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The Stimulus Debate Still Rages, 5 Years On

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Summary

With predictably disappointing results of QE, there is reason to revisit the stimulus on its 5-year anniversary.

The debate over its merits still rages on, five years after it was implemented.

But organizations like the OECD and the IMF are arguing for a substantial public investment blitz even today.

The ARRA, the American Recovery and Reinvestment Act, more commonly known as the economic stimulus of 2009, celebrated its five-year anniversary. There are those who are not joining the party but instead arguing that the ARRA was a complete failure.

This debate is still relevant, as organizations like the OECD and the IMF urge nations to embark on a public investment blitz to kick-start a faltering world economy.

One of these people is Daniel Mitchell from the Cato Institute, who wrote this anti-ARRA, and more generally, anti-Keynesian manifesto. We'll distill the main arguments and provide some counter-arguments.

Mitchell's main case against the ARRA, and against Keynesian demand management, can be summed up as follows:

1. The recovery was weak, so ARRA wasn't a success.
2. There is an opportunity cost when the government borrows and spends: Keynesian policies involve diverting resources from the productive sectors of the economy.
3. Recessions are the result of bad government policies; stimulus only prolongs their effects.
4. Keynesian economics has a long track record of failure.
5. It's much better to do the opposite: to divert resources from government to the productive sectors.

This position could easily be summed up with the phrase "market fundamentalism," an overarching belief that markets can never fail and governments are always the problem, never the solution. It isn't actually so surprising to see someone from Cato arguing along these lines. That's basically what they're paid for, after all.

Weak recovery?

Well, beauty is in the eye of the beholder, but there are at least four reasons why this, as Mitchell has it, was a relatively weak recovery:

1. This was no ordinary recession.
2. Unlike any other recovery, public sector employment didn't rise.
3. Prolonged underutilization of production factors deteriorates their quality and quantity, resulting in slower growth of production capacity.
4. Financial crises cause large misallocations of resources.

The 2008/2009 recession wasn't your garden variety business cycle downturn where the Fed hikes interest rates to keep inflation from getting out of control.

It was a full-blown financial crisis that froze the financial sector, wiped out investment banks and car manufacturers, and slashed a $9 trillion+ hole in household balance sheets as a result of a crash in home prices, by far families' most important asset.

The response to this was to cut back borrowing and spending in order to repair the damage to household (and bank) balance sheets. Below you see the household deleveraging:

This deleveraging takes time (ask the Japanese) and this is an important reason the recovery was fairly weak, in Mitchell's assertion.

But it wasn't weak at all if one compares the US with other countries (and the gap has mostly grown since Q2 2013):

Now, job creation. We already took this topic on (here), but here is another take, from Calculated Risk:

First, here is a table for private sector jobs. The top two private sector terms were both under President Clinton. Reagan's 2nd term saw about the same job growth as during Carter's term. Note: There was a severe recession at the beginning of Reagan's first term (when Volcker raised rates to slow inflation) and a recession near the end of Carter's term (gas prices increased sharply and there was an oil embargo).

Term	Private Sector Jobs Added (000s)
Carter	9,041
Reagan 1	5,360

Reagan 2	9,357
GHW Bush	1,510
Clinton 1	10,885
Clinton 2	10,070
GW Bush 1	-844
GW Bush 2	381
Obama 1	2,018
Obama 2	5,5421
124 months into 2nd term: 11,084 pace.	

Currently, Obama's 2nd term is on pace to be the best ever.

While the private sector employment creation has been as good as any recovery, overall employment creation was held back by a rather unprecedented lack of growth in public sector employment. This never happened before:

And if one compares the post-2009 recovery with other recoveries after a major financial crisis, the conclusion forces itself that the US has done pretty well (especially since the graph below is old and employment creation has been brisk ever since):

Notable is that Japan apart, the actual fall in employment was very moderate in the beginning, and the recovery set in pretty rapidly. Could the ARRA have something to do with that?

Opportunity Cost

Here is Mitchell:

The Keynesians basically assume that there are no "opportunity costs" when the government borrows money and spends it. That's a bit of economic jargon, but it's simply a way of saying that Keynesians think that money, for all intents and purposes, will sit idle and gather dust during an economic downturn in the absence of government. This is a very nice theory…but only on a blackboard. In reality, there is an "opportunity cost" when the government borrows money and spends it. Resources are diverted from the productive sector of the economy. This might not be a problem if government spent money wisely, but stimulus schemes tend to reward interest groups with the most political clout.

Basically, he's saying that public spending simply diverts spending from the private sector, and since the latter is more productive, the result must be a net loss.

This could be true if the economy would perform at full tilt. But it clearly wasn't at the time of the ARRA; there were ample idle resources, like mass unemployment and spare production capacity.

As an aside, it's odd that those who are most inclined to argue employment data give a false picture, even today, and unemployment is much higher in reality, are also the ones most inclined to adhere to this opportunity cost doctrine, which presupposes full employment.

Keynes wrote a *General* Theory (of Employment, Interest and Money). The emphasis is on *general*.

That is, Keynes saw a situation where the economy produced at full capacity as a special case, and explained why there can be prolonged periods away from full capacity/full employment production, as equilibrium-restoring forces could be weak.

For instance, people might suddenly save more, as they become more pessimistic, or in order to restore their balance sheets. The latter was clearly the case after $9 trillion+ was wiped off household balance sheets in the financial crisis and households saved more, as we already showed above.

The point is, Mitchell's opportunity cost argument becomes largely void if there are lots of idle resources, like unused plant capacity and substantial unemployment.

A stimulus could put some of these forces to work, or at the minimum, prevent even further growth in unemployment, as the economy is experiencing situations like in 2008-2009 can easily feed on itself.

Basically, in such a crisis economy there are little or no opportunity costs. Now you might not instantly believe this theoretical expose, but there is some relevant proof.

But if Mitchell is right, and stimulus would merely divert resources from the private to the public sector, we would see this competition for resources in a bidding up of prices (higher inflation) and higher interest rates.

Absolutely nothing of the sort happened; in fact, quite the contrary. Despite massive Federal deficits and debts, interest rates plunged, as did inflation, despite massive expansionary monetary policy by the Fed.

For the Mitchells of this world, this was really unexplainable. Many anti-Keynesians like him were riling against ARRA and the Fed, predicting runaway inflation and interest rates. Some even wrote an open letter to the Fed in 2010.

One could make an even more forceful argument: that *opportunity costs are, in fact, negative*. An employee produces more, pays more taxes, and spends more raising other people's income, compared to an unemployed person.

Idle plants and machinery are a drain to corporations. And the longer resources are unused, the more they tend to deteriorate, both in quality and quantity. This reduces the growth of production capacity itself.

Government Failure

Mitchell implicitly argues that market economies can never produce below capacity and explicitly argues that if they do, some government policy must be at the root.

However, history shows that financial markets in particular can overshoot and even become highly irrational, with valuations losing relation to reality. This has happened time and time again, and when these asset bubbles finally implode, they can create real damage to economies, even producing prolonged slumps and depressions.

Evidence

According to Mitchell, the real-world evidence is "so unfriendly" to Keynesianism and has a "long track record of failure."

But the fact that a simple Keynesian model was able to predict such counterintuitive stuff (huge public debts and deficits but record low interest rates, massive money printing but record low inflation) that completely vexed many critics of Keynesian thinking is a powerful testimony to the strength of Keynesian economics.

There is lots more evidence, we're not going to be exhaustive. Instead, you might also want to consider some academic research on the ARRA.

Mitchell argues that Keynesianism didn't work for Japan in the 1990s. In the last graph above, you might have noticed unemployment didn't rise at all, even though Japan's financial bubble and crash was three times the size of that of the US, both in 1929 and 2008. (We have written more extensively about this here.)

Since the financial crisis, there has been a sort of real-life experiment going on, as different countries reacted with different fiscal policies. Here is some data on different countries, and there is a clear positive correlation between their fiscal stances and levels of GDP growth.

Conclusions

For many Keynesian critics, the market system always automatically yields economies producing at full capacity and full employment. Economies cannot really slump below full capacity for prolonged periods of time. If they do, by definition some government policy must have caused it.

Since economies always produce at full capacity, public stimulus has opportunity cost and takes away resources from the private sector.

Keynes already showed market economies can slump by themselves, as investments slump on reduced confidence ("animal spirits") and/or people start to save more, and remain in such a slump for prolonged periods of time.

We have seen that again in the aftermath of the financial crisis as households saved more and spent less in order to repair their balance sheets, leading to a severe underutilization of resources and a positive role for stimulus (especially fiscal stimulus like the ARRA) to try to get idle resources employed again before decay set in, affecting the quality and quantity of future production capacity.

This is also the reason organizations like the OECD and the IMF urge countries to embark on a public infrastructure blitz, as the deflationary forces of deleverage linger on after the financial crisis.

We would add that an investment blitz would be money better spent than the endless purchase of government paper injecting funds into the financial system otherwise known as QE.