Can Economics Save the Economy?

By Robert Huebscher
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The cost of going to the World Economic Forum in Davos, including admission to the special sessions, a hotel suite, car and driver, travel via private jet, and hosting a cocktail reception for your friends, is several hundred thousand dollars. If that sounds a bit expensive, you could have done what I did. For a mere $80, I attended an economics conference at MIT, honoring the 150th anniversary of the school.

At Davos, Treasury Secretary Tim Geithner told those assembled he was "much more confident" in a sustainable, global recovery, but among the prominent economists and policy makers who gathered in Cambridge, including many with Nobel Prizes, such confidence was scarcely evident.

One panel discussion at the MIT conference stood apart for its discussion of big-picture economic issues, such as whether further short-term stimulus is needed and if the time has arrived to shift the focus to longer-term sustainability issues. Those panelists included Princeton's Paul Krugman, Harvard's Greg Mankiw, Christina Romer, formerly the chairperson of the Council of Economic Advisors and now a professor at Berkeley, Oliver Blanchard, the chief economist at the International Monetary Fund, and Northwestern's Robert Gordon (who was a last-minute replacement for Princeton's Alan Blinder). All have doctorates in economics from MIT.

Those thought leaders, who come from across the political spectrum, cited a lack of sufficiently powerful and politically feasible policy options, calling into question whether economists will be able to produce the clear path to the stronger recovery that Geithner and the Obama administration seek.

Setting the stage, Blanchard said the IMF had just released its official forecast, which anticipates 4.5% global growth in 2011. It will be a two-speed recovery, he said, consisting of 6.5% growth for a group of emerging and developed economies and 2.5% for many of the advanced economies, including the US at 3% and the euro zone at 1.5%.

"These are very low numbers," Blanchard said.

Not only are they low, but Blanchard expects the advanced economies to have substantial output gaps, notably evident in their high unemployment rates. Given the IMF's forecast, Blanchard said unemployment will remain "very high for many, many years to come."

Monetary and fiscal policies are the tools that could counteract that outcome, so let's look at what the panelists said about those options.

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Howitzers, swords and stones

For at least the last 50 years, monetary policy has been the primary tool to influence the business cycle. Paul Samuelson, the legendary MIT economist who passed away just over a year ago, laid the foundation in the late 1940s for the way we apply monetary policy today. Samuelson's framework was used by Fed Chairman Paul Volcker, who raised interest rates to arrest runaway inflation in the 1970s, and more recently by Alan Greenspan and Ben Bernanke, who lowered interest rates in attempts to revive the economy following the last two recessions.

Today, with interest rates near zero, conventional monetary policy options are almost nonexistent. Quantitative easing remains the only viable option for the Fed, and none of the panelists called for an end to the current program of buying longer-term Treasury securities with the hope of pushing those rates further down. Whether quantitative easing will achieve that goal is uncertain. "We don't have strong estimates for how effective it is," Romer said. "The idea that we should be dialing it back is very bad."

Given the fact that the output gap remains so large amid a deficiency of demand, Romer said the economy needs "as much monetary help as possible." That help, it appears, could only come from unorthodox measures.

Gordon invoked a comment made recently by Blinder, who evoked the language of World War I to describe the current state of futility. "We've run out of ammunition for the machine guns and the Howitzers," Gordon said. "We are in the trenches and all we've got left to fight with are swords and throwing stones. The Fed is pretty much out of the picture."

Indeed, the study of zero-lower bounds has emerged as a new field of study within economics, spawning research into policy options when interest rates are near zero. Some of the panelists have proposed unconventional ideas, like Krugman, who has suggested increasing the inflation targets, although he said that doing so would be politically impossible.

The appropriate level of interest rates, given a target growth rate and inflation rate, is given by the Taylor rule. That rule, according to Mankiw, suggests a target interest rate for the Fed of -3% to -4% right now. If the Fed were to set interest rates below zero, however, investors would hold currency instead of bonds.

To counteract this, Mankiw has suggested a tax on currency as a way to stimulate short-term demand, since consumers would then spend their currency rather than incur taxes by holding it.

That idea was so unpopular, Mankiw said, that when he proposed it in a *New York Times* column, a number of people wrote to Harvard President Drew Faust asking that he be fired.

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"Monetary policy needs to be adventurous and non-conventional," Krugman said. "But the support is not there for doing what needs to be done."

Searching for a fiscal push

The lack of monetary policy options has moved the focus of debate in Washington to fiscal policy measures. Here, the panelists debated the multipliers that have been calculated for various options. These multipliers are crucial, since they dictate the effectiveness of a given policy – a multiplier greater than 1.0 is stimulative, producing more than a dollar of growth for every dollar spent.

Romer's research on multipliers has been widely cited, since she found that tax decreases have multipliers as high as 3.0. Many conservatives have used this as the basis for calls for lowering taxes.

Gordon explained some of the difficulties in calculating those multipliers. Much of the research on those calculations, he said, relies heavily on wartime – World War II, Korea and Vietnam – since rapid fiscal expansion took place during those periods. At those times, he said, the government is "crowding out" the industrial capacity and requiring certain kinds of production of its own. Romer noted that those wartime periods have also coincided with large tax increases, further complicating the multiplier calculation process.

Illustrating the inaccuracy of multipliers, Gordon said the Obama administration was expecting a multiplier of approximately 2.0 for its $787 billion stimulus. "The problem," he said, "was the Obama stimulus did not budge the share of government spending in potential output at all … from the end of 2008 until right now."

The reason, he said, was the increase in government spending was offset by a decline among state and local governments.

Some of the highest multipliers – near 2.5 – are for extending unemployment compensation and making the food stamp program more generous, Gordon said. Those efforts, though, which would help liquidity-constrained households, are politically unpopular, especially among those calling for deficit reductions.

Two of the panelists criticized infrastructure investment. Only a small portion of the Obama stimulus went toward infrastructure, and Gordon said much of that money went to renting construction machinery rather than into the wages of construction workers. Mankiw was similarly critical, saying that infrastructure spending typically takes too long to provide the needed short-term stimulation.

On the subject of fiscal policy, few have been as outspoken as Krugman. When the financial crisis first unfolded, he called for measures much greater than what the Obama

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administration implemented. Now, Krugman said, the “apparent inability of policy to really come to grips with this” is worse than he expected.

Krugman said the reliance of economists on fiscal and monetary policy measures as a way to control the economy has proved to be unstable in at least three different ways – intellectually, politically and financially.

Intellectually, Krugman said that over the last 40 years dissent has risen among economists as to how monetary and fiscal policies should interact and react in the economy. Without a clear understanding and consensus on those policies, he said, it is not possible to push through whatever recommendations are most needed at a given time.

Politically, Krugman said there is tension created by those who advocate a free market approach, because that line of reasoning leads to the government having no role in the management of the economy, including the printing of money. Free market advocates are at odds with those who, like Krugman, call for an activist fiscal policy, and the result is gridlock.

Financial instability, according to Krugman, arose because of the prolonged period of relative stability during the Great Moderation. Stability led to increased leverage, lax regulatory policies and the complacency that ultimately resulted in a “Minsky moment” – the instability brought on by the financial crisis.

Romer still sees hope in fiscal measures. She defended the Obama stimulus, calling it “incredibly effective.” She said, however, that at the end of the first quarter of 2011 about $700 billion of the $787 billion will have been spent and, when the stimulus ends, there will be “substantial fiscal contraction.” Romer said another $250 billion in stimulus is coming from measures such as the extensions to unemployment insurance and the payroll tax cut that were recently passed.

“Of course you need to realize that's good,” she said, “but the main thing that it is doing is cushioning the blow of the Recovery Act coming off.”

Romer said that, going forward, “we desperately need more demand in the short run.”

On that score, she said one “distressing feature” of Obama’s State of the Union speech was that the proposals for short-term stimulus were too small, such as the $4 billion for clean energy investments or similar amounts for universal wireless access.

Romer sided with Krugman in calling for high-quality fiscal stimulus, but Romer said additional stimulus needs to be coupled with a “signed, sealed, and delivered agreement for deficit reduction starting in 2012 or 2013, and this agreement is going to have to tackle the true driver of our deficit, long-run entitlement and spending on Social Security and Medicare.”

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Her fear is that we are likely to do the opposite – cut short-term spending and do little to deal with the long-run deficit.

Romer said she was described by the San Francisco Chronicle as "Obama's sunny economic forecaster." Yet, she was not upbeat. "About the best I can say is that people are at least talking about these issues in a serious way and that is, surprisingly, a step forward."

Beyond fiscal and monetary measures

Even if economists and policy makers here could agree on and implement appropriate measures, it is not clear that they will control the destiny of the US economy.

Blanchard spoke of two key issues on the global front that must be resolved. First is the continuing instability among the peripheral European countries. The looming problem for those countries, according to Blanchard, is a rise in sovereign interest rates, which would threaten the ability of governments to meet their debt obligations.

The key, he said, is to allay the fears of investors, which basically means making the balance sheets of the foreign banks that hold sovereign debt more transparent. Recent stress tests helped, he said, but this issue remains "terribly urgent." "When this is done, the markets will realize that the numbers needed to re-capitalize the banks are actually not enormous," he said.

The adjustments the peripheral countries will require to get back to proper health will probably take 10 years, he said. In the meantime, the European Central Bank has to provide liquidity to the banks – something it is not eager to do.

Blanchard said there was a "good chance" the necessary measures would be taken, including additional funds that might have to be provided by the Germans and the French.

The second key issue, according to Blanchard, is the tension between the US and China. China, he said, basically wants to change its growth path from exports to domestic consumption, which ultimately would be good for them and for the US.

The problem, he said, is that China is not eager to do it very quickly, because they are not sure how to satisfy their domestic markets. Because they fear rising inflation and "overheating," they prefer a horizon of "many years."

The US, on the other hand, needs this change to happen "fairly urgently," according to Blanchard, in order to address its fiscal deficit.

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The US, he said, faces a difficult choice. We can force fiscal consolidation, decreasing demand and slowing down growth – which would clearly be bad for the US and for the rest of the world. Or we can continue to have very large deficits, which he said will lead to the question now being posed for Europe – is our fiscal path sustainable?

“There are reasons to think that one might want to worry,” Blanchard said.

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