[HPS] LEADING THINKING

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The Macro Risk-Reward Tradeoff

How To Balance Stability And Growth

Findings:

- **If significantly faster growth is possible, growth beats stability.**
- **If only incrementally faster growth is possible - and would bring with it a disastrous recession - stability beats growth.**
- **Even the impact of another Great Recession would be mitigated if it came with significantly faster growth during boom times.**

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The views expressed in this document represent those of the authors alone.

THE economic trauma of the Great Recession sparked a good deal of "never again" policy-making in Washington. The public reacted strongly to politically unpopular bailouts and an economy at the brink, and politicians responded with regulatory crackdowns on risk-taking. The result has been slow, but steady, growth. In fact, at 32 quarters, this is one of the longer expansions on record, echoing then-President Obama's 2012 reelection campaign slogan: "an economy built to last."

Now, it is arguable whether the pace of this recovery reflects a policy choice or is simply the consequence of a debt crisis and the slow recovery that follows, secular stagnation, or demographic headwinds. But as public discontent shifts from the crisis itself to the relative strength of the recovery, the policy pendulum is also shifting toward boosting the rate of economic and wage growth, elevating concerns about economic and financial stability.

This dynamic raises the obvious question: If we want to maximize economic growth, how long does slow-and-steady growth need to last to make it a better policy choice than boom-and-bust?

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Background and approach

Recent analysis by Blackrock shows that while growth has been slower during this expansion if we adjust for the length of the business cycle, this recovery is in line with previous cycles. In that sense, post-recession policy choices have been a success. The driving assumption in

Figure 1: Comparative Scenarios For Growth Policy

Scenario	Quarters Of Growth	Rate Of Growth	Quarters Of Contraction	Rate Of Contraction	Net Growth
Average Of Last 5 Business Cycles	24	3.9%	4	-2.3%	3.1%
Last Business Cycle (2000s)	24	2.9%	6	-2.8%	1.7%
Current Business Cycle*	47	2.1%	4	-2.3%	1.6%
Current Growth With Long Cycle	105	2.1%	4	-2.3%	1.9%
Prior Growth With Great Recession	24	3.9%	6	-2.8%	2.5%

Note: All rates of growth/contraction are annualized; *Total length of current expansion assumes last quarter was 2/3 through the cycle, with a recession to follow that resembles the average of the last 5 business cycles.

Blackrock's analysis is that we are about two-thirds of the way through the expansion, suggesting we will avoid a recession for the next four years.

To answer whether current policy is the right trade-off, we looked at net gains in GDP over the current and previous business cycles on a per year basis. In our analysis, we used GDP in 2009 dollars with "peaks" and "troughs" as designated by the National Bureau of Economic Research to indicate the bounds of the business cycle. To compare across business cycles, we used measures of quarterly net average growth and annualized net average growth. Net average growth should be thought of as the growth that occurs during the business cycle after you factor in both the expansion and the contraction.

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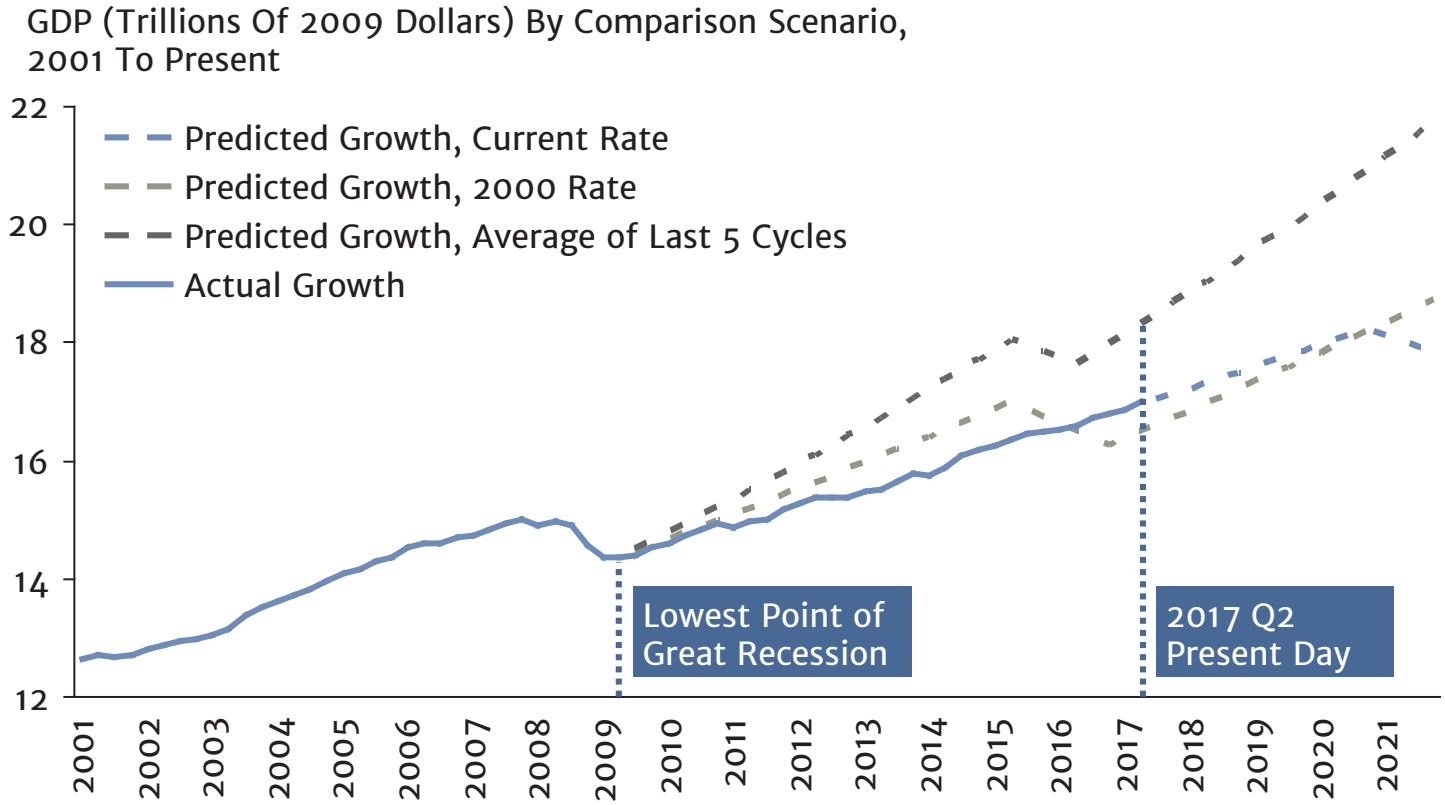
With this approach, we looked not only at the gains during a period of expansion, but also netted out the losses occurring during the contraction following that expansion. The basic policy goal is to grow as fast as possible, after accounting for contractions.

What if significantly faster growth is possible? Growth beats stability.

Prior to the 21st century, the U.S. economy grew at a much faster rate. In fact, over the past five business cycles going back to the late 1970s, net annualized growth (accounting for recessions) was just over 3 percent per year, with an average expansion of about 6 years and less than a year of

Fig. 2: GDP Growth Has Been On Par With The 2000s Cycle, But Not An Average Of The Past Five Cycles



NBER, HPS Analysis

recession.

Meanwhile, our average annual growth in this recovery has been about 2.1 percent, and the recovery has already gone about 8 years. If we assume a future recession on the magnitude of the past five, occurring after almost 12 years of growth, the net annualized gains drop to just 1.6 percent. With the net growth rate of prior business cycles higher than the absolute growth rate of this cycle's recovery, even if this recovery lasts 100 years and is followed by the mildest recession in history, we still will never reach the net annualized growth of those previous cycles.

Effectively, the lost growth during the expansion swamps whatever benefits may be gained by avoiding a recession for an extended period of time. Therefore, if policy is sacrificing faster growth for fewer recessions, we are almost certainly choosing a smaller economy.

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What if incrementally faster growth is only possible with a calamitous recession? Stability beats growth.

The previous analysis does not take into account that the economy has changed a great deal since the 1970s and 1980s. The average annual growth during the previous five expansions was 3.9 percent. In the 2000s, it was 2.9 percent, which is more in line with recent growth rates. Therefore, we also compared the current business cycle to the previous cycle, asking the same question. The challenge with the prior business cycle is that while the economy may be more similar to

today's from a growth perspective, the recession was far beyond what we would usually expect.

If we compare slow and steady growth followed by a moderate recession to slightly faster growth and a deep recession, we would prefer the slow and steady approach. In this scenario, we find that the policy tradeoff is worth it after 40 quarters of growth at the current average rate and a normal recession to follow (i.e., not the Great Recession). This combination of factors leads to the same annualized net growth rate as the last business cycle. Therefore, the expansion needs to last eight more quarters for slow-and-steady to beat slightly more growth with a big bust.

What if significantly faster growth comes with deep recessions? Growth still swamps stability.

Policymakers would certainly be forgiven for guarding against another Great Recession at the expense of slower growth. Yet, our analysis shows that if policymakers are trying to maximize long-term growth, they should aim to return to the average growth rate of the previous five-year expansions - even if it comes with another Great Recession. Virtually no expansion of any length can overcome the power of compounded growth.

To understand this further, let's take it to the extreme. Say that the current expansion lasts for 105 quarters, meaning the U.S. would surpass Australia and the Netherlands for the longest period of growth on record. At our current growth rate, even a record-setting quarter-century expansion would not match the gains brought by robust growth and a Great Recession every 6 years. This is how powerful growth is for the economy.

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Implications

Much of this analysis hinges on what we expect for the future of the American economy. If policy cannot meaningfully combat demographic headwinds and secular stagnation, avoiding recessions by decreasing risk is worth it. However, if policy can jumpstart growth by injecting some more risk-taking in markets and businesses, the faster growth will more than make up for a few more recessions – even a Great Recession. This might suggest we are better off focusing on how to deal with recessions rather than avoiding them and definitely implies we should be focused on policies that will encourage growth.

There are other implications to the business cycle ups-and-downs that we need to think about from a policy perspective. A boom period can enable labor mobility, career changes and risk-taking that are helpful at an individual level. A big crash can result in older workers permanently exiting the workforce, cutting their careers short, while slow growth can stunt job prospects and wages for younger workers before they even begin theirs.

The trade-offs of growth and timing affect GDP, but more importantly, they affect people. The point of public policy is not to create the safest economy possible, even if growth is slow: the point is to create an economy that allows people to pursue their potential and create a better life for themselves and their family. Sometimes that means a safer economy, and sometimes that means accepting the risks that come with a faster growing economy. []

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