American Enterprise Institute for Public Policy Research

Economic Outlook

November 2009

Postcrisis Risks

By John H. Makin

The only thing scarier than the slide of the dollar, which has dropped by 15 percent since March, would be an attempt by the Federal Reserve to stop it. Such an attempt would show that we have learned nothing from the Bank of Japan's disastrous premature exit from a zero-interest policy in August 2000. Closer to home, it would resemble the Fed's premature move to mop up "excess" reserves by doubling reserve requirements in three steps between August 1936 and May 1937, which was followed by the third-worst recession of the twentieth century, from May 1937 to June 1938.

Although last fall's acute phase of the financial crisis is behind us by more than a year, the U.S. economy is still struggling, notwithstanding strong gains on Wall Street. Central banks have a worrisome record of premature tightening. The Fed, or other central banks, could be misled by events driven by China and by signs of economic life that would not survive an abrupt withdrawal of stimulus. Moreover, the poor design of U.S. fiscal stimulus adds to downside risks, now that valid concerns about rising deficits and national debt preclude corrective steps.

Easy Does It

The dollar is falling because U.S. growth and inflation are well below levels consistent with sustained recovery. As of October 27, Bloomberg news service calculated that under current conditions—including falling inflation and a massive output gap—the Taylor Rule for guiding interest-rate policy implied that the federal funds rate ought to be –1.85 percent, or 210 basis points below the current setting of 25 basis points.

The outlook for a sustained recovery of U.S. growth during 2010 is not encouraging, despite the stock market celebration. On the current trajectory, earnings growth for domestic U.S. firms will be disappointing in 2010, while multinational corporations will need all the help they can get from a weaker dollar that enhances sales abroad and increases the dollar value of foreign-generated earnings.

Though the Federal Reserve has consistently articulated its "lower for longer" policy with respect to U.S. interest rates, *Barron*'s October 19 cover story, entitled "It's Time to Raise Rates, Ben," asserted that "the economy can now handle an increase in short-term interest rates to 2 percent from near zero. It is the only way to prevent the dollar from collapsing and inflation from getting out of control. Give savers a break." This is the ultimate conceit from the stock market's prime tout sheet, which apparently believes its own fantasy about a robust economic recovery and stronger future earnings growth.

Savers are getting low interest rates because, in a world of massive excess capacity, the returns to real investment are very low. The resulting low real return on capital and falling inflation—year-over-year inflation is dropping in every major industrial country save the United Kingdom—are the reasons for low interest rates. A deflationary tightening by the Fed at this time would push even more funds into Treasury securities, thereby pushing interest rates for savers even lower. The weaker dollar is about the only thing that is operating now to help improve the outlook for the

John H. Makin (jmakin@aei.org) is a visiting scholar at AEI.

U.S. and global economies. Let me explain further this heresy.

China's Role

The key to understanding the current odd combination of a weaker dollar, rising gold prices, rising stock prices, and falling bond yields lies outside the United States, mainly in China.

Last November, the Chinese effected a massive fiscal stimulus equivalent to about 14 percent of gross domestic product (GDP). The stimulus marked a sharp reversal from the contractionary policies that had been underway due to the Chinese fear, prior to the Lehman shock, of the economy overheating. Given China's ability to press forward with a quick implementation of stimulus, the Chinese economy has grown at about 9 percent so far during 2009. China's rapid growth and recovery and the absence of a housing bubble have drawn a surge of capital into the Middle Kingdom. China's policy of pegging its currency to the dollar has meant that the flow of liquidity into China has continued and accelerated. By July, its money and credit growth were growing at a 31 percent annual rate. By virtue of the currency peg, China has tacitly made the highly accommodative Federal Reserve its central bank and thereby has added substantial monetary stimulus to the huge fiscal stimulus already in place. As a result, the Chinese economy is growing rapidly, and Chinese funds are flooding into the country's rapidly expanding real estate market and into equity and commodity mar-kets worldwide.

Savers are getting low interest rates because, in a world of massive excess capacity, the returns to real investment are very low.

China's currency peg is preventing a much-needed disinflationary appreciation of its currency at a time when massive doses of monetary and fiscal stimulus are pushing the economy toward overheating. Meanwhile, with Chinese policy preventing the renminbi from appreciating, the upward pressure on other Asian currencies has grown stronger, spurring authorities in Korea and Taiwan, just to mention two countries, to intervene to keep their currencies from appreciating further. Brazil, ominously, recently imposed a 2 percent tax on capital inflows to quell currency appreciation.

China is the economy where growth is strongest and where wealth is growing most rapidly. Meanwhile, the United States has suffered the most from wealth losses tied to the bursting of the housing bubble and is forced to put its economy on heavy life support through both monetary and fiscal stimulus. The dollar is falling because interest rates cannot go below zero and because the quantitative easing undertaken by the Fed over the last year has been relatively ineffective.

Events during November will elevate global attention on the U.S.–China relationship. Both the G20 Summit in Scotland November 7–8 for finance ministers and central bankers and Obama's subsequent trip to Asia, featuring a trip to China November 15–18, will afford opportunities for high-level economic and geopolitical discussions.

Life Support Still Needed

The course of the global economy in the aftermath of the post–Lehman Brothers financial crisis will be highly dependent on reaching a clear understanding concerning the role of the dollar. Policymakers and markets are still collectively recovering from what can fairly be described as the "near death" experience of the acute phase of the crisis during September and October 2008. Of course, everyone is more optimistic in the aftermath of an experience that could have witnessed a complete systemic financial meltdown that would have ushered in another Great Depression. That said, the "sequential" improvements in economic and market data—whereby, for example, U.S. home prices stop falling—are encouraging, but stability does not change the fact that those home prices have already dropped a total of 35–40 percent, eliminating over $7 trillion in U.S. household wealth.

G7 economies and asset markets have, for the most part, stopped hemorrhaging. Tourniquets have been applied and refreshed and have largely staunched the bleeding. Yet the patient—the economy—has lost a great deal of blood, especially in the United States, and huge transfusions of monetary stimulus and badly administered fiscal stimulus are keeping it stable. As we move toward 2010, the effect of the transfusions will be wearing off at a time when not much additional medication is likely to be available.

Avoiding a premature exit from stimulus, which would be driven by wishful thinking about the sustainability of the U.S. economic recovery, while avoiding misguided policy measures tied to the path of the dollar exchange rate will be the keys to sustaining recovery. To state the obvious, "defending" a weakening dollar would require a sharp tightening of monetary policy—raising short-term interest rates—at a time when inflation is falling and output growth is far short of potential. That would be the equivalent of ripping the blood transfusion tubes out of a weak patient's arm. While the negative federal funds rate implied by the Taylor Rule could moderate during the second half of 2009, when growth will probably turn out to average 2.5 percent, it could well reverse again sharply in 2010 as growth slips back below 1 or 2 percent and year-over-year core inflation drifts toward zero.

The weaker dollar is about the only thing that is operating now to help improve the outlook for the U.S. and global economies.

Fiscal Stimulus Botched

U.S. private sector demand is weak, as households retrench in the face of falling incomes and a lack of available credit and as firms hold off on capital spending and hiring to contain costs. Given those circumstances, a well-designed fiscal stimulus could have been helpful. A $650 billion one-year payroll tax holiday would have supported spending by increasing take-home pay for U.S. workers while supporting employment by reducing the payroll tax on hiring labor. Instead, the Obama administration has chosen to spend nearly $800 billion on pork-barrel measures and ad hoc nonsense such as "cash for clunkers" and one-time tax credits for first-time home buyers.

The "clunkers" and home-buyer subsidies are, of course, popular with auto producers and home builders who absorb most of their benefits by adjusting prices offered to buyers with incentives from highly touted programs, but the impact is fleeting. U.S. auto sales jumped to an annual rate of 14.1 million units in August only to collapse to a 9.2-million-unit rate in September, with further weakness likely to be reported for October. The brief rise in new home sales during July and August has already begun to fade as the $8,000 tax credit for first-time home buyers is set to expire at the end of November. With regard to the home buyers' tax credit, no one seems to recall that the housing bubble, and with it the widespread purchase of ultimately unaffordable homes by low-income buyers, was created by such artificial incentives. Why then are more such incentives a good idea at this time? The answer, for both auto- and home-buying subsidies is their political popularity and the cynical members of Congress willing to press for them in the name of good policy. Presidents are supposed to resist such counterproductive measures, but our president always goes along, saying they are good for "working Americans."

The clunkers and home-buyer subsidies are like adrenaline shots for the weakened patient—the U.S. economy on life support—still getting heavy transfusions. The patient has felt better for a few months during the time the president has been pushing hard for a health care reform bill that needs every bit of political capital he can muster to pass.

There will be two nasty hangovers from the adrenaline shots. Growth will drop back toward zero in 2010 when the adrenaline wears off, and the new health care program will add substantially to the budget deficit in years ahead when tax cuts will be needed to restore economic growth potential. This is true, notwithstanding the fanciful assertion in October by the Congressional Budget Office that the health care plan is self-financing. The assumed "savings" will not materialize, and the cost of health care will rise. Why would it not, given a government initiative to boost the demand for health care?

It may be desirable to subsidize the purchase of health care for those unable to afford it, but to pretend that such an initiative to shift up the demand curve for health care will simultaneously result in spontaneous cost savings—an outward shift in the health care supply schedule—is fanciful at best and dangerous at worst given the already rapidly deteriorating U.S. fiscal picture. Yet that is exactly what Obama is claiming the outcome will be. Perhaps the exposure of such a dangerous illusion will make him a one-term president, even as the Democrat who achieved the long-held liberal goal of a national health care system. Nearer at hand, the hangover after stimulus wears off next year may jeopardize his Democratic majority in the House of Representatives.

Avoiding a Relapse

All these considerations should serve to remind policymakers that the global economy is at a dangerous stage of its recovery from an acute financial crisis that could have produced systemic collapse and a global depression. Surely it is good news that this did not happen. That reality, along with massive doses of monetary and fiscal stimulus, both in the United States and China, has supported a global rise in stock prices and, especially in

China, sharply higher growth of the real economy. But the bounce in U.S. economic growth during the second half of 2009 is unlikely to be sustained at anything like a trend rate of growth of around 2.5 percent. Consequently, U.S. unemployment will continue to rise while disinflation will drift toward deflation later in 2010. Under those circumstances, and given that the Fed has pushed interest rates to zero, the only alternative remaining to increase the probability of faster U.S. growth and to reduce the probability of intensifying U.S. deflation is a weaker dollar.

> U.S. unemployment will continue to rise while disinflation will drift toward deflation later in 2010.

The trade-weighted dollar is still 10 percent above the low levels it reached in 2008 after the Bear Stearns crisis. On a real—inflation-adjusted—and trade-weighted basis constructed by the Fed, the dollar is actually 3 percent stronger over the last year because of lower U.S. inflation relative to that of its major trading partners. To call now for the Fed to boost interest rates in order to stabilize the dollar would constitute an all too familiar policy error in the aftermath of a financial crisis akin to the premature tightening by the Bank of Japan in 2001 and by the Federal Reserve in 1937.

The Cassandras who have been claiming since 2006 that the United States is headed for a collapse in the dollar and a collapse in the bond market need to calm down. The weakness of the dollar since March is very much a part of the widely discussed need for global rebalancing. The United States needs to mitigate excess supply in the economy as signaled by below-trend growth and falling prices, and a weaker dollar can help bring about such adjustments. If the weaker dollar, which represents the United States exporting deflation, causes other members of the G7 to effect more stimulative policies, the much-praised global rebalancing would be more likely to occur. If China allows its currency to appreciate, the overheating pressures in that exceptional economy would be alleviated, as would pressure on other currencies to appreciate as substitutes for appreciation of the Chinese currency.

The global economy has been through a wrenching experience since the onset of the global financial crisis in August 2007. The fact that the intensity and gravity of the crisis was not fully recognized until more than a year later, when the Lehman collapse marked the acute phase of the financial crisis, should keep us all humble. As they failed to perceive in August 2008 how serious the crisis had become over a year after it had begun, perhaps policymakers need to remain cautious about declaring that the crisis and the economic damage tied to its aftermath are both over.

Containing the postbubble crisis has required injecting massive amounts of liquidity into the financial system—primarily into banks—because a financial crisis sharply boosts the demand for liquidity. It may be tempting to try to preempt any spending surge that might follow from a sharp drop in the demand for liquidity, were that to occur. But for now, there is no sign of excess liquidity today or that banks are extending more credit. Inflation is falling globally, having reached outright deflation in Japan. The jump in the U.S. monetary base has not boosted the static money supply because passive banks are not lending. Households are content to hold the sharp surge in liquidity as measured by the collapse in velocity, the ratio of nominal GDP to the money supply. Until the money supply rises and nominal GDP starts to rise (it is currently falling at a 2 percent rate year-over-year), the temptation to withdraw liquidity should be resisted.