

THIS GENERATION ALREADY KNOWS, MR. IRWIN WEB BUZZ 2010.01.04

The facts of the article reprinted below are accurate with the exception of the last paragraph, yet the causes of first the great depression of the 1930s and next the recent great recession of the 2000s have yet to be understood, says Mr. Irwin. Maybe, as the Washington Post staff writer speculates, economists will finally discover why the just completed lost decade occurred. The fact is that the Austrians already know. They were the only ones to predict both the 30s and the 00s. It is absolutely there for everyone to see if only they would read history as it actually occurred rather than as their ideology wishes it had. Unfortunately, my friends, it is highly probable that one lost decade will turn into two.

Aughts were a lost decade for U.S. economy, workers

By Neil Irwin

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For most of the past 70 years, the U.S. economy has grown at a steady clip, generating perpetually higher incomes and wealth for American households. But since 2000, the story is starkly different.

The past decade was the worst for the U.S. economy in modern times, a sharp reversal from a long period of prosperity that is leading economists and policymakers to fundamentally rethink the underpinnings of the nation's growth.

It was, according to a wide range of data, a lost decade for American workers. The decade began in a moment of triumphalism — there was a current of thought among economists in 1999 that recessions were a thing of the past. By

the end, there were two, bookends to a debt-driven expansion that was neither robust nor sustainable.

There has been zero net job creation since December 1999. No previous decade going back to the 1940s had job growth of less than 20 percent. Economic output rose at its slowest rate of any decade since the 1930s as well.

Middle-income households made less in 2008, when adjusted for inflation, than they did in 1999 – and the number is sure to have declined further during a difficult 2009. The Aughts were the first decade of falling median incomes since figures were first compiled in the 1960s.

And the net worth of American households – the value of their houses, retirement funds and other assets minus debts – has also declined when adjusted for inflation, compared with sharp gains in every previous decade since data were initially collected in the 1950s.

“This was the first business cycle where a working-age household ended up worse at the end of it than the beginning, and this in spite of substantial growth in productivity, which should have been able to improve everyone’s well-being,” said Lawrence Mishel, president of the Economic Policy Institute, a liberal think tank.

Question of timing

The miserable economic track record is, in part, a quirk of timing. The 1990s ended near the top of a stock market and investment bubble. Three months after champagne corks popped to celebrate the dawn of the year 2000, the market turned south, a recession soon following. The decade finished near the trough of a severe recession.

But beyond these dramatic ups and downs lies an even more sobering reality: long-term economic stagnation. The trillions of dollars that poured into housing investment and consumer spending in the first part of the decade distorted economic activity.

Capital was funneled to build mini-mansions in Sun Belt suburbs, many of which now sit empty, rather than toward industrial machines or other business investment that might generate economic output and jobs for years to come.

“The problem is that we mismanaged the macroeconomy, and that got us in big trouble,” said Nariman Behravesh, chief economist at IHS Global Insight. “The big bad thing that happened was that, in the U.S. and parts of Europe, we let housing bubbles get out of control. That came back to haunt us big-time.”

The housing bubble both caused, and was enabled by, a boom in indebtedness. Total household debt rose 117 percent from 1999 to its peak in early 2008, according to Federal Reserve data, as Americans borrowed to buy ever more expensive homes and to support consumption more generally.

Consumers weren't the only ones. The same turn to debt played out in commercial real estate and at financial firms. It resulted in a corporate buyout boom that often produced little of lasting value. It is a truism of finance that for businesses, relying heavily on borrowed money makes the good times better but the bad times far worse. The same thing, as it turns out, could be said of the nation as a whole.

The first decade of the new century was an experiment in what happens when an economy comes to rely heavily on borrowed money.

“A big part of what happened this decade was that people engaged in excessively risky behavior without realizing the risks associated,” said Karen Dynan, co-director of economic studies at the Brookings Institution. “It’s true not just among consumers but among regulators, financial institutions, lenders, everyone.”

The experiment has ended badly. While the stock market bubble that popped in 2000 caused only a mild recession, the housing and credit bubble has had a much greater punch – driving the unemployment rate to a high, so far, of 10.2 percent, compared with a peak of 6.3 percent following the last such downturn.

The impact of the real estate crash has been broad. Among middle-income families, 69 percent owned a home in 2007, more than four times the proportion owning stocks. And as the housing meltdown cascaded through credit markets, the banking system was buffeted, rocking the whole financial system on which the world’s economy rests.

With luck, lessons

Economists and policymakers will be chewing on the lessons of the Aughts for many years to come; the events of the past two years alone are enough to launch a thousand economics dissertations. If past periods of economic trauma are a guide, this research will yield a deeper understanding of how to manage the economy.

The Great Depression of the 1930s led to new insights about the impact a financial collapse can have. The primary lesson – espoused by Ben S. Bernanke as an academic before acting on it as Fed chairman – was “Don’t let the financial system collapse.”

The Great Inflation of the 1970s brought a rethinking of what drives inflation, such that economists now put a premium on maintaining the credibility of central banks and keeping inflation expectations in check.

The lessons of the Bubble Decade are still being formed. At the Federal Reserve, the major lesson that top officials have taken is that bank regulation shouldn't occur in a vacuum; rather than monitor how individual institutions are doing, bank supervisors should try to understand the risks and frailties that the banking system creates for the economy as a whole – and manage those risks.

Fed leaders have been more skeptical of the idea that they should routinely raise interest rates to try to pop bubbles. "I can't rule out circumstances in which additional monetary policy actions specifically targeted at perceived asset price or credit imbalances and vulnerabilities" would be advisable, Fed Vice Chairman Donald L. Kohn said in a recent speech.

"But given the bluntness of monetary policy as a tool for addressing developments that could lead to financial instability, the side effects of using policy for this purpose, and other difficulties, such circumstances are likely to be very rare."

And the question of how Washington can prevent a recurrence is an overarching theme in the Obama administration's efforts to overhaul the financial system and support growth through investments in clean energy and other areas. "One of our challenges now," President Obama said in November, "is how do we get what I call a post-bubble growth model, one that is sustainable."

The financial crisis is, for all practical purposes, over, and forecasters are now generally expecting the job market to turn around early in 2010 and begin

creating jobs. The task ahead for the next generation of economists is to figure out how, in a decade that began with such economic promise, things went so wrong.