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Lucas roundtable: Don't fault the economists

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Robert J. Barro is Paul M. Warburg Professor of Economics at Harvard University. This discussion can be followed in its entirety here.

I AGREE with the argument that, in recent decades, most American economists became too optimistic that a great depression would never happen again. This outlook reflected the tranquility of business cycles in OECD countries, where the most notable contraction since World War II was the 12-14% fall during Finland's financial crisis in the early 1990s. Depressions were more common outside the OECD, such as in the Asian Financial Crisis of the late 1990s and the Latin-American Debt crisis of the early 1980s, but the OECD was typically viewed as immune from these disruptions. Despite the general level of confidence, the truth is that the origins of the American Great Depression of the 1930s were not fully understood. My assessment is that the main policy changes that lessened the chance of another depression were, first, the implementation of deposit insurance in the Banking Act of 1933 and, second, the Federal Reserve's commitment, especially with its policy of near inflation-targeting since the early 1980s, to do whatever was necessary to avoid deflation.

Despite the common opinion that depressions were a thing of the past in the OECD, I became involved since 2005 in a research program on the financial and macroeconomic implications of rare macroeconomic disasters, including the Great Depression and 156 analogous events observed since 1870 in 36 countries. Not surprisingly, the general interest in this research agenda has grown because of the global financial and macroeconomic crisis of 2008-09. Partly the recent events constitute realisations of disasters—declines in real GDP and failures of financial and other companies—and partly variations in the probability that financial markets attach to future disasters. A sharp rise in perceived disaster probability underlies the many stock-market crashes, the reductions in real interest rates to extremely low levels, and the massive increase in the demand for liquidity (which allowed the Federal Reserve to have an extraordinary balance-sheet expansion without causing inflation). In reverse, reduced disaster probability since March of this year likely explains the stock-market rebounds but also heightens concern that the aggressive monetary and fiscal policies will lead eventually to high inflation.

Fortunately, the Federal Reserve chair, Ben Bernanke, never became complacent about great depressions (the main topic of his research in the early 1980s) and acted aggressively especially since last September to head off a financial collapse. Bernanke is also well aware of the challenge of avoiding a sharp rise in inflation—when and if a sustained economic recovery requires the Fed to unwind its dramatic expansion of the monetary base.

Unfortunately, this economic skill at the central bank has not been matched by the quality of the fiscal policies engineered by the White House. The Obama administration began with a large and poorly thought out stimulus package that gave little consideration to the productivity of the added spending. The package was predicated on a Keynesian multiplier of around 1.5, a number that came from nowhere but, if valid, would mean that even useless programs could be socially beneficial. Mixed in with the spending explosion is an apparent plan to promote economic growth by raising current and future tax rates. Clearly, the stimulus package and the proposed expansion of health outlays will require a lot more federal revenues. After trying and failing to raise these revenues by taxing the rich (a poor strategy given the already high marginal tax rates on this group), the administration will inevitably shift to a broad-based tax hike, likely involving a value-added tax. On top of this increase in conventional tax rates, the environment/energy proposals amount to additional large levies on production. The most ludicrous (though, fortunately, small) intervention thus far has to be the cash-for-clunkers program. It's not

Comments

surprising that subsidising people to destroy old cars would raise GDP, because measured GDP includes the replacement cars but not the value lost from destruction. Why not also blow up houses and factories and then enjoy the expansion of GDP from the replacement investment? (Actually, it's best cosmetically to blow up refrigerators and other consumer durables because GDP does include rental income on houses and factories.)

It is true that we lack reliable empirical estimates of the Keynesian multiplier on government spending, a key number for fiscal-stimulus plans. I have been trying to get better estimates from the long-term American data. The key feature of this sample is the dramatic variations in defence outlays, especially during and after World War II (and, secondarily, in World War I and the Korean War), in a context of little destruction of domestic capital and only moderate loss of life. The evidence is that the multiplier for defence spending averages 0.6-0.7 but becomes larger when there is more economic slack, gauged by a higher unemployment rate. A rough estimate is that the multiplier reaches 1.0 when the unemployment rate increases to about 13%. Unfortunately, this approach does not yield reliable estimates of the multiplier for non-defence purchases—the variable most relevant for fiscal-stimulus packages. The problem is that the historical variations in non-defence purchases have not been large (with the biggest changes occurring during the New Deal in 1934 and 1936) and, more importantly, that most of the variations are responses to the economy rather than the reverse.

Economies have natural tendencies to recover from recessions, and such a recovery is the most likely outcome for the American economy going into 2010. No doubt, the Obama administration will then claim that the recovery was due to their brilliant fiscal policies...

Like Bob Lucas, I have a hard time taking seriously the view that the financial and macroeconomic crisis has diminished economics as a field. In fact, the crisis has clearly raised the demand for economic services and economists. There is no more counter-cyclical occupation than economist.

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