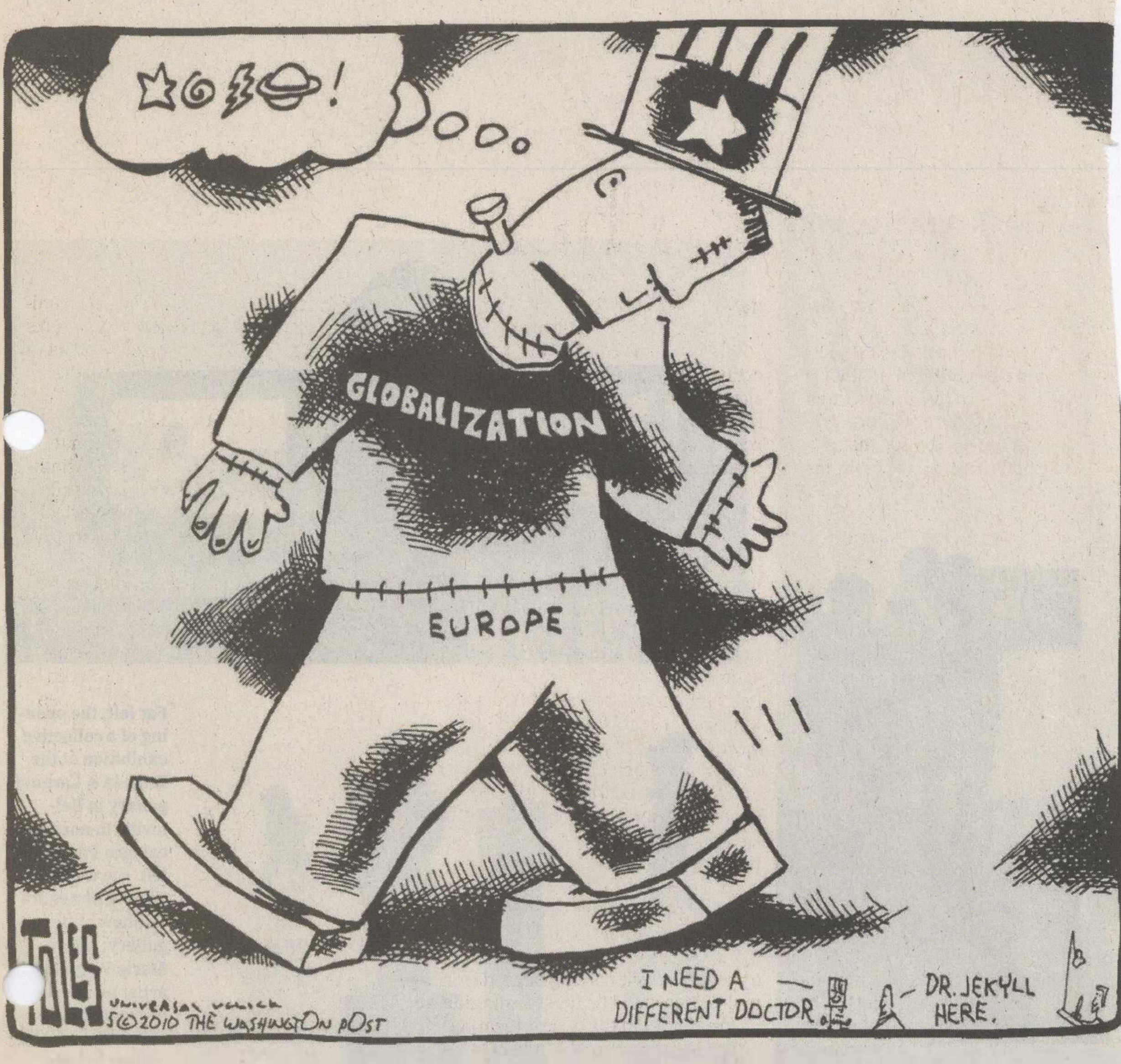
COMMENTARY LETTERS



The pain caucus

Paul Krugman

What's the greatest threat to our still-fragile economic recovery? Dangers abound, of course. But what I currently find most ominous is the spread of a destructive idea: the view that now, less than a year into a weak recovery from the worst slump since World War II, is the time for policy makers to stop helping the jobless and start inflicting pain.

When the financial crisis first struck, most of the world's policy makers responded appropriately, cutting interest rates and allowing deficits to rise. And by doing the right thing, by applying the lessons learned from the 1930s, they managed to limit the damage: It was terrible, but it wasn't a second Great Depression.

Now, however, demands that governments switch from supporting their economies to punishing them have been proliferating in op-eds, speeches and reports from international organizations. Indeed, the idea that what depressed economies really need is even more suffering seems to be the new conventional wisdom, which John Kenneth Galbraith famously defined as "the ideas which are esteemed at any time for their acceptability."

The extent to which inflicting economic pain has become the accepted thing was driven home to me by the latest report on the economic outlook from the Organization for Economic Cooperation and Development, an influential Paris-based think tank supported by the governments of the world's advanced economies. The O.E.C.D. is a deeply cautious organization; what it says at any given time virtually defines that moment's conventional wisdom. And what the O.E.C.D. is saying right now is that policy makers should stop promoting economic recovery and instead begin raising interest rates and slashing spending.

What's particularly remarkable about this recommendation is that it seems disconnected not only from the real needs of the world economy, but from the organization's own economic projections.

Thus, the O.E.C.D. declares that interest rates in the United States and other nations should rise sharply over the next year and a half, so as to head off inflation. Yet inflation is low and declining, and the O.E.C.D.'s own forecasts show no hint of an inflationary threat. So why raise rates?

The answer, as best I can make it out, is that the organization believes that we must worry about the chance that markets might start expecting inflation, even though they shouldn't and currently don't: We must guard against "the possibility that longer-term inflation expectations could become unanchored in the O.E.C.D. economies, contrary to what is assumed in the central projection."

A similar argument is used to justify fiscal austerity. Both textbook economics and experience say that slashing spending when you're still suffering from high unemployment is a really bad idea — not only does it deepen the slump, but it does little to improve the budget outlook, because much of what governments save by spending less they lose as a weaker economy depresses tax receipts. And the O.E.C.D. predicts that high unemployment will persist for years. Nonetheless, the organization demands both that governments cancel any further plans for economic stimulus and that they begin "fiscal consolidation" next year.

Why do this? Again, to give markets something they shouldn't want and currently don't. Right now, investors don't seem at all worried about the solvency of the U.S. government; the interest rates on federal bonds are near historic lows. And even if markets were worried about U.S. fiscal prospects, spending cuts in the face of a depressed economy would do little to improve those prospects. But cut we must, says the O.E.C.D., because inadequate consolidation efforts "would risk adverse reactions in financial markets."

Less than a year into a weak recovery, there is a dangerous urge to stop helping the jobless.

The best summary I've seen of all this comes from Martin Wolf of The Financial Times, who describes the new conventional wisdom as being that "giving the markets what we think they may want in future — even though they show little sign of insisting on it now — should be the ruling idea in policy."

Put that way, it sounds crazy. And it is. Yet it's a view that's spreading. And it's already having ugly consequences. Last week conservative members of the House, invoking the new deficit fears, scaled back a bill extending aid to the long-term unemployed — and the Senate left town without acting on even the inadequate measures that remained. As a result, many American families are about to lose unemployment benefits, health insurance, or both — and as these families are forced to slash spending, they will endanger the jobs of many more.

And that's just the beginning. More and more, conventional wisdom says that the responsible thing is to make the unemployed suffer. And while the benefits from inflicting pain are an illusion, the pain itself will be all too real.

Europe's 'Japanese winter'

Guy Verhofstadt

Now that the Greek crisis seems to have been warded off and Portugal and Spain are more or less covered by a European rescue mechanism, it would seem that Europe can be relieved again. But is that really so? The Greek crisis has led to new agreements over increased European monitoring of national budgets and a guarantees-and-bonds system of more than €750 billion in value. But Europe drags with it a weakened banking system. What used to be a South American and Asian disease now threatens the Continent.

Since the beginning of the financial crisis there has been a rare consensus that banking regulation is best organized at the European level. However, this has not led to E.U.-enforced action because each member state promised to solve the problem within its own country. This issue has subsequently dropped off public radar screens and few people have a clear idea of what exactly each member state has — or has not — actually done. Yet it is now clear that this situation is crippling Europe's economic recovery.

By contrast, the global recovery is well under way. World trade has recovered and growth rates have returned to pre-crisis levels or even higher. This recovery is being led by emerging economies like China and Brazil. What is surprising is that the traditional synchronization between European and U.S. growth rates has been absent. The U.S. quarterly export growth figures for the end of 2009 and the beginning of this year fluctuated between 5 and 10 percent. Europe is achieving barely more than 2 percent. In the next four years, the I.M.F. forecasts economic growth to be between 2 to 2.5 times higher in North America than in the euro zone. This difference can be partly explained by the fact that the U.S. economy is more flexible, but this factor alone is not enough to explain the disparity.

We must seize the chance offered by the Greek crisis and rebuild Europe's banking system.

When the first wave of government interventions in Europe and the United States ended, so-called stress tests to assess banks' health took place in both continents. The tests examine bank portfolios — their assets, debts and levels of risk. Such tests are an essential component of a good recovery policy. However, in the U.S. they were conducted more thoroughly than in Europe — and it shows.

Robust stress-tests by the Federal Reserve evaluated roughly two thirds of American banking assets. The test results for each individual bank have been published. This has ensured absolute transparency in U.S. financial markets so that private capital has been able to refocus efficiently.

European stress-tests were merely a cosmetic exercise, set up in such a way that the banks could not fail. The aim was to avoid loss of face. Moreover, the results for each individual bank were never published. Although the European Central Bank was formally in charge, the many sensitivities of E.U. member states were taken into account. The results were therefore of no practical value to investors. It's true that there has been an injection of private capital into European banks, but this could never be done in a targeted way since the correct figures were not made public.

Similarly, government interventions in the banking sector by means of recapitalization and guarantees were successful but insufficient. It was done very quickly, so that we — in contrast to the U.S. — still face unresolved questions: Did governments pay too much for certain banks, and did they sell them off at too low a price?

This is a dangerous situation. Clearly, confidence in the European banking system is fragile. The result is that we are still waiting for a real economic revival. Europe may now face what I call a "Japanese winter." After Japan's financial crisis in the early 1990s, Tokyo failed to sort out the banks quickly. The consequence was a lackluster economic performance that lasted for more than 10 years. Only in 2003, after thorough reform of the banking system, did growth and employment start to recover.

Europe must learn from its errors and from others' mistakes. We must seize the opportunity provided by the Greek debacle. Now is the time to develop a new European plan for the banks. Now is the time to set up a European financial regulator. Only then will we be able to prevent a Japanese winter and the next crisis.

GUY VERHOFSTADT *is a former prime minister of Belgium and current leader of the Liberal and Democrat group of members of the European Parliament.*