THE WALL STREET JOURNAL.
WSJ.com

OPINION | AUGUST 16, 2010

The Fed Can't Solve Our Economic Woes

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A policy of low interest rates is a textbook response of monetary authorities to the economic weakness brought on by deficient aggregate demand. The policy is justified by pointing to various ways in which money can promote economic activity—including by stimulating investment, discouraging savings, encouraging consumption spending, and allowing individuals to lower their debt burdens by refinancing existing debt. While these effects are theoretically plausible, this textbook policy does not apply to our present situation.

First, our lingering crisis and economic weakness was brought on not by a Keynesian failure of effective demand, but by a Hayekian asset boom and bust. Second, the textbook case for low interest rates treats the policy as one of benefits without costs. No such policy exists.

The housing boom and bust was a classic asset bubble, such as occurred frequently in the 18th and 19th centuries. Easy money working through cheap credit made long-term investments appear more valuable than would otherwise have been the case.

Associated Press

The Federal Reserve building in Washington.

In most cases, investment booms drive industries with sound fundamentals. When the cheap credit keeps flowing, however, fundamentals are forgotten and the process evolves into a mania (to use the old-fashioned term). What cannot be sustained will not be, so the boom ends in a crisis.

In these scenarios, the collapse of demand is a consequence—not the cause—of the bust. Policies to address crises must get cause and effect right.

When housing prices peaked and then turned down, there were repercussions throughout the financial system and then the broader economy. Mortgage-related securities soured, hitting the balance sheets of the institutions that had purchased them. As that became known, the prices of the securities of these institutions (mainly but not exclusively financial) fell. Credit dried up and the economy tanked. A general rout in the stock market ensued.

The financial panic and ensuing great recession was a classic balance-sheet recession. As balance sheets shrank in value, demand collapsed. There was a liquidity crisis as well, centered around Lehman's collapse, but the driving force was collapsing balance sheets, impaired capital values and, for many, insolvencies.

The declines in home values, investor portfolios and 401(k) plans, and the uncertainties surrounding retirement plans, have all had a big impact. The solution lies in restoring balance sheets. For financial firms, that means raising capital. For consumers and businesses alike, that means saving more of their reduced incomes.

Yet public policy has focused almost exclusively on stimulating spending without much regard to why spending, especially consumption, has flagged. Until balance sheets (corporate and household) are restored, increased spending cannot be sustained.

Temporary spending and tax breaks are always dubious, and especially so now when the rational motivation is to save more and consume less. One-off tax credits for homes, for example, merely borrowed sales from the future. These fiscal programs predictably depressed rather than augmented future consumption.

What is in short supply is not liquidity, but savings. The Fed can supply the former but not the latter. Both fiscal and monetary polices need to shift their focus. The Fed has done the heavy lifting and responded more than adequately to liquidity issues. Now there is little further it can do that is beneficial.

Its move toward Japan-style quantitative easing is a misstep. And historically low interest rates—about which the Bank of International Settlements, the bank for central banks, sounded a warning in its 2009/2010 annual report—will inevitably distort economic activity, as they did during the housing boom. Low interest rates slow the process of restoring balance sheets by keeping asset prices artificially inflated. They also penalize saving, thus prolonging the process of rebuilding balance sheets.

In the fiscal realm, policy must be reoriented from stimulating consumption to encouraging productive investment (not renewed financial speculation). That means no income-tax increases or costly new mandates. In particular, the Bush tax cuts should not be allowed to expire. No matter how the administration spins it, their expiration would entail a large increase in marginal tax rates in the midst of economic weakness. That would further impede savings and capital accumulation, discouraging firms from expanding and hiring workers. Treasury Secretary Tim Geithner is proposing to repeat the mistake of Herbert Hoover, who persuaded Congress to raise taxes in 1932.

Markets are resilient, but their recovery can be impeded by bad policies. At present, both monetary and fiscal policies are on the wrong track.

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