This economy could be as good as it gets

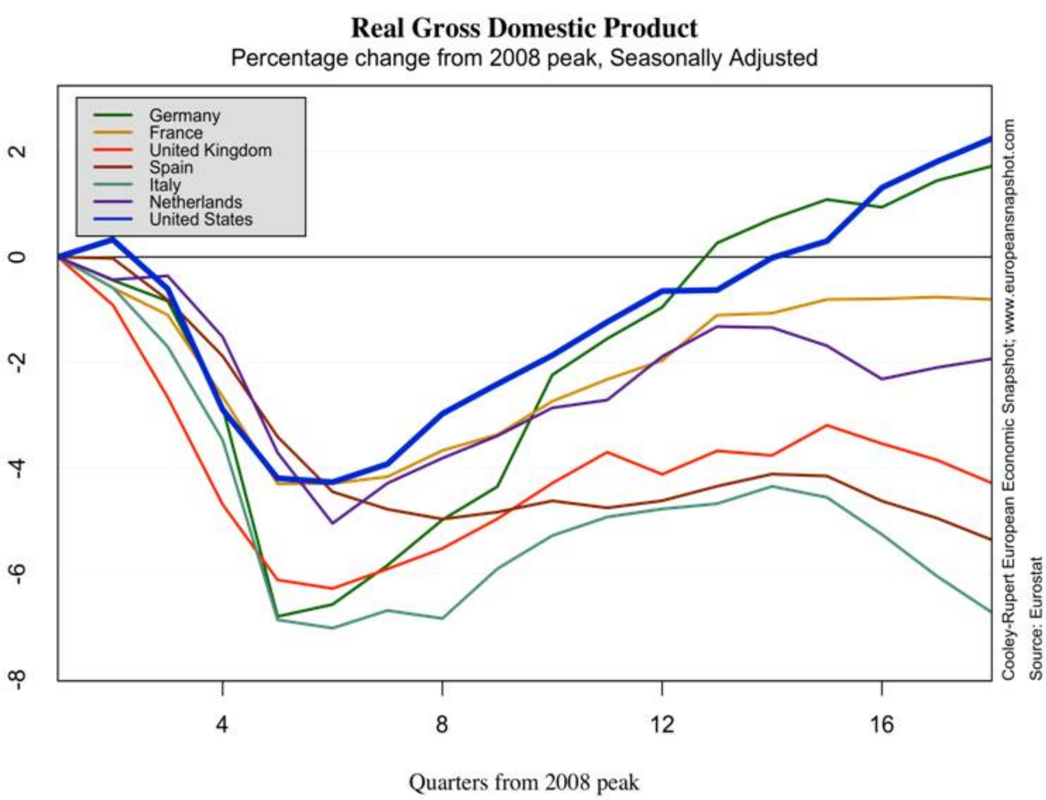
September 10, 2012 @ 3:26 pm

By Thomas Cooley and Peter Rupert

A familiar refrain that was popular in the early 1990s is making a comeback during the great recession of 2008-2009, which has rocked the economy and labor market for more than five years: Is it possible that the children of this generation will not be as well-off as their parents? The labor market has been hobbled. The duration of unemployment has reached unprecedented levels, and it is now the case that unemployed workers in certain age groups face the prospect of never being employed again. If all of this sounds grim (and it is), consider the possibility that this may be as good as it gets.

It is true that the depth of the recession and the current sluggish recovery are much different than anything we have seen since the Great Depression. But rather than look at the current recession in comparison with previous U.S. recessions, consider its comparison with Europe. The events in Europe that sent crippling shockwaves through much of the world might be of such a magnitude that the current speed of the recovery is fast enough. The current downturn is unusual because it was triggered by a large common shock, rather than the idiosyncratic components that usually put individual countries into a recession. We don't have a lot of experience with such shocks, so it may be useful to look across countries to see how others have fared.

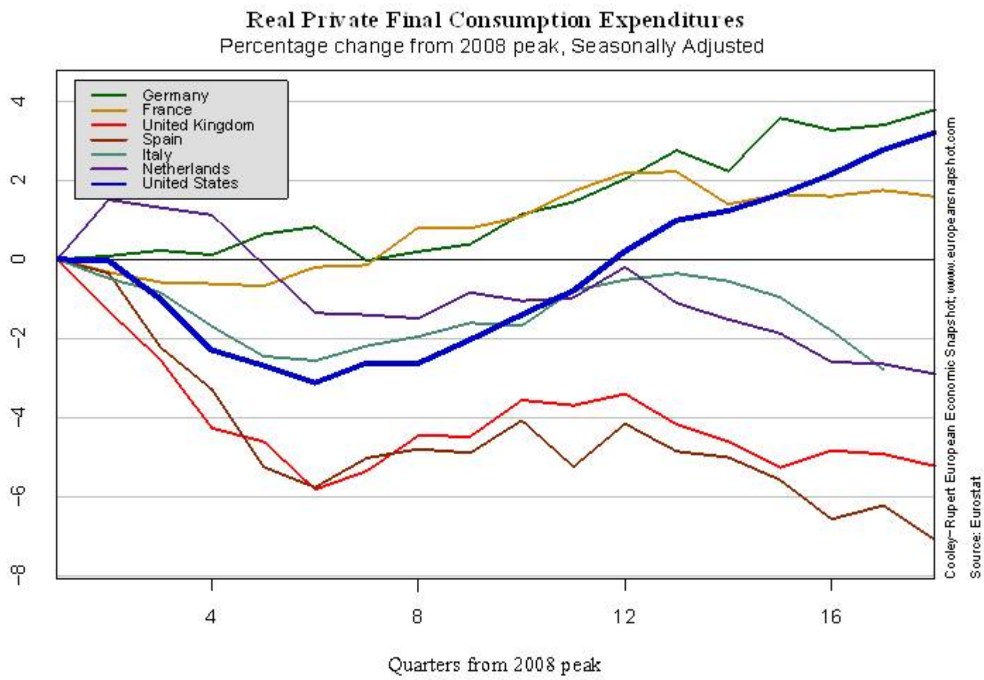
The U.S. economy accounts for about 22 percent of world GDP; the European Union is about 25 percent. The figure below from Europeansnapshot.com [1] compares the 2008 recession and recovery in the U.S. with those in the major economies of Europe. First note that the size of the contraction was much steeper in Germany, the UK and Italy, whose economies fell roughly 6 percent from their peak. In the U.S. it was more like 4 percent. But note as well that the recovery in the U.S. has been steady compared with these countries. All except Germany appear to be headed back into recession.



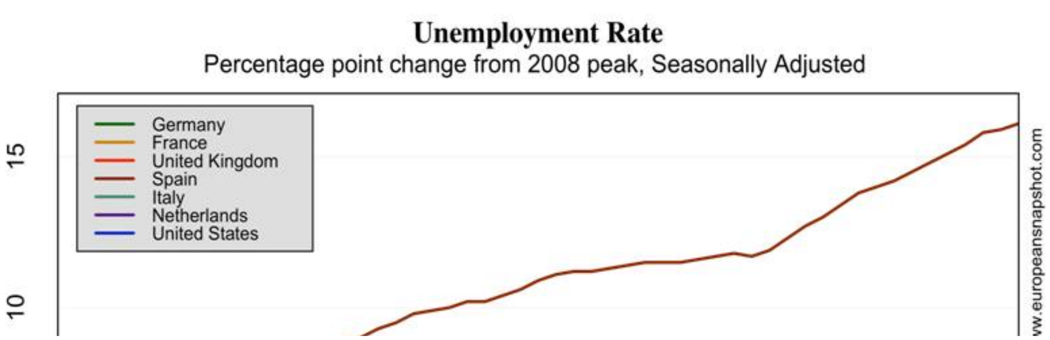
[2]

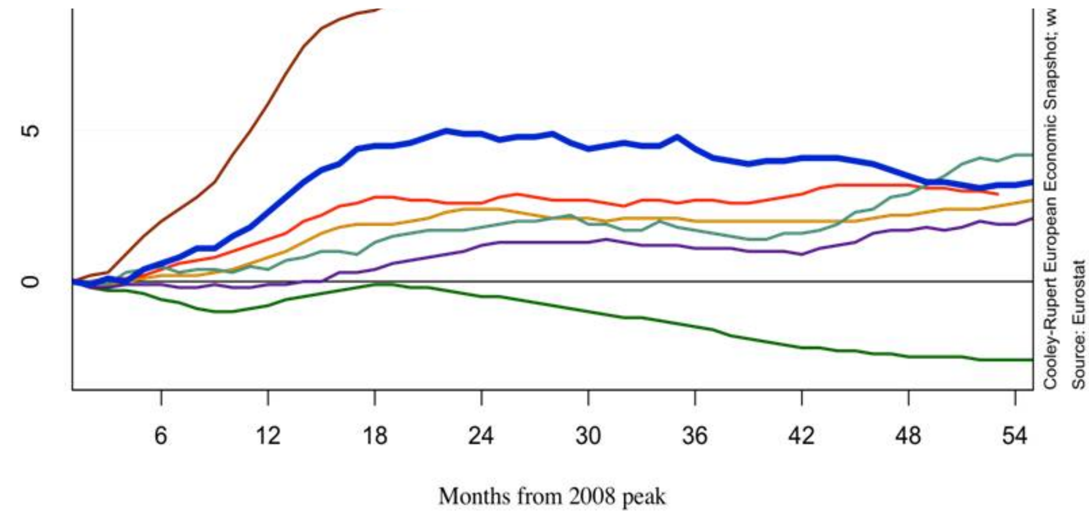
Many argue that the slow recovery in the U.S. is due to insufficient demand. As seen below, consumption – the biggest component of aggregate demand – never fell below its peak in Germany. In the U.S. it fell, but it has recovered and now looks very similar to where Germany is today.

The unemployment rate in the U.S. rose sharply in the first quarters of the recession, but it started from a level that was lower initially than most of the European comparison group. The U.S. is the only country other than Germany where unemployment has fallen from its peak.



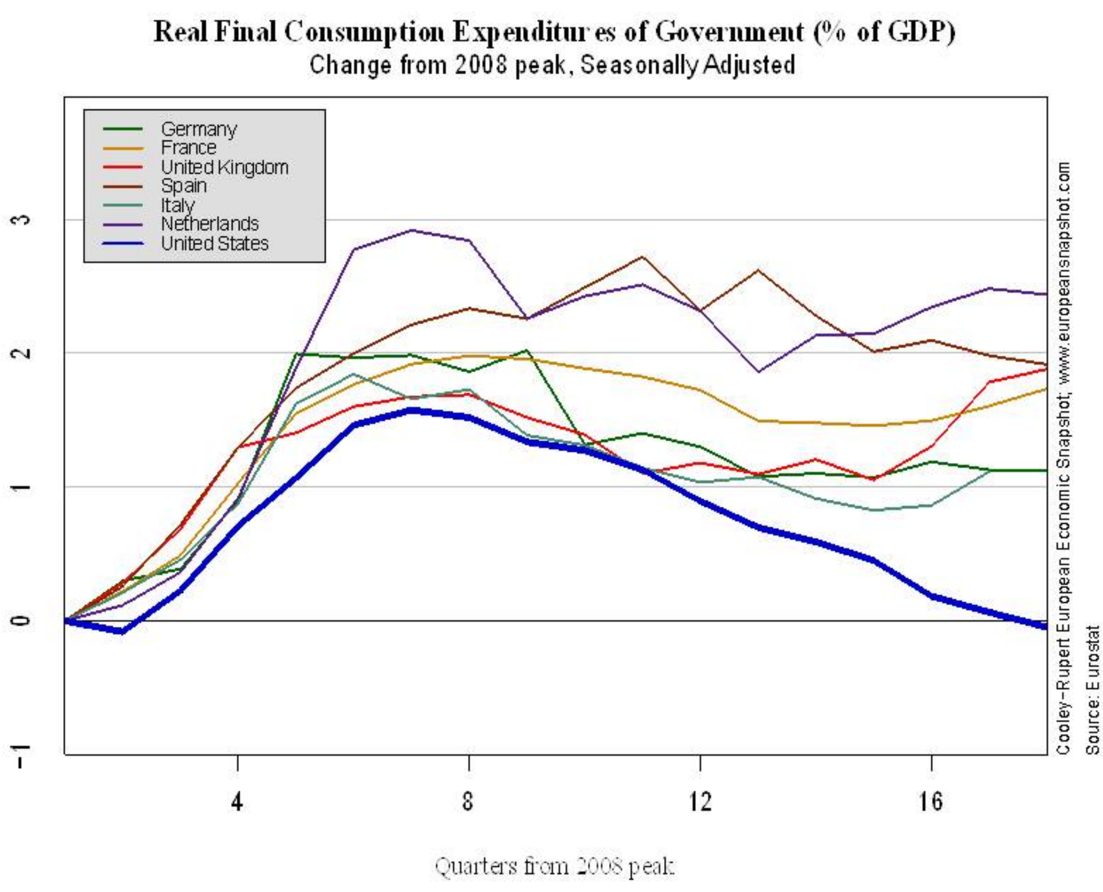
[3]





[4]

Considering how different the recovery has been across these economies, it seems reasonable to consider the role of policy responses by governments or central banks. The impact of "stimulus" is inherently difficult to measure. A simple measure of the change in government consumption as a percentage of GDP is shown below. One has to be careful in interpreting such data, but they don't suggest that the different recoveries are likely connected with governments' willingness to spend in response to the shocks – all of these governments increased spending – with very different results.



[5]

It is worth noting that the continental European economies depicted here all had the same monetary policy, but their economies responded very differently. Moreover, the U.S. the UK and the euro zone economies all engaged in quantitative easing that increased the sizes of their central bank balance sheets by a factor of 2.5 to 3.

There is one notable difference in the European economies. They have been quite variable in the extent that they have reformed labor market institutions and invested in human capital. Germany reformed its labor market beginning in 2003, while Spain and Italy have only now begun to think about it.

The evidence simply doesn't support the conclusion that governments can mitigate business cycle fluctuations through discretionary changes in aggregate public spending or even unconventional monetary policy.

The U.S. recovery is dismal when compared with other post World War Two recessions, and it is far from where it should be in terms of growth and employment. Labor force participation is the lowest it has been since 1979. But this may be the best that we can expect with the tools that the government has used. The important policy question to ask now is which structural reforms and investments in human capital can make our longer-term growth options better. If we focus on quick monetary or stimulus fixes rather than those questions, then we can't expect anything better than this slow, painful recovery.

[1] Europeansnapshot.com: **http://www.europeansnapshot.com/**
[2] Image: **http://blogs.reuters.com/great-debate/files/2012/09/cooleyslide12.jpg**
[3] Image: **http://blogs.reuters.com/great-debate/files/2012/09/Cooleyslide22.jpg**
[4] Image: **http://blogs.reuters.com/great-debate/files/2012/09/Cooleyslide31.jpg**
[5] Image: **http://blogs.reuters.com/great-debate/files/2012/09/Cooleyslide41.jpg**