Central banks think output losses caused by the recession have become permanent. More aggressive policy action to reduce the length and depth of recessions would minimise such damage.

There is growing pessimism among Central Banks regarding the growth potential of advanced economies. In the US, the Euro area and the UK, central banks are reducing their estimates of the output gap, the difference between actual economic output and its potential output. They now think about some of the recent output losses as permanent as opposed to cyclical. Gavyn Davies at the Financial Times reflects on this.

What does this mean for monetary policy? If output is not far from what we consider to be potential, there is less need for central banks to act and it is more likely that we will see an earlier normalisation of monetary policy towards a neutral stance.

Why did they change their minds? Is this evidence consistent with the standard economic models that we use to think about cyclical developments?

Measuring potential output or the slack in the economy has always been challenging. One can rely on models that capture the factors that drive potential output (such as the capital stock or productivity or demographics) or one can look at more specific indicators of idle capacity, such as capacity utilisation or the unemployment rate.

Narrow measures of idle capacity do signal a potential permanent reduction in output. For example, unemployment rates, in particular in the US, are coming down. Capacity utilisation is also approaching levels that can be considered as close to normal. As an example, in the most recent Inflation Report, the Bank of England writes, "surveys suggest that the margin of spare capacity within companies narrowed in 2013 such that companies were, on average, operating at close to normal levels of capacity utilisation".

But both of these measures, while they are capturing short-run idle capacity, are very problematic as indications of potential growth. In the case of unemployment, one of the main reasons it has decreased in the US is because of the fall in participation rates. But some of these permanent changes in the labour force are the result of a long recession. There is evidence that in the US, long-term unemployed workers are giving up and leaving the labour market at increasing rates. A similar argument can be made about capacity utilisation: it might be that we are getting close to normal utilisation levels, but is capacity at a normal level? A long period of low investment rates will naturally lead to lower installed capacity. This is Say’s Law backwards, demand (investment reacting to cyclical conditions) creates its own supply (capacity). [Several years ago I wrote a paper with a model and some empirical evidence in favour of this hypothesis].
Both of these arguments point in the same direction: business cycles can leave permanent (or at least very persistent) scars on output through the effects they have on the capital stock or the labour force. But it is important to understand that the permanent effects are the consequence of the recession itself. If we could manage to reduce the length and depth of the recessions we would be minimising those permanent effects. And in that sense, accepting these changes as structural and unavoidable is too pessimistic, leads to inaction and just makes matters worse. If you read the evidence properly, you want to do the opposite, you want to be even more aggressive to avoid what looks like a much bigger cost of recessions.

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