Episode 435: Why Has the Economic Recovery Been So Sluggish?

Guest: Wolf von Laer

WOODS: I've been checking up on what people have been up to, people I got to know at the Mises Institute through the Summer Fellows Program, and you're one of those people, and I see you on Facebook and so I thought, well, let's check in, see what old Wolf is up to. And I saw that you had co-authored a paper that we're hoping is on the verge of publication on the subject of regime uncertainty and the most recent economic downturn.

So I thought, perfect, absolutely perfect for the show. So I've been going back: I've had David Howden on; I've had Philipp Bagus on; I've had Carmen Dorobat. I've had a number of the people — G.P. Manish — people who have been at the Mises Institute. So I thought, well, what the heck? I want to do what I can to give the old Tom Woods Show bump to my old friends from the Institute.

So let's talk about this paper of yours by starting off with an explanation of what this term "regime uncertainty" means. And is this a term that was actually coined, if not the concept actually invented — was the term coined by Robert Higgs?

LAER: Yes, that's correct. In his 1997 article, "Regime Uncertainty: Why the Great Depression Lasted So Long and Why Prosperity Resumed After the War," he introduced the term and fleshed it out. And I know that you, Tom, also have done extensive work in order to basically change the narrative about the Great Depression, because the standard narrative in the United States is that only after the Second World War, or during the Second World War, that the Great Depression was finally overcome, and that was due to the immense spending of the government and then everybody was suddenly prosperous and the Great Depression was overcome.

That of course, is bogus. We do know that it does not really help if you just produce a lot of tanks and you do not focus so much on producing goods that people actually want. You cannot just spend your way out of a recession all that much.

And Higgs has done tremendous work with this paper, because what he shows is that the actual reason why the recession was actually over was that regime uncertainty was overcome. So what does he mean by that? It is an episodic — so an only temporarily occurring phenomenon — which basically hampers entrepreneurs, investors, and business people to invest. So he uses a definition that is a felt distress by these people, and that they believe — so it's important that it's about the belief — that their private property rights and their capital and the income it will yield in the future are in danger.

So this can be through all kinds of different things. There's another term in the literature called "policy uncertainty." But Higgs' concept is broader than that, and it's about not only all the regulation that comes down from Washington or any other country, but also about maybe the rhetoric of that administration. For instance, like the FDR Administration was very hostile to entrepreneurs, and he was very hard on them and basically threatened them quite a lot in public speeches. But all kinds of other things.

So if you take this concept together with the rhetoric, the regulation, the debts, and so on, then you have an interesting concept capturing all the different things that are going on that basically undermine the trust of entrepreneurs and business people within the economy. And my co-author, Adam Martin and myself — he's at Texas Tech — we are using this concept, changing it a little bit, and looking at the Great Recession. And we want to make the case that, at the moment, we also have regime uncertainty at play, and that is the reason why we see the U.S. recovery being quite sluggish.

WOODS: Now that very point, about the recovery being sluggish, is itself a matter of dispute, because of course the Obama Administration and its supporters have been using the economy; they've been trying to fight back against the Obama critics on the economy by saying that, considering what Obama inherited, he's actually done a pretty good job on the economy.

And a few weeks ago, or maybe a month ago, I had David Stockman on the program, and I asked him about this, and I said, what kind of arguments could you make against people who say that actually, given the circumstances and the conditions that Obama inherited, things are actually pretty good? He was having none of it at all, and among other things, he said, when you look at the jobs figures, he said that you have to remember that of course when you start at rock bottom, you will get some job growth. Eventually things do turn around, but he called these "born again jobs," and that by and large, the figures including investment are not impressive. So presumably, you're of the same school of thought here.

LAER: Yes, I agree on that very much. So of course, the problem with all kinds of social events throughout history is, as Mises put it, we don't have a laboratory environment where we can have things constant and then just test different theories. So people can always so, oh, if Obama wouldn't have done all of these things and the stimulus packages, things would have been worse, and that's very frustrating about these arguments. But we can look at some of the numbers and make sense of the strength or the weakness of the recovery.

So if we just look in terms of Gross Domestic Product, then we see that at the end of 2009, that basically GDP was already at par before the financial crisis. So the crisis officially was from December 2007 until June 2009, according to the National Bureau of Economic Research. Then they said the recovery stepped in.

So if you just looked at GDP, all right, that's fine. However, if you dig a little bit more into it, and I think that's also what your previous guest was talking about — then it's not that clear. It is true; unemployment at the moment is at 5.5%, which is fairly low. Some people could say it's even close to full employment, because there are always some people looking for new jobs, getting off other jobs, etc. However, if you look a little bit at the composition of these jobs, it is less uplifting. So in 2007, there were 121 million fulltime workers in the United States. At the end of 2014, only 119 million. So effectively roughly 2 million people have fewer fulltime jobs. That is not very uplifting.

And one also has to take into account that in 2007, the United States was smaller in terms of people. There were only 301 million Americans, and now they say 319 million. So of course not all of them will be working, because some of them are born and they're still like in primary school and what not, but still, there are more people in the United States, and many of them do seek jobs. It is true there are more part-time jobs, but only 2.5 million more.

So if you look at these numbers from that way, it's really not that uplifting, because there are fewer part-time jobs than before the Great Recession kicked in really, and only a little bit more part-time jobs. And this is also expressed by another economic indicator, this so-called average labor force participation rate, which expresses how many people at a given time are participating within the labor force. And this is at the lowest number since 1978 at 62%, nearly 63%. So this is one piece of evidence that shows that if you just look at the 5.5% unemployment rate, that that is not really satisfying if you look really at the composition of the numbers.

Another indicator Adam Martin and myself are looking at is private investment. Because as you and your audience understand, what really triggers economic growth is the saving of people and then the investment of that capital back into the economy in productive areas. However, there is one measure where we can look at it; this is the so-called domestic private net business investment. That's a mouthful, but that is basically expressing that. The net investment — so after the appreciation of capital — what people are investing into the United States economy — not the government, but private individuals.

And if you look at that number, these investments is in 2014 still — or in 2013; I'm sorry — still below what it was in 2007, 2006, 2005, 2004, 2003. And as a share of GDP, that number's also lower than everything that was before the financial crisis started at the end of 2007. And so we see that people really do not invest that much. And we have to also think about all the wealth that was destroyed in the Great Recession. Sure, much of it was also just bloated numbers, but many people did lose a lot of their jobs and their economic wellbeing, and this has to be caught up upon, right? This is not really happening in the numbers we're seeing.

And I'm not the only one, and Mr. Stockman is not the only one who's arguing that. There's evidence from the IMF which basically says this recovery is really bad. There's an article in the *Bank of Canada Review*, which basically argues this is the worst recovery since all recoveries after World War II. And there have been different other articles in popular and also scientific and academic outlets that argue the same way. So I think these kinds of indicators could give your audience one idea of what I have in mind that I'm saying that the recovery's quite slow.

WOODS: You refer in the paper to an investment shortfall, and we've just been talking about the failure of investment really to recover. The question would arise: how do we know that this failure of investment to recover can be accounted for by regime uncertainty or politically induced uncertainty about the future? There's always uncertainty about the future, but it's politically induced uncertainty about the future that constitutes regime uncertainty. Is there any way we can know that? And in a minute we'll get to what might these factors be that contribute to regime uncertainty, but the separate question is how can we know that this problem that we've identified is due to regime uncertainty and not to a multiplicity of other factors?

LAER: Yes, I really like that question, Tom, because it's quite skeptical, and I like that, because it's normally more complex. So we're quite humble in the paper with our explanation. Our main argument is that there are many arguments why the recovery might be slow, but that we should take regime uncertainty as one factor into account, and we should take it seriously.

So it might be that the Keynesian aggregate demand story — that people don't demand too many goods and that we should stimulate the economy more, and then basically we would be happier — I don't believe in that story, but that might be an alternate explanation. It might be also due to the lack of liquidity; even though interest rates are at record low rates over many, many years, we could still say that yes, banks do not lend to businesses. However, this survey data that we're analyzing in that paper shows that businesses are not really concerned about that.

But one particular piece of evidence could get to the truth of the matter. So we are arguing it is about regime uncertainty, and before — like in the next section I will talk more about why we think that regime uncertainty exists — however one particular piece of evidence is interesting. We could look at corporate bond yield curves. Sounds more complicated than it is.

WOODS: Right, but this actually does help to prove your point, so definitely talk about this.

LAER: Yes, it does; it does. So corporate bond yield curves show the receiving interest rates for the people who are holding that bond for different maturities. So if you hold, for instance, a AAA or best rating bond of a private company, and you can have this for 5 years, for 10 years, for 15 years, for 20 years, obviously longer bonds should give you a slightly higher interest rate, because there's uncertainty. We don't know what will happen in 20 years. Maybe Microsoft and their bonds will vanish, because Apple will take them over or whatever. So this is a useful thing to look at.

So if you look at bond yield curves before the Great Recession in 2007, they were rather flat. A five-year bond was roughly 5% — and this is the average over many different AAA rated bonds. And the 20-year bonds were 6%. So only 1% in between was the difference. So people thought, okay, this is fairly particular, the future. We don't have much fear about the future, and therefore we will not discount it all that much.

After a period of a lot of volatility during the crisis, where the bond yield curve was all over the place, in 2010 it showed basically a much steeper curve. So the five-year bonds yielded only like 1%, because of course of the low interest rate environment, but the 20-year bonds still yielded 4 or 5%. So there was much more difference between the different stages of the years, which basically in our minds, expresses height in uncertainty. People are not so sure about the health of businesses, which are even rated as very secure investments.

And that has been true in 2014 as well. It's still very steep. People still think this is very problematic nowadays. And this is evident that Robert Higgs also used in his article about the Great Depression, and he found the same pattern. So we think this is one very important piece of evidence, besides all the survey evidence of people complaining about uncertainty and the federal government.

WOODS: Let me make sure everybody's following the argument. You're saying that when we look at the differentials between these yields, what we're seeing is uncertainty about the future. If I have to be compensated with a very — let's say a much higher yield — when I go ahead and invest in a long-term instrument than a short-term one, that's because I'm very uncertain about what's going to happen in the long term. So you have to compensate me accordingly if you're going to get me to invest in the long term. Now, if I'm much more at ease and confident about the future, I would be more inclined to accept a lower yield. But when I feel that the future is just very, very hard to figure out, that all these political factors could produce conditions that I can't possibly anticipate today, then that's going to translate into higher yields for the longer term.

LAER: Yeah.

WOODS: So that's your point. That is very, very — to me that's just, as you say, it's hard to identify, to be able to say this factor is the cause a lot of times when you're looking at economic history. But here, these numbers don't lie, and they obviously are telling some kind of story, and it's certainly a story that's compatible with what you're saying.

Wolf, let's get into the specifics though of what is it that's going on, particularly in the United States, in terms of what the government was up to or threatened to be up to that could contribute to regime uncertainty. And by the way, is this a phenomenon that we see all over the world, I might just add in parentheses.

LAER: In the paper, we're only looking at the United States, but in my PhD work, I'm also looking at the changes in the financial sector within the European Union. And I would also make the case that, especially in that sector that we see regime uncertainty there, because they basically created a whole new set of institutions, regulating financial institutions in 27 countries that previously have not existed before — and even more countries; it's not only the European Union countries, but also some peripheral ones. And so I have to write that paper with my co-author, but I would be not surprised if this happens in many other countries as well, who had extensive regulatory changes in the aftermath of the Great Recession, which was a worldwide phenomenon.

But we do focus mostly on the U.S., and I can give you some examples to why we think that there is regime uncertainty. One very interesting piece of evidence comes from basically the regulatory state. People always complain about regulation, but we have some actual numbers there of how this developed. Since 2007 to 2012, within these years regulation have risen by 11.2%. And we are measuring the binding rules, which basically means everything that was in the Federal Code of Regulations which says, "You cannot," "It is forbidden" — all of these phrases have been analyzed with the tool of the Mercatus Center called RegData — it's interesting; maybe your listeners could check it out; it's just RegData; if they Google it, they will find it. And you can see from 2007 to 2012, this has risen 11.2%. If you look at the same timespan between 2001 and 2006, then you see that the binding rules have only increased by 5.3%. So we see there's a much more active regulatory state at place, and that translates of course for changes on the investors and business people on the ground.

We also see more spending on agencies that deal with economic regulation. We also see more people being hired by federal agencies dealing with economic regulation. And it's more sensible to think that more resources and more people power translate in some sense to more regulation on the ground. And this is one piece of evidence.

Other things we could mention are, of course, the bailouts. People don't know really what will be the situation; bigger businesses will be bailed out; smaller businesses will not. But that might has head down after a couple of years now. There are talks about tax hikes and there's "eat the rich" rhetoric within the United States.

And one very important point to think, many of your listeners might also be threatened about, is the huge debt of the United States. It has skyrocketed, and we understand that this is not a situation that can be sustained over decades and decades. We don't know what will happen. Will it translate to high inflation rates, or will there be huge tax rates, or will there be something like financial repression, which is basically a fancy term to say where the government tries to figure out how to rip the people off more, in order, for instance, to make them buy more government debt or something like that?

And then we can just look at survey data. In 2013, United States Americans being surveyed said, 72% said that the federal government is the biggest threat to the future of the United States. 72%. And these are not only business people or classical liberals or libertarians. These are people on the street. This is not only about economic policies, but about the U.S. in general. But that's what it's about. Regime uncertainty is about the perceived threat. The number of people being concerned about regulation has also risen.

But I would also add two specific pieces of regulation that I think had a huge impact on the confidence people have in the economy of the United States. Another chapter in my PhD, I'm analyzing the length of laws in terms of words, as well as how long it takes Congress to pass them. I'm looking at three decades of law making, and I'm comparing different pieces of regulation, especially in the aftermath of the Great Recession compared to other pieces of legislation.

And I find that the PPACA — the Patient Protection Affordable Care Act, also known as Obama Care — is the third longest law in terms of words in the last three decades. Imagine: there are over 8,000 laws that have been enacted by all the Congresses in the last decades, and Obama Care is the third longest. Dodd-Frank is the fifth longest in terms of words. To give you an idea, we're talking about Obama Care being at 374,728 words. So my PhD will be roughly about 100,000 words, which would be about 200-300 pages. So three times as much, basically that is that PPACA.

So that is a lot of regulatory content in there, and we see this being expressed by small and medium-sized enterprises. Even in 2014, a recent Pew Research survey found that only 19% — 19, one-nine — percent of small and medium-sized enterprises responded that they're ready for all the changes from Obama Care. This law has been implemented since 2010, but still people are highly, highly concerned about this, and they don't know what to do with it.

And the situation is similar with Dodd-Frank, with the fifth longest law. So you can also express this from a different angle. Dodd-Frank is a law which basically tells federal agencies to create the law. So there's a lot of different statements which basically have to be fleshed out, a lot of big details that have to be implemented by regulatory agencies. But as of now, even though it has been put into law a couple of years ago, only 66% have been implemented. So all of the other laws still are coming down, and people don't know what will happen.

And banks don't know what will happen. 90% of smaller banks basically say that they have seen their costs being risen by Dodd-Frank, due to Dodd-Frank. And what do they do with these costs? They have to give it in some way back to their customers, because they normally don't have just like tons of gold lying around that they could sell or dollars. So that's a real problem.

And we also see this expressed in other numbers. In 2006, the FDIC, the Federal Deposit Insurance Corporation approved 190 new banks, just new banks that want to get started to get new business in their local community. In 2013, it was only one. So there we really see there's a connection between huge regulatory changes in different aspects and the pain being felt by entrepreneurs and businesses on the ground. And I think these anecdotal pieces of evidence put together, I think, give a good picture that regime uncertainty's really at play during the — after the Great Recession.

WOODS: That was a very interesting statistic there about the banks. I'm interested in your paper — and I need to tell people in case I didn't at the beginning, that the paper, since it's not published yet, I can't link to it, so we're just using the paper as a starting point for a conversation. The section in there about why small businesses might be especially affected in dealing with the consequences of regime uncertainty, as opposed to larger businesses, I thought that was interesting and pretty persuasive. What are some reasons that we might think that small businesses would be especially affected?

LAER: I will offer four different theoretical reasons why this might be the case — or my co-author and I, we do. The first point is that small and medium-sized enterprises, SMEs in short, have fewer margins to adjust. For example, if you own a plant that produces automobiles, then it's a mass of production and you have a lot of resources and you can make a lot of changes happen. You can exchange capital for labor; you can outsource some of your accountant to an external company that is cheaper, etc.

However, if you are a small producer of like only one good, then you have very little margins to adjust. You might be able to change something, but you are much more limited than a business which has many different products or many different product chains. So that is one point.

The second point is the cost of rent seeking. Sure, bigger corporations, as well as small and medium-sized enterprises, have to overcome collective action problems — basically, problems which are that you're having the same goal, maybe to have fewer regulations in your area, but you have to get everyone on board. This is a collective action problem.

But bigger corporations, of course, they have more money, and so they can lobby directly, where SMEs have to pool their resources. And their organization, like the National Federation of Independent Business, were lobbying for that. But they are also very heterogeneous. They are probably active in all kinds of different industries, so it's really hard for them to get to a point where they can lobby the government for specific policies they want to see. So it's more complicated for them and less complicated for bigger companies.

Then you also have the fixed cost of compliance — this is the third point — whereby bigger corporations, they also have to deal very often with intellectual property issues. They see themselves being sued quite often. So they have an army of lawyers there, who have to deal with all kinds of issues. And so when they have to interpret new regulations coming from Washington, then it might be easy for them to just give them to their lawyers, and they will just get on it.

However, if you are a small or medium-sized enterprise with maybe only five to ten employees, it will be now a significant cost if you have to hire someone to interpret these laws. Or that the CEO has basically go and sit down and read 350,000 words of Obama Care in order to understand what this means for his business or her business. That is not really feasible. SO the fixed cost of compliance is issue three.

Number four is that very often the tendency is there that smaller businesses as well as start-ups are more innovative. They disrupt industries; they come up with new products. So what that means is that they leap into the unknown. They often create something which has not been there before. It's not only about small improvements of products; it's about something completely new. So uncertainty for them, which is always there in the economy, is already a problem for them.

However, if you then have an additional level of uncertainty coming from the regime uncertainty, this is additionally problematic for them compared to a business which is in an established sector where they really know the environment and where they don't have to make too many huge changes in order to make money, because they already have business.

So these are the four arguments why SMEs might be theoretically more concerned about regime uncertainty. And now we can look at the data. And maybe one graph I could make available, maybe in the show notes, is survey data from the National Federation of Independent Businesses, and this shows beautifully that at the beginning of the financial crisis, SMEs were very much concerned about sales. People didn't spend much; people didn't buy much; people didn't invest much.

However, already in 2009, that started to ebb down. People were less concerned about that; at least SMEs report that. What we see on the other hand, what is raising as the top concern among small and medium-sized enterprises, and they ask that on a quarterly basis to their members and non-members, is regulation and taxes has been considerably increasing over the time. Basically, at the beginning of 2008, it started to really go up and up and up, which is now at like 42% roughly of people responding that taxation and regulation is the biggest problem for these businesses. That's one survey. But another survey also said that 68% of SMEs reported that taxes and government regulations negatively affect it — so a different source, not only the data from the National Federation of Independent Businesses.

Another piece of evidence is basically what happened to the employers of these different small and medium-sized enterprises, and I have found interesting data that showed that SMEs lost a lot of employers during the Great Recession — employees, I'm sorry — as well as the bigger corporations, but the smaller entities lost more. When the recovery started officially in July 2009, they still lost employees, and bigger corporations started already hiring people. But we see a general trend that the SMEs were faring much worse than bigger corporations. So that's also another interesting fact. They have fewer employees nowadays and they're hiring fewer people, and they really complain about that in different surveys.

And they also, the share of start-ups in the U.S. economy is the smallest since 1974. So the United States, which is normally depicted as this engine of growth and engine of innovation, sees now the smallest share of start-ups, which is normally connected to innovation, which is quite sad. And it's still true in 2014.

WOODS: It sounds to me like you and your co-author, Adam Martin, whom I guess, I haven't seen him in quite a long time, but I know he's a good guy, and it sounds like you're both doing great work and important work. On today's show notes page, which will be TomWoods.com/435, I will link to first of all your website, which is WolfVonLaer.com. I'll link to your Twitter. If you can send me a link to the survey data that you had in mind, I will also link tot that on the page. And best of luck to you in your doctoral work.

LAER: Thank you so much, Tom, for having me on. Keep on the way you work, informing people about economic truth.