

ECONOMIC NEWS UPDATE

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Obama's exit strategy

It grieves me to say so, but President Obama's conservative critics just don't get it. The new President has put forward a plan for economic recovery that is more coherent than they seem willing to admit.

Start with the stimulus package of some \$825 billion. A lot of money, more even than George W. Bush's \$700 billion Troubled Asset Relief Program, but not much more as money is counted these days, especially as Obama's will be spent over two or three years. Critics complain that stimulus spending will add to the already-swollen federal deficit. True: President Bush did leave his successor a \$1.2 trillion deficit. To which Obama will add about \$400 billion per year. Query: what empirical evidence

is there that deficits of \$1.6 trillion are more harmful during a period of economic recession than deficits of \$1.2 trillion? Conservatives who have such evidence should certainly come forward, especially those who remained silent while Bush ran up the huge deficit, and promised even larger ones when the true cost of his prescription drug program hits the federal books. If you liked the Bush administration's \$1.2 trillion and rising deficit, you can't really be shocked, shocked at \$1.6 trillion in red ink.

True, too, such deficits might in the long run make foreigners worry about holding onto dollars and U.S. Treasury IOUs. That would trigger a bout of sales of Treasury bills and

notes, and drive interest rates up to recovery-squashing levels. But so far, so good, as the man who jumped from the Empire State building shouted at the 50th floor. The dollar has not sold off for two simple reasons. First, seekers-after-safety in this troubled world are unlikely to find a safer haven than the U.S. currency. Second, China and other holders of trillions in our dollars and dollar-denominated assets are not eager to start dumping their holdings on the market, a move that would drive down the value of their remaining dollar assets.

Conservatives have also jumped on reports that about half of the planned \$355 billion in infrastructure spending will not occur until after the 2011 fiscal year starts on October 1, 2010. True. But if -- and this is a big "if" -- the projects to be funded have a net social value, that is, are likely to yield net returns to society for decades to come, they should be built whether part of a stimulus package or not. The objection should not be to the construction of the projects, but to the assumption that they cannot be built by the private sector, given proper incentives. Toll roads, schools financed with vouchers, health care

facilities selected by patients and paid for with health-care vouchers -- all are possible, but all are off the Obama radar screen. Democrats are, in the end, Democrats after all, and unlikely to be swayed by such as Harvard economics professor Robert Barro, who pointed out in last week's Wall Street Journal that it might be better to "emphasize reductions in marginal income tax rates." But the need for the projects themselves is in no way diminished if they get built next year, or the year after that, so long as they "pass muster from the perspective of cost-benefit analysis", to use Professor Barro's -- and Larry Summer's - - test. Whether the Harvard crowd will be able to persuade Speaker Pelosi, Barney Frank, Charlie Rangel and other key Democrats that they have it right is another matter.

In fact, there is something to be said for the postponement of the expenditures. The Great Depression was characterized by a modest recovery, followed by a relapse when monetary and fiscal policy were tightened, a so-called "W" pattern. The postponement of some of the stimulus spending into the out years, coming at a time when the economy is healing but still vulnerable to a

relapse, might, just might, turn that “W” into a “V”, and provide the juice to keep the upswing moving along.

That leaves open the question of whether we are living in a fool’s paradise, like the chap at the 50th floor who is doomed to further plunge. Here is where the coherence of the Obama plan comes into play, a two-part fiscal and monetary policy strategy.

When the time comes to unwind the stimulus plan’s effect on budget deficits, and the Fed’s keep-the-presses rolling monetary policy, Obama is counting on two developments. The first is a grand bargain to bring the potentially budget-busting entitlements programs under control. The President will convene a “fiscal responsibility” panel before he presents his first budget to the congress, and then move on to an attack on the unsustainable projected costs of Medicare, which is a far bigger problem than getting the Social Security system on a firm fiscal footing.

The outlines of a health-care deal seem obvious. The cost of Medicare can be cut by a means-tested system of co-payments, to prevent the current overuse of the system by patients for whom a visit to

the doctor or some optional procedure has no cost. Friends living among their retired colleagues in Florida tell me that folks in their community often schedule an away-day to include a visit to some doctor, perhaps en route to a movie. That health care, a free good to the user, should be over-consumed should come as no surprise.

The co-payments will probably be used to fund health care benefits of some sort for lower-income workers now without adequate insurance. Never mind what you think of such a plan, or any of the others that will emerge from the fertile mind of health czar Tom Daschle (after a brief visit at the State Department for a bit of advice of the don’t-do-this variety). The point is that if Obama succeeds in reducing the level of spending now built into the entitlements system, he will have the cake he has eaten -- deficit-increasing stimulus spending -- followed by deficit-reducing entitlement reform. A return to the fiscal probity long since abandoned by a Republican administration.

Meanwhile, back at the Fed, either Ben Bernanke or Larry Summers, if by then the latter has been moved over into the chairman’s chair (you’ll

know when sighs of relief erupt from White House staffers, and groans from the Fed boardroom), will be implementing the exit strategy Bernanke laid out in his speech at the London School of Economics, not exactly a bastion of conservative economic thought. "Put out the fire first and then think about the fire code," he said. The steps he has taken to use the Fed's balance sheet to take on troubled assets, bail out banks and insurers -- these put out the fire that would have consumed the financial system in America, and most probably in the world. When the fire is out, and the economy chugging along, the excess liquidity can be siphoned off by selling Treasury bonds in return for cash, which will by that route be withdrawn from circulation. At that time, with a recovery underway, the banks will presumably want to pay back the loans they have accepted under rather onerous terms. Also, money that has been lent to banks or used to prop up the commercial paper market on which so many businesses rely has been made available under short-term contracts. Allow them to expire, the extra cash disappears, inflation is slain. And if the timing is exquisitely

right, the cash will be withdrawn gradually, in pace with the unfolding recovery.

Sounds like a wonderful exit strategy, from a central banker in whom we have reason, given his performance during this financial crisis, to have confidence. But withhold the cheers until taking a look at Robert Samuelson's "The Great Inflation, which describes how difficult it is for vote-seeking politicians to rein in inflation, and for central bankers to take away the punch bowl in sufficient time to prevent the party from becoming raucous, to borrow from William McChesney Martin, who served as chairman of the Fed from 1951 to 1970, under five presidents.

There you have it. Spend now, and cut taxes now, and run deficits now. Build stuff that has a positive social value. Maintain faith in the currency by brokering a grand bargain to bring entitlement spending and therefore post-recession deficits under control. At the right time, call in all that extra cash that is sloshing around, thereby preventing inflation. And all will be well in this best of all possible worlds.

Perhaps. But if hyper-spending by government freezes out as much or more

private-sector investment; if consumers, seeing tax increases in their future, rein in spending even more; if the government cannot impose its cost-benefit test on politically directed infrastructure spending -- then Obama will not have kept his head when conservatives about him lost theirs. Obama might have it wrong, just as many of his critics say Franklin Roosevelt had it wrong. But nit-picking around the edges of this recovery program won't be enough either to derail or to lay the basis for a "we told you so" campaign in 2010 or 2012. That will take a coherent counter-proposal. Watch these pages.

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