Notations

To Opponents Of The Stimulus

Bruce Bartlett, 08.21.09, 12:00 AM ET

According to a recent *USA Today* poll, 57% of Americans think the $787 billion fiscal stimulus enacted in February either has had no effect or made the economy worse. This brought smiles to the faces of Republicans who voted *en bloc* against the package because it means they won't pay any political price for their vote. But there is still the substantive question of whether we would be doing as well or worse if there had been no stimulus.

Over the past year, we have heard much criticism of the stimulus and Keynesian economics from conservatives, but we have heard precious little about what should have been done instead once it was clear that a very serious recession was underway. This implies that conservatives think the government should have done nothing and allowed the economy to crash or recover on its own. This is in fact the explicit view of those associated with the right-wing Austrian school of economics, which includes Congressman Ron Paul, R-Texas.

If the economy should have been forced to recover on its own without any help from government, then this suggests that the cause of the crisis had nothing to do with government policy; it's all the private sector's fault. As economist William Poole of the libertarian Cato Institute said last November, "I hold the market responsible for the financial crisis."

In this view, private businesses, investors and workers made mistakes and must pay for them. If they are rescued through bailouts, unemployment compensation and stimulus programs, it will reduce the punishment for those mistakes, which will lead them to make the same ones again in the future. Inflicting maximum pain on the private sector, therefore, is just tough love.

If the recession is primarily the result of private-sector mistakes, then perhaps one could justify the conservative do-nothing policy. There are two problems, however. First, many of those suffering from the recession clearly did nothing wrong; they're innocent bystanders--workers who have lost jobs through no fault of their own, investors who have suffered huge wealth losses due to the misfeasance or malfeasance of corporate executives, and well-run businesses that were forced into bankruptcy solely because of the recession.

Basic fairness and compassion demand that something be done to aid those who suffer collateral damage from economic crises. And in a democracy it is inevitable that government will respond to their cries for help. Rather than say that people should just suck it up, I think it would be better for conservatives to support temporary programs to help people cope. By refusing to do so, they make it easier for liberals to use a crisis as an excuse to enlarge government with permanent programs that probably couldn't be enacted except during a crisis.

Second, the do-nothing approach leaves open the question of why vast numbers of investors and businessmen all made exactly the same mistakes simultaneously. Why, for example, did so many people buy houses they couldn't afford, and why did banks lend them the money to do it?

Conservatives believe that the market does not make systematic errors. The profit motive will cause them to be self-correcting. A business that makes bad investments will see its stock price fall, which will lead to a change in management and liquidation of the bad investment or bankruptcy. Greedy investors will short the stock of such companies, and profit-maximizing lenders will cut off their credit. For this reason, conservatives deny the possibility of sustained and simultaneous errors in the private market unless the rules of the game are altered in some way.

Historically, the institution primarily responsible for changing the rules of the game is the Federal Reserve. As our nation's central bank, it controls the money supply and hence the rate of inflation and the level of short-term interest rates. In this sense, the Fed affects every dollar-denominated economic transaction on Earth.

For this reason, most conservatives place primary blame for the recession on the Fed. Hoover Institution economist John

Taylor says that the recession was the direct result of a Fed-induced bubble resulting from a monetary policy that was too easy for too long. This caused interest rates to be lower than they should have been, which encouraged excessive risk taking and bad investments that would not have been made if the Fed had done a better job of managing the money supply and interest rates.

There were other causes as well, such as efforts by government housing agencies to encourage homeownership and actions by private banks that disguised the risks inherent in some of their financial products. But these things by themselves were not sufficient to cause an economic crisis of the magnitude we have seen. That can only happen when the Fed screws up.

So if government, of which the Fed is a big part, is primarily responsible for the recession, then where is the logic in saying that private businesses, workers and investors must bear 100% of the burden of adjustment with no assistance from the entity that caused it? It's like telling Bernie Madoff's victims that it was their fault for giving him their money and punishing them instead of him.

Conservatives respond that while they opposed the stimulus legislation in February they didn't necessarily want to do nothing to counteract the recession. The government could have cut taxes some said. But where is the evidence that tax cuts would have done any good when so many businesses are losing money and going bankrupt, when millions of workers have been laid off and have no wages to tax, and most investors have so many losses to carry forward that they probably won't pay a nickel of capital gains taxes for years after the market recovers?

It's worth noting that, according to the Congressional Budget Office, federal revenues will consume only 15.5% of the gross domestic product this year. That's about three percentage points below the postwar average and lower than any year in generations. It's simply implausible to believe that more tax cuts, of which we had so many in the years leading up to the recession, would have had any effect whatsoever under current economic conditions.

Indeed, many Keynesian economists like Princeton's Paul Krugman argued that the impact of the stimulus package would be severely undermined by the inclusion of tax cuts, which made up a fourth of its budgetary cost, because the money would be mostly saved rather than spent.

Some conservatives say that while fiscal stimulus may have been worthless or even counterproductive, monetary stimulus works. As economist Anna Schwartz put it at a conference in March of this year, "Instead of fiscal stimulus we should have monetary stimulus." At the same conference, University of Chicago economist Robert Lucas said, "I think what the Fed is now doing is going to be enough to get a reasonably quick recovery."

If conservatives wanted monetary stimulus, they got it. Over the past year the money supply has increased dramatically. The narrow money supply (M1) is up 17.4%, and the broader money supply (M2) is up 8.1%. On a seasonally adjusted basis, M1 is up by $245 billion, and M2 is up $622 billion.

Economists associated with the Austrian school have been so alarmed by the skyrocketing money supply that for months they have been predicting that hyperinflation is right around the corner. But the price data continue to show that deflation, not inflation, is the economy's biggest problem. Over the last year the Consumer Price Index is down 2.1%, and the Producer Price Index is down 6.4%.

The problem is, as Keynesian economists have argued since the beginning of the crisis, that when the economy is in a liquidity trap--something that happens when interest rates are extremely low, as they are now--monetary policy is impotent. An aggressive fiscal policy is essential to raise aggregate spending and get money circulating, otherwise it just piles up in bank accounts without having any meaningful economic effect, inflationary or otherwise.

Some conservatives who opposed the stimulus in February now concede that it helped. On Aug. 7, Douglas Holtz-Eakin, John McCain's chief economic advisor during last year's campaign, told reporters, "no one would argue that the stimulus has done nothing." On Aug. 10, Niall Ferguson of the Hoover Institution said the stimulus "has clearly made a significant contribution to stabilizing the U.S. economy."

I think conservative economists need to get together and come up with a consensus opinion on what should have been done about the recession because sooner or later there's going to be one on a Republican's watch. When that happens, I rather suspect that the do-nothing option will not be on the table.

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