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Guest Post: Obama Plan Is Bold, but Not Bold Enough

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By WSJ STAFF

*As details emerge about the incoming Obama administration's stimulus plans, **Peter Boone** and **Simon Johnson** argue that proposals should be even bolder. Boone is chairman of **Effective Intervention**, a U.K.-based charity, and a research associate at the Centre for Economic Performance, **London School of Economics**, and Johnson is a former **IMF** chief economist, and is currently a professor at **MIT Sloan School of Management** and a senior fellow at the **Peterson Institute for International Economics**. They run the economic crisis Web site **http://BaselineScenario.com**.*

There has been very little pushback against the Obama administration's plans to put the U.S. economy on the road to recovery. To the extent there are reservations, these come from people worried about the size of the U.S. deficit and the implications of a higher national debt down the road. These concerns are likely to keep the total fiscal stimulus package (over two years) under $800 billion, but that is still large — around 5% of GDP and the biggest boost ever given to the U.S. economy in peacetime.

Are Obama's stimulus plans ambitious enough? (Reuters)

The problem is not that this stimulus is too large, but rather that the entire Obama strategy now seems to be insufficiently bold. This may seem strange, given the new leadership team's recent stress on the need for large, decisive measures, but consider the following three issues.

First, increasing government spending makes sense as a way to replace or stand in for private spending. But the problem facing the U.S. economy is not only a decline in consumer spending. In fact, this decline is only a symptom of the slow down. The deeper problems are with balance sheets, i.e., the fact that many people feel (rightly) that they or the firms they run owe too much money relative to their incomes. These people are trying hard to save more, hence they are spending less. The government spending more (or taxing less) will help, but the fiscal stimulus likely cannot be scaled up enough to offset the contraction arising from damaged balance sheets.

Second, while the reduction in lending is now being driven more by people not wanting to borrow, it is still the case that — if there is any kind of incipient recovery — banks do not have enough capital. They are under great pressure to rebuild their capital, while all kinds of regulators are jumping on them to tighten lending standards. Earlier this year, the IMF published a controversial estimate of how much bank capital had been raised relative to — and replacing — the likely losses in the financial system. Back in the spring the answer was that the global banking system was about $500 billion short. The best estimates today indicate this gap is now at least $700 billion world-wide and rising, with nearly half of that in the U.S., yet private markets remain closed to the raising of new bank capital. Without a healthy banking system, we risk repeating the mistakes of Japan in the 1990s, when large government spending programs failed to generate significant economic growth on their own.

Third, none of these problems are limited to the United States. In fact, it is hard to find any country where people are not trying to increase their savings and strengthen their balance sheets, or where the banks truly have enough capital. Most of the world was running a major credit boom, although it took different forms in various places. The difficulties of dealing with the end of this boom are particularly acute in the euro zone, where some governments have become overindebted (including Greece and Italy) and in emerging markets, where firms and households overborrowed in foreign currency (including Russia and most of East Central Europe). Most of the signs point to Europe, broadly defined, as being the epicenter of a second wave of crisis in 2009 — potentially more serious than what we saw in 2008.

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We should have no illusions regarding the likelihood of non-US leadership on any of these issues. The G-20 is stuck on a re-regulation agenda which, while probably not a bad idea for managing the next boom, is a great distance from being helpful in the current deep recession. The IMF is providing help for smaller countries that cannot roll over their debts, but this is no more than damage control. Either Obama will provide leadership on these issues or there will continue to be a serious global strategy vacuum.

So what would a truly bold plan look like? A fiscal stimulus, roughly of currently planned proportions, makes sense, but it needs to be urgently supplemented with three additional elements.

First and most important, there should be substantial further easing of monetary policy. The Federal Reserve is already heading in this direction but it needs to pick up the pace, and the president needs to get on board. The Fed should announce that it will create inflation in 2009, i.e., it will do whatever it takes to make sure that wages and prices rise, rather than fall, in the next 12 months. And it should back that up with more aggressive monetary expansion, buying even more government and private securities. We cannot wait for a deflationary death spiral to take hold; this was a key mistake in 1990s Japan. At that point, it would be far too late. Nothing in the Fed policy or the Obama Plan has yet turned the corner on this issue. In fact, expectations implicit in inflation swaps indicate prices are expected to fall over the next several years.

A pro-inflation policy will complicate the Fiscal Stimulus Strategy as any kind of success will push up long-term nominal interest rates. But rising prices and wages mean that the burden of debt (the payments on which are often fixed in nominal terms) declines, and this by itself will help to repair private balance sheets.

More importantly, lower inflation means higher real interest rates, which means lower disposable income for borrowers. Let's say your mortgage rate is 6%, which is roughly the average mortgage rate for the U.S. With inflation around 2%, where it has been for the last several years, your real, inflation-adjusted interest rate is only 4%. But the price level is now expected by the financial market to fall by about 0.1% per annum for each of the next five years, in which case your real interest rate will be 6.1% — 2.1 percentage points, or 52% higher. In other words, lower inflation — or deflation — implies a massive unexpected transfer of income from borrowers (i.e., spenders) to ultimate lenders (net savers). With the face value of outstanding mortgages over $10 trillion, this will likely depress spending by more than can be compensated for by any reasonable fiscal stimulus. The increased real burden of mortgages will also lead to increased delinquencies and foreclosures, further weakening the financial sector.

The other benefit of recreating positive inflation expectations is that it would put downward pressure on the dollar and thus push our major trading partners to cut interest rates and engage in their own forms of monetary expansion — or face appreciation of their currencies and a fall in exports. The result will be higher global inflation, to be sure, but this is the only realistic way to persuade European Union members to take the measures necessary to stimulate their stronger economies or even save their own weaker economies from default.

President Obama can ask our allies to provide stimulus until he is blue in the face, but the fact of the matter is that the very size of our own fiscal expansion gives the Germans and others the incentive to free ride — they are hoping to recover on the back of exports to our infrastructure projects. It is only more expansionary monetary policy in the U.S. that will force their hand in the right direction, for us and for them.

Second, we need a comprehensive bank recapitalization plan. Again, presidential leadership is needed as this will be strenuously resisted by powerful interests in the financial sector. The Treasury should set high depression-proof capital requirements, and give the private sector a limited amount of time to either raise enough new funding or come into a government-provided capital scheme. The net result would likely be much higher government ownership of common stock, but the divestment of this over time can be managed through a Resolution Trust Corp.-type structure.

Third, we need more direct measures on the housing market. There is no question that some refinancing of problematic mortgages and a greater government role in managing the flow of foreclosures make sense in both economic and political terms. But a sufficiently expansionary monetary policy would go a long way to reduce the potential problems in the housing sector. It would be a mistake to rely too much on fiscal policy in this regard.

The current emphasis on fiscal stimulus as the primary means of recovery is reasonable if we think that deflation is unavoidable or that any kind of moderate inflation would be an unacceptable price to pay for avoiding the Second Great Depression. The potential problem lies in failing to create the necessary conditions — positive inflation expectations, a healthy banking system, and an end to the housing bloodbath — for the fiscal stimulus to be successful.

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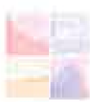

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