

Global Disaster Recovery

Michael Boskin



PALO ALTO – With the global economy mired in recession and financial crisis, policymakers everywhere have launched a series of monetary, financial, and fiscal responses. Nevertheless, economies continue to contract, unemployment to rise, and wealth to decline.

Countries' policy responses have ranged from modest to immense. China has undertaken a 6%-of-GDP stimulus package aimed (mostly) at infrastructure; the United States has enacted a two-year \$800 billion spending and tax rebate package. The Federal Reserve and the Bank of England lowered short-term interest-rate targets to near zero and are adopting "quantitative easing" – i.e., continuous infusions of money.

Despite all this, massive excess bank reserves remain unlent. During Japan's "lost decade," the Bank of Japan mostly bought Japanese government bonds, whereas the Fed is trying to reopen secondary markets for securitized private lending (which in the US is as important as bank lending), buying mortgage-backed securities and consumer and business loans, as well as U.S. Treasury bonds. The Bank of England is buying UK government bonds ("gilts"). The European Central Bank, reflecting a strong inflation concern, has responded more slowly.



The US government is now insuring, lending or spending over \$10 trillion from guaranteeing money market funds to the AIG bailout to the Fed's swap lines supporting foreign central banks. Analogous guarantees and bank bailouts have occurred in the other major economies (the ECB does not play this role for Europe; national governments do).

The fiscal response – tax cuts and spending increases – has varied considerably, being somewhat more tepid in debt-averse Europe than in the US and China. The US is hectoring Europe for more fiscal stimulus, while the Europeans pressure the US for greater and more globally coordinated financial regulation.

Will near-zero interest rates, financial-sector bailouts, and fiscal stimulus work? What else could be done?

As for fiscal measures, the empirical evidence suggests that three-quarters of consumption is based on longer-term economic prospects, not short-run disposable income. Thus, temporary tax rebates are mostly saved, not spent. Targeting liquidity-constrained people, especially the unemployed, is a bit more effective, as well as humane.

Some claim that infrastructure spending creates a big Keynesian "multiplier," a bigger increase in incomes than the initial spending (estimates range up to about 1.5 times the initial increase in spending). But infrastructure spending is usually slow – and almost always driven heavily by parochial political considerations. Japan's annual 15-20 trillion yen infrastructure-intensive stimulus didn't prevent its lost decade. Nor did American government spending end the Great Depression (unemployment was still over 15% in 1939, a decade after the depression's onset).

A more effective stimulus would speed up spending that needs to be done anyway. Or cut taxes to change the marginal calculus of firms on layoffs and consumers on spending – for example, by suspending the payroll tax on firms and workers for a year or suspending part or all of the sales tax or national value-added tax. Better yet would be permanent rate reductions and controls on future spending.

But governments should be wary of expensive fiscal stimulus. It is likely to yield little cushion for employment and income per dollar spent, while servicing the large debt accumulation will impede long-run growth, either by forcing substantial future tax increases or spending cuts, or by forcing central banks to inflate. Indeed, China frets over the safety of the US Treasury bonds that it holds.

In theory, enough quantitative easing implies future inflation, motivating people to buy big-ticket items, like cars and appliances, now to avoid the run-up in prices later. (In practice, it is an experiment.) High and rising inflation creates great costs and is difficult to reverse. After mitigating the downturn, central bankers must withdraw the immense infusion of liquidity before inflation takes off, a tricky maneuver.

The bottom line, though, is that better policies can at best mitigate the economic consequences of this horrible recession. We will not get out of this mess completely any time soon. Sometimes, strong recoveries follow recessions, but recovery following financial crises is always immensely painful, time-consuming, and traumatic.

The economists Ken Rogoff and Carmen Reinhart have argued that the major financial crises of the last century typically lasted a half-decade or longer. In many of the previous banking crises, it was a country or a region that was hit hard (Argentina, Japan, etc.). This time, virtually every economy is suffering substantially and the banking crisis is global. Policymakers will continue to throw whatever ammunition they can find at the problem, but it will take time for the deleveraging from the boom to run its course.

At times of serious economic distress, policymakers thrash about seeking solutions, and some people lose confidence in the economic system itself. Indeed, in the Great Depression of the 1930's, it was common for Western intellectuals to turn to communism and central planning as a hoped-for panacea. Some never returned from that intellectual journey, despite the collapse of communism.

There is, of course, no case for going back to socialism and central planning. Once off government lifelines, we will need a better-regulated financial system. Any financial institution that is too big or too interconnected to fail, or could quickly become so, must be closely regulated and monitored for risk and capital adequacy in real time, or be broken up into smaller firms.

In the meantime, let's hope that Messrs. Bernanke, King, Trichet, and the world's other central bank governors get monetary policy roughly right, and that our politicians don't waste vast sums on ineffective fiscal stimulus.

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