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Who Will Stimulate the Economic Recovery: **A Ghost Story**

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The U.S. economy took a historic nosedive in 2007-2010. It was the worst downturn since the Great Depression of the 1930s. Gross Domestic Product (GDP) declined in five out of six quarters from 2008 to the first half of 2009. At the start of the recession in December 2007, the number of unemployed persons was 7.5 million, and the unemployment rate was 4.9 percent. In January of 2010, the unemployment rate fell from 10.0 to 9.7 percent. The number of unemployed persons was 14.8 million. This is a far cry from the 25 percent unemployment rate of 1933, but this generation has never seen anything like it.

Evidence is emerging which suggests we are in the midst of an economic recovery. In February 2010, the U.S. Commerce Department reported that GDP rose at a 5.9 percent annual rate in October through December 2009. This was due in part to businesses slowing their inventory reduction and increasing their spending. This represents the fastest rate of growth since the third quarter of 2003. Stock markets are widely regarded as leading economic indicators. While still a long way from the high of 14,164.53 on October 9, 2007, the Dow Jones Industrial Average has shown a strong recovery that began in March of 2009 at 6,547.05.

Yet, despite all of the good news, the recovery appears fragile. There is talk of a jobless recovery with unemployment remaining at historically high levels for a year or two. The unemployment rate is regarded as a lagging economic indicator. Even when the economy begins to add jobs, the unemployment rate tends to remain high. New hiring attracts more workers into the labor force, which results in the unemployment rate remaining high even as the economy is adding jobs. Here are a few questions that point to some of the headwinds facing a vigorous economic recovery:

- Will high levels of increased federal spending and high deficits spook business people and consumers and eventually produce high levels of inflation?
- How will the Federal Reserve unwind itself from acting as the "financial rescuer of last resort?"
- How will small businesses get the credit from banks? (Banks have cash to lend but federal regulators want them to lend only to good credit risks. Banks are buying Treasury securities and taking a pass on riskier loans to small businesses and consumers.)
- What will be the impact of the new financial regulations? Will the expected new federal agencies help or hurt institutions and investors?

A Top Policymaker and Two Voices from the Past

The one person with the most influence over the economic recovery arguably was not President Barack Obama or any leader in Congress, but instead the chair of the Federal Reserve System's Board of Governors, Ben S. Bernanke. Economists like to point out that there are two distinct ways of promoting economic recovery: fiscal policy (the use of taxing and spending) and monetary policy (control of the banking system and interest rates). Of the two, fiscal policy is considered weaker and its administration is divided between the president and Congress. Bernanke, as the most influential voice in the setting of monetary policy, had a great deal of authority and responsibility as the economy slowly recovered. We imagined the following scenario if two of the most renowned economists in our history were to visit with Ben Bernanke:

Late one night at his Capitol Hill home, Bernanke was thinking how simple economic policy had seemed when, as a student, he had studied the great economists of the past. Adam Smith, the Scottish moral philosopher, had written his great work The Wealth of Nations*, outlining how human nature leads people to buy and sell and seek profit. In the operation of the British economy of the 1700s, Smith saw how governments could set up the basic institutions, but then stand back and let the system work.*

In contrast, John Maynard Keynes wrote The General Theory of Employment, Interest and Money *in*

the twentieth century when the world economy was on the brink of collapse. Keynes respected Smith's insights but he also thought the tendency of market systems to have wild swings from boom to bust needed to be tamed by government.

As he considered the great thinkers, Bernanke dropped off into a fitful sleep, exhausted by a day of congressional hearings and policy meetings. He was startled when a figure carrying a candle appeared to him. From the woodcut illustrations of old textbooks, Bernanke immediately recognized the ghost of Adam Smith.

What specific advice would Smith have for Ben Bernanke today? We think that Smith would say something like this: "The best course of action is to find the paths with the least amount of direct action by government. Get the incentives right and the economy will recover."

Economists expect periods of expansion to be followed by periods of contraction that, in turn, are followed by new rounds of economic growth producing higher standards of living. These periods of expansion and contraction are the result of imperfect economic institutions created by imperfect human beings who make decisions based on imperfect information. So, unexpected things go wrong. But, for things to go very wrong, as they did beginning in 2007, we suspect that poor government regulatory policies—policies with perhaps the best of intentions—are the cause.

Adam Smith

Adam Smith asks, "Ben, do you think all this intervention in the economy has been excessive? Remember what you used to teach your students at Princeton? Markets are resilient and self-correcting. The proper economic role of government in a market economy is to get the basic institutions right, including respecting private property rights and then let an invisible hand take over. You'll remember that I once wrote this about individuals who engage in commerce:

'... by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which has no part of his intention. Nor, is it always worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good. It is an affectation, indeed, not very common among merchants, and very few words need to be employed in dissuading them from it.'" [1]

—*Wealth of Nations*, Page 456

The seeds for the collapse of the housing market were planted in the early 1990s. The passage of the 1992 Federal Housing Enterprises Financial Safety and Soundness Act, for example, lowered traditional lending standards. Mortgage bankers were under pressure from the Community Reinvestment Act to provide mortgages to individuals who did not meet traditional lending standards. Mortgage bankers were also under pressure to sell these risky loans to Government Sponsored Enterprises—Fannie Mae and Freddie Mac. Fannie Mae and Freddie Mac took on more than $6 trillion of single-family loans from 1992 to 2008. Efforts in 2005 to rein in high-risk, government-sanctioned lending were brushed aside by congressional leaders.

The changes in lending standards and the expansion of Fannie and Freddie coincided with the Federal Reserve keeping its key interest rate—the federal funds rate—too low for too long. Low interest rates encouraged households to take on large amounts of debt. All of this—high-risk lending and low interest rates—was just fine as long as housing prices increased. Housing prices were relatively stable during the 1990s. They began to rise toward the end of the 1990s, and between January 2002 and mid-year 2006 they skyrocketed. But beginning in 2006, the boom turned into a bust and the housing prices declined throughout 2007 and 2008.

It appears that poor regulatory policies and poor monetary policy set the stage for the financial collapse. What would Adam Smith do? Modern fans of Adam Smith stress the idea that unfettered markets have a tendency to recover more quickly than when government intervenes. The collapse of the housing market is an example. In 2005, interest rates increased. Consequently, the interest rates of Adjusted Rate Mortgages reset at higher levels. Then, home prices

collapsed. The default rate on home mortgages increased. Home foreclosures soon followed suit. Government officials scrambled to pass new laws to keep people in their homes but this merely prolonged the suffering. Instead of trying to keep people in the homes they would eventually lose, a less painful policy would have been to let foreclosed home owners leave their properties and find housing they actually could afford—such as rental apartments. For the most part, that is what happened. Following the foreclosures, bargain hunters swooped into the market. Great buys were made. Slowly but surely, home inventories began to shrink and home prices started to recover. It turns out that free markets and time are the best friends of the economic recovery.

Similar developments are emerging in other sectors. Consumer spending and confidence show signs of improving. The weak dollar has increased opportunities for U.S. exporters. Businesses are beginning to build up their inventories.

How would friends of Smith encourage a faster recovery? They would advocate that the federal government show by its actions that it remains committed to the principles of a free market economy. Three actions would give evidence that this is the case:

1. Control federal spending. Many economists regard the $787 billion stimulus package signed into law in February of 2009 as too large and poorly targeted. Efforts should be made to limit additional spending and bring the deficit under control.

2. Resist raising taxes in the midst of a fragile recovery.

   - Marginal income-tax rates are set to rise several percentage points in 2011 unless Congress and the president choose to do otherwise. For example, the top marginal rate of 35 percent would rise to 39.6 percent.

   - The capital gains tax is currently set at 15 percent. It is set to rise to 20 percent in 2011. In addition, dividends would be taxed at the same rate as regular income.

   - The estate tax is set to end in 2010 but to reappear in 2011 as a 55 percent tax on inherited wealth exceeding $1 million. These estates have already been taxed once and maybe twice. Some economists regard this as a confiscatory tax on private property and an incentive for small businesses to cease operations upon the death of the owner.

3. Disentangle the government from owning private sector businesses or favoring some sectors or businesses over others. There has been a rapid expansion of subsidies and mandates from autos to energy to health care. (Remember Cash for Clunkers?) This encourages business owners to put expansion plans on hold and to wait and see what the new rules will be. In addition, economists worry that large companies such as General Motors and Chrysler will over time be managed to meet political rather than business goals. What is the exit strategy for government ownership of General Motors?

The writings of Smith and his modern-day followers note that market economies are successful in increasing our standard of living because of the widespread cooperation that comes from self-interest directed by the invisible hand of market prices. The next time you buy a loaf of marble rye at the grocery store, think about all the people who made it possible. It is unlikely that they acted out of a desire to serve their fellow person. Instead they were motivated by their own self-regard.

Waking with a start, Bernanke realized he had only been dreaming when he saw Adam Smith's ghost. He slowly drifted back to sleep, only to be visited by a second spirit.

John Maynard Keynes

The ghost of John Maynard Keynes appears next and explains that the economy is driven by "animal spirits." It was vital for Bernanke to intervene and prevent those animal spirits from disappearing: "Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as the result of animal spirits—a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities."[2] He encourages Bernanke not to rely too much on the economy's self-correcting abilities.

How specifically would modern day followers of John Maynard Keynes have responded to Adam Smith's argument for a laissez faire approach to the current recession? Put another way, what about this idea that economies will self-correct and that government attempts to "fine tune" the economy are counterproductive? In short, Keynes would have agreed with everything Smith said—as long he was referring to the economy in the *long run*. Keynes agreed

that over a long enough time horizon the economy would emerge from its down cycle for all of the reasons Smith expressed previously in this article. The distinction Keynes would make was one of timing. While the economy will likely cure itself if given enough time, such time may simply cause too much suffering among those affected by the economic downturn. Keynes put it this way: "The long run is a misleading guide to current affairs. In the long run we are all dead."[3]

Keynes's theories fixed what he interpreted as a fundamental error in the economic theories that had come before. Classical economics—the brand of economic theory professed by Adam Smith—teaches that if there's a downturn, the economy will eventually sort itself out. If people aren't spending enough, eventually prices will fall to a level in which people again start spending. Keynes's radical insight was derived from his experiences in living through the Great Depression of the 1930s. He observed that there are times when economies do not correct themselves quickly enough. When an economy goes into a major downward spiral, perhaps Smith's classical theory of supply and demand fails to provide a sufficient explanation of what is taking place.

Keynesian theory is simple. His writings tell us that economic downturns are caused by inadequate aggregate demand. Aggregate demand is the total (or aggregate) demand for final goods and services at various price levels over a period of time. Aggregate demand for an economy is divided into consumption spending by households, investment spending by businesses, government purchases of goods and services, and the value of exports minus imports.

Keynes's prescription to solve inadequate aggregate demand is for government to provide the demand the private sector will not. Keynes argued for increases in government spending and tax cuts to counteract the decline in aggregate demand that occurs during recessions due to decreases in household consumption and business investment. The Great Depression led to a profound shift in economists' thinking about macroeconomic issues. It seems almost certain that Keynes would have endorsed government action to help the ailing economy of 2007–2009.

In the 1930s, Keynes's prescription for the economic affliction of the day was embraced by President Franklin D. Roosevelt in the form of the New Deal. Today's New Deal-style government spending would have made Keynes smile as President Obama's recent $787 Billion American Recovery and Reinvestment Act of 2009 represents a current policy right out of the renowned Great Depression-era economist's playbook. The Act includes federal tax cuts, expansion of unemployment benefits and other social welfare provisions, and domestic spending in education, health care, and infrastructure, including the energy sector—all designed to spend government money today to put Americans back at work and fix the economic problems of the day.

Amid the euphoria in celebrating the government stimulus as the solution to our economic ills, loyal followers of Keynes would offer an important caution. Keynes argued that once good times return, the government must return to the pursuit of balanced budgets. Keynes understood that government borrowing—the source of the stimulus funds—ultimately must be paid back. And, if government borrowing is excessive, at some point we will encounter the worst of all economic worlds—high inflation, high interest rates, high taxes and dollar devaluation—all reminiscent of the woeful days of the 1970s.

Conclusion

Bernanke awoke again, wondering whether he would be visited by a third ghost. But no, there was no ghost—only the scary prospect of deficit spending as far as the eye could see. To get out of the downturn of 2007-2009, the president and Congress had borrowed a lot of money. And on this issue, the guidance of Adam Smith's ghost and John Maynard Keynes's ghost would be the same: that excessive borrowing was dangerous. Smith had written, "Great nations are never impoverished by private, though they sometimes are by public prodigality and misconduct."[4] Smith certainly did not oppose all government spending; in fact, he was very much in favor of what today would be known as infrastructure projects to facilitate commerce—canals in his time, interstate highways in ours. And while Keynes is sometimes portrayed as an unreserved advocate of deficit spending, he actually favored carefully applied deficits and surpluses to maintain full employment. He argued against "collecting taxes less than the current non-capital expenditure of the state as a means of stimulating consumption"[5]

Bernanke knew that he wasn't directly responsible for the deficits, because he had no authority over the federal budget. But he also knew the government can only close deficits by cutting spending, increasing tax revenue, or "printing money"—and he was in charge of the money supply. Would there be pressure on him to increase the money supply greatly, thereby bailing government out of its predicament but with a dangerous side effect of inflation? That was a ghost story for another day, and Bernanke finally dropped off to a sound, peaceful sleep.

Notes

1. Adam Smith, *An Inquiry Into the Nature and Causes of the Wealth of Nations.* R.H. Campbell and A.S. Skinner: General Editors; W.B. Todd: Textual Editor (Indianapolis, Ind.: Liberty Fund, 1981 edition).
2. John Maynard Keynes, *The General Theory of Employment, Interest and Money* (New York: Classic House Books, 1936), 161.
3. Keynes, *A Tract on Monetary Reform* (1923). Reprinted 1978 in *The Collected Writings of J.M. Keynes*, vol. 4 (London: Macmillan, for the Royal Economic Society).
4. Smith, *An Inquiry Into the Nature and Causes of the Wealth of Nations*, 342.
5. Keynes, *Activities 1940-1946 Shaping the Post-War World: Employment and Commodities* (1945). Reprinted 1980 in *The Collected Writings of J.M. Keynes*, vol. 27 (London: Macmillan, for the Royal Economic Society).

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