Reviving the economy

Robert Solow on the need of a coordinated fiscal policy

On February 9, 2009, the Paris-based Cournot Centre for Economic Studies launched its second appeal to European politicians to quickly work on "a common fiscal policy" in order to "relaunch the Eurozone economies". The group, led by 1987 Economics Nobel Laureate Robert Merton Solow (1924), strongly urges European leaders to replace the dwindling private demand by public demand so as to buttress the starving European (and world) economy at a time when ECB monetary policy is near-powerless and unable to differentiate according to the particular needs of each country. What might sound as crass Keynesianism to some is viewed as pure necessity by Prof. Solow and the Cournot Centre. The press conference took place at the WZB and Dr. Tomaso Duso and Dr. Benny Geys (both WZB) afterwards had a chance to talk to Prof. Solow.

The Cournot Centre for Economic Studies was established in 2000 under the presidency of the 1987 Economics Nobel Prize laureate Robert Solow and Saint Gobain chairman Jean-Louis Beffa. As an independent research institute, it aims to be neither a think-tank nor a research bureau, but rather, by drawing on the latest theoretical and empirical research, it aims to become a catalyst in political debates on major issues in European economic policy. This role of "accelerator" was also at the heart of the press conference held at the WZB on February 9, 2009, by Robert Solow (MIT), Jean-Louis Beffa (chairman Saint-Gobain), Gerhard Illing (University of Munich), Günther Schmid (WZB) and Inge Kaul (Hertie School of Governance).

The panel – supported in a common statement by a host of other prominent scholars including Barry Eichengreen (University of California, Berkeley), Rick van der Ploeg (Oxford University) and Paul De Grauwe (Katholieke Universiteit Leuven) – implored European leaders to urgently provide a common fiscal response to the economic crisis. While the recession is arguably worse in the US than Europe, a European rescue package in the range of at least 2 percent of Euro-area GDP is called for (though even more might be necessary later on). They thereby warned that speed is of the essence given that "recessions are cumulative and delay therefore damages the response". Moreover, it is deemed better to do too much now – and deal with the ensuing inflationary pressures when they arise – than do too little and suffer a deeper and longer-lasting recession. "Caution," Prof. Solow stated, "in order to reduce or limit debt- and deficit-growth is *not* the way to go," although he and Prof. Illing added that "a credible commitment to fiscal stability in the medium and long run is obviously required" and that "restoring fiscal responsibility once the stimulus is no longer needed should already be planned now".

While fiscal policy measures can consist of tax reductions or spending increases, the Cournot Centre has a definite preference for the latter. The reason is that direct public spending leads to an immediate boost in demand by replacing the rapidly dwindling private demand by public demand. Tax reductions, certainly of the general kind as recently brought forward by UK Prime Minister Gordon Brown, generate a temporary rather than permanent increase in household income and thereby mostly lead to increased savings. This has definite benefits in the long run, but does not translate sufficiently into a short-term boost of demand. And such a boost in demand is exactly what is required at this point.

Urging governments to spend money is one thing, but what do they need to spend it on? Here, the Cournot Centre proposes looking for those sectors where potential long-run benefits are highest. The panel carefully avoided definite statements concerning which sectors are most likely to deserve government spending and which are not: "Life consists of trade-offs. This is a political matter, not for economists". Nonetheless, Prof. Schmid argued that empirical research has shown that the multiplier effects of public spending are often highest in education, health care, care for the elderly and are lower for public infrastructure investments. Based on this evidence, he criticized the currently proposed European rescue packages as being geared too little towards the creation of human capital and too much towards saving traditional sectors. This, however, is also the case in the US where, according to Prof. Solow, "too much is being made of the automobile industry".

Moreover, public spending decisions should be made to depend on the particular situation in each European country and be tailor ed to the economic capacity in each individual economy. While there are clear differences in the European economies that demand differences in the policies implemented, Prof. Solow and Prof. Illing nonetheless stressed that "a universal, coordinated effort by all European countries" is crucial to address the current crisis.

Robert Merton Solow was born in New York in 1924 and grew up during the Great Depression. He studied economics at Harvard and has been Professor of Economics at the Massachusetts Institute of Technology (MIT) ever since 1958. In 1987, he obtained the Nobel Prize in Economics for his contributions to the theory of economic growth.

The reason is that the European economies are highly integrated such that significant spillovers ensue from the actions of each government onto the other countries. As a result, each government has an incentive to free-ride on the others. Such 'beggar thy neighbor' policies should be prevented via a common, coordinated response. Clearly, this would require an institution with a sufficient degree of independence from political pressures, a strong administrator and the possibility to strictly monitor the actions of member states. Given the entrenched delays in European decision-making procedures and the absence of time to waste on such procedural debates, Prof. Kaul and Prof. Solow suggest the creation of a new secretariat under the auspices of the Eurogroup – the informal EU-committee of economics and finance ministers that aims to coordinate tax- and economic policies within the EU – that can perform the role of a coordination mechanism by working out the details of the European rescue package. Since the Eurogroup already exists, no time is wasted in creating a new institution and discussing its exact political architecture (which would, however, clearly need to be addressed later on).

Finally, while the focus of the Cournot Centre's initiative is on combating the recession through a wide-ranging fiscal policy response, the panel agreed that interventions to restore trust and reduce uncertainty in the financial markets are necessary as well. This, Prof. Solow argued, should be viewed as "a complementary aim, they are not substitutes at all". The reason is that the collapse of the financial markets interacts with the recession. This interaction, according to Prof. Solow, makes both events worse than they would have been in isolation. To combat the credit crunch and ensuing reduction in companies' investment plans, Mr. Beffa and Prof. Solow suggested central banks should dare to lend money directly to companies. While they agree that this is a bold move and historically "not done", it should, at least in theory, be feasible as there are no formal rules that forbid such actions. Moreover, when banks continue to hoard the money they receive, any indirect measure by central banks to urge bankers to change their behavior might not bring any advance. Direct lending by central banks can then be seen as a "measure of last resort", which may just be what we need now.

Following the press conference, Tomaso Duso and Benny Geys had a chance to deepen the discussion and ask Prof. Solow some further questions during a lunch-conversation.

Tomaso Duso: Extensive deregulation of the financial markets has been designated by many as one of the core contributing factors to the current malaise. How do you view the current appeals for widespread re-regulation?

"Too many short-term viewers in the world": Robert Solow (left) in dialogue with Tomaso Duso [Photo: Wiebke Peters]

Robert Solow: The financial crisis suggests that there has been simply too much confidence in the natural stability of the system. The current crisis, thus, is a sort of policy stress test. The American financial system will change as a result of the lessons learnt now. Clearly, financial markets can never be seen as candidates for suitable self-regulation, and political intervention in this area is needed.

Duso: So why did nobody see the collapse coming?

Solow: Some specialists in finance saw that there was a large chance of a significant problem. I did not, but I am not a finance expert. Nouriel Roubini – Professor of Economics at New York University – was arguing long before that the financial market path was heading for disaster.

Duso: But nobody seemed to have reacted to such warnings. Do you believe that there may have been an excess of political pressure or lobbying?

Solow: No. I think there are simply too many short-term viewers in the world. For example, Alan Greenspan – former head of the American Federal Reserve Bank – convinced himself of the truth of what he said. But there may have been truths that he found himself easier to convince about (laughs).

Duso: Still, the rules of the game might have been created in the way they were due to lobbying pressures from vested interests?

Solow: The belief that the markets are self-regulating goes back a very long way. That suggests that there is not much support for such a vested-interest argument. There are simply too many people who want to believe it.

Duso: Does that also relate to the often blind and unquestioning reliance on rating agencies?

Solow: Rating agencies were a case of very bad incentives we allowed to let go. They essentially exist to help us solve an asymmetric information problem: namely, that borrowers may seek to mislead lenders or investors about the riskiness of their investment and thereby the probability of debt servicing. Such information asymmetries cannot be viewed as imperfections in the credit markets. Rather, they are the essence of credit markets. Credit-risk rating agencies help investors overcome this lack of information. The problem, however, is that currently these agencies suffer from acute conflicts of interest. We have allowed these to persist.

Duso: Could one say that the core of the current crisis lies in the uncertainty that reigns supreme on the financial markets?

Solow: Not really. I tend to take a broader view here. I believe each problem – the financial crisis and the economic recession – makes the other worse. The core, if you like, is the interaction between the two.

The very starting point of the crisis lies in the boom of the housing market in the United States. Americans, under the auspices of the one-home-for-every-household policy, simply built too many houses, which lead to excess supply. Had this boom been financed in the "normal" way, monetary policy adjustments might just have led to a period of slow growth after the crash of the housing market. Instead – and here comes the interaction with financial markets – too many new financial high-tech tools (such as "collateral debt obligations" and "credit default swaps") have been created and used in this instance by the banks, which strongly reduced transparency and spread the unusually high risk taken by them to the entire economy. Mortgages were repackaged beyond recognition and sold to people and institutions that could not properly value them. As long as money was to be made, leverage ensured that significant profits were reaped.

Yet, when this asset price bubble burst and a disproportionately large number of bank loans turned bad or "toxic", banks' assets shrank swiftly and created solvency problems. This in turn generated uncertainty and instability in the financial markets, which also greatly damaged other parts of the economy. Indeed, banks currently react to their solvency problems by hoarding cash and reducing loans. Hence, industries unrelated to the original sources of toxic debt likewise become threatened with possible default because their access to credit was – and still is – restricted. This process converted what could have been a "normal" recession and which would have been casually mentioned in future economics classes, into a very deep and serious recession, one that will be remembered as an historical event. So what is the core of the problem? I believe that the core is the interaction between the two problems – the financial crisis and the economic recession – and that the financial markets in this case worked as amplifiers to problems in the real economy.

Duso: Will fiscal policy then be enough to tackle the problem?

Solow: We will need to work on two fronts: fiscal policy to boost demand and get the financial mechanisms working again. Both have to be done.

Duso: Finally, I know this is probably an unfair question given that you are not a finance expert, but do you have any ideas on how the latter issue should be addressed?

Solow: I have no strong opinions about the financial markets, but I do think it is difficult to resolve things when all these assets remain of which banks have no idea what they are worth. As long as they have these assets, it will put things on hold: uncertainty will remain, trust will not be rebuilt, and the system will not have access to credit. As such, there is something to be said in favor of nationalizing banks and setting up a "bad bank" – that is, a financial institution created solely for the purpose of taking on and unwinding banks' bad (or "toxic") debts. This allows a more structured unraveling of assets that does not further disrupt markets while also enabling banks to resume lending. This approach was successfully employed in Sweden in the early 1990s, so, in a sense, the idea has proven its value before. Nonetheless, it is difficult to know how to buy these "bad" assets. At what price? Still, directly giving money to banks has clearly not worked thus far, especially not while leaving all these "bad" assets on their balance sheets. This simply leaves a large amount of uncertainty at the banks, which is not helping.

Literature

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