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TO SPEND OR NOT TO SPEND:

IS THAT THE MAIN QUESTION? [*]

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In the current US fiscal policy debate it is not unusual to start from the assumption that the subprime crisis has brought about a “lack of demand.” From that premise, policies that increase demand look appealing. Fiscal expansion ranks first in line, particularly if the economy is caught in a “liquidity trap” in which conventional monetary expansion runs out of steam. High public debt may become a problem, but the concern is swiftly dismissed by arguing that it will be addressed when full employment returns.

The main difficulty I have with that type of argumentation is that it starts the narrative too late into the game. The subprime is a financial crisis that threw a dark cloud of mistrust on financial intermediation: Lender *L* stopped lending to borrower *B*, not because *B* became a rogue, but because *L* hears that people like her are worried about the health of the financial sector. That's the central reason why a small financial problem catapulted into the present global crisis. Many professional economists agree with that.

Once this is acknowledged, “lack of demand” is almost a corollary. If *L* does not lend to *B*, *B*'s demand will have to fall. *L* is a lender and, therefore, now she has to find a place to park her money. The easiest alternatives are cash or Treasury bills. Therefore, *B*'s forced austerity is not offset by *L*'s overindulgence, and "lack of demand" springs to life. *B*'s sudden austerity -- it is worth stressing -- is due to credit crunch. He didn't become anorexic or lose his self-esteem as some Keynesians want you to believe. These psychological diseases may happen to him as crisis evolves, but the roots of his austerity are in a suddenly malfunctioning credit market.

Proponents of expansionary fiscal policy claim that the government should increase expenditure -- spending what *B* can’t and *L* won't -- by issuing the Treasury bills that *L* wants. This closes the circle, the additional fiscal deficit is financed by *L* and the economy goes back to full employment. But, unfortunately, economies in crisis are not that simple. The argument assumes that the government channels additional spending towards the very same goods that *B* cannot afford. This is not true in general. In the US, for instance, small firms lost access to working capital that the government spends on solar energy. Hence, *sectoral* “lack of demand” is unlikely to vanish. The sun will set on *B* goods and shine on government goods. Thus, fiscal expansion could have little impact on unemployment, because the unemployed in the sector that caters to *B*'s tastes are unlikely to find new jobs in those sectors that benefit from the government's largesse. One important reason for sluggish employment creation is that stimulus packages are *transitory* and hiring-and-firing is costly. Sectors producing government goods will go on overdrive, but will be reluctant to hire new workers. Equally important, labor reallocation is costly and cannot take place in the spur of the moment: a bricklayer does not become a computer technician overnight. This helps to explain why US unemployment is still high even though output is heading to recovery.[2] Moreover, if trust in financial intermediaries does not recover, even this type of inefficient and employment-less recovery may lose steam if fiscal stimulus is discontinued.

The case for fiscal stimulus is stronger if the government spends on *B* goods, which the US public sector has certainly done to some extent through tax credits and the Fed's purchase of *toxic* assets. This is welcome in the short run because it helps to cushion the fall in *B* goods' relative prices (e.g., real estate prices) and gives time for the financial industry to digest the subprime blow. Financial contracts are highly imperfect and their small print does not anticipate improbable or complex events. Therefore,

[2] See Guillermo Calvo and Rudy Loo-Kung "US recovery: A new 'Phoenix Miracle'?", Voxeu, April 12, 2010, available online at http://www.voxeu.org/index.php?q=node/4858.

cushioning the blow may effectively prevent major and unnecessary pain. However, this is temporary relief. It has to be substituted by policies that help to regenerate credit on an efficient and sustainable basis.

Restoring credit would be straightforward if all it takes to go back to full employment is for *B* to resume his expenditure plans *prior* to the subprime crisis. But this is not the case. The economy was seriously distorted by the real-estate bubble. *B* should not build so many houses as before and, therefore, construction workers will have to be reallocated to other activities, which as noted before it is not easy. Unemployment may not fall and may actually rise in the transition. This will call for more generous unemployment compensation schemes which, fortunately, could be implemented at low inflation and public-sector default risks in the US. The dollar is the world reserve currency and *L* is still willing to buy Treasury bills. But going beyond cushioning the losers runs the risk of slowing down the market's discovery process. The US economy relies on markets, there is no central planning agency to guide the private sector in the resource reallocation task. Markets discover the new pattern by trial and error. This is a very strenuous task that is made enormously more difficult if the government keeps employing resources in activities that will have to be phased out.

Moreover, for the credit market to go back on its feet and stay there it is necessary that the non-financial private sector leads the way by finding new and promising activities. The Fed is very concerned about the tepid recovery of the credit market, particularly credit channeled to small firms.[3] But one should not put the cart ahead of the private sector's discovery process. Bankers shuffle paper, and wait behind their desks for someone with a bright idea. Moreover, a common feature in economies recovering from deep financial crisis is that the *bounce-back is not led by (bank) credit*. Instead, experience suggests that output recovery is helped by low real wages and currency undervaluation. In the US, incidentally, the real wage is still close to its level prior to the subprime crisis, and export-led growth will not be a realistic alternative until the rest of the world shows clear decoupling.[4] Thus, I would conjecture that recovery to the new full-employment equilibrium in the US may require further real wage contraction in the transition.[5] If this road is taken, public policy has still a big role to play, namely, to prevent that the pain falls too heavily on the poor and unemployed (e.g., through extension of unemployment insurance), and that the adjustment exacerbates financial distress (e.g., guarding against sharp price deflation).

I am afraid that we have reached a major fork in the road: (1) maintaining or increasing fiscal stimulus will probably prevent a major slump of economic activity and a sharp rise in unemployment (the feared double-dip recession), but at the cost of slowing down growth and technical progress; on the other hand, (2) phasing out fiscal stimulus risks generating double-dip recession but, if unnecessary pain is avoided, it may result in a more vibrant economy in the medium run. The choice is difficult and I am afraid that it will be guided by political expediency, and the outcome will depend, in no small measure, on implementation. Thus, the main question is not so much *to spend or not to spend* but, rather, *how to spend*. In my opinion, it is time to take option (2), phase out government expenditure and phase in social protection programs (e.g., extension of unemployment benefits) to cushion the blow of a necessary transition. Restoring fiscal equilibrium is an important midrange goal, but it is far from a priority

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[3] See Ben Bernanke "Restoring the Flow of Credit to Small Businesses," Board of Governors of the Federal Reserve System, July 12, 2010.
[4] See Guillermo Calvo, Alejandro Izquierdo, and Ernesto Talvi "Sudden Stops and Phoenix Miracles in Emerging Markets," *American Economic Review*, May 2006, pp. 405-410; and Calvo and Loo-Kung, *op.cit.*
[5] This may be partly cushioned by labor subsidies.

compared with helping the economy finding its new equilibrium, away from the real estate sector and into activities that are likely to be less labor-intensive. This will expose less-skilled workers to a harsh reality, which policymakers could not ignore. If social protection policy is not addressed head on, *trade protectionism* could arise as an alternative. This is an undesirable outcome but it may look attractive to policymakers who are now beginning to be concerned about ballooning fiscal deficits.