The Economist

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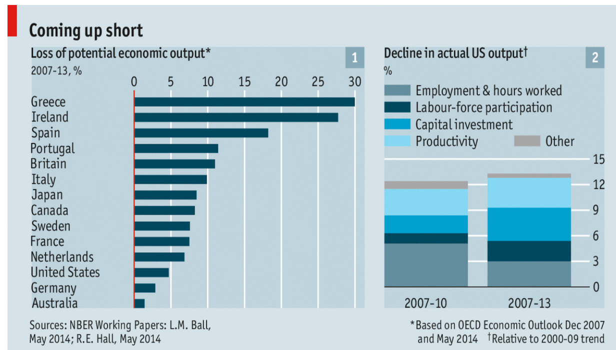
Wasted potential

Counting the long-term costs of the financial crisis

Jun 14th 2014 | From the print edition



THE rich world is at long last clawing its way from the economic ditch of the Great Recession. This year may be the first since 2007 in which all big advanced economies manage to grow. In May employment in America finally surpassed its pre-crisis peak. Later this year British output should regain the level it reached in early 2008. Yet relative to what was expected of them pre-crisis, rich economies are limping along, producing far less than once seemed possible and growing more slowly. New research suggests this weakness may last.

Since early in the recession economists fretted that it might leave permanent scars. A long slump can throttle investment, leaving economies ill-equipped to grow in future. Labour markets can succumb to "hysteresis", in which short-term joblessness leads to higher long-run unemployment as workers' skills, motivation and connections erode.

As the Great Recession retreats further into the past its toll becomes easier to assess. A new working paper by Laurence Ball of Johns Hopkins University tots up its costs by comparing estimates of pre- and post-crisis economic potential published by the Organisation for Economic Co-operation and Development (OECD), a club mainly of rich countries. Each year the OECD releases an economic outlook which includes estimates of members' potential economic output: the highest level of production each economy could feasibly sustain without igniting inflation. This is calculated based on long-run trends in investment, labour-force growth and the productivity of workers and capital; more of each means an economy boasts a greater economic capacity. Mr Ball extrapolates the trend in potential from 2000 to 2009 forward to 2015 and compares that trend-line with the OECD's most recent published figures, released in May.

A Germany-sized hole

Before the crisis some economies were operating a bit above their true potential, thanks to unsustainable credit growth. Yet in the tumult that followed, the rich world gave back that ground and much more. A few rich countries, like Australia and Switzerland, came through the past seven years largely unharmed. Most paid the macroeconomic equivalent of an arm or a leg (see chart 1). As of last year potential output was 4.7% below the pre-crisis trend in America and 11% below trend in Britain. The European periphery has fared even worse: potential output in Greece is about 30% below trend. By 2015 the weighted average loss among rich countries as a whole is projected to reach 8.4%—as if the entire German economy had evaporated.

In many rich economies the drop in potential output is almost as large as the fall in actual output. Were France to fulfil its current potential, GDP would be 2.7% higher than at present, but still 7.5% below what would have been possible were it not for the crisis. The figures suggest that many economies, in Europe especially, have suffered structural damage that can be fixed only with ambitious reform and booming investment—neither of which seems to be on the horizon.

In rather nasty fashion, the slump weakened growth through multiple channels. In another new working paper Robert Hall of Stanford University dissects America's "macroeconomic disaster" to better understand its elements. From the end of 2007 to 2013, American output fell by a cumulative 13.3% below the pre-crisis trend, with most of that shortfall—12.4 percentage points' worth—occurring by the end of 2010. Yet the causes of underperformance have shifted over time, reflecting a condition slipping from the acute to the chronic.

Mr Hall identifies four main contributors to disappointing growth: unemployment, labour-force participation, capital investment and productivity. Unemployment mattered most between 2007 and 2010, when the acute effects of the recession were most severe. Tumbling employment and reduced working hours account for roughly 41% of the decline in GDP relative to trend in that period. Yet these factors became less important over time; through 2013, they were responsible for only 22% of the shortfall (see chart 2).

Conversely, low rates of labour-force participation contributed just under 10% to the shortfall in actual GDP through 2010, but have become a more serious drag since then. About a third of the decline in participation is due to ageing, Mr Hall reckons. Although part of the rest could be reversed with stronger demand for labour, some forms of hysteresis, such as people leaving the workforce to claim disability benefits, will be permanent in the absence of vigorous reform.

Investment looms largest in America's disappointing recovery. America's capital stock is an astounding 13% below its pre-crisis trend. Housing accounts for much of that, and Mr Hall reckons over-investment pre-crisis is to blame. But investment in plant, equipment and intellectual property has also fallen short of the prior trend. That is thanks largely to firms' reluctance to take on medium-term risk, by making investments designed to pay off over a decade.

The investment shortfall may be contributing to weak productivity growth—the fourth culprit behind America's missing GDP. Mr Hall cautions that the data are too thin to draw a direct link between the recession and disappointing productivity growth. But he reckons there is little reason to expect any of the ground lost in recent years to be made up, in the absence of an unexpected technology bonanza.

And America is lucky: its potential growth rate, henceforth, is expected to perk back up to just a bit below the pre-crisis trend, according to Mr Ball's analysis. Where demography and productivity look worse, the picture is far more grim. The rich world survived its years of crisis, but will long be marked by the ordeal.

Sources

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From the print edition: Finance and economics