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Uncertainty and the geography of the great recession

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ABSTRACT

The variation in a state-level measure of local economic-policy uncertainty during the 2007–2009 recession matches the cross-sectional distribution of unemployment outcomes in this period. This relationship is robust to numerous controls for other determinants of labor market outcomes. Using preexisting state institutions that amplified uncertainty, we find evidence that this type of local uncertainty played a causal role in increasing unemployment. Together, these results suggest that increased uncertainty contributed to the severity of the Great Recession.

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Mr. FITZPATRICK: What is the gentleman's plan to take care of the unemployment in this country?

Mr. KNUTSON: What is my plan?

Mr. FITZPATRICK: Yes.

Mr. KNUTSON: Reassure industry.

Mr. FITZPATRICK: How?

Mr. KNUTSON: By removing all the uncertainty that you folks have created. Let us assure industry and we will end unemployment in a short time.

United States House of Representatives, April 12, 1935.

1. Uncertainty and the great recession

Are increased levels of uncertainty an important factor in explaining the cross-sectional distribution of employment outcomes during the Great Recession? We assemble a state-level measure of policy uncertainty from 2006 through 2009 and find that increases in local uncertainty over this period are strongly correlated with local labor market outcomes. The uncertainty channel remains strongly correlated with unemployment increases in regressions that control for other mechanisms. While there is a feedback loop between economic outcomes and uncertainty, we also show that increases in local uncertainty are partially driven by pre-existing state institutions, and that these pre-determined uncertainty amplifications cause unemployment increases.

The key lesson from these findings taken together is that treating uncertainty as an important channel is consistent with the geographic pattern of the recession. Our baseline results suggest that if uncertainty levels in all states had been at those

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of the five states facing the lowest levels of uncertainty in 2009, the national unemployment rate would have been between 0.8 and 1.2 percentage points lower.

The findings contribute to our understanding of the interaction between the different channels that were responsible for the depth and length of the Great Recession. Macroeconomists have advanced a number of hypotheses to explain the severity of the 2007–2009 decline in employment, including insufficient demand due to household deleveraging, slow recalculation or adjustment to sector-specific shocks, credit constraints due to problems in the financial sector, and the increases in policy and general economic uncertainty that we focus on here. Unfortunately, as is often the case in macroeconomics, distinguishing the differential impact of these amplification channels has not been straightforward.

The aspect of the Great Recession that we use here to shed light on this question is the substantial geographic variation in employment losses. The five states most deeply affected by the recession experienced increases in their unemployment rates of 6 percentage points or more from 2006 to 2009 (with the largest increase, in Nevada, exceeding 7.5 percentage points). Conversely, the five states least affected by the downturn saw their unemployment rates increase by less than 2.1 percentage points. Given the importance of this geographic variation, it is desirable that theories of the recession be consistent with this cross-sectional pattern.

In line with an explanation centered around structural sectoral shifts, states with larger housing price run-ups and declines suffered the largest employment losses. Moreover, overall employment losses across states and counties are highly correlated with employment losses in the construction sector. A number of papers have demonstrated that geographic variation in household deleveraging and weaker demand are also correlated with employment losses. [Mian and Sufi \(2011\)](#), in a framework that is underpinned theoretically by [Philippon and Midrigan \(2011\)](#), show that employment losses are most severe in areas with initially high and subsequently falling household debt-to-income ratios. They analyze data from counties with large household balance sheet shocks and claim that lessened aggregate demand was responsible for the majority of the job losses between 2007 and 2009. Another theory, that credit constraints caused by financial sector problems lengthened the recovery (e.g. [Guerrieri and Lorenzoni, 2011](#) and [Chodorow-Reich, 2014](#)), does not necessarily predict such wide variety in regional outcomes. However, work by [Goetz and Gozzi \(2010\)](#) and [Greenstone et al. \(2015\)](#) find that local credit crunches for small businesses did indeed lead to employment and wage losses between 2007 and 2009.

A final popular explanation for the significant duration of the 2007–2009 recession's recovery is the increase in policy and economic uncertainty during the period. Widely discussed in the popular news amidst analyses of the impact of Federal Reserve policy, health care reform, the rise of the Tea Party movement (see [Madestam et al., 2013](#)), debt ceiling disputes and state and federal spending levels, policy and economic uncertainty have also received attention from researchers looking into their possible effects on the U.S. economy during the aftermath of the financial crises (e.g. [Bloom et al., 2012](#)). [Baker et al. \(2016\)](#), for example, show that higher indicator uncertainty from 2008 on was associated with a deeper and longer recession. In their analysis of news and government documents, [Dominguez and Shapiro \(2013\)](#) look to see how the slow recovery was anticipated, and find that the political “stalemate” in the US contributed to the length of the recession, as did shocks from Europe. Similarly, [Bachmann and Sims \(2012\)](#) establish that consumer and firm confidence is of the utmost importance during downturns. [Schaal \(2011\)](#) is able to reproduce many of the dynamics of the Great Recession by introducing uncertainty shocks into a dynamic search model of heterogeneous firms, while [Stock and Watson \(2012\)](#) use a dynamic factor model to establish that heightened uncertainty worsened the recession significantly.

In its simplest exposition, the uncertainty channel does not predict a wide spatial distribution of outcomes. This has led some to argue that the policy uncertainty channel is not consistent with a central feature of the recession. For example, [Mian and Sufi \(2011\)](#) claim that “an increase in business uncertainty at the aggregate level does not explain the stark cross-sectional patterns in employment losses we observe.” This paper presents cross-sectional evidence in support of the uncertainty channel.

The remainder of this paper is structured as follows. In [Section 2](#), we develop a state-level measure of uncertainty and document its association with employment outcomes. The relationship between regional uncertainty and unemployment levels persists after controlling for competing explanations for the high post-2006 levels of unemployment. We then show, in [Section 3](#), that predetermined state government institutions affect regional uncertainty. By using these institutions to instrument for uncertainty, we show that higher levels of uncertainty cause higher levels of unemployment. In [Section 4](#) we discuss our results and conclude.

2. A state-level measure of uncertainty

In this section, we present a measure of uncertainty indicators at the state level. This measure was strongly associated with increases in unemployment during the 2007–2009 recession, and this remains the case after controlling for commonly offered other explanations for the severity of the Great Recession.

Conceptually, one could draw distinctions between the level at which uncertainty is perceived (state or national) and the level at which it originates (again, state or national). Although we would in principle like to separate the four resulting concepts of uncertainty, the different levels of perception and origin of uncertainty are connected through a variety of feedback loops. It is difficult to conceive of them independently in practice, and in our cross-sectional setup it is impossible to measure the effects of uncertainty that is both perceived and produced nationally. We are ultimately interested in measuring uncertainty regarding business conditions as faced by firms locally (as in [Bloom, 2009](#)). We therefore construct a

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