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Economic Discontent:
Causes and Consequences*

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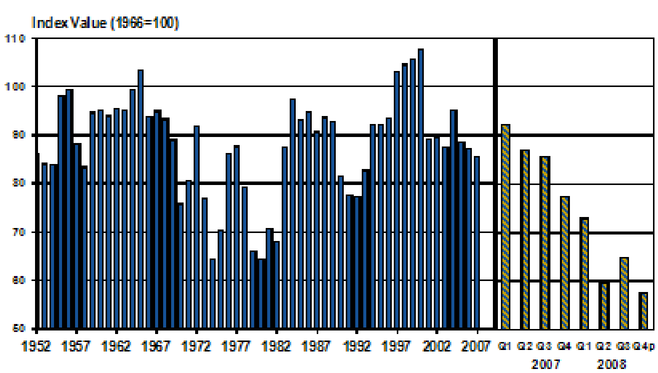
Introduction

The research program that I direct at the University of Michigan since 1976 was begun more than a half century ago by George Katona. His aim was to develop new theories and new methodologies in order to create an interdisciplinary approach called behavioral economics. The driving force was the direct measurement of expectations and behavior, focusing on how consumers formed economic expectations and how those expectations influenced their spending and saving behavior. In the decades that followed the first survey of consumers in 1946, more than fifty other countries, spanning all inhabited continents in the world, adopted this approach and now regularly monitor what is widely known as consumer confidence.

Global leadership is not always enviable, as the plunge in U.S. consumer confidence has preceded a worldwide decline. This presentation will focus on the causes and consequences of the U.S. decline. You know most of the facts already. The central role that confidence plays in the economy has never been more closely scrutinized nor as widely discussed as in the past year. The loss of consumer confidence has been stunning: the Index of Consumer Sentiment fell by 42% in the eighteen months following its January 2007 peak, a greater percentage decline than prior to any past recession (see Chart 1). That was in June of 2008, and since then it has resumed its decline as the financial crisis accelerated. Given that consumers account for more than two-thirds of all U.S. spending, it is no surprise that the data now indicate that the entire economy is in recession, although for a good part of the past year many analysts discounted the recession forecast. People are surprised by the correspondence between trends in consumer sentiment and GDP even though the Sentiment Index has been part of the Index of Leading Economic Indicators for decades (see Chart 2 on next page). Modern economic theory provides a good reason to anticipate this relationship as it views today's consumption as dependent on future economic prospects. As people become more apprehensive about their future prospects they increasingly adopt precautionary behaviors that act to decrease their spending and increase their reserve funds.

Chart 1: Index of Consumer Sentiment



The economic factors that determine changes in confidence have been widely documented as have the consequences for spending and saving. What has eluded scientific analysis is a determination of the mechanisms that propagate the speed of the change across the entire population. Explanations exist only in retrospect; there has never been a proven theory that could forecast a collapse in advance. In normal times, this issue never rises to more than

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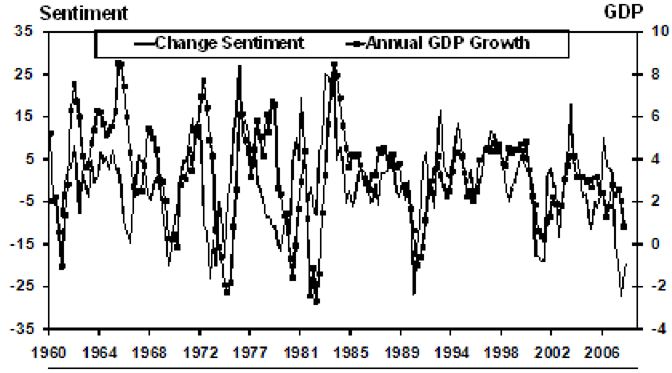
an academic curiosity. These are not normal times. The loss in confidence has been so sudden and so complete that even the most sophisticated financial institutions were frozen by uncertainty. It is no longer acceptable for economists to dismiss these elements as simply representing non-economic factors, discounting scientific understanding with labels such as "animal spirits." Needless to say, the incorporation of these factors is a daunting task, and, quite frankly, outside the scope of any one discipline.

Chart 2: Change in Sentiment Index and Annual Growth in GDP



Moreover, while the fall in confidence was abrupt, restoring confidence will not be accomplished as quickly. There is no symmetry. Simply reversing what caused the collapse in confidence is not sufficient to restore confidence. It would be nice if there was a 12-step program that would guarantee the quick restoration of confidence. No such program now exits nor may ever exist in the future. Nonetheless, the direct survey observations of past episodes of losses and subsequent gains in confidence does offer some valuable clues about the essential characteristics of the process. From the outset, I must admit that even though the decline in consumer confidence has already been steep, this analysis must be viewed as tentative as it is based on incomplete data since the loss in confidence is hardly complete. To paraphrase Winston Churchill's description of another crisis, we are not at the end or even at the beginning of the end, but, perhaps, near the end of the beginning.

My presentation will first identify five typical phases of a collapse in confidence. Economic confidence has been lost and regained repeatedly over the past several decades, but there has been no occasion since the 1930's that all five phases have been present—even the 1980's experience didn't come close. As we shall see, the asymmetry in the speed of collapse compared with the very slow restoration of confidence reflects the interaction between changes in near and longer term economic expectations.

I will then turn to the survey data to document the ongoing plunge in confidence and indicate that persistent declines in spending can now be anticipated. Naturally, the spending forecasts are contingent on the information that is now available, and these forecasts are subject to an unusually large degree of uncertainty. Good forecasts typically exhibit balanced risks of positive and negative errors about the point estimates; the type of Knightian uncertainty (as opposed to quantifiable risk) now faced by the economy, however, indicates that no such symmetry is warranted.

Five Degrees of Economic Discontent

There are five degrees of economic discontent that have occurred to varying degrees over the past half century. The most common form of discontent, and usually the first to appear, results from the inability of consumers to maintain their customary living standards due to rising inflation. High and rising unemployment, which consumers view as a much more serious matter, represents the second degree of discontent. Whereas discontent with inflation can persist for years without much impact on the macro economy, once discontent is driven by fears of rising unemployment, widespread postponement of spending can and has plunged the entire economy into recession. The loss of accumulated wealth represents the third phase of discontent, which can deepen and lengthen the declines in spending. Falling home values and declines in equity prices have added to the growing distress due to lost jobs and high food and fuel prices.

The fourth stage of economic discontent is characteristically different in that it translates economic discontent into political discontent and ultimately increases the lose in confidence. Consumers look toward the government's fiscal and monetary policies to maintain relatively full employment and stable prices. If consumers believe current economic policies are incapable of achieving these goals, there is little reason for consumers to anticipate future improvement—not until a change in the policies or the administration is forthcoming. The typical result is a period of economic malaise born of the failure of policies to accomplish what is widely viewed by the public as an achievable result.

These first four phases of discontent have been repeated to some degree in every economic cycle in the past half century. The economy has never fallen victim since the 1930's to the final stage of discontent when people relinquish any hope for improvement and focus on economic survival. The cherished dream of a better life is not simply put on hold, it is abandoned. This total despair is an apt description of the difference between depressions and recessions, both psychologically and economically. It is a systemic failure.

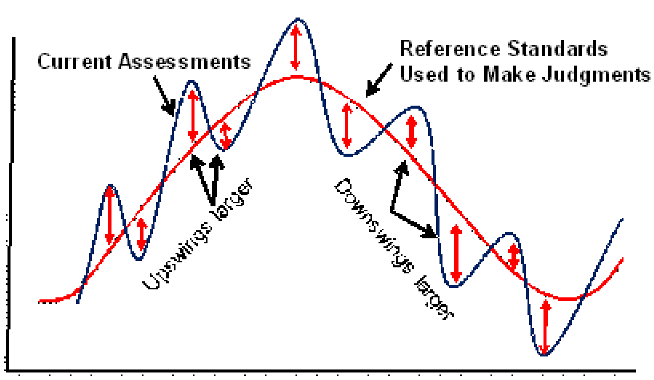
The economic behavior of people who have suffered such total despair is forever changed as was vividly demonstrated by the much more prudent economic behavior of the generation of the 1930's despite the post-WWII surge in the economy and confidence. Such systemic failure also has repercussions for the macro economy since it increases the willingness of people to translate temporary interventions into enduring changes in institutions, regulations, and policies that permanently alter the fabric of economic life. The 1930's sparked such permanent changes, although not every change attempted at that time was upheld. In the past several decades there have been a number of mini crises that prompted what proved to be temporary interventions, the most likely course without systemic failure and a complete collapse in confidence.

It is quite unlikely that the economy would again fall victim to such a complete and persistent collapse in confidence. Nonetheless, the end of the beginning is not yet in sight.

Dynamics of Discontent

Inflation, unemployment, and economic policies are hardly ever viewed as completely satisfactory. Indeed, what is considered to be a low inflation or unemployment rate or an appropriate economic policy relies on some standard for the judgement to be made. The same level of performance, say in terms of the inflation or unemployment rate, can be evaluated quite differently depending on what was thought to be the expected standard. These standards reflect more fundamental and longer term views about the economy. These views are not easily changed by current developments since these views act as a frame of reference that people use to interpret those very events. These standards are not immutable but the change is so slow that it is imperceptible to most people. A stylized depiction of one complete cycle from trough to trough is shown in Chart 3, with assessments of current economic conditions based on the contemporaneous reference standards.

Chart 3: Self-Limiting Cycles in Economic Assessments Made by Consumers



It is difficult to exactly identify when change occurs in these economic yardsticks. Long term performance standards for the economy were at peak levels in the mid 1960's and the mid 1990's, suggesting about a thirty year cycle. Between these periods there were persistent declines in the expected performance of the economy, reaching a low point in 1980, and we have again entered an era of falling economic aspirations, roughly thirty years later.

It is important to note that the timing and amplitude of past cycles cannot be used to predict future cycles. The past is not destiny. But what is past is prologue. It is clear that when people hold very high standards for the performance of the economy, disappointment is more likely with the same objective economic outcome than if that same outcome was judged by very low performance standards. Indeed, it is a persistent gap between actual economic conditions and the performance standards that eventually prompt a change in the underlying standards. The length of time it takes to change these standards determines the length of the long term cycle. It is often argued that the heightened speed of communication will hasten the underlying pace of change—argued ever since the introduction of newspapers in the 19th century. I think that misses the central point.

It is uncertainty, frustration, and persistent failure to achieve economic goals that causes these long term economic expectations to change—what I earlier called the first four stages of economic discontent. Economic setbacks nor even war or political crisis do not erase optimism—the Vietnam War, inflation and Watergate were not sufficient to cause an end to the optimism of the 1960s, just as 9/11 and the Iraqi war did not end the most recent period of optimism. The erosion only begins when economic failure is associated with a growing belief that what was once easily within reach can no longer be accomplished.

The current financial crisis has challenged deeply held beliefs about the performance and stability of the economy as well as the appropriate role of economic policy. The old rules are gone, leaving a vacuum of uncertainty. The challenges to the accepted order are overwhelming, the most serious being to home ownership and wealth accumulation, credit standards, job security, wage growth and future inflation. Without any safe harbor, the tide toward pessimism has rapidly swept across the country. While the speed of the descent reflects the unrealistic expectations of the bubble economy in the past decade, the descent repeats a well worn cycle as consumers move between what had become excessive optimism to what will become excessive pessimism.

This change exaggerates the underlying shifts in consumer spending when evaluations of current economic conditions and long term prospects are in decline and mitigates the declines when current conditions worsen in the midst of favorable long term prospects. This was what helped to make the recessions in the early 1980's deep and long and what kept the recessions in 1990 and 2001 short and shallow. The current coincidence will lengthen and deepen the ongoing recession.

The persistence of the negative economic conditions typically makes the eventual resurgence of optimism more likely. Given that aspirations have been drastically lowered, consumers are more willing to accept fundamental changes in their economic prospects as well as in government policies. Unfortunately, it takes an extended period of time to restore long term optimism. Indeed, the restoration of optimism in the late 1990's took the longest economic expansion in history to accomplish, which just surpassed the prior record expansion which occurred thirty years earlier and produced the peak in optimism in the mid 1960's.

Record expansions are not commonplace even in normal times. So it is of some importance to determine the conditions which could move consumers to the fifth and final degree of discontent, where consumers do not simply become more cautious spenders but people relinquish any hope for improvement and focus simply on survival. Just as economic growth came to be seen as the inevitable course that helped to sustain spending at high levels, economic stagnation could be seen as the inevitable course and promote a lasting curtailment of spending.

I have already noted that I do not believe this final step has occurred or will occur or even could occur this soon. Such complete despair only occurs after the repeated economic failures and the total loss of confidence in the ability of the government to remedy the situation. The drastic impact on the real economy is still more feared than actual, although evidence of the damage can be expected to rapidly accumulate in the months ahead. More importantly, the election of Barack Obama was based in part on the expectation that new economic policies have the potential to ultimately resolve the crisis. Of course, whether consumers slip into the fifth and final phase of economic discontent cannot be known at present; that final descent will take years to determine. More importantly, that descent does not alter the negative economic outlook for 2009, only the eventual length of the downturn. Nonetheless, it would be irresponsible not to consider the possibility, however remote, that we may slip into that fifth stage of discontent that transforms the consumer into a sputtering engine of economic stagnation.

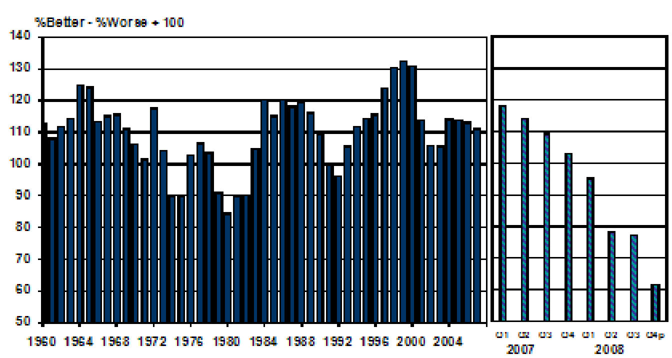
The decline in consumer spending in 2009 will be the largest since the 1930's. There have been only two years in which total personal consumption expenditures declined since the 1940's, in 1980 by -0.3% and in 1974 by -0.8%. The forecast for 2009 is barely worse at -1.0%. Even if this turns out to be too optimistic, it will be well below the average annual decline of -4.9% recorded from 1930 to 1933. Nonetheless, it would be the worst year for consumer spending in well over a half century.

I will briefly review data on the financial situation of consumers, their prospects for income, employment and inflation, and their saving and spending intentions. This review will be mercifully brief since in nearly every case consumers have adopted very negative views of all these economic factors.

Personal Finances

In every survey conducted since 1946 consumers have been asked for their own assessment of their financial situation. In the October 2008 survey, more consumers than ever before complained that their overall financial situation had worsened, reported by six-in-ten households (see Chart 4). Less than one-in-five consumers reported any improvement. The decline since the peak at the start of 2007 has been stunning. Indeed at that time the results were the opposite: the majority reported gains and the small minority financial reversals.

Chart 4: Consumer Finances Worst Ever Recorded



Immediately following this question, each respondent is asked to explain in their own words the reasons underlying their overall opinion. Less income due to job losses, fewer work hours, less overtime, and smaller bonuses and wage increases were reported by record numbers of consumers (see Chart 5). In addition, half of all households reported declines in the value of their homes as well as widespread losses in pension and stock accounts.

Consumers were still quite concerned about the erosion of their living standards due to high prices, with recent complaints shifting more toward food prices and less about gasoline (see Chart 6). Note that the frequency of complaints about high prices is now as high as during the late 1970's and early 1980's when the inflation rate was more than twice as high. This is a rather dramatic illustration of the impact of changed reference standards noted earlier. The last time reference standards for inflation were this low was in the late 1960's and early 1970's; when inflation threatened to exceed 5% in 1971, that dire situation prompted Nixon to impose price controls!

Chart 5: Income Declines Widespread

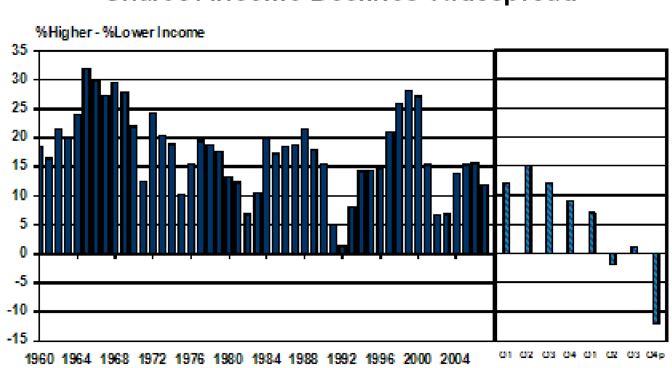
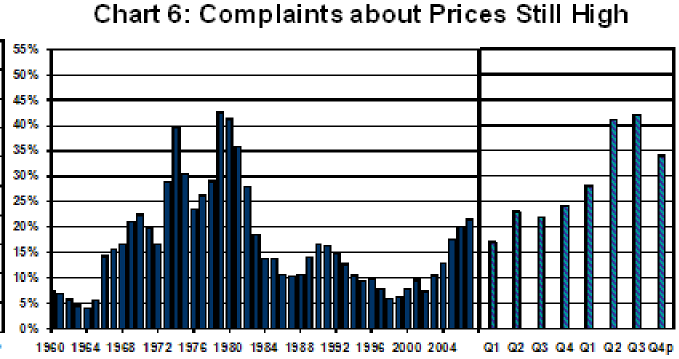
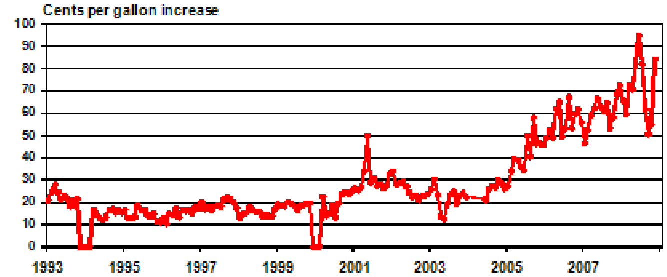


Chart 6: Complaints about Prices Still High



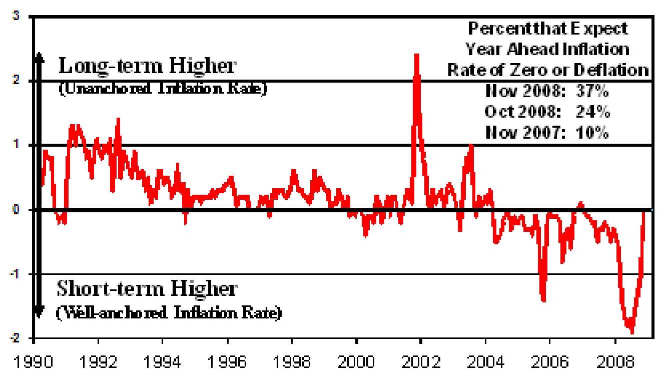
This does not imply that consumers have not recognized the steep drops in gas prices over the past few months. They have welcomed the decline, with lower income households especially vocal in describing the relief on their pinched budgets. Even though consumers widely anticipate continued low gas prices during the year ahead, most consumers view the declines as temporary and expect additional increases over the longer term (see Chart 7). These longer term gas price expectations are important ingredients in consumers' decisions about which vehicle model to purchase and indicate continued pressure on the less fuel efficient models produced by the domestic manufacturers.

Chart 7: Gas Prices Expected to Rebound During the Next Five Years



There has been a widespread recognition that inflation expectations are "well grounded," meaning that people do not expect the recent surges in food and gas prices to be translated into a higher core rate of inflation. This fact is quite unique. Consumers have typically not distinguished between the headline and the core inflation rate, more often anticipating higher inflation to persist over the longer term. That has completely changed in the past few years, as consumers have repeatedly anticipated a higher inflation rate to revert back to a lower long term average (see Chart 8). This result has provided the Fed with a greater leeway to lower interest rates. Although there is hardly enough evidence to suggest that the recent convergence signals an end to that trend, it is hard to deny that recent federal policies have raised concerns about the long term inflation rate.

Chart 8: Year-ahead Inflation Expectations Collapse to Five Year Expectations



Perhaps even more importantly, consumers view the current recession as having a significant impact on the overall inflation rate even aside from the steep decline in gas prices. In the latest survey, more than one-third of all consumers expected the inflation rate to fall to zero or expected deflation during the year ahead. Again, these declines are anticipated to reflect recessionary forces as consumers still anticipate the return to an inflation rate close to 3% over the next five years. This means that efforts to contain deflation may be quickly followed by efforts to contain inflation, for the second time this decade.

Chart 9: Employment Top Concern of Consumers
(Annual Growth Rate in Total Non-Farm Employment)

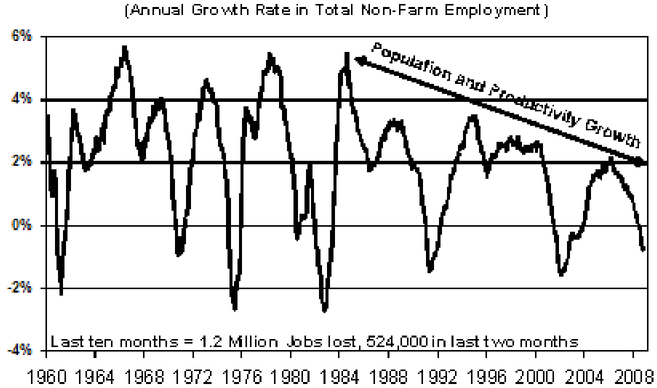
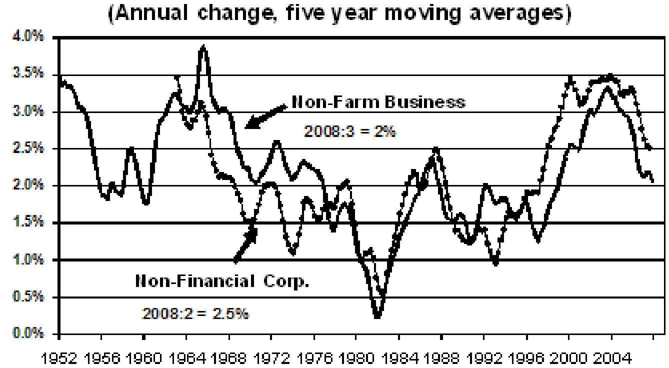


Chart 10: Labor Productivity
(Annual change, five year moving averages)

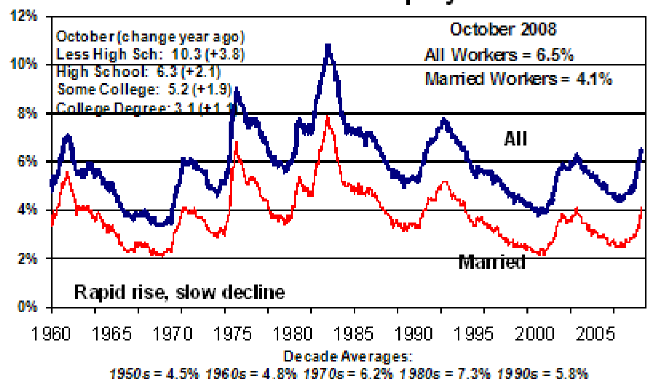


Employment

The economy has lost 1.2 million jobs in the first ten months of 2008, with nearly half of those losses coming in just the past two months (see Chart 9). Unfortunately, the declines have only begun and can be expected to continue throughout most of 2009. Note that job gains have followed a sagging long term trend over the past few decades due to slower population growth and higher labor productivity (see Chart 10).

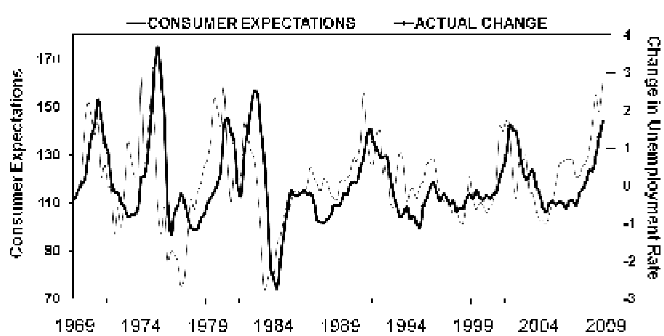
The unemployment rate has rapidly increased as a result, jumping to 6.5% in October, an increase of 1.5 percentage points in just six months (see Chart 11). A rapid increase is typical, as is a very slow decline once a recovery has begun. Thus far, most of the increase in the unemployment rate has been among the younger and less skilled workers. Although no groups will be immune, the eventual increases are still likely to be greater for these groups. The unemployment rate is already higher than in the last recession and can be expected to reach the highest level since the 1980's recession.

Chart 11: National Unemployment Rate



Indeed, consumers now anticipate that the unemployment rate will reach 8.5% by year end 2009 (see Chart 12). The outlook for unemployment rate is critical for most consumers. It's not just about lost jobs; the unemployment rate is taken as an indicator of future work hours, the likelihood of pay raises, and opportunities to obtain better jobs. People use a wide array of what economists call "private information" to determine the outlook for jobs, and have successfully predicted changes in the national unemployment rate over the past several decades. It is the importance of prospective trends in the labor market that makes job losses the second source of discontent and capable of causing consumers to postpone expenditures as a precautionary measure.

Chart 12: Consumers Expect Unemployment Rate to Top 8.5% in Late 2009



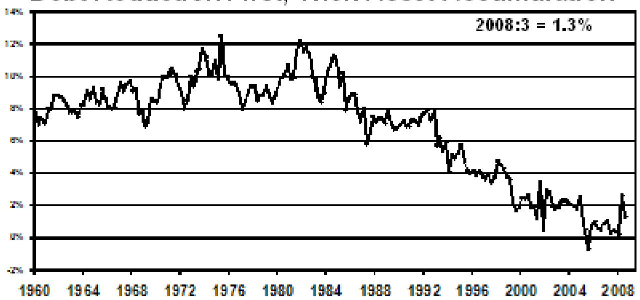
If the fifth degree of discontent is ever reached, it will be primarily caused by continued and widespread losses in employment that appear immune to federal intervention.

Savings and Debt

Part of the legacy of the booms in stock prices in the late 1990's and the more recent housing boom has been the rapid increase in debt and the unprecedented decline in saving out of current incomes (see Chart 13). Greed was not the distinguishing factor, although it surely played its part. The critical error was in people's expectations about future long term price trends. As argued earlier, people made judgements based on a long-term peak in their reference standards. It was not that they couldn't imagine a decline in the rate of gain, but they couldn't imagine a collapse from those lofty peaks. Although people learn from past mistakes, generations tend to repeat the mistakes of the past. Unless there is a fundamental change in human nature, some time in the distant future when another long term peak in economic performance is achieved, the same mistake is likely to once again occur.

Consumers are at present attempting to increase their savings and reserve funds and lower their debts.

Chart 13: Planned Increases Personal Saving Rate: Debt Reduction First, Then Asset Accumulation

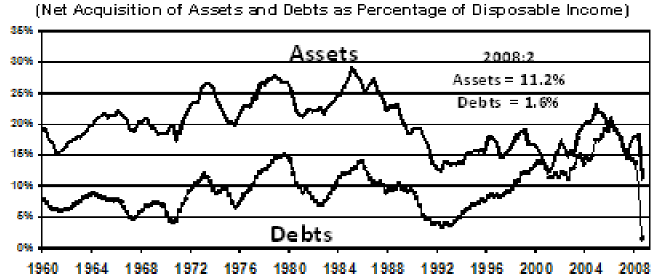


Indeed, the majority of people who received the recent tax rebate reported plans to use the money to pay down their debts and increase their savings. Despite these efforts, monthly debt repayments still account for 13.9% of personal disposable income, only marginally below the peak level of 14.4% (see Chart 14). The data make it clear that the majority of the increase in indebtedness was due to the substantial increase in mortgage debt. Financial obligations, which include legal debt as well as other required payments for rent, vehicle leases, taxes, and the like, also declined marginally to 18.8% from a peak of 19.5%. Given that each of these series have generally increased over the past few decades, it is of some note to mention that these series have recently recorded their largest quarter-to-quarter decline, with presumably more to come in the next several quarters.

Trends in the acquisition of assets and debts as a percentage of household income clearly show the recent collapse in debt incurrence (see Chart 15). It is difficult to know how much of this decline was initiated by consumers and how much was forced by the lack of available credit. Recent survey evidence has consumers equally split between whether they think the declines were the consumers' choice or forced by financial institutions. Unfortunately, it should be clear that we are not near the end of the beginning of this trend in debt reduction.

Chart 15: Credit Limitations & Reduced Consumer Demand Cause Collapse in Debt Incurrence

(Net Acquisition of Assets and Debts as Percentage of Disposable Income)

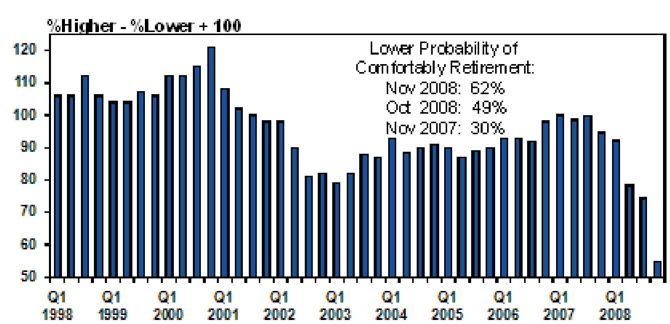


Indeed, the permanent changes in credit standards as well as the renewed emphasis on saving that will emerge from this crisis will have a significant impact on the pace of growth in consumption in the year ahead. In the years ahead, credit will not flow as freely as it has in the past. Financial institutions will require higher credit scores to qualify, demand larger down payments, and charge higher rates compared with their cost of funds. While the reduction in debt will have a positive impact on the rate of saving, savings motivations have also increased, including precautionary savings motives, savings for down payments, and saving for retirement.

One indication of those heightened motives is reflected in a question about the probability of a comfortable retirement (see Chart 16). The majority of consumers reported that the probability of a comfortable retirement considering their accumulated savings, pensions, and Social Security was at the lowest level in a decade. This suggests that consumers, especially those nearing retirement, will attempt to increase their savings to the maximum extent possible as well as delay retirement.

Chart 16: Retirement Savings Top Priority

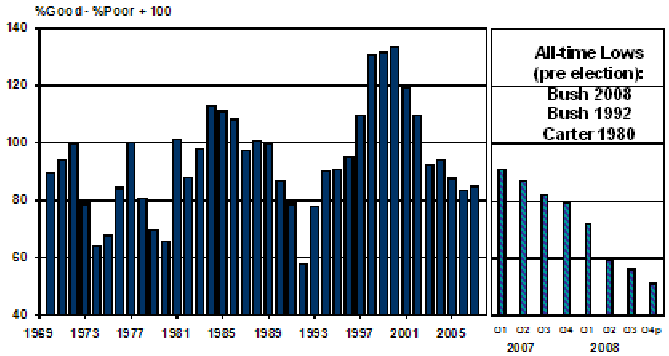
(Change in Probability of a Comfortable Retirement Given Current Assets)



Confidence in Economic Policies

Full employment and price stability are the avowed goal of federal economic policy. The government has never been held to a strict standard, but whenever an economic crisis has developed it has been quickly translated into a political crisis. There have been three Presidents that won their initial term in the midst of economic crisis: President Reagan, President Clinton, and President-elect Obama. The electorates who were won over by these candidates believed that the economy was in serious trouble and that the government's economic policies had failed to resolve the economic crisis. Indeed, the 1980 trough in confidence in economic policies was only outdistanced by an even lower level in 1992 which was then displaced by a new all-time low in 2008—the current President Bush thus took the record from his father who in turn outdid the low recorded by Carter (see Chart 17).

Chart 17: Obama's Challenge: Restore Lost Confidence in Government Economic Policies



On the heels of record lows, it is only natural to anticipate that the election of a new President would generate a burst of renewed optimism. After all, each of these elections was a referendum on the economy, with the winner thought to advocate a better mix of economic policies. Presidents Reagan and Clinton did experience a brief period of renewed optimism and so will Obama.

The ultimate translation of promise into economic confidence is based on performance. Nonetheless, long before the economic performance of a new President can be adequately assessed, judgements are based on whether people's expectations for improvement are being met. Failed economic expectations have immediate consequences. Most presidents want to manage people's economic expectations so that their administration is never seen as promising too much too soon. Obama in his victory speech mentioned that the economic crisis may not be resolved in his first year nor even in his first term as President. Presidents Reagan and Clinton actively engaged in managing expectations, that is, they purposely tried to lower prevailing expectations for a quick solution to pressing problems. President-elect Obama faces a far more difficult economic situation that will take a considerable period to resolve even if he is remarkably successful in office.

Moreover, consumers have lost confidence in both monetary as well as fiscal policies. The loss of confidence in financial institutions is widespread. Importantly, President-elect Obama has the opportunity to appoint three new members to the Federal Reserve Board. When consumers were asked about how their confidence in various financial institutions had changed, the most significant result was that the majority reported that they had lost confidence in the Federal Reserve (see Chart 18). Moreover, the extent of the loss was large in comparison to the lows recorded in the aftermath of the 1987 stock market crash. This represents a significant loss of confidence in the federal agency responsible for monetary policy in the midst of the worst crisis since the Great Depression. It also indicates the ability of President-elect Obama to have a significant influence on all aspects of economic policy. Needless to say, it also increases the potential risk of failed expectations.

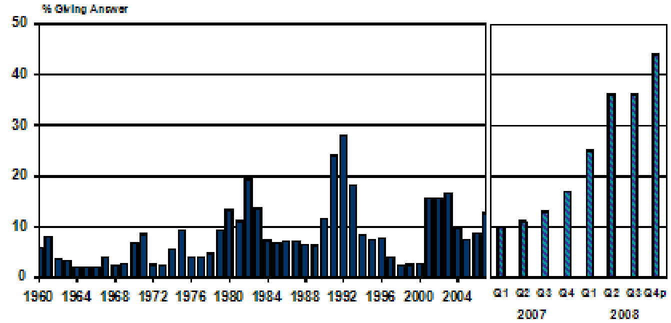
Chart 18: Lost Confidence in Monetary Policy and Financial Institutions

	November - December 1987					October 2008				
	More	Same	Less	DK	Total	More	Same	Less	DK	Total
Federal Reserve	**9**	**67**	**19**	5	100%	**6**	**36**	**55**	3	100%
Brokers & Mutual Funds Companies	8	46	37	9	100%	4	28	65	4	100%
Commercial Banks	7	70	21	2	100%	3	36	60	1	100%
Insurance Companies	13	56	28	3	100%	6	44	49	1	100%
Savings & Loans	11	58	27	4	100%	5	43	49	3	100%
Credit Unions	18	61	11	10	100%	16	55	23	6	100%

Purchase Plans

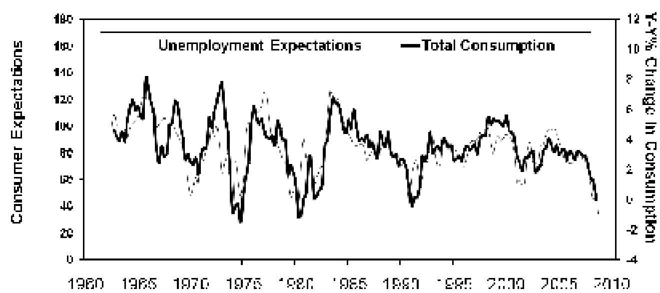
There are two factors that are having a significant negative impact on consumers plans to make discretionary purchases of homes, vehicles, appliances, furniture, home electronics, and other large household durables: the lack of available credit and uncertainty about future job and income prospects. While I believe that the change in credit conditions will have the more important long term impact, I will now focus on job and income uncertainty. Most consumers now report the least favorable buying plans since the early 1980's. Indeed, the majority of households have for some time favored the postponement of purchases across a wide range of household durables including vehicles, and this is supported by evidence of plunging retail and vehicle sales as well as the depressed housing market.

Chart 19: Job and Income Uncertainty Cause of Plunge in Discretionary Spending



After asking about purchase plans for a variety of products, each respondent is asked to state in their own words why they hold their opinions. More than a hundred different references to various factors have been followed over the years, with most of those reflecting some aspect of prices or credit. What dominates the development of recessionary declines in purchases, however, are references to their uncertainty about future jobs and incomes (see Chart 19). These references have exploded in the past year or so, to heights never recorded before. Nearly half of all consumers have cited their uncertainty about future jobs and incomes when asked to explain their negative views toward buying. Such precautionary behavior is not unexpected since the postponement of discretionary purchases is an effective means to curtail their commitment in the face of potential adversity. The extraordinary size of the current response is due to the fact that their past spending had reached or exceeded the limits of their incomes.

Chart 20: Labor Market Uncertainty Primary Correlate of Growth in Personal Consumption



Job and income prospects have always been critical to the outlook for consumer spending (see Chart 20). Unemployment expectations are a proxy for a broad range of job and income concerns. The data indicate an annual growth rate in real total personal consumption expenditures (PCE) will decline through the 3rd quarter of 2009, and average a -1.0% decline for 2009 compared with 2008. The largest prior decline since the 1930's was -0.8% in 1974 (excluding the WWII war years).

Summary Outlook

The economic outlook is dismal, and it is especially bleak for the upcoming holiday shopping season. Credit sensitive purchases will be hardest hit, although the spending cutbacks will encompass every product category. Consumers want to curtail their spending and increase their reserve funds as a precaution against the potential of greater financial setbacks in the future. Purchases that usually entail the use of debt have two disadvantages: the reluctance of consumers to incur new debt as well as the reluctance of financial institutions to make credit available.

Higher credit standards to qualify for loans, larger down payments, and higher risk-adjusted interest rates will effectively curtail consumer spending even after the recovery starts at the end of 2009. Indeed, credit limitations are likely to persist for years to come—limitations when compared with the free-flowing credit of the past, but these limitations will not be viewed as unduly stringent requirements in this new credit environment. Combined with the falloff in household wealth and consumers' desire to increase their saving out of current income, the pace of growth in personal consumption spending will fall short of the 3.5% growth rate recorded in the past decade. Given that consumers account for more than two-thirds of GDP spending, this will represent a drag on the rate of growth in the overall economy. A slower pace of growth coupled with continued productivity gains will mean that fewer jobs will be created. Although the growth in the labor force has slowed, the slowdown in job creation will result in a secular rise in the unemployment rate. Indeed, we may return to the situation in the 1980's when the non-accelerating inflation rate of unemployment was widely considered by economists, and widely accepted by consumers, to be about 6.5%. And when the current economic crisis finally ends, the flood of crash-induced cash in the worldwide economy will come home to roost. We will then return to the more familiar policy trade-off of inflation and unemployment.

You may find this the hardest to believe: that was the more favorable outlook. Importantly, it is the most likely forecast. Given the prevailing Knightian uncertainty that now exits, I will dispense with offering the more positive alternative.

The more negative forecast involves falling into what I have termed the fifth degree of discontent in which consumers lose all hope of any quick resolution to the economic crisis. It is not just that consumers adopt a defensive posture, it is that each consumer wants to attain what is impossible for all consumers to accomplish at the same time: rapid and sustained increase in their saving by cutting their spending. Such widespread spending cutbacks mean falling production and falling incomes, and as a consequence, a declining ability to save. The best way to forestall a descent into the fifth stage of discontent is to bolster employment and prevent the collapse of industries. Moreover, financial institutions need to promptly restore the flow of credit to consumers without the excessively stringent standards that are now in force.

Clearly, government fiscal and monetary policies must be perceived as capable of reestablishing economic stability. This is the minimum, but nonetheless a challenging requirement for the Obama administration. The primary risk is not that the new administration will not pursue policies that would be ultimately successful but that the public may lose confidence in the administration because of very high expectations for immediate relief. President-elect Obama must reduce expectations so as to avoid the consequences of failed expectations and a renewed loss of confidence.

Fiscal policies must be aimed at creating more spending and more employment. The tax rebates of the past year did not spur spending as much as it reduced indebtedness, especially credit card debt. Direct cash transfers must be given to those who will immediately spend the money, such as larger and extended unemployment benefits, increased cash subsidies to those most adversely affected, and financial help to homeowners to avoid foreclosure. Public works projects focused on infrastructure that can be immediately undertaken or quickly accelerated are a good choice as well. Aid to state and local governments to avoid unwarranted layoffs and prevent tax increases would also be useful. Monetary policy must focus on enhancing the availability of credit to consumers as a condition of their financial support to financial institutions.

These are the worst of economic times for many people, and these are the best of political times for many people. I remain optimistic that the best of economic times and the best of political times will converge in our not too distant future.