

WHAT RECOVERY?

THE CASE FOR CONTINUED EXPANSIONARY POLICY AT THE FED

REPORT BY **J.W. MASON** | JULY 25, 2017

The question of whether or not the economy is operating at its full potential is critical for policymakers who might intervene—through monetary or fiscal policy—if GDP is lagging. The question is similarly important to the workers, investors, and businesses who see their prospects rise and fall with GDP growth.

Today's dominant story, told by the Federal Reserve, the media, and many prominent economists, is that the economy has recovered from the recession and is growing about as fast as it can without overheating. This outlook has led the Fed to increase interest rates four times since December 2015, ending the historically low rates it maintained for nearly a decade. As evidence that the economy is at potential—i.e. is utilizing all productive labor, capital, and resources—many cite the unemployment rate of 4.3 percent. This is the lowest it has been since 2001, and it's expected to continue falling, although inflation remains below the Fed's 2 percent target.

However, Roosevelt Fellow J. W. Mason, among others, questions the premise that we have achieved full employment and GDP is currently at potential. In *“What Recovery? The Case for Continued Expansionary Policy at the Fed,”* he shows that output in 2016 remains well below pre-recession expectations. Low demand and reduced investment, he argues, have kept labor and capital on the sidelines. To achieve the kind of high pressure economy that promotes investment, raises wages, and increases work force participation, the Fed should pursue much more expansionary policy.

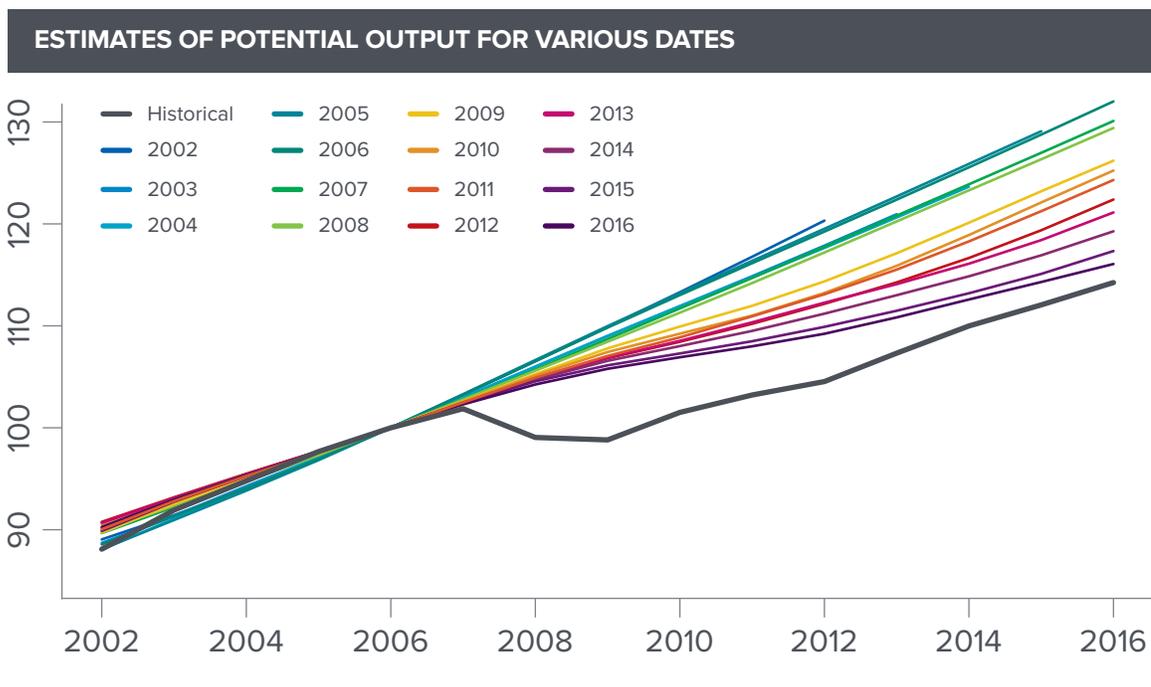
Below, we outline Mason's argument that—nearly a decade after the financial crisis—the economy is still suffering from weak demand. Most importantly, his paper asks policymakers to weigh the risks of error. Continuing expansionary policy if the economy is already at potential will, at worst, lead to inflation rates higher than the targeted 2 percent. But tightening policy while GDP remains below potential could cement current lows in labor force participation and productivity, holding back output for years to come.



WHAT RECOVERY? GDP HAS NEVER RETURNED TO THE PRE-2007 TREND.

U.S. GDP has not recovered from the 2008 financial crisis. Unemployment has returned to the level considered to be full employment, and price inflation is close to—if still short of—the Fed’s 2 percent target, seeming to indicate that the economy is using all productive labor, capital, and resources, or “operating at potential”. But participation in the labor force has declined and labor productivity (output per worker) has stagnated. The result: Output (or GDP) remains 15 percent below the pre-2007 trend line, a gap that is getting wider, not narrower, over time.

There is no historical precedent for the GDP slowdown, nor was it predicted by pre-recession forecasts. In the 60 years since World War II, periods of above-average growth have followed periods of below-average growth, and vice versa. But this is not the story since the Great Recession. The apparent recovery—the closing of the gap between potential GDP and actual GDP—is due to downward revisions of the estimated potential output. These estimates have been steadily revised downward since 2007, as economic growth has continued to disappoint. And so while the proverbial GDP ball has gotten closer to its goal, that is because the goalposts have been moving backward, not because the ball has been moving forward.



CBO estimates/forecasts of potential output for various years. The heavy black line shows the historical path of GDP. The colored lines show historical and forecast estimates of potential output for each year from 2002 through 2016. The blue-green lines are estimates made before the recession, while the red-purple lines are estimates made after the recession. The 2006 value is set to 100. Source: CBO, author’s analysis.



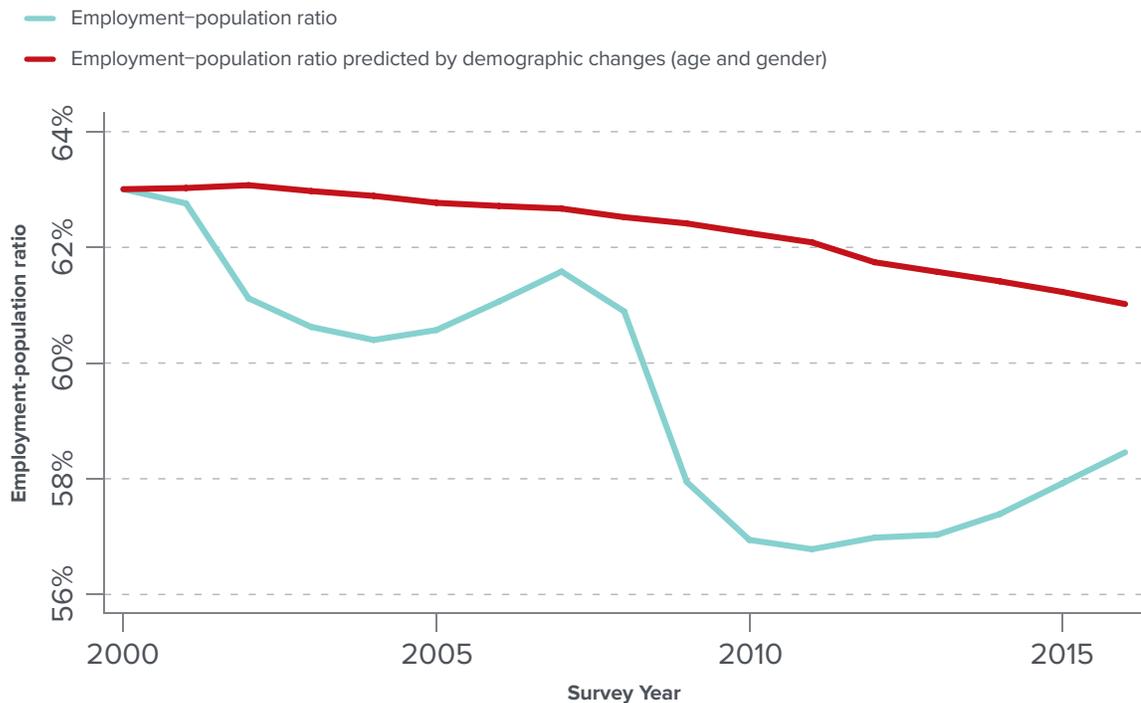
DISCOUNTING THE DOMINANT NARRATIVE

Many economists argue that factors unrelated to the recession—namely, an aging population and slowing technological progress—account for recent declines in output growth. But these theories are flawed. Such ‘supply-side’ factors can explain at most half the decline in employment and don’t offer a plausible account of the slowdown in productivity growth.

Demographic changes do not explain low labor force participation

About half of the gap between actual output and the pre-recession output trend is due to reduced labor force participation. Some economists attribute the decline in labor force participation to an aging U.S. population; retirees don’t work. However, our analysis shows that changes in the age and gender composition of the U.S. population explain only about 40 percent of the reduction in employment. The majority is due not to an aging population, but to decreased labor force participation rates among working-age Americans.

ACTUAL EMPLOYMENT-POPULATION RATIO VS. DEMOGRAPHIC-BASED PREDICTION



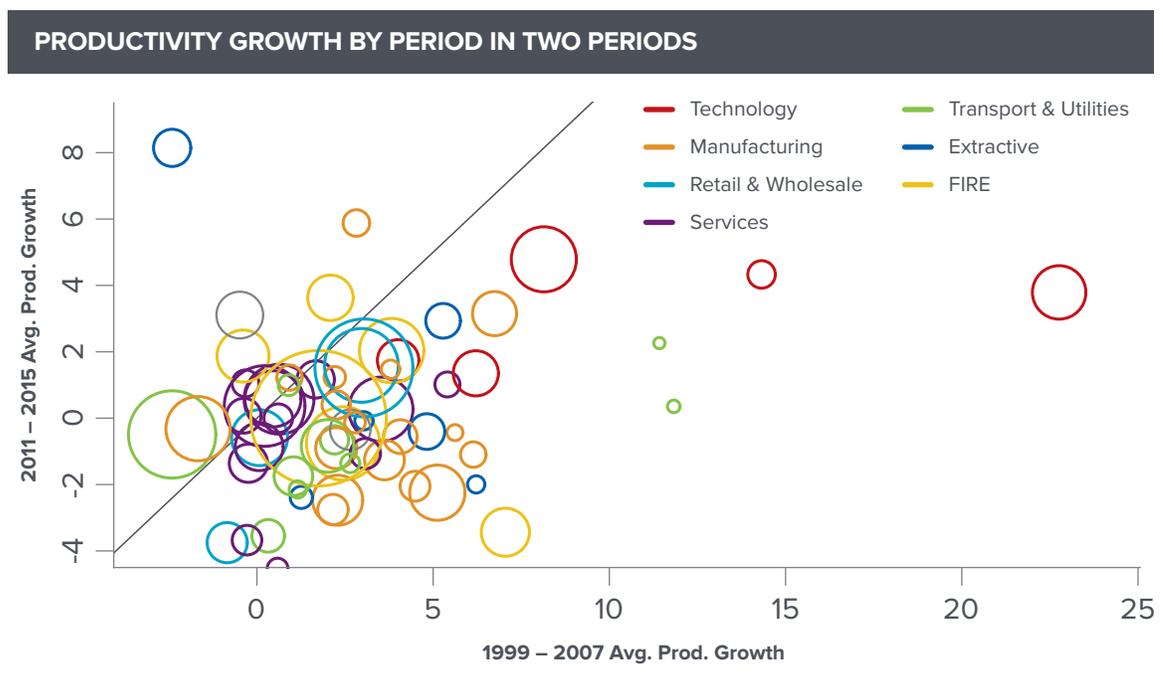
Employment-population ratio is the fraction of all civilians aged 15+ who are employed. The demographic prediction shows how the employment-population ratio would have evolved after 2000 if, in each year, the employment rate within each demographic group (e.g. 28 year-old females) had remained constant while the size of these groups changed. *Source: CEPR, Current Population Survey, author's analysis.*



Slowing technological progress does not explain low productivity

Reduced productivity—output per worker—accounts for the remaining gap between actual output and its pre-recession trend. Here, some economists point to slowing technological progress in Internet technologies, a major driver of growth in the 1990s and early 2000s.

But an emphasis on IT overlooks that productivity slowed across sectors; reduced tech productivity accounts for only about 40 percent of the overall decline. Moreover, a narrow focus on technological growth ignores that technology may be employed more productively under stronger economic conditions. For example, businesses may have invested so little since the recession because existing capital sufficed to satisfy the reduced demand for their products.



Productivity growth by industry. The horizontal axis shows average annual real productivity growth over 1999-2007, the vertical axis shows average annual real productivity growth over 2011-2015. The size of the circles is proportional to the average employment in the industry over the full period. *Source: BEA, author's analysis.*

At a macro-economic level, even these supply-side stories point to weak demand

One cannot explain the state of the economy without a prolonged slump in demand, even if an aging population and slowing technological growth really did decrease the economy's productive potential, and even if these independent shifts happened to coincide with the recession. If the demand for goods had continued to increase while the economy's ability to supply those goods slowed, then we would expect prices to rise, but instead we have observed record lows in inflation despite the Fed's attempts to stimulate the economy.

THE ECONOMIC REALITY AND WHAT TO DO ABOUT IT

The economy is suffering from the prolonged recession

The full range of macroeconomic indicators—low inflation, interest rates, and business investment; slow output, employment, and productivity growth; and a declining labor share of income—point to an economy plagued by weak demand. Most likely, slack labor markets have caused discouraged workers to leave the labor force, while weak demand for products has discouraged productivity-boosting investment by businesses. In short, we are still suffering from the prolonged effects of the Great Recession.

Policymakers should call for increased spending to boost employment and output. Rather than raising interest rates, the Fed should adopt an expansionary stance that stimulates the economy.

We have not yet recovered from the recession. High interest rates or austere spending could cause labor force participation and productivity growth to calcify at their current, stunted levels. Contractionary policy also carries a small risk of deflation—a danger that current policy tools cannot address.

The risks posed by expansionary policy are comparatively remote. Even if the economy were at potential, the worst side effect of a stimulus would be to increase inflation—a problem we do not have yet and could easily deal with if it arises. In fact, many economists have suggested that the Fed seek out a higher level of inflation, in order to create more space to lower rates in future recessions. If inflation does occur, prices for scarce resources—in particular, labor—will rise first. And an increase in the wage share of income would, if anything, be a benefit rather than a cost.

View the full report at <http://rooseveltinstitute.org/what-recovery>.



ABOUT THE AUTHOR

J.W. Mason is a Fellow at the Roosevelt Institute, where he works on the Financialization Project, and an assistant professor of economics at John Jay College, CUNY. His current research focuses on the history and political economy of credit, including the evolution of household debt and changing role of financial markets in business investment. He also works on history of economic thought, particularly the development of macroeconomics over the twentieth century.

ACKNOWLEDGMENTS

We thank Laurence Ball and Jason Furman for their comments and insight. Special thanks for the research assistance from Amanda Page-Hoongrajok and John Sturm. Roosevelt staff Nellie Abernathy, Amy Chen, Mike Konczal, Katy Milani, Marshall Steinbaum and Alex Tucciarone all contributed to the project.

This report was made possible with generous support from the Open Philanthropy Project.

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