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Essays from our Annual Reports, Part II

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This issue represents a second collection of essays originally published in the Richmond Fed's *Annual Report* since 2007. The first issue collected essays relating to the financial crisis and its aftermath. But this was not all that was going on in the last eight years. In other annual reports we have tried to address broad issues affecting the economic well-being of U.S. households. The topics addressed in these essays largely deal with longer-run trends in the economy—phenomena that play out over longer intervals than the typical business cycle. As such, these issues shape the backdrop to the Federal Reserve's monetary policymaking.

The first of these was our 2007 essay on household savings, with a particular focus on life-cycle aspects of savings—saving for retirement. One frequently hears concerns that many households approach retirement age with savings inadequate to support a continuation of their pre-retirement standard of living. These concerns are often motivated by the shift away over time from defined benefit pensions in the work place and by a declining personal savings rate in the U.S. aggregate data. Looking carefully at the breadth of available empirical and theoretical research, our 2007 essay found a more nuanced picture. Looking at household behavior through the lens of the life-cycle theory of saving and consumption suggested that, while there was variation, most households were approaching retirement reasonably well-prepared. Two caveats to this finding are important to note. First, the essay looked entirely at evidence from before the deep recession that began in late 2007 and severely disrupted household finances. Second, for a large portion of the population, government transfers from the Medicare and Social Security programs made up—and continue to make up—a significant portion of their retirement resources. And our aging population means that these transfers will become an increasing source of fiscal strain for the federal government.

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Budgetary issues more generally have been a topic of broad concern in the United States in recent years. The recession of 2007–09 brought with it a large increase in federal deficits, and the polarized political environment has led to near shut downs of the government on a number of occasions, as the Treasury has run up against its legislated debt ceiling. In 2011, a year in which fiscal policy and government borrowing was the subject of intense political debate (and gamesmanship), we examined the notion of sustainability in government financial plans. In our essay for that year, we explained that economic forces would put an upper limit on how much debt a government could issue, although identifying that limit, or how close we are to it at any point in time, is difficult. But financial market investors simply wouldn't be willing to hold—not without sharply higher yields—a level of debt so high that future taxes would not be capable of paying it off. As a government neared such a level, the public would come to expect some adjustment to planned spending and taxes. But uncertainty about the shape that such adjustments might take could itself have the effect of dampening investment spending and thereby weaken growth. Further, fiscal policy stretching the limits of sustainability raises the risks that monetary policy will lose its ability to control the price level. Hence, the possible consequences of continued political gridlock for the long-term performance of the U.S. economy were (and are) significant.

One of the defining characteristics of the recession of 2007–09 was the dramatic increase in the share of the unemployed who were unemployed longer than 26 weeks. This episode was the worst economic contraction in the United States since the Great Depression, with the unemployment rate topping out at 10 percent. This peak was a little below the peak in the 1982 recession. In that earlier period, however, the long-term unemployed never accounted for more than about a quarter of all unemployed. By contrast, in the recent recession the share of the long-term unemployed soared to more than 40 percent of overall unemployment. Our 2010 *Annual Report* essay examined these facts, together with the related phenomenon of "duration dependence"—the tendency for unemployed with longer unemployment spells to have lower probabilities of finding a job. The essay argues that the distinct patterns in the data for the Great Recession suggest that an unusually large number of workers with relatively low employability entered unemployment in the contraction. This finding is consistent with a major source of the economic dislocation of the period coming from structural changes in the economy that reduced the relative demand for lower-skilled workers. While this is a topic that has continued to attract considerable research attention, our 2010 essay's early look at the period suggested that much of the labor market damage in the Great Recession was beyond the ability of monetary policy to correct.

Perhaps related to structural changes that altered the relative demands for workers of varying skill levels, the period since the recession has seen varying rates of improvement for workers and households across the income distribution. Indeed, inequality has increasingly become a topic of economic and political commentary. Our 2012 *Annual Report* essay touched on this topic, but with a focus more on the dynamics of household economic standing, as opposed to the distribution at a point in time. In particular, the essay surveys the evidence on intergenerational mobility—the frequency with which children born into the lower parts of the income distribution are able to climb the economic ladder in their lifetimes. The fact that there is a fair amount of persistence across generations is taken as evidence that people likely face different levels of challenges in developing the human capital necessary for advancing one's standard of living. And these disparities in access to human capital investment likely begin very early in life—pointing to a targeted approach to public early childhood education investments as an avenue for improving the economic mobility of those at the bottom of the distribution.

The broad trends discussed in these essays, as well as the public policy implications, fall mostly well outside the scope of monetary policy. But by identifying forces shaping the real economy, they help us understand the context in which the Federal Reserve pursues its mandates for price stability and sustainable employment growth.