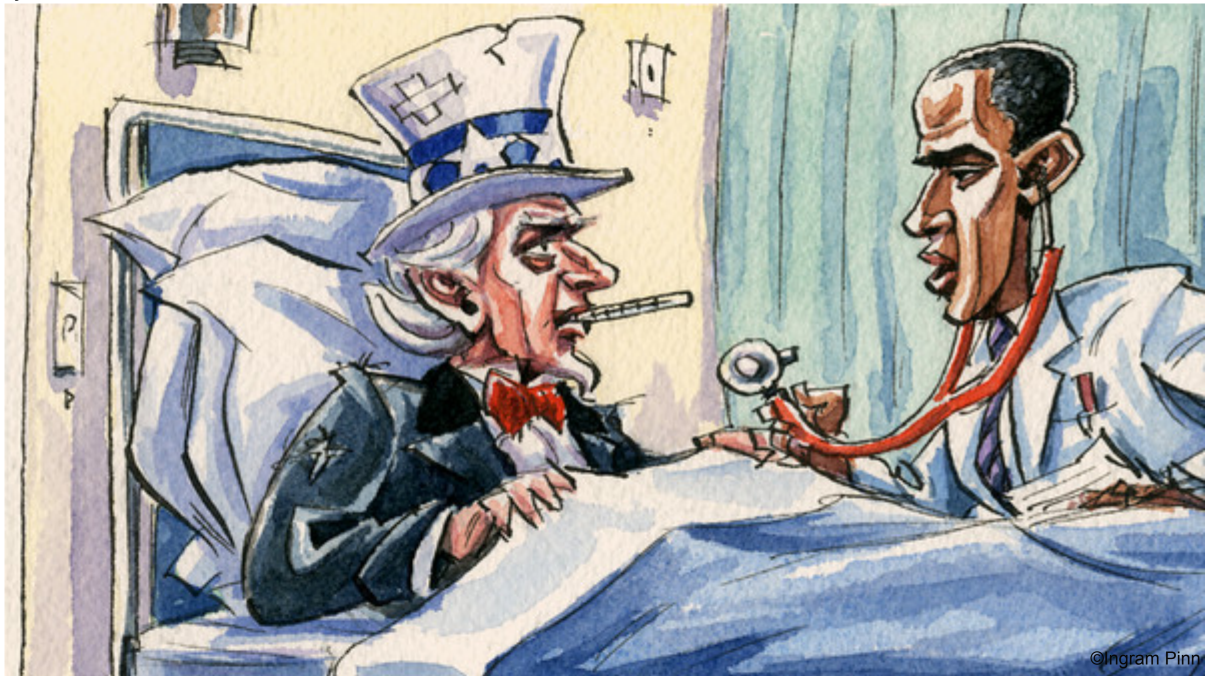
FINANCIAL TIMES

October 23, 2012 7:25 pm

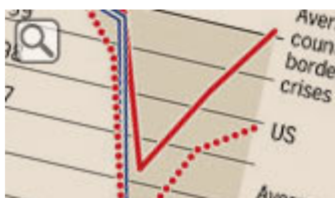
A slow convalescence under Obama

By Martin Wolf



How badly has the US economy performed under President Barack Obama? Ronald Reagan posed the political version of this question in his presidential debate against Jimmy Carter in 1980, when he asked: “Are you better off than you were four years ago?” It is, naturally, the question Mitt Romney asks now.

At first glance, the answer is: just a little better off. In the second quarter of 2012, real gross domestic product was 5.2 per cent higher than in the fourth quarter of 2008, the last full quarter before Mr Obama took office. The seasonally adjusted unemployment rate of 7.8 per cent in September was the same as in January 2009. Yet, since he took office when the economy was in the throes of a huge financial crisis, analysts must ask whether this performance is decent in the circumstances, as supporters argue, or disappointing, as opponents insist.



Click to enlarge

John Taylor, professor at Stanford University, a highly regarded macroeconomist, has no doubt of the answer. In a recent blog, he argues that strong growth normally follows US financial crises, the exception to this rule being the current recovery (see chart). Moreover, he argues, bad policy is to blame. True, Prof Taylor is a member of Mr Romney’s economic team. Yet the question remains: is he right? The

answer is: no. But it is important to ask why.

The first question is whether Prof Taylor is comparing like with like. Against him is widespread agreement that the aftermaths of systemic financial crises are worse than those of more normal downturns. The seminal research of Carmen Reinhart and Kenneth Rogoff in their classic book, *This Time is Different*, has shaped this consensus. It is also supported by the work of the economic historian Alan Taylor, of the University of Virginia, included in a recent paper entitled *The Great Leveraging* .

Profs Reinhart and Rogoff distinguish a "systemic financial crisis" as one characterised by a real estate bubble and high levels of debt. Neither of these preceded the recessions of 1973 and 1981, which are included in Prof Taylor's chart. Both the precursors and results of the recent crisis were quite different from the downturns in the mid-1970s, early 1980s and early 1990s. This is true of real house prices, inflation, interest rates and debt (see chart).

The second question is whether speed of recovery is a good measure of success. The answer is: no. To understand this, focus on the systemic financial crises that began in 1893, 1907, 1929 and 2007, respectively. In his chart, Prof Taylor relies on a paper by Michael Bordo of Rutgers and Joseph Haubrich of the Federal Reserve Bank of Cleveland. My chart uses their data, in which recoveries have the same duration as prior contractions. What marks out the recent recession is not the weakness of the recovery, but that of the contraction. The main reason the recovery seems weak was that the contraction was so mild, given the scale of the financial crisis. That was a huge policy success.

In their response to Prof Bordo and Mr Haubrich, Profs Reinhart and Rogoff also note that the economic contraction after the recent crisis was smaller than after prior systemic crises. Moreover, five years on, real GDP per head, relative to the baseline, is higher than in the average of prior systemic crises. That is what matters. A stronger recovery from a steeper plunge is hardly a better outcome than a slower recovery from a milder plunge.

The third question is whether it makes sense to focus on US experience alone. Prof Bordo has complained that Profs Reinhart and Rogoff lump together countries "with diverse institutions, financial structures and economic policies". But it beggars belief that the US of the late 19th or early 20th centuries, with the gold standard, no deposit insurance, no central bank before 1913 and minimal federal spending is more similar to today's US than Japan or Sweden in the 1990s or Spain and the UK today. Profs Reinhart and Rogoff are surely right to reject this appeal to American exceptionalism. Beyond that, limiting the analysis to US experience also limits the range of comparisons, thereby forcing the researchers to include many US recessions that are of borderline relevance, at best, to the needed focus on systemic crises.

The international comparisons made by Profs Reinhart and Rogoff turn out to be quite revealing. The performance of the US in this crisis has been markedly better than the average of the other high income countries that were hit by the recent wave of systemic

banking crises (see chart). Again, the analysis supports the view that systemic financial crises do cause deeper and longer-lasting recessions. Using a database of more than 200 recessions over 140 years in 14 high-income countries, Prof Taylor argues that the combination of a credit boom with a financial crisis imposes "abnormally severe downward pressures on growth, prices and capital formation for sustained periods".

In sum, we have no reason to regard the performance of the US economy under president Obama as poor, given the conditions he inherited. But this does not mean that recovery could not have been far stronger. Policy was insufficiently supportive of a stronger recovery. That is partly because the administration underestimated the forces for contraction. It is still more because of the opposition of the Republicans to any stimulus. In an economy afflicted by the implosion of a huge credit boom, the forces for contraction were bound to be both strong and enduring. With interest rates at zero, the effectiveness of monetary policy was limited. Given this, the American Recovery and Reinvestment Act, which amounted to an average of a little under 2 per cent of GDP in the years it was effective, was plainly too small.

The great achievement of policy was to limit the severity of the post-crisis recession. This is largely due to the Federal Reserve and the decision to prevent a financial collapse in the autumn of 2008. But it is also due to sensible, albeit limited, action by the administration. Moreover, by historical and international comparisons, the US economy has performed quite well. Focusing on the recovery, without looking at the contraction, is clearly misleading. Finally, to the extent that the recovery was not stronger, the obstructionism of Republicans in Congress has to bear a sizeable part of the blame. But the big question is: what comes next? Who has the policies to ensure a strong and sustained US recovery? I intend to examine that question next week.

martin.wolf@ft.com

You may be interested in

- EU leaders focus sights on fiscal union
- Hollande voices frustration eurozone crisis
- Bavarian ally backs Merkel's balancing act
- Stop this campaign against ECB policy
- Clarity needed on euro's destination
- Rescue hopes boost Spanish bonds
- Kenny needs helping hand from Merkel
- Bank bailouts weigh on Austrian economy
- Rajoy takes long view over summit outcome
- Eurozone must do more than muddle through

Printed from: http://www.ft.com/cms/s/0/791fc13a-1c57-11e2-a63b-00144feabdc0.html

Print a single copy of this article for personal use. Contact us if you wish to print more to distribute to others.

© THE FINANCIAL TIMES LTD 2012 FT and 'Financial Times' are trademarks of The Financial Times Ltd.