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Underwhelming Growth

What the new GDP figures actually reveal.

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Two weeks ago the Commerce Department released its final estimate of Gross Domestic Product for the second quarter. That marked five years since the recession ended—a period of massive experimentation with expansionary fiscal and monetary policy. While those policies were doubtless well intended, all they did was what standard economic theory says they would do—move future economic output to the present. They did not by any means increase long-term economic growth.

The headline seemed encouraging—4.6 percent growth in the second quarter. But the first quarter was negative, so the average for the first half of 2014 was just 1.25 percent. If we get, as expected, growth between 3 and 3.5 percent for the second half of the year, 2014 will come in with average growth of just about 2.25 percent. That compares with average growth of 2.2 percent over the last two years, 2.2 percent over the last three years, 2 percent over the last four years and
2.2 percent over the last five years. Does one see a trend here?

Politicians and the media tend to confuse the two, but there is a huge difference between short-term economic stabilization policy and a long-term growth strategy. Consider deficit spending, of which we did roughly $5 trillion in the last five years. It helps in the quarter in which the money is spent, but creates a gap in government finances that requires either higher taxes or lower spending in the future relative to what would have been the case. So the “demand” created by the deficit is really just borrowed from the future.

Or consider the zero interest rate policy of the Fed and the further stimulus caused by its buying of government bonds. An ultra-low interest rate is designed to encourage firms to build a factory or buy a machine today that they might otherwise not have done or done later. But once that factory is built or the machine purchased, there is less need at some point in the future to build another factory or buy a machine because the firm’s productive capacity has already been increased. So investment spending rises short term, but is merely “borrowed” from investment spending in the future.

The Fed’s bond buying program has a similar effect. By buying almost $3 trillion of “extra” bonds, the Fed pushed down long-term interest rates and drove up the prices of other financial assets because those who would have bought those bonds had to buy something else—higher yield corporate debt, or stocks, or even real estate. It is thought that the higher asset prices created a “wealth effect” that induced people to spend more than they would have. Now consider what happens when the Fed lets its balance sheet go back to normal. Those $3 trillion in bonds have to be bought by someone else. That means less money going into higher yield debt, stocks, or real estate. That means the price of those assets is likely to fall. That in turn will put the wealth effect into reverse.

Let’s face it, if government deficit spending and money printing could produce economic growth, we may as well forget about working harder, getting more skills, or any of the other tedious things that actually generate growth. We could just print and spend. But that’s not the way the world works. So when demand was down in 2008 and 2009 we “borrowed” demand from 2010 and 2011. And when 2010 and 2011 were disappointing we “borrowed” demand from 2012 and 2013. Now we are “borrowing” demand from the second half of this decade. With this as a strategy, you never get to

long-term sustainable growth.

The rest of government policy also didn't really help. In 2009 the administration declared its goal to double exports in five years. It seemed possible at the time as exports had been artificially depressed owing to the global recession. But if the goal was 100 percent cumulative growth over five years, reality fell far short. In nominal terms exports grew only 47 percent over that period, and growth was only 31 percent in real terms. Import growth was only slightly slower, 45 percent nominally and 29 percent in real terms, but because of the larger import base, the net contribution of trade to growth was actually negative over the intervening five years. So much for trade policy.

Perhaps the most striking statistic was in the personal income arena. From the end of 2008, wages and salaries grew only 14.2 percent. Transfer payments in the form of government benefits rose 31.2 percent. This occurred during a period when the unemployment rate declined 4 points—from double digits to less than a point above "full employment." It is a safe qualitative conclusion that an economy that sees government benefits rise from 29 percent of wages to 33 percent of wages during a recovery with falling unemployment has some challenges regarding its dynamism. We now have 15 million more people relying on government benefits with 6 percent unemployment than we had six years ago with 10 percent unemployment. That too is hardly a recipe for long-term growth.

This also affects the "participation rate"—the percentage of working-age individuals who choose to join the labor market. Among the middle aged (25-55), participation is down roughly 3 percent in the last six years. These aren't early retirees and they aren't kids looking for their first job. They have left. Likely they lost their job, signed up for government programs, and now, particularly if their spouse is employed, face confiscatory tax rates (largely from lost benefits) if they return to work. The programs might be well intentioned. For example Nancy Pelosi noted that Obamacare allowed people to "pursue their dreams" instead of being "stuck in a dead end job." That's all well and good, but it does mean a lower labor force participation rate. And fewer people wanting to work is going to mean a smaller potential output for the economy.

So forget the hype about each quarter's numbers. Last week's GDP report gives us a five-year perspective that suggests more of the same. We have borrowed demand from the future—and that means the demand is not going to be there in 2015 and 2016 to give us some magic economic lift-off. More troubling, we have pursued policies that limit supply—lowering labor force participation, reducing energy supply, overtaxing entrepreneurship, and strangling the banking system. These also limit our long-term productive capacity. In case you're on the spot and need an economic forecast for 2015 and beyond? Pick 2.2 percent. It's worked for five years, and it's likely to work in the foreseeable future.

Lawrence B. Lindsey served in the Reagan, George H. W. Bush, and George W. Bush White Houses and at the Federal Reserve during the Clinton administration. His most recent book is What a President Should Know . . . but Most Learn Too Late*.*

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