Will Stimulus Spending Stifle Recovery?*

James W Dean and Richard G Lipsey

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The massive government stimulus packages hastily put together in most of the world's large economies are commonly targets of two kinds of criticisms. Both are unambiguously wrong.

The first criticism is that the spending will either be hurried and wasteful, or that it won't come on stream until employment has recovered and will therefore be inflationary. The second and more fundamental criticism is that whenever government deficits enter the spending stream, they will simply "crowd out" consumer or investment spending, leaving no net stimulus to the economy as whole.

If "crowding out" is significantly less than 100%, then new spending will employ labor and capital that is now idle, and the earnings of workers and investors will reignite both consumer and investment spending. To be sure, stimulus programs should target projects with productive potential. Economies from the U.S. to China are in dire need of new physical and social infrastructure. But even "unproductive" projects are better than none at all if the alternative is to leave labor and capital unemployed.

And if stimulus spending for infrastructure does come on stream after the end of recession, when real resources and financial markets are re-employed, it will not be inflationary, as the critics suggest, because by their own logic there will be no new net spending. In other words, long term plans for infrastructure planning can stand on their own merit.

So the key question is not whether infrastructure projects are put in place too late, after recovery is underway, but rather whether government spending that does come on stream during recession is likely to crowd out new private spending, dollar for dollar. The answer depends on two circumstances: whether real resources are substantially unemployed, and whether financial resources are substantially unemployed.

"Real" crowding out occurs when labor and capital are fully enough employed that further spending leads to inflation. Inflation, in turn, is a disincentive to employment because it raises wages and other input prices, as well as rents. This logic is well understood. But the logic of "financial" crowding out is less intuitive and more complex.

Simply put, financial crowding out results from rising interest rates when government deficits put pressure on bond markets. Notably, the dramatic doubling of US deficits this year and beyond could leave little room for private sector borrowing.

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The US deficit will be financed in several ways. Much if not most will be paid for simply by "printing money". The new jargon for this is "quantitative easing", which means, *inter alia*, that the central bank buys new issues of US Treasury bonds and holds them on the asset side of its balance sheet. In the process it creates liabilities to banks: so-called "high powered money". This process puts zero upward pressure on interest rates. But it does increase the money supply - thus far by some 70% since last year. If this money is not reabsorbed by the Fed if and when full employment is restored, we will witness inflation and consequent "real" crowding out.

The second way that the US will finance its deficit is by selling bonds to foreign buyers, particularly to large central banks like the Chinese and Japanese. Though their appetite for dollar-denominated liquid assets may have diminished, it is still massive. There is still no financial asset as liquid and safe as US Treasury bonds, and for this reason the US dollar has not and will not collapse against the euro or the yen. And by the same token, foreign financing of the deficit has not and will not put significant upward pressure on interest rates and thus will not lead to "financial crowding out".

A third source of financing for the deficit is sales of Treasury bonds to commercial banks. If private borrowers were beating down banks' doors for loans and if banks were willing to make loans, then the Fed's bond sales to banks would indeed crowd out consumer and investment borrowing. But both the demand and supply of credit has collapsed: indeed, that is the core cause of our current meltdown. Hence the part of the deficit that is financed by bond sales to banks will not be crowded out.

A fourth way to finance the deficit is to sell government bonds directly to firms or households. Under different circumstances this too could crowd out investment or consumer spending, since firms and households might simply increase their savings and reduce their spending by enough to offset the amount of new government spending that is financed by the bond sales. But such a dollar for dollar portfolio shift is highly unlikely. Why would firms, which are already sitting on high cash reserves and undistributed profits because they are afraid to invest, increase their savings even more because they are offered safe government bonds? An analogous argument applies to consumers.

In short, arguments that deficit-financed stimuli will be crowded out are far-fetched in the extreme. Yes, "real" crowding out happens both in theory and in practice when real factors of production - labor and capital - are fully employed. But the essence of our present problem is that the enormous productive capacity of our economies is dangerously underutilized, not the reverse.

And yes, "financial" crowding out also happens in theory and in practice when financial markets are fully utilized. But financial markets are demonstrably idle. The core cause of our present problem is that credit markets froze up and financial markets melted down. Financing large fiscal deficits by tapping those markets is much more likely to revive them rather than the reverse.