

The “great moderation”

In ancient times, philosophers advised moderation in all things. In our time, economists and policymakers have wished for moderation in the volatility of employment and output growth. Firms and households prefer to make their economic decisions with a higher level of certainty about what the future holds. While it is not possible to predict the growth of employment and output with precision, producers and consumers all realize that increases in volatility—the variation around the average of an economic measure—mean decreases in certainty.

Since the mid-1980s, U.S. economic growth has become less volatile than it was in earlier decades. During the period from the 1950s through the early 1980s, quarterly employment growth ranged from around 2.0 percent to -1.5 percent. Since the mid-1980s it has fluctuated in a narrower range, from a little less than 1.0 to -0.5 percent. The volatility of growth in output has also shrunk.

What accounts for this moderation in volatility? Has it varied among the States and industries that compose the national economy? Gerald A. Carlino, in “The Great Moderation in Economic Volatility: A View from the States” (*Business Review*, First Quarter, 2007, Federal Reserve Bank of Philadelphia) says the underlying possible causes of the “great moderation” can be grouped into three categories: better policy, good luck, and structural change.

An example of better policy was the emphasis the Federal Reserve placed on controlling inflation during the Volcker-Greenspan era. Planning is well served by low and stable inflation, thus, the Federal Reserve may be increasing stability of employment and output growth by keeping inflation under control.

Good luck might have come in the form of fewer or smaller “shocks” such as natural disasters, political crises, and work stoppages that affect the economy.

Examples of structural change include improved inventory management and just-in-time production practices, banking deregulation, globalization, and the decline in union membership. A significant example of structural change was the contraction of the more volatile goods-producing sector and the expansion of the relatively more stable service sector.

The goods-producing sector includes the industries with the highest measures of employment growth volatility: mining, construction, and manufacturing. Although these industries are more volatile, employment growth volatility has declined in these industries from the 1956–83 period to the 1984–2002 period just as it has declined in almost every other industry.

Every State recorded a reduction in the volatility of employment growth from the 1956–83 period to the 1984–2002 period. The largest decreases were seen in West Virginia, Michigan, Ohio, Indiana, and Pennsylvania. The smallest decreases were in New Jersey, New Hampshire, and New York.

Further exploration of the great moderation of economic volatility at the national and State levels may yield findings that will be useful to policymakers.

Productivity gains: who benefits?

As labor productivity in the United States has increased over the last decade or so, analysts have tended to focus on the *reasons* for productivity gains, rather than on their *effects*. Technological advances and increased

computer use in the workplace are frequently cited reasons, for example. But in a recent study published in the Federal Reserve Bank of Kansas City *Economic Review* (first quarter 2007), senior bank economist Jonathan L. Willis and co-author Julie Wroblewski do look at the effects of increased productivity on the distribution of income. The authors examine changes in compensation for labor and physical capital, as well as changes in the distribution of household income during two different periods of productivity growth, 1973–95 and 1996–2006, when annual productivity growth averaged 1.4 percent and 2.8 percent, respectively.

Willis and Wroblewski find that the shares of income allocated to labor and the owners of physical capital were stable, on average, during both periods. Thus, by this measure, the distribution of income was unaffected by changes in the rate of productivity growth. But they also find substantial changes in the distribution of household income, especially during the more recent period of strong productivity gains. Since 1996, low-income households have experienced no gains in real income. By contrast, real income growth among the top 10 percent of households kept pace with or exceeded productivity gains in that period. The authors attribute part of the disparity to unequal distribution of the benefits resulting from increased productivity. But they also acknowledge that technological advances during the period of strong productivity growth increased the demand for high-skilled workers, which likely would result in larger compensation gains for those workers relative to lower skilled workers. Other factors cited by authors include changes in labor market institutions and fiscal policy, and the acceleration of compensation for CEOs. □