FINANCIAL TIMES

May 22, 2012 7:24 pm

S3

Sensible Keynesians see no easy way out

By Raghuram Rajan

In the long run we are not dead, we will still be recovering from the Great Recession. We should therefore weigh stimulus policies not just on their immediate effect but on their consequences over time. Sensible Keynesians recognise this. They bet that reviving growth through government spending today outweighs the future loss of growth as the debt taken on to fund current spending is paid back. Consider two circumstances where this may apply.

The first is in a fully fledged panic where demand collapses, banks and companies fail and organisational capital is destroyed. Save, possibly, for Greece, it is hard to argue any industrial country is there today.

The second is when persistent high unemployment leads the long term unemployed to lose the habits and skills that make them employable. This is probably the more pertinent case in several industrial countries, such as the US and Spain. Increasing employment in a sustainable way today could more than pay for itself if people who would otherwise drop out of the workforce earn incomes.

The key question then is whether more government spending can make a real difference to the most severe employment problems. Here the case for a general stimulus becomes less compelling. In the US, demand is weakest in communities where a boom and bust in house prices has left an overhang of household debt. Lower local demand has hit employment in industries such as retail and restaurants. A general increase in government spending may be too blunt – greater demand in New York is not going to help families eat out in Las Vegas (and hence create more restaurant jobs there). Targeted household debt write-offs in Las Vegas could be a better use of stimulus dollars.

However, the past build-up of debt in now depressed areas may suggest that demand was too high relative to incomes. If so, demand, without the dangerous stimulant of borrowing, will stay weak. Policy should instead help workers move where there are suitable jobs – for instance, by helping them offload their homes and the associated debt without the stigma of default.

Employment is also lower in states that experienced a housebuilding bust. In these states, unemployment is higher among construction workers and in related jobs such as real estate brokerage. Could big publicly funded infrastructure projects, modelled on those in the 1930s, re-employ them? Possibly not, since today's built-up US is less in need of infrastructure on that scale. Moreover, it is not clear that a worker used to putting up drywall can move easily to laying fibre-optic cable. Perhaps it would be better policy to support retraining for private jobs.

Japan, which had a huge property boom and bust in the late 1980s, provides a salutary warning of the difficulties of stimulus through infrastructure spending. Even though Japan covered much of the country with concrete, it never fully emerged from the crisis. For the Japanese, the long run has arrived, and they are older, fewer and have the highest government debt in the G7.

The US government can still spend. The UK is more on the margin. With a huge financial sector dependent on the government's financial standing, it can take fewer chances with its finances. Austerity is painful, which is why austerity tomorrow is not credible. Yet shared tax increases and spending cuts can instil a sense of national purpose to help a country weather tough times.

For Greece, government spending is the problem, not the solution. A responsible government would implement judicious austerity, firing the party hacks who were hired in the go-go years, cutting wages and pensions and restructuring itself to collect taxes and provide useful services, even while retaining transfers to the indigent and elderly. As public sector workers share the private sector's pain, national solidarity could improve. Also, improved government efficiency and other structural reforms will make it easier for Europe to provide the financing that will prevent even more savage cuts to government functions. And it will make it easier to write down Greek debt further and attract private investment, giving people hope of growth.

Targeted government spending, or reduced austerity, along the lines suggested by sensible Keynesians, might be feasible in some countries and helpful in speeding recovery. But we should examine each policy based on a country's circumstances. We should be particularly wary of populist Keynesians, who parrot "in the long run we are dead" to justify any short-sighted government action. They do the world a disservice by suggesting there are easy ways out. By misleading people and their leaders, they may well precipitate revolution rather than recovery.

The writer is a professor at the University of Chicago's Booth School