

What Kind of Recovery?



Barry Eichengreen

The economic tea leaves are increasingly difficult to read. Although the United States shed 36,000 jobs in February, it is unclear whether those losses should be blamed on the snowstorms that blanketed the country that month or taken as signaling the underlying weakness of the economy. In Europe, growth all but stalled out in the fourth quarter of 2009 — the latest flash numbers show EU GDP growth at 0.1 per cent, down from 0.3 per cent in 2009 Q3. But again, it is not clear whether this reflects exceptional factors like the problems of Greece, where GDP shrank

by 0.8 per cent in 2009 Q4, or a more fundamental malaise. No one knows for sure whether recent reports represent the beginning of a double dip — but they clearly amplify the volume of double-dip talk.

While the short-term prospects may be unclear, one thing is glaringly obvious: who was right and who was wrong in the debate over the speed of recovery. On one side of that debate, you may recall, were adherents to the Zarnowitz Rule, named after business-cycle researcher Victor Zarnowitz of the National Bureau of Economic Research. Zarnowitz

famously argued that the deeper the recession, the faster the recovery. In deep recessions, he observed, firms liquidate inventories with a vengeance. But once demand stabilizes, they start producing for inventory again. The faster the inventory liquidation, the stronger will be the boost the ramped-up production imparts. That alone will be enough to goose growth rates significantly.

In the current recession, moreover, housing starts

Barry Eichengreen is George C. Pardee and Helen N. Pardee Professor of Economics and Political Science at the University of California, Berkeley.

collapsed to virtually zero in the US, Spain, and elsewhere. Even a modest resumption of residential construction starting from such a low base would constitute a significant increase in investment activity. This was another reason, the optimists observed, to believe that the current recovery would follow the Zarnowitz Rule.

On the other side of the debate were those who believed that recoveries from recessions caused by financial crises are slower and shallower than recoveries from other types of recession. Carmen Reinhart and Ken Rogoff in a series of influential papers and now a book document this opinion. Small firms and households, neither of which can access nonbank sources of finance like the bond market, are a drag on recovery from financial crisis-linked recessions. That is exactly what we are seeing now: with banks still repairing their balance sheets, the advanced countries are experiencing credit-less recoveries. Consumption growth is minimal. Small firms, finding it hard to access credit, are slow to

ramp up production, or hiring.

And of course the main engines of growth in the last upswing — not just residential construction but also commercial real estate and the financial sector itself — are still sputtering. Sustaining the recovery will require new engines. Everyone hopes that “green industries” can be the new driver of economic expansion. But mortgage brokers and bond traders cannot be retrained overnight as designers and fabricators of wind turbines. Growth is more difficult when it involves structural change.

It is now clear that the current recovery violates Zarnowitz’s Rule and that the pessimists were right. Double dip or not, recovery in the US and Europe will be slow by historical standards. Yet one of Zarnowitz’s key insights remains valid: at the end of a recession you get an inventory bounce. In fact the inventory bounce explains why growth toward the middle of 2009 looked as good as it did. But without sustained support from final demand, the bounce remains only a bounce. Without new customers

firms will eventually stop adding to inventories. This is why growth slowed again toward year-end.

If the other arguments of the pessimists are not enough, there is also the fact that the effects of fiscal stimulus have now peaked. The weakness of the recovery in the United States and Europe creates an economic argument for additional stimulus. But no matter what the economic merits, another stimulus is not going to happen. Rightly or wrongly, fears about fiscal sustainability are widespread. With 2010 a midterm election year in the United States, members of Congress are reluctant to take responsibility for larger deficits. It is an interesting commentary on who shapes the terms of public debate that people in Congress seeking reelection worry more about being accused of fiscal irresponsibility than about doing too little to combat unemployment.

Worries about debt sustainability may be excessive, but they are an economic as well as a political fact. If deficit spending is to do more good than harm, it must avoid exacerbating such fears. This means that

deficit spending now must be accompanied by credible plans to balance budgets in the future. Only credible plans by US and European governments will reassure those worried about rising debt. And surpluses in the future will mean lower borrowing costs not just then but also now, through the term-structure relationship. This will be helpful if and when the recovery gathers steam and borrowing costs begin to rise.

The challenge lies in making the commitment to future surpluses credible. The Obama Administration's two big ideas for doing so are health care reform and a bipartisan commission to identify and endorse painful but necessary spending cuts. Health care reform that successfully bends the cost curve would make a significant difference to the medium-term budgetary outlook. But as the health care debate sputters to an underwhelming conclusion,

there is little curve-bending in sight. Meanwhile, Congress has refused to pass a bill establishing a bipartisan fiscal commission and committing itself to consider the latter's recommendations, so the president has been forced to create the commission by executive fiat. A commission would make a difference if both political parties bought into the process and if Congress was bound to accept or reject its recommendations in a single up-or-down vote. Alas, neither is true.

In Europe, fears about debt sustainability are even greater, not just because inherited levels of debt are higher but because demographic trends are less favorable. Slower-growing labor forces and more rapidly rising old-age dependency ratios make for less debt-bearing capacity, as investors well realize. But the optimal response, as in the United States, is

not to withdraw stimulus now but to make credible commitments to fiscal consolidation later. Europe seems to be proceeding in exactly the opposite direction.

Circumstances in Latin America and emerging Asia are, of course, different. In both regions, growth is surging. The preoccupation is with the danger of overheating, not with stagnation or a double dip. It is appropriate for emerging-market central banks to begin tightening, but if I am right to worry about unusually slow recovery in both the US and Europe, then it is important for Latin American and emerging Asian central banks not to overreact. They should avoid tightening too quickly, because export growth is likely to slow. They can rely on the US and Europe to help solve — if that is the right word — their overheating problem. ■