The lasting effects of the great recession

The global economy is apparently beginning to recover from the most severe financial crisis since the Great Depression and the deepest recession since the end of World War II. In general terms this is good news, but hold the champagne, we are not out of the woods yet. Financial institutions remain weak and consumers in many of the most advanced economies have been badly battered. Growth, therefore, is expected to be positive but quite modest and unemployment is expected to remain at relatively high levels during the next few years.

The reason for these diminished expectations is that output losses caused by recessions associated with a financial crisis tend to be significantly higher than losses caused by either type of event when occurring in isolation. In addition, many economists agree that much of the loss of output in a severe recession is permanent, and the economy never gets back to its old trend line. The International Monetary Fund explores these issues in the latest edition of its World Economic Outlook, where it examines medium-term output performance following 88 banking crises that occurred over the past four decades, as well as the behavior of world output following major financial crises going back to the 19th century.

The IMF authors found the following: First, output generally does not recover to its pre-crisis trend. On average, output falls steadily until the third year after the crisis and does not rebound thereafter. Second, medium-term output losses following banking crises are quite significant. Seven years after the crisis, output has declined relative to trend by close to 10 percent on average. Third, medium-term growth rates eventually return to the pre-crisis rate. Finally, the IMF found substantial variations in post-crisis outcomes, with output changes in the middle 50 percent of cases fluctuating between -26 percent and +6 percent, which implies that initial conditions and policies implemented post-crisis may have significant effects on output losses in the medium term.

The IMF finds that higher structural unemployment, slower capital accumulation, and lower productivity growth may play an important role in explaining why aggregate output fails to recover after a severe banking or financial crisis. In other

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words, according to the IMF, output does not recover to its pre-crisis trend because the unemployment rate, capital per worker, and productivity do not typically return to their pre-crisis trends within seven years after the crisis.

In terms of post-crisis policymaking, the IMF found that countercyclical, in this case expansionary, short-term macroeconomic policies are associated with smaller medium-term output losses. The IMF also found that the relationship between post-crisis structural policy reforms, such as domestic financial reform, capital account and trade liberalization, and structural fiscal reform, was somewhat weaker and generally not significant. However, the authors acknowledge that this may be due to difficulties in measuring the timing, magnitude, and sequencing of structural reforms. Finally, the IMF also found that spillover effects of external conditions, such as growth in partner economies and global short-term interest rates, could significantly affect medium-term output losses.

All of this is bad news for Puerto Rico. If we assume the current crisis began during fiscal year 2007 and estimate a linear trend for Puerto Rico's real GNP or gross national product, based on average real GNP growth during a seven-year pre-crisis period that ends three years before the onset of the crisis, we find that potential output losses relative to this trend by 2014 could be in excess of $13 billion (at 2008 prices), equal to 17 percent of the pre-crisis trend and thus well within IMF estimates, even if we assume that Puerto Rico's real GNP growth rate reverts to its pre-crisis average in 2010.

Several factors could further complicate this scenario. First, the current administration is not implementing an expansionary fiscal policy. At best, current fiscal policy could be described as mixed: on one hand, the government is cutting back on government spending and raising taxes, while on the other it simultaneously seeks to stimulate the economy through the expenditure of federal American Recovery and Reinvestment Act funds. Second, the government has chosen to implement far-reaching structural reforms in the midst of the crisis. Third, we can expect low economic growth in the U.S., higher short-term interest rates, and rising oil prices in the near term. The interaction among an inadequate fiscal policy, a significant structural reform, and the adverse spillover effects generated by external conditions, could further magnify medium-term output losses in Puerto Rico.

In sum, the medium-term outlook for Puerto Rico is worrisome. Our analysis suggests that output in Puerto Rico may remain well below its pre-crisis trend for the near future. The related losses in capital, employment and productivity could very well be permanent, severely impairing the future productive capacity of the Puerto Rican economy. Those are the lasting effects of the Great Recession.

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