FINANCIAL TIMES All times are London time

ft.com/economistsforum

Bah Humbug: Stagflation is around the corner

April 6, 2009 1:07pm by FT |

By Roger E. A Farmer

“Before I draw nearer to that stone to which you point,” said Scrooge, “answer me one question. Are these the shadows of the things that Will be, or are they shadows of things that May be, only?”

Economic policy is in a muddle. Academic voices are flooding the blogosphere and the intelligent policymaker can be forgiven for being unclear as to which side to listen to. On one end of the spectrum are classical revisionists who blame government for distorting market outcomes. On the other are Keynesians who think that fiscal deficits will rescue capitalism from its excesses. Both are partly wrong. Both are partly right.
The revisionist position was outlined at a recent conference in Washington at the Council on Foreign Relations. The revisionists blame government intervention for deepening recessions through raising distortionary taxes and, given the increase in the size of government that is taking place under the Obama administration, they see a decade of stagnation ahead.

I have some sympathy for the position that high taxes can contribute to an inefficiently low level of employment. But the idea that government is to blame for all our troubles is overstated. History has taught us that sometimes market economies may go wrong without any help from bad policy. Just ask a revisionist to explain what he means by a bubble.

The Keynesian position is the one that currently rules in Washington and economists in the Obama administration believe, following Keynes, that deficit spending will restore full employment. According to this view, we don’t need to worry about inflation until there is no excess capacity.

This textbook position from the 1950s (that inflation and unemployment cannot coincide) was discredited in the 1970s when a decade of stagflation led most academic economists to reject Keynesian economics. This is lamentable because some, but not all, of Keynesian economics is correct.

Keynesians claim that one dollar of government spending will increase aggregate demand by a multiple (bigger than one) of the initial dollar of spending. This idea is called the multiplier.

The revisionists are right in pointing out that evidence for the multiplier is sketchy at best and in practice the multiplier is likely to be a little bigger than zero but probably less than one. The Keynesians are right in pointing out that unemployment may be inefficiently high and that government needs to do something about it.

But increasing the size of the government sector at the expense of our grandchildren is not the right answer. As Niels Bohr famously quipped, ‘prediction is difficult, especially about the future’. A little crystal gazing reveals a wealth of alternative predictions for the world economy over the next two years.

Ben Bernanke, US Federal Reserve chairman, sees the green shoots of a recovery in the recent stock market rally. Alistair Darling , UK chancellor of the exchequer, admits, in a recent Sunday Times interview, that he underestimated the severity of the recession in the UK and has now downgraded his estimate of gross domestic product growth in 2009 by a factor of three from his November forecast. Robert Reich, professor at the University of California at Berkeley, has gone further and announced on his blog that “It’s a Depression”.

Who is right and what will happen in the next two years?

Over the next year, the US unemployment rate will continue to climb at a rate of 1 per cent every two or three months and by the beginning of 2010 it will be well into double digits. Sometime around the middle of 2010, perhaps a little earlier perhaps a little later, GDP will stabilise and will begin to grow. But as the economy recovers, a new problem will arise.

The money supply (the monetary base) doubled from $800bn in March 2008 to $1,600bn in March this year. Most of this new money is being held as excess reserves of the banking system but, as nominal GDP begins to grow, banks will try to lend it. If confidence is not restored in the asset markets, signs of inflation will appear.

At this point the Fed will face a difficult decision. Inflation will reappear while unemployment is still high; perhaps in double digits. Fed economists will be led to the inescapable conclusion that the so called ‘NAIRU’ (the rate of unemployment at which inflation has no tendency to increase or to decrease) has increased. In other words, they will claim that full employment now occurs at 10 per cent, not 4 per cent as it was in the 1950s, 6 per cent as it was in the 1970s or 7 per cent as it was in the 1980s.

This inescapable conclusion is wrong because the hypothesis that there is a unique natural unemployment rate is false. Any unemployment rate can coincide with any inflation rate. The unemployment rate that we observe depends on confidence.

If the Fed tackles inflation, as it has announced it will, it must raise interest rates to remove excess liquidity from the economy. As the interest rate begins to increase, the Keynesians will blame the Fed for killing the recovery by raising interest rates too soon. We will enter a decade of stagnation which revisionists will blame on the Obama administration for raising taxes and the Keynesians will blame on the Fed for raising interest rates and killing off the recovery.

But as Scrooge said to the ghost: “Answer me one question. Are these the shadows of the things that Will be, or are they shadows of things that May be, only?”

Since prediction is a risky business, it pays to hedge ones bets. The disaster scenario is not inevitable since we may get lucky. If market psychology dominates, as it did at the end of World War Two, bullish sentiment in the stock market and the housing market may inject new life into asset prices. If this happens, the economic recovery will be sustained and gdp will continue to grow without the reappearance of inflation. I am not hopeful.

As I have argued for 25 years, confidence is a self-fulfilling prophecy. If households and firms believe the economy will recover, they will put their cash back into real assets. The bull market will return, house prices will increase and firms will start hiring again. If households and firms continue to worry about their economic future, they will hold onto cash and stagflation will return.

There is an alternative scenario which I would like to think is more plausible. In this scenario, policy makers at the Fed and the Obama administration read my FT pieces on the beneficial effects of direct support for asset prices through central bank intervention in the stock market. Of one thing I am certain: a sustainable recovery will not occur unless the stock market and the housing market recover first.

Roger E. A. Farmer is professor of economics and vice-chair for graduate studies at the University of California Los Angeles

April 6, 2009 1:07pm in Federal Reserve, Fiscal policy, Keynesianism, Recession | Comment

---

You need to be signed in to comment. Please sign in or open a free account with FT.com now.

Comments
No comments yet

RSS feed