

MESSAGE FROM  
THE PRESIDENT



**Jeffrey M. Lacker**  
President

THE FINANCIAL CRISIS AND SUBSEQUENT RECESSION  
WERE PERIODS OF SIGNIFICANT TURMOIL FOR  
FINANCIAL MARKETS AND SIGNIFICANT HARDSHIP  
FOR MANY AMERICANS.

Thankfully, the economy is recovering, and I believe it will continue to strengthen over time—though, of course, this will depend on a variety of factors that are hard to forecast.

We are still learning about the causes of the recession of 2007–09. This process will be a lengthy endeavor, one that will occupy the attention of economists for years to come, just as it has been with the Great Depression of the 1930s. This is as it should be. Such a watershed event deserves close scrutiny so that policymakers can take steps to help avoid some of the problems we have recently witnessed.

While I am heartened to say that the economy is rebounding, there can be little doubt that many Americans are still struggling. This is especially true for those who lost work and continue to search for jobs. As the essay in this year's *Annual Report*, written by Richmond Fed economists Andreas Hornstein and Thomas Lubik, points out, the fraction of workers who are experiencing long-term unemployment—defined as being out of the workforce for 26 weeks or more—is significantly larger than it has been following recent recessions. This is true even compared to other “jobless recoveries,” such as those of 1990–91 and 2001. As Hornstein and Lubik note, the prevalence of long-term unemployment is tied, in part, to lower exit rates from joblessness. This process becomes more difficult the longer someone is unemployed. There are many reasons for this phenomenon, but those reasons can be divided roughly into two groups.

The first set of reasons may account for what Hornstein and Lubik call “true duration dependence” in exit rates. They center on reductions in human capital. As people are out of work for longer and longer periods, they may lose skills that employers find desirable, including some largely intangible skills that one obtains simply by being in the workforce. This situation may be compounded by the fact that as the period of unemployment increases, the network of former colleagues and associates who might help someone find employment decreases.

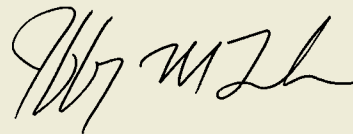
The second set of reasons is related to what Hornstein and Lubik dub “unobserved heterogeneity.” Some job losses are due to factors that are idiosyncratic to the previous employer. In such cases, workers may be able to find work relatively quickly and thus may not suffer from prolonged unemployment. But some of those losses may be due to structural declines in certain sectors of the economy—for instance, areas of the manufacturing sector that have seen a marked decline in output for some time. Workers in those sectors might have rather specific sets of skills that can be hard to transfer to other industries. As a result, they could have significant difficulty finding future employment.

In their essay, Hornstein and Lubik attempt to carefully explain the driving forces behind long-term unemployment and which of those forces are of greatest quantitative importance. This is an important exercise that can help illuminate what is happening in the economy and the options policymakers may consider to assist people who desperately want to find work.

As Hornstein and Lubik note, a rise in long-term unemployment due to structural reasons could mean that the “natural rate” of unemployment—the lowest possible unemployment rate that is consistent with stable inflation—has increased. This would suggest that monetary stimulus may not be a particularly effective means of getting people back into the workforce. Instead, structural and labor market reforms might be more useful. And, indeed, there is some evidence from abroad that these types of reforms have helped reduce long-term unemployment. In my view, the best contribution monetary policy can make to creating more jobs for all Americans, including those who have been out of the workforce for some time, is to ensure that inflation remains low and stable.

Just as we do not fully know the causes of this recession, we also do not fully know which policies will be most

beneficial in fostering the recovery. This may not be a particularly satisfactory response for those Americans who are still suffering from the economic downturn. But it’s a response that I think reflects a necessary humility. Too often, I believe, policymakers have been tempted to solve problems only to find that the measures they implemented made little difference or, worse, actually exacerbated the situation they were trying to improve. Policymakers at the Federal Reserve and other institutions surely should work with all appropriate haste to find answers to tough problems, but should avoid the risk of believing we know more than we actually do about the fundamental sources of those problems. It is my hope that our essay in this year’s *Annual Report* will make an important contribution to that effort.



**Jeffrey M. Lacker**

President