Mitchell's Musings 7-21-14: Coordination Failure or Success?

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Economists have long had the concept of a "coordination failure," often applied in the context of negative externalities that could be avoided if only there was a coordinator. A classic example is overfishing. It is rational for each fishing boat to maximize its catch, even if the collective result is to deplete the stock of fish available in the future. However, all would be better off if there was a regulator that collectively restricted the amount of fishing allowed by each boat.

In the case above, the failure to coordinate produces a bad result. But there are forms of coordination that potentially produce bad results for society even if they produce good results for a subset of participants. For example, if competitive firms find a way to collude, e.g., a cartel of some type, the firms involved are likely to be better off. But consumers will be worse off and a suboptimal level of production will occur to keep the price high.

At the time of the 1992 Los Angeles Riots, it was argued that television acted as a coordinator for looting. Local TV showed that the police were not able to respond. Indeed, the greater the number of looters, the less the police are able to respond. So, at a point, the number of looters becomes self-encouraging. Coordination (by TV) produced a societal loss.

It is likely that phenomena that occur in waves have aspects of implicit coordination. Crime rates go up and down and the usual suspects of explanations such as demographics don't explain the fluctuations, or don't completely explain them. If there is more crime, the effectiveness of the police declines and the word gets out that the probability of getting caught has fallen – which makes committing a crime less risky. It is as if a coordinator had organized potential criminals to commit more crime simultaneously, again benefiting them but not society.

One suspects that the current influx of unaccompanied children as immigrants to the U.S. has elements of a *de facto* coordinator. The influx is attributed in the news media to rumors in Central America that the U.S. had softened its immigration policy. Regardless of the truth of that rumor – and there is some disagreement as to whether a policy change occurred – once lots of people begin coming, the immigration system becomes overwhelmed. It is as if a coordinator told potential immigrants to come *en masse* and at the same time. When the system becomes overwhelmed, word gets back that as a practical matter policy has softened and the process repeats.

Bubbles in financial markets have similar explanations. Prices will go up if demand for assets increases. Asset holders are better off if their assets gain in value but normally they can't act collectively to bid up prices. However, if there is something that starts a rise in the market consensus price, the gain in asset value as the price goes up triggers momentum trading. The price begins going up because it is going up. The process becomes self reinforcing.

All of the examples above involve a kind of coordination without an explicit coordinator. No one is producing mandatory regulations affecting behavior. Unlike the fishing story, where an explicit legal regulator comes in and limits the catch to some mandatory quota, events and observations instead act as coordinators. An interesting question is whether there are counterparts to these tales in the labor market.

One of the puzzles of the early 21st century has been the drop in labor force participation and the employment-to-population ratio. Both are shown below as Figures 1 and 2. Both ratios have the same base, the civilian non-institutional population age 16 and over. But the participation rate includes both employed and unemployed persons in the numerator while the employment-to-population includes only the employed. The employment-to-population ratio is very sensitive to the business cycle and can be seen to be more erratic. Since the participation rate has the sum of employment (which falls in recession) and unemployment (which rises in recession), it is smoother and less affected by the business cycle.

Figure 1: Employment-to-Population Ratio (percent), Seasonally Adjusted

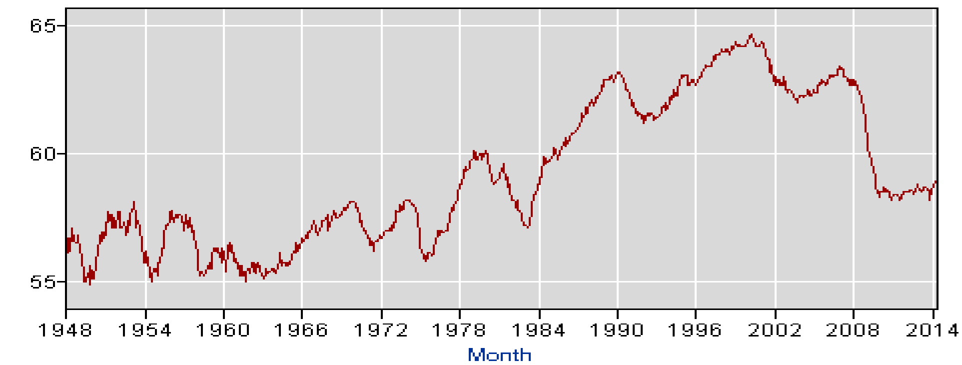
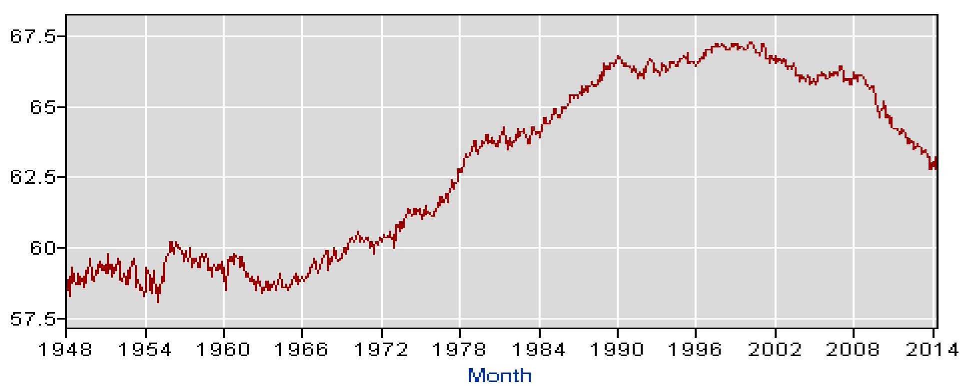


Figure 2: Labor Force Participation (percent), Seasonally Adjusted



Both indexes show a reversal in the early 2000s of the secular upward trend that began in the 1960s and is largely the result of more women coming into the workforce. There are many explanations that can be offered for that rise including the birth control pill and changing norms around the idea of women – particularly women with children – working outside the home. But the question is why did norms change? One possibility is that norms are based on what others are doing. So if more women are in the workforce, the norms shift to "society" expecting women to work.

If the rise in workforce activity had bubble-like elements – i.e., an implicit coordinator – then like other such phenomena at some point the bubble bursts. In this case, the reversal of the labor market bubble seemed to terminate with the end of the dot-com financial bubble. Jobs become less available and the word gets out. You begin to hear about "discouraged" workers, those folks who stop seeking work because they believe none is available. The bursting of the subsequent housing bubble added to downward trend shown on Figures 1 and 2.

In the period after the Great Recession, not only was there much talk about discouraged workers but also about a "New Normal" in which jobs allegedly would forever be harder to get because you needed new skills. On the demand side, employers were said to be cautious about hiring or some other story was offered about why employers should not be hiring. New Normal type stories can also be self reinforcing. One thing we know employers do is to find out what other employers are doing. Benchmarking is the term of art for that tendency. If there is said to be a New Normal in which hiring should be more limited than in the past, then there will be such a New Normal.

It is interesting that the two drops in workforce activity rates occurred in conjunction with two financial bubbles: dot-com and housing/mortgage. Perhaps financial reversals are more dramatic that other types of economic downturns and command more attention. Suddenly, your wealth evaporates. Suddenly, you house is worth less than your mortgage.

In any event, if my interpretation is correct, i.e., that there is *de facto* coordination on both sides of the labor market which is currently impeding recovery, then you need an explicit coordinator to counteract it. In essence, that is what macroeconomics and macro policy is all about. It's about trying to create conditions in which expectations about a New Normal of scarce jobs is replaced by a New-New Normal that, if anything, tilts toward labor shortage. Other than at the Federal Reserve, with its low interest rate policy, there hasn't been much done of late to achieve a New-New Normal. Just as dramatic events created new pessimistic expectations, something dramatic is needed to create a reversal of expectations.

We learned from the Great Depression that hoopla is not enough to change pessimistic expectations. Back then there were parades, movies, and other efforts to reframe the situation. [https://www.youtube.com/watch?v=4jiUu8od_I8][1] Those kinds of

[1] NRA in this video stands for National Recovery Act of 1933 (not National Rifle Association).

approaches don’t work. The one thing that is left is the fiscal approach, as John Maynard Keynes pointed out at the time.