The Reasons Behind the Obama Non-Recovery

It wasn’t the severity of the Great Recession that caused the weak recovery, but government policies.

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The Obama administration and some economists argue that the recovery since the Great Recession ended in 2009 has been unusually weak because of the recession's severity and the fact that it was accompanied by a major financial crisis. Yet in a recent study of economic downturns in the U.S. and elsewhere since 1870, economist Tao Jin and I found that historically the opposite has been true. Empirically, the growth rate during a recovery relates positively to the magnitude of decline during the downturn.

In our paper, "Rare Events and Long-Run Risks," we examined macroeconomic disasters in 42 countries, featuring 185 contractions in GDP per capita of 10% or more. These contractions are dominated by wartime devastation such as World War I (1914-18) and World War II (1939-45) and financial crises such as the Great Depression of the 1930s. Many are global events, some are for individual or a few countries.

On average, during a recovery, an economy recoups about half the GDP lost during the downturn. The recovery is typically quick, with an average duration around two years. For example, a 4% decline in per capita GDP during a contraction predicts subsequent recovery of 2%, implying 1% per year higher growth than normal during the recovery. Hence, the growth rate of U.S. per capita GDP from 2009 to 2011 should have been around 3% per year, rather than the 1.5% that materialized.

Arguing that the recovery has been weak because the downturn was severe or coincided with a major financial crisis conflicts with the evidence, which shows that a larger decline predicts a stronger recovery. Moreover, many of the biggest downturns featured financial crises. For example, the U.S. per capita GDP growth rate from 1933-40 was 6.5% per year, the highest of any peacetime interval of several years, despite the 1937 recession. This strong recovery followed the cumulative decline in the level of per capita GDP by around 29% from 1929-33 during the Great Depression.

Given the lack of recovery in GDP, a surprising aspect of the post-2009 period is the strong employment growth. The growth rate of total nonfarm payrolls averaged 1.7% a year from

February 2010 to July 2016, despite the drop in the labor-force participation rate. The post-2009 period is not a jobless recovery; it is a job-filled non-recovery. Similarly, the drop in the unemployment rate—from 10% in October 2009 to 4.9% in July 2016—has been impressive, though overstated because of the decrease in labor-force participation.

What accounts for the strong recovery in the labor market combined with the non-recovery in GDP? Mainly weak growth of labor productivity. The growth rate of GDP per worker from 2010-15 was 0.5% per year, compared with 1.5% from 1949 to 2009. The recent productivity slowdown is clear since 2011 but may have started as early as 2004.

What could have promoted a faster recovery by enhancing productivity growth? Variables that encourage economic growth include strong rule of law and property rights, free trade, rolling back inefficient regulations and other constraints on market activity, public infrastructure such as highways and airports, strong institutions for education and health, fiscal discipline (including a moderate ratio of public debt to GDP), efficient taxation, and sound monetary policy as reflected in low and stable inflation.

The main U.S. policy used to counter the Great Recession was increased government transfer payments. Federal social benefits to persons as a ratio to GDP went from 8.7% in 2007 to 11.7% in 2010, then fell to 10.9% in 2015. The main increases applied to Medicaid, Medicare, Social Security (including disability) and food stamps, whereas unemployment insurance first rose then fell. Unfortunately, increased transfer payments do not promote productivity growth.

The 2007-08 financial crisis was also followed by vast monetary expansion involving increases in the balance sheets of the Federal Reserve and other central banks. The Fed’s expansion featured a dramatic rise in excess reserves, used to fund increased holdings of Treasury bonds and mortgage-backed securities. Remarkably, the strong monetary growth came without inflation.

The absence of inflation is surprising but may have occurred because weak opportunities for private investment motivated banks and other institutions to hold the Fed’s added obligations despite the negative real interest rates paid. In this scenario, the key factor is the flight to quality stimulated by the heightened perceived risk in private investment.

Given the need for productivity-enhancing policies, it is sad that recent policy suggestions from Donald Trump and Hillary Clinton have emphasized restrictions on trade and immigration and higher minimum wages. The former policies are equivalent to constraining technological progress. Expanded trade in goods and people is like better technology—both raise the total real value of goods and services that can be produced for given inputs. Mandating a higher minimum wage amounts to inefficient regulation of the labor market by pricing young and less-productive workers out of the job market.

At this point, it is hard to imagine U.S. policy makers participating in serious policy discussions aimed at promoting economic growth. But maybe I am too pessimistic—after all, the report on the U.S. fiscal situation in 2010 by the Simpson-Bowles Commission was very good. Too bad the Obama administration ignored it.

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