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Economic Hubris – Fixing the economy: We got it wrong

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In early January 2009 two White House-bound economists — Christina Romer and Jared Bernstein — predicted that if the stimulus bill were passed, unemployment would peak at 8% by midyear and then start coming down. If there were no stimulus, they said, joblessness might hit 9% and not peak until 2010.

Romer and Bernstein had the risky job of hyping policy, but they weren't alone in their optimistic views. Forecasters at the Congressional Budget Office, the Federal Reserve and most private banks all thought that the economy had a natural tendency to right itself, sooner or later. What it needed, the activists urged, was a push.

Well it's now obvious that the push didn't do the job. Even with it, unemployment is higher than the Romer-Bernstein worst case. The optimistic forecasts now look embarrassing, ranking right up there alongside Irving Fisher's 1929 comment that stocks had reached "a permanently high plateau."

About the time Romer and Bernstein issued their assessments, I wrote a cover essay for Washington Monthly attacking predictions of early recovery. The "return to normal" would not happen, I wrote, because the effects of a financial collapse could not be reversed. But though this fact was obvious and in plain sight, somehow many economists missed it. Let's examine that epic failure.

First, the economic models in use were obviously faulty. Why? Because they had assumed a "natural rate of unemployment" to which the economy will return whatever happens. This idea originated with Milton Friedman as part of his attack on John Maynard Keynes — who had argued, based on the stark evidence of the Great Depression, that mass unemployment can persist indefinitely. An economist who builds the natural rate into a model is like a doctor who assumes that her patient will always get better eventually, even without treatment. No such doctors exist, of course; that so many economists think this way is just strange.

Second, the glide path to recovery was obviously wrong. Why? Because it was based on postwar business cycles, and recessions from 1950 to 1990 were caused mainly by tight policies or outside shocks to a fairly sound system. *Those* recessions did have a corrective: as time passed "pent-up demand" would build and a new credit boom would start. In 2009, because American households were now massively upside-down on their mortgages, this could not happen. But postwar experience had no precedent for this, and so it could not be built into a forecast.

Third, the forecasts were reinforced by checking with all the top forecasters, and this was the wrong thing to do. Why? Because in a deep crisis the consensus view, which is necessarily an average, is always wrong! Extreme situations require extreme assessments, meaning that someone must stand up and overrule the crowd. But led by its technicians, Team Obama simply assumed away the crisis, calling it instead a "Great Recession" – which again implied that it would end just because recessions always had.

The next mistake was to base policy on the forecasts. The sensible thing would have been to paint the bleakest possible picture, emphasizing the extraordinary crisis, and so justify the largest possible policy action. Then if things turned out all right President Obama would have gotten credit, and any excess actions could easily have been cut back. Instead, the president set himself and his policies up for blame.

Obama's approach contrasts sharply with how President Reagan handled the recession of 1981-82 — with massive tax cuts enacted in 1981. I did not like Reagan's tax cuts, but everyone could see that they implied a truly massive stimulus. This was politically smart, as Reagan's reelection proved. And when the message had been delivered, the cuts were trimmed in 1982, 1984 and 1986.

Obama's economists had more hubris and less ambition than Reagan's. They thought they could predict events accurately and put just the right policies into place. And that was before politics interfered, cutting the actual package to well below what Romer thought necessary. Larry Summers, however, was later quoted saying that he still thought the stimulus was about right, which raises the question: Why didn't it work as planned?

In fact, stimulus alone was never going to bring recovery. This crisis was caused by financial collapse, rooted in massive banking fraud. The financial system is our economic motor and when it fails it cannot be revived simply by pouring money on it, any more than a wrecked reactor can be restarted just by adding fuel. Team Obama faced a situation not seen since the 1930s — a worldwide banking meltdown. The financial system needed to be rebuilt — and it still does. But Team Obama chose to overlook this.

The result was debt-deflation. Falling asset prices tipped more and more households into insolvency, business stagnated, tax revenues dropped, states and localities cut their budgets and deficits widened. The situation is similar in Europe, with countries rather than households in the deepest trouble, and wild rumors attacking the shares of even the biggest banks.

Federal budget deficits in this situation are like IV-bags in an emergency room: they stabilize things. IV's are definitely linked to sickness, and no one would use them if they weren't necessary. But very few doctors propose to cut back on saline while the patient is still sick. Today, however, the official economists and their followers in Congress, the White House and the media are divided between those who would remove the IV's slowly, whether the patient recovers or not, and those who'd like to charge through the wards, yanking needles from arms. The debt deal enacted earlier this month put the first group in charge, but that's pretty cold comfort.

The solution is not another "stimulus" — a term that stinks of needles and quick fixes. The solution has to be a long-term strategy: both a new direction for economic activity and new institutions to provide the money. The proposed national infrastructure bank — a permanent institution — is the right sort of thing and would be a good place to start.

To go further, let's admit that our problem is not budget deficits or public debt — not now and not later. Let's agree that cutting Social Security and Medicare — inflicting pointless pain on the elderly — will not help. Let's build a new financial system to serve public purpose and private business. And let's start to act on our actual needs and problems: jobs, foreclosures, public investments, energy security and climate change.

Time is short, but at least in recent days it's becoming clear: We're getting it wrong and we must change.

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