Uncertainty and the Slow Recovery

In terms of U.S. output contractions, the so-called Great Recession was not much more severe than the recessions in 1973-75 and 1981-82. Yet recovery from the latest recession has started out much more slowly. For example, real GDP expanded by 7.7% in 1983 after unemployment peaked at 10.8% in December 1982, whereas GDP grew at an unimpressive annual rate of 2.2% in the third quarter of 2009. Although the fourth quarter is likely to show better numbers—probably much better—there are no signs of an explosive take off from the recession.

We believe two factors are behind this rather tepid rebound. An obvious one is the severe financial crisis that precipitated this recession, with many major financial institutions receiving large bailouts from the federal government. The confidence of bankers and venture capitalists has been shattered, at least for a while, and it will take time for them to recover from the financial turmoil of the past couple of years. The household sector also faces a difficult period of financial retrenchment in the wake of a major collapse in home prices, overextended debt positions for many, and high unemployment.

The second factor is less obvious, but possibly also of great importance. Liberal Democrats won a major victory in the 2008 elections, winning the presidency and large majorities in both the House and Senate. They interpreted this as evidence that a large majority of Americans want major reforms in the economy, health-care and many other areas. So in addition to continuing and extending the Bush-initiated bailout of banks, AIG, General Motors, Chrysler and other companies, Congress and President Obama signaled their intentions to introduce major changes in taxes, government spending and regulations—changes that could radically transform the American economy.

The efforts to transform the economy began with a fiscal stimulus package of nearly $800 billion. While some elements served the package's stated purpose and helped to soften the recession's impact, the overall package was not well designed to foster a speedy recovery or set the stage for long-term growth. Instead, the "stimulus" was oriented to sectors that liberal Democrats believe are deserving of much greater federal help. This explains why much of the stimulus money is going toward education, health, energy conservation, and other activities that would do little to soak up unemployed resources and stimulate the economy.

In terms of discouraging a rapid recovery, other government proposals created greater uncertainty and risk for businesses and investors. These include plans to increase greatly marginal tax rates for higher incomes. In addition, discussions at the Copenhagen conference and by the president to impose high taxes on carbon dioxide emissions must surely discourage investments in refineries, power plants, factories and other businesses that are big emitters of greenhouse gases.
Congressional "reforms" of the American health delivery system have gone through dozens of versions. The separate bills passed by the House and Senate worry small businesses, in particular. They fear their labor costs will increase because of mandates to spend much more on health insurance for their employees. The resulting reluctance of small businesses to invest, expand and hire harms households as well, because it slows the creation of new jobs and the growth of labor incomes.

The administration also indicated early on that it would take a different approach to antitrust policy, reversing a 30-year trend toward more consumer-based interpretations of antitrust laws. Likewise, the installation of a pay "czar" in Washington is scary, even though his activities are so far confined to companies that received substantial bailout assistance from the Treasury. Perhaps as a next step, Congress will decide that executive pay is too high generally and levy special taxes on bonuses, or impose other controls over executive compensation—as the British and French have done. Congress is also considering major new regulations on consumer financial products.

In its efforts to combat the financial crisis and recession, the Fed created over $1 trillion of excess reserves at banks through various bailout programs and open market operations. When banks draw on these reserves for loans to businesses and households, there is a potential for the money supply to grow rapidly, possibly producing a substantial inflation. How hard the Fed will fight inflationary pressures through open market sales and other actions that raise interest rates is a significant source of uncertainty about future inflation and about the potential for monetary policy tightening to choke off the recovery.

The uncertainty about monetary policy has important political dimensions as well. The Fed now faces greater political pressures than at any other time in the past quarter century, as seen from the grilling the Senate Banking committee gave to Fed Chairman Ben Bernanke in deciding whether to approve his reappointment. These pressures may intensify greatly if, and when, future Fed actions to restrain inflation conflict with politicians' desires to prop up housing and the major government enterprises enmeshed in housing finance.

Even though some of the proposed antibusiness policies might never be implemented, they generate considerable uncertainty for businesses and households. Faced with a highly uncertain policy environment, the prudent course is to set aside or delay costly commitments that are hard to reverse. The result is reluctance by banks to increase lending—despite their huge excess reserves—reluctance by businesses to undertake new capital expenditures or expand work forces, and decisions by households to postpone major purchases.

Several pieces of evidence point to extreme caution by businesses and households. A regular survey by the National Federation of Independent Businesses (NFIB) shows that recent capital expenditures and near-term plans for new capital investments remain stuck at 35-year lows. The same survey reveals that only 7% of small businesses see the next few months as a good time to expand. Only 8% of small businesses report job openings, as compared to 14%-24% in 2008, depending on month, and 19%-26% in 2007.
The weak economy is far and away the most prevalent reason given for why the next few months is "not a good time" to expand, but "political climate" is the next most frequently cited reason, well ahead of borrowing costs and financing availability. The authors of the NFIB December 2009 report on Small Business Economic Trends state: "the other major concern is the level of uncertainty being created by government, the usually [sic] source of uncertainty for the economy. The 'turbulence' created when Congress is in session is often debilitating, this year being one of the worst. . . . There is not much to look forward to here."

Government statistics tell a similar story. Business investment in the third quarter of 2009 is down 20% from the low levels a year earlier. Job openings are at the lowest level since the government began measuring the concept in 2000. The pace of new job creation by expanding businesses is slower than at any time in the past two decades and, though older data are not as reliable, likely slower than at any time in the past half-century. While layoffs and new claims for unemployment benefits have declined in recent months, job prospects for unemployed workers have continued to deteriorate. The exit rate from unemployment is lower now than any time on record, dating back to 1967.

According to the Michigan Survey of Consumers, 37% of households plan to postpone purchases because of uncertainty about jobs and income, a figure that has not budged since the second quarter of 2009, and one that remains higher than any previous year back to 1960.

These facts suggest that it was a serious economic mistake to press for a hasty, major transformation of the U.S. economy on the heels of the worst financial crisis in decades. A more effective approach would have been to concentrate first on fighting the recession and laying solid foundations for growth. They should have put plans to re-engineer the economy on the backburner, and kept them there until the economy emerged fully from the recession and returned to robust growth. By failing to adopt a measured approach to economic policy, Congress and the president may be slowing the economic recovery, and thereby prolonging the distress from the recession.

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