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Economic Minefields

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Abstract

Institute Fellow Rudy Penner questions the costs and after-effects of heavy economic stimulus. There is a path out of our misery, he says, but it is surrounded by big and little mines, some of which have been planted by public policy.

Commentary

Working in Bosnia soon after their war, I was warned — as though I had to be — not to walk past any of those little triangular signs that said "Mines.". But what if one found oneself standing behind one of those little triangles? I have a feeling that's where our economy is today. There is a path out of our misery, but it is surrounded by big and little mines, some of which have been planted by public policy.

As we tip toe out of the field, our path will be partly guided by natural instincts. Economies eventually recover by themselves even from dire circumstances. Auto production is now far below the normal rate at which cars are scrapped. It will get harder and harder to keep the old clunker going and auto repairmen may be among the few actually enriched by the recession. It is inevitable that people will soon be forced to buy new cars. Housing starts are far, far below the normal rate of household formations and the number of occupied housing units is actually declining. Are kids moving back in with their parents or parents moving in with their kids? Either way, it will get very tiresome very fast. Eventually, either parents or kids will be fleeing to new housing.

More generally, the consumer is key to the outlook because consumption normally accounts for 70 percent of the GDP. Households lost $11 trillion over the last year as housing and stock markets collapsed. They tried to make up for some of their losses by increasing their saving from near zero to about 3 percent of disposable income in the last quarter of 2008. That may have been prudent, but it killed retail sales and economic activity. What will consumers do next? They are unlikely to make up for their losses any time soon. Will they keep trying and keep increasing saving rates? If so, the recession could go on for a good long time. Or will they be happy to accumulate wealth at a slow rate? Because, as noted above, things wear out and houses are becoming more crowded, increased spending seems more likely than increased saving in the not too distant future.

As we wind our way out of the minefield, we are being pushed along, perhaps carelessly, by public policy. Monetary policy has never been as aggressive. Bank reserves are exploding, thus laying a foundation for massive amounts of money creation. The stimulus package passed in February dwarfs anything ever seen. And that was on top of a package passed last year.

The Fed Chair, Ben Bernanke and White House Chief Economist, Christy Romer, are much admired scholars of the Great Depression. Bernanke learned of the perils of letting the money supply fall and

Romer learned that stimulus should not be withdrawn too fast, but did they learn their lessons too well? Will they know just the right time to withdraw reserves and end the stimulus, or will we eventually be afflicted by runaway inflation?

Perhaps the biggest mine out there has been laid by fiscal policy. The Obama budget for 2010 and his stimulus program, combined with recession-depressed revenues, enhanced spending on safety net programs and a generous appropriation for 2009 will create an eye-popping amount of debt. The Congressional Budget Office estimates that Obama's policies will increase the debt by 90 percent between 2008 and 2012. The Congress is balking, but much of the increase is already baked in cement. Who will buy all this debt and at what interest rate? China, our biggest foreign creditor, is worried, and so, most likely are other would-be investors. Even if buyers do not go on strike, we know that the interest bill on our debt will soar and become a budget problem by itself when interest rates return to normal.

But that's a far off problem. Undoubtedly, some fiscal stimulus was necessary. I would have preferred a package that was smaller and better designed and I would really be happy if there were a more credible plan in place for controlling our borrowing in the long run. But so long as foreigners think that we are the best looking horse in the glue factory and continue to love our debt, the fiscal plan, while risky, should do some good.

On top of all this, we have yet another financial bailout plan, fondly known as Pee-Pip. Is it a new mine or a possible pathway out? Whatever else it is, it is highly ironic. We got into this mess partly because people borrowed money to buy bad mortgage-backed securities. Pee-Pip subsidizes private investors to borrow money to buy bad mortgage-backed securities. Granted, there will be less borrowed money per dollar invested and private investors are taking less risk, partly because the FDIC is guaranteeing the necessary borrowing.

If the plan fails, it will be for one of two reasons. There won't be enough sellers or there won't be enough buyers of bad assets. Banks may be reluctant to sell because they are then most likely to have to record a significant loss on their books. The government hopes that the heavy subsidy given to buyers for risk taking will induce them to offer a high enough price to make the deal attractive to current holders of the bad assets. Oddly enough, investors may not buy the assets because of the possibility that they will earn very high profits on the deal. After the AIG bonus fiasco, potential investors have to be concerned that the Congress will attempt to claw back large profits if they appear to be obscene. However, if the plan fails because there are few transactions, it will not cost much and little harm will have been done — except perhaps to confidence. And there is a chance that it will succeed and help restore lending by banks that are able to get rid of some really bad assets.

In summary, we are condemned to live in interesting times. There has never been an economic situation quite like this, and there has never been a policy response quite like this. Consumer and business confidence has fallen through the sub-basement. But take heart. Our economy has recovered from worse situations without much help from policy, as in the early 1890s. Although this is often referred to as the worst recession since the Great Depression and it will be the longest, I am not yet convinced that unemployment will exceed the early 1980's peak of 10.8 percent. If it does, one has to wonder whether monetary and fiscal policies have any kick at all.