From: sbwhoeop[redacted] B6
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COLUMNISTS

Martin Wolf

Obama was too cautious in fearful times

By Martin Wolf
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Suppose that the US presidential election of 1932 had, in fact, taken place in 1930, at an early stage in the Great Depression. Suppose, too, that Franklin Delano Roosevelt had won then, though not by the landslide of 1932. How different subsequent events might have been. The president might have watched helplessly as output and employment collapsed. The decades of Democratic dominance might not have happened.

On such chances the wheel of history turns. But this time was different: the crisis brought Barack Obama to power close to the beginning of the economic collapse. I (among others) then argued that policy needed to be hugely aggressive. Alas, it was not. I noted on February 4 2009, at the beginning of the new presidency: "Instead of an overwhelming fiscal stimulus, what is emerging is too small, too wasteful and too ill-focused." A week later, I asked: "Has Barack Obama's presidency already failed? In normal times, this would be a ludicrous question. But these are not normal times. They are times of great danger. Today, the new US administration can disown responsibility for its inheritance; tomorrow, it will own it. Today, it can offer solutions; tomorrow it will have become the problem. Today, it is in control of events; tomorrow, events will take control of it. Doing too little is now far riskier than doing too much." This was right.

The direction of policy was not wrong: policymakers – though not all economists – had learnt a great deal from the 1930s. Sensible people knew that aggressive monetary and fiscal expansion was needed, together with reconstruction of the financial sector.

But, as Larry Summers, Mr Obama's chief economic adviser, had said: "When markets overshoot, policymakers must overshoot too". Unfortunately, the administration failed to follow his excellent advice. This has allowed opponents to claim that policy has been ineffective when it has merely been inadequate.

In consequence, the administration has lost credibility with the public and the chances of a renewed fiscal expansion have disappeared. With the Federal Reserve cautious, too, the likelihood of a lengthy period of weak growth and heavy joblessness is high. So, too, are the chances of domestic and global political friction.

True, the idea that the policies adopted in the last few months of the Bush administration and the first months of this one were far better than nothing is weirdly controversial in the US. A recent paper by Alan Blinder, former vice-chairman of the Fed, and Mark Zandi of Moody's argues that such critics are wrong. They use a standard macro-economic model to assess what would have happened without any intervention, without the financial interventions (including monetary policy) and without the fiscal action. They conclude that the peak to trough decline in gross domestic product would have been close to 12 per cent with no policy response, compared to an actual decline of just 4 per cent (see chart). Similarly, the unemployment rate would have peaked at 16.5 per cent, instead of the actual 10 per cent. The bigger collapse would also have meant a fiscal deficit of $2,600bn in fiscal year 2011. The outcome is also disastrous with the modest fiscal response but no financial policy response. It is a little better the other way round.

The implication that the modest stimulus package of February 2009 – a mere 5.7 per cent of 2009 GDP, spread over several years – made a positive contribution is supported by the analysis of the Congressional Budget Office: it argues that in 2010, US GDP will be between 1.5 per cent and 4.1 per cent higher and the unemployment rate between 0.7 and 1.8 percentage points lower, as a result of the package.

Panglossians who believe the private economy is always in equilibrium, unless governments intervene, disagree. I wish there were some way to run this experiment without hurting hundreds of millions of people. But I find the idea that allowing the collapse of much of the financial system, avoiding unconventional monetary policy and struggling to close the fiscal deficit would have been consistent with a more rapid and sustained recovery quite bizarre.

A fascinating perspective does come, however, from comparisons with what happened in other advanced countries. The recession in US output (and so demand) has been relatively small, but the decline in employment has been exceptionally large, as a result of an extraordinary surge in US productivity (see charts). This contrast between what would happen to output and what would happen to employment was missed in the initial Congressional Budget Office analysis of the stimulus.

Since the US was the epicentre of the financial crisis, the relatively small decline in output is remarkable. Moreover, since fiscal and monetary stimuli bear directly on demand and output, not jobs, this is a policy success. At the same time, the enthusiasm with which US managers laid off workers is also extraordinary. No doubt, some of this is due to the collapse in construction. But some of it must be due to the ease with which US companies can lay off workers and the incentives for managers to maintain profits in a downturn at the expense of jobs.

Debate is emerging on how much of the surge in unemployment is structural. My answer, from European experience, is that one way to ensure it becomes structural is to let it linger. In the short run, the simplest way to prevent that from happening is to expand demand and so output. Since there is huge slack in the labour market, not the slightest threat of inflation – far more a risk of deflation – and no constraint from bond or foreign exchange markets on further monetary and fiscal stimulus, these are the policies that have to be pursued. Yet, alas, the Fed seems to have decided to fall asleep and the administration has lost the initiative.

So what is going to happen? I assume that, after the midterm elections, resurgent Republicans will offer new tax cuts and ignore the fiscal deficits. They will pretend that this has nothing to do with any reviled stimulus, though it is much the same thing – increasing fiscal deficits, thereby offsetting private frugality. That would put the administration on the spot. It would have to choose between vetoing the tax cuts and accepting them, so allowing the Republicans to get the credit for their "yacht and mansion-led" recovery. Any recovery is better than none. But it could have been much better than this. Those who were cautious when they should have been bold will pay a big price.

martin.wolf@ft.com

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