. They know that the promises made in each period will be paid out of future revenue but that nothing is being put aside to guarantee that payment. Perhaps there will be a budget crisis in the future which would cause the employer to decide not to pay the promised T11. Let’s assume that absent prefunding, therefore, the employee values the promise of a next-period bonus of T11 at T9 rather than the T10 valuation of the previous example in which we assumed a belief that the promise was ironclad.  

With employee skepticism about the fulfillment of the promise, the “saving” to the employer in period 2 is only T9 and thereafter future taxpayers have to pay an extra T2/period for labor services. Again, there is an unfunded liability in each period starting in period 2 of T10 since T10 in one period would be the amount needed to be set aside (but not being set aside) to fund a bonus in the next period of the promised T11.

These examples are quite simple. But they lead to the following five lessons:

1) Making a promise of a deferred benefit - but not prefunding that benefit - shifts some of the cost of current services to future taxpayers.

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17 The discount rate is thus 2/9 or 22.222…% per period consisting of a 10% discount rate and a 12.222…% risk factor.
2) Making a promise of a deferred benefit - but not prefunding that benefit – may reduce the value of future benefits as seen by employees due to risk, potentially increasing costs of a pay-as-you-go system to future taxpayers.

3) As a corollary to lesson #2, prefunding should be viewed primarily as a way of protecting employees from a breach of promise. By making the promise more credible, its value to the employee rises.

4) Making a promise of a deferred benefit - but not prefunding it – should not be termed a “Ponzi scheme.” That is, pay as you go does not inherently require ever-increasing revenues. In the example above, the unfunded liability - once established in period 2 - does not increase period after period. Future taxpayers pay more each period than they would with prefunding, but the amount of extra cost per period is constant, not rising (T1 in one example; T2 in the other). There is nothing inherently unsustainable about pay as you go.

5) Making a promise of a deferred benefit - but not prefunding it - does not mean that employees are overpaid. Each example above adhered to the target of paying the employee an amount he/she would value at T100. By construction, the shift from cash-only pay to cash plus a promised deferred benefit did not change the T100 valuation experienced by employees.

Legacy Lessons

What about “legacy” costs? It is sometimes noted in discussions about defined benefit pensions – particularly in the context of distressed industries such as auto manufacturing – that there is a problem if the ratio of retirees to active workers rises. In such industries, there may have been a decline in the workforce over time due to a loss of market share or due to increased productivity.

Let’s note what should be an obvious point. If the deferred benefit is fully funded, the promised benefits can be paid regardless of the relative size of the current workforce to retirees. The issue of legacy costs is irrelevant to a fully prefunded deferred benefit plan. The legacy concern arises only if there is underfunding or, at the extreme, pay as you go (no prefunding at all). So let’s consider a scenario where we have only pay-as-you-go benefits.

We will assume that through period 3, two workers are required to do the job. In period 4, one worker is laid off and the workforce thereafter consists of just one worker. The table on the next page illustrates that example. We assume the same 10% discount rate used earlier and assume that workers value the T11 next-period bonus at T9 due to discounting and risk.

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18 The essence of a Ponzi scheme is that it offers a high return to investors which can only be met by drawing in more and more investors. Eventually, the scheme collapses because it runs out of potential additional investors.
In period 1, payment to the two workers, each receiving T100, is in cash only. In period 2, the pay
system switches to the promise to each worker of T11 in the next period which each worker values at T9
(T18 for the two of them). Because of the deferred bonus promise in period 2, future taxpayers in
period 3 pay total compensation of T204 including the T22 deferred bonuses. The unfunded liability in
periods 2 and 3 is T20. The ratio of deferred beneficiaries to active workers in period 3 is 1. That is, two
workers receive the bonus promised in period 2 and there are two active workers (2/2 = 1).

In period 4, one active worker is laid off leaving only one worker still active. But the bonus promised in
the prior period to the two workers who worked in that prior period must now be paid. So the ratio of
delayed beneficiaries to active workers rises temporarily to 2. And the pay-as-you-go benefit cost rises
temporarily from 10.8% of total compensation (T22/T204 = 10.8%) to 19.5% (T22/T113 = 19.5%). Once
the legacy cost is paid off in period 4, the ratio of deferred beneficiaries to active workers falls back to 1
(1/1 = 1) and the pay-as-you-go benefit cost falls back to 10.8%.

So there is a legacy cost under pay as you go if the workforce shrinks, although it is temporary and ends
once the workforce stabilizes at the reduced size. But what causes the legacy cost is not deferred
compensation per se, but rather the combination of deferred compensation plus pay as you go (or
underfunding). Put another way, deferred compensation is a necessary, but not sufficient, factor in
creating a legacy problem. Note that the legacy cost cannot be avoided by switching in period 4 to full
funding in the future or abandoning any form of future deferred pay at that point. Changing the policy
going forward still leaves the current debt to be paid.

What is the lesson here for state and local public employers? It is very simple. You cannot change the
past. Switching from an underfunded defined benefit pension plan to defined contribution plan (which
by definition is fully funded) does not erase the legacy costs of past underfunding. Any switch from a

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19 For conservatives anxious to convert Social Security (an underfunded defined benefit pension plan) to
private accounts (defined contribution accounts which, again, are fully funded by design), there is also a
lesson. Indeed, with the baby boom/baby bust phenomenon, there will be a rise in beneficiaries receiving
delayed benefits to active workers. However, there must be a period, unless you don’t pay promised
benefits, in which active workers in some fashion carry the burden of past underfunding in the transition
pay-as-you-go system to a fully funded system involves a transitional cost in which you are paying off old debts plus providing full funding going forward.

The lessons in this musing are simple enough and involve only basic arithmetic. Sadly, they seem to have escaped much of the current policy debate surrounding state and local pay and deferred pay.

from an underfunded pension to some other system. Beyond the arithmetic, when it comes to Social Security, a societal and not a local plan, the issues of pay as you go vs. prefunding are more complex, as we have discussed in earlier musings. Traditional societies supported the elderly through a mix of intra-family transfers and saving, i.e., through the family equivalent of a mix of pay as you go and prefunding. Social Security can be seen as a substitute for the traditional approach as the extended family was replaced with the nuclear family and single parents.
Mitchell’s Musings 2-27-12: Zenger or Zinger?

Daniel J.B. Mitchell

The New York Times has long had the slogan, “All the news that’s fit to print.” So let’s talk about newspapers and what information is fit to print. Here is an excerpt from an item in the San Francisco Chronicle of February 25, 2012:

…The Obama administration on Thursday called on lawmakers to create a “privacy bill of rights” that would give people more control over how companies like Facebook collect, store and use their private data. The same day, Google agreed to add a “do-not-track” button to its Chrome Web browser.

In short, concerns about individual privacy are in the air as newspaper editors surely are aware. In some cases, there are legal restrictions on what information can be made public. Those of us who work at universities know that there are all kinds of rules regarding the confidentiality of student records. At my university – UCLA – staff employees have been fired and prosecuted for accessing and disclosing health records of celebrity patients at the UCLA hospital.

Your individual responses to the Census of Population are guaranteed to remain confidential. Your tax returns are not public documents. In short, there are many records that are private even if they might be of interest to someone. In some cases, individual privacy is guaranteed because it is nobody’s business. In other cases, records are private because, as in the case of the Census, we want cooperation and accuracy in data gathering from respondents.

There are many pieces of information which can be legally obtained about individuals but which newspapers, such as the New York Times, choose not to print. Names of rape victims are generally not published by reputable newspapers, although they appear in public police reports. Exact addresses of other crime victims are often not reported.

For that matter, newspapers have sometimes published stories their editors thought important even though the legal right to do so was at least in question. In the famed Pentagon Papers case, the government sought to stop publication and for a brief time there was a halt in response to an injunction. When the case reached the U.S. Supreme Court, three of the nine justices voted against the New York Times’ decision to publish. In the ongoing Wikileaks affair, the Times has published material that was obtained illegally – although not by the Times itself.

The bottom line is that what is “fit to print” is now, and has always been, a matter of editorial discretion and not just a matter of what a court might say. Newspapers may cloak each editorial decision as a matter of constitutional freedom of the press and give themselves a John Peter Zenger award whenever those decisions are made.

20 http://www.sfgate.com/cgi-bin/article.cgi?f=/c/a/2012/02/25/BUH11NC6HA.DTL.

21 From “The Trial of John Peter Zenger” at http://law2.umkc.edu/faculty/projects/ftrials/zenger/zengeraccount.html. “No country values free expression more highly than does the United States, and no case in American history stands as a greater landmark on the road to protection for freedom of the press than the trial of a German immigrant printer named John Peter Zenger. On August 5, 1735, twelve New York jurors, inspired by the eloquence of the best lawyer of the period, Andrew
However, what the constitution does is give newspapers a right to publish - or not publish - a wide range of information. I can recall an old Mad Magazine newspaper parody in which the Times' slogan became “All the news that fits, we print.” But that hasn't been the operative procedure in the past.

The present, unfortunately, is another matter. With the advent of the Internet and websites, what can fit on a printed page is no longer a constraint, since online publishing allows essentially unlimited databases to be made public. What is fit remains a matter of editorial discretion. But the temptation to print what can fit, as long as it's legal, as long as anyone might be interested, and as long as the interests of the publisher are not harmed, has produced unfortunate results. The most recent example is the New York Times decision to publish “value added ratings” of individual school teachers by name.22

To be fair, the New York Times was not the originator of the idea of publishing such rating by name. The first newspaper to do so, as far as I know, was my hometown Los Angeles Times. And the precedent before that was the wholesale publication of public worker salaries by name in various newspapers because the information was found to be in the public domain and it was legal to do so.

Value added ratings for teachers indicate the pace of student improvement (not absolute achievement) in his/her classroom. The notion is that all kinds of socio-economic and demographic factors affect the absolute level of student achievement but by looking at the increment of achievement, you have standardized for those background influences. There are other statistical issues that could be raised and there are simple questions of whether the databases that have been developed are free of error. But let's assume that the information is accurate and that it is a good performance appraisal tool. Normally, we still think of personnel records as private. So what is the justification for publication by teacher name?

*Taxpayers have a right to know, because they are paying for it.* That rationale is a slippery slope, because many things taxpayers pay for are provided by private firms. The government buys everything from paper clips to missiles from private firms. Roads and bridges are typically built by private contractors. School textbooks are published by private companies. Should the personnel records of individual employees of those firms be made public? Are the personnel records of a government-hired floor sweater everybody's business but those of a floor sweater hired by a private contractor to clean a public building nobody's business?

*Parents have a right to know, because their children are using the service.* How far would you extend that rationale? A teacher who has developed a health problem might be at risk for absences even if he/she had good ratings in the past. Should we therefore publish health records of teachers? If a particular teacher is undergoing a bitter divorce that might be distracting, should that information be public? Financial problems? Religious beliefs? Note that apart from confidential health records, evidence of divorces, financial problems, and religious beliefs may exist in scattered documents that could be found from various sources. It might be hard for individuals, as a practical matter, to pull information from such sources systematically, but an organization as large as the New York Times could.

*School authorities will make better hiring/firing decisions if the information is published.* If bad decisions are being made – and assuming value added ratings will disclose that fact – the problems can be illustrated by publication of summary statistics, illustrative statistics, etc., without naming names of individual teachers. No effort was made by either the Los Angeles Times or the New York Times to start with anonymous data presentations before a wholesale data dump was published.

Hamilton, ignored the instructions of the Governor's hand-picked judges and returned a verdict of 'Not Guilty' on the charge of publishing 'seditious libels.' The Zenger trial is a remarkable story of a divided Colony, the beginnings of a free press, and the stubborn independence of American jurors.”

22 Normally, at this stage in a Mitchell's Musing, I would provide a link. In this case, since I disapprove of what was done, I will not.
*Teachers will perform better if their ratings appear in public.* Note that this behavioral assumption is quite different from whether value added ratings are valid measures of performance. Undoubtedly, there will be a behavioral response by teachers. It could well be perverse. For example, the quickest way for a teacher to improve his/her rating is to get rid of students that are perceived as likely to drag the rating down. Get them expelled or at least out of your class. By the way, private schools – particularly expensive ones that are known for high-achieving students and parent involvement – could, if they wished, make their teacher performance appraisals public. Such schools are typically nonunion and are not required to negotiate about their terms and conditions of employment for teachers. I am aware of no private schools that publish individual teacher performance appraisals. Yet such schools are very concerned about what their teachers do and are responsive to parental concerns. They certainly evaluate what their teachers do, but as internal matters.

*We considered the pros and cons of publication and decided to go ahead.* In recent years, “balanced” journalism has often been based on the notion that every issue has two sides and as long as you quote someone from both, good practice has occurred. That approach often descends into “some say the world is round/others say it is flat.” In the case of value added ratings, the New York Times first published an op ed by Bill Gates of Microsoft fame explaining why – whatever the legalities – no good would come from publishing individual teacher performance ratings.23 Then, having “balanced” itself by printing the Gates op ed, it proceeded to go ahead with its pre-determined plan to publish the teacher ratings by name.

In fact, what Gates had to say puts far more weight on the scale of not publishing the data than any justification: (excerpts)

**Shame Is Not the Solution**

By Bill Gates

Last week, the New York State Court of Appeals ruled that teachers’ individual performance assessments could be made public. I have no opinion on the ruling as a matter of law, but as a harbinger of education policy in the United States, it is a big mistake. I am a strong proponent of measuring teachers’ effectiveness, and my foundation works with many schools to help make sure that such evaluations improve the overall quality of teaching. But publicly ranking teachers by name will not help them get better at their jobs or improve student learning. On the contrary, it will make it a lot harder to implement teacher evaluation systems that work...

Putting sophisticated personnel systems in place is going to take a serious commitment. Those who believe we can do it on the cheap — by doing things like making individual teachers’ performance reports public — are underestimating the level of resources needed to spur real improvement. At Microsoft, we created a rigorous personnel system, but we would never have thought about using employee evaluations to embarrass people, much less publish them in a newspaper. A good personnel system encourages employees and managers to work together to set clear, achievable goals. Annual reviews are a diagnostic tool to help employees reflect on their performance, get honest feedback and create a plan for improvement. Many other businesses and public sector employers embrace this approach, and that’s where the focus should be in education: school leaders and teachers working together to get better… (underline added)

Developing a systematic way to help teachers get better is the most powerful idea in education today. The surest way to weaken it is to twist it into a capricious exercise in public shaming...

The New York Times, like Microsoft, would never dream of publishing the performance appraisals of its employees on line, nor would its predecessor in this endeavor, the Los Angeles Times. There is indeed

“a capricious exercise in public shaming” going on. But it is those two newspapers - and any others following similar paths - that are being shamed by their own editorial decisions, legal though they may be.
Mitchell’s Musings 2-20-12: Ratios of Discontent

Daniel J.B. Mitchell

As readers of this blog will surely know, public sector workers – especially at the state and local level – have been the targets of complaints in the last few years about overpay and cushy benefits. The forthcoming LERA 2012 research volume (which I am editing) will deal with this issue in various chapters. Indeed, some preview chapters were presented at the January 2012 LERA meetings in Chicago. Other papers on the EPRN website have also dealt with the issue of public sector pay relative to the private sector.

There have been three common themes in reviews by economists on the public worker issue. One is that it is incorrect just to compare average pay in the public and private sectors because of different occupational characteristics of the two. Public sector workers include larger proportions of white-collar workers and have higher educational levels, for example. A second theme involves the composition of pay, since many of the complaints about public worker pay have focused on benefits, particularly pensions. Economists will argue that what matters is total compensation, i.e., pay and benefits, and that it is incorrect to look at one component of pay at a time. You have to add up the total value of the pay package. A third theme is that the growth of income inequality is not driven by public sector pay and researchers express some puzzlement as to why CEO pay is not the target, rather than public worker pay.

I got to thinking about the issues raised regarding recent criticisms of the public sector because of an accident. I happened to come across some old children’s records (audios of such records, actually) which suggested that in the 1940s, when the records were made, there was a positive attitude toward public sector workers. I put the audio (in video format) on the EPRN site in anticipation of this Musing.24 See http://www.employmentpolicy.org/topic/402/blog/attitudes-toward-public-workers-1940s-reflected-childrens-records

The puzzlement over the third observation – I think – is natural for academics who study income distribution and who know about what drives the distribution. But most ordinary people don’t know any CEOs (and don’t study income distribution). They don’t interact with CEOs. But they do know and interact with public sector workers such as the teacher or police officer who lives down the block. So apart from some “Occupy” demonstrators, the comparisons ordinary people make are with those they do encounter who are familiar.

24 Some readers or listeners may note that the records cite typically male occupations of that era: policemen, firemen, street sweepers, and postmen. There is no mention of teachers or librarians, presumably occupations children might encounter.
“Lifestyles of the Rich and Famous” is a TV show and not the real world to most folks. So, since the third observation is not such a puzzle, let’s consider the other two themes in recent academic literature.

The kind of standardization in pay research for occupational differences between public and private workers is the technically correct approach if one is concerned about long-term employee quality and about recruitment and retention. Similarly, looking at the entire pay package – wages and benefits – is similarly the correct approach if those are the concerns. But ordinary people are not in the quality and recruitment and retention business. Nor do they have ways of adding up pay packages of the public worker who lives down the block. Put in that framework, the comparisons made are likely to be precisely those that violate themes #1 and #2. Does X who lives down the block get paid more than I do? Does he/she have a better retirement program than I do? Those could be – and may well be - the relevant questions in terms of raising general ire. However, there is a secondary question as to whether and when the economics and political climate brings those questions to the fore.

Given that non-academic political/perceptual framework outlined above, I took a look at the national income (GDP) accounts which provide a gross public (state and local) vs. private pay comparison over a long period of time. What kind of ratios of public/private pay prevailed when those children’s records of the 1940s were made? The chart below summarizes the results.

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25 Military workers could not be removed from the federal sector in the early period discussed below so the analysis was confined to state and local employees.
Note first the result that before World War II, state and local pay per full-time equivalent employee (FTE) – whether on a total compensation or wage-only basis was higher than typical private pay. Indeed, it was higher back then than it is now. However, in the 1940s, the ratio was falling so that by the end of that decade public sector pay was below private. The children’s records were made in a period when public sector workers were losing (relative) ground. It was also a period in which the economy was prosperous, even taking account of the immediate postwar labor-market adjustments.

An advance of public sector pay relative to private doesn’t occur until the 1960s and then proceeds erratically. The 2000s, however, were a period of public-to-private pay advance and ended in the Great Recession. Perhaps that is why you don’t hear children’s songs praising police officers – or, at least, some of the reason.

On the benefit side, the chart on the previous page indicates that the total compensation advance was more dramatic in the 2000s that the wage-only advance. The chart below highlights that point, indicating that the share of pay going to benefits rose in both the public and private sectors – but more dramatically so in the public sector.

Non-wage benefits, which include mandated social insurance as well as voluntary programs, did not amount to much in the earliest period shown. The national income data show only the employer cost. In the pension area, employer contributions were held down in the 1980s by the switch to riskier investments (with assumed higher returns) and then actual high returns from the stock market during the dot-com boom of the 1990s. Employers paid in less to their pension funds because the funds seemed to be earning more on their portfolios. Some cost
control efforts in the health area may also have played a role in the break in trend. But during the 2000s, the upward march of benefit costs resumed – and especially so in the public sector.

In short, the 2000s were running in the opposite direction from the 1940s. Public sector pay was rising relative to private, particularly in the benefit area, and the decade ended in the Great Recession. When we go back to the 1930s, however, public sector pay seemed to be rising in relative terms compared with private and one could hardly view that era as prosperous. If there was great agitation during the Great Depression against public sector workers, I am not aware of it. So the political climate seems to play a role in whether there is anger about public worker pay. Rising public sector pay compared to private in a period of Hard Times is a precondition for such agitation. But apparently, someone has to point to the trend and make an issue of it before the public/private comparison becomes a news item and a source of complaints.

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26 There were complaints about some New Deal “make work” programs with criticisms about leaf-raking and the like. Ordinary state and local civil servants were not the target.
Mitchell’s Musings 2-13-12: Jolting Magnitudes

Daniel J.B. Mitchell

Every once in awhile, it useful to put magnitudes on potential labor-market policies and their possible effects. The U.S. Bureau of Labor Statistics (BLS), as is well known, puts out monthly indicators of the state of the labor force. The unemployment rate receives the most media attention. A less familiar release is the JOLTS (Job Openings and Labor Turnover Survey) report which comes out with less fanfare and with a greater lag. The latest JOLTS report is for December 2011, although we already have the unemployment report for January 2012.

Among other indicators, the JOLTS report provides data on vacancies reported by employers. In December, about 3.4 million job vacancies (“job openings” in the language of the JOLTS report) were found. The JOLTS data go back only to late 2000 so we don’t have a long time series for that survey. However, the lowest vacancy rate reported was 1.6% in July 2009. The December 2011 rate was, of course, higher at 2.5% reflecting the gradual improvement in the labor market since the trough.

Labor market conditions were pretty discouraging at the trough and yet there were still some job vacancies open. That fact suggests that, just as the unemployment rate can never be zero, neither can the vacancy rate. Even in boom times, such as World War II, the unemployment rate was never zero since it always will take a bit of time for workers to find the jobs they seek, even when many job opportunities are on offer. Similarly, in Hard Times, there will always be some jobs open because it takes a bit of time for employers to find the particular workers they seek, even when many workers are available and looking for work.

Let’s take 1.6%, therefore, as an approximation of the lowest vacancy rate that can be realistically expected. By December 2011, there were more job vacancies than that minimum due to the recovery.

27 http://www.bls.gov/news.release/jolts.htm

28 The definition of job openings is provided in the reference in footnote 1: Establishments submit job openings information for the last business day of the reference month. A job opening requires that: 1) a specific position exists and there is work available for that position, 2) work could start within 30 days regardless of whether a suitable candidate is found, and 3) the employer is actively recruiting from outside the establishment to fill the position. Included are full-time, part-time, permanent, short-term, and seasonal openings. Active recruiting means that the establishment is taking steps to fill a position by advertising in newspapers or on the Internet, posting help-wanted signs, accepting applications, or using other similar methods. Jobs to be filled only by internal transfers, promotions, demotions, or recall from layoffs are excluded. Also excluded are jobs with start dates more than 30 days in the future, jobs for which employees have been hired but have not yet reported for work, and jobs to be filled by employees of temporary help agencies, employee leasing companies, outside contractors, or consultants.

29 The job openings rate is computed by dividing the number of job openings by the sum of employment and job openings and multiplying that quotient by 100.
When we adjust the actual 3.4 million vacancies to take account of the irreducible minimum, i.e., when we subtract the irreducible minimum from the 3.4 million openings last December, about 1.2 million vacancies were realistically available that might have been filled. That is, they might have been filled, if only we could have found or trained the right workers and matched them to those vacancies.

Suppose we had a magic training and job matching program that would instantly find workers who would want to fill those 1.2 million vacancies and give them whatever skills were required. What would have happened to the December 2011 unemployment rate that stood at 8.5%? There are three statuses that the BLS includes in its monthly labor force report: 1) employed (has a job), 2) unemployed (essentially actively seeking work), and 3) not in the labor force (has no job and is not actively seeking one). Suppose all of the 1.2 million vacancies had instantly been filled through our magic training and matching program from the ranks of the 13 million unemployed (status #1) persons that were reported in December 2011. That filling of vacancies would have moved those folks into employment (status #2). Then instead of standing at 8.5%, the unemployment rate would have been about 7.7%. It might be noted that an unemployment rate of 7.7% would still be quite high by historical standards.

However, typically when there are gains in employment, many of those who find jobs come not from the unemployed, but from those reported previously as not in the labor force at all (status #3). A crude estimate in fact would be that perhaps a third of those adding to employment come from the unemployment and the rest come from outside the labor force. So if we had a magic training and matching program, it would likely draw in some folks, maybe even two thirds of the folks, from outside the labor force. The labor force would thus be somewhat larger since there would be more employees coming in from outside. And the ranks of the unemployed would be reduced by less than would have occurred if the unemployed had been the sole source of those filling job openings. If we assume one-third came from the unemployed and the rest came from outside, the unemployment rate would have dropped only to 8.2% from the actual 8.5% in the face of our magic training and matching program.

Sadly, although there are programs and policies that provide training and help workers match up with employers, none of them are magic. So even the drop of 0.3 percentage points in the unemployment rate would be a lot for which to hope given a feasible and aggressive program of training and matching. A drop to 7.7% would be even more out of reach.

Dropping the unemployment rate by a few tenths of a point would be a Good Thing, of course. But the next time you hear stories about how our unemployment problem is “structural,” keep these

30 Arjun Jayadev and Mike Konczal, “The Stagnating Labor Market,” Roosevelt Institute, September 19, 2010. See http://www.rooseveltinstitute.org/sites/all/files/stagnant_labor_market.pdf. This study finds that during recent Hard Times, fewer than 30% of those persons transitioning to employment came from the unemployed. In an earlier period (1994-2000), the percentage was 37%. One third is roughly in the middle.

31 We could in theory try to confine our imaginary magic training and matching program to the officially unemployed. However, the existence of such a program would likely entice applicants who are technically counted as not in the labor force.
Mitchell’s Musings 2-6-12: Hearsay Evidence

Daniel J.B. Mitchell

Thomas Friedman, the New York Times columnist, noted the following in a recent op ed:

There is today an enormous gap between the way many C.E.O.’s in America — not Wall Street-types, but the people who lead premier companies that make things and create real jobs — look at the world and how the average congressmen, senator or president looks at the world. They are literally looking at two different worlds — and this applies to both parties.

Consider the meeting that this paper reported on from last February between President Obama and the Apple co-founder Steve Jobs, who died in October. The president, understandably, asked Jobs why almost all of the 70 million iPhones, 30 million iPads and 59 million other products Apple sold last year were made overseas. Obama inquired, couldn’t that work come back home? “Those jobs aren’t coming back,” Jobs replied...

So what do we make of this excerpt? CEOs and politicians do inhabit different worlds. Neither world makes them especially acute analysts of macroeconomic trends. Nonetheless, CEOs are expert in the practice of microeconomics, which often used to be called the “theory of the firm,” at least on the supply side of the supply/demand equation. In this case, the President — whose charge is more on the macro side - was asking a legitimate question. And Steve Jobs was simply telling him that at today’s exchange rates, it was cheaper for his firm to produce iPhones in China. As long as the world cost structure remains as it is, the Apples of the world will continue to make their current production location decisions and “those jobs (won’t) come back.”

But there is more to be said about the issue as the chart on the previous page suggests. The U.S. has net borrowed from the world to import iPhones and other goods. Can that process – borrowing for internal

consumption - continue indefinitely? It shows up on the chart as a large net debt to the world that built up over a long period, but became especially pronounced in the 2000s. Although the value of the net debt fluctuates with exchange rates, simply to keep the debt from growing over the long term would require a switch from the present net export deficit to a situation in which the value of exports equals the value of imports.

To begin to lower the net debt would require an ongoing export surplus. That consideration is something about which Steve Jobs did not have to concern himself. It wasn’t Apple’s problem. But it is something that a president should be pondering. Indeed, a president might also want to concern himself with the chart below.

Foreign central banks, especially in the last decade, have been increasing their holdings (their reserves) of U.S. dollars. When they do so, they tend to keep the dollar’s value high relative to their currencies. So production decisions – such as Apple’s - tend to go abroad. Will foreign central banks continue to pile up their dollar reserves indefinitely? Again, that issue was not a question for Steve Jobs to worry about, but it is one which presidents and other politicians should be asking.

If you ponder these two charts and begin to think that a) ongoing borrowing to finance a U.S. trade deficit is ultimately unsustainable and b) there is some limit to how many dollars foreign central banks will want to pile up, then you will have to come to the conclusion that, one way or another, the U.S. net export balance will have to improve. Such a development will mean more export production in the U.S. and/or more import-substitution production, i.e., domestic production of goods once made abroad will move back toward the U.S. So jobs are coming back. How can you produce more exports and/or substitute more domestic production for imports without using workers? Whether those jobs are iPhone-producing jobs or jobs producing other products is yet to be determined. Also to be determined is whether the adjustment will go smoothly or whether some new financial crisis will be triggered. For politicians looking for advice on such matters, Steve Jobs – were he still alive – and the other CEOs referenced by Friedman are not the obvious go-to persons.
Let’s start with the admission that I am not a lawyer, let alone a constitutional scholar. So I can’t really evaluate the U.S. Supreme Court’s recent unanimous decision which voided the conviction of someone apparently dealing drugs that was obtained based on GPS evidence. All I can say is that the justices seemed upset with the idea of the police attaching a device to a private car which allowed tracking of the car’s movements and eventual finding of incriminating evidence. Trust me; I will ultimately relate that decision to an employment concern.

It appears (to me) that the degree of efficiency in the technology utilized played an important role in the GPS decision although part of the discomfort of the court seemed related to the intrusion on the vehicle needed to attach the device. It also appears (to me) that if the police had done old fashioned following of the vehicle around with another car - and eventually found incriminating evidence as a result - that approach to obtaining evidence would have been OK with the Court.

If that interpretation is correct, there seems – to this non-lawyer at least – to be only a matter of degree between high-tech surveillance - which produced massive amounts of data according to the Court decision – and old fashioned tailing. But obviously the former was much more efficient and much less costly and labor intensive, than the latter. If privacy violations are cheap, they are more likely to occur than if they are expensive.

There are analogies in other controversies in the news involving evolving technology. The recent brouhaha surrounding the congressional political battle between Hollywood and Internet providers over measures to prevent piracy of films and such has similarities to the GPS decision. If you saw the film, The King’s Speech, you may recall the scene – taking place in the 1930s – in which the speech therapist, using a new home phonograph record device said to be from America – records the King.

So it technically was possible in the 1930s, with what must have been an expensive device, to copy phonograph records – possibly violating copyright. After World War II, less expensive home tape recorders and wire recorders became available. It was becoming easier to copy, say, radio broadcasts of
the top-ten tunes, again possibly violating copyright. But record companies didn’t panic since the means of copying and distributing was cumbersome involving reels of tape or spools of wire.

More concern concerning copyrights and intellectual property arose when home video cassette recorders came along and movies might therefore be copied from TV broadcasts. The Betamax case ultimately went to the U.S. Supreme Court on that issue. But home cassette recorders were allowed in the Court’s 1984 decision. That controversy occurred before there was an effective Internet which would allow relatively easy distribution of copied movies by digital means.

In short, courts and legislators are now continually faced with changes in technology which make past transgressions that were once inherently limited much easier. Exactly where you draw the line between what is and what isn’t going to be allowed is a matter of degree and discretion. And a decision at one point in time may be made obsolete as technology advances. There really is no absolute, timeless rule.

That observation brings me to issues of privacy and technology – and employment. A number of newspapers and other organizations have obtained court judgments saying that public payrolls and public pension rolls are public documents – and presumably always were. Therefore, it is OK to post them wholesale on the web with the names of the employee or retiree included.

Now it may well have been the case in a simpler age that one could have gone to a public office and obtained information on payments to employee X or retiree Y, using state and local equivalents of the federal Freedom of Information Act. But copying down the entire payroll of an agency would not have been a simple matter. And wholesale and easy distributing the information, if one had the patience to copy it, would also have been difficult and costly. But currently such wholesale copying and distribution
has become easy, thanks to computer technology and the Internet. With that technological advance, the process today raises issues of privacy and potential identity theft.

Most private employers would not think that publishing their payrolls wholesale, disclosing pay named employee by named employee, was a good idea as a human resource practice. We know that no private employers do it. And among the employers who do not choose to do it are the very newspapers making available public employer databases. Surely, their readers might like to find out what they (the newspapers) pay their editors, columnists, reporters, and – who knows – even their floor sweepers. But the fact that readers might be interested and that the newspapers already have the data on their own payrolls has not impelled any newspapers I know of even to contemplate such publication.

When pushed, the newspaper response is that the public has a right to know where its tax money goes. But actually there are lines drawn. So far there have been no court decisions – again that I know of – that make wholesale health records of public employees available by name, even though taxpayers fund public health insurance benefits for employees. Internal personnel files with performance appraisals are not routinely made public on a wholesale basis. But couldn’t it be argued that the public has a right to know about health expenses and performance reviews? So, in fact, as in the GPS case, it is a matter of degree and balance. Not everything funded by taxpayers is in fact a public document.

There are ways of balancing publication of public payroll data against privacy and identity theft concerns. Pay rates by occupation can be made available – but without names – so that outsiders can judge whether public pay rates are being set correctly. The California state controller, for example, has published municipal pay rates without names. One can learn, for example, that one “police evidence clerk” in the City of Santa Monica in base salary and overtime earned $60,228 while the other earned $59,923. But no names are provided. If you are worried about whether Santa Monica overpays or underpays its police evidence clerks, now you have the data to decide.

The general exception about naming names in the private sector, at least for publically-traded firms, is that top executive pay is made public (with the names known). That practice might also be followed in the public sector. And it typically is - and has been. What the President of the United States is paid has not been top secret. And note that presidents, governors, mayors, or Supreme Court justices are public figures. Police evidence clerks are not.

Undoubtedly, the GPS decision by the Supreme Court will be revisited in the future as technology changes. What if it becomes possible to track a car without actually attaching a device? Cars of the future may have devices built in that transmit information for internal operating reasons. What if the police pick up those signals and use them for tracking?

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33 I rather doubt that the fact that subsidized mailing rates would be viewed by newspaper publishers as grounds to force them to make their payrolls public, even though one might argue that public money is involved in the subsidy. Newspapers also receive other public benefits including antitrust exemptions in some circumstances and, of course, First Amendment protections.

34 Figures are for 2010. The full database is at [http://lgcr.sco.ca.gov/](http://lgcr.sco.ca.gov/).
Bottom line: The public employee payroll issue also needs renewed court and legislative attention. Many more people are affected. That is, many more people work in the public sector than there are drug dealers who police might want to tail. It is clear that those newspapers that are publishing payrolls by name are set on doing so. Sometimes they simply say it is legal – which it apparently is at present. But they don’t routinely publish, say, the home addresses of crime victims or the names of rape victims even though these can be obtained in public police records. So they cannot really take the position that they simply publish everything that is legal without making any judgments about what is appropriate. Since their good judgment on crime victims is evidently not going to be applied to public payroll records, only if courts and legislators say it is not legal would wholesale public payroll publishing by name come to an end.
Mitchell’s Musings 1-23-12: Assume No Ladder?

Daniel J.B. Mitchell

There are many economist jokes out there. One involves two economists walking down a street. One points out to the other that a twenty-dollar bill is lying on the sidewalk. The other says it can’t be true because someone would have picked it up. The joke, of course, is intended to point out the danger of over-reliance on economic theory to the point that contrary empirical evidence is rejected.

The other joke involves two economists who find themselves at the bottom of a deep hole with no way out. One says to the other, “Let’s assume a ladder.” The same lesson is intended; it is best not to rely on theory when empirical evidence points elsewhere.

My son Joshua passed me a blog-column by John Cochrane of the University of Chicago responding to attacks by Princeton economist and NY Times columnist Paul Krugman. The Cochrane blog-column post is at

http://johnhcochrane.blogspot.com/2012/01/stimulus-and-etiquette.html

so you can read it for yourself. But in essence, Krugman has been arguing for a more vigorous stimulus program – through both monetary and fiscal policy - to bring down the unemployment rate, here in the U.S. and - more recently - in the E.U. He has been frustrated by stimulus-policies-don’t-work arguments that have come from “Chicago-school” economists. Cochrane complains about both what he feels are ad hominem attacks by Krugman and about a need for modesty in macro-economic modeling and policy prescriptions.

But here is the problem, embodied in a quote from the Cochrane blog-column:

35 There is even a “stand up economist” comedian on the web http://www.youtube.com/watch?v=cW9dxFrAk-I.
Many stimulus advocates point to WWII spending. Think about what that means: all those tanks, ships, and airplanes on the ocean floor were not a terrible economic sacrifice we paid to win a desperate war. Every ship the Germans sunk let the government buy another ship, and gain a ship and a half worth of GDP in the process!

There are really two ideas here. One is that World War II spending in fact seemed to bring down the unemployment rate dramatically. The other is that it is unfortunate that the spending had to go for items that were destroyed in war. Both propositions are hard to dispute. But only the first one is relevant.

It seems that there is a new economists joke in formation here. It goes like this: Two economists find themselves stuck at the bottom of a hole but they know that in the past there has been a ladder in the hole capable of reaching the top. Rather than look to see if there is still a ladder somewhere in the hole, one says to the other, “Assume there is no ladder.” They make that assumption, don’t search for the ladder, and remain stuck in the hole.

Let’s put aside political gridlock and institutional barriers to macro-policy. The place to start is whether there is any historical evidence that there is a set of policies that could get us out of our current economic hole. World War II does come immediately to mind. But could it be that there are now structural changes in the economy that would prevent such a World War II-type jump in spending from having the same effect at present that it did back then? Possibly - we can’t be 100% sure what worked then would work now. There is always a model of some complexity that can arrive at any conclusion. But is it really best to start with the assumption that there is no ladder out of the hole when – at least in the past – there has been one?

Perhaps another way for any macro-economist to put this matter is to imagine he/she was a benevolent dictator whose sole goal, say as of January 2009, was to bring the U.S. unemployment rate down to some acceptable level in 2 years. As a benevolent dictator, he/she would control the Fed absolutely – buying and selling assets and creating money with no legal impediments. He/she would control taxes and spending absolutely – no Congressional opponents, etc. Could getting the unemployment rate down be done under those circumstances? The virtue of putting the question in that extreme way is that if the answer to the question was surely “no,” then in the real world (without absolute power), the answer would also be “no.”

However, it really is hard to answer “no” to the benevolent dictator question, especially given the World War II experience. But if you don’t like “Big Government,” you are going to want to find some way to answer “no.” Or, if not exactly “no,” it is always possible say we can’t be 100% sure what would happen today and maybe there could be some inadvertent offsets or undesirable consequences.
Being a benevolent dictator is, as noted, an extreme. But in the real political and institutional world in which monetary and fiscal policy is made, even a modest move toward doing anything feasible to lower unemployment is going to involve some governmental action. Obviously, you shouldn’t assume a ladder if it is clear that none is there nor has one ever been there. But if your predilection is not to look and see if there is a ladder, you will surely remain stuck in the hole.
Mitchell’s Musings 1-16-12: Tigers in Hindsight

Daniel J. B. Mitchell

Two items got me thinking about foreseeing risk, and the capacity to underestimate risk. Once was listening to an old broadcast of Jean Shepherd, a New York City radio “raconteur” who told a story in 1976 about once working in a small TV station when his manager got a bright idea. The Clyde Beatty circus was in town. So why not do a live broadcast from inside Beatty’s cage? Beatty was a famed lion tamer of that era. Shepherd obediently entered the cage with his microphone. After all, how dangerous could it be with some as knowledgeable as Beatty in charge? Years later he read in a book by Beatty that letting the TV guy into the cage was the riskiest, scariest thing he (Beatty) had ever done.

http://www.youtube.com/watch?v=0sV7gWad9jA

The other item I read was a Los Angeles Times article about newly-released 2006 “transcripts” of the Federal Reserve’s Open Market Committee – the policymaking arm of the Fed. I put the word “transcripts” in quotes because they are not literal word-for-word transcriptions. If you read them, you will find that everyone speaks perfectly grammatically, never uses verbal pauses such as “um” or “uh,” and always frames complete sentences. The transcripts, in short, are cleaned up versions of what was said. They are routinely released six years after the events, so 2012 saw the release of the 2006 transcripts. The transcripts are very detailed in contrast to the much shorter official statements and minutes that are released soon after the meetings are held.

Years ago, I co-authored a journal article, based on such transcripts, illustrating how Fed policy makers remained hung up on notions of “wage-push” inflation – really an artifact of the period from the 1950s through the 1970s when unions were strong – long after unions had declined.

36 The Federal Open Market Committee (FOMC) consists of twelve members--the seven members of the Board of Governors of the Federal Reserve System; the president of the Federal Reserve Bank of New York; and four of the remaining eleven Reserve Bank presidents, who serve one-year terms on a rotating basis. The rotating seats are filled from the following four groups of Banks, one Bank president from each group: Boston, Philadelphia, and Richmond; Cleveland and Chicago; Atlanta, St. Louis, and Dallas; and Minneapolis, Kansas City, and San Francisco. Nonvoting Reserve Bank presidents attend the meetings of the Committee, participate in the discussions, and contribute to the Committee’s assessment of the economy and policy options. The FOMC holds eight regularly scheduled meetings per year. At these meetings, the Committee reviews economic and financial conditions, determines the appropriate stance of monetary policy, and assesses the risks to its long-run goals of price stability and sustainable economic growth.” Source: http://www.federalreserve.gov/monetarypolicy/fomc.htm.

In any event, what the *LA Times* article essentially indicates is that Fed policy makers did not anticipate the magnitude of the financial crisis that was to come in 2008. The article notes that the members sometimes made jokes. Put in other terms, and with the benefit of hindsight, the Fed policy makers were about to get into the circus cage without a full understanding of the risks involved.

I went online to the 2006 transcripts to see what was actually being said, at least in the cleaned-up version of the remarks. In the Appendix to this musing you can see selected quotes which I culled from the transcripts. Judge for yourself whether my characterizations are accurate.

Meetings typically open with a presentation by Fed staff on the staff’s forecast and on recent economic data. Then there is a back-and-forth interchange between members of the Open Market Committee and the staff. There are regional reports made by the presidents of the various Federal Reserve Banks that are rotated on and off the Committee. Members of the Fed’s Board of Governors also present their views. Fed Chair Ben Bernanke tries to summarize the various views and gives his own interpretations of where the economy is headed. Finally, there is a good deal of discussion of what kind of statement the Committee should release about its current monetary policy. These sessions are lengthy meetings, sometimes intense, and the fact that an occasional “light-hearted joke” is made is hardly reprehensible. (The quote is from the *LA Times* article which seems to find fault with the humor.)

According to the *LA Times’* analysis, “*the transcripts... reveal in painfully embarrassing detail the high degree of overconfidence and lack of foresight just ahead of the real estate collapse and financial crisis.*”

I disagree. First, the housing problem was widely discussed at the meetings, as is apparent from the Appendix quotes. Note that the official dating of the beginning of the Great Recession is December 2007, i.e., 1-2 years after the meetings of 2006 which were held beginning in January 2006 and ending in December of that year. We will have to wait another year to see what went on at the Fed in 2007. Anyone who has done economic forecasting will know that spotting turning points a year or two ahead is difficult. “Just ahead,” is not how I would describe the elapsed time between the 2006 meetings and the Great Recession. Moreover, there are references in the transcripts to the uncertainties involved in interpreting the mixed

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39 You can access the transcripts at [http://www.federalreserve.gov/monetarypolicy/fomc_historical.htm](http://www.federalreserve.gov/monetarypolicy/fomc_historical.htm).
events that were occurring in 2006. No one at the meetings says they are certain of their interpretations and prognostications.

Moreover, the issue facing the Fed was whether the housing bubble should be addressed directly, i.e., apart from the general state of the economy which is the usual Fed target. The prior experience a few years before with the dot-com episode suggested that financial bubble-bursts produced rather mild recessions. Members of the Committee did look to past histories with housing bubbles specifically, but they did not find from past evidence that more than a mild impact could be expected.

Since the downturn was 1-2 years away, what the Committee found was mixed data on economic performance which is typical when the economy nears a peak. The year 2006 featured an economy that by some measures was overheating and by other measures was softening. That mix might have heralded a recession, a growth pause, or maybe nothing at all. Regional conditions were varied.

It was thought that the channel through which a bursting of the housing bubble would affect the economy was directly through reduced employment in construction and housing-related industries and indirectly through a wealth effect on consumers. Higher house prices made home owners feel wealthier and therefore stimulated consumption. A drop in house prices would presumably have the reverse effect. But at the time, house prices were leveling off, not consistently dropping. And standard forecasting models incorporated only limited wealth effects operating in a linear fashion. Forecasting models typically don’t deal with abrupt, suddenly-off-the-cliff responses.

There was concern expressed about potential “non-linearities” that the standard models tend to miss. But the general view on the Committee was that absent a clear direction of the economy, the Fed should simply watch and wait. It could take action later as the situation clarified.

The fault was not really “a glaring absence of alarm” – the Fed was not out of line with most forecasters at the time – but a failure to detect the flaky mortgage securities and practices that escalated what might have been a mild recession into the Great Recession. Some mention of these flaky practices is made in the transcripts and - with hindsight - one can say that the Fed and other financial regulators should have had a greater grasp of the problem. But as is now apparent, the fractured regulatory system was inadequate and some of practices taking place were outside the traditional regulatory framework.

In short, the Fed climbed into the cage with financial lions and tigers because the dangers were not apparent. With hindsight, we can see the danger signs. But there were lots of folks (sometimes mentioned in the transcripts) - such as CEOs of major firms (outside the housing
industry) - saying that as far as they could tell, the economy was moving along just fine despite the housing problem. To put it in a nasty fashion, why worry about the Big Cats in the cage when the Fat Cats ostensibly in charge of the business world seemed to have everything under control?

Anyway, as of 2006, consumers were buying. Business investment was going ahead. Indeed, some Committee members feared that the danger for the U.S. economy was really inflation, not recession. That view was old thinking, as it turned out.\textsuperscript{40} Too bad that neither the Fed, nor the \textit{LA Times} for that matter, could not foresee the future back in 2006.

\begin{quote}
For of all sad words of tongue or pen,
The saddest are these: "It might have been!"\textsuperscript{41}
\end{quote}

\textsuperscript{40} I was sorry to see “wage-push” mentioned by Chair Bernanke a year after Erickson and I published our paper cited earlier. But, then again, he could not have foreseen the paper we published a year later on why even a low-unemployment labor market was unlikely to result in wage pressures. C.L. Erickson and D.J.B. Mitchell, “Monopsony as a metaphor for the emerging post-union labour market,” \textit{International Labour Review}, Vol. 146 (2007), No. 3–4, pp. 163-187. Available at http://www.anderson.ucla.edu/documents/areas/fac/hrob/mitchell_erickson_monopsony.pdf.

\textsuperscript{41} From the poem, “Maud Muller” by John Greenleaf Whittier available at http://www.poetry-archive.com/w/maud_muller.html.
Appendix: Selective Quotes from Transcripts of Federal Reserve Open Market Committee Meetings

Meeting of January 31, 2006

Page 18: The principal source of slowing in aggregate activity in our forecast continues to be the housing sector...

With respect to house prices, the recent data and anecdotes also have pointed to some weakening. As a result, our forecast of a sharp deceleration in home prices... seems less of a stretch than it did a while back...

As we have noted before, our house price forecast also has implications for consumer spending. Slower growth of house prices is the chief factor causing the wealth-to-income ratio ... to drift down over the projection period...

Pages 27-28: ...Our model has a relatively low marginal propensity to consume out of housing wealth, one that is similar to that out of overall household wealth. It’s not difficult to imagine upping those effects. If one wants to assume that, instead of the three and a half cents on the dollar effect that we have incorporated in our model, the marginal propensity to consume was around five to seven cents on the dollar, those effects would obviously be increased. The second potential channel that our straightforward model simulations don’t account for is that a lower path for housing prices could be accompanied by some hit to consumer sentiment. There would be an outsized effect on consumer spending if households really became more pessimistic given the downturn in what is an asset with a high profile in their portfolios...

So I think there are some pretty wide confidence intervals. ... As I contemplate our outlook and the things that I worry about the most on the domestic side of the economy, I’d say the housing sector is clearly one of the biggest risks that you’re currently confronting...

Comment: Generally in this meeting, there was agreement on uncertainties stemming from the housing market and that if there was to be trouble ahead, it would come from that market.

Meeting of March 26-27, 2006

Page 85: ...An overall reflection on the economy: Consumer activity remains strong, but flattening of real estate equities will certainly restrain the wealth effect on consumption to some extent. In the so-called bubble markets, we are clearly seeing prices drop. In the mortgage business, the purchase mortgages are very active, but refinancings are almost entirely eliminated...

Page 92: ...Not only are we faced with the forecaster’s typical dilemma of trying to predict a trend break or a turning point, but we also have relatively few experiences in the United States over the last few decades of a downturn in the housing market...

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Note: Page numbers cited are transcript pages, not pdf file pages.
Page 93: ...Many of the discussions about the housing market suggest that there will be some sort of exogenous shock that somehow may send the housing market down, as opposed to the housing market’s being part of the broader economy in which there are consumption demands for investment and in which houses are an asset as part of a portfolio. It is important to put housing in that context. In the other countries where we have seen downturns and GDP effects, it is hard to pull out what part was due to housing’s lead as opposed to housing’s just being one of the factors affected by a general economic downturn. So with those caveats in mind, and obviously we have to be careful about extrapolating from other countries’ experiences, I do think we should be mindful of the potential risks that are there...

Chair Bernanke on page 95-97: ...We have had, I think, a fairly upbeat group here the last couple of days, which is of course good, both in terms of views of economic activity and in terms of keeping inflation well controlled. The economy appears to be quite strong, but my sense is that most people feel that risks on that score are relatively balanced, which I take to imply that, after being strong in this quarter, growth will slow to something closer to a more-sustainable pace in the remainder of the year. Perhaps the leading source of uncertainty on the output side is the housing market, but I was reassured to hear that most participants think that a decline in housing will be cushioned by strong fundamentals in terms of income, jobs, and continuing low interest rates...

...Housing is the crucial issue. To get a soft landing, we need some cooling in housing. So far there is a good bit of evidence that there has been a peak, but we do not know a great deal more than that. So obviously we are going to have to watch carefully. The range of possible outcomes is quite wide...

Chair Bernanke on Page 137: ...I see the economy as still being basically quite strong, and it needs to moderate to become consistent with its long-run potential. The vehicle by which that is going to happen is the slowing in the housing market. I think we ought to raise the rate today and not to signal an immediate end for several reasons. First, we could think of our policy in terms of the mortgage rate rather than the funds rate. The mortgage rate is currently about the same as it was when we began tightening in June 2004, and it is still providing support to the housing market. If we failed to act today or signaled that we are definitely done, we would create a rally in the long term bond market and in the mortgage market. We would create, I think, some risk of re-igniting what is currently a cooling market. I think that would be a mistake...

Meeting of May 10, 2006

Page 12: I have awoken with the fear that recent developments could provoke us into a familiar trap of overshooting on policy. If policy were to lean against strength in activity and inflation pressure that was largely seen in the rear-view mirror, the risk of tightening too much and for too long would be amplified. In that regard, the evidence has continued to accumulate that housing markets are softening, and last Friday’s employment report at least hinted at some slowing in labor demand. Tightening significantly further when the economy already may have begun to decelerate risks an unwelcome cyclical downturn in the economy. Given our poor track record in predicting recessions, one should not take lightly the risk of overshooting the mark. I’m not embarrassed to admit that I’ve harbored both fears—that of falling behind the curve and that of overshooting—often on the same day and sometimes even in the same
conversation with my colleagues. [Laughter] But in the end, I have come to the view that, while you are almost certainly somewhat behind or somewhat ahead of the curve, there are some good reasons to think that you are not too far from the curve.

Page 28: ...Incoming data on the pace of economic activity surprised me slightly to the upside, although the indications are that housing is continuing to cool. Such an upside surprise is of concern, given that we are probably in the neighborhood of full employment and inflation is already on the high side of a range I consider consistent with price stability. I have also been slightly surprised, and unpleasantly so, by incoming data on core inflation...

Page 37: ...In terms of the housing market, you may recall my last report from a large house builder who built 400,000 homes thus far. I’ve expanded that to another builder of similar size. The cancellation rate now, David, is up to 40 percent—a key indicator. However, it has shifted around the country, and... they report that you’d have to be a princess on a pea to feel any discomfort with the Texas housing market. It is booming, unlike the Florida market—which, as you know, is cascading...

Page 46-47: ...Employment growth will support consumer spending even as house price appreciation slows. The rising gasoline prices will have a damping effect but probably not a dramatic one. There are no signs of a sharp retrenchment in housing. So far, the slowing has been orderly. With the economy expected to remain at full employment and with labor markets tight, we expect hourly compensation growth to accelerate over the forecast period, but not dramatically so...

Page 48: ...In addition, foreclosures also point to some weakening in the housing market. I guess the most notable is a 31 percent increase in March over the previous month that pushed Colorado to the highest foreclosure rate in the nation—as reported anyway. One factor behind the increase is the unusually widespread use of interest-only mortgages in that state...

Page 49-50: ...The CEO of one of the nation’s largest home builders... explained that a number of factors, in his view, have come together to precipitate that slowing—overbuilding, higher mortgage rates, a retreat of housing speculators, earlier conversion of many rental apartments to for-sale units, and now the wait-and-see attitude among those who still expect to purchase at some point. He reinforced my sense that, while the cooling-off in housing is being felt to some extent in most markets, so far it is only the frothy coastal markets, like South Florida, that have seen a significant adjustment..

Page 53: I think that there are a few straws in the wind that suggest that some deceleration is in the offing, including the evolution of housing activity and the diminution of the positive wealth effect, at least from that source. I do not want to exaggerate that effect at this moment. It is based largely on what we are seeing in the most recent data, but the anecdotes, at least that I am getting, are consistent with that...

Page 63-65: ...On the real side, one area that I think is critical is the housing market. As you all know, I have continued to worry about what is going on in housing and mortgages and have wanted to give you another perspective on what we are observing. Most of you are well aware that we put out some supervisory guidance for comment awhile back on nontraditional mortgage loans, which include various
forms of interest-only, adjustable-rate, negative-amortization mortgages. If you look at the 2005 earnings reports of the large mortgage banks and the large savings and loans that do mortgage lending, these institutions have a really striking amount of interest rate risk embedded in their negative amortization loans. As you know, most of the product is securitized and sold. So the relative share of these products originated in the last couple of years that are on the banks’ books is small overall. But the numbers have gotten so bad that now the setters of accounting standards want banks to disclose how much interest income they are recognizing as income that they have not collected, through this negative amortization. In other words, they bill the customer for this interest, but instead of making the customer give them the cash every month, they just add the amount to the outstanding balance and it creates negative amortization. For some of these big organizations, the amount represents 5 or 10 percent of net income from last year. So the number is growing, and we are looking to make sure that banks are appropriately putting aside reserves for the portion that may not be collectible. In the past few weeks, I have become aware that the rising interest rates are creating more problems for customers in servicing debt. …Now, the mortgage industry, ever creative and ever worrying about the ability of homeowners to pay amid rising rates, has now decided to create negative-amortization, fixed-rate mortgages. What these mortgages do is say, “Just borrow for your house. You have a monthly payment, no amortization of principal, and you do not even have to pay the full fixed rate. We will just continue to add to your principal, and you pay what you can afford every month versus what you really owe us on the fixed rate every month.” This process just continues, and one thing that bothers me for the long run is the extent to which housing could slow this year and slow the economy. I just wonder about the consumer’s ability to absorb shocks… So the growing ingenuity in the mortgage sector is making me more nervous as we go forward in this cycle, rather than comforted that we have learned a lesson. Some of the models the banks are using clearly were built in times of falling interest rates and rising housing prices. It is not clear what may happen when either of those trends turns around…

Chair Bernanke page 71-72: I think we are following the path laid out by the Greenbook toward greater moderation in the second half. The main difference is that, since our last meeting, the uncertainty around that prospective path has increased. Obviously, the key to this moderation is the housing market, and fundamental analysis would suggest that the combination of high prices and rising interest rates would make affordability a problem and would bring housing starts and housing prices down. So far we are seeing, at worst, an orderly decline in the housing market; but there is still, I think, a lot to be seen as to whether the housing market will decline slowly or more quickly. As I noted last time, some correction in this market is a healthy thing, and our goal should not be to try to prevent that correction but rather to ensure that the correction does not overly influence growth in the rest of the economy…

Page 83: …The housing falloff that we’re beginning to see signs of could hit not just residential construction but also consumption harder than we expect, and rising energy costs could exact a greater tax on spending. But as I noted, we have yet to see much of that projected slowing in the incoming data. It’s still a forecast…

Meeting of June 28-29, 2006
...Widespread anecdotal reports suggest that the drop in demand is being driven partly by a withdrawal from the market by investors and purchasers of second homes. Data on mortgage originations by investors and those purchasing second homes, which begin on a monthly basis in mid-2003... are available only through March... The first thing to note is that these groups are a relatively small part of the overall market. Moreover, although the data are quite noisy, neither group, at least through March, was leaving the housing market in droves. Nevertheless, the recent spate of reports and a jump in the rate of contract cancellations for new homes, which homebuilders attribute largely to a retreat by investors, pose a downside risk to the housing outlook. Another risk to the forecast is the possibility of a pronounced deterioration in the financial conditions of some vulnerable households, which could cause them to retrench significantly on spending...

...What we have done is to take down the rate of growth roughly ½ percentage point beginning in the third quarter and moving to the end of the projection period, in large part, I'd say, because of the disappointing developments in the housing sector but because of other things, such as weaker consumption news, as well. I would also say that we don’t see this cumulating. We’ve weakened the forecast, but we don’t see the economy falling apart. We continue to see an economy that, as I said, was in a transition to a rate of growth that will be below potential. We just marked it down further below potential than we had in the last Greenbook. But I don’t think that there’s a disconnect between what we’ve done and the news that we have received...

...Of course, housing markets are weakening. At the last meeting we were more pessimistic than the Greenbook. This time, with its large revision, the Greenbook is slightly more pessimistic than we are. However, the overall negative tone of the Greenbook seems a bit puzzling to me given the current conditions that we were discussing earlier. After all, mortgage rates are not that high. The rate of house-price appreciation has not come down more than we expected. Still, current conditions are softening. A contact from a major national builder, Pulte Homes, told us that their new orders had dropped sharply and that the current high level of construction is being supported by working off backlogs. Accordingly, he expected a more marked slowdown in building in 2007...

...The CEO of EDS, who has as his clients GM and Delphi, said, “You hear a lot about quarter-to-quarter slowdown. I’m not seeing it in the general economy.” ... I think all of us saw FedEx’s numbers that were reported. I spoke at length with the CFO of UPS, who reports that sales were up 6 percent in the first quarter. As of last week they are forecasting closer to 5 percent for the second quarter. The CFO said that “there is no dramatic slowdown that we can observe.” The chairman of an airline that moves 80 million passengers, who last time worried aloud about a slowdown that they were seeing in California, says that in terms of realistic bookings, across the nation it is strong without exception...

...Activity related to residential real estate has softened, and I continue to hear from my business contacts that they are concerned that consumer spending will retrench in response to the softer housing market and higher energy prices. But I do not get much indication that this concern is having a substantial effect on their business plans. Capital spending plans in particular seem little changed from the beginning of this year...
Page 55: …Housing prices are not falling quite as much as the decline in sales and the rise in unsold inventories might suggest. We are getting reports that builders are now making concessions and providing upgrades, such as marble countertops and other extras, and in one case even throwing in a free Mini Cooper to sweeten the deal [laughter] rather than reducing prices. So real house prices may be declining more than the data suggest…

Page 73: …We had already anticipated the slowdown in residential investment that has now materialized; therefore, we didn’t see that as a basis for revising down our forecast. We believe the changes in household wealth in general have less effect on consumption than the Board staff believes, and as a result we expect a more modest deceleration in growth. We expect stronger employment growth, too, and we have a stronger view of the rate of growth in private investment going forward. The world economy still looks pretty robust to us…

Page 81: …the bankers I talked with said that they aren’t going to let the amount of loans that they extend drop as much as I think is in that forecast. So I really believe that the drop in housing is actually on net going to make liquidity available for other sectors rather than being a drain going forward and that will also get the growth rate more positive than the current Greenbook forecasts…

Chair Bernanke Pages 92-93: …The housing construction industry is large, bigger than historically normal, and a controlled decline in housing obviously is helpful to us at this stage in bringing us to a soft landing in the economy. But as people have pointed out, the cooling is an asset-price correction. Like any other asset-price correction, it’s very hard to forecast, and consequently it is an important risk and one that should lead us to be cautious in our policy decisions… Another potential nonlinearity is in financial markets, as we’ve seen recently. We don’t have a good understanding of how changes in interest rates are affecting risk reduction and positions in financial markets right now… So let me just conclude by reiterating that we find ourselves in an extraordinarily complicated situation because we have these different themes—the cyclical turning point, the supply shock, and the housing cycle. The implication is that, whatever we do, we’re going to have to be very deliberate and careful; but I think we cannot ignore the inflation side of this equation…

Meeting of August 8, 2006

Pages 21-22: …my contacts are unable to point to explicit examples, apart from housing, showing that such a marked deceleration currently is in train. Indeed, many of the reports that we get are quite upbeat. For instance, one of our national temporary help contacts said his indicators were pointing to a bounce back from a weak second quarter, and he was seeing strong conversions from temporary to permanent status…

Page 25: A large homebuilder in our District summarized the views of many of our contacts when he recently commented that “the housing market has not yet popped, but a hissing sound is now clearly audible.” [Laughter] He pointed to rapidly rising cancellations as a particularly ominous sign. I will be watching the incoming data closely for signs as to whether the housing slowdown remains orderly as hoped or takes a steeper downward slide, posing a greater risk to the economy. My concerns about
inflation have also been somewhat heightened by the recent data or, more precisely, revisions to past data. Core measures of inflation continue to be well above my comfort zone...

Page 28: ...I regularly talk to CEOs of two of the five big builders. They like using analogies. In the words of the second largest builder in the country, “The pig is still in the python.” That is, he expects the decline from peak to trough in home sales to exceed that forecast in the Greenbook. I think we had 17½ percent; he is talking about a correction of 25 percent...

Page 40: ...Some of the veteran Realtors in my District with whom I have been talking are saying that this housing market is the worst that they can recall. Comments like these, although they are selected, do suggest some more uncertain prospects for the housing sector...

Page 53: ...The outlook, therefore, is not particularly encouraging. I think consumption will show some further slowing going forward, especially as we see further shocks in the economy related to energy. Some of the wealth effects related to the housing industry will also affect consumption going forward...

Page 56: ...the economy is going through a set of extremely complicated transitions, including a large, adverse, sustained relative price shock of uncertain duration and a substantial adjustment in asset prices that is now concentrated in housing. Our capacity to anticipate the evolution of these forces and to assess their effect on growth and inflation is, of course, very limited. The forces that now appear to be working on the economy still present the unpleasant combination of upside risk to inflation and downside risk to growth; but for the moment we believe that the former, the possibility that our forecast is too optimistic on inflation, remains the predominant risk...

Page 63: ...When the housing bubble (of the 1980s) burst, all of a sudden we had unsold housing units. They had to be sold before builders could start building on the developments that had already been laid out, and it took us several years to work through that. This time we don’t have the unfinished inventory of developments that we had in the ’80s. So I think that the cycle is likely to be much shorter than it was then and that it will put some firmness in that market. At the same time, this is the sector, aside from energy and commodities, that had a very rapid rise in prices, and it’s good that we’re seeing some correction in those prices right now...

Chair Bernanke Pages 74-75: ...(An) element of uncertainty as we look into the forecast is what I would call parameter risk, which is that the staff assumes that the effect of housing wealth on consumption spending is, through the standard wealth effect, about four cents on the dollar. I happen to think that is a good estimate. I think the econometric calculations are persuasive. Nevertheless, there is the possibility that the effect is somewhat greater, perhaps operating through liquidity effects. There may be buffer stock effects. If people see their equity falling, they may become more cautious about spending in order to avoid eliminating their buffer of reserves. Thus there is the possibility that housing will have a stronger effect on consumption than we now expect...

Meeting of September 20, 2006
Page 12: ...All in all, however, the incoming data over the past week left our forecast pretty much unscathed. I am relieved about that, because, if I do say so myself, it’s a beautifully constructed forecast. [Laughter] After all, with no further tightening of monetary policy, the economy eases into an extended period of slightly below-trend growth led by a retrenchment in the housing sector. That slower growth of activity opens a small output gap by the middle of next year but does not trigger a more precipitous cyclical contraction. Then, as the downturn in housing wanes and the associated multiplier and accelerator effects largely play out, the growth of real GDP picks back up toward potential in 2008...

Page 14: Still, we are not anticipating the weakening in activity to cumulate into outright recession. In our forecast, the fact that the implications of the housing downturn for the broader economy are relatively limited rests importantly on two suppositions, both of which are open to question. The first is that the slump in housing produces a sharp slowdown in house prices but not a large nationwide decline in those prices. In the past, housing prices have been relatively sticky on the downside, with homeowners resisting price cuts and keeping their homes on the market longer. Our forecast envisions something similar occurring in this episode. The second assumption is that housing wealth affects consumer spending like other forms of wealth and that there are no other channels of influence of house prices and housing finance on consumption. For example, we have not incorporated any significant negative effects on consumer sentiment that might accompany a rapid deceleration of house prices. We have also made no special allowance for the decline in mortgage equity withdrawal to restrain consumption because we find the empirical evidence of such a connection to be fragile...

Page 35: ...Labor markets are in good shape, so growth in jobs and wages should continue to support household spending. We are getting a welcome boost to real incomes from lower energy prices; and given the increase in business optimism that I noted earlier, I am less concerned that cautious animal spirits will cause businesses to pull back on spending. Housing remains the major downside risk, but I get the impression that thus far the weakness in residential investment is not spilling over to the other sectors of the economy...

Page 38: ...As one CEO told me, the only subject that has been more analyzed than the housing situation is the birth of Brad Pitt’s baby. [Laughter] According to this view, if we have not discounted what has been happening in the housing market, we have been living on Mars, and I think that is an important point to take into account... All the retailers I talked to—from 7-Eleven to JCPenney to Costco to Home Depot—report that they feel that they have bottomed out and that things are picking up, with one exception. That exception is Wal-Mart, and I think some of that situation relates to the internal dynamics of the way Wal-Mart is positioning itself in the market...

Page 39: ...The CEO of EDS summarized the growth side of the economy much as did the majority of the CEOs I spoke to for this go-round when he said, “We were all expecting things to be worse. They haven’t gotten worse.” They were all expecting things to get tougher, and they haven’t gotten tougher, except for one area—the procurement of labor. There is a shortage of bank tellers and mechanics. By the way, a wrench bender, as they call the job in California now—a simple mechanic without the completion of a high-school diploma—gets $100,000 a year. There is a shortage of truck drivers, of oil field hands, of chemical engineers, and even of unskilled workers such as retail store cashiers in Houston; and for the
first time I have heard from the major hoteliers of a shortage of hotel maids. To illustrate the point, one CEO mentioned that, whereas his company regularly used to get 300 applications for 100 truck driver jobs, they now get 3. So the bottom line is that our contacts are feeling more optimistic than the economists’ forecasts. They are worried about some constraints on domestic labor. As one contact said, the economy feels like a full employment economy…”

Page 41: ...In terms of economic activity, the recent news has been uniformly negative, resulting in a significant downward revision to growth in the Greenbook. Indeed, compared with the outlook of other forecasters, the Greenbook’s projection of real GDP growth for the second half of this year is quite pessimistic; it would now rank in the lower 5 percent tail of the distribution of individual Blue Chip forecasters. I think this pessimism is not completely unfounded, however, largely because of my worries about the housing sector. The speed of the falloff in housing activity and the deceleration in house prices continue to surprise us. In the view of our contacts, the data lag reality, and it seems a good bet that things will get worse before they get better..

Page 47: ...I did talk to Nick Retsinas at the Joint Center for Housing Studies, which Harvard runs, and he was not particularly negative. He felt that a correction is occurring but thought that it would be short-lived. Now, he did say that they were going to come out with some revisions and that he was still working on them, so his outlook may get more negative. But I am going to try to keep tabs on where they see things because they do stay in touch with all the large builders across the country. Again, the knock-on effects of lower residential construction may not be all that great...

Page 53: …On the negative side, housing has weakened more sharply than many expected, and auto production seems to be turning down for the rest of the year. On the positive side, as has already been mentioned by a number of others, business investment and corporate profits remain firm. Employment continues to rise at a moderate pace. The revised wage and salary data are now more consistent with the strength in consumer spending that we’ve seen, and continued growth in income and perhaps lower gas prices will help offset the possible negative effect that we may see from a deceleration in housing prices. On balance, I am somewhat more optimistic than the Greenbook about the growth side of the economy...

Page 60: ...Apparently people are not leaving much to chance. I heard a report yesterday morning that sales at religious stores for statues of St. Joseph have been soaring. [Laughter] It seems as though people who are trying to sell their homes are buying statues of St. Joseph because he’s the patron saint of real estate, and they’re burying him next to the “For Sale” sign. Unfortunately, there is no patron saint for central bankers. [Laughter]...

Page 66: ...I say that even though I can readily imagine that the decline in housing activity turns out to be both more protracted and deeper than you forecast it to be. By the way, as a footnote, if I did the numbers right, back in 1965 and 1966, we did get a decline in aggregate housing starts of better than 20 percent without a recession, although 1966 was considered a mini-recession, or a pause, or something—I’ve forgotten what the exact term was… Growth recession... Yes, something like growth recession. But
the bottom line here is that it hasn’t been a good idea to underestimate or underrate the performance of the U.S. economy since late 1982...

Page 74-75: ...I’ve been worried about the mortgage market and housing for quite a while. In an endeavor to find something good to say, I have noticed that, in the past couple of months, the Mortgage Bankers Association index of new loan applications for purchase mortgages looks as though it’s starting to level off. Very often that could be a leading indicator, so that could be a positive sign. However, as some of you have remarked, there’s a lot of speculation in the housing markets that has to unwind. All the folks who bought housing for investment have to do something as they see housing prices slowing and the financing costs to carry their investments going up. How that unwinding will occur, given the substantial size of the speculative positions in some markets, is something that will need very close monitoring. I know that our supervisory staff is focusing on that, too. People are focusing on the fact that delinquency rates in mortgages still look good. However, we’ve seen a very rapid increase in debt service ratios since 2004. I’m concerned, again, with the amount of adjustable-rate mortgages out there that will re-price in the months ahead. If, as we think, some of these loans, particularly subprime loans, were made mainly on the collateral value of the house and not on the affordability of the mortgage, we could see more distress in the borrowers’ markets coming forward. If that’s the case, it could have spillover effects on consumer spending more broadly...

Chair Bernanke page 86: ...The sense is that, on the real side, there’s a two-tier economy. There’s the housing sector and maybe autos, and there’s everything else. On housing, there’s agreement that a significant correction is occurring, but the views of the risks vary among participants. In particular, some feel that this still could be a quite deep correction, and others say that the fundamentals, such as incomes, interest rates, and so on, will ultimately support housing. With respect to the rest of the real economy, there were some mixed reports; but on the whole, people characterized it as a full employment economy....

Meeting of October 24-25, 2006

Page 9: ...Although it is far too early to conclude that these indicators are pointing to stabilization in housing markets, they provide at least some encouragement to the view that the bottom may now be closer than the top...

Page 16: Our slowdown in the growth rate of house prices, to roughly 1½ to 1¾ percentage points over the next two years, doesn’t make a big dent—if you remember from the briefing that we did one and a half years ago—in the price-to-rent ratio, which we plotted there and showed that that had increased very significantly. So our best guess is that, as in the past, those nominal prices will flatten out rather than actually decline. But the run-up was so large that we couldn’t rule out this time around that the adjustment of house prices could be more significant and more rapid than in the past. But I don’t know of any reliable empirical model or evidence...

Page 23: ...Except for housing and autos, activity remains on a solid footing, and most of our contacts are relatively optimistic about the outlook. For instance, the two large temp firms we talk to regularly both reported that, although billable hours were roughly flat, their clients were upbeat about the outlook.
Furthermore, demand for workers in light industry—the segment most closely tied to the national business cycle—continued to grow. In terms of wages, both temp firms noted that compensation increases have been running much higher than last year at this time...

Page 32: ...If the slowdown in housing continues to be an orderly one, without large spillovers as has been frequently mentioned, I would not characterize that correction as unwelcome. Housing activity has been at an unsustainably high pace in recent years. Of course, at this point we cannot rule out the possibility that the correction in housing from the unsustainably high pace of activity that we’ve seen over the past few years will derail the expansion. But so far, we have not seen spillovers of housing into other sectors. In particular, we have not seen any retrenchment by the consumer for the most part...

Page 40: ...we have continued reports of shortages of skilled and unskilled labor, from chemical engineers to school teachers to bank tellers and even to hotel housekeeping staff. So we have a significant problem in terms of labor shortages—skilled, semiskilled, and now, increasingly, unskilled...

Page 41: ...From the 27 or 28 CEOs and CFOs to whom I spoke in preparing for this meeting, as I always do, I do hear reports of a slowdown. I talked to two of the Big Five house builders this time. They are cutting back significantly. Let me give you some numbers. For example, Centex owns 109,000 lots outright and has 54,000 lots under hard option and 80,000 lots under soft option, as they call it. They’ve canceled 25 percent of their hard options. That is $85 million worth of properties. Hovnanian is walking away from $100 million worth of hard option properties. The effort there is to cut back so that what was a two-month leading supply has now become a three month leading supply. You can see how the dynamics are beginning to work. They’re moving on price, but they are also trying to shut down their inventory and are taking very quick action. That is a depressing factor...

Page 45: ...Retail (real estate) brokerages are starting to contract in terms of both number of offices and number of brokers. It was reported that so-called investors have disappeared entirely from many markets and that inventories of unsold homes are rising and the extent of the increase may be understated by the published data. There was little expectation among this group of improvement in housing in the next several months at least, and I would say not a whole heck of a lot of confidence that there was improvement in store even out beyond that, maybe as you get later into ’07. In contrast, and on a somewhat more positive note, the people who are also in nonresidential construction—in particular, office and retail development—thought that the outlook was promising, indeed positive, and are seeing a lot of activity in that business...

Pages 47-48: We’ve also spent a lot of time talking recently with contacts in the housing industry. The word that we’re getting is that some of the smaller and even regional builders have perhaps six months, and if they don’t see a pickup, they’re going to be filing for bankruptcy. They are very, very hard pressed. A lot of them overbuilt. They are stuck with a big inventory. They have the carrying costs of that inventory, and laying off workers doesn’t solve that problem. They may bring the new construction down very low, but it doesn’t solve the problem of what to do with the unsold inventory. So without a pickup in housing, I think we can anticipate some bankruptcy filings in that area...
Page 50: ...Of course, housing is a relatively small sector of the economy, and its decline should be self-correcting. So the bigger danger is that weakness in house prices could spread to overall consumption through wealth effects. This development would deepen and extend economic weakness, potentially touching off a nonlinear type of downward dynamic that could trigger a recession. But so far at least, there are no signs of such spillovers. Consumption spending seems on track for healthy growth...

Page 70: ...I think that the housing market, although it has retrenched a lot, which I actually consider a rebalancing of the economy, does not look as though it’s going to collapse in a nonlinear way. For example, we see that the market has some expectations along those lines—for example, the stock prices of builders have actually come back a substantial amount. We also see that consumers seem to be holding up very well. The real danger that we were worried about in terms of a housing market retrenchment is that it would spill over in a nonlinear way to the household sector. We don’t see any evidence of that either. Consumer confidence is staying strong. The stock market is up—again, an indication that these spillover effects are not occurring over and above those that we think would be normal in terms of wealth effects and so forth...

Chair Bernanke pages 76-77: ...although we have not yet seen much wage-push inflation, clearly the risk is there. Anecdotally, and to some extent statistically, we have very tight labor markets. It is surprising how little wage push there has been so far, and if labor markets continue to stay at this level of tightness, then one would expect that you would get an inflation effect that would be uncomfortably persistent. That is a real concern, which I share with everyone around the table. If the Phillips curve language doesn’t appeal to you, another way of thinking about it is that, if the labor market stays this tight, which means that growth is at potential or better, then the real interest rate that is consistent with that growth rate needs to be higher than it is now. I agree with that point as well. So my bottom line is that I do agree that inflation is the greater risk, certainly...

Meeting of December 12, 2006

Page 12: ...We see forces at work that, by the middle of next year, should result in a gradual reacceleration of activity back to a pace in line with the growth of the economy’s potential. Importantly, we are expecting some lessening of the contraction in residential investment. Housing starts have now fallen by enough that, if home sales stabilize at something around their recent pace—and I recognize that this is a big if—homebuilders will be able to make substantial headway in clearing the backlog of unsold homes. As they do, we expect construction activity to level off in the second half of 2007 and then to stage a mild upturn in 2008...

Page 23: ...The last time we met I described the situation as a bimodal economy with strength in most sectors and weakness limited to just two sectors, housing and domestic auto production. This description by and large remains apt. The correction in the housing sector has continued, even sharpening somewhat compared with our expectations. Still, there are some encouraging signs that the demand for housing may be stabilizing, probably assisted by recent declines in mortgage rates. After a precipitous fall, home sales appear to have leveled off...
Business confidence appears to be holding up fairly well. Indeed, I’m impressed by the lack of pessimism among my contacts, even those who are experiencing flattening sales or sluggish sales. Finally, real interest rates are low across the maturity spectrum, and risk spreads remain narrow...

Page 32: ...I speak to two of the five largest builders, and I’ve added a third to that sample. ...They are reporting what they call a sense of a turn, but this may be their perpetual optimism. But cancellation rates have improved from 40 percent to 32 percent according to the reports, and actually in November there was a gross pickup in unit sales of about 3 percent according to these reports. So they are feeling that some pent-up demand is building. The interesting thing about that industry in particular is that they are all walking away from their options. One of the largest said that they expect to end up with only 20 percent of their land options, and yet land prices have not yet fallen. So I think that’s the next shoe that will likely drop...

Page 34: ...Moderate employment growth continues. Layoffs are down, and electronic job postings, as opposed to newspaper want ads, are rising. Retailers are cautious about the fallout from the housing market, but except for those in the hardware or furniture businesses, sales were reportedly buoyed by the drop in gasoline prices...

Page 37-38: ...Nationally, there are some indicators suggesting that housing demand has stabilized at a low level. Sales of new homes have been fluctuating around an annual rate of 1 million since July, and purchase mortgage applications have been fairly flat since then as well. But the national data also show a sizable overhang of housing inventory that will continue to depress new building activity going forward. If—and... I recognize this is a big “if”—the demand for housing holds up at current levels—and favorable fundamentals such as moderate mortgage rates and continued real income gains should help—then the adjustment process is simply a matter of working inventories down. This is consistent with the Greenbook’s estimate that residential investment will no longer subtract from real GDP growth after the first half of next year...

Page 38: ...one way the housing downturn could spread to the remainder of the economy is through a wealth effect. So far I’m not persuaded by this gloomy view, and I think there are good reasons to doubt it. Household net worth looks pretty strong, and equities continue to advance. The other leading candidate for a spillover channel is the labor market, but so far the weakness in construction and real-estate-related employment has not been large enough to offset the broader strength in employment. I remain skeptical of a housing-induced step-down in consumption growth...

Page 40: ...I am concerned that we don’t yet have a good handle on where house prices are headed and how the uncertainties surrounding house prices might affect consumer spending. Second, the support to consumption provided by cash-out refinancing is not likely to be available going forward to the same degree that we’ve had during the past several years. Finally, the financial condition of some households has become pretty fragile, and we all know that rates on adjustable mortgages, including some subprime mortgage loans, continue to reset at higher rates. The adjustable rate mortgages are already causing some well publicized problems for some households...
Pages 63-64: ...Delinquency rates are really, really low by historical standards. The one sector that has had a jump in delinquencies is subprime ARMs, and clearly the jump is related to rates that have already reset. We’ve got more to come. Even though these have jumped, they’re still not at alarming levels. But it’s something that I think the banks are watching very, very carefully. One thing I’m hearing more from some folks who have been investing in mortgage backed securities and maybe in some CDOs (collateralized debt obligations), where they’ve been tranched into riskier positions through economic leverage, is the realization that a lot of the private mortgages that have been securitized during the past few years really do have much more risk than the investors have been focusing on. I’m hearing this from folks who understand that the quality of what goes into those pools varies tremendously when you don’t have the Fannie Mae and Freddie Mac framework for the underwriting. When a mortgage is originated through a bank, we do a lot through safety and soundness supervision to make sure, if a bank is buying loans from brokers, that the loans are underwritten in a sound manner and are therefore affordable to the borrower when they’re undertaken. We’re seeing that some of the private-label mortgage-backed securities are having very high early default rates or delinquencies in the mortgages, which usually means that the originator has to buy them back out of the pools. There isn’t a whole lot of transparency in the disclosures around some of these bonds, and some of the brokers are underwriting products that have very high early default rates, which is something that investors are starting to focus on. As more products are generated outside the banking sector, they get funneled to pools through broker-dealers as opposed to the banks. I think that we’re missing a level of due diligence regarding brokers, who may not be doing a good job. As you all know, the fraud rate on mortgages has tripled in the past two years. So I think we could see noise in some of the mortgage-backed private deals and some of the riskier CDO economic leverage positions...

Chair Bernanke page 79-83: ...Looking forward, again to compliment the staff, I think most people around the table accepted the general contour of the Greenbook forecast—that is, moderate growth perhaps below potential for the next few quarters but returning to potential growth later next year, with risks to the upside as well as to the downside. So far there is little evidence of spillover into consumption in particular, although obviously we have to keep an eye on that. There are a number of strong underlying conditions, including supportive financial conditions, strong profits, and a strong international economy, which are providing a cushion to the economy... I think that a soft landing with growth a bit below potential in the short run looks like the most likely scenario. I expect the unemployment rate to increase gradually but income growth and other factors to be sufficient to keep consumption above 2 percent, which is essentially what we need to keep the economy growing. Again, I see the risks going in both directions. Let me add a couple of extra comments about risks in the housing market. I talked last time about the dynamics of starts. Even if final demand stabilizes, starts may take a time to fully work out the inventories. A couple of other factors are like that, which I just would like to bring to your attention. One has to do with the very strong presumption we seem to have now that demand for housing has stabilized. That may be the case, but I would point out that we have seen a very sharp decline in mortgage rates. People may have a sort of mean-reverting model of mortgage rates in their minds. It could be they are looking at this as an opportunity to jump in and buy while the financial conditions are favorable. So even if rates stay low, we face some risk of a decline in demand. The counter argument to that, which I should bring up, is that if people thought that prices were going to fall
much more, then they would be very reluctant to buy. That’s evidence for stabilization of demand. Another point to make about housing is that, even when starts stabilize, there are going to be ongoing effects on GDP and employment. On the GDP side, it takes about six months on average to complete residential structures. Therefore, even when starts stabilize, we’re going to continue to see declines in the contribution of residential construction to GDP... There will be lagged employment effects from the housing sector and presumably from the associated manufacturing sectors, like appliances and furniture, which also tend to lag. So there will be some employment drag coming forward, and I think it’s reasonable to think that unemployment rates will start to rise. But, again, this is about 15 percent of the economy as compared with 85 percent of the economy... I think that we have some reason to think that inflation will slow, but I don’t disagree with the very wide sentiment I hear around the table that the slowing is far from certain and that the risks are still to the upside on inflation...
Mitchell’s Musing 1-9-12: Job Search and the Internet

Daniel J.B. Mitchell

Given the current high unemployment rate, it is not surprising that there is a market for job search hints. It is perfectly rational for job searchers to seek advice to put themselves at the head of the queue. But note that what we have is a classic divide between micro and macro. If there are 100 job seekers and 90 jobs, each of the job seekers should try their best to do whatever makes them more attractive to potential employers. But at the end of the day, ten will be left out in the cold. The only question is who will be in the unlucky ten. So in reading the rest of this musing, please keep in mind that job search hints, however fruitful they may be for individuals, are not the answer to the macro problem.

At the margin, however, the overall unemployment rate could be reduced a bit if we could improve the job matching process. That is, at any point in time, there are job seekers looking for work and employers seeking workers. But it takes time for both sides of the labor market to get together. Information is not perfect, nor is it costless. Putting the eventual matches together faster would reduce the stock of unemployed persons at any point in time.

Malcolm Cohen recently sent me a paper he and his daughter, Laura Steiner, are presenting at one of the ASSA sessions in Chicago. (If you are interested in the paper, get in touch with him at info@employmentresearch.com.) The paper deals with damages in legal cases caused by loss of employment and it notes that plaintiffs in such cases have an obligation to mitigate damages by seeking work. So the issue arises as to how long a plaintiff might need to look for new work, an issue which depends on the occupation involved and other factors.

In the course of discussing this issue, the paper reproduces some U.S. Bureau of Labor Statistics (BLS) data on the duration of unemployment. BLS monthly data refer to “interrupted” spells of unemployment. That is, those currently unemployed are asked how long they have been unemployed. We don’t know how much longer they will remain unemployed, i.e., how long their “completed” spells will turn out to be.

Over the years, various attempts have been made to estimate completed spells but we don’t have regular data collection such spells. Note that some people search for new jobs while employed so their durations of search are not going to be picked up by any survey of unemployed job seekers. Note also that some spells of unemployment end by the individual dropping out of the labor force. For example, some job seekers may give up and return to school or training to improve their credentials.

For all these reasons, the job search process is under-researched and perhaps not well defined. But in some back and forth emails, Malcolm Cohen and I discussed whether the Internet might have reduced the duration of job search. If part of the difficulty of search relates to information, it would seem at first glance that the Internet – by providing much more information and reducing the costs of information –
would reduce duration. Presumably, sometime after around 1990 – other things equal – search duration should have declined if the Internet was having an impact.  

Of course, “other things equal” is a major complication in determining what may have happened. Suppose we use the Cohen-Steiner/BLS indicator of interrupted spells as at least somewhat of a proxy for search (keeping all of the complications noted above in mind). One thing that is evident from the chart below (pulled from the BLS database service) is that a big “other” factor is the business cycle.

Thus, with the advent Great Recession, the median duration of interrupted unemployment spells has gone way up.  


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43 The first easy-to-use web browsers became available in the mid-1990s.

44 BLS also provides data on average spells. However, there is a “top-coding” problem because long spells are left open ended. Moreover, BLS recently changed its top-coding procedure. For details, see http://www.bls.gov/cps/duration.htm.
median interrupted spell was about five weeks. If the Internet was having a major impact in dropping duration, we might expect a decline in 2000 and 2006 relative to 1990. But the trend at the peaks goes the other way; duration goes up, not down. A possible explanation of this counterintuitive result could be that even in 2000, not enough job seekers used the Internet to counteract other unidentified forces.46 But presumably, by 2006, we might expect to see some effect.

Of course, the idea that more and cheaper information should inevitably make the labor market more efficient may be incorrect. My colleague Robert Jensen did find that in India, the spread of cell phones (another form of electronic communication) made the market for fish more efficient in the sense that price differentials could be quickly known – allowing supply to flow toward areas of highest demand.47 And much the same effect seemed to occur in commodity markets in the U.S. as the telegraph spread in the mid-19th century. (http://www.youtube.com/watch?v=DmolT6pl8ei) So why shouldn’t the same be true in the labor market of today?

One answer might be that labor isn’t a homogeneous commodity where all you need to know is a market price. Individuals and their qualifications differ. Employers may have special needs. That’s why we have CVs, job interviews, job tests, etc. In a sense, looking at this issue from the demand side of the labor market, the Internet could be providing an information overload. It is essentially costless for job seekers to send CVs to many employers, even long-shot employers that probably are not interested. Employers then have to sift through a downpour of applicants that come raining in, a task that could make the job matching process more costly and slower. The story might be something similar to anecdotal tales about the Internet making employees less productive by constantly interrupting them with emails and non-work-related activities.

Malcolm Cohen did locate a recent research paper that suggests that the Internet has now (at least as of 2008-2009) speeded up successful job search for those workers who used the Internet as opposed to others.48 That is not quite the same question as to whether overall job search duration – controlling for other factors – has gone down. It could be that Internet users are displacing less tech-savvy job seekers in the queue. As in our starting numerical illustration with 90 jobs and 100 job seekers, the Internet

45 There was a double-dip recession after 1979, so the technical next peak is omitted from the list in the text.

46 Fifteen percent of unemployed job seekers were found to have used the Internet in 1998. See Peter Kuhn and Mikal Skuteru, “Job search methods: Internet versus traditional,” Monthly Labor Review, October 2000, pp. 3-11. Available at http://bls.gov/opub/mlr/2000/10/art1full.pdf. For the entire labor force in 2003 (which would include employed job seekers as well as unemployed – and those who were not seeking jobs), 11.5% indicated use of the Internet for job search between January and October of that year. Not surprisingly, younger people were more likely to be users than older workers. See http://www.bls.gov/news.release/ciuaw.t05.htm.


users may be keeping themselves out of the unlucky ten. But an unlucky ten of others nonetheless remains.

Even the seeming advantage of Internet users could vanish in the future. As noted, employers – if they are deluged with CVs – are forced to sift through them. Employers may come to be favorably impressed with job applicants who use other methods of approach. A recent “Marketplace” public radio story profiled a job applicant who personally delivered her CV to potential employers. She made such a favorable impression by doing so that she was hired by an employer who was not, at the time, looking for a new employee. He took her on because he was impressed by someone who used what used to be the norm for job seekers, i.e., “pounding the pavement.” In today’s labor market, the old approach was seen to be a clever innovation! (Read or listen to the story at http://www.marketplace.org/topics/economy/whats-behind-job-hunt-success.)

In any event, the effect of the Internet on the duration of job search is a worthy topic for future ongoing research. The Internet impact, positive or negative, could turn out to be fluid over time.
Mitchell’s Musing 1/2/12: What Would Florence Nightingale Say?

Daniel J.B. Mitchell

Below are three PowerPoint slides I used to present in my Labor Markets course. The general topic of the portion of the course in which they were used was “productivity.” We discussed measures of productivity including “multi-factor” productivity. Economists will know that the unexplained residual growth that appears when total factor productivity growth is calculated is often attributed to technological advance. The purpose of the slides was to illustrate that technological advance means more than just inventing clever new gadgets. It can also encompass managerial techniques and new ways of interpretation and analysis that raise output without the need for more input.

Most people – if they know the name Florence Nightingale – would say she was the “first nurse” or something along those lines. They would not think of her as a statistician. However, Nightingale believed in using statistics to determine the best course of medical treatment, a new idea at the time. In order to make statistics convincing, however, you need to communicate what they are showing. So she invented what is sometimes mistakenly called the first pie chart, but is really a cross between a pie chart and a bar chart. Different courses of treatment were shown by dividing the circle by the number of treatments. The radius of each circle segment was proportionate to the rate of success being shown. Thus, the most effective treatment results were made visible and, thus, more convincing. By convincing others to use the best treatment option, she improved medical outcomes, i.e., raised productivity of hospitals.

I was reminded of Florence Nightingale’s innovation using statistics by the following announcement posted on the website of the U.S. Bureau of the Census:

What is the Statistical Abstract?

The Statistical Abstract of the United States, published since 1878, is the authoritative and comprehensive summary of statistics on the social, political, and economic organization of the United States.

Use the Abstract as a convenient volume for statistical reference and as a guide to sources of more information both in print and on the Web.

Sources of data include the Census Bureau, Bureau of Labor Statistics, Bureau of Economic Analysis, and many other Federal agencies and private organizations.

The U.S. Census Bureau is terminating the collection of data for the Statistical Compendia program effective October 1, 2011. The Statistical Compendium program is comprised of the Statistical Abstract of the United States and its supplemental products -- the State and Metropolitan Area Data Book and the County and City Data Book. In preparation for the Fiscal Year 2012 (FY 2012) budget, the Census Bureau did a comprehensive review of a number of programs and had to make difficult proposals to terminate and reduce a number of existing programs in order to acquire funds for higher priority programs. The decision to propose the elimination of this program was not made lightly. To access the most current data, please refer to the organizations cited in the source notes for each table of the Statistical Abstract.

Source: http://www.census.gov/compendia/statab/

The notice appears to say there will be no Statistical Abstract published after the latest one which just came out (for 2012).

I poked around on the web to see what was going on. Librarians across the U.S. have protested. The Statistical Abstract is the starting point to which library patrons seeking data on whatever topic they have an interest are first referred. In theory, all of the data are located somewhere else -- if you can find them. But as Florence Nightingale discovered, you have to make data visible for them to matter. (And it might be noted -- as the notice point out - that some data in the Statistical Abstract are proprietary and, therefore, not available to general users.)
If you are an expert in a particular field, you probably know where to obtain data for that subject. But someone who is a novice in the field will not know.\textsuperscript{50} Apart from the data actually appearing in the \textit{Statistical Abstract} – which may not be the latest given publication lags – there is a source note for each table, nowadays often with the web link, from which more recent data can be obtained.

I was further reminded of an earlier episode in which another handy compendium was lost. Back in the day, the \textit{Survey of Current Business}, a monthly statistical journal published by the Bureau of Economic Analysis (which like the Bureau of the Census is part of the U.S. Department of Commerce), used to have a centerfold section. Unlike \textit{Playboy}'s centerfold, however, there were no pictures. But there were reams of data from various sources (some proprietary) on various measures of economic activity, sector by sector. Then – out of the blue - the centerfold section just disappeared, and the \textit{Survey} became a much less useful source.

The Department of Commerce is supposed to promote “business” and there is a saying in business that “the customer is always right.” So – with librarians around the country saying they and their patrons need the \textit{Statistical Abstract} - where is the customer voice in the decision to eliminate it?

\textsuperscript{50} As a personal example, I prepare for students in my course on California Policy Issues an interactive PowerPoint “California IQ” test, with questions and answers about various aspects of the state: education, agriculture, electricity use, crime, etc. I am not an expert in all of those fields, so I make heavy use of the \textit{Statistical Abstract} to find the needed information. Check out http://issuu.com/danieljbmitchell/docs/califiq?mode=window&backgroundColor=%23222222 for the latest example (in a pdf version).
Mitchell’s Musings 12-26-11: The Nature of the Threat

Daniel J.B. Mitchell

The Gallup Poll asks the following question every few years: *In your opinion, which of the following will be the biggest threat to the country in the future -- big business, big labor, or big government?*

The table below summarizes the answers. But let’s note some obvious problems with the question’s wording. First, the question assumes there is a big threat and the respondent merely should choose which of the three indicated ones is greater. If the respondent doesn’t think there is a big threat, there is no direct way of so indicating. Second, and related, the pollster is telling you there is a threat – but only mentions three likely sources. Yet one might have imagined that during the Cold War, some people might have answered that the Soviet Union was a big threat if given that choice. Or, in more recent times, some might have thought global warming was a big threat.

Third, the nature of the threat is not defined. Since the pollster mentions two economic institutions first – business and unions – the question seems to focus on the economy. (If the threat is to civil liberties, it is hard to find a very direct link with business and unions.) There are two clues suggesting an economic interpretation. There is an upward blip in the big business option around the time of the Enron and other corporate scandals in 2002 and another in 2008-2009 after the Wall Street/financial crisis. Perhaps more significantly, the downward trend in the national unionization rate is reflected in the secular decline in the big labor response. It’s hard to make “big labor” into the greatest threat to the U.S. when labor isn’t very big anymore. In 2010, about 13% of employees were union represented; about 8% in the private sector. (The proportions that were union *members* – as opposed to being represented by unions – are still lower.)

<table>
<thead>
<tr>
<th></th>
<th>Big business</th>
<th>Big labor</th>
<th>Big Govt.</th>
<th>No opinion</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011 Nov</td>
<td>28-Dec 1</td>
<td>26</td>
<td>8</td>
<td>64</td>
</tr>
<tr>
<td>2009 Mar</td>
<td>27-29</td>
<td>32</td>
<td>10</td>
<td>55</td>
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<tr>
<td>2008 Dec</td>
<td>4-7</td>
<td>31</td>
<td>11</td>
<td>53</td>
</tr>
<tr>
<td>2006 Dec</td>
<td>11-14</td>
<td>25</td>
<td>9</td>
<td>61</td>
</tr>
<tr>
<td>2005 Dec</td>
<td>5-7</td>
<td>27</td>
<td>8</td>
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<tr>
<td>2004 Dec</td>
<td>5-8</td>
<td>27</td>
<td>11</td>
<td>57</td>
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<tr>
<td>2003 Nov</td>
<td>10-12</td>
<td>29</td>
<td>9</td>
<td>57</td>
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<tr>
<td>2002 Jul</td>
<td>5-8</td>
<td>38</td>
<td>10</td>
<td>47</td>
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<tr>
<td>2000 Oct</td>
<td>25-28</td>
<td>22</td>
<td>7</td>
<td>65</td>
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<tr>
<td>1999 Aug</td>
<td>24-26</td>
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<td>8</td>
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<tr>
<td>1998 Dec</td>
<td>4-6</td>
<td>24</td>
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<td>64</td>
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<tr>
<td>1995 Aug</td>
<td>11-14</td>
<td>24</td>
<td>9</td>
<td>64</td>
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<td>1985 Jun</td>
<td>7-10</td>
<td>22</td>
<td>19</td>
<td>50</td>
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<tr>
<td>1983 May</td>
<td>13-16</td>
<td>19</td>
<td>18</td>
<td>51</td>
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<tr>
<td>1981 Sep</td>
<td>18-21</td>
<td>22</td>
<td>22</td>
<td>46</td>
</tr>
<tr>
<td>1979 May</td>
<td>4-7</td>
<td>28</td>
<td>17</td>
<td>43</td>
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<tr>
<td>1978 Sep</td>
<td>15-18</td>
<td>19</td>
<td>19</td>
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<tr>
<td>1977 Jan</td>
<td>7-10</td>
<td>23</td>
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<tr>
<td>1969 Nov</td>
<td>12-17</td>
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<td>1968 Jul</td>
<td>18-23</td>
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<tr>
<td>1966 Dec</td>
<td>8-13</td>
<td>14</td>
<td>21</td>
<td>48</td>
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<tr>
<td>1965 Feb</td>
<td>17</td>
<td>29</td>
<td>35</td>
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So, if the economic interpretation is correct, when 64% of folks name big government as a threat – as in
the latest poll - do they mean that it’s a threat for mismanaging the economy? And, if so, do they want it
to manage the economy more? More regulation? Or less regulation? Or just better? Or – as seems
most probable - do we have a messy disparate combination of all those possible reasons behind the 64%?

About the only thing that is evident from the Gallup poll results is that it has gone out of fashion to have
“no opinion” on what might reasonably be characterized as a complicated question. The U.S. clearly has
a major macroeconomic challenge in the immediate future in pulling down the unemployment rate and
producing a robust recovery from the Great Recession. And there are longer-term economic challenges as
well. A society in which everyone has a definite, but disparate, opinion on what should be done with
regard to economic policy is also one that is likely to produce a state of polarization and gridlock that
ensures that the challenges are not met. Not a bright prospect for 2012.

Nevertheless, Happy New Years to our EPRN readers. Let’s hope my interpretation turns out to be
incorrect.

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52 The bump up in the big government response in the most recent poll – as Gallup notes – was largely among
Democrats – who don’t typically favor *laisser-faire* approaches to the economy. See the reference in footnote 1.
Hence, it is not at all obvious – as some might want to assume – that respondents naming big government as a
threat therefore want less of it.
Mitchell’s Musings 12-19-11: Model Worker

One of our former doctoral students at UCLA writes an advice-to-employees column in the Los Angeles Daily News. Employees with problems at work ask for his counsel on various workplace issues. Recently, the following question and answer appeared:

By Ken Lloyd, Columnist
12/14/11 Los Angeles Daily News

Q: When I was named Employee of the Month last month, I was so excited. Now, I’m not sure. I sense that some of my fellow employees are mad at me, and when I sit down for lunch with them, the conversation gets quiet, and I feel like an intruder. I’m not sure what to do about this. If I had a choice, I think I’d give the award back.

A: First, congratulations for being selected Employee of the Month. In spite of what you are currently experiencing, this is a terrific honor, and it is unfortunate that you would even think about giving it back. Many employees enjoy having friends at work, until their friends earn an honor or award. At that point, feelings of jealousy, competition, and unfairness can come into play. To deal with this, you can certainly discuss your feelings with your co-workers. If you let them talk and vent a little, you may be able to put the matter to rest.

Full column at http://www.dailynews.com/business/ci_19551104

Reading this exchange reminded me of Alexey Stakhanov. Who is that? Back in the 1930s, you wouldn’t have needed to ask - as this Time magazine cover indicates:

Stakhanov, a Soviet coal miner who supposedly set production records, was set up as a model worker by the authorities and heralded by Stalin himself as someone all workers in the Soviet Union should emulate. Not only did he make the cover of Time, he was also featured in a March of Time newsreel available at:

http://www.youtube.com/watch?v=Bnvt6g8OcFA

The practice of setting up model workers was imitated after World War II in Communist Eastern Europe and – remarkably – was parodied in the Polish film “Man of Marble” made in 1977 well before the
Solidarity revolt or the collapse of the Soviet system. An excerpt from that film can be seen here http://www.youtube.com/watch?v=XQfJ3wYl5g

In my labor markets class as part of a unit on productivity and motivation, I used to put three PowerPoint slides on the screen in succession, with the March of Time newsreel/video played after the second slide:

Of course, no one knew the answer to the question on the first slide. I would explain with the illustration on the second slide. The class would be amused with the idea that such demonstrations would be expected to stimulate productivity. Then I would show the third slide, with various employees of the month pulled off the web, to illustrate that the technique is hardly a foreign one, or even a communist one – which takes me back to the question-and-answer column concerning a frustrated employee of the month.

Certainly, after the fall of European communism, it became clear that Stakhanov-type propaganda, while it undoubtedly inspired some True Believers, was viewed with skepticism by ordinary workers. At a conference in Budapest in the early 1990s, I talked with a British doctoral student who was studying the motivational techniques that had been used in Hungarian factories during the communist era. Following Soviet practice, he had found, Hungarian factory managers would select model workers and tout their supposed accomplishments to the other workers. The problem was that the models became pariahs among their fellow employees. They would last only a short period in that role – some were apparently assaulted – but the deal would be that after a brief time as models, they would be promoted into

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53 Apparently, the film was first released by the Polish authorities omitting sections in which the model worker turns out to have been later betrayed by the system. The complete version of the movie is now available. See http://movies.nytimes.com/movie/31196/Man-of-Marble/overview.

54 My guess is that the Soviets copied the model worker approach from the west, indeed, from the U.S. Stakhanov was likely an economy-wide version of the more micro employee-of-the-month concept. Under communist ideology, capitalism was the most advanced stage of economic activity in the world but it would inevitably collapse into still-more-advanced communism. In the interim, the Soviets consciously emulated what they perceived as the latest capitalist practices such as Taylorism, piece rates, etc.
management. Given that history, it is probable that the factory managers were aware that the model worker approach was ineffective but they had to go along with practices ordered from above.

So what about the employee of the month award in current usage? Has anyone ever studied what effect such selections have on worker productivity? Note that if a workplace selects an employee of the month, there must be twelve of them a year, twenty-four in two years, thirty-six in three years, etc. How special could all of these employees really be?\(^5\) Maybe the true reason the employee-of-the-month who wrote for advice was having trouble was not just jealousy of fellow workers. Maybe his/her fellow workers knew that the supposed model was really not all that special and just was selected because someone had to be. And maybe – just maybe – there are many other standard human resource practices that need to be questioned.