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September 23, 2011

Why Such a Slow Recovery of the U.S. Economy?

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In a late August 2011 report, Ryan Kennelly and I examined the prospects for a double-dip recession and found no reliable indication that another U.S. recession was imminent. The most recent readings on the seven indicators that we examined—GDP growth, the stock market, fiscal policy, the unemployment rate, oil price shocks, the yield curve, and the U.S. index of leading economic indicators—still show that another U.S. recession is not imminent.

Nonetheless, we see the U.S. economy recovering only slowly from the deepest recession since World War II. This continued weakness can be puzzling, particularly when previous economic research (such as that by Balke and Wynne, 1992) finds that deep U.S. recessions have been typically followed by strong recoveries. What is so different about the current recovery?

This Time Is Different

Unlike the previous ten post-World War II recessions that the United States endured, the 2007-09 downturn was precipitated by a financial crisis. Economic research, including that by the International Monetary Fund (2009) and Reinhart and Rogoff (2009), shows that financial crises tend to lead to recessions that are more severe and recoveries that are substantially slower. In some cases, the crisis may affect economic growth for as much as a decade after the recession's official end.

What the researchers find is that financial crises create an uncertain environment that disrupts the relationships between lenders and investors and undermines private investment and job creation, which reduces consumer confidence and lowers consumer spending. The result is weakened economic activity and more uncertainty, both of which further undermine investment. Slower economic activity also puts stress on government revenues, which can lead to curtailed spending, higher tax rates and higher budgetary deficits. All these factors feed on each other, deepening the recession and slowing the subsequent recovery.

Using international data, Reinhart and Rogoff find that the average financial crisis creates a decline in GDP per person that lasts 1.9 years (Table 1). Other effects can take as long as five years.

Table 1. Average Peak-to-Bottom Changes from Severe Financial Crises

	Cumulative Change, %	Duration, Years
GDP per Person	-9.3	1.9
Stock Prices	-56	3.4
Unemployment Rate	7.0*	4.8
House Prices	-36	5.0

*percentage point change, low to high
Source: Reinhart and Rogoff (2009).

By these four measures, the United States fared somewhat better during its most recent recession than the average country hit with a financial crisis. As is shown in Table 2, U.S. GDP per capita sank only 6.4 percent from its prerecession peak and reached its bottom in 1.5 years. The Standard and Poor's (S&P) 500 sank 52 percent from its prerecession peak and reached bottom in 1.6 years—although it has since declined. The U.S. unemployment rate rose 5.7 percentage points from its prerecession low and reached a high in 2.4 years. U.S. house prices fell 36 percent from their prerecession peak and reached a bottom in 3.3 years—although they have since resumed falling.

Table 2. U.S. Peak-to-Bottom Changes, 2007-09 Recession

	Cumulative Change, %	Duration, Years
GDP per Person	-6.4	1.5
S&P 500	-52	1.6
Unemployment Rate	5.7*	2.4
Case-Shiller Index	-36	3.3

*percentage point change, low to high
Sources: CBER calculations based on data from U.S. Bureau of Economic Analysis, U.S. Census Bureau, Standard and Poor's, and U.S. Bureau of Labor Statistics

What the Financial Crisis Might Mean for the Pace of the U.S. Recovery

International experiences show that financial crises tend to result in economic activity staying below its precrisis path for many years. Financial crises have persistent effects on investment, labor productivity, employment, the unemployment rate and real GDP. The effect on growth is much less persistent, with most countries returning to their precrisis rates of growth about four years after the crisis.

According to analysis conducted by the World Bank (2009), the average financial crisis in other countries has meant that real GDP continues to remain below levels consistent with the precrisis trend for years after the financial crisis. At three to four years, the World Bank finds real GDP falls to about 7.5 percent below that implied by a continuation of the precrisis trend. From there, the average experience finds the economy resumes its precrisis pace of economic growth, but real GDP remains well below what would be projected on the basis of the precrisis trend.

Wynne (2011) shows that the U.S. experience resembles the international average through mid-2011, which is about three to four years since onset of the financial crisis. From here, a continuation of the international experience would mean that U.S. activity will continue to recover and the pace of economic growth can be expected to accelerate to prerecession rates in the next few years, but real GDP will remain well below levels that would be implied by a continuation of the precrisis trends. In taking such a path, U.S. real GDP will remain about 7 percent below potential (which also increases over time). Such growth means that employment will grow only fast enough to maintain U.S. unemployment rates in the current range around 9 percent for a sustained period of time. A complete recovery in which economic activity rises to its potential and the unemployment rate is reduced will take a much longer period of time and considerable readjustment in the economy.

Can Policy Make a Difference?

We can take some comfort in the prospect that the U.S. economy is likely to show more robust growth in the near future. Nonetheless, we also face the prospect of the economy running well below potential and unemployment remaining at high levels for a sustained period of time.

In early September 2011, Charles Evans (president of the Federal Reserve Bank of Chicago) said, "It bears keeping in mind that … predictions of a slow recovery are based on historical averages of macroeconomic performances across many different countries. … [T]here is nothing pre-ordained about these outcomes. … The economy can perform better than it did in these past episodes if policy responds better than it did in those situations."

What policies might be recommended? Evans has recommended redirecting U.S. monetary policy toward a hybrid target of lower unemployment and inflation fighting, an idea that Federal Reserve Chairman Ben Bernanke (2011) opposed as eroding Fed credibility. A few days later in September 2011, Richard Fisher (president of the Federal Reserve Bank of Dallas) maintained that the Federal Reserve System has provided all the monetary liquidity necessary for a recovery. It is up to the banks, investors and consumers to restore economic activity to its potential.

If banks, investors and consumers are to restore economic activity to its potential, more needs to be done to improve bank and consumer balance sheets. Ken Rogoff (2011) recently recommended a burst of inflation to make such improvements, but that may be too blunt an approach. A more surgical policy would be to restore consumer balance sheets by using government funds to reduce the amount that consumers owe on their mortgages to the market values of their houses. Those areas of the country where economic activity has been the strongest in recent years did not see the big swings in property values that left consumers holding mortgages that are much greater than the value of their houses.

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