INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
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Why the U.S. Recovery Is Weak

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Returning to prosperity means figuring out what will be profitable to produce in the future.

Between 1950 and 1990—the days of old-fashioned inflation-fighting downturns engineered by the U.S. Federal Reserve—America's post-recession unemployment rate would fall on average 32.4 percent over the course of a year from its initial value toward its natural rate. If the U.S. unemployment rate had started to follow such a path after peaking in the second half of 2009, it would now stand at 8.3 percent, rather than 8.9 percent.

Unfortunately, none of the net reduction in the U.S. unemployment rate over the past year came from increases in the employment-to-population ratio; all of it came from declining labor-force participation. Unemployment has fallen from 10.1 percent over the course of the past eighteen months, but the employment-to-population ratio has remained stuck at 58.4 percent. Perhaps it would be better if unemployed people who could have jobs—and who at full employment would have them—were actively looking for work rather than out of the labor force completely.

What America needs now is not just a recovery in demand, but also structural adjustment.

If you take that view, between 1950 and 1990, the U.S. employment-to-population ratio would rise an extra 0.227 percent annually on average for each year that the unemployment rate was above its natural rate. If the U.S. employment-to-population ratio had started to follow such a path after its 2009 peak, the current ratio would be 59.7 percent, rather than 58.4 percent. (In that case, we would be experiencing "morning in America," rather than the current state of economic malaise.)

This is, I think, the best metric to use to quantify the decidedly sub-par pace of today's jobless recovery in the United States. It is not out of line with other American yardsticks: since the output trough, real GDP has grown at an average rate of 2.86 percent per year, barely above the rate of growth of the U.S. economy's productive potential. And it is not out of line with the experience of other rich economies, whether Japan or in Europe.

Indeed, today's U.S. predicament contrasts sharply only with the current experiences of developing Asia. There, real GDP growth and declining unemployment show a solid, well-entrenched, and rapid recovery—to the point that inflation will soon become a more significant macroeconomic problem than job creation.

The obvious hypothesis to explain why the current U.S. recovery—like the previous two—has proceeded at a sub-par pace is that the speed of any recovery is linked to what caused the downturn. A pre-1990 recession was triggered by a Fed decision to switch policy from business-as-usual to inflation fighting. The Fed would then cause a liquidity squeeze and so distort asset prices as to make much construction, sizable amounts of other investment, and some consumption goods unaffordable (and thus unprofitable to produce). The resulting excess supply of goods, services, and labor would cause inflation to fall.

As soon as the Fed had achieved its inflation-fighting goal, however, it would end the liquidity squeeze. Asset prices and incomes would return to normal. And all the lines of business that had been profitable before the downturn would become profitable once again. From an entrepreneurial standpoint, therefore, recovery was a straightforward matter: simply pick up where you left off and do what you used to do.

After the most recent U.S. downturn, however (and to a lesser extent after its two predecessors), things have been different. The downturn was not caused by a liquidity squeeze, so the Fed cannot wave its wand and return asset prices to their pre-recession configuration. And that means that the entrepreneurial problems are much more complex, for recovery is not a matter of reviving what used to be profitable to produce, but rather of figuring out what will be profitable to produce in the future.

As the economist Dan Kuehn likes to say, a recession is like somebody knocking your jigsaw puzzle, disturbing the pieces, and turning some of them over. When the Fed ends a liquidity squeeze, it turns the pieces right-side up. So it is easy to reassemble the puzzle. Now, however, there is no one to turn the pieces right-side up, so things are much harder to correct.

Indeed, I believe that things are even worse: as long as aggregate demand remains low, we cannot even tell which pieces are right-side up. New investments, lines of business, and worker-firm matches that would be highly productive and profitable at normal levels of capacity utilization and unemployment are unprofitable now.

So what America needs now is not just a recovery in demand, but also structural adjustment. Unfortunately, the market cannot produce a demand recovery rapidly by itself. And it cannot produce structural adjustment at all until a demand recovery is well under way. ◆

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